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The government maintained a large public sector primary surplus of around 4 ¼% of GDP during 2005-06 to ensure a decline in the net public debt to at most 50% of GDP by 2007. This underscores the country's vulnerability to shocks. This vulnerability is deepening as a result of competition with China. There are also warning signs that a prospective downturn, or recession, in the United States could reverberate throughout Latin American and the world.

Vulnerability is exacerbated by the macroeconomic policies promoted by the IMF and World Bank. The institutions rely on short-term deficit (surplus) targets as a measure of liquidity and gross debt. They pay relatively little attention to public assets and net worth. This approach leads to declines in public investment as well as a shift of investment to public-private partnerships (PPPs), where guarantees are off-budget. In their excellent paper, "Fiscal Space for Public Investment: Toward a Human Development Approach," UNDP authors posit that the institutions' fiscal policy framework is of limited relevance developmental (as opposed to the fiduciary) objectives.[4] The authors suggest that the IMF's and World Bank's fiduciary back calculations become less precise and predictable the more an investment serves the public good and provides a development payback.

Aspects of Infrastructure Policy in the World Bank Group's Country Assistance Strategy (CAS) For Brazil

The World Bank's lending program for Brazil totals $1.5 billion per year for five years or $7.5 billion. According to the World Bank's Country Assistance Strategy (CAS) for Brazil, the government has to implement "trigger" policies in order to qualify for this level of borrowing, including:

- Effective reforms for service provision: land, housing, urban services [for example, successful policies for urban land regularization and better designed, targeted housing programs; definition of regulatory framework for water and sanitation provision, and better designed and targeted water and sanitation programs]
- Improved regulatory framework in main infrastructure sectors [for example, strengthened regulatory framework effective in attracting private investments] The Bank's private sector affiliate – the International Finance Corporation (IFC) is in infrastructure.

At present, the Bank's private sector affiliate, the International Finance Corporation, is considering options with commercialized, fiscally independent infrastructure entities…an option that has worked poorly in Brazil to date. A third of the IFC's Brazil portfolio is devoted to infrastructure and logistics.

False Financing Promises of some PPPs. There is an enduring illusion that private investors in electricity and water supply will powerfully supplement public investment. Antonio Estache of the World Bank issued an evaluation of PPPs in Infrastructure from 1994-2004 is (reviewed in Attachment 6) and concluded that 1) poorly structured PPP projects have been pervasive over the past decade and have generated considerable fiscal risks and 2) countries risk giving priority to PPPs at the expense of improving public systems.

Indeed, he found that the public sector committed 70% of total financing for infrastructure PPPs. Percentages of total financing commitments by the private sector and by development aid represent 22% and 8%, respectively. Public outlays can balloon as they did in Eastern Europe when PPPs in electricity required government subsidies representing 6% to 7% of GDP. The IMF's concern with the off-budget liabilities of PPPs are described in its document "Public-Private Partnerships," 2005.

[4] Rathin Roy, Antoine Heity, Emmanuel Letouze, Paper prepared for the G24 Technical Meeting, Singapore, September 13-14, 2006.

Subnational governments and service delivery. In Brazil, about 90% of total federal spending is non-discretionary (including wages, transfers to regional governments, interest payments, pensions, and spending on other entitlement social programs). The World Bank pressures the federal government to reform pensions and cut spending in most of these categories. Indeed, cuts in transfers to regional governments are required in order for these governments to become financially self-sustaining and, hence, gain credit ratings that permit access to domestic and international credit markets.[6]

Credit markets require, among other things, a strict no-bail-out policy for state or local governments in trouble. In short, these markets require that the federal government:

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Attachments:
1. The Infrastructure Dimension of Brazil's Second Programmatic Loan for Sustainable and Equitable Economic Growth ($601.5 billion) from the World Bank

2.. The World Bank's Ratings for "Doing Business" in Brazil

3. The World Bank's Pilot Subnational Development (SND) Program

4. Brazil: Market Conditions for Subnational Development in Brazil

5. Criteria for Subnational Lending in Brazil

6. The Record of Public-Private Partnerships (PPP)

7. Implicit and Explicit Risk Allocation

Attachment 1

The Infrastructure Dimension of Brazil's Second Programmatic Loan for Sustainable and Equitable Economic Growth ($601.5 billion) from the World Bank

