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Being legal and formal? Opportunities and challenges of the timber legality verification system for smallscale furniture producers in Indonesia

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Abstract

Over the last decade, Indonesia has made significant strides in improving forest governance. The Government of Indonesia (GoI) has made curbing illegal logging a strategic goal within the Ministry of Forestry's long-term plan. One of the main milestones in improving forest governance in Indonesia is signing the Voluntary Partnership Agreement (VPA) with the European Union and being the first country that obtains the FLEGT license. The GoI has developed a timber legality assurance system called Timber Legality Verification System (*Sistem Verifikasi Legalitas Kayu* - SVLK). This system enables tracking a piece of timber back until the origin and ensure its legality. One major issue that remains under contention is how small actors should be included in the SVLK system. This paper attempts to assess the financial implications of SVLK certification for small operators in Indonesia. We found that while there are opportunities for smallscale producers to access the international market by having SVLK certificate, they face challenges to become formal entities. Moreover, they are hampered by the scale needed to enable them to meet the demand from global buyers. The paper aims to generate lessons for Indonesia to deal with small operators' inclusion into the FLEGT process and other countries seeking similar VPA arrangements with the EU to draw lessons from Indonesia as the first country that has obtained FLEGT license.

Keywords:

Introduction

Over the last decade, Indonesia has made significant strides to curb illegal logging. It was a strategic goal within the Ministry of Forestry's long-term plan (MoF 2006). As part of its commitment to Forest Law Enforcement, Governance, and Trade (FLEGT), the Government of Indonesia (GoI) has also engaged in multi-agency operations and other measures to curb illegal logging (Luttrell et al. 2011). A major milestone was the signing of the Voluntary Partnership Agreement (VPA) with the European Union (EU) on 30 September 2013. Indonesia also became the first country to issue a FLEGT license, effective 15 November 2016. The GoI developed the Indonesian timber legality assurance system, called *Sistem Verifikasi Legalitas Kayu* (SVLK) that is compatible with the VPA. SVLK enables timber to be traced along the supply chain to ensure its legality.

One remaining issue requiring the attention of the GoI and other stakeholders revolves around the relationship of Micro, Small and Medium Enterprises (MSMEs) to SVLK. There are concerns that small producers have less capacity to meet the conditions in SVLK regulations despite efforts to ease the processes through which they can become SVLK-compliant. Some small actors have become legally verified businesses and operate according to SVLK rules, but these cases are rare compared to the size of the small-scale timber business in the country.

Furniture MSMEs contribute to employment creation by absorbing a significant number of workers. In 2018, for example, the Central Statistics Agency reported 160,000 furniture producers in Indonesia by 2018 (BPS

2019). The furniture MSMEs absorbed around 400,000 workers, most of whom were informal (BPS 2019). Furniture is one major contributor to Indonesian exports, with USD 1.73 billion in 2019 (Bank Indonesia 2020). Second, MSMEs play a role in entrepreneurship and business skill development, resulting in the 'upgrading' from micro-to-small and small-to-medium enterprises (Ascarya and Rahmawati 2015).

Attempts to formalize small-scale informal operators means changing at least some characteristics of the informal sector. Companies would need to change their operation to have more proper documentation. This includes records of workers' salaries, documentation of raw materials and production processes, and development of standard operating procedures (Ascarya and Rahmawati 2015).

Embracing SVLK would enable MSMEs to participate in global value chains. MSMEs with SVLK certificates will be able to address demands from international markets. However, the process of becoming legally verified has been challenging and costly for MSMEs. They must cover several certification costs to maintain their certificate and status as formal entities. The cost implications of SVLK compliance are high and, in some cases, lead to new power relations between large and small producers. For example, under this relationship, several small producers in Central Java and Yogyakarta benefit from access to export markets by using the certificate held by large producers or vice versa (Maryudi and Myers 2018).

This paper attempts to assess the capacity of small-scale furniture producers to comply with the SVLK. It focuses on the furniture sector in Jepara and Pasuruan, which are dominated by small-scale producers. The study aims to describe the business characteristics of furniture production, including revenue and cost structure. More importantly, it will assess the extent to which furniture producers can comply with SVLK requirements in Jepara and Pasuruan.

