

## Brief 2: Barriers and Opportunities for MSMEs under Demand-side Legality Policies

Andrea Johnson

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## About Forest Trends

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This report was released by Forest Trends' Forest Policy, Trade, and Finance program, which since 2000, has sought to create markets for legal forest products while supporting parallel transformations away from timber and other commodities sourced illegally and unsustainably from forest areas.

Forest Trends  
1203 19th Street, NW  
4th floor  
Washington, DC 20036  
[www.forest-trends.org](http://www.forest-trends.org)

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## About the Series

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*The European Union Timber Regulation (EUTR), US Lacey Act Amendments, and Australia's Illegal Logging Prohibition Act (ILPA) were established not only to combat illegal logging and associated trade, but also to facilitate a thriving legal forest product sector that enhances rural livelihoods for forest-dependent communities. Is this happening – or are the processes of formalization and legalization, together with stricter enforcement of existing laws, creating unintended consequences for the most vulnerable actors they were meant to support?*

*A clearer understanding of both the opportunities and the impacts that emergent legality policy frameworks create for rural forest-dependent people, community forestry initiatives, and other small-scale enterprises (collectively referred to as micro-, small-, and medium-sized enterprises, or MSMEs) has increasingly become a priority for international policy dialogues. We take as a starting point that a strong relationship exists between successful MSME activity and improved rural livelihoods, poverty alleviation, and/or economic productivity. Attributing precise figures to this correlation is not easy, but the link between a robust MSME sector and a healthy economy – and the virtues of locally-based forest management for both people and ecosystems – has been demonstrated repeatedly in peer-reviewed literature.<sup>1</sup>*

*This series of briefs attempts to contribute greater clarity to the debate by disaggregating the diversity of MSMEs and providing a conceptual starting point for more coherent dialogues and targeted, impactful policy and research design. It encompasses the diversity of MSMEs because the globalized reach of many wood product supply chains, and the rapid increase of South-South trade flows, obscure the lines between local and international trade. Further, all but one Voluntary Partnership Agreement (VPA) signed to date in Africa and Asia include the aspirational goal of achieving legality in domestic trade as well, making national markets a necessary part of the discussion.<sup>2</sup>*

- **Brief 1** outlines the breadth of MSMEs and suggests a typology for differentiating among them with greater precision. This more nuanced picture helps us to recognize certain invisibilities – blind spots that impede or bias the way in which MSMEs are discussed by decision-makers – and identify new points of entry for MSMEs in legal supply chains and better policy-making in the context of national VPA processes.
- **Brief 2** examines the full range of interconnected barriers faced by MSMEs: barriers to achieving and maintaining legality, barriers to demonstrating legality, and barriers to competitiveness. We look more closely at whether and to what extent legality measures present new barriers and opportunities, and briefly discuss best practices for supporting MSMEs within this context.
- **Brief 3** presents priority directions for applied research that will contribute to finding concrete, specific answers to the pressing question of how to better support MSMEs as part of thriving, legal wood product sectors that generate economic, social, and ecological benefits.

<sup>1</sup>See e.g. Kozak 2006; Gibson and van der Vaart 2008; SEAF 2007; Scherr, White, and Kaimowitz 2003; Macqueen 2008; and AgriCord and FAO 2013.

<sup>2</sup>The information contained in these briefs comes from literature on MSMEs both within and outside the forest sector; project reports and diagnostics from Africa, Asia, and Latin America; and as-yet unpublished experiences within CATIE's Finnfor Project, a Finnish-funded effort to improve rural livelihoods through strengthening wood product value chains in four Central American countries (Guatemala, Honduras, Nicaragua, and Costa Rica).

# Acronyms

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CATIE	Tropical Agricultural Research and Higher Education Center ( <i>Centro Agronómico Tropical de Investigación y Enseñanza</i> )
CFE	community forest enterprise
DKP	Conformity Declaration, Indonesia ( <i>deklarasi kesesuaian pemasok</i> in Bahasa Indonesia)
EIA	Environmental Investigation Agency
EUTR	European Union Timber Regulation
FLEGT	Forest Law Enforcement, Governance, and Trade
JPIK	Independent Forest Monitoring Network ( <i>Jaringan Pemantau Independen Kehutanan</i> ), Indonesia
ILPA	Illegal Logging Prohibition Act, Australia
MFP	Multistakeholder Forestry Programme, Indonesia
MSME	micro-, small-, and medium-sized enterprise
NGO	non-governmental organization
NPFE	Non-Permanent Forest Estate, Cameroon
SVLK	Timber Legality Assurance System ( <i>sistem verifikasi legalitas kayu</i> ), Indonesia
TLAS	Timber Legality Assurance System
VPA	Voluntary Partnership Agreement

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# 1. Introduction

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The effect that demand-side wood legality policies in Europe, the US and elsewhere are having on trade flows, companies, communities, and forests is largely still unmeasured, but mounting anecdotal evidence, sector-specific trade data, and a few systematic studies (Prestemon 2015) indicate that these policies are leading to changes in decision making both at a policy scale and within supply chains. What impacts, positive or negative, might such changes have on MSMEs? The Forest Law Enforcement, Governance, and Trade (FLEGT) Voluntary Partnership Agreement (VPA) negotiations and other policies have shed light on these barriers, and increased pressure on policy-makers to address them.

