



The World Bank

Mato Grosso Fiscal Adjustment DPL (P164588)

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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A

PROPOSED LOAN

IN THE AMOUNT OF US\$250 MILLION

TO THE

STATE OF MATO GROSSO

WITH A GUARANTEE OF THE FEDERATIVE REPUBLIC OF BRAZIL

FOR THE

MATO GROSSO FISCAL ADJUSTMENT AND ENVIRONMENTAL SUSTAINABILITY
DEVELOPMENT POLICY LOAN

April 29, 2019

Macroeconomics, Trade and Investment Global Practice
Latin America and Caribbean Region

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Federative Republic of Brazil

GOVERNMENT FISCAL YEAR

January, 01 – December, 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of 03/31/2019)

Currency Unit

US\$1.00 = R\$3.92

ABBREVIATIONS AND ACRONYMS

ASA	Advisory Services and Analytics	<i>Atividade de Análise e Assessoria</i>
AF	Fiscal Year	<i>Ano Fiscal</i>
AFD	French Development Agency	<i>Agência Francesa de Desenvolvimento</i>
ALC	América Latina e Caribe	<i>América Latina e Caribe</i>
APPs	Areas of Permanent Preservation	<i>Áreas de Preservação Permanente</i>
AT	Technical Assistance	<i>Assistência Técnica</i>
BCB	Brazilian Central Bank	<i>Banco Central do Brasil</i>
BEIS	Business, Energy and Industrial Strategy	<i>Energia Empresarial e Estratégia Industrial</i>
BID	Inter-American Development Bank	<i>Banco Interamericano de Desenvolvimento</i>
BIRD	International Bank for Reconstruction and Development	<i>Banco Internacional para Reconstrução e Desenvolvimento</i>
BNDES	National Bank for Social and Economic Development	<i>Banco Nacional de Desenvolvimento Econômico e Social</i>
CAPAG	Debt Repayment Risk Classification for States and Municipalities	<i>Capacidade de Pagamento de Estados e Municípios</i>
CAR	Rural Environmental Registry	<i>Cadastro Ambiental Rural</i>
CEF	Federal Savings Bank	<i>Caixa Econômica Federal</i>
CGE	Comptroller General of the State	<i>Controladoria Geral do Estado</i>
COMPREV	Pension Compensation	<i>Compensação Previdenciária</i>
CONFAZ	National Fiscal Policy Council	<i>Conselho Nacional de Política Fazendária</i>
COP21	21st Conference of the Parties	<i>21ª Conferência do Clima</i>
CPF	Country Partnership Framework	<i>Estratégia de Parceria de País</i>
DPF	Development Policy Financing	<i>Financiamento para Políticas de</i>

DPL	Development Policy Loan	<i>Desenvolvimento Empréstimo de Políticas de Desenvolvimento</i>
EMBRAPA	Brazilian Agricultural Research Corporation	<i>Empresa Brasileira de Pesquisa Agropecuária</i>
FEEF	State Fiscal Equilibrium Fund	<i>Fundo Estadual de Equilíbrio Fiscal</i>
FETHAB	State Fund for Transport and Housing	<i>Fundo Estadual de Transporte e Habitação</i>
FIPLAN	Integrated System of Planning, Accounting and Finances	<i>Sistema Integrado de Planejamento, Contabilidade e Finanças</i>
FPE	States' Participation Fund	<i>Fundo de Participação dos Estados</i>
FPM	Municipalities' Participation Fund	<i>Fundo de Participação dos Municípios</i>
FUNDEB	Fund for the Development of Basic Education and Appreciation of the Teaching Profession	<i>Fundo de Manutenção e Desenvolvimento da Educação Básica e de Valorização de Profissionais de Educação</i>
GIZ	German Development Agency (<i>Deutsche Gesellschaft für Internationale Zusammenarbeit</i>)	<i>Agência Alemã de Desenvolvimento</i>
GFP	Public Financial Management	<i>Gestão Financeira Pública</i>
GFSM	Government Finance Statistics Manual	<i>Manual de Estatísticas de Finanças do Governo</i>
GRS	Grievance Redress Service	<i>Serviço de Resolução de Reclamações</i>
GSNs	Subnational Governments	<i>Governos Subnacionais</i>
IBAMA	Brazilian Institute of the Environment and Renewable Natural Resources	<i>Instituto Brasileiro do Meio Ambiente e Recursos Naturais Renováveis</i>
IBGE	Brazilian Institute of Geography and Statistics	<i>Instituto Brasileiro de Geografia e Estatística</i>
ICMS	Tax on the circulation of Goods and Services	<i>Imposto sobre Circulação de Mercadorias e Serviços</i>
IED	Foreign Direct Investment	<i>Investimento Estrangeiro Direto</i>
IDH	Sustainable Trade Initiative	<i>Iniciativa de Comércio Sustentável</i>
IFC	International Finance Corporation	<i>Corporação Financeira Internacional</i>
INPE	National Institute for Spatial Research	<i>Instituto Nacional de Pesquisas Espaciais</i>
IPTU	Tax on urban Properties	<i>Imposto Propriedades Urbanas</i>
IPSAS	International Public Sector Accounting Standards	<i>Normas Internacionais de Contabilidade aplicadas ao Setor Público</i>
IPVA	Automotive Tax	<i>Imposto veículos automotivos</i>
ITBI	Tax on Real Estate Transactions	<i>Imposto transações imobiliárias</i>
ITCMD	Tax on Inheritances and Gifts	<i>Imposto de transmissão causa mortis e doação</i>
ITR	Rural Property Tax	<i>Imposto sobre a Propriedade</i>

		<i>Territorial Rural</i>
IVA	Value-added Tax	<i>Imposto sobre o Valor Agregado</i>
KfW	German Development Bank (<i>Kreditanstalt für Wiederaufbau</i>)	<i>Banco Alemão de Desenvolvimento</i>
LDP	Letter of Development Policy	<i>Carta de Política de Desenvolvimento</i>
LRF	Fiscal Responsibility Law	<i>Lei de Responsabilidade Fiscal</i>
M&A	Monitoring and Evaluation	<i>Monitoramento e Avaliação</i>
ME	Ministry of Economics	<i>Ministério da Economia</i>
MIGA	Multilateral Investment Guarantee Agency	<i>Agência Multilateral de Garantia para Investimentos</i>
MMA	Ministry of Environment	<i>Ministério do Meio Ambiente</i>
MTEF	Medium-Term Expenditure Framework	<i>Enquadramento das Despesas a Longo Prazo</i>
MTF-CGU	Ministry of Transparency, Monitoring and Comptroller General of the Union	<i>Ministério da Transparência, Fiscalização e Controladoria-Geral da União</i>
MTPREV	Mato Grosso Pension Agency	<i>Mato Grosso Previdência</i>
NDC	Nationally Determined Contribution	<i>Contribuição Nacionalmente Determinada</i>
OCDE	Organization for Economic Cooperation and Development	<i>Organização para Cooperação Econômica e Desenvolvimento</i>
PAF	Fiscal Adjustment Plan	<i>Plano de Ajuste Fiscal</i>
ONG	Non-Governmental Organization	<i>Organização não governamental</i>
PCI	Produce, Conserve, Include	<i>Produzir, Conservar, Incluir</i>
PER	Public Expenditure Review	<i>Revisão do Gasto Público</i>
PFM	Public Financial Management	<i>Gestão Financeira Pública</i>
PIB	Gross Domestic Product	<i>Produto Interno Bruto</i>
PPA	Multi-Year Plan	<i>Plano Plurianual</i>
PPC	Purchasing power parity	<i>Paridade de poder de compra</i>
PPCDIF	Action Plan for the Prevention and Control of Deforestation and Forest Fires	<i>Plano de Ação para Prevenção e Controle do Desmatamento e Incêndios Florestais</i>
PPCDQ-MT	Action Plan for the Prevention and Control of Deforestation and Burning in Mato Grosso	<i>Plano de Ação para Prevenção e Controle do Desmatamento Queimadas do Estado de Mato Grosso</i>
PNB	Gross National Product	<i>Produto Nacional Bruto</i>
PRA	Environmental Regularization Program	<i>Programa de Regularização Ambiental</i>
PRODEI	Industrial Development Program	<i>Programa de Desenvolvimento Industrial</i>
PRODEIC	Industrial and Commercial Development Program	<i>Programa de Desenvolvimento Industrial e Comercial</i>
PROST	Pension Reform Options Simulation Toolkit	<i>Ferramenta de Simulação de Opções de Reformas Previdenciárias</i>

RCL	Net Current Revenue	<i>Receita Corrente Líquida</i>
REDD	Reduced Emissions from Deforestation and Forest Degradation	<i>Redução de Emissões de Gases de Efeito Estufa Decorrentes do Desmatamento e Degradação Florestal</i>
REM	REDD for Early Movers	<i>REDD para Pioneiros</i>
SCD	Systematic Country Diagnostic	<i>Diagnóstico Estratégico de País</i>
RL	Legal Reserve	<i>Reserva Legal</i>
SIMCAR	Mato-Grosso Rural Environmental Cadaster System	<i>Sistema Mato-Grossense de Cadastro Ambiental Rural</i>
RGA	Annual General Salary Adjustment	<i>Reajuste Geral Anual</i>
SEFAZ	State Secretariat of Finance	<i>Secretaria de Estado da Fazenda</i>
SELIC	Special Clearance and Escrow System	<i>Sistema Especial de Liquidação e de Custódia</i>
SEPLAN	State Secretariat of Planning	<i>Secretaria de Estado do Planejamento</i>
SEMA	State Secretariat of the Environment	<i>Secretaria de Estado de Meio Ambiente</i>
SESP	Secretariat of Public Security	<i>Secretaria de Estado de Segurança Pública</i>
SICAR	Rural Environmental Registry System	<i>Sistema de Cadastro Ambiental Rural</i>
SIMCAR	Rural Environmental Registry System of Mato Grosso	<i>Sistema Mato-grossense de Cadastro Ambiental Rural</i>
STN	National Treasury Secretariat	<i>Secretaria do Tesouro Nacional</i>
SUS	Single health System	<i>Sistema Único de Saúde</i>
TAC	Terms of Conduct Adjustment	<i>Termo de Ajustamento de Conduta</i>
TCE	State Court of Accounts	<i>Tribunal de Contas do Estado</i>
TJLP	Long Term Interest Rate	<i>Taxa de Juros de Longo Prazo</i>
TLP	Long Term Rate	<i>Taxa de Longo Prazo</i>
UNFCCC	United Nations Framework Convention on Climate Change	<i>Convenção-Quadro das Nações Unidas sobre a Mudança do Clima</i>
WBG	World Bank Group	<i>Grupo Banco Mundial</i>

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FEDERATIVE REPUBLIC OF BRAZIL

MATO GROSSO FISCAL ADJUSTMENT AND ENVIRONMENTAL SUSTAINABILITY DPL

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SUMMARY OF PROPOSED FINANCING AND PROGRAM

BASIC INFORMATION

Project ID	Programmatic
P164588	No

Proposed Development Objective(s)

Program Development Objective of this DPL is to support the State of Mato Grosso to (i) regain fiscal sustainability and (ii) increase institutional capacity for sustainable agriculture, forest conservation and climate change mitigation.

Organizations

Borrower: STATE OF MATO GROSSO

Implementing Agency: MATO GROSSO STATE SECRETARIAT OF FINANCE (SECRETARIA DE ESTADO DE FAZENDA – SEFAZ)

PROJECT FINANCING DATA (US\$, Millions)

SUMMARY

Total Financing	250.00
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DETAILS

International Bank for Reconstruction and Development (IBRD)	250.00
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INSTITUTIONAL DATA

Climate Change and Disaster Screening

This operation has been screened for short and long-term climate change and disaster risks

Overall Risk Rating

Substantial

**Results**

Indicator Name	Baseline	Target
Current savings as a percentage of adjusted net current revenues	3.6 percent (2017)	5 percent (2021)
Personnel spending as share of net-current revenue	67.85 percent (2018)	60 percent (2021)
Pension deficit realized in 2021 in percent of current revenues compared to 2018 projection (based on World Bank PROST model)	9.1 percent (2018)	8.5 percent (2021)
Revenues recovered by FEEF (cumulative total)	R\$85 million (2018)	R\$400 million (2021)
Revenues raised from FETHAB commodities (annual)	R\$870 million (2018)	R\$1,350 million (2021)
Annual deforestation in the Amazon biome within the State of Mato Grosso	1,749 km ² (2018)	1,241 km ² (2021)
Area of land for which CAR information has been validated by SEMA	2.9 million hectares (2018)	20 million hectares (2021)
Resources mobilized in coordination with the PCI Institute for the implementation of the PCI strategy (cumulative total)	US\$53 million (2018)	US\$90 million (2021)



IBRD PROGRAM DOCUMENT FOR A PROPOSED FISCAL ADJUSTMENT AND ENVIRONMENTAL SUSTAINABILITY DPL TO THE STATE OF MATO GROSSO

1. INTRODUCTION AND COUNTRY CONTEXT

1. **Brazil is recovering from a deep recession and needs to accelerate fiscal consolidation at Federal and subnational level.** Brazil's economy declined by about 7 percent in 2015 and 2016 combined, and the fiscal deficit peaked at over 10 percent of GDP in 2015. Since then, the economy has recovered slowly, with GDP growing 1.1 percent in 2017 and 2018. Fiscal consolidation at federal level is anchored, since December 2016, by a constitutional rule limiting the increase in primary expenditures. The administration which took office in the beginning of 2019 has pledged to accelerate this expenditure-based fiscal adjustment, starting with an ambitious pension reform. The recession and slow recovery have also affected subnational governments that have seen transfers from federal tax revenues and their own cyclical revenue base decline. Meanwhile, they struggle to adjust fiscally given high expenditure rigidities, largely governed by federal laws and the constitution. As a result, a growing number of state governments have faced liquidity and solvency crises since 2015, which undermines critical service delivery. Further, the stock of outstanding subnational debt represents more than 12 percent of GDP, which poses a significant contingent liability for the Federal Government.

2. **In this context, the proposed Fiscal Adjustment and Environmental Sustainability Development Policy Loan (DPL) aims to support the State of Mato Grosso to regain fiscal sustainability and increase institutional capacity for sustainable agriculture, forest conservation and climate change mitigation.** The operation supports two pillars critical to long-term sustainability of the State: (i) adjustment of State finances through institutional reforms for fiscal sustainability; and (ii) the consolidation of efforts to protect forest assets while promoting agricultural productivity in line with the State's development strategy. The need for fiscal adjustment is paramount as the State Government's excessive growth in expenditure obligations, mostly on salaries and pensions, has resulted in a large accumulation of payment arrears, threatening the delivery of crucial public services. The operation also supports a set of policies in line with the State's ambitious sustainable rural development and climate change strategy, summarized under the "Produce, Conserve, Include" (*Produzir, Conservar, Incluir*; PCI) program. This operation is designed as a stand-alone DPL to support a heavily frontloaded fiscal reform package and ensure continuity and acceleration of critical environmental policies including measures to combat illegal deforestation.

3. **The implementation of the fiscal and environmental reforms supported by this operation is essential to place the State's expenditures on a sustainable path and strengthen its development model.** A State Fiscal Responsibility Law supported by this operation enables the State Government to regain and maintain the sustainability of its finances. Other measures supported by the operation ensure that key expenditure drivers such as wage growth can be controlled going forward, allowing the State Government to clear arrears and create fiscal space to deliver on social and infrastructure priorities. The operation also strengthens Mato Grosso's tax base by reducing tax expenditures and increasing fiscal contribution and environmental performance by export-oriented agriculture in the State. To sustain the State's agricultural export-led growth model, this operation supports policies to control deforestation and forest fires, which threaten the State's natural capital base. The operation also accelerates the implementation of the rural



environmental cadaster, a key tool for land management, and the institutional consolidation of the State's efforts towards attracting investment in sustainable and climate-smart development.

4. **The two pillars supported by this DPL are mutually reinforcing: fiscal and environmental sustainability are both essential for the long-term prospects of Mato Grosso.** Fiscal sustainability is essential to enable the State to invest in the infrastructure, natural and human capital necessary for the State's agriculture-based growth model to succeed. In parallel, the State's long-term fiscal and economic prosperity depends on the sustainable use of its vast natural resources. Depletion of natural capital and the resulting increased exposure to climate events, notably droughts and variable precipitation, would undermine Mato Grosso's agricultural productive capacity. Further, because locally driven environmental management can have important global co-benefits, increased access to international climate finance could be an important source of investment and resources for environmental policy in the State going forward.

5. **The operation provides an innovative model for strengthening fiscal consolidation and for harmonizing conservation and sustainable production at the subnational level in Brazil.** Subnational 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 put further stress on the Federal Government's fiscal position. Initial federal support programs to subnationals through debt restructuring have proven costly to the Federal Government and had limited impact in the fiscal consolidation at the state level. The Federal Government acts as a guarantor of this operation and the Bank is collaborating with the Federal Treasury (*Secretaria do Tesouro Nacional, STN*) to develop a new framework to leverage fiscal reform at subnational level while preserving federal exposure to subnational debt.

6. **This operation is the first of an envisioned new generation of subnational fiscal operations in Brazil.** It aims to restore the capacity of Mato Grosso to access new loans with federal guarantees and serves as a pilot for other subnational governments under fiscal stress. First, it provides financial incentives for the State Government to pursue an ambitious program of fiscal adjustment. Second, it improves the quality of the adjustment, based on reduction of unsustainable recurrent expenditure rather than investment cuts, payment arrears or revenue measures. Third, it provides World Bank technical assistance in the form of detailed fiscal modelling with evidence to help in the decision making. The operation also supports the protection of the natural capital of Mato Grosso's economy. Mato Grosso has adopted an ambitious strategy aiming to reduce deforestation by 90 percent and 95 percent in the Amazon and Cerrado biomes, respectively, by 2030.¹ This will mitigate the impact deforestation has on local rainfall and temperature variability and boost sustainable agricultural and livestock intensification. As a positive spillover, the State's program will support the achievement of Brazil's nationally determined contribution (NDC) targets and global commitments to climate change mitigation.

¹ <http://pci.mt.gov.br/#metas>.



2. MACROECONOMIC POLICY FRAMEWORK

2.1. RECENT ECONOMIC DEVELOPMENTS

7. **After a decade of solid growth, Brazil's economy entered a deep recession in 2015 and 2016 from which it is slowly recovering.** The deterioration of the external environment and domestic policies led to a slowdown in GDP growth from an average of 4.5 percent per year during 2006-2010 to 2.4 percent during 2011-2014. This was followed by two years of recession with GDP growth of -3.5 and -3.3 percent in 2015 and 2016, respectively (Table 1). While external factors contributed to the recession, growing fiscal imbalances, structural bottlenecks and domestic political uncertainty affected investor and consumer confidence. As a result, investment fell by nearly 23 percent during 2015-2016. In 2017, the economy began to recover, growing 1.1 percent at the back of a strong agriculture sector. In 2018, GDP growth remained unchanged at 1.1 percent, supported by recovery in household consumption and investment. Job creation is slowly improving with unemployment declining from a peak of 13.6 percent in March 2017 to 12.3 percent in 2018 but still above pre-crisis levels (6.8 percent in 2014). Also, most of the new jobs are created in the informal sector. Extreme poverty (at US\$1.90/day in 2011 PPP) increased from 4.1 percent in 2014 to 7.4 percent in 2017 and is estimated to have barely changed in 2018.²

8. **The current account deficit has narrowed and is comfortably financed by FDI.** The current account deficit that reached 4.2 percent of GDP in 2014 (US\$101 billion) narrowed to 0.5 percent of GDP (US\$7.2 billion) in 2017 due to import compression because of the recession and large exchange rate depreciation. In 2018, current account deficit remained modest at 0.8 percent of GDP (US\$14.5 billion), supported by commodity export growth and growing FDI inflows that reached 4.7 percent of GDP. Portfolio flows have been negative since late 2016. External debt is relatively low (34.2 percent of GDP as of September 2018), when compared to other middle-income countries. Ample international reserves at US\$375 billion (or 18.3 months of imports) as of December 2018 continue to provide a strong buffer against external shocks. The Central Bank's short position in currency swaps, used since 2013 to mitigate exchange rate volatility, has been reduced from US\$114 billion in 2015 to US\$69 billion in 2018.

9. **Inflation has declined rapidly since 2016, facilitating subsequent monetary policy easing.** Before 2015, inflation was held back by a near-freeze in regulated prices such as fuel, energy, water, and public transport. A large correction of regulated prices in 2015, combined with food price shocks and the sharp exchange rate depreciation, accelerated inflation to 10.7 percent at the end of 2015, well above the Central Bank's 4.5 ± 2 percent target. In response, the Central Bank increased the policy rate (SELIC) to 14.25 percent in October 2015, keeping it at this level for a year. The recession exerted downward pressure on prices and wages and inflation fell rapidly to 2.9 percent at the end of 2017, which allowed the Central Bank to take a more accommodative stance, keeping the policy rate at 6.5 percent since March 2018. In 2018, inflation remained moderate at 3.7 percent.

10. **The banking system's soundness indicators remained adequate throughout the recession, but credit contracted.** Despite the rapid expansion in public banks' portfolios until 2014 and the economic recession, asset quality indicators deteriorated only moderately. The average delinquency rate on all loans increased from 2.9 percent in 2014 to 3.0 percent in the second half of 2018. While delinquency indicators for private banks have fallen since mid-2016, they continue to rise for public banks (especially public

² A break in the comparability of the data masks the full poverty increases after 2015.



development banks). The banking system has been building buffers to withstand possible losses, with aggregate capitalization above OECD averages, and loan loss provision coverage at 170 percent of non-performing loans. Moreover, the capital ratio is at 17.2 percent (as of June 2018), well-above the 11 percent minimum regulatory requirement. However, credit has contracted as consumers and corporates deleveraged, decreasing from a peak of 53.7 percent of GDP in December 2015 to 46.4 percent in February 2018. In December 2018, credit level rose to 47.4 percent of GDP with the increase of non-earmarked credit.

