Brazil - Country Assistance Strategy, Fiscal and Administrative Reform SSAL, and Second Social Security SSAL

1. Brazil is one of the Bank Group’s largest borrowers and the Bank’s Country Assistance Strategy (CAS) for it deserves particularly careful assessment. We find much that we can support, including the proposed low and base case lending scenarios. We also find some points that we do not support or where we would like greater clarity. The Bank Group continues to have difficulty in defining its comparative advantage and a focused program of lending program and non-lending services.

2. We agree that helping Brazil to achieve poverty alleviation and greater economic equality must be the central objective of the Bank Group’s engagement in Brazil. We concur with the CAS’s analysis that maintaining macroeconomic stability and restoring strong economic growth are crucial to poverty alleviation and greater economic equality. Greater effectiveness of public institutions, and improved environmental management are also necessary for Brazil to meet its development challenges successfully. The two loans that we are considering today for Brazil -- the Fiscal and Administrative Reform SSAL and the Second Social Security SSAL -- should contribute to the goal of achieving sustainable fiscal balances, with the consequent beneficial effects on interest rates and private sector investment. These loans are fully consistent with the CAS and we support them.

3. In general, we support the overall low- and base-case lending levels that the CAS proposes. We support the proposed triggers for the two cases. We do not agree, however, with the suggestion, made in a footnote on page 42, that there should be a possible high-case lending scenario. If Brazil’s policy performance and growth rates improve as envisioned in this scenario, its domestic resource mobilization and ability to access international capital markets would also improve. This should lessen, not increase, the need for Bank Group financial support.
4. **Our major concerns relate to the issue of selectivity**: how the Bank Group defines its comparative advantage and, hence, its program of lending and non-lending services and relationship with other lending institutions. It is not illuminating to read that the Bank is most helpful in areas where the Government is strongly committed to reforms. While the Bank may well have, as asserted in paragraph 96, a comparative advantage in social security, administrative and fiscal reforms, education, improvements in poverty reduction policies, water resource management, and energy, the CAS does not provide a clear basis for this assertion and it does not necessarily follow that the Bank should be lending in all these areas.

5. Although Management frequently contends that selectivity should be determined at the country -- rather than institutional -- level, this CAS is unwilling to define selectivity even at a sectoral level (paragraph. 114). Instead, the CAS suggests that selectivity should be defined at the level of activities within sectors based on criteria such as consistency with Government objectives and the Bank’s clear or emerging comparative advantage. This approach does not produce a clear focus. For example, under the rubric of targeted poverty reduction, which is just one of the Bank’s proposed five themes or areas of assistance, we find that staff have aggregated activities in nine distinct sectors.

6. As a result of this lack of focus, we believe that there is potential for substantial overlap with the Inter-American Development Bank (IDB). This CAS does not contain a table or annex of the kind that we have found helpful in other CASs to describe the IDB’s program in Brazil. However, comparing paragraph 110 regarding the IDB’s planned program in Brazil with the Bank Group’s own proposed country program, we find that both institutions plan support for infrastructure development, social services, environmental management, and fiscal administration.

7. Our concern is not that Brazil will not be able to absorb assistance from each institution. Brazil is a large country with room for many lenders, and the possibility of conflicting policy advice can be avoided by a consultative and cooperative relationship between the two institutions. However, this overlap, which demonstrates the lack of a clear vision of the Bank’s comparative advantage, robs the Bank of the efficiencies that can come from specialization.

8. In sum, we would like a clearer explanation of why many of the specific IBRD lending operations proposed in Annex B3 could not be left either to the IDB or the private sector. These include, for example, the highway and urban transport projects, ports restructuring, and some of the water supply and privatization projects. We do not question the potential poverty alleviating effect of these operations, rather the rationale for World Bank involvement in all of these activities within a framework of selectivity. We are also concerned that Annex B3 lists a culture LIL, without any supporting discussion of this in the text of the CAS.

9. We note that there is **no costing of the analytical and advisory activities listed in Annex B4** for fiscal years 01 and 02. How can Management fulfill its commitment to fund CASs fully without such a costing? We are also concerned that the Country Financial Management Overview (paragraph 125(c)), which is to cover the Federal Government and three states, does not figure in Annex B4. This analytical work will be an essential building block for
any eventual expansion of direct lending to the states, as well as for policy-based lending in general.

10. **Intergovernmental fiscal relations** figure prominently in the CAS and are the focal point of the Fiscal and Administrative Reform SSAL. During the past decade, Brazil, like many other countries with a federal form of government, has come to recognize the importance of sound fiscal management at the sub-national level for the achievement of national economic goals. The adverse effects of fiscal mismanagement by some Brazilian states has highlighted the serious flaws in the system of intergovernmental fiscal relationships.

11. The Government's program, which the SSAL supports, is a significant step in the right direction. It will address the rigid requirements for expenditures on government employees, which are one of the major factors behind the high levels of spending at all levels of government. Other initiatives will restrain overall expenditures by state governments and their ability to finance such expenditures by accumulating new debt and enable them to reduce their existing debt burdens.

12. It is not clear, however, how the Bank and the Government plan to carry these reforms forward to achieve a lasting, sustainable reform of the states’ finances. We would have liked to see an analysis of the magnitude and mix of both revenue and expenditure adjustments required for the states to achieve sustainable fiscal balances. There is little to support the Bank's implicit conclusion that it is the states which are primarily at fault for their fiscal problems and that binding financial constraints should suffice to correct the situation. Among the unanswered questions is whether the states will have, both constitutionally and in practice, the revenue raising authority and capacity to meet their current requirements for expenditures in the areas of health and education, much less to manage needed increases.

