

# Tanzania

## 1. Country Context

When Tanzania became independent in 1961, its economy was based on subsistence agriculture and the production of coffee, sisal, and cotton for export. The Arusha Declaration of 1967 changed Tanzania into a socialist state and economic policy was based on central planning and government control. As result, social indicators improved and Tanzania made important progress in building a nation state (IMF, 1999). However, in 1980 the economy collapsed after several years of adverse external conditions including: global recession in the 70's, East Africa community break-up '77, doubling of oil prices '79/'80, and war with Uganda 78/79. By the time of the economic collapse, the country's natural resource base had been seriously degraded (Reed & Kulindwa, 2001).<sup>1</sup>

Today, Tanzania is one of the very poorest countries in the world with a GNP per capita of \$280 in 2000 (GoT, 2002a). The economy is still highly dependent on agriculture, which accounts for approximately half of national income, three quarters of merchandise exports, and the source of livelihood for approximately 80 percent of Tanzanians (GoT, 2002b). The two fastest growing sectors of the economy are tourism and mining. Tourism currently accounts for approximately 14 percent of GDP and mining accounts for about 2.5 percent of GDP (GoT, 2003).

The government has targeted these three sectors as the drivers of future economic growth. As such, these three sectors have been accorded special attention in economic development strategies for the country. The Tanzanian government aims for mining to contribute 10 % of GDP by 2025 (Lissu, 2002). With regards to the extractive industries, Tanzania has significant mineral resources including gold, diamonds, tanzanite, various other gem stones, natural gas, iron ore, coal and phosphates.

## 2. World Bank and IMF Engagement in Tanzania

### 2.1 Overview

After several years of constrained donor relations and subsequent withdrawal of aid, in 1985 a World Bank mission went to Tanzania to assist the Government in the preparation of an Economic Recovery Program (ERP). Following in 1986, pressure from the World Bank, IMF, and bi-lateral donors persuaded the Government of Tanzania to adopt the far-reaching ERP (Bigsten, *et.al.*, 1999).

The Bank-guided ERP was aimed at a broad range of policy reforms including liberalizing internal and external trade, unifying the exchange rate, reviving exports, and restoring fiscal sustainability. In 1986, Tanzania reached agreement on a Stand-by Arrangement (SBA) with the IMF. This agreement paved the way for increased lending by the World Bank and several other donors. The IMF SBA was renewed in 1987, 1988, and 1990.

However, from 1993 to 1995 the government's refusal to adopt more stringent IMF reforms led to donor withdrawal of funding (Reed & Kulindwa, 2001). Relations recommenced in September 1996, with the GoT and IMF reaching an agreement on a three-year Enhanced Structural Adjustment Facility (ESAF) underpinned by a Policy Framework Paper (PFP). This was later followed in 1999 by a Poverty Reduction and Growth Facility (PRGF) program loan.

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<sup>1</sup> A government process know as forced villagization was a major factor contributing to this degradation (Reed, 2001).

From 1986 to 1999, adjustment lending by the World Bank comprised a significant portion of its lending to Tanzania, including for 1986-1995 US\$ 748.7 million or 38.5% of Bank lending; and for 1995 – 1999 133 million or 33.3% of Bank lending (OED, 2000). From 1987 to 1995, the Bank supported the ERP with four sectoral adjustment loans (SECALs) equal to US\$749 million, investment credits of US\$1.2 billion, and economic sector work (ESW) of US\$18 million (OED, 2000). Adjustment lending has continued by the Bank into the 2000's with a PSAC and a Poverty Reduction Support Credit (PRSC). The current analysis mainly focuses on the implications of policy lending provided between 1986 and 1999.

During the 1990's the Bank's overall objective for its lending program in Tanzania was to improve economic efficiency through expanded private investment and production in the economy and reduce the drain upon scarce fiscal resources. In general, the content of policy reforms has largely been the standard structural adjustment package, with limited original Tanzanian input (Bigsten, *et.al.*, 1999). The Bank's Multi-Sector Rehabilitation loan focused on liberalizing foreign investment regulations, deepening reforms in the agriculture sector, and addressing social costs (Reed & Kulindwa, 2001). The Industry and Trade Adjustment Credit mainly focused on trade liberalization, tariff and tax reforms, and industrial restructuring.

As noted above, mining, tourism, and agriculture have been the three main sectors targeted for economic growth and as such have been central in restructuring the economy. Mining and tourism have been the fastest growing sectors of the economy in the last decade. The World Bank has specifically supported mining for growth through a Mineral Sector Development Technical Assistance Loan, which as described below focused on legal, regulatory, and tax reforms to attract foreign investment in mining and other mineral based industries. In addition, conditionality in Bank lending has been marked by increased cross-sector conditionality, such as petroleum sector liberalization.

Table 2.1 provides a summary of Bank lending with relevance to the extractive industries in Tanzania from 1986 to 1999.

**Table 2.1 World Bank Policy and Institutional Lending with Relevance to EI**

<b>World Bank Loan Program</b>	<b>US\$ millions</b>	<b>Approval Year</b>
Power and Energy Rehabilitation	40	1986
Multi-Sector Rehabilitation	300	1986
Industry and Trade Adjustment Credit	242	1988
Parastatal and Public Sector Reform Project		1991
Petroleum Rehabilitation	44	1991
Mineral Sector Development Technical Assist.	12	1993
Structural Adjustment Credit I (SAC1)	125	1997
Tax Administration	40	1999
Privatization and Private Sector Development Project		1999
Programmatic Structural Adjustment Credit I (PSACI)	141	2000
Programmatic Structural Adjustment Credit II (PSACII)		2000

Source: World Bank Project Files

The rest of the section describes specific structural reforms supported by the Bank and IMF loan programs in Tanzania with significant relevance to the extractive industries.

## 2.2 Trade Liberalization

Towards reviving exports, Tanzania's ERP focused significantly on trade liberalization reforms, which were supported by various lending operations of both the IMF and World Bank. The main reforms included:

- Abolish all trade restrictions, except for petroleum products and restrictions for health and security reasons;
- VAT exemption on petroleum products (later requested by the IMF to be abolished);
- Liberalize import regime, i.e. reduce the tax burden;
- Rationalize tariffs;
- Abolish system of export licensing;
- Abolish registration of exporting companies; and
- Liberalize marketing arrangements by deregulating and privatizing the marketing system (This measure has been particularly important in the mining sector).

## 2.3 Investment Liberalization

Investment liberalization was central to both the ERP and the Bank's overall country program objective to increase private investment. As such, the GoT enacted the National Investment and Promotion Act of 1990, which included the following measures:

- Removal of all restrictions on private entry and ownership of commercial enterprises, including mineral resources;
- Full repatriation of profits;
- Incentives to foreign investment; and
- Encouragement for oil and gas exploration.

In addition, the Investment Act of 1997 created the Tanzania Investment Centre (TIC) as a means to hasten the processing of applications from investors. Over the course of the reform program, the TIC has gone through several changes. Through IMF and Bank encouragement, it has shifted from regulatory functions to strictly promotional activities. One of the primary promotional functions the TIC performs is issuing TIC tax incentive certificates allowing the withholding of taxes on interest earnings, dividends, and royalties.<sup>2</sup> These certificates have often been granted for, *inter alia*, imports used in foreign-financed projects. For example, mining companies have been granted TIC certificates that allow 100 percent exemption of all expenditures, including provisions by mining companies on funds for defrayment of future expenses required in land restoration (IMF, 1999).

However, in 2000 the IMF requested that the GoT abolish the tax privileges given by TIC. The GoT reports that tax incentives have been harmonized and now the issuance of TIC certificates no longer confer any tax advantages (GoT, 2000a).

## 2.4 Privatization and Private Sector-led Growth

The privatization and private sector-led growth initiatives that began in 1993 are an extension of the investment liberalization efforts listed above. The Bank reports that the GoT's support for privatization has evolved over time from limited commitment and timid support to strong, open support (World Bank,

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<sup>2</sup> These tax advantages were later abolished through an IMF program in 2000.

1999a). Furthermore, the Bank states that in 1997 the ruling party, CCM, reversed its long held policy on public ownership and formally endorsed private sector led growth.

The GoT's privatization program has taken place in close consultation with the World Bank. The Bank has provided support for the implementation of Tanzania's private sector development strategy consisting of a privatization program, bank restructuring, and utility regulation. The aim of the program is to improve economic efficiency through increased private investment and reduced use of scarce fiscal resources (World Bank, 1999a). Obtaining this overall development objective involves the following specific measures (World Bank, 1999a):

- Reallocation of national resources to achieve development goals and improve the quality of goods and services;
- Reduction of the role of the State in commercial activities;
- Facilitation and promotion of private sector participation in the economy;
- Privatization of major public enterprises (e.g. utilities and infrastructure);
- Streamlining of the government approval of divestiture with greater delegation of implementation to the Parastatal Sector Reform Commission (PRSC);
- Establishment of an institutional framework for regulation of infrastructure and utilities;<sup>3</sup> and
- Promotion of the removal of key regulatory and other business bottlenecks to the expansion of private and foreign direct investment.

Specific extractive industry objectives, included:

- Elimination of the state as a mine operator and divestiture of public mining companies; and
- Dismantling of the state-owned petroleum corporation, Tanzania Petroleum Development Corporation (TPDC).

In addition, the privatization program initiated the setting up of the Parastatal Sector Reform Commission (PSRC) and in 1997 the Tanzania Private Sector Foundation, which was to enhance government collaboration with the private sector.

As part of continuing support from the IMF and the World Bank, in late 1996, the government of Tanzania agreed to expand the privatization program to divest all major utilities, infrastructure, banking, agriculture, and mining assets (World Bank, 1999a). The IMF and Bank operations called for an accelerated disposal of assets managed by the Parastatal Sector Reform Commission (PSRC) (IMF, 1996). As such, the GoT aimed to divest all remaining parastatals by 2000 (World Bank, 1999a).

In 1999, the GoT was further encouraged by the Bank and IMF to make efforts to streamline the public enterprise divestiture process in order to facilitate the accelerated implementation of the privatization program. Thus, the GoT stated that the PRSC would modify its operating procedures, including the following three main changes (World Bank, 1999a):

- 1.) early policy decisions by Government coupled with greater delegation of execution of transactions through the "**fast track**" mechanism, 2.) the use of clearer, simplified procurement

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<sup>3</sup> Bank-funded projects are supporting the development of regulatory rules governing private investment in telecoms, electricity, water, ports and railways. The Bank states that: "In order to facilitate investor confidence, it is likely that these regulatory schemes will place strong reliance on contract-based rules, **with minimal discretion for regulators**. Nevertheless there are likely to remain important roles for regulators, such as contract monitoring, enforcement, resolution of disputes not warranting international arbitration and handling of consumer complaints (World Bank, 1999a)."

procedures, based on outsourcing to competitively selected investment advisors<sup>4</sup>, and 3). generally using price as the final selection criterion, with investor's technical capacity and credentials for larger transactions determined through pre-qualification.<sup>5</sup>

## 2.5 Hydrocarbon Sector Reform

Liberalization of the hydrocarbon sector began with the liberalization of refined petroleum imports in January 1997 and petroleum prices in June 1998 (IMF, 1996). Next the state-owned oil corporation, Tanzania Petroleum Development Corporation (TPDC) ceased operations in October 1999. Due to financial constraints, TPDC was unable to finance its last shipment of oil equal to 60,000 metric tons, which had to stay in storage until April (GoT, 2000a). TPDC was restructured to focus on petroleum exploration, with support from the government budget.

Restructuring efforts trimmed TPDC from a staff of 105 to around 65 (GoT, 2000a). A final decision on whether TPDC will have any future role in the oil and gas sector will be addressed in a forthcoming study of the sector's institutional and regulatory requirements. This study is part of a 2001 IDA Songo Songo Natural Gas Credit.<sup>6</sup> In addition, the Songo Songo project is suppose to provide technical assistance, training, and equipment to assist the Ministry of Energy and Minerals strengthen its institutional and regulatory framework for natural gas and energy management information systems. No further information on specific measures and actual implementation was available at the time of this analysis.

It is also important to note, that in addition to the policy and institutional reforms in the hydrocarbon sector, a 1991 World Bank Tanzania Petroleum Rehabilitation Project provided some provisions for treatment of pre-existing pollution issues, such as controlling pollution from leaking pipes and storage facilities.

## 2.6 Mining Sector Reform

The mining sector in Tanzania has gone through several stages of reform since the creation of the State Mining Corporation (STAMICO) in the early 1970s. CCM, the ruling party of the government, recognized by the late 1970s that reforming the mining sector offered prospects for attracting desperately needed foreign investment (Reed, 2001). However, attempts by STAMICO to attract large capital in the 1970s and early 1980s in the form of aid or joint public-private investments failed, even with the new government mining law that came into operation in 1979 (Chachage, 2001). Under the 1979 Mining Act and 1982 Mining Policy, government participation in mining ventures was no longer mandatory. Furthermore, under the Small Scale Mining Policy of 1983, local small-scale miners could legally peg claims and work on them (Chachage, 2001).

At the end of the 1980's, the World Bank and IMF sponsored new foreign investment codes, investment promotion schemes, and the simplification of licensing and fiscal regimes, as well as some measures

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<sup>4</sup> Transactions will be implemented through contracting them out to competitively recruited investment advisors, this will be true both for the large transactions as well as smaller enterprises (World Bank, 1999a).

<sup>5</sup> Where assurance of bidders' technical capacity and adherence to technical requirements and to government policy matters are needed, particularly for large public enterprises this will be achieved through pre-qualifications, with review of business plans through requiring investors to respond to a common set of investment and policy criteria. Public accountability could be achieved through public opening of bids which would be broadcast on radio and TV and public announcement of winning bidders, which would be politically approved rapidly by the Cabinet. This would be coupled with periodic process audits (World Bank, 1999a).

<sup>6</sup> The government will make the decision before commencement of natural gas production, currently scheduled for sometime in 2003 (GoT, 2000a).

towards good governance. A 1992 World Bank Strategy for African Mining set the stage for the Bank's 1993 Tanzania Mineral Sector Development Technical Assistance project.

Following the advice in the African mining strategy, the Bank's TA assisted the GoT to 1) eliminate the state as a mining operator, 2) restructure the institutional setup of the mining sector for stimulation of private investment, 3) improve regulation of mineral activities, 4) compile and disseminate geo-information; and 5) prepare a modern mineral policy and strategy. The last activity included a revised legal framework and new mining legislation, resulting in the following two legislative reforms:

### **The Mining Policy of 1997 and Mining Act of 1998**

- Establishment of an attractive regulatory framework;
- New fiscal regime with significant tax incentives – these originally included five-year tax holidays for new mining investments (see Table 2.2 for the new fiscal regime);
- Stability of fiscal regime;
- Streamlining of the regulatory environment to ensure effective application of the private sector investment code to the mining sector;
- Privatization of mineral trading activities;
- Stability of environmental management regulations; and
- Security of land tenure.

In addition, the Bank TA also included project activities involving the artisanal and small scale mining (ASM) sector. The project set out to: improve the legal framework, i.e., formalize, ASM activities and thereby increase tax revenue; improve the environmental awareness and management of ASM<sup>7</sup>; improve government capacity to deal with SSM; provide extension services to ASM; and address gender issues (OED, 2003). In 2002, the Bank assessed that the outcome of the ASM-related objectives in the Tanzania project was only moderately satisfactory (OED, 2003) (see section on market, policy, and institutional failures).

Furthermore, the Ministry for Energy and Minerals attached regulations to the new Mining Act that required small-scale miners to acquire licences and extend their rights over claims from one year to five years (Chachage, 2001). The government believed that by doing so, it would be possible to reduce ASM sporadic movements, encourage them to put greater investments in technology and safety and eliminate environmental problems associated with small-scale mining (Chachage, 2001).