11. **Structural reforms have started to remove critical bottlenecks for productivity growth.** Brazil has suffered low productivity growth over the last two decades due to, among other factors, a cumbersome business environment, distortionary tax system, inadequate business support programs and a relatively closed market to external trade and competition. It also experiences low investment in infrastructure (2.1 percent of GDP on average between 2000 and 2013), and declining infrastructure stock that create acute bottlenecks in the economy. With limited fiscal space and a dwindling demographic bonus, accelerating productivity growth remains key to sustain economic growth. To this end, the Federal Government undertook a series of micro-economic reforms such as simplifying the process to register a company and file taxes, and reducing financial distortions by replacing the highly-subsidized long-term interest rate (*Taxa de Juros de Longo Prazo - TJLP*) with a new market-based rate (*Taxa de Longo Prazo - TLP*), thereby improving the allocation of scarce finance to projects with higher returns on investment. In addition, a reform of labor regulations increasing flexibility of labor relations and a reform of the secondary education curriculum should also support human capital accumulation.

12. **Spending increases, and the impact of the recession contributed to a large federal fiscal deficit and growing public debt.** Expansionary fiscal policy until 2014 and the fall of revenue collection during the recession broadened the fiscal deficit from 5.8 percent of GDP in 2014 to 9.5 percent in 2016.³ Deep cuts to public investment and other austerity measures since 2015 were insufficient to control public expenditures, which has been growing strongly for several decades, largely due to constitutionally guaranteed social mandates such as pension benefits.⁴ Despite improved tax collection in line with the recovery of GDP growth and lower interest costs on domestic debt, the fiscal deficit remained high at 7.4 percent of GDP in 2018. Fiscal imbalances for the past five years contributed to an increase in general government gross debt from 51.5 percent of GDP in 2013 to 77.2 percent in 2018.⁵ The fiscal deterioration led Brazil to lose its investment grade rating in August 2015, with a further reduction to BB- (S&P and Fitch) in early 2018. Rollover risks are mitigated in the near-term as net debt (53.8 percent in 2018) remains significantly lower than gross debt and exposure to foreign-currency debt is just 5.9 percent of GDP.

³ These data refer to the General Government, using the GFSM 2014 methodology.

⁴ Social security expenditures have been rising rapidly in recent years because of overly generous benefits, indexing rules and low retirement ages, alongside outdated retirement procedures.

⁵ This data is in accordance with Brazilian methodology.



Table 1. Brazil: Key Economic Indicators, 2013-2022

	2013	2014	2015	2016	2017	2018	2019 (proj.)	2020 (proj.)	2021 (proj.)	2022 (proj.)
Real economy										
	Annual percentage change, unless otherwise indicated									
GDP (nominal - R\$ billion)	5,332	5,779	5,996	6,259	6,551	6,916	7,403	8,014	8,583	9,191
Real GDP	3.0	0.5	-3.5	-3.3	1.1	1.1	2.2	2.5	2.3	2.3
Per Capita GDP (In US\$ Atlas Method)	11,804	11,759	11,245	10,784	10,814	10,849	11,006	11,201	11,374	11,549
Contributions:										
Consumption	3.6	1.7	-2.5	-2.6	0.7	1.3	1.8	-	-	-
Investment	1.3	-1.0	-3.0	-2.3	-0.4	0.7	0.8	-	-	-
Net exports	-0.8	0.2	3.0	1.5	0.1	-0.5	-0.4	-	-	-
Statistical discrepancy and change in inventories	-1.1	-0.4	-1.0	0.1	0.7	-0.4	-0.1	-	-	-
Imports, GNFS	7.2	-2.3	-14.2	-10.3	5.0	8.5	7.9	-	-	-
Exports, GNFS	2.4	-1.6	6.8	0.9	5.2	4.1	5.0	-	-	-
Unemployment rate - average (local definition)	7.1	6.8	8.5	11.5	12.7	12.3	12.3	-	-	-
CPI (average period)	6.2	6.3	9.0	8.7	3.5	3.7	4.0	4.0	3.9	3.8
Fiscal Accounts										
	Percent of GDP, unless otherwise indicated									
General Government Expenditures ^{1/}	39.4	40.9	45.4	47.4	43.9	44.1	42.2	42.7	43.1	43.2
General Government Revenues ^{1/}	36.4	35.2	37.1	37.9	36.8	36.7	35.8	36.2	36.4	36.4
General Government Overall Balance ^{1/}	-3.0	-5.8	-8.3	-9.5	-7.1	-7.4	-6.3	-6.5	-6.7	-6.7
NFPS Overall Balance ^{2/}	-3.0	-5.4	-10.3	-9.0	-7.8	-8.6	-8.0	-7.8	-7.5	-7.0
General Government Primary Balance ^{1/}	2.2	-0.3	-0.8	-1.3	-0.8	-1.5	-1.1	-0.8	-0.6	-0.4
NFPS Primary Balance ^{2/}	1.7	0.0	-2.0	-2.5	-1.7	-2.4	-1.8	-1.1	-0.6	0.0
General Government Gross Debt (Authorities' definition) ^{3/}	51.5	56.3	65.5	69.9	74.1	77.2	79.0	80.7	82.5	84.3
NFPS Gross Debt ^{2/}	60.2	62.3	72.6	78.4	84.0	88.4	-	-	-	-
NFPS Net Debt ^{2/}	30.5	32.6	35.6	46.2	51.6	53.8	-	-	-	-
Selected Monetary Accounts										
	Annual percentage change, unless otherwise indicated									
Base Money	6.9	5.6	-3.1	5.9	9.8	1.8	-	-	-	-
Credit to non-government	13.9	9.7	5.2	-3.0	0.0	6.0	-	-	-	-
Interest rate - Selic (period average)	8.2	10.9	13.4	14.1	10.1	6.5	-	-	-	-
Balance of Payments										
	Percent of GDP, unless otherwise indicated									
Current Account Balance	-3.0	-4.2	-3.4	-1.3	-0.5	-0.8	-1.5	-1.8	-1.9	-2.1
Imports, GNFS	13.2	13.0	13.7	11.5	11.0	13.1	13.6	13.7	13.8	13.9
Exports, GNFS	11.3	10.8	12.6	12.4	12.4	13.9	13.7	13.6	13.3	13.0
Foreign Direct Investment	2.2	2.9	3.5	4.0	3.2	4.7	3.5	3.5	3.5	3.5
Gross Reserves (in US\$, eop)	358.8	363.6	356.5	365.0	374.0	374.7	-	-	-	-
In months of next years imports	13.2	13.7	17.6	21.6	20.1	18.3	-	-	-	-
As % of short-term external debt ^{4/, 5/}	296.1	209.3	214.3	214.8	235.5	237.1	-	-	-	-
External Debt (in US\$, eop) ^{5/}	621.5	712.7	664.4	675.8	667.1	643.2	-	-	-	-
External Debt ^{5/}	25.1	29.0	37.5	38.4	33.1	34.2	-	-	-	-
Terms of Trade (% change)	-2.4	-3.4	-11.0	3.1	5.8	-2.1	-	-	-	-
Exchange Rate (average)	2.2	2.4	3.4	3.4	3.2	3.7	-	-	-	-

^{1/} Data refers to the General Government and are calculated using the GFSM 2014 methodology. Fiscal balances are calculated through the General Government's revenues and expenditures statistics that are obtained from the Fiscal Responsibility Law's reports publicized by the each level of government. The values may differ from the fiscal statistics released by the Brazilian Central Bank (BCB) for the Non-financial Public Sector, which are calculated using below-the-line statistics obtained from the banking sector balance sheets under the methodology of the GFSM 1986.

^{2/} Values for the Non-financial Public Sector presented in the Nota para a Imprensa - Política Fiscal (Central Bank), using "below-the-line" statistics under the GFSM 1986. Projections for 2018 to 2020: IMF, Fiscal Monitor of April/2018.

^{3/} Brazilian Central Bank definition (2008 methodology), that excludes the Federal securities in the BCB portfolio and includes the stock of BCB repo operations.

^{4/} Includes the long-term debt repayments due in the next 12 months as short-term debt.

^{5/} Includes securities issued in Brazil held by foreign residents and intercompanies loans.

Source: IBGE, BCB, IMF, World Bank calculations.



Table 2. Brazil: Key Fiscal Indicators for Brazil's General Government, 2013 – 2022

	2013	2014	2015	2016	2017	2018	2019 (proj.)	2020 (proj.)	2021 (proj.)	2022 (proj.)
<i>General Government Overall Balance</i>	(3.0)	(5.8)	(8.3)	(9.5)	(7.1)	(7.4)	(6.3)	(6.5)	(6.7)	(6.7)
<i>NFPS Overall Balance</i> ^{2/}	(3.0)	(5.4)	(10.3)	(9.0)	(7.8)	(8.6)	(8.0)	(7.8)	(7.5)	(7.0)
<i>General Government Primary balance</i>	2.2	(0.3)	(0.8)	(1.3)	(0.8)	(1.5)	(1.1)	(0.8)	(0.6)	(0.4)
<i>NFPS Primary Balance</i> ^{2/}	1.7	0.0	(2.0)	(2.5)	(1.7)	(2.4)	(1.8)	(1.1)	(0.6)	0.0
<i>Total Revenues (and grants)</i>	36.4	35.2	37.1	37.9	36.8	36.7	35.8	36.2	36.4	36.4
Tax revenues	30.8	30.1	30.5	30.5	30.6	31.1	31.4	31.6	31.6	31.6
Taxes on goods and services	14.2	13.6	13.6	13.3	13.6	13.8	13.9	14.0	14.0	14.1
Direct Taxes	6.8	6.6	6.7	7.2	7.0	7.2	7.2	7.2	7.2	7.2
Social insurance contributions	7.5	7.5	7.7	7.7	7.6	7.7	7.7	7.8	7.7	7.7
Taxes on international trade	0.7	0.6	0.7	0.5	0.5	0.6	0.7	0.7	0.7	0.7
Other taxes	1.7	1.7	1.8	1.8	1.8	1.8	1.9	1.9	1.9	1.9
Non-tax revenues	5.6	5.1	6.7	7.4	6.2	5.6	4.5	4.6	4.8	4.8
o/w interests	1.8	1.9	3.3	3.7	2.9	2.1	1.4	1.5	1.7	1.7
Transfers and Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<i>Total Expenditures</i> ^{3/}	39.4	40.9	45.4	47.4	43.9	44.1	42.2	42.7	43.1	43.2
Current expenditures	37.4	38.7	43.9	45.9	42.9	43.3	41.3	41.9	41.9	41.8
Wages and compensation	10.9	11.1	11.6	11.6	11.7	11.7	11.2	11.1	10.8	10.6
Goods and services	5.2	5.4	5.2	5.3	4.9	4.9	4.9	4.8	4.6	4.5
Interest payments	7.0	7.4	10.8	11.8	9.3	8.1	6.5	7.2	7.8	8.0
Social benefits	12.7	13.2	13.8	15.3	15.7	16.1	16.2	16.3	16.3	16.3
Other Current Expenditures	1.6	1.7	2.5	1.9	1.3	2.5	2.4	2.4	2.4	2.4
Investments (net)	2.0	2.3	1.6	1.5	1.0	0.8	0.8	0.8	1.2	1.4
General Government Gross Debt (Authorities' definition) ^{4/}	51.5	56.3	65.5	69.9	74.1	77.2	79.0	80.7	82.5	84.3
NFPS Net Debt ^{2/}	30.5	32.6	35.6	46.2	51.6	56.5	59.9	63.4	66.7	69.5

1/ Data refers to the General Government and are calculated using the GFSM 2014 methodology. Fiscal balances are calculated through the General Government's revenues and expenditures statistics that are obtained from the Fiscal Responsibility Law's reports publicized by the each level of government. The values may differ from the fiscal statistics released by the Brazilian Central Bank (BCB) for the Non-financial Public Sector, which are calculated using below-the-line statistics obtained from the banking sector balance sheets under the methodology of the GFSM 1986.

2/ Values for the Non-financial Public Sector presented in the Nota para a Imprensa - Política Fiscal (Central Bank), using "below-the-line" statistics under the GFSM 1986. Projections for 2018 to 2020: IMF, Fiscal Monitor of January/2019.

3/ Congress passed a constitutional amendment in 2016 limiting the growth of the federal primary spending to the rate of consumer price inflation of the previous year (measured in June). This spending ceiling will be in effect for 20 years and, as long as nominal GDP growth exceeds consumer price inflation, the federal primary expenditure will decline as a share of GDP in the medium term.

4/ Brazilian Central Bank definition (2008 methodology), that excludes the Federal securities in the BCB portfolio and includes the stock of BCB repo operations.

Source: STN, BCB, IMF, World Bank calculations.

Table 3. Brazil: Balance of Payment Financing Requirements and Sources (US\$ billion), 2013 - 2022

	2013	2014	2015	2016	2017	2018	2019 (proj.)	2020 (proj.)	2021 (proj.)	2022 (proj.)
BOP financing requirements and Sources										
Financing requirements (US\$ million)	-122.0	-117.4	-118.0	-70.2	-63.0	-76.9	-79.0	-86.0	-91.1	-97.0
Current account	-79.8	-101.4	-54.5	-24.0	-7.2	-14.5	-30.2	-37.9	-43.0	-48.5
Long term debt amortization (excl. IMF)	-58.0	-49.6	-76.5	-70.9	-64.3	-70.9	-51.5	-50.9	-51.0	-51.6
Other short term capital outflows	15.8	33.6	13.0	24.7	8.6	8.6	2.7	2.8	3.0	3.1
Financing Sources (US\$ million)	122.0	117.4	118.0	70.2	63.0	76.9	79.0	86.0	91.1	97.0
FDI and portfolio investments (net)	54.4	52.2	43.3	10.5	2.6	11.0	44.9	41.6	41.1	40.7
Capital grants	0.3	0.2	0.5	0.3	0.4	0.4	0.2	0.5	0.5	0.5
Long term debt disbursements (excl. IMF)	60.5	71.2	72.9	55.2	58.7	63.6	48.9	51.4	53.6	56.7
Change in reserves	5.9	-10.8	-1.6	-9.2	-5.1	-2.9	-17.0	-9.7	-6.5	-1.0
Errors and Omissions	0.8	4.6	2.8	13.5	6.4	4.8	2.0	2.2	2.3	0.0

Source: IBGE, BCB, IMF, World Bank calculations.

13. **The difficult fiscal position extends to subnational governments.** The recent recession affected the States and Municipalities across the country, with many of them experiencing fiscal distress. Public expenditure, mainly on wage bill and public pension entitlements, grew as a result of pro-cyclical fiscal rules and growing demand for public services. When revenues collapsed, and federal transfers diminished



because of the recession, liquidity constraints became binding. Despite efforts to trim public investment and reduce non-essential current spending, expenditure commitments continue to grow, creating widespread financing gaps and arrears with providers and civil servants. In 2017, the Federal Government provided financial assistance to highly-indebted States in exchange for fiscal adjustment, but overall results have been limited despite the sizable fiscal cost for the federal government (R\$45 billion in forgone debt repayments by the end of 2018). Furthermore, there are limited instruments available to support states with little debt, which raises the risk of moral hazard and delays fiscal adjustment in states that benefit from federal support once they declare bankruptcy.

14. **Since 2016, the Federal Government has embarked on a long-term fiscal adjustment strategy anchored by a constitutional expenditure ceiling rule.** To stabilize its public debt, Brazil needs to generate primary surpluses of 1.5 percent of GDP until 2026. To restore fiscal sustainability, Congress approved in 2016 a constitutional amendment, limiting for twenty years the nominal growth of federal primary expenditure to the previous years' inflation. The rule implies a reduction in public expenditure as a share of GDP and a gradual stabilization of public debt over the coming decade. The fiscal rule will require reforms that reduce spending rigidities, including pension reform to control a growing pension deficit, and easing some legal (and sometimes constitutional) expenditure commitments. The new administration submitted an ambitious pension reform proposal to Congress in February 2019.

2.2. BRAZIL'S MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

15. **GDP growth is expected to accelerate to 2.2 percent in 2019.** Low inflation and interest rates along with gradually falling unemployment should allow for continued strengthening in household consumption. The recovery in private investment is expected to gain momentum only gradually, given low capacity utilization and policy uncertainty about the pace of structural reforms. Swift progress on reform implementation, including accelerating fiscal consolidation, removing regulatory and policy distortions in product and factor markets, and improving the business environment would positively affect GDP growth. Fiscal constraints on the other hand will hold back government consumption and public investment in the coming years and infrastructure development will highly depend on private sector participation.

16. **The recovery is expected to widen the current account deficit, that is expected to remain fully financed by FDI.** Recovery of domestic demand should result in increased imports in the coming years, curtailing the trade surplus and widening the current account deficit. As the recovery takes hold, and with the passing of structural reforms, FDI flows are expected to remain strong and sufficient to cover the current account deficit. Ample international reserves will continue to provide a cushion to external shocks.

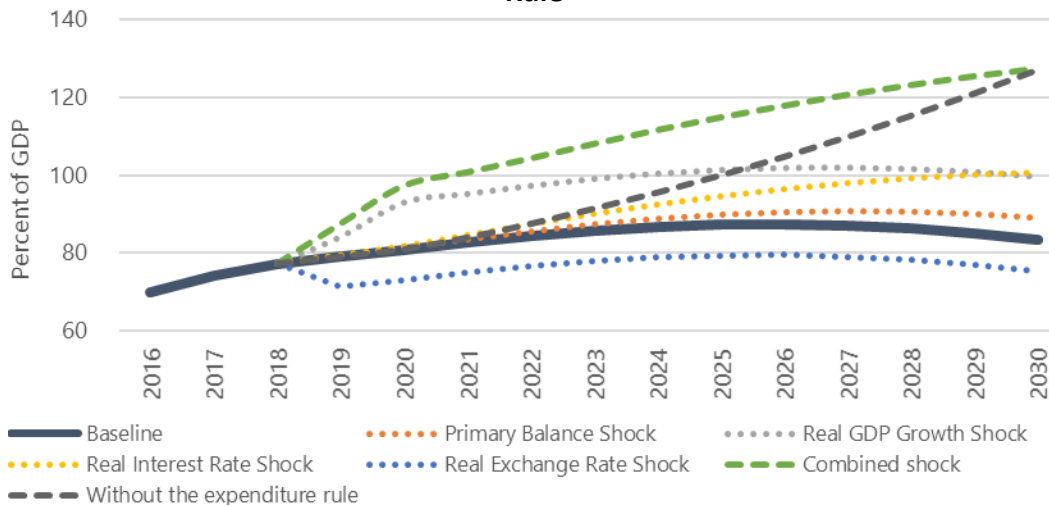
17. **Inflation is expected to remain well anchored, allowing for moderate interest rates that in turn will support economic activity.** Inflation increased to 3.9 percent by February 2019 but remains below the midpoint of the Central Bank's target range. Inflation expectations will remain well-anchored, already incorporating the lowering of Central Bank targets for 2019 (4.25 percent) and 2020 (four percent), which will provide space for continuous monetary policy easing in the near-term.

18. **Fiscal consolidation anchored by the fiscal rule is expected to proceed gradually, with public debt expected to stabilize by 2026.** The positive market sentiment over the past two years is based, at least in part, on the government's commitment to fiscal consolidation expressed in the federal



expenditure ceiling. However, for consolidation under this rule to succeed, the approval of structural reforms, especially pension reform, is essential and the government is expected to prioritize these reforms in the near-term. Compliance with the expenditure rule is expected to restore a primary surplus by around 2023 and stabilize gross public debt-to-GDP at 87 percent by 2026, and then falling gradually (Figure 1). Lower interest rates would reduce the primary surplus needed to stabilize the public debt, though the adjustment needed over the medium term is still large, at about 3 percent of GDP in the primary balance. While the baseline scenario (with the constitutional expenditure ceiling) results in a sustainable debt dynamic, the country remains vulnerable to real interest rates shocks and the combined shock scenarios. Without compliance with the federal expenditure ceiling, debt would be on an unsustainable trajectory, crossing 100 percent of GDP by 2025 and reaching 130 percent of GDP by 2030.

Figure 1: General Government Gross Debt Trajectory Anchored by the Constitutional Fiscal Rule



Source: IBGE, BCB, IMF, Brazil's Treasury and World Bank staff estimation (local definition of gross debt).

19. **Brazil's macroeconomic policy framework is deemed sustainable over the medium term and adequate for the proposed operation.** The budget for 2019 was approved on January 15, 2019 (Law 13.808/2019) and is in accordance with the expenditure rule. This, combined with the adoption of a pension reform and additional structural measures expected to be enacted in 2019, will ensure sustainability over the medium term. However, given the large fiscal deficit and projected gradual consolidation path, the economic outlook is subject to significant external and domestic risks. On the external front, uncertainties related to the policy mix of major advanced and emerging economies could result in disruptions to trade and capital flows, negatively affecting Brazil. Faster than expected hikes in U.S. policy interest rates could cause portfolio reallocations, fostering outflows from Brazil and placing pressure on the exchange rate. The high level of Central Bank reserves and the flexible exchange rate, acting as a shock absorber, would help to partly mitigate these risks. In fact, given the very low foreign currency exposure of the public debt, a strong depreciation is expected to reduce debt-to-GDP due to inflationary effects (figure 1). Domestically, the projected economic recovery and fiscal reforms may be hampered by political fragmentation and inability to adopt reforms in Congress. On the upside, progress on additional structural reforms could boost the economy's growth potential and deliver higher growth and faster fiscal consolidation over the medium term. The proposed operation is also expected to



contribute to mitigating fiscal risks, as it demonstrates a path towards resolving the subnational fiscal crisis without creating large additional liabilities for the Federal Government.

Box 1: Intergovernmental Fiscal Arrangements in Brazil

Brazil is a highly decentralized Federation with subnational governments responsible for the delivery of most public services. The constitution gives Brazilian state and municipal governments substantive fiscal autonomy and large spending responsibilities. Municipalities provide primary education and health care, and States fund most secondary schools and hospital care. Public universities are mostly federal, but many States also maintain public universities of their own. States are the primary provider of policing and public safety. State and municipal governments are also in charge of building and maintaining local and regional infrastructure, and delivering social protection programs.

States and municipalities also raise significant own tax revenues. The Brazilian constitution assigns taxation power to different levels of government. Brazil's largest tax by revenue, ICMS (*Imposto sobre Circulação de Mercadorias e Serviços*), is an indirect tax levied by the States on goods and selected services (inter-municipal transport and communication). The States also tax motor vehicles (IPVA) and inheritances and donations (ITCMD). Municipalities levy a services tax (ISS) on services not covered by the ICMS. They also tax urban properties (IPTU) and real estate transactions (ITBI). States and local governments are fully autonomous to define their tax bases and rates.

