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Promoting legality within the private forest sector: obstacles and incentives to formalization

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Executive Summary

Informal forest sector micro, small and medium-sized enterprises (MSMEs)¹ are often equated with being “illegal” when their mode of production, source of raw materials, or even their legal existence does not conform with their country’s regulatory requirements. This characterization fails to recognize the complex circumstances many MSMEs face, especially in countries where the requirements for legality compliance and achieving formal status are not clear. This situation raises a question frequently faced by practitioners who work with forest sector MSMEs – *should MSMEs be encouraged to formalize to avoid being labelled as ‘illegal’?* Acknowledging that MSMEs have valid reasons to either pursue or avoid formalization, this brief does not judge this question but instead argues that it is more important to ensure that MSMEs receive concrete benefits when deciding to become formalized. It is the task of practitioners, governments, and stakeholders to contribute towards the creation of an enabling environment that rewards MSMEs for formalizing. By doing that, practitioners enable MSMEs to reap the expected benefits of formal status, such as securing livelihoods and opportunities for economic growth and decent employment.

Key Messages

- If the policy or legal context is not conducive to formalization, such as in contexts where the rule of law and/or law enforcement is weak, MSMEs will have little incentive to formalize.
- Raising awareness of the added value of formal status can increase buy-in from MSMEs but needs to be followed by the support that ensures that MSMEs can draw economic advantages from their formal status, such as business development and credit, access to markets, and increased ability to participate in legal and sustainable supply chains.
- Formality is often a prerequisite to “having a voice” as it can confer credibility upon enterprises, creating the possibility to participate in policy dialogues and reform processes.
- Simplifying formalization processes and minimizing associated costs is an essential first step; this can be done through promoting digital registration processes and “on-the-spot” registrations.
- Formalization requires long-term engagement, best achieved through the strengthening or creation of entities that can support MSMEs in the long-term, such as associations or cooperatives.
- The “mainstreaming” of formalization requires significant cross-sectoral support within governments, given that informal MSMEs exist in virtually every industrial sector.
- Disaggregated forest-sector employment data collection mechanisms need to be piloted to obtain clearer statistics on levels of informality, via partnerships between international organizations mandated to collect forest sector and/or labour data.
- There will always be MSMEs for whom formalization is not desirable nor practical; these MSMEs need never be forced to formalize, but incentives must be put in place so that enterprises who choose to formalize will benefit from doing so.

¹ The OECD defines MSMEs as non-subsidary, independent firms which employ fewer than a given number of employees. This number varies across countries. See: <https://stats.oecd.org/glossary/detail.asp?ID=3123> This paper looks at MSMEs in the forest sector that grow, manage and harvest wood (primary segment) as well as processing MSMEs that use forest-derived products but are not physically located within forests (secondary segment).

Introduction

Most of the world's population operates in the informal economy, representing 61.2 percent of global employment.² Forest sector MSMEs operate largely within this context; the 12.5 million people worldwide who are employed in formal forest-sector related businesses are dwarfed by the estimated 41 million people employed in the informal forestry sector.³ The actual number is likely much higher, given that informal employment expands during economic crises and downturns.⁴

The broad concept of “formalization” refers to the process of bringing operators out of the informal economy⁵ and placing them within the oversight of government. However, distinctions between formal and informal are different across countries and sectors, and ‘informal’ entities⁶ may be formalized to a certain degree, such as through fulfilling individual tax liabilities without being officially registered as an enterprise.

The definition of “formalization” requires nuanced interpretation and recognition that there is a spectrum of “formal” status from legal registration to compliance of further requirements as defined by the legal or regulatory framework of the State, such as fiscal obligations, labour regulations, and environmental protection. Within the forestry sector, “formalization” generally applies to registration for business and tax purposes as a legal entity with its own legal identity separate from the owners.



² ILO. 2018. Women and men in the informal economy: a statistical picture. 3rd edition. Geneva: International Labour Office.

³ FAO. 2020. Global Forest Resources Assessment 2020. Rome, Italy.

⁴ Chen, M.A. 2012. The informal economy: definitions, theories and policies. WIEGO Working Paper No. 1.

⁵ The informal economy is defined by the International Labour Organization as: (a) refers to all economic activities by workers and economic units that are – in law or in practice – not covered or insufficiently covered by formal arrangements; and (b) does not cover illicit activities, in particular the provision of services or the production, sale, possession or use of goods forbidden by law, including the illicit production and trafficking of drugs, the illicit manufacturing of and trafficking in firearms, trafficking in persons, and money laundering, as defined in the relevant international treaties.

