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Original Research Article

Agricultural Taxation in Kenya: Exemptions, Incentives, and Comparative Policy Perspectives

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Abstract: Agriculture plays a central role in Kenya's economy, employment, and food security; yet its contribution to tax revenue remains relatively low. This study examines agricultural taxation in Kenya, focusing on tax design, incentives, exemptions, and recent policy reforms, and situates Kenya's experience within a broader international context. Using a qualitative policy analysis and comparative institutional approach, the study reviews finance laws, tax legislation, VAT regulations, and policy documents from the 1990s to 2025. The analysis reveals that Kenya has heavily relied on VAT exemptions and the reclassification of agricultural inputs to protect farmers and maintain food prices. However, the shift from zero rating to exemption has increased embedded tax costs along agricultural value chains, raising production costs without improving revenue performance. The findings further indicate that tax incentives and compliance tools are not neutral, as they tend to favor larger and more formal agribusiness firms while increasing cost pressure on small-scale farmers. Administrative reforms such as withholding tax proposals and digital tax systems have improved visibility but also risk encouraging informality when compliance costs rise without clear benefits. Comparative evidence from the European Union, the United States, China, Brazil, Uganda, and Tajikistan confirms that effective agricultural taxation depends more on tax design, predictability, and institutional capacity than on higher tax rates. The study concludes that Kenya's current approach creates a structural conflict between revenue mobilization and agricultural sustainability. Policy reforms should shift toward more transparent, predictable, and targeted tax instruments that support productivity, safeguard food security, and enhance long-term revenue stability.

Keywords: Agricultural Taxation, Value Added Tax, Tax Incentives, Tax Compliance, Food Security, Comparative Policy, Kenya.

1.0 INTRODUCTION

Agriculture remains the backbone of Kenya's economy and the primary source of livelihood for rural populations. The sector contributes approximately 21.8 percent directly to national Gross Domestic Product and an additional 27 percent indirectly through linkages with manufacturing, trade, transport, and services (Ministry of Agriculture and Livestock Development [MoALD], 2025). More than 40 percent of the population relies on agriculture for employment, while over 70 percent of rural households derive their primary source of income from farming, livestock, and fisheries (MoALD, 2025). These figures confirm that agriculture in Kenya is not only an economic sector but also a foundation for social stability and food security. Similar patterns are observed across many developing and emerging economies, where agriculture supports large populations yet contributes modestly to tax revenue.

Despite its central role, agriculture generates relatively low tax revenue in Kenya. Earlier analyses have demonstrated that the sector has historically been subject to weak direct taxation, with government intervention primarily occurring through price policies, exemptions, and incentives rather than explicit income-based taxes (Ronge *et al*., 2005). This structure has produced a persistent gap between agriculture's contribution to output and its contribution to public revenue. Recent empirical studies confirm that this mismatch remains unresolved, even as agriculture continues to support employment and economic growth (Jordan *et al*., 2023; Kihoria *et al*., 2025). Comparable challenges are reported in countries such as Uganda and

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parts of the European Union, where political considerations, administrative limitations, and sectoral structure constrain effective agricultural taxation (Stewart-Wilson & Waiswa, 2021; Jęczmyk & Ryś-Jurek, 2025).

Kenya has traditionally protected agriculture through tax relief measures, including value-added tax exemptions on inputs, duty waivers on machinery, and income tax incentives for agribusiness investment. These policies aim to reduce production costs and maintain food affordability (Nyamori, 2018). However, broad exemptions narrow the tax base and complicate VAT administration. Evidence from international experience suggests that extensive protection of agriculture often weakens revenue collection and creates hidden costs within value chains, rather than delivering well-targeted support (OECD, 2020). Similar policy trade-offs are observed in emerging economies such as Brazil and China, where governments seek to balance fiscal neutrality with food security and competitiveness objectives (OECD, 2025a; OECD, 2025b).

These dynamics reveal a structural conflict between fiscal objectives and agricultural sustainability. Kenya currently faces increasing fiscal pressure and has introduced reforms aimed at broadening the tax base and strengthening compliance. Changes enacted under the Tax Laws Amendment Act, 2024, have altered VAT treatment, enforcement mechanisms, and compliance requirements affecting agricultural value chains (Ernst & Young Global Limited, 2025). Legal and policy reviews indicate that these reforms reshape how tax burdens are formed and transmitted across producers, processors, and consumers (Cliffe Dekker Hofmeyr, 2024). Similar pressures motivated major consumption tax reforms in countries such as Brazil, where governments sought to protect agricultural competitiveness while improving revenue performance (Rezende & Calçada, 2025).

At the same time, Kenya's agricultural sector remains dominated by small-scale producers operating under conditions of limited access to finance, weak record-keeping, and high informality. In this context, increased reliance on indirect taxation and compliance tools risks raising production costs and encouraging informal market participation rather than improving revenue efficiency (Kimutai, 2019; Omune *et al*., 2024). The tension between revenue mobilization and food security, therefore, becomes more pronounced, as tax reforms designed without complementary support mechanisms may undermine production incentives and affordability.

This study addresses these challenges by examining the structure and effects of agricultural taxation in Kenya, with particular focus on VAT design, tax incentives, and compliance mechanisms. By situating Kenya's experience within a comparative institutional framework, the study draws lessons from international practices to inform a more balanced, predictable, and development-oriented agricultural tax system that supports both fiscal sustainability and food security.

