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BRAZIL

FISCAL MANAGEMENT ENHANCEMENT PROJECT FOR THE STATE OF PERNAMBUCO – PROFISCO II-PE

(BR-L1501)

FIFTH INDIVIDUAL LOAN OPERATION UNDER THE CONDITIONAL CREDIT LINE FOR INVESTMENT PROJECTS (CCLIP)

FISCAL MANAGEMENT MODERNIZATION PROGRAM IN BRAZIL – PROFISCO II

(BR-X1039)

LOAN PROPOSAL

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ABBREVIATIONS

CAT	Coordenadoria da Administração Tributária [Tax Administration Coordination Unit]
CCLIP	Conditional credit line for investment projects
CIAT	Inter-American Center of Tax Administrations
COFIEX	Comissão de Financiamentos Externos do Ministério do Planejamento [External Financing Commission of the Ministry of Planning] comunicação [Goods and services sales tax]
DAFE	Diretoria Geral de Administração Financeira do Estado [General Directorate of State Financial Management]
ECD	Escrituração contábil digital [digital bookkeeping]
EFD	Escrituração fiscal digital [digital tax accounting]
e-Fisco	Sistema Integrado de Gestão Financeira e Tributária do Estado de Pernambuco [Pernambuco State integrated financial and tax management system]
GPF	Sistema Informático de Gestão dos Processos Fiscais [Computerized tax proceedings management system]
IAP	Implementation Acceleration Plan
IBGE	Instituto Brasileira de Geografía e Estatística [Brazilian Institute of Geography and Statistics]
ICB	International competitive bidding
ICMS	Imposto sobre operações relativas à circulação de mercadorias e à
IFI	Instituição Fiscal Independente [Independent Tax Institution]
IMF	International Monetary Fund
IRR	Internal rate of return
IT	Information technology
JUCEPE	Junta Comercial do Estado de Pernambuco [Pernambuco State Board of Trade]
LIBOR	London interbank offered rate
MD-GEFIS	Avaliação da Maturidade e Desempenho da Gestão Fiscal [Fiscal management maturity and performance assessment]
NCB	National competitive bidding
NCI	Net current income
NFC-e	Nota fiscal do consumidor eletrônica [electronic tax invoice issued to the consumer]
NF-e	Fatura eletrônica [electronic invoice]
NPV	Net present value
Pat-e	Processo administrativo tributário eletrônico [Electronic tax management process]
PCU	Project coordination unit
PE	Pernambuco state
PGE	Procuradoria Geral do Estado [Office of the State Attorney General]
PJ-e	Sistema del Tribunal de Justiça do Estado [State court system] prestação de serviços de transporte interestadual e intermunicipal e de
PROFISCO	Fiscal Management Modernization Program
R$	Brazilian reais
RFB	Receita Federal do Brasil [Federal Revenue Department of Brazil]
SAD	Secretaria da Administração [Administration Department]

SCGE	Secretaria da Contraladoria Geral do Estado [Secretariat of the State Comptroller General's Office]
SEF	Sistema de Escrituraçaõ Contábil e Fiscal [Accounting and taxation system]
SEFAZ	Secretaria de Fazenda do Estado [State Finance Department]
SPED	Sistema Público de Escrituração Digital [Digital public accounting
STN	Secretaria do Tesouro Nacional [National Treasury Department] system]
TCE-PE	Tribunal de Contas do Estado do Pernambuco [Pernambuco State Audit Office]

PROJECT SUMMARY

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Financial Terms and Conditions				
Borrower: State of Pernambuco			**Flexible Financing Facility**[a]	
Guarantor: Federative Republic of Brazil			**Amortization period:**	25 years
Executing agency: State of Pernambuco, through its Finance Department (SEFAZ)			**Disbursement period:**	5 years
			Grace period:	5.5 years[b]
Source	**Amount (US$)**	**%**	**Interest rate:**	LIBOR-based
IDB (Ordinary Capital)	37,000,000	90	**Credit fee:**	[c]
			Inspection and supervision fee:	[c]
Local	7,400,000	10	**Weighted average life:**	15.25 years
Total	44,400,000	100	**Currency of approval:**	U.S. dollars

Project at a Glance
Project objective/description: The project objective is to contribute to the State's fiscal sustainability through: (i) modernization of fiscal management; (ii) improvement of tax administration; and (iii) improvement of public expenditure management. This project is the fifth individual loan operation under the PROFISCO II CCLIP (BR-X1039) approved by the Board of Executive Directors through Resolution DE-113/17.
Special contractual conditions precedent to the first disbursement of the loan: (i) The borrower will adhere to the program Operating Regulations previously approved by the Bank for all individual operations under the PROFISCO II CCLIP; and (ii) the project coordination unit has been established, and its members appointed (paragraph 3.6). For special fiduciary contractual conditions, see Annex III, paragraph 4.1.
Special contractual execution conditions: Before starting to execute activities that have outputs intended for the Office of the State Attorney General (PGE), the Administration Department (SAD), the Secretariat of the State Comptroller General's Office (SCGE), or the Pernambuco State Board of Trade (JUCEPE), SEFAZ will sign cooperation instruments with the respective entities, specifying their roles and responsibilities during execution of the activities in question (paragraph 3.5).
Exceptions to Bank policies: None.

Strategic Alignment			
Challenges:[d]	SI ☐	PI ☑	EI ☐
Crosscutting themes:[e]	GD ☐	CC ☐	IC ☑

[a] Under the terms of the Flexible Financing Facility (document FN-655-1), the borrower has the option of requesting changes to the amortization schedule, as well as currency and interest rate conversions. The Bank will take operational and risk management considerations into account, when reviewing such requests.

[b] Under the flexible repayment options of the Flexible Financing Facility, changes to the grace period are permitted provided that they do not entail any extension of the original weighted average life of the loan or the last payment date as documented in the loan contract.

[c] The credit fee and inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with the applicable policies.

[d] SI (Social inclusion and equality); PI (Productivity and innovation); and EI (Economic integration).

[e] GD (Gender equality and diversity); CC (Climate change and environmental sustainability); and IC (Institutional capacity and rule of law).

I. DESCRIPTION AND RESULTS MONITORING

A. Background, problem addressed, and rationale

1.1 This project is the fifth individual loan operation under the PROFISCO II conditional credit line for investment projects (CCLIP) (BR-X1039), which the Government of Brazil has requested from the Bank,[1] with a view to consolidating the progress made by the PROFISCO I CCLIP (BR-X1005) and to continue modernizing the states' fiscal management.

1.2 **Economic and fiscal situation in Brazil.** Brazil is facing significant challenges in keeping its economy on a sustainable growth path. Its GDP contracted 3.8% in 2015 and by 3.5% in the following year; and it only grew by 1.1% in 2017.[2] Nonetheless, economic recovery is now under way, with expansions of 1.9% projected for 2018 and 2.1% for 2019.[3]

1.3 The decline in economic activity caused the consolidated public sector revenue to fall significantly, around two percentage points of national GDP between 2013 and 2016.[4] Despite the downward trend in tax revenue intake, public expenditure climbed steadily over this period from 37.4% of national GDP in 2013 to 41.6% in 2016. Consequently, the primary balance has deteriorated in recent years, in comparison with previous periods, from an average primary surplus of 3.4% of national GDP in 2002-2008, to 1.3% in 2009-2015. In 2016, the primary deficit reached 2.5% of national GDP,[5] and the country is not expected to run a structural primary surplus again until 2019.[6] Public debt also rose by almost one third over three years from 60.2% of national GDP in 2013 to 78.3% in 2016, and is projected to reach 81.2% in 2021.[7]

1.4 The recessionary setting had adversely impacted the fiscal performance of the Brazilian states. Tax revenue intake shrank from 7.6% of national GDP in 2008 to 6.9% in 2015. The goods and services sales tax (ICMS), which is the states' main source of tax revenue, declined by an average 6% in real terms from 6.7% of national GDP in 2013 to 6.5% in 2015. Moreover, federal government transfers to the states lessened over this same period from 2.9% of national GDP to 2.5%.[8]

1.5 As state revenues weakened, current expenditure climbed steadily, driven by rising personnel costs, which went from 10.2% of national GDP in 2011 to 10.9% in 2015.[9] Meanwhile, investment retreated by an average of 16% in real terms between 2013

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1 Ministry of Finance Notice. The project has received a recommendation from the External Financing Commission (COFIEX), No. 02/121. In January 2018 COFIEX approved increases in the loan amount to US$37 million and in the counterpart contribution to US$7.4 million.

2 Brazilian Institution of Geography and Statistics (IBGE), 2018.

3 International Monetary Fund (IMF), 2018. The Focus market report issued by the Central Bank of Brazil, on 5 February 2018, projects GDP growth of 2.7% in 2018 and 3% in 2019.

4 World Economic Outlook. IMF, 2017.

5 Macroeconomic volatility forced the authorities to revise the primary balance targets in fiscal 2016 and 2017. Instituição Fiscal Independente (IFI), 2017.

