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Report No: 66573-BR

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED LOAN

IN THE AMOUNT OF US$480 MILLION

TO THE

STATE OF RIO GRANDE DO SUL

WITH THE GUARANTEE OF

THE FEDERATIVE REPUBLIC OF BRAZIL

FOR A

SWAP TO STRENGTHEN PUBLIC INVESTMENT PROJECT

MARCH 30, 2012

Finance and Private Sector Department
Brazil Country Management Unit
Latin America and the Caribbean Region

CURRENCY EQUIVALENTS
(Exchange Rate Effective January 30, 2012)

Currency Unit = Brazilian Real

1.75 BRL = US$1
0.55 USD = BRL I

BRAZIL-GOVERNMENT FISCAL YEAR
January - December

ABBREVIATIONS AND ACRONYMS

AGDI	Rio Grande do Sul State Development and Investment Promotion Agency (*Agência Gaúcha de Desenvolvimento e Promoção de Investimentos*)
APL	Economic Cluster (*Arranjo Produtivo Local*)
BNDES	National Economic and Social Development Bank *(Banco Nacional de Desenvolvimento Econômico e Social)*
CAGE	*Contadoria e Auditoria Geral do Estado*
CECOM	Central Procurement Agency *(Central de Compras)*
COREDES	Regional Development Councils *(Conselhos Regionais de Desenvolvimento)*
CQS	Consultants' Qualification Selection
CREMA	Maintenance and Repair Contracts (*Contratos de Reabilitação e Manutenção)*
DAER	Autonomous Department of Highways *(Departamento Autônomo de Estradas de Rodagem)*
DLI	Disbursement-Linked Indicator
DPL	Development Policy Loan
EEP	Eligible Expenditure Program
ESMF	Environmental and Social Management Framework
FBS	Fixed Budget Selection
FPE	State Public Financial Management System *(Finanças Públicas do Estado)*
HDM-4	Highway Development and Management Model
ICB	International Competitive Bidding
ICMS	Tax on Circulation of Goods and Services (*Imposto Sobre Operações relativas à Circulação de Mercadorias e Prestação de Serviços de Transporte Interestadual e Intermunicipal e de Comunicação)*
ICT	Information and Communications Technology
IDB	Inter-American Development Bank
IDEB	Indicator of Basic Education *(Índice de Desenvolvimento da Educação Básica)*
IFR	Interim Financial Report

INTOSAI	International Organization of Supreme Audit Institutions
IPERGS	State Social Security Institute *(Instituto de Previdência do Estado do Rio Grande do Sul)*
IPPF	Indigenous Peoples Planning Framework
IPR	Independent Procurement Review
IT	Information Technology
LCS	Least-Cost Selection
LOA	Annual Budget Law *(Lei do Orçamento Anual)*
NCB	National Competitive Bidding
PDO	Project Development Objective
PPA	Multi-year Government Plan *(Plano Plurianual do Governo)*
QCBS	Quality and Cost-Based Selection
RPF	Resettlement Policy Framework
SARH	State Secretariat of Administration and Human Resources *(Secretaria de Estado de Administração e Recursos Humanos)*
SCIT	State Secretariat of Science, Innovation and Technological Development *(Secretaria de Estado de Ciência, Inovação e Desenvolvimento Tecnológico)*
SEDUC	State Secretariat of Education *(Secretaria de Estado da Educação)*
SEFAZ	State Secretariat of Finance *(Secretaria de Estado da Fazenda)*
SEINFRA	State Secretariat of Infrastructure *(Secretaria de Estado de Infraestrutura e Logística*)
SEMA	State Secretariat of the Environment (*Secretaria de Estado do Meio Ambiente)*
SEPLAG	State Secretariat of Planning and Management *(Secretaria de Estado do Planejamento, Gestão e Participação Cidadã)*
SME	Small and Medium-Sized Enterprises
SSS	Single-Source Selection
SWAp	Sector Wide Approach
TCE	State Supreme Audit Body *(Tribunal de Contas do Estado)*

Regional Vice President:	Hasan A. Tuluy
Country Director:	Makhtar Diop
Sector Director:	Marialisa Motta
Sector Manager:	Lily Chu
Task Team Leader:	Thomas Kenyon

BRAZIL – STATE OF RIO GRANDE DO SUL
SWAp to Strengthen Public Investment

Table of Contents

Annexes

PAD DATA SHEET

BRAZIL – State of Rio Grande do Sul

SWAp to Strengthen Public Investment (P120830)

PROJECT APPRAISAL DOCUMENT

Latin America and the Caribbean Region
LCSPF

Basic Information			
Date:	March 30, 2012	Sectors:	General industry and trade sector (30%), Sub-national government administration (20%), Public administration-Financial Sector (20%), Primary education (15%), Rural and Inter-Urban Roads and Highways (15%)
Country Director:	Makhtar Diop	Themes:	Micro, Small and Medium Enterprise support (30%), Public expenditure, financial management and procurement (20%), Tax policy and administration (20%), Education for all (15%), Rural services and infrastructure (15%)
Sector Manager/Director:	Lily L.Chu/Marialisa Motta		
Project ID:	P120830	EA Category:	B - Partial Assessment
Lending Instrument:	Specific Investment Loan		
Team Leader:	Thomas Kenyon		
Does the project include any CDD component? No			
Joint IFC: No			

Borrower: State of Rio Grande do Sul, Brazil.			
Responsible Agency: SEPLAG (*Secretaria do Planejamento e Gestão do Estado do Ceará*)			
Contact:	Margareth Vasata	Title:	Director
Telephone No.:	555132881401	Email:	mvasata@seplag.rs.gov.br

Project Implementation Period:	Start Date:	01-Jan-2012	End Date:	31-Dec-2016
Expected Effectiveness Date:	01-Jul-2012			
Expected Closing Date:	30-June-2017			

Project Financing Data(US$M)

[X] Loan	[ ] Grant	[ ] Other
[ ] Credit	[ ] Guarantee	

For Loans/Credits/Others

Total Project Cost (US$M):	903.5
Total Bank Financing (US$M):	480.0

Financing Source	Amount(US$M)
State of Rio Grande do Sul, Brazil.	423.5
International Bank for Reconstruction and Development	480.0
Total	903.5

Expected Disbursements (in USD Million – without front-end fee)

Fiscal Year	2013	2014	2015	2016
Annual	91.5	128.6	157.5	101.2
Cumulative	91.5	220.1	377.6	478.8

Project Development Objective(s)

The objective of the Project is to support and improve the planning and implementation of public investments by strengthening the capacity of the Borrower's planning agency and selected sector secretariats of the Borrower.

Components (Part)

Part Name	Cost (USD Millions)
Part A. Technical Assistance for Public Sector Management This part will strengthen the Borrower's capacity to design, implement, monitor and evaluate public investment, including, inter alia, support for: investment and human resource planning, contract and public asset management; monitoring and impact assessment; environmental and disaster risk management; public-private consultation; and other technical assistance.	55.3

Part B. Eligible Expenditure Programs (EEP) This part will support the implementation of the Eligible Expenditure Programs through investments in public sector management (inter alia, public asset management), transport (inter alia, highway rehabilitation and repair), education (inter alia, technological modernization, buildings repair), and private sector development for small and medium-sized enterprises (inter alia, cluster programs, industrial extension services and technology parks).	423.5

Compliance				
Policy				
Does the project depart from the CAS (Country Assistance Strategy) in content or in other significant respects?	Yes	[ ]	No	[X]
Does the project require any exceptions from Bank policies?	Yes	[ ]	No	[X]
Have these been approved by Bank management?	Yes	[ ]	No	[ ]
Is approval for any policy exception sought from the Board?	Yes	[ ]	No	[X]
Does the project meet the Regional criteria for readiness for implementation?	Yes	[X]	No	[ ]

Safeguard Policies Triggered by the Project	Yes	No
Environmental Assessment OP/BP 4.01	X	
Natural Habitats OP/BP 4.04	X	
Forests OP/BP 4.36		X
Pest Management OP 4.09		X
Physical Cultural Resources OP/BP 4.11	X	
Indigenous Peoples OP/BP 4.10	X	
Involuntary Resettlement OP/BP 4.12	X	
Safety of Dams OP/BP 4.37		X
Projects on International Waterways OP/BP 7.50		X
Projects in Disputed Areas OP/BP 7.60		X

Legal Covenants

Name	**Recurrent**	**Due Date**	Frequency
Inter-agency agreements	No	Effectiveness	Through

			implementation
Implementing entity agreements	No	As needed	Through implementation
Operating manual	Yes	Effectiveness	
Special bidding committee	Yes	Effectiveness	Through implementation
EEP spending reports	Yes	Feb. 28th & Aug. 31st	Through implementation
Procurement reports	Yes	Feb. 28th & Aug. 28th	Through implementation
Procurement audit	Yes	NA	Annual through implementation
EEP eligibility and adjustment	Yes	NA	Through implementation
Safeguards compliance	Yes	NA	Through implementation
			Through implementation

Description of Covenants

Inter-agency agreements: The Borrower shall enter into Inter-Agency agreements with each of the Borrower's Agencies in charge of Project implementation, setting forth the manner in which each Agency will participate in the implementation of the Project including, *inter alia* financial management provisions detailing the flow of information and/or flow of funds between the relevant Agency and SEPLAG and in the case of DAER (*Departamento Autônomo de Estradas de Rodagem),* special provisions to govern the management of Loan proceeds.

Implementing entity agreements: The Borrower shall select additional public and non public entities to support the Borrower in the carrying out of Part B of the Project. The Borrower shall enter into separate agreements with each Additional Implementing Entity setting forth the manner in which each Additional Implementing Entity will participate in the implementation of the Project.

Operating manual: The Borrower shall carry out the Project, and cause the Project to be carried out, in accordance with the provisions of a manual, satisfactory to the Bank.

Special bidding committee: The Borrower shall set up and maintain, throughout the implementation of the Project, a special bidding committee, with members in numbers, with qualifications and experience, and working under terms of reference, satisfactory to the Bank (the Special Bidding Committee), said Special Bidding Committee to support the Borrower in the procurement of goods, works, consultants' services and non-consulting services under the Project.

EEP Spending reports: The Borrower shall furnish to the Bank immediately following the Effective Date, and on or about February 28 and August 31 of each year, starting on the first such date after the Effective Date, regular reports on EEP spending prepared in accordance with the provisions of the Project Operational Manual and the disbursement letter.

Procurement reports: The Borrower shall furnish to the Bank on or about February 28 and August 31 of each year starting on the first such date after the Effective Date, a Procurement report confirming that all procurement activities under Part B of the Project have been carried out in accordance with the Procurement Plan, and in a manner acceptable to the Bank.

Procurement audit: The Borrower shall: (a) have all the Project procurement records and documentation for each fiscal year of the Borrower audited, in accordance with appropriate procurement auditing principles by independent auditors acceptable to the Bank; (b) furnish to the Bank as soon as available, but in any case not later than six months after the end of each such fiscal year, the procurement audit report of such audit by said auditors, of such scope and in such detail as the Bank shall have reasonably requested; and (c) furnish to the Bank such other information concerning said Project procurement records and documentation and the procurement audit thereof as the Bank shall from time to time reasonably request.

EEP eligibility and adjustment: The EEPs shall comply with the eligibility criteria and procedures set forth in the Project Operational Manual. The Borrower and the Bank may jointly review, once every year, the amounts assigned per budget code to the EEP detailed in Schedule 4 to the Loan Agreement, and adjust as necessary, in a manner satisfactory to the Bank. If, at any time, the Bank determines that any portion of the financing under the Project was used for items improperly procured in violation of the Loan Agreement, was not used for Eligible Expenditures or, in case of the Eligible Expenditure Programs of Part B of the Project, was not supported by evidence of actual spending by the Borrower under said Eligible Expenditure Programs and/or by evidence of satisfaction of other criteria set forth in this Agreement or in the Project Operational Manual, the Borrower shall refund any such portion to the Bank as the Bank shall specify by notice to the Borrower.

Safeguards compliance: The Borrower shall carry out the Project and shall cause the Agencies and the Additional Implementing Entities to carry out the Project in accordance with the Safeguards Documents. In the case of activities under the Project which do not have an environmental management plan, indigenous peoples plan and/or resettlement action plan (as it may correspond) in place to the date of the Loan Agreement, the Borrower shall, and shall cause the Agencies and the Additional Implementing Entities to: (a) prior to the implementation of any activities under the Project, prepare the environmental management plan, indigenous peoples plan, and/or or resettlement plan, as it may correspond, required in the ESMF, the IPPF and/or the RPF, and follow the procedures set forth in the ESMF, IPPF and/or RPF (as it may correspond) with respect to the preparation of assessments, submission to the Bank for approval, consultations and disclosure of the final instruments; and (b) immediately after the Bank's approval of the pertinent plan, carry out said plan in accordance with its terms. The Borrower shall also ensure that the terms of reference for any consultancies related to any technical assistance provided under the Project, shall be satisfactory to the Bank and, to that end, such terms of reference shall require that the advice conveyed through such consultancies and technical assistance be consistent with the requirements of the Bank Safeguard Policies.

Team Composition			
Bank Staff			
Name	**Title**	**Specialization**	**Unit**
Thomas Kenyon	Senior Private Sector Devt. Spec.	Team Leader	LCSPF
Roland Clarke	Lead Public Sector Mgmt Spec.	PSM	LCSPE
Alexandre Oliveira	Senior Procurement Specialist	Procurement	LCSPT
Seynabou Sakho	Senior Country Economist	Fiscal	LCSPE
Michael Drabble	Senior Education Specialist	Education	LCSHE
Gregoire Gauthier	Transport Specialist	Transport	LCSSD
Joaquin Toro	Senior Disaster Risk Specialist	Disaster Risk	LCSUW
Bernadete Lange	Environment Specialist	Env. Management	LCSEN
Tiago Peixoto	Governance Specialist	Public consultation	WBI
Miriam Bruhn	Economist	Impact Assessment	DECFP
Joseph Kizito	Senior Financial Mgmt. Specialist	Financial Mgmt.	LCSFM
Frederico Rabello	Senior Procurement Specialist	Procurement	LCSPT
Miguel-Santiago Oliveira	Senior Finance Officer	Disbursements	CTRLN
Gunars Platais	Senior Environment Specialist	Safeguards/Env.	LCSSD
Mariangeles Sabella	Senior Counsel	Legal	LEGLA
Anita Fiori	PSD Specialist	Private Sector Dev.	IFC
Ruben Gomes	Consultant	Private Sector Dev	LCSPF
Bob Hodgson	Consultant	Private Sector Dev	LCSPF
Ximena Traa-Valarezo	Consultant	Safeguards/Social	LCSSO
Alexandre Arrobbio	Sr. Public Sector Management Specialist	Peer Reviewer	LCSPS
Fernando Blanco	Sr. Economist	Peer Reviewer	AFTP4
Ralf-Michael Kaltheier	Sr. Transport Economist	Peer Reviewer	LCSTR
Micky Ananth	Program Assistant	ACS	LCSPF

I. STRATEGIC CONTEXT

A. Country and State Context

1. The proposed loan is a multi-sector SWAp for US $480 million, to be implemented by the State of Rio Grande do Sul with the guarantee of the Federative Republic of Brazil. The economy of the State of Rio Grande do Sul is the fourth largest in Brazil, after Sao Paulo, Rio de Janeiro and Minas Gerais. It is also among the most well developed, with per capita income 14 percent above the national average and a correspondingly high level of human development. Economic activity is driven by export sectors, high-productivity agribusiness and a well-developed manufacturing sector. Rio Grande do Sul also stands to benefit from the investments associated with the discovery of the 'pre-sal' oil reserves off Brazil's southeastern coast.[1]

2. Despite these advantages, Rio Grande do Sul's relative position in the national economy has declined. Its share of national output fell from 8.9 percent in 1996 to 6.5 percent in 2010. The state's economy is also more volatile than average with large expansions typically followed by deep recessions. Recent growth has been particularly affected by the vulnerability of its agricultural production to drought and other extreme weather patterns and of its exports to the real appreciation of the Real.[2] Economic performance also suffered from a fiscal crisis in the mid-2000s that required sharp cuts in public investment and services and had a disproportionately negative impact on the poor.

3. The state's fiscal position has strengthened in the last four years, partly as a result of the assistance provided and compliance with targets set by the 2008 Rio Grande do Sul Fiscal Sustainability DPL (Development Policy Loan) (P106767). In 2007 Rio Grande do Sul faced the most difficult situation of any Brazilian state. A shrinking tax base, sharply rising personnel expenditures and a large structural deficit in the state pension system meant that it failed to comply with several requirements of the Fiscal Responsibility Law. It also had difficulty meeting its fixed spending obligations, particularly with respect to debt service, pension payments and the maintenance of public infrastructure.

4. The previous administration, elected in 2007, took strict measures to improve the situation. By controlling personnel expenditures and raising the rate of tax collection, it was able to run sustained primary surpluses. The debt restructuring associated with the Bank operation lowered the State's borrowing costs and improved its debt maturity profile. As a result, net debt fell from 280 percent of net current revenue in 2003 to 214 percent in 2010 and debt service from 17 percent of net revenue to 14.8 percent for the same period. Though it remains above the ceiling agreed upon under the Fiscal Responsibility Law and is higher in relation to revenues than in any other Brazilian state, net debt is expected to fall below the required 200 percent of net current revenues by end-2012.

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[1] These deep-sea deposits, so called because they lie underneath a layer of salt up to two kilometers thick, are thought to extend from off the coast of Santa Catarina in the south to Espirito Santo in the northeast.

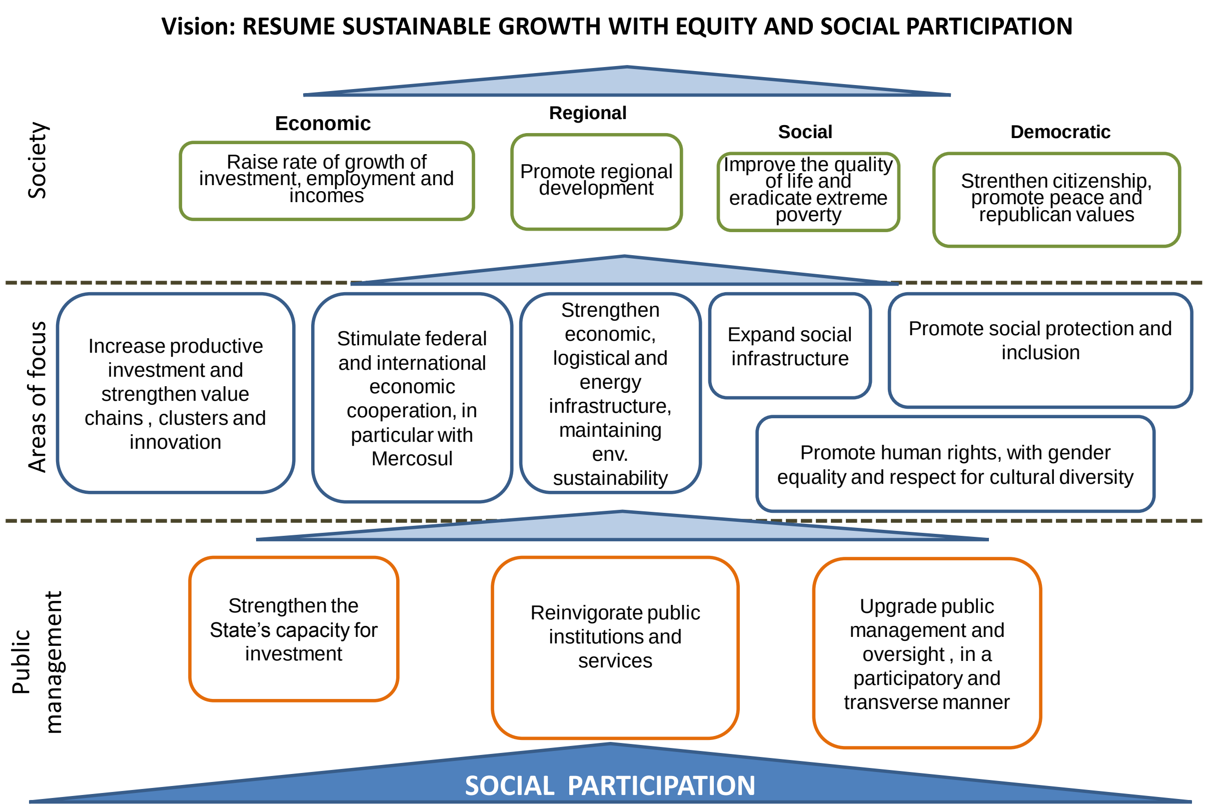
[2] According to Civil Defense data Rio Grande do Sul experienced 1645 extreme weather events between 2003 and 2009, which affected more than 90% of cities. The resulting economic losses were close to US$7 billion.

5. By 2008 these improvements had led the federal government to authorize the state to borrow for the first time since the renegotiation of its debt in 1997. Nonetheless, serious challenges remain. In contrast to the achievements in fiscal sustainability and debt restructuring, relatively little progress was made on the other two elements of the previous Bank operation (Rio Grande do Sul Fiscal Sustainability DPL - P106767) - social security reform and public sector modernization – during the period of its implementation. The state has since passed a new social security law, but still faces the task of building on this improvement in fiscal performance by raising the efficiency and quality of public sector investment and service delivery.

B. Sectoral and Institutional Context

6. After several years in which the focus of government attention was on fiscal consolidation, the chief goal of the Government of Rio Grande do Sul is to stimulate the resumption of economic growth in a tight fiscal environment and to improve the quality of public services. The incoming administration's strategy has four objectives: to raise the rate of growth of investment, incomes and employment; to promote regional development; to eliminate extreme poverty; and to strengthen civic participation.

Figure 1: State Government Strategic Plan



7. The Government is conscious that the fiscal adjustment was achieved largely through cuts in public investment and recognizes that the state has slipped in national rankings of

educational and infrastructural quality as a result. It has therefore requested that the Bank support a set of selective well-targeted green growth-oriented interventions in transport, education and private sector development supported by improvements in public sector management, environmental management and public service delivery.

8. The Government of Rio Grande do Sul is also aware that the quality of many of its current investment projects has suffered from poor selection criteria, failed procurement processes, delays in post-contract execution and cost-overruns. While some progress was made in establishing systems to monitor implementation of investment projects under the previous Bank project, this did not extend to rigorous project selection mechanisms; nor did it include support for monitoring and corrective action. The current Project will help the Government establish integrated institutions for selecting, prioritizing and implementing public investments.

9. The Project will also provide support for evaluation and impact assessment. Rio Grande do Sul has a tradition of collaborative and at times interventionist policies in public sector management and private sector development. The Government views these mechanisms as important tools for improving the efficiency of public investment and stimulating the development of the private sector.[3] At the same time, it is concerned about their effectiveness, as many date back to the early 1990s and are in need of evaluation and probable modernization. An important contribution of the Project will be to advise on and support their adaptation.

10. The Bank's involvement should be understood in the context of several other Government programs, financed by the Brazilian federal government and other agencies, notably the Inter-American Development Bank (IDB) and the National Economic and Social Development Bank (BNDES). The federal government is financing programs in urban transport, basic sanitation and irrigation. The IDB is supporting actions to strengthen the Government's capacity for fiscal management.[4] The BNDES program comprises support for the development of industrial parks; construction of municipal access roads and modernization of regional airports; provision of low-income housing; and support for small-scale agricultural producers.

C. Higher Level Objectives to which the Project Contributes

11. The World Bank's lending in Brazil is increasingly concentrated in multi-sector operations with state and municipal governments, with a focus on policy design and implementation. The World Bank Group's Country Partnership Strategy 2012-2015 (Report #63731-BR) discussed by the Executive Directors on November 1, 2011 emphasizes four strategic objectives: (i) to increase the volume and productivity of public and private investments; (ii) to improve the quality and expand the provision of public services for low income households; (iii) to promote regional economic development; and (iv) to improve natural

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[3] When appropriately implemented, participation in budgetary processes can help better identify citizens' needs, leading to a more evidence-based allocation of resources and increasing the legitimacy of public investment decisions. Participatory budgeting has also been associated with a reduction in tax evasion as it allows citizens to connect government spending to public service delivery.

[4] The IDB loan addressed *inter alia* debt management, tax administration and internal organization and control systems within SEFAZ.

resource management and climate resilience. These are to be achieved through support for the following policies and instruments:

- Improved fiscal and public sector management and more effective private sector development policies.

- Better quality education and access to health care for the poor and stronger social protection; expanded access to affordable housing.

- Improved transport and logistics, expanded access to basic sanitation and a greater supply of clean and efficient energy.

- Integrated water resources management, expanded sustainable agriculture, improved disaster risk management and improved environmental and biodiversity management.

12. The objective of this loan and the policies and programs that it will support are closely aligned with this strategy. The SWAp will strengthen the capacity of the Government of Rio Grande do Sul to plan and execute public investments in education, private sector development and transport while preserving fiscal discipline and improving environmental and natural resource management.