To provide public services, subnational Governments receive intergovernmental transfers. The Federal Government shares its tax revenues with States and municipalities through two general-purpose unconditional transfer funds, the *Fundo de Participação de Estados* (FPE) and the *Fundo de Participação dos Municípios* (FPM). The funds are constitutionally mandated, and their allocation is based on demographic factors with less developed states and municipalities receiving higher per-capita allocations. As a result, these participation funds are a predominant source of revenue for the poorer states and poor, rural municipalities. The Federal Government also provides specific transfers for education (FUNDEB) and health care (SUS) as well as capital transfers for specific programs (*convênios*). States also share 25 percent of the ICMS and 50 percent of the IPVA with municipalities.

Fiscal rules for subnationals are enshrined in the Fiscal Responsibility Law (*Lei de Responsabilidade Fiscal—LRF*) of 2000. To reduce the moral hazard problem in intergovernmental fiscal relations, the LRF explicitly prohibits debt refinancing operations between different levels of government. Complementary Senate resolutions also prohibit subnational borrowing if certain fiscal thresholds are not respected.⁶ The recent subnationals fiscal crisis made evident that the LRF and state-federal fiscal adjustment programs (PAFs) need strengthening. In response, the Federal Government approved: (i) a Fiscal Recuperation Regime for bankrupt states (LC 159/2017), and (ii) debt amortization extensions for states facing liquidity problems (LC 156/2016), conditional on fiscal adjustment measures. Further legislation may be needed to provide an instrument that supports adjustment of subnationals with limited debt but facing liquidity problems. The Bank is providing ongoing assistance to the National Treasury.

The ability of subnational governments to borrow is tightly regulated. States and municipalities cannot issue debt securities. Much of the stock of subnational debt is long-maturity debt due to the Federal Government as part of a 1997 bailout and is governed by State-Federal Fiscal Adjustment Programs (PAFs). Since 2016, the repayment conditions on these loans have been restructured, lowering near-term payments required from States. Subnational governments also have significant debt with public banks (BNDES, *Banco do Brasil* and CEF) and multi-lateral lenders (mostly IBRD and IADB), bilateral development partners and occasionally commercial banks. The Federal Government's system for authorizing federally guaranteed subnational debt (known as *Capacidade de Pagamento*, CAPAG) was reformed in 2017, with technical assistance from the World Bank, limiting federal discretion and

⁶ (i) the net consolidated debt exceeds twice net current revenue (*Receita Corrente Líquida – RCL*); (ii) new credit operations exceed 16 percent of RCL; (iii) debt service exceeds 11.5 percent of RCL; (iv) personnel expenditures exceed 60 percent of RCL. These rules however have been weakened by unclear accounting rules, which in many cases have excluded certain components of payroll spending. The Federal Government is in the process of tightening these standards.



requiring sufficient fiscal space (measured by the current savings rate) from subnational governments to qualify for federal guarantees.

2.3. RECENT ECONOMIC DEVELOPMENTS AND FISCAL SUSTAINABILITY IN MATO GROSSO

20. **The State of Mato Grosso has developed on the back of agricultural production but frontier expansion into forests could undermine economic progress going forward.** Mato Grosso is Brazil's third largest State by area (903,357 km², about the same as France and Germany combined) but home to only 3.4 million people (1.6 percent of the Brazilian population). Its GDP-per-capita (as of 2016) is the fourth highest among Brazilian states at US\$10,700. Over 50 percent of the State's GDP is related to agriculture and it has become a global powerhouse for soy and beef production, with 32 million tons of soy beans - 27 percent and 9 percent of Brazilian and global soy production, respectively - and 5.4 million heads of cattle raised in 2018. This agricultural expansion has historically taken place through clearing of forests, including in the Amazon biome. While average deforestation post-2010 has been 75 percent below its 2001-10 average, deforestation continues to be considerable and its pace has increased again since 2015. In 2018, 1,749 km² of forests were cleared in the Amazon biome (130 percent above the 2012 low point). The expansion of agricultural production into previously forested areas has historically been not only a leading contributor to carbon emissions,⁷ but also has likely come to the detriment of higher productivity.⁸ Moreover, interannual climate variability is impacting crop production patterns.⁹

21. **Despite the relatively strong local economy, the State Government is in fiscal crisis.** Mato Grosso has been relatively less affected by Brazil's recent economic recession, given its strong agriculture exports, with growth averaging 2.6 percent between 2011 and 2016.¹⁰ The unemployment rate in Mato Grosso stood at 8.4 percent in 2018, below the national average (12.3 percent). Yet, revenues trail economic growth as production of agricultural commodities for export is exempt by federal legislation from the State's value-added tax (ICMS) and States cannot tax rural properties.¹¹ Expenditure growth in turn has been high, driven by increases in public employment, a growing pension deficit and generous wage policies. This imbalance has resulted in a growing financing gap, covered by accumulating arrears. As a result, the State Government declared a state of "Financial Calamity" in January 2019, allowing extraordinary measures, such as a freeze on new hiring and career promotions, for an initial period of 6 months, to bring state finances under control.

22. **The State Government's financing gaps have been covered by accumulation of arrears.** Measured in accordance with the cash accounting methodology practiced in Brazil, the State Government has continued to produce primary surpluses. However, when including expenditures with payments in

⁷ An estimated 46 percent of Brazil's carbon emissions are due to land use change and another 22 percent to agriculture.

⁸ A recent paper comparing States across Brazil shows that by effectively enforcing the forest law, local governments can increase productivity in cattle ranching without hurting production. Municipalities which achieved reductions in deforestation were characterized by increases in cattle production and productivity, as limited resources are allocated to productive uses instead of deforestation efforts (Koch et. al 2018: "Agricultural Productivity and Forest Conservation: Evidence from the Brazilian Amazon." <https://doi.org/10.1093/ajae/aay110>).

⁹ Cohn et al (2016): "Cropping frequency and area response to climate variability can exceed yield response." *Nature Climate Change* 6, no. 6 (2016): 601 (<https://www.nature.com/articles/nclimate2934>).

¹⁰ According to IBGE data, which is only available for States up to 2016.

¹¹ The rural property tax (*Imposto sobre a Propriedade Territorial Rural – ITR*) is assigned to the Federal Government.



arrears, the State Government has faced significant fiscal deficits and financing gaps since 2016. The estimated accrual-based financing gap peaked in 2017 at 8.1 percent of revenues and was reduced in 2018 by increasing revenues and cutting investment 32 percent (table 4).¹² Yet, the stock of arrears, including salaries and payments to service providers, continued to rise to R\$2.4 billion (14.9 percent of revenues) at the end of 2018 (table 5). Table 4 provides a World Bank estimate of Mato Grosso's recent fiscal outcomes on an accrual basis (including expenditures with payments in arrears), while table 5 provides fiscal information and projections in accordance with the State's cash accounting practice.

Table 4: Mato Grosso estimated fiscal balances including arrears (2015-2018, current R\$ million)

	2015	2016	2017	2018
I. Current Revenues	13,249	14,361	15,151	16,113
II. Total Expenditures (including arrears)	12,143	14,234	15,893	16,386
Current Expenditures (accrual basis estimate)	11,512	13,449	14,984	15,766
Investment	631	785	909	620
III. Overall Balance (accrual basis estimate) (I-II)	1,106	127	-742	-273
<i>% of revenues</i>	8.3%	0.9%	-4.9%	-1.7%
IV. Net Financing (loans + asset sales - amortizations)	-344	-240	-482	62
V. Financing Surplus/Gap (accrual basis estimate) (III + IV)	761	-112	-1,224	-211
<i>% of revenues</i>	5.7%	-0.8%	-8.1%	-1.3%

Source: SEFAZ Mato Grosso, World Bank calculations.

23. **Mato Grosso Government's expenditures have been dominated by high and rising personnel costs.** Spending on payroll and pensions in Mato Grosso has grown 69 percent in real terms from 2011 to 2018, expanding from 50 percent of total public spending in 2011 to 74 percent in 2018. The state provides personnel-intensive public services (see Box 1) and about one-third of the spending increase is explained by a rise in the numbers of active and retired staff on payroll, with the number of retirees growing at about double the rate of active staff. Most of the increase is due to salary growth, in part due to a 2004 law that grants civil servants universal wage adjustments for inflation, and a 2013 law that aimed to double real wages for teachers between 2014 and 2023. Laws governing career structures also allow for rapid pay increases based on seniority and formal qualifications rather than performance. The State also faces a rapidly increasing pension deficit, as the number of retired civil servants is growing fast, and their pensions are linked to the wages of active staff.¹³ This imposes most of the fiscal adjustment on other current expenditures, and investments that have declined from 40 and seven percent of total spending in 2011 to 20 and four percent, respectively, in 2018. The state also has significant budgetary rigidities as 27 percent of tax revenues are earmarked for education (set in the State's constitution to increase gradually to 35 percent by 2035) and 12.5 percent for health.

24. **The fiscal adjustment supported by this operation, combined with other measures, is expected to close the financing gap and enable a resumption of public investment by 2022.** Given the unsustainable trend in fiscal aggregates and accumulation of arrears, the State Government has embarked on an ambitious fiscal adjustment program. This program includes short term spending cuts as well as structural expenditure reforms and revenue measures supported by this operation. It is expected that

¹² The reconciliation of the State Government's official figures based on cash-accounting and accrual-based figures calculated by the World Bank is tentative, using aggregate figures on cash balances and payments in arrears provided by the State Government.

¹³ This is the case for all civil servants who entered service before 2003, which make up virtually all current retirees and the majority of retirees in the next decade. Among those who entered after 2003, only uniformed personnel (military police, fire brigades) retain this benefit.



these measures will put the State in a position to generate increasing primary surpluses, which combined with the policy financing provided by this operation, are expected to allow the State Government to clear its arrears and increase public investment in the medium-term, all while reducing short-term debt.

25. **While the State's debt stock is not large, its maturity structure is heavily weighted on the short term.** The State Government's total contractual debt at the end of 2018 was R\$6.9 billion which is equivalent to about 5 percent of the State's GDP. The State Government's net-debt as a share of net current revenue stands at 45.9 percent, well below the limit permitted under Brazil's Fiscal Responsibility Law (200 percent). A large share of the State's debt is with the Federal Government and federal public banks, but 21 percent of debt is in foreign currency with foreign banks, and due for repayment within three years. The proposed operation would provide resources that are expected to help the State Government improve its debt profile while restoring adequate short-term liquidity and long-term fiscal sustainability.

26. **A successful multi-year fiscal adjustment program would allow the State Government to recover fiscal space for public investment.** The State's investment rate has been low at an average of four percent of revenue between 2015 and 2018, most of which was financed with ongoing disbursements of loans contracted prior to 2015. This contrasts with the State Government's large investment needs in infrastructure, given the extensive geography, growing agricultural production and population (16 percent growth from 2008 to 2018). With the containment of current expenditure under the proposed operation, it is expected that fiscal space for public investment will materialize by 2021-2022, when the current stock of arrears has been cleared. Also, the operation will support the fiscal adjustment required to receive in the medium term guarantees from the Federal Government for new borrowing for investment.

27. **Intergovernmental fiscal relations are adequate** (See box 1 for a discussion of inter-governmental fiscal relations in Brazil). The Federal Government regulates borrowing of subnational entities and the recent deterioration of Mato Grosso's finances disqualifies the state to receive federal guarantees for new loans, effectively cutting off access to credit financing and forcing fiscal adjustment. However, the Fiscal Responsibility Law and other federal regulations foresee that federal guarantees can be made available for states that have committed to fiscal adjustment. In conclusion, the Government of Mato Grosso's debt is sustainable, and its expenditure program and fiscal arrangements with the Federal Government of Brazil are adequate for the purposes of this operation.

**Table 5: Mato Grosso Fiscal Balances 2015 – 2022 (R\$ million, cash basis unless specified otherwise)**

<i>R\$ Million (constant 2018 prices)</i>	2015	2016	2017	2018	2019f	2020f	2021f	2022f
I. CURRENT REVENUES	15,034	15,332	15,719	16,113	16,818	17,722	18,251	18,540
Taxes (net of transfers to municipalities)	7,157	8,099	8,635	9,434	9,878	10,215	10,583	10,804
ICMS	5,419	5,435	5,665	6,295	6,479	6,782	7,091	7,262
IPVA	242	250	254	295	302	310	317	325
FETHAB (commodities and fuel)	392	959	1,344	1,281	1,512	1,503	1,511	1,510
Other taxes	1,103	1,454	1,371	1,563	1,584	1,621	1,663	1,707
Social Contributions	638	740	733	851	919	995	1,080	1,075
other contributions (including FEEF)	382	119	172	181	270	275	187	96
Transfers	4,015	4,650	4,165	3,936	4,018	4,505	4,667	4,830
Other Current Revenues (incl. interest)	2,842	1,724	2,014	1,711	1,732	1,733	1,734	1,735
Interest Revenues	264	330	187	100	100	100	100	100
II. CURRENT EXPENDITURES	12,558	13,696	14,730	15,276	15,270	15,530	15,816	16,108
Compensation of Employees	8,905	9,927	10,851	11,696	11,837	12,108	12,428	12,758
Active personnel	6,369	7,108	7,582	8,003	7,829	7,771	7,731	7,692
Pensions	2,536	2,820	3,269	3,692	4,008	4,336	4,697	5,066
Interest Payments	536	406	395	398	413	388	347	304
Other Current Expenditures	3,116	3,362	3,484	3,182	3,020	3,033	3,041	3,046
III. GROSS OPERATING BALANCE (I - II)	2,476	1,636	990	837	1,547	2,192	2,435	2,432
<i>% of current revenues</i>	16.5%	10.7%	6.3%	5.2%	9.2%	12.4%	13.3%	13.1%
IV. CAPITAL EXPENDITURES	716	838	943	620	524	523	692	1,181
Investment in Non-Financial Assets	704	836	938	619	523	522	692	1,181
Investment in Financial Assets	12	1	6	0	0	0	0	0
V. OVERALL BALANCE (III - IV)	1,759	798	46	217	1,024	1,670	1,743	1,251
VI. PRIMARY BALANCE (V + Net Interest Payments)	2,031	874	254	515	1,337	1,958	1,990	1,455
<i>% of current revenues</i>	13.5%	5.7%	1.6%	3.2%	7.9%	11.0%	10.9%	7.8%
VII. FINANCIAL TRANSACTIONS	-391	-256	-500	62	-54	-219	-561	-553
New Loans	272	393	170	554	1,473	335	0	0
Amortizations, net	-673	-650	-677	-498	-1,533	-561	-567	-560
Amortizations received	4	0	1	2	2	2	2	2
Amortizations paid	677	650	678	500	1,535	563	569	562
Asset sales	11	2	7	6	6	6	6	6
VIII. FINANCIAL BALANCE (V + VII)	1,369	542	-454	279	970	1,450	1,182	698
<i>% of current revenues</i>	9.1%	3.5%	-2.9%	1.7%	5.8%	8.2%	6.5%	3.8%
IX. ARREARS FINANCING (net, + accumulation/- clearance)	505	662	816	490	(970)	(1,915)	(823)	0
Stock of arrears	571	1,199	1,981	2,400	1,915	823	0	0
<i>% of current revenues</i>	3.8%	7.8%	12.6%	14.9%	11.4%	4.6%	0.0%	0.0%

Source: SEFAZ-MT, World Bank calculation and projections (2019-2022)

2.4 IMF RELATIONS

28. **The federal authorities maintain an ongoing dialogue with the IMF on macroeconomic policy in Brazil.** The IMF concluded the last Article IV consultation on Brazil with a board meeting on July 9, 2018. During the preparation of this DPL, the World Bank discussed with the IMF fiscal and structural issues related to this operation. The Bank and the IMF have also collaborated closely in supporting the Federal Government in linked and complementary areas, including a Financial Sector Assessment Program, public financial management, and public investment management. The IMF has provided technical assistance to the Brazilian authorities in areas, such as, fiscal transparency and public financial management reforms required to implement the new expenditure rule (see the IMF Relations Note in Annex 2); while the Bank



has recently concluded a Public Expenditure Review in collaboration with the Federal Government.¹⁴ The Bank has also been in consultation with other international financial institutions in Brazil.

3. GOVERNMENT PROGRAM

29. **Mato Grosso's new government has expeditiously moved into accelerating fiscal adjustment and sustainable management of its natural resource base.** The current State Governor won the October 2018 state election in the first round with 58.7 percent of valid votes. Upon taking office in January 1st, 2019, the new administration urgently addressed the State Government's fiscal crises, starting with the declaration of "financial calamity". By end of January 2019, it had approved a package of fiscal adjustment and reform measures termed *Pacto por Mato Grosso* (Pact for Mato Grosso). The package focuses on expenditure control, including the State Fiscal Responsibility law (PA#1), changes to public sector pay adjustments (PA#2), changes of the State's public pension system and an administrative reform, reducing the number of State Secretariats and allowing for the closure of State companies. It also increases levies on the main agricultural commodities produced in the State (PA#5). Moreover, the multi-stakeholder PCI program has become a critical instrument to develop and implement a sustainable natural resources-based growth model. The package focuses on scaling-up efforts to reduce deforestation and forest fires (PA#6), accelerating implementation of the environmental regularization in private properties (PA#7), and institutionalizing the PCI strategy (PA#8).

30. **Fiscal adjustment and sustainability are a key priority for the new Government, with a medium-term plan currently being developed.** In his opening speech to the legislature, the Governor emphasized the State's broken public finances and the need to address the fiscal crisis swiftly, as a pre-condition to achieving other government priorities such as improved outcomes in health and education. These priorities are aligned with the governor's program for the 2018 election, which focused on reducing the state bureaucracy and increasing the efficiency of public spending. The program also called for supporting the sustainable management of forests and progress in environmental regularization of rural properties and recovery of degraded areas, as key drivers to the agricultural sector growth.¹⁵ The State Government is currently elaborating a new medium-term plan (*Plano Pluriannual*, PPA) for the 2020-2023 period.

4. PROPOSED OPERATION

4.1. LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

31. **The Program Development Objectives are to support the State of Mato Grosso to regain fiscal sustainability and to increase institutional capacity for sustainable agriculture, forest conservation and climate change mitigation.** It does this by supporting key elements of the State's fiscal adjustment and sustainable rural development agenda while providing financing of US\$250 million that will address the State's near-term funding needs, improving the debt profile and supporting clearance of arrears.

¹⁴ World Bank (2017), A Fair Adjustment: Efficiency and Equity of Public Spending in Brazil, Report N. 121480, pp. 121-126.

¹⁵ The election program can be found at:

http://divulgacandcontas.tse.jus.br/candidaturas/oficial/2018/BR/MT/2022802018/110000612713//proposta_1534268657172.pdf.



32. **The proposed DPL will support policies anchored in the two key elements of the government’s development strategy: fiscal sustainability and management of the nature-based engine of economic growth.** The operation’s fiscal sustainability pillar is aligned with the State Government’s “Pact for Mato Grosso”, taking on board several of the pact’s measures as prior actions. The operation explicitly supports the State’s institutionalization of a fiscal sustainability framework through the State’s Fiscal Responsibility Law (LC 614/2019). It also supports other measures to contain expenditures and broaden the revenue base, responding to the severe fiscal crisis and aiming to restore fiscal space that will allow the State Government to access borrowing with federal guarantees in the medium term. This fiscal program supported by this operation goes beyond the previous attempts to address the fiscal crisis. In late 2017, the State Government enacted a constitutional limit on aggregate current expenditure, but failed to effectively address the expenditure pressures coming from payroll and pensions. Consequently, the Government failed to comply with the expenditure limit in 2018 and the fiscal crisis deepened further. The operation’s pillar on sustainable agriculture and forest conservation is aligned with the new Government’s program, particularly on land regularization, forest protection and transparency and efficiency in the implementation of environmental policies. The policies under this pillar are fundamental to the State’s flagship sector program for climate change action and rural development called “Produce, Conserve, Include” (PCI).

33. **The design of the fiscal pillar incorporates lessons learned from previous subnational DPFs in Brazil:**¹⁶ Between FY09 and FY16 the Bank has undertaken a total of 20 subnational DPFs in Brazil, many of which contained fiscal pillars. A number of them have not been assessed as satisfactory ex-post. Key lessons from the evaluation of these operations are: (i) subnational DPFs to support fiscal adjustment programs in states and municipalities need to include fiscal measures that are sufficient to achieve relevant fiscal outcomes, and these measures need to be front-loaded to contain moral hazard; (ii) ownership and leadership at the highest level are needed to successfully implement reforms, and the beginning of the political cycle is the most promising time for reforms; (iii) selectivity in the choice of sectors is key to keep the operation focused and deliver meaningful results; (iv) DPFs can serve as a vehicle for deepening the policy dialogue on fundamental issues, with the Bank providing technical knowledge; and (v) close collaboration with the relevant federal agencies (STN) strengthens the design of a fiscal program and monitoring of subnational governments’ fiscal status. These lessons are reflected in the proposed operation, which: (i) supports a highly relevant reform program to restore fiscal sustainability with strong ownership of the State Government at the beginning of the political cycle; (ii) supports reforms in just two crucial sectors; (iii) includes technical assistance in the form of fiscal, pension and wage bill modelling; and (iv) has been jointly prepared with STN and the staff of the State.

34. **The design of the second pillar benefited from the experience of the Piauí Green Growth and Inclusion Development Policy Loan (P126449), the first subnational DPL in Brazil focusing on climate change and environmental issues:** (i) given the multi-actor nature of the PCI plan, it is crucial to engage multiple stakeholders beyond the environment and agricultural sectors into the policy discussion and implementation; (ii) there is a need to institutionalize these long-term policies to ensure continuity across administrations; and (iii) there is also a need to establish early on adequate monitoring and evaluation tools to track policy implementation and fulfillment of program targets. The policies supported by this operation incorporate these lessons as follows: (i) they include the state legislative assembly,

¹⁶ These lessons are based on IEG ICRR reports from FY14 to FY18, and also the Completion Learning Report prepared as part of the Brazil CPF FY17-FY23, endorsed by the Board in July 2017 (Report N. 63731-BR).



international organizations, private sector and academia to ensure strong inter-institutional leadership and coordination; (ii) they support the institutionalization of the PCI to ensure long-term policy continuity in this area; and (iii) further, the second pillar supports policies with strong monitoring and evaluation mechanisms such as the interagency process for the rural land cadaster (CAR) and the multi-stakeholder *Instituto PCI*.

