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CHAPTER VI

INCOME TAX EXEMPTION LIMIT : ITS RATIONALE AND INDEXATION

1. Income Tax Exemption Limit : General Considerations

Introduction :

Under all income tax systems prevalent in the world today, income below a certain level has always been tax free. Even in the earliest days of this tax, exemption was granted to small incomes. For example, even under the Aid and Contribution Act of 1798 of England, income level up to £ 60 was tax free.[1] It was reduced to £ 50 by the Act of 1806.[2] In Germany such tax free limit was fixed at 420 Marks by the Act of 1873.[3] Later, it was raised to 3000 Marks by the Act 1891.[4] In France, the earliest tax-free limit of income was fixed at 1250 Francs by the first Income Tax Act of 1909.[5] In Italy this limit was fixed at 250 Lire by the first Income Tax Act of 1864 and it was raised to 400 Lire in 1867.[6] In the U.S.A., this limit was $800 under

1. Seligman, E.R.A., The Income Tax: A Study of the History, Theory, and Practice of Income Taxation at Home and Abroad, op.cit., p.60.
2. Ibid; p.102.
3. Ibid; p.243.
4. Ibid; p.240.
5. Ibid; p.323.
6. Ibid; p.434.

the first Income Tax Act of 1861 and it was reduced to $600 by the Act of 1862.[7] So, we do not find any country wherein income tax system does not grant such tax-free limit. When income tax was first introduced in Nepal in 1960 the exemption limit was set at Rs.7000.[8]

Definition of Income Tax Exemption :

The income tax rates are not applied straight way on the total income of the tax payers under any income tax system. Tax base is only a part of the total income of a tax payer. Expenses incurred to derive income are subtracted from the gross income to arrive at the total income. The income tax laws have been providing deductions for the charitable contributions made by the tax payers and for the medical expenses, educational expenses, child care expenses, local taxes and life insurance premium paid by the tax payers.[9] In some countries including Nepal these deductions have been granted separately only on item by item basis and in some other countries including India and the U.S.A. these deductions have been granted in the form of

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7. Ibid; p.434.

8. The Finance Act, 1959-60, H.M. Government of Nepal, Ministry of Finance, Nepal.

9. Kahn, C. Harry, Personal Deductions in the Federal Income Tax, Princeton University Press, 1960, p.1.

standard deduction of certain proportion of the total income of the tax payer. And in the countries where there is a provision of standard deduction, the tax payers may calculate their permissible deductions either on items by items basis or on the basis of the standard deduction. In developing countries deductions are also granted for specified types of savings and investments. After subtracting all these deductions from total income we arrive at the assessed income. Then from this amount of assessed income a statutory personal exemption is granted on which no tax is levied.

The taxable income, that is, income above the exemption limit is divided into several income brackets and increasing marginal rates of taxation are applied on the corresponding brackets.

In this chapter, we discuss the nature and rationale of statutory exemption limit below which assessed income is not taxable. This limit is often called 'subsistence level'. In short, this process of arriving at the taxable income from the gross income may be put in the following form:

a. Total income = Gross income minus business expenses

b. Assessed income = Total income minus deductions

c. Taxable income = Assessed income minus exemption limit

Objectives of the Exemption Limit :

Though, there is a controversy regarding the real objectives of this limit, some of the important objectives are not difficult to find out, which are discussed below.

a. In the beginning, such tax free level of income used to be called the 'subsistence level'. The rationale behind it under every income tax system of those days seems to be the fact that the people with income below certain level do not possess tax paying ability. And that amount of income was thought to be required for subsistence.

Even today, this limit seems to be justified mainly on the ground of subsistence level as Pechman says - "The basic justification for the personal exemption is that very low income people have no tax paying capacity. Taxation below minimum levels of subsistence reduces health and efficiency, and results in lower economic vitality, less production and possibly higher public expenditures for social welfare programs."[10] Musgrave and Musgrave also express a similar opinion in regard to this limit. According to them, "There is fairly general agreement that an initial slice of income should not be taxed... In defining this

10. Pechman, Joseph A., Federal Tax Policy, op.cit.,p.67.

allowance, we might use the level below which the tax payer is considered to be in poverty."[11] Bagchi also says that "it is generally felt that an equitable tax system should avoid taxing those who are unable to bear the burden of taxation, viz., the poor and the exemption limit serves as a dividing line between the poor and non-poor."[12]

In this regard, the opinion of the Canadian Royal Commission on Taxation popularly known as Carter Commission deserves mention. First of all the Commission defines the level of income above exemption limit as discretionary and below this limit as non-discretionary. The Commission agrees with having such an exemption limit in any income tax system as it reports... "That the first dollars of income should not be subject to tax. Clearly the fraction of income available for discretionary use is extraordinarily small for a family with an income of, say, $2000. Moreover, such a family bears sales and property tax that are disproportionately large relative to its ability to pay."[13] But the commission does not agree with the traditional justification of this

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11. Musgrave, R.A., and Musgrave, P.B., Public Finance in Theory and Practice, op.cit., p.378.

