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Palm Oil Smallholders and Land-Use Change in Indonesia and Malaysia

*Implications for the draft EU delegated act of
the recast Renewable Energy Directive*





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Research Report: **PALM OIL SMALLHOLDERS AND LAND-USE CHANGE IN INDONESIA AND MALAYSIA**

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Summary

The draft delegated act for implementing the recast Renewable Energy Directive was released on 8 February 2019 for public consultation. One of the most contentious issues has been the provisions for phasing out biofuels based on feedstocks with a high indirect land-use change (ILUC) risk by 2030. This has been widely understood to include palm oil, which government and industry advocates in Indonesia and Malaysia have vehemently opposed on the basis that this will hamper rural poverty reduction in their countries, even though global demand for its non-energy uses is projected to continue over the next decade. Major studies have conclusively shown that palm oil expansion is linked to large-scale deforestation and peatland drainage, and that it should be phased out as a high ILUC risk crop due to the associated greenhouse gas emissions. However, the delegated act also proposes certifying low ILUC risk feedstocks, notably including crops produced by independent smallholders who own or lease less than two to five hectares.

This research review on smallholders in Indonesia and Malaysia demonstrates that the proposed exemption of palm oil smallholders is impractical and opens up a potential loophole for exploitation. 'Smallholders' can encompass a variety of types of producers. There is no consistent definition across international standards and national regulation of their landholding size, nor are there comprehensive or accurate statistics for identifying and disaggregating them. Available evidence points to a significant proportion of larger farmers and local elites with more

than five hectares taking advantage of opportunities to expand, including through informal land documentation processes into frontier areas, but who are still counted as 'smallholders' and would be very difficult to separate in practice. There is also no evidence of a workable and robust system for certifying hundreds of thousands of such independent farmers and producers. Current standards and certifications have failed to date to adequately regulate large corporations and their complex supply chains, and the barriers to ensuring smallholder compliance and verifying and auditing their feedstocks are even more prohibitive. Consequently, there is a major risk that the proposed voluntary systems would not be transparent, accurate, reliable and protected against fraud. While corpo-

rate plantations have played a major role in deforestation and peatland conversion, independent smallholders of all sizes are also present in frontier areas and should not be categorised as 'low-risk' as a matter of course. Agricultural land scarcity combined with restrictions on corporate plantations may have spill-over effects by encouraging smallholders to expand even further.

In sum, **it is recommended that the low ILUC risk exemption for palm oil smallholders should be removed from the delegated act altogether**, because there is no evidence to justify how it could be effectively implemented. Alternatively, as a minimum, biofuels certified under this exemption must meet the condition for additionality measures in Article 5.1 (a) (i) that they meet robust rules for financial analysis or barriers analysis, and not just the condition that they are applied by smallholders as per Article 5.1 (a) (iii). This is a precondition for ensuring that only a project additional to a business as usual counterfactual scenario would be credited, rather than potentially any good agricultural practices or other measures to improve independent smallholders' yields. It would be the only way to ensure low ILUC risk due to smallholder production. 

◀ It is recommended that the low ILUC risk exemption for palm oil smallholders should be removed from the delegated act altogether. ▶▶

Context



Photo: Forest Heroes

The recast Renewable Energy Directive (RED II) adopted by the European Parliament on 13 December 2018 sets out a new framework for capping overall use of food-based biofuels and phasing out high indirect land-use change (ILUC) risk crop feedstocks, which are associated with higher greenhouse gas emissions¹. Member states' maximum share of high ILUC risk biofuels is capped at 2019 levels until 2023, and then progressively phased out of renewable targets to 0% by 2030.

One of the most contentious issues throughout the development of RED

II has been how it will apply to biofuels produced from palm oil. Over the last 50 years, the area of palm oil plantations has expanded rapidly due to rising global demand for its use in foodstuffs, cosmetics, biofuels and other goods. There is ample evidence of its links to rapid deforestation, massive biodiversity loss and increased greenhouse gas emissions, and key studies have demonstrated that it generally has the highest ILUC impacts of all crops². The report 'Driving Deforestation' by Ceruly and Rainforest Foundation Norway found that growing biofuel demand carries the threat of further

large-scale deforestation and peatland drainage, which will have profound impacts on carbon storage³. Given such evidence, it was widely understood that **all** palm oil would be phased out under RED II as a high-risk feedstock for biofuels.

The draft delegated act to define high and low ILUC risk biofuels was released on 8 February 2019 for public consultation⁴. It sets out the criteria for determining high ILUC risk feedstock for which a significant expansion of the production area into land with high-carbon stock is observed. However, this draft also

establishes provisions for certifying low ILUC risk biofuels that would not be phased out, which includes crops cultivated by independent small farm holders. This group is defined in Article 2 as *'farmers independently conducting an agricultural activity on a holding with an agricultural area of less than [2 – 5] hectares for which they hold ownership or lease rights'*. A 'smooth certification process' for compliance with the sustainability criteria in RED II is broadly outlined, notably through voluntary schemes.

The proposed low ILUC risk smallholder exemption has major implications. In the two largest palm oil producer countries in the world, Indonesia and Malaysia, official statistics estimate that different types of smallholders account for over 30% of palm oil planted land. The proposed smallholder certification assumes that additionality measures to improve their practices on currently cultivated land, thereby increasing palm oil yields for biofuel feedstocks, can avoid displacement of other uses leading to ILUC. This is a highly contentious assumption. While corporate plantations are evidently a high-risk driver of forest- and peatland conversion, it is debatable whether independent smallholders are comparatively low-risk. Additionality is a very difficult concept to implement and enforce robustly; a recent review by Cerology for Transport and Environment⁶ found no evidence of a workable system or clear-cut criteria for certifying low ILUC risk crops in general, let alone those specifically produced by independent smallholders.

