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The U.S. Government's Global Hunger & Food Security Initiative

POLICY BRIEF
INCREASING CSA INVESTMENT THROUGH FISCAL INCENTIVES

The Catalytic Sustainable Agribusiness Investment (CSA-I) project aims to accelerate the deployment of capital in climate-smart agriculture enterprises and projects. One of the project's goals is to improve the enabling policy environment for CSA investment. Collaboration with stakeholders led to a barrier analysis that identified three key issues to serve as the basis for a series of policy briefs. This brief examines fiscal incentives to climate-smart agricultural investment, as well as current challenges and future opportunities to stimulate CSA investment.

I. Introduction

Fiscal incentives are a flexible policy tool that allow governments to shape the investment landscape for a given sector while also providing a source of potential revenue through taxes, levies, and other fees. If designed to do so, fiscal policies can respond to market distortions by internalizing incorrectly valued costs, benefits, and externalities, leading to more efficient outcomes. However, if poorly designed, fiscal incentives can themselves lead to market distortions: taxation can be mispriced and prove burdensome to small and medium enterprises, stifling growth, and high subsidies on inputs such as fertilizer could lead to over-application and potentially harm the environment. In addition to fiscal incentives for CSA, policymakers may also consider taxes on environmentally damaging activities to correct market distortions.[1]

In agriculture, fiscal incentives can be applied at different points of the value chain to achieve the targeted outcome. For example: fiscal incentives for secondary markets can encourage input use; disincentives towards producers may limit health or environmental impacts; polluters may be subject to penalties at the point of pollution; or targeting the output to manipulate prices for the end-consumer can change market behavior.[2] A variety of fiscal tools are available across the value chain. For example, two broad categories for tax incentives include "cost-based" and "profit-based." Cost-based incentives reduce initial capital and production costs and are generally effective tools for attracting investment (e.g. VAT and import duty exemptions).[3] By contrast, "profit-based" tax incentives seek to maximize the profits of investing in a sector. These can cause distortionary effects such as a focus on short-term profits, compromising their effectiveness in driving longer-term investments such as CSA (e.g. income tax exemptions).[4]

2. What is the Issue?

Many of Kenya's existing fiscal policies and incentives in the agriculture, environment, and forest sectors are inefficiently designed and/or insufficiently managed to drive climate-smart outcomes. Kenya has a range of taxation laws and a myriad of national and sub-national institutions, strategies, and policies across the agriculture, forestry, and environment sectors. This complex regulatory landscape is vulnerable to conflicting policy signals, making it difficult to decipher the direct or indirect impacts on a cross-sectional policy area like climate-smart agriculture.

Negative externalities may include harmful impacts on budgetary resources, equity issues, inefficient use of government resources, or even environmental degradation.[5] *The Green Sector Economy* analysis by the UNEP notes that Kenyan agriculture is subject to a myriad of taxes that distort market prices, compromise global competitiveness, and depress foreign investment.[6] Despite the Kenyan government's promotion of a green economy and green growth, fiscal incentives neither effectively include nor target climate-smart agriculture.

Climate-smart agriculture's cross-cutting nature complicates the design and implementation of comprehensive fiscal policies. In order to be effective in achieving the suite of climate-smart agriculture goals, a selection of interrelated incentives or a single CSA incentive with a selection of potentially complex qualifying criteria would have to be designed (i.e. taking into consideration productivity, mitigation, adaptation, and gender aspects). Such an approach is unlikely considering that existing fiscal incentives generally have simple qualifying criteria for a particular activity. One example of an existing incentive is the 33% deduction on capital expenditures for "farm works" for up to three years, applying to "immovable buildings" such as farmhouses and workers' quarters.[7] Another example in the forestry sector is an incentive that allows the owner of a private or community forest to apply for exemption from all relevant land rates and other levies.

The current institutional framework for deploying fiscal incentives does not effectively accommodate CSA investment. First, fiscal incentives for importing goods are concentrated in the renewable energy sector, including exemptions/reductions from the VAT, customs, and/or import duties for variety of renewable energy equipment, materials, and technology.[8] These are not directly encouraging CSA investment. Second, eligibility to receive a range of fiscal incentives is mostly tied to Export Processing Zones (EPZs) and Special Economic Zones (SEZs) that are attractive to businesses but may not serve to incentivize and mainstream CSA throughout the country due to their narrow reach. Two entry points for considering fiscal incentives for climate-smart agriculture in a more comprehensive fashion include: (a) the *Green Economy Strategy and Implementation Plan, 2016-2030*, which does not mention climate-smart agriculture but promotes the need to achieve 10% tree cover nationally as a component of agriculture,[9] and (b) the *Strategic Investment Framework for Sustainable Land Management 2017-2027*, (KSIF-SLM) that does not mention climate-smart agriculture per se but stresses the incorporation of climate change into planning.

