Rio Grande do Sul – Fiscal Sustainability for Growth Program (P106767)
Release of the Second Tranche - Partial Compliance of Tranche Release Conditions

Tranche Release Document

I. Background

1. The Rio Grande do Sul Fiscal Sustainability for Growth Loan has provided financial support to the State’s Program to attain a more sustainable fiscal position and undertake important public sector reforms. Key objectives have included: (a) fiscal consolidation, through rationalization of expenditures and improvement of tax collection efficiency; (b) debt restructuring; (c) social security reforms; and (d) modernization of the public sector, strengthening monitoring and evaluation capabilities, reorganizing the civil service and improving the provision of public services.

II. Macroeconomic Policy Framework and Recent Economic Developments

2. Over the last decade Brazil has built a solid macroeconomic framework which has allowed the country to smooth the effects of the financial turmoil with relative speed. The federal government has been using its increased fiscal and external solvency and its enhanced credibility to adopt expansionary fiscal and monetary policies without compromising the sustainability of its fiscal framework. Nevertheless, despite the country’s ability to smooth the effects of the crisis, the impact on sub-national governments has not been insignificant.

3. The global economic crisis’ impact on the Brazilian economy was immediate and strong, but the country has demonstrated significant resilience. Twelve consecutive quarters of GDP growth since 2006 were interrupted by seasonally adjusted declines of 3.5 percent in the fourth quarter of 2008 and 0.9 percent in the first quarter of 2009. GDP figures for Q4 2009 indicate a year on year contraction of 0.2 percent for 2009. The negative 2009 GDP figures owed much to a drop in investment of 9.9 percent per year.

4. Resurgent growth, buoyant aggregate demand and record low unemployment indicate that a swift and strong economic recovery is underway. Seasonally adjusted growth resumed after the second quarter of 2009 and has recorded positive quarter on quarter growth since then. The recovery of domestic demand has been driven by the strong resumption of investment since the second half of 2009 as well as the strengthening of consumption. Industrial production, capacity utilization, the retail index, and the jobless rate also point to a buoyant Q1 2010. Seasonally adjusted industrial output capacity utilization and retail activity kept expanding at a fast pace. Recovery in the industrial sector has been driven mainly by manufacturing. The number of jobs created in Q1 2010 was record high, and the seasonally adjusted jobless rate was lower than a year ago. The recovery is expected to continue in 2010 and beyond. Market expectations for GDP growth are around 5.5 percent for 2010 close to the before-crisis
growth peak. As a consequence of the fast pace of recovery as well as seasonal and temporary factors, inflation (as measured by the IPCA index) has been increasing since October 2009 reaching 5.1 percent seasonally adjusted in March 2010, above the center of the target (4.5 percent). Market expectations for inflation are around 5.2 percent for 2010 and at the center of the target for 2011. Indeed, the Central Bank has started in April a series of aggressive interest rates hikes which are expected to quell inflation concerns.

5. **The strong economic recovery is widening the current account deficit and fueling international investors’ confidence and appetite for Brazil.** As a result of depressed global demand, both imports and exports dropped in 2009. The current account deficit narrowed in 2009 on the back mostly of a lower deficit of the services and income balance. Although the domestic and global recoveries in Q1 2010 have increased the seasonally adjusted trade balance surplus, they were not sufficient to compensate for the widening of the services and income deficit. As a result, the current account deficit is further widening and expected to reach 3 percent of GDP in 2010. The Real has appreciated to its pre-crisis level at about R$1.75 per dollar, which is increasing exporters’ concerns over declining competitiveness in international markets. The BOVESPA stock market index reached in March 2010 its highest level since June 2008 catching up with its pre-crisis level. Capital inflows have resumed beyond their pre-crisis trend, which led the government to impose a 2 percent tax on foreigners’ bond and equity acquisitions and a 1.5 percent tax on American Depositary Receipts (ADRs) to slow portfolio investment inflows. The country’s international reserves reached US$244 billion by the end of March 2010, well above the pre-crisis peak. Sovereign spreads are below their pre-crisis levels at about 170 bps.

