MEMO ON MANAGEMENT OF NON-RENEWABLE NATURAL RESOURCE REVENUES BY INDONESIAN RESOURCE RICH DISTRICTS AND PROVINCES

For: OFFICE OF THE PRESIDENT

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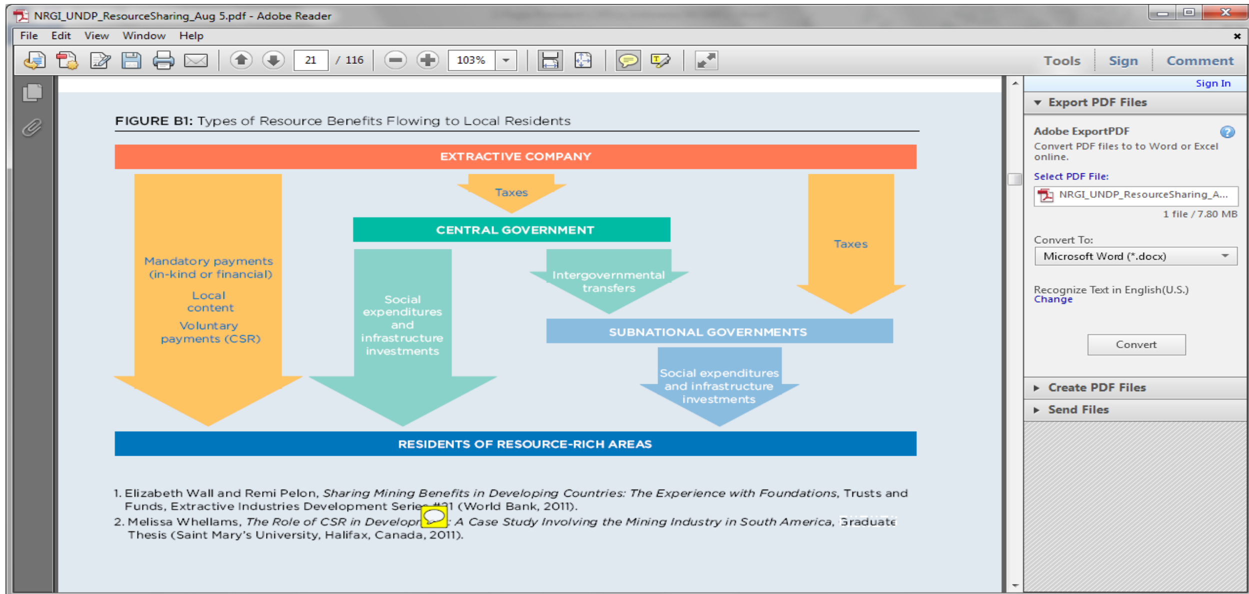
Key messages:

- Indonesia's natural resource revenue sharing system creates incentives for wasteful spending in resource-rich regencies. This harms Indonesia's economic growth and development.
- Special rules should be created to allow natural resource-dependent regencies to save a portion of their oil, gas or mineral revenue windfalls for future generations and smooth volatile public spending. These savings can be placed in sovereign wealth funds. The interest earned from these investments can be used to finance specific infrastructure, education, or health projects.
- For sovereign wealth funds to function properly and avoid becoming channels of corruption or patronage, there must be a high degree of fund transparency and independent external oversight. The funds must also have strong governance structures. The Office of the President could provide the necessary guidance or rules for creating well-functioning regency-level sovereign wealth funds.

Benefiting from the presence of oil, gas and mining industries

There are many ways that local residents can benefit from the presence of extractive activities in Indonesia. Essentially, there are seven types of 'benefit sharing', as shown in the diagram below.



First, subnational governments can collect some taxes themselves. These taxes can then be transformed by these governments into social services and infrastructure. Already, Indonesian subnational governments collect some land and property taxes, however direct tax collection powers are quite limited.

Second, subnational governments can receive transfers from the national government, which are then transformed into social services and infrastructure. While Indonesia has a general intergovernmental transfer system, it also has a special system for transferring oil, gas and mineral revenues, which will be discussed below.

Third, national governments can prioritize natural resource producing regions when delivering social services and infrastructure.

Fourth, companies can make mandatory in-kind payments in the form of infrastructure or health services. For example, in Kyrgyzstan, Liberia, Nigeria, Sierra Leone and Yemen, national mining laws require extractive projects to spend a certain percentage of their revenue on local development.[1] In other cases, extractive projects can be required to provide additional infrastructure such as communication technologies, power stations, water systems, roads, rails and ports, or share access to this infrastructure with local citizens and businesses. In Mozambique, Vale is required to share its railroad from the Moatize coal mine to the Nacala port with freight and passenger cars.

