



**FOREST GOVERNANCE, MARKETS AND TRADE:
IMPLICATIONS FOR SUSTAINABILITY AND LIVELIHOODS**

**LINKING FLEGT VOLUNTARY
PARTNERSHIP AGREEMENTS
TO JOBS AND GROWTH:**

**POTENTIAL CHALLENGES AND
BENEFITS FOR SMALL AND MEDIUM
SIZED FOREST ENTERPRISES**

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COORDINATING INSTITUTIONS

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LINKING FLEGT VOLUNTARY PARTNERSHIP AGREEMENTS TO JOBS AND GROWTH: Potential Challenges and Benefits for Small and Medium Sized Forest Enterprises

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Linking FLEGT Voluntary Partnership Agreements to jobs and growth: Potential Challenges and Benefits for Small and Medium Sized Forest Enterprises
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EXECUTIVE SUMMARY

This brief report discusses the potential impact of the European Commission's Voluntary Partnership Agreements (VPAs) on the extent to which improved investment and business climates supported by VPA programs can support the small and medium forest enterprise (SMFE) sector. Recognizing the important roles that SMFEs play in rural development and the alleviation of rural poverty, the report argues that VPAs must seek to support opportunities for SMFEs to improve competitiveness, productivity and revenue, as well as mitigate any additional challenges these enterprises may face due to changes in market or trade structures caused by the VPA itself. It goes on to explain how policy makers can design a process whereby the potential risks to SMFEs arising from the VPA are minimized, and the wider vision of development and alleviating rural poverty can be realized. It proposes that the goals of VPAs – and those of emerging schemes such as REDD – are co-dependent with the aspirations of SMFEs and forest communities.

Greater SMFE benefits can be supported if the associated programs can: ensure broad stakeholder participation in the VPA design and implementation stages, ensure clarity of land tenure, contribute to organizational capacity building through nurturing the growth of industry associations, provide clarity and transparency of legality verification transaction costs, ensure that a broad range of forest products are included in the agreement, and recognize the contribution of SMFEs in achieving development and poverty alleviation goals.

While the FLEGT VPA programs are not a silver-bullet solution for governance problems in producer countries, they can seek to improve the overall business environment for responsible small and medium forest enterprises, thereby helping to alleviate rural poverty through the promotion of jobs and growth based on the responsible use of natural resources.

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INTRODUCTION

In May 2003, the European Commission published its proposal for a Forest Law Enforcement, Governance and Trade (FLEGT) Action Plan. This set out a range of measures that aim to tackle illegal logging and associated trade in developing countries, including financial and technical support to achieve improved forest governance. It also provides for Voluntary Partnership Agreements (VPAs) between developing timber-producing countries and the European Union. Partner Countries will implement an agreed licensing scheme that assures that their timber exports to the EU have been legally produced. EU border control agencies will allow shipments of timber products from Partner Countries entry to the single market only if they are covered by FLEGT licenses. This arrangement aims to boost buyers' confidence in increasingly sensitive EU markets that they are not purchasing illegal timber, thereby enhancing the reputation of exporters in Partner Countries.

The FLEGT Action Plan recognizes that through strengthening forest governance, VPAs have the potential to assist partner countries to promote rural development and alleviate poverty. Recognizing the important role that local and small-scale enterprises play in this regard, VPAs must seek to support opportunities for small and medium scale forest enterprises (SMFEs) to improve competitiveness, productivity and revenue, as well as mitigate any additional challenges these enterprises may face due to changes in market or trade structures caused by the VPA itself.

This note discusses the likely impact of VPAs on jobs and growth in partner countries, and the extent to which improved investment and business climates supported by VPA programs can support the SMFE sector. It goes on to explain how policy makers can design a process whereby the potential risks to SMFEs arising from the VPA are minimized, and the wider vision of development and alleviating rural poverty can be realized. It proposes that the goals of VPAs – and those of emerging schemes such as REDD¹ – are co-dependent with the aspirations of SMFEs and forest communities.

At the time of writing none of the VPAs in negotiation have yet been completed. Therefore, while some VPA impact studies have been referenced, this paper takes a theoretical approach and attempts to speculate how the VPAs may best be designed, negotiated and implemented, and what kinds of ancillary programs may be required to ensure that the process supports jobs and growth.²

THE IMPACT OF VPAS ON FOREST ENTERPRISES

In consumer countries, the success of FLEGT will be judged principally on the reduction in illegal timber entering the market. However, for the scheme to be sustainable, it will also need to contribute to more ambitious outcomes in partner countries. An important goal will be to help improve the overall business environment for responsible forest enterprises, thereby helping to alleviate rural poverty through the

¹ Reducing Emissions from Deforestation and land Degradation

² There is an implicit assumption that the VPA in each case will involve the positive and constructive engagement of all stakeholders, as to assume otherwise would involve a wider debate and exposition beyond the scope of this paper.

promotion of jobs and growth based on the responsible use of natural resources. Effective implementation of FLEGT schemes will help to achieve this if the following considerations are made.

