



# Small and micro-sized entities in the Mekong region's forest sector: a situational analysis in the FLEGT context

Member States of the Association of Southeast Asian Nations (ASEAN) use different indicators to define micro, small and medium enterprises. While the two main indicators used by ASEAN member States are the number of employees and the amount of capital,<sup>1</sup> others include installed electrical power use, annual revenue and annual production capacity. Literature exists on the state of micro, small and medium enterprises in ASEAN countries. However, little is known about the small and micro-sized entities (SmEs) engaged in the forestry sector in the Mekong region, their characteristics, the number and gender of people involved, the related supply chains, or their levels of compliance with relevant regulations.<sup>2</sup>

In this context, the Swedish International Development Agency (Sida) supported the EU FLEGT Facility in conducting regulatory assessments of forest and timber-based SmEs in Lao People's Democratic Republic (PDR), Myanmar/Burma, the Kingdom of Thailand and the Socialist Republic of Vietnam. The assessments were conducted from June 2017 to June 2018. They used a supply chain analysis model, which assumes that by understanding the interactions between actors in specific supply chains, it is possible to identify points of intervention. In total, the EU FLEGT Facility assessed 14 supply chains<sup>3</sup> producing timber products for domestic and in part for international markets. The assessments found that these supply chains consist predominantly of informal households that operate without business registration. This brief synthesises the results from these assessments. It also includes preliminary findings from ongoing pilot studies in Mekong countries undertaken by the EU FLEGT Facility.

# 1. Key findings

## 1.1 SmEs characteristics

SmEs in the forest and timber sector can include individual tree growers, plantation smallholders,<sup>4</sup> community forest and village forest entities, household entities,<sup>5</sup> small-sized entities in the primary and secondary processing sector, traders and community entities. Among the 14 supply chains analysed, the main actors in the four countries are individual tree growers and timber processors that operate formally or informally. In most countries, having a business registration is a key indicator that distinguishes between formal and informal businesses. For example, in Vietnam, business registration is the criteria used by the General Statistics Office to differentiate formal from informal businesses.<sup>6</sup>

The assessments found that individual tree growers are an increasingly significant source of timber for the national timber industry in the four countries. In Vietnam, the 1.4 million tree growers possess an average of one to two hectares of forestland per household. They play a crucial part in the plantation timber supply chain. They annually produce approximately 10 million cubic metres of timber with a value of USD 500-700 million.<sup>7</sup> This production feeds the wood chip and value-added timber processing industries for domestic and international markets. In addition, one study estimated that there are more than 300 wood villages in Vietnam. These wood villages employ tens of thousands of households and hundreds of thousands of labourers, including both household and hired labour in the manufacturing process of timber products.<sup>8</sup> In Lao PDR, only approximately 17 percent of household timber-processing entities are registered. The situation in Myanmar/Burma is unknown because official data does not capture businesses that operate without registration.<sup>9</sup>

SmE operators and traders often use their houses as storefronts and processing workshops. This practice contributes to unsafe and unhealthy working conditions. In particular, the assessments have found lower level of compliance with occupational health and safety and environmental standards.

SmEs mainly produce for the local market. In contrast, the medium to large-sized processing enterprises mostly comply with the national requirements for registration. Their market reach is far greater and wider than that of SmEs. In general, the assessments found that the percentage of timber processing households operating in the four countries with business registration is significantly lower in comparison with unregistered entities.

Finally, the assessments indicated that in the four Mekong countries, a majority of individual tree growers and processing SmEs are not part of any business association or any form of sector organisation, whether they operate formally or informally. The legal frameworks in these countries enable the formation of groups, cooperative enterprises and industry associations. However, the assessments found that individual tree growers and processing operators, in particular in Lao PDR and Myanmar/Burma, do not regard membership of business associations as beneficial. Nonetheless, in practice, the national timber industry associations in Lao PDR and Myanmar/Burma are influential. They gain preferential treatment with respect to access to timber sold at auctions for example. They are also consulted in the setting of timber quotas and in regulatory reform processes. When SmEs do not participate in these structures, they are often unaware of relevant information related to applicable regulations, support initiatives and other business development opportunities. This in turn makes cooperation among SmEs more challenging. Cooperation could help them obtain common benefits such as increased market access, larger job orders, material procurement, and access to training and technology.