2.0. METHODOLOGY

This study adapts a qualitative policy analysis, combined with a comparative institutional approach, to examine the evolution of agricultural taxation in Kenya over time, the application of tax instruments, and their impact on the agricultural sector. Laws, tax design choices, and administrative practices mainly shape agricultural taxation. Due to this, a document-based qualitative approach is suitable for understanding how tax policies operate in practice and their impact on costs, incentives, and compliance across agricultural value chains.

The study relies only on secondary data. The sources include Kenya's finance laws, tax legislation, VAT regulations, and official policy documents from the National Treasury and the Ministry of Agriculture, Livestock Development, and Fisheries. These sources are supported by reports and policy studies from reputable institutions, including the OECD, IFPRI, the World Bank, KIPPRA, and EY, as well as relevant academic literature. The period reviewed spans the early 1990s, when VAT was introduced, through to 2025, encompassing major reforms and structural changes in agricultural taxation.

The analysis is divided into three main areas. The first focuses on tax design and the formation of the tax burden, with attention to VAT exemptions, zero-rating, and classification changes affecting agricultural inputs and outputs, and how these create both direct and hidden costs along the value chain. The second examines distributional effects by comparing how tax exemptions and investment incentives affect small-scale farmers and larger formal agribusiness firms, with emphasis on inequality within the sector. The third assesses administrative capacity and compliance tools, including withholding tax proposals, reverse invoicing, and digital tax systems, and how these affect compliance costs and informality.

A comparative perspective is used to situate Kenya's experience within a broader context, drawing lessons from the experiences of the European Union, the United States, China, Brazil, Uganda, and Tajikistan. These cases reflect varying levels of development and approaches to agricultural taxation.

The study identifies patterns, policy tensions, and institutional features that shape agricultural taxation outcomes in Kenya, where small-scale farming, informality, and limited income-based taxation are established.

3.0. FINDINGS AND DISCUSSION

3.1. Tax Design and the Formation of the Tax Burden: The Evolution of the VAT Regime in Agriculture

Tax design plays a central role in shaping how the agricultural tax burden is created, distributed, and experienced along value chains. In Kenya, Value Added Tax has become the most important fiscal instrument affecting agriculture, not through direct taxation of farm income, but through the treatment of inputs, outputs, and intermediate transactions. Understanding how the VAT regime has evolved is therefore essential for explaining current cost structures, compliance outcomes, and revenue performance.

3.1.1. Historical Trajectory of Agricultural Taxation and the Protective Approach in Kenya

Agricultural taxation in Kenya has historically been shaped by a protection-oriented policy logic rather than explicit revenue extraction. Agriculture has been treated as a socially and politically sensitive sector due to its significant role in ensuring food security, generating employment, and supporting rural livelihoods. Before the introduction of Value Added Tax in the early 1990s, agricultural producers were rarely subject to formal taxation. Instead, fiscal pressure was applied indirectly through marketing boards, price controls, and export regulations. These mechanisms generated implicit taxation, where surplus was extracted without the use of formal tax instruments (Ronge *et al*., 2005).

The introduction of VAT in 1990 represented a structural shift in Kenya's tax system. However, agriculture remained largely insulated from its effects. During the 1990–2005 period, most agricultural inputs and outputs were either zero-rated or exempt from taxation. This design reflected concerns that taxing food and farm inputs would raise consumer prices and undermine rural incomes (Nyamori, 2018). Political economic considerations, therefore, outweighed revenue objectives.

Over time, this protective framework contributed to a persistent mismatch between agriculture's economic importance and its fiscal contribution. Evidence from Jordan *et al*., (2023) and Kihoria *et al.,* (2025) confirms that while agriculture expanded its share of GDP and employment, tax revenue from the sector remained modest. The historical evolution summarized in Table 1 indicates that policy changes occurred primarily through changes in VAT classification rather than adjustments to statutory tax rates.

Table 1: Historical Evolution of Agricultural Taxation in Kenya

Period	VAT Rate	Tax Treatment of Agriculture	Key Policy Features
Pre-1990	No VAT	Implicit taxation	Price controls and marketing boards dominated (Ronge *et al*., 2005)
1990–2003	18%	Mostly exempt or zero-rated	Protection of food prices and rural incomes
2004–2012	16%	Continued exemptions	Limited revenue mobilization from agriculture
2013–2022	16%	Selective zero rating	Rising VAT refunds and administrative pressure
2023–2025	16%	Shift toward exemption	Revenue protection and compliance focus (EY Global Tax Desk, 2025)

The pattern in Table 1 confirms that agricultural taxation in Kenya has evolved through design adjustments rather than explicit tax increases. This approach reduced visible tax burdens but weakened long-term revenue performance.

3.1.2. Transition from Zero Rating to Exemption: The Emergence of Hidden Tax Burdens

A central finding is that recent VAT reforms have increased the effective tax burden through hidden channels. Zero rating and exemption differ fundamentally in their economic effects. Under zero rating, VAT is charged at a rate of zero percent, and VAT is refundable, meaning tax costs do not accumulate throughout the production process. While zero rating maintains the refundability of input VAT, exemption eliminates refunds, transferring tax pressure from the tax system to the production process (OECD, 2020).

