

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

**BRAZIL**

**FISCAL STABILITY CONSOLIDATION PROJECT FOR THE  
ECONOMIC AND SOCIAL DEVELOPMENT OF THE STATE OF  
PERNAMBUCO (PROCONFIS-PE)**

**(BR-L1381)**

**LOAN PROPOSAL**

This document was prepared by the project team consisting of Luiz Villela (IFD/FMM), Project Team Leader; Fernando Bretas (INE/WSA), Project Team Co-leader; Fátima Cartaxo (FMM/CBR); Emilio Pineda (FMM/CUR); Cristina MacDowell (FMM/CBR); Sylvia Larrea (INE/ENE); Mariano Lafuente (IFD/ICS); Cesar Rodríguez (SPD/SPV); Fabiano Bastos (CSC/CBR); Betina Hennig (LEG/SGO); Monica Merlo (PDP/CBR); Eugenio Lira, Flavio Galvão and Marcio Cracel (consultants); Daniela do Nascimento (FMM/CBR); Javier Beverinotti (IFD/FMM); and Marina Massini (IFD/FMM).

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ELECTRONIC LINKS	
<b>REQUIRED</b>	
1.	Policy Letter <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38155343">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38155343</a>
2.	Means of Verification <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37693375">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37693375</a>
3.	Results Matrix <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37692741">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37692741</a>
<b>OPTIONAL</b>	
1.	Monitoring and evaluation plan <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37692703">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37692703</a>
2.	Economic analysis (cost-benefit) <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37692717">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37692717</a> <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37692764">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37692764</a>
3.	Study on the State of Pernambuco's public finances and fiscal sustainability <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37730586">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37730586</a>
4.	Fiscal Restructuring and Adjustment Program (PAF) agreement for 2012-2014 <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37693295">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37693295</a>
5.	Inclusion of PROCONFIS-PE in the Fiscal Restructuring and Adjustment Program (PAF) <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37693327">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37693327</a>
6.	Brazil Fiscal Sector Note 2011 <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37693052">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37693052</a>
7.	PROCONFIS-PE Consultation Letter <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37693203">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37693203</a>
8.	Law authorizing the PROCONFIS-PE operation <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37693343">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37693343</a>
9.	Technical Notes of the Departments of Finance, Administration, and Economic Development, and of the Office of the State Comptroller General - specially prepared for PROFISCO-PE <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37682247">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37682247</a>
10.	SUAPE – SEPLAG 2013 master plan <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37693159">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37693159</a>
11.	SUAPE – Industrial-port complex business plan for 2010-2012 <a href="http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37693168">http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37693168</a>

12. Impact study of investments in PE – CONDEPE/FIDEM  
<http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37693217>
13. State competitiveness index  
<http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37693353>
14. IDB 2010, The Political Economy of Fiscal Reform in Brazil  
<http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37693226>
15. IDB 2012a, Reforma del Fondo de Participación de los Estados  
[Reform of the States Revenue Sharing Fund]  
<http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37693231>
16. IDB 2012b Reform Priorities for Subnational Revenues in Brazil  
<http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37693243>
17. IDB 2013 Evaluación de la Estructura y Desempeño del Sistema Tributario Brasileño  
[Evaluation of the structure and performance of the Brazilian tax system]  
<http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37693365>
18. Multiyear plan (2012-2015)  
<http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37730352>
19. Matrix of problems, solutions, results, and policies  
<http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37730551>
20. IDB 2012c Génesis, mutaciones, actualidad y caminos para su recuperación  
[Genesis, mutations, current situation, and paths to recovery]  
<http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37730447>
21. Impact of the PNAFE on state tax administrations  
<http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37730458>
22. Presentation of the “Todos por Pernambuco” [Everyone for Pernambuco] program  
<http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=37730473>

## ABBREVIATIONS

CONDEPE/ FIDEM	Agência Estadual de Planejamento e Pesquisas de Pernambuco [Pernambuco State Planning and Research Agency]
FPE	Fundo de Participação dos Estados [State Revenue Sharing Fund]
GVA	Gross value added
IBGE	Instituto Brasileiro de Geografia e Estatística [Brazilian Institute of Geography and Statistics]
ICMS	Imposto sobre Circulação de Mercadorias e Prestação de Serviços [Goods and services sales tax]
IMA	Independent macroeconomic assessment
IPCA	Índice de Preços ao Consumidor Amplo [Expanded consumer price index] (official inflation)
IPI	Imposto aos Produtos Industrializados [Industrialized products tax]
PAF	Programa de Reestruturação e Ajuste Fiscal [Fiscal Restructuring and Adjustment Program]
PBL	Policy-based loan
PE	Estado de Pernambuco [State of Pernambuco]
PNAFE	Programa Nacional de Apoio à Administração Fiscal para os Estados Brasileiros [National Fiscal Administration Program for Brazilian States]
PPP	Public-private partnership
PROCONFIS-PE	Fiscal Stability Consolidation Program for the Economic and Social Development of the State of Pernambuco
PROFISCO	Program to Support the Management and Integration of Tax Administrations in Brazil
R\$	Brazilian reais
RMR	Região Metropolitana de Recife [Metropolitan Region of Recife]
SAD	Secretaria de Administração [State Administration Department]
SCGE	Secretaria da Controladoria Geral do Estado [Office of the State Comptroller General]
SDEC	Secretaria de Desenvolvimento Econômico [State Economic Development Department]
SEFAZ	Secretaria de Fazenda [State Finance Department]
SEGOV	Secretaria do Governo [State Governance Department]
SEPLAG	Secretaria de Planejamento e Gestão [Planning and Management Department]

## PROJECT SUMMARY

### BRAZIL

## FISCAL STABILITY CONSOLIDATION PROJECT FOR THE ECONOMIC AND SOCIAL DEVELOPMENT OF THE STATE OF PERNAMBUCO (PROCONFIS-PE) (BR-L1381)

Financial Terms and Conditions			
<b>Borrower:</b> State of Pernambuco <b>Guarantor:</b> Federative Republic of Brazil <b>Executing agency:</b> State of Pernambuco, through its Planning and Management Department (SEPLAG/PE)		<b>Flexible Financing Facility (FFF)*</b>	
		<b>Amortization period:</b>	20 years
		<b>Original weighted average life:</b>	12.5 years
		<b>Disbursement period:</b>	2 years
		<b>Grace period:</b>	5 years
		<b>Inspection and supervision fee:</b>	**
<b>Source</b>	<b>Amount (US\$ million)</b>	<b>Interest rate:</b>	London Interbank Offered Rate (LIBOR)
<b>IDB: Ordinary Capital</b>	400	<b>Credit fee:</b>	**
<b>Total:</b>	400	<b>Currency:</b>	U.S. dollars from the Flexible Financing Facility of the Ordinary Capital
Project at a Glance			
<b>Objectives and description.</b> The project's objective is to support a sustainable level of investment to underpin continued development of the State of Pernambuco (PE), by maintaining a medium-term fiscal framework, increasing collection of own revenues, enhancing management of public investment, and promoting private investment. To that end, the project will support policy actions aimed at: (i) preserving fiscal sustainability; (ii) obtaining greater revenue from the goods and services sales tax (ICMS); (iii) improving the efficiency and transparency of public spending; and (iv) strengthening the management of public investment and the promotion of private investment (paragraph 1.15).  This operation is a policy-based loan for an estimated US\$400 million, to be disbursed in two tranches of US\$200 million each (paragraph 2.1). The operation stems from the proposal for the establishment of a reallocation program (document FN-672-1) associated with the prepayment made by Brazil; for that reason in no case can the amortization schedule be altered; it will consist of equal, consecutive, semiannual payments once the grace period has expired.			
<b>Special contractual clauses:</b> Disbursement of the two loan tranches will be subject to fulfillment of the conditions defined in the Policy Matrix (see Annex II).			
<b>Exceptions to Bank policies:</b> None.			
<b>Project consistent with country strategy:</b> <div style="display: flex; justify-content: space-around; width: 100%;"> <span>Yes [ X ]</span> <span>No [ ]</span> </div>			
<b>Project qualifies as:</b> <div style="display: flex; justify-content: space-around; width: 100%;"> <span>SEQ [ ]</span> <span>PTI [ ]</span> <span>Sector [ ]</span> <span>Geographic [ ]</span> <span>Headcount [ ]</span> </div>			

\* The loan will benefit from the options offered under the Flexible Financing Facility (document FN-655-1), including currency and interest rate conversions, except for the flexibility to change the amortization schedule. The amortization schedule will be one of consecutive, semiannual (and equal, to the extent possible) installments upon completion of the grace period.

\*\* 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 provisions of the Bank's policy on lending rate methodology for Ordinary Capital loans.

