Program Information Document (PID)

Appraisal Stage | Date Prepared/Updated: 15-Mar-2019 | Report No: PIDA26564
### BASIC INFORMATION

#### A. Basic Project Data

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<th>Country</th>
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<tr>
<td>Brazil</td>
<td>P164588</td>
<td>Mato Grosso Fiscal Adjustment and Environmental Sustainability DPL (P164588)</td>
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#### Proposed Development Objective(s)

Program Development Objective of this DPL is to support the State of Mato Grosso to (i) regain fiscal sustainability and (ii) increase institutional capacity for sustainable agriculture, forest conservation and climate change mitigation.

#### Financing (in US$, Millions)

<table>
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<td><strong>Total World Bank Group Financing</strong></td>
<td>250.00</td>
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#### Decision

The review did authorize the team to appraise and negotiate
B. Introduction and Context

Country Context

Brazil is recovering from a deep recession and needs to accelerate fiscal consolidation at Federal and subnational level. Brazil’s economy declined by more than 7 percent in 2015 and 2016 combined, and the fiscal deficit peaked at over 10 percent of GDP in 2015. Since, the economy recovered slowly, with GDP growing 1.1 percent in 2017 and 2018. Fiscal consolidation at Federal level is anchored, since December 2016, by a constitutional rule limiting the increase in federal primary expenditures. The Federal Government which took office in 2019 has pledged to accelerate this expenditure-based fiscal adjustment, starting with an ambitious pension reform. The recession and slow recovery have also affected regional governments that have seen transfers from federal tax revenues and their own cyclical revenue base decline. They, in turn struggle to adjust fiscally given high expenditure rigidities, largely governed by federal laws and the constitution. As a result, a growing number of state governments have faced liquidity and solvency crises since 2015 which undermines critical service delivery. Also, the stock of outstanding subnational debt represents more than 12 percent of GDP, which poses a significant contingent liability for the Federal Government.

The State of Mato Grosso has developed on the back of agricultural production but frontier expansion into forest could undermine economic progress going forward. The State is Brazil’s third largest by area (903,357 km², about the same as France and Germany combined) but home to only about 3.4 million people (1.6 percent of the Brazilian population). Its GDP-per-capita (as of 2016) is the 4th highest among Brazilian states at US$10,700. Over 50 percent of the State GDP is directly related to agriculture and it has become a global powerhouse for soy and beef production, with 32 million tons of soy beans - 27 percent and 9 percent of Brazilian and global soy production, respectively - and 5.4 million heads of cattle produced in 2018. This agricultural expansion has historically taken place through clearing of forests, including in the Amazon biome. While average deforestation post-2010 has been 75 percent below its 2001-10 average, deforestation continues to be considerable and its pace has increased again since 2015. In 2018, 1,749 km² of forests were cleared in the Amazon biome (130 percent above the 2012 low point). The expansion of agricultural production into previously forested areas has historically been not only a leading contributor to carbon emissions but has likely come to the detriment of higher productivity. Moreover, interannual climate variability is impacting crop production patterns.

Relationship to CPF

The proposed DPF is consistent with the World Bank Group’s Country Partnership Framework (CPF) for FY2018-2023. The CPF is built on three pillars: (i) fiscal consolidation and government effectiveness; (ii) private sector investment and productivity; and (iii) equitable and sustainable development. In line with the CPF, the proposed operation is the first of a potential series of subnational DPLs to support fiscal adjustment and sustainable development. The proposed operation is fully aligned with the first and third pillars of the CPF. The fiscal pillar of the DPF specifically support the first objective under the first CPF pillar (“Strengthen fiscal management at all levels of government”). It does so by providing technical assistance to generate evidence that facilitates policy decision for fiscal adjustment in Mato Grosso in close cooperation with the Federal Government. This will be a pilot for other subnational governments, which will ultimate reduce the contingent liability to the Federal Government. The operation provides financial incentive for States to address their fiscal deficits, reducing risk of unsustainable State debt paths and restoring the (fiscal) capacity of subnational entities to receive federal guarantees for additional borrowing. The second pillar of the operation is closely aligned with the first objective

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1 The CPF was endorsed by the Board in July 2017 (Report No. 113259-BR).
under the third CPF pillar (“Support the achievement of Brazil’s NDC with a particular focus on land use”). This operation will support Brazil to reach its COP21 Nationally Determined Contribution (NDC) targets, by focusing particularly on land use planning, deforestation, environmental compliance, and environmental climate finance mechanisms in a State which is critical to Brazil’s climate mitigation commitment and which heavily relies on adaptation and climate resilience efforts to sustain its growth model. This pillar also is consistent with the WBG Climate Change Action Plan 2016-2020, which aims to work with countries to help them deliver on and exceed their Paris ambitions, including through financing, technical assistance, and knowledge sharing.