The shift from zero rating to exemption has therefore transferred tax pressure from the treasury to producers. VAT paid on transport, energy, storage, and financial services becomes embedded in input prices and passed forward along the value chain. This design reduces refund claims but raises production costs without appearing as an explicit tax.

As illustrated in Table 2, this shift has affected nearly all primary agricultural inputs.

Table 2: Changes in VAT Treatment of Key Agricultural Inputs

Input	Earlier VAT Status	Recent VAT Status	Resulting Tax Effect
Fertilizer	Zero rated	Exempt	Embedded VAT in the final price
Seeds	Zero rated	Exempt	Higher seed costs
Pesticides	Zero rated	Exempt	Increased input prices
Animal feeds	Zero rated	Exempt	Cost pass-through to livestock producers

Input	Earlier VAT Status	Recent VAT Status	Resulting Tax Effect
Farm machinery	Exempt	Selective exemption	Unequal access across farm sizes

The evidence confirms that the effective tax burden increases without an increase in tax rates. Extensive VAT protection weakens revenue collection by eroding the tax base while simultaneously creating hidden costs along agricultural value chains (Cliffe Dekker Hofmeyr, 2024; EY Global Tax Desk, 2025).

3.1.3. Effects of Input-Based Indirect Taxation on the Production Chain

Input-based indirect taxation reshapes the agricultural production chain by embedding unrecoverable tax costs at multiple stages of production and exchange. When agricultural inputs are exempt rather than zero-rated, suppliers pay VAT on upstream services such as transport, storage, fuel, packaging, insurance, and finance, but cannot reclaim these costs. These taxes do not disappear. They accumulate and are transferred forward through higher input prices. As a result, the effective tax burden rises even though statutory tax rates remain unchanged. This mechanism shifts unrecovered input taxes into production costs, making the tax burden less visible in formal accounts but strongly felt by producers and consumers through higher prices.

This study finds that the compounding nature of embedded VAT distorts production decisions along the value chain. Input suppliers increase prices to maintain margins, farmers respond by reducing input use, and processors face higher raw material costs that are passed on to consumers. Fertilizer and seed markets are particularly sensitive, as price changes directly affect application rates, crop yields, and output quality. The evidence indicates that these cost effects weaken productivity growth and undermine the intended protective role of agricultural tax exemptions.

Small-scale farmers are the most exposed to these dynamics. MoALD (2025) indicates that smallholders account for approximately 75 percent of agricultural output; however, more than half of them rely on borrowed funds, while access to formal credit remains limited. In this context, even small increases in input prices translate into binding constraints. Farmers delay fertilizer application, postpone mechanization, or switch to lower-quality inputs, thereby increasing their vulnerability to climate shocks and yield variability. These responses reduce surplus and reinforce subsistence-oriented production patterns.

The analysis also shows that rising input costs alter market behavior. The findings confirm what Kimutai (2019) demonstrated: higher compliance and cost pressures encourage informal trading, underreporting, and cash-based transactions outside regulated value chains. Input-based indirect taxation, therefore, weakens compliance incentives, reduces transparency, and further erodes the tax base. From a policy perspective, indirect taxation of inputs can unintentionally depress productivity, fuel informality, and raise food prices, contradicting both revenue and food security objectives.

3.2. Distributional Effects: Asymmetric Outcomes of Tax Policies for Small-Scale Producers and Agribusiness

Tax outcomes in agriculture depend strongly on the producer's identity and their operational approach within the sector. Farm size, access to finance, level of formal registration, and ability to meet administrative requirements all shape how tax policies are experienced in practice. Although tax incentives and exemptions are often designed as broad sector support measures, they do not translate into equal benefits across producers. In practice, the structure of these policies interacts with existing economic and institutional conditions, creating uneven effects between small-scale farmers and larger agribusiness firms. These differences become more visible when examining investment-related incentives and capital-based tax advantages, where the capacity to invest and comply determines who gains and who is left out.

3.2.1. Structural Distribution of Agricultural Incentives and Investment Tax Advantages

Kenya uses tax incentives to promote modernization, including VAT exemptions on machinery and accelerated depreciation allowances. While these instruments aim to stimulate investment, their benefits are unevenly distributed.

As illustrated in Table 3, incentives favor large and formal firms with access to capital and administrative capacity. Smallholders are excluded mainly due to credit constraints and informality.

Table 3: Agricultural Investment Incentives and Distributional Effects

Incentive Type	Intended Objective	Main Beneficiaries	Observed Outcome
VAT exemption on machinery	Promote mechanization	Large agribusiness	Limited smallholder access
Accelerated depreciation	Encourage capital investment	Formal firms	Capital bias
Storage incentives	Reduce post-harvest losses	Commercial actors	Uneven regional uptake

This pattern reflects a structural capital bias within agricultural tax policy (Konyimbih, 2000). Incentives designed as neutral instruments operate asymmetrically in practice.

3.2.2. Tax Burden, Access to Finance, and Vulnerability of Small-Scale Farmers

Tax design is closely linked to access to finance, and together they shape how farmers experience the real tax burden. Embedded VAT and compliance-related costs do not affect all producers equally. Their impact becomes much heavier when farmers have limited access to affordable credit. In Kenya, less than 5 percent of commercial bank lending is allocated to agriculture, despite the sector's significant importance for employment and income (MoALD, 2025). This credit gap limits farmers' ability to manage higher costs, invest in inputs, or respond to price shocks linked to tax reforms.