These issues have also been coloured by fierce opposition to RED II from some government, industry and farming groups in Indonesia and Malaysia, whose case largely centres on the economic benefits of palm oil. One of their key arguments is that it has lifted millions out of poverty by supporting smallholders' livelihoods, and that restrictions will be detrimental to them⁶. Such claims are difficult to substantiate and are by and large overstated. Nonetheless, the palm oil commodity boom has evidently transformed the rural economies of

◀ The palm oil commodity boom is set to continue, irrespective of restrictions in RED II, due to growing global demand for other uses. ▶

both countries and generated considerable wealth through export earnings⁷. This boom is set to continue in the next decade, irrespective of the biofuel restrictions in RED II, due to growing global demand for non-energy uses. Although agribusiness corporations dominate the sector by controlling plantations and commodity value chains through an industrial-scale infrastructure of mills, refineries and plants and a vast logistical and transport network, independent palm oil smallholders have also increased markedly to take advantage of potentially higher returns from their land and labour⁸, and their share of production is anticipated to continue growing. This report reviews the current research evidence on independent smallholders in Indonesia and Malaysia. It focuses on the challenges in defining and counting different types of smallholders, the difficulties in certifying smallholders, the role of smallholders in frontier expansion and land-use change, and the relationship between palm oil development and rural poverty reduction. The implications of these issues are identified together with policy recommendations. While the EU RED II process is the main point of reference, these findings and recommendations have broader

relevance for how palm oil sustainability standards and certifications can be applied to smallholders. The issues surrounding RED II are symptomatic of wider debates over how to balance restrictions on further palm oil expansion due to its negative environmental impacts, while also supporting rural poverty alleviation. 

Identifying Smallholders in Indonesia and Malaysia



2.1 Defining Smallholders

The definition of ‘smallholder’ is far from straightforward. Reports and statistics often refer to them as if they are a homogeneous group, when they can actually encompass farmers with varying characteristics in terms of their crops, landholding

size, labour and capital. Smallholders typically rely on their own family labour and capital to work the land. With regard to palm oil, planted areas larger than six hectares typically require hired labour⁹. A useful point of reference is the Association of Independent Smallholders (SPKS) in Indonesia, which defines small-

holders as: *Farmers who cultivate oil palms on their own land with a maximum holding size of six hectares using their own family labour and capital, without assistance from banks*¹⁰. Government and industry standards on palm oil smallholders encompass considerably larger planted areas. For example, the RSPO defines

them as farmers with '*planted palm oil areas less than 50 hectares*'¹¹. In Indonesian regulations, farmers with less than 25 hectares are meant to obtain a cultivation registration letter (STD-B) whereas producers with more should have a Plantation Business Licence (IUP-B). In Malaysia, areas larger than 40.46 hectares are categorised as estates. This lack of consistency contributes to varying understandings of who qualifies as a smallholder.

Two main types of smallholders are generally identified by their mode of production and market access:

- **Independent smallholders** are characterised by their ability to choose how they manage their land and crops without being contractually bound to any particular mill or association. They may cultivate individually owned or collectively held land. Smaller farmers usually supply their fresh fruit bunches (FFB) through local agents (often only one agent) whereas larger ones may sell directly to a local trader or mill¹². Some may also be organised into cooperatives or farmer groups.
- **Schemed smallholders** are structurally bound to a particular mill and organised, supervised or managed by the estate-mill to which they are linked. These schemes take various forms, but in general companies run the plantation estate and support development of two to four-hectare smallholder plots through finance and other inputs. They are essentially tied out-growers or contract farmers integrated into the vertical model of production and processing.

Indonesia and Malaysia have differing histories with regard these two types of smallholders, although there are some broad similarities. Government-backed schemes were actively promoted from the 1960s, but by the 1990s they had petered out due to lack of support from corporate plantations and the changing state policy in favour of liberalisation¹³. The more

recent models have instead facilitated access for companies to collectively-held customary land while minimising smallholder support. Since 2000, the major trend has been marked increase in independent smallholders in response to the palm oil commodity boom, often in areas opened up by the infrastructure such as mills developed for prior schemes and corporate plantations¹⁴.

2.2 Indonesian Smallholders

The Badan Pusat Statistik (BPS) is the main official source of statistics on palm oil cultivation and production. It reports that smallholders held 5.6 million hectares in palm oil planted land (46% of the 12.3 million total hectares) and produced 12.7 million tonnes of palm oil (37% of the total 34.5 million tonnes) in 2017¹⁵. More recent estimates suggest that the total area may have increased to above 14 million hectares¹⁶. The BPS provides total figures by province, but little further detail. Schemed smallholders in two-three hectare 'plasma' plots as part of nucleus estate schemes (NES) were established from the 1970s, and were estimated to account for 900,000 hectares in 2013¹⁷. It is difficult to find figures for current 'partnership' schemes, under which companies are meant to allocate 20% of their plantation concession to the community as either smallholder plots or dividends (potentially for land outside the concession boundaries)¹⁸. There are signs that they are sometimes not fulfilling such obligations¹⁹.

