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PERFORMANCE AUDIT REPORT

BRAZIL

MUNICIPAL DEVELOPMENT PROJECT IN THE STATE OF PARANÁ
(Loan 3100-BR)

AND

MUNICIPAL DEVELOPMENT PROJECT IN THE STATE OF RIO GRANDE DO SUL
(Loan 3129-BR)

June 12, 1998

Operations Evaluation Department

Currency Equivalents

Currency Unit = Brazilian Reais (R$)
(As of December 1997)

US$1.00 = R$1.070
R$1.00 = US$0.9337

Abbreviations and Acronyms

BADESUL	Rio Grande do Sul (RGS) State Development Bank
BANRISUL	RGS State Commercial Bank
CORSAN	RGS Water Company
FAP	Financial Action Plan
FAMEPAR	Paraná State Municipal Assistance Foundation
FUNDOPIMES	RGS State Urban Development Fund
FDU	Paraná State Urban Development Fund
ICR	Implementation Completion Report
IDB	Inter-American Development Bank
MDP	Municipal Development Project
OED	Operations Evaluation Department
ParanaCidade	Paraná State Urban Development Fund (under IDB)
PEDU	Municipal Development Project in the State of Paraná
PIMES	Municipal Development Project in the State of Rio Grande do Sul
PRAM	Paraná Market Towns Development Project
RGS	Rio Grande do Sul
SANEPAR	Paraná State Water Company
SAR	Staff Appraisal Report
SEDU	Paraná State Secretariat of Urban Development

Fiscal Year

Government: January 1 - December 31

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The World Bank
Washington, D.C. 20433
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Office of the Director-General
Operations Evaluation

June 12, 1998

MEMORANDUM TO THE EXECUTIVE DIRECTORS AND THE PRESIDENT

SUBJECT: Performance Audit Report on Brazil
Municipal Development Project in the State of Paraná (Loan 3100-BR) and
Municipal Development Project in the State of Rio Grande do Sul (Loan 3129- BR)

Attached is the Performance Audit Report (PAR) on Brazil: Municipal Development Project in the State of Paraná (Loan 3100-BR, approved in FY89) and Municipal Development Project in the State of Rio Grande do Sul (Loan 3129-BR, approved in FY90) prepared by the Operations Evaluation Department (OED).

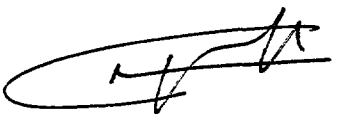
The municipal development project (MDP) in Paraná was a follow-on to the Paraná Market Towns Development Project (Loan 2343-BR). The MDP in Rio Grande do Sul (RGS) was the first project of its kind in that state. Because this demand-driven style of lending instrument in the urban sector has been widely replicated Bankwide, OED audited both projects to draw lessons. The two projects had identical objectives of increasing the institutional capacity of municipalities and state urban development agencies, especially for fiscal and financial management. The project comprised (i) creating an Urban Development Fund to provide a long-term line of credit to municipalities; (ii) establishing strict municipal creditworthiness and management improvement standards as conditions for allowing local governments to participate in the fund; and (iii) on-lending to municipalities to finance infrastructure investments such as street improvements and community facilities.

The audit confirms the completion reports' findings that the projects in both states have achieved their institutional and physical objectives. The Urban Development Fund successfully established itself as a financial intermediary, and its on-lending mechanism was fully institutionalized as a statewide program. Ninety-nine percent of municipalities in Paraná and 48 percent in RGS took out subloans to finance various infrastructure subprojects. Participating municipalities improved fiscal and financial management by meeting the creditworthiness requirements to participate in the program, and their officials learned how to prepare and implement investment projects. The audit also concludes that the project impact on the municipalities' own revenue generation was significant.

The main lesson is that a project design, which aims at setting the institutional framework right and putting financial reform in place before undertaking physical investments, will reduce risks for implementation delays and cost recovery.

The audit rates the outcomes of both projects as satisfactory, their institutional development impacts as substantial, their sustainability as likely, and performance of both the Bank and the borrower as satisfactory. The ratings concur with those of the ICRs except the ICR of the MDP in RGS rated its sustainability as uncertain. The audit finds its sustainability likely because of the fund's favorable financial condition, increasing demand for subloans, the high quality staff, and the state government's commitment to the program.

Attachment



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Municipal Development Project in the State of Paraná (Loan 3100-BR)

Principal Ratings

	ICR	*Audit*
Outcome	Satisfactory	Satisfactory
Sustainability	Likely	Likely
Institutional Development	Substantial	Substantial
Borrower Performance	Satisfactory	Satisfactory
Bank Performance	Satisfactory	Satisfactory

Key Staff Responsible

	Task Manager	*Division Chief*	*Country Director*
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Mid-term	Mary Sheehan	Gobind Nankani	Rainer Steckhan
Completion	Braz Menezes	Paul Meo	Gobind Nankani

Municipal Development Project in the State of Rio Grande do Sul (Loan 3129-BR)

Principal Ratings

	ICR	*Audit*
Outcome	Satisfactory	Satisfactory
Sustainability	Uncertain	Likely
Institutional Development	Substantial	Substantial
Borrower Performance	Satisfactory	Satisfactory
Bank Performance	Satisfactory	Satisfactory

Key Staff Responsible

	Task Manager	*Division Chief*	*Country Director*
Appraisal	Braz Menezes	Mohan Munasinghe	Amin Choksi
Mid-term	Braz Menezes	Gobind Nankani	Rainer Steckhan
Completion	Braz Menezes	Paul Meo	Gobind Nankani

Preface

This is a Performance Audit Report (PAR) on two municipal development projects (MDPs) in Brazil: one in the State of Paraná (Loan 3100-BR), the other in the State of Rio Grande do Sul (Loan 3129-BR). The Paraná project was approved on June 22, 1989, for US$100 million equivalent. The Rio Grande do Sul project was approved on October 24, 1989, for US$100 million equivalent, of which US$20 million was canceled. Both projects closed on December 31, 1995.

The PAR is based on the Implementation Completion Reports (ICRs, Report No. 16556, and No. 16557), both issued on April 28, 1997, the Staff Appraisal Report, President's Report, loan documents, a review of project files, and discussion with Bank staff. An audit mission visited Brazil December 5–23, 1997. The Evaluation Coordinator of the Federal Ministry of Planning participated in the entire mission, and participatory evaluation workshops took place in two municipalities. The cooperation and support of federal, state, and local government officials during the audit mission are gratefully acknowledged.

