

Reforming the State



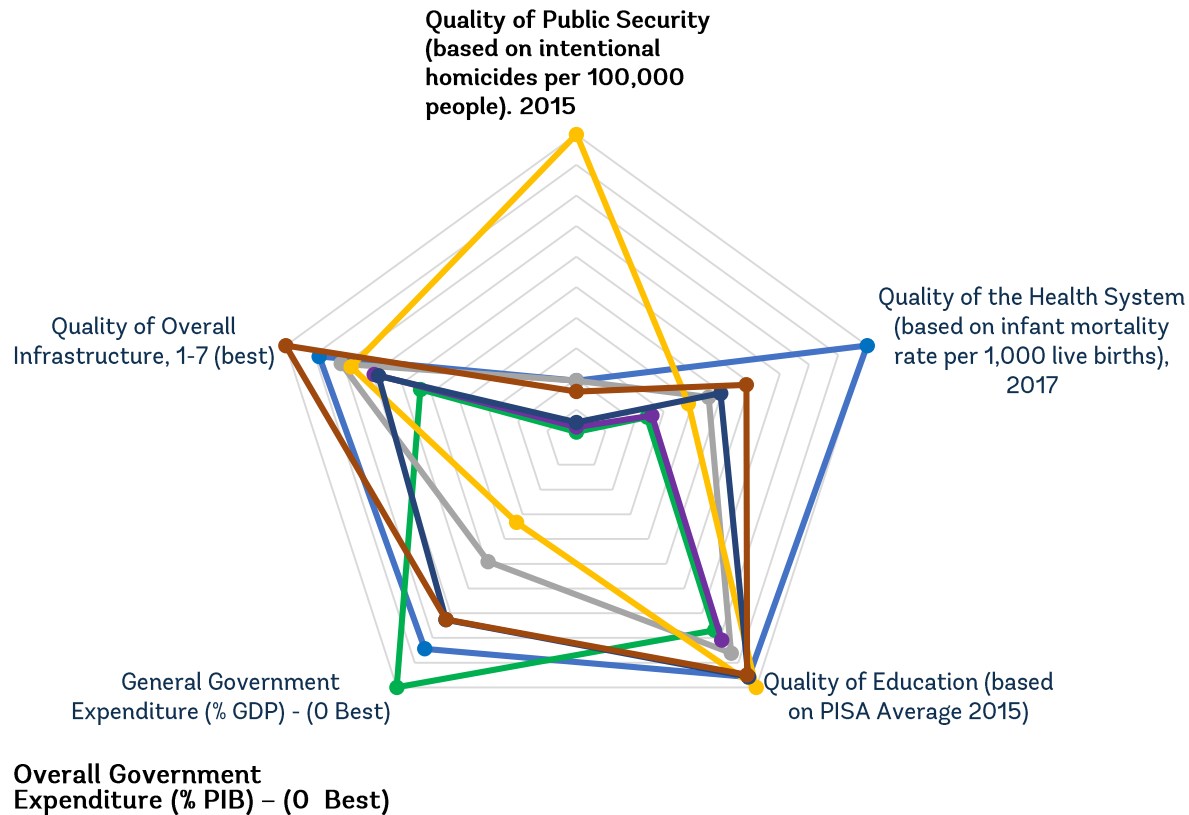
THE WORLD BANK
IBRD • IDA | WORLD BANK GROUP

September 6, 2018

I. Key Sectoral Challenges

The Core Issue: The size of State has increased, but public services remain poor

Brazil's State Spends More than Most Peers but Achieves Less



- **Government spending has grown continuously for 30 years.** Entitlements in the 1988 Constitution and additional laws since have driven a continuous rise in spending, with growing rigidity.
- **Brazil's state is large, but service delivery is poor compared to peers.** Improvements in service delivery will need to rely on efficiency gains, which will require fundamental changes in governance
- **Private provision can improve service delivery but only with better regulation.** Large PPP investments have not closed the service quality gap. Poor project selection, inadequate regulation, judicial uncertainty, weak contract management are the key issues.