6. **A favorable pre-crisis external environment and sound economic policy choices helped foster resiliency, create strong macroeconomic foundations and restore economic growth.** First, far-reaching structural reforms and price stabilization in the 1990s were followed by consistent adoption of sound macroeconomic policies in the past decade. Second, floating exchange rates and the accumulation of foreign reserves have allowed Brazil to adjust well to external shocks. Third, adoption of an inflation-targeting regime has contributed to lowering inflation to the center of the target range and enabled the independent Central Bank to focus on countercyclical monetary policy. Fourth, the Fiscal Responsibility Law (LRF) framework has generated significant primary surpluses, which contributed to decrease net debt and consolidate fiscal adjustment prior to the crisis. Fifth, a pre-crisis boom in commodities and buoyant global demand contributed to dramatically reduce Brazil’s fiscal and external vulnerabilities.

7. **The strong fundamentals built in the last decade have allowed the use of a wide range of policy tools.** The government used its increased fiscal and external solvency and enhanced credibility to adopt expansionary fiscal and monetary policies during the crisis. Monetary, fiscal, and quasi-fiscal countercyclical policies have included lowering the SELIC policy rate to a historical low of 8.75 percent, reducing the reserves requirement on financial institutions, injecting credit into the financial system through public banks, extending credit lines to exporters, and more modest fiscal policy measures.
8. In sum, the macroeconomic policy framework for Brazil is considered adequate for the purposes of the ongoing Development Policy Loan. Therefore, **Condition 2 is met**: that the Guarantor is maintaining a macroeconomic policy framework which does not jeopardize the objectives of the Program.

9. Despite the country’s overall resilience, the crisis has put some strains on the finances of subnational governments, which is likely to slow the resumption of growth in some parts of the country. Subnational governments suffered considerable reductions in fiscal revenues, both as a result of lower tax collections and reduced federal transfers. Given the hard budget constraints and limited credit access entailed by Brazil’s Fiscal Responsibility Law (LRF), subnational governments had limited space to implement countercyclical fiscal policies. Instead, they cut discretionary expenditures, mainly investments.

10. As assessed during project preparation, in the recent past Rio Grande do Sul has had difficulties complying with the Fiscal Responsibility Law and was in a difficult fiscal situation. The state had not been able to meet most of the requirements of the LRF since its enactment in 2000. RGS is the most indebted of the 27 state governments. Its debt is above the LRF indebtedness ceiling of 200 percent of net current revenue and the state has been slow in reducing its indebtedness. Personnel expenditures by RGS absorbed more than 70 percent of its Net Current Revenue (NCR), which was the highest ratio among Brazilian states, exceeding the LRF limit of 60 percent. In 2006, debt service payments represented 13.5 percent of NCR, which was above the LRF limit of 11.5 percent. Since 1998 the state had only partially met the targets in the fiscal adjustment plans (PAFs) negotiated with the National Treasury Secretariat.

11. Moreover, despite the privileged position that Rio Grande do Sul holds in the Brazilian context, economic and social development was seen as having deteriorated since the mid 1990's. RGS economic growth has been anemic, averaging 2.1 percent from 1994 to 2006, lower than the national economic growth of 3.1 percent in the same period. As a consequence, Rio Grande do Sul’s share in national GDP has fallen from 8.9 percent in 1996 to 6.8 percent in 2007.

12. The difficult fiscal situation was seen as being behind the recent deterioration in economic and social conditions. Chronic fiscal imbalances had reduced the investment capacity of the state government, harming growth prospects and social development. Continuous fiscal deficits from the seventies to the nineties had led to a debt overhang. This, combined with increasing current expenditures (derived from high debt service payments, rising personnel expenditures, and civil service pension deficits), had squeezed the fiscal space for public infrastructure investments. Public investment fell from 30 percent of state government revenues in the eighties to less than 3 percent in 2007.

13. In light of this poor state of affairs, upon taking office in early 2007, the new administration moved quickly and forcefully to deal with the fiscal situation of the state. The Government concentrated its efforts on two priorities: (a) the implementation of a strong emergency fiscal adjustment in the short run; and (b) a process of
reorganizing and modernizing the state’s public administration system. The latter was the core of a series of medium-term measures designed to reinforce and consolidate the emergency fiscal adjustment and to ensure long run fiscal sustainability.