Methodology

In Jepara, the Office of Trade and Industry provided the list of furniture producers. We selected 117 respondents (51%) from the list of 228 furniture producers provided. In Pasuruan, the Industry and Trade Office provided a list of 183 furniture producers. We also received the names of additional 38 producers from the Forum of Furniture and Handicraft Producers (*Forum Mebel, Kerajinan dan Seni* – Formekers) of Pasuruan. These two lists combined make a total of 221 producers. We selected 122 producers (58%) based on respondents' availability. In total, we surveyed 239 producers.

We collected the data via a structured interview with respondents using online questionnaires. The structure of the survey covers five major areas: 1) respondent and business characteristics; 2) timber source and the first destination of product sales; 3) production, revenue, and costs; 4) ownership to certification; and 5) producers' practices in areas auditable for SVLK. For producers' compliance level, we provided an incremental option: (1) not at all; (2) a few items under question are available or carried out; (3) some items under question are available or carried out; (4) most items under question are available or conducted; (5) all items under question are available or implemented. We also conducted a Focus Group Discussion (FGD) in each district. The FGD aimed to present preliminary survey results, receive feedback from key stakeholders and obtain additional information on the benefits of obtaining SVLK and challenges to comply with it. We applied a descriptive analysis of the small furniture producers' performance and gaps with full SVLK compliance.

Results

Producer and business characteristics

The producers' average age is between 41 (in Pasuruan) and 46 (in Jepara). Most respondents (98% in Jepara and 67% in Pasuruan) were male. About 20% of respondents in Jepara and 26% in Pasuruan had university degrees. More than half had a secondary school degree.

More than 80% in Jepara and more than 50% in Pasuruan were home-based industries (Table 1). Based on the number of workers (BPS 2019), 87% of respondents in Jepara fell under the micro and small business category, while the rest were medium-scale businesses. Table 1 also presents the certificate owner of the furniture producers in Jepara and Pasuruan. Only 11 respondents (9%) in Jepara and 2 (1%) in Pasuruan had the timber certificate. One of the 11 respondents in Jepara also had an FSC certificate. Meanwhile, the two respondents in Pasuruan had an SVLK certificate.

Table 1: Business characteristics

	Jepara		Pasuruan	
Average year of operation	17		21	
Form of business				
- IRT*	96	82.1%	67	54.9%
- UD*	16	13.7%	45	36.9%
- CV*	5	4.3%	9	7.4%
- PT*	0	0.0%	1	0.8%
Scale				
- Micro	45 (1)**	38.5%	81	66.4%
- Small	57 (5)**	48.7%	39 (2)**	32.0%
- Medium	15 (5)**	12.8%	2	1.6%

Note:

*IRT: *Industri Rumah Tangga* (household industry); UD: *Usaha Dagang* (trading business); CV: *Commanditaire Vennotschap* (joint venture); PT: *Perseroan Terbatas* (limited liability companies).

** number in the parentheses represents the number of respondents with timber certificate (SVLK, FSC).

Origin of timber and destination of products

Table 2 shows the regions where furniture producers in Jepara and Pasuruan buy their timber. Most respondents sourced timber first from local markets and then from timber markets within the same province. Jepara shows more diversity, with some producers sourcing timber from Sumatra, Kalimantan and Sulawesi. Meanwhile, producers in Pasuruan only sourced timber from the local market and markets within East Java.

Table 2: Source of timber

	Jepara		Pasuruan	
	Number of respondents	% of total respondents	Number of respondents	% of total respondents
Within the same district	94	80.3	113	92.6
Central Java	32	27.4	0	0.0
East Java	22	18.8	49	40.2
West Java	2	1.7	0	0.0
Sumatra	10	8.5	0	0.0
Kalimantan	0	0.0	0	0.0
Sulawesi	19	16.2	0	0.0
Others in Indonesia	1	0.9	0	0.0
Imports	0	0.0	0	0.0

Table 3 shows where furniture producers sell their products. In Jepara, producers sold their products to both domestic and export markets. In the domestic market, producers sold within the district, to Central Java and to other places in Indonesia, mainly Yogyakarta. According to the certification status, certified producers in Jepara either served domestic or export markets. Meanwhile, most noncertified producers served the domestic market. However, noncertified producers also indirectly served export markets through sales of “export warehouse” (*gudang ekspor*), which is owned by companies that serve export markets. Meanwhile, in Pasuruan, almost all producers sold their products within Pasuruan and the province. A certified producer served the domestic market, while the other served the export market.

