Report Number : ICRR0020634

1. Project Data

Operation ID
P148083

Operation Name
RS:Strengthening Fiscal & Water Mgmt DPL

Country
Brazil

Practice Area(Lead)
Macro Economics & Fiscal Management

L/C/TF Number(s)
IBRD-83790

Closing Date (Original)
31-Dec-2015

Total Financing (USD)
280,000,000.00

Bank Approval Date
27-Jun-2014

Closing Date (Actual)
31-Dec-2015

	IBRD/IDA (USD)	Co-financing (USD)
Original Commitment	280,000,000.00	0.00
Revised Commitment	280,000,000.00	0.00
Actual	280,000,000.00	0.00

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2. Project Objectives and Policy Areas

a. Objectives

According to the Program Document (PD, para. 45, p. 14), the Program Development Objective (PDO) was to improve Government capacity to mitigate economic volatility in the State of Rio Grande do Sul by supporting measures to increase resources available to the government and to reinforce the Integrated Water Resource management framework.

b. Were the program objectives/key associated outcome targets revised during implementation of the series?

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c. Pillars/Policy Areas

There were two policy areas:

Fiscal management: This policy area aimed to increase revenues and reduce expenditure. On the revenue side, the aim was to improve tax collection rates and reduce tax expenditures (tax exemptions which limit revenue mobilization). On the expenditure side, the focus was on lowering procurement costs, increasing efficiency gains in spending agencies, and improving the management of contingent liabilities.

Irrigation and Water resource management: This policy area focused on promoting sound irrigation policies, strengthening the State Water Resources Management System, and enhancing capacity for planning and operations of water infrastructure. The program supported a program of financial assistance to small farmers for the installation of dams and irrigation systems; capacity strengthening of the Department of Water Resources to manage water resources on the basis of individual water basins and adjudicate and issue water rights; and improving water resource management data through the installation of hydro-meteorological stations.

d. Comments on Program Cost, Financing, and Dates

The stand-alone Development Polic Loan (DPL) was approved on June 27, 2014 and became effective on September 30, 2014 The total amount of US$280.00 million was fully disbursed upon effectiveness. The operation closed as scheduled on December 31, 2015. There was close alignment with a parallel Inter-American Development Bank (IDB) operation which supported the same government program in the same policy areas of fiscal consolidation and water resource management.

3. Relevance of Objectives & Design

a. Relevance of Objectives

The PDOs were, and remain, relevant to the State′s economic challenges. The public finances of Rio Grande Do Sul are on an unsustainable path. They are undermined, not only by tax exemptions and administrative weaknesses, but also by the volatility of the state′s economy. This volatility in turn stems in considerable part from the vicissitudes of the important agricultural sector, which have a direct and indirect impact on both the revenue and the expenditure of the state government. Agricultural output is rendered unstable by acute variations in availability of water. Dry summers and periodic droughts seriously affect medium and small size production and income, while only seven percent of farms benefit from irrigation facilities.

The operation′s objectives are well aligned with the goals of the state′s Multi-Year Plans and of the World Bank Group′s 2012-2015 Country Partnership Strategy for Brazil, where there is an emphasis on enhancing public sector finances, regional economic development, and water and environmental management. The objectives remain relevant to the 2017-2023 Country Partnership Framework, the first pillar of which is "supporting fiscal

consolidation and foster government effectiveness for inclusive, equitable and efficient service delivery."

Rating
High

b. Relevance of Design

The links between the policy actions supported by the operation and the ambitious program development objective are weak. Realistically, the expected results of the policy measures supported by the operation were likely to be too limited to achieve more than relatively minor steps towards the objective's achievement. The fiscal prior actions are mostly focused on assessments, procedures, mandates, and policy declarations. For example, in the key area of tax exemptions, the prior action consists of "improving assessment procedures for new tax expenditures." This is remote from actually reducing exemptions or increasing tax revenue. On contingent liabilities, the government "has created a policy" to identify and estimate the fiscal risks created by contingent liabilities and to prevent and mitigate their fiscal impact. On procurement, the use of price information from the electronic data base was to be made mandatory. With regard to water management, the actions consist of such measures as "reinforcing commitment to sustained irrigated agricultural practices;" "enhancing the staff organogram and launching a corresponding recruitment process" of the Department of Water Resources, and adhering to the National Pact for Water Management. These measures may well be important. However, it is unclear how they could have been expected to lead to the achievement of the program development objective as stated.