This brief is one of the first attempts to systematically describe how these processes are game-changing. It proposes three interrelated but distinct categories of barriers, and describes some of the policies and actions most likely to improve the odds of MSMEs benefitting rather than losing out from demand-side policy. It highlights that more data collection is needed to better understand the scale of these impacts, and argues investing more donor and government support in a few best-practice approaches will enable MSMEs to succeed at scale.

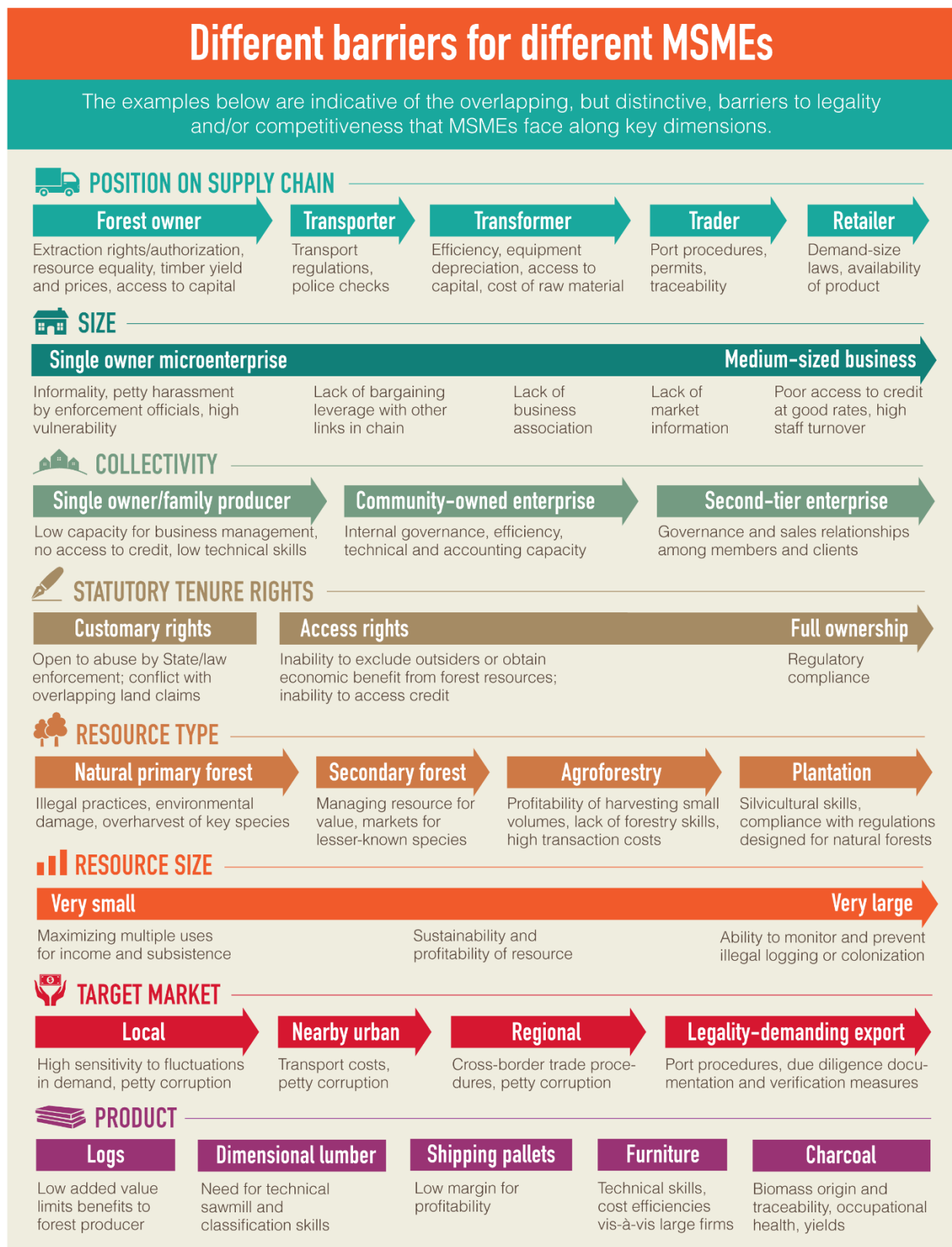
## Key Findings

1. **Demand-side policies, by emphasizing demonstration of legality as a requisite to market entry and generating regulations or systems in producer countries, can interact with and amplify existing barriers to MSMEs** including high transaction costs, regulatory burden, and lack of access to certain markets and buyers.
2. **Demand-side policies may also induce positive changes that increase MSME competitiveness or create a comparative advantage for MSMEs whose products are low-risk, demonstrated to be legal, or with inelastic demand.** However, truly capitalizing on these opportunities will require more active support by producer country governments, private-sector associations, and donors and support organizations, as well as active participation by the correct types of actors in policy processes.
3. **Affirmative policies that simplify regulations and create a more regulatory environment for MSMEs, and value-chain approaches focused on improving competitiveness, are proven best practices that should be applied in producer countries.**
4. **Policy processes or programs that focus exclusively on legality without taking competitiveness, size, or levels of informality into account are less likely to succeed.**

## What Barriers do MSMEs Face in being Successful within Legal Global Trade?

In asking whether and to what extent new policies might create new barriers for MSMEs, an obvious next question is: which MSMEs? The diversity of MSMEs within timber product supply chains is enormous (see *Brief 1* of this series), and enterprises have distinct opportunities or barriers depending on their place within a complex typology.

