

International Workshop on Reform of Forest Fiscal Systems

October 19-21, 2003

World Bank, Washington DC

Aide Mémoire

The International Workshop on Reform of Forest Fiscal Systems took place October 19-21 at the World Bank in Washington DC. The Workshop brought together a total of 21 participants from seven countries (Brazil, Cambodia, Cameroon, Ghana, Honduras, Indonesia, and Nicaragua), representing finance ministries, forest departments, academia, and the private sector. A number of bilateral donor and international development agency observers also attended the meeting. The objectives of the workshop were to promote South-South learning, and frank discussion on the political economy of forest fiscal reforms.

The importance of mobilising forest revenues and maximising their contribution to broader policy objectives is increasingly recognised and the importance of well-designed and effectively implemented forest fiscal systems – specifically concession and revenue systems - has been long appreciated. Issues of resource tenure and security, royalties (in terms of their value and method of collection) and benefit distribution, set the fundamental parameters of the private sector's utilisation of an often publicly owned asset. Experience has shown that a well designed and effectively implemented concession and revenue system – particularly one emphasising incentives to sustainable forest management and investment in value added processing industries - can be a far more effective instrument in maximising the forest sector's contribution to growth and development than a narrow regulatory based approach.

An active debate on concession policies and forest fiscal systems has taken place for a number of years. Several countries, encompassing a diverse range of forest types and associated industries, are implementing or considering new approaches to allocating rights to utilise forests. While their situations are different, in all cases the objective is to identify the practical ways to ensure that forests can be utilised sustainably and make a more positive contribution to national poverty reduction objectives (as defined in PRSPs or similar statement of policy) through stimulating growth and providing regular and enhanced revenue flows to governments. The Workshop provided a valuable forum to facilitate these discussions.

The Workshop was organized and funded by German Technical Cooperation (GTZ), the Program on Forests (PROFOR), UK Department for International Development (DFID), and the World Bank Institute (WBI). Finally, by highlighting the key issues and challenges in implementing fiscal reforms in the forest sector through country case studies, the Workshop has provided an important input to the OECD-DAC work program on Environmental Fiscal Reform (EFR).

OPENING REMARKS

Jim Douglas, Forests Team Manager, World Bank, welcomed participants to the Workshop and chaired the opening remarks. Kevin Cleaver, Director Agriculture and Rural Development Department, World Bank, said the Workshop would provide an opportunity for technical discussions, possibly foster a learning network on forest fiscal systems, and lead to better collaboration with development agencies. Dan Biller, Environmentally and Socially Sustainable Development Program Leader, World Bank Institute (WBI), stressed capacity building for policy formulation and highlighted the WBI's work on markets for biodiversity, natural resource management conflict resolution, and compliance and enforcement in natural resource management.

Objective and Focus

Tapani Oksanen, Workshop Facilitator, reviewed the main objectives of the workshop:

- Engage key policy makers to review experience with forest fiscal reforms

- Share lessons learned on emerging best practices and define strategies to move from current policies to best practices
- Define concrete steps to move the forest fiscal reform process forward in participating countries
- Disseminate this experience to other countries and stakeholders

The scope of discussion encompassed components of a forest fiscal system - timber royalties, concession fees (both industrial and community), forest-related taxes and fees, export duties and fees, exemptions, and other incentives such as grants or preferential interest rates. Beyond considering forest fiscal systems for revenue maximization and efficient revenue collection, the Workshop set out to look at forest fiscal instruments as tools to promote sustainable forest management (SFM), other forest policy objectives and broader societal goals including poverty reduction, gender equality, and good governance.

The Workshop focused on three key themes:

- How to define the mix of fiscal instruments and set the right levels?
- How to use revenues collected?
- How to manage the politics of forest fiscal reform processes?

COUNTRY CASE STUDY PRESENTATION HIGHLIGHTS

Countries presented case studies on the status of their forest fiscal reform processes that were prepared in advance of the Workshop.