The findings indicate that when tax changes raise input prices without accompanying financial measures, small-scale farmers tend to adjust defensively. Higher costs reduce fertilizer use, delay the adoption of improved seeds, and slow down the mechanization process. These choices increase exposure to climate risks and market instability, thereby locking farmers into low-productivity paths. Under such conditions, tax reforms meant to improve revenue performance instead end up increasing vulnerability at the farm level.

Comparative evidence supports this pattern. In Brazil, tax reforms affecting agriculture were introduced alongside concessional credit, delayed tax payments, and input credits that protected farmers' cash flow during transition periods (Rezende & Calçada, 2025; OECD, 2025b). In China, tax relief for small producers has been coordinated with subsidized credit and targeted support, allowing farmers to remain active in formal markets (OECD, 2025a; Yan *et al*., 2023). The lack of similar coordination in Kenya strengthens resistance to taxation and discourages formal economic participation.

3.2.3. The Potential of Tax Policies to Deepen Intra-Sectoral Inequalities

The combined effects of VAT design, investment incentives, and compliance rules have increased inequality within Kenya's agricultural sector. Capital-intensive and export-oriented value chains are better able to absorb embedded taxes, access incentives, and meet compliance requirements. Small-scale farmers, by contrast, face higher costs and shrinking margins.

The analysis shows that tax incentives favor scale and formality. VAT exemptions on machinery, accelerated depreciation, and investment allowances mainly benefit firms with capital and formal accounting systems. Most smallholders remain excluded from these benefits. As a result, tax policy reinforces capital bias and regional differences, concentrating gains in well-connected and formal value chains.

Informality emerges as a rational response to rising costs and policy uncertainty. When taxes increase production costs without visible reinvestment in extension services, credit access, or rural infrastructure, producers withdraw from formal markets. The evidence confirms that tax incentives are not neutral. They shape market outcomes by favoring large and formal actors, deepening inequality within the sector, and weakening inclusive agricultural development.

3.3. Administrative Capacity and Tax Compliance: New Compliance Tools in Agricultural Value Chains

Recent reforms in Kenya's tax system have increasingly emphasized administrative capacity and compliance tools as a response to persistent challenges in taxing the agricultural sector. Given the dominance of small-scale producers, weak record-keeping, and high informality, traditional income-based taxation remains difficult to enforce. Policy attention has therefore shifted toward value chain-based compliance instruments that aim to collect tax at identifiable transaction points, improve visibility, and reduce leakage across agricultural markets. This shift reflects a broader assumption that strengthening compliance mechanisms can compensate for structural limitations in tax administration. However, the analysis indicates that the effectiveness of such tools depends heavily on institutional design, sequencing, and alignment with sector realities.

3.3.1. Withholding Tax Proposals and Value Chain Taxation Logic

Withholding tax proposals seek to collect tax at upstream or downstream points in the value chain, such as cooperatives, processors, or large buyers, rather than at the farm level. The underlying logic is administrative efficiency. Buyers are fewer, more visible, and easier to monitor than dispersed producers. This approach aims to reduce enforcement costs while expanding the effective reach of the tax base.

However, the findings show that withholding taxes reshape incentives within agricultural value chains. Deductions at source reduce farmers' cash flow and transfer compliance responsibilities to intermediaries. Cooperatives, which play a critical role in aggregation, input access, and credit facilitation, become tax enforcement agents. Evidence from Kenya suggests that this weakens cooperative legitimacy and encourages side selling and cash-based transactions outside formal channels (Omune *et al*., 2024).

Rather than increasing compliance, poorly coordinated withholding measures risk narrowing formal participation. The analysis confirms that value chain taxation can only function effectively when aligned with stable prices, transparent pricing mechanisms, and strong cooperative governance.

3.3.2. Digital Tax Systems, Reverse Invoicing, and Increased Visibility

Digital compliance tools, including electronic invoicing and reverse invoicing mechanisms, are introduced to improve transaction visibility and reduce

tax evasion. Reverse invoicing shifts reporting responsibility from sellers to buyers, limiting false input claims and underreporting. These systems enhance audit capacity and strengthen VAT control.

As illustrated in Table 4, the benefits of digital compliance tools are unevenly distributed across the agricultural sector. Formal processors and large agribusiness firms benefit from improved compliance clarity and reduced exposure to fraud. Small-scale farmers and informal traders face higher adjustment costs, limited digital access, and weak technical capacity.

Table 4: Digital Compliance Tools and Distributional Effects in Agricultural Value Chains

Compliance Tool	Policy Objective	Primary Beneficiaries	Key Limitation
Reverse invoicing	Reduce VAT fraud	Formal processors	Excludes informal suppliers
E invoicing	Improve reporting accuracy	Large agribusiness	High compliance costs
Digital filing systems	Increase visibility	Registered firms	Limited rural connectivity

The evidence suggests that digitalization enhances control but does not automatically expand the tax base. Without transitional support, digital compliance reinforces structural inequalities within the sector.

3.3.3. Compliance Pressure and the Risk of Encouraging Informality

Compliance costs play a central role in shaping producer behavior. When reporting requirements, documentation obligations, and delayed reimbursements raise costs without delivering visible benefits, producers respond by avoiding formal channels. Rising compliance pressure, therefore, encourages informal transactions, weakening revenue performance and data quality (Kimutai, 2019).