6 IMF, 2017.

7 IFI, 2017.

8 Secretaria do Tesouro Nacional (STN), 2016.

9 Rossi, 2016.

and 2016. Thus, the primary balance began to deteriorate in 2012, recording primary deficits in three of the last four years. In 2016, 10 of the 27 states ran primary deficits.[10]

1.6 **Fiscal situation in Pernambuco**. The economic crisis in Brazil caused the state's public accounts to deteriorate, as reported in Pernambuco fiscal performance. The real growth rate of the state's GDP fell from 4.5% in 2011 to -4.2% in 2015, and dropped by a further 3.5% in 2016. This had a major effect on ICMS intake, which accounts for approximately 82% of the state's tax revenue. ICMS revenue contracted sharply from 15.57% of state GDP in 2011 to 10.44% in 2016.

1.7 The impact of the economic crisis on federal tax revenue intake and changes in the federal government's fiscal policy also affected the volume of resources shared out to state governments. Transfers to Pernambuco state decreased by 4.15 percentage points from 12.10% of state GDP in 2011 to 7.95% in 2016.

1.8 In this lower-income context, the state introduced expenditure-reducing measures,[11] which managed to cut total expenses from 34.5% of its GDP in 2011 to 23.51% in 2016. This was achieved by cutting current expenses from 26.15% of state GDP in 2011 to 18.78% in 2016, and in particular by sharply reducing personnel expenses from 13.01% of GDP in 2011 to 9.82% in 2016. The good results obtained also partly reflect a significant cut in public investment, which dropped from 3.09% of GDP in 2011 to 0.89% in 2016. This lackluster investment progressively reduced the state's capacity to provide public goods in the quantity and quality required by its citizens. To increase public investment, the state needs to improve its fiscal planning, grow its own revenues, and improve expenditure quality, all of which are actions supported by the project.

1.9 In 2013 and 2014, Pernambuco recorded primary deficits of around 1.2% of GDP. In the two following years, measures to rein in expenditure made it possible to reverse this situation, and the state posted primary surpluses of 0.1% and 0.5% of its GDP, respectively. Pernambuco has a low debt level: its consolidated net debt represented 61% of net current income (NCI) in 2016, compared to an average of 70% for all Brazilian states and below the threshold of 200% of NCI. In 2017, a primary deficit of 0.8% of primary income was forecast; and state projections indicate a primary deficit of about 0.4% of primary income in 2018, followed by a slight recovery in 2019 to a surplus equivalent to 0.87% of primary income.

1.10 **Rationale.** The country's macroeconomic difficulties and the deterioration in the state's public accounts highlight the need to implement new fiscal management modernization initiatives, with the aim of keeping the public accounts in balance and consolidating fiscal sustainability. In addition, new complementary approaches are required to bolster Pernambuco's fiscal performance. PROFISCO I-PE placed particular emphasis on improving tax administration and promoted the integration of the state treasury with other levels of government by updating the State Accounting and Taxation System (SEF). This new project will pursue these lines of action and will also promote the following: (i) strengthening the administration of public spending; (ii) migration of the state's digital tax accounting (EFD) from the SEF to the Digital Public Accounting System (SPED), as well as utilization of SPED and

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10 STN, 2017.

11 Expenditure Reduction Plan (Decree 41.466 of 2 February 2015) and Expenditure Monitoring Plan (Decrees 42.601 of 26 January 2016 and 44.279 of 3 April 2016).

digital technologies; and (iii) simplifying tax compliance to improve the business environment.

1.11 The effectiveness and efficiency of public institutions is limited by the restrictions faced by their constituent public employees, access to information technology, availability of financial resources, and the legal framework (Arenas de Mesa, 2016; Finan et al., 2017). In this regard, SEFAZ needs to address remaining weaknesses that limit its performance. Although it has a payroll of 1,202 and 208 contract staff, it does not have a management model to plan and manage its human resources.[12] Nor does it have procedures for evaluating and determining the size of its workforce, which would make it possible to quantify and be aware of the profiles and composition of its staff. As a result, the allocation of civil servants does not meet current and future needs and does not make it possible to target training based on competencies.[13] In turn, despite the fact that 31% of current employees are of retirement age, no knowledge transfer or ongoing training program has been implemented, which creates a risk of service discontinuity. Nor does SEFAZ have profiles identified to develop training programs for new processes or knowledge transfer programs.

1.12 As regards technological infrastructure constraints,[14] although SEFAZ's technology stock was upgraded in 2016 with 465 new notebooks, 801 video monitors, and 904 microcomputers, it still has a large quantity of obsolete equipment (roughly 38% of the total existing stock of microcomputers). In addition, the technological platform in place today is insufficient to meet the need to protect and recover data and information and ensure its integrity, and to meet new demands for new technologies and the processing of large volumes of data.[15] There are also deficiencies, restrictions, and obsolescence in network-monitoring, server, and system software, which cause delays in response times and lengthens service processing times.

1.13 Lastly, in relation to the legal framework, the rules for granting and monitoring tax incentives (exemptions) are not reliably implemented, owing to insufficient controls, deficient systems, and weak planning. Although there are 2,000 companies that enjoy tax incentives, it is not possible to automatically detect and report when a breach of the established rules occurs.

1.14 There are other important challenges to strengthening Pernambuco's fiscal sustainability that were identified during the application of the Fiscal Management Maturity and Performance Assessment (MD-GEFIS)[16] and Technical Notes prepared by the SEFAZ corporate areas.[17] A closer diagnosis of the state's fiscal management reveals three specific problems:

1.15 In the **fiscal management** of SEFAZ's corporate processes relating to its governance, strategic management, personnel, and technology present

[12] SEFAZ (2017). Technical Note P1.2.1.

[13] SEFAZ (2017). No unit determines the size of its permanent staff by work process requirements.

[14] SEFAZ (2017). Technical Note P1.3.1.

[15] In 2017, the e-Fisco system was down for an average of 3½ hours per month (Source: SEFAZ/IT Superintendency report).

[16] This methodology was developed by the Bank, the Fiscal Management Committee (COGEF), and the Fiscal Policy Council (CONFAZ) to assess the level of maturity of the states' fiscal management processes.

[17] Set of 27 technical notes prepared by SEFAZ's corporate areas.

insufficient development and integration. The underlying causes of this specific problem are:

a. Difficulty for SEFAZ's various areas to reach the strategic targets planned,[18] because: (i) the strategic framework does not have defined indicators and targets, which makes it hard to monitor strategic planning and project execution in a timely manner.[19] Moreover, there is little exchange and integration of fiscal information between the strategic levels of government; and (ii) there are difficulties in executing fiscal activities related to administrative and financial processes.

b. Inefficient utilization of the workforce,[20] as a result of: (i) shortcomings in management procedures for human resource development, in terms of skills mapping and evaluation of managers and officials, compounded by the low level of automation of personnel management procedures; and (ii) an outdated training methodology that is not competencies-based.

c. High risk of IT systems' non-availability and loss of financial data,[21] due to: (i) inadequate contingency tools and procedures in the case of failures or disasters; (ii) inadequate monitoring of the performance of systems and the availability of services, in contrast to the growing demand for new technologies and the increased volume of data; and (iii) inadequate hardware to meet the new demands of the state's fiscal modernization.

1.16 The **tax administration's** revenue intake performance falls short of its potential[22] and the complexity of tax compliance has a negative impact on the business environment and saps the state's competitiveness.[23] This is the result of a loss of revenue stemming from inadequate estimation, planning and monitoring of tax incentives (exemptions), because: (i) the process of granting and monitoring tax concessions is almost entirely paper-based;[24] and (ii) it is difficult to quantify revenue forgone (tax expenditure) and the benefits and losses arising from a tax break.[25]

a. It is difficult for the taxpayer to complete the tax administration's main procedures and obligations, in an efficient and timely manner, because: (i) information on the taxpayer register is spread across several databases,

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[18] SEFAZ (2017). In 2013-2016, 54.5% of strategic targets were met, on average.

[19] MD-GEFIS: 23. SEFAZ does not define outcome indicators to verify compliance with each of its strategic objectives or their associated outcome targets.

[20] SEFAZ (2017). No unit determines the size of its permanent staff by work process requirements.

[21] SEFAZ (2017). In 2016, the e-Fisco system was down for an average of 3½ hours per month.

[22] Brazil displays an ICMS revenue gap of 34% relative to 2009-2014 potential collection; tax evasion is estimated to represent 7.6% of national GDP. Brazilian Union of National Treasury Counsels (SINPROFAZ), 2016.

[23] Pernambuco was ranked 13th out of 27 states plus the Federal District in the 2016 Competitiveness Ranking, with a score of 50.03, well below the average of 64 among the best-ranked states. In Brazil, 2,038 hours/year are spent on tax compliance compared with a regional average of 564 hours. There are no specific data for Pernambuco. World Bank, 2017.

[24] SEFAZ (2017). Over 2,000 taxpayers receive tax incentives under more than 10 different programs; these incentives are only partly registered in the control system, which, in turn, is not integrated with e-Fisco.