Ghana

In Ghana, the forest sector provides 6% of GDP, 11% of export earnings, 100,000 jobs and 75% of energy consumed. Trade liberalization and deregulation of the forest sector as part of structural adjustments in the 1980s created a too rapid and unsustainable growth in the forest sector. Ghana's forest policy reform process began in 1995 with a log export ban. Reforms since then include a competitive bidding procedure for resource allocation, revision of stumpage rates to reflect international market prices, an export levy on lumber according to species, a value added tax for domestic sales, removal of import duties on logs, and a levy on veneer and lumber exports.

Constraints to implementing forest fiscal reform in Ghana have included: the strong influence of the industry lobby; skewed distribution of forest revenue to industry, leaving little incentive for landowners (both government and communities) to manage forests; a weak regulatory/institutional framework characterized by too many fees (approximately 30) inefficiently collected; and an inefficient processing sector.

Remaining challenges in Ghana include how to increase financial flows to communities, improve monitoring and information systems, and enforce laws. Recommendations for successful fiscal reform were for: regular adjustment of taxes; institutional reform to enhance interagency coordination; long-term fiscal/taxation systems to allow for long-term planning for the private sector; improved monitoring effectiveness; increased transparency and stakeholder consultations. Legislating forest fiscal policy is important to ensure policy consistency when Ministers change.

Cameroon

Timber is Cameroon's second largest export after oil, and may soon surpass oil. The forest sector is comprised of a few large operators and many small scale and informal operators. Forest sector reforms in Cameroon have focused on broadening the tax base and improving enforcement through decentralization. In 1999 a Forestry Revenue Enhancement Program was established, constituting a collaborative framework between the Ministries of Finance and Environment and Forestry. This new partnership along with the reforms have resulted in significant increases in forest revenues. A bidding system was established, area taxes were increased, forest concession management plans were made mandatory, and a system of bank guarantees to cover fiscal and

environmental obligations was initiated. This reform has contributed to overall economic growth and possibly to poverty alleviation. 10% of area taxes collected are transferred to local communities, contributing to poverty alleviation efforts. However, how effectively this money is being invested in rural area services is not yet clear. Additionally, a special forest development fund has been established.

Private forest industry in Cameroon views the reforms as having reduced the profitability of many enterprises and suggests that some of the fees could be fine tuned. For example, the area tax penalizes larger concessions, and should be adjusted to exclude areas of the concession not logged. Similarly, the usage tax should be based on the value of the species and quantity logged, and a log tax levied on mills is a disincentive to processing. Additionally, the bidding process is viewed as insufficiently informed in terms of the quality of forest concessions, resulting in imbalances in domestic supply of round timber. Moreover, industry feels that fiscal policy must fight tax evasion across the board and provide incentives for legal operations and good governance.

Indonesia

In 1985, a log export ban was put in place to stimulate domestic industry. In the 1990s high export taxes were levied on sawn timber to further encourage processing. Taxes and levies in Indonesia now include a one time area-based utilization fee, a reforestation fund fee based on cubic meters harvested, a forest resource tax of 10% of log check price. Since 2001, forest management has been decentralized and regions now impose taxes – such as corporate taxes, timber export taxes, and processed timber export taxes - without informing the central government. Starting in 2004 fees will be paid before trees are felled, in accordance with a “cruising report,” based on expected harvest.

In Indonesia illegal logging poses many problems in terms of lost revenues and skewed timber markets and incentives. This also results in an inability to calculate the real cost of timber extraction. Better monitoring and data and information is needed to inform fiscal policy, optimize fees and address illegal activities.

Cambodia

In Cambodia, forests contribute around 5% to GDP and provide 90% of rural energy. In 1992, a concession-based forest management system was introduced, and resulted in problems that led to the suspension of logging activities in 1994. Subsequently, concession agreements were renegotiated and an inter-ministerial technical working group was established. A long-term management plan is required for each concession, along with an approved annual harvesting volume and a block management plan for harvesting.

The Ministry of Economy and Finance and the Ministry of Agriculture, Fisheries and Forests (MAFF) hold annual forest revenue planning meetings. MAFF sets quotas for forest product export, and a round timber export ban encourages local processing. An export tax is paid to the government budget and a payment of 1% FOB value goes to a fund for tree planting. With regard to illegal logging, efforts are being made to illuminate such activity, including a bar code system for tracking logs and independent forest monitoring.

