

## Policy pointers

**To be attractive,** formalisation must be economically viable: farmers need to see benefits, not just costs. Formalisation must add value to what informal markets already offer.

**Formalisation can be a** tool for social and economic inclusion. Tax contributions can strengthen citizenship, with obligations accompanied by rights. Formalisation should include benefits such as social security, which are in great demand.

**Transition towards** formalisation must be gradual and voluntary. Formalisation must build farmers' confidence, ensuring all stakeholders can access information throughout the process.

**Adapting taxes to** small-scale farmers' reality is an investment in the taxpayers of tomorrow. Farmers' choices about formalisation depend on what markets and prices they can (or wish) to access; their circumstances must be understood through consultation, research and strong evidence.

## Taxes and transition: formalising small-scale farmers in Peru?

Like many developing countries, Peru needs to increase tax collection to provide public goods and services for its people. In the agricultural sector, out of a total of 2.2 million farmers only 42,000 pay taxes; 1.8 million work on less than five hectares of land, most in the informal sector. As competition in markets that demand formality in their supply chains becomes central to policy and development interventions, formalising the very significant sector of small-scale farmers is key. But if smallholders are to join the formal economy, the benefits must outweigh the costs of compliance. This paper reviews the government's formalisation efforts to date, focusing on a specific programme and tax mechanism designed to support farmers' voluntary transition to formalisation. Applicable in Peru and beyond, the lessons learnt can contribute to a revised approach to formalisation that is 'win-win' — acting both as a lever for tax collection and as a tool for economic and social inclusion.

Governments need income. During the liberalisation process of the 1990s, Peru — like many other developing countries — withdrew from regulating functions and dismantled public institutions. But successive governments have since paid special attention to reinforcing tax collection and strengthening the capacity of SUNAT, the national tax collecting body.<sup>1</sup> As a result, total tax collection increased from US\$2.3 billion in 2000 to US\$8.7 billion in 2014.<sup>2</sup>

At the same time, competition in global markets became central to policy and development interventions, particularly after the US-Peru Trade Promotion Agreement was signed in 2006. Since then, Peru has passed many laws supporting its agriculture sector, and while mostly benefiting agribusiness and agri exports, they have also enabled small-scale farmers to compete in more liberalised markets.

Peruvian agriculture is dominated by small-scale farmers, with nearly 82 per cent of all producers working on less than five hectares.<sup>3</sup> The vast majority also work in the informal economy: less than one per cent of the country's 2.2 million producers are a legally registered business.

Formalisation would allow small- and medium-scale farmers better access to markets that demand formality in their supply chains, both at home and abroad. But these farmers are unlikely to formalise as long as they see it as a heavy tax burden with few economic benefits; they need to be convinced that the returns will outweigh the costs.

This briefing analyses how APOMIPE — a programme designed to make small-scale producers more competitive — has promoted gradual and voluntary formalisation. The

# Farmers need to be convinced that the returns of formalisation will outweigh the costs

experiences of the programme as a whole, illustrated here through a project in Cajamarca, provide interesting lessons for countries where small-scale agriculture and informal markets are still dominant.

## Laws and taxes promoting agriculture

Peru has passed numerous laws and fiscal regulations to make its agricultural sector competitive on the global stage:

- Agricultural businesses pay income tax at 15 per cent, half that of other sectors
- They are exempt from VAT and can claim back VAT on inputs
- Agroexporters can claim back 5 per cent of customs duties
- Specific laws and tax reduction schemes promote agribusiness in remote areas of the Andes and Amazon.

To benefit from these laws and incentives, enterprises must be legally registered and accountable, keeping official business and banking records. For small- and medium-scale farmers, the cost of complying with such requirements is often too high and the laws and regulations too complex. Significant barriers to competing in formal markets include: scale,

geographical dispersion, weak negotiating power, low capital, high production and administrative costs, lack of information, and subsidies in other countries. This indicates a lack of government understanding of small-scale farmers' needs and the context in which they work. Small-scale producers tend to remain informal, leaving larger formal companies to reap the benefits of the laws and regulations.<sup>4</sup>

To ensure that small-scale farmers benefit from legislation, farmers' trade unions have proposed a variety of tailored schemes to formalise small-scale agriculture. CONVEAGRO, the national agricultural producers' confederation, has long stated that current laws and fiscal regulations benefit the middlemen, who take advantage of farmers' weaker market power to set prices. CONVEAGRO proposes formalising the whole chain, from production to trade, through legal farmers' associations whose members would benefit from laws, tax incentives and cost recovery schemes. This would strengthen their position to compete in the liberalised market, allowing the state to increase tax collection.<sup>5</sup>

In response to demands from farmers' cooperative federations associated with CONVEAGRO the government passed the new Cooperative Law (2013),<sup>6</sup> which recognises cooperative associates as social security affiliates when they declare their incomes.