II. PROJECT DEVELOPMENT OBJECTIVES

A. Project Development Objective

13. The Project Development Objective (PDO) is to support and improve the planning and implementation of public investments by strengthening the capacity of the State planning agency and selected sector secretariats of the State.

14. These investments will be in infrastructure, education, economic development and science and technology. The Project will provide cross-cutting technical assistance in public investment and human resource planning, procurement management, contract management, impact assessment, environmental and disaster risk management and citizen participation in decision-making. It will also support, through eligible expenditure programs, investments in transport (*inter alia* highway rehabilitation and maintenance), education (*inter alia* technological modernization and buildings repair) private sector development for small and medium-sized enterprises (*inter alia* cluster programs, industrial extension services and technology parks) and public sector management (*inter alia* public asset management).

B. Project Beneficiaries

15. The beneficiaries of this Project are: teachers at all levels, primary and secondary school students and their parents (education component); small and medium-sized enterprises and technologically innovative firms (private sector development component); and personal and commercial users of the state highway network (transport component). Other beneficiaries are those state institutions benefiting from Project technical assistance that will enable them to improve the quality of public services.

C. PDO Level Results Indicators

16. The PDO level results indicators are: (i) the implementation of a road pavement management system; (ii) the implementation of a system for learning assessment at primary and secondary levels; (iii) the completion of the impact evaluation of industrial extension services; and (iv) the submission of a draft public asset management law to the state legislative assembly.

D. Disbursement linked indicators

17. The eligible expenditure program in transport, education and private sector development will be monitored via a set of disbursement-linked and performance indicators (see Annex 1). The state's fiscal performance will also be monitored via three additional disbursement-linked indicators. The disbursement-linked indicators are as follows: (i) transport – cumulative percentage of state paved highway network under performance-based maintenance and repair contracts (CREMA - *Contratos de Reabilitação e Manutenção*); (ii) education – number of school construction and refurbishment projects completed; (iii) private sector development – number of agreements signed or renewed with clusters; (iv) private sector development – number of agreements signed or renewed with extension service providers; (v) private sector development - operators of science parks (Triple Helix Alliances); (vi) fiscal performance – primary balance; (vii) fiscal performance - investment expenditures; and (viii) fiscal performance - revenue from value-added tax on circulation of goods and services (ICMS - *Imposto Sobre Operações relativas à Circulação de Mercadorias e Prestação de Serviços de Transporte Interestadual e Intermunicipal e de Comunicação*).

18. The definition and targets to be met for the PDO, disbursement-linked and performance indicators (see below) will be subject to revision by the Government and the Bank during a mid-term review, to be held on or about September 30, 2014 or as needed, during implementation.

III. PROJECT DESCRIPTION

A. Project Parts

19. The Rio Grande do Sul SWAp has two parts: (i) a cross-cutting public sector management part comprising of technical assistance of approximately US$55.3 million and (ii) an eligible expenditure program (EEP) part of approximately US$423.5 million. The purpose of the technical assistance is to strengthen the capacity of the State Government to plan and execute the eligible expenditure program.

Part A: Technical Assistance

20. The technical assistance part will strengthen the Borrower's capacity to design, implement, monitor and evaluate public investment, including, *inter alia*, support for:

21. Investment and human resource planning, contract and public asset management, through: (a) carrying out a review of the Borrower's current project planning process and developing terms of reference to develop the relevant procedures and manuals; (b) developing a methodology and providing training in project preparation; (c) providing support for long-term

integrated transport and logistics infrastructure planning; (d) carrying out a diagnostic study of SEDUC's human resources system; (e) developing and implementing a contract management information system; (f) developing and implementing a bidding management system; and (g) setting up a system for managing public assets and disposing of surplus real estate assets.

22. Monitoring and impact assessment, through: (a) setting up a multi-channel system for public service evaluation; and (b) providing training in firm-level benchmarking methodology.

23. Environmental and disaster risk management, through: (a) setting up an environmental licensing and public communications system; (b) setting up an ecological-economic zoning system; (c) developing a disaster risk management coordination system; (d) setting up a disaster risk information and monitoring system; (e) establishing a disaster risk management situation room; (f) carrying out a feasibility study for industrial symbiosis; and (g) providing training in firm-level waste reduction techniques.

24. Public-private consultation, through: (a) designing an ICT strategy, systems and implementation support; (b) designing and implementing a multi-channel participatory budgeting platform and participation portal; and (c) drafting a proposed new legal framework on participatory procedures and third party monitoring, supporting its application to organizational processes and providing training to strengthen third party monitoring.

25. Other technical assistance, through: (a) providing technical assistance to economic clusters on, inter alia, marketing strategies; (b) surveying new entrepreneurs and recently established firms to understand constraints on firm formation and foster coordination among private sector development interventions; (c) carrying out a critical point survey road program, and developing a bridge management system; (d) providing support for the modernization of the management of the Borrower's pension system; (e) providing support for the institutional strengthening and institutional modernization of DAER *(Departamento Autônomo de Estradas de Rodagem)*; (f) providing support to Rio Grande do Sul State Development and Investment Promotion Agency management (AGDI - *Agência Gaúcha de Desenvolvimento e Promoção de Investimentos)* throughout the first year of the Project; and (g) carrying out the technical audits referred to in Section II.A.2 of Schedule 2 of the Loan Agreement.

26. The technical assistance part will also fund an independent technical audit of compliance with disbursement-linked indicators (DLIs).

Part B: Eligible expenditure programs

27. Under this part the project will finance eligible expenditure programs (Table 1) encompassing investments in public sector management (*inter alia*, public asset management), transport (*inter alia*, highway rehabilitation and repair), education (*inter alia*, technological modernization, buildings repair), and private sector development for small and medium-sized enterprises (*inter alia*, cluster programs, industrial extension services and technology parks) identified by the Government as critical for restarting economic growth. There will be two sets of

conditions for disbursement: the achievement of DLIs; and expenditure thresholds for each EEP (70 percent rule).[5]

Sector 1: Transport (US$ 222.2 million)

28. This component will support state paved highway rehabilitation and maintenance and DAER's modernization. The Project will finance the implementation of CREMAs on up to 1,600 km of the state highway network considered a priority for economic growth and regional integration.

Table 1. Eligible Expenditure Programs

Program name and budget line number	FY 2013 (BRL m)	FY 2014 (BRL m)	FY 2015 (BRL m)	FY 2016 (BRL m)	Total (BRL m)	Total (US$ m)	IBRD Financing (US$ m)
Transport:							
CREMA – 3252	0	146.7	248.5	225.0	620.2	354.4	222.2
Education:							
Construction and refurbishment of facilities – 6344	192.5	122.0	121.1	78.7	514.2	293.8	95.6
Technological modernization – 1909	41.9	35.8	34.5	19.3	131.4	75.1	21.0
Participatory evaluation system - 5791	6.2	6.2	6.3	0.3	19.1	10.9	10.2
Private sector development:							
Cluster governance and monitoring – 3342/3335	4.7	5.1	4.5	4.1	18.5	10.6	6.2
Industrial extension services – 3334	6.6	12.3	12.3	11.9	43.1	24.6	23.5
Science parks & innovation networks – 6704	33.2	32.1	32.6	19.7	117.6	67.2	35.6
Public sector management:							
Public asset management - 8089	5.2	4.3	3.7	5.2	18.4	10.5	9.2
TOTAL						**847.1**	**423.5**

Note: US$ = 1.75 BRL

[5] "70% Rule" means a condition to be met by the Borrower for certain Loan disbursements to take place, namely that for the aggregate amount of all EEPs there has been spent, in the previous July 1 to June 30 period, 70% of the budgeted EEP's funds (specified in Schedule 4 to the Loan Agreement) for said period under Component B of the Project.

Sector 2: Education (US$ 126.8 million)

29. This component will support technological modernization, school construction and refurbishment and a participatory evaluation of the state education system. The Project will finance the upgrading of IT laboratories in schools, a one-computer per child pilot program (US$ 21.0 million) and the refurbishment of school facilities (US$ 95.6 million). It will also support the introduction of a web-based participatory evaluation system that will gather data on pupil, teacher and director performance to be used in policy-making (US$ 10.2 million).

Sector 3: Private Sector Development (US$ 65.3 million)

30. This component will support economic cluster programs, industrial extension services and the expansion of science parks and innovation networks. The Project will support a study to guide regional development policy in the state and support the development of a strategic plan and management training for each of approximately 20 clusters (US$ 6.2 million). It will also fund extension services (e.g. for benchmarking and lean manufacturing) to enterprises and evaluate their impact on firm performance using a rigorous methodology (US$ 23.5 million). And it will strengthen existing science parks, finance up to seven new parks via a competitive bidding process (US$ 21.6 million) and support existing university-business innovation networks (‘polos tecnologicos’) to stimulate technology adaptation and diffusion (US$ 14.0 million).

Sector 4: Public Sector Management (US$ 9.2 million)

31. This component will support the development of systems for managing and disposing of public real and non-real estate assets (US$ 9.2 million).

IV. Lending Instrument

A. Choice of SWAp

32. The Rio Grande do Sul SWAp follows the model first employed in Ceará and replicated in Minas Gerais, the Federal District and Pernambuco combining support for public sector management with financing of selected sector programs. It is an appropriate means of continuing the support begun under the Rio Grande do Sul Fiscal Sustainability DPL (P106767) to increase the efficiency of public investment while guarding against any relaxation of fiscal discipline.

Table 2. Project Costs and Financing Plan (US$ millions)

Project Parts	Project cost	IBRD Financing	State Government Financing	% IBRD Financing
1. Technical Assistance for Public Sector Management	55.3	55.3	0	100
2. Eligible Expenditure Program (EEP)	847.0	423.5	423.5	50.0
Total Project Costs	902.3	478.8	423.5	53.1
Front-End Fees	1.2	1.2	-	-
Total Financing Required	903.5	480.0	423.5	53.1

B. Lessons Learned and Reflected in the Project Design

33. *Education:* Lessons from previous Bank-financed education projects in Brazil have emphasized the importance of providing multiple inputs simultaneously (e.g. information technology and upgrading of physical facilities, as financed under the Project, and teacher training, as financed from other resources).

34. *Transport:* The focus of the transport component on CREMA reflects the Bank's experience with similar projects in Brazil. Performance-based contracting has been shown to improve the efficiency of road maintenance and rehabilitation in other states, both in terms of life-cycle cost and in quality of execution of the works. Part of these efficiency gains comes from the greater involvement of the private sector in road maintenance, with contracts bundling initial rehabilitation with subsequent routine maintenance, and including performance-based remuneration as an incentive. Pioneered in Rio Grande do Sul in the early 2000's, the CREMA model has improved steadily, factoring in lessons learned in other jurisdictions. The contractual arrangement proposed under the Project will build on this experience, including in particular: a simplified but adequate technical solutions catalogue to streamline design and save costs; and easily intelligible monitoring systems that specify credible sanctions for non-compliance and are associated with tight contract supervision. The Project contains significant technical assistance to strengthen project planning and supervisory capacity at DAER.

35. *Private sector development:* There is a long record of productive development projects financed by the Bank and other agencies in Brazil, offering many lessons. First, the more successful projects are driven by industry demand and not from the supply side by government agencies or other service providers. Second, it has proved important to include 'soft' upgrading in the form of technical assistance and training as well as 'hard' support for capital investments. Third, demonstration projects can serve as catalysts, building credibility and support for scaling-up in subsequent phases. These lessons are reflected in the design of the project. The industrial upgrading and science park sub-components will require a participant contribution equivalent to 15-25 percent of cost. The industrial extension services component will also advise on both 'soft' and 'hard' upgrading options, though the Project will not finance any capital expenditures. It will include a one-year pilot, capped by a rigorous impact assessment, to allow for lessons to be learned and adjustments made before a scaled-up second phase. Finally, particular attention will be paid to ensuring that the design principles embodied in the more successful science and technology parks are replicated in other locations.

36. *Implementation:* A lesson learned from previous SWAp operation in Brazil has been the need to provide technical assistance efficiently. The Project will address this by dedicating staff in SEPLAG specifically to this procurement function via a special bidding committee. The Project design has also delinked disbursement-linked indicators from technical assistance sub-projects. Other mitigating factors include the centralization of the procurement plan into a single document to assist with monitoring; the relegation of most non-consultant expenditures to EEPs; and the provision of training in preparing terms of reference and cost estimates to all implementing agencies, in particular to the State Secretariat of the Environment (*SEMA* - (*Secretaria de Estado do Meio Ambiente)* which is responsible for approximately $21 million of the technical assistance part.

V. IMPLEMENTATION

A. Institutional and Implementation Arrangements

37. Responsibility for coordinating and reporting on Project activities[6] will lie with SEPLAG. The details of these arrangements will be specified in the Operational Manual. The Government will also monitor implementation of the broader program to which the Project is contributing. Relationships among the implementing agencies listed in Table 3 will be governed by Inter Agency Agreements, the drawing up of which will be a condition of effectiveness.

Table 3. Implementing Agencies and Activities

Agency	Component/sub-component	Type of assistance & activity number
SEPLAG (*Secretaria de Estado do Planejamento, Gestão e Participação Cidadã)*	Public sector management – public investment planning, consultative mechanisms, disaster risk	TA (A1, A2, A11, A15, A17, A20, A21, A22)
SARH (*Secretaria de Estado de Administração e Recursos Humanos)*	Public sector management – procurement, public asset management	EEP (B8) & TA (A8, A9, A10)
IPERGS *(Instituto de Previdência do Estado do Rio Grande do Sul)*	Public sector management – state pension system modernization	TA (A6)
SEMA (*Secretaria de Estado do Meio Ambiente)*	Public sector management – environmental management, disaster risk	TA (A13, A14, A16, A17)
DAER (*Departamento Autônomo de Estradas de Rodagem)*	Transport – performance-based contracts, institutional strengthening, road safety	EEP (B1) & TA (A4, A24)
SEINFRA *(Secretaria de Estado de Infraestrutura e Logística*)	Transport – infrastructure and logistics master-plan	TA (A3)
SEDUC *(Secretaria de Estado da Educação)*	Education – all	EEP (B2, B3, B4) & TA (A5)
AGDI *(Agência Gaúcha de Desenvolvimento e Promoção de Investimentos)*	Private sector development – cluster government and industrial extension services	EEP (B5, B6) & TA (A7, A12, A18, A19, A23)
SCIT *(Secretaria de Estado de Ciência, Inovação e Desenvolvimento Tecnológico)*	Private sector development – science parks, innovation networks	EEP (B7) & TA (A25)

38. Additional Implementation Agreements are expected to be entered between most of the implementing agencies and state universities, labor unions, city halls, non-governmental

[6] See Annex 2 for more detailed information.

organizations, and so forth. Such agreements are governed by the State of Rio Grande do Sul Auditor and Accountant General. They should also be consistent with the provisions of the loan agreement to be entered into between the State Government and the Bank, including with respect to procurement, financial management, safeguards and anti-corruption.

B. Results Monitoring and Evaluation

39. The Bank will rely on the state's systems for monitoring and evaluation (the 'System for Monitoring and Evaluation of Strategic Projects') while contributing to their strengthening through technical assistance. Responsibility for timely and accurate reporting of results lies wholly with the Government of the State of Rio Grande do Sul. The specific tasks for which the State Government is responsible are as follows:

- Ensure general coordination with the Bank, the various secretariats and government stakeholders and timely implementation of all activities to ensure compliance with loan conditionality;

- Monitor and report on loan activities in a timely manner, including the presentation of financial and performance reports as needed by the Bank for disbursement and in accordance with Bank fiduciary and performance oversight requirements;

- Ensure that procurement is carried out following Bank rules for EEPs and technical assistance parts, including the preparation of procurement plans for the latter. SEPLAG will also advise on the drafting of terms of reference where required;

- Hold monthly meetings of the System for Monitoring and Evaluation of Strategic Projects to track and monitor results and develop, propose and carry out any necessary corrective measures to ensure compliance with loan conditions;

- Host, facilitate and participate in Bank supervision missions.

40. The Bank will review the performance reports provided. In addition, the Government will be responsible for contracting out an independent technical review of compliance with the DLIs, to be completed no later than 31st August each year.

41. The data will also be corroborated through independent surveys of Project beneficiaries (e.g. teachers and parents, users of the state highway network, users of the environmental licensing system, small business owners).

C. Sustainability

42. The State Government of Rio Grande do Sul has demonstrated its commitment through its agreement to finance a substantial proportion (50 percent) of the eligible program expenditures. This strong ownership is evident in the prioritization of strategic projects in the annual budget document *(LOA - Lei do Orçamento Anual)* and the multi-year government program *(PPA - Plano Plurianual do Governo*), both of which are presented to the Legislative

Assembly and whose implementation is closely monitored and reported to the public on a regular basis.

43. There still remains a substantial risk that the programs supported by the Project, notably the cluster and industrial extension services planned under the private sector development component, may be affected by the political cycle. Their sustainability will be strengthened via the institutionalization of AGDI and the development of joint public-private financing mechanisms, including the establishment of a matching grant fund for collective private investment.

VI. KEY RISKS AND MITIGATION MEASURES

44. Implementing agency risk: Capacity risk is Substantial. Both procurement and financial management risk are Substantial, reflecting the absence of an effective system for managing contract and procurement data within CECOM *(Central de Compras)*, the varying capacity across implementing agencies to draft technical specifications and the inherent nature of a SWAp operation. The rating also reflects the relatively recent establishment of one of the key implementing agencies (AGDI). The Project will strengthen CECOM's capacity to manage procurement data, establish a special bidding committee within SEPLAG as a condition of effectiveness and provide training in Bank procurement guidelines prior to effectiveness. It will also provide interim management support to AGDI, in particular for the contracting out of technical assistance activities.

45. Social and environmental risk: Social and environmental risk is Moderate. The Project will support highway maintenance, technological parks and school refurbishment. No need for acquisition of rights of way or resettlement is envisaged but all activities involve physical works and consequent management of noise and dust and disposal of waste materials. Contractors will be required to comply with state and federal legislation and to meet any additional requirements imposed by the Bank's safeguards policies (see also paragraphs 63 and 64).

Table 4. Risk Ratings Summary

Risk	**Rating**
Stakeholder Risk	Substantial
Implementing Agency Level Risk	
Capacity	Substantial
Governance	Low
Project Level Risk	
Design	Moderate
Social and Environmental	Moderate
Program and Donor	Low
Delivery Monitoring and Sustainability	Moderate
Overall Implementation Risk	Moderate

46. Stakeholder risk: Stakeholder risk is Substantial. The Project will support the activities, either through technical assistance or as Eligible Expenditure Programs, of eight agencies. This

imposes a large burden of coordination and monitoring on SEPLAG. However, experience elsewhere in Brazil (e.g. from the Ceara Inclusive Growth SWAp II (P106765)) has shown that this is feasible provided there is formal and regular communication between the planning and sector agencies. The Project will rely on the State Government's own System for Monitoring and Evaluating Strategic Projects, which meets monthly and involves senior representatives from all secretariats and agencies participating in the Project.

A. Overall risk rating explanation

47. The overall implementation risk for the Project is Moderate. See the ORAF in Annex 4.

VII. APPRAISAL SUMMARY

A. Economic and financial analysis

Project Level

48. The projected medium term fiscal and debt paths for Rio Grande do Sul are sustainable. The baseline scenario is characterized by both revenue and expenditure growth. Revenue growth is driven by the ICMS and current transfers from the federal government. Other current revenues grow more slowly and capital transfers are constant in real terms. Expenditure growth remains largely driven by current expenditures in the medium term. Current expenditures rise in absolute terms on account of new judicial payment obligations and increases in wages and salaries.

49. The state's debt dynamics are sustainable. Based on data for scheduled amortizations and interest payments, net consolidated debt is projected to decline in real terms in the medium term to within the Fiscal Responsibility Law limits set by the federal government. Debt service payments would peak in 2013, declining thereafter to 11.5 percent of net current revenue in 2016. Personnel costs are expected to stay below 50% of net current revenue for the entire period of projection.

50. The projected fiscal and debt trajectories are robust to joint adverse macroeconomic shocks (see Annex 6 for details). Lower growth rates have large negative impacts on current revenues, which fall by more than current expenditures. Higher personnel growth rate is reflected in higher employee compensation expenses and interest payments rise due to the deteriorating exchange rate. Nonetheless, both the primary and overall balances remain positive throughout the period, and there is fiscal room for investment expansion. The ratio of debt to net current revenue falls from 214 percent in 2010 to 156 percent of revenues by 2020, compared to 113 percent in the baseline.

Table 5. Baseline Fiscal Projections

		Projections					
	2010	2011	2012	2013	2014	2015	2016
I. Revenue (I)	**33,893**	**32,069**	**33,585**	**35,326**	**37,141**	**38,455**	**39,683**
Taxes	21,420	19,949	20,672	21,643	22,693	23,580	24,543
Social Contributions	7,471	7,860	8,353	8,981	9,601	9,908	10,215
Transfers	6,185	5,737	6,122	6,386	6,680	6,923	7,020
Current Transfers	5,972	5,556	5,754	6,024	6,319	6,565	6,834
Capital Transfers	214	181	182	184	185	185	185
Other Current Revenues	2,031	1,815	1,847	1,883	1,909	1,932	1,953
Deductions	(3,214)	(3,291)	(3,408)	(3,568)	(3,743)	(3,888)	(4,048)
II. Expediture (II)	**30,152**	**31,632**	**32,757**	**34,368**	**36,058**	**37,121**	**38,150**
Compensation of Employees	6,999	7,092	7,472	8,034	8,588	8,863	9,138
Pensions	6,627	6,546	6,891	7,188	7,497	7,963	7,994
Interest Payments	164	1,482	1,494	1,442	1,389	1,342	1,291
Transfers	5,360	4,940	5,116	5,356	5,618	5,837	6,076
Goods and Services	4,902	4,517	4,678	4,898	5,138	5,338	5,557
Precatorios	-	809	639	681	725	398	412
III. Gross Operating Balance (I - II)	**3,741**	**437**	**829**	**958**	**1,083**	**1,334**	**1,533**
% of NCR	18.4%	2.3%	4.1%	4.5%	4.9%	5.8%	6.4%
IV. Transactions in Non-Financial Assets	**1,937**	**835**	**856**	**878**	**916**	**1,003**	**1,115**
% of NCR	9.5%	4.3%	4.3%	4.2%	4.1%	4.4%	4.7%
VI. Net Lending / Borrowing (III-IV)	**1,804**	**(398)**	**(28)**	**80**	**167**	**331**	**418**
% of NCR	8.9%	-2.1%	-0.1%	0.4%	0.7%	1.4%	1.8%
V. Primary Balance (VI + Net Interest Payments)	**1,520**	**726**	**1,175**	**1,283**	**1,375**	**1,580**	**1,694**
% of NCR	7.5%	3.5%	5.3%	5.2%	5.1%	5.4%	5.4%
Memo Item:							
Net current revenue (NCR)	20,298	19,241	20,081	21,166	22,273	23,037	23,839

51. The model analyses the risks associated with changes to the allocation formula for federal transfers, royalties, and tax reform on state revenues. Receipts from the ICMS (*Imposto Sobre Operações relativas à Circulação de Mercadorias e Prestação de Serviços de Transporte Interestadual e Intermunicipal e de Comunicação)* represented 50 percent of the State's current revenue in 2010 yet there is uncertainty over their future. In particular, adoption of the destination principle for taxation of interstate trade – taxing consumption not production – would impose heavy losses on Rio Grande do Sul. Current revenues are also likely to be affected by proposed changes to the sharing rule determining state specific transfers. On the other hand, changes to the allocation formula for royalties currently being considered in Congress would work to the state's advantage, offsetting potential revenue losses from transfers and tax reform. Furthermore, any reforms implemented would be gradual, minimizing the total net effects on revenue collection and allowing for adjustment in the meantime. The projections indicate that the sustainability of the fiscal and debt trajectories over 2010-20 remains robust to these changes.

Transport

52. Investments in paved road rehabilitation and maintenance have been appraised with the Highway Development and Management Model (HDM-4), using a consumer surplus cost-benefit analysis that captures benefits in terms of reduction of vehicle operating costs and passenger time. The appraisal compares the costs and benefits of the project scenario (with CREMA rehabilitation) to a base-case scenario, with only routine maintenance and a major

overhaul when the pavement reaches some minimal condition. The detailed analysis has been carried out on a subset of approximately 400km of State highways to be rehabilitated in the Bento Gonçalves area. For this subset the investment generates an internal rate of return of 36.1%, for a net present value of approx. US$66 million, discounted at 12% over a 20-year evaluation period. The results obtained on this road network subset are assumed to be representative of the rest of the state highway network requiring rehabilitation given their similar traffic level and pavement conditions. On this basis, the internal rate of return and net present value for transport investments are estimated at 36% and US$260 million respectively.

Education

53. A growing number of studies underline the impact of the school environment, in particular the quality of physical facilities, on teacher effectiveness and student achievement. International experience also shows that preventive maintenance is often cheaper than the cost of repairing and rebuilding schools[7].