13. Therefore -- and in light of the lack of success of loans the Bank extended to help three states correct their fiscal situations -- we support the recommendation that the Bank should shift its lending away from lending to the states and toward greater emphasis on non-lending services. We do not support the suggestion (paragraph 103) that the Bank could continue adjustment lending to a few states and even introduce new instruments for this purpose. This is at odds with the thrust of the rest of the CAS and, as indicated earlier, is not supported by convincing analysis. We strongly recommend that this idea be dropped from the strategy.

14. We found five dimensions of this CAS particularly positive, and will comment on these below.

15. **Participatory Process.** We welcome the participatory process that the Government and the Bank employed to prepare the CAS and the recognition that community participation in defining priorities and designing and implementing specific lending and non-lending activities can greatly enhance development effectiveness and sustainability. We were interested to read Annex 6, summarizing comments received during the CAS consultation process. We would appreciate further information on specific modifications that the Government and the Bank made in the proposed lending and non-lending services as a result of the consultative process.
the consultative process underpinning this CAS, we trust that the authorities will request the Bank to release the CAS publicly. Can staff confirm this?

16. **Poverty Analysis.** We appreciate Annex 4 regarding the profile of, and trends in, poverty. In this context, we welcome the recent gender review and the recognition of the need to address gender directly in the design of most projects, including by ensuring full participation of women in consultative processes and community associations. We note the association between race and poverty and the finding that households headed by persons of African descent are three times as likely to be poor as households headed by persons of primarily Caucasian descent. We request that this disparity also be directly addressed in poverty alleviation projects, including through ensuring full participation of persons of African descent in consultative processes and community associations. We welcome the Bank’s plan for further analytic work to understand better the income inequality dynamic in Brazil, which is essential to target the Bank’s efforts better in the future.

17. **Private Sector Strategy.** Annex 5, regarding the Bank Group’s private sector strategy, is more thorough than most that we have seen and sets a standard for other joint Bank Group CASs. We agree that the Bank’s emphasis should be on supporting the Government’s efforts to deepen fiscal reform. Eliminating the phenomenon of government crowding-out is essential to lower interest rates sustainably to levels that will promote private sector investment. However, as indicated above, we believe that the IDB or the private sector itself could take the lead in satisfying infrastructure needs for a more dynamic private sector. Also, we remain to be convinced about the need for World Bank support for higher education, skill and technology development. The IFC should also be highly selective. It should support companies that create significant numbers of jobs for the poor, including through mechanisms that support SMEs or microfinance, which the CAS recognizes is underdeveloped in Brazil. We also support IFC involvement in private sector provision of infrastructure and social services, although careful analysis is needed of development effects of financing specific private sector education and health services.

18. **Labor Issues.** We welcome the importance that the CAS assigns to labor issues. The inclusion of union organizations in the CAS consultative process is a constructive development. We also welcome the increased attention to social protection issues, especially child labor prevention. We look forward to Bank support for scaling up the pilot Program to Eradicate Child Labor. We also look forward to the comprehensive report that the Bank is preparing together with the Institute for Applied Economic Research (IPEA) on labor market policy and regulation. In this context, we concur that reduction of the high costs of labor regulations is an important policy objective. However, the effects of labor market regulatory reforms on fundamental workers’ rights must also be considered, especially the rights of association and collective bargaining, the importance of which goes beyond workplace representation and has broad implications for civil society rights and governance. We urge the Bank to consult with the ILO in preparing its report with IPEA to ensure that policy dialogue and reforms that emerge from this effort strengthen implementation of internationally recognized workers’ rights in Brazil.
19. **Environmental Issues.** Brazil has enormous needs to improve its environmental management and we were pleased to see environmental challenges addressed in the CAS. We urge the Bank to place high priority in consulting with civil society to build constituencies for environmental protection efforts and promoting the kind of institutional capacity in Brazil’s environmental institutions that can consistently and transparently enforce crucial environmental protections. In this light, we also underscore the need for the Bank to work closely with the IMF to ensure that needed fiscal reforms preserve crucial social and environmental expenditures.

20. In conclusion, we commend staff for the consultative process employed in producing this CAS and trust that, consistent with this process, the authorities will request public release of the CAS. We welcome the close attention to labor, environment, and poverty -- including gender -- issues, as well as the thorough explanation of the Bank Group's private sector strategy. We support the lending levels and conditions of the proposed low- and base-case scenarios, although we do not concur with the suggestion of a possible high-case scenario. Also, we have serious reservations about the lack of selectivity in the proposed specific lending operations in Annex B3. We request that, in finalizing the CAS, staff both sharpen the focus on operations that will contribute directly to the CAS's central objective of supporting the Government's efforts to achieve poverty alleviation and greater economic equality and drop operations that can be financed either by other multilateral institutions or by private capital. Any direct lending to states to support their fiscal adjustment should await conclusion of appropriate analytical work and development of the necessary political consensus on needed comprehensive reforms. We also request that the final CAS cost out the analytical and advisory services proposed for fiscal years 01 and 02. Finally, we wish the authorities full success in implementing the fiscal, administrative, and social security reforms supported by the two SSAL operations. The reforms are essential to Brazil's efforts to establish a stable macroeconomic environment within which the sustainable, high rates of growth needed to alleviate poverty can be achieved.