# Forest taxation in 'Fragile States'

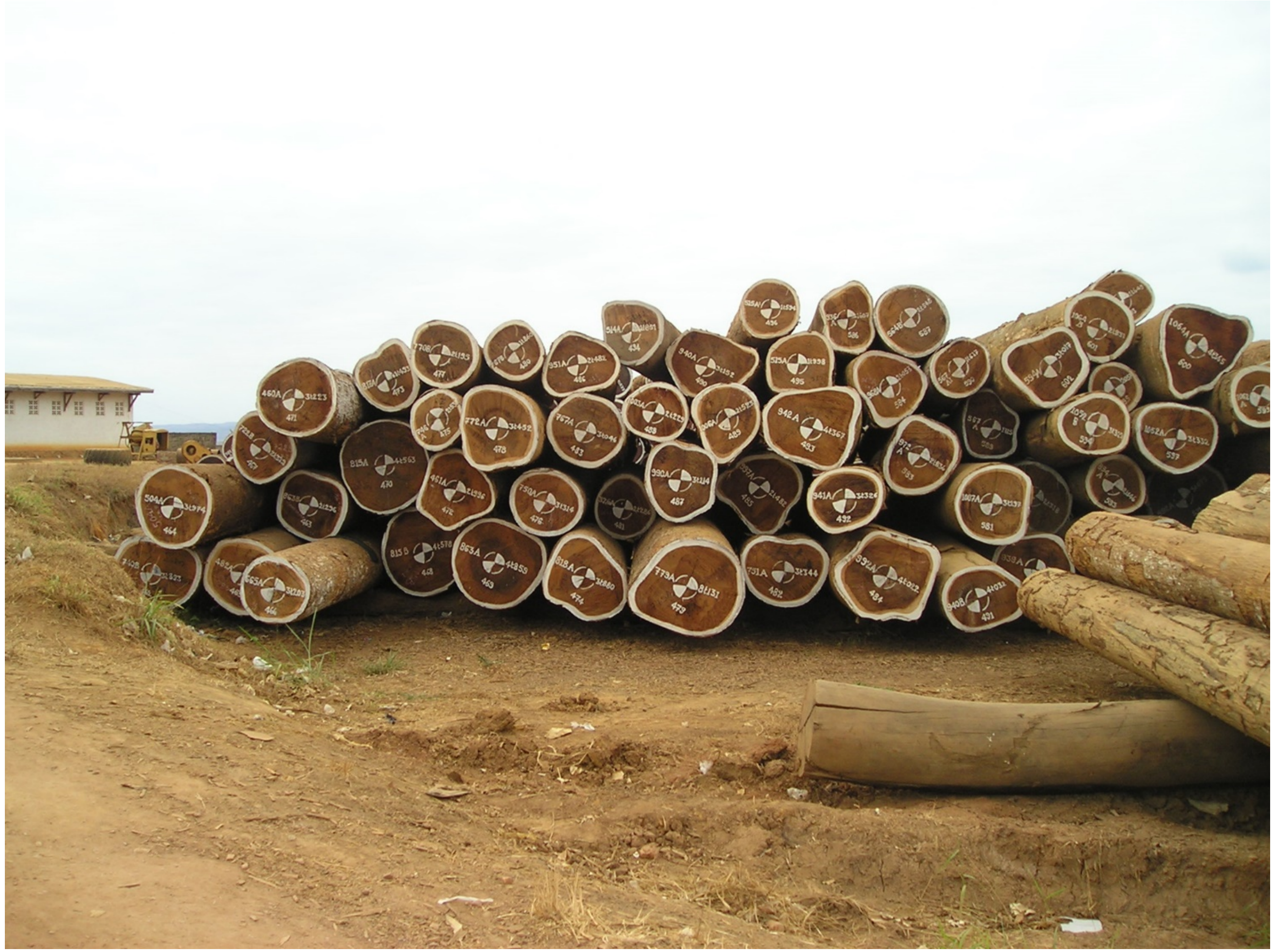
# The Forest Economic Rent (FER) issue

- "*The difference between the return derived from a factor of production and the remuneration needed to keep this factor in its same use*" (Bannock *et al*., 2003 )
- What is usually targeted by the fiscal system: "capturing the economic rent"
- Evaluation of FER magnitude is uneasy
    - Real corporate benefits unknown by the fiscal administration ('fiscal optimisation')
    - Declared export prices (FOB) on sales contracts often abnormally low (transfer pricing easy)
    - Third-party market information (i.e. FOB prices listed by ITTO) not exhaustive (numerous qualities and products) (tropical timber = imperfect commodity)
    - Prices vary amongst different trade networks
    - Vertical integration gives more room to diversification in value added production and makes information less directly collectable
    - Growing heterogeneity of timber companies
    - What to do with the "cost of doing business", especially high in Africa? And how to know it?