[25] SEFAZ (2017). It is impossible to automatically detect and notify a taxpayer that does not comply with the rules applicable to the incentives granted.

which are often mutually incompatible and not integrated.[26] In addition, there is difficulty in integrating information on legal entities whose parent company is in another state, which causes delays in creating, amending, or eliminating a taxpayer record; (ii) poor integration of SPED data with the other state declarations;[27] and (iii) difficulty in paying foreign trade taxes.[28]

b. Loss of revenue and the high cost of border supervision in Pernambuco's current tax inspection model,[29] owing to the following: (i) the state's inspection model does not make full use of the information available in electronic documents to combat tax evasion; nor does it have adequate technology for the physical inspection of cargo;[30] and (ii) the selection of cargo to be inspected does not have suitable risk management tools, nor artificial intelligence to single out potential evaders.

c. Inefficient recovery of tax claims, due to: (i) lack of integration in the collection of claims between SEFAZ and the Office of the State Attorney General (PGE);[31] (ii) deficient processes and support systems for first and second instance tax collection, and the PGE (judicial process);[32] (iii) significant delays by SEFAZ in judicial decisions on tax issues; (iv) inefficiency in the management of reimbursement and compensation procedures for the taxpayer; and (v) poor integration between the PGE's Judicial Automation Systems (SAF), SEFAZ's Electronic Tax Administrative Process system (Pat-e), and the State Court of Justice system (PJ-e).

d. The current model of the tax invoice issued to consumers (NCF-e) is deficient,[33] because: (i) it is impossible to extract tax information from the data displayed; (ii) storage infrastructure is insufficient; and (iii) the instruments used to process and cross-reference data from the NCF-e are deficient.

1.17 **Financial administration** lacks effective instruments with which to generate reliable and timely budgetary, financial, and asset information for decision-making and optimization of the use of public resources.[34] The underlying causes of this specific problem are:

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[26] SEFAZ (2017). The state registration databases are not integrated with the Federal Revenue Department (RFB). The taxpayer has to appear in person in at least six government entities to register a company (board of trade, city hall, RFB, fire brigade, health surveillance, and SEFAZ).

[27] SEFAZ (2017). The taxpayer has to complete at least five declarations to fulfill the obligations, when this could be done in a single one.

[28] SEFAZ (2017). SEFAZ is not integrated with the RFB so as to receive information on the import declaration. It can take up to three days to calculate the ICMS on imports.

[29] SEFAZ (2017). There are 10 tax posts on the border with Alagoas alone, where roughly 130,000 cargoes (trucks) circulate every month, generating 600,000 tax documents.

[30] SEFAZ (2017). Owing to the weakness of inspection tools there is substantial typing of documents in tax posts. In other states that implemented modern systems, document typing was eliminated.

[31] SEFAZ (2017). The average recovery rate of administrative debt in 2010-2016 was 9.2% (1st instance), and in the case of adjudicated debt (judicial action) it was 1.3%.

[32] SEFAZ (2017). Adjudicated debt is recorded manually. In 2014-2016 there were 6,015 cases of appeal for improper tax collection. Errors in the calculation of interest and fines are estimated at R$130 million per year.

[33] SEFAZ (2017). The revenue obtained from retail sales declined steadily by roughly 10% per year in the period 2012-2015.

[34] SEFAZ - State Balance Sheet - In 2016 the discrepancy between the planned and executed budget was 3.1%, while the international standards defined in the PEFA recommend a maximum of 5%.

a. The state's financial management is inefficient, because of: (i) control shortcomings between the financial programming limits and payment flows;[35] and (ii) inefficiencies in the accounts payable process in respect of state suppliers' invoices.[36]

b. The state does not efficiently control transfers made through agreements and partnerships with municípios and philanthropic entities, owing to: (i) deficient computerized control procedures and mechanisms;[37] and (ii) inefficient monitoring of cases of non- or partial execution of partnerships that give rise to refunds.[38]

c. The accounting-financial management of the indirect administration payroll and state assets is deficient, because: (i) payroll bookkeeping is done manually and without standardized accounting, thereby generating errors in the state's fiscal reporting;[39] and (ii) the state's immovable property data are substantially out of date and not integrated with its accounting system.[40]

d. Inefficiency in the public debt management process, because it is impossible to calculate debt service on a timely and systematic basis, or to make medium and long-term projections of debt trends.[41]

e. Impossibility of quantifying the cost of public services, making it difficult to make management decisions,[42] as a result of: (i) information on the costs of public services that is scattered across various departments; and (ii) low institutional capacity as regards public costs.

1.18 **The Bank's experience in the country.** The Bank has supported several operations to improve fiscal management in Brazil, particularly at the state level, under the National Fiscal Administration Program for the Brazilian States (PNAFE) (loan 980/OC-BR) and the PROFISCO I CCLIP (BR-X1005). It also supported the Fiscal Modernization Project in the State of São Paulo, the Program to Support Fiscal Management Modernization and Transparency in the State of Bahia,[43] and fiscal stability consolidation projects in the states of Amazonas, Alagoas, Bahia, Pernambuco, and Rio Grande do Sul.[44] At other levels of government, the Bank supported the Federal Revenue Service Fiscal Modernization Program [45] and the

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35 SEFAZ (2017). In 2016, the average monthly divergence between budgetary expenditures and cash flow expenses was R$15 million, whereas the bank reconciliation showed an average error of R$2 million per day.

36 SEFAZ (2017). The process is precariously automated, and suppliers' invoices have to be typed. In 2016, 300,000 documents were typed in the government's management units.

37 SEFAZ (2017). Consolidation of the balances of agreements and associations takes an average of 80 days.

38 SEFAZ (2017). Between 2008 and 2017, R$256.5 million were returned.

39 SEFAZ (2017). No indirect-administration executing unit has a system that automatically records its payroll in the state's accounting system.

40 SEFAZ (2017). 95% of asset databases are out of date, and 20% of real estate addresses contain errors.

41 SEFAZ (2017). 300 contracts per month are calculated in electronic spreadsheets, amounting to a total of about R$12 billion.

42 SEFAZ (2017). The costs of the services provided by the state are unknown.

43 Loan 1727/OC-BR.

44 Policy-based loans: 2081/OC-BR; 2841/OC-BR; 2850/OC-BR; 3039/OC-BR; 3061/OC-BR; 3138/OC-BR; and 3139/OC-BR.

45 SRF,1996.

Program to Support the Administrative and Fiscal Management of Brazilian Municípios (PNAFM I, II, and III).[46]

1.19 According to the midterm evaluation of the PROFISCO I CCLIP,[47] ICMS tax revenue intake as a share of GDP rose more in states with a PROFISCO project where execution was further along than in those where the level of execution was low. Between 2009 and 2013, this difference in intake averaged 6%.

1.20 The project completion report for PROFISCO I-PE[48] rated the project as: probable to achieve its development objective; satisfactory on implementation progress; and probable to be sustainable. The project achieved 100% of the three impact targets and 73% (eight) of the 11 planned outcome targets. Of the 46 planned output targets, the project fully met 41 (89%), three targets were partially met, and just two were not attained. In terms of innovation actions implemented, the SEF, with emphasis on the NF-e (wholesale sales), was undoubtedly the cornerstone of efficient taxpayer selection and improving the accuracy of compliance actions. In view of the good outcomes achieved from a considerable investment in technology, the current project will continue supporting the state's expansion and improvement of these solutions, mainly by enhancing the electronic tax invoice for retail sales (end consumer).

1.21 **Lessons learned from operations in the country.** The main lessons learned from previous programs, including operations under PROFISCO I-PE (loan 2151/OC-BR), include:

a. The need to address the issue of fiscal management through comprehensive actions and the lack of a tool with which to identify these innovative solutions, considering best practices that can support the design of fiscal modernization operations. To address this lesson, MD-GEFIS was developed. Based on this evaluation it is possible to identify the areas that need strengthening activities. The results of its application will be used as the baseline for project monitoring and evaluation.

b. In terms of the achievement of the outcomes, it was identified that the SPED, including the NF-e, Digital Tax Accounting (EFD), and Digital Bookkeeping (ECD), were the outputs making the biggest contribution to increasing the efficiency of the states' tax audits.[49] This operation will make a major investment in SPED's development and seek to maximize its potential by expanding the use of the information it generates to automate tax auditing,[50] simplifying tax obligations, and improving public procurement,[51] etc. by leveraging new digital economy technologies.

c. Executing operations necessitates instruments to compensate for the delays observed. For this purpose, in the case of the PROFISCO I CCLIP, the Bank

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[46] Loans 1194/OC-BR (completed in 2012), 2248/OC-BR (completed in 2017), and 3391/OC-BR (approved, awaiting contract signature).

[47] BR-X1005: Midterm evaluation, 2014.

[48] Project completion report, loan 2151-OC/BR.

[49] McKinsey&Company, 2014: NF-e and SPED increased tax evaders' risk of being identified and has helped reduce informal employment in Brazil over the past 10 years (from 55% to 40%).

[50] The use of SPED, coupled with artificial intelligence, will expand the possibility of identifying tax fraud. See Araujo, 2013.