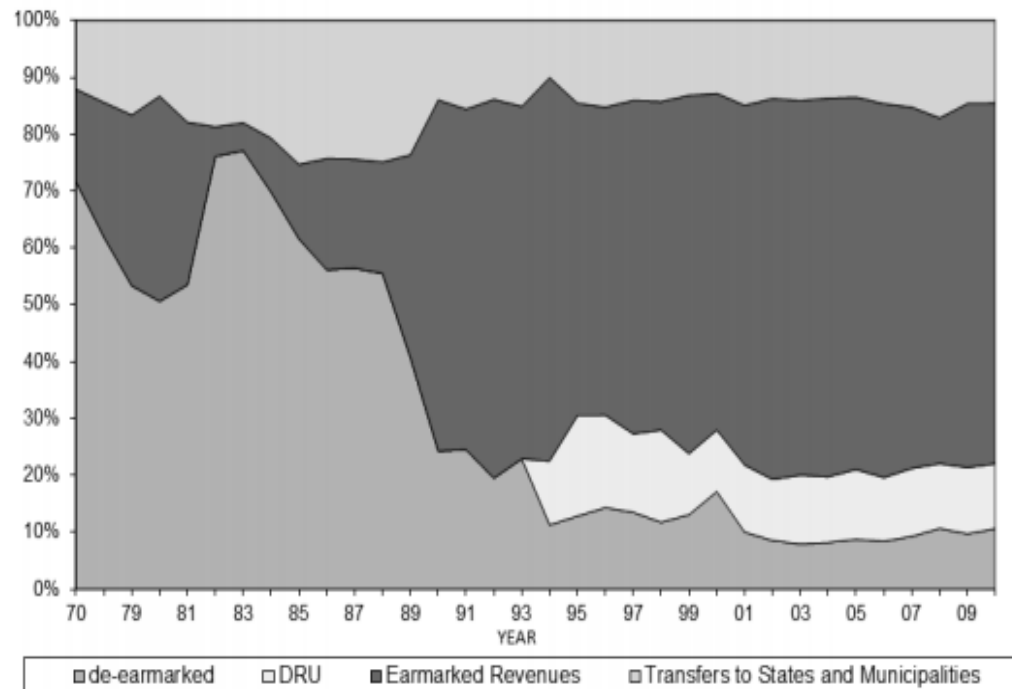
Note: The graph is normalized; best performance in each category is ranked 1 and all others are dimensioned as a proportion of the "leader". Best ranked country has the lowest homicide rate, lowest infant mortality rate, higher PISA and better quality infrastructure. Exceptions are government expenditures, for which grades are from the highest (Brazil) to the lowest (China)

I. Key Sectoral Challenges

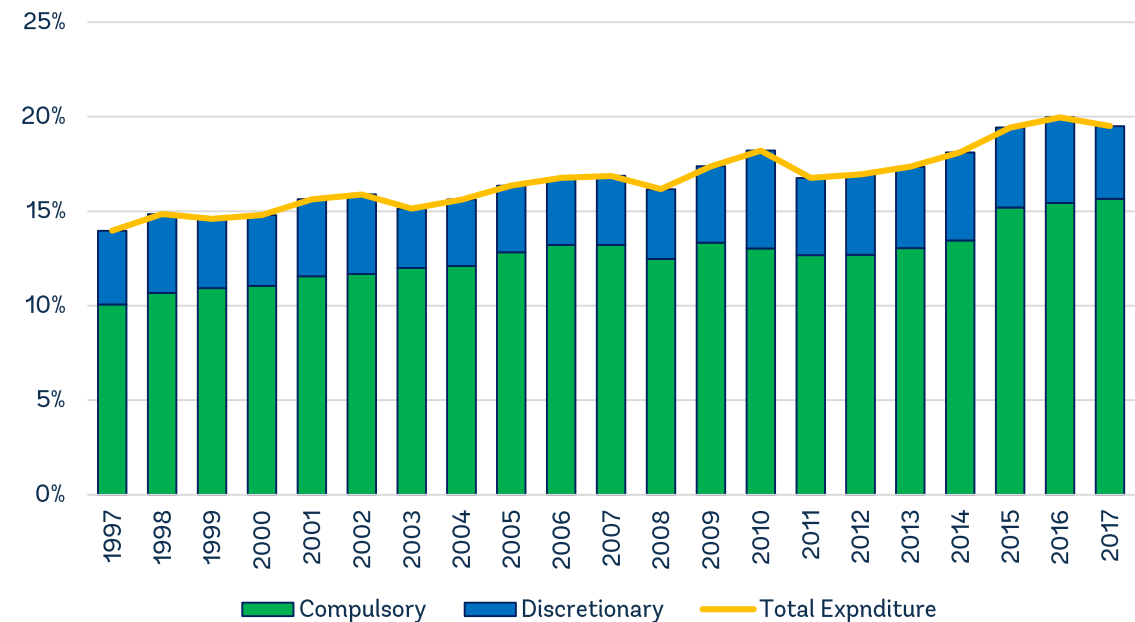
Multiple rules make the budget rigid and limit performance incentives

- Over 90% of total expenditures are pre-determined by legislation, with negative consequences for public financial management
 - Earmarked tax revenues and compulsory expenditures
 - No incentives for cost control, limited room for innovation or long-term planning