Private sector development

54. Evidence from randomized trials has shown that the returns on investments in training in management and working practices, as provided by the industrial extension services component, can be very large. It also suggests that the reason firms do not make these investments is partly due to lack of awareness about deficiencies in their own performance and an absence of information about service providers. These problems are particularly marked among the small and medium-sized enterprises that are the focus of the private sector development component.

B. Technical

Transport

55. The design of all highway rehabilitation and maintenance works will reflect the state's prior experience with CREMA contracts, the Bank's experience in other Brazilian states and national and international best practice. Rehabilitation and maintenance will include a full range of technical solutions such as local repairs, slurry seals, surface treatment, concrete asphalt overlay, localized base reconstruction, bridge rehabilitation and upgrading drainage systems, signalization improvements and resolution of dangerous cross and access roads. A catalogue of standardized technical solutions for rehabilitation has been agreed on with DAER. Likewise, technical specifications for the CREMA contract works have been defined.

C. Financial Management

56. The Project will use the state's own public financial management arrangements. The Bank's initial assessment is that they meet minimum requirements and are adequate to provide assurance that the proceeds of the loan will be used for the agreed purposes. They are also sufficient to support project management in the control, planning, implementation and

[7] Barbara Bruns, Deon Filmer, and Harry Patrinos. "Making the School Work: New Evidence on Accountability Reform." Bank, 2011.

monitoring of the project and in the achievement of its objectives. The public financial management environment in Rio Grande do Sul is governed by a strong legal and institutional framework whose foundation is based on the Federal Constitution and federal level laws. These laws lay out the fundamental requirements in the areas of planning and budgeting, accounting, financial reporting, internal controls, audits and external scrutiny of the budget preparation and execution processes. Implementation depends on an internal control framework that features automated processes and controls, documented procedures in which personnel are trained and arrangements for financial management oversight. The state also follows common practice in Brazil in its use of various media, including the internet, to grant public access to information on the use of public funds, enhancing transparency and accountability.

D. Procurement

57. The state's central procurement department (CECOM) is currently overburdened and not capable of handling additional procurement tasks that are required by Bank rules. For this reason, the Project will create a special bidding committee to process the consultants' services contracts and all eligible expenditure activities involving ICB (International Competitive Bidding) envisaged under the Project. CECOM also lacks a system to manage and integrate procurement data, but the Project will finance the design and implementation of a new bidding and contract management system. This will improve CECOM's capacity to handle the electronic auctions *('pregões eletrônicos'*) required for procurement under the eligible expenditure programs.

58. The capacity of the implementing agencies (SEPLAG, DAER, AGDI, SARH, SCIT, SEDUC, SEINFRA and SEMA) to produce technical specifications and terms of reference of sufficient quality varies from good to poor. In some cases (e.g. AGDI) the Project will support the hiring of external consultants to assist in their drafting. Quality control will be the responsibility of the special bidding committee. The Bank will provide training to all implementing agencies and the special committee in Bank procurement guidelines prior to effectiveness and afterwards as needed.

59. Particular attention was given to the capacity of SEMA since it will be responsible for implementing $21 million of the technical assistance part. SEMA is already implementing a GEF grant and is therefore familiar with Bank procurement guidelines and procedures.

E. Social (including safeguards)

60. The Government has drawn up a social assessment that identifies the main Project stakeholders, evaluates the socio-economic situation of Rio Grande do Sul's indigenous populations, highlights the potential positive and negative impacts of the Project, particularly from the education and transport components, and suggests mitigation measures. The Government has carried out formal consultations to ensure broad community support for the Project and to agree on permanent mechanisms for information dissemination, further consultation, grievance and redress. These were held on 10th November 2011 (Regional Development Councils – COREDES), 15th November 2011 (Coordenadoria *Regional de Educação*) and the 18th November 2011 (*Conselho dos Povos Indigenas*).

OP/BP 4.10: Indigenous Peoples:

61. Given the possible presence of indigenous peoples in the Project area, SEPLAG has prepared an Indigenous Peoples Planning Framework in collaboration with the Coordenação de Gestão e Aprendizagem-Educação Indígena of the Secretariat of Education, the Secretariat of Public Works and Urban Planning and the Coordenação Executiva do Conselho Estadual dos Povos Indígenas of the State Secretariat of Justice and Human Rights. This was published in-country on January 26, 2012 and on the World Bank's website on February 1, 2012.

OP/BP4.12: Involuntary Resettlement:

62. DAER and SEDUC have prepared a Resettlement Policy Framework for the implementation of performance-based rehabilitation and maintenance contracts and the rehabilitation of schools, including those on indigenous territories. This was published in-country on January 26, 2012 and on the World Bank's website on February 1, 2012.

F. Environment (including safeguards)

63. World Bank safeguards policies apply to both the cross-cutting public sector management component and the EEP component. The activities in transport (performance based rehabilitation and maintenance contracts), education and private sector development all present some safeguards risks. The Project triggers and will address the following Bank safeguards policies:

OP/BP 4.01: Environmental Assessment:

64. The Project classification is Environment Category B, since it will support no major infrastructure investments. The environmental assessment concluded that the main potential environmental impacts relate to road rehabilitation, technological parks and school refurbishment. An ESMF was prepared and published in-country on January 5, 2012 and on the World Bank's website on February 1, 2012.

OP/BP 4.04: Natural Habitats:

65. This policy is triggered in light of the importance of the environmental management subcomponent for the protection of natural habitats in relation to land use planning. The Project does not anticipate the creation of new protection areas.

OP/BP 4.11: Physical Cultural Resources:

66. Since the Project involves civil works that might require excavations, with potential impact on physical cultural resources, the policy is triggered. Screening criteria will be developed within the environmental management framework and any environmental impact assessment carried out for specific sub-projects will ensure that adequate measures are in place to identify physical cultural resources and take appropriate action to minimize, avoid or mitigate potential adverse impacts. In addition, civil works contracts will include appropriate clauses defining steps to be taken in the event of chance-finds of physical cultural resources during any excavation or earthworks.

Annex 1: Results Framework and Monitoring

BRAZIL – STATE OF RIO GRANDE DO SUL: SWAp to Strengthen Public Investment Project

Project Development Objective (PDO): The objective of the Project is to support and improve the planning and implementation of public investments by strengthening the capacity of the Borrower's planning agency and selected sector secretariats of the Borrower.

PDO Level Results Indicators	Core	Unit of Measure	Baseline	Target Values				Frequency	Data Source/ Methodology	Responsibility for Data Collection	Description (indicator definition etc.)
				FY 2013	FY2014	FY2015	FY2016				
Indicator One: implementation of road pavement management system.			No system	-	System ready	-	-	Single occurrence		DAER	
Indicator Two: implementation of system for learning assessment at primary and secondary levels.	X		No system	-	-	System ready	-	Single occurrence		SEDUC	
Indicator Three: completion of impact evaluation of industrial extension services.			No evaluation	-	Evaluation complete	-	-	Single occurrence		AGDI	
Indicator Four: submission of draft public asset management law to legislative assembly.			No draft law	-	-	Draft law submitted	-	Single occurrence		SARH	

PDO Level Results Indicators	Core	Unit of Measure	Baseline	Target Values[8]				Frequency	Data Source/ Methodology	Responsibility for Data Collection	Description (indicator definition etc.)
				FY 2013	FY2014	FY2015	FY2016				
DISBUSRSEMENT-LINKED AND PERFORMANCE INDICATORS											
Disbursement-linked Indicators:											
DLI one: Primary fiscal balance		BRL millions	-	1483	1573	PAF target[9]	PAF target	Annual		SEFAZ	
DLI two: Investment expenditures		BRL millions	882	944	1,010	1,100	1,200	Annual		SEFAZ	
DLI three: Revenue from ICMS		BRL millions	19503	20500	21500	22500	23500	Annual		SEFAZ	
DLI four: Cumulative percentage of the paved road network under CREMA contracts		Percent	0	0	5%	15%	20%	Annual		DAER	
DLI five: Number of construction and refurbishment school projects undertaken		Units	75	40	60	100	40	Annual		SEDUC	
DLI six: Agreements signed/renewed with APLs		Units	0	10	20	20	20	Annual		AGDI	

[8] Fiscal indicators (DLIs # one, two and three) are measured and will be checked on a calendar year, not a fiscal year, basis. Thus, for these indicators, the baseline corresponds to calendar year 2011, the first year of the Project to calendar year 2012 and so on.

[9] The PAF is an agreement between the Federal and State governments to reinforce sub-national fiscal discipline. See Annex 6. DLI targets for calendar years 2014 and 2015 will correspond to those agreed under the PAF methodology for those years; those for 2012 & 2013 may also be revised subject to any changes in the PAF for those years agreed between the State and the Federal Government.

PDO Level Results Indicators	Core	Unit of Measure	Baseline	Target Values[8]				Frequency	Data Source/ Methodology	Responsibility for Data Collection	Description (indicator definition etc.)
				FY 2013	FY2014	FY2015	FY2016				
DLI seven: Agreements signed/renewed with Extension Centers		Units	0	10	20	20	20	Annual		AGDI	
DLI eight: New triple helix alliances implemented		Units	0	5	5	5	5	Annual		SCIT	
Performance indicators:											
Performance indicator one: Days to emit an environmental license		Days	532	-	-	426	319	Annual		SEMA	
Performance indicator two: Cumulative number of real estate assets in inventory		Units	0	2000	8000	11000		Annual		SARH	
Performance indicator three: Disaster risk policy formulated			-	-	-	Policy designed	-	Single occurrence		SEPLAG	
Performance indicator four: Contract management data system operational			-	-	-	System operational	-	Single occurrence		CECOM	
Performance indicator five: Implementation of pavement management system			Not operational	Surveys ready	Systems ready	1/3 surveys updated	1/3 surveys updated	Annual		DAER	

PDO Level Results Indicators	Core	Unit of Measure	Baseline	Target Values[8]				Frequency	Data Source/ Methodology	Responsibility for Data Collection	Description (indicator definition etc.)
				FY 2013	FY2014	FY2015	FY2016				
Performance indicator six: Cumulative km rehabilitated		Km	0	0	450	750	1400	Annual		DAER	
Performance indicator seven: Quality of educational infrastructure		1-5 scale	-	Evaluation of buildings complete	Initial rating published (on 1 to 5 scale)	Reduction of 10% in # schools rated '1'	Reduc-tion of 20% in # schools rated '1'	Annual		SEDUC, Secretariat of Civil Works	As measured by participatory evaluation system
Performance indicator eight: Quality of learning outcomes		1-5 scale	-	Standar-dized evaluation complete	Report on learning outcomes published	Improve-ment of 2% in Port. & Math in 5^{th} & 9^{th} grades over baseline	Improvement of 2% in Port. & Math in 5^{th} & 9^{th} grades over baseline	Annual		SEDUC	As measured by participatory evaluation system
Performance indicators nine: Number of collective actions among cluster participants		Unit	Initial measure	5% increase over initial measure	10% percent increase over initial measure	15% increase over initial measure	20% increase over initial measure	Annual		AGDI	
Performance indicator ten: Percentage of firms subsequently contracting other upgrading services			Initial measure	5% increase over initial measure	10% percent increase over initial measure	20% increase over initial measure	20% increase over initial measure	Annual		AGDI	
Performance indicator eleven: Direct jobs generated by three consolidated parks			8200	8600	9050	9500	10000	Annual		SCIT	

PDO Level Results Indicators	Core	Unit of Measure	Baseline	Target Values[8]				Frequency	Data Source/ Methodology	Responsibility for Data Collection	Description (indicator definition etc.)
				FY 2013	FY2014	FY2015	FY2016				
Performance indicator twelve: Leverage ratio of private to public investment			15	17.5	20	22.5	25	Annual		SCIT	Calculated for consolidated parks & networks

Annex 2: Detailed Project Description

BRAZIL – STATE OF RIO GRANDE DO SUL: SWAp to Strengthen Public Investment Project

Project Development Objective

1. The Project Development Objective is to support and improve the planning and implementation of public investments by strengthening the capacity of the state planning agency and selected sector secretariats. These will be in education, science & technology, economic development and infrastructure. The Project will provide technical assistance in public investment and human resource planning, procurement management, contract management, impact assessment, environmental and disaster risk management and citizen participation in decision-making. It will also support, through eligible expenditure programs, investments in education (technological modernization and buildings repair), transport (highway maintenance) and private sector development (cluster programs, industrial extension services and technology parks).

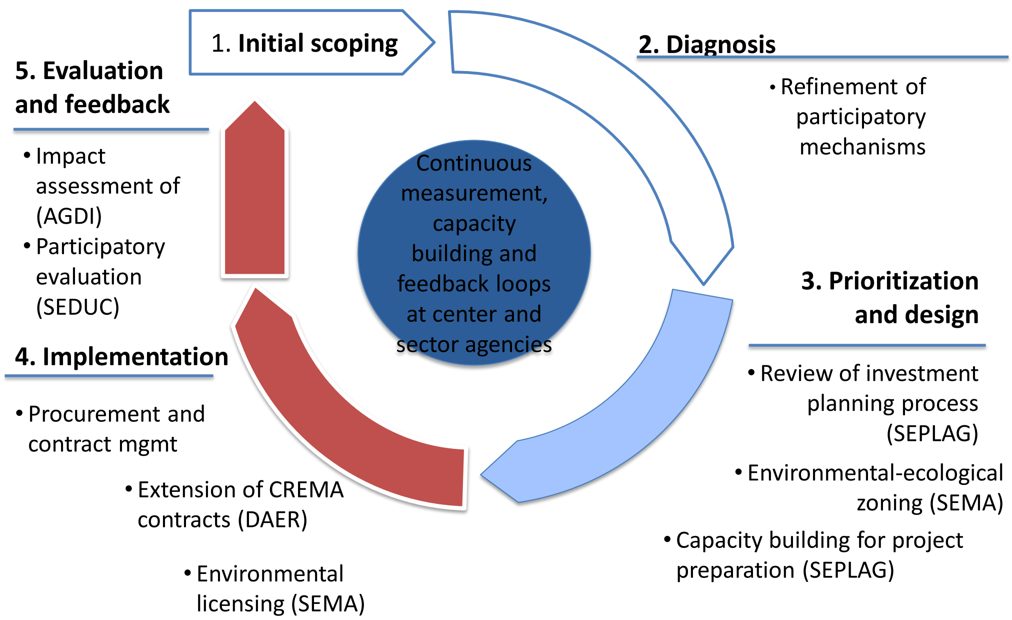
A: Public Sector Management ('umbrella sector'): cross-cutting technical assistance

2. Public sector management is a 'sector' whose reach spans all the others. The operation will focus on four cross-cutting aspects of PSM, to be supported through technical assistance: investment, contract and asset management; impact assessment; environmental management; and strengthening of participatory mechanisms. These activities will assist the sector agencies (e.g. AGDI, DAER, SEDUC) as well as the planning and administrative units SEPLAG, SEINFRA and SARH. The public sector management component will also support the state's fiscal consolidation by providing technical assistance for the modernization of the state pension system and including fiscal targets as disbursement linked indicators. And it will include a small component of sector-specific technical assistance.

Public investment, contract and public asset management

3. The Government recognizes that the quality of many of its current projects has suffered from poor selection criteria, failed procurement processes, delays in post-contract execution and cost-overruns. It also lacks the capacity to manage public real estate and other assets effectively. The Project will strengthen these functions through technical assistance to SEPLAG and SARH. The contract management function will also be reinforced through the inclusion of DLI targets for performance-based (CREMA) coverage under the transport component. The Project will finance the following activities:

Figure 2: The Project will strengthen all Stages of the Policy Cycle



Public investment and human resource planning

4. SEPLAG lacks a standard process for presenting, screening, evaluating and prioritizing investment projects. In practice, there is very little prioritization – 'strategic' projects often encompass the majority of activities in a sector, including both investment and current expenditure programs – and the actual allocation of resources is made on a week to week basis by the state budget council ('Junta de Orçamento'). The outcome is that many projects are subject to cost overruns and are sometimes left unfinished (implying that efforts to monitor priorities under the SGG are ineffective). SEPLAG and the Bank have proposed two projects to identify and secure political support for measures to strengthen the investment appraisal and screening process. Their objective is not to supplant the function of political decision-makers but to provide them with the information necessary to ensure that resources are directed to priorities consistent with their programmatic commitments. This should then allow a close integration of the planning and prioritization process within SEPLAG with that of monitoring and implementation under SGG. This component will also support an integrated transport infrastructure planning process within DAER, long-term logistics and transport planning within SEINFRA, the development of a new human resource management system at SEDUC and interim management support at AGDI.

A1: Review of Investment Planning Process (US$0.12 million)

5. This activity will diagnose the state's current project planning process, analyzing the possible advantages to political authorities of reform and outlining possible improvements (e.g. a

project database). It will also develop terms of reference for a second consultancy to develop procedures and manuals (A2).

A2: Methodology and training in project preparation (US$0.78 million)

6. Drawing on the conclusions of the previous consultancy, this activity will develop a methodology for standardizing the presentation of projects, the requirements for project appraisal and the process of decision-making. It will also train SEPLAG and other secretariats in the new methodology.

A3: Support for long-term integrated transport and logistics infrastructure planning (US$6.0 million)

7. This activity will support the development of a new state logistic and transport master-plan (*Plano Estratégico de Logística e de Transportes do Estado*) to model and anticipate medium and long term transport and logistics demand, based on production growth scenarios and plan infrastructure needs. The plan will also address any issues related to the regulatory framework that might hinder the development of the sector.

A4: Support for institutional modernization of DAER (US$7.5 million)

8. The Project will finance the following activities to strengthen capacity at DAER: technical and contractual supervising units for the performance-based road rehabilitation program; an updated road infrastructure planning tool to reflect the output of the master-plan; and general training and the acquisition of technical equipment to support the agency's modernization.

A5: Diagnostic of SEDUC human resources system (US$0.27 million):

9. SEDUC also lacks an adequate human resources data system. The Project will finance a diagnostic study to identify ways of reducing delays and improving the flow of information through the use of communication technology and automatization of manual processes.

A6: Support for modernization of the management of the state pension system (US$1.2 million)

10. This activity will support the modernization of the state pension system by reforming human resource management, improving the electronic management of documents, setting up a platform for e-government services and acquiring equipment to be used for a biometric census of state employees (the census itself will be financed by the Government).

A7: Interim management support for AGDI (US$0.55 million)

11. The Project will assist in the establishment of AGDI by providing interim management support for the first year of implementation.

Procurement and contract management

12. The state does not have the wherewithal to generate reliable data on bidding processes and contracts. CECOM, the central procurement agency, has a limited information system for goods but not for services or works. Data on prices paid for goods, services and works exists but is not shared or used for procurement purposes. As a consequence, estimated costs tend to be unrealistic and many procurement processes fail. Information on contract execution is hard to find and the state is consequently unable to evaluate the performance of suppliers. As a result CECOM is unable to devise procurement strategies to generate savings and improve the quality of expenditures. To remedy these shortcomings, the Government has proposed two technical assistance projects. Their objective is to supply CECOM with real-time data on procurement processes and contract execution and, based on this data, to implement processes that support performance-based procurement management.

A8: Development and implementation of a contract management information system (US$0.98 million)

13. This activity will establish a contract management system to serve as a central repository for all goods, works and services contracts. The data gathered will enable CECOM to make informed decisions when planning and executing procurement processes. Procurement specialists will be able to rely on data from past contracts when negotiating prices with suppliers. This should reduce the number of failed bidding processes and allow the state to monitor supplier performance more effectively.

A9: Development and implementation of a bidding management system (US$3.7 million)

14. This activity will collect data on all bidding processes for goods, works and services (e.g. time to signature, strength of competition, failed processes, non-competitive bids). This will enable CECOM to identify the reasons for failed bidding processes, curb uncompetitive procurement and ultimately work towards improving quality of public expenditure.

Public asset management:

15. In addition to weak procurement and contract management systems, the state also lacks an effective means of managing public assets. There is no centralized inventory of real estate holdings and no reliable or comprehensive information on their value, tenancy situation and legal status. Numerous buildings appear to be underused or idle. Meanwhile non-real estate assets such as vehicles, machinery and equipment, are not properly accounted for (e.g. amortization criteria are not applied). Some other important public assets, such as equity investments in corporations, are not recorded at all. SARH and the Bank therefore decided to establish a Public Asset Management system. The fiscal benefits of adopting a more active and systematic approach are expected to accrue inter alia through lower maintenance costs and the disposal of surplus assets. The following technical assistance project is proposed:

A10: System for management of public assets and disposal of surplus real estate assets (US$1.6 million)

16. This activity will support the updating of a registry and information system for public assets. It will also draw up a list of real estate assets for disposal and establish a system for pricing them, through market research and partnerships with private real estate agents.

Monitoring and evaluation frameworks and impact assessment

17. Rio Grande do Sul currently lacks integrated systems to allow monitoring of the implementation of budget items and projects. Nor does it have the capacity to undertake regular evaluations of the quality of public service delivery, even though required to do so by law. This component will support the development of frameworks for monitoring and evaluation by integrating IT systems across agencies and providing assistance in data collection and analysis. It will also provide training in impact assessment methodologies and contribute to a rigorous impact assessment of private sector development interventions.

A11: Multi-channel system for public service evaluation (US$1.1 million)

18. This activity will set up a mobile and web-based system for collecting data on public perceptions of the quality of public services. The system will allow for the simultaneous implementation of surveys based on random samples stratified by household income and region. It will also permit the data to be viewed in aggregate and raw formats and enable users to visualize and geo-reference results.

A12: Training in firm-level benchmarking methodology (US$0.6 million)

19. The Project will train Brazilian extension agents in firm-level benchmarking techniques. The methodology will cover, among other topics, the following: financial performance, cost control, quality, value chain reliability and value chain flexibility. Data collection will involve a combination of management questionnaires and site visits and will be used to evaluate the impact of public interventions on firm performance (see below under private sector development). The Project will also provide participating firms and AGDI with access to data for comparator firms by sector and size in other countries.

Environmental management

20. Rio Grande do Sul has advanced environmental laws, reflecting a political culture of strong environmental protection, but needs to strengthen its management systems and improve environmental education. The Government also seeks to improve the quality of land use decision-making to reconcile environmental and economic objectives in areas of high biodiversity and growth potential (e.g. around the Polo Naval in the southern part of the state). Also, Rio Grande do Sul lacks permanent institutionalized capacity to respond to adverse natural and climate-change induced events. In view of the state's vulnerability to extreme weather patterns, including floods, landslides, cyclones, droughts and hailstorms, the Government understands that a new more systematic approach is needed. Finally, in common with other Brazilian states, Rio Grande do Sul is facing the challenge of implementing the 2011 federal law on treatment of solid wastes (Lei dos Resíduos Sólidos) which obliges private companies to assume responsibility for the final disposal of industrial waste. The Project will finance the following technical assistance projects in this area:

A13: Environmental licensing and public communications (US$9.0 million)

21. There is at present a backlog of around 16,500 unprocessed requests for environmental licenses. The environmental licensing system will ensure that responsibilities for ensuring compliance with environmental legislation are properly allocated and that the necessary data and systems are updated. It will be used to monitor and control productive landscapes, vegetation cover in private landholdings, logging concessions and water rights management. The Project will finance training for managers and operational staff, investments in computer hardware and software and mapping and analysis of the system's users, processes and information flows.

A14: Ecological-economic zoning (US$8.7 million):

22. The ecological-economic zoning system will broaden the criteria employed in land use decision-making to include socio-economic as well as environmental and physical factors. It will operate at two scales: for the whole state at 1:100,000; and for a handful of priority areas at 1:25,000. These priority areas are defined by the boundaries of the adjacent municipal districts: Lago Guaiba; Hidrovia São Gonçalo/Barra de Rio Grande; Litoral Norte do Rio Grande do Sul; Bacia do Rio Gravatai and Bacia do Rio dos Sinos. The Project will finance technical assistance for the organization of existing information and the acquisition of satellite images and preparation of a digital cartographic database. It will also assist in land use negotiations, with an information campaign and with workshops and public consultations.

A15: Disaster Risk Management Coordination (US$0.48 million):

23. The Government will set up a committee to draft a participatory disaster risk management plan, develop a policy and the institutional arrangements for implementing it. The committee will led by the Secretaries of Planning, Environment, and Civil Defense, and will also include those of Housing and Sanitation, Public Works, Irrigation and Urban Development, Agriculture, Livestock and Agribusiness, Infrastructure and Logistics, Science, Innovation and Technological Development and other relevant governmental and non-governmental organizations.

A16: Disaster Risk Information and Monitoring System (US$2.5 million):

24. The Project will establish a system for identifying disaster risks and providing early warning. It will include the following modules: collection of data on conditions related to extreme events (monitoring); scenario building and forecasting (prevention); warning of changes in risk levels (alert); determination of affected areas (response); coordination between the various areas of knowledge and action of the various institutions involved in the system (management).