4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar A: Regaining Fiscal Sustainability

35. **Restraining current expenditures is crucial for the Government of Mato Grosso to restore fiscal sustainability.** The World Bank prepared jointly with the government of Mato Grosso and the Brazilian National Treasury (STN) an in-depth diagnostic of the State Government's finances.¹⁷ Beyond the cyclical reduction in revenues associated with the recent economic recession, the current fiscal crisis has deeper structural roots, notably related to the continued, rapid expansion of primary current expenditures, especially payroll and pensions. Previous government efforts to reduce investment or maintenance expenditures failed to close the financing gap, resulting in arrears with providers and delays in civil servants' salary payments. Therefore, unless structural measures to contain spending are adopted, expenditure pressures will result in increasing fiscal deficits, even if economic activity and fiscal revenues recover.

36. **Based on the results of the in-depth fiscal diagnostic, the State Government has adopted a fiscal adjustment package to restore fiscal sustainability.** In November 2017, the State adopted a constitutional amendment (EC 81/2017) that limits the growth in current spending to the rate of inflation for five years. These spending limits are binding individually for the expenditures of each branch of the State Government.¹⁸ However, in 2018, the executive branch did not comply with its spending limit, as personnel costs continued to grow significantly in real terms (7.8 percent), resulting in payment arrears to public employees and suppliers. To close the financing gap and be able to continue providing quality public services for the population (notably health, education, and public security), the legislature adopted in January 2019 a structural reform program, "The Pact for Mato Grosso". It includes the State Fiscal Responsibility Law (PA#1), an administrative reform reducing the number of State Secretariats and authorizing the closure of loss-making state enterprises, specific measures on controlling payroll spending (PA#2) and revenue increases (PA#4 and PA#5). It streamlines the governance of the State's civil service pension agency (PA#3), a key reform to approve structural changes to the State's pension system which will likely be needed once the Federal Government reforms national pension rules. These measures are expected to generate an improvement of the annual operating fiscal balance of almost R\$3 billion (13.7 percent of revenues) by 2022, with two-thirds of this resulting from the control of personnel expenditures (see Figure 2 and Table 6).

¹⁷ The fiscal analysis was prepared at the request of the government of Mato Grosso. It incorporates World Bank pension projections (PROST model) pension model and micro-simulations of the State's wage bill.

¹⁸ The different powers covered by the Law are executive, judiciary, legislative, court of accounts and *Ministerio Público*.



Table 6: Expected annual fiscal gains from supported measures (R\$ million)

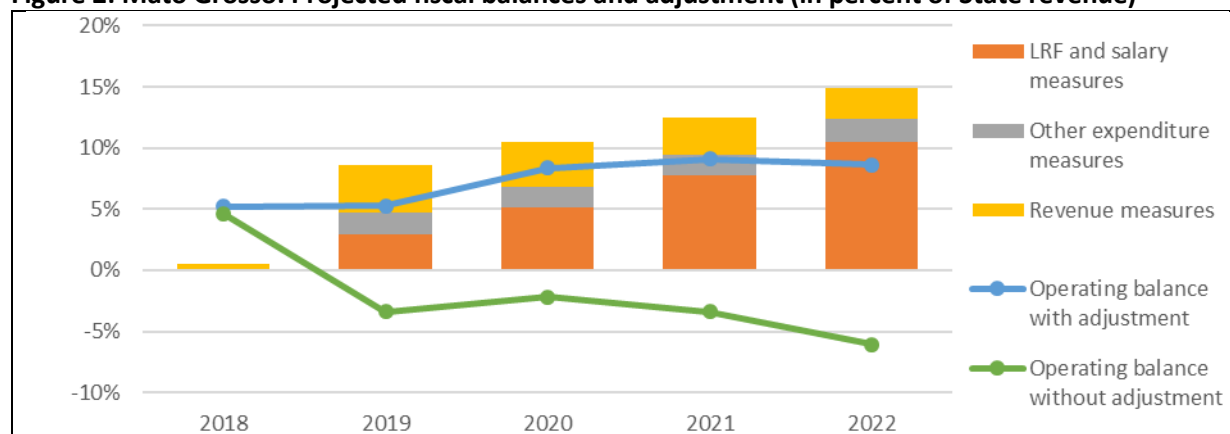
Measure	2018	2019	2020	2021	2022
DPL Program measures	85	991	1,479	1,949	2,539
as % of current revenue	0.5%	5.7%	7.7%	9.5%	11.8%
LRF and salary measures*	-	516	985	1,583	2,266
Fiscal Emergency Fund (FEEF)	85	182	193	103	-
Increased FETHAB (non-earmarked)	-	293	301	262	272
Other expenditure measures**	-	317	330	343	413
All measures	85	1,308	1,809	2,292	2,951
as % of current revenue	0.5%	7.5%	9.4%	11.2%	13.7%

* since their impact overlaps, they are assessed jointly

** includes administrative reforms and spending cuts triggered by the "financial calamity" declaration

Source: World Bank fiscal diagnostic modeling in collaboration with Mato Grosso State Government and Brazilian National Treasury.

Figure 2: Mato Grosso: Projected fiscal balances and adjustment (in percent of State revenue)



Source: World Bank fiscal diagnostic modeling, in collaboration with Mato Grosso State Government and Brazilian National Treasury.

Prior Action 1: The Borrower has enacted legislation that clarifies and tightens personnel spending limits and sets targets for current savings, as evidenced by the adoption and publication of the Borrower’s Fiscal Responsibility Law (Law No 614/2019).

37. **Rationale:** Fiscal policy in all Brazilian states has been governed since 2000 by the national Fiscal Responsibility Law (LRF, LC101/2000). It enshrines basic sustainability principles and monitoring mechanisms, but over time its effectiveness has been eroded. First, it links key expenditure items (i.e. wage bill) to revenue collection, raising public expenditure in boom times but constraining fiscal adjustment when revenues fall, given strict civil service management rules. Second, monitoring is undermined as accounting rules are subject to divergent interpretations by the states. To overcome these shortcomings, states can adopt their own fiscal rules to better reflect their economic realities and address fiscal challenges, while the minimum standards of the national LRF continue to apply. In the case of Mato Grosso, this calls for a greater control of current expenditures (mainly wage bill), limits on tax-incentives granted by the State Government and more prudent revenue and expenditure planning procedures.



38. **Substance of the prior action:** The State has adopted its own Fiscal Responsibility Law (LC 614/2019) that complements the national LRF and provides more stringent expenditure rules, especially to manage the wage bill in the executive branch. It provides a clearer and broader definition of personnel expenditures that reduces the scope of interpretation (i.e. related to exclusion of pension contributions and income taxes). It also clarifies the definition of “adjusted net current revenue” which defines the available revenues for discretionary spending once all revenues earmarked for other purposes (*receita vinculada*) are accounted for. The law states that: (i) when total personnel spending exceeds 60 percent of “adjusted net current revenue” salaries cannot be increased, even if pay rises were approved in previous laws; (ii) current administrations cannot approve pay increases that come into effect in subsequent administrations; (iii) any new expenditure program must be evaluated by the Secretariat of Finance (SEFAZ) for fiscal impact and sustainability; (iv) the total amount of tax incentives that can be provided to businesses on any given tax is limited to a fixed percentage of gross revenues from that same tax (25 percent for ICMS); and (v) the State Government must achieve a current savings rate of 8 percent in the medium term (8 years). Achieving this savings rate would allow the State to regain access to borrowing with federal guarantees.

39. **Expected Results:** The law is expected to increase current savings as a percentage of adjusted net current revenue from 3.6 percent as measured in 2018 (using data up to 2017 as baseline) to five percent (target) by 2021. The current savings are to be assessed using the current savings indicator established and published by the STN.¹⁹

Prior Action 2: *The Borrower has enacted legislation that conditions annual adjustments of the Borrower’s civil servants’ salaries on the Borrower’s fiscal capacity, as evidenced by the adoption and publication of Law No 10.819/2019.*

40. **Rationale:** The approved law modifies a pre-existing State law (Lei 8.273/2004) that regulates pay increases to all civil servants²⁰ foresees adjustment in line with the national consumer price index. Although the law foresaw that the State’s financial capacity should be considered when granting salary increases, in practice, they have been automatic.²¹ Salary increases of active staff are also applied to all retirees who entered the civil service before 2003, virtually all current retirees and the majority of new retirees over the next decade.²² All these norms have contributed to Mato Grosso Government’s payroll spending soaring from R\$5.8 billion in 2013 to R\$11.7 billion in 2018. It is estimated that the employees of Brazilian States enjoy an average wage premium of 31 percent over formal private sector employees (controlling for education and experience), and the Mato Grosso civil service is among the highest paid in most categories.²³ Therefore, a reduction in the growth of public sector salaries is justified on grounds of both equity and efficiency.

¹⁹ As the STN indicator defined as (current expenditure / current revenue), current savings is calculated as (1- STN indicator).

²⁰ Known as “General Annual Readjustment” (*Reajuste Geral Anual*, RGA).

²¹ Given already binding liquidity constraints, increases for 2017 and 2018 were delayed and rescheduled over seven separate increments during 2018 and 2019 (Lei 10.572/2017). This resulted in a lower adjustment in 2017 but increased scheduled salary increases for 2018 and 2019 (to 10.6 percent cumulative increase).

²² This benefit, known as *paridade*, was abolished for most new public servants by the 2003 pension reform. Only uniformed personnel (military police, fire brigades) retain this benefit. Retirees only make contributions on the amount of their benefits that exceeds the ceiling of social security benefits (R\$5,645.89 per month in 2018).

²³ See: World Bank (2017): A Fair Adjustment. Efficiency and equity of public spending in Brazil, p. 46.



41. **Substance of the prior action:** The modification introduced by Law 10.819/2019 formalized the fiscal conditions that need to be met for the inflation-based adjustment to be granted. The law stipulates that to adjust salaries in line with inflation, the state must: (i) have available fiscal capacity (ordinary net revenues greater than total expenditures not financed from other sources), considering the most recent 12 months data; and (ii) ensure that any salary increase would not lead to a loss of this fiscal capacity.

42. **Expected Results:** Given a current lack of fiscal capacity, it is expected that wage bill as a share of net-current revenue²⁴ would be reduced from 67.85 percent (in 2018) to 60 percent (FRL legal limit) in 2021. This would be critical to ensure fiscal adjustment and restore the State's performance under the LRF's indicator on personnel spending (as assessed externally by the STN) by 2021.

Prior Action 3: *The Borrower has enacted legislation that strengthens the governance of its pension agency (MTPREV) by transferring the authority to approve actuarial studies and propose financing plans, as evidenced by the adoption and publication of Law No 613/2019.*

43. **Rationale:** The deficit of the State's civil service pension system has increased from R\$0.7 billion in 2014 to R\$1.2 billion in 2017 (a 71 percent increase in real terms), absorbing 8.2 percent of State net current revenues.²⁵ As the number of retirees relative to active staff is expected to grow by 40 percent over the next decade, actuarial projections made by the Bank using the Pension Reform Options Simulation Toolkit (PROST) model, highlight that the pension deficit is expected to grow by 41 percent real terms over the next ten years. Therefore, in the absence of reform, the pension deficit will absorb an even larger share of government resources jeopardizing the delivery of essential public services by the State. The MTPREV was created in 2014 to be the single administrator for the State's pension system, incorporating the systems of all government branches and autonomous organs. However, the incorporation of the non-executive branches foreseen in the law has still not taken place. These branches however are represented in the MTPREV Council, allowing them to prevent changes to the pensions system governed by MTPREV, even though they are not currently subject to it. Specifically, it has undermined the inability of MTPREV to commission of actuarial studies showing growing deficits and approve proposals aimed at addressing these deficits in the MTPREV council, even before any such proposals could be advanced to the legislature for approval.²⁶

44. **Substance of the Prior Action:** Complementary Law 613/2019 modifies the Law which created the MTPREV (LC 560/2014), stating that, while the integration of government branches to the MTPREV has not been completed, the MTPREV directory rather than the MTPREV council will be authorized to approve actuarial studies and propose financing plans for deficits identified in these studies, which includes the proposal of parametric changes to be considered by the legislature. This is a necessary first

²⁴ As published by the STN's Boletim de Finanças dos Entes Subnacionais, using PAF methodology.

²⁵ The deficit of the public pension system is defined as the State's expenditures on old age and survivor's pensions, less the contributions made by state employees (11 percent of salary), the regular contribution made by the State as the employer (22 percent of salary), and the compensation received by the National Social Security Institute (through COMPREV).

²⁶ Most key parameters of civil service pension regimes (notably, the rules governing retirement age and replacement rates) are enshrined in the Federal Constitution. One of the parameters which Brazilian States can modify by themselves is the employee contribution currently at 11% in most States (Courts' interpretation of the Federal Constitution defines a maximum of 14 percent). States can also reduce long-term deficits by only guaranteeing incomes up to the national social security limit and offering a system of individual, capitalized accounts (*previdência complementar*) beyond this.



step in proposing parametric reforms that can mitigate the current deficit, regardless of whether such reforms are based on current federal pension legislation or aim to adjust Mato Grosso's pension system to changes introduced by a yet-to-come pension reform at the federal level.

45. **Expected Results:** It is expected that the changes to the MTPREV governance will allow the State to make parametric changes to its pension system, aimed at reducing short- and long-term deficits. However, given the ongoing discussion on pension reform at the federal level, the form that these parametric changes will take remains unclear. Nevertheless, it is expected that the annual deficit of the State's pension system, which in 2018 was estimated to reach 9.1 percent of the State's net current revenues by 2021 (based on World Bank PROST model), will be contained at no more than 8.5 percent (expected result in 2021).

Prior Action 4: *The borrower has enacted legislation that establishes its State Fiscal Equilibrium Fund (FEEF) to increase public revenues from companies benefitting from tax incentives, as evidenced by the adoption and publication of Law No 10.709/2018.*

46. **Rationale:** Brazilian States award far-reaching tax benefits to attract investment, create employment and broaden the tax base, as ICMS – a VAT tax on goods that is the main own-source of revenue for several states – is paid based on where the good is produced instead of where it is consumed. This has resulted in significant overall loss of revenues for the states as a whole, despite efforts to coordinate tax incentives through the National Fiscal Policy Council (*Conselho Nacional de Política Fazendária, CONFAZ*). The State of Mato Grosso is no exception and fiscal incentives are estimated to forgo tax revenues (mostly of ICMS) of R\$3.5 billion a year, or 27 percent of expected total tax revenues in 2018. The two main programs granting tax benefits in the State are the *Programa de Desenvolvimento Industrial (PRODEI)* and the *Programa de Desenvolvimento Industrial e Comercial (PRODEIC)*. Benefits under these programs are granted to a large number of companies and for long periods of time (10 years under the PRODEIC). The concession of new benefits is already limited by the State's new Fiscal Responsibility Law, but there is also a need to recover a part of previously granted tax expenditures, in a way consistent with the legislation which granted these benefits.

47. **Substance of the Prior Action:** Considering its situation of fiscal distress, the State created in June of 2018 a fiscal emergency fund (*Fundo Emergencial de Estabilização Fiscal, FEEF*). Under Law 10.709/2018, companies benefitting from certain tax exemptions are obliged to contribute to the fund, which amounts to a partial and temporary “claw-back” of the previously granted tax benefit. For those benefitting from the PRODEI and PRODEIC contributions are set between 10 and 20 percent of the benefit received (depending on sector of operation) until June 2021 when the FEEF is set to expire.

48. **Expected Results:** The FEEF already raised R\$85million in 2018 and the total cumulative revenues are expected to reach R\$400 million by 2021, to be primarily dedicated to the payment of arrears in the health sector. Going forward, the provisions in the State's Fiscal Responsibility Law limiting tax expenditures is expected to reduce the amount of benefits conceded by the State.

Prior Action 5: *The Borrower has enacted legislation that increases the per-unit levies charged on agricultural commodities produced in the Borrower's territory, as evidenced by the adoption and publication of Law No 10.818/2019.*



49. **Rationale:** The State's main economic activity is export-oriented agriculture, which is exempt of ICMS taxation by federal law. To capture part of the State's agricultural value added and to provide for important public infrastructure, the Government of Mato Grosso created the State Fund for Transport and Housing (*Fundo Estadual de Transporte e Habitação, FETHAB*) in 2000.²⁷ A levy is charged on the State's main agricultural export crops (soy, maize, cotton, cattle, wood) and on diesel fuel consumption. The contributions on commodities are set as a per-unit levy, which are adjusted for inflation every six months and collected R\$870 million in 2018.²⁸ Resources are shared with municipalities and, until 2018, were largely earmarked for investments in transport infrastructure and housing. At the end of 2018, higher rates on commodities expired, threatening a reduction of FETHAB revenues by around 32 percent (see table 6 for details on FETHAB contribution rates). Although it is not its main objective, the levy is also contributing to the State's climate change mitigation efforts. The levy on cattle is estimated to amount to a R\$9.25 (US\$2.5) tax per ton of CO₂ equivalent.²⁹ Since the effective tax rate is highest on inefficient, low-value producers, evidence exists that the introduction of this tax has supported intensification of livestock production, which leads to a reduction in carbon emissions per kilogram of beef. The introduction of the levy on wood has also been shown to have reduced deforestation.³⁰

50. **Substance of the Prior Action:** The State has adopted Law 10.818/2019 to: (i) renew the FETHAB on commodities for four years (2019-2022); (ii) set rates on agricultural commodities above the rates prevailing until December 2018 (significantly in the case of cotton, see table 7), broadening the coverage of the FETHAB on livestock production and introducing a new levy on maize destined for out-of-State consumption; and (iii) increase the non-earmarked share of revenues from 30 percent to 60 percent for 2019 and 2020, then declining gradually to 40 percent by 2023, and thereby providing greater budget flexibility to the State.

51. **Expected Results:** The reform is expected to increase annual revenues from the FETHAB levies on agricultural production from R\$870 million in 2018 to R\$1,350 million by 2021. Also, the reform increases the per-unit tax on activities that are directly linked to carbon emissions (particularly cattle raising) and is expected to have an impact on reducing carbon emission through a reduction in these activities and by providing an incentive to switch to more efficient, high-value added methods of livestock management that result in lower carbon emissions.

²⁷ The FETHAB was restructured in 2015 (Lei nº 10.353/2015). Also, rates were increased in 2017 and 2018 (Lei nº 10.480/2016), doubling the rates levied on agricultural commodities (except cattle) and increasing the rate on diesel fuel from R\$0.18 per liter to R\$0.21.

²⁸ For diesel fuel, the tax is set directly as a nominal value (currently R\$0.21) per liter. The FETHAB on fuel does not generate net-revenues as tax payers can deduct the amount paid from the regular state tax on fuel (ICMS).

²⁹ Based on enteric emissions estimates in EMBRAPA (2016) and exchange rate of January 2019.

³⁰ Impacts on cattle are based on discussion with agricultural associations. The impact on wood is studied by Dalfovo (2016).



Table 7: FETHAB levies by product (R\$)

Product	Unit	Levy until 2018	Fallback levy (before 2019 law)	New levy under 2019 law	Estimated ad-valorem (%)
Cotton	R\$ per ton	28.69	14.34	104.60	1.63%
Soy	R\$ per ton	26.76	13.38	27.86	2.51%
Maize	R\$ per ton	0	0	8.36	2.35%
Cattle (for slaughter, male)	R\$ head	31.88	16.45	32.17	1.44%
Cattle (for slaughter, female)	R\$ head	0	0	32.17	1.97%
Cattle (for fattening/breeding)	R\$ head	0	0	32.17	1.97%
Semi-processed beef	R\$ per ton	0	0	42.18	0.55%
Wood	R\$ per m3	13.02	13.02	13.99	2.73%

Source: SEFAZ Mato Grosso and World Bank calculations.

Pillar B: Increasing institutional capacity for sustainable agriculture, forest conservation and climate change mitigation.

52. **The Government of Mato Grosso has developed an ambitious strategy to support sustainable agricultural and livestock production while limiting deforestation and forest degradation, with resulting climate co-benefits.** Until 2016, the State did not have a comprehensive set of policies in place to promote inclusive green growth in the agricultural and livestock sectors. During the UNFCCC Paris Agreement negotiations in 2015, the State Government announced a strategy called “Produce, Conserve, Include” (PCI) to increase production while reducing deforestation, improving forest management and reducing rural poverty and inequality. The strategy was constructed from a collective and participatory process involving public and private sectors, representatives of non-governmental organizations, and entities representing sectors across the State’s economy. From 2016 to 2018, the State was able to raise over US\$50 million from international climate financing.³¹ This ambitious plan seeks to reduce deforestation in Mato Grosso’s portions of the Amazon and Cerrado woodland by 90 and 95 percent respectively (compared to the 2001-10 annual average), regrow natural forests on 27 thousand square kilometers of land, eliminate illegal deforestation by 2020 and continue to increase cattle and soy production. It also aims to provide technical assistance to the state’s 104,000 small-scale farmers by 2030.

53. **This operation supports selected State Government reforms aimed at increasing the institutional capacity for sustainable agriculture, forest conservation and climate change mitigation.** First, the operation supports the adoption of a new Deforestation and Forest Fire Prevention and Control Plan (PPCDIF) with important improvements to the State’s institutional capacity. Second, the supported program includes two legal commitments between the Secretariat for the Environment and the Public Prosecutor’s Office that provide for increased transparency and efficiency in the implementation of the registry for rural properties, thereby enhancing compliance of these properties with environmental legislation. Third, the operation supports the State Government’s recognition of the “PCI Institute” as the coordinating agency to accelerate implementation of the “Produce, Conserve, Include” strategy. These actions put Mato Grosso in a leadership position on the environmental, climate and inclusive rural development agenda in Brazil, providing a key model for other States.

