Policy Brief

The KENYA INSTITUTE for PUBLIC POLICY RESEARCH and ANALYSIS

No. 12/2006

Improving public policy making for economic growth and poverty reduction

Reducing Implicit Taxation of the Agricultural Sector in Kenya

Agriculture is the dominant sector in terms of its contribution to Grosss Domestic Product in Kenya (27% of GDP), employment (66% of labourforce), and exports (70% of export earnings, excluding refined petroleum exports). Transforming the Kenyan economy requires that resources flow from the agriculture sector to other sectors of the economy, although opinions differ on how this can be achieved. There are those who hold the view that the sector should be taxed heavily, while others believe that the sector should be taxed just like any other sector. In Kenya, where agriculture also provides the sole means of livelihood for the bulk of the population (51.6% of Kenya's population and 65.5% of the poor depend on subsistence farming), explicit taxation of the sector to facilitate the transfer of resources is problematic.

Much of the Kenya government's policy reforms in the agriculture sector over the last two decades have aimed at improving the incentives facing farmers in a bid to increase the sector's productivity. These reforms include price decontrols, promotion of private trade in marketing of agricultural commodities, decontrols in movement of agricultural produce, deregulation of foreign exchange markets, and trade liberalization. Further, the different taxation measures proposed over the years including, *inter alia*, reduction of duties on imported agricultural inputs and continued tariff protection against competing agricultural imports, have reinforced the previous reforms.

However, the various reform measures do not seem to have gone far enough because the continued use of trade, macroeconomic and other industrial policies to protect the industry sector, for example, have continued to act as an indirect, or implicit tax on the agricultural sector.

The imperative of transferring resources from the dominant sector to other sectors, and the peculiarities of the agricultural sector in the Kenyan economy, include, *inter alia*: (i) dominance of the sector in terms of output and employment; (ii) severe administrative and logistical limitations facing the government in taxing agricultural income; (iii) direct and indirect linkages between rural (mainly agricultural) labour markets and other labour markets in the economy; (iv) difficulty of taxation of agricultural production given the effect of the level of government subsidized inputs such as water, fertilizer and electricity (from the post independence period to early 1980s) on agricultural prices; and (v) the effect of direct taxation of agriculture on the availability, distribution, quality and pricing of food, which may serve to justify implicit taxation of the agricultural sector.

There are two main channels of transmission by which government policies can be an implicit tax on the agricultural sector:

This policy brief is based on KIPPRA Discussion Paper No. 52 on Implicit Taxation of the Agricultural Sector in Kenya. The study sheds some light on how the agriculture sector in Kenya is taxed, either directly or indirectly, and proposes how this can be done more efficiently to ensure that the sector plays its role in economic development, employment creation and poverty reduction.

The trade liberalization efforts that took place from the mid 1980s did not sufficiently reduce the bias against the agriculture sector. The relative internal terms of trade continued to decline adversely against agriculture. The relative (internal to external) terms of trade index declined before the intensive reform years in 1994 but improved thereafter.

(i) Import tariffs on non-agricultural products

The widening of the tax base as well as the development of other tax handles to replace reliance on import duties have rendered Kenyan import tariffs to have more of a protective than revenue-raising function. Protective duties mainly seek to develop the local manufacturing capacity. However, because Kenya has a comparative agricultural production, such duties drive a wedge between international and domestic relative prices of both agricultural and manufacturing goods, and renders relative prices of manufacturing goods higher than those of agriculture, which is both a direct and indirect tax on agriculture. This improves the terms of trade of domestic manufactures and hence raises the share of profits and therefore savings and growth of the non-agricultural sector. Further, to the extent that they make imports of manufactured goods, which are also consumed by the agriculture sector, more expensive, import tariffs are an indirect tax on agriculture and hence make the non-agricultural sector a more promising investment prospect.

(ii) Price and macroeconomic policies

Macroeconomic and exchange rate policies, even when pursued to favour domestic industry, may result in an overvalued exchange rate, which is a tax on exports. When such policies alter the terms of trade in favour of industry, they also tax agriculture indirectly. Expansionary monetary and fiscal policies aimed, for example, at reducing unemployment may result in inflation and therefore an overvalued exchange rate, which will inevitably result in a loss of agricultural exports earnings. A real exchange rate appreciation may affect the relative profitability of import competing industries and agricultural exports, compounding the effects of real exchange rate appreciation that arises from tariff protection of industry. Expansionary fiscal policies result in budget deficits, and hence higher interest rates, as well as increased expenditure on home goods whose prices subsequently rise, leading to real exchange rate appreciation, which is a negative incentive on agricultural exports.