A17: Disaster Risk Management Situation Room (US$0.6 million):

25. The Government will also create an Emergency and Disaster Situation Room to improve decision-making and coordination during emergencies. It will be integrated with the Disaster Risk Information and Monitoring System.

A18: Feasibility study for industrial symbiosis (US$ 1.0 million)

26. Industrial symbiosis facilitates the direction of production waste and by-products from firms into production inputs at other firms. The objective is to engage traditionally separate industries into a network that maximizes the use of resources in a sustainable way. This study will identify such potential connections among selected clusters in Rio Grande do Sul and assist the government in promoting compliance with the Lei dos Resíduos Sólidos.

A19: Training in firm-level waste reduction techniques (US$0.6 million)

27. This activity will train extension agents in cleaner production and other waste reduction techniques to be diffused through the industrial extension services supported as a private sector development eligible expenditure program.

Strengthening of participatory mechanisms

28. Rio Grande do Sul has a strong tradition of citizen participation in public sector management. When appropriately implemented, participation in budgetary processes can help better identify citizens' needs, leading to a more-evidence based allocation of resources and increasing the legitimacy of public investment decisions. Participatory budgeting has also been associated with a reduction in tax evasion as it allows citizens to connect government spending to public service delivery. However, the current system suffers from a number of problems, among them inadequate participatory designs, which lead to a poor interface between citizen participation outputs and the Government's more strategic policies; an absence of articulation between the budgetary process and other forms of citizen participation (e.g. sector councils); and the transaction costs associated with face-to-face meetings imposed by the state's large geographic area and population. This sub-component will strengthen the participatory system through the following technical assistance projects:

A20: Design of ICT strategy, systems and implementation support (US$0.25 million)

29. This activity will finance the development of an ICT strategy, focusing on the articulation among the various components of the system to ensure interoperability and scalability. It will also develop detailed specifications, including the choice of architecture, draft of prototypes/mock-ups and other requirements, and support the implementation of the strategy for three years.

A21: Multi-channel participatory budgeting platform and participation portal (US$2.0 million)

30. This activity will design and implement a web-based platform to allow citizens to submit and vote on proposals and to follow up on the progress of projects under execution. The platform will be designed so as to inform participants about the trade-offs associated with different options. It will also integrate existing participatory websites into a single portal, allowing citizens to register and receive information on the various forms of participation and related events by sector and geographic area.

A22: Rationalization of participatory procedures and third party monitoring (US$ 0.6 million)

31. The current legal framework governing participation contains a number of inconsistencies that lead to duplication of effort among public agencies. This activity will assist in the drafting of a new legal framework and support its application to organizational processes. It will also provide training for public officials and citizen representatives to strengthen third party monitoring.

Additional technical assistance

A23: Marketing strategies and management training for economic clusters (US$1.5 million)

32. This activity will finance the research and writing of development plans for clusters (e.g. in fashion, furniture, precious stones and food processing), identifying new market opportunities, logistical and other constraints and potential for branding via trademarks and other instruments.

A24: Fostering road safety (US$2.1 million)

33. This activity will finance two programs to improve road safety: a critical point program and a bridge management system. The critical point program will survey parts of the road network particularly prone to accidents, undertaking an assessment of causes and proposing options for improvement. The information will be made available through DAER's road management system. The bridge management system will contribute to the critical points program.

A25: Constraints on new firms and coordination across PSD interventions (US$1.6 million)

34. This activity will finance a survey of new entrepreneurs and recently established firms in Rio Grande do Sul to understand the constraints on innovative firm formation, support a network of science park managers to diffuse experience and ensure that lessons learned from the first round of parks are applied to the planned expansion and finance a study on the potential for articulation between innovation networks and other publicly-supported programs such as economic clusters (APLs).

B: Transport, Education, Private Sector Development and Public Sector Management: Eligible Expenditure Programs

Sector 1: Transport (US$ 222.2 million)

Sector background

35. The Government views the transport and logistics sector as key to support economic growth, contributing to market integration and regional development. As in some other Brazilian

states, Government strategy is to rebalance the transport modes matrix towards greener and more efficient forms of transport. However, with approximately 85 percent of freight carried by trucks (compared to 58 percent for Brazil as a whole), the short to medium term priority is to improve the road network. The condition of the 6,700km paved highway system has worsened in recent years, with adverse consequences for logistics costs and road safety. The Government has responded by identifying three areas of focus: the removal of infrastructure bottlenecks through new construction; the improvement of access to remote communities through upgrading of municipal access roads; and the rehabilitation and maintenance of the state highway network. The Project will contribute to the third by partially financing the expansion of the use of performance-based CREMA contracts.

Programs to be supported

36. This component comprises road infrastructure investment.

B1: State Paved Highway Rehabilitation and Maintenance (CREMA) (US$ 222.2 million)

37. The Project will support the state highway maintenance program, through the implementation of CREMAs. Rio Grande do Sul pioneered the use of CREMAs in Brazil; they are now widely used in Brazil, including approximately a third of the federal paved highway network and have brought significant efficiency gains. Over the last decade however their expansion in Rio Grande do Sul has been hampered by a chronic shortage of funds. Recent efforts enabled the recovery of around 1000km of highway but at high cost and for only one or two years. The road network to be managed through CREMA contracts has not yet been determined. However it is estimated that the Bank and counterpart funding could rehabilitate and maintain up to 1,600 km of the state road network over the next five years. The approximate location of the first 500km to be included has been decided on, though the exact stretches have not yet been identified. The location of the remaining 1200km will be confirmed during the first year of the Project. The Bank will finance up to 100% of related EEPs.

The timeline for expenditures under this program is as follows (US$):

	FY 2013	**FY 2014**	**FY 2015**	**FY 2016**
CREMA (US$ 222,200,000)	0	53,800,000	100,000,000	68,400,000

Sector 2: Education (US$ 126.8 million)

Sector background

38. Rio Grande do Sul has always been among the top five performers in the Brazilian educational system. However, standardized evaluations show that that its position has slipped in recent years. The state fell from sixth to ninth nationally on the Index of Basic Education *(Índice de Desenvolvimento da Educação Básica – IDEB)* combined scores for fourth and eighth graders in Portuguese and mathematics between 2007 and 2009; and from third to fifth for twelfth graders between 2005 and 2009. The key concern is low internal efficiency. Repetition rates are in the double digits: 17.8 percent for state and 13.8 for municipal schools in 2009. As a result

grade-age distortion is very high at all levels. In 2010 22.6 percent of students in fundamental and 30.5 percent of those in secondary education were two or more years older than the normal grade-age level. The Government is committed to reversing this trend and has made improving the quality of education a priority. SEDUC has identified five focus areas: teacher training, professional development, democratization and participation, the rehabilitation of school buildings and technological modernization. The Project will support two of these: the modernization and expansion of the use of information and communication technology and improvements in the school environment through the repair, reconstruction and expansion of school buildings. It will also strengthen SEDUC's capacity for monitoring and evaluation through the implementation of a system of participatory evaluation.

Programs to be supported

39. The content of the eligible expenditure programs will be as follows:

B2: Modernization and expansion of the use of ICT in education (US$ 21.0 million):

40. The Government would like to expand IT access in schools and train teachers to use it more effectively. It is expected that this will improve the quality of instruction and provide greater autonomy to students in the acquisition of knowledge. Most schools have computer labs but the equipment is often old, installed in poorly adapted classrooms or otherwise unsuitable. The Project will therefore support two activities: the modernization of computer laboratories and a one-laptop per child pilot project. The modernization will entail the purchase and installation of new computers and servers, the physical refurbishment of computer laboratories including the upgrading of broadband access and the establishment of a system of preventive equipment maintenance. It is expected to benefit 800 schools, 400,000 students and 25,000 teachers. The one-laptop per child pilot project will benefit 160,000 students in the first five grades. It will target the border regions with Argentina and Uruguay and the *Territórios da Paz* in the metropolitan area of Porto Alegre.

B3: Refurbishment of facilities (US$ 95.6 million):

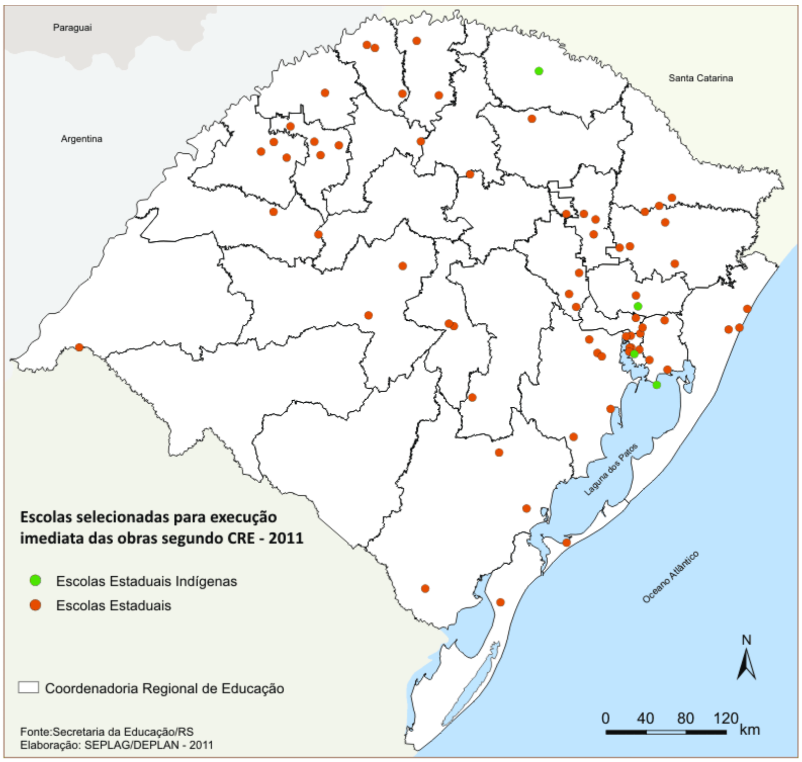
41. A growing number of studies underline the impact of the school environment on teacher effectiveness and student achievement. The Government has drawn up a multi-year investment program to refurbish existing schools, build new facilities and develop a system for preventive maintenance.[10] The Project will support the refurbishment and repair of existing facilities. SEDUC has drawn up a preliminary list of 65 schools with repairs to be financed by the Project, including a small number in indigenous areas (see map below). The list includes several for which detailed civil works assessments have already been undertaken and where works can start rapidly. The average unit cost of civil works is estimated at US$200,000.

42. SEDUC at present lacks the wherewithal to record and systematize data on the performance of the education system. This complicates planning and prevents effective

[10] Small repairs and regular maintenance of school building will be more easily financed through a rotating fund providing small grants to schools, whose value was recently increased from BRL 8000 to BRL 150,000 Real per year.

correction of any deficiencies. The Government is therefore establishing a web-based participatory evaluation system. The system is organized along several dimensions: condition of physical infrastructure and equipment in schools; teacher performance and criteria for promotion; director and vice-director performance; performance of other service providers; student performance on standardized tests; effectiveness and quality of support provided by SEDUC. Work on several of these dimensions is well-advanced and the whole system is expected to become operational in 2012. The Project will finance the printing and distribution of materials, training of staff, contracting of higher education institutions, standardized evaluations and any other logistic costs.

Figure 3: Location of Planned Works



43. *B4: Participatory evaluation system (US$ 10.2 million):*The timeline for expenditures under these programs is as follows (US$):

	FY 2013	**FY 2014**	**FY 2015**	**FY 2016**
Technological upgrading (US$ 21,000,000)	2,840,000	9,460,000	8,690,000	0
Refurbishment of facilities (US$ 95,616,000)	56,000,000	15,700,000	10,500,000	13,416,000
Participatory evaluation system (US$ 10,200,000)	3,400,000	3,400,000	3,400,000	0

Sector 3: Private Sector Development (US$ 65.3 million)

Sector background

44. The Government attributes the weakness of the state economy in part to a lack of innovation by the private sector and to the limited diffusion of modern management and production techniques. Rio Grande do Sul has a record of supporting private sector development through cluster programs, publicly-subsidized extension services and innovation networks. However, many of these have been in operation since the 1990s, some were discontinued in the mid-2000s, and almost all require evaluation and possible adjustment. Some are also under-subscribed, failing to attract sufficient firms to justify their budgets.[11] In addition there is a lack of coordination among and between the state and federal-level public providers of upgrading services. The challenge for the Government is to ensure that the content of public enterprise support programs reflects real demand on the part of enterprises, that any such programs are periodically evaluated and that the results of any evaluations are taken account into subsequent rounds of program design. The objectives of this component will be to: strengthen the internal management and external monitoring of cluster programs; improve the responsiveness of publicly-subsidized industrial extension services to private sector demand, including through the provision of interventions to assist in compliance with environmental legislation; to strengthen mechanisms for learning from and replicating examples of successful science and technology parks; and to improve the cooperation between innovation networks, clusters and other public interventions to support private sector development.

Programs to be supported

45. The content of the eligible expenditure programs will be as follows:

B5: Cluster governance & monitoring (US$ 6.2 million):

46. The Government has identified five regional economic clusters that it intends to support on a pilot basis, with a further 15 to be supported during the course of the Project. The five pilot clusters have been chosen on account of their relatively advanced internal organization, their economic importance and contribution to regional development. All are in established sectors consistent with the state's comparative advantage (furniture, precious stones, fashion, automotive and farm equipment). The remaining clusters will be identified and supported on the basis of their economic importance and readiness to benefit from collective efficiencies. The Project will support the development and implementation of a strategic plan for each APL, to be undertaken by the hosting institutions themselves. Each plan will cover the following: i) cluster governance and management; ii) management training and business advisory; iii) technological and organizational innovation; iv) environmental and social sustainability (including waste reduction and opportunities for industrial symbiosis); v) market and export development. The Project will also support the development of system of monitoring and evaluation of cluster activities within AGDI, to gather and diffuse lessons learned. And it will support a study to define possible points

[11] The industrial extension service program was started in 1999, reaching 13,298 firms in 2002, but was scaled back from 2004 and cut entirely from the 2010 budget.

of intervention for regional development policy (e.g. clusters, industrial districts and extension services), taking into account each region's socio-economic characteristics, the state's sector priorities and the capacity of participating firms to benefit from collective efficiencies.

B6: Provision of industrial extension services (US$ 23.5 million):

47. The government will finance industrial extension services to small and medium-sized enterprises via convenios with hosting institutions. These services will combine support for investment planning with training in 'leaner and cleaner' production to improve the efficiency of manufacturing processes, but without financing any capital expenditures directly. They will be made on a partial cost recovery basis (with the initial contribution by firms set at 30 percent of cost) and coordinated with other SME public service providers and local financial institutions. The program will be structured in two stages: a pilot phase of one year involving ten extension centers and approximately 1000 firms, at the end of which there will be a formal appraisal of its impact; and a second phase which, contingent on the results of the pilot, will scale up the program to a further ten centers.

48. The Project will evaluate the impact of the pilot phase on firm performance using firm-level benchmark data and a rigorous randomized methodology jointly designed by the Government and the Bank (see below). The evaluation will serve two purposes: to demonstrate the financial benefits of participation to non-participating firms and stimulate demand for further rounds of the program; and to refine the content of the services provided. The Project will also support the establishment of a monitoring unit which will review progress after the pilot phase – including the short-term results of the impact assessment – and recommend any changes required in program content or delivery. Each extension center will be evaluated by a regional committee, whose membership will include senior private sector representatives and affected communities.

Box 1: Impact Assessment of Industrial Extension Services

The Project proposes to use a randomized experiment, combined with a benchmarking exercise, to measure the impact of the industrial extension program. The program will establish 20 extension centers in collaboration with local universities. Each center will have 5 agents who will work with approximately 20 firms during the course of each year. The program will last three years with the first three centers to be launched in January 2012, another 12 in mid-2012 and the remainder in early 2013.

The impact evaluation will be conducted with 10 of those centers starting the program in mid-2012. The evaluation will compare firms associated with these centers with a control group of the same size. Once the centers are established and extension agents trained, AGDI will launch a call for participation in the program. All participating firms will receive a benchmarking report after each interview, detailing how the firm compares to its local and international peers. Half will then randomly be selected to work with an extension agent who will help them improve on any weaknesses identified in the benchmarking exercise (the treatment group). The remainder will receive only the benchmark (the control group). All participating firms will be obliged to agree to these conditions before the start of the project.

The Project will measure the impact of the industrial extension program by comparing firm outcomes in the treatment and control group, one, two and three years after the implementation of the program (for this reason firms excluded from treatment in the first year will not be allowed to participate in subsequent years). Since selection into treatment will be random, this should provide an unbiased estimate of the impact of the program. The benchmarking questionnaire will comprise firm-level indicators of competitiveness, such as quality and effectiveness of management, production processes, cost control and financial performance. It will be designed by an international consultant who will train extension agents to apply it (with the data subject to ex-post random accuracy checks by a third party).

B7: Support for science parks and innovation networks (US$ 35.6 million):

49. Rio Grande do Sul has three operational science and technology parks at different stages of development. These evolved from a 'triple helix' mix of inputs (municipal, university and business) which should be maintained. This component will strengthen the operation of the existing parks and support the setting up of up to a further seven parks via a competitive bidding process, for which expressions of interest have already been received (US$ 21,400,000). It will be important to ensure that lessons derived from the first round of parks (e.g. with respect to zoning and physical layout) are taken into account. Among the criteria against which proposals will be evaluated are the extent to which the activities they support are consistent with the state's comparative advantage; their potential contribution to relaxing constraints on private sector competitiveness; and the degree to which they involve partnership with other parks. A minimum private counterpart contribution of 20 percent (to be revised at the Project mid-term review) will be required, either financial or in-kind over the lifetime of the intervention (both start-up and operation). The Project will also provide support to established university-business innovation networks to stimulate technology adaptation and diffusion ($14,230,000). These will be selected on the basis of the degree of private sector involvement and their relevance for the development of local value chains.

50. The timeline for expenditures under these programs will be as follows:

	FY 2013	**FY 2014**	**FY 2015**	**FY 2016**
Cluster governance (US$ 6,184,000)	1,682,000	1,816,000	1,462,000	1,234,000
Extension services (US$ 23,495,000)	3,510,000	6,732,000	6,721,000	6,532,000
Support for science parks and innovation networks (US$ 35,590,000)	10,790,000	10,560,000	10,790,000	3,450,000

Sector 4: Public Sector Management (US$ 9.3 million)

Sector background

51. The state lacks the capacity to manage public real estate and other assets effectively. This component will support the development of systems for managing and disposing of public real and non-real estate assets.

Program to be supported

B8: Capacity building for public asset administration and management (US$ 9.3 million)

52. This activity will define and implement an IT system for managing real estate assets, integrating the inventory with management applications software and centralized accounting and controls. It will also establish an inventory of non-fixed assets and transfer the current vehicle registry to a web-based system.

53. The timeline for expenditures under this program will be as follows:

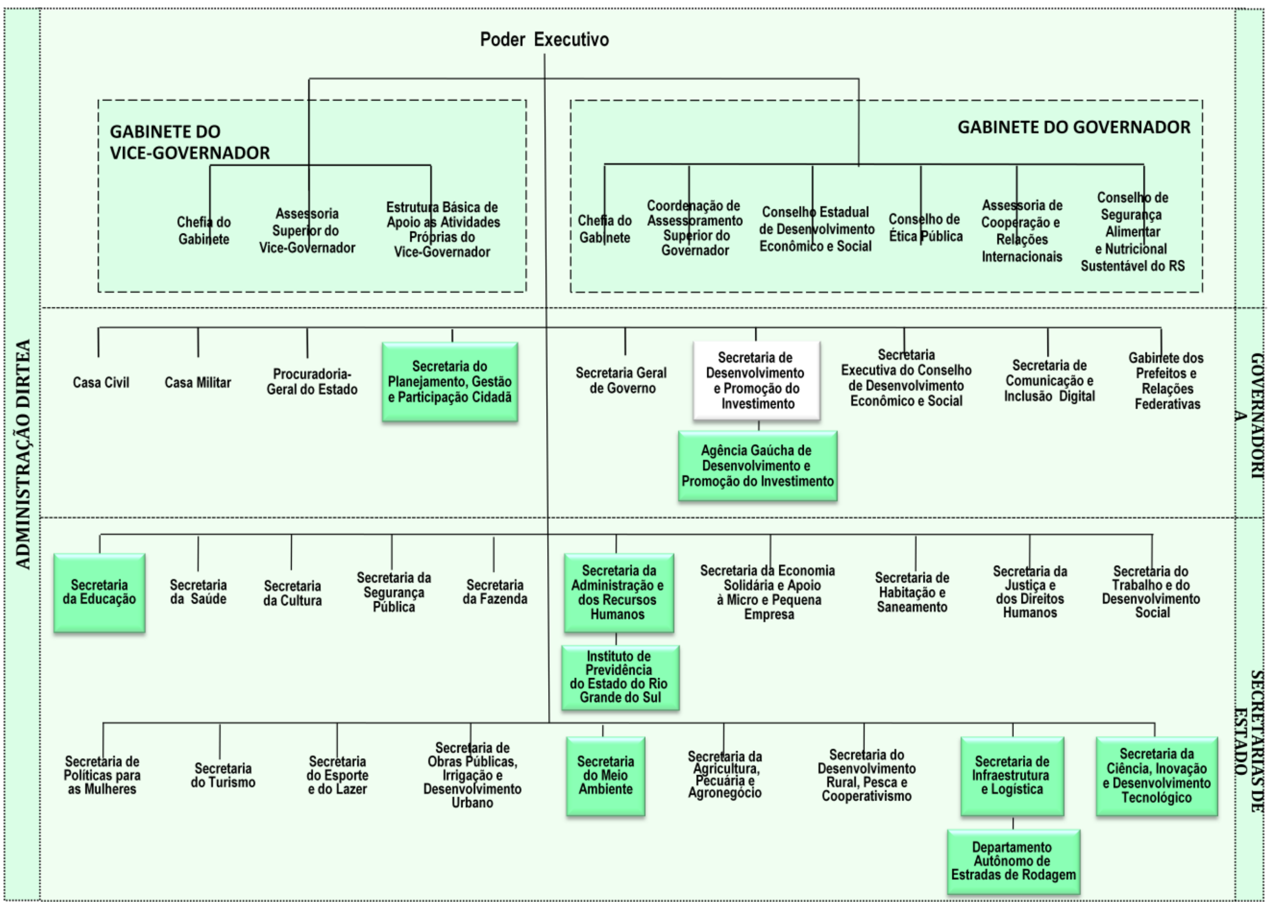
	FY 2013	**FY 2014**	**FY 2015**	**FY 2016**
Public Asset Management (US$ 9,252,000)	2,440,000	2,230,000	1,872,000	2,710,000

Annex 3: Institutional and Implementation Arrangements

BRAZIL – STATE OF RIO GRANDE DO SUL: SWAp to Strengthen Public Investment Project

1. The loan finances the programs of and provides technical assistance to six secretariats and agencies (AGDI, DAER, IPE, SARH, SCIT, SEDUC) and provides technical assistance alone to a further three (SEINFRA, SEMA, SEPLAG). Project implementation responsibilities will be carried out by SEPLAG. No separate implementation unit is contemplated. SEPLAG will assemble an internally-recruited team to manage the procurement of technical assistance activities financed under the Project. Relationships among the implementing agencies shown in Figure 4 will be governed by Inter Agency Agreements, the drawing up of which will be a condition of effectiveness.

Figure 4: Structure of Government of Rio Grande do Sul



2. In addition, Implementation Agreements are expected to be entered between most of the implementing agencies and state universities, unions, City Halls, non-governmental organizations, and so forth. Such agreements are governed by the State of Rio Grande do Sul Auditor and Accountant General. They should also be consistent with the provisions of the loan

agreement to be entered into between the Government and the Bank, including with respect to procurement, financial management, safeguards and anti-corruption.

Project administration mechanism:

3. SEPLAG's responsibilities under the Project will be to:

- Ensure general coordination with the Bank, the various secretariats and government stakeholders and timely implementation of all activities to ensure compliance with loan conditionality;

- Monitor and report on loan activities in a timely manner, including the presentation of financial and performance reports as needed by the Bank` for disbursement and in accordance with Bank fiduciary oversight requirements;

- Ensure that procurement is carried out following Bank rules for EEPs and technical assistance parts, including the preparation of procurement plans for the latter. SEPLAG will also advise on the drafting of terms of reference where required;

- To participate in regular monitoring meetings to track results and ensure that any necessary corrective measures are taken to ensure compliance with loan conditions;

- Host and facilitate Bank supervision missions.

4. The responsibilities of the various line secretariats will be to:

- Implement EEPs in a timely and efficient manner to as to ensure compliance with EEP and DLI disbursement requirements; develop terms of reference for and management the procurement and contracting of technical assistance activities;

- Participate in SWAp supervision activities and collaborate closely with SEPLAG to report interim and final results and remove any impediments to program implementation (e.g. delayed budget release, slow procurement processing).