Table 2.2 provides a comparison between the old and new fiscal regime for the mining sector. As shown in the table, the post reform fiscal regime provides substantial tax incentives to attract mining investment by significantly lowering the tax rates across the board.

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<sup>7</sup> Introduce better equipment and more environmentally sensitive disposal of tailings.

**Table 2.2 Tanzania: New Fiscal Regime for the Mining Sector**

<b>Description of Measure</b>	<b>Old</b>	<b>New</b>
Income Tax	35%	30%
Royalties	3% of gross value (5% diamonds)	3% netback value (5% diamonds). 0 for cut and polished gemstones (plus deductible for corporation tax)
Depreciation Allowances	40% first year than 10% annually	100% on all mining capital expenditure
Additional Capital Allowance for Development Capital Expenditure	0	An additional 15% allowance each year for any un-recovered development capital expenditure
Withholding Tax on Interest	15% (not deductible)	0
Withholding Tax on dividend and tax on distribution of branch profits to non-residents	20%	10%
Import duty and Sales Tax for mining equipment and supplies directly related to operation of project	Various Rates	Exempted up to one year after start of production. Thereafter, limit of 5% import duty and 5% sales tax.
Sales Tax	10% deductible	Full sales tax exemption for purchase of inputs and supplies (where product is exported)
Export Duty	2% of sales value, deductible	0
Losses		Losses may be carried forward for an unlimited period of time.
State Participation	Mandatory	There is no concessional state participation
Stamp Duty	1 – 2%	Reduce to a minor tax
Domestic Withholding Tax on goods and services supplied	2%	0
Domestic Withholding Tax on goods and services purchased	2%	2% (credited towards recipient's corporate tax liability)
Withholding Tax on technical service payments to both resident sub-contractors and non-residents and management fees	30%	3% of gross payment
Accounting for tax purposes	Tanzanian Shillings	US dollars permitted

Source: Ministry of Energy and Minerals, Tanzania

### **3. Development Outcomes**

This section discusses various indicators, observations, and data for Tanzania, including parameters of economic growth and indicators more directly tied to poverty and the environment.

Overall, the main outcomes were the following. In the late 1990's, structural reforms aimed at attracting investment and a high international gold price contributed to a mining exploration boom in Tanzania. The hydrocarbon sector, on the other hand, is only now starting to attract investors to offshore exploration. Although export earnings from mining have increased significantly, the sector has not had an impact on the GDP growth rate which remained chiefly unchanged over the time period. Furthermore, the trade deficit has increased and tax revenue is at low levels. Moreover, growth in minerals has made Tanzania's economy more dependent on primary commodities.

Furthermore, growth in the mining sector has had little impact on employment or incomes for the poor and social conflict continues to be intense surrounding the sector. Lastly, overall environmental degradation has increased due to significant growth in mining activities.

### 3.1 Investment and Production in the Extractive Industries

Mining is currently the fastest growing sector in Tanzania. The operationalization of the new Mining Act and investment promotion measures resulted in a mining exploration boom and the establishment of four large gold mines (see Table 3.6 below).<sup>8</sup> Investment made in mineral development and exploration reached US\$ 1 billion by mid-2001 (Tanzania Investment Centre, 2002).

Table 3.1 provides a summary of mineral production trends for diamonds, gold, and gemstones from 1989 to 2000. As the table figures illustrate, all three commodities experienced significant growth throughout the period. However, gold production fell sharply from 1995 to 1999 because the Bank of Tanzania had stopped buying gold at the market value, on the pretext of lack of funds (Chachage, 2001). Moreover, starting in 1994, areas such as Bulyanhulu, Geita, Buhemba, etc. which had been previously worked by small-scale miners were being granted to foreign companies and mining by small-scale miners was banned in many of these areas (Chachage, 2001).

**Table 3.1 Mineral Production in Tanzania (1989-2000)**

Year	Diamonds (10 <sup>3</sup> carats)	Gold (kgs)	Gemstones (kgs)
1989	75.9	112.0	11,398.0
1990	84.6	1,643.0	38,700.0
1991	99.8	3,779.0	59,626.0
1992	67.3	4,525.0	48,938.0
1993	40.8	3,370.0	32,979.0
1994	17.2	2,861.4	48,938.0
1995	49.5	320.0	111,403.8
1996	126.7	318.0	142,160.0
1997	123.1	232.0	509,489.0
1998	97.8	427.0	48,518.0
1999	235.0	4,767.0	95,200.0
2000	354.4	15,060.0	150,800.0

Source: Bank of Tanzania/Ministry of Energy and Mines

As Table 3.2 below shows, mineral exports increased substantially from 1996 to 1998 (note the new Mining Act was adopted in 1997). Mineral exports have increased from a value of US\$15 million in 1990 to US\$312 million in 2001. Government revenue from the export of gold rose from virtually nothing to \$120 million between 1996 and 2000 (OED, 2002). Diamonds and gold continue to be the leading minerals, equaling 64% of total mineral exports in 1998 (Reed & Kulindwa, 2001). These figures would be higher if not for the widespread illegal trade, which takes place despite the substantial tariff reductions and attractive business environment (76% gold and 80% gems) (Reed & Kulindwa, 2001).

<sup>8</sup> Information based on an interview with Heike Mainhardt-Gibbs and staff from the Ministry of Energy and Mines, Dar es Salaam, Tanzania, July 2002.

**Table 3.2. Tanzania Exports (Million USD)**

Year	Total Exports	Mineral Exports	% of mineral exports to GDP	% of mineral exports to total exports
1980	508.0	38.9	0.9	7.7
1985	324.7	19.6	0.2	6.0
1990	402.0	27.0	0.7	6.7
1995	661.2	44.9	0.9	6.8
1996	768.0	55.9	0.9	7.3
1997	717.1	92.8	1.3	12.9
1998	676.2	103.0	1.3	15.2

Source: Ministry of Energy and Minerals, Bank of Tanzania, IMF Staff Country Report No. 98/5

With the exception of the Songo Songo Gas to Electricity project, the hydrocarbon sector has not seen any significant growth. Furthermore, petroleum products declined since the dismantling of the state petroleum company. With regards to Songo Songo, the project will deliver natural gas to a 112 MW gas turbine power generator and thereby replace diesel fuel with natural gas. Songo Songo plans to begin production sometime in 2003.

For the near future, the natural gas sector in Tanzania is poised for growth as several companies are currently planning offshore exploration. Environmentalists have stated concerns over the high value marine biodiversity in the areas of exploration.

### **3.2 General Macroeconomic Indicators**

As previously stated, the Tanzanian economy is dominated by the agriculture sector, which accounts for approximately 50 percent of GDP and 75 percent of foreign exchange earnings. Thus, the extractive industries impact on aggregate macroeconomic data is very small relative to agriculture, unlike the case of Peru where mining accounted for over 50% of exports. However, given that the mining sector is the fastest growing sector, increasing its share of GDP from 0.9 percent in 1980 and 1995 to 4.3 percent in 2000, and is targeted as the engine for economic growth, macroeconomic indicators will give some indication of the sectors' contribution to overall economic stability.

Table 3.3 provides a summary of available data on some general macroeconomic indicators for Tanzania comparing across time periods beginning with 1973 to 2001. Even though the GDP growth rate has been higher from 1997 to 2000 than it was from 1985 to 1996, according to the IMF over the decade 1991 to 2000, as a whole per capita GDP remained relatively unchanged (IMF, 2003). Furthermore, investment as a percent of GDP is below that of pre-reform years. Foreign currency deposits were continuing to grow rapidly albeit to a substantial extent on account of a few large transactions by foreign investors (GoT, 2000a).

**Trade Deficit** – The trade deficit has increased despite increase in foreign exchange earnings generated by mining and tourism (Reed & Kulindwa, 2001). Analysis shows that declining terms of trade for other exports (notably agriculture), has helped boost the overall share of earnings from mining and tourism (Reed & Kulindwa, 2001). Overall, exports in the first quarter of 2000 were almost 50% higher than over the same period in 1999, reflecting strong growth in both gold and cashew nuts (GoT, 2000a). However, the significant increase in mining exports has not been able to overcome the increases in imports.

**Table 3.3 General Macroeconomic Indicators**

	1973-78	1979-84	1985-90	1991-93	1994-96	1997-99	1999	2000	2001
<b>Real GDP Growth (%)</b>	2.3	(-) 1.0	4.0	1.7	3.1	4.0	4.7	4.9	5.9
<b>Budget Deficit (% of GDP)</b>	NA	NA	NA	5.6	3.9	4.0	2.3	5.8	4.6
<b>After grants</b>	NA	NA	NA	2.2	1.3	0.3			
<b>Investment (% GDP)</b>	33.6 (1979)	28.6 (1981)	18.7 (1985)	26.3	20.5	18.5	15.5	17.6	17.4
<b>Current Account Balance (% GDP)</b>	NA	NA	NA	NA	-15.9 (1996)	-14.4 (1998)	-15.3	-15.4	-17.4
<b>Gov. Revenue (% GDP)</b>	NA	NA	NA	NA	NA	12.6	11.3	12.2	12.2

Sources: Bank of Tanzania; IMF; Ministry of Finance, and National Bureau of Statistics in GoT, 2001; Bigsten, et. al., 1999

**Decreasing Tax Revenues & Illegal Trade** – As shown by data in Table 3.3, tax revenue levels as a percent of GDP experienced a downward trend since 1997 despite the increased tax contributions from both mining and tourism (Reed, 2001). The mining industry is generally weak on tax compliance and the government makes little effort to collect from small-scale operations. As discussed in section 2, the Tanzanian Investment Act of 1997 included tax incentives for mining and tourism, such as tax holidays. These incentives have generated tax revenue losses estimated to equal about US\$30 million a year (Reed & Kulindwa, 2001). In 2003, the IMF reports that revenue mobilization still remains weak due to the proliferation of tax exemptions (IMF, 2003).

Furthermore, Tanzania experiences a significant loss in government revenue due to widespread illegal mineral exports. The Tanzania Investment Centre has revealed that more than 90 percent of Tanzanian minerals are exported out of the country illegally (Chachage, 2001). According to the officials of the Center, Germany has been recording imports from Tanzania of minerals worth USD 300 million. However, the official GoT records show that Tanzania has been exporting only USD 10 million to Germany. In addition, figures show that the US has imported from Tanzania USD 328 million worth of tanzanite. However, the records of the Ministry of Minerals and Energy only have Tanzania exporting USD 31 million (Chachage, 2001).

In July 2001, the media was full of reports about the sinking of six containers of sand containing mineral ores, e.g. gold at Tanga Port (Chachage, 2001). Interviews for this analysis revealed that there are reports of containers being transported across the Tanzanian borders that are declared as containing only sand, when in fact they have undisclosed amounts of mineral ore such as gold. The deregulation and privatization of transportation enterprises and ports has yet to improve this situation and may have even made it more difficult for the government to track transport across its borders. Often the government does not have good data on the richness of mineral deposits and must depend on the private sector for data. Government inspectors are unable to handle the new amount of mining operations and are in need of basic equipment such as vehicles for transportation to mining sites.<sup>9</sup>

<sup>9</sup> Information obtained from interviews between Heike Mainhardt-Gibbs and staff of the Tanzanian Ministry of Energy and Mines, Dar es Salaam. July 2002.

The GoT has in recent years placed emphasis on increasing the ratio of government revenue to GDP largely through measures to broaden the tax base and strengthen the tax administration (GoT, 2000a). The issuance of sector regulations in December 1999 now require that all imports of petroleum products need to be channeled through bonded warehouses, which has begun to address the problem of large-scale tax evasion in the petroleum sector (GoT, 2000a).

In addition, upon IMF request, the petroleum products VAT exemption mentioned in the trade liberalization section above was eventually repealed in 2000, and petroleum taxes<sup>10</sup> have been consolidated into VAT and product-specific excises on a revenue-neutral basis (GoT, 2000a). Moreover, the subsidy to the TPDC that previously happened through levies on petroleum products have been eliminated, with the levies now included in the new petroleum excise tax (GoT, 2000a). The application of the VAT to petroleum products is expected to bring additional companies into the tax net (GoT, 2000a). These new tax measures appear to be somewhat working. In 2000, a slight revenue increase in the terms of GDP came mainly from the inclusion of all fees, charges, and taxes on petroleum products, plus a 5 percent increase in excise tax rates, and an increase in the Road Fund tax (GoT, 2000a).

### 3.3 Macroeconomic Vulnerabilities

**Increased Dependency on Primary Commodities** – The various measures of manufacturing value added of the Tanzanian economy provided in Table 3.5 all have decreased in the post reform decade. Such data indicate that post structural reform, Tanzania’s economy has become more dependent on primary commodities. Furthermore, additional data indicate that the manufacturing sectors share in GDP has shrunk in the last decade (OED, 2000). Both of these measures indicate that the mining sector is not providing any significant forward or backward linkages to the economy.

**Table 3.5 Tanzania – Manufacturing Value Added (MVA)**  
(at constant 1990 prices in \$US)

Indicator Year/Period	MVA per capita (US\$)	Share of MVA in GDP (%)	Real average annual growth rates of MVA (%)	Real average annual growth rates of per-capita MVA (%)
1980	18	11.6	NA	NA
1990	12	8.2	NA	NA
1997	11	7.4	NA	NA
1998	11	7.6	NA	NA
1970 – 1980	NA	NA	3.7	0.6
1980 – 1990	NA	NA	-0.7	-3.8
1990 - 1998	NA	NA	1.8	-1.2

Source: UNIDO, Country Industrial Statistics, 2003.

**Greater Vulnerability to Adverse External Shocks** – Related to the increased dependency on primary commodities is vulnerability to external shocks. Following the terrorist attacks of September 11, 2001, the economy of Tanzania experienced multiple adverse shocks. The purchase of tanzanite gemstones, over 80 percent of which is marketed in the United States, declined sharply, and prices plummeted by as much as 77 percent (GoT, 2001). According to IMF assessment, Tanzania is highly vulnerable to developments in terms of trade and other exogenous shocks (IMF, 1996). [For a discussion on the relative importance to macroeconomic stability, e.g. balance of payments, please see the Peru Case Study].

<sup>10</sup> Including the Energy Fund and other levies, but excluding import duties and the Road Fund tax.

**Energy Deficits.** Mining is an energy intensive industry. In 1997, a lack of rain in catchment areas for hydropower caused electricity shortages. In May 2000, thermal electricity generation was brought on line to help alleviate these shortages (GoT, 2000a). However, thermal power generation has created substantial demand for fuel imports. In 2000, badly needed fuel imports were at low levels due to fiscal and monetary restraints (GoT, 2000a). Electricity usage had to be rationed which negatively impacted the manufacturing sector. The expanding mining sector is a significant contributor to the rising energy demand in Tanzania. However, this situation is expected to get better with the production of natural gas from Songo Songo in 2003.

### 3.4 Production Regime Effects & Small-Scale Mining

In assessing the production regime effects of reform two primary comparisons are used: Domestic vs. foreign and large- vs. small-scale. Table 3.6 provides a summary of post reform large mining projects in Tanzania. As indicated in the Table, none of the post reform large mining projects have Tanzanian ownership.

**Table 3.6 Large Mining Projects in Tanzania**

Name of Company	Owner	Mineral	Resources/Reserves (Million ounces)	Investment (US \$ million)	Commencement Date
Golden Pride Mine	Resolute (Australia)	Gold	2.71 / 1.01	77.0	February 1998
Bulyanhulu Gold Mine	Barrick Gold Corporation (Canada)	Gold	14.5 / 10.0	280.0	July 2001
Geita Gold Mining Ltd.	Ashanti Goldfields (Ghana) & AngloGold (S. Africa)	Gold	14.0 / 7.0	400.0	August 2000
Afrika Mashariki Gold Mining Co. Ltd.	Afrika Mashariki Gold Mines Ltd. (Australia)	Gold	4.1 / 1.9	72.0	2002
East Africa Mines Ltd.	Spinifex (Australia)	Gold	1.37 / 0.91	11.2	
Merelani Mining Ltd.	AFGEM (S. Africa)	Tanzanite	N. A.	20.0	2001
Williamson Diamonds Ltd.	Debeers (S. Africa) & Tanzania Government	Diamonds	50.9 mil. carats	12.3	1940
Kabanga Nickel Project	Barrick Gold Corporation (Canada)	Nickel	21.3 mil. tonnes ore	N. A.	N. A.