## I. PROJECT DESCRIPTION

### A. Frame of reference and rationale

- 1.1 **Macroeconomic situation of the country and state.**<sup>1</sup> The Brazilian economy grew by 0.9% in 2012, with inflation at 5.84% ending the year above the central bank target.<sup>2</sup> The positive performance of the balance of payments helped to cushion the effects of an adverse external scenario, by maintaining a robust level of international reserves.<sup>3</sup> Fiscal performance deteriorated in the latter months of 2012, owing to the growth slowdown and tax exemptions granted to stimulate economic activity.<sup>4</sup> Both of these had impacts on state and municipal revenues,<sup>5</sup> although the country's public debt remains sustainable ([required electronic link 4](#)). Market projections for GDP growth in 2013 have been revised downward to around 3%, while inflation is expected to remain above the central bank's target.<sup>6</sup>
- 1.2 The economy of Pernambuco (PE) is the 10th largest of Brazil's 27 states and generates 2.5% of the country's gross domestic product (GDP). In the period 2003-2011, the PE economy grew by an average of 4.1% per year, outpacing economic growth nationwide (3.9%); and in 2012, it posted GDP growth of 2.2%.<sup>7</sup> This rate of expansion, above the national average, has enabled PE to make several important social and economic advances,<sup>8</sup> which have been supported by private investments, particularly industrial enterprises that PE helped attract with supporting investments.<sup>9</sup> Despite the progress achieved, PE still faces major

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<sup>1</sup> Data from the Brazilian Institute of Geography and Statistics (IBGE) and the Central Bank of Brazil.

<sup>2</sup> Measured by the extended consumer price index - IPCA/IBGE. The inflation target set by the central bank was 4.5%  $\pm$  2.0%.

<sup>3</sup> US\$378.6 billion according to the central bank.

<sup>4</sup> Economic stimulation measures involving cuts in federal taxes on production and social contributions levied on wages amounted to R\$46 billion in 2012. These also reduce the State Revenue Sharing Fund (FPE).

<sup>5</sup> Economic growth slowed from 2.7% in 2011; the primary surplus dropped from 3.1% of GDP in 2011 to 2.4% in 2012, and the public sector's gross debt rose from 54.2% of GDP to 58.7% in the same period (see the IMA).

<sup>6</sup> Central bank inflation forecasts: 2013 = 5% and 2014 = 5.1%.

<sup>7</sup> Source: Pernambuco State Planning and Research Agency (CONDEPE/FIDEM) (<http://www2.condepefidem.pe.gov.br/web/condepe-fidem>).

<sup>8</sup> For example, the creation of 485,000 jobs in the last five years, producing significant societal benefits for PE, such as a 32% reduction in the poverty rate and 43% growth in the population's average income (SEPLAG).

<sup>9</sup> Between 2007 and 2014, R\$33.5 billion of investment is scheduled in the state's five largest private investment projects: BR Foods, HEMOBRAS, Astilleros Atlántico Sul, Polo Petroquímico, and Refineria Abreu Lima. Source: Study of the impacts of investments on the PE economy, CONDEPE/FIDEM ([see optional electronic link 12](#)). An example is the port of Suape and its logistics infrastructure which facilitates merchandise inflows and outflows. Total investments, both public and private, amounted to R\$44 billion.

development challenges; it is ranked 13th among Brazilian states in terms of the infrastructure index, and displays major social and economic shortcomings.<sup>10</sup>

- 1.3 To address these challenges, PE needs to make investments that currently exceed its fiscal capacity<sup>11</sup>— a situation that has been aggravated by the slowdown in federal government transfers. The State Revenue Sharing Fund (FPE),<sup>12</sup> which provides the main unrestricted transfer, grew by just 3.1% in 2012, thereby failing to keep pace with inflation.<sup>13</sup> This slowdown had an adverse effect on the state's fiscally funded investment capacity, and impacted both the primary balance and the public debt.<sup>14</sup> To offset this effect, alternatives need to be found to finance public investments, particularly in infrastructure projects, and to stimulate job creation and income generation, as well as the adoption of measures that can sustain the pace of private investment and economic growth. In short, PE's main problem is to maintain levels of public investment together with actions that generate suitable conditions for private investment, without becoming overly dependent on borrowing or federal transfers.<sup>15</sup>
- 1.4 The issues identified in the dialogue with the state<sup>16</sup> to support public and private investments include the following:<sup>17</sup> (i) the need to shorten times taken to issue environmental permits and expropriation decrees associated with priority investment projects; (ii) the improvement of current public-private partnership (PPP) mechanisms and the promotion of this instrument; (iii) the promotion of specific sectors, such as clothing in the state's *agreste* region and the electro-mechanical industries;<sup>18</sup> and (iv) support for the "Sustainable Pernambuco" project by implementing the Water and Energy Efficiency Fund.<sup>19</sup>

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<sup>10</sup> According to the State Infrastructure Competitiveness Index, which measures quality and coverage in the transportation, communication, health, and energy sectors ([see optional electronic link 13](#)). PE has a poverty index of 42.2% (compared to 16.3% for Brazil as a whole), an illiteracy rate of 16.3% (compared to 9.8% nationwide), and an urban sanitary sewerage coverage rate of 19.7% (compared to 53.5%). Sources: IBGE, 2012 and National Sanitation Information System (SNIS), 2010.

<sup>11</sup> The state's current saving financed just 11% of its investments in 2012.

<sup>12</sup> Comprising 21.5% of the revenue from Industrialized Products Tax (IPI) and Income Tax (IR).

<sup>13</sup> The total transfer amounted to R\$3,316 million in 2011 and R\$3,420 million in 2012. Cumulative growth between 2003 and 2011 had been 160%, well above the level of cumulative inflation (66.8%).

<sup>14</sup> Between 2011 and 2012, the primary deficit grew from 0.4% to 1.1% of GDP, and the public debt increased from 6.2% to 7.7% of GDP.

<sup>15</sup> About R\$3 billion per year.

<sup>16</sup> See the Matrix of Problems, Causes, and Solutions in the optional links.

<sup>17</sup> Component IV.

<sup>18</sup> The first because it involves 19,000 businesses located in 10 municípios of a poor region of the state that has clear training needs; and the second because it is a fundamental input for Suape, FIAT, and the Petrobras refinery.

<sup>19</sup> The fund exists to finance actions that reduce water and energy consumption in public buildings and companies, estimated at R\$266 million per year, as well as projects to develop capacities and teams in these sectors.



- 1.5 **Status of public finances in Pernambuco.**<sup>20</sup> The state's total income rose from 17.1% to 22.8% of its GDP between 2003 and 2012, thanks to<sup>21</sup> the increase in current transfers for the education and health sectors,<sup>22</sup> and larger ICMS revenue ([see optional electronic link 20](#)). Tax receipts grew by two percentage points from 9.1% to 11.1% of GDP in the same period,<sup>23</sup> driven fundamentally by ICMS revenue,<sup>24</sup> which rose from 8.0% to 9.3% of GDP.<sup>25</sup> Current transfers from the federal government<sup>26</sup> remain an important revenue source, representing 7.3% of GDP in 2012. The most important of those transfers is the FPE, which accounted for 54.2% of the total in 2012.<sup>27</sup> For 2013, the fund's resources are expected to be unstable owing to the possibility of changes in the distribution criteria and a potential drop in federal revenue obtained from income tax and the industrialized products tax and the consequent reduction in the FPE ([see optional electronic link 15](#)).
- 1.6 Public expenditure has increased over the last few years, rising from 18.1% of GDP in 2006 to 21.7% in 2012. Payroll-related expenditure, which accounted for 50.6% of current spending in 2012, trended upwards over the period 2006-2012, rising from 7.6% to 8.4% of GDP owing to the installation of new hospital and education infrastructure by the government.<sup>28</sup> This was accompanied by other current expenditure, which rose from 6.7% to 8% of GDP.<sup>29</sup> Public investment also expanded from 1.3% of GDP in 2006 to 2.7% in 2012, essentially from new loans and current saving. Over the period 2003-2008, PE maintained a primary surplus averaging 1.1% of GDP, but from 2009 onwards it posted a primary deficit

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<sup>20</sup> Pernambuco government transparency portal (<http://www2.transparencia.pe.gov.br/web/portal-da-transparencia>).

<sup>21</sup> Transfers to the education sector grew from 0.8% to 1.6% of GDP between 2003 and 2012. In the Northeast region, they grew on average from 0.7% to 1.3% of GDP, and for Brazil as a whole they rose from 0.4% of GDP to 0.7%.

<sup>22</sup> Health sector transfers grew from 0.4% to 1.1% of GDP between 2003 and 2012. In the Northeast region, they increased on average from 0.2% to 0.5% of GDP, and for Brazil as a whole, they rose from 0.2% to 0.3% of GDP.

