Verité insights

‘Cess’ – End the Deception and Build ‘Street Lights’

DailyMirror – 27th November 2013

In Sri Lanka, ‘Cess’ is the name given to a special tax imposed on sales, where the revenue is earmarked for a specific fund with a particular economic purpose. But the government has stymied export promotion and local value addition by ‘stealing’ the Cess. Budget 2014 is poised to further the malpractice.

Currently, most Cess is introduced under the Sri Lanka Export Development Act No 40 of 1979. Cess on imports and exports is imposed under Section 14 of the act. The section stipulates that “proceeds of the Cess recovered under this section shall be paid monthly by the Principal Collector of Customs to the credit of the Fund.” This fund, referred to in Section 13 of the act as the “Export Development Fund” exists to provide support to exporters.

Economics of taxing to assist

Taxing to assist can seem like a contradiction. Is there a point to subsidising exporters if they end up paying for it anyway? There is in fact an economic logic to this, based on the twin ideas of public goods and free riding.

Imagine 20 people living down a dark street who would each place a value of Rs.10,000 on street lighting. Imagine street lighting costing a total of Rs.100,000; and if set up, even by a few, everyone benefitting equally (it is a public good). Each might hope that the others would pay for it, allowing them to free ride on the benefit. The result often is that there is no street lighting, which they collectively value at Rs.200,000 though it costs only Rs.100,000.

In such a situation there is a role for the government. The municipality could set up the street lights and do so by charging each resident Rs.5,000 (just half of how much they value it). The result is a net-benefit for all, even though they all paid for it. Taxing to assist does work, when it solves this kind of coordination and collective action problem. That is what a Cess in Sri Lanka is supposed to do.

Losing trust

There are two ways in which the municipality can lose the residents' trust. Two analogies can explain. First, imagine a municipality that charged Rs.5, 000 per resident and instead of setting up street lights, beautified the road with flowers – which the residents may still value, but much less, say at only Rs.1,000 each. This is still a benefit, but a net loss to the residents. Second, imagine the municipality simply spent the money to colour wash its buildings, bringing the residents no benefit at all.

The implementation of the Cess in Sri Lanka is violating trust in both of these ways. According to many industry sources and reports (which received coverage in the press) the Cess revenue under the act ends up in the "consolidated fund" of the government and not in the Export Development Fund. The government is "colour washing its buildings" and at times "planting some flowers", but it is not building the "street-lights."

Cess-budget tradition continues

With every budget since 2006, Cess imposed on imports and exports has increased, the rates have been revised upwards and the product coverage expanded. Budget 2014 continues with the trend.

Prior to 2006, there was no Cess on exports, only on imports. But since then, Cess has been applied to exports as well and export Cess has gradually increased to hover around 10 percent of total Cess revenue in 2012-13. Budget 2014 revisions to Cess are expected to add an additional Rs.4 billion to Cess revenue (an increase of 14 percent from 2012).

Assisting through punishing – does it work?

Despite this broken trust and increased Cess on exports, Budget 2014 continues with the rhetoric that Cess is intended to promote exports. It offers, however, a different economic argument for how Cess can help exporters: that it helps to incentivise value addition by punishing exports of the more basic products.

For example, Section 14.1 (page 11) of the budget states, "high value tea and rubber product exports will be encouraged… by maintaining a high level of Cess on primary commodity exports (14.1, page 11). Annex 1, Section 5.2 states that export Cess has been introduced to pepper, cinnamon, clove, nutmeg and cardamoms to promote local value addition.

The punishment idea is strange because it would need to assume that it is lethargy that prevents value addition. Otherwise, why punish to incentivise? If value addition was indeed feasible and profitable the government should not need to follow the industry around with a stick in order to action it. But if supportive infrastructure or availability of investment is what prevents value addition, then the punishment policy and 'stealing' the Cess, are going to make matters worse – it takes away from industry excess profits that could have been ploughed into value addition investments and robs the industry of the supportive infrastructure it expected to receive in return for the Cess.

Tea sector case

Within the Sri Lankan culture, punishing children may sometimes work in getting them to study harder, but that sort of paternalism is likely to be counter-productive, when it comes to promoting a vibrant export industry in a national economy.

Vibrant or not and whether in need of a stick or not, the tea sector is a case to be examined – because punishment has not worked.

The tea sector has been paying export Cess under the Sri Lanka Tea Board Act since the inception of the institute in 1975. But export of value-added tea still remains under 10 percent of the total tea exports of the country. Historically, Cess has not worked to promote value addition.

When the Cess on tea was ploughed back to industry in various forms, it has been in the form of "planting flowers", not setting up "street lights". For example, the industry valued technological development and brand development, but the government did not align with the industry's priorities. The present trajectory, where the Cess is being absorbed by the consolidated fund, for "colour washing buildings" will make matters even worse.

Positive promise in the budget

Budget 2014 does have positive promises to reverse the trend and incentivise long-term investment. Section 11.1 proposes "to implement a credit scheme with eight-year maturity and 6 percent interest to every company that has so far performed well, provided they commit to replant an agreed extent, are committed to ensure social development of its plantation workers and increase the volume of its value-added tea exports."

But the promises create incentives only in a context of trust. A government that breaks the trust with one hand cannot expect it be taken seriously, when offered with the other. The tea industry in fact has good reason to nurture a trust-deficit. The government in 2010 imposed a tea promotion levy promising to promote the brand of 'Ceylon tea' globally, but to the dismay of the tea industry the money ended up "colour washing buildings", not building the Ceylon brand.e

Trust and "street-lights" make for better economics

Lack of trust in government and arbitrary impositions of Cess are also increasing uncertainty in the trading environment and export industries. It is counter-productive to export growth.

It has been the case that Cess is not only revised annually with the budget, but many times a year. The sudden upward revision of Cess on tea exports earlier in 2013 took the industry by surprise and delayed tea shipments. (After some wrangling that Cess revision was then withdrawn). Restoring trust and building the "street lights" could make the Cess useful for local value addition and the promotion of exports. Currently, it is detrimental to both.

(Verité Research is an independent think-tank based in Colombo that provides strategic analysis to high level decision-makers in economics, law, and media. Comments are welcome. Email publications@veriteresearch.org.)