Figure 1. Different Barriers for Different MSMEs



Within the diverse spectrum of barriers are those to participating successfully in legal trade. In practice, legality is only one aspect of the larger question of survival and competitiveness with which MSMEs deal on a daily basis; furthermore, being legal is a relatively new end goal spurred by external, demand-side initiatives. The majority of barriers reviewed in this section are those with which small enterprises have always had to struggle, rather than problems newly imposed by the advent of demand-side policies. The underlying structural and institutional issues that can make operating legally so difficult are perceived as problems because they prevent MSMEs from achieving better and more sustainable revenue streams, limit market opportunities, and are a constant source of underlying worry over bribes, harassment, or confiscation. While appropriate regulation is necessary to prevent widespread negative environmental or social externalities, many regulations in the forest sector implemented in specific response to common illegal activities or to protect valuable ecosystems inadvertently create insurmountable hurdles for MSMEs.

It is important to note, however, that simply removing barriers is not sufficient to fully enable MSMEs. They will still have less capital and fewer technical skills than larger industry players. And reducing regulations could inadvertently create legal loopholes that may be exploited by illegal actors. A fine balance in the regulatory sphere, coupled with affirmative policies to support MSMEs and reverse the link between forests and poverty, is clearly needed.

## **Barriers to Achieving and Maintaining Legality**

The majority of the world's MSMEs, particularly on the smaller end of the spectrum, operate informally. Others achieve formal status but struggle to comply with regulations. Legal, commercially successful community and smallholder forestry is unfortunately still the exception to the rule in most countries.

### **Lack of clear tenure rights**

When individual or collective rights to a forest, farm, or trees are not formally recognized in statutory law, there is little incentive to engage in a long-term economic activity like forestry, and little hope that an MSME will be able to receive the fair economic benefit afforded to a landholder under legal and economic paradigms that benefit larger production models. Procedural hurdles and technical requirements are particularly insurmountable when communities do not fully own the resource in question (RRI and RECOFTC 2013). (See *Brief 1* for a deeper discussion of progress toward recognizing indigenous and other local communities' forest tenure.) Within most countries, rights regimes for natural forests are quite distinct from those for forests and trees within agricultural landscapes or for planted trees; others have distinct regimes for sub-soil, land, and tree tenure. Non-forest (agrarian) smallholders' struggle for tenure clarity often differs from that of forest communities, and is often more burdensome (Gutiérrez 2016; RRI and RECOFTC 2013).

### **Legal frameworks that preclude MSME formality**

Even where countries have established a legal framework for community or smallholder rights to own or manage forests, restrictive legal frameworks may be setting MSMEs up to fail. In Cameroon, MSMEs face so many structural barriers that in practice legality is out of reach: the cost of meeting requirements for an Annual Harvesting certificate makes legal production far too expensive to be competitive in comparison to the thriving informal chainsaw milling sector, Community Forest Enterprises (CFEs) are barred by law from joint management with industrial loggers, and their usufruct rights are limited to a maximum of 5,000 hectares (ha) of Non-Permanent Forest Estate (NPFE), while industrial concessions are given access to the more intact high-value forests (Cerutti and Lescuyer 2011; Julve Larrubia 2013). This same dynamic is repeated throughout many African and Asian countries (Blomley 2013; RRI and RECOFTC 2013). In Peru, the basic design of the forest concession system set in motion pervasive timber laundering that implicates MSMEs of all sizes, from indigenous communities to loggers, sawmills, transporters, and export companies (EIA 2012). In Vietnam, communities lack the right to transport harvested timber and therefore must pay authorized transport companies at a high cost (RRI and RECOFTC 2013).

### **Complex regulatory systems coupled with inadequate capacity**

Since the 1980s, legal reforms have opened the door for community forestry enterprises and other MSMEs to formalize, and enabled them to operate under simplified procedures. There are valuable lessons to be learned in examining these

processes, but procedural hurdles and technical requirements still serve as effective barriers to communities, and the combination of complex, highly prescriptive forest laws with inadequate state capacity to provide technical assistance or consistent enforcement is a recipe for informality and corruption. Each step in the process of registering even a simple formal business entity requires the capacity to navigate legal documents, rules and regulations, and the development of internal processes for accounting, taxes, licensure, and compliance with labor and environmental standards. Moreover, the pervasive economic model favoring large-scale, industrial forest and agricultural activity has meant that private companies often face fewer regulations than communities (RRI and RECOFTC 2013). These complexities are amplified with additional requirements to operate legally with each link along a supply chain. Centralized bureaucratic processes that must be done, in person, in regional or capital cities, make “simple” steps a considerable investment of time, energy and scarce financial resources for MSMEs (Larson and Pulhin 2012).