Honduras

Forests cover 53.2% of Honduras' surface area and the forest industry is the fourth most competitive industry in Honduras. Honduras' forest fiscal system has developed through stages. During the period 1974-1991 – the Forest Development Corporation (COHDEFOR) was authorized to oversee fee collection, state investments, forest management, purchase and sale contracts, domestic forest product marketing and exports. From 1992-2002 –productive and commercial activities were separated, with COHDEFOR the owner of national forests and timber sold through public auction administered by COHDEFOR. Honduras is now in the process of simplifying its forest legislation and reforming the forest fiscal system to promote protection of environmental services, incentives for reforestation, increased value added, NTFP promotion, and use of smaller wood diameters.

Nicaragua

Nicaragua's forest area covers 43%, or 5.7 million hectares, of its territory, and approximately 3.8 million hectares of that area could be used for commercial forest production. In Nicaragua, the forest sector has been challenged by policy with contradictory goals for conservation and industry, resulting in illegal activity constituting up to 70% of all logging. In June 2003, new legislation was passed, establishing a system for preservation and sustainable development that will help address the current chaotic situation in the sector. Now there is only one law for forests, the forest resources have been returned to land owners, and the forest administration is being decentralized.

The new law encourages export through fiscal incentives and establishes a national fund that will provide fiscal incentives to help develop legal operations. For example, incentives include as municipal and sales taxes exemptions for plantations, and up to 100% tax deductions for reforestation costs. However, the forest fiscal policy incentives and objectives have created controversy in the context of the national fiscal simplification process underway.

Remaining challenges are to improve registration and control system to help combat illegal logging. The private sector is pleased by the new law, but concerned about problems with internal debt and with the long-term stability of the forest fiscal rules.

Brazil

In Brazil, the forest sector accounts for 7.1% of exports, 2 million jobs, and 4% of the GDP. Although 70% of the Amazon is publicly owned, Brazil does not have a concession system. Brazil is assessing its forest fiscal policy within the context of its national forest program (NFP). Plantations comprise less than 1% of Brazil's forest area, but produce 60% of industrial roundwood. Integrated businesses like pulp and paper and steel industries have fewer taxes placed on them and do not pay forest resource use. In Brazil, paying for forest resource use is a new concept, and earlier efforts to improve sustainability in the forest sector through regulations and monitoring and assessment have resulted in land conversion for agricultural use to avoid regulations.

Now policy is focused on motivating forest producers toward sustainable practices and markets through technical assistance, information and technology, subsidies and innovations such as the clean development mechanism. Next steps to promote this approach include allocation of public lands to protection and production, national forest information systems, and the development of a third party logging control system. Regarding illegal logging in Brazil, up to 50% may be illegal. However, an environmental crimes law in Brazil has had deterrent impacts as the illegal operators are fearful of going to prison.

Case Study Discussion

In discussion following the case studies, auction systems were a topic of interest. Indonesia considered following Malaysia's system of setting and auctioning an annual area to be harvested. However, implementing this system would require detailed information on the forests and how many trees could be extracted from each hectare. Indonesia is considering auctioning concessions that are revoked as a result of poor performance. Ghana is adopting a competitive bidding system.

Regarding how to monitor and regulate illegal activity, Indonesia noted that this is an international problem because of involvement of other companies and illegal trading and markets that consume the illegally harvested timber trade. Cameroon suggested steps to work on illegal logging: ensure documents relating to logging are all coherent; personalize documents to companies; and establish a log tracking system (a bar code system is being implemented in Cameroon).

In discussion regarding the use of domestic prices versus international prices in setting royalties and other payments, it was suggested that international prices are more reflective of the real value of wood. An approach to calculate the price based on a “basket” of local, regional and international prices was also suggested.