<sup>23</sup> Between 2003 and 2011, tax revenue rose from 8.6% to 9.2% of GDP in the Northeast region, and from 7.9% to 8.4% in Brazil as a whole. The last year for which data are available for all states is 2011.

<sup>24</sup> In 2012, the ICMS accounted for 48.1% of total current income.

<sup>25</sup> Between 2003 and 2012, the ICMS rose by 99.9% in real terms in PE, compared to 78.1% in the Northeast region and 88.8% for Brazil as a whole. As a result, PE's share in total ICMS revenue grew from 2.7% to 3.2%.

<sup>26</sup> In 2012, current transfers will represent 36.7% of total income.

<sup>27</sup> The FPE accounts for 19.9% of total current income, but only increased from 3.8% to 3.9% of GDP between 2003 and 2012. In the Northeast region as a whole, the FPE represented 4.6% of GDP in 2010.

<sup>28</sup> During this period, four new regional hospitals were built in the state, and the public school network was expanded.

<sup>29</sup> Current expenditure accounted for 21% of total spending in 2012.

averaging 0.5% of GDP owing to the expansion of public investments and related current expenditure.<sup>30</sup>

- 1.7 The public debt continued to shrink as a proportion of GDP between 2005 and 2011, retreating from 10.3% of GDP to 6.2%. In 2012, however, the debt level rose in the wake of a higher level of investment and related current expenditure,<sup>31</sup> to reach a level of R\$8.5 billion,<sup>32</sup> or 7.7% of the state's GDP and 55% of its net current income.<sup>33</sup> These debt levels are substantially below the threshold of 200% of net current income set in the Fiscal Responsibility Law (LRF), and put PE among the 10 least indebted states in Brazil, measured as a percentage of GDP.
- 1.8 **Progress and management results.** Since 2007, the state has adopted a new management model entitled Todos por Pernambuco [Everyone for Pernambuco] (see optional electronic link 22), to identify the population's demands through participatory mechanisms, turn them into priority government targets, align public agencies around these targets, and link the planning and budgeting systems to ensure resources are made available to meet them. These efforts have been based on a centralized weekly routine to monitor the progress achieved and eliminate obstacles that could affect execution.<sup>34</sup> This model, with a strong results focus, is designed for the period 2011-2014 in three lines of action, aimed at improving quality of life, promoting economic development, and building capacity to obtain results. Consolidation of the new form of governance has produced results such as: (i) the guaranteed supply of drinking water 24 hours a day to an additional 1.5 million people; (ii) the construction of three additional hospitals with 1,307 new beds; (iii) the inauguration of 147 new benchmark schools at the middle school level and 13 new technical schools; (iv) the reduction of violence, with a 34% drop in the homicide rate between 2007 and 2012; and (v) the promotion of investment such as the Suape industrial and port complex.<sup>35</sup>

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<sup>30</sup> See the study of the public finances and fiscal sustainability of the state of Pernambuco at [optional electronic link 3](#).

<sup>31</sup> Such as operating expenses, including payroll, arising from the new hospitals and schools.

<sup>32</sup> The debt concept used in the analysis includes the PE's contractual debt and obligations, but does not include contingent debts that could result from court cases (*precatórios*), or contingent liabilities arising from PPPs. Although the team considers that the issue of *precatórios* warrants attention, they are not seen as representing a risk for debt sustainability so they are not used in the analysis. Nonetheless, an exhaustive analysis of the fiscal risks arising from PPPs would be useful to gain a broader understanding of fiscal risks.

<sup>33</sup> Net current income is measured in terms of real net incomes, defined as tax revenues (including federal government transfers), less legally stipulated transfers to the municípios and the pension contributions of state workers.

<sup>34</sup> In general, actions of other areas of the government itself (bureaucracy).

<sup>35</sup> See the 2010-2020 Suape business plan ([optional electronic link 12](#)).

## **B. Challenges for the continued development of the state<sup>36</sup>**

- 1.9 To maintain and consolidate its economic and social development process, the state needs to act on the level, financing, and composition of both public and private investment. For that purpose, it needs to expand fiscal space to achieve fiscally sustainable public investments and adopt policies that facilitate and promote the growth and efficiency of public and private investment.<sup>37</sup> The main challenges are:
- a. **Income level below revenue potential** ([see optional electronic links 14 and 16](#)). Caused by: (i) shortcomings in fiscal actions targeted on economic activity sectors, owing to the geographic organization of inspection processes;<sup>38</sup> (ii) inefficient inspection at interstate border posts owing to the lack of timely information and a selective inspection methodology;<sup>39</sup> (iii) tax evasion in the alcohol production and marketing sector, owing to the lack of suitable technology for monitoring its production;<sup>40</sup> (iv) tax evasion in the beverages production and marketing sector, owing to the lack of physical control over the marketing of mineral water;<sup>41</sup> (v) tax evasion risk owing to the ineffectiveness of fiscal sanctions applied to taxpayers;<sup>42</sup> and (vi) low recovery rate of tax claims from recurrent tax defaulters, owing to the lack of a suitable regulatory framework.<sup>43</sup>
  - b. **Inefficient management of public expenditure.** Caused by: (i) shortcomings in the preventive actions undertaken by the internal control body, owing to a

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<sup>36</sup> The diagnostic of this section is based on the Matrix of Problems, Causes, Solutions, and Policies ([optional electronic link 19](#)).

<sup>37</sup> Fiscal space is defined as “the availability of budgetary room that allows a government to provide resources for a desired purpose without any prejudice to the sustainability of a government’s financial position.” Source: IMF, *Understanding Fiscal Space*, 2005.

<sup>38</sup> Of total tax claims amounting to R\$1.3 billion in 2012, just R\$473 million are subject to specialized inspection by economic sector. See [Nota Técnica Reestructuración de la SEFAZ](#). [Technical note on SEFAZ restructuring].

<sup>39</sup> Although the Suape tax inspection post handled 14.7% of the total volume of freight passing through tax inspection posts in 2012, of a total movement of R\$28 million, just R\$737 million was reported as a violation (2.6%). See [Nota Técnica sobre Fiscalización por exclusión de puestos fiscales](#). [Technical note on inspection by exclusion at tax inspection posts].

<sup>40</sup> Alcohol fuel consumption averages 24% of gasoline consumption in Brazil as a whole, and 57% in São Paulo, for example. In the case of Pernambuco, the rate is just 13%, despite the fact that it is the sixth largest producer of alcohol in the country. See [Nota Técnica sobre Medidor de salida de alcohol combustible](#) [Technical note on alcohol fuel output metering].

<sup>41</sup> In the beverages sector, Pernambuco has only partial control of the marketing of mineral water, which is restricted to 20 liter vessels. See [Nota Técnica sobre Control de comercialización del agua](#). [Technical note on the control of water marketing].

<sup>42</sup> See [Nota Técnica Matriz de riesgo de evasión fiscal](#) [Technical note on tax evasion risk matrix].

<sup>43</sup> Although the active debt stock totals R\$10 billion, just 28 taxpayers (representing R\$14.9 million) were registered in the private sector credit protection system (Credit Bureau). See [Nota Técnica Deudores reincidentes SERASA](#) [Technical note on reoffending tax defaulters, SERASA].

lack of criteria for the planning and selection of audits;<sup>44</sup> (ii) difficulty in auditing the expenditure of public administration bodies, owing to the lack of criteria for identifying risks and signs of irregularities; (iii) difficulty in analyzing the accounts filed by direct public administration owing to the lack of a specific methodology;<sup>45</sup> (iv) irregularities in expenditure execution, owing to shortcomings in the support and orientation given to public sector managers;<sup>46</sup> (v) poor integration between transparency mechanisms and the state's internal control actions, owing to problems of fragmentation in the organizational structure;<sup>47</sup> (vi) deficient mechanisms for promoting and providing access to information, owing to a lack of regulation; (vii) deficient budgetary and financial management of maintenance expenses, owing to problems in financial programming mechanisms;<sup>48</sup> (viii) inefficient management of operating expenses, owing to the lack of an expenditure rationalization methodology;<sup>49</sup> (ix) difficulties in the management of state property, owing to the lack of standardization of procedures between sector units;<sup>50</sup> (x) inefficiency in the procurement of off-the-shelf goods and services, owing to the low rate of utilization of the price list procurement modality;<sup>51</sup> (xi) shortcomings in the planning and operating procedures of activities relating to procurement, bidding processes, and the property register, since these are not integrated;<sup>52</sup> and (xii) the occurrence of improper payments to staff, owing to the lack of preventive audit routines.<sup>53</sup>

c. **Deficient management of public investment.** Owing to: (i) difficulty in managing the costs of public investments, which should inform resource

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<sup>44</sup> Nonexistence of criteria for selecting the bodies to be subjected to preventive internal control action, with just 12 technical staff to audit 63 management units. See [Nota Técnica Reestructuración organizacional](#) [Technical note on organizational restructuring].