⁶ While there is no fixed definition of an “informal enterprise” a 1993 ILO Resolution concerning statistics of employment in the informal sector classifies enterprises as informal based on their level of registration under specific forms of national legislation which may include factories or commercial acts, tax or social security laws, professional groups’ regulatory acts, or other similar acts, laws or regulations.

The forestry sector hosts unique challenges for formalization, primarily since forest-sector MSMEs can be categorized as being part of both an “agriculture production sector” and an “industrial manufacturing sector,” depending on their place in the value chain. Informal primary processors often lie at the interface between the two sectors, making it difficult to categorize them adequately or collect accurate data on their numbers. Informal timber producers have fewer reasons to formalize than agricultural producers who harvest their products several times a year. By comparison, community forests and smallholder timber producers may harvest timber on annual, multi-year, or multi-decadal rotations. For these enterprises, it can be challenging to justify the pursuit of formalization as a goal, especially when considering local preferences for flexible livelihood options dependant on seasons or shifting economic conditions. Lack of data on informality in the forest sector represents a fundamental barrier to better facilitating widespread formalization.

Overall, precise data on employment in the forest sector remains difficult to obtain, but more accurate data is available for some countries at the national and local levels. For example, in Indonesia, 1.5 million people are employed in the informal timber processing sector, which in 2010 contributed EUR 63 million to the local economy.⁷ In Peru, according to the National Institute of Statistics (INEI) labor informality in 2017 was 96 percent in rural areas and 67 percent in urban areas.⁸ In Cameroon, the Center for International Forestry Research (CIFOR) estimates that around 50 000 people in rural areas are engaged in small-scale logging and processing, where only 8 percent of chainsaw millers surveyed have ever held a legal permit.⁹ In Liberia, an estimated 19 000-24 000 individuals work as chainsaw millers; most of them are informal due to a lack of regulatory clarity on the formal registration process. Despite this, chainsaw milling contributes a total estimated annual trading value of between USD 31 million and USD 41 million.¹⁰ In Viet Nam, the national Labour Force Survey indicates that as of 2018, there were around 470 000 workers in the forest product processing industries, of which about 77 percent were in informal household and household business units.¹¹ The FAO-EU Forest Law Enforcement, Governance and Trade (FLEGT) Programme supported local partners in Viet Nam to collect data on formal enterprise registration at the village level, which offers greater nuance. The data revealed that of the 10 070 household businesses surveyed in 6 wood villages, almost all are registered as household businesses with district authorities, but only 33 percent took the step to register as a formal enterprise with provincial authorities.

Viet Nam’s registration requirements

Viet Nam has changed the requirements determining which households must register as formal enterprises, as per the Decree 01/2021/NĐ-CP dated 4 Jan 2021 on Business Registration. The threshold is now based on monthly income per household member, defined by locality. For example, in Dong Thap province, household businesses must register when they earn above 1 950 000 VND/person/month (USD 84) in urban areas and 1 500 000 VND/person/month (USD 65) in rural areas. This new rule simplifies previous registration requirements, which considered income and number of workers as thresholds. The FAO-supported surveys in the six wood villages revealed that households are reluctant to register as enterprises because they are afraid of higher taxes and the cost of hiring trained accountants to produce tax and revenue reports.

Several actions could be taken to obtain more accurate estimates on formalization. The first is the collection of disaggregated data specific to the forestry sector. The second is an in-depth revision of data collection processes at country level and definition of pilot census processes to quantify the level of informality, which can be replicated across countries. Results of these censuses can be shared with governments to illustrate the need to conduct wider national censuses. These efforts would require closer collaboration between reporting countries and FAO as well as among global data providers such as the International Labour Organization (ILO), FAO and the World Bank.

⁷ Contribution to local economy is calculated in terms of workers compensation. Cerutti, P.O., Y. Artati, A. Dermawan, A. Kelly, G. Lescuyer, E. Mejia, K. Obidzinski, P. Pacheco, L. Putzel, R. Tsanga and A. Wardell. 2014. Policy options for improved integration of domestic markets under the voluntary partnership agreement (VPA) regime. CIFOR Info Brief No. 80.

⁸ Diario Correo. 2018. *Informalidad creció a 73.3% en el 2017, según INEI*. 16 February 2018.

⁹ Cerutti, P.O. and Lescuyer, G. 2011. *The domestic market for small-scale chainsaw milling in Cameroon: Present situation, opportunities and challenges*. Occasional Paper 61. CIFOR, Bogor, Indonesia.

