THE BUSINESS ADVOCACY FUND
Supporting Private Public Dialogue

Impact assessment

AAK: The impact of tax on local manufacture of pesticides

Contents

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1. Background

The Agrochemicals' Association of Kenya (AgroAK)[1] is a Business Member Organisation (BMO) comprised of users of pesticides and manufacturers, importers, formulators, and distributors of pest control technologies for agricultural production in Kenya.

BAF has supported AgroAK on various advocacy issues since 2008 in relation to the Pest Control Products Act and its regulations.

The VAT Act, 2013 exempted[2] pest control products from VAT and introduced VAT at 16% on all imported ingredients used in processing and manufacting Pest Control Products (PCP). VAT is also incurred on inputs such as packaging materials and transport, none of which can be claimed back due to the exemption of the finished product. In addition to VAT, the carrier materials, solvents and emulsifiers attracted a 10% import duty and a 25% excise duty. This made locally manufactured pesticides more expensive than importing ready formulated and packaged products which are exempt from excise and import taxes.

Consequently, the import of finished products manufactured outside the country was more favourable than manufacturing in Kenya. Local manufacturers, who had been formulating pesticides for the East African Community (EAC) and Common Market for Eastern and Southern Africa (COMESA) markets, were scaling down their operations and investments in the local formulation of pesticides, some by as much as 88% (according to AgroAK). Investments in the supply chain also declined as demand for packaging materials and labels reduced. This led to a loss of revenue for the government and loss of jobs in agrochemical manufacturing.

AgroAK wanted to persuade the National Treasury instead to zero-rate pest control products for VAT (which would then allow manufacturers to recover the VAT on their inputs) and to reduce the import taxes on the imported ingredients and inputs to ensure the survival of the sector. AgroAK received a BAF grant of KES 1.3 million to undertake a study to gather evidence on the impact of this taxation framework on the agrochemical sector and to suggest solutions to the government. The target was to incorporate those policy proposals in the 2016 budget cycle.

2. Outcome

AgroAK engaged a tax consultant who undertook research and analysis on the impact of the taxation framework, in terms of profitability and sector growth

[1] Note that the Agrochemicals Association of Kenya abbreviates their name to AAK, but so does the Architects' Association of Kenya, so BAF abbreviates it to AgroAK.

[2] VAT exemption is different from zero rating in that, while the tax is not charged on outputs, tax paid on inputs cannot be refunded.

across the value chain, and its wider effect on agriculture and the economy. The research was also intended to describe global best practice in the taxation of pest control products and to use that to inform policy proposals. The key findings were:

- Exemption of PCPs in the VAT Act, 2013 increased the overall cost of production;
- Some products which cannot be categorised as pesticides, but are commonly used with pesticides to improve their application, were subjected to 10% import duty; and,
- Imported pouches and plastic films for packing pesticides, carrier materials, solvents and emulsifiers attracted both a 10% import duty and a 25% excise duty.

As the research was underway, the National Assembly advertised for input by the public on the proposed Finance Bill 2017. AgroAK submitted a policy proposal to request the government to re-consider zero rating of PCPs. Their submission explained:

- Reclassification of PCPs by the VAT Act, 2013 from zero-rated to tax-exempt increased costs substantially. They noted that packaging of PCPs contributed some 30 per cent of the production costs for both locally manufactured and imported products, but the high levels of import duty and excise duty on packaging materials raised the costs even further. The consequences of passing on these cost increases included:
    - A reduction in the use of PCP products by farmers and thus a reduction in crop production and reduced incomes for farmers;
    - A decline in the local manufacture of PCPs, and thus less tax revenue for the government;
    - Reduced investment in local manufacturing in favour of the import of PCPs which is tax-free; and
    - Reduced sales by the packaging industries who supply PCP manufacturers.
- PCPs and medicaments had previously been treated the same way by government but the 2016 Finance Bill, which followed the VAT Act, returned medicaments to zero-rating which discriminated against the PCP manufacturers.

AgroAK requested the government to zero-rate:

- All finished agricultural PCPs, therefore, enabling the manufacturers to claim VAT refunds; and
- All inputs and raw materials supplied to the manufacturers of PCPs upon recommendation by the Cabinet Secretary for Agriculture.