ENSURING OR INCREASING ACCESS TO MAJOR MARKETS SUCH AS EUROPE AND NORTH AMERICA

Several countries, including seven EU countries plus Japan and New Zealand, have adopted public procurement policies that require their government departments to purchase legal and sustainable timber. For example, a new EU communication on Green Public Procurement³ states that European public procurement policies should hold legality as a minimum requirement for the purchase of wood construction, paper / printing and furniture products. These policies are having far-reaching influence, affecting all companies that do business with public agencies, in turn steering their procurement policies as well. In many cases, credible demonstration of legality has become a minimum requirement.

Since FLEGT licenses will be issued on the basis of agreed assurance systems, timber products exported from Partner Countries will be effectively provided with a government-backed guarantee of legality. This will lower the transaction costs of companies that buy from Partner Countries, giving them a competitive advantage over those buying similar products from non-Partner Countries. Partner Countries, especially those that apply FLEGT licensing to all their exports – both in terms of products and destination – will become associated with a brand: 'always legal' timber, provided that they remain in compliance with the terms of the VPA.

Over time, as FLEGT licenses become more common, this process will further stigmatize timber in EU markets that is not from known legal sources, making it very hard for businesses to claim that they have no means to determine the legality and origin of their products. FLEGT licenses will likely become more widely recognized, since the EU is often influential in setting standards in other jurisdictions,⁴ and usually works within the World Trade Organization (WTO) rules that permit regulations relating to conservation of natural resources.⁵ With the recent amendment to the Lacey Act in the USA,⁶ the FLEGT approach is likely to be given significant weight by the US government when it considers which sectors of the timber trade may be given more scrutiny, or during any investigation into the legality of, and/or any criminal liability related to, timber imports into the United States. A proposal for new EU legislation that would require businesses placing timber products on European markets maintain systems to exclude illegally produced products specifically identifies FLEGT licensed products as meeting this requirement.⁷

³ European Commission. 2008. Environment: Green Public Procurement. <http://ec.europa.eu/environment/gpp/index_en.htm>. Accessed October 22, 2008.

⁴ Kelemen, R.D. 2007. Globalizing EU Environmental Regulation. New Jersey: Rutgers University.

⁵ GATT Article XX, 'general exceptions' clause (b): 'necessary to protect human, animal or plant life or health'

⁶ Gregg, R.J. and Porges, A. 2008. Amendment to the U.S. lacey act: Implications for chinese forest products exporters. Washington, DC: Forest Trends.

⁷ European Commission Website. 2008. Environment: Forests. <http://ec.europa.eu/environment/forests/illegal_logging.htm>. Accessed October 22, 2008.

PROMOTING SUSTAINABLE FOREST MANAGEMENT

Depending on the eventual terms of each VPA, including the extent to which broader governance reforms are included alongside the implementation of the required legality assurance system, VPAs should bolster national laws aimed at sustainable forest management.

There is an important difference between legality assurance and sustainability. Depending upon local regulations (and their application), sustainable timber may not be legal, and legal timber may come from unsustainable sources. While not all illegal operations produce unsustainable results, where illegal forestry activities occur it is impossible to *guarantee* that forest ecosystems are sustainably managed. Timber legality assurance systems that base their definition of legal timber on laws aimed at sustainable forest management (i.e. those that address the ‘three pillars of sustainability’⁸); that include effective verification of compliance; and that apply sanctions where necessary, will improve the reputation of the producing countries and prepare the groundwork for subsequent revenue generation from emerging markets for ecosystem services (e.g. carbon offsets). Furthermore, more forest management organizations will be willing to invest in voluntary certification of sustainable forest management when there is predictable and consistent application of forest law, an outcome that should result from VPA implementation