Source: Tanzania Chamber of Mines, 2002

The foreign ownership trend also extends to a majority of the junior level mining companies, which are dominated by Canadian companies. Stakeholders interviewed for this analysis, including staff of the Ministry of Energy and Mines and NGOs, claim that the big foreign companies are benefiting the most from reforms. Furthermore, they claim that before reforms, when mining was conducted largely by

small-scale miners, more profits stayed inside the country. Initial data on declining government revenue levels and low levels of investment in non-mineral sectors indicates some support for these claims.

In the wake of mounting criticism, especially in the Parliament, about public firms being sold away to foreigners with no meaningful participation of Tanzanians, in 1998 the government established The Privatization Trust to promote share ownership among Tanzanians (Bigsten, *et.al.*, 1999). Unfortunately, no further information was available at the time of this analysis regarding the results of this initiative.

In addition to concerns over concentrated foreign ownership, many individuals interviewed for the analysis stated concerns over negative impacts on the small-scale and artisanal miners. In the early 1980's, the Tanzanian government legally recognized artisanal/small-scale mining (ASM) and earmarked large areas for their activities as well as encouraged foreign suppliers of mining equipment to do business with them (Lissu, 2002).

However, the economic reform program started in 1986 did not continue this government support for ASM, which is a significant income earner for the poor. Rather, the legislative changes, e.g. 1998 Mining Act and 1990 Investment Promotion Act, cultivated a favorable and protective environment that was mainly targeted at attracting large-scale mining operations (Chachage, 1993).

Back in 1976, ASM experienced a spectacular boom with the discovery of the large gold deposit at Bulyanhulu and the influx to it of workers who had been laid off in diamond mining (Bills et al, 1991). For many years after, small-scale miners had continued making new discoveries in many parts of the country, to the extent that by 1993 there were officially 1,440 small-scale claim holders and 480 prospecting certificate holders (Chachage, 2001). At a conservative estimate of 10,000 people per site, it is possible that there were over 900,000 people involved in small-scale mining and auxiliary activities in 1993 (Chachage, 2001).

However, in recent years post the 1989 Mining Act, activities of the small-scale miners have been mainly undertaken at old mine sites where known alluvial deposits existed up until the early 1970s (Chachage, 2001). Many of the large and lucrative mineral sites, such as Bulyanhulu, Geita, and Buhemba have been taken over by large foreign mining firms resulting in thousands of ASM-displaced miners [there are no reliable estimates of the net loss to ASM displacement]. In 1994, 80% of revenue came from ASM. Now, medium and large-scale operations provide more revenue in terms of percent and overall amount compared to ASM.<sup>11</sup>

However, a study by Chachage (1993) indicates that at least in one case in the early 1990's ASM had a more positive experience. In the case of the Mererani tanzanite mining village, local pit owners had organized to become Arusha Regional Miners' Association (AREMA) and had been awarded a 25 percent block. AREMA members dominated village government and used influence to win back land allocated to outsiders.

As a result, at least initially, mineral accumulation by small-scale sector operators was taking place, with the accumulation dependent upon collective organization for entry and competitive efficiency for possible expansion. Here, Chachage explains, accumulation by the small-scale sector is rooted in exploitation of the production process rather than trade. In addition, this village had experienced vast expansion of commercial activity, investment in transport, and significant expansion in neighboring agricultural villages. Please note that this case study was conducted in the early 1990's and that there are some indications that the conditions of this case may have changed.

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<sup>11</sup> Information obtained through an interview between Heike Mainhardt-Gibbs and a staff member of the Ministry of Energy and Mines, Tanzania, July 2002.

When Bank staff in the Tanzania office were questioned about the absence of support for ASM development in the Bank’s policy-lending of the early 1990s, the staff replied that the 1994 Mineral Sector Development TA was mainly geared towards fiscal policies and the operative scheme for large-scale operations. Bank staff recognized the importance of the ASM sector and stated that it remained an unfinished agenda. Although Bank staff recognized the need to address ASM development and associated poverty issues, staff appeared not to recognize any negative implications on ASM of policies that favor large-scale operations such as lack of access to mineral rights, credit/finance, and, thus, inability to compete with large foreign corporations.

### 3.6 Employment Effects

Estimates of employment in the mining sector during the 1990s vary widely. Two studies put the direct employment figure at 555,000 for 1996 and 1997 (Tan-Discovery and FEMATA). However, some estimates put it as high as 1 million. The vast majority of this direct employment is attributable to the ASM sector. In 1995, ASM contributed enormously to rural job creation overall, accounting for about 46% of total middle income jobs (Phillips et al., 2001 in Lissu, 2002).

Although the earlier phases of the structural reform program which ushered in trade liberalization contributed to the boom in small-scale and artisanal mining and thus job creation for the poor, the later reforms on investment promotion and mining policy aimed at large-scale operations undermined the labor intensive ASM sector. Thus, the overall long-term impact of the reform program has done little for the incomes of the poor as illustrated by the GoT’s analysis of mining sector growth impacts on poverty, as quoted by the IMF (2003):

“[The] government has done some good initial work...trying to trace through the linkages between sectoral growth and poverty; showing for example, that several of the ‘pacesetter’ sectors of growth – mining and tourism – are having fairly little impact on employment or incomes of the poor.”

In 2002, mining represented only 0.6 percent of the labor force (PHDR, 2002). The GoT further states that while the impact of economic reforms that began in the mid-1980s has been fairly positive on economic growth, the employment challenge has yet to be addressed adequately (GoT, 2002b).

In general, the Bank did not elect to support the development of the mineral sector for its employment opportunities for the poor. In the Bank’s 1992 Strategy for African Mining, it advised African governments against using mining as a potential source of employment creation. Table 3.7 shows the relatively low employment needs of the largest mine operations in Tanzania.

**Table 3.7 Employment in Tanzania’s Major Mines**

Mine	Number of Employees
Williamson Diamonds	900
Golden Pride	490
Geita Gold Mining	467
Bulyanhulu Gold	1,200
Afrika Mashariki Gold	250
Merelani Mining	315
<b>Total</b>	<b>3, 622</b>

Source: Tanzania Chamber of Mines, 2002

### **3.7 Poverty Effects**

The GoT states that the incidence of poverty declined during 1983-1991 and 1991-1993, and increased again during 1993-1998.<sup>12</sup> Estimates for 2000 suggest that the poverty level has increased to well over 50 percent for mainland Tanzania (GoT, 2000b). In 2001, using the basic needs measurement method,<sup>13</sup> rural poverty was estimated at 57 percent (GoT, 2002a). Furthermore, the GoT believes that the more recent deterioration in the poverty situation is probably attributable to worsening income inequality, and a relatively low rate of economic growth in the rural areas (GoT, 2000b), where much of the mining is located.

In general without mining specific poverty data, it is difficult to indicate the direct link between poverty effects and reforms that foster development in the mining sector. However, these data do indicate that a development strategy significantly concentrated in mining sector growth does not appear to have an overall positive impact on poverty reduction. Furthermore, as previously stated, a GoT analysis has shown that growth in the mining sector has had little positive impact on improving incomes or creating employment for the poor. Moreover, the World Bank (OED, 2000) reports that after almost four decades of its Tanzania strategy "...the best available estimates suggest that per capita income today is certainly no higher than it was four decades ago."

With that said, social benefits that have occurred through expansion of large-scale mining are generally in the form of improved infrastructure that may include water supply, schools, hospitals, and sometimes roads and power supplies. For example, the Songo Songo natural gas project has plans to subsidize gas supplies to surrounding communities. This will help reduce the need to collect charcoal, which has both environmental and social benefits. However, the degree to which benefits exist varies greatly from project to project as there are no specific government requirements attached to the development of these operations even though they are often located in or near established communities. Furthermore, at least one study of the mining sector (Chachage, 1993) indicates that there has been very little visible commerce expansion in local villages.

Lastly, in the course of this research no information could be found regarding EI revenue management by the government. Based on local interviews, there are no indications of government commitment to return revenue to the EI affected communities.

### **3.8 Social Antagonism Effects**

Significant social antagonism has resulted from the new foreign mining developments that have entered the country post reform. Especially since the late 1980s when many foreign companies started taking over areas which were being worked by local small scale miners, there has been much social conflict between local Tanzanian miners and new foreign mining claim holders (Chachage, 1993).

The most publicized case is the social unrest surrounding the Bulyanhulu gold operation in western Tanzania. In February 2002, a Tanzanian NGO filed a complaint with the Compliance Advisor Ombudsman (CAO) of IFC/MIGA regarding MIGA's guarantee to Bulyanhulu. The complaint alleged a lack of due diligence on the part of MIGA, inadequate compensation for land, ignored property rights, human rights abuses, and forced eviction in the area of the mine, namely thousands of artisanal miners. The CAO found weaknesses in MIGA's due diligence approach, but overall found no substantiation for the complaint. Social conflict continues to surround the Bulyanhulu case.

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<sup>12</sup> Available data indicate that the percent of population below the poverty line decreased from 64.6 percent during 1980-85 to 50.5 percent during 1990-95 (World Bank, 1997b)<sup>12</sup>.

<sup>13</sup> Unable to meet food and non-food basic requirements.

Conflicts have remained intensive and frequent throughout 1995 – 2002. Other mining areas associated with social conflict include: Arusha, Tarime District, Bukombe District, Twigg Gold Exploration Ltd., and Mererani Tanzanite mines.

### **3.10 Environmental Performance Effects**

The environmental costs to Tanzania associated with the significant expansion of the mining sector under the aegis of structural and mineral sector adjustment in the last decade have been substantial. Although there is a great lack of environmental data for Tanzania, which indicates that the Bank is not monitoring the environmental impacts, some studies do exist. For example, studies of mining operations in Mererani in Arusha, Geita in Mwanza, and Umba in Tanga indicate widespread water contamination, deforestation, loss of biodiversity and degradation of agricultural fields (Chachage, 2001). Silt, salt, oil, chemicals, and tailings are regularly dumped around mining sites large and small (Reed & Kulindwa, 2001).

The GoT highlights in its 2001 development Assistance Strategy (GoT, 2002b) that one of the major environmental problems facing the country are the negative environmental effects of mining and quarrying, including land degradation, river diversion, disturbance to wildlife and vegetation and air and water pollution. Priority interventions planned by the Strategy include environmentally sound practices for small-scale mining and the development of alternative energy sources (GoT, 2002b).

In addition, the 2001 Tanzania Poverty Reduction Strategy's environmental objective is to "enhance the ability of the poor to adapt to climatic change and protect the environment" (GoT, 2001). The support for policies and structural changes that promote investment in and expansion of petroleum and mining industries without adequate laws and institutional capacity to protect the environment undermines this poverty objective.

However, with that said, according to industry and NGOs interviewed for the analysis, the only environmental management that does take place in the mining sector is driven by World Bank social and environmental impact assessment requirements at the project level. Although, those interviewed said these impact assessments have been no more than guidelines as there is no legal backing to enforce minimal social and environmental standards. In June 2002, more than a decade after Bank- and IMF-led structural adjustment began, the GoT still had no legal framework for environmental management of the extractive industries. Draft environmental legislation was expected later in the year.

Although the Bank has made efforts to improve the environmental performance of EI in Tanzania, assistance has clearly been inadequate to handle the significant mining expansion associated with the Bank's support for policies that usher in investment to this environmentally destructive sector. Moreover, with regards to GoT poverty and development priorities, the Bank has not done enough to assist Tanzania to implement both policies and an institutional framework to develop the capacity for alternative and renewable energy sources or for the protection of the coastal mining areas, which would be especially susceptible to climate change.

## **4. Market, Policy, and Institutional Failures**

In Tanzania, the Bank and IMF-supported reform program focused on improving conditions for private sector development. Subsequently, the structural reform program reduced barriers to foreign investment in Tanzania and established a functioning commercial court. However, social and environmental

capacities have not received equal attention. As a result, many significant problems still persist such as inadequate social and environmental standards for the EI sector and illegal mineral trade.

Furthermore, in some cases reforms have created policy and institutional failures, including preferential tax treatment for the mining sector and privatization of several major mining assets without adequate government capacity to manage or regulate the growth in the sector. These failures have provided multiple opportunities for companies in the mining sector to take advantage of the weak regulatory framework through tax evasion, commercial land grabs, corruption, and rent-seeking behavior.

The following section starts by identifying market, policy, and institutional failures that were corrected through structural reform. The section follows with a more detailed discussion of failures either left uncorrected or that were created through the structural reform program in Tanzania.

#### **4.1 Corrected Failures**

Fewer Barriers for Foreign Investment - The program was successful in correcting several existing failures towards improving the investment climate. These include corrections such as: abolished monopoly on refined petroleum imports; dismantled government administered price regime resulting in significantly reduced cost-price distortions (according to the IMF and World Bank); and strengthened large-scale EI commercial land tenure and mineral rights.

Improvements in Governance – a newly established commercial court is resolving disputes expeditiously and helping to restore respect for the judiciary (GoT, 2000a).

Growth in CSOs – Although the role of World Bank assistance is unclear, it should be noted that the growth in civil society organizations (CSO) has been significant post reform program. In the mid-80s, there were approximately 200 CSOs and by mid-1997 there were approximately 8,400 CSOs registered (Bigsten, *et.al.*, 1999). Many of these CSOs have been active in lobbying for a new Land Bill (Bigsten, *et.al.*, 1999), which has important implications for mineral and social development as well as environmental protection.

#### **4.2 Persisting Failures**

##### ***Market***

Lack of domestic access to capital and credit – Tanzanian operations can not compete with the capital and credit conditions of the large foreign enterprises that came to Tanzania under investment liberalization, privatization, and the tax incentives offered by the new mining law. Credit is very expensive for local Tanzanians (~ 25% interest rate). This is especially true for small-scale and artisanal miners. The adoption of improved technology by small-scale miners is tied to their access to capital and credit. It is impossible to secure a loan from the banks for purposes of acquiring equipment on the basis of a small claim alone (Chachage, 2001). In 2000, the 12-month growth of credit to the private sector declined to 14%, the smallest growth since 1996 (GoT, 2000a).

Social and environmental costs not internalized – If left un-checked and un-regulated, the market does not automatically internalize the significant social and environmental costs associated with the extractive industries. These costs should be accounted for through appropriate fiscal regimes and regulations. This has not been done in the case of Tanzania.

Weak forward and backward linkages – Mining and hydrocarbon sector linkages with the rest of the Tanzanian economy have continued to be weak. Program reforms ushered in many large foreign

enterprises. But, this has not been coupled with a capacity of any significant degree to develop forward and backward linkages with smaller firms and other sectors of the economy, such as adding more value through the refining and fabrication of products.

### ***Policy and Institutional***

EI revenue management and distribution – As part of structural reforms, there were no government provisions or mechanism set up for the distribution of revenues from resource extraction to meet compensation of local communities, local development, or other national priorities such as job or value-added creation.

Slow progress on land reform – Land resources are essential for both mineral and social development as well as protection of the natural environment and biodiversity. However, according to the GoT, land policies and laws in Tanzania have not changed in tandem with other economic reforms (GoT, 2002b). Improvements in land tenure for individuals and local communities has lagged well behind the commercial land grab that started to take place with the initiation of privatization and mining investment promotion.

In 1995, the GoT approved a new National Land Policy<sup>14</sup> and early in 1999, GoT enacted new land laws. However, it was not until June 2001 that new land regulations were completed. In 2001, the GoT reported that there are conflicts over land use, absence of adequate and coordinated information, and inadequate human, institutional, and infrastructural capacities to manage land resources (GoT, 2002b).