¹⁰ Bickel, A. and Cerutti, P.O. 2017. *Liberia: Domestic timber value chain analysis*. Extractive Overview Report, USAID, Monrovia, Liberia.

¹¹ EFI.2020. *Gender + FLEGT + VPAs. Vietnam Situation Analysis*. Unpublished manuscript.

Methodology

Acknowledging the existing body of work developed by practitioners regarding formalization, this brief is meant to complement existing knowledge by providing perspective specifically on forest sector MSMEs. It builds on the experiences of the European Forest Institute (EFI) and the FAO-EU FLEGT Programme, whose programmatic work has focused on helping MSMEs to produce and process legal timber for integration into legal and sustainable value chains.

FAO staff members conducted interviews with both local partners and, where possible, end beneficiaries of eighteen MSME support projects in 8 countries from Africa, Latin America, and Asia that explicitly sought to formalize MSMEs. The impacts of these projects were analyzed to determine best practices for supporting MSMEs to formalize and the effect that formalization can have on MSMEs. EFI respectively analysed fourteen value chains producing timber products for domestic and in part for international markets in Laos, Myanmar, Thailand, and Viet Nam and conducted six pilot interventions to test solutions to MSME challenges identified in the analysis. Through the pilots, EFI worked closely with more than 100 MSMEs in the 4 Mekong countries.¹²

Both FAO and EFI have seen operators benefit in many ways from support and training, beyond the initial objective of formalization towards increased legality compliance. MSMEs report making fundamental improvements in operations, and an appreciation of their role in providing productive employment and decent work. This shift in thinking helps MSMEs embrace broader issues such as sustainability and conservation of forest resources.

Formalization is, therefore, the critical “first step” to take. Still, this first step is challenged by a conflicting number of obstacles and incentives – that affect both MSMEs who desire to formalize and those who prefer to continue operating informally. A modified version of Kurt Lewin’s force field analysis¹³ (Figure 1) can be used to describe these obstacles and the incentives for MSMEs to formalize, recognizing that a critical restraining force is the desire to continue “business as usual” in contexts when the flexibility of informality or less governmental oversight is desirable.

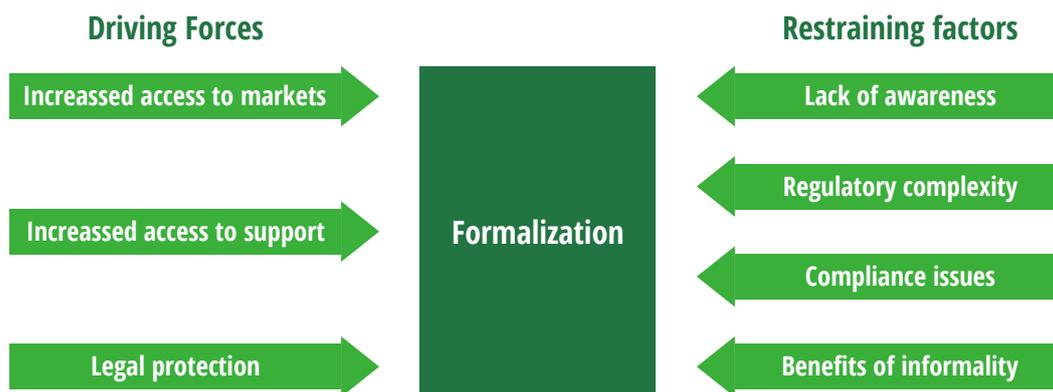


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¹² See: www.euflegt.link/smes-mekong

¹³ Lewin, K., and Dorwin Cartwright. 1951. Field theory in social science. The graph is adapted from Sagawa. *Formalization of Small and Micro-Enterprises in Myanmar's Wood Based Industries*. 2020. Unpublished.

Figure 1: Driving forces and restraining factors influencing formalizations of forest sector MSMEs



Factors impeding formalization

The following section details some of the factors most commonly cited in interviews and observed during fieldwork and illustrates examples of how they can be overcome. A discussion follows to reflect on whether formalization should be a default goal of technical support to forest sector MSMEs.

1. Lack of awareness of legality requirements and benefits

MSMEs are often unaware of national-level regulations affecting them, as the information takes time to trickle down, and they may not be aware of the need to comply. This is especially the case for MSMEs located in remote areas without connectivity or with forest owners who predominantly speak indigenous or non-official languages. This lack of awareness is also driven by a lack of law enforcement and government authority oversight; if MSMEs can continue running their businesses profitably without formal registration, there is no need for them to maintain awareness of regulatory requirements or changes. For this reason, MSMEs do not necessarily understand the benefits that formalization can bring. Owners of informal businesses often do not want to change their status due to a lack of awareness of available legal markets and how to use formal registration as an added value to access support and markets.