## 1.2. Reasons for SmEs to remain informal

While playing a major role in the national economies and rural livelihoods, literature suggests that the principal barriers to the formalisation of SmEs are unfamiliarity with regulations, lack of incentives and lack of understanding of the benefits of being formal.<sup>10</sup> This resonates with the situation of SmEs in the timber-processing sector in the four countries studied. In these countries, most informal household businesses do not register their business, partly because they think they do not have to do so, even if their business operations surpasses the national thresholds for business registration (for example, the number of workers employed and/or total income). This highlights the need to circulate more extensively information on regulations, as well as relevant support programmes for registered SmEs, possibly in a standardised format, across different jurisdictional levels in country.

Informal SmEs in the four countries that reach the national thresholds for registration currently have very few incentives to register their businesses. In addition, as mentioned above, a majority of these entities see no advantage in becoming formal. SmEs operating mills or timber processing shops in the assessed supply chains hardly ever request their local suppliers to provide evidence of the origin of the timber, the payment of taxes or fees, or compliance with environmental and occupational health and safety regulations. They do not provide this evidence to their customers either. In addition, the sanctions in case of non-compliance may not have a deterrent effect. They can be less onerous than the costs of operating with a business registration. For example, interviewees in Thailand reported that to reduce transaction costs due to the complex, bureaucratic, contradictory or overlapping requirements, SmEs often need to make unofficial payments to authorities. If formality means fewer profits while unofficial payments can address such issue, the case for SmEs to operate informally remains. Moreover, the assessments found that SmEs often neglect basic occupational health and safety standards in their workshops due to a lack of awareness, the absence of controls or financial constraints.



◀ Photo: EU FLEGT Facility

### 1.3 Consequences of SmEs remaining informal

Even if SmEs can continue to operate informally, this practice contributes to the creation of an unclear and unfair business environment for them and other stakeholders in the supply chains. For example, while informally operating households are not required to issue invoices with tax codes, their customers may be subject to such requirements. This could unintentionally lead to a misunderstanding, where as a precautionary measure, medium and large export-oriented enterprises exclude these informal households from their vertical supply chains to comply with international market demands. This stresses the need for information on supply requirements applicable to informally operating households to be made available to medium and large export-oriented enterprises.

In addition, the assessments indicated that a majority of the informally operating SmEs exceed thresholds for registration. These entities are therefore required to pay government taxes based on their financial turnover rate but often do not do so.<sup>11</sup> Workers for these informal SmEs, specifically those that reach the taxable income thresholds, do not contribute to the national tax system either. Nor do these SmEs provide benefits and entitlements to their workers to increase their profit margins. This practice therefore creates unfair competition and deprives the government of public revenue, thereby limiting its ability to provide social services. This in itself is a vicious cycle.

SmEs within the assessed supply chains often raised bureaucratic obstacles as a substantial impediment to their business viability. There are two types of bureaucratic obstacles: insufficient, unclear or unnecessarily burdensome legal frameworks; and improper or inadequate monitoring and enforcement of compliance. These two factors frequently overlap and explain why many SmEs that surpass the registration thresholds operate informally. Such SmEs could be excluded from legal supply chains on the ground that they are not legal operators, as defined by the applicable national laws listed in the timber legality definition of the Voluntary Partnership Agreements (VPAs) on Forest Law Enforcement, Governance and Trade (FLEGT) of the studied countries. Finally, due to various constraints for accessing legal and affordable timber, some SmEs will try to continue to deal with illegal timber. The revision and effective implementation of relevant regulations might prevent the circulation of illegal timber in the supply chains. This would lead some SmEs to cease their economic activities and migrate to other sectors, for example agriculture or trading. However, since many SmEs are engaged in timber processing as their main source of income, their closure could have broad livelihood consequences.



Photo: EU FLEGT Facility



◀ Photo: EU FLEGT Facility

## 1.4 Gender gaps: women empowerment and participation in SmEs

Participation and empowerment of women, through equal opportunities and equal wages, are enshrined in the national regulatory frameworks of all four countries. However, implementation of these frameworks has been challenging. In Vietnam for example, the National Gender Equality Strategy (2011-2020) emphasises the need to support women-owned enterprises and women workers in various economic sectors. However, there is no definition on what constitutes a women-owned enterprise. Government agencies therefore face difficulties in identifying which businesses are eligible for support. In Lao PDR, the 2013 Labour Law provides a legal basis for equal wages for women and stipulates that female employees have an equal right to employment in production, business and management. In practice, the assessment found that female employees in the assessed supply chains tend to be paid less than men for the same work. Interviewees suggested that this discrimination is rooted in broader traditional, cultural and social arrangements. Finally, women appeared to be better represented in management and financial roles in smallholder plantations, and less in primary and secondary processing activities. For example, interviewees in Lao PDR considered the wood processing sector to be a male-dominated sector that is unfit for women due to the demanding physical tasks.