In Bolivia and Peru, most indigenous groups are not able to pay the costs of developing forest management plans without external support, and thus turn to timber companies or middlemen to buy their standing timber (Del Gatto unpublished; Cossío et al. 2014; EIA 2012). In Mexico, the costs involved in compliance with labyrinthine regulation is cited as the primary cause for the decline of timber production and logging permits in *ejidos* across the country (Hodgdon et al. 2013). A recent survey of regulations in six Asian countries found that they “exceeded the capacity of the communities and smallholders” in all countries studied, required fees were prohibitively expensive, and that rent-seeking – particularly in the transportation link of supply chains – was a pervasive problem (RRI and RECOFTC 2013). For example, in the Philippines, approval of management plans can take from 8 to 18 months, leaving cooperative members with few options other than to work for illegal operations in the meantime (ibid).

These barriers can be seen one of two ways: as burdensome regulations and state intransigence, or as a lack of sufficient capacity to conduct good business on the part of MSMEs. In practice, both perceptions are valid. The challenge and the art, then, lies in designing procedures that are workable for small businesses without creating loopholes big enough for true illegal activity. This requires analyzing and identifying the bottlenecks of capacity and political economy in any given sector’s supply chain: is the main barrier technical? Logistical? Financial? Can practical fixes be made on the basis of better data? Or are there underlying issues of political economy or corruption that make technical and administrative adjustments unlikely to succeed? Is there an additional cultural barrier, where foresters and government authorities implicitly doubt communities’ capacities and interest in managing their resources (ibid)?

### **Lack of market or other incentives to operate legally**

Going legal may actually be within the capacity of many MSMEs but not yet be in their immediate interest. Small operators are eminently rational within a short-term financial timeframe. When the costs of changing their sourcing, paying taxes and fees, or otherwise complying with safety and environmental regulations do not make business sense – either because the market does not demand it, or because the consequences of noncompliance are less burdensome than the alternative – informality is likely to win out. In Cameroon, many chainsaw millers are professionally accredited and could technically obtain a permit to perform the same operations in the same landscapes, but in the context of an indifferent market and an entrenched system of petty bribes that allow the ongoing flow of local commerce they “do not recognize any benefit to legality” (Cerutti and Lescuyer 2011). In Vietnam, household furniture makers rarely ask suppliers about legal origins, pay taxes or fees, or comply with safety or environmental regulations, and attribute this dynamic to weak law enforcement and a lack of consequence for operating illegally (Forest Trends 2012).

## **Barriers to Demonstrating Legality**

Demonstrating legal supply or compliance to the satisfaction of buyers or government officials presents a set of barriers related to but distinct from simply “being legal.” These include the complexities and costs of developing traceability systems, obtaining independent verification or certification, or complying with new requirements that emerge from national policies. In the short term, as companies and governments become more risk-averse, this is where new impacts from demand-side legality policies or national responses (such as VPAs) are most likely to appear.

Mandatory traceability is a question of regulatory compliance to the extent that it becomes in itself part of obtaining full legal authorizations. However, there is a legitimate distinction to be made in that MSMEs may be conducting their

operations in a way otherwise consistent with allowable felling, but are unable to demonstrate it. Lacking vertical integration, market power to insist on formalization by their raw material producers, or political power, they are at a disadvantage either to achieve traceability without reconfiguring their supply chain, or to advocate for a change in regulations. The case of Nicaraguan charcoal producers, whose raw materials are sustainable but not demonstrably legal, highlights this dilemma (see *Brief 1, Box 2*). Likewise, MSMEs in the export-oriented furniture value chain of Jepara, Indonesia (which make up the vast majority of the sector's 12,000 workshops) were found to be in a weaker bargaining position than large manufacturers, leading to inefficient resource use and presenting complications for the process of certifying companies under the national timber legality assurance system (Purnomo 2013).

## Barriers to Competitiveness

Competitiveness and legality are intimately linked. Lack of financial capital or technical capacity impedes MSMEs from meeting legal requirements such as management plans or environmental protection obligations, and these failures in turn result in lower revenues and lack of capital accumulation. The structural disadvantage of MSMEs relative to industrial operations will always be their lack of scale efficiencies and bargaining power with other links in the supply chain, while capacity and organizational gaps among smallholders can hamper their ability to offer larger volumes, negotiate prices, or advocate effectively for the reduction of regulatory barriers.