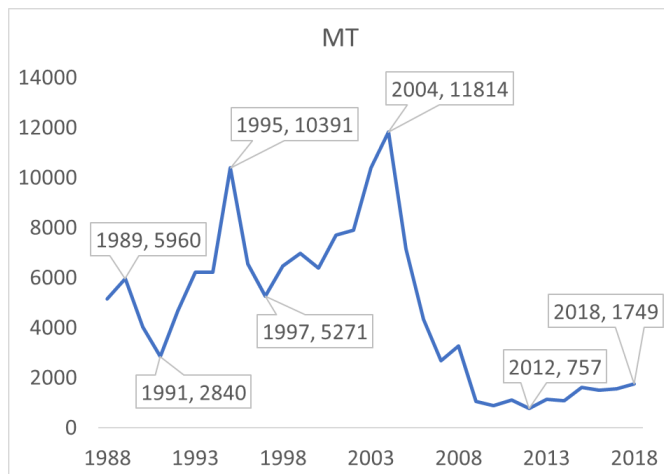
³¹ Most of this was raised through the REM (“REDD for Early Movers”) program: Euro 17 million from KfW and 24 million British Pounds from the UK Department for Business, Energy and Industrial Strategy (BEIS) in addition to a smaller IDH grant of about Euro 2.5 million.



Prior Action 6: The Borrower has enacted regulation that improves prevention and control of illegal deforestation and forest fires through remote sensing, early warning and swift response, as evidenced by the adoption and publication of the Borrower’s Decree No 1490/2018.

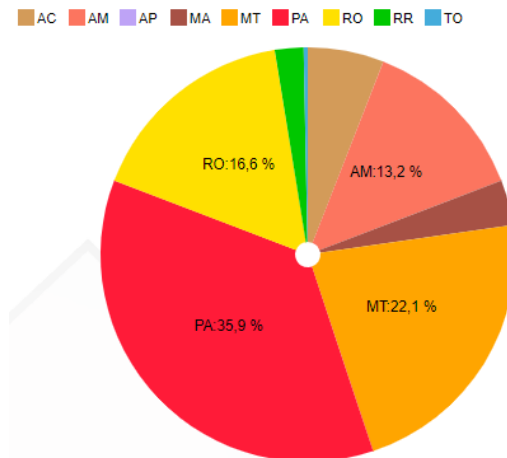
54. **Rationale:** Mato Grosso has featured historically high levels of deforestation in the 1990s and early 2000s (Figure 3a). While the state achieved substantial results in reducing deforestation since the 2004 peak, deforestation is rising again, especially since 2014, with a 130 percent increase relative to the 2012 low of 757 km². Moreover, Mato Grosso still has the second highest level of deforestation in the Amazon biome with 1,749 km² deforested in 2018, accounting for 22 percent of total deforestation in the Brazilian Amazon (Figure 3b). Forest integrity is key for a range of ecosystem services important to production and livelihoods. Nutrient recycling, erosion control, climate change mitigation and water provisioning can have significant economic benefits³² and their loss undermine future agricultural productivity and create public health concerns at the local level. Reversing the current upward trend in the rate of deforestation is made difficult by State’s large dimensions, remoteness of affected areas and obsolete monitoring and controlling systems. In 2018, 55 percent of total deforestation occurred in areas about 1000 km away from the state capital and the existing satellite monitoring system provides information with an average delay of 45 days. Thus, enforcement agents only arrive in areas identified with suspect activity after deforestation has occurred and the transgressors have already left the area. Moreover, the high frequency of false alerts hampers and reduces the efficiency of fieldwork.

Figure 3a. Annual deforestation in Mato Grosso’s portion of the Amazon biome (in km²)



Source: INPE - Instituto Nacional de Pesquisas Espaciais.

Figure 3b. Distribution of deforestation among the States of the Legal Amazon (2018)



55. **Substance of the prior actions:** The State established its first Deforestation and Forest Fire Prevention and Control Plan (*Plano de Ação para Prevenção e Controle do Desmatamento Queimadas do*

³² Castro and Andrade (2016) estimated that the cost of deforestation, in terms of loss of ecosystem services, was in the order of R\$15 billion at the peak of forest cover loss in 2004, and R\$2.66 billion at low deforestation levels in 2014. Source: Castro A.S. and Andrade D.C. “O custo econômico do desmatamento da Floresta Amazônica brasileira (1988 – 2014), *Perspectiva Economica*, 12(1): 1-15.



Estado de Mato Grosso, PPCDQ-MT) in 2013. However, this plan expired in 2016 and since then the State lacked a proper coordination mechanism to prevent and control illegal deforestation and forest fires. The new plan (*Plano de Ação para Prevenção e Controle do Desmatamento e Incêndios Florestais no Estado de Mato Grosso*, PPCDIF/MT) provides for: (i) the creation of an integrated monitoring center (the first of its kind in Brazil) to monitor and control legal and illegal deforestation, timber extraction, the quality of water, air, and soil, and all the information regarding the licensing process for investments with environmental impact; (ii) replacement of the existing obsolete satellite monitoring system through the adoption of a state-of-the-art satellite system, in coordination with the National Institute for Spatial Research (INPE), providing information within 48 hours; (iii) training and capacity building of key operational partners, such as the Brazilian Institute of the Environment and Renewable Natural Resources (*Instituto Brasileiro do Meio Ambiente e dos Recursos Naturais Renováveis – IBAMA*), *Polícia Militar Ambiental* and *Delegacia de Meio Ambiente*, and (iv) confiscation of machinery from deforested areas, preventing them to be reused in other areas. Together, these actions will allow a more efficient planning to prevent deforestation and a rapid deployment of scarce human resources to where the actual needs are, increasing de facto presence in the field. The resources for these activities are in large part provided through Mato Grosso's existing REDD/REM program and other domestic and international partnerships, providing a large degree of financial independence from the State's budget and substantially reducing the risk of delays in implementation due to lack of funding. Moreover, the prior action implementation can rely on initiatives such as the "MapBiomass Alertas" initiative³³, a multi-institutional project involving universities, NGOs and technology companies that promotes Brazil's annual land cover and land use mapping over the last three decades, and provides free and open data and maps. This type of collaboration can help validate deforestation alerts in a shorter time, allowing effective action even at the most remote points.

56. **Expected Results:** The measures adopted under the PPCDIF are expected to help the State reach its goal of reducing annual deforestation in Mato Grosso's part of the Amazon biome from 1,749 km² in 2018 to 1,241 km² in 2021.³⁴ Specific measures supporting the achievement of this result are: the satellite system providing information on deforestation within 48 hours, trained and strengthened technical and operational support, and the machinery confiscation and removal service (both expected to be operational by 2020), and the integrated monitoring center expected to be operational by 2021.

Prior Action 7: *The Borrower has improved the transparency and effectiveness of the Rural Environmental Registry and of the Program for Environmental Regularization through: (i) the definition of procedures and oversight for the Rural Environmental Registry and the Program for Environmental Regularization, as evidenced by the agreement (Termo de Compromisso Ambiental) signed among the Borrower's Public Prosecutor, the Borrower's Secretary for Environment and the Borrower's Secretary for Public Security; and (ii) the definition of operational procedures for public access to environmental information, as evidenced by the settlement (Termo de Ajustamento de Conduta) signed between the Borrower's Public Prosecutor and the Borrower's Secretary for Environment.*

³³ Source: www.mapbiomas.org, but also <http://www.obt.inpe.br/cerrado/downloads.html>.

³⁴ Currently it is not possible to say whether deforestation is illegal or more simply it has not been legally vetted given the environmental data gaps of the cadaster system. However, prior action 7 is supporting increased effectiveness in the environmental rural cadaster which will facilitate this type of assessments in the future.



57. **Rationale:** The Native Vegetation Protection Law (Law No. 12.651/2012), known as the Brazilian Forest Code, mandates minimum conservation standards for private landholdings.³⁵ This represents a cornerstone of Brazil’s approach to promote climate change mitigation and adaptation through its agriculture, forest and land use sector. Mato Grosso’s Rural Environmental Registry (SIMCAR), adopted in 2017, aims at verifying whether properties comply with the Brazilian Forest Code. Following validation of the information by the State Secretariat for the Environment (SEMA), and if an environmental liability is detected, properties can enter a process of environmental regularization which entails a Terms of Conduct Adjustment (TAC) with the State Public Prosecutor (*Ministério Público do Estado*). Implementation has been slow owing to limited financial and human resources and lack of clear and transparent implementation process. By the end of 2018, only 53 percent of the State’s private rural land (63,886 properties) had been registered with the SIMCAR, of which only 3 percent (1,420 properties) had already been validated. Further, merely 156 properties (out of 770 which are required to) had started the Environmental Regularization Program (PRA) process and were under evaluation by SEMA. Also, the lack of transparency on environmental permits and registry entries undermines effective monitoring and oversight. During 2018 there have been concerns about the possibility of irregularities in the implementation of SIMCAR (e.g. by treating Amazon forest as Cerrado forest).

58. **Substance of the prior action.** The prior action entails a set of two interrelated measures to support the implementation of the cadaster in compliance with the Brazilian Forest Code and seeking climate change mitigation and adaptation co-benefits. First, the Terms of Environmental Commitment between SEMA, the Secretariat for Public Security (SESP) and the Public Prosecutor facilitates implementation of SIMCAR and PRA establish, inter alia, that: (i) the State Comptroller General (CGE) analyzes the processes and makes an internal audit of rural environmental records by SEMA; (ii) SESP periodically scans the registry for possible weaknesses in the system; and (iii) SEMA simplifies the template used by registry implementing agencies. Second, the Terms of Agreement between SEMA and the Public Prosecutor ensures that environmental information complies with the Law on Access to Information including, inter alia: SIMCAR information; land use change and vegetation suppression authorizations; environmental compensations; and environmental impact studies. This second measure is necessary to ensure the effective implementation of the SIMCAR and PRA under Prior Action 7(i) and resulting in strengthened control. The prior action removes the most significant barrier in the swift application of SIMCAR by clarifying implementation procedures, simplifying the analysis of data, and strengthening control systems. The Transparency Portal of SEMA provides environmental information such as SIMCAR data, Licenses and Permits, including APFs - Provisional Operation Authorization of Rural Activity, information about embargoed areas, and data related to the control of commercialization and transport of forest products, which directly supports the implementation of Brazilian Forest Code and curbs non-compliance.

³⁵ The Brazilian Forest Code (Law 12.651 of 2012) requires that all private rural landholdings maintain a percentage of native vegetation as Legal Reserves (*Reservas Legais*, RLs), and that Areas of Permanent Preservation (*Áreas de Preservação Permanente*, APPs), such as riparian forests along watercourses, steep slopes, mountaintops, etc., also be maintained by landholders. The Forest Code also obliges landholders to register their landholdings in the Rural Environmental Cadaster (*Cadastro Ambiental Rural*, CAR). This registry contains details on the total area of individual farms, the areas earmarked for alternative land use, APPs and RLs. The percentage to be held as natural vegetation varies from 80 percent in the Amazon biome to 35 percent in the Cerrado biome within the 9 States that make up the “Legal Amazon”, to 20 percent in the rest of Brazil. The enforcement of the “Forest Code” establishes economic and financial instruments to achieve these objectives.



59. **Expected results:** The impact of the prior action is to advance more rapidly and transparently the implementation of the SIMCAR and the PRA. Specifically, it is expected that the total area of properties for which SIMCAR information has been validated by SEMA will increase from 2.9 million hectares in 2018 to 20 million hectares by 2021. This will have, as an impact, a reduction in the rate of deforestation with its related co-benefits in terms of climate change mitigation and adaptation. Implementation of the policies under this prior action counts on the financial and technical assistance to temporarily increase the number of SIMCAR analysts at SEMA, increase their information technology equipment, and establish a clear specialization in analytical tasks, hence accelerating execution.

Prior Action 8: *The Borrower has enacted regulation that strengthens the implementation of its PCI Strategy and institutional capacity (including by appointing the PCI Institute as the independent agency to implement its PCI Strategy) in order to improve agricultural production while protecting its forests, as evidenced by the adoption and publication of the Borrower's Decree No 46/2019.*

60. **Rationale:** Mato Grosso's efforts to protect and restore native vegetation where required by the Forest Code, while increasing production, calls for agricultural intensification and the adoption of environmentally sound agricultural practices that can have important climate co-benefits. To effectively reconcile increased agricultural production with conservation of the remaining native vegetation, the livelihoods and opportunities of small-scale producers, indigenous peoples and traditional communities, which tend to be most vulnerable to climate variability, also need to be improved. The PCI Strategy, which entails an innovative long-term development vision for the State, takes a multi-stakeholder approach to combine production, conservation and inclusion. However, until the creation of the PCI Institute, the State lacked a coherent institutional framework to implement the strategy, hampering coordination and scalability of existing programs and initiatives between stakeholders (research institutes, NGOs, sector associations, civil society, government). Further, the State had not yet created the enabling environment to attract environmentally-minded donors and investors at scale, raising the difficulty to reach its ambitious PCI goals. Removing barriers to green finance is key as the transition of Mato Grosso's agriculture and livestock production to ambitious low carbon, climate resilient and environmental standards will require substantial investments, estimated at R\$46 billion (US\$13 billion) until 2030.³⁶

61. **Substance of the prior action:** The PCI Institute was founded in early 2019 as a private, non-profit institution to coordinate the dialogue with donors and investors, and raise resources for the transition to sustainable agriculture aiming at climate co-benefits. It is a financially self-sustained institution governed by a multi-stakeholder board, providing for transparent and independent decision making. Its mandate is to advise on public policies and measures, as well as on a balanced mix of innovative technical and financial incentives. Moreover, the Institute will provide technical assistance to create a robust monitoring, reporting and verification system to evaluate programs and projects implemented under the PCI strategy. By issuing the Decree No. 46 of February 27, 2019, the State Government appointed the PCI Institute to perform these functions on behalf of the State. Given that the Institute will operate at arm's length with respect to the State, it will be able to ensure transparency and a governance structures appropriate to meet donors' requirements.

62. **Expected results:** Strengthening the PCI and giving it a permanent institutional structure is expected to raise national and international resources amounting to a cumulative total of US\$90 million

³⁶ Source: GCP and IPAM (2016): "Unlocking Forest Finance".



by 2021. Ultimately, a stronger PCI and additional funding are expected to contribute to the PCI Strategy's overarching goal of decoupling the increase in agricultural and livestock production from deforestation.

Analytical Underpinnings

63. **The operation is supported by analytical and technical work under a range of instruments.** The operation benefitted greatly from the Brazil Public Expenditure Review, in particular the analysis on fiscal sustainability, public sector wage bill, pensions and education spending.³⁷ The operation further benefitted from analytical work done in intergovernmental fiscal relations in close collaboration with the Federal treasury (STN), which supports the redesign of the federal framework for the provision of federal guarantees to subnational entities (based on the CAPAG methodology) and the fiscal adjustment programs (PAFs). On pensions, the operation also benefitted from an analytical work program on subnational pension systems in Brazil.

Table 8: DPL Prior Actions and Analytical Underpinnings

Prior Actions	Analytical Underpinnings
Operation Pillar 1: Regaining Fiscal Sustainability	
Prior action #1 (State Fiscal Responsibility Law)	- Brazil SCD (report number 101431) and Brazil Public Expenditure Review (P154992). - Technical assistance by Bank team on in depth fiscal modeling as part of Brazil Intergovernmental Fiscal ASA (165693).
Prior action #2 (Control of public sector wage increases)	- Brazil Public Expenditure Review (P154992), specifically chapter on public sector payroll showing high salary premiums in the public sector, including for State servants - Technical assistance (payroll and work force modeling) provided during the preparation of the operation
Prior action #3 (Strengthening Governance of the State's Pension Institute)	- Brazil Public Expenditure Review (P154992), specifically chapter on pensions, showing growing deficits of State systems and need to reform them. - Technical assistance (PROST model) provided during the preparation of the operation
Prior action #4 (Fiscal Emergency Fund to raise revenue from ICMS tax expenditures)	- Brazil Public Expenditure Review (P154992), specifically chapter on business support policies, showing high cost and limited effectiveness of tax incentive programs.
Prior action #5 (Increase and broadening of FETHAB levies)	- Calder (2015) and Metcalf and Weisbach (2009) discuss the carbon tax effect of a per-head tax on cattle - Dalfovo (2016) shows impact of FETHAB on wood reducing deforestation - World Bank agriculture Global Practice, study on climate impact of agricultural taxes and subsidies (forthcoming). - EMBRAPA (2016): Second International Symposium on Greenhouse Gases in Agriculture – Proceedings: Estimates of carbon emission from cattle

³⁷ World Bank (2017), *A Fair Adjustment: Efficiency and Equity of Public Spending in Brazil*, Report N. 121480, pp. 121-126.



	Cohn et al. (2014) "Cattle ranching intensification in Brazil can reduce global greenhouse gas emissions by sparing land from de-forestation." Proceedings of the National Academy of Sciences 111.20: 7236-7241.
Operation Pillar 2: Increasing institutional capacity for sustainable agriculture, forest conservation and climate change mitigation	
Prior Action #6 (Plan to Combat Deforestation and Forest Fires)	<ul style="list-style-type: none"> - FAO (2015) "Global Forest Resources Assessment 2015", 2nd edition. http://www.fao.org/3/a-i4793e.pdf. - Castro A.S. and Andrade D.C. "O custo economic do desmatamento da Floresta Amazonica brasileira (1988 – 2014), <i>Perspectiva Economica</i>, 12(1): 1-15, janeiro-junho 2016. - INPE - Coordenação-Geral de Observação da Terra, available at http://www.obt.inpe.br/OBT/assuntos/programas/amazonia/prodes - INPE – TerraClass, Projeto TerraClass Cerrado Mapeamento do Uso e Cobertura Vegetal do Cerrado, available at http://www.dpi.inpe.br/tccerrado/
Prior action #7 (Strengthening of the Land Registry and Regularization Program)	<ul style="list-style-type: none"> - Azevedo A.A. et al. (2017) Limits of Brazil’s Forest Code as a means to end illegal deforestation. PNAS, - Chomitz and Wertz-Kanounnikoff (2005): Measuring the initial impacts on deforestation of Mato Grosso’s program for environmental control. World Bank Policy Research Working Paper 3762. - Jung, Suhyun, Laura Vang Rasmussen, Cristy Watkins, Peter Newton, and Arun Agrawal. "Brazil's national environmental registry of rural properties: implications for livelihoods." <i>Ecological economics</i> 136 (2017): 53-61. - Brancalion, Pedro HS, Letícia C. Garcia, Rafael Loyola, Ricardo R. Rodrigues, Valério D. Pillar, and Thomas M. Lewinsohn. "A critical analysis of the Native Vegetation Protection Law of Brazil (2012): updates and ongoing initiatives." <i>Natureza & Conservação</i> 14 (2016): 1-15. - Soares-Filho, Britaldo, Raoni Rajão, Marcia Macedo, Arnaldo Carneiro, William Costa, Michael Coe, Hermann Rodrigues, and Ane Alencar. "Cracking Brazil's forest code." <i>Science</i> 344, no. 6182 (2014): 363-364.
Prior action #8 (Institutionalization of the agency for raising carbon financing)	<ul style="list-style-type: none"> - Arvor, Damien, et al. "Combining socioeconomic development with environmental governance in the Brazilian Amazon: The Mato Grosso agricultural frontier at a tipping point." <i>Environment, development and sustainability</i> 20.1 (2018): 1-22. - SEEG (2017): Environmental and climate policies, including carbon credits from REDD activities provide a financial incentive for conservation and reduce the pressure for legal deforestation, thus enabling green growth while reducing GHG emissions. Data from WDI (World Development Indicators) indicate a 39 percent increase in agricultural GDP in Brazil between 2005 and 2015 and a 48 percent reduction in GHG emissions from AFOLU in the same period.

4.3. LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY

64. **The proposed DPL is fully aligned 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.³⁸ In line with the CPF, the proposed operation is the first of a potential series of subnational DPLs to support fiscal adjustment and sustainable development, including climate co-benefits, 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 DPL specifically supports 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 effect for other subnational governments, which will ultimately reduce the contingent liability to the Federal Government. The operation creates an incentive mechanism for States to address their fiscal deficits, reducing risk of unsustainable State 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, deforestation, environmental compliance, and environmental climate finance mechanisms in a State which is critical to Brazil’s climate mitigation commitment, and which heavily relies on adaptation and climate resilience efforts to sustain its growth model. This pillar is also consistent with the WBG Climate Change Action Plan 2016-2020,³⁹ which aims to work with countries to help them deliver and exceed their Paris ambitions, including through financing, technical assistance, and knowledge sharing.

4.4. CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

65. **Public consultations in Mato Grosso took place both during preparation of public policies and during approval in the State legislature.** In the case of state laws, these consultations follow the procedures laid out in the State Constitution and rules on legislative procedures. This consultation process increased the legitimacy of policies and allowed the authorities to benefit from advice and technical knowledge. The State Government of Mato Grosso ensured that the program supported by this DPL operation was based on a broad consultation process.

66. **The State government, under the leadership of SEFAZ, undertook an extensive consultation process on the State’s fiscal adjustment program, ultimately gaining the backing of elected representatives.** This process involved a 60-day period of public debate on the constitutional amendment limiting expenditures (EC 81/2017), which involved stakeholders within and outside the government including public sector unions. The laws underlying the prior actions on fiscal adjustment were analyzed, discussed, amended and ultimately adopted by the State Assembly—whose members are directly elected by the population. The revenue measures (FEEF and FETHAB) were also discussed thoroughly with industry and agribusiness representatives.

67. **The policies under the second pillar of the operation were thoroughly discussed with interested stakeholders and civil society.** The Plan to Combat Deforestation and Forest Fires (PPCDIF, PA#6) underwent a process of public consultation with relevant stakeholders before being sanctioned by the Government. Similarly, the SIMCAR and PRA land regularization policies were developed with public consultation over several years. The specific changes under PA#7 resulted from an interagency process

³⁸ The CPF was endorsed by the Board in July 2017 (Report No. 113259-BR).

³⁹ “World Bank; IFC; MIGA. 2016. World Bank Group Climate Change Action Plan 2016-2020. <https://openknowledge.worldbank.org/handle/10986/24451>



between the State Government (represented by SEMA) and relevant independent control organs (*Ministerio Público*, PGE). An extensive consultation process accompanied the “PCI Strategy Implementation Plan in Mato Grosso” in 2017. The PCI process has been based on stakeholder coordination through its council, which includes representatives of the State Government, private sector, and civil society. The creation of the PCI Institute and its recognition by the State Government (PA#8) was a result of this continuous process.

