# Program Information Document (PID)

Concept Stage | Date Prepared/Updated: 13-Apr-2018| Report No: PIDC24673

## BASIC INFORMATION

### A. Basic Project Data

| Country | Project ID | Project Name | Parent Project ID (if any) |
|---|---|---|---|
| Brazil | P164588 | Mato Grosso Fiscal Adjustment DPL (P164588) | |
| **Region** | **Estimated Board Date** | **Practice Area (Lead)** | **Financing Instrument** |
| LATIN AMERICA AND CARIBBEAN | Dec 20, 2018 | Macroeconomics, Trade and Investment | Development Policy Financing |
| **Borrower(s)** | **Implementing Agency** | | |
| State of Mato Grosso | Mato Grosso State Secretariat of Planning (Secretaria de Estado de Planejamento – SEPLAN) | | |

**Proposed Development Objective(s)**

The Program Development Objectives of the DPL are to support the Government of Mato Grosso's efforts to (i) regain fiscal sustainability (ii) enhance environmental protection by supporting selected aspects of the State's climate change strategy.

**Financing (in US$, Millions)**

**SUMMARY**

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| **Total Financing** | 340.00 |

**DETAILS**

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| **Total World Bank Group Financing** | 340.00 |
| World Bank Lending | 340.00 |

Decision

The review did authorize the preparation to continue

## B. Introduction and Context

### Country Context

**The proposed Fiscal and Environmental Sustainability Development Policy Loan (DPL) aims to support the State of Mato Grosso to regain fiscal sustainability and to enhance environmental protection by supporting selected aspects of the State's climate change strategy.** The operation supports the implementation of a fiscal consolidation reform agenda agreed by the State and the Federal Treasury, with technical support of the World Bank. Sub-national fiscal adjustment is a central piece of the needed fiscal consolidation in Brazil as a whole. It helps to control the growing contingent liabilities to the Federal Government stemming from rapidly deteriorating public finances at the subnational level, which would exacerbate the Federal Government's fiscal position. The operation also supports the implementation of the State's ambitious "Produce, Conserve, Include" (*Produzir, Conservar, Includir*; PCI) program of socially and environmentally sustainable agriculture which the State presented to the 2015 COP21 meetings in Paris. This operation is designed as a stand-alone DPL to start building a track record with the State, and in consideration that the fiscal reform package needs to be heavily frontloaded.[1]

**Mato Grosso plays an important role for climate change mitigation in Brazil, Latin America, and globally, as it is home to large parts of three globally important biomes: The Amazon rainforest, the Pantanal and the Cerrado.** Brazil, and especially Mato Grosso, are subject to climate vulnerabilities but also play a critical global role in mitigating climate change. Exogenous climate induced shocks are an important source of vulnerability and Brazil is considered a "high risk" country in the 2017 Climate Vulnerability Index. The State covers a surface of 900,000 square kilometers in the center of the South American sub-continent, and contains large parts of three important biomes (Amazon rainforest, Pantanal and Cerrado). Over half of the State's territory is in the Amazon biome and the expansion of agricultural production in the State has historically been a leading contributor to carbon emissions in Brazil.[2] However, the State has adopted an ambitious program of conservation and climate change mitigation, aiming to reduce deforestation by 90 percent by 2030 and to preserve the State's native vegetation on 60 percent of the State's territory. By achieving these goals, the State will play a key role supporting the achievement of Brazil nationally determined contribution (NDC) targets and it will support global commitments to climate change mitigation.

**The two pillars supported by this DPL are mutually reinforcing: Fiscal and environmental sustainability are both essential for the long-term prospects for the agricultural sector, and the economy at large, in Mato Grosso.** Fiscal sustainability is essential to enable the State to invest in the infrastructure and human capital necessary for agricultural production. In parallel, the long-term fiscal and economic prosperity depends on the sustainable use of its vast natural resources. Depletion of its environmental capital and resulting climate events, notably droughts, would severely undermine Mato Grosso's agricultural productive capacity. Further, the possibility of access to international climate financing could also be an important revenue source for the State going forward.