Following standard OED procedures, copies of the draft PAR were sent to the borrowers for comments. Their comments are attached as Annex B.

1. Background

Paradigm Shifts in the World Bank's Urban Lending

1.1 The legacy of the World Bank's urban lending operations during the past two decades can be characterized as a sequence of paradigm shifts from (a) sites and services and slum upgrading projects for low-income areas to (b) citywide infrastructure projects for selected cities to (c) municipal development projects (MDPs) to reach numerous municipalities by encouraging competition among them. In the 1980s, the MDPs shifted the urban project design from a complex supply-driven (top-down) approach to a demand-driven (bottom-up) approach that provided a large number of municipalities with access to credit they could use to finance their own investment projects.

1.2 As of July 1997, 16 MDPs had been completed Bankwide in 11 countries, including Jordan, the Philippines, and Côte d'Ivoire. Nineteen more MDPs in 15 countries, including Georgia, Tunisia, and the West Bank and Gaza, are currently being implemented with total lending reaching US$2 billion. The MDP lending instrument has been popular in the Bank's urban sector because its project concept is consistent with the current Bank emphasis on demand-driven, bottom-up approaches with strong ownership and local participation.

1.3 The Bank undertook the first MDP in Brazil, the Paraná Market Towns Development Project (Paraná I, Loan 2343) in 1983. Paraná I was completed successfully and was for a time known as a best practice case. The Bank subsequently approved an MDP for the state of Santa Catarina (Loan 2623, approved in 1985), continued its operations in Paraná with a second MDP in that state (Paraná II, Loan 3100, approved in 1989), and undertook an MDP in the state of Rio Grande do Sul (RGS I, Loan 3129, approved in 1989).

1.4 OED commissioned this audit to draw lessons from the successfully completed MDPs in Paraná and Rio Grande do Sul that could be used in ongoing and future projects in Brazil and elsewhere. This audit will also be used as a case study for an impact evaluation that will document the institutional and financial impacts of MDP programs on the development of local economies.

MDPs in a Period of Macroeconomic Instability

1.5 Paraná II and RGS I were implemented during a period when annual inflation stayed above 1,000 percent and peaked at 2,488 percent in 1993. The 1994 Real Plan (for macro stabilization) brought annual inflation down to 9 percent in 1996 using, among other things, an exchange rate anchor and a tight monetary policy. After the Real Plan, however, federal authorities asked the Bank to prepare a series of state reform loans as many state governments were in fiscal crisis. By 1996, the operational deficits of subnational governments amounted to 2.7 percent of GDP, or about half the consolidated public sector deficit. Subsequently, five states including RGS, where labor expenses accounted for over 80 percent of current revenues, undertook Bank-financed State Reform Loans (Dillinger 1997, paras. 20 and 38–39; World Bank 1997a, paras. 1.5–1.7 and 1.24).

1.6 The State Reform Loans deal only with state-level issues, however. In hindsight, the Paraná MDP II and RGS I turned out to be important mechanisms for introducing financial and managerial reforms at the municipal level. When the projects were appraised, the intergovernmental fiscal reform of the 1988 Constitution was expected to raise municipalities' current revenues by as much as 20 to 40 percent through increased revenue sharing and local tax items (Paraná II SAR, para. 1.08). According to one estimate, the disposable income of municipalities in Paraná increased on average by 37 percent (Guarda, 1997, para. 5.8). The sudden increase in fiscal transfers to local governments dampened incentives for municipalities to generate local revenues (Paraná II ICR, para. 13). At this point, undertaking the MDP program, aiming to increase the institutional and financial capacity of municipalities, was very timely. Subsequently, three more states, Minas Gerais (Loan 3639), Ceará (Loan 3789), and Bahia (Loan 4140) undertook MDPs with loan amounts ranging from US$100 to US$150 million. More than 2,100 municipalities come under the purview of these five ongoing MDPs (RGS ICR, para. 18).

1.7 The main objectives of the MDP program—to enhance the local government capacity to efficiently manage increased revenues and expenditure responsibilities—are still part of the policy agenda in the region. The Bank's recent Country Assistance Strategy (World Bank 1997d, para. 34) included in the development agenda a line of action to "strengthen local administrations, in order to build their ability to manage essential public services, as well as to increase their investment capacity."

Participatory Audit

1.8 The audit mission held two participatory workshops at Novo Hamburgo, RGS, and São Jose dos Pinhais, Paraná. The workshops provided a forum where representatives of different stakeholder groups could exchange their views about experiences during project preparation and implementation, project impacts, and lessons learned. The underlying methodology used the Bank's Groupware method, but without using computers. The workshop results were an important element in the qualitative evaluation of project results and in triangulating those results. Participatory evaluation using a series of focus group meetings provided useful inputs in a recent impact evaluation study in Brazil (World Bank, 1997g).

1.9 The participants represented municipal government, city council, PIMES, PEDU, the state water company, a fire brigade, community associations, private construction companies, private transport companies, day care centers, health posts, and schools. The workshops lasted about five hours and covered five areas: (i) problems during implementation; (ii) solutions to the problems; (iii) conditions before and after the project; (iv) benefits from the projects; (v) lessons (positive and negative) learned.

1.10 The workshops provided useful first-hand evidence from the beneficiaries that validates project impacts, namely improvements on the ground in transport, water supply, health, education and safety; indicates unanticipated problems during implementation; and provides lessons for the future. The most significant lesson was that the participants appreciated the opportunity for open communication with the Bank and both state and municipal governments, and they suggested that such workshops be held before and during project implementation. A secretary recorded results during the workshop and the report was prepared on the same day for distribution to all participants. More details on the logistics and results of the workshops are available from Gonzalez and Gonzalez (1997) and Osorio (1997).

2. Project Objectives, Components, and Key Agencies

2.1 The two projects were prepared concurrently by the same project team and using identical project objectives and designs. The project objectives were to (a) increase the institutional capacity of municipalities and state urban development agencies to plan, finance, and execute investment programs; (b) improve the fiscal and financial management capacity of municipalities; (c) provide basic economic and social infrastructure in urban areas; and (d) improve targeting of urban programs to lower-income populations.