This loan, the second in a series of three, was approved in June 2006 and closes at the end of 2007. It supports an agenda that involves passing laws (or constitutional amendments), but also "a) defining approaches to public-private interactions, b) strengthening the institutional capacity of regulatory agencies to plan and regulate, and c) enforcing laws and regulations consistently and predictably." (p. 38)

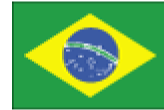
Infrastructure regulation is seen as not only essential to establishment of public-private partnerships (PPPs), but also to the appropriate enforcement of contracts. In the 1990s, 41% of concession contracts in Brazil were eventually renegotiated, compared to 28% in the Latin America/Caribbean region. Most of

Attachment 2

The World Bank's Ratings for "Doing Business" in Brazil

The rankings show how the Brazilian government's performance stands in relation to the performance of 174 other governments. This rating system has been strongly criticized by the United States Senate for, among other things, promoting violation of labor rights and standards.

Brazil



Population:186,404,913
GNI per capita (US$): 3,460.00

ke below. Each index assigns values
g igidity of Employ

Region

34.0

Details | Compare All Economies

Paying Taxes (2006)

The data below shows the tax that a medium-size company in must pay or withhold in a given year, as well as measures of the administrative burden in paying taxes. These measures include the number of payments an entrepreneur must make; the number of hours spent preparing, filing, and paying; and the percentage of their profits they must pay in taxes.

Indicator	Brazil	Region	OECD
Payments (number)	23	41.3	15.3
Time (hours)	2,600	430.5	202.9
Total tax rate (% profit)	71.7	49.1	47.8

Details | Compare All Economies

Trading Across Borders (2006)

The costs and procedures involved in importing and exporting a standardized shipment of goods in Brazil are detailed under this topic. Every official procedure involved is recorded - starting from the final contractual agreement between the two parties, and ending with the delivery of the goods.

Indicator	Brazil	Region	OECD
Documents for export (number)	7	7.3	4.8
Time for export (days)	18	22.2	10.5
Cost to export (US$ per container)	895	1,068	811
Documents for import (number)	6	9.5	5.9
Time for import (days)	24	27.9	12.2
Cost to import (US$ per container)	1,145	1,226	883

Details | Compare All Economies

Enforcing Contracts (2006)

The ease or difficulty of enforcing commercial contracts in is measured below. This is determined by following the evolution of a payment dispute and tracking the time, cost, and number of procedures involved from the moment a plaintiff files the lawsuit until actual payment.

Indicator	Brazil	Region	OECD
Procedures (number)	42	39.3	22.2
Time (days)	616	641.9	351.2
Cost (% of debt)	15.5	23.4	11.2

Details | Compare All Economies

Closing a Business (2006)

The time and cost required to resolve bankruptcies in is shown below. The data identifies weaknesses in existing bankruptcy law and the main procedural and administrative bottlenecks in the bankruptcy process. The recovery rate, expressed in terms of how many cents on the dollar claimants recover from the insolvent firm, is also shown.

Indicator	Brazil	Region	OECD
Time (years)	4.0	2.6	1.4
Cost (% of estate)	12.0	13.6	7.1
Recovery rate (cents on the dollar)	12.1	25.7	74.0

Attachment 3

BRAZIL: MARKET CONDITIONS FOR SUBNATIONAL DEVELOPMENT

(Source: World Bank, IFC, MIGA, "Subnational Development Program," January 4, 2006)

D. Investment Needs

- In 1999-2001, Brazil invested 2.1% of GDP in infrastructure
- The Government will invest $117 billion in infrastructure projects over 2004-07, representing annual investments of 4% of GDP.