68. **The World Bank also collaborated with national and international development partners.** On the fiscal adjustment component of the operation, the World Bank team worked in close partnership with the National Treasury Secretariat (STN) which is the Federal Government agency charged with supervising the fiscal affairs of subnational government. Representatives of STN joined World Bank missions to the State and closely participated in the development of the fiscal adjustment program. The team has also consulted with international development partners who are working with Mato Grosso and other States on the climate change agenda, particularly the *Agence France de Développement* (AFD), the Sustainable Trade Initiative of the Netherlands (IDH), the German *Gesellschaft für Internationale Zusammenarbeit* (GIZ) and the German Development Bank (*Kreditanstalt für Wiederaufbau*, KfW), which is directly involved in the State’s REDD financing.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1. POVERTY AND SOCIAL IMPACT

69. **The Prior Actions supported under this operation are not expected to have adverse consequences on poverty and inclusion, although some moderate inclusive gains are expected over the medium to long term from fiscal consolidation that is equity enhancing.** The expenditure rule supported under this DPL will force a decline in primary spending in the State. As highlighted in the Brazil PER, abundant opportunities exist for spending cuts that do not affect the poor and that are equity enhancing. In this regard, it is expected that changes that reduce future increases in civil service pay will not directly affect the most vulnerable segments of the population, as civil servants are typically among the top 40 percent income earners of the State population. It is estimated that 89 percent of Brazilian state employees are in the top 40 percent of the national income distribution.⁴⁰ Indirect impacts on the poor, such as a fall in demand for domestic employees or other low-skilled workers cannot be ruled out, but should be marginal given the gradual impact of the measure. Any adverse impact on labor demand should be cushioned by the fairly strong and improving local labor market. More generally, allowing the State to regain fiscal sustainability will have positive impacts on the State’s ability to deliver public services, which will support poverty reduction and boost shared prosperity over the medium and long term. In the absence of fiscal adjustment, it is to be expected that the State would struggle to provide these services adequately. In fact, the State’s liquidity problems have already led to sporadic disruptions in the provision of public health services. Annex 4 summarizes the analysis carried out on the potential effects of the reforms supported under the operation.

70. **The DPL prior actions in the area of fiscal sustainability are expected to have the following social and poverty impacts:**

⁴⁰ World Bank (2017), *A Fair Adjustment: Efficiency and Equity of Public Spending in Brazil*, Report N. 121480, p. 51



- The enactment of the State's Fiscal Responsibility Law (PA#1) is not expected to have poverty and social impacts as it does not cut any specific state expenditures. In the medium term, controlling expenditures at a sustainable level is expected to have a positive impact relative to an alternative path of fiscal crisis. The expenditures controlled by the law on public payroll and tax incentives are not progressive.
- Reductions in the increase of public sector wages (PA#2) and stronger governance of public servants' pensions (PA#3) are not expected to have a significant impact on poverty since very few State employees are poor or vulnerable and the wages of the lowest paid state workers and retirees are protected by federal minimum wage laws and the national teacher salary floor.
- The revenue measures supported by the program (Fiscal Emergency Fund reducing ICMS incentives, PA#4 and FETHAB rates, PA#5) are not expected to have significant poverty and social impacts, as they affect large profitable companies, mostly in wholesale and food processing (slaughterhouses, meat packing plants) and other industrial firms as well as large-scale export oriented agrobusiness. While these levies will increase production cost in the state, these increases are quite marginal (FETHAB rates account for only about two percent of product value, with recent increases in rates a fraction of this for most products), and the measures were calibrated for each sector (FEEF) and product (FETHAB) to minimize negative impacts on formal employment. The increased levies on agricultural commodities under the FETHAB (PA#5) could - *prima facie* – impact food prices or employment in the agricultural sector. However, these effects are expected to be minimal at best, since the prices for commodities targeted (soy, maize, cotton, cattle) are determined on world markets, where an increase in a Mato Grosso specific levy should have a negligible effect.

71. The actions supported on implementing selected aspects of the State's climate change mitigation strategy are expected to have the following social and poverty impacts:

- The Plan to Combat Deforestation and Forest Fires (PA#6) is expected to have some positive impacts on the poor. In some cases, indigenous populations who live within or in close proximity of forests, derive their livelihoods from sustainable forest management and are threatened by forest fires.
- The strengthening of the Rural land Registry and Regularization Program (PA#7) is not expected to have significant negative social and poverty impacts. It could have positive impacts for smallholder farmers and producers' associations who are able to certify their compliance with environmental rules and use this as a marketing advantage for their product. The speedy registration of smallholder farmers (*assentamentos*) has been identified as a priority for SEMA, aiming to certify 70 percent by 2021.
- Strengthening the institutional structure of PCI and creating a framework for capturing carbon finance (PA#8) does not have direct poverty and social impacts, but is expected to have important positive impacts on poor and vulnerable populations that depend on the sustainable use of forest resources, which includes indigenous communities. Not only will it help to protect these landscapes, but also the resources raised by through REDD contracts or other vehicles, which are also to be used to improve the livelihoods of these populations. For example, under the existing contract between the State of Mato Grosso and KfW, the financial contribution to be provided by KfW will be earmarked as following: at least 60 percent of the resources will be used to benefit the population from areas of intervention in 4 subprograms: a)



family agriculture, and traditional populations and communities in the Amazon Biome; b) indigenous territories; c) sustainable smallholder agriculture (*agricultura patronal*); d) sustainable family agriculture, and traditional populations and communities in the *Cerrado* and *Pantanal* Biomes. The remaining 40 percent of resources will be used to enhance policies and institutions of REDD+, and to avoid deforestation.

5.2. ENVIRONMENTAL ASPECTS

72. **The Brazilian environmental legislation is by and large complete and well structured, including in aspects related with environmental licensing.** The normative set, legal framework, policies and procedures are materially consistent with the requirements of World Bank Policies. This also includes the legislative aspects where the state level complements the national environmental framework. The State of Mato Grosso has always been at the forefront of territorial control policies. Implementation however has faced challenges, lacking in transparency and efficient control mechanisms. Nevertheless, transparency indexes in the State of Mato Grosso are improving.

73. **The policies supported by this DPL are not likely to cause any negative effect on the environment, forests, or other natural resources.** The policies supported under the first pillar of this DPL on fiscal adjustment are unlikely to have significant effects on the environment. The fiscal responsibility law (PA #1) is institutional in nature and thus, does not have direct effects on the environment. Budgetary impacts on environmental policies are mitigated by the fact that SEMA has sources of earmarked funding (from environmental fees and fines) as well as a pipeline of donor-funded projects in priority areas. The Prior Actions on payroll (PA #2) and public-sector pensions (PA #3) are also not expected to have any impact on the environment. Specifically, they are not expected to result in reduced staffing for state agencies dealing with environmental protection. The Prior Action which aim to support State revenues through the Fiscal Equilibrium Fund (PA #4) is also not expected to have negative effects on the environment. The increase in the FETHAB rates on agricultural commodities can be expected to have at least a small impact on reducing carbon emissions from cattle production. The FETHAB on wood and products which can be produced on deforested land can be expected to reduce deforestation. As a per-unit tax on products and activities directly linked with carbon emissions, the FETHAB is capable of generating climate change mitigation co-benefits. Metcalf and Weisbach (2009) conclude that a per-head tax on cattle can be effective on reducing greenhouse gas emissions in this sector. In addition, Dalfvo (2016) shows that the initial introduction of the FETHAB levy on wood reduced deforestation in the State and Cohn et al. (2014)⁴¹ show how taxes can favor intensification of livestock production and therefore reduce greenhouse gas emissions.

74. **The policies under the second pillar are designed to improve environmental management and likely to have significant positive effects.** The Plan to Fight Deforestation and Forest Fires (PA#6), with its specific improvements in state capacity to detect and respond to illegal deforestation, is expected to have an important positive environmental impact on forest protection. The integrated environmental monitoring center included in the plan is expected to have a positive impact even beyond forest protection. The policy reforms associated with land management (PA #7) are expected to have significant

⁴¹ Cohn, Avery S., et al. "Cattle ranching intensification in Brazil can reduce global greenhouse gas emissions by sparing land from deforestation." *Proceedings of the National Academy of Sciences* 111.20 (2014): 7236-7241.



positive effects progress on rural land registration, and will direct production to the areas found apt for agriculture reducing pressure on environmentally fragile areas, in part, by re-directing agricultural credit to those areas with valid registrations. The regularization program (PRA) will also provide a strong economic incentive for producers to regularize their land as it will allow customers to control the status of agricultural producers. The institutionalization of the PCI, as a coordination and fundraising agency for the State's climate change strategy and carbon finance (PA #8), is expected to have a positive effect by reducing deforestation as it provides an economic and financial incentives to protect forest land as well as additional resources for conservation and sustainable forest management.

5.3. PFM, DISBURSEMENT AND AUDITING ASPECTS

75. **A well-developed legal framework—including the Federal Constitution, the Fiscal Responsibility Law (LRF) and other laws and regulations—underpins Mato Grosso's public financial management (PFM).** In addition, institutional arrangements for PFM are clearly established between the Secretariat of Planning (SEPLAG) and the Secretariat of Finance (SEFAZ). The State Audit Court (TCE) is responsible for external scrutiny, and the legislature plays an external oversight role. The Secretariat of Internal Control has sufficient independence to perform its role. Federal rules consistent with international standards govern the budget classification system. Budget preparation includes participation by key stakeholders and sector agencies. The State Government's PFM environment features strong internal rules and commitments controls. The State Government's information system, the Integrated Financial Administration System (FIPLAN), is also adequate for most purposes. The use of the single treasury account model of cash management, and a clear allocation of responsibility for managing it, facilitate the performance of bank reconciliations on a regular and timely basis. In addition, the budget is widely available for public access, primarily through the Internet. The state is also implementing international public sector accounting standards (IPSAS) to: (i) improve the quality and relevance of financial information available for decision making; and, (ii) enhance transparency, accountability and efficiency in PFM.

76. **The State has been able to prepare timely financial statements of reasonable quality.** The TCE report identifies some exceptions, but they do not compromise the overall consistency and usefulness of the financial statements. TCE has been able to carry out audits of a reasonable scope, and its reports are timely issued —the latest audit of State accounts is for 2017.

77. **The control environment governing the Central Bank's operations within which the loan's foreign exchange would flow continue to be adequate.** The IMF's Safeguards Assessment of the Central Bank of Brazil (2004) concluded that it does not present any widespread vulnerability that could compromise the safeguarding of Fund resources. Given the long period since the last Safeguards Assessment, the Bank examined the Audited Financial Statements of the Central Bank for the years ended December 31, 2005 to 2016, and the reports of the independent audits carried out by an international audit firm. The auditors' opinion was unqualified for all these years, based on which the Bank deems that the foreign exchange control environment of the Central Bank continues to be adequate.

78. **The loan proceeds will be disbursed based on satisfactory implementation of the DPL supported program and will not be tied to any specific purchases.** Once the loan is effective, the World Bank will



disburse the loan proceeds into a new, US\$ denominated bank account opened by the State Government at the *Banco do Brasil* branch in New York. The *Banco do Brasil* is a commercial bank deemed acceptable to the World Bank, as it is: (i) financially sound, audited regularly, receiving satisfactory audit reports, and is able to execute a large number of transactions promptly; (ii) performs a wide range of banking services satisfactorily; and (iii) provides detailed bank statements. The account will be denominated in foreign currency and will not form part of the foreign exchange reserves. However, the Central Bank will be informed of the deposit. Within 30 days after payment, the State Government will confirm to the World Bank that (i) the loan proceeds were received into the foreign currency denominated account, and (ii) an equivalent amount was credited to the account that finances its commitments (i.e. the receipt of the proceeds are recorded in the state's accounting and budgeting system/records, and are available to be used for budgeted commitments). If loan proceeds are used to finance excluded expenditures, as defined in the Loan Agreement, the World Bank will require the State Government to refund the amount. As a result of the conclusions about the adequacy of the state's public financial management environment, no additional fiduciary arrangements will be put in place for the operation.

5.4. MONITORING, EVALUATION AND ACCOUNTABILITY

79. **The State Secretariat of Finance of Mato Grosso (*Secretaria de Estado da Fazenda, SEFAZ*) is responsible for collecting and monitoring information related to program implementation and progress towards the achievement of the results.** SEFAZ is responsible for coordinating necessary actions among the agencies involved in the reform program supported by this DPL. It is directly in charge of the first pillar of the operation, while the State Secretariat for Environment (SEMA) oversees policies under the second pillar of the program. The World Bank team has worked closely with the above agencies as well as the Federal Treasury to define results indicators that are clearly spelled out and measurable, giving preference to those that are collected on a regular basis to avoid additional reporting.

80. **Grievance Redress.** Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the World Bank's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of World Bank non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit: <http://www.worldbank.org/GRS>. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

6. SUMMARY OF RISKS AND MITIGATION

81. **The overall risk rating for this operation is substantial.** The reforms supported by the operation are a high priority for the Government of Mato Grosso and are significantly front-loaded, reflecting the acute fiscal crisis in the state. Sustainability of some of the more controversial policies may be challenged in the medium term since the current State Government's mandate ends in 2022, and need for



expenditure control may not be so pressing. The most relevant risks are related to the political, governance and macroeconomic context, sector strategies and policies, and stakeholders.

82. Macroeconomic risks arise mainly from the uncertainty in the pace of reforms at the federal level, as well as, from potential volatility in Mato Grosso's export volumes and prices. The pace of the implementation of fiscal reforms at the federal level is a key source of risk. Adherence to the federal expenditure ceiling calls for the adoption of a stringent pension reform and other fiscal measures that may be delayed in congress, undermining fiscal sustainability at federal level, and likely triggering a loss of market confidence. Against this, the Federal Government is determined to pursue congressional approval of a pension reform that will also have a positive impact on the state finances, providing additional leeway for fiscal adjustment. If the pension reform were to be delayed, the Federal Government is committed to finding other fiscal savings to comply with the constitutional expenditure ceiling. In addition, Mato Grosso's economic growth, highly dependent on agricultural exports, has been on average above Brazilian GDP growth in recent years. A potential slowdown of exports or fall in agricultural prices might slow economic growth in the state, reducing the State Government's revenues and jeopardizing fiscal adjustment. Against this, revenues from FETHAB are collected based on quantity of commodities produced rather than value, which is expected to be a more stable revenue base. Also, the State LRF triggers additional expenditure cuts should revenue collection fall. Overall, risks in this category are substantial.

83. Sector strategies and policies risks reflect the uncertainty related to implementing some of the policy reforms and ongoing fiscal adjustment process. Structural fiscal measures supported by the operation are front-loaded and being implemented immediately upon their approval in the State Legislature. However, given the ambitious scope of the fiscal adjustment package and the sensitive nature of some of the measures, especially on public sector payroll, the implementation of fiscal policies is still subject to substantial risks. In particular, on public sector pensions, further reform action will be needed, subject to the outcomes of an ongoing national policy debate, as well as, to the policy making process in the state with a number of relevant stakeholders. These risks are mitigated by the strong ownership of the fiscal adjustment program by the State Government; positive incentives provided by the Federal Government regarding access to new borrowing in light of ongoing reforms; and the fact that these reforms were undertaken very early in the political cycle (sectoral and policy risks related to pillar two are discussed under environmental risks below).

84. Risks related to institutional capacity are substantial in some policy areas. The institutional capacity required to implement fiscal reforms is generally assured as these reforms built on existing institutions and policy structures. The Fiscal Responsibility Law and changes to public sector salary adjustments will require some additional technical capacity related to fiscal analysis and budgeting. The administrative reform approved in January 2019, which moved the responsibilities for budgeting from the Secretary of Planning (SEPLAN) to the Secretary of Finance (SEFAZ), and created a Secretariat for Planning and Management (SEPLAG) in charge of human resources and procurement, will help in this regard. Capacity constraints are more of a risk on with regards to the policies under the second pillar, especially prior actions #6 and #7, which will require significant resources at SEMA. However, this risk is mitigated by SEMA's earmarked resources (environmental fees and fines) and existing external funding (especially under the state's REDD-REM program), which are earmarked for costly aspects of the environmental policy program.



85. **Risks related to the environment are substantial.** While there has been substantial progress in reducing deforestation from the high levels experienced in the 1990s and 2000s, deforestation continues to be substantial and appears to be on the rise again (with a 130 percent increase between 2012 and 2018, if estimates for 2018 are confirmed). Land use change is a private sector decision and recent embargoes on private activities, issued following the demonstration of non-compliance with the Brazilian Forest Code, are producing virtuous effects. These efforts, however, need to be sustained over time. The policies supported by the operation address these risks by promoting more effective coordination among stakeholders, with programs such as the PCI that includes the business community and civil society, increasing efficacy of control operations, and increasing efficiency in the operation of the rural environmental cadaster. SEMA has already identified extra-budget funding sources to implement the PPCDIF and the SIMCAR, thus minimizing the risk of slow implementation of the prior actions.

86. **Stakeholders’ risks are substantial.** These risks relate to the sensitive reform agenda, especially on public spending and public-sector payroll. Public-sector unions are strongly opposed to wage bill control measures adopted by State Government. The role of the autonomous non-executive branches of government adds stakeholder risks, as these branches may resist fiscal adjustment efforts, insofar, as it also affects their budgets and they wield considerable institutional power. The authorities are aware of these risks and are utilizing a consultation process with the stakeholders, mainly those in the non-executive branches. The aim is to convince those affected that the sustainability of public finances will allow the payment of salaries and pensions on time, while paying back current arrears.

Table 9: Summary Risk Ratings

Risk Categories	Rating
1. Political and Governance	Moderate
2. Macroeconomic	Substantial
3. Sector Strategies and Policies	Substantial
4. Technical Design of Project or Program	Moderate
5. Institutional Capacity for Implementation and Sustainability	Substantial
6. Fiduciary	Moderate
7. Environment and Social	Substantial
8. Stakeholders	Substantial
9. Other	
Overall	Substantial



ANNEX 1: POLICY AND RESULTS MATRIX

Prior actions		Results	
Prior Actions	Indicator Name	Baseline	Target
<i>Pillar A--- Support the Government of Mato Grosso's efforts to regain fiscal sustainability</i>			
<p>Prior Action #1.</p> <p>The Borrower has enacted legislation that clarifies and tightens personnel spending limits and sets targets for current savings, as evidenced by the adoption and publication of the State Fiscal Responsibility Law (Law No 614/2019).</p>	<p>Current savings as a percentage of adjusted net current revenue (assessed using the current savings indicator established and published by the STN)</p>	<p>3.6 percent (2017)</p>	<p>5 percent (2021)</p>
<p>Prior Action #2.</p> <p>The Borrower has enacted legislation that conditions annual adjustments of the Borrower's civil servants' salaries on the Borrower's fiscal capacity, as evidenced by the adoption and publication of Law No 10.819/2019.</p>	<p>Personnel spending as share of net-current revenue (as published by the STN's <i>Boletim de Finanças dos Entes Subnacionais</i>, using PAF methodology)</p>	<p>67.85 percent (2018)</p>	<p>60 percent (2021)</p>
<p>Prior Action #3.</p> <p>The Borrower has enacted legislation that strengthens the governance of its pension agency (MTPREV) by transferring the authority to approve actuarial studies and propose financing plans, as evidenced by the adoption and publication of Law No 613/2019.</p>	<p>Pension deficit realized in 2021 in percent of current revenues compared to 2018 projection (based on World Bank PROST model)</p>	<p>9.1 percent (2018)</p>	<p>8.5 percent (2021)</p>
<p>Prior Action #4.</p> <p>The borrower has enacted legislation that establishes its State Fiscal Equilibrium Fund (FEEF) to increase public revenues from companies benefitting from tax incentives, as evidenced by the adoption and publication of Law No 10.709/2018.</p>	<p>Revenues recovered by FEEF (cumulative total)</p>	<p>R\$85 million (2018)</p>	<p>R\$400 million (2021)</p>
<p>Prior Action #5</p> <p>The Borrower has enacted legislation that increases the per-unit levies charged on agricultural commodities produced in the Borrower's territory, as evidenced by the adoption and publication of Law No 10.818/2019.</p>	<p>Revenues raised from FETHAB commodities (annually)</p>	<p>R\$870 million (2018)</p>	<p>R\$1,350 million (2021)</p>



Pillar B--- Increasing institutional capacity for sustainable agriculture, forest conservation and climate change mitigation

<p>Prior Action #6. The Borrower has enacted regulation that improves prevention and control of illegal deforestation and forest fires through remote sensing, early warning and swift response, as evidenced by the adoption and publication of the Borrower’s Decree No 1490/2018</p>	<p>Annual deforestation in Mato Grosso’s portion of the Amazon biome</p>	<p>1,749 km² (2018)</p>	<p>1,241 km² (2021)</p>
<p>Prior Action #7. The Borrower has improved the transparency and effectiveness of the Rural Environmental Registry and of the Program for Environmental Regularization through: (i) the definition of procedures and oversight for the Rural Environmental Registry and the Program for Environmental Regularization, as evidenced by the agreement (<i>Termo de Compromisso Ambiental</i>) signed among the Borrower’s Public Prosecutor, the Borrower’s Secretary for Environment and the Borrower’s Secretary for Public Security; and (ii) the definition of operational procedures for public access to environmental information, as evidenced by the settlement (<i>Termo de Ajustamento de Conduta</i>) signed between the Borrower’s Public Prosecutor and the Borrower’s Secretary for Environment.</p>	<p>Area of land for which CAR information has been validated by SEMA (cumulative total)</p>	<p>2.9 million hectares (2018)</p>	<p>20 million hectares (2021)</p>
<p>Prior Action #8. The Borrower has enacted regulation that strengthens the implementation of its PCI Strategy and institutional capacity (including by appointing the PCI Institute as the independent agency to implement its PCI Strategy) in order to improve agricultural production while protecting its forests, as evidenced by the adoption and publication of the Borrower’s Decree No 46/2019.</p>	<p>International and domestic resources mobilized in coordination with the PCI Institute for the purpose of implementing the PCI strategy (cumulative total)</p>	<p>US\$53 million (2018)</p>	<p>US\$90 million (2021)</p>



ANNEX 2: FUND RELATIONS ANNEX

BRAZIL—ASSESSMENT LETTER FOR THE WORLD BANK

April 1, 2019

DPL for the Mato Grosso Fiscal Adjustment and Environmental Sustainability

Context. The economic recovery remains weak. After the severe 2015–16 recession, GDP grew by only 1.1 percent in both 2017 and 2018. Inflation remained below its target range prompting the central bank to cut interest rates to historic lows in March 2018. The current account deficit worsened from 0.4 percent of GDP in 2017 to 0.8 percent of GDP in 2018 on the back of higher oil prices. Although the primary deficit of the non-financial public sector closed the year at 1.7 percent of GDP, substantially smaller than the authorities' target, gross debt (IMF definition) reached 88 percent of GDP in 2018 and continues to grow. In February, the government sent to Congress an ambitious pension reform proposal that is projected to save about 1.1 trillion *reais* over ten years. Approval of the reform is essential to allow compliance with the constitutional spending ceiling in the coming years and to ensure the sustainability of the pension system. However, there is substantial uncertainty in passing the full reform package, and further structural reforms will be needed to anchor strong, durable, and inclusive growth. The most critical structural reforms include: enhancing the efficiency of the financial sector, streamlining the tax system, addressing the infrastructure gap, and opening up the economy to foreign trade. The IMF's Executive Board concluded the 2018 Article IV with Brazil on July 9, 2018 and the staff report was published on August 3, 2018. The 2019 Article IV consultation is scheduled for May 2019.