Evolution of Earmarked Revenues



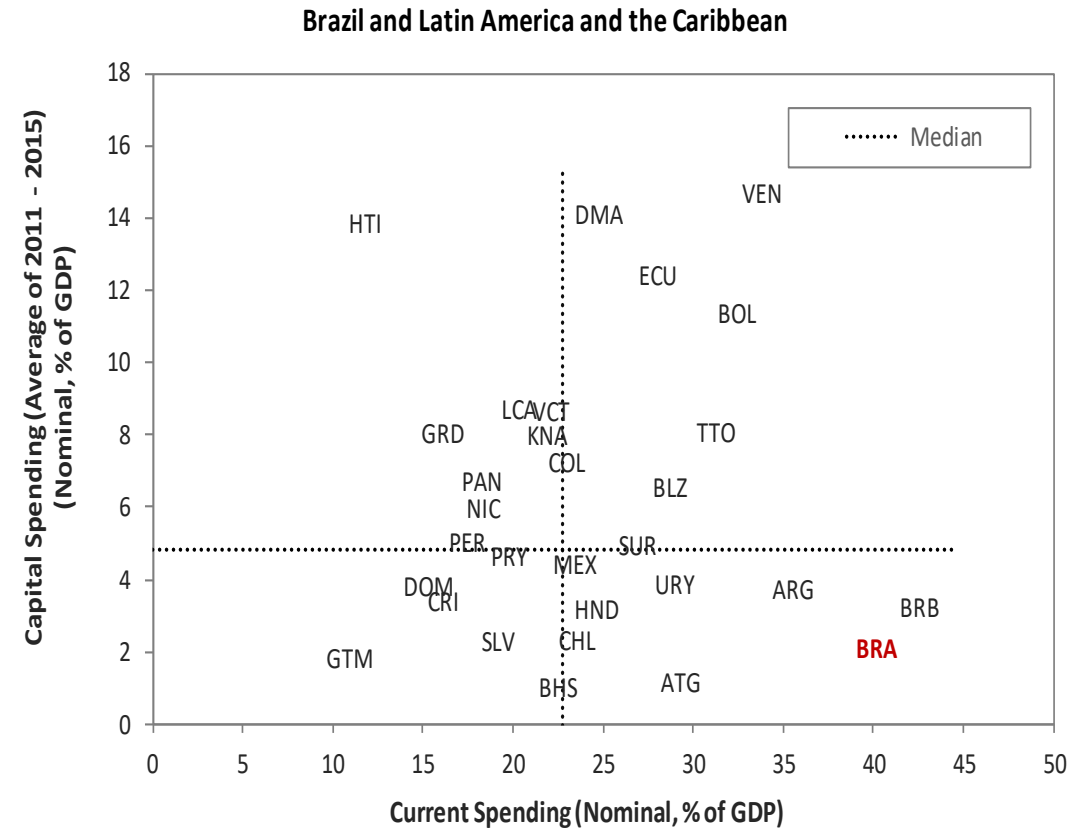
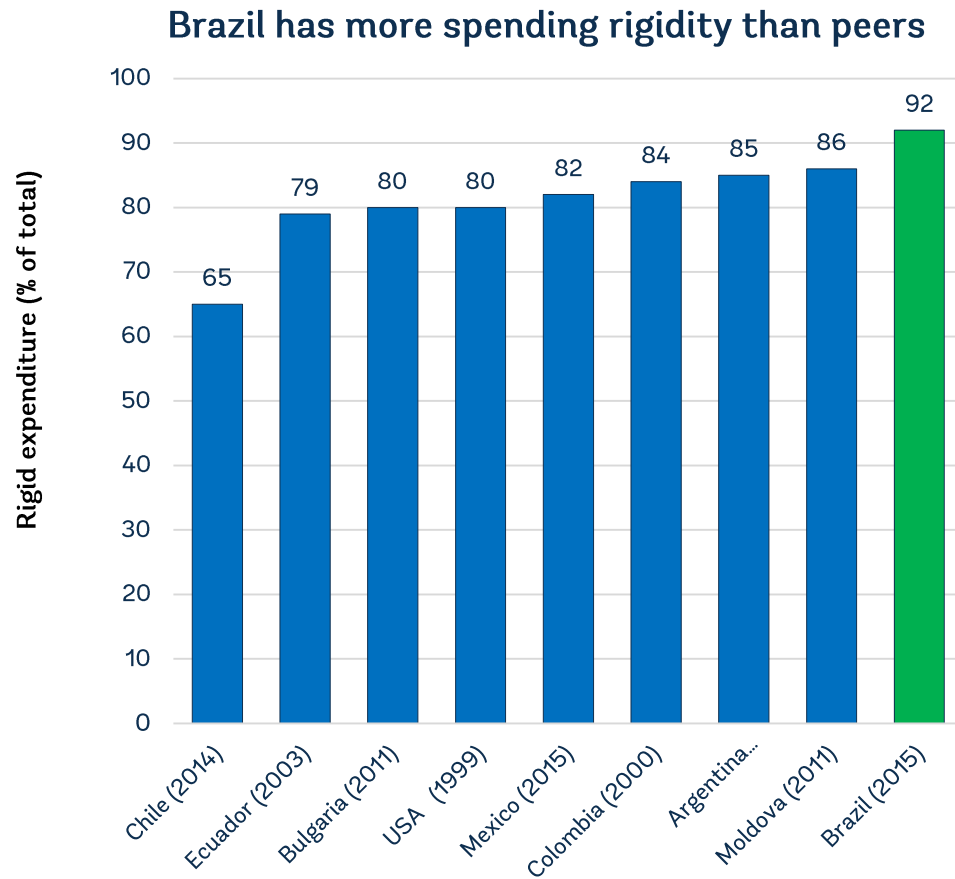
Total, Compulsory and Discretionary Expenditure of the Central Government (% of GDP)