Financial Management, Disbursement and Procurement

Financial management

5. Project funded activities will be implemented using the state's public financial management systems. SEPLAG has experience in managing Bank projects and will be responsible for the Project's financial management arrangements. These include the preparation of the program budget and of periodic financial reports, in addition to ensuring that the program financial statements are submitted for audit. While transactions under the programs financed by the Bank will be recorded in the state's accounting system by staff in the Secretariats responsible for the implementation of individual programs, SEPLAG will be responsible for consolidating this information at the stage of preparation of the financial reports.

6. The Bank will make periodic disbursements based on a percentage of the EEP expenditures supported under the project. EEP expenditures are part of the State's own budget and investment program, classified programs as Strategic Programs ('*Programas Estratégicos')*. They satisfy the requirements of the relevant Bank policies, in particular the three pillars enumerated in OP 6.0 that require that expenditures: (a) are productive; (b) that the impact of the operations financed under such loans on the borrowing country's fiscal sustainability is acceptable; and (c) that acceptable oversight arrangements, including fiduciary oversight arrangements, are in place to ensure that such loan proceeds are used only for the purposes for which the loan is granted, with due attention to considerations of economy and efficiency.

Risk Assessment

7. The key objective of the financial management arrangements is to ensure that Project funds are used for the purposes intended and agreed between the Bank and the Government. The risk is assessed as Substantial due largely to the fact that, as a SWAP operation, project funds will be used to finance a large volume of transactions. The arrangements for the coordination of the financial management arrangements within SEPLAG and the use of the state's financial management procedures and integrated financial management system will help to mitigate these risks. The table below summarizes the financial management risk assessment.

Table 6. Financial Management Risk Assessment

Risk	Risk Rating	Comments
<u>Inherent Risks:</u>		
Country level	L	There is a robust legal and regulatory framework governing public financial management systems in Brazil.
Entity Level	M	A number of state secretariats will be involved in the implementation of project activities. In mitigation of this however, most of the financial management duties in respect of the project will be undertaken by SEPLAG. The use of integrated financial management systems will also facilitate the consolidation of information on project transactions. Finally, institutional arrangements will include arrangements for the coordination of the actions of the implementing agencies.
Project Level	S	The Project is a SWAp with a large number of transactions and programs implemented by several agencies. SEPLAG will be responsible for ensuring project coordination, and the state's public financial management systems will mostly be used for the project.
Overall Inherent Risk	**S**	

Budgeting	M	There is a risk that links between budgets and sector plans may be weak. However, the budgets are prepared according to well defined procedures
Accounting	L	The state has a strong integrated financial management system that will be used for the project.
Financial Reporting	L	The FPE will be used for the generation of the financial reports, to be prepared from the basis of a consolidated database.
Flow of Funds	M	Two DA's will be used for the Project-one for the TA part and one for the EEP part.
Internal/External Audit	M	The wide scope of audit may raise detection risks, but the TCE has adequate number of staff to provide sufficient audit coverage in accordance with terms of reference to be agreed with the Bank.
Overall Control Risk	**M**	
Overall Risk	**S**	

H-High S-Substantial M-Moderate L-Low

Budget execution cycle

8. Expenditures under eligible programs will be incurred using the normal budget execution regulations. Under these, a budget execution decree is issued every year to trigger the budget execution cycle. In Brazil, this is comprised of three phases: commitment (*empenho*), verification (*liquidação*) and payment (*pagamento*). The sector agencies responsible for the implementation of the eligible programs will thus be responsible for the first two phases in the cycle. The transaction data for all the phases is recorded in the State's integrated financial management system (*Finanças Publicas do Estado* - FPE) by the sector agencies.

9. The payment phase is initiated through the issuance of a payment request after the requisite steps are undertaken to verify the delivery of goods or services. The request is made by the sector agency to the Treasury in SEFAZ, which makes the necessary payments.

10. The above steps will be applied to the project. In addition, SEPLAG will have access to transaction data within the FPE system with which it will prepare periodic financial reports. The diagram below shows how the budget execution cycle will be applied to the project and the allocation of responsibilities for record keeping and financial reporting between SEFAZ, the sector agencies and the project coordination unit.

Accounting

11. Accounting records will be maintained in accordance with the state's accounting procedures and policies that reflect the Fiscal and Budgetary Law. The state has consistently applied these public accounting standards which are acceptable to the World Bank. They will be the basis for preparation of the Financial Statements that will include the programs financed

using the proceeds of the Bank loan. The Government is in the process of implementing a new accounting framework (chart of accounts), following the guidelines established by federal regulations (Lei 4320/64, Fiscal Responsibility Law) and norms dictated by the Federal Internal Control Agency (*Secretaria Federal de Controle*) and the Federal Accounting Council (*Conselho Federal de Contabilidade*).This framework is based on International Accounting Standards. The new accounting regime is based on a recently adopted Chart of Accounts that is based on a federal based standard that includes aspects that are adapted to the circumstances of each federal entity. In addition, the state is currently upgrading its information systems to meet the requirements of the new accounting environment.

Table 7. Allocation of Responsibilities for Financial Reporting

		STATE AGENCY RESPONSIBILITY		
		Sector Agencies	**SEFAZ**	**SEPLAG Coordination Unit**
Budget execution stage	**Commitment**	Order goods or services in accordance with procurement plan		
	Verification	Verify delivery of goods or services		
	Payment	Send Request for payment to Treasury	*Treasury* makes payments to suppliers	
Record keeping		Record transaction information in FPE	Record transaction information in FPE	• Access to financial information in FPE • Submits disbursement requests to the Bank
Financial Reporting		Prepares periodic financial reports		Prepares consolidated financial reports for project

Internal controls and financial procedures manual

12. The internal control environment and procedures upon which the financial management arrangements for the project are based are well documented. The state recently published a Public Sector Management Manual (*Manual do Gestor Publico*) that includes financial management procedures to be used for the operation. An operational manual will also be elaborated to document the specific procedures that are applicable to the operation. The state's integrated financial management system will also be used for recording transactions under the EEPs. This system features inbuilt controls that help to ensure that transactions are properly authorized and that payments are made only for due circumstances (eg where goods or services

are confirmed as delivered). The state's institutional arrangements and procedures also provide for adequate segregation of duties, thus enhancing the control environment.

Reporting

13. Interim financial reports (IFRs) will be used for project financial monitoring and follow the format of the existing government reporting, to the extent possible. The IFRs will be sent to the Bank within sixty (60) days after the end of each calendar semester. SEPLAG is capable of generating IFRs that meet bank requirements and an appropriate format for the required reports was agreed at negotiations. The description of the IFRs is indicated below and the final format of the reports will be included in the Operational Manual.

- IFR 1. Sources and Uses of Funds, by category cumulative (project-to-date; year-to-date) and for the last calendar semester;

- IFR 2. Uses of Funds by project components (by sector and budget line), cumulative (project-to-date; year-to-date) and for the period, showing budgeted amounts versus actual expenditures, (i.e., documented expenditures), including a variance analysis.

14. The second semester IFRs generated during the year, showing the cumulative figures for the year, may be used as the project annual financial statements that would be audited.

15. In-year financial management reports reflecting EEP program expenditures will be prepared by SEPLAG. These EEP spending reports will indicate the calculation and demonstration of EEP expenditures eligible for World Bank financing, including the presentation of actual EEP expenditures, to prove that the actual EEP expenditures during that period were sufficient to justify the previous Advance against estimated EEP expenditures. They will also provide information that will confirm compliance with the 70% rule where necessary, and the achievement of each relevant DLI. Compliance with DLI requirements will be subject to confirmation by the independent technical audit. The EEP spending reports will be used for the documentation of eligible expenditures for which advances were made under the loan. An appropriate format for the required reports has been agreed and the ability of the Secretary of Planning, Management and Citizen Participation to generate them has been verified.

Internal Audit

16. The state has in the recent past reorganized its internal audit function through the restructuring of the *Contadoria e Auditoria-geral do Estado* (CAGE). This institution enjoys the status of a cabinet secretariat, thus enhancing the independence of the function. The CAGE is in the process of strengthening its institutional capacity to enable it to improve the effectiveness of its internal audit processes. Its recommendations are generally implemented due to its independent status.

External Audit

17. The state's supreme audit institution, the *Tribunal de Contas do Estado* (TCE), has the constitutional mandate to audit all state expenditures, including those under the current operations. The TCE is required to verify the Governor's accounts every year and submit a report

to the Legislative Assembly for approval. The TCE has recently completed a self assessment based on INTOSAI standards to determine its strengths and weaknesses. The Bank is satisfied that the TCE will be able to conduct an audit based on agreed terms of reference that will be geared towards enabling it to provide an audit opinion relating to its financial statements and a management letter identifying any internal control weaknesses with respect specifically to the transactions under the operation. The audit report will be submitted to the Bank within six months after the end of the Fiscal Year.

Financial Management supervision during implementation

18. During the first year of implementation, supervision intensity will be increased to be carried out at least twice per year, considering the complexity of the project, and will take the form of technical assistance (in the area of public financial management) to the government. This will be complemented by desk reviews of the Interim Financial Reports, EEP spending reports and the annual state audit. Thereafter, the supervision intensity may be reduced to an annual supervision mission.

Banking arrangements

19. Disbursements in respect of EEPs will be made into a segregated Designated Account at the state commercial bank, Banrisul, with the exception of the first disbursement only, which will be a reimbursement disbursement for retroactive expenditures. Disbursements in respect of the Technical Assistance part will also be deposited into a segregated Designated Account at Banrisul. The Designated Account for Technical Assistance will be denominated in United States Dollars (US$) and have a Fixed Ceiling of US$ 10,000,000. The Designated Account for the EEP part will be denominated in United States Dollars (US$) and have a Variable Ceiling according to the limits set out in Section IV (iv) of the Disbursement Letter. The frequency for reporting eligible expenditures paid from the Designated Account's will be at least once every six months. The Project will also have the option of reimbursements for the Technical Assistance component (to cover any retroactive expenditures for example), with the account to be reimbursed specified in each withdrawal request.

Disbursements under Eligible Expenditure Programs

20. Loan proceeds will be applied to finance eligible expenditure programs (EEPs –Programa de Gastos Elegiveis). EEPs are to be included as line items in the government PPA and annual budget law. Disbursements under the loan will be made as set out in Table 8 and in accordance with the following rules:

- The first disbursement of up to US$ 10,000,000 will be for retroactive expenditures and will take place immediately after loan effectiveness to cover expenditures paid prior to 12 months (but not earlier than January 1, 2012) before signing.

- Authorization for the fourth, sixth and eighth disbursements will be contingent on satisfying the '70 percent rule' for individual EEP budget expenditures as well as Disbursement-Linked Indicators (DLIs).

- If the 70 percent rule is not met for an EEP, then the planned disbursement amount in that period will be reduced by 12.5 percent (i.e. the value of each of the eight EEPs). The unwithdrawn amount will be added to the next planned disbursement amount.

- After applying the 70 percent rule, the total eligible disbursement will be divided by the number of DLI to be met in that period. That same amount will be withheld for each DLI not met. If all DLI are met, the entire amount will be disbursed. If the Bank has not received evidence of full compliance with the DLIs in respect to the fourth, sixth and eighth disbursements the Bank shall: (i) deduct a set amount for each non-compliant DLI from the otherwise disbursable amount; (ii) request the Borrower to prepare a time-bound action plan to achieve such DLI or DLIs in a manner satisfactory to the Bank; and (iii) when satisfied that the DLI or DLIs have been complied with and/or such action plan has been implemented, authorize that the unwithdrawn amount by which the corresponding disbursement had been reduced to be advanced in the immediately subsequent withdrawal.

- Advance amounts not documented will be deemed available to cover the next period's EEP expenditures and will be deducted from the calculation of the amount to be disbursed (after the application of the two bullet points immediately above).

- The Bank will formally review progress in implementing the Project and verify the achievement of DLIs and the 70 percent rule during supervision missions prior to disbursements. Sector specialists will travel to Rio Grande do Sul twice a year and maintain continuing contact with counterparts in their sectors.

- In addition, the Government will be responsible for contracting out an independent technical review of compliance with the DLIs, with the reviews to be completed no later than September of each year.

21. The proceeds of the Bank loan will be deposited periodically in a segregated Designated Account managed by the Secretariat of Finance (SEFAZ). The state's accounting system can be relied upon to record the use of Bank resources. The funds disbursed by the Bank will be recorded and accounted for under the budgetary code related to the receipt of external or foreign funding/financing sources.

22. Apart from the first and second disbursements, requests for disbursement will be accompanied by a customized Statement of Expenditures (EEP Spending Report) for a six month calendar period (see Table 8), together with a list of payments against contracts that are subject to the Bank's prior review. EEP Spending Reports will include the following information: the calculation and demonstration of EEP expenditures eligible for World Bank financing, including the presentation of actual EEP expenditures, to prove that the actual EEP expenditures during that period, were sufficient to justify the previous Advance against estimated EEP expenditures; where applicable, confirmation that at least 70% of each EEP budget was spent by the Government; and a certification of compliance with each relevant DLI, where applicable. In the case of the first disbursement, the EEP Spending Report will need to report expenditures paid in the period 12 months prior to the signing date (but in no case earlier than January 1, 2012). In the case of the second disbursement, the EEP Spending Report will need to

justify (forecast) the need to advance the full amount, set to be spent in the period from the signing date to December 31, 2012.

Table 8. Disbursement schedule

Disbursements[12]				Reporting Requirements (see key below)				
No.	**Date**	**Estimated amount ($m)**	**Disbursement type**	**A**	**B**	**C**	**Forecast (where required)**	**Expenditure reports (where required)**
1	July 2012	10,000,000	Retroactive[13]	√			-	12 months prior to the signing date (but in no case earlier than January 1, 2012)
2	July 2012	30,000,000	Advances in respect of forecast EEP expenditures				Signing date to December 2012	-
3	March 2013	40,700,000					January to June 2013	Signing date to December 2012
4	September 2013	50,000,000			√	√	July to December 2013	January to June 2013
5	March 2014	53,700,000					January to June 2014	July to December 2013
6	September 2014	72,000,000			√	√	July to December 2014	January to June 2014
7	March 2015	71,400,000					January to July 2015	July to December 2014
8	September 2015	48,000,000			√	√	July to December 2015	January to June 2015
9	March 2016	47,700,000					January to June 2016	July to December 2015
10	September 2016	0						January to June 2016

Key	
A	Up to 50% of eligible expenditures paid in twelve months prior to signing but not earlier than January 1st 2012.
B	Compliance with 70% rule for previous July 1 to June 30 period.
C	Compliance with DLIs for previous calendar year in respect of the fiscal DLI's and the July 1 to June 30 period for all the other DLI's.

[12] These amounts represent the maximum to be advanced (or reimbursed in case of the first disbursement) using a 55 percent financing ratio. Thus, for the first disbursement of US$ 10,000,000 the State will need to present total expenditures equal to or greater than US$ 18,181,818 and for the second disbursement of US$ 30,000,000 planned expenditures equal to or greater than US$54,545,454.

[13] In the event the full amount of the first withdrawal is not made, any balance remaining to be disbursed, will be evenly distributed over the next eight disbursements with a resultant increase in the planned disbursement amounts.

23. The Bank's financial contribution for each disbursement request will correspond to a maximum of 55 percent of overall expenditure for all the eligible programs. For each disbursement, the Borrower will be required to submit proof or a calculation that the Bank's financial contribution did not exceed 55 percent of overall program expenditures for the previous period.

Disbursements for the Technical Assistance Part

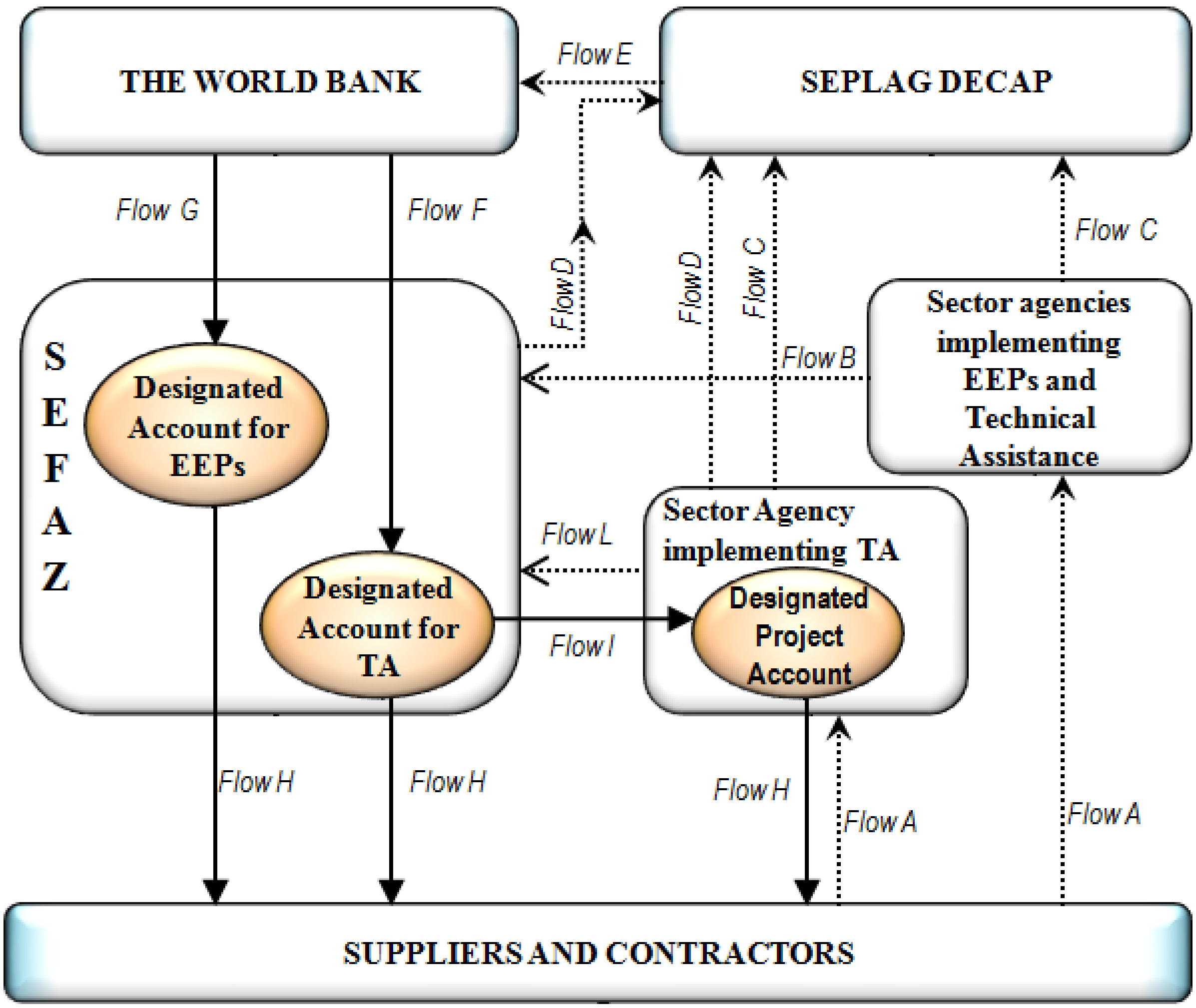
24. Disbursements for the Technical Assistance part will be deposited in a segregated Designated Account managed by SEFAZ in the name of the Project (Advances-Primary disbursement method). The Project will also have the option of reimbursements for the Technical Assistance part (to cover any retroactive expenditures for example), with the account to be Reimbursed specified in each withdrawal request. An amount of $1,000,000 is available for retroactive expenditures under the Technical Assistance part. The expenditures financed under this part will be documented to the Bank using traditional or standard Statements of Expenditure and/or Summary Sheets with Records as appropriate. Withdrawal requests will be made by SEPLAG. Payments to suppliers and contractors for activities under the Technical Assistance part will be made primarily from this DA account by SEFAZ. However, DAER will maintain a bank account specifically for the project into which SEFAZ will transfer project funds for the purposes of payments to be made on contracts managed by DAER. These transfers will be made on the basis of requests made by DAER and in accordance with a payment schedule reflecting the procurement plan.

25. The Minimum Application Size for Reimbursements (both EEP and TA) will be US$ 3,000,000 equivalent and the Project will be granted a 4 month Grace Period. This period is granted in order to permit the orderly project completion and closure of the Loan Account via the submission of withdrawal requests and supporting documentation for expenditures incurred on or before the Closing Date.

Table 9. Withdrawal Schedule

Category	Amount of the Loan Allocated (expressed in USD)	Percentage of Expenditures to be financed (inclusive of Taxes)
(1) Goods, non-consulting services, consultants' services, and Training under Part A of the Project	55,300,000	100%
(2) Eligible Expenditure Programs under Part B of the Project	423,500,000	Up to 55%
(3) Front-end Fee	1,200,000	Amount payable pursuant to Section 2.03 of the Loan Agreement in accordance with Section 2.07 (b) of the General Conditions
(4) Interest Rate Cap or Interest Rate Collar premium		Amount due pursuant to Section 2.07(c) of the Loan Agreement
TOTAL AMOUNT	**$480,000,000**	

Figure 5: Flow of funds



Key

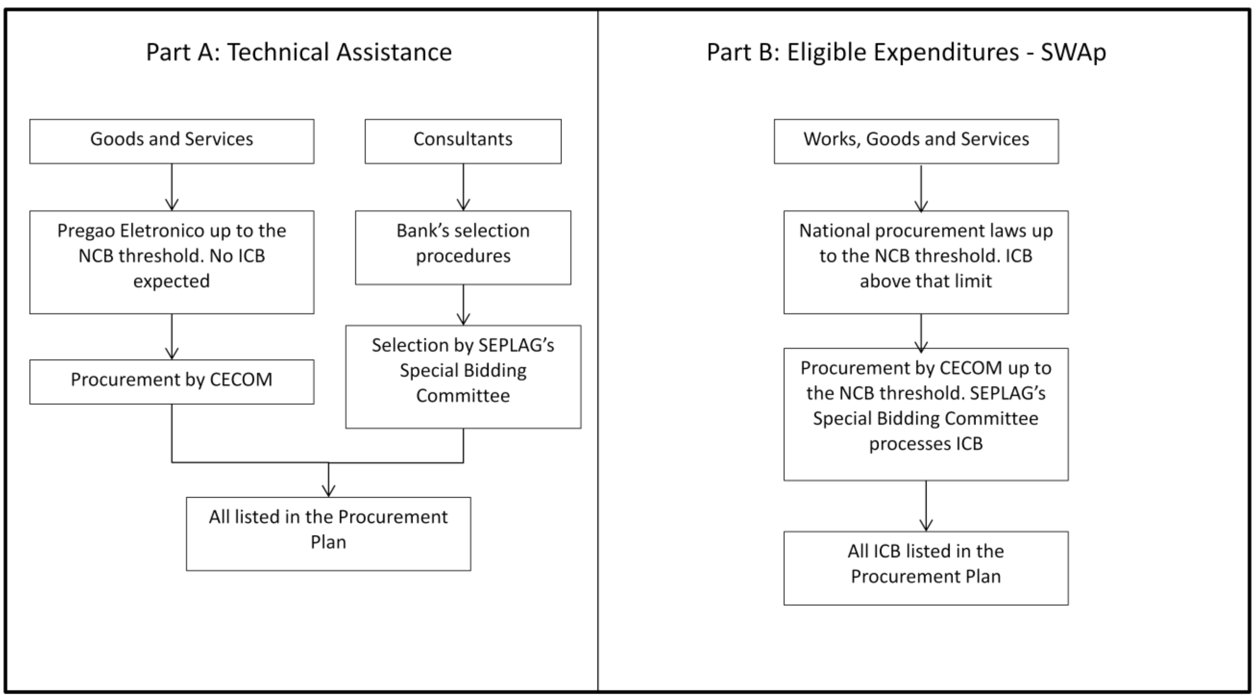
→	-	Flows involving the movement of funds
⇢	-	Flows involving documentation or supply of goods and services
Flow A	-	Suppliers provide goods and services, and related invoices
Flow B	-	Sector agencies submit payment requests to SEFAZ
Flow C	-	Transaction data provided to SEPLAG through access to FPE
Flow D	-	SEFAZ and DAER provide bank statements to SEPLAG
Flow E	-	IFRs and Requests for disbursement submitted to Bank by SEPLAG
Flow F	-	Disbursements in respect of Technical Assistance
Flow G	-	Disbursements in respect of EEPs on the basis of advances
Flow H	-	Payments to suppliers and contractors
Flow J	-	Transfer of funds from Designated Account to DAER project account

Procurement

26. Procurement will be carried out in accordance with the World Bank's "Guidelines: Procurement under IBRD Loans and IDA Credits" dated January 2011 and "Guidelines: Selection and Employment of Consultants by World Bank Borrowers" dated January 2011 and the provisions stipulated in the Legal Agreement. The procurement or consultant selection methods, needs for prequalification, estimated costs, prior review requirements and time frame will be agreed on in the Procurement Plan. The Plan will be updated as required to reflect actual project implementation needs and improvements in institutional capacity.