2.2 These objectives were to be achieved through three components: (a) creating an Urban Development Fund (FDU) providing a long-term line of credit to municipalities; (b) establishing strict municipal creditworthiness and management improvement standards as conditions for allowing local governments to participate in the Fund; and (c) on-lending to municipalities to finance various infrastructure investments such as street improvements and community facilities (e.g., health posts and day care centers).

2.3 In Paraná, the state government's Secretariat of Urban Development (SEDU) had overall project responsibility for Paraná MDP II (known locally as the PEDU project, the name used in the rest of the report). The Paraná Municipal Assistance Foundation (FAMEPAR) handled day-to-day project management; and the Paraná State Water Company (SANEPAR) was responsible for water and sanitation subprojects. In Rio Grande do Sul, the MDP (known locally as the PIMES project, the name used in the rest of the report) was executed by the RGS State Development Bank (BADESUL), which was merged later into the State Commercial Bank (BANRISUL), and the RGS State Water Company (CORSAN), under the general direction of the state government's Secretariat of Coordination and Planning.

3. Implementation

Changes in Government

3.1 State elections were held in 1991, a year after the loans became effective. The change of state government did not affect project implementation in Paraná and the project continued without difficulties. In RGS, however, the new administration did not fully support the PIMES project. After BANDESUL merged with BANRISUL in 1992, the staff turnover was disruptive. The state government of RGS was able to provide only a small part of the anticipated counterpart funding (US$27 million out of a total commitment of US$76.2 million), which led to a cancellation of US$20 million of the Bank loan. The implementation difficulty in RGS was clear from the data provided to the audit mission: of the 226 subloans executed during the implementation period (through November 1997), only 56 were approved during the first four years (1990–1993).

3.2 According to PIMES staff and senior state government officials, the current administration is fully committed to supporting further growth of PIMES. Since 1996 the state government has been making loan repayments to the Bank from its resources, indirectly compensating for the arrears in counterpart funding by the previous government. Therefore, the audit cannot support the ICR's conclusion that "the current RGS administration, in spite of maintaining in place senior officials who were responsible for the preparation of the PIMES program, still does not treat FUNDOPIMES as the priority instrument of municipal development in RGS state..." (RGS ICR, para. 22).

Wholesaling Statewide Participation

3.3 From the time of the first project (Paraná I, locally called PRAM, the name used in the rest of the report), the implementation strategy was to operate the MDP as a statewide program by maximizing the number of participating municipalities. Hence, at the outset, PRAM's project coordinator visited more than 200 municipalities giving lectures and holding seminars with local officials to introduce the project concepts. Intensive marketing of project ideas to the clients (municipalities) and creating strong borrower ownership were key elements in stimulating demand for project financing at the local level. This tradition was followed in the PEDU project as the focus of the project shifted to capacity building of all municipalities in Paraná. Indeed, 99 percent of Paraná's 371 municipalities participated in PEDU. This "wholesale model" of project implementation was followed in the PIMES project, which was implemented concurrently with PEDU, attracting 48 percent of the states 333 municipalities to the project. In RGS too, the PIMES staff held a series of seminars in each subregion of the state to explain the basic project concepts such as debt service capacity and loan financing. The project was innovative in that opportunities to improve creditworthiness and increase local revenues served as a strong incentive for a large number of municipalities to participate in the program (Paraná II ICR, para. 25; RGS ICR, para. 32).

3.4 Implementing agencies with a small number of staff (fewer than 20) successfully supervised a large number of subprojects from preparation to successful completion. PEDU had a network of specialized agencies in such fields as health and education. FAMEPAR had 16

regional offices throughout the state which supervised day-to-day operations with necessary technical assistance, especially in the areas of municipal finance and law. PIMES, however, lacked such network arrangements. Its successful completion is largely due to the hard work of the PIMES staff who made frequent visits to participating municipalities.

4. Findings and Results

4.1 In addition to holding discussions with the state government officials and state implementing agencies, the audit mission made seven site visits. Four were participating municipalities in RGS (Porto Alegre, Novo Hamburgo, Venancio Aires, and Campo Bom) and three were participating municipalities in Paraná (São Jose dos Pinhais, Campo Largo, and Cascavel).

Infrastructure Investment

4.2 In both states the project achieved the objectives of "providing basic economic and social infrastructure in urban areas," and "targeting of urban development programs to low-income populations." A large number of participating municipalities took out subloans to finance such infrastructure subprojects as street paving, drainage, water supply, sanitation, garbage collection, and such community facilities as health posts, day care centers, and school buildings.

4.3 *Subproject types*. Most of the subprojects financed, 81 percent in Paraná and 75 percent in RGS, were street paving with drainage improvements. The only revenue-generating subprojects financed were a few bus terminals. This result was partly due to the project design, which had limited the subproject eligibility to public goods–type infrastructure (RGS SAR, para. 2.05; Paraná II SAR, para. 2.06). Revenue-generating projects were supposed to be left to the private sector. Nevertheless, street paving was popular because it is visible, simple to implement, easy to supervise, and amenable to betterment charges. It has served well as an "entry ticket" to the program for a large number of municipalities to participate in financial reform, which was the focus of the project design. In hindsight, the "wholesale model" would not have been possible with more complex subprojects.

4.4 The site visits and participatory workshops (para. 1.10) confirmed that in both states most subprojects are located in low-income areas. Street paving and lighting with drainage improvements enhanced the quality of life in these areas with better public transport access and garbage collection services. Public health posts and day care centers also significantly improved the income earning opportunities of women. The audit mission also observed important side-effects[1] of the MDP program. Venancio Aires is a municipality of 50,000 people, an urban center in the tobacco growing subregion. Here PIMES financed infrastructure projects, such as street paving and lighting, bridges, and water supply extension, helping to increase the overall efficiency of industries.