At the time of preparation in 2013, Brazil's macroeconomic situation was stable. According to the IMF's Article IV Consultation for that year, "Brazil's strong macroeconomic frameworks have contributed to preserve macroeconomic stability, support robust growth, and underpin sustained poverty reduction." The federal government's primary fiscal deficit was a moderate 1.7 percent of GDP in 2012, an improvement from 2.2 percent in 2011.The economy was recuperating gradually from a downturn in 2011. Investment had begun to recover. Inflation was below the upper limit. There seemed to be almost no sign of the major recession that would strike the economy less than two years later, and no macroeconomic grounds for not engaging in policy lending.

Rating
Modest

4. Achievement of Objectives (Efficacy)

Objective 1

Objective

Increase resources available to the government

Rationale

The goal of increased fiscal resources for investment was not achieved. Policy actions had, at most, a modest impact in terms of improving the state's fiscal management. Moreover, Brazil was affected by an unexpectedly deep economic downturn from 2015 onwards which had a negative impact on Rio Grande do Sul's economic growth. While the State's operational fiscal deficit was expected to worsen slightly to 2.7 percent of Net Current Revenue (NCR) in 2015, it deteriorated sharply to 8.8 percent. For reasons which the ICR does not mention, amortization expenditure was also considerably larger than projected, resulting in a significant cash flow deficit equal to 13.7 of NCR. The measures supported by the operation may have contributed to improved fiscal management, but were too modest to reduce vulnerability to economic volatility.

Raising revenue. The aim was to raise revenues, not by raising taxes, but by improving collection efficiency. Two measures were expected to contribute to this objective:

- The percentage of tax expenditure measures evaluated according to revised procedures increased from zero in 2012 to 43 percent at the end of 2015 (against a target of 25 percent). At the same time, however, the value of fiscal incentives (the fiscal cost ways in which companies can legally reduce their value added tax liabilities) was 9 percent higher in real terms at the time of the ICR mission in September 2016, than it had been in 2012.
- The State Government established improved procedures to assist the recovery of tax arrears. As a result, the share of tax arrears recovered within 60 days of their generation had increased from 20.8 percent in 2012 to 28.6 percent in November 2015, exceeding the target of 27 percent. However, only modest progress was made in collecting tax arrears generally (R$ 1.35 billion or 11 percent of the R$ 12 billion which the State considers to be collectible was collected).
- The ICR does not provide data on the impact of these two measures on overall tax collection. The tax-to-GDP ratio deteriorated sharply over 2014-2015, mainly as a result of the economic downturn. Over the 2012-2015 period, actual revenue.

Expenditure savings were expected to be obtained in the short term through actions on procurement policy, and in the longer term through actions on costing, tax expenditures and contingent liabilities. The operation built on an earlier DPO (the first to Rio Grande do Sul in 2008) by supporting improvements in the identification of market prices for the goods and services to be publicly procured.

- The Government mandated the use of price information from the electronic fiscal invoice database as a reference price to inform the application of the procurement process. The share of goods procured using price information from the electronic fiscal invoice database increased to 51 percent in 2015, exceeding the 25 percent target. This measure resulted in savings estimated at R$ 31 million in the pharmaceutical sector, but had a limited impact elsewhere.
- Secretariats in the 14 line secretariats have been requested to prepare a managerial cost report, as part of their annual report (the so-called Cost Policy and System). According to the ICR, this has the potential of improving expenditure efficiency if policy makers apply the recommendations of those

reports. Such reports have been issued by 13 government agencies (i.e. not only line secretariats) out of 94. However, only one line secretariat had issued a report by the time of the ICR mission.