[51] National Council of State Administration Departments (CONSAD), 2016.

developed a monitoring tool called the Implementation Acceleration Plan (IAP), which will be used to support this project in conjunction with the Bank's formal instruments. The IAP uses the progress monitoring report to identify all the outputs subject to execution delays and the parties responsible for them. It prepares mitigating measures and supports progress on these indicators until execution is progressing normally.

d. Specifically, PROFISCO I-PE itself lasted 24 months; and the negative factors were recognizably centered around the following: (i) fragmentation of outputs, which complicated the corresponding contracting (46 outputs); (ii) difficulty in generating financial reports that meet the Bank's standards (absence of an IT system); (iii) difficulty in achieving targets that did not depend on the state government; (iv) insufficient time to execute 46 outputs (four years); and (v) delay in obtaining the Bank's accreditation for the state's electronic procurement system. PROFISCO II-PE has taken account of these lessons and will generate fewer outputs (13); the entities participating in the project will be required to sign cooperation agreements with SEFAZ; and the new project will last five years.

1.22 **The Bank's experience in other countries of the region.** Recent Bank experience with tax administration reform in Ecuador (3325/OC-EC), El Salvador (3852/OC-ES), Guatemala (3786/OC-GU), Jamaica (2658/OC-JA), and Peru (3214/OC-PE); modernization of financial management systems in Guatemala (2050/OC-GU and 2766/OC-GU), Guyana (1550/SF-GY and 1551/SF-GY), Honduras (2032/BL-HO); and management of public investment in Argentina (3835/OC-AR), Ecuador (2585/OC-EC), and Mexico (2550/OC-ME) has been reflected in this operation and highlights the role of fiscal management strengthening. Some of the lessons learned are detailed here.

1.23 **The Bank's country strategy.** The project is aligned with the Bank's country strategy with Brazil 2016-2018 (document GN-2850) in relation to improving the business climate and enhancing efficiency in the management of public resources. The operation is included in the 2018 Operational Program (document GN-2915).

1.24 **Strategic alignment.** The project is consistent with the Update to the Institutional Strategy 2010-2020 (document AB-3008), and strategically aligned with the development challenge of productivity and innovation, through reducing tax collection costs, and with the crosscutting area of institutional capacity and rule of law, through the strengthening of tax systems[52] and public resource management and planning systems.[53] The project contributes to the Corporate Results Framework 2016-2019 (document GN-2727-6) via the indicators for: (i) percent of GDP collected in taxes;[54] and (ii) government agencies benefited by projects that strengthen technological and managerial tools to improve public service delivery, through strengthening of e-Fisco; (iii) accountability institutions strengthened; and (iv) subnational governments benefited by decentralization, fiscal management, and institutional capacity projects. Lastly, it is aligned with the Sector Strategy on Institutions for Growth and Social Welfare (document GN-2587-2) and consistent with the sector framework documents on Decentralization and Subnational Governments (document GN-2831-3), and Fiscal Policy and Management

52 Output Indicators 2.1 to 2.8 of the Results Matrix.

53 Output Indicators 3.1 to 3.3 of the Results Matrix.

54 Output Indicators 2.1 to 2.8 of the Results Matrix.

(document GN-2831-3) under the dimensions of: (i) improving the efficiency and quality of expenditure and service delivery; (ii) improving own revenue collection; and (iii) working with greater transparency and accountability.

B. Objectives, components, and cost

1.25 The project objective is to contribute to the State's fiscal sustainability through: (i) modernization of fiscal management; (ii) improvement of tax administration; and (iii) improvement of public expenditure management.

1.26 Enhancing the performance of public finance, increasing tax revenue intake, increasing the efficiency of public expenditure, and strengthening the fiscal sustainability of the state will benefit its citizens through better service delivery. This operation will finance the following components:

1.27 **Component I. Fiscal management and transparency (US$10.97 million**). This component seeks to improve management instruments and modernize the technological infrastructure, and also increase the transparency of SEFAZ's relationship with society and improve its institutional performance. The component will finance the following activities:

a. **Implementation of strategic fiscal management**, through: (i) implementation of an IT system that enables real-time planning and monitoring of SEFAZ's strategic targets and project execution, as well as the processing and dissemination of the information generated; and (ii) redesign of SEFAZ's administrative and financial processes and improvement of the respective IT support systems.

b. **Implementation of a competencies-based staff management model**, through preparation of: (i) a methodology for the evaluation and scaling of human resources, covering the competencies-based hiring and training regime, supported by a specific IT system; and (ii) a competencies-based human resource development and training plan.

c. **Strengthening of IT governance,** through: (i) implementation of a strategy for data storage, protection, and recovery, including the necessary software and hardware tools; (ii) adoption of tools to support IT service monitoring among SEFAZ internal and external users, in terms of data integrity, failures, response times, and unauthorized access; and (iii) updating of the supporting hardware and software technology stock.

1.28 **Component II. Tax administration and litigation (US$16.21 million).** This component seeks to grow internally generated revenues and simplify taxpayers' tax compliance. It will finance the following activities:

a. **Strengthening of the management of tax incentives** through: (i) review and adjustment of management procedures for granting tax benefits, including issues related to estimation and evaluation of the losses and benefits arising from a tax break; and (ii) implementation of an IT system to support the management of tax incentives, including automatic notification of any breach of the rules laid down by the Treasury.

b. **Simplification of tax obligations** through: (i) implementation of the National Network for the Simplification of Business Registration and Incorporation; (ii) simplification of taxpayers' obligations in the SPED; and (iii) integration of integrated tax administration system with the Unified Foreign Trade Portal.

c. **Strengthening of the goods-in-transit inspection model**: (i) reviewing and upgrading transit inspection procedures, including the creation of a virtual tax office for the control of goods in transit (e-PostoPE) and expansion of the strategic operations center. This will include adapting the physical and technological infrastructure of the control units; and (ii) implementation of risk analysis and fiscal intelligence methodologies to support timely, effective, and efficient selection of the cargo to be physically examined at the control units.

d. **Improvement and integration of collection systems**, through: (i) implementation of a methodology to support administrative collection that includes facilities for taxpayers to pay overdue taxes; (ii) improvement of the computerized tax proceedings management system (GPF), including functions for calculating fines and interest in administrative collection, and control of nontax claims; (iii) implementation of an IT system for the control and monitoring of court rulings (AJ-SEFAZ) in cases of litigation; (iv) an IT system for the restitution and recovery of claims in favor of taxpayers; and (v) integration of the PGE’s computerized judicial automation system with the GPF, Pat-e, and PJ-e information technology systems.

e. **Strengthening of the NFC-e** by (i) restructuring the information shown on it and its respective management information system; (ii) expanding the storage of data generated by the NFC-e, including the purchase of storage devices and systems; and (iii) implementing methodologies and tools for processing the data generated by the NFC-e.

1.29 **Component III. Financial administration and public expenditure. (US$16.66 million).** This component seeks to increase the efficiency of financial planning and execution. It will finance the following activities:

a. **Improvement of financial management,** through implementation of: (i) a computer system for managing cash flow and the Treasury Single Account, integrated into the state financial and tax administration system (e-Fisco); and (ii) an IT system for managing accounts payable to state suppliers, integrated into e-Fisco.

b. **Strengthening the management of transfers to federative entities and municípios** by reviewing transfer procedures and implementing a management information system that also controls refunds from the entities.

c. **Strengthening the state’s accounting management model,** through: (i) improvement of the indirect and direct administration payroll system of the state executive branch to make it possible to automatically pay payroll in e-Fisco and generate the accounting records in the state’s general accounts; and (ii) updating the registry of state assets, and evaluating and upgrading the computerized asset management system.

d. **Improvement of public debt management**, by upgrading the corresponding IT system, allowing payment calculations and projection scenarios to be made in a timely manner, as well as enabling the accounting records to be automatically generated in e-Fisco and in the state’s general accounts.

e. **Implementation of new public cost management procedures** through adoption of a methodology for estimating them based on an IT system integrated into the state’s corporate systems and implemented in sector-level bodies.

1.30 For all the components, the project will finance consulting services (individual consultants and firms) for the sum of US$15.8 million; nonconsulting services for US$613,000; goods for US$25.5 million; training for US$1.6 million; and office space remodeling works for US$931,000.

C. Key results indicators

1.31 The expected impacts are: (i) a decrease in the ratio of the state's primary fiscal deficit to GDP; (ii) an increase in the ratio of the state's tax revenue intake to GDP; and (iii) a decrease in the ratio of the state's net current debt to GDP. The expected outcomes are: (i) an increase in the ratio of strategic planning targets met to total planned targets;[55] (ii) a decrease in the ratio of administrative cost of tax collection to total revenue intake; and (iii) a narrowing of the gap between the budget as planned and as executed.[56]

1.32 **Economic evaluation.** An economic analysis of the project was conducted based on the results of higher tax revenue intake, lower cost to the taxpayer, and lower SEFAZ operating costs. Using a discount rate of 12%, at end-2027 the project will generate a net present value (NPV) of US$34.5 million with an internal rate of return (IRR) of 46.4%. A sensitivity analysis was also performed for four scenarios, the least favorable of which envisaged a devaluation and reduced benefits, in which the IRR would be 11.9% and the NPV would be US$1,991,074.