I. Key Sectoral Challenges

Rules that drive current spending and affect investment

- Brazil has one of the most rigid budgets among peers and one of the lowest share of investment in total spending



I. Key Sectoral Challenges

Planning and budget process lead to huge inefficiencies

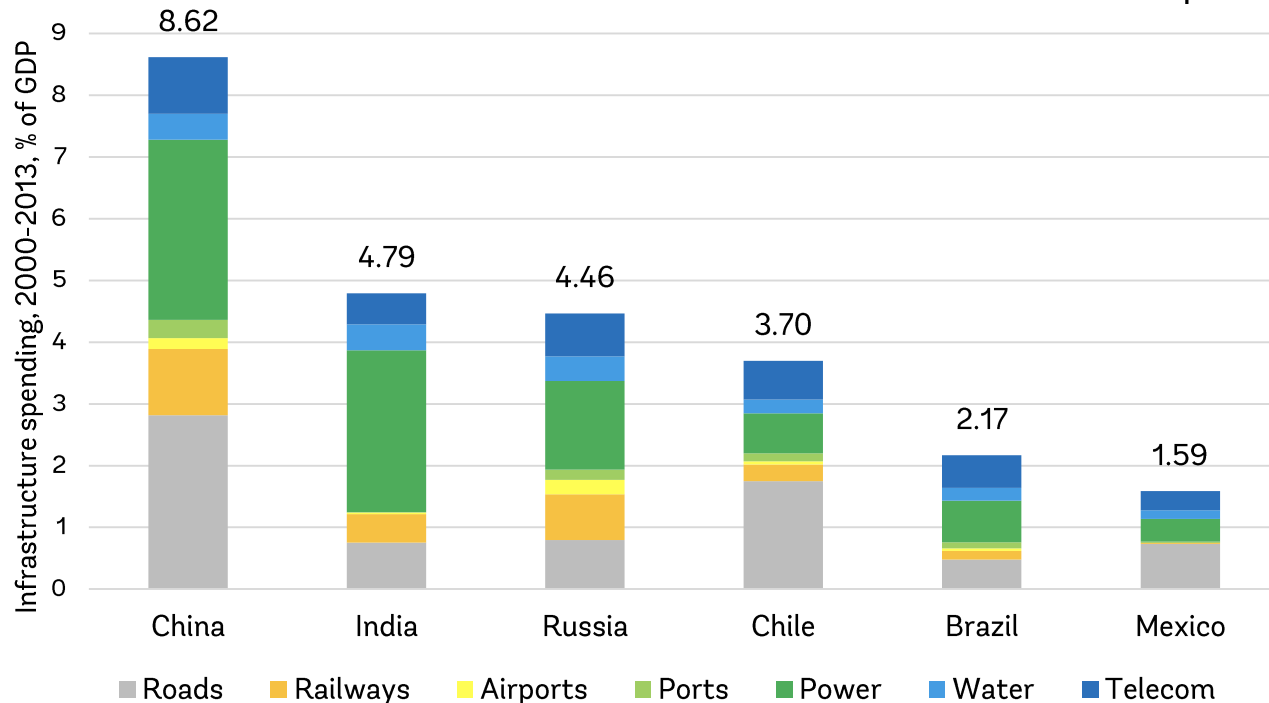
- Budget rigidities greatly limit the fiscal space for investment and weakens strategic planning.
- Planning has become mostly a formal exercise with limited impact on resources allocation.
- Budget discussion in Congress drives further wedge between plan and approved budget – representatives have the right to revise revenue estimates and thereby create room for the inclusion of pork-barrel projects (so-called “amendments”).
- Project preparation and appraisal capacity of the executive has declined, leading to poor selection and substantial misallocation of public resources. Capital budget is fragmented and dominated by short-term, often unrealistic priorities.
- Limits to competition during procurement and poor contract management capacity mean that even when plans and projects are sound, execution often does not generate value for money.
- Extensive use of budget sequestration to reach fiscal targets further undermines execution, causing implementation delays, cost overruns, and disincentives for budget units to present reasonable plans.
- Absence of Monitoring and Evaluation means limited accountability, although this is improving with greater oversight by external auditing bodies as well as civil society.