14. **In its first year, the new government was able to reverse deteriorating fiscal trends.** Favored by the strong recovery of state economic activity, the state increased its primary fiscal balances to R$967 million in 2007 (6.9 percent of Net Current Revenues, NCR) compared to R$471 million in 2006 (3.4 percent of NCR). As a consequence, the budget deficit was reduced to R$1 billion (7.8 percent of NCR), down from R$2.6 billion in 2006 (19 percent of NCR) and much lower than the initially projected budget deficit of R$2.4 billion.

15. **Following the initial emergency measures, the Government proceeded to work on its medium-term program. At the core of the program is a public sector reform agenda.** The Government recognized that to buttress and sustain the fiscal adjustment there was a need to carry out fundamental public sector reforms. As mentioned above, the Bank operation with Rio Grande do Sul contains four components designed to resume fiscal sustainability, to improve debt profile, to reduce social security imbalances and to enhance the efficiency of state public sector.

16. **Significant progress has been made over the last eighteen months in the implementation of the Government's program and this may be seen in the improved fiscal situation, despite the negative effects of the economic crisis on the state's economy and finances.** As further discussed below, as a result of the measures adopted, especially those related to improving the state revenue collection, the Government was able to meet the targets set in the fiscal sustainability component of the operation. Despite the reduction in federal transfers and other sources of revenues, the Government ended 2009 with a budget surplus of R$10 million.

17. As a result of these measures, despite the reduced State revenues, the Government was able to maintain an expenditure program and fiscal arrangements with the Federal Government that are consistent with the objectives of the Program. Overall, we can conclude that **Condition 3 is also met:** that the Borrower's expenditure program, and/or its fiscal arrangements with the Guarantor, is consistent with the objectives of the Program.

III. Progress in Implementing the Reform Program

18. Overall progress in implementation of the Government of Rio Grande do Sul medium term strategy for the attainment of a more sustainable fiscal position and undertaking important public sector reforms, especially in order to create room for public investment has been satisfactory. The activities supported under the Program’s four components progressed well, as discussed in paragraphs 21 to 46 below. Therefore, **Condition 1 is also met.**
Condition 1: the progress achieved by the Borrower in carrying out the Program is satisfactory.

19. Nonetheless, in spite of the Government’s efforts and significant progress in the implementation of the program, not all tranche release conditions under the components were fully achieved. Therefore, **Condition 4 is only partially met**, as further discussed below.

**Condition 4:** that the policy actions designated in the Loan Agreement as second tranche release conditions have been carried out.

**Component 1: Fiscal Sustainability**

20. This component was aimed at supporting the continuity of the State Government’s adjustment efforts, which were designed to achieve the targets set out in the Program of Fiscal Adjustment for 2007-2009 signed with the National Treasury Secretariat (STN) and to improve the state’s Fiscal Responsibility Law indicators. In 2007, the new RGS Government implemented a strong fiscal adjustment program; the achievements under this effort constituted conditions for the first-tranche release. For the second tranche, three tranche release conditions were included under this component.

**Tranche release condition 1:**

(a) **Fiscal Adjustment:** The Borrower has achieved a primary surplus of at least R$1.1 billion in 2008 and of R$1.4 billion in 2009, in compliance with the PAF, as evidenced through official data included in letters sent by STN to the Borrower for 2008 and by the Borrower to STN for 2009; sent to the Bank in form and substance satisfactory to the Bank.

(b) **Public Expenditures:**

(i) The Borrower has reduced its payroll compared to its net current revenue to 66% in 2008 and to 65% in 2009 as evidenced through official data included in letters sent by STN to the Borrower for 2008 and by the Borrower to STN for 2009; sent to the Bank in form and substance satisfactory to the Bank;

(ii) The Borrower has adopted and published a decree in form and substance satisfactory to the Bank for the restructuring of the Borrower’s procurement system in accordance with a strategic program called “Fazendo Mais com Menos” established and operating pursuant to the Borrower’s Decree No. 45273 dated October 4, 2007.

(c) **Revenue Collection:**

(i) The Borrower has complied with the PAF’s targets on revenue collection as evidenced through official data included in letters sent by STN to the Borrower for 2008 and by the Borrower to STN for 2009; sent to the Bank, confirming a revenue collection of at least R$14.5 million for 2008 and R$16.0 million for 2009, all in form and substance satisfactory to the Bank;

(ii) The Borrower has included an annex to its annual budget laws for 2009 and 2010 reporting the tax expenditures of 2008 and 2009 respectively in form and substance satisfactory to the Bank as evidenced through the published budget law for 2009 and 2010.
21. This tranche release condition is met. Significant progress has been made under this component and despite the global economic downturn, which particularly affected the State’s economy on account of its heavy reliance on the external sector, the State has obtained a primary balance of R$ 2.047 million in 2008 and R$ 1.537 million in 2009, above the PAF official targets. The required documentation has been presented to the Bank.