Fifth, companies can make voluntary payments to communities in the form of infrastructure, services or cash, usually as part of their Corporate Social Responsibility (CSR) package. For example, the Yanacocha Mine in Peru controlled by Newmont Mining—which has a history of environmental contamination and conflict—makes voluntary payments to affected communities near the mine site through its community relations department and to all districts in the Cajamarca region through La Asociación Los Andes de Cajamarca (ALAC), a corporate foundation. Financed projects have included water and sanitation systems in affected communities, school supplies and new technologies and feeding systems for small dairy farmers. These projects are often not sustained once the mine

1 Elizabeth Wall and Remi Pelon, *Sharing Mining Benefits in Developing Countries: The Experience with Foundations, Trusts and Funds,* Extractive Industries Development Series #21 (World Bank, 2011).

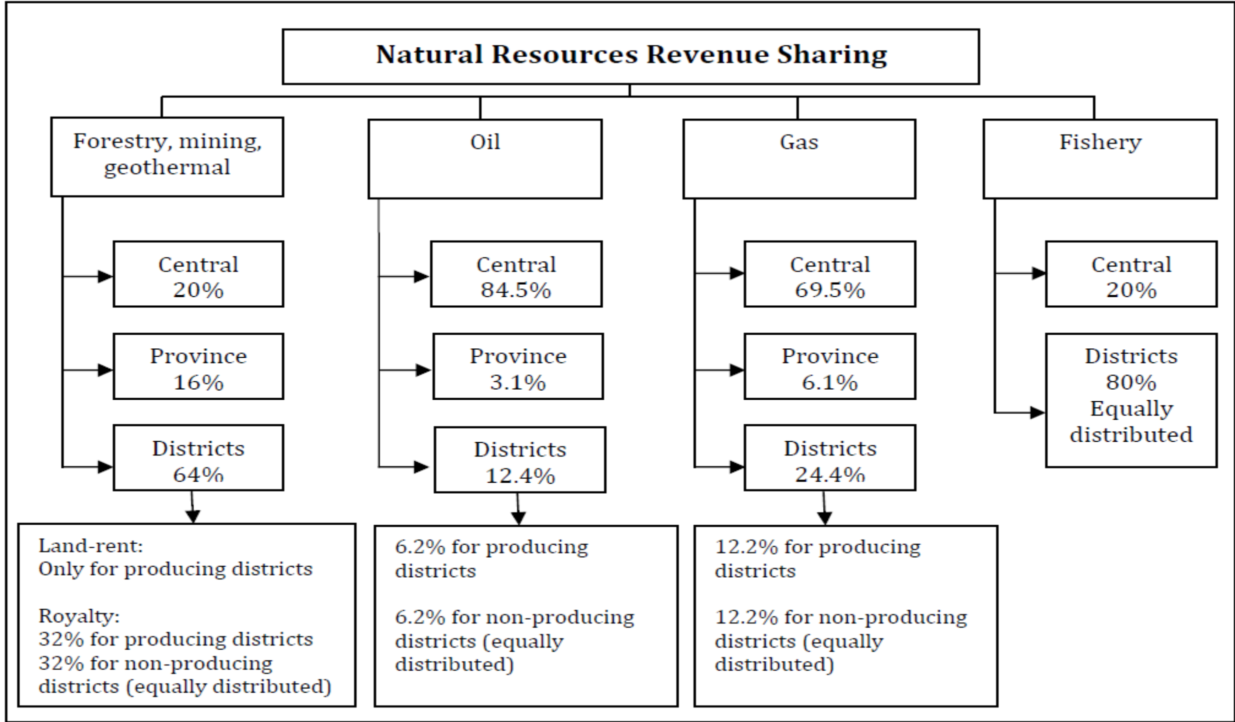
or oil field closes, except in cases where long-term capacity is built and communities are involved in designing the programs.[2]

Sixth, for certain commodities such as gas or coal, instead of collecting revenues from extraction, local citizens can directly benefit from access to the commodity itself. In the Omnogovi region in Mongolia, a few coal mines offer free or subsidized coal to local residents over peak winter months.

Seventh, the presence of extractive companies can generate non-fiscal benefits such as employment, local business development through local content procurement policies, technology transfer from foreign to local companies, and skills development opportunities. In some countries, large-scale extractive companies have negotiated arrangements to allow artisanal and small-scale (ASM) miners from the local community to mine in delineated areas of their concessions or support 'buying schemes' to purchase minerals from artisanal miners, often at a higher price than what would be offered by middle men operating in the ASM sector.