# FER and SFM: not a straightforward issue

- Is high FER favourable of unfavourable to SFM and do Governments need to capture it fully?
    - Discussion: Hyde, Amacher & Magrath *vs* Vincent & Gillis (WB Res. Obs. 1998)
    - Profits “in excess” (due to low taxes): wood wastes likely and limited incentives to technical and marketing innovation
    - But, conversely: no or negative rent will reduce investment capacity in SFM & certification
- No general rule: empirical and context-dependent issue
    - Need to make a difference between FER derived from efficiency and rent allowed by low taxation burden
    - How to allow for the first one while putting pressure on non-efficient companies?
    - Pay attention to other national objectives and constraints: African companies, small-scale logging and community issues

# The existing situation under concession regime



# Allocation of concessions and management: the logical (and ideal) steps (Congo Basin)

1. **Zoning plan** proposing different area categories (land use planning)
2. **Survey inventory** of the area: results freely accessible
3. **Design of the concessions** (proposed boundaries) within the projected production area
4. **Gazetting** (“titling”) of the concessions to establish in law the private domain of the State (or of local councils): public inquiry with debates on the field
5. **Adjustment** and **mapping** of the definitive boundaries of the concessions
6. **Announcement of first round of allocation**: at least 6 months in advance
7. Private companies are allowed to make their own surveys
8. **Bidding** and allocation
9. Signature of a **provisional conventions** for 3 years during which the forest management plan (FMP) is prepared: 3 first AACs allowed for logging
10. The company achieves the management inventory on all the concession as a key component of the FMP
11. Revision (i.e. raise) of **Minimum Diameter of Cutting** (MDC) by species after the analysis of forest management inventory
12. After 3 years: the 25 or 30 AAC are mapped, a **long term contract** (15 years, 30 years, more…) is signed

# Why tax structure matters?

- Forest taxes generally used:
  - **Area fee** (or concession rent in Ghana) to be paid annually [*set through bidding in Cameroon*]
    - Could be set only on AAC area
    - On “productive surface” only
    - Could be set also on stumpage volume derived from inventories (and valued according to market prices) – difficult to handle with heterogeneous forests and changing prices.
  - **Royalties on felled volume** (and indexed on commercial value of each specie)
  - **Royalties on log volumes entering mills** [in *Cameroon, but dropped now*] or on processed timber (output)
  - **Export taxes** on :
    - Logs
    - Lumber [*air-dried / kiln-dried distinction in some countries*]
    - Plywood & veneer
  - In several African countries, the FOB price is reduced by an average “transport cost” (EXW or Ex Works basis)

# The pro and cons of area fees

- Area fees (general):
  - + easy to set up and control,
  - + discourage “land speculation” and “under-exploited” concessions (but do not discourage large concessions, since AACs and annual production are larger)
  - + discourage waste in logging and in downstream processing
  - + (little) incentive to use more “less-used species” (if minimum market conditions met)
- Area fees set through bidding:
  - Resolve the “information asymmetry” problem and avoid some pressures and conflicts
  - Select efficient companies (if regulations correctly enforced)

# The Cameroon bidding system

- For each concession, one single assessment

Bidders

TECHNICAL PROPOSAL: 30%

FINANCIAL OFFER: 70% (area annual fee)

Elimination threshold < 65/100

Floor price: 1,5 €/ha/year

Winner

*Technical proposal content:*
-*Industrial facilities to be set up, employment planned*
-*Social commitments …*

# Risk with area fees – and bidding

- Area fee is a fixed cost, while timber prices and production costs vary
  - Exacerbated when set through bidding for a 15-year period: risk for the industry when prices downturn
- Possible “winning curse” with bidding, if:
  - Public survey inventories of poor quality
  - Insufficient time allocated for private surveys
  - Management plans to reduce the annual possibility for main species after the management inventory (achieved 1-2 years after the allocation)

# Royalties on harvested volume

- Option 1: On trees felled:
  - Taxation proportional to the activity and the species collected
  - Could be modulated between species (rate and market prices)
  - <u>But</u>: low collection rate due to the weakness of public control
- Option 2: Prepaid, based on precise inventories :
  - Based on logging inventory and declaration of trees to be harvested (Congo-Brazaville)
  - Trees once marked are taxed whether they will be harvested or not
    - Good collection in Congo B.
    - Discourage log abandon
    - <u>But</u>: generate conservative strategies regarding harvest composition (loggers mark only main species they are sure they can sell)