Independent smallholders therefore represent the great majority of this group in Indonesia, but the BPS statistics have a number of limitations, primarily because there is no comprehensive, official record of smallholder land. Studies have found that in practice STD-Bs are rarely applied for or even known about by farmers, and that larger producers may not obtain IUP-Bs in order to evade further scrutiny²⁰. Such local data underpins the national statistics, and indicates that there may be considerable under-counting of smaller farmers and over-counting

of larger producers. The latter can include plantation staff, government officials, local politicians, investors and others with positions of relative status in society who are able to access the finance and broker land deals to plant palm oil, typically on landholdings of 10-20 hectares and sometimes well over 100 hectares²¹. There is also evidence of a rising class of local 'elite' farmers buying multiple small parcels under different names and acting as landlords²². They may also sub-divide their land into smaller areas.

Detailed quantitative analyses by the Centre for International Forestry Research (CIFOR) of random samples in a cross-section of established and frontier areas in Sumatra and Kalimantan have disaggregated smallholders²³.

- In Rokan Hulu district, Riau province in Sumatra, a random sample of smallholder acreage found that small independent farmers (with less than three-hectare plots) made up over half of the population but held only about 20% of the land. Large farmers with over 15 hectares, including absentee owners, comprised only 8% of the 'smallholder' population but accounted for nearly 50% of the land. They were particularly prevalent in frontier areas.
- In two districts in Central Kalimantan and two in West Kalimantan, a random sample survey of 947 palm oil farmers found that only 46.5% of them held less than five hectares²⁴. Over half therefore held larger areas, and included better resourced farmers converting forests and peatlands. Only 11.1% of farmers with more than 25 ha had obtained an IUP-B, and only 2.7% of those with under 25 ha had the STD-B.

Based on the data from these studies in Riau and Central Kalimantan, the distribution of farm sizes as a proportion of total population is shown in Figure 1 and as a proportion of the total land area in Figure 2²⁵. They reveal that sizeable

proportions of farmers held more than five hectares, and that larger farmers were more prevalent in the frontier areas. While relatively few in number, the largest farms over 25 hectares accounted for considerable amounts of total land area.

FIGURE 1: FARM SIZE DISTRIBUTION IN SAMPLE AREAS IN RIAU AND CENTRAL KALIMANTAN (CK), AS A PROPORTION OF TOTAL FARMER POPULATION

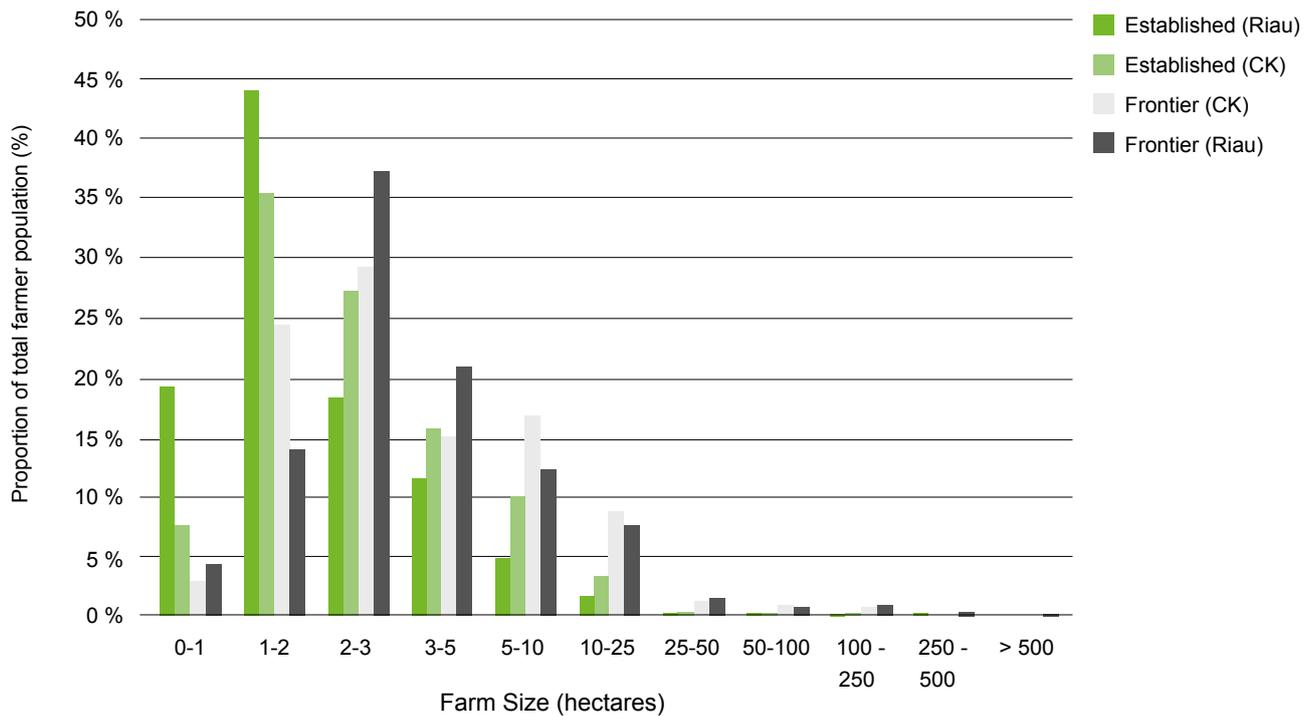
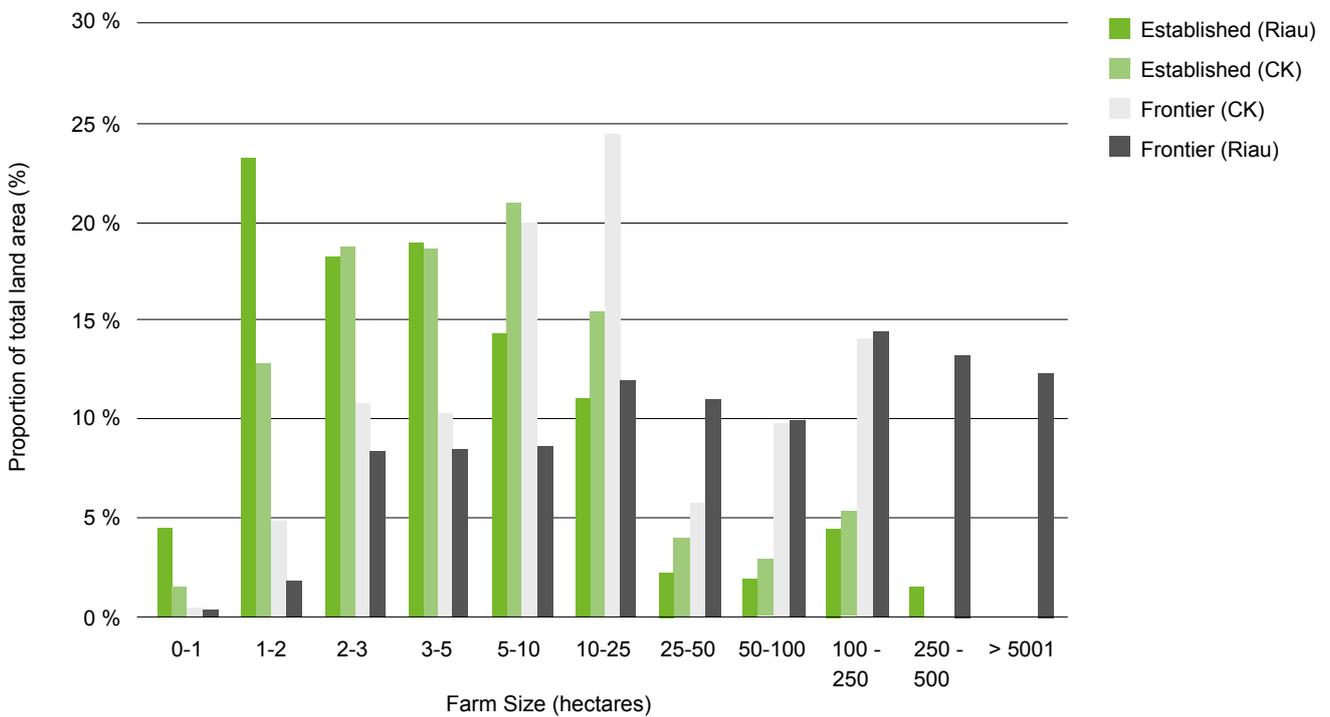