27. This operation is a Sector Wide Approach with nine implementing agencies: SEPLAG, DAER, AGDI, IPERGS, SARH, SCIT, SEDUC, SEINFRA, and SEMA. Implementation will be carried out by each of the implementing agencies, but with centralized procurement and arrangements for the selection of consultants. The project comprises two parts: a cross-cutting public sector management component comprising technical assistance of US$ 55,3 million and an EEP part of US $ 423.5 million. Procurement arrangements for each part are as follows:

Table 10. Procurement Arrangements



28. Part A – Technical Assistance: procurement under this part will apply Bank's procurement methods. For off-the-shelf goods and readily-available non-consulting services to the national competitive bidding (NCB) threshold of US$5,000,000, the procurement method known as "pregão eletrônico" may be applied, as provided for the Brazilian Law, through "COMPRASNET", the procurement portal of the Federal Government, "COMPRAS RS" the procurement portal of the state of Rio Grande do Sul, or any other e-procurement system approved by the Bank. Such "pregões eletrônicos" will be conducted by CECOM, the state's centralized procurement unit. All consultant selections will be conducted by SEPLAG's special

bidding committee, yet to be established. All procurement under part A must be listed in the project procurement plan.

29. Part B – Eligible Expenditures - SWAp: procurement under this part will apply national procurement methods and does not require a procurement plan. However any procurement estimated above the NCB threshold of US$5,000,000 for goods and non-consulting services or US$25,000,000 for works must be conducted through international competitive bidding (ICB), needs to be listed in the procurement plan and will follow Bank's ICB procedures. Also, any consultancy services under this part with an estimated value above US$500,000 must be conducted through Quality and Cost-Based Selection (QCBS). In such cases, the special bidding committee will be responsible for the process. They should also be listed in the procurement plan.

30. Each implementing agency will be responsible for establishing a technical team to prepare its technical specifications and terms of reference and that same team will be requested to join the special bidding committee and become part of the evaluation team. The establishment of the special bidding committee is a condition of effectiveness.

31. Procurement of Works: Procurement of works such as renovation of roads is expected only under part B. DAER is expected to have ICB estimated above US$ 25,000,000 and such procurement will be conducted by the special bidding committee. All contracts estimated to cost more than US$25,000,000 will be subject to prior review by the Bank.

32. Procurement of Goods: Procurement of goods is expected under both parts of the project and will include IT equipment and so forth. Under part A they can be processed through shopping, NCB, ICB, or Direct Contracting but it is very likely that all of them be processed through pregão eletrônico, as provided in Brazil's Law, under "COMPRAS RS", the procurement portal of the Rio Grande do Sul state. Under part B goods, works and services within the procurement thresholds for NCB will be processed through national procurement methods. All bidding documents and resulting contracts are required to include Bank's clause on preventing and combating fraud and corruption in order to be eligible for financing. All contracts under part A estimated to cost more than US$2,000,000 would be subject to prior review by the Bank. Only ICB under part B would be subject to prior review by the Bank.

33. Procurement of non-consulting services: Procurement of non-consulting services are expected under both parts of the project and will include training logistics (hotel services, catering, travel services, printing services), workshops, seminars, events, printing services and so forth. Under part A they can be processed through shopping, NCB, ICB, or Direct Contracting, but it is very likely that all of them be processed through pregão eletrônico, as provided in Brazil's Law, under "COMPRAS RS", the state's procurement portal. Under part B goods, works and services within the procurement thresholds for NCB will be processed through national procurement methods. All bidding documents and resulting contracts are required to include Bank's clause on preventing and combating fraud and corruption in order to be eligible for financing. All contracts under part A estimated to cost more than US$2,000,000 per contract will be subject to prior review by the Bank. Only ICB under part B would be subject to prior review by the Bank.

34. Selection of Consultants. Selections of consultants will only take place under part A of the project and will include studies, researches and so forth. These services will be selected through Quality and Cost-Based Selection (QCBS), Selection Based on Consultants Qualification (CQS), Least-Cost Selection (LCS), Fixed Budget Selection (FBS), Single-Source Selection (SSS – with due Bank's No-objection on a case-by-case basis) and Individual Consultants (IC). Short lists of consultants for services estimated to cost less than US$500,000 per contract may be composed entirely of national consultants in accordance with the provisions of paragraph 2.7 of the Consultant Guidelines.

35. Direct agreements ("convênios"): Under part B, agreements are expected to be entered between most of the implementing agencies and state universities, unions, City Halls, non-governmental organizations, and so forth. Such agreements are governed by the State of Rio Grande do Sul Auditor and Accountant General – CAGE through "Instrução Normativa" IN 01/06 issued on March 21, 2006.[14] Procurement by those receiving funds through convênios will follow one of two arrangements: (i) beneficiaries which are government agencies follow national procurement laws or (ii) beneficiaries which are from the private sector are required by IN 01/06 to follow commercially acceptable procurement practices, getting at least 3 quotations for all purchases. Such private beneficiaries are also required to: (a) appoint a person responsible for the funds, who has to justify the procurement method of choice and who is held responsible for any misprocurement; (b) have a public accountant issuing a statement in relation to the correct use of funds in regard to the proposed objectives of the agreement. These and all procedures outlined in CAGE's IN 01/06 were reviewed and found acceptable to the Bank up to the NCB thresholds. Above those thresholds ICB should be used. All convênios are required to include the Bank's anti-fraud and corruption clause.

36. In view of the need to develop knowledge about Bank's guidelines in the implementing agencies, procurement risk has been rated as Substantial and the prior review and procurement method thresholds defined as follows:

Table 11. Procurement Thresholds

Expenditure Category	Contract Value Threshold (US$ thousands)	Procurement Method	Processes Subject to Prior Review
Works	≥ 25,000	ICB	All processes
	< 25,000 ≥ 200	NCB	None, as they will be under part B
	< 200	Shopping	None, as they will be under part B
Goods	≥ 5,000	ICB	All processes
	< 5,000 ≥ 100	NCB	First process and all processes above US$2 million
	< 100	Shopping	First process.

[14] http://www.legislacao.sefaz.rs.gov.br/Site/Document.aspx?inpKey=108475&inpCodDispositiv=&inpDsKeywords=

Expenditure Category	Contract Value Threshold (US$ thousands)	Procurement Method	Processes Subject to Prior Review
Non-consulting services	≥ 5,000	ICB	All processes
	< 5,000 ≥ 100	NCB	First process and all processes above US$2 million
	< 100	Shopping	First process
Consulting (firms)	≥ 200	QCBS/QBS/ LCS/FBS	First process for each selection method and all processes above US$500,000
	< 200 ≥ 100	FBS/LCS	
	< 100	CQS	
Individual consultants		Section V in the Guidelines	First process
Direct contracting			All cases regardless of the amounts involved

37. Procurement Plan: SEPLAG has consolidated the procurement needs from all implementing agencies into one project procurement plan. This procurement plan for the first 18 months for project implementation provides the basis for the procurement methods and it was agreed between the agencies and the Project Team. It will be available in the project's database and in the Bank's external website. The Procurement Plan will be updated as required to reflect the actual project implementation needs and improvements in institutional capacity.

38. Frequency of Procurement Supervision: In addition to the prior review supervision to be carried out by the Bank, the capacity assessment of the Implementing Agencies suggests the need for yearly supervision missions to visit the field to carry out post-review of procurement actions. A yearly external procurement audit satisfactory to the Bank or yearly Independent Procurement Reviews (IPR) has been agreed as a covenant in the Loan Agreement and will be required to assess and verify a sample of processes procured under part B. As a result of the post-reviews, IPR and external procurement audits, the Bank would be in a position to identify cases of noncompliance and apply the remedies provided for in the loan agreement.

Safeguards Policies

39. The Rio do Grande Sul SWAp has been rated Category B in accordance with the Bank's Social and Environmental Safeguards. World Bank safeguards policies apply to the SWAp's eligible expenditures programs as a whole, though the activities in transport, technological parks and education present the greatest risks. The specific policies triggered are OP 4.01 – Environmental Assessment, OP 4.04 Natural Habitats, OP4.10 Indigenous Peoples, OP 4.11 Physical Cultural Resources, and OP 4.12 Involuntary Resettlement.

40. Given that: (i) the programs to be financed under the transport component pose certain environmental risks; (ii) there is a high degree of variation in the nature of the activities planned

and in the capacity of the various sector agencies to implement them; and (iii) the counterpart has only limited familiarity with the Bank's safeguards policies, an Environmental and Social Management Framework has been prepared for the Project as a whole. This was published in-country on 21st January 2012 and via the World Bank's website on February 1, 2012.

41. At the time of negotiations, none of the investments to be supported by the Project had been identified with sufficient certainty to permit or justify the development of environmental or social management plans. However, the ESMF outlines expected impacts and arrangements to be followed for consultation with stakeholders. Also, in cases where technical assistance will be provided, the TORs for this assistance will incorporate environmental and social objectives consistent with the Bank's safeguards policies.

42. The authorities plan to or have held informed consultation with affected parties with respect to the following activities: i) education – via the Regional Coordinating Bodies and for indigenous peoples via the Indigenous People's State Council; ii) private sector development – via various means including special audiences of the Regional Development Councils (COREDES) targeted towards particular stakeholders.

OP 4.01 Environmental Assessment:

43. *Disaster Risk Management*: The Project will support the development and approval of a Disaster Risk Management Policy and will have no direct environmental implications. However, the terms of reference for the development of the policy will ensure a robust consultation process that takes any relevant environmental concerns into account.

44. *Transport*: The Project will support road maintenance and rehabilitation (CREMA) activities. These will take place on state highways with established rights of way and in the sites associated with civil works. It is therefore expected that the Project work will have no significant negative environmental impact. The environmental impacts of road works are primarily related to quarries and borrow pits, disposal of used pavement materials and other wastes and the activities of road crews. The ESMF will provide guidance, in accordance with state and federal legislation, on the design and implementation of mitigating measures. The Project will also provide technical assistance to strengthen DAER's capacity to reduce and manage the adverse environmental impacts of the state's road programs, including activities not part of the SWAp.

45. *Education*: The Government, through SEDUC, intends to invest BRL 90 million in refurbishing school facilities. Given that the location of all sites is not yet clear, the Environmental Framework will provide guidance on minimizing the impact of works as and when they become known. Mitigating measures will be made public and, where appropriate, included in bidding documents. These will comprise: sub-project eligibility criteria; waste disposal measures; criteria for managing construction sites, including the use of protective equipment by workers; and measures to control dust and noise and prevent any adverse effects on teachers and pupils. The ESMF specifies the institutional arrangements for supervising their implementation.

OP 4.04 Natural Habitats:

46. *Environmental management*: The Government is seeking to improve the quality of land use decision-making to reconcile environmental and economic objectives in areas of high biodiversity and growth potential. It also recognizes that the conservation of natural habitats is essential to safeguard their biodiversity and for the state's long-term sustainable development. It will therefore adopt a precautionary approach to natural resource management. The ESMF includes specific screening criteria to ensure that potential habitat impacts are identified and mitigated during implementation. It also outlines measures for taking into account the environmental and social implications of any new protected areas that might be created as a result of the land-use decision-making process.

OP 4.10 Indigenous Peoples:

47. The state's indigenous population is around 33,000 people or 0.3 percent of the total, the majority being Guarani and Kaingang. It was not possible to identify exactly the impact on this population during Project preparation but given the potential benefits, especially from the education component, OP 4.10 is triggered. In collaboration with *Coordenação de Gestão e Aprendizagem-Educação Indígena* of the Secretariat of Education, the Secretariat of Public Works and Urban Planning and the *Coordenação Executiva do Conselho Estadual dos Povos Indígenas* of the State Secretariat of Justice and Human Rights, SEPLAG has drafted an Indigenous Peoples' Planning Framework (IPPF), based on the desk review and stakeholder consultations conducted under the Social Assessment. The IPPF includes: (a) a description of Project activities that might trigger the policy and their potential effects on indigenous and Quilombola peoples; (b) procedures for the preparation, submission and approval of Indigenous People's Plans (IPPs) for any sub-projects; (c) provisions for guaranteeing free and informed consultation during Project preparation and implementation, including a description of the institutions involved and grievance and redress mechanisms; (d) a description of dissemination methods for IPPs. It was published in-country on January 26, 2012 and on the World Bank's website on February 1, 2012.

OP 4.11 Physical Cultural Resources:

48. Since the Project involves civil works that might require excavations, with potential impact on physical cultural resources, the policy is triggered. Screening criteria have been developed within the ESMF and will be developed within any EIA carried out for specific sub-projects to ensure that adequate measures are in place to identify physical cultural resources and take appropriate action to minimize, avoid or mitigate potential adverse impacts. In addition, civil works contracts will include appropriate clauses defining steps to be taken in the event of chance-finds of PCRs during any excavation or earthworks.

OP 4.12 Involuntary Resettlement:

49. As a principle the operation will avoid land purchases and involuntary resettlement wherever possible. However, in the event that any Project activity (e.g. school rehabilitation or road maintenance) involves the acquisition of buildings and consequent resettlement of families or businesses, OP 4.12 will apply. OP 4.12 protects against social and economic impacts caused

by: (a) relocation or loss of shelter; (b) loss of assets or access to assets; (c) loss of sources of income or means of livelihood; (d) involuntary restriction of access to parks and protected areas. It also supports the involvement of those likely to be affected in resettlement planning and implementation. To ensure compliance SEPLAG has prepared or will prepare the following documents:

- A Resettlement Policy Framework (RPF) applicable to the entire Project with sections for each source of foreseen impact (e.g. road maintenance, rehabilitation of schools, disaster risk management etc.). The framework points out discrepancies between OP 4.12 and state legislation and provides recommendations for addressing them. It describes procedures for: (a) identifying affected people and assets and establishing means of consultation; (b) carrying out a census of affected people and setting a cut-off date; (c) collecting baseline socio-economic data; (d) establishing a methodology for evaluating the value of affected assets and agreeing on a process for compensation at full replacement cost; (e) establishing a timeline for public works, resettlement and compensation; (f) monitoring, evaluation and follow-up. The framework establishes the institutional and financial responsibilities for land purchases and resettlement. It also specifies the methodologies to be used in developing resettlement action plans.

- Resettlement action plans for each affected group of more than 200 persons; and abbreviated action plans for smaller groups. Both should be presented to the World Bank for approval prior to the start of works.

The IPPF and RPF have been approved by the Bank and were published on the World Bank's website on February 1, 2012 and the SEPLAG and other Government websites on January 26, 2012.

Annex 4: Operational Risk Assessment Framework (ORAF)

BRAZIL – STATE OF RIO GRANDE DO SUL: SWAp to Strengthen Public Investment Project

<table>
<tr><td>Stakeholder Risks</td><td colspan="4">Rating: Moderate</td></tr>
<tr><td rowspan="2">Description:
The operation involves eight implementing agencies and puts a substantial burden of coordination on SEPLAG.
SEDUC staff and teachers might reject the new performance evaluation proposed under the Participatory Evaluation System.
The government's program depends on additional sources of funds (e.g. from BNDES).</td><td colspan="4">Risk Management:
The Government's monitoring mechanism for strategic projects comprises senior representatives from all agencies that will meet monthly to monitor progress and take corrective action where necessary.
SEDUC has consulted broadly with stakeholders and teacher unions on the new system of performance evaluation.</td></tr>
<tr><td>Resp: SEPLAG, SEDUC</td><td>Stage: Preparation/Implementation</td><td>Due Date : Continuous</td><td>Status: Ongoing</td></tr>
<tr><td colspan="5">Implementing Agency Risks (including fiduciary)</td></tr>
<tr><td>Capacity</td><td colspan="4">Rating: Substantial</td></tr>
<tr><td rowspan="2">Description:
Procurement: the procurement risk is Substantial, given the absence of an effective system for managing procurement and contracting data and the varying capacity across implementing agencies to develop technical terms of reference.
Financial management: the financial management risk in Substantial, given the SWAp nature of the operation and involvement of multiple agencies.
Technical: AGDI is recently formed and will require time to acquire the capacity to oversee the programs for which it is responsible.</td><td colspan="4">Risk Management:
The Project will strengthen CECOM's capacity to manage procurement data. It will also establish a special bidding committee within SEPLAG as a condition of effectiveness and provide training in Bank procurement guidelines prior to effectiveness.
Financial management arrangements will be based on strong state procedures. The use of an integrated financial management system will help ensure that only approved transactions are undertaken and recorded and that financial reports are regularly submitted to the Bank. Payments will be made using the State's banking arrangements and will be monitored by SEFAZ.
The Project will provide interim managerial support to AGDI and longer term training in project management.</td></tr>
<tr><td>Resp: SEPLAG/AGDI</td><td>Stage: Preparation/implementation</td><td>Due Date: Complete by 2014</td><td>Status: Ongoing</td></tr>
<tr><td>Governance</td><td colspan="3">Rating: Low</td><td></td></tr>
<tr><td rowspan="3">Description:
There are no risks related to governance associated with the borrower or any of the implementing agencies that might require mitigation.</td><td colspan="4">Risk Management: NA</td></tr>
<tr><td>Resp:</td><td>Stage:</td><td>Due Date :</td><td>Status:</td></tr>
<tr><td>Resp:</td><td>Stage:</td><td>Due Date :</td><td>Status:</td></tr>
<tr><td>Project Risks</td><td colspan="4"></td></tr>
</table>

Design	Rating: Substantial			
Description: Stakeholders may not adhere to the ecological-economic zoning process. Insufficient firms may make use of the extension service to allow for an effective impact evaluation. Regional education councils may lack capacity to implement the Participatory Evaluation System effectively. Technical assistance may not disburse in timely manner.	Risk Management: The Project will conduct a campaign to sensitize and mobilize producers, associations, and local governments to the benefits from participation in the zoning process. Experience with an earlier extension program suggests that potential demand is large. The Project will collaborate with local industry organizations to advertise the program. SEDUC will pilot the use of the different evaluation modules before rolling out the system and will make adjustments as needed. Project design has delinked DLIs from technical assistance projects; training has been provided in Bank procurement methods.			
	Resp: SEMA/AGDI/SEDUC	Stage: Implementation	Due Date: Complete by 2014	Status: Future
Social & Environmental	Rating: Moderate			
Description: Implementing agencies lack familiarity with Bank safeguards requirements. The education and transport components involve physical works that may have environmental impacts.	Risk Management: The Bank will provide training in safeguards policies during implementation. Bidding documents will explicitly mention the environmental and social conditions to be met by the contractors, including compliance with Brazilian State and Federal legislation.			
	Resp: Bank/DAER/SEDUC	Stage: Preparation and implementation	Due Date: End-2012	Status: Ongoing
Program & Donor	Rating: Low			
Description: There are no additional donors.	Risk Management: NA			
	Resp:	Stage:	Due Date :	Status:
Delivery Monitoring & Sustainability	Rating: Moderate			
Description: There is a risk that the private sector development programs may not be sustainable without the public funding provided under the program. There is a risk that SEDUC may not be able to sustain new investments in educational infrastructure and ICT. The current Government was elected in November 2010, meaning that most of the project period will fall within its four year term.	Risk Management: The Project will require participating enterprises to contribute towards the cost of the program and seek to increase the proportion met from private sources over time. SEDUC will develop a system of preventive maintenance for all public schools and train staff to follow it. It will also train staff from the regional education councils to maintain ICT investments.			
	Resp: AGDI/SEDUC	Stage: Implementation	Due Date: End-2014	Status: Future
Overall Implementation Risk	Rating: Moderate			

Annex 5: Implementation Support Plan

BRAZIL – STATE OF RIO GRANDE DO SUL: SWAp to Strengthen Public Investment Project

1. The strategy for implementation support reflects the nature of the project and its Moderate risk profile. It focuses on those risk mitigation measures defined in the ORAF, in particular those relating to safeguards and procurement.

2. The Bank will carry out formal supervision missions semi-annually, focusing on compliance with EEP and DLI disbursement requirements and the execution of technical assistance projects. Sector specialists will undertake technical reviews of terms of reference and bidding documents and provide No Objections as needed. In addition the Bank will oversee the following aspects of project implementation:

    a. Safeguards: Environmental and social specialists will review compliance with the requirements detailed in the EMPs, IPPs and RAPs, providing additional training where necessary.
    b. Fiduciary requirements: The financial management specialist will review compliance with loan requirements twice during the first year of the project and once a year thereafter. These field visits will be complemented by desk reviews of the interim financial reports and annual state audits.
    c. Procurement: Given the substantial risk associated with this function, the Bank's procurement specialist will provide training prior to and, if necessary, after effectiveness. The specialist will also carry out an annual post-review of procurement actions in the field.

3. The implementation support plan is as follows:

Table 12. Implementation Support Plan

Skills needed	Number of staff weeks/year	Number of field trips per year
Task team leader	8 staff weeks	Two
Transport specialist	4 staff weeks	Two
Highway specialist	2 staff weeks	Two
Education specialist	4 staff weeks	Two
Private sector devt. specialist	4 staff weeks	Two
Public sector mgt. specialist	4 staff weeks	Two
Environmental specialist (tech assist.)	2 staff weeks	One
Procurement specialist (country-based)	4 staff weeks	One
FM specialist (country-based)	2/4 staff weeks	Two in first year; one thereafter
Social specialist (safeguards)	2 staff weeks	One
Environmental specialist (safeguards)	2 staff weeks	One

The Bank will review the plan at least once a year to ensure that it continues to meet the needs of the project and is adequate to ensure compliance with fiduciary and safeguards requirements.

Annex 6: Fiscal Sustainability Analysis

BRAZIL – STATE OF RIO GRANDE DO SUL: SWAp to Strengthen Public Investment Project

Introduction

1. Five years of consistent fiscal adjustment efforts have turned around Rio Grande Do Sul's finances. In 2003, Rio Grande Do Sul's fiscal situation was one of the most difficult in Brazil. RGS did not meet the Fiscal Responsibility Law (FRL) indicators with a ratio of net consolidated debt to net current revenue of 280 percent – well above the FRL ceiling of 200 percent, and the ratio of debt service obligations to net current revenue at 14.4 percent (above the FRL limit of 11.5 percent). The state had difficulty meeting its fixed spending obligations, including civil service wages, infrastructure maintenance, civil service pension payments and debt servicing and consequently significantly reduced investment spending to avoid a fiscal crisis. A new administration elected in 2007, adopted strict measures to promote a turnaround in fiscal accounts. The state government introduced a set of reform measures directed to curb the increasing trend of current expenditures through tight control of personnel costs. On the revenue side, measures were taken to improve the efficiency of tax collection. As a result, the State has generated positive and increasing fiscal balances and debt levels have experienced a pronounced reduction.

2. Overall, the fiscal adjustment reform measures have been successful. The reforms, supported by the World Bank have resulted in a significant improvement in Rio Grande do Sul's fiscal position, as reflected by the FRL indicators (see box 1). Net consolidated debt, fell from 280 percent of net current revenue in 2003 to 214 percent of net current revenue in 2010. Personnel expenses as a share of net current revenue fell from 58 percent in 2003 to 47 percent in 2010, below the 60 percent FRL ceiling. While the debt level still remains above the FRL limit, it is expected to fall below 200 percent of Net Current Revenue (NCR) by end-year 2013. This improvement has led the National Treasury to authorize Rio Grande do Sul to contract new credit obligations, for the first time since its debt renegotiation agreement with the federal government in 1997.

3. Baseline projections for the period 2011-2020 depict a favorable evolution of the main fiscal indicators. Debt levels are forecast to stabilize below 200 percent of NCR while annual budget balances increase. A significant reduction in debt service pressure is projected in the medium term, following a period of accelerated "extra-limite"[15] debt amortization payments. However, to maintain its sound fiscal position, RGS will need to sustain the high performance of its own revenue collection through further improvements in collection efficiency. RGS will also need to continue its efforts to control spending.

[15] Debt that is not within the debt renegotiation agreement with the Federal Government.

Box 2: Results from the Rio Grande Do Sul Fiscal Sustainability for Growth Loan

The RGS Fiscal Sustainability for Growth Development Policy Loan supported key reforms in four areas: fiscal sustainability, debt restructuring, social security and modernization of the state public sector. Overall, program implementation was satisfactory and resulted in substantial achievements. Program objectives in the reform areas of fiscal sustainability and debt restructuring were fully achieved, but achievement of objectives in the policy areas of social security and public sector management reform was uneven. Specific outcomes of the operation include, *inter alia:*

Fiscal Sustainability:

- Sustained primary surpluses
- Reduction of personnel costs further below the threshold of 60 percent of net current revenue
- Reduction in the burden of state debt
- Restructure of the procurement system

Debt Restructuring:

- State debt profile (duration, net present value, and debt service pattern) improved by paying off extralimite debt.

Civil Service Social Security:

- Reduction in the deficit of the pension scheme for state employees.