# Royalties on logs entering mills

- Two objectives:
  - Penalise low wood processing recovery rate
  - A component of the chain of control against illegal logging
- Mitigated results in Cameroon:
  - Unsatisfactory tax recovery
  - Control agents (temporary contracts) quickly corrupted
  - Dysfunction of the Fiscal Securisation Program: information not used for coherence control of data
  - Compliers face unfair competition with sawnwood processed with mobile material

# Export taxes

- Used both as rent capture instrument and for protection of local processing (especially when set on logs)
  - Collected downstream: adverse effect regarding creaming and wastes
  - A quite correct rent capture, but fine tuning uneasy:
    - too low: limited FER capture;
    - too high: equivalent to log export ban (opportunity costs of full local processing, overcapacities risk, overprotection of less efficient industries)
- Export taxes on processed products:
  - Tend to be used selectively: air-dried but not kiln-dried
    - <u>But</u>: some timbers must <u>not</u> be dried (e.g. for decking or immersion)
  - Stages of processing is not a good proxy for added value (e.g. sliced veneer / plywood)

# Performance of taxes: capacity to capture revenues and "corruption-proof"

- Area fee: good fiscal performance if minimum political will (i.e. concession contract cancellation), but a fixed cost disconnected from commercial activity
  - Corruption-proof: +++-
- Royalties on harvested volume: overall, mitigated performance, but connected to company's activity and critical for field control
- Corruption-proof: +--- *to ++--*
- Royalties on log entering the mills: good in theory, but poor performance with weak administration (high number of mills, mobile saws, corruption of isolated agents, no data consistency check)
  - Corruption-proof: +---
- Export taxes: good overall recovery (*but real FOB prices unknown, …)* and very connected to the commercial activity
  - Corruption-proof: ++--
- **For all taxes**: species values not well reflected in the "administrative FOB price" and not updated frequently enough

# Summary: potential recommendations for improving the existing forest fiscal regime

1. Need to keep the 3 main taxes (area, harvested, export) as aach one has its own advantages
2. Bidding procedure:
   - Not only an economic instrument for capturing the FER: improve transparency, create fair competition and favours governance innovation (Independent Observer)
   - <u>But</u>, beware of the abuse of “technical criteria” to eliminate competition!
3. Need to consider that forest taxation is not only a “fiscal matter” but also a critical instrument for regulating the sector and controlling illegal logging

# Formal taxes: only one part of the story

- Importance of “fake” or special taxes (“parafiscalité”) set by administrative services and other local bodies
- Significant fiscal pressure on companies, but limited receipts by the Public Treasury, i.e. DRC
- More receipts is possible only if parafiscalité is reduced
- Reforming taxation raise the issue the functioning of the State and its administration

# Some suggestions for innovation and fine tuning of taxation systems

# Bidding system for area fees

- Public investment is needed for providing upfront public information (large scale exploration inventories)
- How to foster competition?
- “Technical criteria” is subjective and favours corruption
- Financial offer is the only objective criteria
    - Specific rounds might be reserved for national companies
- **Indexation of area fees to international market prices** (ITTO price list): reduce the risk when prices are down, increase Govt revenues when up
- Allow revision reflecting lower “possibility” on main species set by management plans (depend on forest structure)