II. Financing Structure and Main Risks

A. Financing instruments

2.1 **Compliance with the eligibility conditions for the PROFISCO II CCLIP (BR-X1039).** This project is the fifth individual loan operation under the PROFISCO II CCLIP (BR-X1039), approved by the Board of Executive Directors through Resolution DE-113/17. The project complies with the eligibility criteria envisaged in the policy applicable to CCLIPs (document GN-2246-9) and its guidelines (document GN-2246-11) for individual loan operations, given that: (i) it belongs to the fiscal sector and is compatible with all components of the PROFISCO II CCLIP; (ii) it is included in the 2018 programming for Brazil;[57] (iii) the state will implement the operation through SEFAZ, which was the executing agency for the first individual operation under the PROFISCO I CCLIP (loan 2151/OC-BR), concluded in November 2016 with 100% of the resources disbursed; and (iv) the findings of the institutional analysis show that SEFAZ's capabilities have not deteriorated, and the same project execution and monitoring tools may be used for this new operation as for the previous project. The project coordination unit (PCU) staff will also be the same. As mentioned in paragraph 1.20, according to the project completion report for loan 2151/OC-BR, the project was rated as probable on development objective, satisfactory on implementation progress, and probable on sustainability. The project execution unit complied with the contractual requirements and Bank policies, and its accounts were audited and meet the required quality standards.

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[55] SEFAZ corporate goals.

[56] Verified by comparing the amounts of the approved budget and its execution as recorded in the State Balance Sheet.

[57] Country Program Document Brazil 2018, document GN-2915.

2.2 This operation was designed as an investment loan for specific projects with an estimated total cost of US$44.4 million, to be financed by an investment loan of up to US$37 million from the Bank's Ordinary Capital resources, and a local counterpart contribution of US$7.4 million. The distribution of resources by source of financing and categories is given in the table below:

Table 1. Total budget (US$)

Categories	IDB	Local	Total	%
A. Direct costs	**36,440,000**	**7,400,000**	**43,840,000**	**98.7**
Component I. Fiscal management and transparency	10,970,000		10,970,000	24.7
Component II. Tax administration and litigation	8,810,000	7,400,000	16,210,000	36.5
Component III. Financial administration and public expenditure	16,660,000		16,660,000	37.5
B. Project management	**560,000**	**-**	**560,000**	**1.3**
1. Monitoring and evaluation	260,000	-	260,000	0.6
2. Auditing	300,000	-	300,000	0.7
Total	**37,000,000**	**7,400,000**	**44,400,000**	**100.0**
%	**83.3**	**16.7**	**100.00**	

2.3 **Disbursement schedule.** Disbursements will be made over a five-year period, as follows:

Table 2. Disbursement schedule (US$)

Sources	Year 1	Year 2	Year 3	Year 4	Year 5	Total
IDB	4,564,000	10,815,000	10,532,000	6,263,000	4,827,000	**37,000,000**
Country	-	1,850,000	1,850,000	1,850,000	1,850,000	**7,400,000**
Total	4,564,000	12,665,000	12,382,000	8,113,000	6,677,000	**44,400,000**
%	10	29	28	18	15	**100**

B. Environmental and social safeguard risks

2.4 In accordance with the Bank's Environment and Safeguards Compliance Policy (Operational Policy OP-703) and the results of the safeguards policy filter, this is classified as a Category "C" operation. The project will support the strengthening of taxation and financial processes, so no socioenvironmental risks are envisaged.

C. Fiduciary risks

2.5 An assessment of the executing agency's institutional capacity identified and rated the following risks: (i) high – delays in project execution owing to difficulties in preparing the terms of reference and technical specifications for procurements, compounded by lack of clarity on internal flows (roles, responsibilities, and response times). This risk will be mitigated by: (a) setting up a special bidding commission exclusively for the project; (b) preparing process and workflow documentation; and

(c) hiring individual consultants to support the preparation of the terms of reference and training provided by the Bank; (ii) medium – delays in project execution because of coordination difficulties arising between the areas involved in procurement processes (PCU/SEFAZ, PGE, and the ATI information technology agency). This risk will be mitigated by forging agreements between SEFAZ and the PGE and ATI to prioritize project procurements; and (iii) medium – delays in payments and accountability because of the lack of a tool to support financial and contract management. This risk will be mitigated by implementing an automated contract management tool.

D. Other project risks and key issues

2.6 A risk management workshop was conducted, following the Bank's methodology, and determined that the operation carries medium risk. The risks are:

a. **Fiscal sustainability**. There is a medium risk that targets planned for the project may not be achieved, because of the major challenges facing Brazil in keeping its economy on a sustainable growth path. This could hamper the state's economic and fiscal performance, particularly in terms of expected revenue intake. The economic recovery that began in 2017 is expected to continue in 2018, with growth rates of 1.9% for that year and 2.1% for 2019. To mitigate this risk, the state adopted a series of preventive measures to ensure a balanced budget, the most significant of which were: (i) a plan to curb current expenditure (personnel, services, goods, and supplies); and (ii) an expenditure monitoring plan.

b. **Public management and governance**. There is a medium risk of delays or interruptions occurring in the implementation of project outputs, due to a lack of coordination among the participants (SEFAZ, PGE, SAD, SCGE, and JUCEPE). This risk will be mitigated by signing formal cooperation instruments with the beneficiary entities, defining roles and responsibilities.

2.7 **Program sustainability**. To ensure that the capacities generated by the project are sustainable, the project includes outputs such as: the adoption of new technologies for inspecting merchandise in transit; a new payroll management system and automation of the registration and control of supplier invoices, which will contribute to higher revenue intake, the reduction of tax evasion and lower costs for the government and, hence, its fiscal improvement. As regards technology investments, in addition to direct procurements, SEFAZ will use its permanent staff and the software development firm contracted to work in-house. The project will finance the implementation of a data protection and monitoring system for IT services, including cybersecurity measures.

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

3.1 The borrower will be the State of Pernambuco, which will execute the operation through the State Finance Department (SEFAZ). The Federative Republic of Brazil will be the guarantor of the borrower's financial obligations related to the loan. A project coordination unit (PCU) will be established for project execution. The PCU will have a general coordinator, a technical coordinator, a financial coordinator, and a technical assistant for planning and monitoring (with project management experience). The PCU will coordinate the activities related to monitoring, evaluation,

and auditing, in order to monitor that the project is executed properly, and its objectives met.

3.2 The main functions of the PCU will include: (i) planning and coordinating activity execution; (ii) preparing, implementing, and updating the project's operational tools, including the multiyear execution plan, the annual work plan, the procurement plan, the monitoring and evaluation plan, and semiannual status reports; (iii) supervising execution and submitting status reports; (iv) conducting the processes for the preparation of terms of reference, procurement of goods, and selection and contracting of services; (v) submitting supporting documentation and disbursement requests to the Bank; (vi) preparing the audited financial reports; and (vii) delivering the project evaluation.

3.3 The project is to be executed in compliance with the program Operating Regulations approved by the Bank for the PROFISCO II CCLIP, which establish: (i) eligibility criteria for projects and outputs; (ii) project execution roles, procedures, and rules; and (iii) operational and contractual relationships between the parties involved in the project.

3.4 **Coordination mechanism**. SEFAZ will collaborate with the PGE, SCGE, JUCEPE, and SAD in the execution of activities benefitting them. The PGE will work with SEFAZ in activities for improvement and integration of tax collection procedures output, putting the entire tax administration process online. It will also work with the SAD on activities to produce a new accounting management model output, which involves the payroll management system and the management of assets and materials; with the SCGE in activities involving the management of agreements; and with JUCEPE in activities to simplify the registration and legalization of businesses. Procurement coordination and information sharing protocols will be applied in all cases. The signing of formal cooperation instruments between SEFAZ and those entities, defining their respective roles and responsibilities, will be a special execution condition.

3.5 **Special execution conditions.** Prior to the start of execution of activities with outputs deliverable directly to the PGE, SAD, SCGE, or JUCEPE, SEFAZ will sign cooperation instruments with the respective entities, specifying their roles and responsibilities during the execution of the activities in question. This condition is justified to ensure that the activities' beneficiary entities extend the necessary cooperation to SEFAZ, which will be responsible for executing them.

3.6 **Special contractual conditions precedent to the first disbursement of the loan proceeds: (i) The borrower will adhere to the program Operating Regulations previously approved by the Bank for all individual operations under the PROFISCO II CCLIP**. This condition is justified on operational, fiduciary, and institutional-responsibility grounds; **(ii) the PCU has been established, and its members appointed**. This condition is justified by the fact that the PCU must be formally established, to mitigate the risk of execution delays and conduct the project's operational and fiduciary processes exclusively and with the required experience.

3.7 **Procurement.** Project procurement and contracting will comply with the Policies for the Procurement of Goods and Works Financed by the IDB (document GN-2349-9) and Policies for the Selection and Contracting of Consulting Services Financed by the IDB (document GN-2350-9), together with the provisions of the procurement plan. No advance procurement or retroactive financing is envisaged.