2. Regulatory complexity and financial and administrative obstacles

Formalization can be hindered by administrative costs and barriers, such as time-consuming administrative processes and the expertise needed to complete complex paperwork. This is especially the case in countries where formalization requires interaction with multiple government institutions. For example, in Myanmar, there are four different registration options for informal wood processing MSMEs under four different Directorates. The processes and requirements under these options are not harmonized. MSMEs, often with limited skills and knowledge of the regulations that apply to them, have difficulty navigating these procedures, which can be cumbersome, unclear, or contradictory. Logistical access to the relevant departments for registration can be difficult, especially for MSMEs in rural areas.

However, the cost of formalizing (or misperceptions about the cost of formalizing) is cited by local partners as the single-most limiting step. In Côte d'Ivoire, local partners report that it costs USD 85-265 for an MSME to formalize, but this does not include the cost of legal fees of legal experts needed to navigate and complete complex procedures.



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Forest-sector MSMEs also face high costs in complying with forest regulations. In Perú, the cost of legal timber harvesting represents 27 percent of the total cost of timber extraction, calculated from the initial step of developing a management plan to the final step of reaching the processing industry logyard.¹⁴ In contrast, in Honduras, this cost of accessing forest legality is 12 percent¹⁵, in Colombia 21 percent¹⁶, and in Guatemala 19.2 percent.¹⁷ These costs remain very high and compromise competitiveness in comparison with illegal operators.

Interviews with informal businesses and industry associations in Myanmar, Viet Nam, Cameroon, Guatemala, Honduras, and Côte d'Ivoire all reveal that informal business owners are afraid of the additional expenses they would incur upon registering. Taxation is perceived as a significant disincentive to register by informal business owners, and the accompanying need to pay accountants to handle tax payments and auditing.¹⁸ In Côte d'Ivoire and Cameroon, MSME representatives are advocating in favour of tax incentives as well, albeit unsuccessfully thus far. This is because ministries in charge of finance are often reluctant to approve such incentives, as they fear it could result in lower tax revenues. In some cases, this fear of paying extra taxes stems from unawareness of the actual costs, which can be lower than MSMEs expect.

¹⁴ Gallardo, J., Santamaría, O.J., Navarro, G.A. and A. von der Ohe. 2021. *Estimando y mejorando la legalidad de la madera en el Perú. Costos ¿Cuánto cuesta ser legal en el Perú?*. Lima, Perú. PCM, USAID, US Forest Service 106 pp.

¹⁵ Navarro, G.A., Esquivel, M. and M. Durán. 2018. *Fortalecimiento de la gobernanza forestal en Honduras. Un factor indispensable para la conservación de los bosques. Análisis del aporte de las acciones FLEGT para el fortalecimiento de las opciones de la Estrategia Nacional REDD+ en Honduras 1st Ed.* Turrialba, Costa Rica. CATIE. 60p

¹⁶ Navarro, G.A., Esquivel, M., Bohórquez, N. and A.Y. Quintero. 2018. *Las políticas de uso de la tierra y gestión del bosque como instrumentos para alcanzar la paz, el desarrollo rural y la conservación de bosques. Aporte de las acciones FLEGT al fortalecimiento de la Estrategia Nacional REDD+ en Colombia.* 1st Ed. Turrialba, Costa Rica. CATIE. 63p

¹⁷ Navarro, G.A., Bonilla, C.R. and A. Mariajosé Esquivel. 2018. *Fortalecimiento de la gobernanza de los negocios forestales como instrumento para la conservación de los bosques y generación de bienestar humano en Guatemala: Contribución de las acciones FLEGT para el fortalecimiento de la Estrategia Nacional REDD+ en Guatemala.* 1st Ed. Turrialba, Costa Rica. CATIE. 61p.

¹⁸ However, informality does not always exempt businesses from paying taxes. EFI's interviews with 10 informal household furniture makers in Attapeu, Lao PDR revealed that all pay taxes to the local authorities.

Indonesia's One-Stop-Shop for Business Registration

In 2020, Indonesia rolled out an online platform called the “Online Single Submission” (OSS), where businesses in all sectors can complete their business registration process online by applying for all crucial permits at once, such as business permits, distribution permits, timber forest product collection permits, building, and environmental permits. While the OSS was an initiative of the government of Indonesia designed to improve the country’s investment climate, the private sector in other countries recognize the need for their governments to move towards electronic permitting systems that would improve transparency, reduce corruption and prevent delays in the registration process – one of the critical barriers organizations face in pursuing legal compliance.