C. Proposed Development Objective(s)

The Program Development Objectives of this DPL are to support the State of Mato Grosso to regain fiscal sustainability and to increase institutional capacity for sustainable agriculture, forest conservation and climate change mitigation. The operation supports two pillars critical to long-term sustainability of the State: (i) adjustment of State finances through institutional reforms for fiscal responsibility; and (ii) the consolidation of efforts to protect forest assets while promoting agricultural productivity in line with the State’s development strategy. The need for fiscal adjustment is paramount as the State Government’s rapid growth in expenditure obligations, mostly on salaries and pensions, has resulted in a large accumulation of payment arrears, threatening the delivery of crucial public services. The operation also supports a set of policies in line with the State’s ambitious sustainable rural development and climate change strategy, summarized under the “Produce, Conserve, Include” (Produzir, Conservar, Incluir; PCI) program. This operation is designed as a stand-alone DPL to support a heavily frontloaded fiscal reform package and ensure continuity and acceleration of critical environmental policies that builds upon previous engagement in the rural and environment sectors (including ecological economic zoning, support to the State Secretariat for the Environment and rural cadaster in selected municipalities).

Key Results

The proposed Fiscal Adjustment and Sustainability Agriculture Development Policy Loan aims to support the State of Mato Grosso to regain fiscal sustainability and increase institutional capacity for sustainable agriculture, forest conservation and climate change mitigation. Specifically, the expected results in the fiscal pillar of the DPF include an increase in current savings to 5 percent of revenues, a reduction in the share of net current revenues spent on wages and pensions to 60 percent, containment of the State pensions deficit and increases in State revenues. Under the environmental protection and climate change pillar expected results include a 29 percent reduction of deforestation in the State’s part of the Amazon biome (relative to 2018 estimates), a seven-fold increase in the area covered by validated rural land cadasters and an increase in resources mobilized for the State’s flagship green growth strategy.

The implementation of the fiscal and environmental reforms supported by this operation is essential to place the State’s expenditures on a sustainable path and strengthen its development model. A State Fiscal Responsibility Law supported by this operation enables the State to regain and maintain sustainability of the State’s finances. Other measures supported by the operation ensure that key expenditure drivers such as wage growth can be controlled going forward, allowing the State to clear arrears and create fiscal space to deliver on social and infrastructure priorities. The operation also

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strengthens Mato Grosso’s tax base by reducing tax expenditures and increasing fiscal contribution and environmental performance by export-oriented agriculture in the State. To sustain the State’s agricultural export-led growth model, this operation supports policies to control deforestation and forest fires which threaten the State’s natural capital base. The operation also accelerates the implementation of the rural environmental cadaster, a key tool for land management deployed at the federal level, and the institutional consolidation of the State’s efforts towards attracting investment in sustainable and climate-smart development.

D. Project Description

The DPF has two pillars: (i) supporting the State of Mato Grosso to regain fiscal sustainability and (ii) to increasing institutional capacity for sustainable agriculture, forest conservation and climate change mitigation. Under the first pillar, the operation supports a set of measures aimed at controlling current expenditures and broadening its revenue base, allowing the State to overcome its current fiscal difficulties and increase public investments in the medium term. Under the second pillar, the operation supports selected government actions that have a positive impact on sustainable agricultural development and reduced carbon emission from deforestation.

Restraining current expenditures is crucial for the Government of Mato Grosso to restore fiscal sustainability and enable sustainable agriculture, forest conservation and climate change mitigation. The World Bank prepared jointly with the government of Mato Grosso and Brazilian National Treasury an in-depth diagnostic of its public finances. Beyond the cyclical reduction in revenues associated with the recent economic recession, the current fiscal crisis has deeper structural problems, notably related to the rapid structural expansion of primary current expenditures, especially payroll and pension spending. Previous government efforts to reduce investment or maintenance expenditures failed to close the financial gap which translated into arrears with providers and delays in civil servants’ salaries. Therefore, unless structural measures to contain spending are adopted, expenditure pressures will result in increasing financial gap, even if economic activity and fiscal revenues recover.

Based on the results of the in-depth fiscal diagnostic, the State Government has adopted a fiscal adjustment package to restore fiscal sustainability. In November 2017, the State adopted a constitutional amendment (EC 81/2017) that limits the growth in current spending to the rate of inflation for five years. These spending limits are binding individually for the expenditures of each branch of the State government. However, the executive branch did not comply in 2018 with its spending limit, as personnel costs continued to grow significantly in real terms (7.8 percent), resulting in payment arrears to public employees and suppliers. To close the financing gap and be able to continue providing quality public services for the population (notably health, education, and public security), the legislature adopted in January 2019 a structural reform program, “The Pact for Mato Grosso”. It includes, among others, a State Fiscal Responsibility Law, an administrative reform reducing the number of State Secretaries and authorizing the closure of loss-making state enterprises, and specific measures controlling payroll spending and increasing revenues. It streamlines the governance of the State pension institute, a key reform to approve structural changes to the State’s pension system which will likely be needed once the Federal Government reforms national pension rules. These measures are expected to generate fiscal primary surpluses, closing the financing gap and allowing the State to increase investment with own resources.