22. In respect of payroll expenditures, the State has reached ratios to NCR of 60.37% in 2008 and 64.30% in 2009, below PAF official caps. As for the restructuring of the procurement system, the State has over-delivered since, beyond an implementation schedule, the system is fully operational and analyses have documented substantive economies ignited by the adoption of new procurement standards and procedures.

23. Finally, In regard to tax revenues, the State has reached R$ 16,484 million in 2008 and R$ 17,324 million in 2009, hence above PAF official targets. Since 2009, the annual budget laws include an appendix with a complete account of tax expenditures, an important step along with several other actions taken by the State to increase budget transparency. Accordingly, the full historical statistic series of tax incentives, including FUNDOPEM, are available at the State’s Finance Secretariat website, and the 2008 and 2009 annual budget laws (LOAs) published in State’s official gazette make reference to the corresponding appendixes, which can be freely accessed at the afore-mentioned website.

24. From the above, it is possible to conclude that besides reaching the targets set under the Program, the State has over-performed in respect to some of them: in 2009, tax revenues and the primary balance were 14% and 10% above their targets, respectively. Fiscal gains have arisen both from the expenditure-side as from the revenue-side. The restructuring of the procurement system allowed substantive economies; furthermore, payments to suppliers are no longer delayed, which has led to higher competition and smaller prices in State purchases of goods and services. On the revenue-side, structural actions to avert tax evasion, regarded as permanent, and a more rational utilization of tax incentives has led to very positive results.

25. The combination of revenue enhancing measures and the rationalization of expenditures have allowed the State to achieve budgetary surpluses during two consecutive years. These results have reversed a secular trend of structural deficits, even under a global economic crisis scenario which led to considerable reductions in tax revenues on account of the State economy’s heavy reliance on manufacturing. Most importantly, the structural fiscal adjustment has created space for increasing public investment. While in 2009 public investment did not surpass R$ 662 million, by the end of May 2010 the State had already invested R$ 1.1 billion. The administration’s goal is
to end 2010 with investments reaching around R$ 1.7 billion, while still maintaining a balanced budget.

26. Furthermore, Rio Grande do Sul has stepped up its efforts to increase transparency in tax expenditures: since 2008, detailed reports of the State’s tax incentives are published along with the annual budget laws (LOAs), which can be freely accessed through the on the Finance Secretariat’s website. In addition, citizens are able to access a detailed account of expenditures for every public administration entity.

Component 2: Debt restructuring

27. This component was aimed at supporting the Government’s debt restructuring activities that sought to smooth the profile of debt service, reduce the debt stock in net present value terms, increase debt duration, and improve the state’s liquidity. As the extra-limite debt profile was responsible for the uneven total debt schedule, the proposed restructuring would pay down the debts with the Banrisul Foundation (Fundação Banrisul, FB), the floating debt bonds (LFT), and a smaller debt with the National Bank of Economic and Social Development (Banco Nacional de Desenvolvimento Econômico e Social, BNDES). The payment of these debts was included in the program as prior actions for the first tranche. For the second tranche, the program aims to support further payment of a debt with the National Treasury Secretariat related to PROES.

28. Overall, this component has been successfully implemented. The payment of selected debts under the first tranche allowed for a smoothing of the State’s debt path. This was achieved by swapping previous highly volatile debt service obligations with a much steadier debt service pattern with the Bank, as well as by an expansion of the maturity of the State’s overall debt. As a result, for the first time the State has been able to meet the fiscal adjustment targets negotiated with the federal government in terms of reducing its financial debt to net real revenue ratio.

29. The tranche release condition below is required for the release of the second tranche.

Tranche release condition 2:

(a) Immediately after the disbursement of the First Tranche, the Borrower has furnished to the Bank official data in form and substance satisfactory to the Bank evidencing payment of the Selected Debts under the First Tranche.