I. Key Sectoral Challenges

The result: public investment is both low and of poor quality

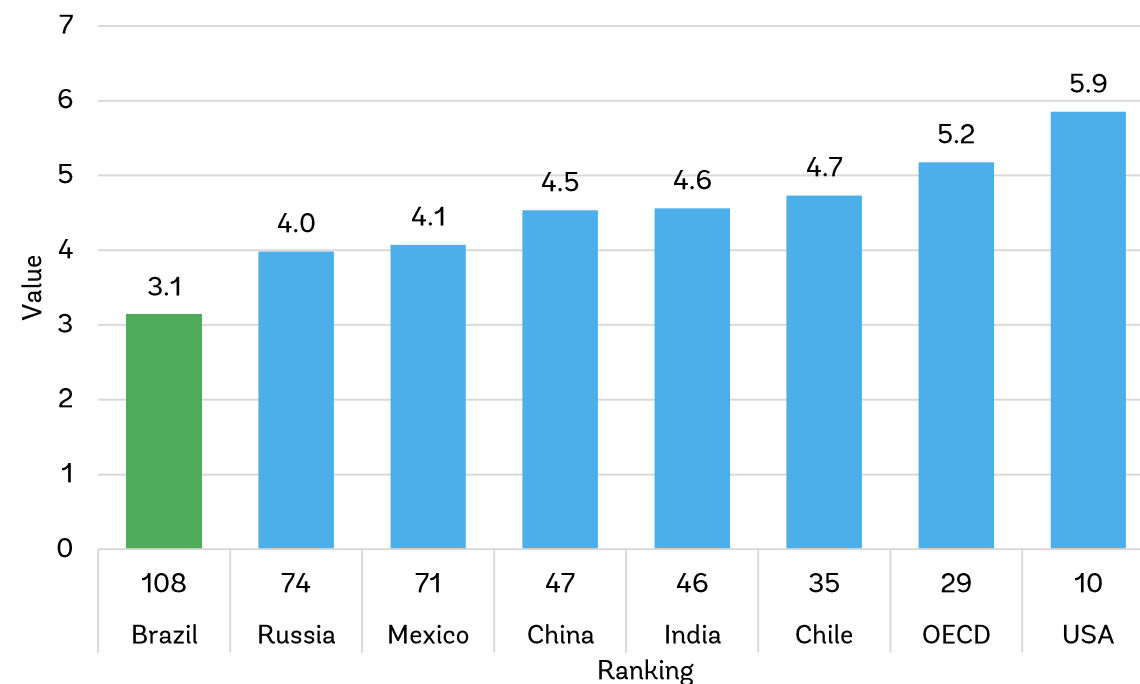
- The quality of public investment management in Brazil in most dimensions is substantially lower than the Latin American average, emerging markets and BRICs
- Brazil invests less than many peers and returns to public investment are well below the frontier

Brazil invests much less in infrastructure than most of its middle-income peers



Source Calderon and Servén (2017); Frischtak (2017)