- **Lack of access to credit, lack of capital and/or reinvestment:** Without assets, an enterprise or individual cannot obtain necessary credit to have working capital to conduct the annual harvest, much less to invest in new technologies or infrastructure. MSMEs must often rely on local creditors who charge usurious interest rates; buyers who are willing to advance cash in return for reduced prices;<sup>1</sup> or personal connections (approximately 80 percent of financing for SMFEs comes from owners themselves, friends, and families (Kozak 2006)).
- **Balancing investment with job generation:** MSMEs with collective governance structures face tension between improving efficiency and capital generation on the one hand, and maximizing employment on the other. This pressure can result in lack of reinvestment in vital equipment or in decisions that put a business at financial risk – for example, more labor-intensive value-added processing – without a clear analysis of the costs involved in utilizing these investments (Gutiérrez 2016; Del Gatto unpublished).
- **Lack of human resources capacity:** MSMEs struggle to find and maintain personnel for tasks that require specialized skills or knowledge such as bookkeeping or marketing, without which they may incur costly missed tax exemption or inadvertent legal infractions with corresponding fines, further delays and losses, as well as poor business decisions. Even communities with a long tradition of forest management under indigenous or local knowledge systems are not necessarily equipped with the technical forestry skills to conform to rules imposed by national forest sector regulations (V. Lopez. 2014. Pers. comm., September; Larson and Pulhin 2012). Lack of “connections” with government agencies, financiers, buyers, or retailers is also an often unacknowledged but very real limit in facilitating good deals or quicker permits (J. Campbell. 2014. Pers. comm., September).
- **Unequal access to information:** Forest rights-holders or community producers are typically at a disadvantage with buyers given remote locations, poor communication infrastructure, and lack of formal education (Del Gatto in press). Informality further compounds the barrier by limiting an MSME's selling options to those intermediaries willing and able to use or launder “illegal” products (Gutiérrez 2016). Lack of information (such as baseline growth rates) may also hamper MSMEs' long-term forest or plantation management ability.
- **High transportation, transaction, or compliance costs:** Transport costs and time can make the difference between a profit and a loss in competitive markets, and distance is a prohibitive factor for remote communities or smallholders, even if there is identified market demand for their wood. MSMEs also spend a higher

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<sup>1</sup> See e.g. Lescuyer et al. 2011; Biggs and Shah 2006.

proportion of funds on administrative costs to legally producing wood than industrial operations, and poor governance and weak law enforcement may further increase transaction costs.<sup>2</sup>

- **Lack of organization and representation:** Individual MSMEs are well served by banding together into secondary associations, clusters, or networks for both economic and political reasons (Kozak 2006; FAO 2013; Macqueen et al. 2014): they can offer higher volumes more consistently, pool human and financial resources, or advocate as a single entity to make state agencies more accountable to forest-dependent communities (Paudel et al. 2012). Yet establishing networks among many small actors in multiple and often remote locations increases transaction costs, while the diversity of actors makes creating a unified political voice with a common agenda challenging (Mayers 2006).
- **Competition with illegal or informal products:** Higher per-unit operating costs and precarious financial situations may make MSMEs particularly vulnerable to being undercut by illegal goods, and even MSMEs in the formal sector are more likely to be operating in domestic markets where informality is common or even dominant.
- **Vulnerability to economic stochasticity:** Few MSMEs have deep reserves to dig into during crisis events. Small firms are more vulnerable to shocks such as increased cost of raw materials, energy, or labor (Luo et al. 2009), weather-related or infrastructure disasters, social conflict (Biggs and Shah 2006), or major policy changes such as trade liberalization agreements (FAO and Forest Connect 2009).

## 2. Impacts and Opportunities related to VPAs and Demand-side Legality Policies

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Achieving and demonstrating legality take on a new relevance as demand-side legality policies insert additional barriers to market entry or competitiveness, and producer country governments establish regulations or enforcement activities to adapt to the new paradigm. Existing barriers may be amplified in unintended ways, especially if policy negotiations are conducted without MSMEs' participation. However, a revision of legal frameworks can also create market and political opportunities for MSMEs. VPA negotiations also necessitate multi-stakeholder consultation processes, which can serve to bring MSMEs to the table.

### Possible Impacts and Risks

#### Additional regulations or required documentation

The specific document requirements under the EUTR, US Lacey Act, and Australian Illegal Logging Prohibition Act (ILPA) place the onus on the importer or operator of "first placement" on the market, but in practice, new informational demands are passed down the supply chain, either contractually or informally. Exporters to the US report being sent the Lacey Act Plant and Plant Product Declaration Form (which exists only in English) and asked to fill in all information themselves, including quantitative information regarding country(ies) of origin and scientific species names as well as container number, Bill of Lading and US Customs Entry Number.<sup>3</sup> For the EUTR and ILPA, exporters must be able to provide information on the country of harvest, species, quantity, and compliance with national legislation.

Providing documents that indicate compliance with national legislation may require that an MSME producing export-oriented timber implement new bookkeeping procedures or comply with regulations or tax payments that previously were ignored or were non-existent, increasing transaction costs. While in principle these costs may be offset by demand from overseas markets, price signals for legal or sustainable products remain variable and entrenched systems of petty corruption do not change overnight.

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<sup>2</sup> E.g. Kozak 2006; Macqueen 2008.

<sup>3</sup> The Plant and Plant Product Declaration form is available at [http://www.aphis.usda.gov/plant\\_health/lacey\\_act/downloads/declarationform.pdf](http://www.aphis.usda.gov/plant_health/lacey_act/downloads/declarationform.pdf)

## **Additional requirements for national Timber Legality Assurance Systems in VPA countries**

Countries that have entered into FLEGT VPAs are obliged to develop country-specific Timber Legality Assurance Systems (TLAS) and issue licenses for all timber shipments, though no TLAS has yet been fully implemented. While for the most part they are built on existing legislative and regulatory processes, there will likely be additional transactions in obtaining and maintaining licenses. It is also possible that the very systems designed to ensure legality will create their own opportunities for corruption in countries where governance remains fundamentally weak.