3. Potential Solutions

Defining and harmonizing existing fiscal policies to account for CSA

- Establishing a common definition on the vital components of CSA is a first step towards harmonizing policies across the agriculture, environment, energy, and forest sectors. For example, the collection of wood products as biomass for energy is identified as one of the major drivers of deforestation in Kenya.[10] *The 2006 Energy Act* created the *Rural Electrification Program (REP)* and promotes renewable electricity generation for rural communities, yet it and further provisions in the *2015 Energy Act* include fuel-wood within the definition of renewable energy technologies.[11] [12] More clearly defining CSA principles and objectives could provide a framework to begin harmonizing policies.

- An additional example is in the *2009 Agriculture (Farm Forestry) Rules* that stipulate any landowner of agricultural land must maintain 10% forest cover or be subject to a fine or imprisonment.[13] If the definition of "farm works" in the existing agricultural incentive for farm works deductions were expanded to include natural capital and tree cover, a market incentive to invest in the trees could be created, hastening expanded forest coverage and compliance with the forestry laws.

Reforming perverse incentives that contribute to deforestation, degradation, or other non-CSA outcomes

- An exhaustive review should take place to identify and remove or reform the fiscal incentives that actively deter investment or contribute to non-climate-smart outcomes. Indirect taxes, where the burden of the tax is often passed to an end-user or consumer through increased prices, may be more likely to cause the perverse incentives that lead smallholders to employ unsustainable agricultural practices. 14 VAT taxes on CSA-related technologies increase the price of using the technology, limiting their uptake. This serves as a disincentive for farmers and businesses to invest in CSA infrastructure. Examples of possible exemptions to VAT, customs, and other duties could include: improved water systems for irrigation, drainage, and/or storage; climate-smart livestock management systems; various types of adaptation infrastructure for droughts/floods; trees or other agroforestry systems; and weather-monitoring infrastructure. Refining land definitions may allow for intercropping/agroforestry systems to qualify for forest incentives.

- Another indirect subsidy that leads to non-CSA outcomes is the failure to enforce existing laws or fines.[15] In a 2013 analysis on the drivers of deforestation and land degradation, the Kenya Forest Service identified poor governance, "unwritten policies," and political interference as primary indirect causes.[16] Examples include a lack of enforcement in fines or countering illegal encroachment, or shifting the political status of formerly protected lands. Strengthening the enforcement capacities of relevant authorities can correct these failures and ensure regulations encoded within the Forestry Law, the Agriculture and Food Authority Law, Agriculture Farm Forestry Rules, and other related land and environment laws are adhered to.

Designing and implementing clear policies and policy linkages at the national level

- The Kenyan government has been taking a more unified perspective on CSA, especially through the "Kenyan Climate-Smart Agriculture Strategy 2017-2026" (KCSAS). The KCSAS is an overarching national strategy document that devolves responsibility for designing actionable policy to the subnational level. It acknowledges the role of National Treasury to develop taxes and subsidies to align with the strategy's goals, but offers little guidance on how to do so moving forward.[17] Several policy approaches to deploy fiscal resources are explored below based on relevant case studies.

Box 1: ***Fiscal Mechanisms to Finance CSA Policies***

A centralized CSA-funding source could further signal policy linkages between uncoordinated laws. While the KSCSA calls for CSA activities to be primarily funded by national and county resources and development partner finance, it also calls for the establishment of a CSA fund basket and for earmarking CSA provisions in the climate change fund in the Climate Change Act of 2016.[1] The upcoming publication of an "Agricultural Policy Investment Framework" could further serve as an entry point to adopt fiscal policies.

The *Climate Change Act* allows for different sources of finance to be payable to the fund, leaving an entry point for redirecting existing revenues from fines or levies into a centralized fund for reinvestment to strengthen environmental outcomes. The target of these funds could vary, with the potential to be channeled back to country governments, relevant environmental management authorities, or even offered directly as grants or subsidized loans to businesses or farmers for pursuing CSA activities. The National Treasury is responsible for managing the Climate Funds as well as designing future fiscal incentives and should consider working with local authorities to design fees or taxes to prevent non-CSA outcomes from occurring while also creating a revenue source to support CSA activities.