(b) The Borrower has presented an irrevocable commitment to pay the Selected Debt under the Second Tranche, in form and substance satisfactory to the Bank.

(c) The Borrower has presented to the Bank the Separate Agreement with the creditor of the Selected Debt under the Second Tranche.

(d) The Borrower has achieved in 2008 and in 2009 a financial debt to net real revenue ratio in accordance with the current PAF, all as evidenced through official data included in letters to be sent by STN to the Borrower for 2008 and by the Borrower to STN for 2009; all in form and substance satisfactory to the Bank which may include prior exchange of views between the Bank and STN.
30. This tranche release condition is met. The Bank has received the official receipts evidencing payment of the selected debts under the Loan’s first tranche, all satisfactory in form and substance. The State has also complied with letter (b) and presented an irrevocable commitment to pay the PROES, as evidenced by an Oficio from the Governor to the Bank. The Bank has received the Separate Agreement with the National Treasury Secretariat in respect to the payment of the PROES debt, satisfactory in form and substance. Finally, the State has reached a financial debt to NRR ratio of 2.74 in 2008 and 2.64 in 2009, hence within the PAF adjustment track.

Component 3: Social Security

31. This component sought to support government actions directed at reducing the large deficits generated by the pension system, which exerted considerable pressure on state finances. The actions proposed by the Government envisaged a progressive reduction of the share of total state spending devoted to retirees’ benefits and the establishment of a better relation between benefits and contributions.

32. Progress in implementation of the activities planned under this component has been slower than expected due to factors that have been beyond the Government’s control, namely the need to secure legislative approval for some of the key reforms. In particular, the Government has submitted a draft law to the State Assembly, which would create a Complementary Pension System for new retirees. Submission of this law was a prior action for the release of the First Tranche of the Loan.

33. Despite the fact that in February 2010 the draft law received a positive legal opinion from the Special Committee on Constitution and Justice (Comissão de Constituição e Justiça), the State’s Legislative Assembly vote on the bill is still pending. Indeed, the necessary broad political support needed for its approval has not been achieved so far, despite the Government’s efforts in this regard. Given that state elections will be held in October, 2010 and political campaigns will officially start in early July, it is unlikely that the State Assembly will pass the law during the present year.

34. Nonetheless, the Government has taken other measures that will also contribute to the objective of improving the sustainability of the State’s pension system. The contributions of the military were equalized with that of every other civil servants, a relevant step in terms of treating all civil servants in an equal manner and towards reducing social security actuarial imbalances. Moreover, a legal opinion from the State’s General Attorney’s Office (Procuradoria Geral do Estado) which was given normative status by the State’s Governor advises the Legislative to explicitly address whether wage increases apply to pension benefits, a fundamental step towards breaking with parity between active and inactive workers.

35. The action that was to be completed prior to the release of the second tranche is the following:

Tranche release condition 3:
(a) The Borrower has adopted and published a law to regulate the Borrower’s complementary funds for its social security system in form and substance satisfactory to the Bank.

(b) The Borrower has implemented a pension reform for new civil servants in accordance with the provisions of paragraph 37 of the Program through the adoption and publication of a decree in form and substance satisfactory to the Bank.

36. This tranche release condition is only partially met. As mentioned above, the Government has been facing obstacles beyond its control to adopt the necessary legislation to completely comply with this action. Nonetheless, significant progress has been made in this component. As mentioned above, the draft law has been submitted to the Legislative; however, the steps for its approval have been progressing very slowly due to the complex political circumstances in the state. This law is not expected to be approved before the end of 2010 in light of the electoral process. The text of the draft law has been found to be satisfactory by the Bank.

37. In respect to the second part of the tranche release condition, the State was also not able to implement a pension reform for new civil servants in accordance with the provisions of paragraph 37 of the Program, which would introduce new rules of the computation of the final benefits on the basis of average earnings over the beneficiary’s working life, adopt a different approach to pension benefits and rights related to certain special ex gratia allowances, and change the indexing mechanism of pensions, in line with the Constitutional Amendment no. 41, as to end parity between active and inactive civil servants.

