USAID
FROM THE AMERICAN PEOPLE

BIZCLIR Business Climate Legal & Institutional Reform

Briefing on the Agribusiness Enabling Environment

# AgCLIR LESSONS FROM THE FIELD: PAYING TAXES

The business of agriculture occupies a critical space in most economies. Distinct and special among industries, agriculture is the dominant source of employment for a large share, even a majority, of the population in developing nations.

Accordingly, governments treat the regulation of agriculture and food differently than any other sector. Unlike the output of other sectors, many agricultural products are basic necessities: agriculture provides the food, fiber, fuel, and construction materials necessary to sustain human existence. Governments everywhere assume responsibility for assuring that the distribution of agricultural commodities is great enough and equitable enough to provide a reasonable quality of life for its citizens.

*Agriculture and Agribusiness: Paying Taxes* is a briefer that mirrors the analytical framework used by the World Bank Group's *Doing Business* series (www.doingbusiness.com) and adopted by *USAID's Business Climate Legal and Institutional Reform Project* (www.bizclir.com). Divided into four sections (Legal Framework, Implementing Institutions, Supporting Institutions, and Social Dynamics), this briefer highlights the specific issues that must be addressed in local legal, regulatory, and institutional environments if agribusiness is to be economically productive, contribute to environmental sustainability, and assure a safe and reliable food supply.

## PAYING TAXES: KEY CONCEPTS

The fairness and efficiency of a tax system has significant impact on whether entrepreneurs (particularly smaller and micro enterprises) and individual citizens choose to join the formal sector. If they believe that the tax system is fair and that the state will use their tax revenues wisely, they are more likely to participate. A state with a larger tax base can typically pursue more growth-oriented priorities, including expenditures on public goods such as education, health, and infrastructure, all key to the success of the agribusiness sector. Moreover, when more individuals and businesses participate in the tax system, the state can reduce the amount of the payments it seeks from each taxpayer.

The tax system also helps to determine the incentives agricultural producers face. Historically, agricultural products were taxed at relatively high rates when compared to other products in the same economy—leading to distortions in the market that had the perverse effect of discouraging agricultural investment where it was needed most.

Agribusinesses that could also be described as manufacturing firms (e.g., those producing biofuels, flour, fertilizer) are likely to be subject to corporate taxes (e.g., turnover taxes, taxes on profits) similar to those paid by any other manufacturing firm. Depending on the defining laws, cooperatives functioning as agribusinesses often retain a "non-profit" character. As such, they may not be subject to standard corporate taxes.

An analysis of the 2004 *Doing Business* data indicated that higher corporate tax rates discourage investment, are positively associated with the size of the informal economy,

This publication was produced for review by the United States Agency for International Development by Booz Allen Hamilton under the Business Climate Legal and Institutional Reform (BizCLIR) project.

and are inversely correlated with growth.[1] Agriculture-based economies, especially in Africa, tend to have poor scores.

To understand the full impact of taxation on the small and micro enterprises dominant in the agricultural sector, it is important to assess how taxes are levied on specific commodities (and producers or traders of those commodities). To understand the relative rates of taxation (or subsidy) on agriculture and non-agriculture, an analysis of the terms of trade is useful.

Taxes on the majority of agricultural enterprises are of two types:

- *explicit or direct* taxes on land, outputs, inputs, and sales; and
- *implicit or indirect* taxes on or subsidies to the non-agricultural sector that change the terms of trade for agriculture.

**Direct taxes.** Direct taxes on land (property taxes) are a key element of agricultural taxation in developed countries but are relatively less important in the developing world, in large part because of limitations on private ownership of property. Some countries (e.g., Vietnam) have circumvented the ownership issue by levying taxes on use. However, collection of taxes on rural real estate is relatively difficult and costly in administrative terms.

By comparison, market-based taxes or trade taxes on sales of agricultural products are relatively easy to collect, especially when the commodity is imported or exported. Private trading agencies and state trading enterprises provide centralized tax collection points and offer lower administrative costs. This relative ease of collection has encouraged governments to place greater reliance on market-based taxes for a limited range of commodities.