Brazil lags all peers in the quality of its infrastructure

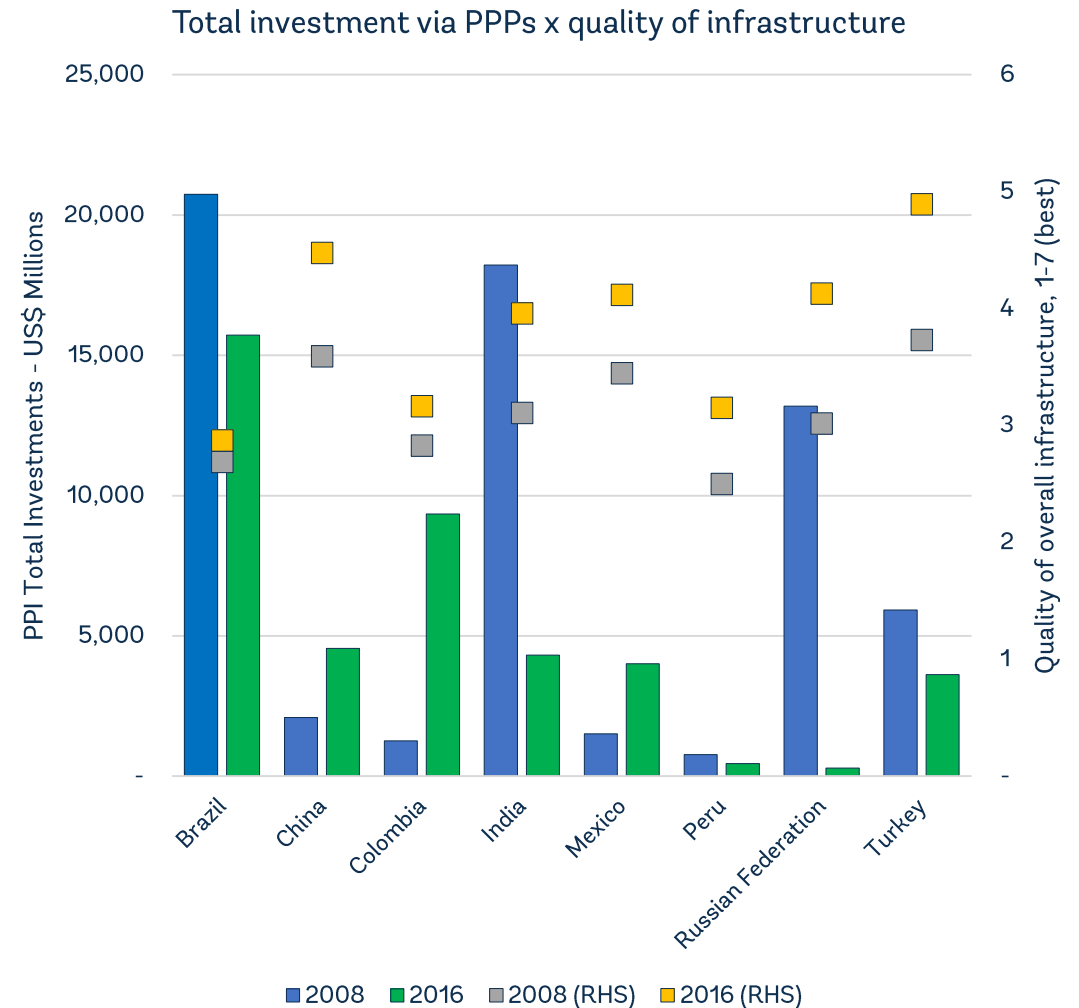


Source World Economic Forum, 2017

I. Key Sectoral Challenges

PPPs and Concessions did not lead to improved outcomes

- Between 2005 and 2015, Brazil contracted over 500 PPP projects representing USD 202 billion (more than PAC I and II combined).
- Cost effectiveness of many PPPs is questionable; contract renegotiation is frequent; completion delays and high incidence of corruption occur.
- Key issues:
 - Poor project pipeline
 - Extensive use of PMIs distorts competition
 - Uncertain regulatory framework increases risks and thus costs of PPPs
 - Viability often only through subsidized state finance – but this is now drying up
 - Limited presence of foreign, strategic investors until recently
 - Control institutions expose inefficiencies, but do not lead to policy correction

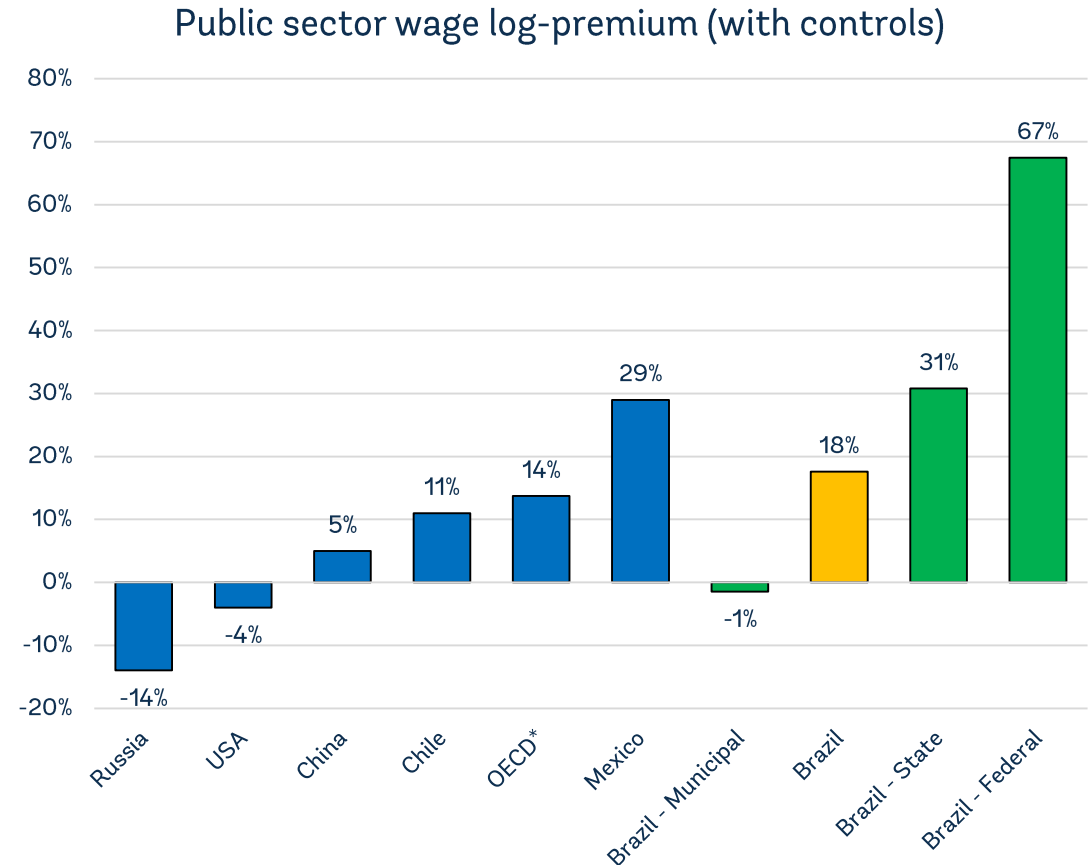


I. Key Sectoral Challenges

Overpaid civil servants and fragmented human resource management

- Brazil's public sector wage bill at 13% of GDP is high by international standards.
- Civil servants receive significantly higher salaries than their private sector peers, including the federal government, the judiciary and the legislative.
 - High wages and associated high pensions are the key source of fiscal distress – particularly at subnational level – and represent a transfer from tax payers to well off civil servants.
 - 67% of federal civil servants are in the top decile of the income distribution; 94% are in the top 40%.