Facilitator observations from case studies and discussion

Based on the country case study presentations, the following key points and issues were identified:

- Countries are at different stages in their reform processes as well as in the analysis underlying such reforms;
- The mix of fiscal instruments considered varies from a narrow focus on timber concessions to a broader focus on a wide range of forest tenure arrangements and products;
- forest fiscal systems have contributed to raising funds, the next step is how to use fiscal systems to attain policy goals;
- improved transparency and accountability in the use of forest revenues for social and community development is needed;
- royalties and payments are increasingly determined on the basis of market values;
- the mix of fiscal instruments and system for setting levels is complex and difficult to administer in a transparent manner;
- Incentives for SFM are emphasized by some countries, but are sometimes in conflict with overall government fiscal policies;
- Only in a few countries are forest fiscal reforms linked with broader sectoral processes such as NFPs;
- Ensuring compliance and eliminating illegal competition are seen as key to successful reform;
- Increasing revenue collection from formal operators combined with failure to control illegal or informal operators creates imbalances;
- Private sector expectations for fiscal reform differ from those of government, and the creation of a stable and competitive environment for investments is emphasized;
- Reform should be backed by an act of parliament to ensure long-term stability; and
- There are a few promising examples of partnerships between ministries responsible for the forest sector and finance/economy.

DISCUSSION ON KEY THEMES

Following the case study presentations, workshop participants met groups to discuss the three key themes of the workshop. The outcomes of the discussions were reported to Plenary the subsequent (on October 21st) morning.

I. Mix of Fiscal Instruments

The group discussion centered on the following questions:

- *What is the right mix of instruments that meets the basic criteria of economic efficiency, is administratively feasible and supports broader social and environmental objectives?*
- *What is the most appropriate basis and mechanism for determining forest-related fees and other fiscal instruments and their right levels?*
- *What provisions can/should be made to introduce specific incentives into the forest fiscal system for sustainable forest management and other identified policy objectives*
- *How can we minimise inconsistencies between the different instruments and mechanisms?*

In general, participants noted that an effective mix of instruments depends on the country context as what is effective in one country is often very different from what works in the next.

Regarding various instruments, an area tax was viewed as appropriate due to the high recovery rate and low administration cost for implementation. A stumpage tax indicates extractive activity, but how to set the price remains a question and differentiating the tax by species was stressed. Export taxes applied to unprocessed timber were viewed as a useful incentive to encourage value added products domestically.

Regarding the basis and mechanisms for determining forest-related fees, market-based approaches were preferred, and clear administrative procedures and third party involvement were viewed as helping to ensure a transparent process. To minimize inconsistencies between instruments, clear policy objectives, clear roles and stakeholder dialogue were emphasized. In discussion on implementing an area tax, clear, verifiable procedures for concession management and auctions were stressed as essential to assure “clean” results and avoid corruption.

In Nicaragua property ownership issues pose potential complications because forests are not nationalized and land ownership can be claimed after living on an area of land for more than ten years, a situation with the potential to result in conflicting ownership claims. Conversely, in Cameroon the government owns all land and can thus allocate all land for conservation or intensive use.

In discussion on why high taxes on log exports may be preferred to an export ban, it was noted that although one point of a ban is to encourage value added through processing, that if domestic processing capacity is poor such a policy can be detrimental.

II. How to Allocate Revenues

This group discussed how revenues collected should be used to support objectives identified, and the pros and cons of different arrangements such as:

- *Allocating resources through the central government budget vs. more decentralised structures*
- *Sharing revenue between communities, local government and central government*
- *Earmarking revenue for specific uses such as monitoring and law enforcement*

The group identified as allocation objectives the promotion of SFM, good governance, poverty reduction, and environmental objectives, and clarified stakeholders in allocation to be the government (federal, state/province, and local), landowners, and communities.

The need for improved transparency and accountability was emphasized, and guidelines for revenue use at the local level and incentives for local officers to motivate enforcement and combat corruption were suggested.

Countries shared their general structure for resource allocation:

Cameroon: 50% to federal government, 40% to local councils, and 10% to villages where exploitation occurs

Cambodia: 20% revenue goes to the Forest Department;

Indonesia: tax and non-tax revenues are differentiated with non-tax revenues used for reforestation;

Honduras: revenue from timber sales go directly to COHDEFOR

Brazil: except for the Forest Recovery Fee, all revenues are allocated to the federal budget

Nicaragua: resource allocation is decentralized to strengthen local communities; In the Atlantic region: 25% to local communities; 25% to regional government; 25% to municipality of indigenous peoples; and 25% to federal level. The allocation is different for other parts of the country.

Regarding decentralization, it was noted that delegation of roles without clear rules can undermine effectiveness or resource use.