IMPROVING OVERALL FOREST GOVERNANCE AND REDUCING INVESTMENT RISK

Responsible enterprises prepared to invest in the long-term will tend to avoid weak governance environments; considering the investment climate too risky. Weak governance taints the general business climate, creating uncertainty in procedures and regulations, increasing the risk of forfeiture or litigation. Physical operations may be contested due to traditional land use or ownership conflicts, and products could be tainted by negative publicity. VPAs do not oblige partner countries to introduce new laws, or beyond broad principles, specify which existing laws should be included in a country’s definition. Instead they provide a platform first for a wide range of interest groups to participate in developing a legality definition, and second, to identify areas where governance reform is needed. This may entail a process of reviewing existing regulations and procedures (e.g. through a Regulatory Impact Assessment), clarifying the rights and obligations of concession holders, and spatial planning that encapsulates traditional tenure and use rights. It may include a review of laws that reach beyond the forestry sector. As laws become more transparent and streamlined, and providing they are applied in a consistent manner, business and investment conditions become more predictable, thus lowering risk.

Although these developments will take time to materialize and in many cases will need to be supported by broader improvements in the investment climate, they should lead to a comparative advantage for partner countries, allowing them to increase their exports to higher-value markets and attract further investment that can, in turn, be used to increase productivity and move processing higher up the value chain.

⁸ Economic, environmental and social concerns

THE ROLE OF SMALL AND MEDIUM FOREST ENTERPRISES IN THE FOREST ECONOMY

Most of the forest enterprises in developing countries are SMFEs, defined as businesses employing up to 100 employees engaged in activities that extract or process timber or non-timber forest products. They are estimated to represent 50% of forest sector employment, generating \$130 billion of gross value added.⁹ In certain areas, many of these enterprises are owned by indigenous people with their own customary rights, or other community-based groupings (thus termed ‘community enterprises’). However, rural economies are complex, encompassing economic migrants (such as transmigrasi communities in Papua, Indonesia) and long-term settlements communities (e.g. Para, Brazil). Many are efficient, modern businesses. The descriptor SMFE can therefore cover a broad range of business types, encompassing both entrepreneur-driven businesses and collectively-owned enterprises, as well as those operating informally.

There is a tendency to characterize small forest enterprises as too weak to play a significant role in forest management. These views may arise from environmental concerns that greater commercialization of forest communities will lead to increased degradation of both canopy cover and biodiversity; economic judgments that large vertically-integrated enterprises possess economies of scale; and cultural determinism that suggests indigenous rural communities are unable (or unwilling) to manage complex businesses and believe that market participation entails unacceptable risks for vulnerable communities. In order to move away from such generalizations, for the purposes of judging the relevance of the sector to the VPA process, an assessment of the economic, environmental and social impact of SMFEs can be summarized as follows.

- **Economic impact:** In both developing and developed countries, small and medium sized enterprises (SMEs) can be the engine of economic and social development. Though larger businesses benefit from economies of scale, they often lose the ability to innovate and adapt to rapid changes in market conditions. They are also less resilient in times of economic shocks (as demonstrated in the 1998 Asian financial crisis).

Contrary to popular belief, the success of the first ‘Asian Tiger’ economies was not achieved only through supporting large companies (such as the chaebols in Korea). The process started with radical land reform, investment in education and creating dense networks of rural organizations with strong decision-making structures, leading to an increase in added value per hectare.¹⁰ This released surplus could be invested in small local enterprises. Export industries then built up upon this strong foundation by relying on small domestic businesses for diffusion of innovation and competitive strength. Approximately 40% of South Korea’s exports are directly from SMEs,¹¹ and a large proportion of exports from large companies are comprised of components manufactured by SMEs.

Conversely, the management of the forestry sector in developing countries has proceeded from the

⁹ Macqueen, D. 2008. Supporting Small Forest Enterprises – A cross-sectoral review of best practice. IIED, London

¹⁰ Prakash, D. 2000. Development of agricultural cooperatives - Relevance of Japanese experiences to developing countries. Tokyo: Institute for the Development of Agricultural Cooperation in Asia (IDACA).

¹¹ The Australian APEC Study Center (APEC). 2004. Innovation and SME development - Korea’s perspective and APEC Cooperation. <<http://www.apec.org.au>>. Accessed October 22, 2008.

hypothesis that industrialization of timber processing will be able to utilize excess labor in the agricultural sector, attract capital investment and form upstream and downstream linkages. There is now some evidence that vertical integration of forest industries has an impact at the macro economic level, for instance in raising GDP, and some integrated timber complexes require a wide variety of skills and supporting businesses. However, in many cases investment has flowed to those industries - such as plywood - that at the micro level generate low skilled and insecure employment, thereby failing to strengthen rural economies.¹²