The tumultuous Indonesian experience is instructive of the complex trade-offs between creating a system feasible for SMEs without forming huge loopholes. The SVLK (*sistem verifikasi legalitas kayu* in the Indonesian acronym), which came online in 2010, requires all wood product businesses using domestic timber to be certified. While the government's original vision was that certifications under this system will be the basis for issuance of FLEGT licenses, full implementation of this scheme in a country with over 100,000 MSMEs was perhaps not surprisingly challenging. With only months to go before the first certification deadline in late 2013, only 637 of 3500 rattan furniture and craft makers (*Jakarta Post* 2014), 18 of 252 Bali-based handicraft exporters, and almost no community forest enterprises (Winarti 2013) had obtained certificates. Widespread complaints over the added costs and procedures of SVLK certification by SME producers led the government to respond by simplifying requirements in early 2014, allowing MSMEs to use a "Conformity Declaration" (DKP), a self-statement of legal origin that does not require an independent auditor's verification (MFP 2014). However, even this was not enough for some businesses, who successfully lobbied the government to exclude certain handicrafts and furniture products (and producers) altogether from the SVLK as an unfair burden, instituting an alternative "Export Declaration". Controversy around these declarations, which independent civil society monitors demonstrated to be a loophole that permitted some companies to continue illegal timber exports (JPIK 2016), further delayed implementation of the VPA until April 2016 when the Indonesian government bowed to pressure and clarified that all exporters and producers must comply with the SVLK (European Commission 2016).

## **Legality verification in high-risk environments**

The Lacey Act, the EUTR, and ILPA differ in what information they ask businesses to provide or to keep on file, but all require risk assessment. While none call for importers to provide proof of third-party legality verification, forest, or chain-of-custody certification against voluntary standards, but anecdotal evidence suggests that, faced with complicated national legislation and reports of illegal and informal activities, buyers from demanding markets increasingly view such third-party seals of approval as valuable when they choose to source from high-risk countries. If the cost of preparing a compliant forest management plan is out of range for most MSMEs, the costs of going through a credible third-party legality verification or certification process are even more so. While there are exceptions to this rule, MSMEs in low-value supply chains are often unable to provide such verification.

## **Increased barriers to markets**

Demand-side legality policies aim to improve market access for legal operators. By definition, this excludes informal producers, making MSMEs (who sell raw materials to larger processors, such as on-farm tree smallholders, artisanal charcoal producers, or cooperative enterprises harvesting logs) particularly vulnerable. Such MSMEs will either need to be brought into formality through intensive processes that require technical accompaniment or shift their focus to domestic markets, or risk going out of business. Facing demand for legally-verified wood – and in the absence of active programs to support MSME legality demonstration – buyers, importers, and retailers will logically seek more vertically-integrated companies with whom transaction costs will be lower and communication easier (Agricord and FAO 2013). MSMEs that do not horizontally integrate (i.e., organize into second-level associations with more leverage or ability to afford certification and verification) may be at a distinct disadvantage.



## Possible Opportunities

### Higher demand for single-source legal wood

The new legality paradigm also holds meaningful opportunities for MSMEs, both economically and politically, although some are better placed than others to realize them. MSMEs in certain market niches may find that the demand for legal, traceable wood products can actually offer them a comparative advantage. The most obvious example is producers and vendors of high-value, highly regulated tropical hardwoods. Such MSMEs, due precisely to their size, are likely to be sourcing from a well-identified area and have direct links to the forest managers, facilitating traceability.

In Guatemala, FORESCOM, a second-level business that offers processing and marketing services to the nine community forest concessions certified by Forest Stewardship (FSC) in the Maya Biosphere Reserve, consolidated business with Spanish retailer Leroy Merlin to sell a line of hardwood outdoor furniture across Europe. This helped the concessions to secure new deals for mahogany with several US musical instrument makers who are particularly concerned about legal sourcing in the wake of Gibson Guitar's prosecution under the Lacey Act. Strict government oversight and donor-financed capacity building have been instrumental to assuring the legality and sustainability of this product. Likewise in Honduras, the "green broker network" Coyote Verde offers highly traceable mahogany from small community cooperatives. The supply chain has been honed through a long-standing relationship with Taylor Guitars and has benefitted from a US Forest Service project to install a Helveta bar-code traceability system in this difficult governance environment (Fundación Madera Verde 2014; Nogueron and Middleton 2013).

### Added credibility through TLAS

Although the transition stage offers new difficulties, formal MSMEs in countries with signed VPAs may also eventually find themselves with a comparative advantage as national TLAS' are implemented and FLEGT licenses become a sign of credibility in European (and possibly Australian and US) markets. The EUTR exemption for FLEGT-licensed timber was designed to have this effect, although the EU has thus far resisted creation of reduced tariff incentives.

There are positive market signals. For example, the Indonesian government projects furniture exports to grow 50 percent through 2016 and reports an uptick in sales already in 2014 (*Tempo.co* 2014). That said, larger MSMEs may be better able to capitalize on this opening, while Indonesian sources suggest that small farmer associations supplying plantation timber may be in a better position than small furniture workshops as SVLK-certified raw material prices increase without corresponding price margin increases (Michael Richards. 2014. Pers. comm., September). Finally, market response will ultimately depend on Indonesia's and other VPA countries' ability to demonstrate that the FLEGT licenses are credible – a larger governance question.