Small-scale farmers face higher relative compliance burdens than larger firms. Informality emerges as a rational response to cost pressure, uncertainty, and limited state presence. The analysis confirms that compliance tools can increase revenue; however, if poorly designed, they can fuel informality rather than reduce it. The central finding is clear: administrative capacity matters, but compliance instruments must be carefully designed to avoid shifting costs onto the most vulnerable actors within agricultural value chains.

3.4. Policy Tension between Revenue Mobilization and Food Security

Agricultural taxation in Kenya operates within a structural policy tension. On one side, the state faces rising pressure to mobilize revenue, stabilize public finances, and reduce reliance on borrowing. On the other side, agriculture remains the primary source of livelihoods for rural households and a key driver of food availability and price stability. This tension is not abstract. This plays out in the design of VAT rules, the choice between zero rating and exemption, the use of withholding mechanisms, and the broader shift toward compliance-driven reforms.

The analysis confirms that Kenya's agricultural tax system has historically leaned toward protection, with VAT relief being particularly prevalent for basic food products and key inputs. This protection has a clear logic. It reduces visible tax pressure on food markets and helps limit inflationary effects in a country where many households spend a large share of their income on food. However, this protection also narrows the tax base and keeps agriculture outside stable revenue channels. As fiscal pressure rises, reforms attempt to tighten administration and adjust VAT classifications instead of introducing clear and transparent income-based taxation. The result is a policy mix where the state seeks revenue while trying to avoid direct taxation of smallholders, and this is where trade-offs become sharper.

A central finding is that revenue gains have increasingly been pursued through indirect pathways that shift burdens along the value chain rather than expanding adequate tax capacity. VAT reclassification, embedded VAT, and compliance tools can generate short-run fiscal benefits, but they also raise input costs and weaken incentives for formal participation. Over time, this can lead to reduced productivity, increased food prices, and heightened vulnerability in rural areas.

3.4.1. The Gap between Agriculture's GDP Contribution and Tax Revenue Performance

Agriculture contributes more than 21 percent directly to GDP and makes a significant indirect contribution through its linkages with trade, transport, and agro-processing, yet its tax revenue contribution remains modest (Jordan *et al*., 2023; Kihoria *et al*., 2025). This gap reflects both deliberate policy choices and structural constraints. The policy choice is a long-standing reliance on exemptions and zero rating to protect food markets. The structural constraint is the dominance of small-scale farming and the high level of informality, which makes farm-level income taxation difficult to administer consistently.

The findings indicate that agriculture is not lightly taxed because it lacks value, but because it is politically sensitive, socially essential, and administratively complex. Instead of collecting stable revenue through direct and income-linked mechanisms, the system relies on indirect taxation and implicit burdens. Earlier work on implicit taxation shows how farmers can face fiscal pressure through price controls, marketing rules, and policy distortions even when formal

tax instruments remain limited (Ronge *et al*., 2005). In modern settings, indirect burdens shift from controlled prices toward embedded VAT and compliance costs.

The analysis also confirms that recent reforms are shaped by a revenue logic that targets easier points of collection rather than farm-level taxation. Marketing points, cooperatives, input suppliers, and formal agribusiness entities become the visible nodes. This approach may raise short-term revenue capture, but it does not solve the more profound mismatch between sector weight and tax performance. It also risks creating a cycle where reforms increase cost pressure on formal channels, pushing more transactions outside the recorded economy, which then weakens revenue performance again (Kimutai, 2019). In this sense, the revenue gap is partly self-reinforcing.

A further issue is predictability. Frequent changes in VAT treatment create uncertainty for value chain actors, leading to cautious investment, pricing adjustments, and, at times, reduced participation in formal systems. Revenue efforts that depend on changing classifications can therefore reduce the stability of the tax base, rather than strengthening it in a durable manner (EY Global Tax Desk, 2025).

3.4.2. Effects of Indirect Taxation on Food Prices and Consumer Welfare

Indirect taxation affects food prices through the cost pass-through mechanism. When VAT is applied in a way that prevents the recovery of input tax, costs accumulate along the supply chain. Even where goods appear "tax-free" at the point of sale, embedded VAT remains inside transport, storage, packaging, processing services, and compliance activities. These costs then appear as higher farm gate prices, higher wholesale prices, and ultimately higher consumer prices.

The key mechanism is the embedded VAT created by exemption. Under zero rating, the VAT rate on the supply is zero, and suppliers can claim back input VAT, meaning tax does not accumulate within costs. Under exemption, the supply is not taxed; however, suppliers cannot claim input VAT refunds, so the VAT paid earlier becomes part of the production costs. This design conceals VAT as a hidden cost rather than a visible tax, and it is passed on through pricing. Over time, the system produces inflationary pressure even without statutory tax rate increases.

This matters because food markets in Kenya are susceptible to cost increases. For many households, small increases in staple prices can alter consumption patterns, compromise diet quality, and heighten food insecurity risks. The analysis confirms that indirect taxation is regressive in effect because low-income households spend a larger share of their income on food and have a lower ability to absorb price changes.

Table 5 summarizes the trade-offs that emerge when policy choices favor revenue visibility over affordability and sector support.