## 1.5 FLEGT VPAs can create incentives for SmEs to operate formally

Lao PDR, Thailand and Vietnam are moving closer to achieving and demonstrating legality in their timber supply chains, mainly through their VPA processes. Many studies have cautioned that if SmEs do not participate meaningfully in governance reform processes, existing challenges for their legal operation might increase.

**Formal business operations in the VPA context and competitiveness are not mutually exclusive. The VPA processes can bring opportunities for both formal and informal SmEs.**

- First, once the national systems to assure the legality of timber are operational and the countries start issuing FLEGT licences, formally operating SmEs integrated in the vertical supply chains could have a comparative advantage. For example, timber product exports have been increasing since Indonesia began issuing FLEGT licences.<sup>12</sup> Sources suggest that this increase benefited small farmers that supply plantation timber as the price of raw material certified under the Indonesian system to assure the legality of timber increased. Evidently, area of forests planted by smallholders on private land is increasing in Indonesia (Java).<sup>13</sup>
- Second, the legality requirement for timber sources within the supply chains could offer SmEs economic and political opportunities. For example, a recent study found that the higher demand for legal timber offers a comparative advantage to formal SmEs that deal with high-value and highly regulated tropical hardwoods. In terms of political opportunities, formal operation helps SmEs to be better represented in policy dialogues that have implications for them. This is particularly true for those SmEs that are at the household level, where no organisational structure, communications or regional trade clusters exist. These opportunities generally materialise by SmEs joining associations.
- Third, regulatory reforms associated with the VPA process could facilitate individual tree growers' access to financial loans. For example, in Thailand, standing trees grown by farmers are now accepted by government banks as collateral to support loans.<sup>14</sup>
- Fourth, VPA experience shows that, if all stakeholders actively participate in the VPA process, it can bring various benefits to SmEs. For example, in Thailand, the VPA process has simplified the regulatory framework, and the EU FLEGT Facility's work with SmEs operating with reclaimed wood has helped them integrate the legal supply chain.

Another example is the ongoing pilot study carried out by the EU FLEGT Facility in collaboration with the Food and Agriculture Organization of the United Nations (FAO) in the Attapeu province in Lao PDR. This pilot aims to find viable means for 21 SmEs to comply with the Government's regulations and improve their competitiveness. At the second VPA negotiation session between the EU and Lao PDR, held in June 2018, parties agreed that there is a need to increase the involvement of the informal sector/household businesses in the VPA's multistakeholder consultation process. This should also create opportunities for the creation of clusters or associations, the building of tactical coalitions with key stakeholders, capacity building and access to credit. The assessments did not systematically evaluate SmEs' participation in the VPA processes. Nonetheless, they have shown the importance of understanding the specificities of SmEs and the potential challenges and opportunities they might face as a consequence of the VPA processes.

## 2. Cross-cutting policy recommendations

While the Governments of the four countries should lead on the cross-cutting recommendations listed below, other stakeholders, including development partners, civil society and private sector actors, should provide relevant support. It is recommended to:

1. Clarify and improve legal frameworks through processes aimed at defining timber legality. These processes should identify and address overlapping or contradictory regulations that affect SmEs. Clarifying land-use policies and instituting tenure reforms is the first and most essential step to support forest-based SmEs. Legal frameworks affecting SmEs involved in timber processing also need to be clarified, particularly those related to business registration, taxes, and occupational health and safety.
2. Support the creation of SmE groups and their organisational structures to increase their competitiveness. These platforms serve two main purposes. First, they make it easier for those who could provide information, finance and other business development services to access SmEs. Second, the platforms should enable SmEs to better express their needs in policy processes, including VPAs. This horizontal integration should also increase SmEs' access to information, finance and other business development services. This in turn should increase their competitiveness and eventually allow for their direct integration in vertical supply chains. With a reduced number of intermediaries within the supply chains, groups of household businesses could cooperate directly with larger companies to increase information flows and reduce transaction costs.
3. Provide incentives and technical support to SmEs that reach the registration thresholds to register their businesses. At the same time, those that are close to the registration thresholds should be encouraged to formalise as this will likely improve their operating conditions and prospects for growth. This implies addressing the disincentives towards formalisation and clarifying the regulations on business registration thresholds. Incentives for SmEs' formalisation could include restructured tax systems for SmEs, streamlined registration and permitting procedures, and access to credit. Where possible, VPA processes should pay special attention to the situation of SmEs that surpass the thresholds for registration as required by national law. VPA processes should also consider measures to overcome potential challenges that come from the implementation of systems to assure the legality of timber.
4. Support synergies among relevant initiatives led by national stakeholders/beneficiaries, and where relevant, in partnership with development partner-led initiatives. This is of particular importance for supply chains where SmEs represent a key source of employment and use a substantial amount of forest resources.
5. Identify and support alternative timber sourcing and production options for SmEs. These options will be needed where demand for timber exceeds supply from natural forests, and where SmEs wish to decrease their dependence on logs and sawnwood. They include shifting to plantation timber or to engineered materials such as fibreboard, particle-board and veneer, bamboo and rattan, or even non-wooden materials.
6. Provide necessary support to improve and implement existing regulations aimed at bridging gender inequality gaps. Moreover, further research should be conducted to identify gender-specific constraints for equitable participation in the processing sector and in accessing business development support in supply chains.