Recommendations from the discussion included that allocations should be based on clear criteria and take into account projects and programs required to achieve objectives at national, regional, local and community levels. If funds are earmarked, this should be for a specific, targeted use and only for a certain period of time.

In discussion, it was emphasized that revenue distribution should not be legislated because circumstances can change, and suggested that resources for municipalities should be determined at the regional level and only used for investment in forests.

III. Managing the Politics of a Forest Fiscal Reform Process

The group discussion on the politics of forest fiscal reform framed its discussion with the following questions:

- What processes are used to define and implement appropriate forest fiscal systems, and how do we identify who should participate?
- How do we identify “champions”, build coalitions, and sequence reforms to overcome private sector and political vested interests?

The group noted that internal and external drivers that influence fiscal reform:

- Internal – NFPs, national budget and fiscal requirements, enhancement of instruments and legislation
- External – conditionality from donor agencies, global influence on trade and the competitive environment

A reform process is generally initiated by a ministry, subsequently cleared with other ministries/institutions, then opened for broader consultation, taken to the council of ministers or cabinet and parliament, and then implemented. Identification of stakeholders to participate in the reform process should be guided by analysis of issues, identification of beneficiaries and losers, identification of interest groups, and analysis of development partners.

To build coalitions to support reform, it was suggested that effective “lobbying” mechanisms should be established, that trade-offs should be balanced in a mutually beneficial way, and that decision making should be made transparent. Strategies to overcome vested interests in public and private sectors include: timing the reform to avoid elections; keeping the public well-informed; encouraging competitive/transparent rather than administrative/discretionary pricing of resources; and balancing interests of different groups (i.e. national vs. subnational groups). In conclusion, a level playing field should be established for all stakeholders.

Regarding the issue that measures for automatic review of fiscal reforms without referral to parliament would reduce the influence of various lobbies, it was suggested that the lobbies are in fact stronger at the administrative and ministerial level than in parliament. Additionally, it was noted that: forest fiscal reform must take into account other national reform processes, increased access to information might increase the ability of stakeholders to sit together, and improved dialogue between forest experts and politicians may facilitate reform.

NEXT STEPS – COUNTRY AND DEVELOPMENT AGENCY PERSPECTIVES

Country Perspectives

Brazil plans to develop a system for forest concessions in the Brazilian Amazon. The system will include two types of concessions: 100 million hectares under a system of forest conservation unit concessions; and 150 million hectares under public land concessions. A law regarding the forest conservation unit system will be submitted to congress by the end of 2003 for debate and

approval. A workshop with broad stakeholder participation to develop a draft concession model and define an appropriate legal framework will be held by the end of November 2003. A key stakeholder at the workshop will be the general attorney who will act as mediator and provide guidance on legal solutions. The public land concession system is expected to be tested and implemented in 2004.

Honduras noted a number of lessons learned, including that: forests contribution to GDP must be well articulated to strengthening the argument for allocating more funds to forest management and protection; environmental service such as climate regulation and ecosystem services should be valued in economic terms and compensated for; and revenues captured should be distributed in a more equitable manner.

The forest sector needs to be included in broader national fiscal policy reform negotiations. There should be broad stakeholder participation in forest fiscal policy reform, and forest fiscal policy should be harmonized with the laws of other sectors. Additionally, politicians need to be educated about the forest sector and its role in development and poverty reduction.

As actions to be taken, Honduras identified: approval of the new forest bill; development of the national dialogue; improvement of information and awareness on forests' contribution to the national economy, quality of life and poverty alleviation; and linking forest fiscal reforms to the national poverty reduction strategy. Additional measures include conducting social audits to inform reform, and reviewing and updating fiscal regulations on an ongoing basis to ensure they reflect changing situations.

Fiscal reforms in **Nicaragua's** forest sector are part of a larger societal public policy reform process that has been ongoing for the last decade. Under the new forest law, specific regulations are being developed under the general regulations, and must be standardized within the national development plan. Steps to do this will be taken once Nicaragua has completed the heavily indebted poor country (HIPC) process for debt relief.