3.8 **Single-source selection**[58] will be used for: (i) government schools and entities: The organizational structure of finance departments in Brazil includes entities responsible for the development of staff knowledge, skills, and competencies, for training services. This is a continuation of investments made in the framework of the loan contract, aligned with SEFAZ's Training Plan, so single-source selection is planned pursuant to paragraphs 1.11 (c) and 3.10 of document GN-2350-9, for the state and federal government schools: (a) School of Finance Administration (ESAF); and (b) the National School of Public Administration of the Ministry of Budget Planning and Management. The state data processing companies responsible for IT development that have been involved in developing SEFAZ's IT systems will also be contracted through single-source selection; (ii) Specialized international agencies: Pursuant to paragraphs 3.10 and 3.15 of document GN-2350-9, the Inter-American Center of Tax Administrations (CIAT), an international organization, will be contracted directly in view of its specialization in providing technical assistance for updating and modernizing tax administrations. The CIAT is already supporting finance departments in other Brazilian states on tax issues of national interest; (iii) Research and study institutes: the Institute of Applied Economic Research and the Institute of Fiscal Studies will also be contracted directly, pursuant to paragraph 3.10 (d) of document GN-2350-9. The Institute of Applied Economic Research is considered the most important research center in Brazil and is internationally recognized for the production of scientific data and studies. The Institute of Fiscal Studies, an entity associated with the Ministry of Finance and Public Administration of Spain, has a mission that includes conducting studies and research, providing advisory services, and promoting training activities that will help the state civil servants benefited by the program's activities to improve their skills to fulfill their functions; and (iv) A software development firm will also be contracted.

3.9 **Audited financial statements.** The borrower will deliver audited financial statements to the Bank annually within the first 120 days following the close of each fiscal year. The audit may be performed by the Pernambuco State Audit Office (TCE/PE) or an eligible auditing firm. The auditor will be contracted by SEFAZ on terms of reference that will require PCU clearance and the Bank's no objection.

B. Summary of arrangements for monitoring results

3.10 **Monitoring** will be based on: (i) the multiyear execution plan and annual work plan; (ii) the procurement plan; (iii) the Results Matrix; and (iv) the monitoring and evaluation plan. The PCU will prepare semiannual reports on progress toward the outcome, output, and financial targets for the Bank's approval. The Bank will conduct inspection visits and ex post reviews as part of project monitoring.

3.11 **Evaluation.** The project will be evaluated against the annual targets and indicators for outcomes and outputs in the project Results Matrix. The monitoring and evaluation plan calls for a midterm and a final independent evaluation. Should the Bank deem it necessary, the borrower will prepare and deliver a midterm evaluation report to the Bank 90 days after the date on which 50% of the loan proceeds have been disbursed, or 36 months of execution have elapsed, whichever occurs first. It will also deliver a final evaluation to the Bank, including an ex post economic evaluation, which will serve as an input for the project completion report, 90 days after the end of the original disbursement period or any extensions thereof.

[58] See Section IV of Annex III.

Development Effectiveness Matrix		
Summary		
I. Corporate and Country Priorities		
1. IDB Development Objectives	**Yes**	
Development Challenges & Cross-cutting Themes	-Productivity and Innovation -Institutional Capacity and the Rule of Law	
Country Development Results Indicators	-Percent of GDP collected in taxes (%) -Government agencies benefited by projects that strengthen technological and managerial tools to improve public service delivery (#)* -Subnational governments benefited by decentralization, fiscal management and institutional capacity projects (#)* -Accountability institutions strengthened (#)*	
2. Country Development Objectives	**Yes**	
Country Strategy Results Matrix	GN-2850	(i) Improve the business climate and (ii) enhance efficiency in the management of public resources.
Country Program Results Matrix	GN-2915	The intervention is included in the 2018 Operational Program.
Relevance of this project to country development challenges (If not aligned to country strategy or country program)		
II. Development Outcomes - Evaluability		Evaluable
3. Evidence-based Assessment & Solution	9.6	
3.1 Program Diagnosis	3.0	
3.2 Proposed Interventions or Solutions	3.6	
3.3 Results Matrix Quality	3.0	
4. Ex ante Economic Analysis	9.0	
4.1 Program has an ERR/NPV, or key outcomes identified for CEA	3.0	
4.2 Identified and Quantified Benefits and Costs	3.0	
4.3 Reasonable Assumptions	1.0	
4.4 Sensitivity Analysis	2.0	
4.5 Consistency with results matrix	0.0	
5. Monitoring and Evaluation	7.4	
5.1 Monitoring Mechanisms	1.4	
5.2 Evaluation Plan	6.0	
III. Risks & Mitigation Monitoring Matrix		
Overall risks rate = magnitude of risks*likelihood	Medium	
Identified risks have been rated for magnitude and likelihood	Yes	
Mitigation measures have been identified for major risks	Yes	
Mitigation measures have indicators for tracking their implementation	Yes	
Environmental & social risk classification	C	
IV. IDB´s Role - Additionality		
The project relies on the use of country systems		
Fiduciary (VPC/FMP Criteria)	Yes	Financial Management: Budget, Treasury, Accounting and Reporting, External Control. Procurement: Information System, Price Comparison, Contracting Individual Consultant.
Non-Fiduciary	Yes	Strategic Planning National System, Statistics National System.
The IDB's involvement promotes additional improvements of the intended beneficiaries and/or public sector entity in the following dimensions:		
Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project		

Note: (*) Indicates contribution to the corresponding CRF's Country Development Results Indicator.

Evaluability Assessment Note:

The main goal of the operation is to contribute to the fiscal sustainability of the State of Pernambuco. To achieve this end, the proposal defines three specific areas on which the project will intervene. The first area is fiscal management and transparency. The second area is tax administration and litigation. The third area is financial administration of public expenditure. Each of these areas define a component. The document includes a description of the process gaps that lead to weaknesses in each of these three areas. The project is the first child of a series of operations under the Conditional Credit Line for Investment Projects (CCLIP) parent BX-L1502.

The project proposal diagnoses a primary balance as a share of the State PIB of 0.49 percent in 2016, and a Current Net Debt as a share of the State PIB of 7.8 Percent (Ministry of Finance, 2016). The diagnosis is based on the MD-GEFIS tool which analyzes processes in the three main areas which define the components. The Ministry of Finance provides a diagnosis for a total of seventeen sub areas. Each diagnosis identified the main restrictions for the Ministry to increase tax revenue, decrease running costs or improve efficiency in expenditures, and improve service delivery to citizens. Overall, the diagnosis identifies gaps in institutional arrangements (such as weak coordination and outdated legal documents), deficits in personnel management and training, and gaps in capital investments (resulting in outdated technological infrastructure, limited availability of information, and lack of mechanisms to communicate with citizens). The quantification of these needs is disaggregated for each of 12 processes.

The economic analysis provides a quantification of savings to the State through technological tools which allow for efficiency gains. The quantification of benefits is associated to savings in management by automatizing the monitoring of fiscal receipts. Benefits are also associated to the reduction errors in payments to public employees. The costs include investment in technology and maintenance. The analysis concludes with a net present value of US$10 million.

The monitoring relies on reports by the Ministry of Finance. The ex post evaluation consists of estimating the effects of the program on tax revenue. The analysis will use administrative data and a synthetic-controls methodology. However, the assumptions behind the estimation of program effects are not likely to hold. For the rest of the result indicators, the proposed methodology is a before-after comparison.

There is only one risk out of five classified as high. The main risk identified for the program to succeed are delays in execution. The mitigation measures include publication of a workplan and the formalization of consultancy contracts.

RESULTS MATRIX

Project objective:	To contribute to the state's fiscal sustainability through: (i) modernization of fiscal management; (ii) improvement of tax administration; and (iii) improvement of public expenditure management.

EXPECTED IMPACT

Indicators	Measurement unit	Baseline	Baseline year	Year 1	Year 2	Year 3	Year 4	Year 5	Final target	Means of verification	Comments
IMPACT 1: Reduction in the state's primary fiscal deficit/GDP ratio											
Primary balance/GDP	% (R$/R$)	0.49	2016	0.04	0.32	0.44	0.46	0.50	0.50	Treasury report – Pernambuco State Finance Department (SEFAZ-PE)	The reduction in the primary fiscal deficit contributes directly to the fiscal balance, in conjunction with the increase in revenue collection and effective control of public spending.[1] **Calculation formula (CF):** primary balance as a percentage of GDP **Baseline (BL):** 0.49.[2] Primary balance (2016) = R$724.8 million. GDP (2016) = R$163.1 billion

[1] IMF-A Macroeconomic Perspective on Resilience, 2016.

[2] Pernambuco fiscal restructuring and adjustment program (PAF) 2016-2018.