Source: World Bank team's calculations based on Worldwide Bureaucracy Indicators, World Bank Bureaucracy Lab., and PNAD Continua



Note: OECD average based on data available includes Canada, Chile, Estonia, Finland, Germany, Greece, Ireland, Italy, Luxemburg, Mexico and USA

I. Key Sectoral Challenges

Overpaid civil servants and fragmented human resource management

- **The career structure of the federal and state governments is extremely fragmented and rigid, which does not allow for much mobility, either vertical or horizontal.**
 - There are over 300 different careers in the Federal government, and many negotiate salary progression and benefit levels separately.
 - This makes it difficult to set consistent remuneration policies, creates significant ratchet effects from one career to another, and limits the mobility of civil servants across careers thus reducing the flexibility of the public administration.
- **Public sector employees have no clear incentives to improve and are generally not held accountable for poor performance.**
 - Most career progressions are automatic and based on years of service.
 - Many civil servants reach top of career within 10-15 years of service.
 - Subjective evaluation criteria and labor jurisprudence protect non-performing staff even in the case of egregious violations.
- **Where performance incentives such as bonuses are used they are often not linked with performance reviews.**
 - Bonuses are paid to the vast majority of staff and become non-pensionable salary increase (in 2017, \$23.2 Billion were paid in bonuses to federal government employees)

I. Key Sectoral Challenges

Governance issues persist despite growing role of control institutions

- Judiciary (MPF and the courts) and audit institutions (TCU, CGU and regional bodies) have played a critical role in unmasking systemic corruption.
- However, culture of compliance, together with the absence of positive performance incentives and tight control, led to increasing risk aversion among civil servants.
- A growing number of policy issues are being transferred to the courts (e.g. access to medical benefits) or audit institutions (e.g. structure of public sector contracts) for decision, reducing the accountability of the executive to formulate policies.
- Lack of continuity in jurisprudence creates significant uncertainty – both because of frequent changes to legislation and discretionary interpretations of the law by prosecutors and judges. Uncertainty is also generated as a result of the expanding role of control institutions in policy making.
- Despite growing exposure and strong independent control institutions, perceptions of corruption and poor governance have not improved.
- There should be open discussions among governance actors to discuss how control institutions can have a greater impact on both public-sector accountability and performance.

I. Key Sectoral Challenges

Political institutions and incentives are behind Brazil's state inefficiencies

- In Brazil's "coalition presidentialism", new spending commitments have often been the way to buy political support.
 - Budget rigidities and public rejection of corruption mean the space for traditional deal making is shrinking.
 - Fragmentation of political parties have increased the cost of building coalitions.
- **Inclusion of vested interests generates large inefficiencies - particularly in public investment.**
 - Brazil's various flagship infrastructure and PPP programs have mostly been disappointing.
 - Brazil spends 4.5 percent of GDP on transfers to the private sector with little evidence of impact.
- **Strength of unions has hampered attempts to introduce stronger governance and performance incentives in civil service**
 - Wage pressures are a key source of growing fiscal disequilibria.
 - Super-salaries and tolerance to misconduct emphasize loss of control by the executive over payroll and human resource management.

II. Policy Recommendations

Improve the allocation, efficiency and quality of public spending

- **Adopt the new Public Finance Law :**
 - Limit the ability of the Congress to revise revenue estimates
 - Improve the PPA methodology to incorporate elements of a medium term investment framework
 - Streamline project appraisal methodologies
 - Introduce a project bank/unified pipeline
 - Introduce systematic ex-ante and ex-post evaluation of policies and programs, with adequate monitoring of results to assess whether results are attained
- **Strengthen the framework for PPPs (see infrastructure note):**
 - Develop robust project pipeline, reduce reliance on PMIs
 - Strengthen independence of regulators, increase judicial certainty, modernize licensing system
 - Introduce regular spending reviews (institutionalizing the CMAP)
- **Move from compliance to results based oversight and strengthen role of service users in accountability for quality of services**

II. Policy Recommendations

Improve human resources management and wage bill sustainability

- **Strategic Planning and Career Structure:**
 - Do the strategic workforce planning to identify hiring needs in specific areas with the required skill-set; allow workforce to adjust down when needs decline (e.g. education)
 - Increase use of contract workers or non-state providers to allow workforce to adjust more quickly to changing needs (e.g. in ECD)
 - Reduce the number of careers, establish a pyramidal structure, and create cross-cutting careers with broader assignments that enable horizontal mobility
 - Establish inter-agencies cooperation to allow support to different agencies when needed
 - Subject payroll policies in judiciary and legislative to overall budget control
- **Wage Bill and Performance Management:**
 - Reduce wage premia of public servants over time through conservative wage adjustments throughout their career.
 - Revise salary scales, progression and promotion rules linked to good performance; make bonus payments contingent on good performance
 - Revisit legal framework and jurisprudence to facilitate the possibility of dismissal due to poor performance
 - Improve monitoring of public servants during probation period