Source: Rio Grande Do Sul Fiscal Sustainability for Growth Loan ICR (2011)

State Context and Recent Economic Developments

4. With a GDP of R$ 199 billion (US$109 billion[16]), Rio Grande do Sul is the fourth largest state economy in Brazil. The state is an important centre for industry, and its contribution to national GDP is estimated at about 6.6 percent. Industry and services combined represent 90 percent of state GDP while agriculture contributes the remaining 10 percent. Economic activity is driven by export sectors[17,] high-productivity agro-business, and a well developed industrial sector. RGS is the fifth most populous state in Brazil. Its current population of 11 million inhabitants represents 4.6 percent of the Brazilian population.

5. Rio Grande do Sul is a well developed state and has enjoyed high socio-economic welfare standards in the Brazilian context. Per capita GDP was US$ 10,006 in 2008, the fourth highest in Brazil and 15 percent larger than the national average. Rio Grande do Sul is among the top-4 states in socio-economic development in the country, with social indicators well above national averages. In 2009, Rio Grande do Sul's poverty headcount rate was 13.7 percent, while

[16] GDP was converted using the average exchange rate prevailing in 2008 (1 US$ = R$ 1.83).
[17] RGS is the fourth largest state exporter in Brazil, after Sao Paulo, Minas Gerais and Rio de Janeiro. In 2010, RGS exports were valued at US$15.4 billion, and accounted for 7.6 percent of Brazil's total exports. Rio Grande do Sul's main exports in 2010 were food products and beverages 25.1%, soybeans 13.6%, tobacco 13%, chemicals 11.4%, leather, leather goods, and footwear 8.7%, motor vehicles 4.9% (Source: Fundaçao de Economia e Estatistica).

the national poverty rate was 25.6 percent. With a Gini index of 0.49 in 2009, Rio Grande do Sul's inequality is the fourth lowest in Brazil (which has a Gini index of 0.54). Education and health indicators are also well above national averages. Access of the population to public services, including sanitation, water, electricity and garbage collection put RGS among the top positions on public services coverage among Brazilian states.

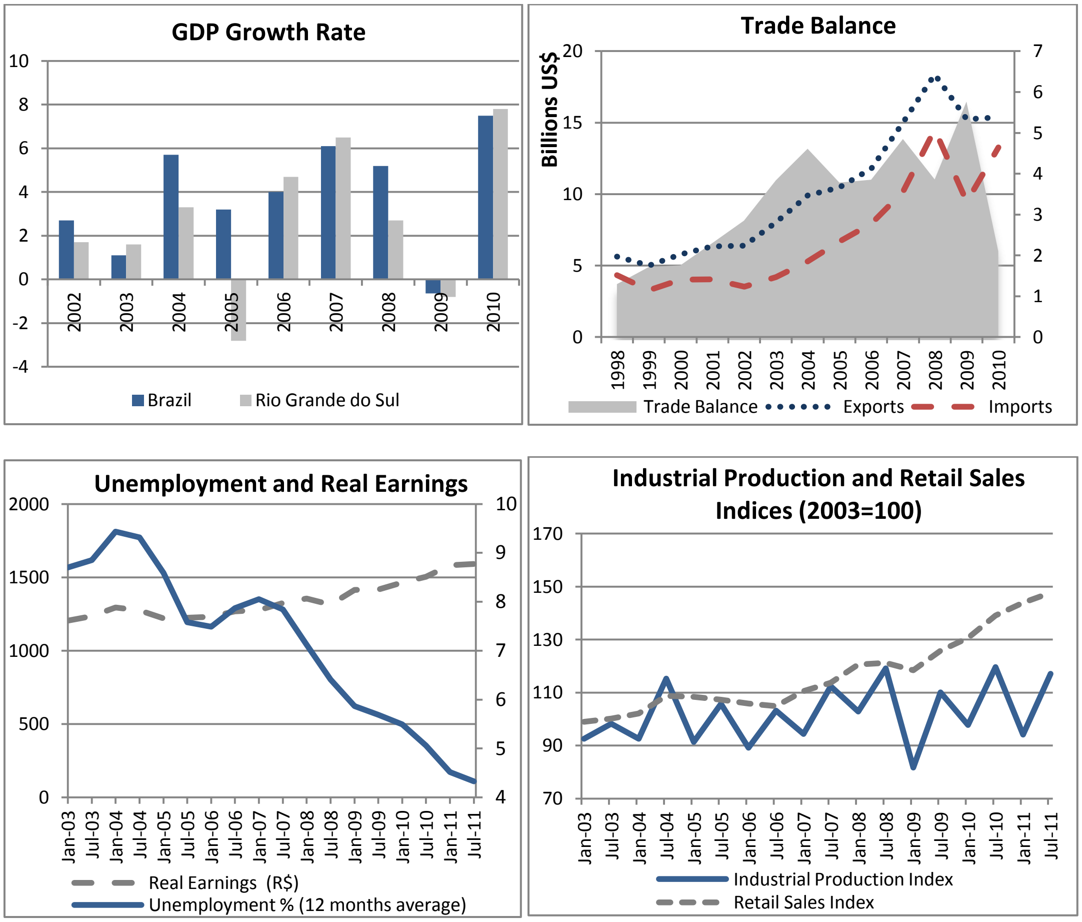
6. The state economy has been growing moderately since 2003. In real terms, the economy grew by 1.7 percent during the period 2002-2006 and in the last four years this rate increased to 4.1 percent annually, on account of broad-based growth across the agriculture, industry and services sectors. But despite improvements over the years, Rio Grande do Sul's growth performance of 2.8 percent over the last 8 years (2002-2010) falls lower than the national average growth rate of 3.9 percent. The state's growth performance was affected by the difficult fiscal situation, which reduced its investment capacity; Growth has been, and remains constrained by infrastructure bottlenecks, as efforts to increase public infrastructure investment are only beginning to bear fruit. As a result, RGS's share of national GDP has declined from 8.9 percent in 1996 to 6.6 percent in 2008.

7. In addition, Rio Grande do Sul's recent growth performance continues to exhibit considerable volatility, much higher than other Brazilian states, and the national economy due to its high share of exports in economic production. The state economy is highly vulnerable to climate effects concerning water resources (rainfall), exchange rate movements, global demand, and fluctuations in commodities prices which affect export-oriented agro-business and industrial sectors oriented to exports. While long run trends are similar, in the short run the RGS growth cycle has a variance two times larger than the national one. Overall, output volatility presents a challenge for the State Government in maintaining its positive fiscal outlook and high level of socio-economic development[18].

8. The state economy has rebounded strongly from the global financial crisis. The strong recovery is reflected in indicators of economic activity, most of which have surpassed their pre-crisis levels. GDP estimates for 2010 show that the economy grew by 7.8 percent. The industrial sector, the hardest hit during the crisis, has recuperated to its pre-crisis levels. Industrial production increased by 10.3 percent in 2010 compared to a year earlier. The retail sales index increased at annual rate of 6.2 percent in 2010, benefiting from the expansion of formal jobs and real increases in the minimum wage. Exports also grew modestly in 2010, at 1%.

[18] The evolution of socio-economic indicators shows a marked deterioration in socio-economic development. In 1990, Rio Grande do Sul was second in Brazil in terms of its Human Development Indicators, while in 2000 the state fell to fourth, and is currently in fifth position according to the 2008 United Nations Human Development Index.

Figure 6: Economic Indicators for Rio Grande Do Sul



Rio Grande do Sul State Government Finances, 2004-2010

Fiscal Balances

9. Over the last six years, the fiscal situation of the state of Rio Grande do Sul has improved markedly. Fiscal balances improved substantially from primary deficits over 1970-2004, to surpluses thereafter. Further improvement took place after 2007, which saw low primary and operating balances become high surpluses, in what marked a period of strong fiscal adjustment measures. Operating surpluses increased from 9 percent of net current revenues in 2007 to 18 percent in 2010, and the primary balance tripled. In 2007, a generated positive overall balance was obtained that has been maintained and expanded, despite an increase in debt amortization payments. However, in 2010, total balances were negative, largely because of a sharp rise in investment (see Table16).

Evolution of Fiscal Revenues, 2004-2010

10. Robust revenue growth has been an important factor in the achievement of the state's improved fiscal position. Between 2004 and 2010, total revenues increased by 80 percent in real terms. Tax revenue, the most important revenue item (accounting for 63.2 percent of revenues in

2010), grew by 47 percent, resulting from measures to enhance tax collection efficiency such as the electronic fiscal receipts system (NF-e), the tax substitution regime for VAT collection (Substituição Tributária)[19] and Gestão matricial das receitas. In addition, the strong performance of tax revenues was driven by increased domestic demand which boosted ICMS revenues. As a result, ICMS performance remained resilient as external demand fell during the 2009 global economic crisis.

11. Federal transfers also grew robustly (59 percent) between 2004 and 2010. The increase was largely on the back of rising transfers from FUNDEB (multi-governmental transfers earmarked to education) and the State Participation Fund. FUNDEB grew by 103 percent, while the State Participation Fund had an accumulated growth of 53 percent. Social contributions rose sharply in 2009 to 37 percent of NCR due to the inclusion of the social security fund of state employees in the state accounts. Meanwhile, other current revenues-which include interest income, rents, service charges, and other miscellaneous sources-grew by 61 percent during this period.

12. ICMS performance still suffers from the fact that RGS has lower tax rates and higher exports than other states. As a percentage of GDP, ICMS—the largest tax source for RGS, representing 80% of tax revenues and 50% of current revenues— remains much lower than other states[20,] due to (i) the lower rates (‘*aliquotas*’) compared to other states (17% compared to 18% in Sao Paulo, Minas Gerais and Parana and 19% in Rio de Janeiro)[21] and (ii) the higher rate of exports abroad, which are exempt from ICMS. Given these limitations to increasing tax revenue potential, increasing ICMS will depend greatly on the ability of the authorities to enhance tax collection efficiency and expand interstate trade. If instead of exporting to foreign markets RGS sold to other states, its tax additional revenue could reach between R$1.15 billion and R$1.98 billion, higher than the reimbursement amount of R$300 million which RGS receives from the federal government as compensation for export exemption from ICMS. The resilience of ICMS revenues during the 2009 crisis reflects the potential opportunities of this shift to the domestic market.

Evolution of Expenditures, 2004-2010

13. RGS’s improved fiscal performance was also based on the control of state expenditures. From 2004 to 2010, total expenditures grew at an average annual rate of 9.4 percent, slightly lower than the total revenue growth rate of 10.5 percent. Personnel expenditure, the largest expenditure category, had a real increase of 13.9 between 2004 and 2007, and this rate reduced to 12.1 percent between 2008 and 2010. Personnel expenditure includes wages and salaries for active personnel, social contributions, and pensions to retired personnel. Between 2007 and 2010, wages and salaries and social contributions grew at an annual rate of 2 percent while

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[19] Substituição tributária is a VAT tax collecting mechanism that puts the tax collection burden on the first firm of the production chain to avoid tax evasion.

[20] According to data available for 2010, RGS ranked 16th out of 27 states, with an ICMS revenue to GDP ratio of 7 percent.

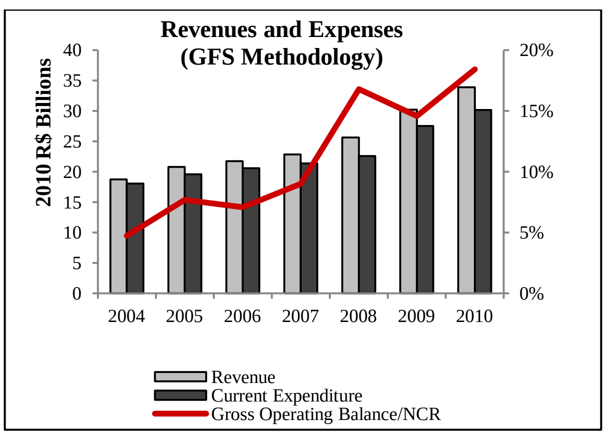
[21] Furthermore, special rates applied to specific products like alcoholic beverages, cigarettes, guns, bullets, and other goods and services determined by the state legislation are 25% in Rio Grande do Sul, but range from 25% to 30% in other Brazilian states.

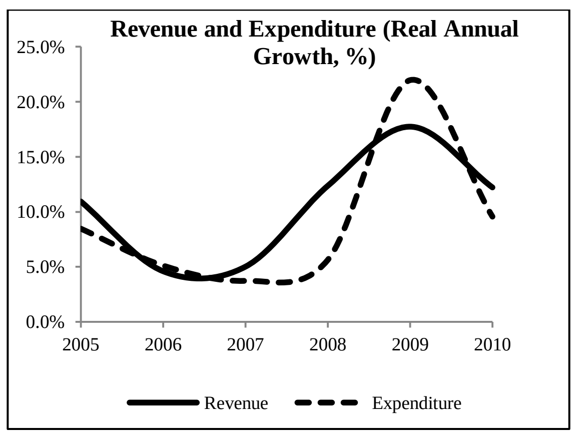
pensions grew by 4.5 percent. The control of active personnel expenditures allowed the state to reduce the Fiscal Responsibility Law indicator of personnel expenditure to net current expenditures from 54 percent in 2004 to 47 percent in 2010, thus meeting the Fiscal Responsibility Law requirement.

14. The second most important component of current expenditures corresponds to operating expenses, which include purchases of goods and services, as well as operations and maintenance. Annual growth in this expenditure category was also low (3.6 percent since 2004). In contrast, growth of constitutional transfers to municipalities was relatively high (9.1 percent from 2004 to 2010). The robust increase in transfers to municipalities reflects the good performance of state tax revenue, since transfer amounts to municipalities are defined by the Constitution as a proportion of tax revenue[22]. Interest payments on state debt declined by 44 percent on the back of debt restructuring measures adopted as part of the World Bank support.

15. Public investment fell from 6.1 percent of net current revenues in 2004 to 2.9 percent in 2007. However, since 2007, investment has risen modestly by an annual average of 3.2 percent, and in 2010, investment expenditure levels tripled to 9.5 percent of net current revenue. While the 2010 increase in investment is in part attributable to the 2007 fiscal consolidation efforts by the State Government, it was also driven by extraordinary revenues in that year. The approval in May 2011 of the law to establish a complementary pension fund will control growth in pensions costs in the medium term, by imposing a ceiling on pension benefits — one of the largest structural sources of fiscal imbalance in RGS.

Figure 7: Current Revenue and Expenditure





Source: SEFAZ

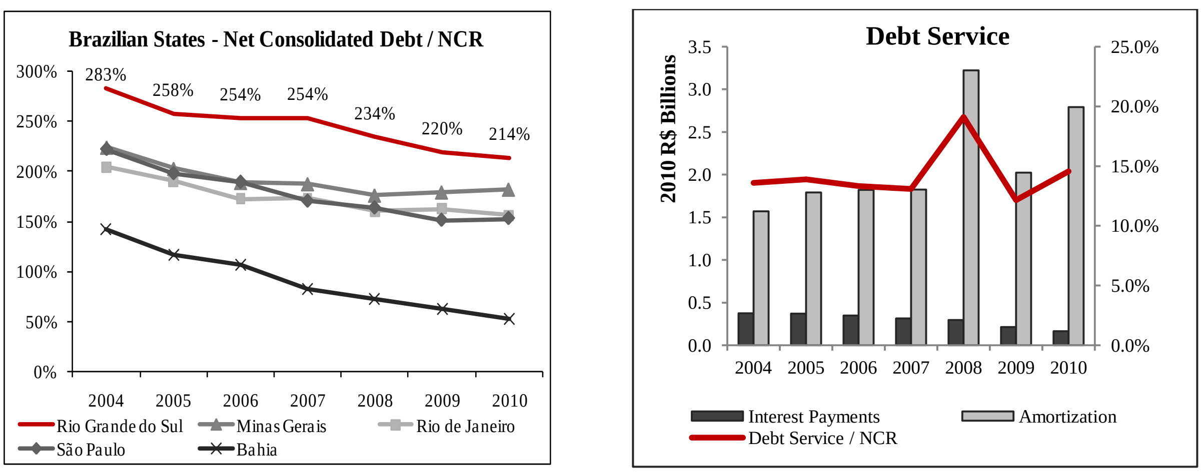
Evolution of Consolidated Debt, 2004-2010

[22] Two of the three taxes collected by the state (ICMS, IPVA and ITCMD) are shared with the municipalities, which receive 25 percent of ICMS and 50 percent of IPVA.

16. The State's fiscal position has strengthened in the last four years, partly as a result of the debt restructuring measures, which lowered the interest rate and improved the maturity profile. Debt in relation to net current revenue has been falling (from 254 percent in 2007 to 214 percent in 2010), faster than in any other Brazilian state. This improvement has led the National Treasury to authorize RGS to contract up to BRL 2.3 billion in new obligations, for the first time since its debt renegotiation agreement with the federal government in 1997. Since the "extra limit" debt restructuring operation with the World Bank, debt service payments have consisted mainly of amortization, given lower interest payments and accelerated amortization repayments.

17. As of 2010, RGS's net consolidated debt stood at R$ 43.4 million, or 214% of net current revenues. Public contracted debt is the main component at R$ 40.6 billion, followed by Judicial debt at R$ 3.3 billion. Most of its contracted debt (92.1 percent) is that owed to the Union/Treasury renegotiated under Law No. 9496/97, named 'intra limit'. This debt is indexed by inflation (IGP-DI) and has a rule capping debt service payments at 13% of net real revenues. The remainder is for the most part external debt owed to IBRD and internal debt owed to the Treasury and INSS.

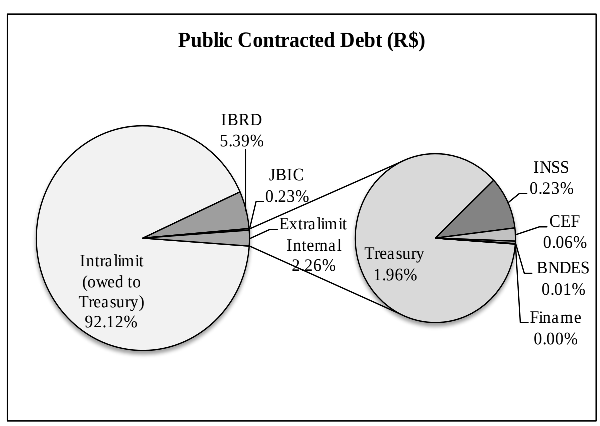
Figure 8: Debt and Debt Service



Source: SEFAZ, WB Calculations

Table 13. Public Debt

R$	2009	2010
CONSOLIDATED DEBT	**39,645,535,000**	**44,412,294,000**
Public Contracted Debt	**36,929,741,187**	**40,617,442,737**
Intralimit (owed to Treasury)	33,646,732,393	37,417,491,023
Extralimit	3,283,008,794	3,199,951,715
Internal	1,627,187,832	917,200,365
Treasury	1,501,941,971	796,671,048
INSS	97,567,815	92,488,029
Caixa Economica Federal (CEF)	26,973,196	22,919,838
BNDES	-	4,416,600
Finame	704,851	704,851
External	1,655,820,962	2,282,751,349
World Bank (IBRD)	1,558,140,792	2,189,597,964
JBIC	97,680,170	93,153,385
Judicial Debt (Precatorios) after 5/5/2000	**2,537,347,000**	**3,344,389,000**
Residual (Divida Mobiliaria and Other)	**178,446,813**	**450,462,263**
Deductions of Net Financial Assets	**1,474,858,000**	**975,268,000**
NET CONSOLIDATED DEBT	**38,170,677,000**	**43,437,026,000**
% of NCR	*220%*	*214%*



Compliance with the Fiscal Responsibility Law Indicators, 2004-2010

18. Despite improvements in its fiscal position, Rio Grande do Sul has not been complying with the limits set by the FRL on net consolidated debt stock and debt service payments. These have been exceeding the ceilings established under the FRL, respectively at 200 and 11.5 percent of net current revenues (see Table 14). However, net consolidated debt is expected to fall below the limit by end 2013. In addition, debt service is projected to fall after the period of extra-limite debt payment concentration has ended[23], since the current high level is due to accelerated amortization repayments.

19. With the exception of debt and debt service fiscal indicators, the RGS met all key Fiscal Responsibility Law indicator requirements. The ratio of personnel expenditures to net current revenue, declined from 54 percent in 2004 to 47 percent in 2010 below the 60 percent limit. Credit operations and guarantees were well below the legally imposed limits of 16 and 22 percent of net current revenue, respectively.

Table 14. Fiscal Responsibility Law Indicators, Thousands R$ 2010

FISCAL RESPONSIBILITY LAW Indicators	Legal Limit	2004		2005		2006		2007		2008		2009		2010	
	% NCR	Value	% NCR	Value	% NCR	Value	% NCR	Value	% NCR	Value	% NCR	Value	% NCR	Value	% NCR
Personnel Expenditures	≤ 60%	7,752,020	54.2%	7,830,290	50.3%	8,337,739	51.3%	8,497,116	60.7%	8,531,789	51.2%	9,088,053	52.3%	9,549,109	47.0%
Executive	≤ 54%	6,190,705	43.3%	6,231,365	40.0%	6,719,007	41.3%	6,925,376	49.5%	7,013,420	42.1%	7,450,378	42.8%	7,825,737	38.6%
Legislative	≤ 3%	350,123	2.4%	372,316	2.4%	404,580	2.5%	386,038	2.8%	380,879	2.3%	381,779	2.2%	394,634	1.9%
Judiciary	≤ 6%	904,093	6.3%	918,601	5.9%	903,582	5.6%	884,741	6.3%	842,405	5.1%	928,510	5.3%	984,936	4.9%
Public Ministry	≤ 2%	307,098	2.1%	308,007	2.0%	310,570	1.9%	300,961	2.2%	295,085	1.8%	327,387	1.9%	343,802	1.7%
Net Consolidated Debt	≤ 200%	40,437,211	282.7%	40,128,866	257.8%	41,263,027	253.6%	41,550,482	253.8%	43,149,955	234.5%	40,426,063	219.5%	43,437,026	214.0%
Guarantees	≤ 22%	784,006	5.5%	607,224	3.9%	487,121	3.0%	390,847	2.8%	360,259	2.2%	263,515	1.5%	201,104	1.0%
Credit Operations	≤ 16%	306,511	2.1%	160,493	1.0%	35,944	0.2%	-	0.0%	1,316,874	7.9%	-	0.0%	786,825	3.9%
Debt Service	≤ 11,5%	1,943,719	13.6%	2,160,893	13.9%	2,169,815	13.3%	2,141,473	15.3%	3,515,963	21.1%	2,237,131	12.9%	2,955,751	14.6%
Net Current Revenue (NCR)		**14,303,690**		**15,566,447**		**16,269,241**		**16,369,351**		**18,402,709**		**18,414,648**		**20,297,847**	

Source: SEFAZ

[23] Debt service payments on *extra-limite* debt, as projected in the 2008 debt restructuring operation, show a strong accumulation of debt payments during the period from 2008-2012 (peaking at 5 percent of net current revenues in 2008 and thereafter falling to 2 percent in 2015).

Table 15. Government Balances, GFS Methodology

GFS - Government Balances	2004	2005	2006	2007	2008	2009	2010
	(Millions R$ 2010)						
I. REVENUE	**18,734**	**20,783**	**21,739**	**22,830**	**25,654**	**30,203**	**33,893**
Taxes	14,583	15,928	16,501	16,660	18,890	18,914	21,420
Social Contributions	1,156	1,184	1,236	2,103	2,249	6,518	7,471
Transfers	3,891	4,208	4,611	4,907	5,680	5,798	6,185
Other Current Revenues	1,255	1,306	1,237	1,250	1,492	1,852	2,031
II. EXPENSE	**18,058**	**19,587**	**20,589**	**21,358**	**22,562**	**27,519**	**30,152**
Compensation of Employees	5,510	5,667	6,128	6,039	6,227	6,583	6,999
Pensions	4,923	5,100	5,552	5,845	5,927	6,239	6,627
Interest Payments	374	370	349	316	294	215	164
Goods and Services	3,994	4,269	4,314	4,092	4,362	4,410	4,902
Transfers	3,257	4,181	4,245	4,257	4,815	4,903	5,360
Intra-Budgetary Expenses	-	-	-	809	937	5,170	6,099
III. GROSS OPERATING BALANCE (I - II)	**676.2**	**1,195.7**	**1,150.0**	**1,472.8**	**3,091.7**	**2,684.1**	**3,741.2**
(as % of NCR)	*4.7%*	*7.7%*	*7.1%*	*9.0%*	*16.8%*	*14.6%*	*18.4%*
IV. TRANSACTIONS IN NON-FINANCIAL ASSETS	**877**	**776**	**812**	**469**	**730**	**701**	**1,937**
Net acquisition of non-financial assets	760	684	749	432	658	633	1,864
Other investments in assets	117	92	63	37	72	68	72
(as % of NCR)	*6.1%*	*5.0%*	*5.0%*	*2.9%*	*4.0%*	*3.8%*	*9.5%*
V. NET LENDING / BORROWING (III - IV)	**(201)**	**420**	**338**	**1,004**	**2,362**	**1,983**	**1,804**
VI. PRIMARY BALANCE (V + Net Interest Payments)	**(36)**	**509**	**263**	**1,006**	**2,191**	**1,631**	**1,520**
(as % of NCR)	*-0.3%*	*3.3%*	*1.6%*	*6.1%*	*11.9%*	*8.9%*	*7.5%*
VII. TRANSACTIONS IN FINANCIAL ASSETS AND LIABIL	**(1,025)**	**(1,578)**	**(1,437)**	**(275)**	**(1,873)**	**(1,972)**	**(1,961)**
New Loans	307	160	36	-	1,317	-	791
Amortizations, net	(1,556)	(1,775)	(1,757)	(1,784)	(3,194)	(2,004)	(2,756)
Asset sales	225	37	283	1,509	5	32	4
TOTAL BALANCE (incl. Intra-Orcamentaria) (VI + VII)	**(1,225)**	**(1,158)**	**(1,099)**	**729**	**489**	**11**	**(157)**
Memo Item:							
Net current revenue (NCR)	**14,304**	**15,566**	**16,269**	**16,369**	**18,403**	**18,415**	**20,298**

Source: SEFAZ, WB Calculations

Medium Term Fiscal and Debt Sustainability

20. The projected fiscal and debt paths for the state of Rio Grande do Sul are deemed sustainable in the medium-term. The baseline scenario projections indicate a sustainable path, with positive primary fiscal balances. Rio Grande do Sul's operating balance is expected to record an increasing surplus over the projection period, allowing for fiscal space for state investments, while net consolidated debt is projected to fall from 214 percent of net current revenue in 2010 to 113 percent by 2020.