Indicators	Measurement unit	Baseline	Baseline year	Year 1	Year 2	Year 3	Year 4	Year 5	Final target	Means of verification	Comments
<u>IMPACT 2:</u> Increase in the state's tax revenue/GDP ratio											
Tax revenue/GDP	% (R$/R$)	8.65	2016	8.58	8.70	8.73	8.78	8.79	8.79	Treasury report, SEFAZ-PE	The real increase in revenue collection provides additional funds to the public treasury, thereby contributing directly to fiscal balance, in conjunction with more effective control of public spending, such as promoted by Component III. **CF:** Value of revenue collection at the end of the project/GDP of the corresponding year. **BL**: 8.65% Tax revenue (2016) = R$14.1 billion. GDP (2016) = R$163.1 billion
<u>IMPACT 3:</u> Reduction in state net current debt/GDP ratio											
Net current debt/GDP	% (R$/R$)	7.76	2016	7.58	7.85	8.09	7.89	7.0	7.0	Treasury report, SEFAZ-PE	The decrease in net current debt contributes directly to the fiscal balance, in conjunction with the increase in revenue collection and effective control of public spending.[1] **CF:** Net current debt as a percentage of GDP **BL: 7.76%**.[3] Net current debt (2016) = R$14.4 billion

[3] PAF PE 2016-2018.

EXPECTED OUTCOMES[4]

Indicator	Measurement unit	Baseline	Baseline year	Year 1	Year 2	Year 3	Year 4	Year 5	Final target	Means of verification	Comments
<u>OUTCOME 1:</u> Increase in the ratio between strategic planning targets that were met, and the total number of targets planned											
Number of targets fulfilled/total number of targets planned	% (quantity/ quantity)	59	2016	62	64	66	68	70	70	Strategic planning end-year report – Strategic Planning Superintendency (SPE)/SEFAZ-PE	The increase in this ratio demonstrates an improvement in SEFAZ institutional capacity, which contributes to improving institutional performance. **CF:** Number of targets fulfilled/total number of targets planned. Refers to SEFAZ strategic planning targets. Target = total of projects completed in the fiscal year + total of projects executing without delays. **BL (2016)**: 59% **Targets planned (2016)**: 22 **Targets fulfilled (2016)**: 13
<u>OUTCOME 2:</u> Reduction in the ratio between collection cost and tax revenue collected											
SEFAZ operating budget/tax revenue	% (R$/R$)	3.36	2016	-	-	-	-	3.16	3.16	State Balance Sheet/SEFAZ-PE	A lower value for this ratio is evidence of resource savings in tax management and/or revenue growth. **CF:** Budgetary execution of the tax administration/tax revenue. **BL: 3.36%** Collection cost (2016) = R$526 million. Tax revenue (2016) = R$15.656 billion.

[4] Outcomes are cumulative.

OUTCOME 3: Reduction in the discrepancy between the planned budget and the executed budget											
Planned budget/executed budget	% (R$/R$)	3.1	2016	-	-	-	-	2.5	2.5	Annual Budget Law (LOA) and SIAFI-SEFAZ-PE report	A decrease in this ratio evidences better fiscal planning and more efficient execution. **CF:** 1 - (budget executed/budget planned). **BL:** discrepancy of **3.1%**. Planned budget (LOA) = R$31.042 billion. Executed budget = R$30.093 billion (Planned budget + supplements - cancellations).

OUTPUTS[5]

Component 1: Fiscal management and transparency											
1.1 Strategic fiscal management implemented	Model[6]	0	2016	0	0	0	1	0	1	IT support system report (SPE/SEFAZ)	Includes: consulting, software, hardware, and training. See annual work plan (AWP) for further information.
1.2 Competency-based staff management model implemented	Model	0	2016	0	0	1	0	0	1	Personnel Management Directorate reports	Includes: consulting, hardware, training, small-scale space remodeling. See AWP for further information.
1.3 Strengthening of information technology (IT) governance	IT tools	0	2016	0	1	1	0	1	3	Information Technology Directorate reports	Includes: consulting, software (software tool for data protection and recovery, a tool for monitoring IT services, a processing and storage tool), hardware (storage, cloud, network, protection, desktops, notebooks), training, expansion of the data center (bunker for equipment and data protection).

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5 Outputs are annual.

6 Model includes: (i) the procedures and business rules that define its operation; (ii) the application or computer system (software) that makes it operational; (iii) training in execution of the procedures and operation of the software; and (iv) in many cases it is necessary to expand processing capacity by installing more servers, user workstations, and storage devices owing to the larger volume of data, and to improve communication for remote users.

Component 2: Tax administration and litigation											
2.1 Management of tax incentives implemented	Module	0	2016	0	1	1	1	0	3	Tax incentives management system report –Tax Benefits Monitoring Directorate (DBF)	Module 1: Analysis of Incentives; Module 2: Granting of Incentives; Module 3: Monitoring of incentives Includes: consulting, software, hardware, and training. See AWP for further information.
2.2 Simplification of tax compliance implemented	Systems	0	2016	0	0	1	1	1	3	Reports of the three systems (National Network for Simplifying the Registration and Legalization of Enterprises and Businesses – REDESIM, SPED, and the Foreign Trade Portal), Tax Administration Coordination Unit (CAT)/SEFAZ.	Includes: consulting, software, hardware, and training. See AWP for further information.
2.3 Goods in transit inspection model implemented	Model	0	2016	0	0	0	1	0	1	SEFAZ control of goods in transit management report	Includes: consulting, software (data mining), hardware (various items of office equipment, fixed and mobile OCRs, traffic lights, boom gates, monitoring panels, aerials), training and adaptation of physical space in the control center. See AWP for further information.
2.4 Improvement and integration of tax collectioı systems implemented	Systems	0	2016	0	0	1	1	3	5	SEFAZ Tax Office reports	Includes: consulting, software, hardware, and training; a collection regulation system; a tax proceedings management system; a system for monitoring compliance with judicial decisions; a refund system; a judicial automation system (SAJ-PGE).
2.5 Electronic consumer tax invoice (NFC-e) management system implemented	System	0	2016	0	1	0	0	0	1	CAT/SEFAZ NF-e management IT system report	Includes: goods, consulting, software, hardware, and training. See AWP for further information.

<u>Component 3:</u> Financial administration and public expenditure											
3.1 Financial management model implemented	Model	0	2016	0	0	1	0	0	1	Integrated system report – General Directorate of State Financial Management (DAFE)/SEFAZ	Includes: goods, consulting, and training; an automated cash flow system; a computer solution for registration, monitoring and control of tax invoices
3.2 Management model for transfers to entities and municípios implemented	Model	0	2016	0	0	0	1	0	1	Computerized transfer management system report – DAFE/SEFAZ	Includes: consulting, software, and training. See AWP for further information.
3.3 State accounting management model implemented	Model	0	2016	0	0	0	0	1	1	Systems reports (Indirect administration payroll and assets) – DAFE/SEFAZ	Includes: goods, consulting, software, hardware, and training. See AWP for further information.
3.4 Public debt management module implemented	Module	0	2016	0	0	0	0	1	1	Debt management system report – Administrative and Financial Superintendency (SAFI)/SEFAZ	Includes: consulting and training. See AWP for further information
3.5 Public cost management system implemented	System	0	2016	0	0	0	0	1	1	Computerized public cost system report – DAFE/SEFAZ	Includes: consulting, software, and training. See AWP for further information.

FIDUCIARY AGREEMENTS AND REQUIREMENTS

Country:	Brazil
Project number:	BR-L1501
Name:	Fiscal Management Enhancement Program for the State of Pernambuco – PROFISCO II–PE
	Fifth individual loan operation under the PROFISCO II CCLIP
Executing agency:	State of Pernambuco, through its Finance Department (SEFAZ)
Fiduciary team:	Marília Santos and Fabia Bueno (VPC/FMP)

I. EXECUTIVE SUMMARY

1.1 The institutional assessment for the project's fiduciary management was based on: (i) the country's current fiduciary context; (ii) the results of the evaluation of the main fiduciary risks; (iii) the report on fiscal management maturity and performance assessment (MD-GEFIS); (iv) the institutional analysis; (v) previous experience in PROFISCO I; and (vi) working meetings held with the project team and the Pernambuco State Finance Department (SEFAZ).

1.2 Brazil has robust country fiduciary systems that enable sound management of administrative, financial, control, and procurement processes, fulfilling the principles of transparency, economy, and efficiency. In terms of their capacity for planning an organization, execution and oversight, the executing agency's systems display a medium level of development and represent a medium risk.

1.3 SEFAZ has the legal capacity and experience to execute the program's activities, since this is the second phase of PROFISCO. It will take advantage of the already implemented and consolidated structure, drawing on the lessons learned from execution of the first phase.

II. THE EXECUTING AGENCY'S FIDUCIARY CONTEXT

2.1 The State of Pernambuco will be the borrower and will execute the activities through SEFAZ, with responsibility for the project's institutional and technical coordination. For project execution, SEFAZ will reissue the instrument creating the Project Coordination Unit (PCU) within its Strategic Planning Superintendency.

2.2 The project will benefit the executing agency and the following entities: the Administration Department (SAD), the Pernambuco State Board of Trade (JUCEPE), the State Comptroller General's Office (SCGE), and the Attorney General's Office (PGE).

2.3 Procurement processes will be carried out by the PCU/SEFAZ, which will set up a Special Bidding Commission (SBC) exclusively to implement the project's bidding and contracting processes.