FIGURE 2: FARM SIZE DISTRIBUTION IN SAMPLE AREAS IN RIAU AND CENTRAL KALIMANTAN (CK), AS A PROPORTION OF TOTAL LAND AREA



It is not possible to generalise from these case studies to other areas or nationally. The history of palm oil development differs across the islands. Parts of Sumatra have the most well-established sector, which has led to land concentration to an extent, whereas in new areas such as Papua there is little infrastructure for supporting independent smallholders. Nonetheless, these analyses give a strong indication that large proportions of the 'smallholder' population and land area reported in official statistics does not fall within the proposed RED II threshold of two to five hectares (or even the national regulation threshold of 25 hectares). The five-hectare threshold still encompasses large volumes of palm oil production, and the available evidence suggest there is a risk that larger farms may sub-divide their land and/or find other ways to avoid being excluded under such criteria.

2.3 Malaysian Smallholders

Official statistics on palm oil smallholders are available from the Malaysian Palm Oil Board (MPOB). In 2017, they indicate that independent smallholders held nearly 1 million hectares (16.9%) and various schemed smallholders and other state schemes held some 1.3 million hectares (22.1%) of the total 5.8 million hectares of palm oil planted land in 2017²⁶. Government authorities have developed a number of schemes, of which the Federal Land Development Authority (Felda) is the main one. From the 1960s, Felda developed large agro-industrial palm oil schemes on the Malaysian Peninsula for the resettlement of mainly ethnic Malay peasants to around four-hectare plots on centrally managed plantations²⁷. In line with the government's privatisation drive, a new model was officially declared in 1991 and such schemes largely ended. The authorities have become essentially corporate entities²⁸, and many of the original settlers and their descendants are now absentee landowners or shareholders who have leased their plots to centrally-managed plantations²⁹. As such, they bear little resemblance to smallholders. More recent 'joint venture'

schemes with corporate plantations in Sabah and Sarawak avoid smallholder development altogether and instead promise community dividends through a trust held by the Land Custody and Development Authority, although in practice they have been found to leave customary landholders vulnerable to significant exploitation and losses³⁰. Since the 1990s independent smallholders have increased in number to cover 538,490 hectares in Peninsular Malaysia and 441,268 hectares in the states of Sabah and Sarawak in Borneo in 2017³¹. Although these statistics indicate that the average landholding by state is between three to six hectares, there are no readily available data or sample area analyses to reveal the distribution in landholdings. Some case studies provide an indication that may include larger farmers. For example, a survey of 385 independent smallholders in Peninsular Malaysia found that they held an average of 3.46 hectares, but with a maximum of 28 hectares³². It also found that such farmers often use hired migrant labour (which raises questions of their definition as smallholders). Studies in Sabah and Sarawak, where palm oil development has expanded most since the 1990s, have found that the majority of farmers have average areas of five hectares and fit the characteristics of independent smallholders, but there are also signs of a tier of larger farmers in well-situated villages emerging with access to over 10 hectares of palm oil and using hired labour³³. Overall, the available evidence indicates that a large volume of independent smallholder palm oil production is by farmers with less than five hectares, but there is currently no data to differentiate them from ones with larger areas.

