

Taxation for investment in the Uganda Agricultural Sector

Executive Summary

The Ugandan agricultural sector is grossly underfunded. The Ministry of Agriculture Animal Industry and Fisheries receives only 3 percent of the national budget despite the sector accounting for 70 percent of employment in the country. On the other hand, over the past 15 years, the agricultural sector has been a major beneficiary of tax exemptions. Recent attempts to change the tax exemption regime for sector were met with resistance. This brief examines the various ways through the agricultural sector has benefited from tax exemptions and identifies some of the beneficiaries of tax reforms. We shows that future attempts to realize taxes from agriculture should be balanced by increased support to the sector.

Introduction

The agricultural sector remains the main source of livelihoods for majority of Ugandans, despite the dismal growth registered by the sector in the recent past. According to the 2012/2013 Uganda National Household Survey, at least 72 percent of Ugandans are engaged in agriculture—with more females (77 percent) than males (67 percent) employed in the sector. Furthermore, about 43 percent of Uganda's working population is engaged in subsistence agricultural production.¹ On the other hand, during the past five years, the agricultural sector has underperformed both industry and services. In particular, the annual growth of the agricultural sector averaged 2 percent during 2000/1-2013/14 compared to an average of over 8 percent for both the services and industrial sectors.² Due to poor agricultural performance during the past 10 years, the relationship between the agricultural sector and public finances has been defined more through subsidies and tax exemptions, rather than direction taxation. Agricultural tax exemptions have targeted lending to agriculture, support for agro processing, and the increased use of agricultural inputs.

Tax exemption for the Agricultural Sector

In a bid to spur particular sectors of the economy as well as attract private investment in priority sectors, the GoU has, over time, offered tax exemptions. During the past 15 years, each budget speech appears to expand tax exemptions. Specific to agriculture, tax exemption has been offered through zero-rating of Value Added Tax (VAT) on various inputs and services. For instance in 2002/3, the GoU exempted the supply of cereals grown, milled or produced in Uganda as a means of supporting the establishment of milling capacity in the country.

In 2006/7, the Government of Uganda (GoU) exempted from tax interest earned by financial institutions on agricultural loans as a means of making credit more affordable for farmers. In the following year, it made losses and bad debts arising from agricultural lending tax deductible. In 2008/9, support was extended to agro processing with new investments in rural areas becoming income tax exempt. Subsequently, in 2009/10, the GoU introduced an Agricultural Credit Facility (ACF) of UGX 30 billion at a preferential interest rate of 12 percent per

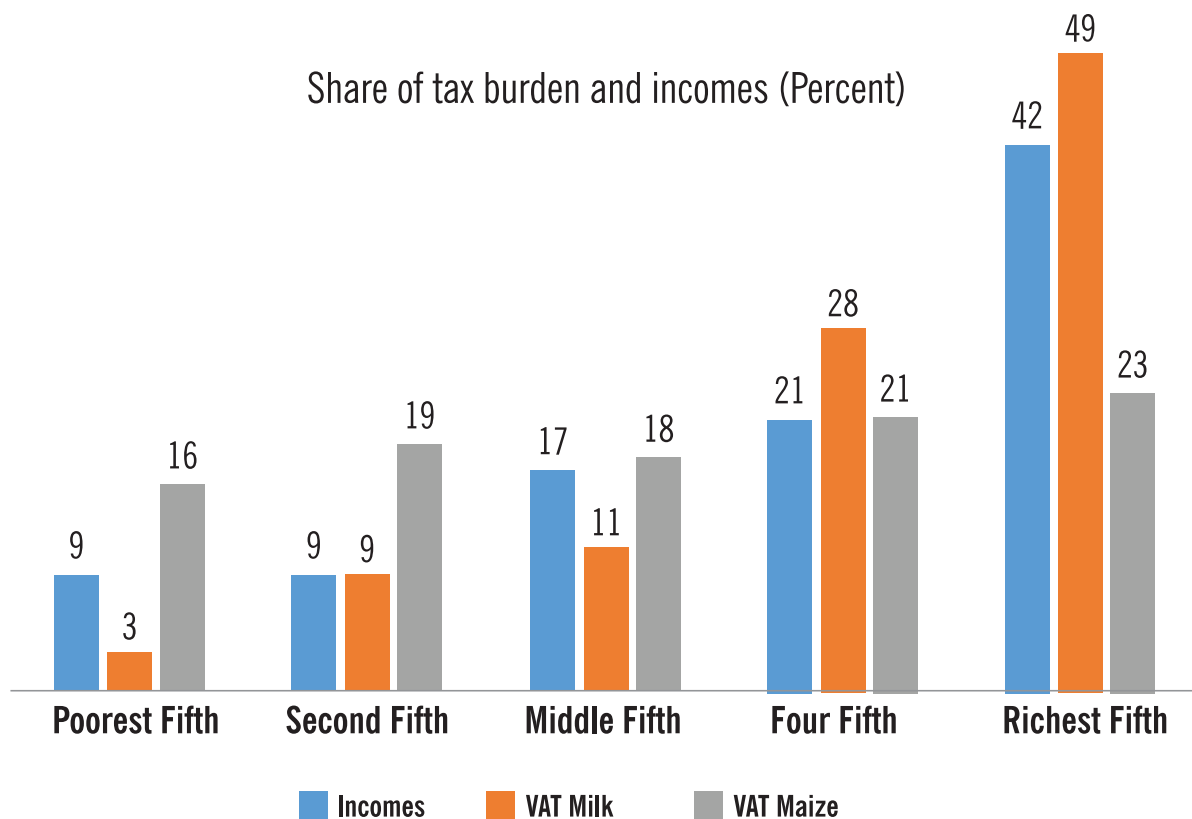
annum. Apart from the above measures, most agricultural inputs were zero-rated for VAT. In 2014/15, in a bid to raise tax revenues and also address tax avoidance, the government eliminated most of VAT exemptions on agricultural inputs and imposed new tax on some agricultural products. Specifically, tax exemptions on interest earned from agricultural loans were terminated and the measure was expected to generate UGX 25 billion. Furthermore, zero-rating on VAT on agricultural supplies was proposed for termination with the measure expected to generate UGX 30 billion.