# Footnotes

<sup>1</sup> For example, according to Decree No.25/GOV (2017) on the Classification of Small and Medium Enterprises, a micro-sized enterprise in Lao PDR refers to enterprises with a total asset not exceeding LAK 100 million (USD 11,700) and annual revenue not exceeding LAK 400 million (USD 46,800).

<sup>2</sup> This brief uses the acronym 'SmE' with lower case 'm' rather than SME to exclude medium-sized enterprises, which in some countries can employ up to 300 workers.

The SmE acronym is used in our assessments to differentiate these small and micro-sized entities from the mainstream micro, small and medium enterprises, or the more commonly used SME.

<sup>3</sup> Supply chains assessed in the four countries:

- **Lao PDR** (1. timber from forest conversion for the domestic market; 2. timber from village forest areas for customary use; and 3. Timber from unidentified sources for sawmills and traders in domestic or international markets)
- **Myanmar** (1. timber used for furniture; 2. timber used for doors and window frames; and 3. timber used for wood-based handicrafts)
- **Thailand** (1. domestic plantation rubber-wood for the export market; 2. domestic plantation teak for domestic and export markets; 3. rain tree/garden tree for domestic and export markets; 4. reclaimed/recycled hardwood timber for domestic and export markets)
- **Vietnam** (1. imported rosewood used in wood villages for domestic and export markets; 2. domestic acacia plantation timber for domestic and export markets; 3. domestic rubberwood plantation timber for domestic and export markets; and 4. domestic scattered trees for domestic and export markets).

<sup>4</sup> Each country has its definition of and threshold to differentiate 'plantation smallholders' from other entities.

<sup>5</sup> According to nationally-defined characteristics, household entities can include tree growers, micro entities in the primary/secondary processing sector and traders.

<sup>6</sup> Pasquier-Doumer Laure, Xavier Oudin, Nguyen Thang. 2017. The importance of household businesses and the informal sector for inclusive growth in Vietnam. A co-publication of the Vietnam Academy of Social Sciences and the French National Research Institute for Sustainable Development.

<sup>7</sup> EFI EU FLEGT Facility. 2018. Diagnoses and regulatory assessment of small and micro forest enterprises in the Mekong Region. Internal Document.

<sup>8</sup> Tô Xuân Phúc, Dang Viet Quang, Nguyễn Tôn Quyền, Cao Thi Cẩm. 2018. Wood Villages in the context of market integration: Status and policy options for sustainable development. Forest Trends.

<sup>9</sup> Myo, E. 2017. Identifying major labour policy issues in Myanmar. Japan Labour Issues 1: 83-94.

<sup>10</sup> International Labour Organization 2002. Resolution concerning decent work and the informal economy.

<sup>11</sup> These can include income tax, contribution tax and profit tax.

<sup>12</sup> According to the International Tropical Timber Organization, the EU's imports of wood products from Indonesia increased by 7% in the first half of 2018, increasing Indonesia's share of total EU imports from 15.7% to 16.6%.

<sup>13</sup> Andrea Johnson. 2016. Barriers and Opportunities for micro, small and medium enterprises under demand-side legality policies. CATIE-Finnfor and Forest Trends.

<sup>14</sup> While this is a positive development, it would be necessary to follow up on the conditions of the loan, particularly on loan default. Remaining issues to address include whether the bank will repossess the trees that were used as collaterals and how this repossession will affect the borrowers' livelihoods.

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## About the EU FLEGT Facility

The EU FLEGT Facility supports the implementation of the EU FLEGT Action Plan with a focus on Voluntary Partnership Agreements (VPAs). The EU FLEGT Action Plan sets out a programme of actions that forms the EU's response to the problem of illegal logging and the trade in associated timber products. The Facility is hosted by the European Forest Institute (EFI), and was established in 2007.

## Disclaimer

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