4.5 *Direct cost recovery*. At the time of subloan application, the betterment tax (which can be considered a one-time "connection fee" to a new service) is included in the financial plan of municipalities as a means for direct cost recovery. The levying of such a tax is up to the local council, however. Even after the municipal council approves the measure, collection of the tax often proved difficult. The success of implementing the betterment tax was mixed. Among the seven municipalities the audit mission visited, only small municipalities in RGS have been using it effectively: Venancio Aires and Campo Bom have recovered about 75 percent of their

1. Hirschman's concept of the "centrality of side-effects" in project evaluation was explored in an OED impact evaluation study (World Bank, 1997f).

investment costs. Individual municipalities determine the tax amount and terms of payment. Campo Bom, for example, collects its tax in 36 installments. The city council of Porto Alegre did not approve the tax. In Paraná, both São Jose dos Pinhais and Campo Largo did not levy the betterment tax as they have access to alternative sources of revenues. In Cascavel, although 100 percent of the projects were covered by the tax, more than 70 percent of the tax was not collected.

4.6 The ICR of the PIMES project concludes that the revenue from the betterment tax is an insignificant source of own revenues based on aggregate figures. Only 1.6 percent of own revenues for all RGS municipalities comes from this tax (para. 17). Nevertheless, the betterment tax can be an effective means to promote recovering the investment costs from the beneficiaries. Even residents in lower-income communities are willing to pay for improved services as shown in Campo Bom and Venancio Aires.[2] In Paraná, under the ongoing third follow-on project financed by the IDB, 90 percent of the municipalities adopted the betterment tax, which is expected to recover 80 percent of the investment costs. Even with the mixed performance of direct cost recovery, the paved streets and related infrastructure have been adequately maintained as the municipalities have kept maintenance budget items.

Municipal Financial Reform

4.7 In both states the project achieved the objective of "improving the fiscal and financial management capacity of participating municipalities." The project design required strict municipal creditworthiness and management improvement standards as conditions for allowing local governments to participate in the program. To apply for a subloan, a municipal government had to submit a Financial Action Plan (FAP) analyzing the municipality's debt-servicing capacity (with revenue and expenditure projections) and demonstrating the subproject's eligibility for financing based on required technical standards. The FAP also presents a plan for institutional development, including training and technical assistance needs (SARs, para. 2.03; PEDU ICR, para. 6).[3] The FAP has been the key instrument for financial and fiscal reforms. Also, the requirement for sequencing of institutional reform before allowing physical investments was an effective way of minimizing possible implementation delays and cost recovery problems.

4.8 Based on observations in the seven municipalities, the FAP exercise was more strictly followed in RGS than in Paraná. After the municipalities in RGS submit the FAP to PIMES, the PIMES staff reviews it, then visits the municipality to discuss and negotiate the reform package in relation to the subproject proposal and loan agreement so that they become acceptable to the program. In Paraná, municipalities submit the FAP to the Central Bank as part of the routine creditworthiness review. The PEDU staff accepts the clearance by the Central Bank without an independent review. This process has become routine in Paraná as many municipalities repeated subloans under PEDU. In RGS, PIMES is the first project, and of the 48 percent of participating municipalities, not more than a dozen municipalities came back to PIMES for a second subloan. The PIMES program is still at its learning and growing phase. In RGS as well as in Paraná, however, the MDP program brought to municipal management a new culture that values creditworthiness.

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2. A number of previous Bank research results show that the willingness to pay for reliable services at the margin is higher for a low-income group than for a high-income group (Lee et al., 1996).

3. Details of the FAP performance are not presented in the PIMES ICR.

4.9 *Small versus large municipalities.* Contrary to the expectation at appraisal of early disbursements to large cities, the impact of the MDP program was less significant for large cities than for small municipalities, partly because the former had access to alternative sources of funding and had less need of technical assistance for their operations. On the other hand, for many small and medium-size municipalities, the MDP program provides the only access to long-term credit, and its technical assistance for institutional reform has been significant for them. An unintended side-effect could be that MDP stimulated economic and social development in the rural areas as small market towns became more productive.

4.10 *Impact on local revenue generation.* The ICR of Paraná II indicated that municipalities "succeeded in increasing their property tax revenues more than three times in real terms during 1989–1994," and concludes that these results are "consistent with the hypothesis that PEDU project municipalities increased their tax effort in order to qualify for project financing and to be able to repay FDU loans" (para. 6). But such results cannot be entirely attributed to the project without more disaggregated analysis.

4.11 The audit mission collected annual municipal finance data for all municipalities in RGS for 1990–1996. To see the project impact on municipalities' own revenue generation, several indicators have been calculated for municipalities participating in PIMES and those that did not (that is, the control group), including 295 municipalities with a population of 2,000 to 250,000. As Table 4.1 shows, the increase in municipalities' own revenues from 1990 to 1996 was much greater for the participants than nonparticipants on all three indicators, total own revenue per capita, property tax revenue per capita, and betterment tax revenue per capita. The per capita property revenue of the participants in 1996 was 65 percent larger than that of nonparticipants, and the per capita betterment tax of participants was more than twice that of the nonparticipants. The project impact on municipalities' own revenue generation was therefore significant.

4.12 The ICR of the PIMES project indicated that counterpart fund contributions by municipalities in RGS exceeded the appraisal estimate by 61 percent, US$81.8 million actual versus US$50.8 million planned (para. 19). This outcome is remarkable considering the state government's arrears in counterpart funding; it also corroborates the favorable impact of the project on the fiscal performance of the participating municipalities. Moreover, this result implies that the financial discipline imposed on the participating municipalities through the FAP exercise for institutional reform must have prevented a possible substitution effect of the increased revenue sharing (after the 1988 Constitution) on the local tax effort.

Table 4.1: Project Impacts on Municipalities' Own Revenues (per capita in constant US$)

	Own Revenue	Property Tax	Betterment Tax
1990			
Participants	38.25	2.63	1.37
Nonparticipants	36.96	1.96	1.25
1996			
Participants	64.78	17.02	3.10
Nonparticipants	48.15	10.48	1.56

Note: Includes 132 participating municipalities and 185 nonparticipating municipalities.
Source: PIMES

Urban Development Fund

4.13 In Paraná, the fund known as FDU was created in 1989 under PEDU. Until then, PRAM financed with "matching grants" (65 percent from the state), administered by the Secretariat of Urban Development only for municipalities with fewer than 50,000 inhabitants. With the establishment of the FDU, the grant financing was eliminated except for social facilities such as health centers, and all municipalities were allowed to borrow from the fund mainly for infrastructure subprojects. The innovative element in PEDU was the revolving fund. The FDU successfully established itself as a financial intermediary providing long-term credit to the municipalities, and the lending mechanism has been fully institutionalized as a statewide program. As the ICR found, the project was implemented expeditiously as planned.