2.4 Implications

Smallholders represent a heterogeneous group of different types of farmers and producers, but there is no consistent definition of them – nor are there comprehensive, accurate data sources to identify and disaggregate them in either Indonesia or Malaysia. This situation raises a

number of difficulties for RED II and other initiatives:

- Land size thresholds for smallholders vary from [2 – 5] hectares in the draft RED II delegated act, to 25 and 40.46 hectares in Indonesian and Malaysian regulations respectively, to up to 50 hectares in the RSPO. Consequently, there is no consistent basis for identifying them on the basis of land area, nor is there a clear understanding of how multiple small parcels of land may be counted.
- There are a variety of schemed smallholders in both countries. Although the draft RED II delegated act makes clear that it applies to independent smallholders, it does not specify their relationship to labour and capital, nor does it specifically exclude the different types of schemed ones. It may be open to varying interpretations and implementation in practice as a result.
- Detailed analyses of sample areas show that potentially over half of the independent smallholder population and/or land area is made up of larger producers with over five hectares, including commercial operations and absentee owners. Those with less than five hectares still represent a large volume of palm oil production that could be certified as low ILUC risk.
- Available evidence indicates that current regulations to register or licence different smallholders and producers are rarely applied on the ground in Indonesia in particular. Local government does not currently have the resources or capacity for such a large task, and the addition of another category of less than five hectares will complicate matters further. 🌱

Challenges for Certifying Smallholders



3.1 Verifying Palm Oil Feedstocks

In response to sustainability concerns, a number of palm oil certification initiatives and standards have evolved in recent years. The draft RED II delegated act refers to the potential role of voluntary national or international schemes for verification of compliance with its sustainability criteria. The most widespread standard is the voluntary, industry-led Roundtable on Sustainable Palm Oil (RSPO), which certifies around 19% of global production. Other initiatives have emerged such as

the International Sustainability and Carbon Certification (ISCC) and the Roundtable on Sustainable Biomaterials (RSB), which mostly focus on palm oil used in biofuels. Experience to date of these initiatives points to several key challenges, which are far from resolved in relation to corporate plantations, let alone smallholders.

First and foremost, it is inherently difficult to verify that palm oil is produced in compliance with given sustainability standards due to the long, complex supply chain of fresh

fruit bunches (FFB) from many different sources on to mills for processing and then to use in myriad different products, including biofuels. It is particularly difficult to establish chain of custody for independent smallholders because they tend to supply through local intermediaries who aggregate the FFB together. Establishing direct supply relations carries high transaction costs. Repeated investigations have shown that the vast majority of palm oil is traced only as far as the mill when it is processed, not the land where it is produced, and therefore fail to

mitigate risks of illegalities contributing to destruction of forests and peatland³⁴. A review of the RSPO, RSB and ISCC, amongst others, by the Changing Markets Foundation found that none of them had proven effective to date in tackling land conversion³⁵. The RSPO has been subject to trenchant criticisms that nominally 'sustainable palm oil' is still often associated with recent habitat degradation and forest loss³⁶, that companies are not enforcing their commitments on suppliers³⁷ and that the standard obscures these issues as much as addresses them³⁸. Auditing and verification requirements for certification have also been found to be lacking in practice. For example, the Environment Investigation Agency found that the RSPO auditing and monitoring system is critically flawed because the auditing firms are failing to identify and mitigate unsustainable practices; at worst there was evidence of collusion with companies to disguise violations of the RSPO standard³⁹.

3.2 Barriers to Smallholder Compliance

To date, smallholders have generally not participated in sustainability initiatives in large numbers due to several barriers to their compliance. The experiences to date of the government-led Indonesian Sustainable Palm Oil (ISPO) and Malaysian Sustainable Palm Oil (MSPO) measures offer important lessons in this regard. Such measures are essentially legality requirements more than sustainability initiatives, and there are plans in both countries to make them mandatory on smallholders by 2020. They will also potentially underpin the RSPO and other initiatives to certify smallholders.

Studies have shown that many smallholders are poorly equipped to comply with the requirements for such standards, such as land documentation, cultivation registration, membership of officially recognised farmer group or cooperative, or use of official seedling sources⁴⁰. Land legality requirements can be difficult for many farmers to

meet. While there is no reliable data on how many independent smallholders have insecure land rights, it appears to be a very large proportion of smaller farmers from indigenous groups in particular⁴¹. In frontier areas in particular, land documentation is typified by informal processes, overlapping claims, weak institutions, and corruption, at the bottom of which many smallholders have little incentive to formalise their insecure land tenure⁴². Case studies have also found that few smallholders participate in farmers' groups or cooperatives, due to limited knowledge of how they work and a reputation of poor governance⁴³. Although certification ostensibly offers market access and promotes good agricultural practices, in practice studies have found that it is a relatively costly process for smallholders that offers few economic benefits and does not reduce their vulnerability to price fluctuations⁴⁴. The Forest Peoples' Programme assessed the ISPO and MSPO to offer little protection for smallholders' fair treatment, credit, prices and market access, for example⁴⁵.