### Relationship to CPF

**The proposed DPL is consistent with the World Bank Group's Country Partnership Framework (CPF) for FY2018-2023.** The CPF is built on three pillars: (i) fiscal consolidation and government effectiveness; (ii) private sector investment and productivity; and (iii) equitable and sustainable development.[3] In line with the CPF, the proposed operation is the first of

[1] The French Development Agency (*Agence Française de Développement,* AFD) has expressed an interest to participate in this operation to support the fiscal and environmental sustainability program of Mato Grosso. Details of the collaboration with AFD will be defined before the ROC Decision Meeting.

[2] An estimated 46 percent of Brazil's carbon emissions are due to land use change and another 22 percent to agriculture.

[3] The CPF was endorsed by the Board in July 2017 (Report No. 113259-BR)

several subnational DPLs to support fiscal adjustment in subnational entities, in collaboration with the Federal Treasury. The proposed operation is fully aligned with the first and third pillars of the CPF. The fiscal pillar of the DPF specifically support the first objective under the first CPF pillar ("Strengthen fiscal management at all levels of government"). It does so by supporting fiscal adjustment in Mato Grosso in close cooperation with the Federal Government. This is expected to have a demonstration affect for other subnational governments, which will ultimate reduce the contingent liability to the Federal Government. The operation creates an incentive mechanism to address subnational fiscal deficits early on, reducing risk of State unsustainable debt paths and restoring the (fiscal) capacity of subnational entities to receive federal guarantees for additional borrowing. The second pillar of the operation is closely aligned with the first objective under the third CPF pillar ("Support the achievement of Brazil's NDC with a particular focus on land use"). This operation will support Brazil to reach its COP21 Nationally Determined Contribution (NDC) targets, by focusing particularly on land use planning, environmental compliance, and environmental compensation mechanisms for REDD in a State which is critical to Brazil's climate mitigation commitment. This pillar also is consistent with the WBG Climate Change Action Plan 2016-2020,[4] which aims to work with countries to help them deliver on and exceed their Paris ambitions, including through financing, technical assistance, and knowledge sharing.

## C. Proposed Development Objective(s)

**The Program Development Objective of this DPL is to support the Government of Mato Grosso's efforts to restore fiscal sustainability and to enhance environmental protection by supporting selected aspects of the State's climate change strategy.** It does this by supporting key elements of the State's fiscal adjustment and climate change mitigation agenda.

### Key Results

**This operation support fiscal reforms, which if left unresolved could result in severe hardship for the State's population and constitute a fiscal liability to the Federal Government.** The State is facing a severe liquidity problem, which is gradually turning into a solvency issue as well. Current expenditures, especially on personnel, are growing at unsustainable rates. This was combined with falling revenues resulting from the recent severe economic crisis in Brazil. In recent months, the State has had to delay salary payments. It is also seeking to renegotiate its debt repayments to foreign creditors. The fiscal measures supported by this operation aim at placing current expenditures on a sustainable path. An expenditure rule supported by this operation limits spending for the next five years, and other measures supported by the operation ensure that this limit is attainable without further compromising core social spending priorities. The operation also addresses the weakness of Mato Grosso's tax base by reducing tax expenditures that erode the tax base.

**This operation supports selected measures that implement parts of the State's climate change mitigation strategy with a view to improve the sustainability of agriculture and livestock production.** Mato Grosso faces the challenge of generating inclusive and sustainable growth in an economy based on agribusiness. The State is the agricultural powerhouse of Brazil: it produces 27 percent of Brazilian soy and 15 percent of beef, most of which are exported to the rest of Brazil and abroad. This combination provides the basis for significant potential conflict between economic, social and environmental interests. To address these challenges and ensure long term sustainability, the State has brought together the various stakeholders to support a sustainable program combining increased agricultural production, environmental conservation and social inclusion, as articulated in its PCI program. Measures in this operation support selected elements of that plan.