4.14 The World Bank, however, rejected the Paraná state government's proposal for a follow-on third MDP. In 1996 the Inter-American Development Bank approved the ParanaUrbano project (that is, Paraná III) with a total loan amount of US$259 million to be implemented within four years. Under ParanaUrbano the FDU has evolved to a self-financing private entity called ParanaCidade, which is independent from the government with five of the eight board members coming from the private sector. The Secretary of Urban Development serves as the chairperson of the board with the power to make the final loan approval. In addition, the lending operations have been decentralized. FAMEPAR was dissolved and merged with ParanaCidade, which now operates with a network of 18 municipal associations covering all regions of the state. Loan applications for less than US$200,000 (about 60 percent) are handled by the associations. If the efficiency of the current management continues in coming years, ParanaCidade—with a healthy cash position[4] from the revolving funds—is expected to self-finance subprojects totaling US$100 million annually by the year 2002 (based on a recent projection) , sooner than projected in the ICR (p. 14–15).

4.15 In Rio Grande do Sul, FUNDOPIMES, a fund with identical design to FDU, was established when the project started. This fund has been managed by the PIMES implementation unit within the RGS State Commercial Bank (BANRISUL). After four years of slow implementation, the PIMES project picked up speed after 1995 when the original architects of the project returned to the state administration. Since 1995, 78 subloans have been approved and an additional 123 applications have been received for processing in 1998.

4.16 As the subloans with five-year terms are reaching maturity, the financial position of FUNDOPIMES has become strong. As of November 30, 1997, the total disbursement for subloans was US$216.3 million, of which US$102.8 million (48 percent) was from the revolving fund, that is, repayments from the municipalities. The balance came from the Bank loan (US$80 million) and from the state government (US$33.5 million). The total cash accumulated was US$35.8 million and the cash flow projection has healthy prospects as the demand for subloans is increasing rapidly. In November 1997, 187 municipalities were participating in the program; more than 300 will be participating by the end of 1998.

4.17 The mayors of municipalities visited by the audit mission indicated that the MDP program is the most important source of long-term credit for infrastructure financing. For smaller

4. As of December 1997, ParanaCidade's balance sheet and income statement were available only for the last quarter of 1996 as the entity was created in that year.

municipalities it is the only credit line available and it comes with technical assistance. Even the larger municipalities prefer the MDP program, since it involves less red tape.

4.18 All of the mayors also indicated that the automatic deduction of loan repayment from the value-added tax transfers that was required by the project (that is, the "intercept" mechanism) is acceptable to them. In both states, this mechanism prevented any default in repayments of subloans by municipalities.

Institutional Capacity Building

4.19 The projects achieved their objective of "increasing the institutional capacity of municipalities and state urban development agencies to plan, finance, and execute investment programs." The projects gave officials of participating municipalities opportunities to learn all phases of project preparation and implementation. At the state level, PIMES and PEDU (now ParanaCidade) established themselves as statewide urban development agencies with the necessary institutional capacity to function as viable financial intermediaries as discussed above.

4.20 In addition to improving their fiscal and financial management through the FAP, the participating municipalities had gone though the valuable process of "learning by doing" in every phase of a project cycle, including the feasibility study for subprojects proposed, economic analysis for cost recovery, and technical analysis for engineering design, procurement, and construction work. Furthermore, by using computers funded under the project, some municipalities were able to streamline payroll, cadastre, accounting and budget operations, and improve overall administrative efficiency.

4.21 ParanaCidade is now developing a computer network linked to participating municipalities with extensive data management and operations simulation systems (under the follow-on IDB project). The new system will allow constant monitoring of the financial position of participating municipalities. This system will make it possible to monitor the quality of the FAP's submitted by municipalities and continuously analyze their creditworthiness.

4.22 The MDP programs in both states did not establish a formal training institute for local government officials. Training programs were undertaken ad hoc and as needed without systematically training the officials of a large number of participating municipalities. An effective formal training program needs to be established, preferably through a training institute that can operate in collaboration with local universities, as in the case of the Philippines Local Government Academy (World Bank, 1997e). The initial investment in such an institute could be financed jointly by several states and its program operations designed to become independent of the state governments through a self-financing mechanism with private sector participation.

Water Supply

4.23 In both RGS and Paraná, the water supply and sewage services are provided by the states' independent water companies, the RGS State Water Company (CORSAN) and the Paraná State Water Company (SANEPAR). In both cases, all activities ranging from plant expansion to operations and maintenance are carried out by the water companies. CORSAN provided services to 343 municipalities and SANEPAR to 313. Day-to-day operations are carried out by the

regional offices. CORSAN financed a total of US$68 million from PIMES and SANEPAR a total of US$93 million from PEDU.

4.24 During the implementation of PIMES, CORSAN improved its debt service ratio, revalued its assets, rationalized its tariffs, and reduced its workforce from 6,500 to 4,000 (ICR, para. 9). To further improve its performance and expand its services with private sector resources, the government included CORSAN in the ongoing RGS State Reform Loan program, under which concessions or full service management contracts will be awarded (World Bank, 1997a). Access to 49 percent of the shares will be opened to the public and the privatization process is scheduled to be completed by August 1998. The laws establishing the legal basis for this move were passed in November 1997.

4.25 SANEPAR also met agreed financial ratios under PEDU and its reevaluations of company assets reduced the debt leverage of the company (ICR, para. 6). One of the most serious problems that contributed to the company's financial difficulty during implementation was the municipalities' inability to pay their counterpart funds. Of the US$20 million planned, 25 percent of the total investment, only 7 percent, was paid by the municipalities. Although Paraná is not included in the current state reform program financed by the Bank, the possibility of some form of partnership with the private sector was discussed during the audit mission.

5. Agenda for the Future

Changing Demand for Project Finance

5.1 Even though both PEDU and PIMES were intended to follow the demand-driven approach of the MDP program, their design at appraisal offered only a limited menu of subprojects from which participating municipalities could choose. Consequently, the subprojects financed by the FDU and the FUNDOPIMES were uniformly similar across municipalities with the majority of subprojects in street paving and drainage improvements.