<sup>45</sup> There are no criteria for selecting the sample for analysis, which is the key issue given the large number of accounts filed (122,318 in 2012) and the few that are audited (2,670), and the different risks and amounts involved in each sector.

<sup>46</sup> Many instructions are given to managers individually (a total of 2,809 in 2012), but few regulatory guidelines are produced (101). This generates an opportunity cost in training time.

<sup>47</sup> This fragmentation has caused delays in government response times. With a total of 90,849 complaints presented to the ombudsperson network, just 13,036 (14.34%) were resolved within the eight-day legal deadline.

<sup>48</sup> In 2012, 25% of requests for alterations in financial programming were rejected, which shows that applications for funding often do not match real needs.

<sup>49</sup> Costing expenses (Code 3.3.00.00.00) in 2012 accounted for 22.3% of total spending, compared to 21.7% in the Northeast and 21.6% recorded in PE for 2010, thus indicating room for saving.

<sup>50</sup> Of the 28 direct administration units, just five have a property control unit.

<sup>51</sup> Of a universe of 20 sets of off-the-shelf items procured by the government, just nine are procured through corporate price lists.

<sup>52</sup> No state body uses the corporate system of procurement, tendering, and property management.

<sup>53</sup> A 2012 audit of a state government payroll of R\$7,054 million detected 200 cases of illegal accumulation of posts, jobs, and functions in the state Executive Branch, as well as other improper payments, representing a total of R\$9.4 million.

allocation for executing priority investments;<sup>54</sup> (ii) difficulty in generating the medium-term fiscal scenarios that are essential for planning investments, owing to the lack of specialized instruments;<sup>55</sup> (iii) delays in implementing projects owing to the slow process of expropriation, environmental licensing and internal legal procedures;<sup>56</sup> and (iv) delays in the processing and approval of PPPs by the executive branch.<sup>57</sup>

**a. Obstacles to private investment.** Caused by: (i) deficient wastewater collection and treatment services in the metropolitan region of Recife (RMR) and in the município of Goiana, which degrades the business climate for private investors;<sup>58</sup> (ii) inefficient use of water and energy resources, which holds back the modernization of PE's industrial estate;<sup>59</sup> (iii) low institutional capacity of municipal governments outside the state capital, for attracting private productive investments;<sup>60</sup> (iv) informality in the clothing sector in PE's *agreste* region, thereby restricting the sector's modernization and hindering productivity growth;<sup>61</sup> and (v) a lack of mechanisms to promote synergies and greater participation by the state's existing metalworking sector in the opportunities arising from new investments in the automotive, naval, and oil sectors.<sup>62</sup>

### C. The Bank's strategy in the country and sector

1.10 The project's areas of intervention are aligned with the Bank's strategy with Brazil (2012-2014) (document GN-2662-1), the objectives of which stress: (i) promoting sustainable fiscal balance subnationally and improving the institutional capacity of public entities; (ii) improving the efficiency and quality of public expenditure; (iii) expanding the coverage of sanitary sewerage services and raising treatment

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<sup>54</sup> Lack of a project costs databank to inform public investment planning.

<sup>55</sup> Currently the projections are based on historical data alone, which are insufficient.

<sup>56</sup> The average time taken to obtain an environmental permit is 120 days, and the legal analysis of priority government investment projects takes 60 days.

<sup>57</sup> On average it takes 180 days to gain approval for a PPP project.

<sup>58</sup> In 2012, sanitary sewerage coverage in RMR was 26.05%, one of the lowest rates among Brazil's metropolitan regions. The respective services are the responsibility of the state-owned Pernambuco Sanitation Company (COMPESA).

<sup>59</sup> In 2012, PE reported an energy consumption rate of 324 kWh per R\$1,000 of output, compared to 286 kWh in the neighboring state of Ceará, which has similar production and climatic conditions.

<sup>60</sup> According to the State Economic Development Department (SDEC), no PE município has an institutional structure for attracting private investment.

<sup>61</sup> Garment making, which is the most important industry clusters in the state's *agreste* region, employs 107,000 people in 19,000 companies distributed across 10 municípios—80% on an informal basis (Source: SEFAZ/PE and survey conducted by the Brazilian Microenterprise and Small Business Support Service – SEBRAE/PE).

<sup>62</sup> According to a CONDEPE/FIDEM study, of the R\$54.2 billion of gross value added (GVA) resulting from the state's main investments, the metalworking sector requires a GVA of R\$1.9 billion. The sector's current GVA is 832 million (43.8%).

levels for sewage collected in the large cities; (iv) promoting energy efficiency projects; and (v) promoting regional innovation systems for productive enterprise. The project also contributes to achieving the institutional strategy on the Ninth General Increase in the Resources of the Bank (GCI-9) (document AB-2764) by building capacity in public institutions for growth and social welfare and acting in the priority areas identified in the sector strategy document on institutions for growth and social welfare.<sup>63</sup>

- 1.11 Over the last 15 years, the Bank has been one of Brazil's key partners in decentralizing and modernizing fiscal management tools, having successfully implemented several operations at the three levels of government. The Bank has been leading a major sector dialogue with the country's fiscal authorities, involving lending operations, technical cooperation programs, and national seminars and studies,<sup>64</sup> such as the National Fiscal Administration Program for Brazilian States–PNAFE (loan 980/OC-BR) approved in 1996; the Program to Support the Management and Integration of Tax Administrations in Brazil–PROFISCO (BR-X1005) approved in 2008; and the National Program to Support the Administrative and Fiscal Management of Brazilian Municípios–PNAFM (loan 1194/OC-BR) approved in 1999. Those activities have increased harmonization and integration between the different Brazilian tax administrations.<sup>65</sup>
- 1.12 The Bank embarked on a direct fiscal dialogue with PE, which involved loan 2151/OC-BR, PROFISCO-PE, approved in 2009. The respective US\$22.2 million investment loan aims to enhance the efficiency and transparency of the state's fiscal management, by increasing internally generated revenues; raising the efficiency and efficacy of public spending and controlling it more effectively; and upgrading taxpayer services. Many of the PROCONFIS-PE policy actions have their origins in needs identified during implementation of PROFISCO-PE, which is consolidating the institutional foundations for the identification and implementation of the policies subject to this operation. Accordingly, there are major synergies and complementarities between these two operations.
- 1.13 **Collaboration between the Bank's divisions.** The broad scope of the proposed policy framework requires articulation with other Bank sectors; and in this sense, the project is a double booking between the Fiscal and Municipal Management Division (IFD/FMM) and the Water and Sanitation Division (INE/WSA), with

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<sup>63</sup> Document GN-2587-2 states that the Bank will continue to support subnational and local governments in their efforts to improve public sector management, mobilize resources and deliver services, as conditions for macroeconomic stability and effective implementation of public policy. This element of the strategy will be based on three pillars: public-sector management, income generation and macrofiscal management, and institutional capacity strengthening in subnational and local governments.

<sup>64</sup> See: (i) Tax Reform in Brazil–IDB 2003; (ii) The Political Economy of Fiscal Reform in Brazil–IDB 2010; and (iii) Structural Reforms in Brazil–IDB 2012.

<sup>65</sup> See Brazil Fiscal Sector Note and the study of the impact of the PNAFE on Brazil's state tax administrations ([optional electronic link 21](#)).

support from the Energy Division (INE/ENE) and the Institutional Capacity of State Division (IFD/ICS).

- 1.14 **Interagency collaboration.** The IDB and the World Bank have been working with PE in a complementary way without overlapping actions. In 2012, the World Bank approved a policy-based loan for US\$500 million (for disbursement in a single tranche), to support PE's strategy to reduce inequality and in particular strengthen its decentralization (*interiorização*) agenda.<sup>66</sup> The World Bank is also working with the state on another policy reform operation in 2013 amounting to US\$550 million (single tranche) to support the removal of administrative barriers to the creation of new firms and promote technical training. As is the case with Component 4 of the present project, those actions promote private investment and the state's economic development.

#### **D. Objective and description**

- 1.15 The project's objective is to support a sustainable level of investments to underpin the continued development of the State of Pernambuco, by maintaining a medium-term fiscal framework, increasing collection of own revenues, enhancing management of public investment, and promoting private investment. To that end, the project will support policy actions aimed at: (i) preserving fiscal sustainability; (ii) obtaining greater revenue from the goods and services sales tax (ICMS); (iii) improving the efficiency and transparency of public spending; and (iv) strengthening the management of public investment policies and the promotion of private investment.
- 1.16 The project will benefit: (i) the PE government by providing additional resources to implement its public policies; (ii) taxpayers, through a fairer method of tax collection; and (iii) the population at large, by providing better services and infrastructure in areas that are crucial for economic development.<sup>67</sup>

#### **E. Components**

- 1.17 The reforms envisaged in the project are classified and prioritized in four components, which are described below along with their objectives. The policy conditions to be fulfilled for the disbursement of each tranche of the operation are described in the Policy Matrix (Annex II).
- 1.18 **Component 1. Macroeconomic stability and fiscal sustainability.** Fulfill the state's fiscal responsibility and stability policies, with the expansion of public

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<sup>66</sup> To promote the development of the interior of the state, by reducing the concentration of productive activity in the RMR.