Indonesia is also making efforts to lessen the economic burden of formalization on MSMEs. The government has introduced subsidies to lower some of the costs associated with achieving certification under the Indonesian timber legality assurance system, including providing subsidies for certification audits, providing self-declaration options on timber legality to smallholders, and operating in groups.

3. Inability to comply with regulations

Informal businesses often lack the basic technical and operational skills to comply with registration requirements and to have obtain business operating licenses. For example, in Lao PDR, having a timber input-output management system is a requirement for acquiring a business operating license. Many MSMEs lack the capacity to install such a system without specific training. Another chronic challenge is the inability to comply with labour codes or occupational health and safety requirements. In Honduras, FAO supported a survey of MSMEs in three regions which found that only 22 percent of employees had fixed contracts, and only 17 percent met minimum wage requirements. Almost none of the enterprises complied with occupational health and safety requirements. While large companies have the resources to hire skilled personnel to manage their compliance requirements, MSMEs do not generate enough revenue to hire the personnel needed to support them in these processes.



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Building financial management capacity in Myanmar

Barriers can be overcome through targeted training and information sessions in collaboration with industry associations. In EFI’s pilots, business administration and marketing training proved catalytic in transforming the way owners see their businesses. It motivated them to improve their practices and pursue business registration to access further support and new markets. For example, in Myanmar, in a pilot project, EFI’s local partner coached 15 informal household furniture makers in Thaketa, Yangon, on financial management. The training was well received by the households who applied their knowledge straightaway to produce financial records which is a requirement for business registration. Furthermore, the pilot made the industry associations aware of formalisation requirements and encouraged them to support their members to register formally. As a result of the above activities, in January 2021, 13 household furniture makers applied for formal business registration with the support of the wood-based furniture association.

4. Perceived “benefits” of remaining informal

Many MSMEs enjoy the flexibility that informality offers, as they can commence, halt or alter production outputs in accordance with market opportunities. This is especially convenient for forest-sector MSMEs that offer piece-meal work and hire temporary workers to fill orders or offer seasonal work, such as in countries where timber harvesting takes place during specific seasons. Informal, seasonal employment arrangements can be more practical and less costly and may be preferred by employers and employees even if these arrangements are not in line with labour regulations. In Viet Nam, where many household businesses employ and work with relatives, local partners have expressed reluctance to formalize and comply with labour regulations that would require them to issue contracts to family members. This preference to maintain informal working systems also disincentivizes formalization.

Forces that drive MSMEs to formalize

EFI and FAO’s fieldwork and partner interviews also identified a range of common denominators to incentivize formalization for MSMEs working in the timber sector. While these points largely confirm what other practitioners have observed, the section below offers tangible examples of how local partners have taken advantage of these drivers to promote formalization.

1. Increased access to markets

For small-scale timber producers, legal status (i.e., land ownership or utilization rights) is often a condition for harvesting and commercially selling timber.¹⁹ Without this, producers often rely on traders or intermediaries to arrange necessary paperwork, such as harvest and transport permits, forcing them to accept lower prices. For processing enterprises, legal status can be the first step to obtain preferential and reliable access to raw materials, linkages with lead companies, eligibility to compete for public tenders, and the ability to access premium export markets.

Formalization can also be a prerequisite for access to legal raw materials. For example, in Myanmar, starting from 2018/2019, the Ministry of Natural Resources and Environmental Conservation increased access to timber for legally established micro and small businesses in special auctions that exclude larger companies, tender small batches of timber, and require payment in the local currency.

Legally operating enterprises can provide the documentation and traceability information, such as Value Added Tax (VAT) invoices, to form linkages with supply chain actors producing for sensitive export markets. Interviews with medium to large enterprises in Viet Nam, which primarily export to the United States and the European Union (EU), revealed that they mainly look for subcontractors that can issue VAT invoices as a form of documentation, as this meets the need of buyers to have official evidence of transactions. This bore fruit in Viet Nam, where the combination of EFI’s technical training and visits to larger enterprises motivated eight MSMEs (three enterprises and five households) from Lien Ha wood village to join hands and establish a formal joint-stock company. In April 2021, the company inaugurated a showroom to market Lien Ha’s products in the south of Viet Nam. Informal enterprises can also benefit from these support activities, but their unclear legal status limits their access to markets, renders them less attractive to investors, and overall less eligible for extension services.