5.2 International experience shows that municipalities have different financing needs depending on their size and their stage of socio-economic development. In the Philippines MDP program, which is demand-driven without any restriction, small resource-poor municipalities tend to finance rather simple, low-risk, revenue-generating projects first, such as public markets. After successfully completing such a subproject, they can enhance their creditworthiness with the increased revenues coming from the project. Then they can expand their investments in public infrastructure-type projects such as roads and drainage (World Bank, 1997e). As municipalities grow, they have an increasing need to finance economic infrastructure for production activities such as manufacturing and commerce as well as social infrastructure for household consumption. They eventually become ready to "graduate" from the MDP program and start borrowing from the private capital market. The project design of PEDU and PIMES did not envisage this process of municipal development and growth. The MDP program plays a catalytic role of helping poor, less-creditworthy municipalities to develop, grow, and eventually "graduate" from the program and participate in the private financial market. This role is analogous to that of the World Bank in helping developing countries until they "graduate" from the Bank.

MDP in Paraná

5.3 As ParanaCidade's operations as a self-financing private financial intermediary expand rapidly, both its financial services and types of subloans need to be diversified. Diversifying the subloan product mix to include revenue-generating subprojects (with positive externalities such as public markets) could come sooner than diversifying financial services since the latter would depend on the speed of the overall capital market development in Brazil. New financial services could include managing bond issues for selected municipalities; introducing risk guarantee functions; and developing mechanisms for the private sector participation through build-operate-transfer, concessions, and management contract for specific services such as certain maintenance functions. The audit mission discussed this agenda at the wrap-up meeting with the Secretary of Urban Development. The recommendation for the establishment of a formal training institute like the Local Government Academy in the Philippines was well received at the meeting.

5.4 ParanaCidade is ready to take these new challenges. The Bank's opportunity to collaborate with ParanaCidade in this exciting phase of institutional growth has not been lost, however. The Secretary of Urban Development indicated to the audit mission the need to collaborate with the Bank in the coming years either in a form of studies or lending operations. As a "best practice case" ParanaCidade is pushing the frontier of the MDP program and will continue to provide useful lessons for the ongoing MDPs in Brazil and in other countries.

MDP in Rio Grande do Sul

5.5 As the program regained its momentum and enthusiasm with the return of the original "champions" of the MDP program in the state government in 1995, 1998 is expected to see further expansion of the fund's operations in response to the high demand and further strengthening of its financial position (para. 4.16). The state government's continued protection of PIMES's organizational integrity within BANRISUL will be most crucial for the sustainability of FUNDOPIMES as it pursues further institutional growth during the current phase of Bank-financed statewide reform.

5.6 At the wrap-up meeting with the Secretary of Coordination and Planning, discussions on the future agenda touched on the need to diversify the loan product mix to include revenue-generating subprojects; diversify financial services; and establish a formal training program. The secretary indicated to the mission his interest in pursuing a Bank-financed "Local Government Reform" project as a second follow-on PIMES project.

6. Ratings

6.1 The audit rates the outcome of the MDPs in Paraná (PEDU) and Rio Grande do Sul (PIMES) as satisfactory. It rates their institutional development impacts as substantial and their sustainability as likely. The ratings concur with those of the ICRs except the ICR of PIMES rated its sustainability as uncertain. The factors that support the sustainability of the results achieved by the PIMES project include (i) the favorable financial situation of the FUNDOPIMES; (ii) increasing demand for subloans by municipalities; (iii) the high quality of the PIMES staff; and (iv) the state government's commitment to and ownership of the project. The ICR's conclusion that current RGS state government lacks commitment to the PIMES project is misleading as indicated Section 3 above. At the time of the ICR mission, the state government was preoccupied with the implementation of the state reform loan and perhaps paid less attention to the PIMES project.

Borrower Performance

6.2 The audit rates the performance of the state governments and implementing agencies in both Paraná and RGS as satisfactory. The projects were successful owing to the high quality of the project staff and the leadership within the state governments. In particular, the PIMES staff should be commended for their dedication, enthusiasm, and high standard of professionalism, which made it possible for the project to continue under adverse conditions.

Bank Performance

6.3 The audit rates Bank performance as satisfactory. The Bank project teams were innovative in adopting a project design based on the sequencing of financial reform before the physical investments. The Bank was flexible during implementation especially in restructuring the PIMES project in its early stage. The Bank supervision teams did their best in supervising the project implementation with frequent site visits.

7. Lessons and Recommendations

7.1 In April 1997, a policy seminar was held in Curitiba, Paraná, to draw lessons from the past urban operations for the future work. The lessons were succinctly summarized as follows: "Current trends in political, fiscal, administrative and operational decentralization entrust the provision of typically local services to local authorities. The Municipal Development Program of Paraná has greatly reduced local dependence on State grants through a mechanism that is increasingly self-financing. This relieves the State of some responsibilities and helps reduce social tensions by offering a direct response to local needs. It also stimulates municipal tax collection as a means to improve creditworthiness..." (Secretariat of Urban Development, 1997, p. 41). The overall findings of this audit support this statement. More specific lessons follow.

7.2 *Demand side.* The Financial Action Plan with stringent conditions for subloans provided an effective incentive for municipal reform. This design, with a follow-up monitoring scheme at the time of subsequent subloan applications, enabled a "wholesale" approach that covered a large number of municipalities.

7.3 *Supply side.* The MDP program in Paraná demonstrated the process of institutional evolution of an urban development fund from a government-operated disbursement mechanism to an independent, self-financing, private financial intermediary for providing long-term credit to municipalities. ParanaCidade is a best practice case for the MDP program; it can be replicated in other states in Brazil and in other countries.

7.4 *Sequencing of project components.* The project design, which aimed at setting the institutional framework right and putting financial reform in place before undertaking physical investments, reduced the risks for implementation delays and cost recovery.

7.5 *Champions and political support.* During implementation, the MDP program in Paraná was not affected by government changes. The MDP program in RGS did suffer from such changes and was on the verge of collapsing until the original "champions" (those who prepared the project) returned to power in 1995. Continued political support over time is crucial for successful project implementation.