Table 5: Revenue Mobilization and Food Security Trade-Offs

Policy Action	Revenue Impact	Food Price Impact	Distributional Effect
VAT relief on inputs	Lower revenue	Lower food prices	Supports consumers and food access
Shift from zero rating to exemption.	Moderate revenue gain	Higher production costs and prices	Burden shifts to producers and consumers
Withholding taxes at marketing points	Higher visibility	Neutral to rising prices	Regressive for smallholders
Recycling revenue into agriculture	Long-term gains	Can stabilize prices	Pro poor when targeted

The analysis confirms that revenue measures that operate through the input side often deliver revenue through cost shifting rather than efficiency. When the system raises the cost of fertilizers, seeds, feeds, and machinery services, the farmer absorbs part of the cost through reduced margins and reduced input use, and the consumer absorbs the rest through higher prices. This creates a double burden across the chain. It also reduces productive investment, which can lower supply over time and further increase price pressure.

In this way, indirect taxation can conflict directly with food security goals. The policy tension is not only about raising revenue versus protecting farmers, but also about striking a balance between these two objectives. It also includes consumer welfare, inflation control, and broader political stability.

3.4.3. Reinvestment of Tax Revenues in the Sector and the Issue of Legitimacy

Tax legitimacy in agriculture depends on whether farmers and value chain actors see visible returns. When taxes are collected or costs are imposed without reinvestment in the sector, the tax system is viewed as an extraction rather than a development tool. This matters more in agriculture than in many other sectors because producers face high risks from climate shocks, price volatility, and seasonal cash flow constraints.

The findings confirm that legitimacy is weakened when revenue collected from agriculture does not translate into better services such as extension support, irrigation, rural roads, storage facilities, and affordable finance. Without these returns, the system reduces production incentives and encourages risk-avoiding behavior. Producers respond by reducing formal participation, cutting investment, or shifting to informal marketing channels where documentation is lighter and tax pressure is lower (Kimutai, 2019).

International experience supports this point. A core lesson from broader agricultural taxation debates is that sustainable taxation requires a credible link between taxation and sector support, especially in settings dominated by smallholders (OECD, 2020). Where this link is weak, resistance grows, compliance declines, and the state ends up collecting less than expected while also damaging productivity.

One thing is clear, taxation in agriculture cannot be treated only as a revenue tool. In Kenya's context, taxation becomes legitimate and sustainable only when it is paired with reinvestment that improves productivity and reduces vulnerability. When this return is missing, taxation without return becomes destructive for production and food security.

3.5. Policy Consistency and Investment Confidence: Consequences of a Frequently Changing Tax Regime

Policy consistency plays a critical role in shaping investment decisions in agriculture. Unlike short-term trading activities, agricultural production and agribusiness investment require long planning horizons, high upfront costs, and delayed returns. Stability in tax rules is therefore as important as the level of taxation itself. In Kenya, however, agricultural taxation has been characterized by frequent legal amendments, shifting VAT classifications, and changing incentive structures. This pattern has created uncertainty that affects both domestic and foreign investors.

The analysis confirms that recent tax reforms have focused more on short-term revenue objectives than on long-term policy coherence. Annual Finance Acts and repeated amendments to VAT schedules alter the tax treatment of inputs, machinery, and outputs with limited transition periods. As a result, producers and investors face difficulty forecasting costs, returns, and compliance obligations over time. This uncertainty weakens confidence and discourages capital formation in the sector.

3.5.1. Uncertainty in VAT Classifications and Planning Problems

Frequent changes in VAT classifications represent one of the most disruptive features of Kenya's agricultural tax regime. Inputs such as fertilizers, seeds, pesticides, animal feed, and machinery have repeatedly been moved between zero-rated and exempt status. While these changes are often justified on fiscal or administrative grounds, they generate planning challenges across the value chain.

Legal and tax advisory reviews confirm that VAT amendments in recent years have altered the cost structure of agricultural production without providing clear long-term direction (Cliffe Dekker Hofmeyr, 2024; EY Global Tax Desk, 2025). Input suppliers must adjust pricing systems, accounting methods, and refund expectations. Farmers face uncertainty regarding future input prices and cannot plan their production cycles or investment decisions reliably. Agribusiness firms must continuously revise contracts, cash flow projections, and investment appraisals.

This instability increases compliance costs and administrative burdens, particularly for smaller firms and cooperatives with limited technical capacity. When VAT rules change frequently, the risk of unintentional non-compliance also rises, exposing producers to penalties and disputes. Over time, uncertainty erodes trust in the tax system and reinforces risk-averse behavior.

3.5.2. Tax Uncertainty, Investment Delays, and Risk Perception

Investment decisions are influenced not only by tax levels but also by perceived risk. The analysis confirms that tax uncertainty discourages investment more strongly than moderate tax burdens. Investors are more willing to operate under predictable taxation, even at higher rates, than under unstable regimes with unclear future obligations.

Evidence from agribusiness investment behavior suggests that uncertainty leads to delayed or scaled-down investment, particularly in machinery, irrigation, storage, and processing facilities. When VAT treatment or incentive eligibility can change within a single budget cycle, estimating expected returns becomes challenging. This raises perceived risk and increases the cost of capital. Table 6 summarizes the relationship between policy instability and investment behavior in the agricultural sector.