Raw or minimally processed agricultural commodities exported into regional or global markets have traditionally been the most significant source of agriculture-based revenue for the exporting country. Generally, licenses to export are limited in scope and number, and national revenues can be collected in a cost-efficient way as the products must pass through ports or airports where they are weighed and valued and a clear paper trail is created. However, high rates of taxation on agricultural exports have been shown to pose strong disincentives to production and/or increased incentive to ship commodities through neighboring countries with less onerous export taxation regimes.[2]

Under the Uruguay Round of international trade negotiations and the ongoing debates within the World Trade Organization (WTO) on the Agreement on Agriculture, as well as within the regional trading negotiations that have led to the creation of regional trading blocs, developing countries have come under some pressure to rethink these policies. Many countries have brought export tariff rates down and now allow tariff-free export within a trading bloc of neighboring commodities. Some countries, such as Ghana, have recently lowered export tax rates on processed agricultural commodities to provide an incentive to foreign companies to invest and to domestic companies to add greater value-added (and create jobs) in-country.

Import tariffs on inputs (e.g., fertilizer, seeds, machinery) are another explicit tax on agribusiness. In the interests of encouraging upgrades to agricultural technologies, though, many developing countries keep these tariffs low.[3]

**Indirect taxes.** While international trade talks have led to reduced direct taxes in many cases, several analysts have pointed to the implicit or indirect taxes imposed on agriculture as important, negative impacts on agribusinesses:

> *The indirect tax on agriculture, through overvalued currencies and industrial protection, was nearly three times the direct tax on the sector [in 1982]…With reforms in the 1980s and 1990s to restore macroeconomic balance, improve resource allocation, and regain growth in many of the poorest countries, both direct and indirect taxes were reduced. The reform of overvalued currencies, which taxed agricultural exports (usually exported at the official rate of exchange) and subsidized food imports, is reflected in the huge reduction in the parallel market premiums for foreign currency in developing countries.*[4]

## LEGAL FRAMEWORK

Tax codes and regulations are fundamental in every country. They provide the information needed to assess the incidence and burden of explicit taxes on agribusinesses: property, production or marketed surplus, sales, or inputs. When analyzing the impact of taxes on agribusinesses, it is important to consider a broad range of taxes, fees, and contributions likely to impact firms operating in agricultural sectors, including:

- tariffs on agricultural products;
- water charges for irrigated production, processing, and manufacture;
- waste collection taxes;
- any environmental mitigation fees that might be levied; and
- vehicle and road taxes.

Information on import tariffs for specific categories of goods is also useful in assessing the extent of discrimination against agribusiness in favor of other kinds of industrial or sectoral growth. Customs regulations (valuation, reporting) are likely to be of some importance in computing the actual amount of taxes paid on either imports or exports.

Regarding implicit taxes, the rules governing management of exchange rates are likely to be found in financial sector and trade policies and in the administrative mandates of organizations (e.g., central banks, treasuries, or ministries of finance) that play some role in determining exchange rates. Taxes at local, regional, and national levels often amount to a burden that renders agricultural commodities uncompetitive in global and regional markets; implicit taxes are frequently missed in any analysis, yet they affect the competitiveness of products just the same.

Full accounting for subsidies to other sectors that might disadvantage agribusinesses is complex, although these sectors can play a role in establishing the terms of trade between agriculture and non-agriculture. Subsidies may take the form of reduced tariffs on imports, tax holidays, or other kinds of tax forgiveness. Such measures are likely to be embodied in specific "infant industry" rules and regulations, pricing for public goods and services, and the provision of preferential credit terms.

1 Simeon Djankov et al., "The Effect of Corporate Taxes on Investment and Entrepreneurship," *available at* http://www.doingbusiness.org/features/Research-Corporate-Taxes.aspx.
2 A World Bank brief, "The Plundering of Agriculture in LDCs" summarizes these. *See* www.worldbank.org/html/dec/Publications/Briefs/DB3.html.
3 If a private business is doing the importing, however, that firm will be subject to corporate taxes and is likely to pass some of that burden along to input buyers.
4 World Bank, *World Development Report 2008* (2007), at 98, *available at* http://siteresources.worldbank.org/INTWDR2008/Resources/WDR_00_book.pdf.

