



POLICY BRIEF

**REFORMING PERSONAL INCOME TAX
EXEMPTION IN AGRICULTURE AS A MEASURE
TO SUPPORT A SHIFT TOWARDS SUSTAINABLE
AGRICULTURE IN THE KYRGYZ REPUBLIC**

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Reforming personal income tax exemption in agriculture as a measure to support a shift towards sustainable agriculture in the Kyrgyz Republic

Personal income tax exemption from sales of agriculture produce

This is one of the priority subsidies for reform. It re-enforces current agriculture practices that are often harmful to the environment and people and has indirect impacts across all environmental domains. The purpose of the subsidy is to support agriculture producers, but because it is not targeted, it benefits wealthy farmers more than those who are poor.

The reform could create an estimated net 3.9 billion som revenues annually. Despite stakeholder concerns, the cost of tax administration is not excessive and is not a factor that would prohibit reform feasibility.

It should not be seen as a measure to increase public revenues but as a measure to support transition to more sustainable agriculture. In particular, it could support programmes that would reduce food loss and waste, and measures to support organic farming. This aspect of re-directing revenues is essential because there is a strong opinion among all stakeholder groups that the government support to the sector should not be reduced.

A phased removal of the current tax exemption on personal income tax from selling agricultural produce, supplemented with necessary compensatory measures, is most likely to be politically, socially and administratively feasible.

Agriculture plays an important part in the lives of the people of the Kyrgyz Republic and its economy. It is a source of livelihood for most of the country's population and is key to ensuring food security. According to official statistics it contributes 12% of gross domestic product and provides 18% of jobs for the economically active population.¹ Recognising the importance of the sector, the government of the Kyrgyz Republic has adopted fiscal policies to strengthen it. The government also recognises the need to reform its current support to the sector and to develop incentives for the transition to an inclusive green economy.²

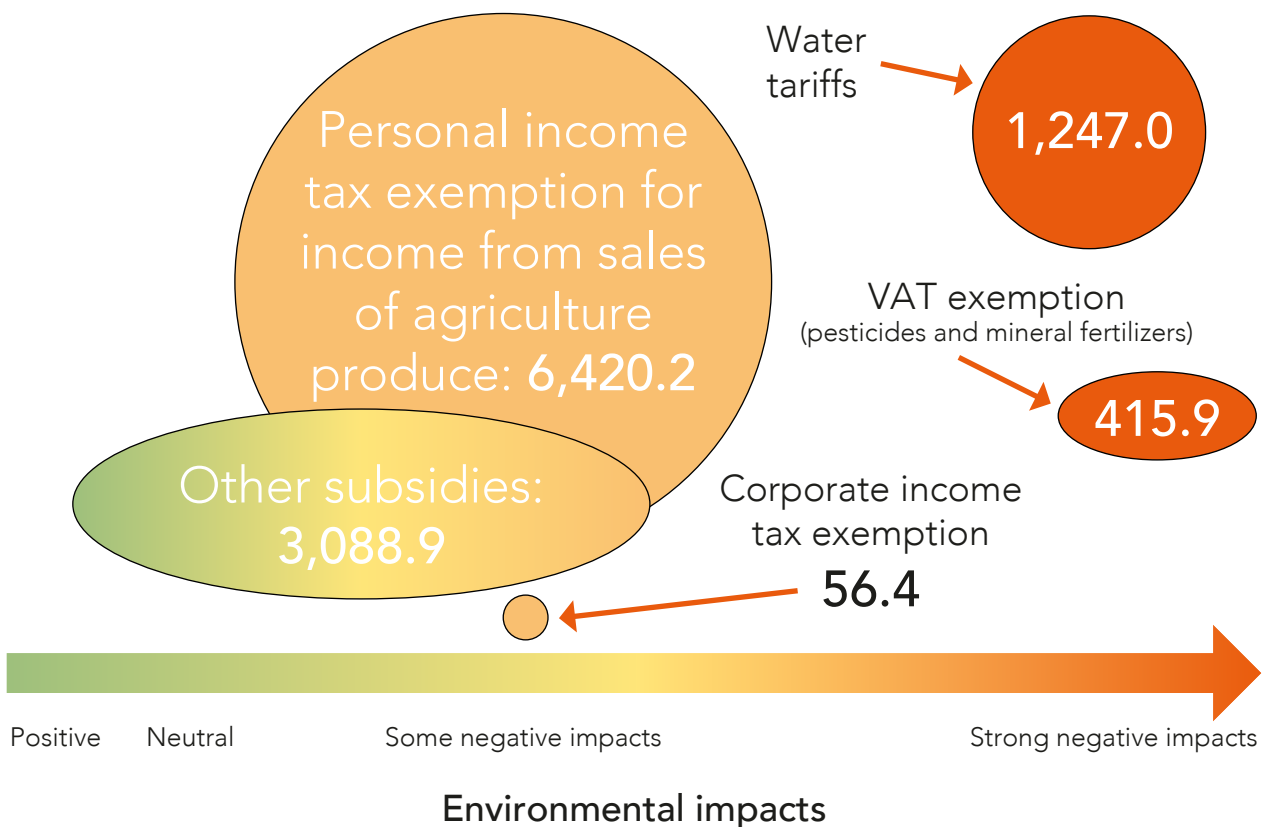
The agriculture sector is largely exempt from taxes and faces a tax burden of just 1.2%.³ Support in terms of funds allocated from the state budget and in the form of different tax exemptions constituted an estimated 11.2 billion som in 2019.⁴