Improving independent smallholder compliance implies potential trade-offs between strict and more achievable standards, and between environmental and socio-economic goals⁴⁶. The RSPO consulted in 2018 on a standard to apply exclusively to independent smallholders, which aims to develop a lower burden for their entry and a simpler process for verifying their compliance⁴⁷. Notably, it adopts land thresholds in producer country regulation, such as up to 25 hectares in Indonesia. Competing agendas may also result in compromises. For example, the ISPO has been found to lack adequate regulations on deforestation and biodiversity loss, possibly due to reluctance to adopt stricter measures when the government's main target has been to promote economic expansion of the sector⁴⁸. Attempts to lower burdens, simplify processes and balance agendas to facilitate smallholder inclusion may result in weaker measures. These considerations do not mean that formal certification of

smallholders should not be pursued, but that this is a long process that requires better design and implementation of systems that reflect the actual situation in producer countries.

3.3 Implications

There are massive governance challenges for certifying hundreds of thousands of smallholders on the ground. The track record of existing standards and certifications highlights major challenges, and there is little evidence to suggest that a 'smooth certification process' as envisioned in the draft RED II delegated act is achievable in the near term for the following reasons:

- Palm oil supply chains are inherently complex, and there is no current system to transparently trace and verify feedstocks from the land where it is produced. The auditing, monitoring and enforcement systems for voluntary standards have proven inadequate to date for corporate plantations and their suppliers, and would be even more difficult to establish chain of custody for independent smallholders.
- Smallholders face major barriers to compliance with existing standards and certifications, and have little incentive to address them due to the relatively high costs and limited economic benefits. This alienates them from certification standards. Although there are efforts to introduce mandatory public standards for smallholders in Indonesia and Malaysia, it remains to be seen how effectively they protect against fraud at the local level. They also have different criteria to that proposed for RED II, however, and attempts to simplify systems and balance competing agendas may weaken their implementation. 

Role of Smallholders in Land-Use Change



Expansion of corporate plantations has been an important driver of forest and peatland conversion in both Indonesia and Malaysia, but the extent to which different types of smallholders are also contributing to this trend is more open to debate. They obviously play some part in frontier expansion, often using fire, but there is evidence to suggest that larger farmers are often at the forefront of this trend⁴⁹. This finding

is backed up by the two detailed analyses by CIFOR in Indonesia discussed in section 2.2.

- In Rokan Hulu district in Riau Province, Sumatra, larger independent operations were particularly prevalent in recently converted frontier forest and peatland areas. This evidence pointed to land speculation by more affluent and entrepreneurial groups, who are able to access land that could not otherwise be alienated through complex networks including “land mafia”⁵⁰.
- In the districts of West and Central Kalimantan, conversion of particularly fragile ecosystems in more isolated areas was associated with more affluent farmers cultivating, given the

relatively high costs for such ventures. This dynamic and sometime illicit land market was also more often tied to local elites and public bureaucracies⁵¹.

While these analyses point to larger farmers converting marginal forest peatland in particular, the latest study in Kalimantan also found that smallholders with less than five hectares were present in non-forested peatland and other forest areas in similar proportions to those with more than five⁵². These findings detract from others who contend that independent smallholders play a relatively minor role in land conversion because they tend to prioritise land already cultivated with other crops⁵³. Further research is necessary, but overall there is little basis for assessing independent smallholders to be relatively low-risk.

There is also conjecture about how the dynamics of palm oil expansion may shift due to measures like the moratoria on new corporate plantation licences and 'no deforestation, no peat and no exploitation' pledges in Indonesia, the pledge by Malaysia in the 1990s to maintain 50% forest cover, and the demands for sustainability certification of corporate supply chains⁵⁴. Modelling of future trends in Indonesia predicts that such measures will limit corporate plantations, but will also indirectly increase independent smallholder cultivation resulting in higher rates of deforestation attributable to them⁵⁵. This is based on the expectation that relatively less-regulated smallholders will fill the available space. There are also signs that accessible agricultural land with good soil quality is also becoming increasingly scarce in some areas, which may have spillover effects in pushing smallholders to expand onto peripheral lands with marginal soils⁵⁶. Corporate interests may also favour the 'partnership' model of smallholder development in Indonesia as a way of circumventing restrictions.

Overall, within the current context there is little evidence to support the low ILUC risk certification provision

for independent smallholders in the draft RED II delegated act. Additional measures, such as improved agricultural practices that result in higher smallholder palm oil yields, will not necessarily avoid displacing other uses. Under market-driven conditions, intensification projects can shift production to higher value crops and provide incentives for further expansion⁵⁷. Robust rules are necessary for determining additionality. The Clean Development Mechanism (CDM) is a well-established protocol in this regard that potentially could serve as a model for certifying low ILUC risk feedstock production⁵⁸. As it currently stands in the draft RED II delegated act, it is a sufficient condition for additionality measures to be applied by smallholders, but at the very least it should also be a pre-condition that they meet rules based on the CDM tool. As Cerology points out, such tools are necessary to require financial analysis or barrier analysis to assess that such projects would not otherwise be viable⁵⁹. In other words, they would only certify projects that would not happen in the business-as-usual counterfactual scenario.