Although tax exemptions were considered to be temporary measures - to kick start particular sectors and provide temporary relief to struggling sectors - attempts to reverse such exemptions have caused protests in the recent past. For instance, during 2014/15, the removal of VAT exemptions on agricultural inputs and machinery, announced during the 2014/15 budget speech, sparked uproar from Members of Parliament and civil society organizations (CSOs). The 2014/15 tax changes were geared towards increasing the tax revenue. However, the agricultural tax proposals were reversed within 3 months of the pronouncements.

Beneficiaries of tax policies

Taxation of agriculture affects different segments of the population in various ways. Previous research by EPRC indicated that the termination of VAT zero rating on processed milk would generate revenue in the range of UGX 19-22 billion annually and this tax would be progressive as shown in the Figure 1 below since relatively few households consume pasteurized milk.³ On the other hand, because maize is consumed by about one in every two households in Uganda, the removal of VAT exemption would generate about UGX 129-148 billion in additional tax revenues but the relatively poor households would bear the burden of tax compared to the case for milk. Indeed, Ssewanyana and Kasirye (2015) note that the removal of VAT exemption on maize flour would affect most households whose head is a female, those in rural areas as well as residents of the eastern and western regions. The food security of the above categories of individuals could be compromised, given that maize is a staple foodstuff.

Figure 1: Estimated impact of removal of VAT exemptions on milk and maize flour



Source: Ssewanyana and Kasirye (2015)

Challenges of tax exemptions for agriculture

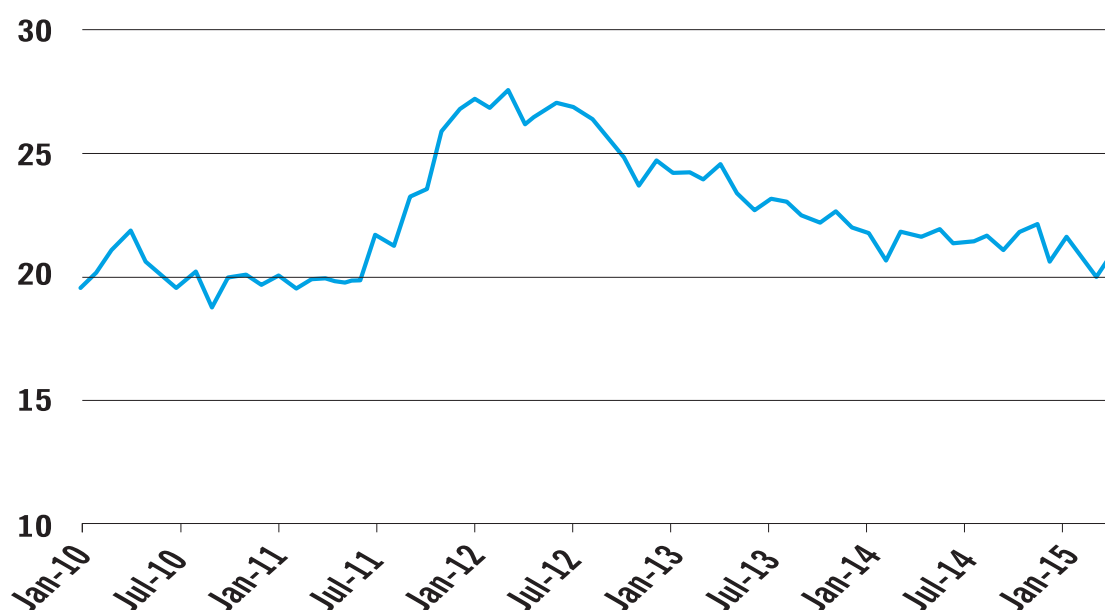
There is limited evidence to show that the support to the agricultural sector through tax exemptions have reached the intended beneficiaries. For instance, tax exemption on interest income from agricultural loans did not significantly increase agricultural lending. Specifically, although overall access to credit has increased in the country—from UGX 626 billion in 2001 to UGX 8,618 billion by 2013, the share of agricultural loans in total commercial bank lending only increased from 7.1 to 8.4 percent during this period.