Personal income tax exemption constitutes more than half of the state support to agriculture: in 2019 this was estimated to be 6.4 billion som.⁵ The purpose of the subsidy is to support agriculture producers but because it is not targeted, it benefits wealthy farmers more than poor farmers. The subsidy re-enforces the current agriculture practices that are often harmful to environment and people, and has indirect impacts across all environmental domains. These negative effects are higher due to gaps in the legal framework and limited enforcement of existing legislation; the negative effects in animal husbandry are likely to be higher than in other subsectors because of overgrazing. This subsidy places an (unfair) tax burden on people earning income from means other than sales of agricultural produce. It also leads to higher differences in revenues between rural and urban local governments. (The government has been testing the possibility of increasing revenues of local governments by decentralising the revenues of personal income tax to this level.)

Other subsidies that should be seen as priority for reform are subsidised water tariffs (reform options are currently being analysed with support from the World Bank) and VAT exemption for pesticides and mineral fertilizers (reform options are currently

being analysed with BIOFIN). In the medium term, as the agriculture sector becomes more formalised, corporate income tax exemption should also be prioritised. See Figure 1.

Figure 1: Comparative significance of priority subsidies (expenditures or lost revenues, million som/y for 2019)



How could personal income tax exemption be reformed?

The options for reforming the personal income tax exemption focus on environmental effectiveness (to what extent the proposed reform may influence the currently unsustainable agriculture practices), political and social feasibility and socio-economic impacts. On this basis we can use the following for building the reform options:

- Subsector focus - removing the income tax exemption for the whole agriculture sector, or some subsectors, or some farm categories.
- Mechanism for taxation - tax on actual income or simplified schemes (eg. presumed income based on land area and livestock).
- The need for any compensatory measures.

Using these building blocks, the following three reform scenarios can be formulated and supplemented by two revenue use options.

Reform scenarios

Reform scenario 1: The tax exemption is removed in all subsectors and without any compensatory measures. This scenario could be combined with simplified tax regimes to ease the tax administration (eg based on hectares of land owned and/or number of animals owned).

Reform scenario 2: The tax exemption is maintained for poor farmers. For this scenario, two options have been developed: Option A: the tax exemption is removed only for wealthier livestock owners (depending on the number of livestock owned). Option B: the tax exemption is removed only for wealthy farmers in all sectors. This scenario could be combined with simplified tax regimes to facilitate tax administration.

Reform scenario 3: The reform scenario 2 is complemented with measures to compensate food price increases for the lowest income groups. This scenario can be combined with simplified tax regimes to facilitate tax administration.

Revenue use option 1: Measures to reduce food loss and waste.

Revenue use option 2: Measures to support organic farming.

Analysis of reform scenarios

Despite the costs of tax administration, all three reform scenarios can generate additional revenues for the state budget that could then be redirected to increase government support for more sustainable agriculture. The estimated net revenues are summarised in Table 1 below.

Table 1 Net revenues of the reform scenarios analysed*

Net revenues (million som/y):	Minimum	Maximum
Reform scenario 1	3,314	6,752
Reform scenario 2		
Option A	1,118	2,929
Option B	2,332	6,202
Reform scenario 3		
Option A	1,021	2,695
Option B	2,132	5,705

* Not including one-time costs estimated to be between 1 and 6 million som.

Source: Исследование по реформам фискальной политики для устойчивого сельского хозяйства, UN-PAGE – IIED, 2021



The high ranges in these estimates are due to uncertainties about the actual tax base (number of farmers who will be paying the personal income tax under each of the three reform scenarios and their income).

All three reform scenarios, and especially reform scenarios 2 and 3, offer possibilities to ensure a fairer system where wealthier farmers would contribute to tax revenues, creating funds that could be used for development interventions. Stakeholders consulted favour sub-option A of Scenarios 2 and 3 because they feel that the current income tax exemption is particularly unfair in the way it favours individuals who own high numbers of livestock.

Because of fairness concerns, if a simplified income tax regime were to be applied, it should be designed in such a way that farmers would pay tax proportional to their income. This means that a simplified tax regime should be based on presumed income (based on, for example, number of cattle owned or hectares of land owned).

The proposed changes are likely to lead to some relatively low increases in food prices (not more than 3%). The poorer part of the population should be compensated for this increase. The additional expenditure for this compensation is small compared to the potential tax revenues and is not a cause for delaying the reform.

Another group to be affected is the farmers. In order to reduce potential negative effects on poorer farmers, reform scenarios 2 and 3 assume that they will continue to enjoy the tax exemption. This does not reduce the revenues significantly. To gain support for the reform, the revenue use options should focus not only on agriculture sustainability, but also on providing clear and tangible benefits to the farmers.