<sup>67</sup> The literature reports evidence of the positive effects of public investment on economic growth, as a complement to private investment. Some results suggest that investment has a positive and significant effect on growth, particularly in the areas of transportation, telecommunications, and education. For further information see Aschauer, D. (1989) "Is public expenditure productive?" *Journal of Monetary Economics* 23; 177-200, and Aschauer D. (2000). "Public Capital and Economic Growth: Issues of Quantity, Finance, and Efficiency," *Economic Development and Cultural Change* 48 (2).



investment in a sustainable fiscal context, through: (i) the maintenance of a stable macroeconomic context that fosters the development of PE to achieve the project's objectives; and (ii) fulfillment of the primary balance target agreed on with the federal government in the framework of the ongoing Fiscal Restructuring and Adjustment Program (PAF).

- 1.19 **Component 2. Management of public revenues.** Improve the revenue collection performance index through the following actions:<sup>68</sup> (i) improved inspection by economic sector; (ii) establishment of a special system for controlling the transit of freight vehicles; (iii) regulating a specific model for inspection in the production and marketing of fuel; (iv) strengthening tax inspections of the beverage sector; (v) achievement of higher rates of tax compliance by raising the risk of sanctions for taxpayers; and (vi) an increase in the recovery rate on overdue tax debts.
- 1.20 **Component 3. Financial management and public expenditure control.** Improve budgetary and financial management, as well as the control and transparency of public expenditure through the following actions: (i) restructuring the SCGE; (ii) definition of criteria for preventive audits and strengthening of risk management in the internal control area; (iii) improvement of procedures for rendering of accounts in direct administration units; (iv) support and guidance for managers in executing public expenditure; (v) support for the integration of transparency mechanisms (ombudsperson offices or *ouvidorias*) and internal control; (vi) improvement of mechanisms to promote and provide access to information; (vii) establishing coordination between the state's financial and budget control actions; (viii) upgrading of the management of public expenses by establishing a rationalization model; (ix) support for the standardization of property management procedures between sector units; (x) improvement of the management of public procurement to achieve economies of scale; (xi) create an Annual Public Procurement Plan for a set of items indicated in Annex 1 of State Decree 38.943/2012; and (xii) creation of routines for eliminating improper payments to staff.
- 1.21 **Component 4. Management of public investment and promotion of private investment.** Improve the management of public investment projects, and promote private investment for economic development, with actions targeted as follows:
- a. **Management of public investment:** (i) create a source of budget resources for the project; (ii) support the implementation of methodologies for monitoring project costs; (iii) build capacity to generate and analyze medium-term fiscal scenarios; (iv) make the processes involved in expropriation more efficient; (v) create a special committee for monitoring environmental projects; and (vi) create a special committee for legal analysis of the government's priority projects.

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<sup>68</sup> Performance index (PI) = ICMS / GDP. See [Nota Técnica Índice de desempeño de la recaudación](#) [Technical note on the revenue performance index].



- b. **Promotion of private investment:** (i) strengthen the PPP management model; (ii) improve the business environment by expanding sanitation infrastructure with private sector support; (iii) define mechanisms for financing projects for the sustainable and efficient use of water and energy resources; (iv) promote a culture enabling the municípios themselves to attract private investors; (v) foster value-added and access to new markets by firms located outside of the state's capital; and (vi) promote synergies among the existing metalworking sector for the purpose of taking advantage of the opportunities created by large industrial investment projects in the state.

## II. FINANCING STRUCTURE, RESULTS, AND RISKS

### A. Amount and financing instrument

- 2.1 This operation is structured as a policy-based loan (PBL),<sup>69</sup> under the guidelines and directives defined in the New Lending Framework, Assessment Report and Recommendations (document GN-2200-13) and the respective preparation and implementation guidelines (document CS-3633). The PE government requested the sector policy loan modality because of this instrument's comparative advantages: only a single approval is required by the Senate, and the policy measures in both tranches are predefined.<sup>70</sup> The loan in question is for a total of US\$400 million,<sup>71</sup> to be disbursed in two tranches of US\$200 million each, with funds drawn in United States dollars from the Flexible Financing Facility of the Bank's Ordinary Capital.
- 2.2 The first tranche aims mainly at the laying of the regulatory foundations for the project, including issuance of the regulatory decrees, resolutions, and institutional adjustments needed to adopt the new procedures for managing income, public expenditure, and investment projects. The second tranche will mainly involve policy actions to support the implementation of the activities undertaken in the first stage of the operation.
- 2.3 Brazil and PE have made significant headway in building capacity to execute investment and policy projects. Policy projects have shown a maturing of institutional capacity in government organizations and have shown that, by using the two operating modalities jointly, it is possible to achieve results that go beyond what was planned, and in less time.<sup>72</sup>

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<sup>69</sup> These loans provide fungible resources to support a policy reform program, defined by common agreement, and/or institutional changes in a given sector or subsector.

<sup>70</sup> The policy measures in both tranches are already at an advanced stage of implementation.

<sup>71</sup> According to SEPLAG estimates, the present operation will provide the Government of Pernambuco with 19% of its financing needs for 2013 and 2014, estimated at US\$2.1 billion.

<sup>72</sup> See, for example, the World Bank article entitled *DPLs Now over Half of World Bank Lending: Gaping Hole in Transparency and Accountability*. Source: <http://bic.caudillweb.com/en/Article.11612.aspx>.

## **B. Main impact and outcome indicators**

- 2.4 To measure the impact and outcomes of the policy measures and reforms envisaged in the project, a [Results Matrix](#) was prepared in conjunction with the borrower. The results will also be monitored and evaluated by common agreement with the borrower. The project's expected impacts are a 29%-35% increase in levels of public investment funded from own resources, and maintenance of the state's average rate of economic growth at 4.1%. The main expected results are: (i) an increase in the performance index (PI) for tax collection from 9.3% in 2012 to 9.5% in 2014,<sup>73</sup> thereby affording PE greater autonomy in financing its investments; (ii) an increase in the current income/current expenditure ratio, from 118.6% in 2012 to 120% in 2014, to boost current saving and enhance capacity to finance investments out of own resources; (iii) shortening from 120 days to 60 the average time taken to issue environmental permits for priority investment projects; and (iv) reduction from 180 days to 90 in the average time taken by the state to approve PPP projects.

## **C. Economic rationale and debt sustainability analysis**

- 2.5 **Economic rationale.** The project team made a comparative analysis of the project's financial costs and benefits ([optional electronic link 2](#)), considering just three of its main results, which produced the following conservative forecasts: (i) the regulation and installation of production flow meters in alcohol-producing factories will generate an annual increase in ICMS revenue of roughly R\$48 million (US\$24 million) as from 2014; (ii) the regulation of a special regime for inspecting recurrent tax defaulters will contribute an annual increase in ICMS revenue of about R\$260 million (US\$130 million) as from 2015; and (iii) the implementation of a new public expenditure rationalization model will generate savings of approximately R\$36 million (US\$18 million) as from 2014.
- 2.6 The financial cost-benefit analysis of the project reports an internal rate of return (IRR) of 34% and a net present value (NPV) of US\$359.6 million in 2022, which justifies financing by the Bank. Moreover, other economic benefits were not quantified,<sup>74</sup> and could further enhance the robust result of the financial evaluation.
- 2.7 **Analysis of Pernambuco's debt sustainability.**<sup>75</sup> The analysis performed shows that the state's debt is on a sustainable path, but it is crucial that the planned primary deficit<sup>76</sup> be temporary. The deficits forecast for 2013 and 2014, followed by a primary surplus from 2015 onwards, make it possible to increase investment in the short run while also maintaining long-term sustainability. Nonetheless, if the 2013 and 2014 deficits are repeated in the ensuing years, debt levels will embark on

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<sup>73</sup> ICMS-PE / GDP-PE as a percentage.

<sup>74</sup> Such as those associated with the reduction in taxpayer and investor time, mainly because they are hard to calculate.

<sup>75</sup> Study of the public finances and fiscal sustainability of PE ([optional electronic link 3](#)).

<sup>76</sup> The primary deficit for those years is agreed on with the federal government in the context of the PAF.

an unsustainable medium-term path. The project promotes medium-term fiscal stability, with higher income levels and tighter expenditure control.