- **Environmental impact:** Limiting the livelihood options available to forest communities in the name of conservation has not been successful in protecting environmental services.¹³ Widespread evidence from around the world demonstrates that private property holders, including those with community-based property rights, can and do protect public goods if the appropriate incentive structure is in place. In fact, rural communities own, or administrate under license, at least one quarter of forests in developing countries; they invest \$2.6 billion in conservation, exceeding state funding and all forms of international conservation expenditure combined.¹⁴

Of course, just as there is a range of responsible and irresponsible large enterprises, not all SMFEs are careful stewards of the environment. However, where SMFEs are situated close to the natural resources on which they rely, and draw on a local pool of labor that derives other services from those same resources, they have a vested social and economic interest in considering their long term management. Furthermore, a mosaic of different types of SMFEs, all utilizing forest services in slightly different ways, requires negotiation and accommodation of competing demands on the environment. Therefore, in theory if not always in practice, SMFEs can be said to possess an inherent interest in aspects of environmental stewardship. Conversely, where a large enterprise dominates a particular area of forest, decisions over environmental management often overlook the immediate needs of the proximate community.

- **Social impact:** A vibrant SME sector is often a key driver of pro-poor economic development. Where smaller businesses engender empowerment and self-reliance at the grassroots level, demand for education and other public services also increases, thus promoting development.

In the forestry sector, stronger community economies with clear tenure and resource rights reduce conflict by empowering communities and providing stable employment. Community enterprises engaging in long-term sustainable timber harvests have better economic and social outcomes than areas where rapid liquidation of the forest takes place.¹⁵ Most of the profits made by SMFEs may be recycled within the local economy, alleviating some aspects of material poverty and enhancing quality of life.

¹² Mayers, J. 2006. Poverty reduction through commercial forestry. What evidence? What Prospects? The Forests Dialogue. New Haven, CT: Yale University.

¹³ Sherr, S.J., White, A. and Kaimowitz, D. 2003. A new agenda for forest conservation and poverty reduction: Making markets work for low-income producers. Washington, DC: Forest Trends.

¹⁴ *ibid*

¹⁵ Power, T. 1996. Lost landscapes and failed economies: The search for a value of place. Washington, DC: Island Press.

SMFES AND VPAS - CHALLENGES AND OPPORTUNITIES

In general, SMFES face many constraints that are common to rural enterprises around the world, including, *inter alia*: poor links to markets, business development and financial service providers, inadequate access to market information and weak bargaining power, limited staff capacity and difficulty navigating centralized bureaucratic procedures usually designed for large enterprises. Many of these constraints are caused by their isolation – both physical and social – from the networks and services that could improve their operating environment.

In many developing timber-producing countries, larger companies dominate exports, with small and medium scale forest enterprises (SMFES) restricted to subcontracting or supplying the domestic sector. Often they rely on insecure, and in many cases illegal, raw material supplies and their weaker political influence means they are frequently targeted in crackdowns on illegal logging. There are risks therefore that strengthened law enforcement arising from VPA implementation will exclude forest communities and SMFES from domestic markets and further impoverish them. This risk will be exacerbated if legality assurance systems are poorly designed or applied in an inequitable manner. Furthermore, there is a risk that VPAs will be limited to a narrow range of commoditized industrial products (such as logs, sawnwood and plywood) which favor the larger export oriented firms.

Many of the potential risks of VPAs to SMFES can be analyzed via a framework originally designed by IIED to describe the characteristics of many small and medium-sized forest enterprises and the challenges that they face compared to their larger competitors:¹⁶

- **Social isolation, where local ownership and management often do not have access to a larger body of corporate protocols, expertise and advice:** Demand for verified legal supplies are likely to cause a consolidation in supply chains, favoring suppliers that are able to supply large quantities of verified or certified wood to export oriented manufacturers/exporters. SMFES are fragmented and will likely face a more difficult time securing large supplies of verified legal supplies. Many SMFES lack the skills or access to information to understand quickly how the market is changing (including how to engage in the required legality assurance systems) and limiting their access to international markets. Even access to domestic markets, which may be the only area of interest for many SMFES, may become more complex.
- **Financial vulnerability, with SMEs heavily reliant on the immediate financial resources of the owners themselves, usually without substantial financial reserves:** Legality assurance systems introduced as part of the VPA may favor larger, better organized companies that can comply with complex requirements. For instance, the relative costs of assurance systems will be proportionately higher for SMFES, relative to their turnover, especially if they are overly complex. Large firms with more business and assets have better access to capital and can better absorb fixed administrative costs such as permits, licenses, and costs associated with the assurance systems.