Second, there is limited evidence to show that there were any preferential interest rates offered by lenders to agricultural borrowers, as result of tax exemptions. Instead, agricultural producers have been subjected to the same borrowing environment as other enterprises. The only exception was through the ACF by which government made available UGX 30 billion annually to participating financial institutions at zero interest, on the condition that they on-lend for medium to longer term agricultural investments at a fixed interest rate, initially set at 10 percent per annum, which was later raised to 12 percent. As shown in the Figure 2 below demonstrates that the commercial banking sector in Uganda has been characterized by interest rates nearly double that offered on loans financed through the ACF.

Third, although the overall objective of zero-rating of VAT on agricultural products was to provide a subsidy to the agricultural sector and also support the formalization of agricultural enterprises (through providing an incentive to claim VAT on final products). However, the zero-rating of VAT on seeds, fertilizers, and pesticides did not produce noticeable changes in the use of these specific inputs. For instance, the 2013/14 Uganda National Panel Survey (UNPS) report shows that use of both organic and inorganic fertilizer among households stagnated at 5% since 2009/10.⁵ Nonetheless, beyond credit there other constraints e.g. lack of extension services.

Fourth, due to challenges of tax administration, unscrupulous middlemen were able to exploit the agricultural tax exemptions to evade taxes. For instance, the VAT exemption on supply of animal feed and poultry encouraged some businesses engaged in other activities to mis-declare their products as feeds. Similarly, the VAT exemption on agricultural machinery was abused by importers, declaring other machinery as agricultural equipment. Overall, the zero-rating of VAT on agricultural products did not benefit farmers because the price paid for agricultural inputs did not significantly reduce despite the import subsidy. Furthermore, the constrained ability by farmers to claim VAT on final products (due to the highly informal nature of most agricultural enterprises) meant that the benefits of the tax exemption to majority farmers were minimal.

Figure 2: Trends in commercial bank lending rates 2010-2015



Source: Bank of Uganda (2015)⁴

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Finally, some of the incentives were captured by relatively well-to-do households. For instance, the zero-rating of VAT for supply of milk was a subsidy to the final consumers of milk products (typically middle to high income group) and not processors. There is hardly any justification for such a tax subsidy when products consumed by the poor e.g. soap and salt are not VAT exempt.

Conclusion

The direct budget allocation to the agricultural sector in Uganda is relatively low. During 2013/14 and 2015/16, Uganda allocated about 3 percent of the national budget to the sector and this is projected to remain the same during 2016/17 (Ministry of Finance Planning and Economic Development, 2015). As such, attempts to realize taxes from agriculture should be balanced by increased support to the sector. As earlier noted, the GoU made attempts to spur the formalization of agricultural enterprises (through tax

incentives for which agricultural enterprises could benefit through formal registration) as well as include agricultural firms into the tax bracket. For instance, some of the removals of VAT exemptions mentioned earlier were geared towards forcing agricultural enterprises to register for VAT.⁶ On the other hand, the removal of VAT exemption on maize milling was intended to bring economically viable agricultural enterprises into the tax bracket. Similarly, the removal of VAT on poultry feeds targeted discouraging informality among poultry producers. It is worth noting that proposals targeting the formalization of agricultural enterprises are not based on hard data. Overall, given the relatively very low public funding to the agricultural sector, any attempts to raise tax revenues from the sector should be matched by increased public spending to the sector. In particular, there is need to allocate more funding to the extension service as well as to the input supply chain, if substantial growth in the Ugandan agriculture sector is to be achieved.

Endnotes

- 1 Uganda Bureau of Statistics, (2014a) *Uganda National Household Survey 2012/13 Social Economic Report* Uganda Bureau of Statistics, Kampala, Uganda.
- 2 Ministry of Finance, Planning and Economic Development, (2014a) *Background to the Budget 2014/15 Fiscal Year: Maintaining the Momentum: Infrastructure Investment for Growth and Social Economic Transformation* (Kampala: Ministry of Finance, Planning and Economic Development).
- 3 Ssewanyana, S and I. Kasirye (2015) "Progressivity or Regressivity in Uganda's Tax System: Implications for the 2014/15 Tax Proposals" *Economic Policy Research Centre Research Series No 123*.
- 4 Bank of Uganda (2015) *Macroeconomics Indicator Table*, July 2015.
- 5 Uganda Bureau of Statistics, (2015) *Uganda National Panel Survey 2013/14 (Wave IV)* (Kampala: Uganda Bureau of Statistics).
- 6 Ministry of Finance, Planning and Economic Development, (2014b) *Press Briefing on Tax Revenue Measures FY 2014/15* (Kampala: Ministry of Finance, Planning and Economic Development).

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