2.4 The executing agency will be subject to both internal and external control. Internal control will be exercised by the Secretariat of the State Comptroller General's Office (SCGE), with procurement processes being supervised by the PGE. The latter will conduct ex ante reviews pursuant to Decree 43.134/2016, on all contracts with an estimated cost above R$2 million, and on direct contracting (bidding not required) and agreements over R$300,000. External control is exercised by the Pernambuco State Audit Department (TCE/PE), a strategic partner of the Bank in project audits.

III. FIDUCIARY RISK AND INSTITUTIONAL CAPACITY EVALUATION AND MITIGATION ACTIONS

3.1 The institutional capacity assessment and its validation with the PCU staff and key stakeholders concludes that SEFAZ has an average institutional capacity with experience in implementing Bank operations.

3.2 The institutional capacity assessment identified and rated the following risks: (i) high –delays in project execution owing to difficulties in preparing the terms of reference and technical specifications for procurements, compounded by lack of clarity on internal flows (roles, responsibilities, and response times). This risk will be mitigated by: (a) setting up an SBC exclusively for the project; (b) preparing process and workflow documentation; and (c) hiring individual consultants to support the preparation of the terms of reference and training provided by the Bank; (ii) medium –delays in project execution because of coordination difficulties arising between the areas involved in procurement processes (PCU/SEFAZ, PGE, and the ATI information technology agency). This risk will be mitigated by forging agreements between SEFAZ and the PGE and ATI to prioritize project procurements; and (iii) medium –possible delays in payments and account filing because of the lack of a tool to support financial and contract management. This risk will be mitigated by implementing an automated contract management tool.

IV. CONSIDERATIONS FOR THE SPECIAL PROVISIONS OF THE LOAN CONTRACTS

4.1 **Special contractual conditions precedent to the first disbursement of the loan proceeds: the borrower will present evidence to the Bank that an exclusive SBC has been formed to implement all of the project's procurement and contracting processes.** This condition is considered essential to mitigate the risk of delays in program procurement and contracting processes.

V. AGREEMENTS AND REQUIREMENTS FOR PROCUREMENT EXECUTION

5.1 The fiduciary agreements and requirements on procurement specify the provisions applicable to the execution of all procurements envisaged in the project.

A. Procurement execution

5.2 **Procurement of works, goods, and nonconsulting services.** The contracts will be subject to international competitive bidding (ICB) and will be implemented using the standard bidding documents issued by the Bank. Procurements subject to

national competitive bidding (NCB) will be executed using national bidding documents agreed upon with the Bank.

5.3 **Selection and contracting of consultants.** These contracts will be executed using the Standard Request for Proposals issued by the Bank. The corresponding terms of reference will be reviewed by the project's sector specialist. The selection and contracting will abide by the Policies for the Selection and Contracting of Consultants Financed by the Inter-American Development Bank (document GN-2350-9).

5.4 **Use of the country procurement system.** The country procurement (sub)system approved by the Bank ("*pregão eletrônico*") will be used to procure off-the-shelf goods costing up to US$5 million. Any system or subsystem that is approved later will be applicable to the operation. The procurement plan and any updates thereto will identify the contracts to be executed using the approved country systems.

5.5 **Advance procurement/retroactive financing.** Not anticipated.

B. Direct contracting

5.6 **Government schools and entities.** The organizational structure of Finance Departments in Brazil includes entities responsible for developing knowledge, skills, and competencies. At the federal level: (i) the School of Finance Administration (ESAF), and (ii) the National School of Public Administration of the Ministry of Budget, Planning, and Management (ENAP/MP). At the state level: (i) government civil servant training schools; and (ii) state data processing firms. Pursuant to paragraphs 1.11 (c) and 3.10 of document GN-2350-9, the aforementioned federal and state entities that provide staff training will be contracted directly, to make the outputs developed and financed by the program sustainable.

5.7 **Specialized international agencies.** Pursuant to paragraphs 3.10 and 3.15 of document GN-2350-9, the Inter-American Center of Tax Administrations (CIAT), an international organization specialized in technical assistance for modernizing tax administrations, will also be contracted.

5.8 **Research and study institutes.** As indicated in paragraph 3.10 (d) of document GN-2350-9, the Institute of Applied Economic Research (IPEA) and the Institute of Fiscal Studies (IEF) will also be contracted. The Institute of Applied Economic Research is considered the most important research center in Brazil, internationally recognized for its production of scientific data and studies. The Institute of Fiscal Studies, an entity attached to the Ministry of Finance and Public Administration of Spain, promotes training activities that will help civil servants to refine their skills to fulfill their functions.

5.9 Financing of up to US$2 million is also expected to be approved for services provided by the software development firm (Pitang Agile IT) already contracted by SEFAZ through an open competitive process, while the new software development firm envisaged in the project actions is being contracted.

Table 1. Thresholds for international competitive bidding and international shortlist

Method	ICB for works	ICB for goods and nonconsulting services	International shortlist for consulting services
Threshold	US$25 million	US$5 million	US$1 million

Table 2. Main procurements

Activity	Selection method	Estimated date of tender/invitation	Estimated amount (US$ million)
Goods			
IT infrastructure for NFC-e	*pregão eletrônico*	2nd half 2018	2.50
Contracting of software development firm	NCB	2nd half 2018	8.73
Human resource solution and technology	NCB	2nd half 2018	13.00

A. Procurement supervision

5.10 Procurements will be supervised ex post, except where ex ante supervision is justified and in cases of direct contracting. Procurements processed through the country system will also be supervised through that system (paragraph 5.11). The supervision method will be determined for each selection process. Ex post reviews will be performed every 12 months in accordance with the project supervision plan. Ex post review reports will include at least one physical inspection visit, selected from among the procurement processes subject to such review.

Table 3. Threshold for ex post review

Works	Goods	Consulting services
NCB and shopping	NCB and *pregão eletrônico*	Below US$5 million

B. Records and files

5.11 The PCU will be responsible for documentation of the process and will keep all documents needed for supervision and audit purposes.

VI. Financial Management

6.1 **Programming and budget.** SEFAZ/PCU will plan the execution of the activities as foreseen in the multiyear execution plan and annual work plan.

6.2 SEFAZ uses the following national instruments to plan and organize project actions:[1] (i) the multiyear execution plan, which sets guidelines, objectives, and targets for public administration; (ii) the Budget Procedures Law (LDO); and (iii) the Annual Budget Law (LOA), which estimates and specifies the expenses of the public administration for the current fiscal year.

6.3 The PCU will make sure that budgetary funds (Bank and local contribution) are duly budgeted annually and secured for execution according to the project timeline.

[1] Planning and budget instruments.

Budgetary funds will be recorded as an external source in the state's integrated financial and tax management system (e-Fisco) in the year of execution. The LOA will include the funds needed for execution, both for the external loan and for the local contribution.

6.4 **Accounting and information systems.** SEFAZ uses e-Fisco as the main tool for record keeping, monitoring and budgetary execution, accounting, treasury, and revenue collection. It is an integrated, auditable, and secure system where project transactions are identified by financing source and investment category. Microsoft Excel is used in a complementary way to manage the project's procurements and financial reports.

6.5 **Disbursements and cash flow.** The project will use the country treasury system. Expenses will be subject to the budgetary and financial execution process, and will be duly registered in e-Fisco.

6.6 Bank funds will be managed through the State Single Account, consisting of one bank account used to record the entry of funds and another for payments—both in public banks. The loan proceeds will be identified through an accounting subaccount, which will enable the funds to be reconciled.

6.7 Disbursements will be made in U.S. dollars in the form of advances of funds. The Bank will make advances based on a 120-day projection presented by the executing agency. Future advances will require a rendering of accounts for at least 80% of funds previously released.

6.8 The exchange rate agreed upon with the executing agency for recording expenses paid out of the loan proceeds will be the internalization rate. To determine the equivalence of expenses paid out of the local counterpart or the reimbursement of expenses charged to the loan, the agreed-upon exchange rate will be that prevailing on the day before the request for reimbursement or recognition of expenditure is submitted to the Bank.

6.9 Expenses considered ineligible by the Bank will be reimbursed from the local contribution or from other funds, at the Bank's discretion, depending on the nature of the ineligibility.

6.10 **Internal control and internal audit.** SEFAZ uses the SCGE, the central government internal control body, which operates through the following units: internal oversight, ombudsperson activities, social control, and transparency.

6.11 **External control and reports.** The financial statements and the eligibility of expenditures will be audited annually by the TCE/PE, which is eligible to perform external audits of the Bank's loans, or else by an eligible external audit firm.

6.12 Audited financial statements will be submitted annually, under terms of reference agreed upon with the Bank, either by the TCE/PE or by a firm of external auditors acceptable to the Bank, no later than 120 days after each fiscal year-end.

6.13 **Financial supervision plan.** This plan may be altered during execution, in response to evolving risk levels or for additional control needs.

Table 4. Supervision plan

Nature-scope	Frequency	Entity responsible	
		Bank	Executing agency
Ex post review of disbursements and procurements	Annual	Fiduciary team	PCU – External auditor – TCE/PE
Annual audit	Annual	Fiduciary team	PCU – External auditor– TCE/PE
Review of disbursement requests	Periodic	Fiduciary team	
Supervision visit	Annual	Sector specialist and fiduciary team	