The second pillar of the operation supports selected State Government reforms aimed at increasing the institutional capacity to enable climate smart agriculture and forest conservation. First, the operation supports a new Deforestation and Forest Fire Prevention and Control Plan (PPCDIF) with important improvements to the State’s institutional capacity. Second, an agreement signed between the State’s Public Prosecutor, the Secretariat for Environment and the Secretariat for Public Security increases transparency and effectiveness in the registry and compliance of rural properties with the environmental legislation. Third, the State recognizes the “PCI Institute” as the key agency to accelerate implementation of the “Produce, Conserve, Include” strategy and attract international resources for climate protection. These actions put
Mato Grosso in a leadership position on the environmental, climate and inclusive rural development agenda in Brazil, providing a key model for other States.

The two pillars supported by this DPF are mutually reinforcing: fiscal and environmental sustainability are both essential for the long-term prospects of Mato Grosso. Fiscal sustainability is essential to enable the State to invest in the infrastructure, natural and human capital necessary for the State’s agriculture-based growth model to succeed. In parallel, the State’s long-term fiscal and economic prosperity depend on the sustainable use of its vast natural resources. Depletion of natural capital and the resulting increased exposure to climate events, notably droughts and variable precipitation, would undermine Mato Grosso’s agricultural productive capacity. Further, because locally driven environmental management can have important global co-benefits, the possibility to access international climate finance could also be an important source of investment and resources for environmental policy in the State going forward.

E. Implementation

Institutional and Implementation Arrangements

The State Secretariat of Finance of Mato Grosso (Secretaría de Estado da Fazenda, SEFAZ) is responsible for collecting and monitoring information related to program implementation and progress towards the achievement of the results. SEFAZ is responsible for coordinating necessary actions among the agencies involved in the reform program supported by this DPF. It is directly in charge of the first pillar of the operation, while the State Secretariat for Environment of Mato Grosso (Secretaría de Estado do Meio Ambiente, SEMA) oversees policies under the second pillar of the program. The World Bank team has worked closely with the above agencies as well as the Federal Treasury to define results indicators that are clearly spelled out and measurable, giving preference to those that are collected on a regular basis to avoid additional reporting.

F. Poverty and Social Impacts and Environmental Aspects

Poverty and Social Impacts

Prior Actions supported under this operation are not expected to have adverse consequences on poverty and inclusion, while some moderate inclusive gains are expected over the medium to long term from fiscal consolidation that is equity enhancing. The expenditure rule supported under this DPF will force a decline in primary spending in the State. As highlighted in the Brazil Public Expenditure Review, abundant opportunities exist for spending cuts that do not affect the poor and that are equity enhancing. In this regard, it is expected that changes that reduce future increases in civil service pay will not directly affect the most vulnerable segments of the population as civil servants are typically among the top 40 percent income earners of the State population. Indirect impacts on the poor, such as a fall in demand for domestic employees or other low-skilled workers cannot be ruled out but should be marginal given the gradual impact of the measure. Any adverse impact on labor demand should be cushioned by the fairly strong and improving local labor market. More generally, allowing the State to regain fiscal sustainability will have positive impacts on the State’s ability to deliver public services which will support poverty reduction and boost shared prosperity over the medium and long term. In the absence of fiscal adjustment, it is to be expected that the State would struggle to provide these services adequately. In fact, the State’s liquidity problems have already led to sporadic disruptions in the provision of public health services.
Environmental Aspects

The policies supported by the DPF are not likely to cause any negative effect on the environment, forests, or other natural resources. The policies supported under the first pillar of this DPF on fiscal adjustment are unlikely to have significant effects on the environment. The policies under the second pillar are designed to improve environmental management and likely to have significant positive effects. The Plan to Fight Deforestation and Forest Fires, with its specific improvements in state capacity to detect and respond to illegal deforestation is expected to have an important positive environmental impact on forest protection. The integrated environmental monitoring center included in the plan is expected to have a positive impact even beyond forest protection. The policy reforms associated with land management are expected to have significant positive effects progress on rural land registration that will direct production to the areas found apt for agriculture and reduce pressure on environmentally fragile areas in part by re-directing agricultural credit to those areas with valid registrations. The regularization program (PRA) will also provide a strong economic incentive for producers to regularize their land as it will allow customers to control the status of agricultural producers. The institutionalization of the PCI as a coordination and fundraising agency for the State’s climate change strategy and carbon finance is expected to have a positive effect by reducing deforestation as it provides an economic and financial incentives to protect forest land as well as additional resources for conservation and sustainable forest management.

G. Risks and Mitigation

The risk rating for this operation is substantial. The reforms supported by the operation are a high priority for the Government of Mato Grosso and are significantly front-loaded, reflecting the acute fiscal crisis in the state. Sustainability of some of the more controversial policies may be challenged in the medium term since the current government’s mandate ends in 2022 and need for expenditure control may not be so pressing. The most relevant risks are related to the political and governance, macroeconomic, sector strategies and policies and stakeholders.

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APPROVAL

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