[4] "World Bank; IFC; MIGA. 2016. World Bank Group Climate Change Action Plan 2016-2020. https://openknowledge.worldbank.org/handle/10986/24451

### D. Concept Description

**The DPF has two pillars:** (i) restoring the State's fiscal sustainability (ii) improving the sustainability in agriculture by supporting the implementation of selected aspects the State's climate change mitigation strategy. Under the first pillar, the operation supports a set of measures aimed at controlling current expenditures, allowing the State to overcome its current fiscal difficulties and increase public investments in the medium term. Under the second pillar, the operation supports selected government actions that have a positive impact on sustainable agricultural development and reduced carbon emission from deforestation.

**Restraining current expenditures is crucial for the Government of Mato Grosso to return its finances to sustainable path**. Considering the severe liquidity shortage the State is experiencing (which has resulted in rapid accumulation of arrears and delays in the payment of civil servants' wages) as well as structural challenges (notably the growing pension deficit), the State of Mato Grosso solicited World Bank technical assistance to carry out an in-depth diagnostic of its public finances. The diagnostic was carried out in late 2017 in a tripartite collaboration between the World Bank, the Brazilian National Treasury, and the State Government. The results of the analysis have highlighted that, beyond the cyclical reduction in revenues associated with the recent economic recession, the current liquidity crisis originates in deeper structural problems, notably related to the rapid structural expansion of primary current expenditures, especially payroll and pension spending. Without measures to contain spending, this trend will result in increasing fiscal deficits, even in a scenario of a recovery in economic activity and fiscal revenues.

**Based on the results of the in-depth diagnostic, the State Government has committed to a fiscal adjustment package to restore fiscal sustainability.** The State Government is aware that restoring fiscal balances is essential to continue providing quality public services for the population (notably health, education, and public security), to continue to be able to pay civil servants' salaries, to honor its debt service obligations and to be able to make investments in public infrastructure. Hence, the State has adopted a series of short-term as well as structural adjustment measures on the expenditure side. For 2018, the government has already reduced non-payroll spending by more than R$1 billion relative to the approved 2018 budget in its budget execution decree (*Decreto* 1.349/2018). At the same time, the State's current expenditure is facing continued pressure from the civil service wage bill, pensions benefits, as well as from the education sector, where revenue earmarking is scheduled to increase from 26.5 percent of tax revenue in 2018 to 35 percent by 2035 (EC 76/2015). Therefore, a series of specific measures to contain current spending is required. In this context, the State is undertaken meaningful adjustment measures which are supported under this pillar. The package of measures is expected to allow the State to contain current spending growth to the rate of inflation, as required under the State's constitutional expenditure ceiling. This expenditure control combined with temporary revenue measures, is expected to lead to a recovery of primary surpluses, restoring fiscal sustainability and allowing the State to increase investment with own resources.

**The second pillar of the operation supports selected state policies and programs to assist in the implementation of the PCI plan in two areas.** To achieve the ambitious goals the State has set for conservation, land use planning and regulation is of critical importance. To incentivize environmental compliance and enhance transparency, the State has created an innovative Environmental Regularization Program (PRA). In addition, the State is also working to generate positive incentives and income for vulnerable groups by tapping international climate finance initiatives. Specifically, the State has created a framework for the development of economic instruments for REDD financing and begun capturing resources through a contract signed in 2017 with the KfW Development Bank of Germany.

## E. Poverty and Social Impacts and Environmental Aspects

Poverty, Social and Environmental Impacts

**The prior actions supported by this operation are not likely to have significant negative poverty, social, distributional or environmental effects**. While significant poverty, social and distributional effects are not likely for most of the prior actions, a more detailed poverty and social impact analysis will be presented for the policies on public spending. As for environmental effects, any effects of the policies supported under the first pillar of the operation would be of an indirect nature, and are not likely to be significant. The policies under the second pillar are designed to improve environmental management and likely to have significant positive effects.

## CONTACT POINT

### World Bank

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### Borrower/Client/Recipient

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### Implementing Agencies

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## APPROVAL

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### Approved By

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|---|---|---|
| Country Director: | Martin Raiser | 19-Apr-2018 |