- A system to identify and estimate the fiscal risks created by contingent liabilities, and to prevent or mitigate their fiscal impact was created (contingent liabilities amount to R$ 68 billion or more than twice annual revenues). Two reports have been produced by a special unit under the Treasury. The ICR does not provide information on the effectiveness of this unit or on the content and use of the reports. There is no information regarding the possible impact of this measure on prevention and mitigation of the fiscal impact of contingent liabilities or their reduction in the future.

Rating
Modest

Objective 2
Objective
Reinforce the Integrated Water Resources Management Framework

Rationale

- The State has aligned its "More Water, More Income" Program with its Irrigation Policy and its Water Resources Policy (the Program relies on federal lines of credit. It assists candidates in obtaining the environmental licenses and water rights required to apply for federal loans, and then reimburses farmers for part of the costs of amortizing them. In the case of small scale farmers, the program pays 100 percent of the first and last payments). The number of medium and small-scale farmers who have joined the Program increased from 274 in 2012 to 2,414 in 2015. The overall target of 3,300 was not achieved as the number of small landholders joining the program increased only from 217 to 1,733 against a target of 3,000. On the other hand, the target for medium landholders was surpassed. This suggests difficulty in reaching out to smaller landholders. The total land area under irrigation increased by 69 percent.
- The institutional capacity of the Department of Water Resources (DRH) was strengthened The number of river basin plans completed, discussed and approved by the river basin committees, with the supervision and facilitation of the DRH team, increased. Progress was slower than anticipated as DRH capacity and staffing constraints staffing persisted, partly because of staffing limitations imposed by the Fiscal Responsibility Law and the State's own inability to offer competitive salaries. Seven river basin plans out of target of twelve had been completed and approved by the river basin committees at closure The remaining 5 are underway and 15 additional plans were to be procured in 2017.
- The state government adhered to the National Pact for Water Management, and signed an agreement with the Guarantor's Water Agency committing itself to compliance with specific water resource

management targets in exchange for financial support.

- 80 new hydro-meteorological stations were meant to be installed in key river basins (among the 25 State's river basins) with information analyzed by the State. However, only 27 stations had been installed by closure. The new DRH team is reconsidering the need for and location of new stations. A situation room to monitor hydro meteorological data and river levels on a real time basis has been installed and is operating satisfactorily. The ICR does not report on the impact of these 27 additional stations or of the situation room.

No concrete evidence is presented to demonstrate more effective management of water resources. According to the PD, improved management was meant to reduce perceived risks and hence stimulate investment in water projects. There is no indication that this has occurred.

Rating
Modest

5. Outcome

The operation's objectives were highly relevant. They were consistent with Government and Bank strategies and addressed important development issues of fiscal and water resource management. Design, however, supported policy actions which were insufficient to achieve the objectives. A wide range of agreed measures were implemented, and management tools put in place and used. However, despite the attainment of many established targets, the state's fiscal position deteriorated sharply to the point that the State has difficulty in paying its bills, including wage payments. While Brazil's sharp recession of 2015 was difficult to anticipate, the program could have included stronger fiscal measures to address the state government's fiscal distress. There is no evidence of progress in improving water resource management. Efficacy of both objectives is, therefore, rated modest.
These constitute significant shortcomings, and outcome is rated Moderately Unsatisfactory.