Challenges faced by Indonesian resource-rich regions in managing resource windfalls

Oil, gas and mineral-producing regions in Indonesia are faced with unique challenges. According to Indonesian fiscal balancing law no 33 / 2004, resource rich districts and provinces are entitled to the following revenue share:



Source: UU33/2004

This system has led to significant dependency by several regencies. For instance, in 2014, oil, gas and mining revenue transfers constituted 27 percent of fiscal revenues in Bojonegoro, East Java. Revenue projections for Bojonegoro suggest that once oil production in the Cepu block peaks in 2017, more than 50 percent of fiscal revenues will come from extractive-related transfers.

2 Melissa Whellams, *The Role of CSR in Development: A Case Study Involving the Mining Industry in South America,* Graduate Thesis (Saint Mary's University, Halifax, Canada, 2011).

Similar problems arise at the provincial level, where producing provinces are entitled to 3.1 percent of petroleum revenues generated in their jurisdictions, 6.1 percent of gas revenues and 16 percent of mineral royalties. The system has resulted in massive oil and gas revenue windfalls for certain regions, such as a USD 1.2 billion windfall for Riau (pop. 6.4 million) and a USD 280 million windfall for North Kalimantan (pop. 628,000) in 2014.

While these revenues succeed in making producing regions much wealthier and are sometimes used to improve standard of living in resource-rich regencies, "derivation-based" allocations, such as those in Indonesia, generate perverse incentives for local governments and can destabilize local economies, for at least three reasons.[3]

First, fiscal revenues from oil, gas and mining are volatile because of the dramatic booms and busts of commodity prices and unexpected stoppages in production. When revenues increase too quickly, bureaucracies find it difficult to transform them into tangible infrastructure or social services, which can lead to poorly conceived, designed and executed projects. In these situations, there is a tendency for governments to spend on conspicuous infrastructure projects (e.g., new municipal buildings; new roads) or increase government salaries unsustainably rather than spend on social programs or well-conceived productive infrastructure. Conversely, when revenues decline unexpectedly, governments often respond by borrowing unsustainably or by cutting expenditures, leading to half-finished roads, unmaintained buildings or public sector layoffs even massive protests against the governments. Evidence from Brazil shows that large oil royalty windfalls to municipalities was associated with an increase in government housing and urban infrastructure spending, but significantly harmed the efficiency of social service provision. Access to piped water, trash collection and connection to sewage networks decreased as more oil revenues flowed into municipal coffers.[4]

Second, the size of resource revenues can be overwhelming for subnational governments. Where resource revenue inflows cause a sustained rapid increase in fiscal revenues, and these revenues are spent the same year they are collected, money can be wasted or, worse, the revenue inflow can cause permanent damage to the local economy. The reason why we see this phenomenon is that government administrations are constrained by available skilled labour, managerial systems, and information technologies. What's more, in most cases, local economies are similarly constrained, meaning that even if the government wanted to outsource projects to the private sector, they would not be able to without bringing in foreign workers. This lack of 'absorptive capacity'—the ability to transform financial resources into goods and services—leads to wasteful spending and rising costs of public projects.[5]

Third, over the longer-term, oil, gas and minerals will eventually be depleted. Since these sources of revenue are finite, unless the government establishes alternative sources of tax revenues or revenues are saved in a fund over the long-term, the government will eventually have to cut spending or borrow unsustainably when these resources are exhausted. As a result, governments in oil-, gas-

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3 NRGI (2014), The Natural Resource Charter, Precept 7. and Collier, P., Ploeg, F. Van Der, Spence, M., & Venables, A. J. (2009). Managing Resource Revenues in Developing Economies, *44*(0).

4 Ardanaz, Martin (2014) "Fiscal Windfalls, Transparency, and the Efficiency of Public Good Provision: Evidence from Brazilian Local Government" in *Transparent Governance in an Age of Abundance: Experiences from the Extractive Industries in Latin America and the Caribbean* (eds. Juan Cruz Vieyra and Malaika Masson), Inter-American Development Bank: Washington DC.

5 Absorptive capacity depends on the domestic supply of qualified labor, speed at which people can be trained, ease of access to inputs, ease of access to credit for businesses, and the presence of management systems and institutions that can cope with an increase in spending.

or mineral-rich regions may want to save some revenues and invest them in foreign assets for the future. There is also a moral case that revenues from natural resources belong to future generations as much as present generations. Therefore they should be saved, to be spent later (as long as the cost of public debt is not large than the interest on savings). Finally, precautionary savings are useful to have in case of environmental, social or economic crisis, such as drought or financial crisis.