Table 3: Destination of sales

Destination	Jepara		Pasuruan	
	Number of respondents	% of total respondents	Number of respondents	% of total respondents
Within the same district	72	40.7	52	42.6
Central Java	10	5.6	0	0.0
East Java	8	4.5	83	68.0
West Java	3	1.7	0	0.0
Jakarta	15	8.5	4	3.3
Yogyakarta	2	1.1	0	0.0
Bali/Nusa Tenggara	14	7.9	11	9.0
Sumatera	6	3.4	0	0.0
Kalimantan	1	0.6	3	2.5
Sulawesi	5	2.8	2	1.6
Others in Indonesia	5	2.8	0	0.0
Export	24	13.6	1	0.8
Number of respondents with:				
	Noncertified	Certified	Noncertified	Certified
Only domestic market	80	3	90	1
Only export market	8	5	0	1
Both domestic and export	8	0	0	0
No response	10	3	30	0

Production, revenue, and cost

Table 4 presents the summary of the revenues and the cost structures in the Rupiah value and the percentage of the revenues. First, in Jepara, the gap of the revenue between micro and small industries are small compared to the gap between the revenues of small and medium scale business. Meanwhile, in Pasuruan, the gap between small and medium is smaller compared to the one between micro and small. Second, the cost of timber is significant, it ranges between 48-64%.

Table 4: Revenue, cost, and profit (million IDR)

	Jepara			Pasuruan		
	Micro	Small	Medium	Micro	Small	Medium
Revenue	322,9	430,0	2035,2	230,2	635,6	797,6
Cost	226,6	253,1	1038,5	163,9	416,3	612,5
- Timber	144,5	139,0	520,5	105,2	200,4	351,8

- Worker	61,0	65,5	272,2	24,2	96,5	82,7
- Finishing	19,5	25,9	56,1	8,8	18,0	10,4
- Others	1,6	22,6	189,7	25,6	101,4	167,6
Gross profit	96,3	176,9	996,6	66,4	219,3	185,2

Certification

We found that no producers see the benefits of certification on the product's price or increased demand from existing markets. One producer in Pasuruan indicates a demand from a new market. However, certified producers responded positively about nonfinancial benefits, from improved management practices, enhanced business reputation, receipt of government support, involvement in local decision making and invitation to participate in exhibitions.

Compliance to the SVLK

Figure 1 summarizes the average score of the current practices against the SVLK standard. Better practices are presented as lines farther from the center. Certified producers implement better practices than noncertified producers in all areas. In terms of hiring workers above the age of 18, producers in Jepara and Pasuruan show the highest score. Other than that, producers need to pay attention as average scores were low. Only a small number of producers used imported timber and used timber from waste. Similarly, only producers with SVLK certificate put the V-Legal sticker on their products. Only a few respondents had the SVLK certificate.