Furthermore, the insecurity of claim ownership is a major problem for small-scale and artisanal miners. ASM claims are currently issued annually, and can also be taken away at any time, unlike large-scale licenses (Chachage, 2001). This situation makes it very difficult for ASM to undertake any long-term investments such as those needed for the adoption of safer and less polluting technologies. This difficulty is further compounded by ASM's absence of capital/credit.

Bank efforts to improve the situation of ASM have had insignificant impacts. Of the Bank supported extension services planned for ASM, only one of eight planned pilot projects were undertaken due to higher than anticipated costs.<sup>15</sup> The Bank TA involved the participation of local communities to discuss mineral rights of small-scale miners, but there was no long-term concrete measures or mechanism established (OED, 2002).

Lastly, there was only a limited introduction of practices to decrease adverse environmental impacts of small-scale mining. Overall, even though the Bank attempted to address some ASM issues, there should have been an integrated approach, one that considers ASM and local communities in the reforms of legal, regulatory, and fiscal frameworks that promote mining investments.

Inadequate social standards for EI – In Tanzania, local community rights are unclear. There are no mechanisms for enforcing local community rights or for arbitrating individual claims against mining operations or the private sector in general. Furthermore, the new Mining Act provided no mechanism for local community involvement regarding the establishment of mineral rights.

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<sup>14</sup> Note the analysis was unable to assess the adequacy or social equity of the new land laws and regulations.

<sup>15</sup> Information obtained through interview between Heike Mainhardt-Gibbs and staff from the Ministry of Energy and Mines, Dar es Salaam, Tanzania. July 2002.

In addition, the overall privatization process has lacked public participation.<sup>16</sup> In general, the public has been involved only to the extent that they have been the target of communication campaigns seeking to raise awareness and acceptance of the privatization program. This has been recognized as a weakness by both the Bank and other donors.

Under funding from DFID, international consultants have been recruited to help design and implement a much wider communications campaign that is seeking to inform and involve the public about the privatization program and how they can participate in or benefit from it (World Bank, 1999a). However, it is unclear to what degree these new communications efforts will actually empower local Tanzanians.

Inadequate environmental standards for EI – With regards to environmental regulations, there has also been a failure to establish clear and effective regulatory capacity or a legal framework for enforcement. As previously mentioned, the only presence of environmental management in the mining sector is driven by Bank required EIAs, which offer little more than voluntary guidelines without enforcement. Even so, EIAs do not cover the full range of social and environmental impacts from the mining sector, such as the coastal stripping taking place from the new mining operations located near the Tanzanian coasts.

Mid-sized mining companies have been known to take advantage of conflicting and vague regulations, and the uncertainties surrounding community rights (Reed, 2001). These companies have often complied with no environmental regulations and paid no reparations to local villages for contaminated water, clearing of forests or digging up of agricultural lands (Reed, 2001).

Illegal Mineral Trade – Highly porous marketing arrangements inherited from years past allowed 76% of gold and 80% of gem stones to be smuggled out of the country and marketed in neighboring countries and Thailand (Reed, 2001). Now privatized, TRA has stepped up controls along the borders and the government is working on the specification of vessels allowed to carry certain goods and strengthening of the customs administration (GoT, 2000a). However, Tanzania continues to have smuggling problems over the borders (GoT, 2000a) and with the significant expansion in mining production associated with the structural reform programs, the amount of illegal trade has also increased significantly.

Adding to the problems of border control is the fact that the GoT does not really know the value of gold deposits and must simply trust the private claim holders. Government inspectors are unable to handle the new amount of mining operations and are in need of basic equipment such as vehicles for transportation to mining sites.<sup>17</sup> Some estimate that there is currently approximately six years between inspections, which means there is virtually no monitoring of mineral extraction. A comparison of Tanzania mineral export data with mineral import data from mineral importing countries indicates that mineral trade figures provided to GoT are wrong (for details see Development Outcomes – Decreasing Tax Revenue Levels).

The World Bank states that progress on the institutional front has been affected by the fluctuating commitment from mineral authorities (OED, 2003). In many cases, Bank funding to train government workers in the mining sector has resulted in those newly trained employees scooped up by the new mining firms. One can not blame the individuals for leaving as government wages are exceptionally low. It is not clear with respect to social and environmental issues that the mineral authorities are the right agency to target in the first place.

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<sup>16</sup> In light of the findings on poverty and the impact of growth, i.e. growth in mining had little impact on income for the poor, there is now some talk between the GoT and WB/IMF regarding the need to integrate sectoral strategies with the PRSP (IMF, 2003).

<sup>17</sup> Information obtained from interviews between Heike Mainhardt-Gibbs and staff of the Tanzanian Ministry of Energy and Mines, Dar es Salaam. July 2002.

### 4.3 Reform-Created Failures

#### *Market Failures*

Signs of Dutch Disease – There are early indications of declining terms of trade for other exports, notably agriculture.

Lack of competition – In the Tanzanian mining sector, 90% of mineral trade is controlled by only five large mining houses. Small-scale and artisanal miners are typically not mobile and must accept whatever mineral price they are offered, which is often below fair value.

#### *Policy and Institutional Failures*

Preferential tax treatment of mining sector – Instead of internalizing the significant social and environmental costs associated with mining development, the long list of tax breaks given to the mining sector under the 1989 Mining Act (See Table 2.2) is providing subsidies. For example, exemptions on equipment etc. for mining exploration and development should be considered an input subsidy that provides a competitive advantage to the mining sector over other sectors (Wobst, 2001).

Privatization and Promotion of EI without establishing new government role or adequate capacity – The privatization and investment liberalization programs supported by the Bank and IMF have done a lot to reduce the role for the state in the economy, but largely without defining a new role for the government with respect to the newly created, especially foreign, private sector. Given Tanzania's socialist past, there was little history of technical or managerial capacity for private industries, such as mining. As a result, more than a decade into the structural reform program, the GoT reports that the government's capacity to deal with large-scale private projects is very limited regarding all aspects – social, environmental, and private sector demands (GoT, 2000a). Moreover, the lack of competition policies/agencies and weak government capacity to negotiate economically and socially beneficial contracts with private companies seriously constrains the development benefits of the foreign investment goals of the structural reform program.

World Bank experience in Tanzania suggests that the privatization or selling of major mineral assets without a proper regulatory framework in place can lead to economically disadvantageous agreements with many of the potential benefits to society captured by the private sector (World Bank, 1999a). Furthermore, streamlined privatization and investment liberalization processes have created an area of ambiguity with regard to who gives the go-ahead for foreign mining operations. Some investments seem to have directly entered the country by only going through the newly formed Investment Promotion Center (IPC) (Chachage, 2001), which has no social or environmental responsibilities.

The GoT reports that Technical Assistance has not been optimally used for institutional capacity building (GoT, 2002b). Phase One of the Civil Service Reform Program (1993-1999) mainly focused on re-defining the role of the state by determining the “right” size of civil service, i.e. cutting the civil workforce from 355,000 (1992) to 270,000 (1997) (GoT, 2002a). In addition, the program helped to formulate a plan for the Local Government Reform program. However, the GoT says that more was needed, specifically a “comprehensive program for effective and sustainable capacity building” (GoT, 2002b).

The World Bank's assessment of its privatization program (World Bank, 1999a) points out two main lessons learned in Tanzania: 1) the need to define a better privatization modality and roles of various institutions and agencies (line ministries, cabinet, etc.)<sup>18</sup>; and 2) the need for better communication with stakeholders (including general public) on the policies, the program and the use of the proceeds (World Bank, 1999a).

## 5. Tanzania Conclusion

Tanzania's structural reform program initiated new oil, gas, and mining laws and promoted investment in the mineral sector through significant economic incentives. As a result, the mining sector is now the fastest growing sector in Tanzania. Before the reform program, Tanzania had only one large scale mining operation now there are four new large scale mines. After an initial lag, mineral exports and earnings increased substantially. However, Tanzania's trade deficit also increased and tax revenue levels remained comparatively low. Furthermore, the Government of Tanzania found that growth in the mining sector had little impact on employment and incomes of the poor.

In general, Bank-supported reforms tended to concentrate on improving policies and institutions in favor of investors without commensurately strengthening policies and institutions for the poor and environment. While reforms corrected some failures, such as decreasing barriers to foreign investment, the program did not adequately address other significant policy and institutional failures. Three of which are highlighted here.

First, the reform program initiated the privatization of several major mineral assets prior to establishing government capacity to manage and regulate large scale operations. The government is unable to monitor mineral extraction and does not have adequate information on the value of reserves. As a result there is significant illegal mineral trade and little environmental mitigation.

Second, in the name of mining investment promotion, the GOT offers significant economic incentives. These incentives equal preferential tax treatment for the mining sector and have been partly to blame for relatively low levels of tax revenue in Tanzania. Furthermore, less tax revenue means there is less for social spending needs.

Third, structural reforms aimed at promoting large scale mining operations have left the small-scale and artisanal miners at a disadvantage. The Bank somewhat recognized the plight of the small-scale miner in Tanzania and provided technical assistance as a way to address the problem. However, the Bank's assistance fell well short of its intended activities and the small-scale miners continue to struggle.

Overall, by promoting EI before establishing a functioning government and adequate environmental and social standards, companies in the mining sector take advantage of the weak regulatory framework through tax evasion, commercial land grabs, corruption, and rent-seeking behavior.

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<sup>18</sup> Elsewhere in the report, the Bank states that all of the line ministries have had a strong say in the divestiture strategy for the firms that fall within their ministries and each ministry has at least one member on the Divestiture Task Team for each of its enterprises (World Bank, 1999a). In addition, the relevant ministries have all been included in discussions of regulatory arrangements (World Bank, 1999a). However, there is no indication that an environmental ministry, if one exists, has been involved.

# Indonesia

## 1. Country Context

From the 1970's through most of the 1990's, the "New Order" regime of ex-president Soeharto utilized Indonesia's vast natural resources, primarily oil, minerals, and timber, as the engines for rapid economic development. Over this 30-year period, real economic growth averaged 7 percent per annum ushering the way for Indonesia to join the ranks of the lower-middle income countries (World Bank, 1998). In addition to abundant natural resources, Indonesia's economic development during this period largely depended upon a heavy-handed military apparatus, authoritarian politics, and a depoliticized peasantry and urban workforce (GoI, 2003).

In 1997, the golden years of economic growth came to an abrupt end with Indonesia experiencing the hardest fall of countries hit by the East Asian financial crisis. Indonesia witnessed private capital outflow on the order of US\$ 10 billion or about 6 percent of GDP (GoI, 2003). New foreign Investment in Indonesia halted. The financial crisis also brought with it significant increases in poverty and environmental degradation. Poverty increased from 11 percent in 1996 (World Bank, 1998) to close to 60 percent in 2002<sup>19</sup> (GoI, 2003).

Amidst political, economic, and security concerns, investment in the mining and hydrocarbon sectors continued to fall, even in 2001. For example, new mining capital invested in 2001 was only US\$ 7 million compared to \$200 million spent on exploration in 1997 (Guerin, 2003). Even so, both the mining and hydrocarbon sectors remained highly significant to Indonesia's economy. In 2000, Indonesia's hydrocarbon sector generated about US\$ 5.5 billion per annum, which represents 27% of total government revenue and 5% of GDP (World Bank, 2000a).<sup>20</sup> In 2002, the mining sector contributed approximately 11% of export earnings (Policy Review Task Force, 2002).

While the Peru and Tanzania cases reviewed the effects of a decade of World Bank/IMF structural adjustment, the Indonesia case looks at Bank/IMF engagement from 1998 to 2002, i.e., following the onset of the 1997 economic crisis. This short amount of time since reforms began, limits the ability of this analysis to determine or quantify actual effects. Thus, much of the Indonesia case focuses on identifying market, policy, and institutional dynamics surrounding or inherent in the reform program. The Indonesia case study provides an important example of how the expansion of EI occurs in the context of a financial crisis and with significant political and institutional change, notably decentralization.

## 2. World Bank and IMF Engagement in Indonesia

As Indonesia struggled to overcome the financial crisis, it agreed to a reform program with the IMF backed by a US\$ 46 billion, multi-year bailout package funded by the IMF, World Bank, Asian Development Bank and bilateral donors. This multi-institution reform program had two main phases. The first emphasized financial sector reforms and the second focused on wider structural reforms to the economy.

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<sup>19</sup> Based on people living on less than US\$ 2 a day.

<sup>20</sup> In 2000, Indonesia's hydrocarbon sector produced about 500 million barrels of crude oil and condensate and 3 trillion cubic feet (tcf) of natural gas, both for domestic consumption and export (World Bank, 2000a).

World Bank structural adjustment lending to Indonesia soared after the financial crisis from essentially none to US\$ 2.4 billion for loans approved in 1998 and 1999 alone.<sup>21</sup> The overriding objective of Bank adjustment lending was to rebuild investor confidence in Indonesia and rapidly restore poverty-reducing economic growth while shielding the poor<sup>22</sup> (World Bank, 1998).

In terms of investment lending, direct participation of the World Bank in extractive industries in Indonesia has been relatively small, but its role as a policy advisor and a standard reference used by foreign investors in the country cannot be underestimated. In its advisory role, backed by a hefty bailout package, the Bank advised the Government of Indonesia (GOI) to make changes to the mining and oil & gas laws in order to revive investment in these sectors.

Bank recommended changes to the EI laws must be understood in the context of the other significant structural reform processes taking place at the same time, mainly fiscal and administrative decentralization, trade and investment liberalization, and privatization. The rest of this section discusses these structural reform processes supported by the Bank and IMF programs.

## 2.1 Decentralization

Although Bank and IMF lending programs both encourage and assist decentralization, the process is widely considered to stem from an Indonesian homegrown plan driven by regional demands for more autonomy. Starting in January 2001, Indonesia took a “big bang” approach to decentralization, which neither the Bank nor IMF encouraged.

Bank technical assistance to the decentralization process has been provided for the development of the two main legislative reforms (World Bank, 1998): administrative decentralization law No. 22/1999, which grants more autonomy to local administrations, and fiscal decentralization law No. 25/1999<sup>23</sup>, which provides a larger proportion of revenue to the provinces and regencies. Under these laws, a vast majority of government functions have been devolved to the regions, including greater control over mineral resources<sup>24</sup> and land administration.<sup>25</sup> In addition, two million civil servants were reassigned from central government to regional governments (World Bank, 2002b).

The fiscal decentralization framework specifies principles for sharing natural resource-based government revenue, notably the regional authorities will now receive the following distribution in the extractive industries: 15% of onshore oil non-tax revenue, 30% of gas onshore non-tax revenue, 80% of mining non-tax revenue, and 80% of forestry non-tax revenue (GOI, 2000a). In addition, the General Allocation to regional authorities is mandated to be at least 25% of total domestic revenue.<sup>26</sup>

Other decentralization activities supported by the Bank and IMF, include:

- Development of anti-corruption laws;

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<sup>21</sup> Mainly including Policy Reform Support Loan Project I & II (\$ 1.5 billion), Social Safety Net Adjustment Loan Project (\$ 600 million), and Water Resources Sector Adjustment Loan Project (\$ 300 million).

<sup>22</sup> Including subsidies to shield the poor and special initiatives to sustain education and health services to the poor.

<sup>23</sup> Bank program documentation specifies that the fiscal decentralization law must be acceptable to the Bank (World Bank, 2002b).

<sup>24</sup> The new mining law still being deliberated by Congress (or DPR) has measures for the Central Government to retain certain elements of control, i.e., GoI responsible for contract negotiation and contract content while regions have approval authority.

<sup>25</sup> Responsibilities such as the printing of currency, foreign affairs, justice department, and religion remain under the central government (Hollenbeck, 2003).