B. Market Segmentation and Creditworthiness

1. Local Governments

- Brazil has 25 States, the Federal District (Brasilia) and over 5,500 municipalities ranging from small rural envlaves to Brazils mega-cities, Rio de Janeiro and Sao Paulo
- None of the subnational governments have domestic or foreign currency ratings

2. Public Utilities

- There are 267 public water, sanitation and sewerage companies; only Sabesp and Sanepar have local and foreign currency ratings; Sabesp has accessed the local and international capital markets
- Of the public sector electric utilities, Cemig, Cesp, and Copel have local currency ratings and have accessed the domestic capital market. Cemig and Copel have foreign currency ratings and have accessed the international capital market.
- 12 public utilities trade in the Brazilian Stock Exchange

3. Development Finance Institutions (DFIs)

- Caixa Economica Federal (CAIXA) and Banco Nacional de Desinvolvimento Economico e Social (BNDES) have local and foreign currency ratings
- In 2004, BNDES and CAIXA combined had an outstanding loan portfolio of approximately $30 billion, of which 31% was disbursed for infrastructure projects
- Banco da Amazonia S.A. and Banco do Nordeste do Brasil have local currency credit ratings
- Municipal deve lopment funds, such as Desenbahia, Banco de Desenvolvimento de Minas Gerais, Servicio Social Autonomo Parannacidade do not have local currency ratings

C. Commercial Bank Loans

- Local governments do not have access to medium or long-term financing from commercial banks
- Funding for infrastructure projects is provided mainly through redistribution of federal funds by BNDES, CAIXA, state banks and municipal development funds
- CAIXA is funding federal, state and local governments at rates between 8

Attachment 4

The World Bank's Pilot Subnational Development (SND) Program

The Bank loaned $2.8 billion to subnational infrastructure projects in fiscal year 2005, but the Bank's Articles of Agreement have prevented it from lending directly to subnational entities. The Articles stipulate that national governments must provide a sovereign guarantee or its equivalent for a subnational loan. Many national governments do not favor the provision of sovereign guarantees as desirable or feasible.

The Bank views the limitations in its subnational lending as a major obstacle to establishing public-private partnerships (PPPs), especially for infrastructure. It also prevents the Bank from deepening its work in decentralization, even though the Bank spent $5 billion to support decentralization reforms in FYs 2004-05.

2003 Pilot Program. In 2003, as an experiment in lending to subnationals without sovereign guarantees, the Bank Group established the IFC Municipal Fund offering $100 million in financial support to subnational entities, which catalyzed $570 million in investments.

2006 Pilot Program. On July 1, 2006, a larger, three-year (FY07-09), $800 million subnational development (SND) program was launched to scaled up this initiative and offer guarantees and loans (mostly in local currency) to focus on three types of entities, which to provide or finance services: local governments, public utilities and development finance institutions. The SND program may have a fund for technical assistance to which donors would be expected to contribute. Alternatively, the assistance may be administered through the Public-Private Infrastructure Advisory Facility (PPIAF), a multi-donor consortium housed at the World Bank.

The IFC will bear the entire risk for the SND program.

Governance. To administer the program, the World Bank and the IFC established a joint department. The head of the SND Unit reports to the Bank Vice President for Infrastructure and the IFC Vice President for Industries. Projects will be approved by the IFC's Board of Executive Directors. A future option involves the World Bank's establish a subnational development institution run by its own management and staff.

Ultimately, the Bank may create a new legal entity, such as IDA, devoted to subnational lending in order to skirt the legal problem posed by its Articles of Agreement. This option is viewed as more feasible than amending the Bank's Articles of Agreement.

The program follows the IFC procedure which entails seeking consent for subnational lending from the national government on a no-objection basis before the loan proposal goes to the Board of Executive Directors for approval.

SND Among donors and creditors. Each of the development banks has the capacity to lend to sub-sovereigns, including the African Development Bank, the EBRD, the European Investment Bank, the Asian Development Bank (as of August 2005) and the Inter-American Development Bank (as of March 2006). Many bilateral agencies also have this capacity, including USAID's Development Credit Authority, Germany's KfW, and Agence Francaise de Developpement (AFD).

SND services:
Technical Assistance:
- Capacity and policy development
- Upstream market development
- Project facilitation

Financial Support:
- Leverage local private financial markets
- Use of guarantees and derivatives*
- Loans (local currency)

Utility Eligibility. To qualify for financing from the SND program, public utilities would need to operate on commercial principles, independently of support from the national government.