Nicaragua's next steps include establishing mechanisms for monitoring and follow up resulting from fiscal reform, finalizing agreements with municipalities to guarantee fiscal reform success and improve governance, continuing an open dialogue with civil society and the private sector, and developing a communications strategy to inform civil society and media on reforms. Additionally, agriculture and forest sector policies must be harmonized.

Cambodia outlined issues it faces, including forest concessionaires opposition to reform, limited human capacity and lack of good equipment, and a lack of trust among stakeholders (from government, donor, NGO, and the public and private sectors). One of Cambodia's planned next steps is to work with the public to define a procedure to formulate forest, budget and taxation laws and to define what stakeholders will be involved and at what level. At the technical level, the SFM plan, forest revenue management system, and agreement on land concessions need to be implemented, monitored and audited to improve transparency and good governance. Cambodia would like to improve human capacity, increase research, and strengthen communication among stakeholders to improve cooperation and identify win-win policies.

Indonesia identified the need for an inventory of the forest sector operations, detailing producers, scale of production, production type, type of permits issued (central or district) and type of fees as an important next step to better inform sector policy. Reviewing revenue collection mechanisms and the optimality of the fiscal systems, collecting better information on the cost of production and on setting an acceptable profit level for the private sector, is also an important task.

Cameroon identified short-term, mid-term and long-term actions. In the short-term, a national workshop will be held on the results of this workshop, a review of the results from fiscal reforms during the period 1999-2003 will be carried, and the log tracking system will be implemented. In

the midterm, developing tax targeted at NTFP and informal sector and raising revenues for the national fund for environmental activities were set as priorities. A task for the long-term is to work with sub-regional partners to ensure coherence of forest policies in the central Africa region with a view to harmonizing fiscal policies. Such harmonization would help to regulate trans-boundary timber movements, a priority for the private sector in Cameroon.

Ghana identified issues to be addressed and areas for improvement, such as: illegal logging and related market price distortions for forest products and services; the large number of agencies involved in the collection of forest fees; capacity building for accurate media coverage of forest sector issues; effectively balancing national revenue objectives and forest sector objectives; and improved information dissemination to facilitate the reform process. Ghana's next steps will be to broaden the decision making process and dialogue with stakeholder, develop mechanisms for inter-ministerial collaboration, study cost structures to set appropriate taxes for industry, and institute a log and product tracking system to improve revenue collection.

Donor and Development Agency Perspectives

The **International Monetary Fund (IMF)** noted an emphasis in the discussions on taxes over other revenue instruments, and commented on the importance of property ownership, land tenure policy and associated rights and responsibilities in meeting the two objectives of capturing forest revenues and promoting sustainable forest management. The IMF recommended sharing success stories and good practices in gaining fiscal dividends and raising awareness of large costs to society from poor fiscal policy management.

The **United Kingdom's Department for International Development (DFID)** emphasized developing the relationship between finance ministries and forest agencies. Regarding support for log tracking systems, DFID said assistance and capacity building to initiate such a system would be appropriate, but cautioned that the costs of maintaining such a tracking system ultimately should be absorbed into the market. DFID encouraged the development of a learning group on forest fiscal systems and suggested that participants could share their experience at the upcoming session of the United Nations Forum on Forests in 2004.

German Technical Cooperation (GTZ) emphasized the need for forest fiscal reform to be considered within broader development frameworks and for improved dialogue and political bargaining among forest sector stakeholders. As part of an OECD program on environmental fiscal reform, a meeting will take place in Berlin in November 2003 and forest is one of the pilot sectors in the program. GTZ may be able to provide assistance to fiscal reform processes through ongoing support to NFPs. Additionally, a new GTZ program to support COMIFAC could support a process for regional fiscal policy harmonization in central Africa.

In closing the workshop, Jim Douglas, World Bank, commended participants for discussing not just how to collect revenue, but how much revenue to collect and how it should be allocated among various uses. Noting that concession management systems' have typically focused on input-based regulation resulting in inefficient management, he suggested a closer examination of outcome-based regulatory systems as a topic for future discussions. He supported a learning group and suggested that PROFOR could provide a platform for such information sharing. Additionally, he expressed the Bank's willingness to support activities such as a side-event on the reform of forest fiscal systems at the next session of UNFF in 2004.