Case Study: China's Eco-Compensation

"Eco-compensation" refers to a broad set of policies aimed to realign economic and market activities reorienting economic activity to compensate for environmental services and to charge or penalize environmental pollution.[18] This includes fiscal policies such as payments for ecosystem services, subsidies, pollution charges, deforestation fees, preferential VAT fees, and green credits and differentiated taxation including exemptions and rebates.[19] Policies, while centralized, seek to be adaptable to local innovation with some "hybrid" policies providing additional funding sources for local authorities.[20] [21] One CSA-related penalty under the *Eco-Compensation* framework is the *Forest Restoration Fee* charged to developers that impact forests, with local forest management authorities responsible to reinvest the revenue to renovate and rehabilitate existing forests and "offset" the damage.[22]

Case Study: Brazil

Since the 1990s, Brazilian states have followed a reformed revenue-sharing mechanism from a national tax, similar to a VAT, that includes land use indicators.[23] Protected land area, conservation measures, land-use restrictions, and other biodiversity or ecosystem services are utilized in the revenue-sharing agreement, and states have flexibility on which indicators are used. One state, Parana, allocated 5% of its allocation to biodiversity conservation areas and watershed protection areas, generating roughly $70 million in revenue in 2009 from the federal government.[24]

Box 2: ***Ecological Fiscal Transfers – Brazil and India***

Reforming the existing intergovernmental fiscal transfer allocation formula to include CSA-related indicators could funnel fiscal resources to county government budgets, creating an "*Ecological Fiscal Transfer*" (ETF)." This reform aligns with a decentralized government structure by incentivizing sub-national entities to design and implement CSA-friendly policies while also penalizing non-CSA outcomes (i.e., it is "two-sided). The policy could send strong signals to investors and county governments on national priorities with minimal intervention required by the national government.

Case Study: India

Kenya's 2017 Allocation Formula	
Population	45%
Basic Equal Share	25%
Poverty Index	20%
Land Area	8%
Fiscal Responsibility	2%

In 2014, India's 14th Finance Commission utilized the fiscal transfer mechanism as a tool to reach national forest cover goals. The commission first increased the amount of revenue allocated to the states by 10% before recalculating the formula to include a 7.5% weight towards "forest cover." The Indian government estimated it will distribute up to $12 billion to states per year in 2015-2019, implicitly assigning a value of $174-$303 per hectare of forest.[25]

Application to Kenya: These or similar policies would align with the *KCSAS*' strategy to devolve implementation responsibility to the county governments, and could incentivize counties to design a policy/budget framework that mobilizes public and private resources into CSA. These changes, especially the Indian revenue-sharing model, could assist county governments in increasing their CSA budgets to at least 10% of their total spending as recommended in the *KCSAS*. It would also contribute to the national objective of reaching 10% national tree cover, as codified in Kenya's constitution.[26] Altering

Box 3: ***Agricultural Growth Poles – Ongoing Evidence throughout Africa***

Agriculture growth poles, or "agripoles," deploy public and private sector investment to promote agricultural transformation. Investments are targeted to specific geographic areas, including finance for related infrastructure such as transport, power, communication, etc. SEZs and EPZs may be regarded as one type of agropole, but others such as agrocorridors and agro-based clusters tend to be larger, focus on rural areas, and utilize integrated planning to improve the absorptive capacity of investments, such as through network linkages or agglomeration. Agropoles can also assist in securing finance for infrastructure that would otherwise be unavailable, and for attracting foreign investments seeking to capitalize on the pooled resources within agropoles.

Kenya's allocation formula requires a vote by Parliament on the recommendation of the Commission on Revenue Allocation (CRA) and the National Treasury. Operational challenges may include[27]:

- developing indicators that do not unfairly punish different climatic region, such as the Arid and Semi-Arid lands;
- ensuring applicability to biodiversity goals
- ensuring that increased budget resources actually go towards CSA
- strengthening monitoring and enforcement
- preventing negative social impact of resource allocation.

Case Studies: Several African Examples

Agropoles have been broadly supported by African governments and multilateral organizations with an aim to support agriculture as an engine of overall growth. There have been over 30 agricultural growth poles in Africa over the last 15 years at varying stages of implementation and rates of success.[28] Aggregation strategies, such as those in Morocco, group farmers around private actors to catalyze positive spillovers and economies of scale through enhanced productive capacity and access to effective technology.[29] Others, such as Cameroon's agropoles, focus on leveraging private sector investment into many smaller projects, with mixed results due to a focus on production over enabling environment investments.[30]

The agropole and agro-based cluster strategy complements decentralization, offering a focused tool to enhance national and sub-national collaboration on design and implementation.[31] While agropoles could build on Kenya's experiences from SPZs and EPZs, they can be used to raise standards to international best practices and avoid the common criticism that SPZs and EPZs tend to lower standards or exacerbate poor enforcement.[32] Tax policies are recognized as an important component of agropoles, but it is noted that going beyond incentives that already exist within tax codes heightens the perceived risk of corruption and the government's ability to secure adequate revenue.[33]Agropoles could offer a platform for joint fiscal policy development at the national and county levels. However, the likelihood of success grows if fiscal policies for CSA are first harmonized and enforced and any perverse incentives are removed.

DISCLAIMER

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