**D. Environmental and social safeguards**

- 2.8 The potential environmental effects of the operation were evaluated pursuant to [Directive B.13](#) of the Bank's environmental policy; and it was concluded that the project will not cause any direct or indirect adverse impacts on the environment.

**E. Fiduciary risks**

- 2.9 The financial instrument proposed provides unrestricted funds for budgetary support, assuming the existence of a responsible fiscal policy framework. There is therefore no relevant fiduciary risk because the executing agency, PE acting through its Planning and Management Department (SEPLAG), has the necessary financial management instruments and control systems.

**F. Other risks**

- 2.10 The operation is considered low risk. The political context foreseen until the end of the operation does not present any difficulties that could affect the achievement of the results, since the project has broad support from all PE political sectors. The main risks identified by the project team and the PE government, based on the risk analysis performed during project preparation, are in the sustainability, development, and governance areas.
- 2.11 The greatest risk concerns the sustainability of the policies included in this project, and will materialize if the policy actions adopted are discontinued or limited in the future, or if the authorities fail to implement the policies of the second tranche of the agreement as stipulated in the Policy Matrix. The PE government has made a clear commitment, to both the federal government (through the PAF) and the Bank, to implement and maintain the policy actions that strengthen public finances within the project. The progress and achievement of objectives in previous projects with the Bank (see paragraph 1.12), as well as the World Bank project and the PAF, provide evidence of PE's commitment to the sustainability of the reforms it is implementing.
- 2.12 The second most important project risk relates to development and the possibility of the project's resources being used to finance current expenses. This risk is virtually mitigated to the extent that the project was designed with its resources earmarked exclusively for investments contained in the state's multiyear plan (PPA).<sup>77</sup>
- 2.13 The third risk is associated with governance, given the possibility of changes in government teams. To mitigate this risk, the project has been designed in conjunction with the Departments of Planning, Finance (SEFAZ), Administration (SAD), and Internal Control, to ensure that its actions are disseminated across the

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<sup>77</sup> The resources of PBL programs are unrestricted. Nonetheless, given the objectives of this operation, the state government has agreed to use them exclusively in investment programs. See Component 3 of the Policy Matrix.

public sector. Comprehensive work is also being done with the permanent SEPLAG/PE technical team, to ensure that any new government authorities are aware of the project's objectives and actions.

- 2.14 Lastly, an additional risk could arise as a result of current international economic conditions, which could affect the economic performance of Brazil and PE and result in lower-than-expected revenue and less capacity to generate the fiscal space needed to allow for more investments. The measures being adopted under this operation aim to support fiscal sustainability in PE, even under a scenario as described above.

### **III. IMPLEMENTATION AND MANAGEMENT PLAN**

#### **A. Project implementation and management**

- 3.1 The State of Pernambuco will be the borrower in this program, with responsibility for fulfillment of the actions contained in the Policy Matrix, acting through SEPLAG/PE. The latter<sup>78</sup> will be responsible for: (i) coordination with the other departments involved in the operation (SEFAZ, SCGE, SAD, SEGOV, and SDEC),<sup>79</sup> which are responsible for the adoption of measures and technical execution of the activities in Components 2, 3, and 4; (ii) monitoring and promoting actions to achieve the policy goals defined in the project; and (iii) preparing and presenting the reports and evidence of fulfillment of the conditions precedent to the disbursement of the loan proceeds, as well as any other reports that the Bank may request, according to the established and agreed-upon deadlines.
- 3.2 The Bank's project team has adopted a strategy for supporting PE which consists of: (i) providing the necessary technical assistance on preidentified issues; (ii) undertaking missions to coincide with key moments in the project's design and implementation; and (iii) close monitoring, in conjunction with SEPLAG/PE, to anticipate and mitigate any strategic, technical, and coordination risks and difficulties that might occur during the operation's implementation.

#### **B. Results monitoring and evaluation**

- 3.3 The project team, supported by specialized consultants, will monitor and evaluate the project through the monitoring and evaluation plan. A reflexive evaluation of the project is expected to be performed, comparing the results obtained in 2014 with the baseline set in the Results Matrix. As the operation is a PBL, a project completion report (PCR) will be produced within three months following the conclusion of disbursement of the second tranche. The borrower will compile and

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<sup>78</sup> In Pernambuco's management model, SEPLAG is responsible for the coordination and monitoring of all government actions, for which purpose it holds periodic meetings with the departments that implement priority projects.

<sup>79</sup> The following state departments, respectively: Finance, Office of the State Comptroller General, Administration, Governance, and Economic Development.

process all data needed for the evaluation of the operation, including the financial costs.

**C. Policy letter**

- 3.4 The Policy Matrix (Annex II) for the proposed operation is aligned with the [Policy Letter](#) sent by the Government of the State of Pernambuco.

Development Effectiveness Matrix			
Summary			
I. Strategic Alignment			
1. IDB Strategic Development Objectives		Aligned	
Lending Program			
Regional Development Goals		i) Ratio of actual to potential tax revenues, and ii) Public expenditure managed at the decentralized level as % of total public expenditure.	
Bank Output Contribution (as defined in Results Framework of IDB-9)		i) Public financial systems implemented or upgraded, and ii) Municipal and other sub-national governments supported.	
2. Country Strategy Development Objectives		Aligned	
Country Strategy Results Matrix	GN-2662-1	i) Reduce institutional disparities and inequalities between Brazilian tax administrations and promote cooperation and integration of finance administrations in three levels of government, ii) Promote sustainable fiscal balance at the subnational level, and iii) Improve tax education and citizenship programs and initiatives on transparency and dialogue with society.	
Country Program Results Matrix	GN-2696	The intervention is not included in the 2013 Country Program Document.	
Relevance of this project to country development challenges (If not aligned to country strategy or country program)			
II. Development Outcomes - Evaluability		Highly Evaluable	Weight
		7.5	Maximum Score
			10
3. Evidence-based Assessment & Solution		8.0	33.33%
4. Ex ante Economic Analysis		9.0	10
5. Monitoring and Evaluation		5.7	33.33%
III. Risks & Mitigation Monitoring Matrix			10
Overall risks rate = magnitude of risks*likelihood		Low	
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		B.13	
IV. IDB's Role - Additionality			
The project relies on the use of country systems (VPC/PDP criteria)	Yes	Financial Management: Budget, Treasury, and Accounting and Reporting. Procurement: Information System, Shopping Method, Contracting Individual Consultant and National Public Bidding (Use of some National Sub-System).	
The project uses another country system different from the ones above for implementing the program			
The IDB's involvement promotes improvements of the intended beneficiaries and/or public sector entity in the following dimensions:			
Gender Equality			
Labor			
Environment			
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			
The ex-post impact evaluation of the project will produce evidence to close knowledge gaps in the sector that were identified in the project document and/or in the evaluation plan			

This is a Policy Based Loan for the government of Brazil. It will be financed entirely with resources from the Bank's ordinary capital by US\$ 400 million. Resources to fund this operation will be disbursed in two parts of US\$ 200 million each. The general objective of the program is to facilitate a sustainable level of investments to enhance and support Pernambuco's development by maintaining a fiscal result in the medium term, increasing the state's own revenues, improving public investment management and promoting private investments. The program will specifically: i) maintain fiscal sustainability, ii) increase the state's ICMS, iii) improve efficiency and transparency of public expenditure, and iv) strengthen public investment management and the promotion of private investments.

The project has a reasonable diagnosis that identifies the main deficiencies and clearly quantifies them with empirical evidence. The justification for the effectiveness of the intervention in other or similar contexts is less clear. Results are correctly defined and all indicators are SMART. In most cases the objectives are realistic and outputs are defined in a clear way. General mechanisms of monitoring have been defined and there is a budget for this activity. The program has an evaluation plan defined and the main activities to perform. There is an economic analysis for some of its components with costs and benefits correctly quantified. Almost all assumptions are correctly spelled out and are reasonable.

The program has identified risks, as well as all the required mitigation measures.