## IMPLEMENTING INSTITUTIONS

Ministries of finance, industry, customs, and trade, as well as central banks/treasuries, are likely to be responsible for setting policy, administering tax collection, and reporting. Many countries delegate authority for collecting certain taxes (e.g., property tax, school tax, road tax) to local administrative units. In some cases, the authority extends from levying to collection and use; in other cases, local administrations simply collect taxes on behalf of national revenue units. Corruption at the local level may be disguised as quasi-legal fees and imposts: ad hoc market fees, establishment of roadblocks, fines for contravention of various rules. Reportedly, these have significant impacts in some areas.

State trading enterprises (STEs) often fall under independent jurisdiction. Where exports are involved, the STEs may play an important role in the administration of marketing or export taxes.

## SUPPORTING INSTITUTIONS

Tax accountants and lawyers can provide advisory services to agribusinesses seeking to comply with tax legislation but facing a complex and perhaps contradictory set of rules. Brokers in the transport and warehousing sectors provide services that facilitate the verification and payment of export and import taxes and fees.

Most agribusiness cooperatives are tax exempt as non-profits, but the products they deal in may be subject to taxation. Further, cooperatives are not immune to the impacts of implicit taxes, local fees, and corruption. Many donors and a growing number of domestic non-governmental organizations support cooperatives in developing countries. Many are likely to be prepared to provide accounting, training, and/or advisory services if needed.

## SOCIAL DYNAMICS

Agribusiness and cooperative associations have been vocal regarding tax reforms in some countries. In the 1990s, organizations of private Kenyan horticultural exporters, for example, successfully negotiated the removal of an export cess on their products as they argued they were getting no service for the fee. It has been difficult, however, for governments to resist the temptation to impose new fees. In 2001, the government again proposed an export fee, this time to fund the parastatal Horticultural Crops Development Authority.[5] The private associations again objected.

Often, however, producers have simply responded to the disincentives posed by excessive taxation by changing production patterns or, where possible, by marketing products through alternative routes. Relatively high taxes on cocoa exports in Ghana in the 1980s, for example, led to cross-border smuggling and increased exports out of Cote d'Ivoire. Ghana learned its lesson and has, since 2000, adopted a more pro-business attitude.

The cumulative effects of taxation, however, are often not clear to the agribusinesses themselves. Governments intending to stimulate agribusiness should undertake studies of potential problems in the area of taxation. The government's short-term needs for revenue may compromise long-term investment and increasing productivity over time.

5 Mary Magdalene Opondo, "Trade Policy in the Cut Flower Industry in Kenya," n.d., *available at* http://www.gapresearch.org/governance/HORT1.pdf.

**About AgCLIR:**

AgCLIR is a unique agribusiness enabling environment diagnostic that provides a comprehensive method to diagnose the root causes and inefficiencies of an underperforming agricultural sector. AgCLIR is one of a series of sector specific diagnostics produced under the USAID BizCLIR project. BizCLIR, or the Business Climate Legal & Institutional Reform Project, is a multi-year initiative of the United States Agency for International Development (USAID) with the goal of improving the business enabling environments through sound analysis and strategic interventions. This series, Briefings on the Agribusiness Enabling Environment is intended to shed light on some of the most important, and least understood, components at the intersection of agribusiness and commercial law and institutional reform. All issues are available at www.bizclir.com.


Lawrence Paulson
EGAT/AG
202.712.0506
lpaulson@usaid.gov

Kenneth Baum
EGAT/AG
202.712.0532
kbaum@usaid.gov

Anastasia Liu
USAID/EGAT
202.712.5837
aliu@usaid.gov

Wade Channell
USAID/EGAT
202.712.1909
wchannell@usaid.gov

Russell Brott
Booz Allen Hamilton
703.377.7719
brott_russell@bah.com