¹⁶ Thomas, R., Macqueen, D.J., Hawker, Y. and DeMendonca, T. 2003. Small and medium forest enterprise in Guyana. London: Guyana Forestry Commission and IIED.

- **Political marginalization, with SMEs having little influence over the market (due partly to low market share) and those who govern the market:** SMFES are often unduly targeted in enforcement crackdowns since they usually do not have elite connections that can protect them. Even though the VPA process should involve wide participation, the new regulatory frameworks may have been designed without much consultation. Any non-compliance by SMFES may give large companies a justification for monopolizing the market, or consolidating extraction rights over community-held lands.
- **Corporate expediency, where many SMEs are driven by immediate needs without the reserves or scale efficiencies to implement long-term sustainability:** Many smaller forest operations operate in the informal economy and are often considered illegal even if their actual forest operations are sustainably managed. Some are avoiding paying taxes; others cannot cope with the complexity or legal requirements to register as a formal business. Many have no incentive to formally register to become 'legal'. They may or may not be involved in unsustainable or illegal harvesting operations. But ultimately because they are not officially registered, they are unlikely to be able to participate in the legality assurance system, unless it is designed to interlock with existing extractive rights.

POTENTIAL BENEFITS OF VPA TO SMFES

The benefits that may accrue to SMFES from the VPA process will depend on various factors, not least how policies are actually implemented on the ground. An impact study for Ghana¹⁷ suggests that certain benefits may take some time to materialize, and are contingent on the extent to which wider sector reform is included in the process. There may even be some negative short term impact (for instance if large enterprises shed labor in response to decreased raw material supply). However, taking a longer term view of the process, the VPAs, if implemented properly, could provide the following benefits to SMFES:

- **Increased opportunities for exports:** If legality assurance systems are applied to all domestic and all export timber, a VPA will lead to a country's timber output being regarded as 'always legal'. This should improve exports to many markets, consolidating strength in certain areas of competitive advantage. For products where SMFES are part of the value chain, this overall improvement in exports can lead to increased sales and more stable markets, encouraging SMFES to invest their own labor and capital, and improving the chances that credit and investment will flow to the sector.
- **Less distortion in local markets:** Domestic timber markets in developing countries are often flooded with illegal products, making processing legal timber uncompetitive. Curbing illegal logging through correct implementation of the legality assurance system (and applying it to both domestic and export timber as recommended) will help reduce such unfair competition and stabilize local timber markets by removing distortion. Communities and smallholders that sell legal timber will be able to enjoy higher prices, whilst processors will benefit from a level playing field through improved

¹⁷ Mayers, J., Birikorang, G., Danso, E.Y., Nketiah, K.S. and Richards. M. 2008. Assessment of Potential Impacts in Ghana of a Voluntary Partnership Agreement with the EC on Forest Governance. London: IIED. Mimeo.

governance. In practice, while many SMFEs often rely on illegal timber sources, they rarely benefit from the lower raw material costs that are a result of illegal logging, as local regulations are weakly or selectively applied, favoring businesses with political or military connections.¹⁸ The decrease in illegal timber should lead to an increase in raw material costs, thus favoring small local processing enterprises that are closely aligned with sources of legal timber. As SMFEs switch to legal timber, they may find their overall cost structure remaining largely the same as before, as the bulk of the additional ‘rent’ embedded in the illegal timber was captured by other actors in the value chain.

- **Improved business environment:** World Bank research has shown that small and medium sized enterprises often stand the most to benefit from overall improvements into their business environment due to governance reforms. In many developing countries, SMFEs face arbitrary transaction fees at every stage of operating their business, from registration through to transport. For instance, over 80% of all firms operating in Cambodia (not just in the forest sector) report paying bribes to individuals in authority, with the total cost representing up 6% of all sales. Almost 60% of firms operating in Ecuador and Guatemala pay bribes, costing them 5.4% and 7.4% of total sales, respectively. In the domestic markets of Cameroon, “informal taxes” levied by corrupt law enforcement officials represent between 30-50% of total expenses for the seller.¹⁹

A VPA process that instigates governance reform alongside the design of legality assurance systems has the potential to address the regulatory complexities that so often create the opportunities for corruption.