a. Outcome Rating
Moderately Unsatisfactory

6. Rationale for Risk to Development Outcome Rating

Given the magnitude of the state's fiscal crisis, the specific management and administrative reforms supported under the fiscal policy area are likely to be sustained. Nevertheless, these actions are likely to have only a modest impact on the state's fiscal position over the medium term. The continued existence of extensive tax

avoidance incentives for broad sectors of the state's economy and low value added tax rates on important items, as well as increases in staffing levels and in the level of individual salaries, are significant risks to the program's fiscal objectives.
While most of the institutional, procedural and regulatory achievements in the water resource policy area seem likely to be sustained, there are substantial risks to the "More Water, More Income" Program. While the state has managed to overcome the administrative problems that faced the Program at the outset, there is now some doubt that it will be in a position to pay the first block of subsidies due to farmers who joined the program in 2013 and those due in the coming years. Non-payment will likely cause loss of credibility.

a. Risk to Development Outcome Rating

High

7. Assessment of Bank Performance

a. Quality-at-Entry

The preparation team benefited from analytical and prescriptive materials, as set out in the PD. Throughout the preparation stage, the team maintained an intense technical dialogue with the state government and other stakeholders. However, the Bank's decision to proceed with the operation within a timeframe dictated by the political calendar (the Federal Fiscal Responsibility Law prohibits states from borrowing in the final four months preceding an election, and there were gubernatorial elections in October, 2014,) meant that the preparation of the operation was rushed and opportunities for substantial reform might have been missed. The program could have included an increase in value added tax rates, reductions in exemptions, a more vigorous pursuit of tax arrears, and a reduction in fiscal incentives, as well as expenditure containment and rationalization measures. While these would have had an immediate and more significant fiscal impact, they were unlikely to be palatable to the Borrower on the eve of an election. Although the preparation team benefited from the Bank's thorough familiarity with the State and its institutions, there was insufficient time to reach an accommodation among the relevant political actors in favor of high impact reforms. The PD identified macroeconomic, environmental and developmental risks, but rated them moderate. In the event, this underestimated the macroeconomic risk and overestimated Brazil's capacity to withstand a deteriorating macroeconomic environment. There were significant shortcomings in M&E design (see Section 9a below).

Quality-at-Entry Rating

Moderately Unsatisfactory

b. Quality of supervision

The Bank conducted three supervision missions (October of 2014 and March and November of 2015), although only two Implementation Status Reports were filed. These missions focused on the implementation of the reforms supported by the prior actions and tracked through the results indicators. In addition, in the face of the macro-fiscal crisis, the dialogue on fiscal policy issues strengthened considerably with the new government that was elected in late 2014, contributing to the pursuit of agreed

reforms through the political transition. Supervision missions monitored the results closely while – in the case of the second and third missions -- also observing the State's overall fiscal situation. Supervision reports from the last two missions changed the rating of the macroeconomic risk from modest to substantial; given the situation in Brazil in late 2015, a high rating would have been more appropriate..

Quality of Supervision Rating
Moderately Satisfactory

Overall Bank Performance Rating
Moderately Unsatisfactory

8. Assessment of Borrower Performance

a. Government Performance
The Government of Rio Grande do Sul completed the prior actions and issued all the required decrees as well as related regulations and directives. It also remained committed through the implementation and monitoring of results, providing all information needed for supervision in a timely and consistent manner. However, the Administration that was in office at the time the DPL was prepared was impeded by political considerations from pursuing meaningful fiscal reforms which could have had a direct and significant impact. In addition, the Government did not fully achieve the targets it had committed to under the water pillar.

Government Performance Rating
Moderately Unsatisfactory

b. Implementing Agency Performance
The implementing agency for the first policy area was the Secretariat of Finance (SEFAZ). SEFAZ played a key role in coordinating the fiscal components of the program, and was directly responsible for adopting the measures agreed. Within the constraints imposed by the relative modesty of the prior actions, SEFAZ and its subordinate agencies did a creditable job in reaching four of the five targets established.
In the water resource area, the Secretariat of Agriculture, Livestock and Irrigation (SIAPI)and the Secretariat of Environment and Sustainable Development (SEMA) worked together to establish procedures for implementing the new legislation, including the State Irrigation Policy. As noted earlier, they were particularly instrumental in solving the cumbersome and time-consuming process for obtaining environmental licenses and water-use rights by farmers who were interested in benefiting from the "More Water, More Income" Program . While the Department of Water Resources (DRH) may have foreseen its staffing difficulties, part of the problem also lies with the State's overall fiscal situation, which prevented DRH from rapidly filling the positions vacated by the departure of temporary staff.