Financial developments. Banks weathered the recession well and remained resilient despite considerable losses on their loan portfolios. High interest margins and fees helped preserve their profitability and capital, while liquidity remained adequate. The economic recovery led to a decline in delinquency ratios that boosted profits, while capital ratios are well above regulatory minima. Nonfinancial corporates and households' balance sheets have improved somewhat. Credit growth turned positive in 2018, supported by looser financial conditions. Earmarked credit is decreasing after the big expansion following the financial crisis, but private banks and capital markets are taking up the slack.

Outlook and risks. Conditional on the approval of pension reform, confidence effects are expected to boost growth to 2.1 percent in 2019 and 2.5 percent in 2020 driven by a recovery in domestic consumption and investment, while inflation is projected to remain subdued at around 4 percent. Even if federal expenditure remains constant in real terms as mandated by the constitutional rule (baseline scenario), public debt is expected to rise further, reaching almost 98 percent of GDP in 2024. Failure to pass a pension reform reasonably close to the government's original proposal could undermine confidence in debt sustainability, leading to higher government bond yields and a depreciation of the exchange rate. Brazil is also vulnerable to lower global growth, a tightening of global financial conditions, and continued trade disruptions, even though trade diversion effects may attenuate the impact.



Policies. Fiscal consolidation is necessary given the worsening debt dynamics. Consolidation measures should include a robust pension reform and limits to the public wage bill. Deep structural reforms are needed to boost growth, such as improving the efficiency of financial intermediation, promoting trade integration, undertaking privatization, and reforming the tax system. Given the lack of inflationary pressures, monetary policy should remain accommodative to offset the contractionary effect of fiscal consolidation. Exchange rate flexibility should be the first line of defense against external shocks.



Table 1. Brazil: Selected Economic Indicators

I. Social and Demographic Indicators								
Area (thousands of sq. km)	8,512	Health						
Agricultural land (percent of land area)	31.2	Physician per 1000 people (2018)						
Population		Hospital beds per 1000 people (2018)						
Total (million) (2018)	208.5	Access to safe water (2015)						
Annual rate of growth (percent, 2015)	0.8	Education						
Density (per sq. km.) (2018)	24.5	Adult illiteracy rate (2016)						
Unemployment rate (Jan 2019)	12.0	Net enrollment rates, percent in:						
Population characteristics (2017)		Primary education (2017)						
Life expectancy at birth (years)	76	Secondary education (2015)						
Infant mortality (per thousand live births)	13	Poverty rate (in percent, 2017) 1/						
Income distribution (2017)		GDP, local currency (2018)						
Ratio between average income of top 10 percent of earners over bottom 40 percent	12.4	GDP, dollars (2018)						
Gini coefficient (2017)	54.9	GDP per capita (2018)						
		R\$6,826 billion						
		US\$1,868 billion						
		US\$8,960						
Main export products: airplanes, metallurgical products, soybeans, automobiles, electronic products, iron ore, coffee, and oil.								
II. Economic Indicators								
	2017	2018	Proj.					
			2019	2020	2021	2022	2023	2024
(Percentage change)								
National accounts and prices								
GDP at current prices	4.6	4.2	5.9	7.0	6.6	6.6	6.6	6.6
GDP at constant prices	1.1	1.1	2.1	2.5	2.2	2.2	2.2	2.2
Consumption	0.8	1.5	2.3	1.7	1.3	1.3	1.4	1.4
Investment	2.0	2.6	6.3	6.9	7.1	6.6	6.3	6.1
Consumer prices (IPCA, end of period)	2.9	3.7	3.9	4.0	4.0	4.0	4.0	4.0
(Percent of GDP)								
Gross domestic investment	15.0	15.4	15.9	16.5	17.1	17.7	18.3	18.9
Private sector	13.7	14.2	14.8	15.5	16.2	16.8	17.5	18.1
Public sector	1.3	1.2	1.1	1.0	0.9	0.9	0.8	0.8
Gross national savings	14.7	14.6	14.2	14.9	15.5	16.0	16.5	17.0
Private sector	21.1	20.2	20.3	20.7	21.3	21.5	21.7	21.9
Public sector	-6.5	-5.5	-6.1	-5.8	-5.9	-5.5	-5.3	-5.0
Public sector finances								
Central government primary balance	-1.9	-1.7	-1.8	-1.2	-0.6	-0.1	0.4	0.9
NFPS primary balance	-1.8	-1.7	-1.8	-1.0	-0.5	0.1	0.6	1.0
NFPS cyclically adjusted primary balance	-0.6	-0.6	-1.0	-0.5	-0.2	0.2	0.6	1.0
NFPS overall balance	-7.9	-6.8	-7.3	-7.0	-6.9	-6.6	-6.2	-5.8
Net public sector debt	51.6	54.1	56.2	58.7	60.9	62.8	64.2	65.7
General Government gross debt, Authorities' definition	74.1	77.2	...	...	...	...	...	...
NFPS gross debt	84.1	87.9	90.4	92.4	94.1	95.6	96.5	97.6
Of which: Foreign currency linked	3.7	4.2	4.2	4.2	4.2	4.1	3.9	3.7
(Annual percentage change)								
Money and credit								
Base money 2/	9.6	4.2	5.9	7.0	6.6	6.6	6.6	6.6
Broad money 3/	4.6	6.1	8.7	11.6	12.2	12.9	12.9	12.9
Bank loans to the private sector	0.0	4.7	5.8	5.9	6.3	6.1	6.2	6.0
(Billions of U.S. dollars, unless otherwise specified)								
Balance of payments								
Trade balance	64.0	53.6	50.0	54.2	57.5	62.4	64.9	66.9
Exports	217.2	239.0	250.7	262.2	275.6	291.7	306.9	322.5
Imports	153.2	185.4	200.7	208.0	218.1	229.4	242.0	255.6
Current account	-7.2	-14.5	-33.2	-33.1	-35.5	-38.6	-43.0	-46.6
Capital account and financial account	0.8	9.8	33.2	33.1	35.5	38.6	43.0	46.6
Foreign direct investment (net)	50.9	74.3	66.2	60.9	58.4	57.4	57.7	58.0
Terms of trade (percentage change)	0.0	-5.4	2.4	0.0	0.0	-0.3	-0.4	0.0
Merchandise exports (in US\$, annual percentage change)	17.8	10.0	4.9	4.6	5.1	5.8	5.2	5.1
Merchandise imports (in US\$, annual percentage change)	9.9	21.0	8.2	3.6	4.9	5.2	5.5	5.6
Total external debt (in percent of GDP)	32.3	36.9	36.4	35.5	34.8	34.0	33.3	32.5
Memorandum items:								
Current account (in percent of GDP)	-0.4	-0.8	-1.7	-1.6	-1.6	-1.7	-1.8	-1.9
Unemployment rate	12.8	12.3	11.4	10.2	9.8	9.5	9.3	9.0
Gross official reserves	374.0	374.7	374.7	374.7	374.7	374.7	374.7	374.7
REER (annual average in percent; appreciation +)	6.8	9.6	...	...	...	...	...	...

Sources: Central Bank of Brazil; Ministry of Finance; IBGE; IPEA; and Fund staff estimates.

1/ Computed by IBGE using the World Bank threshold for upper-middle income countries of US\$5.5/day. This number is not comparable to the estimates provided by IPEA in previous years due to methodological differences.

2/ Currency issued plus required and free reserves on demand deposits held at the central bank.

3/ Base money plus demand, time and saving deposits.



ANNEX 3: LETTER OF DEVELOPMENT POLICY



GOVERNO DO ESTADO DE MATO GROSSO

CARTA POLÍTICA DE DESENVOLVIMENTO

Cuiabá/MT, 20 de março de 2019.

À Sua Senhoria,
DOINA PETRESCU
Diretora Interina – Brasil
Região da América Latina e do Caribe
The World Bank

Assunto: Carta de Políticas – *Development Policy Loan (DPL)*

Senhora Diretora,

Este documento apresenta o conjunto de medidas de políticas fiscal e ambiental, que tem como objetivo realizar a integração das políticas públicas ambientais, sociais e econômicas, alicerçadas na sustentabilidade das contas públicas, visando melhorar a qualidade de vida dos cidadãos mato-grossenses.

O Governo do Estado de Mato Grosso tem a convicção de que o apoio técnico-financeiro do Banco Internacional para Reconstrução e Desenvolvimento – BIRD, por meio do *Development Policy Loan (DPL)*, representa um importante reforço às iniciativas adotadas pelo Estado com intuito de reequilibrar as contas públicas, melhorar a gestão ambiental e promover um desenvolvimento sustentável.

Mato Grosso: Contexto, avanços recentes, diretrizes e desafios



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1. O Estado de Mato Grosso é destacado pela disponibilidade de recursos naturais e por sua dimensão territorial, Com 903.357,91 Km², é o terceiro estado com a maior dimensão territorial do país, possuindo uma população estimada, em 2018, de 3.441.998 habitantes. Embora tenha baixo potencial de consumo interno, decorrente da baixa densidade demográfica, possui outro lado positivo, que é o elevado potencial de produção agropecuária, criado pelo arranjo institucional e legal que fomentou a expansão dessa atividade e a especialização da produção voltada especialmente ao mercado externo.

2. Figura-se entre os oito estados com a maior renda nominal mensal domiciliar per capita do país, com cerca de R\$ 1.386,00 e rendimento médio do trabalho principal de R\$ 2.329,00, terceira faixa de distribuição dos rendimentos (até R\$ 2.624,00). A taxa de ocupação observada é de 60,9%, ocupa a 8ª posição nacional. O índice de desenvolvimento humano (IDH), apurado com os dados do censo populacional de 2010, coloca Mato Grosso entre os estados brasileiros com médio nível de desenvolvimento humano (0,725).

3. Por conta da sua extensão geográfica e da disponibilidade de recursos naturais, o Estado de Mato Grosso apresentou nas últimas duas décadas um forte dinamismo econômico, despontando entre as economias estaduais. Em geral, esse desempenho se deve à ampliação da participação da agropecuária (22,40% participação no valor adicionado em 2016) e do setor de serviços (61,2% participação no valor adicionado no ano de 2016). Conjuntamente, essas atividades são responsáveis pelo crescimento do PIB estadual, com contribuições atribuídas à produção da lavoura e da pecuária e à viabilização dos serviços correlatos.

4. Devido às políticas de incentivo fiscal nos anos 70, foram implementados vários projetos agropecuários, transformando a agricultura de subsistência e a pecuária extensiva em uma agricultura moderna, acompanhada de produção de gado especializada. O Estado tornou-se uma potência global da produção de soja e de carne bovina, produzindo, em 2018, 31,8 milhões de



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toneladas de soja e 1,2 milhões de toneladas de carne bovina. Esta expansão agrícola ocorreu, em primeiro lugar, através de um vigoroso processo de ocupação e abertura de terras e, ao longo dos anos, com a incorporação de avanços tecnológicos. Destaca-se, ainda, na produção de milho e algodão.

5. A economia de Mato Grosso teve nas últimas décadas um desempenho econômico significativo frente aos demais entes da federação e da economia brasileira de forma global. Esse resultado se deve, em grande parte, às condições favoráveis ao comércio exterior advindas com a isenção do ICMS de produtos voltados à exportação e da viabilização de investimentos internos, inovações tecnológicas incorporadas na produção e no desenvolvimento do setor de serviços.

6. O desempenho econômico médio da economia mato-grossense de 2010 a 2014 foi de 5,34% ao ano. Em contraste, no ano de 2015 a economia do estado recuou em termos de volume em 1,9%, resultado menos pior que o desempenho médio do centro-oeste (-2,1%). Para o ano de 2016, puxado pelo baixo desempenho nacional, a economia de Mato Grosso teve retração de 6,3%. Alguns fatores explicam esse desempenho, em especial a queda no índice do comércio varejista (10,80%) e das exportações, que reduziram de US\$ 13,05 bilhões em 2015 para US\$ 12,58 bilhões em 2016, redução de 3,69% na comparação entre os anos.

7. Portanto, agravada pelo desempenho da economia nacional, o estado de Mato Grosso teve, no biênio 2015-2016, um dos seus piores desempenhos econômicos da história recente. Esse cenário refletiu na receita pública, impondo ao estado uma série de restrições, diminuindo sensivelmente sua capacidade de financiamento e até mesmo de manutenção de políticas públicas essenciais.

8. Em 2018, Mato Grosso, assim como outros Estados brasileiros, observou os efeitos de uma série de medidas e políticas de ajuste instituídas em 2016 e 2017, que objetivaram mitigar os efeitos da forte crise fiscal e financeira à



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qual ainda estão submetidos. Frente a essas medidas foi possível ampliar o espaço fiscal por meio da renegociação da dívida pública interna do Estado, atenuando o peso dos juros e conferindo prazo para amortização.

9. Apesar da renegociação da dívida interna, o Estado vem enfrentando grave crise de liquidez, gerando atrasos no repasse de duodécimos, de pagamentos a fornecedores e de proventos aos servidores públicos estaduais, além de perder a capacidade investir com recursos próprios. Em virtude dessa crise, parte das despesas correntes não é paga no mesmo exercício fiscal, criando um estoque de restos a pagar não processados sem disponibilidade financeira.

10. Nesse contexto, ainda que a recuperação da atividade econômica esteja refletindo sobre a recuperação da capacidade de arrecadação, inclusive influenciando positivamente a expectativa para a receita de impostos no estado, os desafios sob a ótica do dispêndio ainda são latentes. O problema das contas públicas é estrutural e está relacionado ao elevado comprometimento das receitas com gastos obrigatórios, notadamente despesas com pessoal e encargos sociais.

11. De fato, o problema das contas públicas atual do Estado não é o elevado estoque de dívidas contraídas no passado. No que diz respeito à dívida, os dados mostram que no encerramento de 2018 a relação entre a dívida e a receita corrente líquida (RCL) esteve na proporção de 45,91%, substancialmente abaixo do limite estabelecido na LRF de 200% da RCL.

12. Por outro lado, as despesas com pessoal ativo e inativo do Estado, como proporção da RCL, foi de 67,85% em 2018. Esse resultado excede em 7,85 p.p. o limite de gastos com pessoal e encargos sociais em relação ao limite fixado na Lei Complementar nº 101/2000

13. Com efeito, a despesa com inativos e pensionistas é um grande desafio às contas públicas do Estado, pelo simples fato do volume de contribuições



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não fazer frente ao de benefícios. Em 2018, o déficit financeiro da previdência estadual representou cerca de 7,45% da RCL.

14. Nessa matemática perversa, observa-se que a postergação de despesas via restos a pagar se materializa como verdadeira fonte de financiamento do Estado. Conseqüentemente, tem sobrado pouco espaço para os investimentos. Em um momento de forte retração da atividade, conforme observou-se no período recente, o baixo nível de Investimentos é um desafio para a recuperação da economia e, conseqüentemente, da própria arrecadação de tributos. O Estado de Mato Grosso investiu em 2018 apenas 6,4% da RCL, sendo que a principal fonte de financiamento foram os recursos oriundos das operações de crédito.

15. Desse diagnóstico, extrai-se que as contas públicas estaduais deterioraram gradativamente nos últimos anos, tornando necessária a adoção de medidas que desacelere tal processo. A situação fiscal é cada vez mais crítica. Os saldos fiscais do Estado retraíram drasticamente e uma aguda escassez de liquidez tem resultado em um aumento nos atrasos dos pagamentos e do estoque de restos a pagar sem lastro financeiro. A principal e estrutural fonte da deterioração fiscal é o crescimento excessivo das despesas obrigatórias, em especial das despesas de pessoal.

16. Diante desse quadro, propôs-se o Pacto por Mato Grosso, constituído por um conjunto de ações voltadas ao estabelecimento de regras fiscais consistentes, medidas de contenção e melhoria da eficiência do gasto, ampliação dos mecanismos de transparência financeira e envolvimento da sociedade matogrossense e dos Poderes constituídos com intuito de instrumentalizar o reequilíbrio fiscal do estado de Mato Grosso.

Nesse contexto, a prioridade do governo estadual consiste em mudar a trajetória de degeneração das contas públicas estaduais, mediante a adoção das seguintes medidas, sem prejuízos de outras a serem implementadas num futuro próximo:



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- Reorganização da estrutura administrativa do Poder Executivo estadual, implementada através da lei complementar nº. 612, de 28 de janeiro de 2019;
- Definição de critérios objetivos para mensurar a capacidade financeira do Tesouro Estadual no tocante à revisão geral anual da remuneração e do subsídio para os servidores públicos do Poder Executivo Estadual, cuja alteração foi efetuada através da lei nº. 10.819, de 28 de janeiro de 2019;
- Estabelecimento da prerrogativa da Diretoria Executiva do MT PREV para aprovação do estudo atuarial e da proposta do plano de custeio da previdência estadual, até a implementação da gestão centralizada do Regime Próprio de Previdência Social do Estado de Mato Grosso;
- Reestruturação das receitas do Fundo Estadual de Transporte e Habitação (FETHAB), com aumento das contribuições incidentes sobre os produtos agrícolas, sendo as alterações implementadas por meio da aprovação da Lei nº 10.818, de 28 de janeiro de 2019;
- Estabelecimento de normas de finanças públicas no âmbito do Estado de Mato Grosso, voltadas para a responsabilidade da gestão fiscal, por intermédio da aprovação da lei complementar nº. 614/2019;
- Proposição de diretrizes para controle, reavaliação e contenção das despesas no âmbito da Administração Pública Direta e Indireta do Poder Executivo, com a publicação do Decreto nº. 08, de 17 de janeiro de 2019;
- Criação do Fundo Estadual de Equilíbrio Fiscal, constituído pelo recolhimento de contrapartidas pela fruição de incentivos fiscais.

17. No âmbito do meio ambiente, o Estado de Mato Grosso destaca-se por possuir uma paisagem complexa, abrangendo três biomas - 53% da floresta amazônica no norte, 40% da savana florestal (Cerrado) em toda a região central e



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7% das zonas úmidas (Pantanal) no sul. No que tange aos desafios relacionadas à proteção ambiental, uma ampla gama de esforços públicos e privados conseguiram reduzir o desmatamento em Mato Grosso. Entre 1996 e 2011, Mato Grosso passou de 6.543 km²/ano de área desmatada para 1.120 km², o que representa uma redução de 83%.

Ainda assim, desde 2012, Mato Grosso mantém um patamar acima de 1.000 km² de desmatamento por ano. Entre agosto de 2016 e julho de 2017, a taxa de desmatamento da área florestal na Amazônia, levantada pelo Projeto de Monitoramento do Desmatamento na Amazônia Legal por Satélite (Prodes), do Instituto Nacional de pesquisas Espaciais (Inpe), foi de 6.624 km². Mato Grosso foi responsável por 20% de todo o desmatamento detectado na Amazônia, o que significou mais de 1.341 km² de florestas desmatadas em corte raso. A conversão de florestas no estado detém um alto grau de ilegalidade. De todo o desmatamento identificado, apenas 10% foi realizado em áreas com autorizações para desmatamento ou supressão de vegetação válidas emitidas pela Secretaria de Estado de Meio Ambiente (SEMA).

18. Recentemente, o Governo do Estado mudou sua abordagem para lidar com o desmatamento e incentivar o crescimento de uma produção agrícola sustentável, aumentando o diálogo com o setor produtivo e desenvolvendo instrumentos para mensurar e recompensá-los por seus serviços ambientais sustentáveis. Além disso, Mato Grosso tem uma parcela considerável de áreas protegidas, incluindo 104 unidades de conservação (níveis federal, estadual e municipal), somando 6% da área total do Estado. Através de um processo participativo, o Governo do Estado estabeleceu uma ambiciosa estratégia de sustentabilidade para 2030, chamada "Produzir, Conversar e Incluir", a fim de reduzir o desmatamento, melhorar o manejo florestal e reduzir a pobreza rural.

Políticas incluídas no Development Policy Loan



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Como contrapartida ao empréstimo para políticas de desenvolvimento, o Governo do Estado de Mato Grosso pretende desenvolver um conjunto de ações prioritárias nas áreas de sustentabilidade fiscal e meio ambiente.

19. Área de sustentabilidade fiscal: Com apoio do DPL, o Governo desenvolverá um conjunto de ações e medidas que garantam a sustentabilidade das contas públicas no curto e médio prazo. Isto permitirá que o Estado tenha capacidade de gerar resultados operacionais suficientes para equalizar o déficit financeiro e reduzir gradativamente os passivos financeiros, especialmente os restos a pagar sem lastro financeiro. Dentre as ações prévias implementadas pelo Estado de Mato Grosso, enfatizam-se:

- i. Aprovação da Lei Estadual de Responsabilidade Fiscal, limitando os gastos pessoais e incentivos fiscais e fornecendo uma meta de poupança corrente.
- ii. Estabelecimento de condicionantes financeiros para revisão anual dos subsídios, aposentadorias e pensões dos servidores do Poder Executivo, através da aprovação da Lei Estadual nº. 10.819/2019;
- iii. Fortalecimento da governança da autarquia gestora das aposentadorias e pensões estaduais, transferindo a autoridade para aprovar estudos atuariais e propor planos de financiamento do Conselho para a Diretoria Executiva, enquanto os Poderes e os órgãos autônomos não tiverem sido integrados à Mato Grosso Previdência (MT PREV). Essa medida foi implementada pela lei complementar nº. 613/2019;
- iv. Criação do Fundo Estadual de Equilíbrio Fiscal de Mato Grosso, visando aumentar as receitas públicas oriundas de empresas



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beneficiárias de incentivos fiscais, através da aprovação da lei nº. 10.709/2018;

v. Aprovação da lei nº. 10.818/2019, aumentando as contribuições sobre commodities agrícolas produzidas no Estado destinadas ao FETHAB, com discricionariedade do Tesouro para alocar 60% a partir do ano de 2019.

