PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

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Operation Name	RIO STATE DEVELOPMENT POLICY LOAN III
Region	LATIN AMERICA AND CARIBBEAN
Country	Brazil
Sector	Sub-national government administration (50%); Secondary education (30%); Health (20%)
Operation ID	P126465
Lending Instrument	Development Policy Lending
Borrower(s)	THE STATE OF RIO DE JANEIRO
	Secretaria de Fazenda 42 Rua da Alfandega Centro Rio de Janeiro Rio de Janeiro, RJ Brazil Tel: (55-21) 2334 4300 ptafner@fazenda.rj.gov.br
Implementing Agency	SECRETARIA DA FAZENDA
Date PID Prepared	January 30, 2012
Estimated Date of Appraisal	February 13, 2012
Estimated Date of Board Approval	July 5, 2012
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.
Other Decision	

I. Country and Sector Background

The state of Rio de Janeiro is the second largest economy in the country. It is second only to Sao Paulo and equivalent to Portugal or Venezuela. The state of Rio accounts for 11 percent of national GDP or US$176 million in 2009. Its GDP per capita was R$22,103 in 2009 – about twice the national average. The population of Rio de Janeiro with 16 million inhabitants is the third largest in the nation.

After years of stagnation, the state economy experienced moderate growth from 2003 to 2008 and since 2009 has been growing well above national average. After a long period of economic decline, due to the migration of the capital to Brasilia and of businesses to Sao Paulo, Rio's economy experienced its first turning point in 2003. Since then, rapid industrial growth (in particular petroleum and steel) has spurred renewed economic activity in the state. The oil and gas industry accounts for 30 percent of industrial production and 6.4 percent of industrial employment. The discovery of oil fields in Bacia de Campos in the 80's has been a boon for Rio. This has revitalized industries that rely heavily on petroleum and has had a positive impact throughout the economy. Besides that it created an important source of fiscal revenue from the

sharing of royalties on oil production. The revenue from oil royalties accounts for 11 percent of the state's total revenues. In real terms the economy grew on average 2.8 percent in the period 2002-2009, although in the last four years this rate increased to 3.4 percent annually. In 2009, state GDP grew 2.0 percent above Southeast and national average. Services dominate the economy but industry has been the most dynamic sector in recent years. Participation of industry in total GDP increased in the past 10 years with significant advances in the mining industry (oil and gas) which doubled its contribution.

The state economy remained buoyant in 2010 and 2011, with indicators of economic activity rising above their pre-crisis levels. The industrial sector which was the hardest hit, especially in the first half of 2009 has recovered from the crisis. Industrial production increased by 23 percent in November 2011 compared to its lowest point in February 2009, well above pre-crisis levels. Indices of employment and hours worked also peaked at the end of 2010. In 2011, however, industrial production stagnated at about end 2010 levels. The service sector was largely unaffected by the crisis due to its structure as seen in the performance of retail sales. The service sector is benefiting from the expansion of formal jobs, real increases in the minimum wage and expansion of conditional cash transfer programs as well as the expansion of credit.

Economic activity was resilient in Rio de Janeiro in 2011 compared to 2010. Industrial production experienced a very small drop (-0.1 percent) in September 2011 compared to September 2010, in contrast to the rest of Brazil where industrial production markedly dropped in 2011 as a result of tightening measures as well as the global crisis effects. The small drop of industrial production in Rio de Janeiro was on the back of a sharp drop of extractive industries in 2011 (-14 percent) which was balanced by growth in transformative industries (+3.4 percent), when at the national level transformation industries dropped (-1.7 percent) up to September 2011. Economic activity in Rio de Janeiro also benefitted from strong growth of retail sales, up 10.3 percent in 2011 compared to 2010. The index of economically active population (PEA) for Rio de Janeiro increased 3.2 percent in September 2011 compared to the same month in 2010. The level of formal employment also increased 7.1 percent during this period.

The strong growth has come with robust job creation in the formal sector. Indeed from 2004 to 2010 the state created almost one million net formal jobs. The crisis temporarily reversed this trend. In 2010, the effects of the crisis were overcome and the economy generated more than 217,000 formal jobs (Figure 3), with strong performance from industrial and services sector. The service and retail sectors accounted for 78 percent of them. As of November 2011, 203,722 formal jobs were generated in last 12 months. However, the average wage of workers although growing, did not grow as fast as in other states. One possible explanation for that is that the jobs being created are mostly in the service sector and are mostly minimum wage jobs. The unemployment rate in metropolitan region is decreasing, but at a slower pace than Brazilian average.