38. Nevertheless, structural reforms fundamental to the pursuit of this policy objective have been implemented. For instance, the State has recently passed a law equaling the contributions to social security by the military to that of the other civil servants. Up to the approval of this law, the military contributed only with 7.4%, while the rest of the civil servants contributed with 11%. Moreover, several military did not contribute at all, due to a judicial sentence based on the lack of a specific law on the matter of military contributions to social security. Resolving this represents significant progress in reducing the disequilibrium of the state social security system. Finally, significant progress was also made in ending parity between compensation of active and inactive civil servants. The State’s General Attorney’s Office recently issued a legal opinion advising the Legislative to explicitly address whether proposed wage increases apply both to active and inactive civil servants or only to one of these categories. The Governor accepted this legal opinion and therefore it received normative status so as to be binding on all legislation regarding wage increases.

39. In sum, despite the achievement of significant progress in this area, the State has not been able to comply with the tranche release condition. The State has requested that a waiver be given to this tranche release condition, since every effort within its ability has been taken and progress was halted due to circumstances beyond the Executive’s control.
42. Despite this progress, the implementation of alternative service delivery methods, the OSCIPs model, has advanced at a slower pace, mostly due to external conditions. After approving the required legislation to introduce this new model, which was a prior action for the release of the first tranche, the State took the necessary efforts to institutionalize the new model. Therefore, an additional regulation was prepared clarifying the roles and procedures within the Executive, training was conducted with public entities, and manuals were prepared. Moreover, the State identified the areas and services that were to be given priority under this model and started identifying civil society organizations that could potentially offer the service under a partnership agreement.

43. Despite these efforts, the Executive has not been able to sign six partnership agreements. Thus far it has signed one agreement that is fully operational and satisfactory. Another bidding document was launched in 2009, but no proposals were presented. In light of that, the State conducted further preliminary research and dialogue with potential organizations and is about to launch four additional tenders.

44. As described above, the State is committed to this reform agenda and has made significant progress in its institutionalization and in making the model operational. Obstacles have been mostly external to the Executive, namely the lack of interested and capable organizations to participate in the bidding processes. Nonetheless, the state is still making efforts to overcome these issues.

45. In respect to item (a)(ii), the monitoring and evaluation system, the Portal is fully operational with the adequate characteristics and has generated very positive results, since the quality of public services, measured by users' satisfaction indexes, has increased for the majority of areas. The State has been making adjustment to the monitoring procedures throughout implementation, so as to maximize their utility to project managers and to the central secretariats. Among such changes has been the disaggregation of the 42 original projects into 120 actions, for which budgetary and physical execution can be closely monitored. Considering this new metric, 57.5% of the monitored actions have satisfactory status, which is just below the 59% required by the condition. Nonetheless, the task team is satisfied with the progress achieved, especially since part of the implementation delays are explained by the effects of the global economic downturn, which particularly hit the State. Despite the State's effort to protect the strategic programs from budget cuts and the use of the monitoring information to introduce rational cuts on those programs with lower execution rates, the overall disruption introduced by the economic slowdown contributed to additional delays in some programs.

46. Finally, in respect to item (b), the State has also made important progress towards establishing meritocracy and strengthening the civil service career. The first step for introducing meritocracy in the civil service career, breaking with the past emphasis of seniority, moving towards a more equalitarian system, and giving priority to performance, was taken with the submission of several proposals of amendments to the State Constitution. Also, the draft law for the creation of the public management career
was submitted for Legislative approval. While the debate around these important topics has delayed approval, several other laws that have put in place payment for performance in the public sector have been approved and are already binding. The corresponding Oficios and justifying memos from the Governor to the Legislative have been assessed to be in form and substance satisfactory to the Bank.

IV. Conclusion and Recommendation

47. Based on the information provided above, it is possible to assess that:

- Condition 1 is met: the progress achieved by the Borrower in carrying out the Program is satisfactory.
- Condition 2 is met: the Guarantor is maintaining a macroeconomic policy framework which does not jeopardize the objectives of the Program.
- Condition 3 is met: an appropriate expenditure program and fiscal arrangements is maintained between the Borrower and the Guarantor.
- Condition 4 is mostly met: two of the four policy actions designated in the Loan Agreement as second tranche release conditions have been fully carried out, and the remaining two policy actions have been partially carried out.

48. In light of the progress achieved by the State of Rio Grande do Sul in implementing the Program and given that full compliance with two of the prior actions under Condition 4 were mostly due to factors beyond the control of the Executive, it is recommended that a partial waiver be granted to Condition 4 and the second tranche released.