<sup>26</sup> The newly created grants administration is charged with ensuring fiscal transfers to the regions – supposedly ensuring equity based on regions’ revenue capacity and spending needs (GoI, 2000a).

- Clear and transparent framework for public procurement and project bidding;
- Transparency and efficiency of budget, including a Public Expenditure Review by the Bank and IMF;
- Audit<sup>27</sup> of Pertamina (state oil, gas, and geothermal company), PLN (state electricity company), and the Reforestation Fund; and
- Uninterrupted public service delivery.

It should be noted that the Bank has devoted considerable resources to ensuring uninterrupted public service delivery. As would be expected, the IMF's primary involvement has been on budget allocation issues, including Public Expenditure Reviews and a program benchmark for fiscal decentralization by June 2001 (GoI, 2000a). Bilateral donors are also involved in assisting Indonesia with decentralization. For example, GTZ heads a donor working group on decentralization, which also includes the Bank.

## 2.2 Hydrocarbon Sector Reform

Based on Indonesia's proven and potential oil reserves, the World Bank estimates that if domestic consumption increases only by about 5% per year, the country will need to import all of its oil by 2008, at an estimated cost of US\$ 11 billion a year (World Bank, 2000a). Thus, the Bank says energy diversification is a central part of the energy strategy for maintaining economic growth in Indonesia.

The Bank believes that the two biggest problems in both the oil and natural gas sectors in Indonesia is the pricing policy and the role and functions of Pertamina, the State oil, gas, and geothermal company. With regards to the pricing policy, the Bank estimates that the amount of economic subsidy, including direct electricity subsidies, that results from the government controlled fuel pricing system for oil and gas in Indonesia is about 5% of GDP and represents over 25% of the Government's expenditures (World Bank, 2000a). Furthermore, the Bank points out that unlike rice, fuel accounts for a very low share of spending by the poor (World Bank, 2000b). Thus, the fuel subsidies paid by the GOI go largely to the upper and middle class consumers. In order to fix the pricing policy and to restructure Pertamina, the Bank called on the GOI to adopt a new oil and gas law.<sup>28</sup>

In response to this Bank recommendation, the GOI attempted to pass a new law in 1998, but failed amidst strong public resistance over attempts to increase prices of major petroleum products. In 2002, the GOI's second attempt resulted in passing a new oil and gas law. As part of providing input to the new law, the Bank's advisory activities for Indonesia included an Oil and Gas Sector Study (2000) that focused on a new pricing system to reduce fuel subsidies.<sup>29</sup> In general, the Bank study recommended that the new Oil and Gas Law should be designed to:

- Attract increased private investment in exploration and production activities;
- Promote accelerated domestic use of natural gas in place of liquid fuels;
- Improve efficiency of petroleum refining and transportation operations;
- Promote a more reliable supply of "cleaner fuels",<sup>30</sup> and
- Ensure that domestic product prices reflect international market levels.

Table 2.1 provides specific reforms advanced by the World Bank and reported GOI progress to date.

<sup>27</sup> An efficiency and forensic audit by international auditors.

<sup>28</sup> ADB and JBIC also have lending operations related to the gas sector.

<sup>29</sup> In addition, in June 2002, the IFC organized a Private Sector Forum for Indonesia at which the private sector representatives suggested that one of the key issues to improving Indonesia's investment climate was near-term improvements to specific policy and regulatory issues, including oil and gas sector reforms (World Bank, 2002b).

<sup>30</sup> Mainly through decreased use of unleaded gasoline and reducing subsidies on oil and gas.

**Table 2.1 World Bank Indonesia Program Benchmarks for Oil and Gas**

<b>World Bank Program Benchmarks<sup>31</sup></b>	<b>GOI Actions</b>
Deregulate oil and gas sector  Establish new oil and gas regulatory bodies	New oil and gas law passed (2002)  New law provided for the establishment of an agency to allocate acreage and supervise exploration and production contracts and for an independent agency to regulate monopoly elements of downstream businesses (GoI, 2000a).
<u>Fuel Pricing Reforms</u> Increase the average administered prices for fuel and power by 38 and 20 percent respectively, with the poor exempt from power tariff increases <sup>32</sup>  Increase power tariff for large residential consumers  Increase aviation fuel prices to international market levels	Fuel subsidies have been reduced and fuel pricing system changed (2002)  No progress indicated  Price controls on aviation fuels lifted (World Bank, 2000a)
<u>Restructuring of Pertamina</u> Regulations for the transition to a new industry structure in which Pertamina will be transformed into one or more normal state enterprises  Establish effective competition in fuel supply  Design regulations for key infrastructure to ensure non-discriminatory open access	No progress indicated  Refinery subsector opened to private participation and liberalization of the market for lubricants (World Bank, 2000a)  No progress indicated
<u>Environment</u> Establish an Inter-Agency Committee to develop and oversee the implementation of a short term action plan for reducing air pollution from petroleum fuels. Eliminate the use of lead in gasoline.	No progress indicated

Sources: World Bank Indonesia CAS Policy Matrix September 2002 (World Bank, 2002a) and April 1999 (World Bank, 1999b).

In addition to the reforms listed in Table 2.1, the GOI letter of intent to the IMF lending program in 2000 also included the establishment of a coherent and sound policy framework for promoting efficient and environmentally sustainable patterns of domestic energy use (GoI, 2000a).

Recently the GOI has made changes to its Production Sharing Contract (PSC). In 2003, as part of hydrocarbon sector investment promotion encouraged by the Bank, the Ministry of Energy and Mineral Resources has increased the foreign partner revenue share in the country's PSC from 15 percent to 20-25 percent for oil and from 30 percent to 40-45 percent for gas (MiningIndo News Service, 2003c). However, the GOI indicated that these changes are not necessarily permanent and may only apply to eleven newly offered hydrocarbon concessions.

<sup>31</sup> World Bank Indonesia CAS Policy Matrix September 2002 (World Bank, 2002a) and April 1999 (World Bank, 1999b).

<sup>32</sup> Low income households were also supposed to be protected from the hike in fuel prices by a targeted subsidy scheme to be developed in close consultation with the Bank.

It is interesting to note that back in 2000, the GoI's stated objectives for the hydrocarbon sector included (World Bank, 2000a): meet the domestic market demand for oil and gas, as well as to provide fuel for Indonesia's economic growth; maximize the generation of revenue for the county; ensure security of supply; and develop national capabilities in the sector. In addition, policy objectives included: efficiency and reliability; transparency and competition; minimization of the use of public funds (e.g. phasing-out of subsidies); and environmental soundness.

According to available information, there is no indication of progress on the GOI objectives of national capabilities in the sectors or on environmental soundness. With regards to domestic private sector capabilities, it is unclear whether specific reforms to address this priority have been included in either the Bank or IMF reform programs.

## **2.3 Mining Sector Reform**

As in the oil and gas sector, the World Bank has implemented a short-term assistance program to advise Indonesia on the drafting of a new Mining Law and in the preparation of associated regulations. As of April 2003, the new mining law was still being deliberated in the House of Representatives (DPR). Thus, at the time of this analysis, it was too early in the process to determine the effects or the actual measures of the new Mining Law.

However, there is one particularly controversial measure that the World Bank has promoted during the drafting period, and which the GoI has since already begun initial implementation. This Bank recommendation involves the removal of impediments to new mining projects by relaxing restrictions on mineral exploration and extraction in officially protected forests and small islands. The Bank states that it has encouraged such a measure because "the prohibited areas include a number of potentially rich mining prospects" (World Bank, 2001b).<sup>33</sup> The implications and initial effects of this recommendation are discussed in the following two sections.

In addition, several other recommendations have been put forward by a Policy Review Task Force that was created to: 1) develop a common understanding of the necessary policy and conceptual framework of a new Mining Law, and 2) draft the necessary policy and regulations to implement mineral resource development for consideration by the Indonesian Legislature by June 2003. The partners involved in this drafting initiative included the World Bank, the governments of Indonesia, Canada, USA, and Australia, the Indonesian Mining Association, the International Business Chamber, and the Colorado School of Mines. Agencies involved from the GOI included the Ministries of Energy & Mineral Resources, Ministry of Finance, Ministry of Trade, Ministry of Forestry, Investment Coordinating Board, Coordinating Ministry of Economy, and National Parliament. There was no indication of participation by civil society groups.<sup>34</sup>

Recommendations from this Task Force included some of the following (Policy Review Task Force, 2002):

- With regards to fiscal policy, the "overall effective tax rate" on existing contracts is in excess of 60 percent (PWC, 2001). The Task Force suggested that this overall rate should be "between 36 to 45 percent to bring Indonesia in line with the more progressive nations to promote mineral development." Legislation should put a cap on the maximum tax rate or another option could be a tax stabilization

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<sup>33</sup> World Bank, 2001b. Indonesia: The Imperative for Reform. Report No. 23093-IND. Section: Revitalizing Mining. November 2001.

<sup>34</sup> Although it should be pointed out that back in October 2001, the Bank held a two-day international workshop on policy priorities for the Indonesian mining sector, which included the GoI, companies, and civil society representatives.

agreement between the investor and the government. Furthermore, the Task Force recommended exemption from import duties and import VAT on all mining equipment and consumables (spare parts and supplies).

- With regards to concession area size, the Task Force concluded that the area should be governed by the financial capability of the company and commitment to active exploration of an area. On mine closures, it recommended reserve accounting, reclamation guarantees, and other forms of “best practices” be included in the new law. In addition, the new law should require community development elements and a transparent and accountable revenue sharing process should be established.

- With regards to the decentralization process, the new mining law will also determine a new framework of responsibilities between the regional governments and the central government. The Task Force (2002) recommended that the central government should be responsible for the general licensing of mining companies and that the regional governments be in charge of planning concession areas. Furthermore, it has been indicated that the law will do away with the current contract of work (COW) system that requires presidential signature. The new agreement system will be subject only to approval from local authorities, but the central government will still draft the contents of contracts with foreign mining firms.

In addition to recommendations on the new mining law, prior to the crisis, the Bank financed a three-year (1996-1998) Technical Assistance Mining Environmental Project that provided assistance on environmental performance of large-scale and medium-scale mines. Objectives included policy development, organizational improvement, institutional capacity building, and improvements to review procedures for environmental impact assessments (EIA). Information regarding specific project measures as well as the appraisal of project implementation and results was unavailable.

## **2.4 Additional Structural Reforms**

Other structural reforms that augment initiatives to increase investment in the EI sectors include trade and investment liberalization, privatization, and corporate restructuring. These reform programs are outlined below.

### ***Trade Liberalization***

Trade liberalization measures under the reform program consisted mainly of the following (GoI, 2000a):

- Bank of Indonesia to sustain and guarantee trade finance.
- Deregulate domestic trade to reduce costs and increase efficiency:
  - Ensure freedom for traders to buy, sell, and transfer all commodities across district and provincial boundaries.
  - Prohibit provincial government or district government from charging export taxes (retribusi).
- Rationalize policies governing tax holidays and free trade zones to keep the tax system from being used to promote or discourage specific sectors.
- Replace all export taxes and levies by resource rent taxes, specifically for the extractive industries:
  - Reduce maximum export tax on minerals to 15% by end-December 1999.
  - Replace quantitative export controls on crude oil with an export tax of 60% ad-valorem or less, eventually reduce to 10% by Dec. 31, 2000.

- Create an Indonesian export credit agency – Bank Export Indonesia (BEI) will be created as an independent Export Credit Agency with the aim of expanding access to trade finance (GoI, 2000a).<sup>35</sup>

Please note that the trade liberalization measures were largely committed to under the IMF country program.

### ***Investment Liberalization***

Investment liberalization measures under the reform program consisted mainly of the following:

- Streamline business licensing and regulations;
- Review domestic provincial and local government regulations and licensing restrictions;
- Continue to streamline business licensing and regulations based on the findings of the above review;
- Reduce the number of activities reserved for domestic investors; and
- Reduce the number of activities reserved for small-scale enterprises and reduce the number of activities reserved for large-scale activities in partnership with small-scale enterprises.<sup>36</sup>

### ***Privatization and Corporate Restructuring***

The privatization and corporate restructuring initiative largely comprised of the following measures:

- Restructure and partially privatize state owned enterprises (for measures specific to Pertamina, see Hydrocarbon Sector Reform above);
- Facilitate corporate restructuring through a newly created Jakarta Initiative Task Force (JITF), *inter alia*, to assess the effect of restrictions on property ownership for corporate restructuring (World Bank, 1999a);
- Create a one-stop shop for accelerated regulatory approval of restructurings – this took the form of the Regulatory Facilitation Group within JITF (GoI, 2000a); and
- Develop an Action Plan satisfactory to the Bank on inter-institution cooperation on corporate restructuring.

Under the IMF Indonesia country program, reform and privatization of state owned enterprises is aimed at reducing public debt (GoI, 2000a).

As an indication of continued Bank assistance relevant to the extractive industries, Table 2.2 provides a list of the selected planned Bank policy-lending activities for fiscal year 2003.

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<sup>35</sup> March 2000 government was to present the Law on Bank Export Indonesia (BEI) to Parliament.

<sup>36</sup> The GoI (2000a) found that many current small-scale and medium enterprise (SME) programs have failed to meet the needs of the SME community. As of June 2000, Bank Indonesia announced that it planned to phase out mandatory requirements on commercial bank lending to SMEs (GoI, 2000a). However, it is not clear what, if any, SME initiative will replace the abolished SME requirements.

**Table 2.2 Selected World Bank Technical Assistance for FY03 in Indonesia**

<b>General Policy Area</b>	<b>Specific Assistance</b>
Financial and Private Sectors	Policy advice and TA on corporate restructuring, corporate governance, SME development, & mining sector regulation
Infrastructure	Policy advice and TA on oil and natural gas deregulation
Decentralization	Policy advice and TA on health and environmental management
Natural Resource Management	Policy advice and TA on land policy and forest policy strategy
Empowering and Investing in the Poor	TA for GoI poverty strategy preparation, rice policy advice, report on education sector, rural services for the poor, and assessments of poverty

Source: World Bank, 2002b

### 3. Development Outcomes

Despite the early stage of reform implementation, initial information available at the time of this analysis in mid-2003 offered a handful of early indications of structural reform impacts. To begin with, it is likely that there will be an increase in oil and gas investments. Price effects from reducing fuel subsidies stand to raise production costs across the economy and slightly lower overall output. Meanwhile, social antagonism has continued to accelerate surrounding the EI sectors and Bank supported reforms affecting the mining sector are linked to increased loss of protected forests.

#### 3.1 Investment and Production in the Extractive Industries

Even though the new oil and gas laws were only adopted in 2002, there are already signs that the new law as well as restructuring of the sector may lead to some increases in investment and production in the oil and gas sectors. As a result of GoI promotion efforts and increases to foreign revenue sharing in the Production Sharing Contract, 17 companies have put in bids for 11 newly offered oil and gas blocks in Indonesia. The government expects these new investments to increase total investment in the oil and gas sectors to US\$ 6 billion in 2003 up from US\$ 3.42 billion in 2002 (MiningIndo News Service, 2003c).

In terms of the mining sector, impacts on investment and production are unclear for many reasons. Many of the large-scale operations that have recently begun production were planned before the crisis and thus, are not associated with reforms. Furthermore, sector investors seem to be waiting for the new mining law to be finalized before making significant investment decisions. Employment in the mining sector also does not indicate any significant changes thus far. In the last five years the number of people employed directly by the mining sector has remained relatively constant at 33, 000 employees (PwC, 2002).