- **More effective monitoring of governance performance:** A VPA, and its associated processes, will lead to more effective monitoring of governance performance. This is partly as a result of the monitoring instruments that will be put in place (such as the legality assurance system and planned independent monitoring), but also by those civil society members who engaged in the participatory VPA design process – many of whom are concerned that promised reforms will not materialize or illegal timber will be merely laundered into the licensing system. This monitoring is an important dimension of the VPA policy process – and is also a means to ensure that SMFEs are not sidelined.
- **Increased market awareness:** Although legality is the key concern at the moment, some markets may become more demanding in future. As certification schemes proliferate and notions of ‘fairtrade’ labeling gain traction, discerning buyers may take additional issues into account when making timber-purchasing decisions, and retailers may be motivated to seek market opportunity in differentiation through features other than price and minimum legality standards. Whilst these issues may seem speculative, at the least Partner Country governments cannot be complacent about market access; it will always be contingent on other factors.

¹⁸ Contreras-Hermosilla, A. 2003. Current state of discussion and implementation related to illegal logging and trade in forest products. United Nations Food and Agricultural Organization. Background Paper: Impact Assessment of Forest Products Trade in Promotion of Sustainable Forest Management. Rome: FAO.

¹⁹ World Bank. 2005. A Better Investment Climate for Everyone. World Development Report 2005. New York: The World Bank and Oxford University Press.

RECOMMENDATIONS TO MINIMIZE THE RISK TO SMFES

If the VPA is to be implemented with a wider view of long term economic development in mind, the risks to SMFES will need to be minimized. Programs to help mitigate these risks could include:

- **Participation of all stakeholders:** The wide participation of all stakeholders in defining legality and subsequent regulatory reform is an integral part of the VPA process. It is also an important step in improving the design, efficiency and effectiveness of the measures. A Regulatory Impact Assessment (RIA) process can determine how legality assurance systems will affect SMFES.
- **Tenure reform:** Clarity of tenure and usage rights (and obligations) over forest resources allow SMFES, smallholders and community forest enterprises to gain more control over a sustainable future income, encouraging investment of labor and capital, and accrual of long-term assets.²⁰
- **Build organizational capacity:** SMFES can tackle some of the constraints that face them by acting collectively in associations. This enables them to reduce transaction costs, lobby for policy change and diffuse innovation and best practice.²¹ Stimulating the formation of such associations, and ensuring their effectiveness, will require organizational capacity building.
- **Review and monitor transaction costs:** The transaction costs of legality assurance systems will likely disproportionately affect the competitiveness of SMFES, adding to the plethora of other transaction costs (both official and unofficial) that all enterprises must pay. SMFE Associations, NGOs and independent monitors should conduct a survey of transaction costs in order to encourage transparency and accountability. The data may also be used for benchmarking, either between provinces, or against other countries, enabling policy makers to better understand the types of challenges to competitiveness that SMFES are facing and how to address them.
- **Broaden scope of VPA:** As most SMFES are engaged in activities that fall outside capital-intensive processing industries, it is important that partner countries plan to widen the VPA scope to encompass as many processed products as possible, including furniture, and to include both domestic and export production in the legality assurance system. To do otherwise would be to run the risk that illegal timber is merely displaced into products that are outside the VPA list, perhaps endangering established export markets in higher added-value goods.
- **General Support for SMFE Business Climate:** This paper argues that the VPA process, viewed as part of the wider process of institutional reform, may be able to release the potential of the SMFE sector as a driver of sustainable development and poverty alleviation.

However, to take advantage of this opportunity, timber-producing countries in partnership with donors and the private sector will need to take certain steps to improve the general enabling environment for all SMEs,

²⁰ De Soto, H. 2000. *The Mystery of capital*. New York: Basic Books.

²¹ Macqueen, D et al. 2006. *Working together: Forest-linked small and medium enterprise associations and collective action*. Gatekeeper Series No. 125. London: IIED.

not just the SMFE sector. Much literature has been produced on this subject²² and it is not the purpose of this briefing note to provide a comprehensive guide to SME development, however a brief outline of some ways to support SMFEs is below (see Box 1).

Box 1 – General Strategies for Upgrading SMFEs

SMFEs are not usually as productive as larger companies, and may lack access to financial resources and the latest technology. However, they may be more adaptable and nimble than larger enterprises, able to quickly assemble new strategies and tactics. As a starting point, like any enterprise, SMFEs need to understand how the value chain operates and where they are located on it. Wherever their position on the chain, they are extracting a ‘rent’ through their activities, either passively through natural resource extraction or actively through value-added processing and manufacturing. There are various ways in which SMFEs can organize themselves in networks and produce both tangible and intangible value. All these approaches will require support from relevant NGOs, agencies and donor-funded programs.