Implementing Agency Performance Rating
Moderately Satisfactory

Overall Borrower Performance Rating
Moderately Unsatisfactory

9. M&E Design, Implementation, & Utilization

a. M&E Design
Monitoring and evaluation design relied heavily on existing indicators known to the Government, thus reducing the need to set up additional resources for tracking the results indicators. A manual was developed together with the client before negotiations detailing the methodology and sources for all indicators. The fiscal pillar of the program was monitored by the SEFAZ, while SEMA and SEAPI monitored the implementation of the reforms under the water pillar. These agencies were responsible for collecting and consolidating the information pertaining to the results indicators.

A significant weakness in M&E design was the lack of indicators for measuring the degree of attainment of the broader development objectives. Instead M&E seems to have focused on the prior actions despite the latters' inadequacy in relation to the objectives.

b. M&E Implementation
Within the limits imposed by the modest results framework, M&E implementation was satisfactory, focusing on the result indicators related to the prior actions, and with clear data and information sources to facilitate data collection and monitoring.

c. M&E Utilization
The Bank used the results indicators to conduct supervision and for the ICR. The indicators were, however, of little use in assessing the program's impact on development objectives or in deciding among strategic options.

M&E Quality Rating
Modest

10. Other Issues

a. Environmental and Social Effects
No environmental or social safeguard policies were triggered by this operation. The PD states that no

significant environmental impact was expected from the fiscal policy area, while net positive impacts were expected from the water resource management improvements.

b. Fiduciary Compliance

The ICR reports no fiduciary compliance issues.

c. Unintended impacts (Positive or Negative)

No unintended impacts signaled in the ICR.

d. Other

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11. Ratings

Ratings	ICR	IEG	Reason for Disagreements/Comment
Outcome	Moderately Unsatisfactory	Moderately Unsatisfactory	---
Risk to Development Outcome	High	High	---
Bank Performance	Moderately Unsatisfactory	Moderately Unsatisfactory	---
Borrower Performance	Moderately Unsatisfactory	Moderately Unsatisfactory	---
Quality of ICR		Substantial	---

Note

When insufficient information is provided by the Bank for IEG to arrive at a clear rating, IEG will downgrade the relevant ratings as warranted beginning July 1, 2006.
The "Reason for Disagreement/Comments" column could cross-reference other sections of the ICR Review, as appropriate.

12. Lessons

The following two lessons are taken from the ICR with some adaptation of language:

- **Delivering development policy operations close to elections involves high risk**. In this case, delaying the operation until after the election could have provided the conditions for a more ambitious reform program addressing the short and medium-term issues more forcefully.
- **National legislation may prevent or constrain a state government from undertaking key structural reforms**. In this case, there several examples of this. Where this occurs, the goals of the DPO are more likelyto be achieved if parallel efforts are made to address the federal level constraints.

IEG adds a third lesson:

- **A serious disconnect, as in this case, between the reform measures supported by the operation and the program development objectives, is likely to undermine the outcome of the operation and reduce its credibility as a catalyst for change**. If only limited reforms can, for political or other reasons, realistically be attained, and it is not possible to change the timing of the operation, then the objectives may be adjusted to reflect these realities.

13. Assessment Recommended?

No

14. Comments on Quality of ICR

The ICR provides a candid analysis of the merits and the shortcomings of the operation's design and implementation and draws meaningful lessons. It rightly acknowledges its limited ability to analyze the impact of targeted results on development outcomes. A discussion of the measures taken by the new state government to address the macro-fiscal crisis in 2015 and 2016, and which are considered in the Borrower's ICR (ICR, pages 50-51), would have been useful.

a. Quality of ICR Rating

Substantial