On the privatization front, in 2000, two out of ten state firms prepared for privatization were mining firms: PT Tamban Batuara Bukit Asam (coal mining) and PT Aneka Tambang (*Jakarta Post*, 2000a). In addition, another state mining firm, PT Tambang Timah, was put on a stand-by list to be privatized. As of October 2003, according to the stock listings for Tamban Batubara Bukit Asam and Aneka Tambang, the two firms had not yet been privatized.<sup>37</sup>

With regards to production data, the implementation of structural reforms is only in the initial stages and, thus, available data do not yet indicate reform related effects. This is also true for the general

<sup>37</sup> Tamban Batubara Bukit Asam – GOI 84% shareholder and Aneka Tambang – GOI 65% shareholder.

macroeconomic data and overall poverty statistics, thus these data are not discussed for the Indonesia case. However, with regards to price, social unrest, and environmental effects, there are already some initial results as discussed below.

### 3.2 Price Effects

A 2003 IMF study (Clements, et. al.) assessed the impact of higher petroleum prices, as called for under the reform program, on the aggregate price level, real growth, and income distribution through the use of a computable general equilibrium (CGE) model. The model predicts that a reduction in government subsidies raises petroleum prices and production costs throughout the economy. Consumer demand, production, and incomes will decline as output prices increase and consumer purchasing power decreases. The simulated results for Indonesia predicted a slight increase in price levels and a slight decrease in output levels. Furthermore, the study predicts that urban households will be the most affected in Indonesia by a subsidy reduction.

### 3.3 Social Antagonism Effects

Examples of social conflict in the extractive industries that have taken place since 1998, include:

Conflicts surrounding the Mining Sector – The MMSD study (2002) found that land problems associated with mining have been escalating in complexity for the last three years and have been a prime source of conflict in rural areas. Specific problems include: repressive local authorities, inadequate compensation assessments, and the loss of cultural values associated with the loss of land. Unless solutions acceptable to local communities are found, it is predicted that the land disputes will only escalate (MMSD, 2002). Social conflict has affected mining investment in Indonesia. Foreign companies have frozen or abandoned mining investments worth \$2 billion since 1998 stating that disruptive activism at mine sites and a weak policy framework led to the withdraw of their investments (Guerin, 2003).

Increased Fuel Prices – In 1998 and in January 2002, social unrest around the country took place to protest the government's decision to raise fuel prices by 22% as part of an IMF loan package aimed at weaning the economy away from costly subsidies. These dates correlate to the two times the GOI proposed the new oil and gas law. In response to protests, the government had to delay selected fuel and electricity price increases both times. All along, the World Bank has been concerned about the effects on poverty and social unrest and has encouraged a phasing in approach and protection for the poor. It is unclear to what degree the eventual price increases have followed the Bank suggested plan.

Caltex Oil Production – Since 1998, Caltex<sup>38</sup>, Indonesia's largest oil producer responsible for 80 percent of production, has experienced a series of protests and vandalism, including fires and blockades (*Jakarta Post*, 2000b). The protests are mainly to do with local farmers demanding higher compensation for land acquired by the company during Soeharto's era. Protests in 2000 cost the company hundreds of thousands of US\$ in damage as well as significant losses in oil production (*Jakarta Post*, 2000b).

Decentralization and the Creation of New Regencies – The number of regencies in Indonesia has increased by 25 percent since decentralization.<sup>39</sup> Some of these new regencies have been created in connection to large EI operations (e.g., Freeport and BP in Papua). The creation of a new regency that encompasses a large EI operation has several effects. To begin with, the newly created regency will be wealthier than its surrounding regencies. For example, of the 80 percent of mining revenue now allocated

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<sup>38</sup> Caltex is a joint venture between US oil companies Chevron Corp. and Texaco Inc.

<sup>39</sup>Figure obtained from interview between Heike Mainhardt-Gibbs and Indonesia-based World Bank staff, April 2003.

to regional governments, 16 percent goes to the province, 32 percent goes to the producing regency, and 16 percent goes to each of two surrounding non-producing regencies. Staff of the Ministry of Mining and Energy (MME) state that the creation of new regencies is often driven by companies and creates conflicts between the new resource rich regency and surrounding regencies. In addition, social conflict is associated with significant migration to the new, richer regency. The central government has the authority to grant the creation of new regencies.

### **3.4 Environmental Effects**

The new mining law that opens protected forests to mining operations coupled with new pressures from decentralization has resulted in increased loss of natural forest and biodiversity as well as an increase in environmental degradation associated with mining operations in Indonesia.<sup>40</sup>

Promoting Mining in Protected Forests – If the current rate of deforestation is not arrested<sup>41</sup>, it is estimated that the Indonesian forests will be significantly diminished in less than 10 years (FLB, 1999). The office of the state minister of environment reports that deforestation is mainly caused by illegal logging, forest fires and mining activities. The World Bank recommendation to remove impediments to mining operations in protected forests puts further pressure on Indonesia's dwindling natural forests.

According to data gathered by the Indonesian Department of Forestry in 2001, there are at least 19 mining companies with a total of over 200,000 ha currently operating in protected forest areas. Another 180 mining companies hold licenses for exploration and exploitation in locations overlapping forested areas. The Department of Energy and Mineral Resources (DEMR) proposes to allow 50 companies with current licenses to proceed with exploration and development operations in areas designated as protected forest (MiningIndo News Service, 2002b).<sup>42</sup> In November 2002, the Ministry of Energy and Mineral Resource and the Ministry of Forestry had not been able to reach an agreement on how to proceed with a change of status and function of protected forests, which would allow mining operations to proceed and circumvent the Forestry Law (MiningIndo News Service, 2002b).

Decentralization and Increased Pressure on Natural Resources – With the implementation of the regional autonomy and fiscal decentralization, the regions have both an increased need to be self-supporting as well as an increased incentive to exploit extractive industries based on the revenue sharing framework for natural resources. An IMF background paper on tax assignment options for Indonesia (Ahmad and Krelove, 1999) explains that “assigning forestry revenues [and other natural resource based revenues] to regional levels [as in the new law on fiscal decentralization] introduces incentives to utilize the resources more intensively.” The IMF goes on to say that these effects need to be carefully modeled, although the IMF did not attempt to address the issue.

Two examples that the local governments are using their natural resources more intensively at the cost of environmentally sensitive locations include: 1) coal discoveries in East Kalimantan have initiated the redrawing of boundaries for Kutai National Park so that coal deposits could be developed by Kaltim Prima Coal (World Bank, 2001a); and 2). In 2000, the provincial-level forestry service of South Sulawesi

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<sup>40</sup> The current environmental mining trends range from disturbance to land and ecosystems, poorly mitigated long-term risks due to acid rock drainage and mercury contamination, large amounts of solid waste, and water quality impairment, to complete lack of government oversight of the mushrooming medium to artisanal-scale coal and gold mining activities.

<sup>41</sup> Over 1.3 million hectares per year (FAO, 2001).

<sup>42</sup> The MiningIndo News Service (2002b) claims that much of the current protected forest status was newly reclassified land as a result of the implementation of the new Forestry Law. However, Indonesian NGOs state that this claim is simply not true, that there were not new protected areas established under the new Forestry Law. The conflicts stem from the fact that mining concessions were granted by the government without coordinating with the Ministry of Forestry responsible for protected areas.

granted 14 mining exploitation permits in a geologically unique area that has protected forest status (World Bank, 2001a).

## **4. Market, Policy, and Institutional Failures**

Indonesia illustrates the challenges of unleashing market forces and broad-based structural reforms that often have immediate social and environmental impacts while the necessary mitigation responses require long-term institutional development. Of particular concern in Indonesia is the fast pace of decentralization coupled with the promotion of EI development. Other significant issues include military involvement in EI, a lack of meaningful local community participation, inadequate environmental management, and conflicting forest and mining priorities of the Bank.

The following section starts by identifying market, policy, and institutional failures that were corrected through structural reform followed by a more detailed discussion of failures either left uncorrected or that were created through the structural reform program in Indonesia.

### **4.1 Corrected Failures**

Corrected failures associated with the reform program as it relates to the extractive industries include:

#### ***Market***

Reduction in hydrocarbon fuel subsidies – The GOI has implemented reductions to both oil and gas fuel subsidies and in doing so brought these prices closer to international market prices. Government revenue savings associated with these subsidy reductions could potentially be used for social spending. However, some of the government revenue has been transferred to private investors (see discussion below).

Reduced state monopoly control in oil and gas sector – The refinery sub-sector has been opened for private participation.

#### ***Policy and Institutional***

Progress in streamlining the investment approval process – New agencies have been created to facilitate a faster approval process for new investments, mainly the Jakarta Initiative Task Force and the Regulatory Facilitation Group.

Environmental Law – Water pollution control regulation has been issued as part of a World Bank program benchmark (2002b) calling for the implementation of regulations for the Environmental Law. Furthermore, new clean fuel specifications are soon to be issued reducing the allowable content of lead in gasoline.

## 4.2 Persisting Failures

### *Policy and Institutional*

Military Involvement in Extractive Industries – Neither the World Bank nor the IMF loan programs have included benchmarks or assistance towards the phasing out of military involvement in the extractive industries despite other policy and institutional reforms aimed at expanding production in these sectors. Only 25 percent of the military’s operational budget is covered by the Indonesian government. Thus, the military must raise the remaining 75 percent of its budget through other means. The Bank reports that off-budget financing of the military and police has created opportunities for corruption and illegal activities (World Bank, 2002b).

Indonesia has a history of military corruption and human rights abuses both directly and indirectly linked to the military’s involvement in extractive industry operations. Many extractive industry companies pay fees to the military for “security”. For example, in West Papua, the US-based Freeport mine (largest gold mine in the world) represents a major source of income for the military. Since 1996, Freeport has paid fees to military and police forces of US\$ 34.8 million (Institute for Human Rights Study and Advocacy, 2002). The New York Times reported that both Freeport and the military admitted to payments of US\$4.7 million and US\$5.6 million for 2001 and 2002 respectively. Unfortunately, in guarding the resource companies in Papua, there are many accounts of troops and police committing murders and other human rights abuses against local communities (O’Sullivan, 2002).

Bank and IMF programs have put emphasis on transparency measures to try and address some of the military issues. However, it is too early to determine progress.

EI concession contracts awarded under corrupt government – Under the call for improved governance, the Bank and IMF push the GoI to uphold commercial contracts, including some in protected forests. However, many of these contracts in the EI sectors as well as other sectors were signed during the Soeharto regime under conditions that are considered by many to violate local community rights. For example, the PT Kelian Equatorial Mining (Rio Tinto) gold mine was forced to cease operations for over 4 weeks in May 2000 due to community blockades. The community claims that the military had forced them to move from the mine operation areas in 1990 and they were thus compelled to accept payments for less than the land’s actual value (World Bank, 2001a). Indonesian civil society organizations interviewed for the analysis say that the public did their part by ousting Soeharto and that they would like to see the Bank support this improvement in democracy by not supporting extractive industry contracts that are linked to corruption from the Soeharto era.

Lack of institutional capacity for local development – Weak government institutions have little or no capacity to manage local community development surrounding EI operations. Thus, this responsibility often falls on the EI private sector, mainly large foreign corporations. While participation of the private sector is important, private companies should not be in charge of wider development programs. Interviews at some of the community development projects sponsored and carried out by large foreign EI companies in Indonesia revealed that when social problems came up, companies tended to throw money at problems<sup>43</sup> rather than work out a meaningful long-term solution. Industry in all three country case studies has indicated that building capacity for and giving development responsibility to local government agencies is one of the most important areas needing assistance – both for environmental responsibilities and local community development.

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<sup>43</sup> For example, give motorcycles to the displaced farmers who were not provided employment at the mine.

Lack of Meaningful Local Participation – There are reports in Indonesia of communities that have been unaware that the government has given away their land for EI development. Even in cases where some form of public consultation has taken place, this often has not translated into meaningful participation in development decisions. Currently, the Bank’s advice on mining and hydrocarbon legal reform emphasizes securing commercial land tenure and mineral rights. However, the new mining and oil and gas codes do not incorporate the principals Prior Informed Consent for EI development. According to Bank assessment (World Bank, 2002b), local communities continue to be ignored as development partners.

Poor governance<sup>44</sup> – Indonesia is widely considered to be one of the most corrupt countries in the region. The Bank (2002b) states that there is a lack of an overall strategy on governance and no champion within the government to lead governance reforms. The Bank has assisted in the development of a governance and anti-corruption strategy. However, there is no political will to take it forward. Improvements to governance in the EI sectors is sorely needed. The Bank has found that mining concessions establish patron relations at both the central and more local government levels (OED, 1999). Although decentralization has been widely implemented, significant conflict over autonomy issues in provinces with extractive industries – Aceh and Papua – continue on a large scale. Furthermore, the Bank states that decentralization has not to any significant degree contributed to accountability mechanisms that would bind local governments to the will of the local electorate (World Bank, 2002b).

Slow Progress on Land Reform - According to Bank assessment, the Government’s lack of progress on land reform limits how widely the poor will reap from economic growth (World Bank, 2002b). The poor’s ability to secure title to land is compromised by a heavy handed and corrupt bureaucracy. Furthermore, according to the Bank there is insecure access to and constrained management authority over natural resources. The USAID is providing ongoing support through its Natural Resource Management project for strengthening community mapping and rights identification for forestry land. Although the Bank is also working with the GoI to prioritize identified land policy issues, in the mean time the Bank continues to encourage opening land to mining operations. By the Bank supporting such a measure, a commercial land grab most likely will result before the land rights of the poor are addressed.

Inadequate Environmental Management for EI – Despite training and capacity building efforts of the Bank’s TA Mining Environmental Project (1996-1998), a 2001 Bank report on natural resource management in Indonesia (World Bank, 2001a) discusses several significant weaknesses surrounding environmental management of the extractive industries such as ineffective environmental impact assessments (EIA), missing regulations for certain mining emissions, and a lack of coordination between Ministry of Mines and Energy agencies responsible for EIA and project feasibility approvals.

The Bank reports that although the Indonesian EIA is now consistent with international standards, “the way it is implemented in most cases limits or totally negates its effectiveness in influencing project planning, design, and implementation...[furthermore] key issues unique to mining are not adequately addressed” (World Bank, 2001a). For example, in monitoring water quality surrounding mining operations, there are no standards for fine coal particulates. In line with the Bank’s assessment, Indonesian NGOs further point out that an EIA would never influence whether a project goes forward or

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<sup>44</sup> Governance has three pillars: economic, political, and administrative. Economic governance include decision-making processes that affect a country’s economic activities and its relationships with other economies. Political governance is the process of decision-making to formulate policy. Administrative governance is the system of policy implementation. Encompassing all three, good governance defines the processes and structures that guide political and socio-economic relationships.

not. NGOs say that no matter how bad the environmental impacts, as long as a company shows the government it has some sort of management plan, the project will go forward.

World Bank September 2002 report states that due to a lack of adequate natural resource management, there is potential for further degradation following decentralization (World Bank, 2002b). The same report further states that additional funding is needed to keep pace with major increases in pressure on land affected by mining operations<sup>45</sup> ...” (World Bank, 2001a).

Insufficient Environmental Budgetary Resources – A World Bank (2001a) report states that “public expenditure on environmental activities is extremely low in Indonesia<sup>46</sup> and that additional funding is needed to keep pace with major increases in pressure on Indonesia’s forests, biodiversity stock and land affected by mining operations.” Declines in GOI environmental spending from FY97 to FY98/99 were greater than in any other East Asian crisis country (World Bank, 2001a).

Poor GOI interagency coordination – Bank field staff in Indonesia report that there is a big problem of no inter-agency coordination within the GoI. As previously discussed, conflicts between protected forests and mining operations are endemic and highly problematic in Indonesia. According to the World Bank (2001a), a long-standing Presidential Decree gives mining priority over all other land uses, and a recent inter-ministerial decree (No. 2002 K/20/MPE/1998) fails to give the Ministry of Forestry a voice in the permitting process for small-scale mining. Interagency coordination regarding development and investment decisions is necessary for appropriate natural resource management. This is especially critical given the conflicts between the new Forestry Law and the new Mining Law.