Brazil's state is large relative to its peers, but the quality of services delivered is poor

Political institutions and incentives are behind the poor quality of state governance in many areas

- These incentives and institutions are not easy to change – state reform is very challenging but also critical for Brazilians to get better services from their governments

Four key areas for reform stand out:

1. reduce budget rigidities to regain capacity for investment;
2. improve management of public investment along the whole budget and project cycle;
3. Introduce monitoring and evaluation systems in all areas of public policies, including ex-ante and ex-post evaluation of policies.
4. improve management of human resources both to contain fiscal pressures from payroll and pensions and to improve performance incentives

Key World Bank studies and other references

- Alston LJ, Melo MA, Mueller B and Pereira C (2008). On the Road to Good Governance: Recovering from Economic and Political Shocks in Brazil. In: Stein E, and In: Tommasi M, eds. Policymaking in Latin America: How Politics Shapes Policies. David Rockefeller Center for Latin American Studies. Washington, DC.
- Alston LJ, Melo M, Mueller B and Pereira C (2009). Presidential Power, Fiscal Responsibility Laws, and the Allocation of Spending: The Case of Brazil. In: Hallerberg M., In: Scartascini C G, and In: Stein E, eds. Who Decides the Budget?: A Political Economy Analysis of the Budget Process in Latin America. Harvard University Press.
- Alston L, Melo MA, Mueller B and Pereira C (2006). Political Institutions, Policymaking Processes and Policy Outcomes in Brazil. Inter-American Development Bank (IDB). Washington, D.C.
- Araujo JT and Barroso R (2014). Impact and Implications of Recent and Potential Changes to Brazil's Subnational Fiscal Framework. World Bank.
- Dutz, Mark, Cláudio Frischtak, and Robert Willig. 2015. Selected Competition, Regulation and Ownership Issues Related to Ports. Washington D.C.: Unpublished paper, World Bank.
- Curristine, Teresa, Fabien Gonguet, Mary Betley, Matt Crooke, Eivind Tandberg, Andrés Muñoz Miranda, Frederico Rabello and Lorena Viñuela. 2017. Public Investment Management Assessment Brazil. International Monetary Fund, Washington, DC.
- Rajaram, Anand, Tuan Minh Le, Nataliya Biletska, and Jim Brumby. 2010. A Diagnostic Framework for Assessing Public Investment Management. Washington DC: World Bank: Policy Research Working Paper 5397.
- Raiser, Martin, Roland Clarke, Paul Procee, Cecilia Briceno-Garmendia, Edith Kikoni, Joseph Kizito, and Lorena Vinuela. 2017. "Back to Planning: How to Close Brazil's Infrastructure Gap in Times of Austerity." World Bank, Washington, DC.

- Viñuela, Lorena. 2015. “Trends and Quality of Decentralized Public Investment.” In *Decentralization and Infrastructure in the Global Economy: From Gaps to Solutions*, edited by Jonas Frank and Jorge Martinez. Abingdon, Oxon ; New York, NY: Routledge.
- Viñuela, Lorena, and Laura De Castro Zoratto. 2015. “Do Performance Agreements Help Improve Service Delivery?: The Experience of Brazilian States.” Policy Research Working Paper; No. 7375. World Bank, Washington, DC.
- Viñuela, Lorena, and Marcos José Mendes. 2016. *Institutional and Governance Challenges in Public Investment Management*. World Bank, Washington, DC.
- World Bank, (2009). *Brazil: Federal Public Financial Management Performance Based on the PEFA Methodology*. World Bank.
- ———. 2012a. *Beyond the Annual Budget: Global Experience with Medium Term Expenditure Frameworks*. World Bank Publications. Washington, D.C.
- ———. 2012b. “How to Decrease Freight Logistics Costs in Brazil.” Transport Papers 39.
- ———. 2016a. *Retaking the Path to Inclusion, Growth and Sustainability: Brazil Systematic Country Diagnostic*. The World Bank.
- ———. 2017a. *Baseline Assessment of Proposals to Revise Federal Environmental Licensing in Brazil: A Contribution to Discussions*. Brasília: World Bank, Environmental Risk Management Team.
- ———. 2017b. *Infrastructure Development and Accountability Institutions*. Background paper for Brazil Infrastructure Analysis.
- ———. 2017c. *Infrastructure Investment and Financing in Brazil over the Last Two Decades*. Background paper for Brazil Infrastructure Analysis.
- ———. 2017d. *Regulatory Governance Practice in Brazil: Evolution and International Benchmarking*. Background paper for Brazil Infrastructure Analysis.



THE WORLD BANK

IBRD • IDA | WORLD BANK GROUP