Creditworthiness. The World Bank views its engagement with subnational entities as helping to enhance their credit ratings, so that they can borrow on domestic and foreign capital markets. In order to achieve this goal, subnational entities must become financially autonomous by raising sufficient taxes and fees (e.g., user fees for basic services) and diminishing reliance on central governments in order to cover their expenses. The Bank promotes Fiscal Responsibility Laws governing subnational debt that requires subnational entities to balance their budgets. In order to achieve balance, many subnational entities (as with central governments) have increasing levels of contingent (off-budget) liabilities.

Client Countries. The program is aimed at middle-income countries. Indeed, the World Bank has produced in-depth analysis of the potential for SND in Brazil, China, India, Mexico, Poland, Russia and South Africa. However, it will not exclude low-income countries. Technical assistance in qualifying for SND program financing would be provided in the form of grants. The program anticipates providing 40-50 grants per year during FY07-09 to help subnational entities improve fiscal performance and financial management.

India. India has a three tier government structure comprising the center, 28 states and about 2700 urban local bodies, of which only 50 are creditworthy enough to access domestic capital markets. Expenditures on core services account for 12% of subnational GDP, of which only 62% are covered by "own revenue" sources.

Brazil. Brazil has 25 states and over 5,500 municipalities. None of the subnational governments have domestic or foreign currency ratings. There are 267 public water, sanitation and sewerage companies, only 2 (Sabesp and Sanepar) have local and foreign currency ratings. Of the public sector electric utilities, three (Cemig, Cesp, and Copel) have local currency ratings and have accessed the domestic capital
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Brazil.

Attachment 5

BRAZIL: CRITERIA FOR SUBNATIONAL LENDING

(Source: World Bank, Country Assistance Strategy (CAS) Progress Report for fiscal years 2004-07, May 8, 2006, p. 11)

Some criteria for lending to **states**:

- Fiscal health. Strong fiscal and financial performance, as evidenced by compliance with the Fiscal Responsibility Law and debt rescheduling agreements with the federal government. Relevant projects must be included in the state's PPA ("Brazil for All" – the national development strategy) and budgeted.
- Commitment to reform. "States must have demonstrated a commitment to a clear, unambiguous and unchanging reform agenda, elaborated clearly in the PPA, and the proposed project must play a clear and unambiguous role in achieving the core development objectives of the state."
- Public sector management impact. The state must have demonstrated commitment to building public sector institutional capacity and public sector expenditure efficiency and transparency and the proposed project should help address those objectives.
- Sustainable growth impact. Priority would be given to those projects which have a direct impact on sustainable growth, preferably in the context of regional development.
- Poverty levels and the impact of the proposed interventions.

Additional criteria for lending to **municipalities**:

- Clustering. In response to government request and to ensure economies of scope in preparation and supervision, all municipal projects would be clustered in a consortia or regional package. The legal (and financial, if relevant) structure for the clustering arrangement should be clear.
- Strategic intervention. Bank engagement must focus on competitiveness and growth of the municipality, and on improving fiscal performance, municipal management and economically-critical issues, such as land management. Specific investments must be embedded in, and supportive of, these higher-level objectives.
- Lending in local currency is to be done whenever appropriate and whenever agreed upon by the municipality and federal government.

Subnational lending in well-governed states, such as Ceara and Bahia. SNGs need to comply with the requirements of Brazil's Law on Social Responsibility. The richer states of the South and Southeast are most severely indebted, whereas the poorer states of the North and Northeast have greater capacity to borrow. Bank just approved a subnational loan to the state of Minas Gerais that had not met two of the five rules within the FRL.

Attachment 6

Public-Private Partnerships: The Record

In identifying the risks involved in PPPs, the IMF reached a conclusion that: *"First and foremost, the decision whether to undertake a project, and the choice between traditional public investment and a PPP to implement it, should be based on technically sound value-for-money comparisons. It is particularly important to avoid a possible bias in favor of PPPs simply because they involve private finance, and in some cases generate a revenue stream for the government."*[7]

World Bank infrastructure specialist Antonio Estache evaluated infrastructure PPPs during 1994 to 2004 and concluded that 1) poorly structured PPP projects have been pervasive over the past decade and have generated considerable fiscal risks and 2) countries risk giving priority to PPPs at the expense of improving systems for public investment.[8] Findings of this study follow:

Volume of Investment. Between 1984 and 2002, the level of investment in PPPs in key sectors is as follow: energy ($242 billion), telecom ($332 billion), transport ($129 billion) and water/sewerage ($39 billion).[9]

Who Invests? Governments are primarily financing the shift of their own power to the private sector since they provided 70% of total financing for infrastructure PPPs. Percentages of total financing commitments (not contributions) by the private sector and by development aid represent 22% and 8%, respectively.