Vertical linkages (e.g. sub-contracting): Vertical linkages between SMFEs on the value chain (e.g. between a community forest and a sawmill) ensure inter-dependence on fairly negotiated terms. Linkages between SMFEs and larger industries (e.g. between a community plantation and a pulpmills) should be based on a partnership or joint venture agreement, negotiated with the assistance of an independent third party and complying with a code of practice.

Horizontal linkages (e.g. clusters): Forest businesses tend to be remote from both markets and similar businesses. They may feel wary of sharing ideas and market intelligence with similar businesses; however the evidence shows that an open exchange of such ideas can benefit all units in the cluster, reducing costs and increasing margins. This is known as ‘the economics of agglomeration’ and can be witnessed amongst leather goods manufacturers in Italy, and woodcarvers in Bali. According to the Harvard Business Review,²³ networks of SMEs constitute a region’s key competitive advantage through their proven ability to diffuse innovation, interpret market demand and utilize raw materials efficiently. Although the Review was not referring to forest enterprises, one may speculate that their physical isolation means that these sorts of linkages are likely to be even more useful than for those clusters that already enjoy proximity.

Tangible value: Improving productivity, reducing waste through finer cutting of timber and reclamation of off-cuts, improved logistics and upgrading of product quality all contribute to adding more value from the same amount of raw materials. Where raw materials are scarce, or extraction is capped by regulations and government-approved forest management plans, SMFEs need to be more innovative to improve price performance.

Intangible value: If SMFEs are trading in a commoditized product, in direct competition with larger enterprises, then networking and maximizing tangible values may not be sufficient to ensure sustainable profits. By seeking intangible value, SMFEs can exploit niche markets and establish competitive strengths that differentiate them from the mainstream. This may be through product design, specialization in high value species, and transmitting cultural authenticity. Demonstrable sustainability and environmental stewardship are key forms of differentiation, most commonly achieved through certification schemes such as FSC. Arguably, the VPA adds a form of intangible value to all exports from a Partner Country by conveying the assurance that the timber is ‘always legal’.

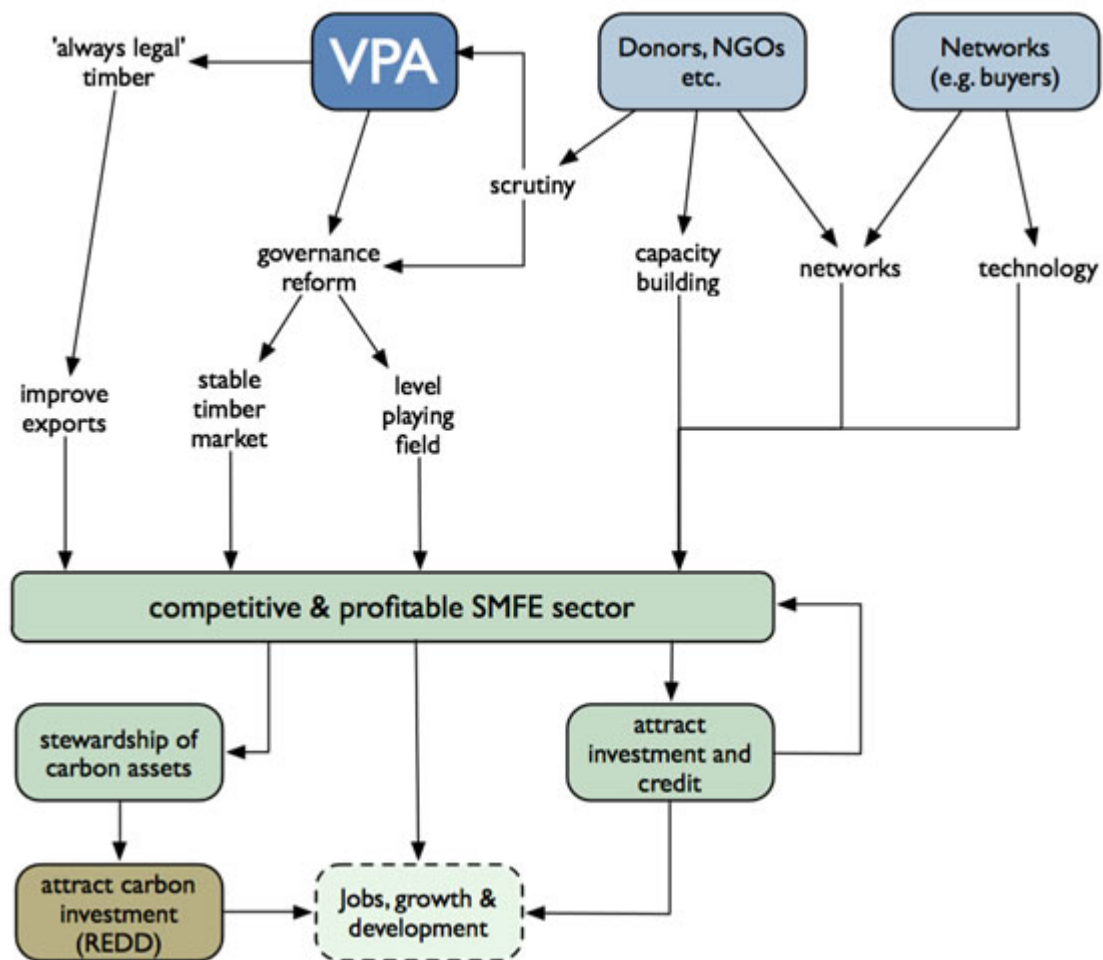
²² In particular see Macqueen, D. 2008. Supporting Small Forest Enterprises – A cross-sectoral review of best practice. London: IIED.