## POLICY MATRIX

<b>OBJECTIVE:</b>	The project's objective is to support a sustainable level of investment to underpin continued development of the State of Pernambuco (PE), by maintaining a medium-term fiscal framework, increasing collection of own revenues, enhancing management of public investment, and promoting private investment.
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Objective	Actions Precedent to Disbursement of the First Tranche	Actions Precedent to Disbursement of the Second Tranche
<b>COMPONENT I. Macroeconomic stability and fiscal sustainability</b>		
Maintain fiscal stability	(i) Maintenance of a macroeconomic scenario in the state that is conducive to achieving the project's objectives <b>Means of verification:</b> Independent macroeconomic assessment (IMA) prepared by the Bank	(i) Maintenance of a macroeconomic scenario in the state that is conducive to achieving the project's objectives <b>Means of verification:</b> IMA prepared by the Bank
	(ii) Fulfillment of the primary balance fiscal target, as agreed upon with the federal government in the framework of the current Fiscal Restructuring and Adjustment Program (PAF) <b>Means of verification:</b> Official document of the National Treasury Department (STN), reporting on fulfillment of the primary balance fiscal target, complemented by the management report of the State of Pernambuco Finance Department (SEFAZ/PE) for the months not covered by the STN report, and considering the same information sent by the STN	(ii) Fulfillment of the primary balance fiscal target, as agreed upon with the federal government in the framework of the current PAF <b>Means of verification:</b> Official document of the STN, reporting on fulfillment of the primary balance fiscal target, complemented by the SEFAZ/PE management report for the months not covered by the STN report, and considering the same information sent by the STN

Objective	Actions Precedent to Disbursement of the First Tranche	Actions Precedent to Disbursement of the Second Tranche
<b>COMPONENT II. Management of public revenues</b>		
Increase collection of the ICMS	(i) Creation of the new model for taxpayer inspection by strategic economic sector (fuel, telecommunications, and energy) <b>Means of verification:</b> - State Government Decree, published in the Official Gazette of the State (DOE), creating a tax office for the inspection of strategic economic sectors (fuel, telecommunications, and energy) - Technical Note from SEFAZ/PE showing the changes in the structure of SEFAZ from Decree 37.561/2011 to the new Decree.	(i) Implementation of the new model for taxpayer inspection by strategic economic sector (fuel, telecommunications, and energy) <b>Means of verification:</b> Record from the Governor, published in the DOE, appointing the managers of the office created
	(ii) Establishment of the special system to control the transit of freight vehicles <b>Means of verification:</b> SEFAZ/PE Ordinance, published in the DOE, regulating the special system to control the transit of freight vehicles	(ii) Implementation of actions under the special system to control the transit of freight vehicles through the pilot project in the Suape tax inspection post <b>Means of verification:</b> SEFAZ/PE report verifying the implementation of the special system to control the transit of freight vehicles through the pilot project in the SUAPE tax inspection post
	(iii) Regulation of the specific model for controlling tax revenue in the fuel sector <b>Means of verification:</b> State Government Decree, published in the DOE, regulating the installation of flow meters in points of sale for fuel, including alcohol	
	(iv) Strengthening of the control of tax revenue in the beverages sector through the regulation of new procedures for the certification and fiscal control of the marketing of mineral water <b>Means of verification:</b> - SEFAZ Ordinance, publishing in the DOE, expanding the use of the duty stamp for certification and fiscal control of the marketing of mineral water - SEFAZ/PE Technical Note showing the expansion of control and new procedures, moving from Ordinance 152/2009 to the new Ordinance	(iv) Implementation of the new fiscal control model for the marketing of mineral water <b>Means of verification:</b> Report extracted from the control system of the supply of mineral water brands, issued by SEFAZ/PE, verifying the increase in the number of brands issued since the new regulation entered into force
	(v) Regulation of the new risk management system, aimed at making more effective the sanctions imposed on taxpayers at higher risk of evasion <b>Means of verification:</b> SEFAZ/PE Ordinance, published in the DOE, instituting new risk monitoring categories and procedures, along with the respective sanctions, aligned with the taxpayers' tax behavior profile	(v) Implementation of the new risk monitoring routines in the treasury management sphere <b>Means of verification:</b> SEFAZ/PE report, showing the results of the application of the new risk monitoring system, indicating the sanctions applied



Objective	Actions Precedent to Disbursement of the First Tranche	Actions Precedent to Disbursement of the Second Tranche
	(vi) Broadening of the subjective risk of taxpayer noncompliance, through the regulation of the new special inspection regime for recurrent tax defaulters <b>Means of verification:</b> Proposed ordinary statute, published in the DOE, instituting the special inspection regime for recurrent tax defaulters listed in the DOE	
<b>COMPONENT III. Financial management and public expenditure control</b>		
Make public expenditure more efficient and transparent	(i) Restructuring of the State Comptroller General's Department (SCGE) to strengthen the organizational planning area <b>Means of verification:</b> Government Decree, published in the DOE, altering the SCGE regulations (State Decree 36.673/2011) by redefining the responsibilities of the SCGE planning area	(i) Regulation of the SCGE's annual integrated plan of action in state government management units <b>Means of verification:</b> SCGE Ordinance, published in the DOE, instituting the annual integrated plan of action
	(ii) Institution, in the SCGE, of the methodology for risk monitoring and analysis and identification of signs of irregularities in state public management <b>Means of verification:</b> - SCGE Ordinance, published in the DOE, approving the methodology manual - Consultants' report verifying the availability of the methodology manual under the terms indicated in the Ordinance	(ii) Implementation of the methodology for risk analysis and monitoring and the identification of signs of irregularities, in an SGCE unit <b>Means of verification:</b> SGCE report demonstrating implementation and application of the methodology for risk monitoring and analysis and the identification of signs of irregularities
	(iii) SGCE organizational restructuring to create the Audit and Accounting Actions Coordination Unit <b>Means of verification:</b> State Government Decree, published in the DOE, creating the Audit and Accounting Actions Coordination Unit, and defining its responsibilities	(iii) Definition of the methodology for analyzing the state's reported accounts <b>Means of verification:</b> - SCGE Ordinance, published in the DOE, approving the methodology manual - Consultants' report verifying the availability of the methodology manual under the terms indicated in the Ordinance
	(iv) Definition of the methodology for providing permanent support and guidance to state government managers in executing public expenditure <b>Means of verification:</b> SCGE Ordinance, published in the DOE, instituting the methodology for providing support and guidance to government managers	(iv) Implementation of the methodology for providing permanent support and guidance to state government managers in executing public expenditure <b>Means of verification:</b> - Publication of Frequently Asked Questions (FAQ) on the SCGE Internet portal, providing technical guidance for state government managers, particularly on the execution of public expenditure - Consultants' report verifying the availability of the FAQ on the SCGE portal

Objective	Actions Precedent to Disbursement of the First Tranche	Actions Precedent to Disbursement of the Second Tranche
	<p>(v) Organizational restructuring of the SCGE to incorporate the Office of the General State Ombudsperson (<i>Ouvidoria Geral do Estado</i>) into its structure, as a body coordinating the ombudspersons network (<i>Rede de Ouvidores</i>), as a tool of social control and management</p> <p><b>Means of verification:</b> State Government Decree, published in the DOE, incorporating the General State Ombudsperson into the SCGE</p>	<p>(v) Production of a manual systemizing and standardizing procedures applicable to the ombudsperson network</p> <p><b>Means of verification:</b> - SCGE Ordinance, published in the DOE, approving the procedural manual applicable to the ombudsperson network - Consultants' report verifying the availability of the manual under the terms indicated in the Ordinance</p>
	<p>(vi) State-level regulation of the access-to-information law</p> <p><b>Means of verification:</b> State law and decrees, published in the DOE, regulating the access-to-information law</p>	<p>(vi) Implementation of the access-to-information policy at the state level</p> <p><b>Means of verification:</b> Consultants' report confirming the presence of the legally stipulated information on the official Internet sites of at least 20 state government bodies and entities</p>
	<p>(vii) Organizational restructuring of the SCGE, to create a unit to coordinate the state's financial control and budgetary actions</p> <p><b>Means of verification:</b> State Government Decree, published in the DOE, creating the new coordination unit and defining its responsibilities</p>	<p>(vii) Definition of the methodology for controlling changes in the financial programming of maintenance expenses (increase, reduction, carry forward, and transfer)</p> <p><b>Means of verification:</b> State government financial programming decree, published in the DOE, establishing: (i) the procedure for planning and requesting changes in the financial programming of maintenance expenses by government agencies; and (ii) the procedure of analysis by the SCGE</p>
	<p>(viii) Definition of the public expenditure rationalization model</p> <p><b>Means of verification:</b> - State Government Decree, published in the DOE, instituting the public expenditure rationalization model - Ordinance of the Administration Department (SAD), published in the DOE, regulating the public expenditure rationalization model - Public expenditure rationalization model - Consultants' report verifying the availability of the public expenditure rationalization model on the SCGE portal</p>	<p>(viii) Implementation of the model for public expenditure rationalization by management units in state agencies</p> <p><b>Means of verification:</b> Expenditure management report, issued by the SCGE, evaluating application of the expenditure rationalization model in three management units</p>
	<p>(ix) Establishment of the new property management model for state public administration</p> <p><b>Means of verification:</b> State Decree, published in the DOE, instituting the property and materials management subsystem, as part of the state government's administrative management system</p>	<p>(ix) Regulation of the new property management model for state public administration</p> <p><b>Means of verification:</b> Administration Department Ordinance, published in the DOE, instituting operational procedures for property management</p>