The Bank recognizes this fact and has included several natural resource management related program benchmarks. Unfortunately, the Bank’s September 2002 Country Assistance Strategy Progress Report (World Bank, 2002b) states that there has been no progress on operationalizing an Inter-Department Committee on Forests (IDCF); no progress on improved community access to resources; and no progress on secure tenure for resources. Furthermore, Indonesia-based Bank staff interviewed for this assessment said that even though the Bank has encouraged the GoI to have inter-agency coordination, the Bank has not taken concrete measures to push for it.

Although the Bank recognizes the conflicts between GoI agencies’ goals, the Bank itself is also inconsistent in its policy priorities regarding forest protection and mining development (please see discussion below).

## **4.3 Reform-Created Failures**

### ***Policy and Institutional Failures***

Hydrocarbon subsidies taken away from consumers and given to private investors - As part of investment promotion encouraged by the reform program, in 2003 the GoI actively promoted 11 new oil and gas blocks for investment. To attract interest in the blocks, the Ministry of Energy and Mineral Resources has increased the foreign partner revenue share in the country’s Production Sharing Contract (PSC) from 15 percent to 20-25 percent for oil and from 30 percent to 40-45 percent for gas (MiningIndo News Service,

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<sup>45</sup> The office of the state minister of environment states that deforestation is mainly caused by illegal logging, forest fires and mining activities.

<sup>46</sup> In terms of percentage of GDP and percentage of government expenditures. The declines from FY97 to FY98/99 were greater than in other East Asian crisis country.

2003c). Increasing the private sector revenue share should be considered a government subsidy. As such, this investment incentive diminishes the government revenue anticipated under the reform program from the reduction in subsidies provided to domestic fuel prices. This also represents a transfer of benefits from the Indonesian public to foreign investors as the 17 companies who have submitted bids for the 11 blocks are all foreign. Furthermore, such an incentive seems to go against the IMF program stated objective of not giving any preference to specific sectors.

Decentralization: increased pressure on NR and low local government revenue – As previously stated, under decentralization the revenue sharing structure coupled with the need for agencies to be self sufficient<sup>47</sup> has put increased pressure on the development of extractive industries and associated social and environmental issues. Both on taxation and revenue distribution grounds, incentive structures at the provincial/district level governments are skewed towards promoting extractive industries development. Under fiscal decentralization law No. 25/1999, local governments do not have a share in corporate income or property tax. A main source of revenue for local governments now comes from revenue sharing in the extractive industries, including for non-tax revenue 80% for forestry and mining, 15% for oil; and 30% for natural gas.

However, these revenue sharing proportions are somewhat misleading. The actual amount distributed to local governments is relatively small compared to the overall revenue generated by these sectors. According to Ministry of Mining and Energy (MME) staff, only a small portion of actual EI revenue generated makes it back to the local governments. This is because the local governments only get a portion of the royalties, i.e., non-tax revenue. Other significant sources of government revenue, such as corporate income tax and VAT taxes go the central government. Thus, the portion of overall revenue or resource rent captured by the government that makes it back to the local governments in some cases may only amount to 2 to 10 percent.<sup>48</sup> In September 2002, the Bank reported that inequalities in the fiscal system are high (World Bank, 2002b).<sup>49</sup>

Furthermore, in some cases, such as large gas projects, revenue will not make it to the regional level until ten years after the project start date when royalties on profits start (i.e., after loan and project development costs). However, the central government will receive revenue from day one from corporate income tax, land license fees, and VAT taxes.<sup>50</sup> As a result, tensions may rise as the local government and communities bear the burden for ten years without revenue benefits. Although there will be other benefits in the form of jobs and infrastructure.

Pace of Bank Structural Reforms Too Fast to Manage EI Expansion – Although, foreign companies often complain that mining and hydrocarbon policies that will liberalize the sector are too slow in the making, at least a few medium-sized companies interviewed for this analysis believed that the investment process for the EI sectors in Indonesia has been too fast. Specifically, they thought that governance had to be strengthened prior to increased investments – “there are no shortcuts around good governance”. In addition, they recommended that feasibility studies should be given a longer timeframe for adequate consideration.

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<sup>47</sup> Local governments are now responsible for the salaries of the 2 million civil servants relocated to the regions. As such 50-90 percent of revenue goes to paying for civil servants and some social services (Hollenbeck, 2003).

<sup>48</sup> Based on preliminary estimates made by USAID, Natural Resource Management project in Indonesia.

<sup>49</sup>The Bank has worked on a pro-poor fiscal transfer framework and assisted the GoI in drafting an interim borrowing procedures for sub-national governments. The Bank has several planned projects for fy04 to support the sub-national governments to improve the openness and fairness of government operations in districts and municipalities.

<sup>50</sup> Information based on interview between Heike Mainhardt-Gibbs and large scale foreign gas company, April 2003.

In addition, at least one large-scale gas company interviewed said that the biggest challenge they faced was the lack of local government capacity to manage a large-scale gas development with respect to both community development and environmental issues. Given the Bank did not support the Big Bang approach to decentralization, at the same time the Bank should not be pushing for the quick implementation of new mining and oil & gas laws that will put even more responsibilities and demands on weak local governments.

It should be noted that the Bank has plans for sectoral interventions to support line ministries in working out roles and responsibilities best suited for central, provincial, and local government, including in the EI sectors (World Bank, 2002b). However, these capacity building activities should have been completed prior to the promotion of EI.

Lack of Bank Assistance for Alternative Energy Sources – Based on Indonesia’s known and potential hydrocarbon reserves, the Bank says that energy diversification is a central part of the GoI’s strategy for maintaining economic growth (World Bank, 2002a). However, the Bank is only advising and providing assistance to the GoI on fossil fuel-based energy sources. In its oil and gas sector study (2000a), the Bank estimates climate change benefits of reducing subsidies to the oil and gas pricing structure.

Although reduction of such subsidies, at least on environmental grounds, is very welcome, it is unclear how the estimated climate change benefits are to be realized given the Bank’s policy emphasis on accelerating exploration and production in both of these greenhouse gas emitting sectors coupled with no investment and no policy incentives for renewable energy resources such as wind, solar, or geothermal. With regards to geothermal alone, Indonesia’s geothermal reserves have a total estimated capacity of generating 20,000 MW power, representing 40 percent of the world’s geothermal reserves (MiningIndo News Service, 2003b). However, Indonesia’s geothermal capacity is largely untouched with only six geothermal plants constructed to date for a total capacity of 800 MW (MiningIndo News Service, 2003b).

Inconsistent Bank policy advice & loan objectives – The World Bank has given the GOI conflicting policy messages. With regards to forest resources, the Bank reform program calls for improved protection of forest cover and strengthened forest management (World Bank, 1999). However, with regards to the new mining law, the Bank advises the GoI to relax restrictions on mineral exploration and extraction in protected forests (World Bank, 2001b). Bank Indonesia-based staff interviewed for this analysis said that there is a clear division within the Bank between those who push for a stronger Forestry Law<sup>51</sup> and those who push for weakening it (because they believe it is unrealistic) to support mining development.

The inconsistencies do not stop on policy advice, but affect the Bank’s assistance to Indonesia for environmental objectives. In 2002, the World Bank warned that foreign donors will further reduce their environmental grants to Indonesia in response to Indonesia’s decision to allow several mining firms to operate in protected forests (*Jakarta Post*, 2002a).

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<sup>51</sup> Article 38 of the Forestry Law No. 41/1999 specifically prohibits any open pit mining in forest areas zoned as protected forest.

## 5. Indonesia Conclusion

The Indonesia case provides an example of Bank opportunities and also limitations in a middle-income country during a time of extreme financial and political crisis. Given a significant withdrawal of investment in the country and a substantial increase in poverty after the crisis, the Bank turned to Indonesia's rich mineral and hydrocarbon resource base to regenerate economic growth.

In this context, the Indonesia case highlights three specific concerns associated with the Bank reform program approach. First, the Bank recommended specific reforms to promote investment in oil, gas and mining at a time when rapid decentralization was taking place. Although the Bank was against the "big bang" approach taken by the GOI and not necessarily supportive of the new revenue sharing structure, the Bank should have given more consideration to how the various dynamics associated with decentralization increased pressure on these resources at rates and on scales unmanageable by the existing capacities of local governments.

Second, adding to the challenges posed by decentralization, the Bank recommended relaxing restrictions on mining in protected forests at a time when the GOI was struggling with alarming deforestation rates. This specific recommendation by the Bank directly ran contrary to Bank objectives in the forest sector of improving forest management and arresting the deforestation rate. Furthermore, if mining operations go ahead in high value forests as a result of this Bank policy advice, then the Bank would be in violation of its own Forest Policy. When Bank staff were questioned on this point, they pointed out that policy advisory activities of the Bank were not covered under the Forest Policy. This points to a significant gap in the coverage of Bank safeguards, i.e. policy lending activities are not covered.

Third, one of the GOI's objectives in reforming the energy sector is energy supply diversification. Bank assistance has targeted increased use of natural gas in place of petroleum. This strategy ignores Indonesia's vast reserves for geothermal power generation, which represent 40 percent of known geothermal reserves in the world. The Bank should be doing more to assist Indonesia to develop its renewable energy sources.

## Main Findings and Conclusions

**Research Question 1:** Are World Bank structural reform programs and related effects in the extractive industries having sustainable development outcomes, i.e., positive or negative effects on poverty, national/local economies, and the environment?

**Main Findings:** Under Bank supported structural reform programs, new extractive industry investments were initiated in all of the study countries, with Peru and Tanzania experiencing exceptional growth in the mining sector.<sup>52</sup> Both mineral exports and government revenues received from these sectors increased. In Peru and Tanzania, growth in the EI sectors could be tied to improvements in macroeconomic performance in the short-term. However, Peru experienced slippage in macroeconomic indicators after

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<sup>52</sup> It is also important to keep in mind that some of this growth was due to other factors, for example the increased international market price for gold.

the mining investment boom. Furthermore, in some cases the structural reforms appeared to exacerbate macroeconomic imbalances, including:

- Increased vulnerability to external shocks associated with significant reliance on EI and fluctuating international EI commodity prices [Tanzania & Peru]
- Decreased tax revenue ratios<sup>53</sup> [Peru & Tanzania]
- Increased economic dependency on primary commodities<sup>54</sup> [Peru & Tanzania]
- Significant negative pressure on balance of payments from increased energy imports, largely to support the expanding mining sector [Peru]
- Domestic private sector development stifled by significant concentration of foreign-controlled EI assets [Peru & Tanzania]

In addition, social benefits associated with the expansion of large-scale EI operations were generally in the form of improved infrastructure, including water supply, schools, and hospitals in specific localities near extraction sites. Employment effects have been mixed. Privatization in the petroleum sector reduced employment. Mining sector data for Peru indicated a modest increase in employment. However, small-scale and artisanal mining, which provides the majority of employment opportunities for the poor in the sector, experienced both positive and negative employment effects as a result of reforms. Overall, the EI sectors in these countries did not constitute a significant percentage of employment. Moreover, data are insufficient to determine the net effect of reforms on employment, e.g., how EI growth affects employment in other sectors such as fishing and agriculture.

Furthermore, the Bank generally recognized that the extractive industries in these three countries were associated with negative environmental and social impacts. To address these anticipated outcomes, the Bank designed complementary program measures to help improve the social and environmental performance of these sectors.<sup>55</sup> However, despite these efforts by the Bank, the complementary projects tended to fall short of significant and long-lasting improvements. As a result, growth of the EI sectors considerably outpaced any progress on social and environmental governance.

Overall, the limited impact of the Bank's complementary projects coupled with expansionary measures of structural reforms, resulted in unnecessarily high social and environmental costs. Furthermore, the case studies found no evidence of poverty reduction associated with growth in the EI sectors. The main social and environmental findings of the analysis include:

- No evidence of poverty reduction – From 1991 to 2000, the poverty reduction that initially took place in Peru, which later eroded, was in Lima and the urban highlands and not in the rural highlands and the Amazon, which is where the mining and hydrocarbon developments are concentrated.<sup>56</sup> In addition, a study by the Government of Tanzania, indicates that the significant growth in the mining sector has had little impact on employment and incomes for the poor (GoT, 2003).

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<sup>53</sup> Measured by government revenue as a percentage of GDP.

<sup>54</sup> Measured by percent of manufacturing value added of GDP and growth rates of value added for EI related products in the economy.

<sup>55</sup> Examples of Bank activities include: treat pre-existing petroleum pollution issues by repairing leaking pipes and storage facilities (Tanzania Petroleum Rehabilitation Project); provide extension services to small-scale miners<sup>55</sup> (Tanzania Mineral Sector Development TA); Require companies to develop environmental management plans (Peru's new Hydrocarbons Law - Energy and Mining TA); develop permissible emissions from the mining sector (Peru Energy and Mining TA); and analyze problems facing small-scale miners (Peru Energy and Mining TA).

<sup>56</sup> World Bank, 2001. Peru: Country Assistance Strategy Progress Report. R2001-0043, April 3, 2001.

- EI revenue seldom transferred to affected communities – In Peru and Indonesia, laws were created to ensure that EI revenue would be returned to the local communities or governments. However, due to the specific design of the laws and lack of transparency, little of the revenue has reached the communities.<sup>57</sup> In Tanzania, no such revenue sharing laws or mechanisms have been created.
- EI Operations tend to take place in more socially and environmentally sensitive areas – New opportunities for foreign investment and technological progress has allowed access to more environmentally and socially sensitive frontier areas. In Peru, 112 of 143 new hydrocarbon exploratory wells are in the Amazon. Many of the EI concessions overlap indigenous and biodiversity-rich protected areas, including protected areas supported by Bank project funding.<sup>58</sup> In Indonesia, the new Mining Law contradicts the new Forest Law by permitting open pit mining in protected forests. The Bank recommended the removal of restrictions on mining in protected forests.
- Increased insecurity surrounding natural resource tenure – EI development and the strengthening of commercial land rights has induced more tenure insecurity of natural resources for local peoples, including conflicts over land and water rights. The case studies provided examples of military intimidation, lack of community consent, inadequate compensation, and ignored land rights of local peoples.
- Increased social antagonism and conflict – In these study countries, significant social unrest is associated with many of the extractive industry investment activities initiated under the structural reform programs. Furthermore, this social unrest has had direct negative impacts on the investment climate in all three countries. For example, in Indonesia foreign companies have frozen or abandoned mining investments worth \$2 billion since 1998 stating that disruptive activism at mine sites and a weak policy framework led to the withdraw of their investments.<sup>59</sup>
- Increased overall environmental degradation – Marginal gains in environmental mitigation linked to Bank assistance has been unable to offset the overall increase in environmental degradation associated with the significant expansion in exploration and production of the EI sectors. For all three countries, the World Bank recent reviews assert that government environmental management remains weak. For example, in Tanzania the environmental impact assessments, which are driven mainly by World Bank requirements, are no more than guidelines with no legal requirements to mitigate identified impacts.<sup>60</sup>
- Electricity deficits and increased air pollution – A significant increase in energy demand from the expanding mining sector has produced electricity deficits in Tanzania and Peru. To address this demand, both countries have expanded thermal power generation, which predominantly relies on fuel oil or coal. These fuels are significant emitters of particulate matter, sulfur dioxides, and nitrous oxides – adding in some cases to the existing air pollution problems faced by these countries.

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<sup>57</sup> In Peru, regulatory improvements are needed to identify who exactly should benefit and what type of investments should be made with the money. In Indonesia, the Revenue Sharing law amounts to only a small percentage of the revenue going to the regencies as it only accounts for royalties. Corporate tax and VAT, the larger revenue generators, still go to the central government.

<sup>58</sup> Camisea natural gas wells and pipeline overlap with an indigenous reserve involved in the Participatory Conservation Planning in Vilcabamba Project. The Yanacochoa gold mine and Mobil Oil concession overlap with areas involved in the Peru-Participatory Management of Protected Areas Project.

<sup>59</sup> Guerin, Bill. 2003. Indonesia's mining quagmire. Asia Times. May 12, 2003.