Fiscal Jeopardy. Despite the fact that increased revenue is touted as one of its main justifications for PPPs, there is actually a risk of fiscal deterioration. This is the case since private firms have become more risk averse, especially in Africa and, as a result, they have increasingly insisted on guarantees and financial supports that ensure profitability, minimize capital outlays, and greatly increase the fiscal exposure of government.

In Eastern Europe, more costs than benefits accrued to taxpayers and consumers. Although there was an average increase in electricity prices of 16% between 2000 and 2002, "…the combination of high losses, non-payment of bills, and below-cost recovery tariffs added up to a fiscal cost of, on average, 7.5% of GDP at the end of the 1990s." Through additional cost recovery, costs dropped to 5.9% of GDP by the end of 2002.

Finally, it found:
**Impact on the poor.* "…efficiency gains were achieved at the cost of an increase in the burden imposed on the lowest income groups connected."
*"*Cream-skimming* in the design of reforms has often left rural and suburban areas out of the service obligations." When the private sector engages in "cream-skimming," it serves the paying customers and leaves the rest. He predicts, "Cream-skimming is likely to be much more common from now on."
**Corruption.* Low middle and low-income countries have seen corruption increase.
**Reporting.* For now, there are no internationally agreed fiscal accounting and reporting standards for PPPs, which exacerbates risks.

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[7] http://www.servicesforall.org/html/Privatization/Summary_public_private.html

[8] A. Estache, "PPI partnerships vs PPI divorces in LDCs, World Bank and ECARES (Universite Libre de Bruxelles," October 2004.

[9] NEPAD's "Short-Term Infrastructure Plan" compares the volume of infrastructure investments in African PPPs ($14 billion) with the volume in Latin American PPPs ($237 billion) during the period 1990-1998.

**Collusion.* In another study by Benitez and Estache, "How Concentrated are Global Infrastructure Markets?" the authors found that infrastructure projects were highly political, in part, due to the degree of concentration of corporate investors, which can pose the risk of collusion. [10] They found that concentration was present in 20% of their sample, while presumed concentration was found in an additional 30% of the sample. The authors explore the need for a supranational competition or regulatory agency.

Since the water sector and parts of the electricity sector are "natural monopolies," strong regulation is needed to protect and benefit consumers. However, transnational corporations often capture regulators, especially in low-income countries. In the water sector, key companies are French: Suez (Ondeo), Veolia Environment (formerly Vivendi), and SAUR and German: RwE (which owns Thames Water and American Water Works).

Efficiency.* In Estache et al., the authors conclude that "Infrastructure performance and reform in developing and transition economies: evidence from a survey of productivity measures," the authors find that, for utilities, ownership often does not matter as much as sometimes argued. ***Most cross-country studies find no statistically significant difference in efficiency scores between public and private providers.*

[10] D. Benitez and A. Estache, "How Concentrated are Global Infrastructure Markets?," World Bank, February 2005.

Implicit and Explicit Risk Allocation

In a World Bank Institute book, "Granting and Renegotiating Infrastructure Concessions: Doing it Right," J. Luis Gausch states that in Latin America, 41% electricity, transportation, and water and sanitation contracts are renegotiated. In the water and sanitation area, 74% of contracts are renegotiated within 1.6 years. He contends that the renegotiations adversely affected users and contribute to the negative perception of PPPs. That is, the interests of consumers are compromised when renegotiations change factors such as tariffs, investment plans and levels, exclusivity rights, guarantees, lump-sum payments or annual fees, coverage targets, service standards, and concession periods. (Standard scheduled tariff adjustments and periodic tariff reviews do not count as renegotiation.)

The incidence of renegotiation is much higher when the regulatory framework is imbedded in a decree or in a contract rather than imbedded in law. The World Bank required decrees and regularly imbeds regulation in contracts. The risks involved in PPPs or concession contracts include the following:

1. Design or development risk
2.