4.1 Implications

The low ILUC risk biofuels category is discussed in detail in a recent report by Cerology⁶⁰, which finds that the lack of stringent criteria and robust additionality assessment make the concept of low ILUC risk biofuels a potentially major loophole for exploitation. In addition, available evidence and modelling indicates that independent smallholders should not be considered 'low-risk' because there is evidence that they also contribute to expansion of the production area into land with high-carbon stock :

- Although larger farmers and local elites with greater access to capital and speculative land markets are at the forefront of conversion of fragile ecosystems such as peat forests, small farmers with less than five hectares are also present in other forest and peatland areas. Landholding size is therefore

◀◀ **Corporate interests may favour the 'partnership' model of smallholder development in Indonesia as a way of circumventing restrictions.** ▶▶

not a good indicator for land-use change risk; instead there is a stronger case that all independent farmers irrespective of size are high-risk.

- Measures focused on corporate plantations, such as moratoria, no deforestation pledges and sustainability standards, have the potential to indirectly increase independent smallholder cultivation and resultant land-use change. Rising agricultural land scarcity in some areas may have spillover effects by pushing smallholders to expand onto peripheral lands with marginal soils. Additionality measures applied by smallholders to intensify production is an inadequate condition for determining risk. 🌱

Relationship of Palm Oil Development to Rural Poverty Reduction

There is a large body of literature on the relationship between palm oil cultivation and poverty reduction in Indonesia and Malaysia. The earlier rounds of smallholder schemes in both countries were largely successful in providing a secure income and better quality of life⁶¹. Direct government support and subsidies were a key factor for this, but as noted earlier, this approach largely ended in the 1990s and recent models have delivered poorer returns to communities. Therefore, the record of poverty reduction since 2000 relates primarily to independent smallholders. At a macro-level, various analyses have shown a correlation between increased palm oil production, higher GDP growth and poverty reduction⁶². For example, the World Bank found that Indonesian districts with the greatest increases in palm oil production had had the most significant poverty declines between 2005 and 2008⁶³.

Detailed analyses of household-level data in parts of Sumatra in Indonesia have shown that independent smallholders have benefitted from palm oil cultivation in terms of increased

incomes and improved living standards, such as higher dietary quality⁶⁴. Underneath these headline findings, a more complex picture emerges. Through labour-saving and capital-intensive management of palm oil, the observed income increases can mainly be attributed to households who are able to cultivate larger areas of palm oil and other crops and dedicate more labour to off-farm activities⁶⁵. In short, palm oil cultivation alone is not necessarily the main determinant in poverty alleviation. Those with better access to land, capital and other factors of production can enjoy significantly larger benefits, whereas those with less resources and more traditional livelihoods are not able (or willing) to make this transition and can lose out⁶⁶. A GINI analysis in Sumatra found that income inequality had increased among farmers through the expansion of oil palm, and it is possible that further expansion would worsen social inequality⁶⁷. Case studies in both Indonesian and Malaysian Borneo have also found that independent smallholders have raised their incomes through palm oil cultivation, although they also point

to varying outcomes for indigenous and migrant groups as well as social marginalisation of some ethnic groups⁶⁸.

Various factors shape the opportunities and outcomes of palm oil cultivation for different independent smallholders. In general, smallholders have markedly lower productivity than corporate plantations, receive considerably less than the mandated FFB price, and face financial credit constraints⁶⁹. Access to supporting infrastructure such as transport and mills is also key. In sum, well-situated smallholders and larger independent producers can profit markedly from palm oil cultivation, but others face serious barriers. Measures to promote good agricultural practices are often proposed to raise yields and support smallholders, but analysis has found that smallholders across the board generally prefer a low-input, low-output strategy⁷⁰. These problems are linked to the barriers around smallholder compliance with certification standards. Poor design of funds and support initiatives is also a factor; furthermore, it has been found that the

difficulties faced by smallholders are not visible enough to government and industry actors to influence improvements⁷¹.

In addition, there is also considerable evidence of the negative social impacts of the corporate palm oil industry on communities and labourers. The industry depends on access to a low-wage, casual labour force, in particular by taking advantage of migrant workers, and several studies have demonstrated how it systematically exploits workers through precarious, unprotected conditions, under which forced labour, child labour and gender discrimination is rife⁷². Another major issue is thousands of rural conflicts across both Indonesia and Malaysia, in particular in newer areas for expansion such as Papua and Sarawak, due to lack of consultation and consent over alienation of customary land and limited benefit sharing with local communities⁷³. Loss of traditional livelihoods and food insecurity has also documented in such contexts⁷⁴. Human rights commissions in both countries have found that the palm oil industry has compounded conflicts and failed to reduce poverty among indigenous peoples⁷⁵. Concerted efforts are needed to address such conflicts, in particular to recognise customary land rights, which is fundamental to inclusion and poverty reduction amongst indigenous peoples and local communities.