¹⁹ This is often not the case when referring to community-based forest enterprises, as community forestry frameworks in several countries prohibit the commercial sale of timber harvested under such frameworks.



Ghana – Online portals to foster business-to-business linkages

In Ghana, with FAO-EU FLEGT Programme support, the Forestry Commission's Timber Industry Development Division (TIDD) has established a business-to-business platform known as the Un-Removed Yield Portal. The online portal links registered buyers with legally sourcing timber-producing companies to help them access unexploited timber from legal concessions, usually lesser-used species. This benefits both producers and processors. Both buyers and producers are primarily MSMEs, and the platform is now seeing increased interest from MSMEs and timber trading associations.

The Un-Removed Yield Portal was established as part of the government's Domestic Timber Trade Network (DOTNet) process to regulate and promote trade in legal timber on the domestic market, while promoting formalization of actors and linkages along the domestic timber value chain.

In some countries, public procurement policies that require governments to procure timber of verified-legal origin have either been introduced or are being developed. Such policies will favour formal enterprises and enable formalized MSMEs to document legal timber origin to participate in public tenders, giving them access to significant market shares. This expands market opportunities for formalized MSMEs. For example, in Cameroon, the manager of an MSME that received FAO support to formalize, reported having won a public tender for timber infrastructure work for the Army in the country's Eastern region. This expands market opportunities for formalized MSMEs.

Finally, formalization can be a stepping stone towards more lucrative export-oriented supply chains. In Indonesia, the Indonesian Furniture and Handicrafts Association (ASMINDO) helped three groups of MSMEs to receive SVLK certification,²⁰ which resulted in several group members securing clients in Europe and exporting their products abroad for the first time.

²⁰ System Verifikasi Legalitas Kayu. SVLK is Indonesia's timber legality assurance system.

2. Increased access to financial and technical support

One of the most commonly cited drivers to formalize is potential access to financial mechanisms, such as credit. While this is difficult to realize, given that even formalized MSMEs may lack the collateral needed to access financing, some countries offer formalized MSMEs access to credit at subsidized rates from state-owned banks, making them more competitive compared to informal enterprises which do not have access to such credit lines and tend to receive credit with much higher interest rates and increased risk of losing their assets in case of default. EFl currently supports a group of tree growers in Lampang, Thailand, to register as a group and access subsidized loans from the Bank for Agriculture and Agricultural Cooperatives using their trees as collateral. To support the operations of MSMEs in Colombia FEDEMADERAS facilitated a meeting between the MSMEs and the financial institutions catering specifically to the forest sector, such as the Banco Agrario and the Fiduciary Society for Agricultural Development. As a result, 43 timber processors learned how to access credit. This access to credit is vital for enabling MSMEs to purchase the equipment they need to improve their efficiency and produce value-added products, ultimately generating more revenue for their business.

In some countries, government institutions offer technical training and subsidies to purchase equipment only to formally registered MSMEs. For example, the Peruvian government's Center for Technological Innovation of Wood (CITEmadera) provides support programmes only to legally registered enterprises. Although support from donors and international organizations may target both formal and informal MSMEs in efforts to promote local livelihoods and poverty alleviation, due to their legal status, formalized enterprises are more likely to capitalize on such support to increase their competitiveness and profitability. By virtue of being formalized, MSMEs can apply these skills to grow their businesses by engaging in more profitable markets such as those requiring legal or sustainable timber.

3. Protection through the legal system

Informal enterprises do not typically have access to the formal court system. This requires them "to restrict their transactions to the immediate local and to be with those parties with whom they have personal or social ties".²¹ While these arrangements allow the parties to use informal dispute resolution processes and traditional means of justice, they can be locked out of formal dispute resolution mechanisms and courts.²²

While formalization alone is insufficient to alter the overall operating context of MSMEs and to completely eradicate fraudulent practices, formal enterprises often have a better negotiating position when solicited for informal payments. Legal status can also offer some level of judicial recourse should MSMEs wish to lodge disputes or invoke laws and regulations in their favour. Although most MSMEs lack the expertise and resources needed to pursue these legal routes, membership in associations and federations can provide a pathway through which this legal support is provided.

Legal status can also protect MSMEs from potentially detrimental changes in local frameworks. Even when given a period to achieve compliance, these regulatory changes can still affect their continued capacity to operate. In some countries where governments have strengthened controls over forest sector businesses, unregistered MSMEs may have been spared forced closures if they had formalized before the policy change.