All these factors make the task of spending revenues effectively at the local level rather difficult. So much so that studies conducted in Brazil and Colombia suggest there is no relationship and in some cases even a negative relationship between resource revenue shared and spent at the local level and growth, education and health indicators, among others.[6]

At the same time, local governments can enact policies that address these issues. First, subnational governments can mitigate spending volatility by delinking expenditures from revenues—paying down debt or saving in a fund when revenues are high and borrowing or drawing on savings when revenues are low. However in Indonesia they are constrained by a limited authority to borrow or save; Indonesia prohibits external borrowing by subnational governments, but allows a 3 percent fiscal deficit financed by domestic borrowing.[7] Furthermore, unspent funds cannot be saved and must be returned to the national government resulting in less revenue the following year. This incentivizes local government to prioritize rampant spending on "white elephant projects" in order to get money out the door.

Even if subnational governments have the authority and capacity, several smoothing mechanisms may prove inefficient at the local level. For example, it may be very costly for local governments to borrow from capital markets to plug a deficit caused by plunging commodity prices as local governments will often have a significant risk premium, especially in emerging economies. In extreme cases, local government may be cut off from credit markets entirely.

In response, resource-rich governments can save a portion of their revenues from natural resources in **sovereign wealth funds (SWF)**. Such funds accumulate resource revenues in the form of financial capital. The interest generated from fund investments can allow the government to generate 'permanent' income that lasts beyond the lifespan of the petroleum or mine field. While several sovereign wealth funds have helped subnational governments withstand declines in mineral production—such as the Investment Corporation of Dubai and the Texas Permanent University Fund—most sovereign wealth funds globally are either ineffective or have become sources of corruption and patronage. As a result, these funds need to be governed by appropriate deposit, withdrawal and investment rules, adequate oversight provisions, and a high degree of transparency.[8]

POLICY OPTIONS

The following are three policy options for consideration by the Office of the President, based on the challenges mentioned above and global experiences.

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6 Caselli, Francesco and Guy Michaels (2009) *Do Windfalls improve living standards? Evidence from Brazil*. National Bureau of Economic Research. Working paper 15550; Perry, Guillermo and Mauricio Olivera (2009) El *impacto del petróleo y la minería en el desarrollo regional y local en colombia*. CAF documentos de trabajo.

7 Seifert, Jan (2012) *Fiscal rules, decentralization and public finances: Making sense of balanced budget requirements for sub-national governments*. Lee Kwan Yew School of Public Policy, Working Paper 12-19.

8 Natural Resource Governance Institute-Columbia Center on Sustainable Investment (2014) "Natural Resource Fund Governance: The Essentials" in *Managing the public trust: How to make natural resource funds work for citizens*. Online: http://www.resourcegovernance.org/sites/default/files/NRF_Complete_Report_EN.pdf

Option 1: A legal opinion from the President's office on the validity of subnational funds

Currently, national government agencies and ministries, such as MOHA and the Ministry of Finance, and subnational governments are unclear as to the President's views on creating subnational sovereign wealth funds. The Office of the President could release a legal opinion supporting their creation. This would signal to subnational governments to begin planning and to government ministries that they can endorse such plans. However this option would provide little guidance to subnational governments on how they should proceed and what good sovereign wealth fund governance entails. Thus, there is a strong probability that regencies would create sovereign wealth funds without adequate transparency, oversight or organizational structure, and that they would become new sources of patronage and corruption at the local level.

Option 2: Technical support for regencies to create funds

The Office of the President could provide technical support in the form of public finance experts and lawyers to regencies in order to help them draft local legislation and regulation to create sovereign wealth funds. Local governments have limited capacity to draft said legislation or regulation and would need to rely on external support in order to work through the issues.

This option would require a fairly large budget and a broad commitment in terms of man-hours. It may also lead to a diverse range of legislation without necessarily meeting a common standard of good governance.

Option 3: Create national legal framework for establishment of subnational funds

The Office of the President could call for the drafting of a national legal framework that would allow subnational governments to create sovereign wealth funds subject to a set of national rules. These rules could include transparency and independent oversight requirements, management of the fund, asset allocations, accounting and deposit and withdrawal rules. It would also permit a degree of flexibility to respond to local contexts—for instance in terms of percentage of natural resource revenues saved and oversight bodies. Funds would only be permitted in natural resource-dependent jurisdictions. This can be in a form of laws or presidential regulations. It would provide useful guidance for subnational governments and a national standard for how resource revenues are saved and managed locally.

Technical support

Resource Governance in Asia Pacific, UGM and Natural Resource Governance Institute would be pleased to discuss any of these options or issues in further detail, at the discretion of the Office of the President. We would also be available to provide additional information upon request.