**Table 1. CSCI and the cooperative model: a comparison**

	CSCI	Cooperative
<b>Legal requirements</b>	Producers organise themselves in a consortium (network) No legal structure or registration	Legal structure Legal registration
<b>How it works</b>	One consortium member acts on behalf of the associates to: <ul style="list-style-type: none"> <li>• buy inputs or sale products</li> <li>• declare contracts to SUNAT</li> <li>• distribute costs and benefits among associates</li> </ul>	Complex and heavy, with minimum of five committees including: <ul style="list-style-type: none"> <li>• administration</li> <li>• accounting</li> <li>• management</li> </ul>
<b>Taxes payable</b>	Individual income tax	Individual income tax Collective tax on cooperative sales
<b>Member benefits</b>	Individual incentives VAT recovery	Individual incentives VAT recovery Recognised as social security affiliates More tax exemptions
<b>Share of profits</b>	All profits distributed among members	A percentage of profits is held for the cooperative investment fund
<b>Share of investments</b>	All investments remain with the association. Retiring members have no claim on any share of investments.	Retiring members can claim their share of investments — a strong incentive to invest and prosper
<b>Lifespan</b>	Three years	No limit

Source: Based on Torres (2014)<sup>9</sup> and Quispe (2012)<sup>7</sup>

Although this law does not answer the needs and demands of all small-scale farmers, it is a step forward in the formalisation process, conferring obligations, benefits and rights.<sup>7</sup>

### APOMIPE: helping small-scale farmers compete

In its search for ways to overcome the barriers to formalisation facing very small-scale farmers, Peru's Ministry of Production joined efforts with the Swiss Cooperation Agency to set up APOMIPE. The programme, which ran from 2005 to 2014, sought to overcome obstacles to equitable, inclusive and sustainable development by improving the competitiveness of micro and small enterprises.<sup>8</sup>

When the government passed a law on the development of micro and small enterprises in 2008, recognising small-scale farmers as micro enterprises and valuable economic actors, APOMIPE entered its second stage. It helped farmers form associations or entrepreneurial networks by seeking to get the right product into the right markets. It looked at value chains and territories with meaningful potential that would benefit from other economic promotion initiatives, such as public procurement by local governments. The APOMIPE approach helps farmers become formal autonomous businesses with the capacity to diversify their portfolio, rather than linking them to a single market or buyer.

The programme followed three basic steps when setting up producers' associations: building trust among members; identifying a product with market potential; and professionalising the business (APOMIPE worked with local NGO staff to set up and run associations until they were strong enough to pay a manager). But building trust, improving incomes and profits, and understanding the benefits of adopting a formal enterprise structure all take time.

When designing and implementing inclusive formalisation strategies, APOMIPE sought to avoid significant costs for farmers. It used CSCI ('consortium without an independent accounting system'): a little-known tax mechanism that enables small-scale producers to compete in formal markets. Designed by SUNAT, CSCI facilitates the transition from informal to formal by allowing a group of individuals or small enterprises to buy or sell goods and services without immediately creating a legal structure. The group elects an operator, who registers the contract with SUNAT for tax collection purposes. Group members can then issue invoices and recover costs, giving them access to bigger, formal markets.

### Box 1. Lessons from going formal

In 2008, Peruvian NGO CEDEPAS started working with guinea pig ('cuy') producers in Cajamarca, who had identified a high demand for cuy meat as a result of expanding urbanisation. Many of the small-scale farmers involved — mainly women — were already breeding cuy. The majority were also small-scale milk farmers, selling to the biggest national milk companies.