To empirically validate these mechanisms, the study employed both the terms of trade approach and the real exchange rate approach to determine the extent and magnitude to which government policies act as a bias against agriculture.

Using the two approaches the study found that:

(i) The trade liberalization efforts that took place from the mid 1980s did not sufficiently reduce the bias against the agriculture sector. The relative internal terms of trade continued to decline adversely against agriculture. The relative (internal to external) terms of trade index declined before the intensive reform years in 1994 but improved thereafter.

These results suggest that although the reform measures pursued in the 1980s did not necessarily reduce the bias against the agricultural sector, developments on the international market since 1994 reduced the bias against agricultural exports. Following the reforms in 1994, it was still profitable to undertake manufacturing than agricultural activities. However, it was more profitable to produce agricultural commodities for the local market than for exports. Reforms therefore did not go far enough to remove the bias against agriculture and, more so, against agricultural exports.

(ii) Inappropriate policies resulted in real exchange rate overvaluation and led to an implicit tax of agriculture to the extent of about 25.6 percent over the period 1966-2002.

The low explicit taxation of the agriculture sector, which is purely the result of administrative and logistical difficulties, does not say much about the actual level of taxation of the sector. Protective trade policies as well as other macroeconomic distortions indirectly tax the sector.

Although the agricultural sector was highly protected in the years prior to 1980, the period since mid 1980s when both macroeconomic and sectoral reforms intensified saw a significant reduction in the level of protection. Although the reforms reduced the protection of the sector, the policies pursued resulted in exchange rate overvaluation, raising the implicit level of taxation of the agricultural sector. Between 1981 and 2002, when the reform effort was most intense, the average level of taxation of the agricultural sector resulting from overvaluation of the exchange rate was about 167% percent. As such, overvalued exchange rates resulting from policy distortions were indeed a bias against the agricultural sector.

(iii) Implicit taxation of the agricultural sector at the commodity level shows that nominal protection offered to wheat has been declining, from 61 percent in 1980 to about 21 percent in 1990 to 1998. At the same time, maize, a food staple consumed by most of Kenya's poor population, was taxed at an average of 18 percent over that period. Other crops have continued to enjoy protection, though at a declining level.

From the foregoing we can conclude that the low explicit taxation of the agriculture sector, which is purely the result of administrative and logistical difficulties, does not say much about the actual level of taxation of the sector. Protective trade policies as well as other macroeconomic distortions indirectly tax the sector.

Policy Recommendations

To reduce the level of implicit taxation of the agriculture sector in Kenya:

1. Macroeconomic managers at the Ministry of Finance, and the Central Bank of Kenya, should ensure that macroeconomic policies, such as monetary, fiscal and exchange rate policies lead to a competitive exchange rate, which will not implicitly tax the agricultural sector.

2. The Ministry of Agriculture should ensure that microeconomic and sector-specific policy reforms such as competition, and legal and regulatory measures are pursued to ensure that farmers get the right signals and are not unfairly disadvantaged by the policies in place.

3. The Government should pursue policies that improve the competitiveness of the agriculture sector relative to other sectors through, for example, increasing appropriate productivity-enhancing investments in agriculture such as rural infrastructure, agricultural extension, irrigation and seed technology.

4. A research programme should be put in place and coordinated by major stakeholders, through KIPPRA and or KARI, to explore the viability and modalities of implementing land-based taxes and specifically of designing crop-based levies in view of the diversity of agro-climatic zones in the country. Such a research programme should precede any effort to adopt a land tax, which is generally accepted as a more efficient form of taxation. Land-based taxes are bound to ensure increased land use efficiency in addition to helping in revenue generation, especially by local administrations who would naturally have a higher incentive to collect the revenues. Such revenues would then be applied directly to building infrastructure and other utilities consumed by farmers in the production process.

About KIPPRA Policy Briefs

KIPPRA Policy Briefs are aimed at a wide dissemination of the Institute's policy research findings. The findings are expected to stimulate discussion and also build capacity in the public policy making process in Kenya.

KIPPRA acknowledges support from the Government of Kenya, the European Union (EU), the African Capacity Building Foundation (ACBF), and all the other development partners who have supported the Institute's activities.

For More Information Contact:

Kenya Institute for Public Policy Research and Analysis
Bishops Road, Bishops Garden Towers
P.O. Box 56445-00200, Tel: 2719933/4, Nairobi
Email:admin@kippra.or.ke
Website: http://www.kippra.org