### Increased political space and competitiveness in legal markets

The legality paradigm, if actively addressed by governments, the private sector, donors, and technical assistance providers, can incentivize regulatory simplification, formation of secondary associations, strategic alliances with buyers, group certification, capacity building, or credit provision for MSMEs. Ghana, the first country to sign a VPA, offers two success stories: the Kumasi Wood Cluster, a private association working to support small producers and exporters of plywood, veneer, and other products, has engaged in VPA policy discussions to raise the profile of small enterprises, and is working to obtain group certification for their members, develop new products, and improve efficiency and wood utilization (Adu 2014). Tropenbos, meanwhile, is undertaking in a process to forge alliances between artisanal millers and timber concessionaires that would allow the millers to use wood left behind after harvest in concessions (Nketiah 2014).<sup>4</sup> These successes came about due to the opening of political space for new or renewed discussion on resolving longstanding barriers faced by MSMEs such as land and tree access and complex regulatory systems. The economic rewards or risks underlying the logic of all demand-side policies are a factor that can serve to generate the impetus to overcome these issues, but it needs to be channeled into genuinely consultative processes.

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<sup>4</sup> See [http://www.tropenbos.org/country\\_programmes/ghana](http://www.tropenbos.org/country_programmes/ghana)



While there has been no systematic review of MSME participation in the eight countries in which VPAs have been negotiated or signed, anecdotal evidence offers insight into the extent to which MSMEs and their barriers to legality and competitiveness have factored into the negotiations. This evidence<sup>5</sup> suggests that while VPAs are effective at creating commitments to hold governments accountable to their own laws (many with positive outcomes for MSMEs most have not dealt directly with the challenge of small enterprises (much less households or informal operators) on either procedural or substantive fronts.

Participation by MSME actors has been mixed at best, with conflation between “civil society” or “communities” and small businesses, and almost no engagement of the informal sector. While there is overlap between these actors, MSMEs may have distinct interests or priorities than communities and NGOs. In Liberia, for example, part of the motive behind the new chainsaw regulation was to give communities more power to *prevent* small-scale logging in their forests. MSME interests are necessarily commercial in a way that other civil society concerns regarding forest sector governance are not. It is important that these priorities be understood separately and that both are allowed voice and representation in formal VPA processes. However, most VPAs do include some commitment to clarifying tenure, improving regulations for smallholders and communities, and formalizing informal logging.

### 3. Recommendations: Ameliorating Existing Barriers

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It is largely acknowledged that the best methods to support forest product MSMEs combine a focus on both the enabling environment – policies, business conditions, and overall governance context – and the full supply chain in which enterprises are embedded (CATIE and FAO 2006). Policymakers, donors, and NGOs should also focus interventions more broadly in the context of MSME competitiveness, since barriers to achieving or demonstrating legality are implicated within a complex knot of other structural, procedural and technical barriers.

Strengthening women’s roles in MSMEs is a crucial first step to address barriers both within and outside of the legality paradigm. Increasing women’s participation in forest businesses leads to better conservation outcomes, increased knowledge of rules and regulation of illicit activities, and improved conflict resolution (Mwangi et al. 2011). There are myriad ways to better address the additional barriers that women face in terms of land tenure, credit access, business establishment, and legal compliance – once these barriers are recognized. Solutions range from mandatory joint land titling in marriage to improving women’s legal literacy, to affirmative action strategies in credit institutions, to larger policy changes to ensure women’s work opportunities are equal to men’s (El-Fattal 2012).

Decision-makers in producer countries should therefore commit to supporting the development of MSME legality and competitiveness through the following strategies:

#### Policy Strategies: Creating an Enabling Environment by Ensuring Good Governance

- **Clarify land use policies and institute tenure reforms:** Tenure security, particularly rights that allow communities and individuals to benefit from forest resources are the first and most fundamental step to supporting MSMEs. When implemented at scale, tenure reforms can lead to larger regularization of the industry if accompanied by the political will to deploy further resources, as demonstrated in China where over 1,500 “Forest Tenure Management and Service Centers” have been established across the country and issue forest-backed mortgage loans to ensure collectives’ ability to access credit (Luo et al. 2009; Hong 2014).
- **Institute affirmative policies and regulations that actively support MSME activities:** As we have seen, laws and administrative procedures often stack the cards against MSMEs. Reversing this dynamic is an uphill but essential battle. Countries should undertake robust analyses to determine country-specific solutions to

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<sup>5</sup> Unless otherwise mentioned, sources are Duffield and Richards 2013; Penelon, A. and T. de Francqueville presentation “Opportunities and challenges in VPA and LAS” at Chatham House workshop “Small-scale and Community Forest Producers: the Challenges and Opportunities of Legality Verification.”

adjusting business registration requirements, tax structures, permitting procedures, and export paperwork (Kirkpatrick 2001).