Objective	Actions Precedent to Disbursement of the First Tranche	Actions Precedent to Disbursement of the Second Tranche
	(x) Regulation of the new government procurement management model using the price list modality <b>Means of verification:</b> State Government Decree, published in the DOE, altering the rules governing the price list system, instituted by State Decree 34.314/2009	(x) Implementation of the new government procurement management model using the price list modality <b>Means of verification:</b> Administration Department report on the administrative management system, demonstrating the use of the new price list system
	(xi) Creation of the annual procurement plan for the designated items under the terms of Annex 1 of Decree 38.493 of 6 August 2012 <b>Means of verification:</b> - SAD Ordinance, published in the DOE, instituting the annual procurement plan for the state executive branch - SAD Ordinance, published in the DOE, approving the 2013 annual procurement plan for the items designated in Annex 1 of Decree 38.493/2009 - Consultants' report verifying the availability of the 2013 annual procurement plan for the designated items under the terms of Annex 1 of Decree 38.493 of 6 August 2012	(xi) Establishment of the requirement to use the integrated procurement, tendering and property management annual plan in state public administration <b>Means of verification:</b> State Government Decree, published in the DOE, making it compulsory to use the integrated government procurement system
	(xii) Establishment of a permanent state payroll monitoring policy to identify improper payments and irregular situations involving the accumulation of post, jobs, and functions <b>Means of verification:</b> State Government Decree, published in the DOE, instituting a policy for continuous monitoring of the state's payroll.	(xii) Implementation of sharing of databases containing records of civil servants with federal and municipal bodies, and those of other state governments and other authorities <b>Means of verification:</b> Extract of at least two agreements, published in the DOE, of an exchange of databases containing civil servant records
<b>COMPONENT IV. Management of public investment and promotion of private investment</b>		
<b>MANAGEMENT OF PUBLIC INVESTMENT</b>		
Strengthen the management of public investments and promote private investment	(i) Creation of a source of exclusive budgetary funding for this project, earmarked for investment projects envisaged in the multiyear plan (PPA) <b>Means of verification:</b> State Planning and Management Department (SEPLAG) Ordinance, published in the DOE, providing budget resources exclusively for this project	(i) Proof of the existence of a source of exclusive budgetary funding for this project, earmarked for investment projects envisaged in the PPA <b>Means of verification:</b> SEPLAG Ordinance, published in the DOE, providing budget resources exclusively for this project
	(ii) Installation of a new system (processes and tools) of cost control in investment projects related to the priority targets contained in the PPA and in the budget <b>Means of verification:</b> State Government Decree, published in the DOE, instituting the cost control system for priority investment projects in the PPA and in the budget	(ii) Implementation of the cost control system in investment projects related to the priority targets contained in the PPA and in the budget <b>Means of verification:</b> First SEPLAG report comparing the costs foreseen in the PPA and in the budget for investment projects related to the priority targets, with the costs actually incurred in 2013

Objective	Actions Precedent to Disbursement of the First Tranche	Actions Precedent to Disbursement of the Second Tranche
	<p>(iii) Establishment of a system (processes and tools) to build medium-term fiscal scenarios <b>Means of verification:</b> State Government Decree, published in the DOE, instituting the system for building medium-term fiscal scenarios</p>	<p>(iii) Implementation of the system (processes and tools) for building medium-term fiscal scenarios <b>Means of verification:</b> SEPLAG report on the latest meeting held to monitor medium-term fiscal scenarios</p>
	<p>(iv) Implementation of a specialized unit to handle expropriations in the state's priority investment projects within the organizational structure of the State Attorney General's Office (PGE) <b>Means of verification:</b> - PGE Ordinance, published in the DOE, instituting the operational procedures of the specialized expropriation unit - Consultants' report verifying the publication of the new operating procedures on the portal cited in the Ordinance</p>	<p>(iv) Definition of special budgetary mechanisms to provide funding for the specialized expropriation unit <b>Means of verification:</b> Government Decree, published in the DOE, instituting the special budgetary mechanisms</p>
	<p>(v) Creation of the special unit for monitoring priority projects being analyzed by the State Environment Agency (CPRH) <b>Means of verification:</b> State Government Decree, published in the DOE, instituting a special environmental analysis unit for priority projects, comprised of SEPLAG and CPRH</p>	<p>(v) Implementation of the special unit for monitoring priority projects subject to CPRH analysis <b>Means of verification:</b> Activities report issued by the special environmental analysis unit for priority projects, relating to the latest quarter available, demonstrating the progress of the processes under analysis</p>
	<p>(vi) Creation of the special unit for monitoring priority projects subject to PGE analysis <b>Means of verification:</b> State Government Decree, published in the DOE, instituting the special legal analysis unit for priority projects, comprised of SEPLAG and the PGE</p>	<p>(vi) Implementation of the special unit for monitoring priority projects subject to PGE analysis <b>Means of verification:</b> Activities report, issued by the special legal analysis unit for priority projects, relating to the latest quarter available, demonstrating the progress of the processes under analysis</p>
	<b>PROMOTION OF PRIVATE INVESTMENT</b>	
	<p>(i) Regulation of the internal bylaws of the State Public-Private Partnership Project Management Committee (CGPE) <b>Means of verification:</b> CGPE Regulatory Decision, published in the DOE, instituting the internal bylaws of the CGPE</p>	<p>(i) Regulation of the responsibilities of the independent auditor (<i>verificador independente</i>) in public-private partnership projects, including pre-operational aspects of the projects <b>Means of verification:</b> CGPE Regulatory Decision, published in the DOE, regulating the powers of the independent auditor</p>
	<p>(ii) Contracting of an administrative concession for the exploration, maintenance, expansion, and conservation of the sanitary sewerage network of the Metropolitan Region of Recife (RMR) and in the</p>	<p>(ii) Start of the execution of the PPP contract signed between the Pernambuco Sanitation Company (COMPESA) and Foz do Atlântico Saneamento SA</p>

Objective	Actions Precedent to Disbursement of the First Tranche	Actions Precedent to Disbursement of the Second Tranche
	<p>município of Goiana</p> <p><b>Means of verification:</b> Extract of the public-private partnership (PPP) contract, published in the DOE, signed between COMPESA and Foz do Atlântico Saneamento SA, as well the actual signed contract</p>	<p><b>Means of verification:</b> Report by the independent auditor verifying the start of execution of the PPP contract, available on the PPP portal (<a href="http://www.ppp.segov.pe.gov.br">www.ppp.segov.pe.gov.br</a>)</p>
	<p>(iii) Constitution of a budget unit for the indirect administration of the Pernambuco Water and Energy Efficiency Fund (FEHEPE)</p> <p><b>Means of verification:</b> SEPLAG Ordinance, published in the DOE, constituting a FEHEPE budget unit for the indirect administration</p>	<p>(iii) Regulation of the FEHEPE</p> <p><b>Means of verification:</b> State Government Decree, published in the DOE, regulating the functioning of the FEHEPE</p>
	<p>(iv) Creation of a program to support the institutional development of the municípios, prioritizing those outside the state capital, for the purpose of attracting private investment</p> <p><b>Means of verification:</b> State Government Decree, published in the DOE, instituting the program to support the institutional development of municípios outside the state capital for the purpose of attracting private investment</p>	<p>(iv) Implementation of the program to support the institutional development of municípios outside the state capital, for the purpose of attracting private investment</p> <p><b>Means of verification:</b> Extract of technical cooperation agreements between the state and at least 10 municípios in the interior, published in the DOE, to provide support for the institutional development of these municípios</p>
	<p>(v) Preparation of the marketing intelligence program for the local clothing industry cluster in the state <i>agreste</i> region</p> <p><b>Means of verification:</b> Extract of the management contract, published in the DOE, between the SDEC and the social organization of the Pernambuco Textile and Clothing Chain Management Unit (NTCPE), for preparation and implementation of a marketing intelligence program</p>	<p>(v) Implementation of a training event for entrepreneurs, and dissemination of Pernambucan fashion products under the Pernambucan fashion brand</p> <p><b>Means of verification:</b> Extract of the agreement transferring the management of the Pernambucan fashion brand from the SDEC to the NTCPE, published in the DOE</p>
	<p>(vi) Implementation of the governance model for the state's metalworking sector development plan</p> <p><b>Means of verification:</b> State Government Decree, published in the DOE, instituting the metalworking sector development plan governance model</p>	<p>(vi) Implementation of the state's metalworking sector development plan</p> <p><b>Means of verification:</b> Extract of the agreement, published in the DOE, to promote business partnerships and technology transfer to the state's metalworking sector, signed between the State of Pernambuco, the Small Business Support Agency (SEBRAE) and the Lombardy region in Italy</p>