The perspectives for the economy in the near future are good. The oil and gas industry should continue its strong growth with the exploration and starting of production of the giants fields of pre-salt. Associated with oil industries the ship industry is being revitalized and is also growing fast. The state is also becoming an important logistic hub with a huge project in the north (Porto do Açu). The state has a growing petrochemical complex (Comperj) and a consolidated auto

industry. Finally, the upcoming mega sports events (World Cup 2014 and Olymics 2016) have been an opportunity to accelerate investments in physical and social infrastructure which should lay the foundations for higher state growth.

II. Operation Objectives

The objective of the proposed operation is to assist the Government of Rio de Janeiro in strengthening its tax policy and tax administration, improving the efficiency of public financial management, increasing the quality of public service provision in education and health and ensuring that policies adopted are both consistent with priorities of the State Government and with resources likely to be available in the medium term.

III. Rationale for Bank Involvement

Brazil and the World Bank Group have a long-standing partnership. The Country Partnership Strategy 2012-2015 (CPS) for Brazil recognizes significant achievements in tackling development challenges using innovative approaches, and contributing to shaping the global policy agenda. The CPS also responds to the demand for more flexible and efficient products that are better suited to the country's evolving needs, while maintaining a focus on key long-range development issues.

The aim of this operation is to build upon the partnership with the state of Rio de Janeiro by consolidating reforms which address complex and challenging development issues that have significant long-term implications. The reforms and the challenges in Rio de Janeiro are a microcosm of those facing Brazil as a whole (both in terms of development of institutions and with regard to poverty and margination). By working with a State such as Rio de Janeiro with relatively high capacity, the policies and innovations being supported can serve as models for other States in the Brazil. The DPL will help the GORJ reinforce fiscal and financial discipline, in the face of increasing pressures on expenditure while improving public service delivery and reintegrating the social fabric of the State.

The proposed operation is fully consistent with and closely linked to the objectives of the CPS, 2012-2015. This operation is one of a number of sub-national DPLs and SWAps designed to reinforce fiscal discipline, public financial management and service delivery as an integral part of the Bank's Country Partnership Strategy in Brazil. By focusing on a State with such a large economy and high inequality as Rio de Janeiro, the DPL will address both the Investment and Service delivery pillars of the CPS. In particular, the policy measures supported by the loan are aligned with the CPS objectives of (i) increasing the efficiency of public and private investments; (ii) improving the quality of public services for low income households, and expanding their provision through public and private channels. By supporting policies such increasing State revenue performance, improving efficiency in tax collection, implementing a merit-based selection process for school directors, and new management models for health units as well as improvements on the efficiency of the budget transfers to small municipalities in health, the DPL will contribute to improve such CPS outcome indicators for the whole country. The contribution will both be direct and indirect through the contribution that the reforms make to knowledge transfer within Brazil.

IV. Tentative financing

Source:	($m.)
Borrower	0
International Bank for Reconstruction and Development	300
Borrower/Recipient	
IBRD	
Others (specifiy)	
Total	

V. Tranches *(if applicable)*

	($m.)
First Tranche	300
Second Tranche	
Etc.	
Total	300

VI. Institutional and Implementation Arrangements

The preparation of this operation is being led by the State Secretariat of Finance (SEFAZ), which is also responsible for the fiscal consolidation; the work is in close collaboration with the Secretariat of Planning (SEPLAG) and the Office of the Chief of Staff (casa Civil). The Secretariat of Health (SES) is in charge of the reforms associated with the quality of urgent and emergency care, and the efficiency of state health services. The Secretariat of Education (SEEDUC) is conducting reforms to improve the quality and efficiency of basic education, mainly through the introduction of modern management techniques to improve education services in State schools.

SEFAZ, together with SEPLAG and the individual sector monitoring units, will be responsible for the overall implementation of the proposed operation, for reporting on progress, and for coordinating actions. It will collect the necessary data to indicate that the results indicators have been achieved. SEPLAG has a monitoring tool for certain strategic programs, called SigeRio, which allows real-time monitoring of the status of the program implementation through a web-based interface. Other programs are monitored within the purview of the sectors.