Como medidas adicionais adotadas pelo Estado de Mato Grosso, merecem ênfase a implantação de um Regime de Recuperação Fiscal que impõe um teto no gasto primário corrente do estado; execução da reforma administrativa do Poder Executivo, com extinção de órgãos e entidades públicas, redução de servidores temporários e comissionados; decretação do estado de calamidade financeira com adoção de medidas complementares para melhorar a eficiência e diminuir os gastos com custeio.

20. Área de proteção ambiental e câmbio climático: Com a perspectiva de aumentar a capacidade institucional para a agricultura sustentável, a conservação florestal e a mitigação das mudanças climáticas, as ações prévias adotadas pelo Estado foram:

i. Adoção do Plano de Ação para o Controle e Prevenção do Desmatamento e dos Incêndios Florestais (PPCDIF), instituído pelo Decreto nº. 1490/2018. Busca-se com essa medida melhorar a capacidade institucional do Estado para prevenir e controlar o desmatamento ilegal e os incêndios florestais, estabelecendo mecanismos específicos e ações prioritárias que permitam alertas e respostas rápidas. Essa medida visa reduzir o desmatamento anual em Mato Grosso;



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ii. Definição de procedimentos operacionais entre a Secretaria de Estado do Meio Ambiente do (SEMA) e o Ministério Público do Estado para acelerar e assegurar a operacionalização e supervisão da implementação do Sistema Mato-Grossense de Cadastro Ambiental Rural (SIMCAR), mediante celebração de Termo de Compromisso Ambiental assinados no mês de fevereiro de 2019, além do estabelecimento de detalhes operacionais para o cumprimento da Lei de Acesso à Informação, através de Termo de Acordo entre o Ministério Público e a Secretaria de Estado de Meio Ambiente.

iii. Implementação da “Estratégia: Produzir, Conservar e Incluir”, com o objetivo de captar recursos destinados à expansão e aumento da eficiência da produção agropecuária e florestal, a conservação dos remanescentes de vegetação nativa, recomposição dos passivos ambientais e a inclusão socioeconômica da agricultura familiar, bem como a redução de emissões e sequestro de carbono de 6 GTonCO₂, mediante o controle do desmatamento e o desenvolvimento de uma economia de baixo carbono. Trata-se do maior esforço global para mitigar mudanças climáticas já idealizado por um estado subnacional. Adicionalmente, para implementar a estratégia de PCI do Estado, nomeou-se, através do Decreto nº 46/2019, o Instituto PCI como instrumento de implementação da Estratégia, responsável por articular e coordenar as múltiplas partes interessadas; sugerir e fomentar políticas e ações públicas relacionadas à Estratégia,; liderar os esforços de identificação e captação de recursos junto a doadores e investidores; e administrar e monitorar programas e projetos financiados com esses recursos.



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Apoio financeiro

21. O Mato Grosso possui relevância econômica e ambiental em níveis nacional e internacional. Outrossim, merecem destaque as características geográficas e econômicas do Estado, que lhe conferem grande relevância global para a mitigação das mudanças climáticas e para a produção de alimentos.

22. Ante o exposto, o Governo do Estado de Mato Grosso está pleiteando um empréstimo no valor de US\$ 250 milhões (duzentos e cinquenta milhões de dólares americanos), na modalidade DPL - Empréstimo de Políticas de Desenvolvimento para Ajuste Fiscal e Sustentabilidade Ambiental no Estado de Mato Grosso, no âmbito do Banco Internacional para Reconstrução e Desenvolvimento – BIRD, com os objetivos de apoiar a recuperação sustentabilidade fiscal e aumentar a capacidade institucional para a agricultura sustentável, a conservação florestal e a mitigação das mudanças climáticas.

23. De maneira inequívoca, essa operação DPL melhorará o perfil da dívida pública estadual, bem como contribuirá para ampliar a liquidez financeira e reduzir atrasos em pagamentos a fornecedores, servidores públicos e municípios.

24. Aproveitamos a oportunidade para agradecer o apoio que o Banco Mundial tem ofertado ao Estado de Mato Grosso, ao tempo que colocamo-nos à disposição para esclarecimentos adicionais.

Respeitosamente,


MAURO MENDES FERREIRA
Governador do Estado de Mato Grosso



Government of Mato Grosso

Letter of Development Policy

Cuiaba, MT, March 20, 2019

To Madam
Doina Petrescu
Acting Country Director for Brazil
Latin America and the Caribbean Region
The World Bank

RE: Letter of Development Policy – Development Policy Loan (DPL)

Madam Director,

This document presents a set of fiscal and environmental policy measures aimed at integrating environmental, social and economic policies, based on the sustainability of public accounts, aiming at improving the quality of life of the citizens of Mato Grosso.

The Government of the State of Mato Grosso is convinced that the technical and financial support of the International Bank for Reconstruction and Development (IBRD), through a Development Policy Loan (DPL), represents an important reinforcement to the initiatives adopted by the State in order to restore balance to the public accounts, improve environmental management and promote sustainable development.

Mato Grosso: Context, recent advances, strategies and challenges

1. The State of Mato Grosso is characterized by the availability of natural resources and its territorial dimension of 903,357.91 Km², it is the state with the third largest territorial dimension of the country and the estimated population in 2018 is 3.441.998 inhabitants. Although it has a low potential for domestic consumption, it has another positive side, which is the high productive potential of agriculture, created by the institutional and legal arrangements that have fostered the expansion of this activity and the specialization of production focused especially on exports to foreign markets.

2. Mato Grosso is among the eight leading states in terms of gross monthly household income per capita, at approximately R\$ 1,386.00, with the average income of full-time workers standing at R\$ 2,329.00, which falls in the third quintile of the income distribution (up to R \$ 2,624.00). The observed employment rate is 60.9%, occupying the 8th highest position in the country. The human development index (HDI), based on data from the 2010 population census, places Mato Grosso among the Brazilian states with a medium level of human development (0.725).



3. Due to its geographic extension and the availability of natural resources, the State of Mato Grosso has presented strong economic dynamism over the last two decades, standing out among state economies. In general, this performance is due to the increase in the share of agriculture and livestock production (22.40% participation in value added in 2016) and the service sector (61.2% of value added in 2016). Jointly, these two sectors are responsible for the growth of the State's GDP, with contributions attributed to the production of crops and livestock, and the induction of related services.

4. Due to fiscal incentive policies in the 1970s, several agricultural and livestock projects were implemented, transforming subsistence agriculture and extensive livestock farming into modern agriculture and specialized livestock production. The State has become a global powerhouse for soy and beef production, producing in 2018 31.8 million tons of soybeans and 1.2 million tons of beef. This agricultural expansion occurred, at first, through a vigorous process of occupation and land clearing and, over the years, through the incorporation of technological advances. Also noteworthy is the State's production of cotton and maize.

5. The economy of Mato Grosso has, in recent decades, shown positive economic performance in relation to the other entities of the Brazilian Federation and the Brazilian economy as a whole. This result is largely due to favorable conditions for foreign trade, due to the exemption export-oriented products from ICMS taxation, the growth in domestic investments, incorporation of technological innovations in production and the development of the services sector.

6. The average economic growth of Mato Grosso's economy from 2010 to 2014 was 5.34% per year, only in the last of these years GDP grew by 4.4%. By contrast, in the year 2015, the economy of the State declined in real terms by 1.9%, a result less bad than the average performance of the center-west region (-2.1%). In the year 2016, pulled down by the weak national performance, the economy of Mato Grosso suffered a contraction of 6.3%. Several factors explain this performance: the drop in the index of retail sales (10.80%) and exports, which decreased from US\$13.05 billion in 2015 to US\$12.58 billion in 2016, a decrease of 3.69% in the comparison between the years.

7. Therefore, aggravated by the performance of the national economy, the State of Mato Grosso had in the biennium 2015-2016 one of its worst economic performances in its economic history. This economic performance is reflected in the performance of government revenues, imposing a series of restrictions on the State, significantly reducing its ability to finance and even maintain essential public services.

8. In 2018, Mato Grosso, like other Brazilian states, observed the effects of a series of adjustment measures and policies instituted in 2016 and 2017 that aimed to mitigate the effects of the strong fiscal and financial crisis to which they are still subject. In view of these measures, it was possible to expand the State's fiscal space by renegotiating some of the State's domestic public debt, reducing the weight of interest payments and extending amortization schedules.



9. Despite the renegotiation of the domestic debt, the State has been experiencing a severe liquidity crisis, resulting in delays in transfers to non-executive branches, payments to suppliers and salaries to State public servants. In addition, the State has lost the capacity to invest with own resources. As a result of this crisis, part of current expenditures is not paid in the same fiscal year, creating a stock of unpaid arrears without available financing.

10. In this context, although the recovery of economic activity is being reflected in a recovery of the tax base, hence positively influencing the expectations tax revenues in the State, the challenges from the point of view of expenditures are still latent. The public accounts problem is structural and is related to the high commitment of revenues to payment of mandator expenditures, notably personnel expenses and related social contributions.

11. In fact, the current problem of the State's public finances is not a high stock of debt contracted in the past. With regard to debt, the data show that at the end of 2018, the debt-to-net-current-revenue (RCL) ratio was 45.91%, substantially below the limit established in the LRF of 200%.

12. On the other hand, the State's spending on active and inactive personnel as a proportion of the RCL was 67.85% in 2018. This result exceeds by 7.85 percentage points the limit of spending on personnel and social contributions in relation to net-current revenue (RCL) defined in Complementary Law 101/2000.

13. In fact, the expenditure on retirees and recipients of survivor pensions is a great challenge to the State's finances, simply because the volume of contributions does not equal that of benefits paid out. In 2018, the financial deficit of the state pension system represented about 7.45% of the RCL.

14. In the context of this adverse arithmetic, it can be seen that the postponement of expenses through arrears has materialized as a de-facto source of financing for the State. As a result, there is little room left for the State to invest. In a moment of strong contraction in economic activity, as observed in the recent period, the low level of investments is a challenge for the recovery of the economy and, consequently, for tax collection itself. The State of Mato Grosso invested less than 6.4% of the RCL in 2018, and the main source of investment financing was funds coming from disbursements of loans.

15. From this diagnosis, it can be seen that the State's public accounts deteriorated gradually in recent years, necessitating the adoption of measures that reverse this process. The fiscal situation is increasingly critical. State fiscal balances have deteriorated, and acute shortages of liquidity have resulted in increased delays in payments and accumulation of a stock of arrears without available financing. The principle and structural source of this fiscal deterioration is the excessive growth of mandatory expenditures, especially personnel costs.

16. Against this background, the "Pact for Mato Grosso" was proposed, consisting of a set of actions including the establishment of consistent fiscal rules, measures to contain and improve the efficiency of spending, expansion of the mechanisms of financial transparency and involvement of



the society of Mato Grosse and the branches of government constituted with the intention of facilitating the fiscal rebalancing of the State of Mato Grosso.

In this context, the first and foremost priority of the State Government is to change the deteriorating trajectory of the State's public accounts, by adopting the following measures:

- Reorganization of the administrative structure of the State's Executive Branch, implemented through Complementary Law no. 612, of January 28, 2019;
- Definition of objective criteria to measure the financial capacity of the State Treasury regarding the annual general review of the remuneration and allowance for public servants of the State Executive Branch, whose amendment was made through Law no. 10,819 of January 28, 2019;
- Establishment of the prerogative of the Executive Board of the MTPREV for the approval of actuarial studies and the proposal of financing plans for State Pension system, until the implementation of the centralized management of the public sector pension system of the State of Mato Grosso;
- Realignment of the State Fund for Transport and Housing (FETHAB), with increased contributions on agricultural products, changes that were implemented through the approval of Law no. 10,818 of January 28, 2019;
- Establishment of public finance standards in the State of Mato Grosso, targeting responsible fiscal management, through the approval of complementary law no. 614/2019; and
- Proposal of guidelines for control, revaluation and reduction of expenditures in the scope of the Direct and Indirect Public Administration of the Executive Branch, with the publication of Decree no. 08 of January 17, 2019.
- Creation of the Fiscal Equilibrium Fund constituted by contributions from the beneficiaries of tax incentives.

17. With regard to the challenges related to environmental protection, the State of Mato Grosso stands out as having a complex landscape, comprising three biomes: 53% of State territory lies in the Amazon forest in the north, 40% in the forest savannah (*Cerrado*) in the entire central region and 7% in the seasonal wetlands (*Pantanal*) in the south. With regards to environmental challenges, a wide range of public and private efforts have succeeded in reducing deforestation in Mato Grosso. Between 1996 and 2011, Mato Grosso went from 6,543 km² of territory deforested annually to 1,120 km², representing a reduction of 83%.

Even so, since 2012, Mato Grosso has maintained a level of more than 1,000 km² of deforestation per year. Between August 2016 and July 2017, the deforestation rate in the territory in the Amazonian Forest, as observed by the Project for Monitoring Deforestation in the Legal Amazon by Satellite (Prodes), of the National Institute of Space Research (INPE), was 6,624 km². Mato Grosso accounted for 20% of all deforestation detected in the Amazon, which meant more than 1,341 km² of forest were cut down. The conversion of forest areas in the State occurs to a large degree illegally. Of all the deforestation identified, only 10% was carried out in areas with valid authorizations for



deforestation or vegetation suppression issued by the Secretariat of State for the Environment (SEMA).

18. The State Government has recently changed its approach to dealing with deforestation and encouraging the growth of sustainable agricultural production, increasing the dialogue with the productive sector and developing instruments to measure and reward them for their sustainable environmental services. In addition, Mato Grosso has a considerable portion of protected areas, including 104 conservation units (at the Federal, State and Municipal levels), accounting for 6% of the total area of the State. Through a participatory process, the State Government has established an ambitious 2030 sustainability strategy called "Produce, Conserve and Include" to reduce deforestation, improve forest management and reduce rural poverty.

Policies included in the Development Policy Loan

As government policy actions for this Development Policy Loan, the Government of the State of Mato Grosso commits to a set of priority actions in the areas of fiscal and environmental sustainability.

19. Pillar on Fiscal Sustainability: With the support of the DPL, the Government will develop a set of actions and measures that ensure the sustainability of public accounts in the short and medium term. This will allow the State to be able to generate sufficient operating balances to eliminate the financial deficit and gradually reduce its financial liabilities, especially the outstanding arrears. Among the prior actions implemented by the State of Mato Grosso, we emphasize:

- i. Approval of the State Fiscal Responsibility Law, limiting personal expenses and tax incentives and providing a current savings target.
- ii. Establishment of financial constraints for the annual revision of the salaries and pensions of the Executive Branch's employees, through the approval of State Law no. 10,819 / 2019;
- iii. Strengthening the governance of the State's pension authority, transferring the authority to approve actuarial studies and to propose financing plans from the Council to the Executive Board, as long as the various government branches and autonomous bodies have not been integrated into the *Mato Grosso Previdência* (MTPREV). This measure was implemented by Complementary Law no. 613/2019;
- iv. Creation of the State Fiscal Equilibrium Fund of Mato Grosso aiming to increase public revenues from companies benefiting from tax incentives, through the approval of State Law no. 10,709 / 2018;
- v. Approval of State Law no. 10,818 / 2019, increasing the contributions on agricultural commodities produced in the State destined to the FETHAB, with discretion of the Treasury over the allocation of 60% of revenues beginning in the year 2019.

Additional measures adopted by the State of Mato Grosso, that deserve mention are: the



implementation of a Fiscal Recovery Regime that imposes a ceiling on the current primary expenditure of the State; execution of an administrative reform of the Executive Branch, with the extinction of public bodies and entities, reduction of temporary employees and political appointees; decreeing of a state of financial calamity with the adoption of complementary measures to improve efficiency and reduce current expenditures.

20. Pillar on Environmental Protection and Climate Change: With the prospect of increasing institutional capacity for sustainable agriculture, forest conservation and climate change mitigation, the prior actions adopted by the State are:

i. Adoption of the Action Plan for the Control and Prevention of Deforestation and Forest Fires (PPCDIF), established by Decree no. 1490/2018. This measure seeks to improve the State's institutional capacity to prevent and control illegal logging and forest fires by establishing specific mechanisms and priority actions that allow for quick alerts and responses. This measure aims to reduce annual deforestation in Mato Grosso;

ii. Definition of operational procedures between the State Secretariat of the Environment (SEMA) and the State Public Prosecutor's Office to accelerate and ensure the operationalization and supervision of the implementation of the Mato Grosso Rural Environmental Registry System (SIMCAR), by means of an Environmental Commitment signed in February 2019, and also establishing operational details for compliance with the Law on Access to Information, through an Agreement between the Public Prosecutor's Office and the State Secretariat of the Environment.

iii. Implementation of the "Produce, Conserve and Include" strategy, with the objective of raising funds for the State of Mato Grosso aimed at expanding and increasing the efficiency of agricultural and livestock production and forestry, conservation of the remaining native vegetation, restoration of environmental liabilities and the socioeconomic inclusion of family farms, and the reduction of carbon emissions and sequestration of 6 giga-tons of CO₂ by controlling deforestation and developing a low carbon economy. This presents the largest effort to mitigate climate change devised by a subnational entity to date, globally. In addition, in order to implement the State's PCI strategy, the PCI Institute was designated by Decree No. 46/2019 as an instrument for implementing the strategy, responsible for articulating and coordinating the various stakeholders; to suggest and encourage policies and public actions related to the strategy; to lead efforts to identify and raise funds with donors and investors; and administer and monitor programs and projects funded with these resources.

Financial support

21. Mato Grosso has economic and environmental relevance at national and international level. Further, the economic and geographic characteristics of the State that give it a special role in climate change mitigation and global food production deserve special mention.



22. In light of the preceding, the Government of the State of Mato Grosso is seeking a US\$250 million (two hundred and fifty million US dollars) financing in the form of the Fiscal Adjustment and Environmental Sustainability Development Policy Loan for in the State of Mato Grosso, within the framework of the International Bank for Reconstruction and Development (IBRD), with the objectives of supporting the recovery of fiscal sustainability and increasing institutional capacity for sustainable agriculture, forest conservation and climate change mitigation.

23. Without a doubt, this DPL operation will improve the profile of the State's public debt, as well as contribute to increase the State's financial liquidity and reduction in delays in payments to suppliers, public servants and municipalities.

24. We take this opportunity to acknowledge the support that the World Bank has offered to the State of Mato Grosso, and also make ourselves available for further clarification.

Respectfully,

MAURO MENDES FERREIRA
Governor of the State of Mato Grosso



ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior Actions	Significant positive or negative environment effects	Significant poverty, social or distributional effects positive or negative
Operation Pillar 1: Regaining Fiscal Sustainability		
Prior action #1 (State Fiscal Responsibility Law)	No significant positive or negative effects	No direct impacts on the poorest segments of the population from this action on fiscal rules. Even though it is expected to result in a reduced civil service wage bill, a relative reduction in civil service pay is not expected to have significant impacts on poverty (see below). On the other hand, the fiscal deterioration which the action addresses, has significant poverty impacts through lost incomes (due to arrears) and deterioration of public services on which the poor depend most heavily. Restoring fiscal space for effective public service delivery will have positive impact on the poor relative to a counterfactual of continued fiscal crisis.
Prior action #2 (Control of public sector wage increases)	No significant positive or negative effects.	No direct impacts on the poorest segments of the population. Civil servants may experience real income loss, but very few are in the bottom 40 percent of the state population. Indirect impacts (e.g. on domestic employees of civil servants) are expected to be very limited given the moderate and gradual nature of the action.
Prior action #3 (Strengthening Governance of the State’s Pension Institute)	No significant positive or negative effects.	No direct impacts on the poorest segments of the population, since this is a measure on pension governance. Eventual changes to public sector pensions are also not expected to have significant poverty impacts, as low-income pensioners are protected by minimum pension rules.



<p>Prior action #4 (Fiscal Emergency Fund to raise revenue from ICMS tax expenditures)</p>	<p>No significant positive or negative effects.</p>	<p>The small reduction in tax benefits for mostly large industrial and wholesale businesses is not expected to have significant employment impacts, as rates were calibrated to maintain economic activity of the affected sectors.</p>
<p>Prior action #5 (Increase and broadening of FETHAB levies)</p>	<p>Positive effects on the environment. FETHAB works similar to an environmental tax or negative per-unit subsidy, as it is levied on activities directly related to carbon emissions and other environmental impacts. The FETHAB on wood has been shown in the past to contribute to reduced deforestation. The expansion of the FETHAB on cattle is expected to accelerate transition to more efficient low-carbon forms of livestock management.</p>	<p>The impact on food prices should be minimal since the contribution is levied on commodities the prices of which are determined on world markets. Impact on employment is also expected to be minimal, given the marginal impact of these measures on production costs (FETHAB levies are about 2 percent of most products' value, with increases under this action a fraction of this).</p>
<p>Operation Pillar 2: Increasing institutional capacity for sustainable agriculture, forest conservation and climate change mitigation</p>		
<p>Prior Action #6 (Plan to Combat Deforestation and Forest Fires)</p>	<p>Significant positive effects on the environment, due to more effective control of illegal deforestation and forest fires.</p>	<p>No significant positive or negative effects.</p>
<p>Prior action #7 (Strengthening of the Land Registry and Regularization Program)</p>	<p>Significant positive effects as the improved implementation of the rural land registry system increases the pressure on land owners to behave in accordance with environmental regulations and to correct past transgressions (e.g. reforest land which was illegally deforested)</p>	<p>Significant positive effects are expected for small landholders and family farmers as the registration of these groups are to be prioritized by SEMA under the agreement, and a verified rural land registration is expected to improve their ability to market their products and gain access to credit.</p>
<p>Prior action #8 (Institutionalization of the agency for raising carbon financing)</p>	<p>Significant positive effects as the PCI is expected to raise additional resources for forest protection in the State.</p>	<p>Significant positive effects as the benefit-sharing scheme currently in place favors indigenous peoples and traditional communities, who are amongst the socially most vulnerable groups in the State rural areas. Future resources can be expected to also benefit these communities.</p>