CEDEPAS worked to earn the farmers' trust and encouraged them to form entrepreneurial networks using the APOMIPE approach and the CSCI mechanism. By 2011, 34 networks were benefiting 350 farming families. All 350 producers who took the step of organising into networks reported increased incomes, and the price of cuy rose from US\$5 to US\$11 per kilo as quality improved and demand grew.<sup>10</sup>

But despite these gains, only 110 of the original 350 joined a cooperative when the three years of semi-formal CSCI were over. Some worried about expectations of quality, while many failed to understand or appreciate that a cooperative would keep 30 per cent of recovered VAT to invest in their processing facilities. Those who were not ready to enter the cooperative structure instead formed new consortiums — SUNAT has no clear guidance around the number of times a farmer can enter a new CSCI scheme, so 'they just do it!'<sup>11</sup>

This points to the need for formalisation to be both voluntary and gradual: farmers need enough information and time to make a commitment. Joining a second CSCI scheme is giving these cuy producers time to consider the benefits of formalising their position in the economy, and to become confident that delivering better quality products and investing in their business will bring sustainability in the long term.

The CSCI is a useful transition mechanism towards full formalisation: it aims to demonstrate that formalisation is neither difficult nor expensive. A group can use it for three years, after which they should create a legal structure — preferably a formal cooperative, which can bring yet more benefits to farmers (see Table 1).

### Understanding markets and farmers' choices

Between 2008 and 2014, APOMIPE promoted 118 entrepreneurial networks or consortiums — the first step towards fully entering the formal economy — benefiting some 1,500 small-scale producers. But results have not been uniform: the Cajamarca study is one example where farmers do not feel confident enough that the benefits of formalisation outweigh the costs to take the next step (see Box 1).<sup>12</sup>

To understand the process leading — or not — to formalisation, we must understand the markets in which small-scale farmers operate, their customers (informal and formal), and the benefits they enjoy. Before joining the CSCI scheme, the farmers described in Box 1 relied on two big, formal milk companies for their main income and on informal intermediaries to sell a few guinea

pigs ('cuy') for extra income. Buyers set the prices. After organising into networks and developing cuy production to meet growing local demand, the farmers were able to establish contracts with new clients including restaurants, exporters, public food programmes and mining companies, negotiating their terms.

To diversify their client portfolios and the volume and quality of their produce, farmers change their strategies and investments over time. Market demand, product quality, price and profits all determine how and to whom small farmers sell their produce. When demand or quality is low, it may be easier or more lucrative to sell informally; when demand is relatively high and customers require paperwork, farmers are better off selling as part of a consortium or cooperative. This reality means small-scale farmers will engage with both formal and informal markets.

### Learning from experience

The APOMIPE programme provides important lessons for policymakers in countries where small-scale agriculture and informal markets remain dominant. Considering this learning in policy design and implementation can help ensure that formalisation benefits all stakeholders: expanding the tax base, offering tangible benefits to small-scale farmers, and acting as a successful component of economic and social inclusion.

**Formalisation has to be economically profitable for farmers.** Farmers will buy into formalisation processes if they see concrete benefits, not just increased costs. Although reducing the cost of formalisation is important, it only makes sense where there are profits to be made. Costs, benefits and risks determine market choices: the formalisation process must add value to what informal relationships and transactions already offer. Small-scale farmers are entrepreneurs, always measuring and managing risks and costs — their decision to operate in formal or informal markets will depend on the benefits each present at the time.<sup>13</sup>

**Formalisation with economic and social inclusion strengthens citizenship.** The Cooperative Law (2013) is certainly a step forward, as it guarantees the two pillars of true citizenship: rights and obligations. However, other benefits — such as insurance against losses from climate change or natural catastrophes, health insurance and pensions — could make a crucial difference in encouraging farmers to formalise.

**The transition to formalisation must be gradual and voluntary.** It will take time for farmers to have confidence in policies and development interventions that incentivise more formal structures and ways of working. A longer and more strategic framework than the current three-year CSCI approach is needed and must be communicated clearly to all stakeholders, alongside all other relevant information about the formalisation process.

**Taxation must be adapted to farmers' reality.** The state needs its citizens to increase their incomes — and pay tax — in order to deliver public services, institutions and law enforcement. At the same time, small-scale farmers are trying to enter and compete in profitable markets. Successful cooperatives prove that farmers pay taxes when they see the benefits of doing so — further consultation and research to understand farmers' realities will help in the design of processes that support small-scale producers to transition into the formal economy. Supporting small-scale farmers today is an investment in a large number of potential taxpayers tomorrow.

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### Notes

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