7.6 *The dynamics of municipal development.* The MDP program was most effective in assisting smaller, less creditworthy municipalities in remote regions of the states. Large cities had access to alternative sources of financing and better technical capacity. As shown in the Philippines (World Bank, 1997e) and Jordan (World Bank, 1998), in Brazil too, the urban (municipal) development fund is catalytic in helping smaller, resource-poor municipalities become more creditworthy and financially strong, and in helping them to make a transition to "graduating" from the MDP program and eventually participating in the capital market. But international experience shows that municipalities' direct participation in the capital market has been slow in most developing countries.

7.7 *MDP as an instrument for rural development.* The project's financial and institutional impacts were most significant for small and medium-size municipalities in remote regions. Enhancing the efficiency and productivity of these market towns should contribute significantly to the economic and social development process of rural regions. As an important side-effect, this process would reduce regional income disparities between large urban centers and rural areas.

Recommendations

7.8 *Diversify the types of subprojects to be financed.* Both ParanaCidade and FUNDOPIMES should expand the scope of the lending program by allowing revenue-generating projects (with positive externalities) where the private sector can participate.

7.9 *Diversify financial services.* ParanaCidade has reached a phase where it could consider diversifying its financial services to include credit guarantee service; debt financing; and a catalytic role for build-operate-transfer, concessions, contract management, or other services for private sector participation. FUNOPIMES could follow the ParanaCidade's path in the near future.

7.10 *Emphasize training.* The MDP program in Brazil lacks a continuing training program with a formal training institute. Since the Brazil MDP is implemented in a "wholesale" manner for numerous municipalities, it may be useful to explore the feasibility of establishing a training institute (possibly jointly by several states) so that municipal capacity building can be achieved. This in turn would enhance the local capacity to generate high-quality subloans and lessen the need for close supervision by the state's implementation agencies.

7.11 *Streamline municipal administration and management.* Computerizing the accounting and budgeting systems and updating financial data would enhance the efficiency of municipal administration and management. It would also make it easier for ParanaCidade and FUNDOPIMES to monitor continuously the financial health of participating municipalities by sharing a common database. ParanaCidade is heading in this direction by adopting sophisticated data management and operations simulation systems.

7.12 *Use the betterment tax effectively for direct cost recovery.* This tax for a new infrastructure service is a one-time "connection fee" to the service. Studies show that low-income households tend to have a greater willingness to pay at the margin for reliable services than high-income households. Therefore, this tax measure could be an effective means of direct cost recovery if the government commits itself to its implementation.

7.13 *Protect PIMES and FUNDOPIMES from political interference.* With a healthy cash position and the high demand for subloans, the PIMES program is entering a critical phase for institutional growth and financial stability. Therefore, it is important to protect its organizational integrity, financial independence, and its highly dedicated staff in a period of ongoing state reform.

7.14 *Monitor the creditworthiness of municipalities in Paraná.* Ninety-nine percent of municipalities are participating in Paraná. For such a large number of participants, more stringent monitoring of the Financial Action Plan will be desirable to maintain healthy financial conditions of both municipalities and the fund.

7.15 *Disseminate lessons learned.* The Evaluation Coordinator of the Federal Ministry of Planning participated in the audit mission. He has suggested that, upon completion of OED's ongoing impact evaluation study, a dissemination seminar be held in Brasilia for the Brazilian local government officials involved in MDPs.

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Basic Data Sheet

BRAZIL: Municipal Development Project in the State of Paraná (Loan 3100-BR)

Key Project Data *(amounts in US$ million)*

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	226.9	221.5	97.6
Loan amount	100.0	100.0	100.0
Date physical components completed	12/94	12/95	

Cumulative Estimated and Actual Disbursements

	FY90	*FY91*	*FY92*	*FY93*	*FY94*	*FY95*	*FY96*
Appraisal estimate (US$M)	11.0	34.0	59.0	86.0	100.0	100.0	100.0
Actual (US$M)	0.0	5.8	22.8	45.4	59.8	92.6	100.0
Actual as % of appraisal	0%	17%	39%	53%	60%	93%	100%

Date of final disbursement: May 3, 1996

Project Dates

	Original	*Actual*
Identification (Initial Executive Project Summary)	02/23/88	02/23/88
Preparation	12 months	12 months
Appraisal	02/13/89	02/13/89
Negotiations	05/04/89	05/04/89
Board approval	06/22/89	06/22/89
Signing	08/14/89	08/14/89
Effectiveness	10/89	01/19/90
Closing date	12/31/94	12/31/95

Annex A

Staff Inputs (staff weeks)

Stage of Project Cycle	*Weeks*
Through appraisal [1]	40.7
Appraisal-Board	56.4
Board-effectiveness	7.2
Supervision	88.5
Completion	4.0
Total	196.8

1. Jointly with Rio Grande do Sul Municipal Development Project (Ln. 3129-BR).

Annex A

Mission Data

Stage of Project cycle	*Date (month/year)*	*No. of persons*	*Staff days in field*	*Specialization represented*[1]	*Performance rating*	*Types of problems*
Through appraisal[2]	March 1988	2	7	Urb; Coff.	N/A	
	December 1988	2	10	Urb; Fin; Hous; Econ.		
Appraisal through board approval	February 1989	7	21	Fin; Inst; Econ; Law; Hous; Fin.	N/A	
Board approval through effectiveness	(none)					
Supervision 1	May 1990	4	2	Urb; Fin; Inst; MunF.	1	Changes in coordination team of project. Lack of counterpart funds.
Supervision 2	January 1991	3	4	Fin; Inst; Econ.	1	Need to strengthen PEDU project coordination.
Supervision 3	September 1991	2	2	Fin; Econ.	1	Restrictions imposed by Resolution #58 of 1990- which prevented those municipalities not current with Federal social security obligations from incurring debt.
Supervision 4	March 1992	2	2	Fin; Econ.	1	Need emphasis by PEDU on technical assistance component.
Supervision 5	October 1992	2	2	Urb; Fin.	1	Lag in implementation of institutional development component.
Supervision 6	June 1993	4	7	Fin; Econ; EngC; EngS.	1	Lag in implementation of institutional development component.
Supervision 7	November 1993	4	3	Fin; Econ; EngC; EngS.	1	Implementation of institutional development component continues to lag.
Supervision 8	July 1994	2	3	EngC; EngS.	S	No pending issues.
Supervision 9	August 1994	3	2	Fin; EngC; EngS.	S	No pending issues.
Supervision 10	October 1995	3	2	Econ; EngC; EngS.	S	No pending issues.
Completion	August 1996	1		Econ.		