# Markets of export rights for logs

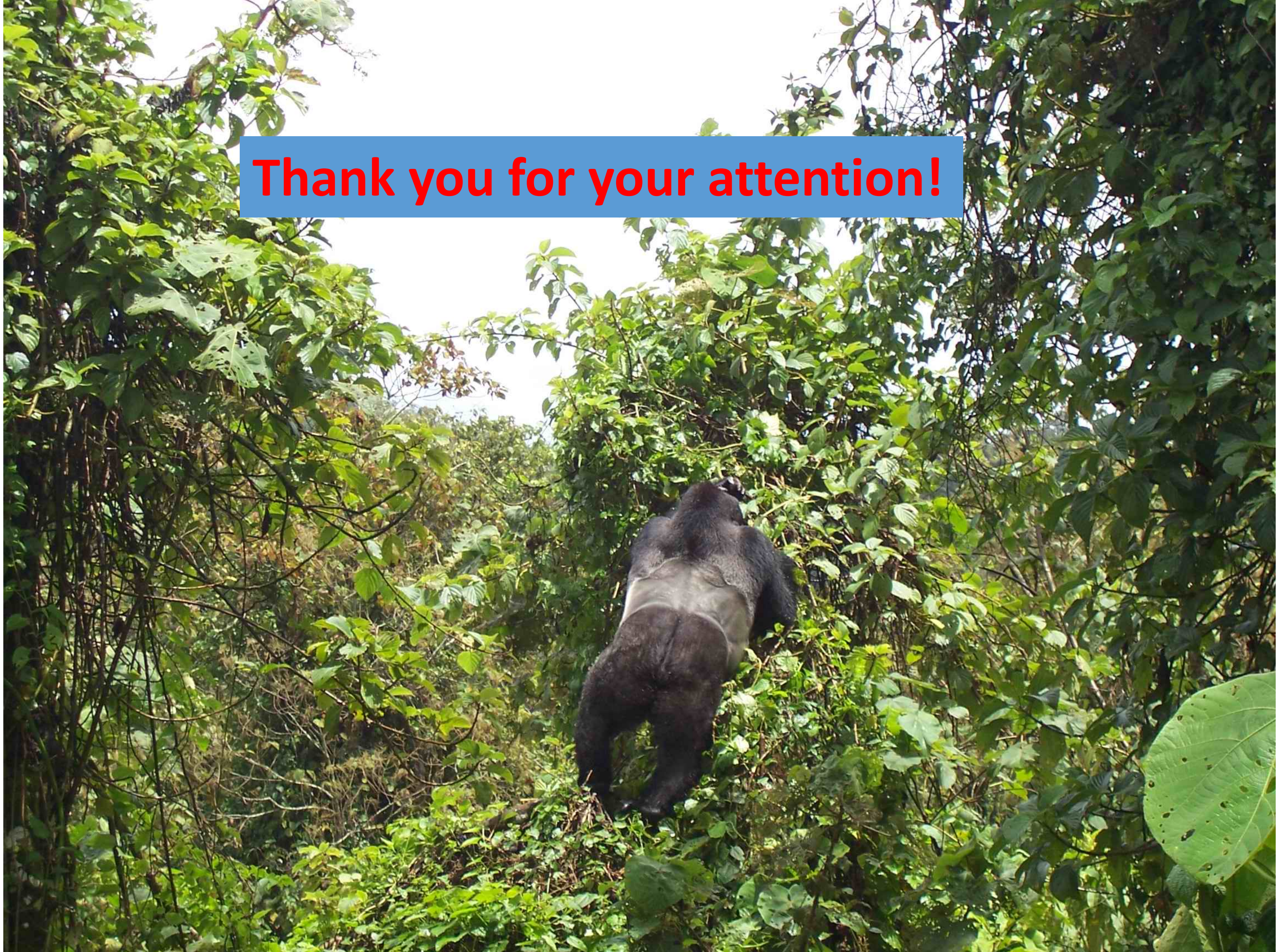
- Quota of log exports granted to companies, but without clear allocation rules (“imperfect grandfathering”)
- Alternative: quotas set at national level and individual transferable quotas auctioned each year
  - National quota can be revised year after year (market opportunities and industry performance)
  - Allow for further specialisation of enterprises and development of inter-industry log market
  - Transferability reduce risks (prices downturn)
  - Good substitute to export taxes (better capture of economic rents)

# Public policies to rescue private certification?

- If the demand (higher prices) is not sufficient to increase certified tropical forest areas, incentives should be considered upstream of the market
- A reduction in forest taxation for certified concessions (FSC, or a Forest Management certificate deemed credible by all parties) seems the easiest solution to implement, provided that donor partners compensate (for a period to be determined) the States of producing countries for the loss of tax revenues
- A reduction in costs would provide an incentive even for companies (e. g. Asian) whose markets do not demand (yet?) certified wood

# Difficulties related to the lack of transparency

- Difficulties related to the lack of transparency
- Many companies do not pay the amount of theoretical royalties and taxes they should pay: many confidential bilateral agreements between authorities with tax powers and companies (services rendered offset by tax reductions)
- Importance of advancing the consideration of the forest sector in the EITI process (Extractive Industries Transparency Initiative – “Publish what you pay!”


Thank you for your attention!

# Coupling certification and fiscal incentives for ‘zero deforestation’ commodities

- Agricultural commodities imported in developed countries are subject to tariffs (import taxes)
- Palm oil, soy beans, coffee, cocoa, beef… are commodities which development often lead to deforestation.
  - Many pledges made by corporations and governments for zero deforestation
  - Recent report (Greenpeace): corporations’ voluntary commitments not translated in effective ZD supply chains
- Proposal made during SNDI (Imported Deforestation) discussions in France:
  - Check the criteria of private certification (e.g. RSPO, RPSO Next) regarding ZD
  - Remove tariffs for accredited certified commodities imported (or introduce tariffs for non-certified)
  - **Reinvest all the revenues yielded in support programs for small-scale producers in developing countries** (in proportion to the amount of taxes generated by the imports)