21. In particular, baseline projections for the period 2010-2020 depict a fiscal framework marked by both revenue and expenditure growth. The principal drivers of revenue growth are taxes (primarily from ICMS, which is heavily dependent on economic growth) and current transfers from the federal government (from Convenios, FPE, and FUNDEB). Other current revenues are also increasing, albeit at a lower rate, while capital transfers are constant in real terms. On the expenditure side, growth remains largely driven by current expenditures in the medium term. Current expenditures rise mainly on account of new judicial debt payment

obligations (precatorios), increases in employee compensation and goods and services, as well as sub-national transfers to municipalities and to FUNDEB. While capital expenditures increase modestly in the medium term, they are expected to reach up to 4.7 percent of net current revenue by 2016.

22. In the baseline scenario, the debt dynamics are sustainable and comply with the Fiscal Responsibility Law. Based on data for scheduled amortizations and interest payments, net consolidated debt is projected to decline in real terms in the medium term. As a share of net current revenue, net consolidated debt and debt service are projected to decline to levels within the Fiscal Responsibility Law limits set by the federal government. Debt service payments would peak in 2013, declining thereafter to 11.5 percent of net current revenue in 2016. Personnel costs are expected to stay below 50% of net current revenue for the entire period of projection. (Table 16).

Table 16. Fiscal Responsibility Law Indicators Projections 2011-16

Millions R$ 2010 Constant Prices	Legal Limit	2011		2012		2013		2014		2015		2016	
	% RCL	Amount	% RCL	Amount	% RCL	Amount	% RCL	Amount	% RCL	Amount	% RCL	Amount	% RCL
Total Personnel Expenses	60	6,999	34.5	7,092	36.9	7,472	37.2	8,034	38.0	8,588	38.6	8,863	38.5
Net Consolidated Debt	200	43,409	213.9	43,898	228.1	43,048	214.4	42,017	198.5	40,964	183.9	39,809	172.8
Debt Service	11.5	2,956	14.6	2,379	12.4	2,676	13.3	2,734	12.9	2,722	12.2	2,650	11.5
Net Current Revenue		**20,298**		**19,241**		**20,081**		**21,166**		**22,273**		**23,037**	

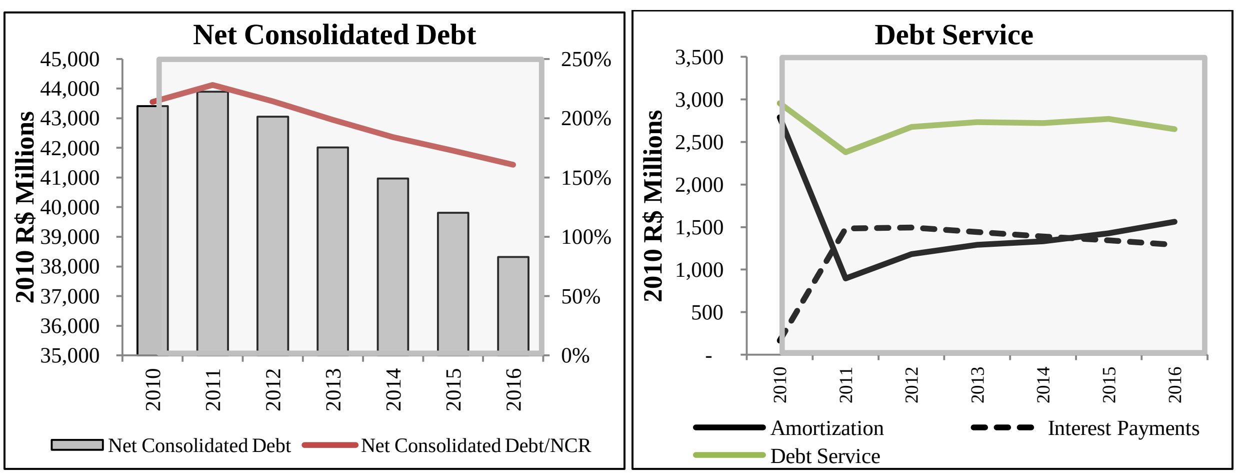
23. Data for the baseline year, 2010, were taken from SEFAZ and were reclassified according to the Government Finance Statistics (GFS) classification. The figures presented in the state's fiscal account differ from both the GFS estimates and those compiled by the federal government and presented in the fiscal adjustment program (PAF).[24] According to the GFS classification methodology, net current revenues include capital transfer revenues (as reported by the Brazilian statistics), which are otherwise excluded in the Brazilian Central Bank's definition of current revenues. The baseline fiscal projection results for 2010 to 2016 are presented in Table 17, while the assumptions used for the projections are found in Table 18.

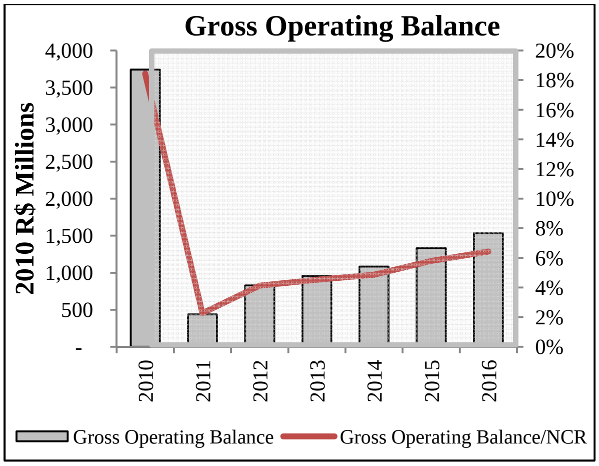
[24] The PAF agreed with 25 state governments under the Debt Restructuring Program was a tool used by the Federal Government to reinforce fiscal discipline for sub-national governments. The achievement of the targets enables state to engage in new borrowing.

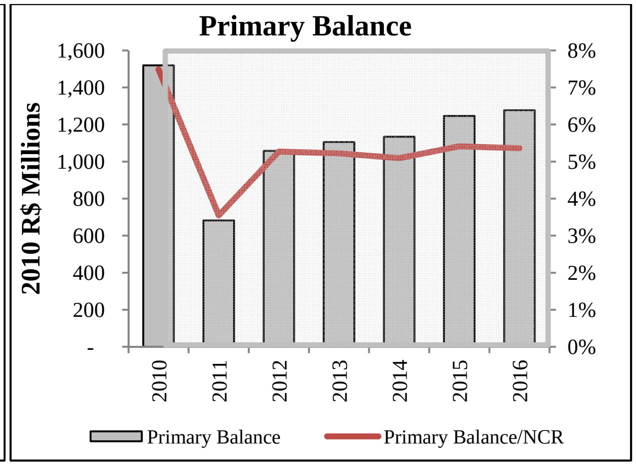
Table 17. Baseline Fiscal Projections 2011-16, 2010 R$ Million

		Projections					
	2010	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
I. Revenue (I)	**33,893**	**32,069**	**33,585**	**35,326**	**37,141**	**38,455**	**39,683**
Taxes	21,420	19,949	20,672	21,643	22,693	23,580	24,543
Social Contributions	7,471	7,860	8,353	8,981	9,601	9,908	10,215
Transfers	6,185	5,737	6,122	6,386	6,680	6,923	7,020
Current Transfers	5,972	5,556	5,754	6,024	6,319	6,565	6,834
Capital Transfers	214	181	182	184	185	185	185
Other Current Revenues	2,031	1,815	1,847	1,883	1,909	1,932	1,953
Deductions	(3,214)	(3,291)	(3,408)	(3,568)	(3,743)	(3,888)	(4,048)
II. Expediture (II)	**30,152**	**31,632**	**32,757**	**34,368**	**36,058**	**37,121**	**38,150**
Compensation of Employees	6,999	7,092	7,472	8,034	8,588	8,863	9,138
Pensions	6,627	6,546	6,891	7,188	7,497	7,963	7,994
Interest Payments	164	1,482	1,494	1,442	1,389	1,342	1,291
Transfers	5,360	4,940	5,116	5,356	5,618	5,837	6,076
Goods and Services	4,902	4,517	4,678	4,898	5,138	5,338	5,557
Precatorios	-	809	639	681	725	398	412
III. Gross Operating Balance (I - II)	**3,741**	**437**	**829**	**958**	**1,083**	**1,334**	**1,533**
% of NCR	18.4%	2.3%	4.1%	4.5%	4.9%	5.8%	6.4%
IV. Transactions in Non-Financial Assets	**1,937**	**835**	**856**	**878**	**916**	**1,003**	**1,115**
% of NCR	9.5%	4.3%	4.3%	4.2%	4.1%	4.4%	4.7%
VI. Net Lending / Borrowing (III-IV)	**1,804**	**(398)**	**(28)**	**80**	**167**	**331**	**418**
% of NCR	8.9%	-2.1%	-0.1%	0.4%	0.7%	1.4%	1.8%
V. Primary Balance (VI + Net Interest Payments)	**1,520**	**726**	**1,175**	**1,283**	**1,375**	**1,580**	**1,694**
% of NCR	7.5%	3.5%	5.3%	5.2%	5.1%	5.4%	5.4%
Memo Item:							
Net current revenue (NCR)	20,298	19,241	20,081	21,166	22,273	23,037	23,839

Figure 8: Net Consolidated Debt and Debt Service - Baseline Projections







Source: SEFAZ, WB Projections

Table 18. Rio Grande do Sul State Fiscal and Debt Baseline Projection Assumptions

Variables	**Assumptions 2012 ownwards**
Base year figures - 2010	
REVENUES	
Tax Revenues	
ICMS	Increase with IPCA inflation, state's GDP growth and a tax collection efficiency gain
IPVA	Increase with IPCA inflation and licensed vehicle growth.
Other Tax Revenues	Increase with IPCA inflation.
Social Contributions	Increase with IPCA inflation and personnel growth.
Current Transfers	
Federal Current Transfers	Increase with IPCA inflation and state's GDP growth
Convenios	Increase with IPCA inflation and state's GDP growth.
FUNDEB	Increase with IPCA inflation and state's GDP growth.
Private Transfers	Increase with IPCA inflation and state's GDP growth.
Capital Transfers	Increase with IPCA inflation
Other Current Revenue	
Interest Revenue	Increase with IPCA inflation
Non Financial Assets	Increase with IPCA inflation and state's GDP growth.
Miscellaneous	Increase with IPCA inflation and state's GDP growth.
Deductions to Revenue	Increase with IPCA inflation and state's GDP growth.
Net Current Revenue (NCR)	Current revenue minus deductions to revenue (line above).
Net Real Revenue (NRR)	Net current revenue multiplied by 0.7862 (the average ratio of NRR-to-NCR for 2004-10).
EXPENDITURE	
Current Expenditure	
Wages and Salaries	Increase with personnel growth and IPCA inflation.
Pensions	Increase with personnel growth and IPCA inflation.
Interest Payments	Calculated based on data from Debt Department of SEFAZ.
Goods and Services	Increase with state's GDP growth and IPCA inflation.
Precatorios	Actual values provided by SEFAZ.
Subnational Transfers	Increase with state's GDP growth and IPCA inflation.
Capital Expenditure	
Investment in Non-financial Assets	Calculated based on data from SEFAZ.
Other Investments	Increase with real state's GDP growth and IPCA inflation.
Amortization	Calculated based on data from Debt Department of SEFAZ.
IBRD Loan	Total US$480 million. S$120 million disbursed annually between 2012-2016.

Table 19. Macroeconomic Assumptions for Fiscal Sustainability Analysis

Year	Real GDP Growth		Growth Variable		IPCA Inflation		Exchange Rate		Personnel Growth	
	Baseline	Alternative (Lower)	Baseline	Alternative (Lower)	Baseline	Alternative (Higher)	Baseline	Alternative (Higher)	Baseline	Alternative (Higher)
2010	7.5%	7.5%	0.5%	0.0%	5.9%	5.9%	1.76	1.76	5.0%	6.0%
2011	2.7%	1.6%	0.9%	0.0%	6.5%	7.8%	1.68	1.66	5.0%	6.0%
2012	3.3%	2.2%	0.9%	0.0%	5.3%	6.6%	1.72	1.71	5.5%	6.5%
2013	4.2%	3.1%	0.9%	0.0%	5.5%	6.8%	1.73	1.72	6.5%	7.5%
2014	5.0%	3.9%	0.9%	0.0%	4.9%	6.2%	1.78	1.78	6.5%	7.5%
2015	4.2%	3.1%	0.9%	0.0%	4.7%	6.0%	1.83	1.84	3.0%	3.0%
2016	4.5%	3.4%	0.9%	0.0%	4.7%	6.0%	1.89	1.92	3.0%	3.0%

Source: EIU, BCB Focus, WB Staff Calculations

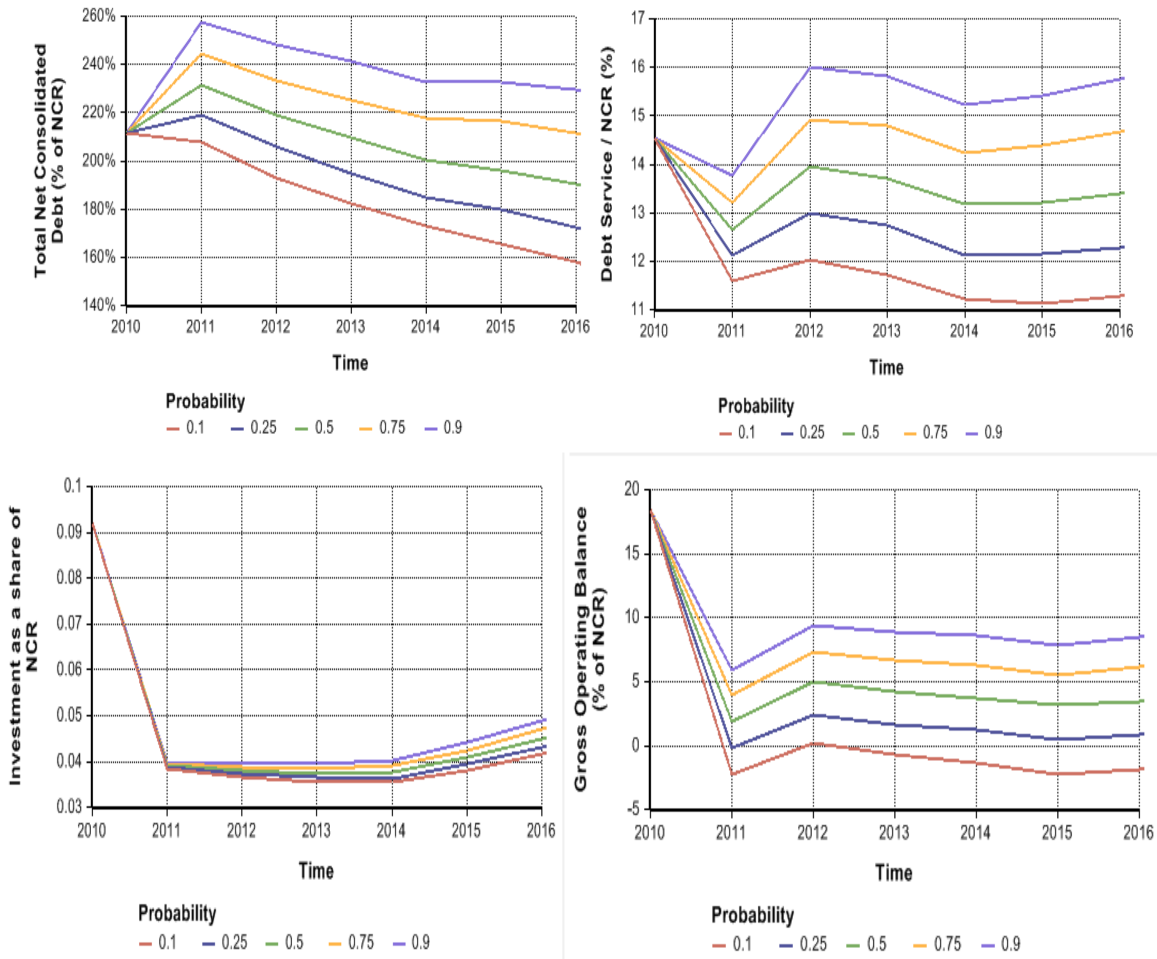
Risk Analysis

24. The risk analysis assesses the impact of uncertainty surrounding fundamental variables for RGS's fiscal outlook. Specifically, the analysis examines the impact of fluctuations in key macroeconomic variables (the exchange rate, IPCA and IGP inflation, real GDP growth, and personnel growth) on projected fiscal and debt aggregates. The objective of the analysis is to establish whether any given shock would have a negative impact on revenues or increase expenditures and compromise fiscal and debt sustainability. Alternative scenarios were modeled for each of the variables, the combined outcome of which produces the joint shock analyzed, painting a highly pessimistic view of the macroeconomic environment.

25. The macroeconomic assumptions underlying the alternative scenarios are found in Table 18 and are explained as follows. The baseline assumptions for the variables are based upon forecasts by the Central Bank of Brazil (BCB), the Economist Intelligence Unit (EIU) and the IMF World Economic Outlook (WEO). In particular, estimates for real GDP growth, the exchange rate and IPCA inflation were taken from the BCB Focus Report (as of March 16, 2012) for 2010-2013 and from the EIU for 2014-16 and were assumed to remain at their 2016 levels for 2017-20 (except for the exchange rate which is assumed to depreciate at 3.3 percent). The alternative scenario assumptions were the baseline level less (or plus) 0.5 times the variable's standard deviation over 2000-09 for the respective lower (or higher) scenarios for the GDP growth and inflation variables. The alternative exchange rate assumed an additional 30 percent depreciation rate each year. Estimates for personnel growth were provided by SEFAZ, and the alternative was taken to be 1 percent higher.

26. The projected fiscal and debt trajectories are deemed sustainable in the scenario of joint adverse macroeconomic shocks. While this pessimistic scenario causes a rise in both revenues and expenditures in nominal terms (due to the inflation component), in real terms both fall. Lower growth rates have large negative impacts on current revenues, which fall by more than current expenditures. The higher personnel growth rate is reflected in higher employee compensation expenses, and interest payments rise due to the deteriorating exchange rate. Nonetheless, despite these adverse effects, both the primary and overall balances remain positive throughout the period, and there is fiscal room for investment expansion. The ratio of debt to net current revenue falls to 156 percent of NCR by 2020, compared to 113 percent of NCR in the baseline.

Figure 10: Risk Analysis of the Impact of Macroeconomic Variable Fluctuations



Source: WB Staff Estimates

Impact of tax and federal grants reform on revenues

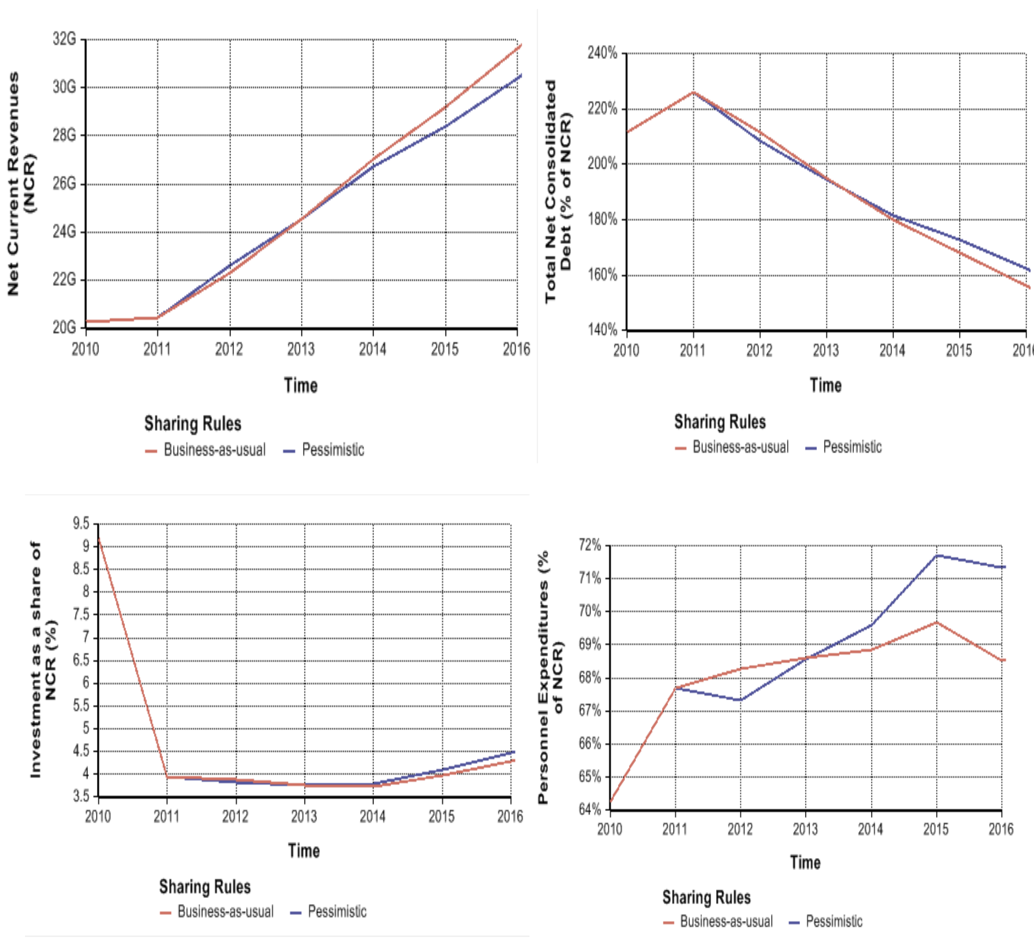
27. This analysis models the risks associated with changes to the allocation formula for FPE transfers, royalties, and tax reform on state revenues. ICMS revenue represented 50 percent of RGS's current revenue in 2010 but the tax reform under discussion in Congress has cast doubt on its future. Adoption of the destination principle for taxation of interstate trade— a key aspect of the discussions— would impose heavy losses on Rio Grande do Sul. As an important centre for industrial production in Brazil, the state would lose revenues through the taxation of consumption rather than production. Rio Grande do Sul's current revenues are also likely to be affected by proposed changes to the FPE sharing rule applied to determination of state specific transfers. In contrast, royalties reform, the most advanced of the reforms, is expected to result in a distribution design advantage over the current situation. Changes to the allocation formula of royalties, as presented in the bill of royalties[25] provide for an increasing distribution of royalties to all states, offsetting potential revenue losses from FPE and tax reform. In addition,

[25] A revision to the distribution criteria of royalties is well advanced, having passed the Senate in October 2011.

implementation of the changes will be gradual, minimizing the total net effects on revenue collection. It is worth noting that royalties revenues will be transferred a year before the compensating revenues creating a kink on revenues and investment in 2012.

28. Projected figures indicate sustainable fiscal and debt trajectories over 2010-20, assuming changes in the revenue sharing rules and tax reforms are implemented. Implementation of tax reforms has a significant impact on total tax revenues. In this pessimistic scenario, despite the reduced revenues, increases in current transfers (from royalties); compensate for the tax revenue losses, resulting in a modest reduction in current revenues (4 percent) over the projected period. As a result, fiscal space for investment remains positive. The trajectory for the ratio of net consolidated debt remains negatively sloped, falling to a median value of 116 percent by 2020. Figure 11 illustrates this combined effect of tax reform and a revenue sharing rule shocks on key fiscal and debt indicators under the case of baseline macroeconomic variables.

Figure 11: Risk Analysis of the impact of a change in revenue sharing rules and tax reform



Source: WB Staff Estimates