²³ Howard, R. 1990. Can Small Business Help Countries Compete? Harvard Business Review 68, Issue 6 (November/December): 88-103.

THE ROLE OF SMFES IN ENSURING THE SUCCESS OF FLEGT AND OTHER INITIATIVES SUCH AS REDD

In many timber producing developing countries, SMFEs are engaged mainly in the domestic market for timber and non-timber products. Policymakers may therefore believe that their relevance to the export-oriented VPA process is peripheral. However, this ignores the export potential of SMFEs and the technical developments that are opening up new opportunities and comparative advantages. It also overlooks the role that SMFEs can play in ensuring the success of FLEGT and other schemes (such as certification) that aim to differentiate forest products in the marketplace. The relationship between SMFEs and VPAs is depicted in Figure 1, below.

Figure 1: Structural Model of Relationship between VPA and Jobs, Growth and Development



Bearing in mind their predominance in the forest sector of most developing countries, failure to take account of the needs of SMFEs in VPA processes could lead to widespread leakage of illegal logs (a strong likelihood given the widespread informality of the sector), and capture of community forests by large companies and elites (who can cite their superior ability to comply with the legality assurance requirements as justification for

consolidating forest management). When subjected to scrutiny by markets, regulators and civil society, however, these events may undermine the credibility of VPAs both as a means to alleviate rural poverty, and also as a way to tackle illegal logging. If a country's ability for implementing its VPA effectively were called into question in this way, it would risk losing its 'always legal timber' status in the market. The consequences of undermining VPA reputation (either officially because of non-compliance, or unofficially through market sentiment) are likely to be loss of market access and erosion of comparative advantage.

Moreover, if weak and impoverished communities are excluded from the benefits of the timber trade brought about by the VPA, this would logically also undermine emerging schemes for payments for forest carbon, such as REDD, the World Bank's Forest Carbon Partnership Facility, or voluntary markets for forest carbon offsets. It would raise doubts about the capacity of local communities to be partners in canopy and soil conservation, and the willingness of local governments to regard them as such. Reduced carbon values will reflect the greater risk inherent in such projects, reducing national and regional income from such projects. Therefore, VPAs and REDD need to be seen as mutually reinforcing initiatives, both of which need to take the needs of small forest enterprises into account.

CONCLUSION

The FLEGT action plan, and the VPA process that accompanies it, is not a 'magic bullet' that will abolish illegal timber whilst making poverty of forest communities an artifact of a less enlightened era. It is a complex program, and its effects in each country will depend in part on the seriousness of the broader sector reform, the design of the legality assurance systems and the current state of the timber industry. This paper does not attempt to suggest that FLEGT is the best, or the only, means through which environmental, social and political objectives may be achieved. However, it does propose that the VPA process provides a catalyst for governance reform, whilst laying the groundwork for a revitalized and profitable domestic forestry industry.

Broadening the scope of the timber industry to encompass all actors on an equal basis, at all levels of the value chain, introduces new talent, entrepreneurship and innovation. As SMFEs and forest communities begin to participate in the legal timber trade and its associated industries, they could become partners in the process of law enforcement, as their interests become entwined with the objectives of sustainable forest management and legal timber production. This will reinforce and legitimize good forest governance, as well as supporting emerging ecosystem payment schemes such as REDD. Therefore, SMFEs are not only the ends of the VPA process, as they should be beneficiaries of governance reform, but they are also the means by which a country may improve its performance. Not only will this be a valuable outcome for the natural resource assets of tropical countries, it will be a story told in terms of jobs, growth and human development.

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