Notes:

1. Key to specializations:
2. Jointly with Rio Grande do Sul Municipal Development Project (Ln. 3129-BR)

Coff.	County Officer	Inst	Institutional Development specialist
Econ	Economist	Hous	Housing Specialist
EngC	Civil Engineer	Law	Lawyer
EngS	Sanitary Engineer	MunF	Municipal Financial Specialist
Fin	Financial Analyst	Urb	Urban Planner

Annex A

BRAZIL: MUNICIPAL DEVELOPMENT PROJECT IN THE STATE OF RIO GRANDE DO SUL (LOAN 3129-BR)

Key Project Data *(amounts in US$ million)*

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	227.0	189.0	83.3
Loan amount	100.0	80.0	80.0
Cancellation		20.0	
Date physical components completed	12/94	12/95	

Cumulative Estimated and Actual Disbursements

	FY90	*FY91*	*FY92*	*FY93*	*FY94*	*FY95*	*FY96*
Appraisal estimate (US$M)	12.6	24.2	40.8	63.4	88.0	100	100
Actual (US$M)	0.0	6.9	12.9	23.8	31.0	67.2	79.9[1]
Actual as % of appraisal	0%	29%	32%	38%	35%	67%	80%
Date of final disbursement: May 3, 1996							

1. US $20 million canceled in 1994.

Project Dates

	Original	*Actual*
Identification (Initial Executive Project Summary)	02/23/88	02/23/88
Preparation	12 months	12 months
Appraisal	02/13/89	02/13/89
Negotiations	08/28/89	08/28/89
Board Presentation	10/24/89	10/24/89
Signing	01/22/90	01/22/90
Effectiveness	04/90	06/25/90
Closing date	12/31/94	12/31/95

Annex A

Staff Inputs (staff weeks)

Stage of Project Cycle	*Weeks*
Through appraisal[1]	20.3
Appraisal-Board	3.8
Board-effectiveness	9.7
Supervision	107.7
Completion	4.5
Total	146.0

1. This project was prepared jointly with Paraná Municipal Development Project (Ln. 3100-BR), and it is assumed that half the preparation time was allocated to each project.

Annex A

Mission Data

Stage of Project cycle	*Date (month/year)*	*No. of persons*	*Staff days in field*	*Specialization represented*[1]	*Performance rating*	*Types of problems*
Through appraisal[2]	March 1988	2	7	Urb; Hous.	N/A	
	December 1988	2	10	Hours; Inst.	N/A	
Appraisal through board approval	Feb. 1989	7	3	Urb; Inst; Fin; Econ; Law; Hous; Fin.		
	July 1989	1	5	Urb.		
Board approval through effectiveness	(none)					
Supervision 1	May 1990	2	3	Urb; Inst;	1	No impending issues.
Supervision 2	January 1991	3	4	Urb; Inst; MunF.	2	Lack of state counterpart funds. Need focus on institutional development component.
Supervision 3	May 1991	3	3	Urb; Inst; MunF.	2	Lack of state counterpart funds. Need focus on institutional development component.
Supervision 4	July 1991	2	1	Urb; Inst.	2	Lack of timely provision of state counterpart funds. No convenio agreement between BADESUL, BANRISUL & STASC re: Housing Pilot Project
Supervision 5	October 1991	4	4	Urb; Inst; Econ*; EngC.	2	In addition to the above, PIMES Coordinator resigned.
Supervision 6	June 1992	3	2	Urb; Inst; Fin.	3	Evidence of increased intra-administration conflict; constant management changes; transitional problems following merger of BADESUL (executive agency) into BANRISUL (state commercial bank); and chronic shortage of counterpart funds.
Supervision 7	October 1992	4	10	Urb; Inst; Fin; EngC.	2	Resolution 36&58 require that municipalities must be approved by both the BACEN and Senate each time they borrow may further delay processing of subloans.
Supervision 8	February 1993	2	5	Urb; Inst.	2	Lack of counterpart funds.
Supervision 9	June 1993	3	3	Inst; EngC; EngS.	2	Lack of counterpart funds.
Supervision 10	February 1994	4	4	Urb; Inst; EngS; Fin.	2	Lack of counterpart funds.
Supervision 11	June 1994	3	7	Fin; Inst; EngS.	1	No pending issues
Supervision 12	November 19944	3	5	Fin; Inst; EngS.	S	No pending issues
Supervision 13	June 1995	3	3	Fin; EngC; EngS.	S	No pending issues
Completion	August 1996	1		Econ.		

Notes
1. Key to specializations: (* indicates participation of Division Chief)
2. Jointly with Paraná Municipal Development Project (Ln. 3100-BR).

Econ Economist
EngC Civil Engineer
EngS Sanitary Engineer
Fin Financial Analyst
Inst Institutional Development specialist
Hous Housing Specialist
Law Lawyer
MunF Municipal Financial Specialist
Urb Urban Planner

Annex B

Comments from the Borrowers

MINISTÉRIO DO PLANEJAMENTO E ORÇAMENTO
Secretaria de Assuntos Internacionais

FAX N° 1108 /98 Brasília, 8 de junho de 1998

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n° de Páginas: 1 (incluindo capa)	OBS: Em caso de má transmissão ligar para In case of a bad transmission, please call (061) 225-7185

Prezado Senhor.

Após consultas às agências envolvidas na execução dos Projetos de Desenvolvimento Municipal nos Estados do Paraná e Rio Grande do Sul (Empréstimos 3100-BR e 3129-BR), manifestamos nossa concordância com o teor do Relatório de Auditoria de Desempenho, elaborado pelo OED, destacando suas conclusões e recomendações, que poderão ser de grande valia para a aprovação de futuros projetos no Brasil.

Salientamos, entretanto, observação feita pelo BANRISUL: na página 10, item 3.1 (Mudanças no Governo), não é correta a afirmação de que a posição de coordenador do projeto foi deixada vaga por três anos, visto que a mesma foi preenchida, à época, pelo Secretário de Planejamento, Dr. Walter Nique, como Presidente do Conselho Diretor do Fundopimes.

Atenciosamente