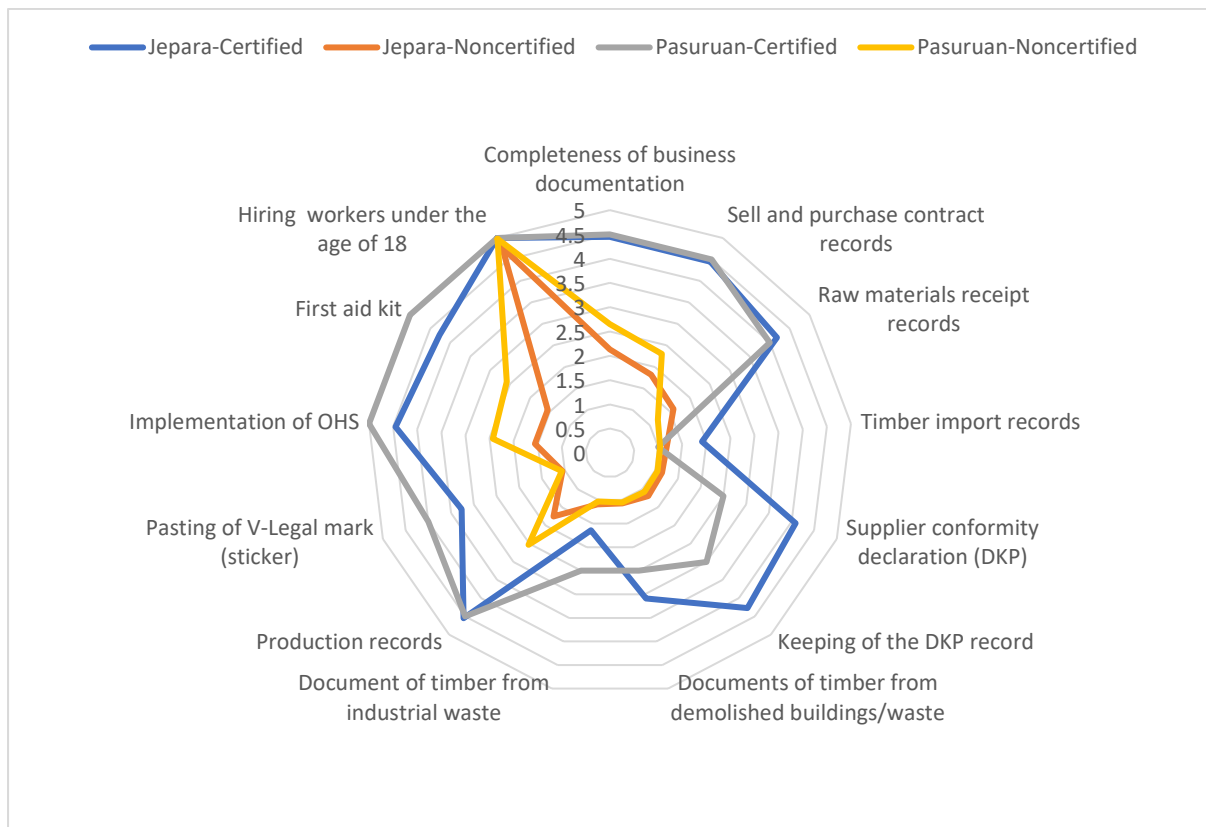


Fig. 1: Average score of indicators of SVLK compliance areas

Discussion

We highlighted several areas from the findings that showed opportunities and challenges facing the industry. First, earlier studies show that SVLK drives formalization, where informal actors register for a formal business license before they can apply for SVLK certificates (e.g. Obidzinski et al. 2014; Setyowati and McDermott 2017). It is encouraging that SVLK does not restrict business registration types that can have a legal certificate. More important than the type of business registration is implementation of good business administration practices, one of which is to manage and record transactions properly.

Second, the respondents did not see the financial benefits of having certificates. This finding is especially concerning for producers that run micro-scale businesses, where additional costs for preparation, audit and surveillance can reduce profits. For them, a feasible option is to apply for group certification. Medium-scale companies or those with high profits may apply for SVLK individually without compromising their financial structures.

Third, producers who wish to comply with the SVLK need to pay attention to the following areas: (1) keep the record of business documents; (2) keep the record of sales and purchase of timber; (3) keep the record of the production; and (4) procure first aid kits and implement OHS. These are areas where small producers would need to improve. Changing behavior may take a long time; consistent facilitation by the government and nongovernmental organizations (NGOs) is necessary. Quick fixes such as hiring a consultant to fix the problems come at exorbitant costs (Maryudi and Myers 2018).

Conclusions

The report aims to present the furniture-making industry's situation in Jepara, and Pasuruan and assess the gaps between current practices and the SVLK standard. The finding that the industry is profitable, and producers with any business license can apply for SVLK. Simultaneously, a major challenge is to change the current practices toward those compliant with SVLK. While SVLK is about timber legality verification, its scope goes beyond forestry or industry domains. Cross-sectoral partnership is required to address challenges and seize opportunities.

The study finds that MSMEs have more flexibility in the formalization process, despite having to register. Jepara's government has a legal basis for protecting the furniture industry and has issued an implementing policy that is more friendly toward MSMEs. If the Pasuruan government sees the need to issue a regulation that would facilitate the furniture industry, Jepara could provide a learning experience.

Producers also need to improve current practices to narrow the gap with the compliance of SVLK. Relevant government offices such as Manpower Office, Cooperative and MSME Office, and Industry Office, should establish and revitalize the SVLK clinic. Emphasis should be put on assisting MSMEs in improving their business administration practices and focusing on the SVLK audit's technicalities. The MoEF could continue facilitation to cover the audit costs and support group certification. Government Procurement Agency can help create demand in domestic markets through public procurement.

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