As a result of their submission, AgroAK were invited to make a presentation to the Finance and Budget Committee of the National Assembly who were meeting to review the proposed amendments to the Finance Bill. AgroAK had several discussions with the members of the Parliamentary Committee on Finance, Planning and Trade, and with the Head of Budgeting at the Directorate of Budget, Fiscal and Economic Affairs in the National Treasury. AgroAK successfully convinced the committee to amend the Bill to zero rate Agricultural PCPs and all the inputs. This was adopted and assented in the Finance Act 2017, Kenya Gazette Supplement No 95 (Acts No. 15) of 23 June 2017. The effective date of the zero rating of PCPs in the Act was 3 April 2017. This should have resulted in lower prices for locally manufactured pesticides.

3. Further ideas

Following this amendment, AgroAK organised two meetings in September 2017 at the MoALF chaired by the Cabinet Secretary, Agriculture attended by representatives of AgroAK and the Kenya Association of Manufacturers (KAM), and accounting staff representing various agrochemical manufacturers to discuss:

- Implementation of the zero rating of PCPs; and
- Matters relating to taxes, levies and fees that affect the entire industry.

As a result, they were able to map the current taxes as applicable to the agrochemical industry and develop a comprehensive matrix. AgroAK completed their research and analysis report in October 2017[3]. The report outlined some areas that could promote investment in the agrochemical industry. As well as the VAT zero rating, ideas included:

- Establishing Special Economic Zones (SEZ) which would offer reduced corporate income tax, exemption from withholding tax on dividends and exemption from stamp duty on legal instruments;
- Broader reduction in the corporate tax rate of 30 per cent which would encourage investment, entrepreneurship and production by increasing the net reward for productive effort;
- Application of tax incentives including tax holidays, investment allowances and tax credits, accelerated depreciation and investment subsidies to all investors;
- The removal of excise duty on telecommunication and financial services (mobile phone services and bank transfer charges) to reduce costs otherwise transferred to the farmer; and
- Discontinuation of the VAT withholding system to eliminate the inconvenience and additional cost of VAT collection by agrochemical businesses.

The report proposed increased agrochemical industry involvement in National and County Government in:

[3] Research and Analysis of the Impact of Taxation on Local Manufacturing of Pesticides: Prepared by Philip Odeny Galaxy Fiscal Solutions Ltd. 19 October 2017

- The budget process so that matters that may affect the industry are addressed before they are included in policy rather than taking the challenging route of fighting for reversal.
- The issues of rationalisation and harmonisation of taxes and levies in the National government.

These recommendations would ultimately enable the industry to become more competitive and assist Kenya to achieve the objectives of Vision 2030 via the 'Buy Kenya, Build Kenya Policy.'

4. Impact

4.1 Qualitative analysis

The most significant change from AgroAK's advocacy was the zero-rating of both inputs and finished products. Section 90 of the Finance Act, 2017 indicated that "inputs for the manufacture of pesticides upon recommendation by the Cabinet Secretary for the time being responsible for matters relating to agriculture" should be zero rated. However, an error by the draftsman resulted in inputs being classified as both zero-rated and exempt. This hampered the implementation process as some inputs were also used in other industries.

To address this, AgroAK engaged with the MoALF and the Pest Control Products Board (PCPB) to agree and distinguish which list of inputs used for local manufacture and packaging of pesticides required zero-rating. AgroAK gathered the list from its members and submitted it to the Cabinet Secretary (CS) under MoALF who then wrote a letter to the National Treasury. AgroAK followed up on the matter until early 2018 when Treasury agreed to the list of inputs to be zero-rated. They then submitted the list to the Kenya Revenue Authority who are in the process of implementing it. The manufacturers have had to factor in the VAT paid on inputs into their cost of supply and hope that they can backdate the tax refunds for their inputs.

Nevertheless, AgroAK is confident that key benefits from this change will include:

- Reduced cost of supply and by extension, reduced cost of locally manufactured PCPs;
- A consequent reduction in imported PCPs;
- Availability of PCPs to farmers at a lower cost should allow them to treat a higher acreage;
- Increase in agricultural production as a result of higher farm output by farmers, leading to increased national supply and greater food security;
- Promotion of local suppliers in the value chain;
- Increased employment both in pesticide manufacturing and packaging manufacturing;
- A higher level of tax revenue for the government as the industry creates more jobs and increases its profitability.

4.2 Quantitative analysis

The analysis below attempts to show the difference made to local manufacturers. The company imports pesticides in large quantities and repacks in average and affordable packs of 200ml to sell to small scale farmers. The company imports over 88 per cent of what it sells. The table shows the locally repacked volumes for Company A for three years.