Table 6: Policy Consistency, Tax Uncertainty, and Investment Effects

Policy Feature	Observed Pattern	Investor Response	Sector Outcome
Frequent VAT reclassification	High legal volatility	Delayed investment decisions	Slower modernization
Short-lived tax incentives.	Uncertain duration	Selective uptake by large firms	Capital concentration
Complex compliance rules	Rising administrative costs	Avoidance or informality	Narrower tax base
Unclear reform direction	Mixed policy signals	Risk aversion	Reduced long-term planning

As illustrated in Table 6, instability does not lead to increased productive investment. Instead, it encourages caution, favors firms with higher risk tolerance and capital reserves, and disadvantages smaller actors. Large agribusiness firms are better positioned to absorb uncertainty through legal advice and diversified operations. Small and medium producers, in contrast, respond by postponing investment or remaining informal.

The findings align with broader evidence that predictable tax systems are a key condition for investment confidence in agriculture (Gadwin, 2022). Where tax rules change frequently, incentives lose credibility and fail to influence behavior as intended. Instead of supporting transformation, policy volatility slows structural change and weakens revenue performance over time. It is clear that tax uncertainty discourages investors more than the tax burden. A stable and transparent tax framework is essential for fostering long-term investment, promoting modernization, and establishing a robust tax base in the agricultural sector. Without policy consistency, even well-designed incentives and moderate tax rates fail to achieve their intended outcomes.

3.6. Comparative Perspectives on Agricultural Taxation: Kenya and Selected International Experiences

Comparing Kenya's agricultural taxation framework with international experiences helps clarify whether the challenges identified are country-specific or structural in nature. Evidence from various regions indicates that agriculture is often treated as a distinct sector for tax purposes. However, outcomes depend less on whether agriculture is taxed lightly or heavily, and more on how tax instruments are designed, how they interact with farm structures, and the strength of administrative institutions. Across countries, agriculture generally faces lower taxation than other sectors, but the reasons and consequences differ depending on levels of development, farm size distribution, and policy priorities.

3.6.1. Agricultural Taxation in Advanced and Structured Systems

In advanced economies, such as the European Union and the United States, agricultural taxation primarily relies on income sensitivity and economic performance rather than broad consumption taxes on inputs. In the European Union, farm taxation is closely tied to income levels, price volatility, and dependence on subsidies. Evidence from Poland between 2004 and 2022 shows that farm tax burdens adjust to macroeconomic conditions, allowing farmers to cope with income shocks without facing rigid tax pressure (Jęczmyk & Ryś-Jurek, 2025). Instead of taxing inputs heavily, EU systems combine income-based taxation with direct support under the Common Agricultural Policy.

A similar pattern is observed in the United States. Farm tax burdens vary across states, but they are mainly linked to income taxes, land values, and property taxes rather than input taxation (Moravec *et al*., 2019). This structure limits cascading tax effects and allows farms to absorb weather and market shocks more effectively. Compared to Kenya, where VAT reclassification creates embedded costs within input prices, these systems emphasize transparency, predictability, and responsiveness to income. This evidence supports the argument that income-based taxation is less distortionary than indirect input taxation when administrative capacity is strong.

3.6.2. Agricultural Taxation in Emerging and Reform-Oriented Economies

China and Brazil provide important lessons for countries undergoing fiscal reform and structural transformation. In China, agricultural taxation evolved away from direct agricultural taxes toward exemptions and targeted policy instruments. Rather than taxing all producers uniformly, China applies environmental and sector-specific taxes to large-scale and intensive operations, particularly in livestock systems. This approach targets scale and externalities while protecting small farmers (Yan *et al*., 2023; OECD, 2025).

Brazil's experience with consumption tax reform is especially relevant to Kenya. Brazil replaced its fragmented consumption tax system with a unified VAT framework, while introducing strong safeguards for the agricultural sector. These included reduced rates, zero rating for basic foods, deemed credits for small producers, and delayed tax payments to protect cash flow (Rezende & Calçada, 2025; OECD, 2025). This experience demonstrates that VAT-based systems can be effective in agriculture when combined with predictable rules, access to credit, and transitional reliefs.

3.6.3. Agricultural Taxation in Low- and Middle-Income Contexts

Uganda and Tajikistan reflect structural challenges similar to those observed in Kenya. In Uganda, agriculture contributes significantly to the country's GDP and employment but generates limited tax revenue. Attempts to introduce agricultural income taxation and withholding taxes have faced strong resistance due to concerns about burdening smallholders and potentially increasing food prices (Stewart-Wilson & Waiswa, 2021). Weak record keeping, informality, and fragmented value chains limit the effectiveness of direct taxation.

In Tajikistan, agricultural taxation remains constrained by low administrative capacity and rural informality. The state relies mainly on exemptions and implicit taxation rather than formal income taxes, resulting in low revenue mobilization and weak incentives for modernization (World Bank, n.d.). These experiences mirror Kenya's reliance on indirect taxation and exemptions, often at the cost of transparency and efficiency.