Once prior conditions for disbursement are agreed, the disbursement will take place once the GORJ has provided evidence that the conditions have been met. A Project Implementation Committee made up of officials from the agencies directly involved in the DPL-supported reform agenda will monitor implementation, including all essential technical assistance activities. In addition to monitoring and management systems, this project will support a number of evaluation activities that will generate data to inform State policies and thereby strengthen a culture of evidence-based policy-making.

VII. Risks and Risk Mitigation

The proposed operation is considered to have moderate risks.

The operation is subject to three main risks:

Economic and fiscal risks: On the economic front, ICMS tax revenues and oil receipts are highly susceptible to macroeconomic fluctuations in Brazil and partners countries, and oil price volatility respectively. Risks to state finances, and consequently successful implementation of the operation, are also associated with ongoing royalties reform and World Cup/Olympic Games investments. Additional fiscal pressures exist due to structural increases in expenditures related to, among others, World Cup and Olympic Games investment expenditures, as well as personnel, health and security expenditures and contingent liability expenditures. In addition, high costs of successful government programs (pacification of the favelas, establishment of emergency health care clinics) also imply increasing fiscal pressures. These risks are mitigated by (i) the set of key efficiency reforms supported by this operation; (ii) the commitment and capacity of the State government to continued fiscal discipline so that fiscal repercussions of the global slowdown and of the sporting events will be managed prudently so as not to offset the gains made in the last five years; (iii) the Fiscal Responsibility Framework which monitors the state's new borrowing and sets up fiscal targets accordingly, and (iv) recent approval by the House of Representatives of a new sharing rule that would be applied to all royalties coming from all Pre-Salt fields, including those already licensed, mandates that Rio's government be compensated by the resulting disadvantage, ensuring that the current inflow of oil revenues will not drop significantly.

External risks:Brazil could be affected by a possible crisis in the Euro zone through its growth, its external sector, its fiscal and debt accounts and its financial sector. A worsening of the global economy caused by a full-blown euro zone debt crisis and/or a US recession, may translate into lower external demand for Brazil's exports[1], while a Chinese hard landing would hit Brazil's terms of trade, and demand for exports, given the significant demand from China[2]. Secondly, the banking sector is vulnerable to continued global slowdown given the exposure of some small and medium sized banks to liquidity risk.Further worsening of the global economic environment also poses risk to the fulfillment of fiscal targets. These risks are mitigated by the fact that the country would enter the crisis with a strong external position, a reasonable fiscal position and a strong financial sector position. System-wide assessment of banks indicates that Brazil's banking system currently has solid liquidity levels and capital cushions. Brazil rebounded quickly from the 2008 crisis to achieve the highest GDP growth rate (7.5 percent) in the last 20 years in 2010. Brazil is poised to respond to a possible crisis, actively using a wide array of policy tools. Early interventions in recent months with the easing of monetary policy and the reduction of capital controls indicate that it is ready to promptly deal with any external threats to domestic growth

Political and institutional risk: The political situation in the State of Rio de Janeiro remains complex and reforms can be opposed by groups with entrenched political interests, such as public employee unions. The World Cup and Olympics generate additional institutional and financial risks due to the proliferation of legislation reducing controls and oversight of

[1] Currently, exports to the Eurozone represent about 20 percent of total exports, while exports to the US account for 9.5 percent of total exports respectively.

[2] China is the primary destination of Brazil's exports. The share of China in Brazil's exports stood at 16.8 percent in October 2011.

investments associated with these events. These risks are mitigated by the pace of reforms, such as the implementation of improved PFM practices that would enable taking decisions on the allocation of resources in the full knowledge of possible trade-offs and the future cost implications of policy decisions.

Risks related to specific sectors

Strengthening Fiscal Consolidation, Improving Tax Policy and Tax Administration. Internal resistance to tax policy reforms, specifically, possible resistance to Government actions to reduce tax expenditures may present challenges to reform implementation. This risk is further compounded by the tax competition environment prevalent among Brazilian states, referred to as the “fiscal war”: inter-state tax competition to attract mobile investment. Mitigation efforts to address these risks will rely on well planned and thoroughly explained policy measures, as well as the Government's political will to curb tax expenditures growth, demonstrated by the repeal of Lei Rosinha.