Table 1: Repacked chemicals by Company A

	2013	2014	2015
Locally repacked agrochemicals, Litres	390,000	195,000	48,000
Percentage increase (decrease)		(50)	(75)

Source: AgroAK.

As can be seen, the change of VAT status led to a significant decline in sales from 2013. Their import volume of almost 400,000 litres in 2013 would have filled two million bottles. These sell at KES 100 each, giving total revenue of KES 200 million. Sales fell by 87 per cent over two years, leading to loss of revenue of KES 175 million and a consequent loss of corporation tax, which we estimate at KES 5 million assuming a 10 per cent profit on total revenue.

The Kenya National Bureau of Statistics reports that the total value of insecticides and fungicides rose by KES 500 million between 2013 and 2016. However, the total market is worth more than KES 11 billion[4]. Recapturing the sales lost because of the VAT increase and capturing a further 10 per cent of the market currently served by imports would increase the revenue of the sector by KES 1.5 billion and contribute as much as KES 45 million in tax revenue in a single year.

A detailed assessment of the actual increase in revenues, profits and taxes paid to government would be possible but would require the cooperation of the industry. Unfortunately, the majority of AgroAk's members are yet to receive their VAT refunds, and thus the detailed assessment would not be possible just yet.

5. Progress

5.1 Duty remission scheme

AgroAK and the Kenya Association of Manufacturers (KAM) have learned that in the budget statement read in June 2018, there is a proposed duty remission scheme for pesticide manufacturers that states that the Government would allow them to import raw materials and inputs under the EAC Duty Remission Scheme. This would have a further additional benefit to local manufacturers and possibly mean that they could capture a much larger proportion of the market. AgroAK is in the process of understanding the impact of this statement for its members, its benefits to the sector and the constraints that may be imposed.

5.2 Current advocacy

AgroAK continues to lobby for amendments to the Finance Act to ensure that the sector is not adversely affected by its implementation. They plan to advocate the

[4] Statistical Abstract 2017 (*Table 7.13*). Kenya National Bureau of Statistics. The Government Printer.

removal of the requirement for the Cabinet Secretary Agriculture to approve the list of products to be zero-rated.

A new challenge arose in April 2018. A new bill was introduced in Parliament to move all zero-rated items to exempt which would once again include pesticides. AgroAK prepared a further policy position and presented it to the Clerk of the National Assembly. They were invited in May 2018 to present to the Parliamentary Finance Committee and the Parliamentary Attorney General Committee. AgroAK has managed to obtain some background information concerning the reason why there is a current drive to push all zero-rated items back to exempt, which may be due to the Treasury deficit or the inability to keep up with the refunds.

To avoid the politics of government officials, they plan to tackle the issue via a new strategy. AgroAK is in the process of working out a partnership with KPMG and the Eastern Africa Policy Centre (EAPC), an economic think-tank that focuses on the impact of the fiscal environment on businesses. They plan to research and map out graphically and in measurable terms how the various variables (tax and non-tax, tariff and non-tariff) have an effect on agrochemicals businesses and more generally on manufacturing businesses, which would take AgroAK's findings to a higher practical level. One area would be to advise on the current agrochemicals tax position, the proposed changes in the 2018 budget and the draft Income Tax Bill (2018)[5], and prepare a policy position which can detail how the proposed exemptions undermine the big four agenda roles of the agrochemicals industry and the manufacturing sector in general.

6. Lessons learned

The key lessons learned by AgroAK are:

- It is essential to understand how to navigate through the political interests of the parliamentarians when engaging them. It may be strategic to negotiate available options to achieve and retain the policy change.
- Through research and analysis, AgroAK was able to present fair, clear and vivid arguments to the National Treasury which provided the policy win that they sought.
- AgroAK made good use of the media[6] and believe that it may have been a factor in their success.

[5] National Treasury Media Centre: Draft Income Tax Bill, 2018. Available at http://www.treasury.go.ke/media-centre/news-updates/478-the-draft-income-tax-bill-2020.html

[6] See for example, Lusenaka, Evelyn. (2017 Feb 11) Abolish Taxes on agro-chemicals, they are killing the industry. Daily Nation. Retrieved from www.mobile.nation.co.ke. Accessed 16 July 2018.