²¹ Zinnes, C. and DCED. 2009. *Business Environment Reforms and the Informal Economy*. The Donor Committee for Enterprise Development

²² According to the ILO, policy reforms in this field typically focus on improving access to formal dispute resolution channels, strengthening and improving the quality of customary and traditional governance methods, improving linkages between (and greater awareness of) formal and informal systems of justice, and improving access to justice in bureaucratic administration. ILO.2016. *Policies, Strategies and Practices for the Formalisation of Micro and Small Enterprises*. ILO, Geneva, Switzerland.

Gender Equality and the Human Rights-Based Approach

The informal sector is a critical source of rural livelihoods, given that limited provision of public services in rural areas leads to weak governance and limited industrial activity.²³ It is often one of the only sources of employment for women and rural youth. However, it is acknowledged that these livelihoods are characterized by income inequality and a lack of social protection. A study in Colombia found that informality was associated with lower income levels, with 87.5 percent informality amongst the lowest income strata and only 20 percent informality amongst the highest income strata.²⁴



For this reason, formalisation in connection with gender equality and human rights deserves special attention in the design of support provided by donors, governments, and stakeholders to forest sector MSMEs. From a human rights perspective, formalisation can increase accountability and empower MSMEs to access markets and support on fair terms. Accountability, empowerment, and capacity development are fundamental principles of the human rights-based approach.²⁵ Formalisation can also help to address discriminatory practices within businesses. The levels of wage inequality and employment insecurity, especially for women, are higher in the household business and micro-enterprise segment of the forest industry. Informality exacerbates inequality and insecurity because informal business owners mostly employ workers without formal contracts. During economic crises, female workers tend to be laid off first, and the absence of formal contracts prevents them from claiming social protection benefits. Also, aspects of the labour code meant to protect women and promote gender equality at work are often not complied with because the labour authorities rarely inspect informal businesses. The obligation for formal enterprises to comply with labour regulations can benefit workers and drive gender equality.²⁶

²³ ILO. 2019. *Transitioning to formality in the rural informal economy*. Policy Guidance Note.

²⁴ Diario Correo. 2018. *Informalidad creció a 73.3% en el 2017, según INEI*. 16 February 2018.

²⁵ For more information on the human rights based approach, please see Sida's compilation of thematic area briefs. In particular: Sida. 2015. *A Human Rights Based Approach to Market Development*. Sida, Stockholm, Sweden.

²⁶ In this respect, the ILO highlights the importance of "an integrated and coherent strategy for employment, social protection and other social policies" in facilitating the transition to the formal economy. See: ILO.2019. *Decent Work in Forestry*. Decent Work in the Rural Economy Policy Guidance Notes. ILO, Geneva, Switzerland and ILO.2015. *Recommendation 204 on the Transition from the Informal to the Formal Economy*. ILO, Geneva, Switzerland.

Discussion

Many practitioners question whether pursuing formalization need be the default pathway for policy-makers and MSME support interventions. It is recognized that there is a subset of businesses that will never aspire to formalization, and a subset of entrepreneurs who would be deterred from formalizing and growing their businesses if the process is too daunting. Formalisation as a goal is most appropriate when MSMEs will clearly benefit from being formal, and should not be a definite target otherwise. For example, in Cameroon, a CIFOR study noted that chainsaw millers with permits faced stricter operating conditions and higher operating costs without enjoying any real economic benefits in return.²⁷ Intervention should therefore be oriented to ensure there are sufficient incentives and benefits to formalize, and to provide the tools available for those who aspire to formalize.

The following enabling conditions would ensure that formalisation is genuinely beneficial for MSMEs:

- In cases where the legal framework does not prescribe a clear legal pathway towards formal registration, the development and/or the revision of laws and regulations, as well as the simplification of procedures, are critical for formalization. Without a clear legal process, pursuing formalization risks putting a strain on MSMEs in the forest sector.
- When costs of formalization are unreasonably high, encouraging businesses to formalize would require extensive and long-term technical, administrative, and financial support, which limits the upscaling potential of support projects. For example, in Cameroon, Action for Sustainable Development estimates the cost of formalization for timber processors to fall between 800 000 and 1 200 000 XAF (USD 1 480-2 220), which is beyond the means of most MSMEs. This can negatively affect businesses without sufficient turnover to recover the costs. In such cases, exploring options for lowering or subsidizing costs are critical for encouraging formalisation.
- In countries where the government has limited resources and capacity to deliver benefits or provide oversight, MSMEs can see little point in formalization because the State is neither monitoring status, nor offering economic benefits (i.e. access to capital, loans or extension services) for those who do formalize. In such cases, governments require support to increase their capacity to enforce the law and incentivize formalisation.