Improving the Efficiency and Transparency of Public Financial Management. Implementation of the new procedures to improve the management of public investments will require considerable coordination between various secretariats and leadership from the center. Given that public investment management always has a strong political dimension, there is a risk that procedures may not be fully adopted if there is significant opposition from any of the institutions involved. In addition, there is a risk that that procedures developed are seen as being too complex to be useful and therefore quickly abandoned, or that costing procedures are developed by not integrated into the budgetary process. In both cases, mitigation efforts will focus on providing technical assistance to ensure workable procedures are developed and consensus building and workshops to illustrate the collective benefits of instituting new procedures.

Increasing Accountability for Results in Education. The implementation of policy reforms could be affected if the political and budgetary commitment to the program is not preserved over time. All of the education sector reforms supported under the DPL were started under the current leadership in October 2010. These are major, high visibility, politically difficult reforms that have faced stakeholder resistance because they have introduced transparent, merit-based and results-oriented management processes. For example, parliamentarians used to be able to select school directors (as a benefit for their constituents -- now it is a transparent, merit-based, process. Teacher bonus pay used to be through political connections; now it is a transparent process based on schools' attainment of previously published targets). The key risk in education is therefore turnover in leadership. Inasmuch as the new incoming administrations do not share the priorities of their predecessors, the implementation and/or the funding of the sector reform program supported by the DPL might be affected. The strategy to mitigate this risk is centered on support to the State (though this program and the allied Pro-Gestao TAL and new Additional Financing TAL) to complement the management and accountability reforms with support for teachers and schools through new, high-quality teacher training opportunities (the "Escola SEEDUC" to upgrade teachers), investments in school infrastructure and learning materials, and impact evaluation and dissemination to make sure that parents and civil society are aware of the progress being made.

Increasing the efficiency of Health Services: the main potential risks include: (i) insufficient inter-institutional coordination of health services overall; and (ii) insufficiently informed consumers on the location and functions of the UPA. The first is being addressed by the introduction of an inter-institutional and interagency system to improve coordination among services, as well as implementation of a real-time information monitoring system for UPAs. The community issues are being addressed by public awareness campaigns, as well as consultations with and involvement of communities in their local UPAs.

VIII. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

Overall, the specific policy reforms supported by this loan are expected to have significant and positive poverty alleviation and social development impacts in Rio de Janeiro. During preparation, the Bank undertook a poverty and social impact analysis to explore the disaggregated social impacts on different stakeholder groups to enhance the positive impacts and minimize and reduce negative impacts and risks associated with the operation. The policies and reforms supported by this operation include consolidating fiscal sustainability, and improving the delivery of health and educational services. Each of these policies has a likely overall positive poverty and social impact. Reforms in health and education are expected to generate the most rapid positive gains for poor people and vulnerable populations.

Poverty and social inequality are high in the Rio State and present significant inter-regional differences, even though the gap between families living in informal settlements and the rest of the area has declined in the last decade. The poverty rate reached 10.2 percent in the city of Rio de Janeiro in 2008 and 13.7 percent in the metropolitan region as a whole. In peripheral areas it rose to over 30 percent, and in the informal settlements it ranges from 16 percent to 24 percent. Nearly 45 percent of the city's poor live in informal settlements. The metropolitan Gini Index remained stable during the past decade, dropping slightly from 0.578 to 0.576.

Environment Aspects

The specific actions supported under the proposed DPL under the first and second components are not likely to have significant positive or negative effects on the country's environment, forests, and other natural resources as they have to do with fiscal management and public sector management reform. There are no conditions in those pillars that may trigger environmental concerns or that may affect environmental laws and regulations, their enforcement or associated organizational framework in Rio de Janeiro.

The Environmental assessment will focus during appraisal on the following potential environmental risks: related to the Health component including adequate management and disposal of hospital waste. Improvements in the health sector in particular with OS and with ramped up demand in PAHI 2 hospitals should support the necessary adaptation of health units and staff capacity-building programs to ensure compliance with national legislation.

IX. Contact point

World Bank
Contact: Roland Clarke
Title: lead Public Sector Specialist
Tel: (202) 458-4820
Fax:
Email: rclarke@worldbank.org

X. For more information contact:

The InfoShop
The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 458-4500
Fax: (202) 522-1500
Web: http://www.worldbank.org/infoshop