- **Increase political will within agencies to support MSMEs, particularly at the local level:** Lack of effective decentralization to the provincial or district level (at which inspections are conducted and permits are processed) relegates local forest offices to a one-stop shop for bribes. Cultivating collaborative relationships between forestry officials and MSMEs can result in better regulatory innovations, which can later be scaled up.
- **Convene private and public sector actors in a participatory planning process:** In areas where wood-product MSMEs represent an important source of employment and resource use, convening public and private actors across sectors to develop a joint vision can be beneficial (Purnomo 2013).
- **Issue direct subsidies as a short-term solution:** Though out of favor in market-friendly policy contexts, direct subsidies may also stimulate MSMEs' growth by removing policy-imposed distortions, addressing market failures, supporting the creation of sound institutional structures, and enabling better technical and strategic decision-making (Biggs 2002). However, governments should couple subsidy policies with more sustainable solutions.

## Financial and Business Development Strategies<sup>6</sup>

- **Conduct participatory Value Chain Analysis (VCA):** Mapping supply chain actors, characterizing relationships, and identifying critical interventions are valuable diagnostic tools. Participatory VCA analysis on MSMEs allows for the collaborative identification of bottlenecks that impede competitiveness, the design of an action plan to resolve them, and the formation of alliances with other stakeholders in the value chain or with financial and technical service providers.
- **Ensure better access to finance and financial services:** Governments may focus on generating and disseminating information to potential creditors, developing new structures to offset risk, establishing revolving funds with a mandatory savings component, encouraging financial service providers to streamline procedures, using technologies that allow better communication with rural stakeholders, or offering advisory services.
- **Provide business capacity development services:** Providing information on price fluctuations and buyers in the market; technical training on sustainable logging, machinery operations and quality control, or accounting and sales, better enables MSMEs to understand and work within market opportunities. Building capacity for longer-term planning is also vital to MSME development.
- **Invest in the right people:** Capacity is only "built" when it stays within the community in which it is needed. Donor-funded projects often substitute this difficult, long-term task by employing consultants or external project staff to do much of the technical work, instead of supporting local service providers and facilitating lasting alliances. There is also a need for a new vision in the training of forest sector professionals, "one more rooted in local landscapes and local systems of governance", grounded in ensuring that forest management MSMEs and communities have internal expertise (Alexiades et al. 2013).

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<sup>6</sup> Unless otherwise noted, this section is drawn from CATIE-Finnfor's experience strengthening MSME value chains in Central America; IIED's work with locally controlled forestry as summarized in Macqueen 2008; and lessons shared during the May 2014 Chatham House workshop "Small-scale and Community Forest Producers: the Challenges and Opportunities for Legality Verification" <http://www.chathamhouse.org/event/small-scale-and-community-forest-producers-challenges-and-opportunities-legality-verification>

## 4. Recommendations: Making Demand-side Approaches and the Legality Paradigm Work for MSMEs

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Policy-makers and researchers in both producer and consumer countries should, firstly, obtain strong data on true impacts of demand-side policies. Given the large consensus that supporting MSMEs leads to sustainable development and poverty alleviation in addition as well as improving legal supply chains, the following strategies should be utilized:

- **Policy makers and research institutions should increase data collection** to better understand whether ‘possible’ impacts from demand-side policies are really occurring. However, given that supporting wood product MSMEs has diverse benefits not only for legal supply chains but for sustainable development and poverty alleviation, the strategies and actions described in the previous section should be deployed and scaled up in many producer countries.
- **Facilitate horizontal integration:** Organized MSMEs, whether in associations or sectoral platforms, are in a better position to advocate for their needs in policy processes such as the VPAs; access information, credit and other business services; reduce transaction costs to demonstrating legality; and transform and market value-added products.
- **Facilitate vertical integration:** In a legality-sensitive market, reducing the number of actors in a supply chain can reduce transaction costs while increasing confidence in compliance. While MSMEs are seldom in a position to ambitiously expand their business model in one direction or another along the supply chain, establishing long-term alliances with companies further along the chain increases trust to invest in the processes or technologies needed to ensure and demonstrate legality. Primary or secondary transformers that are often vulnerable to scarcity or illegality in their raw material supply can forge stronger relationships with wood traders and tree growers (Purnomo 2013; Adu 2014).
- **Incentivize MSMEs’ transition to formality:** Prioritizing tax reform, simplified registration and permitting procedures, and access to credit will decrease the cost of going legal for MSMEs. Procurement policies for legal timber and facilitating legal small-scale entrepreneurs’ access to these contracts may enable this transition as well. VPA texts should include formal commitment and concrete measures to advance MSME formalization, and to help them overcome any transaction costs or other barriers imposed by TLAS implementation.
- **Invest in innovative systems for demonstrating legality:** Traceability tools such as DNA and barcode tracking have flourished since the 2008 Lacey Act, but remain unaffordable for most producers. But as satellite technologies and cellphone applications become increasingly common and affordable, even in remote rural areas, a new generation of tools could allow MSMEs to demonstrate legal practices at an accessible cost.
- **Ensure involvement of MSME actors in VPA negotiations:** If a legitimate existing representative body exists within the broader MSME sector, they should be given a seat at the table. If no such body exists, platforms or consultations should be organized in such a manner that a wide representation of MSMEs is granted a voice in the process, and financial and logistical resources should be deployed accordingly.
- **Improve participation of a wide range of relevant government agencies:** MSMEs (and larger timber companies) further along the supply chain are regulated less by the forest authority, and more by agencies that oversee taxes, trade, transport, and customs procedures.

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