<sup>60</sup> Statement supported by in-country interviews with private sector and civil society, July 2002.

As a result of the findings discussed above, the first conclusion of the analysis is the following:

**Conclusion 1:** Despite efforts by the World Bank to improve the social and environmental performance of the extractive sectors, expansion of these sectors under the aegis of structural reform programs has led to higher than necessary social and environmental costs, and, in some cases, exacerbation of macroeconomic vulnerabilities. The World Bank structural reform programs associated with the extractive industries in the three country case studies did not have sustainable development outcomes.

**Research Question 2:** Where negative effects are detected, what factors lead well-intended policy and institutional reforms to have unintended negative economic, social, and environmental consequences?

**Main Findings:** In some cases, Bank and IMF structural reform programs corrected important market, policy, and institutional failures, such as state monopolies, political interference in price setting, investment barriers, and lacking environmental regulations. However, in all of the study countries significant failures persisted and, moreover, new problems were created by program reforms. As a result, significant extractive industry expansion occurred prior to addressing several important failures that were harmful to the poor, the environment, and the economy.

Overall, the Bank's structural reform programs failed to convey that sustainable development requires not only good economic policies, but strong institutions and good governance as well. This is especially important for the development of the extractive sectors, which are prone to corruption and rent-seeking behavior. The three country case studies revealed three main weaknesses in the Bank's, as well as the IMF's, approach to structural reform programs.

- First, the Bank and IMF supported reforms tended to concentrate on improving policies and institutions in favor of investors, mainly foreign, without commensurately strengthening policies and institutions for the poor and environment and thereby creating an imbalance. For example, new contract models with fixed environmental costs locked in inadequate environmental standards for ten to twenty years. While foreign investment is an essential element for economic development, it is only one of many elements needed to contribute to sustainable development and poverty reduction.
- Second, where the Bank has made efforts to address the policy and institutional failures that have negative effects on the poor and environment, the scope of activities in these complementary programs tends to be too limited. Furthermore, perhaps the biggest constraint to the effectiveness of these programs has been a lack of leverage with governments and/or weak capacity of governments to ensure implementation of World Bank advice.
- Third, although the Bank fully recognizes the limited social and environmental capacity of these countries, the Bank is not questioning the policy and institutional reforms themselves. Current Bank structural reform programs are built on the assumption that foreign investment in EI will lead to broad-based growth and poverty reduction. Furthermore, the EI growth takes place in the context of weak state structures whose role has been redefined through structural reform as one of facilitation and regulation aimed at creating a favorable investment climate. As the Bank's structural reform strategy currently stands, there is a significant imbalance between unleashing market forces that have immediate social and environmental impacts and developing mitigation responses that require long-term institutional development.

The following list provides examples from all of the country case studies of institutional, policy, and market failures that were exacerbated or, in some cases, created by Bank supported reforms:

### Institutional Failures:

- Privatization of State owned extractive enterprises without adequately building State capacity to regulate the private sector.
- Absence of a governmental authority to address social and environmental compliance issues that is independent of the institutions in charge of EI sector or investment promotion.
- Significant increase in EI revenue without adequate management, accountability, or transparency.

### Policy Failures:

- Preferential tax treatment for the EI sectors
- New EI contract models that lock in inadequate social and environmental standards
- Policy and institutional reforms that are designed for larger-scale enterprises and, in turn, create some disadvantages for small-scale miners<sup>61</sup>
- Commercial land tenure strengthened, while land tenure of the poor remains weak

### Market Failures:

- Domestic firms unable to compete with finance terms offered to large foreign enterprises

As a result of the findings discussed above, the second conclusion of the analysis is the following:

**Conclusion 2:** Unintended negative economic, social, and environmental outcomes of structural reform programs have been due to market, policy, and institutional failures that were either left uncorrected or were created by structural adjustment and policy/institutional reforms. The findings of the case studies draw attention to the need for closer scrutiny of the design of World Bank policies and structural reforms associated with the extractive industries.

**Main Findings** (question 2 continued): In the case study countries, World Bank collaboration with IMF operations took place mostly at the lead economist level. There was very little, if any, interaction between Fund staff and World Bank sectoral, poverty, or environmental specialists. This collaboration is very important to the outcomes of World Bank structural reform programs on many fronts.

First, IMF operations have significant implications for Bank-supported development objectives. Second, as a pre-requisite for World Bank structural adjustment lending a country typically must have an IMF program in place. In one of the case studies, socially- and environmentally-based Bank loans were cancelled due to a lack of progress on IMF structural benchmarks. Third, even though the IMF has no environmental and few social requirements for lending, the Bank operations staff has repeatedly stated that the Bank has no responsibility for assessing the environmental or social impacts of IMF policy prescriptions.<sup>62</sup>

In general, IMF objectives and program specific targets tend to put less importance on institutional reforms. To begin with, the IMF's objective for structural adjustment is for short-term macroeconomic

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<sup>61</sup> The World Bank has in recent years recognized the need to provide more assistance on small-scale mining issues and has created the Communities in Artisanal and Small-scale Mining initiative (CASMI). However, experts following this initiative state that progress is slow and the effort is significantly under funded.

<sup>62</sup> Even though, according to the framework for World Bank-Fund collaboration, the World Bank is the lead agency responsible for environmental policy areas.

stabilization. Thus, IMF program conditionalities are often based on aggregate economic indicators or specific targets regarding the number of privatizations and commercial legislative measures. It is extremely rare for an IMF program to consider, much less require, the soundness of social or environmental policy and institutional frameworks.

In the case studies, the IMF's approach to the extractive sectors was mainly one that promoted aggressive privatization of significant mining and hydrocarbon assets for short-term financing of the deficit. Such an objective did not ensure the creation of competition, efficiency gains, development of a domestic private sector, or environmentally and socially sound development strategies for the extractive sectors.

For example, in Peru the IMF required the awarding of the Camisea natural gas concession as a structural benchmark for continued lending despite the government of Peru's stated concerns regarding competition in the hydrocarbons sector. As it turned out, the awarding of Camisea handed over a significant portion of the natural gas production to the same foreign enterprise that controls a majority of the petroleum production in the country. Furthermore, the Camisea concession overlaps with the Vilcabamba Indigenous Peoples Reserve supported by the World Bank.

As a result of the findings discussed above, the third conclusion of the analysis is the following:

**Conclusion 3:** The World Bank's collaboration with the IMF on structural adjustment programs associated with the extractive industries has been ineffective with regards to social and environmental development objectives.

## 6. Recommendations

In light of the conclusions drawn from the three case studies, the following six recommendations are offered to the World Bank to improve the outcomes of structural adjustment and other policy lending associated with the extractive industries.

**1. Strategic Social and Environmental Analysis of Policy Lending** – The World Bank's updated operational policy on structural adjustment (OP 8.60) should require upstream social and environmental analysis of policy lending (SAL, SECAL, TA, and AAA)<sup>63</sup> for countries where EI development is likely to or is intended to occur as a result of structural reform programs. The main objective is to ensure that socially and environmentally appropriate incentives and disincentives for the private EI sector are built into structural adjustment.<sup>64</sup>

**2. Social and Environmental Accountability of Investment Liberalization and Privatization** – The World Bank should establish mechanisms and standards for EI investment approval processes, sector codes, and private sector contract models that ensure local community benefits & rights, and

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<sup>63</sup> Structural Adjustment Loan (SAL), Sectoral Adjustment Loan (SECAL), Technical Assistance (TA), and Analytical and Advisory Activities (AAA).

<sup>64</sup> The current analysis could be used to provide initial guidance to Bank staff.

environmental protection.<sup>65</sup> Furthermore, Bank assistance for investment liberalization and privatization should include specific activities to enhance domestic private sector opportunities, such as access to finance and markets and formalization of small-scale and artisanal mining.

**3. Government Capacity for the Poor and Environment** – In countries anticipating development of the extractive sectors, the World Bank should place priority on building government capacity to ensure that EI development benefits the poor and improves environmental protection. This will require assessing and strengthening revenue distribution policies and mechanisms, improving the capacity of EI-independent regulatory agencies, and establishing mechanisms for informed stakeholder participation. Furthermore, the Bank should ensure that central and local government agencies have clear social development and environmental protection mandates associated with EI development.

**4. More Value Added to the Economy** – When EI development is promoted, World Bank lending should support policy and institutional reforms that ensure EI resource rents are used to stimulate more value-added and labor intensive sectors. Conventional wisdom asserts that drawing down natural resource assets is appropriate to the degree that they are converted into other forms of capital, be it productive, human, or financial, which can increase a country’s productivity over time. The Bank should provide guidance and assistance on how a country can utilize EI to stimulate other sectors of the economy and, thereby, move beyond mainly using EI to increase exports.<sup>66</sup>

**5. Strengthened Collaboration between Bank and IMF Operations** - The World Bank should enhance social and environmental accountability and collaboration between World Bank and IMF lending operations especially in countries with significant extractive industries. To begin with, the Bank should institute a monitoring mechanism of governance, social/poverty, and environmental management indicators to complement the IMF’s macroeconomic monitoring.

**6. Strengthened Civil Society** – The World Bank should establish clear guidelines and mechanisms that ensure substantive and sustained interaction among national government agencies, civil society organizations (CSO), and the World Bank. Bank guidelines should provide social and environmental performance criteria by which CSOs can monitor the impacts of structural reform. Furthermore, the guidelines should identify the specific stages in the reform program cycle and the mechanisms whereby the Bank receives feedback from civil society. Lastly, the World Bank should revise program activities in response to CSO monitoring feedback.

In addition to the main recommendations highlighted above, the following section provides further specific suggestions.

### **Strategic Environmental and Social Analysis of Policy Lending**

As a prerequisite for structural adjustment and policy lending (e.g., TA, AAA), the World Bank should require social and environmental analysis at both the country program level (e.g., Country Assistance Strategy) and the individual loan operation level for any country with anticipated development in the extractive industries. Most importantly, the social and environmental analysis should guide the Bank structural reform program design in order to:

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<sup>65</sup> Special attention needs to be given to the use of “stability agreements” that at times lock in inadequate environmental and social standards. Further work is needed to develop guidance on socially and environmentally appropriate codes and contract models for the extractive industries.

<sup>66</sup> For example, the Bank should provide guidance on how a country can move beyond primary production, e.g., mining and smelting, and into activities of refining and fabrication of products that capture more value-added.

- Ensure that market, policy, and institutional failures that are important to poverty reduction and environmental management are adequately addressed prior to or in parallel with structural reforms linked to the extractive industries<sup>67</sup>.
- Determine if individual Bank supported reforms will potentially create new or intensify the effects of existing market, policy, or institutional failures and, if so, develop appropriate alternative approaches to the reform process.
- Ensure that socially and environmentally appropriate incentives and disincentives for the private EI sector are built into structural adjustment.
- Establish social and environmental performance benchmarks that are attached directly to the structural adjustment loan.<sup>68</sup> Benchmarks should include indicators that demonstrate the contribution of extractive industry development to poverty reduction and improved environmental management.

### **Government Capacity for the Poor and Environment**

To improve both the follow-up on Bank advice and the effectiveness of economic reforms, the Bank should make a concerted effort within SALS and SECALs to improve governance and provide significant measures for the poor and environmental management.<sup>69</sup> To begin with, the following nine specific measures are suggested:

- The Public Expenditure Review (PER) should be set up to track revenue generated from the extractive industries. Furthermore, EI revenue management mechanisms/legislation should clearly indicate who should receive benefits and what type of investments should be made from EI revenue.<sup>70</sup>
- Community development and environmental responsibilities of the government with regards to EI must be clearly identified along with assistance to build the specific capacity necessary to carry them out. It is especially important to reach the local governments at the provincial and district levels. The World Bank should target building governance at the local level where large extractive industry projects are anticipated or where small-scale mining is prevalent.
- Approval of social and environmental impact assessments and management plans should be the responsibility of a government agency independent of ministries charged with the promotion of the extractive industries or investment in general. The agency or agencies should have the primary objectives of poverty reduction and environmental protection with accompanying staff expertise. The World Bank may need to provide assistance to develop such agency (ies).
- Assist the government to develop a mechanism to clarify land regimes and strengthen land use planning systems to justly resolve the overlaps of the mineral/hydrocarbon claims with local community/indigenous territories and protected areas. This must be done before commercial interests are given the upper hand.

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<sup>67</sup> These would include, *inter alia*, reforms intended to usher in investment, increase production, or change production regime (privatization) in the extractive industries.

<sup>68</sup> Complementary Bank projects were shown to have very limited leverage to ensure government implementation.

<sup>69</sup> Such an approach would also provide for more comprehensive loan packages, would reduce inconsistent Bank advice/policies, and would hopefully lead to more cross sector Bank staff collaboration.

<sup>70</sup> The Extractive Industries Transparency Initiative (EITI), led by the UK Department for International Development (DfID), should be consulted regarding revenue management issues.

- Assist the government to develop mechanisms for representation of stakeholders and conflict resolution, including improvement of informed participation during the EIA/SIA processes.<sup>71</sup> This should not be the responsibility of the private sector as often is the case.
- Assist the government to formalize small-scale mining (SSM), increase SSM market & finance access, and improve environmental & worker health issues of SSM. Towards this end, the Bank should provide more funding and give higher priority to the Communities in Artisanal and Small-scale Mining (CASM) initiative.
- Concession contract models should include specific provisions for community development objectives and concrete environmental management/protection measures.
- Government investment promotion schemes should integrate opportunities for domestic and small-medium enterprises and social and environmental strategic planning.
- IFC lending in the extractive industries should be initiated by indicators of reasonable progress on socially and environmentally sound policy and institutional frameworks, not just conditionalities on individual projects.<sup>72</sup>

### **Value Added to the Economy**

The Bank should help countries reduce their dependence on extractive industries and primary production. Extractive industries should be used to stimulate other sectors of the economy and not solely for the purpose of increasing exports, which is often the case. The growth of more value-added and labor intensive sectors would contribute more to poverty reduction than primary extractive commodity production and could potentially relieve pressure on natural resources. To this end, the Bank should:

- Provide guidance on how a country can move beyond mining and smelting into activities of refining and fabrication of products that capture more value-added.
- Develop investment schemes for the extractive industries that encourage enterprises to re-invest in other sectors in the country.
- Analyze how the developed countries' tariff and non-tariff barriers that hamper developing countries' access to value-added markets can be addressed.

### **Strengthened Collaboration between Bank and IMF Operations**

The case studies indicate that there is a gap regarding social and environmental accountability of IMF program requirements associated with Bank lending. The IMF has no environmental and few social requirements for lending. Also, the Bank refuses to assess IMF programs for impacts even though it is the lead institution on environmental policy advice to the IMF. Given the potential social and environmental impacts of the extractive industries, it is especially important to address such gaps when IMF program requirements are linked to the expansion of these sectors. Towards meaningful social and environmental collaboration with the IMF, the World Bank should:

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<sup>71</sup> Environmental Impact Assessment and Social Impact Assessment.

<sup>72</sup> This could help the competitiveness of IFC loans. IFC at times has reasoned that Bank environmental lending requirements hurt its competitiveness.

- Require a social and environmental assessment of IMF reforms and structural benchmarks that are linked to Bank program lending. When potential significant impacts are indicated, the Bank should advise the IMF of alternative policies or design specific Bank measures to respond to social and environmental pressures of IMF prescriptions. In cases where the IMF will not adhere to sound social and environmental advice of the Bank, the Bank should not link lending to IMF programs.
- Stop the practice of linking environmental and social program lending to IMF conditionalities, especially those dictating privatization and expansion of the extractive industries.
- Institute a monitoring mechanism for social/poverty, governance, and environmental management to complement the IMF's macroeconomic monitoring.
- Develop communication mechanisms and incentive structures that provide for more meaningful consideration of poverty and environmental issues among staff at both institutions and at all levels (not just lead economists).

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