Table 8: Comparative Agricultural Taxation Approaches and Sectoral Outcomes

Country or Region	Dominant Tax Instruments	Treatment of Agricultural Inputs	Compliance and Administration	Sectoral Impacts
European Union (Poland)	Income-based farm taxation	Minimal input taxation	Strong record keeping and subsidies	Stable incomes and low production distortions (Jęczmyk & Ryś-Jurek, 2025)
United States	Income and land-based taxes	Inputs largely untaxed	State-level tax systems	Predictable tax planning and lower cost pressure (Moravec *et al*., 2019)
China	Targeted sector and environmental taxes	Selective input taxation by scale	Strong policy coordination	Productivity gains with limited smallholder burden (Yan *et al*., 2023; OECD, 2025)
Brazil	Unified VAT with sector concessions	Reduced rates and zero rating	Tax credit support and delayed payments	Protected cash flow during reform (Rezende & Calçada, 2025; OECD, 2025)
Uganda	Proposed income and withholding taxes	Broad exemptions	Weak enforcement capacity	Low revenue and political resistance (Stewart-Wilson & Waiswa, 2021)
Tajikistan	Minimal formal taxation	Exemptions dominate	Low administrative capacity	Low revenue and weak commercialization (World Bank, n.d.)
Kenya	VAT exemptions and reclassification	Embedded VAT in input prices	High informality and weak compliance	Higher production costs and weak revenue performance (EY Global Tax Desk, 2025)

3.6.4. Comparative Implications for Kenya

The comparison confirms that the effectiveness of agricultural taxation depends more on design than on tax levels. Advanced economies avoid hidden input taxes and rely on income-sensitive instruments. Reform-oriented economies pair VAT systems with targeted relief and credit support. Low-income contexts demonstrate that weak institutions hinder the effectiveness of direct taxation.

Kenya's reliance on VAT reclassification has reduced refund pressure but increased embedded costs for producers, particularly smallholders (Cliffe Dekker Hofmeyr, 2024; EY Global Tax Desk, 2025). Agriculture continues to contribute significantly to GDP, while generating limited tax revenue, reflecting weaknesses in tax design and compliance rather than a low sectoral importance (Kihoria *et al*., 2025). The comparative evidence suggests that Kenya should shift its approach to taxation from hidden to more transparent, predictable, and targeted instruments that align revenue goals with productivity and food security objectives.

4. CONCLUSION AND POLICY RECOMMENDATIONS

4.1 Conclusion

Agricultural taxation in Kenya remains shaped by a long-standing policy choice to protect food production and rural livelihoods through exemptions, zero rating, and targeted incentives. The analysis confirms that agriculture plays a central role in economic output and employment, yet its contribution to tax revenue remains low relative to its importance. This outcome is not accidental. It reflects deliberate tax design choices combined with structural constraints such as informality, fragmented production, and weak administrative reach.

The findings show that recent tax reforms have not increased statutory tax rates but have altered the

effective tax burden through changes in VAT treatment. The shift from zero rating to exemption has reduced refund pressure for the government but created embedded VAT costs along agricultural value chains. These hidden costs increase production expenses without being explicitly taxed, with the burden falling most heavily on small-scale farmers who lack access to credit and risk management mechanisms.

Investment incentives and exemptions have supported the expansion and modernization of the agribusiness sector, but access to these benefits remains uneven. Formal and capital-intensive actors benefit more, while smallholders remain excluded mainly due to informality and financing constraints. At the same time, new compliance tools such as withholding taxes, digital systems, and reverse invoicing have increased visibility but also raised compliance costs. When such tools are introduced without compensatory support, they encourage informal responses rather than improving long-term compliance (Kimutai, 2019).

Comparative evidence confirms that Kenya's challenges are structural rather than unique in nature. Countries that rely on income-sensitive taxation, targeted instruments, and visible reinvestment achieve better revenue and productivity outcomes. In contrast, systems that depend on hidden input taxation face weak revenue performance and rising sectoral inequality. Clearly, the evidence confirms that taxing agriculture through indirect and opaque mechanisms weakens both revenue efficiency and sector sustainability.

4.2 Policy Recommendations

First, agricultural tax policy should prioritize stability and predictability. Frequent changes in VAT classifications create uncertainty for farmers, input suppliers, and investors. A medium-term agricultural tax framework should clearly define VAT treatment for key inputs and outputs, reducing policy volatility and planning risks (EY Global Tax Desk, 2025).

Second, VAT design should minimize hidden taxation. Essential agricultural inputs, such as fertilizers, seeds, and pesticides, should remain zero-rated rather than exempt, where fiscal space allows. Zero rating prevents cost accumulation and protects productivity. If exemptions are retained, targeted compensatory mechanisms should be introduced to offset embedded VAT costs.

Third, tax incentives should be redesigned to reach small-scale producers. Simplified incentive schemes linked to cooperatives, farmer groups, or presumptive systems would improve access and reduce capital bias. Incentives that only benefit formal and large-scale actors deepen structural inequality.

Fourth, tax reform must be coordinated with agricultural finance. Limited credit access amplifies the impact of taxation. Linking tax compliance to concessional credit, guarantee schemes, or input financing would reduce resistance and support formalization (MoALD, 2025).

Fifth, compliance tools should be gradual and supportive. Withholding taxes and digital systems should include thresholds and exemptions for smallholders. Training, simplified reporting, and phased implementation are critical to avoid pushing producers into informality (Omune *et al*., 2024).

Finally, tax legitimacy depends on reinvestment. Agricultural tax revenues should visibly support extension services, irrigation, storage, rural infrastructure, and market access. Comparative experience shows that taxation without return undermines production incentives and food security, while reinvestment strengthens compliance and political acceptance.

In conclusion, agricultural taxation in Kenya should be treated not only as a revenue instrument but also as a development tool. With careful design, predictable rules, and strong coordination with agricultural policy, Kenya can improve its fiscal performance while protecting farmers, supporting food security, and promoting long-term sector transformation.

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