The above scenarios all point to the need to addressing the three “low hanging fruits” that all countries could pursue to promote formalization: (1) ensure there is a clear legal pathway to formalizing, (2) reduce the cost and complexity of formalizing, and (3) conduct outreach and provide incentives.

Ways forward

The issues presented above are intended to advise all actors who work together with forest sector MSMEs to better understand the necessary enabling environment to ensure formalization delivers concrete benefits. The following lessons are presented for consideration to all those designing and providing MSME support interventions, recognizing that many obstacles to formalization need to be addressed by actors beyond the forestry sector.

Raising awareness of the added value of formal status can increase buy-in from MSMEs. Raising awareness is critical for combating misconceptions, such as potential tax liabilities and the actual cost of registration. There is ample evidence to suggest that MSMEs who witness the economic benefits of formalization are more willing to leave informality behind. This momentum towards formalization can be built upon if stories and testimonies of MSMEs who receive direct benefits from formalisation are put forward and used in awareness-raising campaigns.

²⁷ Cerutti, P.O. and Lescuyer, G. 2011. *The domestic market for small-scale chainsaw milling in Cameroon: Present situation, opportunities and challenges*. Occasional Paper 61. CIFOR, Bogor, Indonesia

Simplifying and reducing the overall cost of the formalization processes is an essential first step. The formalization process needs to be cost-effective so that it does not discourage entrepreneurship, and so it enables formal MSMEs to remain competitive against informal and illegal operators. This cost-effectiveness would factor in both direct and indirect costs, such as staff time spent on compliance processes. The concrete components of simplification therefore include the following points:

- Limit the number of steps in the process;
- Reduce the number of documents requested;
- Guarantee reduced time periods for completing the formalization process;
- Adapt the cost of formalization to MSMEs, especially the cost of registration;
- Adopt simple processes for renewal of registration and/or permits and licenses.

Simplified registration processes have been piloted, including “on-the-spot” registrations in training on administrative requirements and the adoption of digital application processes. However, internet access constraints for MSMEs – especially producers living in remote areas – would have to be considered when designing digital tools. The development of applications for mobile phones facilitating registration and communication with the authorities could offer a solution.

Support needs to ensure that MSMEs can draw economic advantages, such as business development and credit, from their formal status. Support can focus on enabling formalized MSMEs to access new markets. For example, tree growers and community forestry enterprises need to be integrated into legal supply chains by creating business-to-business linkages with processors, traders, and retailers. For timber processing, MSMEs facilitating market linkages with industrial companies and lead firms is critical, ensuring that MSMEs have sustainable financing, including through access to credit to purchase new equipment and tools. These measures can ensure that MSMEs do not slip back into informality by not renewing costly permits or failing to comply with the law.

The possibility to participate in policy dialogues can be a further incentive for MSMEs to formalize. Informality limits the opportunity of MSMEs to advocate for their interests in policy processes, such as revising or simplifying regulations in conjunction with the negotiation of a voluntary partnership agreement (VPA) on the trade of legal timber products with the EU. This is because governments are often reluctant to consider informal MSMEs as legitimate interlocutors. Joining associations that allow informal businesses to become members can facilitate participation in policy processes but cannot substitute for the legitimacy conferred by formality.

Opportunities for cross-sectoral support need to be pursued. Forest-sector MSMEs share many of the same formalization challenges as MSMEs operating in other sectors, raising the need for inter-ministerial cooperation to address this common issue in line with countries’ priorities. Formalization is a broad government policy decision. Different countries approach the case based on different concerns ranging from impacts on tax revenues to supporting rural livelihoods to avoid potential destabilisation if drastic changes are made. Although these fundamental issues lie outside the remit of the forestry sector, catalysing inter-ministerial collaboration could pool resources to amplify the number of MSMEs reached while allowing more experience-sharing across sectors to adopt effective measures and incentives to promote formalization. It would also improve data collection, which is currently limited by the fragmentation of sources and conflicting jurisdictions when it comes to regulating the status of forest sector MSMEs.

Formalization requires a long-term engagement, as the needs of MSMEs change with, and are sometimes dictated by, domestic and international market trends. It is essential that support can continue to be channelled and adapted to MSMEs to adapt to these evolving trends. This can be done through strengthening associations and cooperatives, as lasting institutions that can provide support in the long-term. It can also be done by ensuring that incentives and pathways for MSME formalization are reflected in legal and policy reviews, and that MSMEs remain on government policy agendas as potential drivers of sustainable and equitable economic growth.

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