The opposition to RED II is symptomatic of wider debates over the need to limit palm oil expansion and the implications for economic growth and poverty reduction. This is not just a question of restricting palm oil demand through EU biofuel policy. Phasing out palm oil-based biofuels as a renewable energy source may slow some global demand, but global palm oil production is still expected to increase over the coming decade for non-energy uses⁷⁶. This will no doubt also continue to generate considerable wealth in producer countries, and how this wealth is distributed has the potential to alleviate rural poverty. A comprehensive review of the palm oil industry

complex in Indonesia and Malaysia concluded that the allocation of resources and distribution of benefits is skewed in favour of powerful political and agribusiness interests that control the industrial palm oil complex⁷⁷. Reducing both rural poverty *and* inequality amongst smallholders and communities more effectively requires a major shift in direction. Comprehensive programmes with better designed and implemented measures are necessary to target the issues faced by independent smallholders such as low productivity and high replanting costs, and improve their agricultural practices on currently planted palm oil land, without incentivising displacement of other crops and expansion into forest and peatlands. Such measures are warranted irrespective of RED II or any other restriction on palm oil expansion. It is essential that the argument that independent smallholders should be supported as part of rural poverty alleviation is **not** conflated with the claim that they should be certified as low ILUC risk. As discussed in Section 4, additionality measures need to meet a robust set of rules and only reward truly additional feedstock production. As Cerulogy warn, “anything less will lead to cherry picking of the most sustainable feedstock for import to Europe, followed immediately by the same indirect land use change impacts that we are trying to avoid⁷⁸.”

5.1 Implications

Although palm oil development has made a major contribution to economic growth in Indonesia and Malaysia, claims made by palm oil advocates on poverty reduction do not reflect the complex relationships on the ground and overstate the potential harm from restrictions on biofuels. Their case does not justify weakening RED II by exempting smallholders:

- By phasing out biofuels as a renewable energy source, the EU may slow some demand, but overall global demand for palm oil is expected to continue increasing over the coming

decade. This will no doubt generate considerable wealth in favour of agribusiness, and poverty reduction depends on shifting the wider economic model rather than on restrictions such as RED II.

- Although palm oil cultivation is linked with increased incomes for some farmers, there is also evidence of rising rural inequality between different type of smallholders. Recent initiatives to address these issues have been piecemeal and often failed to reach the more vulnerable groups. Better designed and implemented measures at a systemic level are needed to improve agricultural practices and increase yields, which also have the potential to alleviate poverty, but this argument should not be conflated with the notion that smallholders can be certified as low ILUC risk.
- The palm oil industry is linked to entrenched rural conflicts. Conflicts have been driven by the lack of consultation, consent and benefit-sharing when corporate plantation move into customarily-held community land. Indigenous peoples exercise customary rights over vast areas, and their rights need better recognition and protection.

Policy Recommendations

As part of the public consultation on the draft RED II delegated act, **it is recommended that the provision for certifying independent smallholders on the basis of their low ILUC risk should be removed altogether.** This key recommendation is based on the fact that there is no evidence to demonstrate how the proposed smallholder ‘additionality measures’ could be effectively implemented. In the absence of further compulsory conditions to ensure ILUC risk mitigation, this provision is therefore clearly not fit for purpose.

Alternatively, as a minimum, biofuels certified under this exemption **must** meet the condition as stated in Article 5.1 (a) (i) that the additionality measures ‘become financially attractive or face no barrier preventing their implementation only because the biofuels, bioliquids and biomass fuels produced from the additional feedstock can be counted towards the targets for renewable energy’, and not just the condition in Article 5.1 (a) (iii) that ‘they are applied by small holders’. This is a precondition for ensuring that only a project additional to a business as usual counterfactual scenario could be credited following financial analysis or barrier analysis, rather than potentially any independent smallholders as defined by the act. It would be the only way to ensure low ILUC risk due to smallholder production.

The overall conclusion that independent smallholders should not be exempted as a low ILUC risk under

RED II is based on the following key points:

- **The definitions and statistics on palm oil smallholders are too imprecise for providing the basis for a certification system:** There is no comprehensive dataset that allows for identifying different types of smallholders with less than five hectares, nor is it foreseeable that the necessary systems and capacity will be dedicated to collecting such data. Consequently, a significant proportion of larger farmers and local elites are likely to continue to be counted as ‘smallholders’. Changing the threshold landholding size will also not make a difference, because it is a poor indicator of ILUC risk in general.
- **There is no evidence of a workable and sufficiently robust system for certifying palm oil smallholders:** Current standards and certifications have failed to adequately regulate large corporations and their suppliers, and the barriers to ensuring palm oil smallholder inclusion and tracing their production are prohibitive. Consequently, there is a major risk that such voluntary systems would not be transparent, accurate, reliable and protected against fraud.
- **The low ILUC risk certification opens up a loophole for high-risk producers to drive further forest and peatland conversion:** Available evidence points to larger farmers and local elites being active in frontier expansion, but independent smallholders with less than five hectares are also present in these areas. There is a risk of spillover effects as agricultural land scarcity combined with moratoria and sustainability restrictions on corporations may encourage relatively less regulated independent smallholders to expand.
- **The claims made by advocates of palm oil in Indonesia and Malaysia on how phasing out palm-oil based biofuels would adversely affect smallholder poverty reduction do not stand up to scrutiny:** Palm oil production is expected to continue increasing to meet global demand for its non-energy uses and will also continue to generate considerable wealth. Discussion should focus on major long-term reforms to reduce poverty and inequality by addressing barriers to smallholders and mitigating rural conflicts. Within this context, it is vital that well-meaning biofuel policies do not instead become piecemeal measures that end up indirectly supporting further expansion into forests and peatland.

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Rainforest Foundation Norway supports indigenous peoples and traditional populations of the world's rainforests in their efforts to protect their environment and secure their customary rights. RFN was established in 1989 and works with local environmental, indigenous and human rights organisations in the main rainforest countries in the Amazon region, Central Africa, Southeast Asia, and Oceania. RFN is an independent organisation, and part of the international Rainforest Foundation network, with sister organisations in the United Kingdom and the USA.

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