All three reform scenarios offer possibilities to improve environmental outcomes, but only under certain conditions. First, if applying a simplified tax regime, the tax should be linked with pressures on the environment. For example, the tax on income from sales of animal husbandry produce can be calculated based on the number of livestock owned by the person. This would create a disincentive to

increase the number of cattle (Option A of the reform scenarios 2 and 3). Secondly, the reform must be combined with measures to strengthen the existing regulatory framework governing environmental and occupational health and safety requirements in agriculture, as well as its enforcement, training and education (in particular for farmers). Thirdly, the revenues from reform must be used to support the implementation of more sustainable agricultural practices. The Ministry of Economics and Finance, the Ministry of Agriculture, Water Management and Regional Development are the main institutions responsible for making sure these conditions are met.

Policy options and recommendations

According to our assessment a **phased removal of the current tax exemption on personal income tax from selling agricultural produce** supplemented with necessary compensatory measures (reform scenario 3) is most likely to be politically, socially and administratively feasible.

During the first phase, the personal income tax exemption could be removed for more wealthy cattle-owners based on presumed income (Option A). Specific guidance would have to be developed on how to determine which cattle owners should be subject to the tax (for example on basis of the number of cattle owned). It would also require preparation of a specific methodology for calculating the presumed income on basis of the number of cattle owned, as well as building the capacity of the Tax Authority.

The first phase could be followed by evaluation of results. Based on this evaluation the second phase could be developed to cover other subsectors - either on the basis of presumed or actual income (Option B).

This could potentially create 1.8 billion som annual net revenues (taking into account the cost of tax administration) in the first phase, which could be increased to an estimated 3.9 billion annual revenues in the second phase.

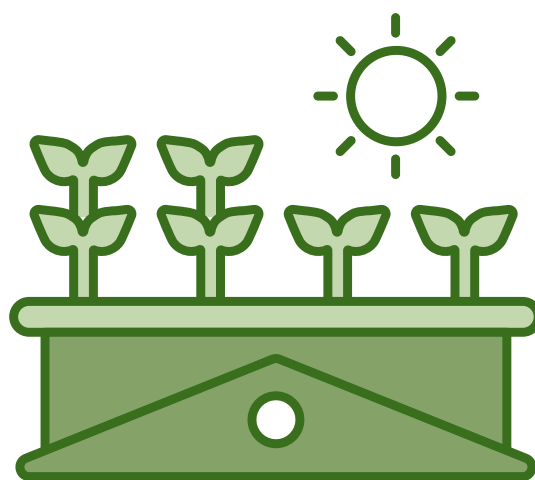
The reform of the tax exemption on personal income from sales of agricultural produce should not be seen as a measure to increase public revenues but rather as a measure to stimulate more sustainable agriculture. This aspect of re-directing revenues is essential because there is a strong opinion among all stakeholder groups that the government support to the sector should not be reduced.

The government could use these revenues to support measures that focus on reduction of food loss and waste. Such measures could include: access to improved harvesting techniques and storage technologies, including access by farmers to modern storage facilities; access to infrastructure and markets by farmers, including access to processing companies; improved supply chain management; partnerships to donate unsold food from open markets. Such measures are likely to increase the productivity of the sector even more, increase the incomes of farmers and create jobs in food processing (and hence also increase revenues to the state budget). It would also make a positive contribution towards food security in the Kyrgyz Republic. In addition, the revenues could be used for targeted interventions to support organic farming, including support to biodiverse local seed systems and participatory plant breeding.

In order to ensure successful implementation of the recommended reform, the Ministry of Economics and the Ministry of Agriculture, Water Management and Regional Development should ensure implementation of a number of complementary activities:

- **Additional studies** in order to define appropriate methodologies for determining who should become subject to the personal income tax from sales of agriculture produce, and determining the presumed income; and additional studies to analyse food waste and losses along different stages of the value chain in order to prioritise necessary interventions;
- Addressing gaps in **legislation and enforcement**;
- Early and clear **communication** regarding the objectives of the reform.
- **Capacity building and training** of the Tax Authority and farmers.

The combined result of these interventions will be a substantial increase in the share of green subsidies for agriculture in the Kyrgyz Republic.



Endnotes

1. Calculated using open data on GDP and employment from www.stat.kg
2. Постановление No 605 Правительства Кыргызской республики (14.11.2019), об утверждении Программы развития зеленой экономики в кыргызской республике на 2019-2023 годы
3. “Анализ налоговой нагрузки по отраслям экономики”, Ministry of Economics, unpublished.
4. Отчет о результатах первого этапа работы по контракту РМ20228 от 28 сентября 2020 года «Оказание консультативной поддержки для реализации финансового решения БИОФИН по «Реформе вредной для биоразнообразия сельскохозяйственной субсидии для продвижения и внедрения зеленого/органического сельского хозяйства», 2021, page 14
5. Ibid. See footnote 4, page 40