12. Bagchi, Amaresh, "Inflation and Personal Income Tax: A Note", Economic and Political Weekly, April 24,1982, p.734.

13. Report of the Royal Commission on Taxation, Vol.3: Taxation on Income, 1966, p.21.

limit, that is, for subsistence. As it reports - "The idea that income tax should not reduce income below subsistence is laudable in its intention but, we believe, misconceived. Subsistence has no absolute meaning. It is the relative positions of individuals and families that are important."[14]

b. Another important objective of this limit is to make the income tax system administratively manageable and effective. If no such limit is granted in the tax system whole population or all the tax paying units as defined by the respective income tax laws would come in the roll of tax payers irrespective of their level of income and this would make the administration of tax well-nigh impossible. The cost of assessment and collection of tax would become enormous without having a commensurate increase in the revenue. This problem would be even more pronounced in the countries where poverty and illiteracy are more rampant. As Pechman states - "The personal exemptions also serve as an administrative device to remove from the tax rolls people with very low incomes."[15] Bagchi also states that the exemption limit serves the purpose of keeping the task of administration within a manageable proportions."[16] In the

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14. Ibid.

15. Pechman, J.A., op.cit., p.67.

16. Bagchi, Amaresh, op.cit., p.735.

opinion of Prof. Lakdawala also the reason for an exemption level in general income tax is purely administrative.[17] It has, therefore, been generally agreed that determination of exemption limit in personal income tax system is well justified on administrative ground.

From the literature of income taxation it seems that the economists have come up with mainly two real rationales behind this tax-free limit. As Kahn rightly says the reasons for such personal exemptions of given amount of income have been variously presented as the need for keeping untouched by the tax a subsistence amount of income, or a reasonable standard of living, and also the desire to eliminate as tax payers those whose liability would be too small to warrant the expense of processing such returns.[18] But, however, it is almost unanimously agreed that some exemption keyed to atleast a minimum subsistence standard of living is desirable.[19]

Types of Income Tax Exemption :

Basically this exemption is of three types as follows:

a. Initial exemption, b. Vanishing exemption, and,

c. Continuing exemption.

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17. Lakdawala, D.T. Direct Taxation of Agriculture, Presidential Address to 35th sossion of the All India Agricultural Economic Conference, p.10.

18. Kahn, C. Harry, op.cit., p.3.

19. Blum, Walter J., and Harry Kalven Jr. The Uneasy case for Progressive Taxation, University of Chicago Press, 1953, p.4.

The initial exemption is defined as the complete exemption from tax liability of assessed income up to a certain level, beyond which assessed income (including the amount which was initially exempted) is fully taxable. This further means that assessed income below certain level is fully exempted from taxation and as soon as the assessed income crosses this level, the whole assessed income is taxed or no exemption is allowed for beyond that limit.

The vanishing exemption is defined as the complete exemption from taxation of assessed income up to a certain level, beyond which the amount exempted from assessed income in order to derive tax base declines as assessed income increases, until the exemption vanishes altogether. It means that under this type of exemption, complete exemption of assessed income from taxation is granted only up to a certain level but as the assessed income exceeds that level and goes on increasing, the tax exempted amount of income goes on declining gradually step by step and at a certain level of assessed income, it vanishes completely and beyond that level of assessed income, exemption is not allowed for at all. This type of exemption is found in some of the British Commonwealth Countries.

Continuing exemption is defined as the complete exemption from taxation of assessed income upto certain level, beyond which taxable income is the amount by which assessed income exceeds this exemption. Under this type of exemption, the same amount of exemption is granted however large may be the level of income. Even the assessed income level chargeable to the highest marginal rate is provided with this exemption. This type of exemption is found in practice in most of the countries including Nepal and India.

All these three types of exemptions have in common, the complete exemption from taxation of assessed income up to a certain level. The difference among them lies only when the income crosses this level. Exemption becomes nil instantly as soon as the assessed income exceeds this limit under initial exemption system. Exemption gradually declines as soon as the assessed income crosses this limit and becomes nil after reaching certain level under vanishing exemption and exemption continues as it is and never becomes nil whatever amount of assessed income may be under continuing exemption.[20] Nepal has continuing exemption limit.

<u>Ways of Exemption</u> :

This exemption is granted to the tax payers on the basis of the tax paying unit as specified in the respective tax laws.

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20. Levy, Michael E, Income Tax Exemption: An Analysis of the Effects of Personal Exemptions on the Income Tax Structure, North Holland Publishing Company, Amsterdan, 1960, pp.4-7.

In consonance with this if family has been specified by the tax law as a tax paying unit, then this exemption is granted to the tax payers on the basis of their marital status. As for example, exemption is separately specified for unmarried individual, couple and family. In such case, exemption limit in absolute terms is lowest for individuals, little higher for couples and highest for families. And individual, couple and family are defined specifically by the tax laws for the tax purpose.

And if individual has been specified as the tax paying unit, then single exemption limit is granted for all types of tax payers without having regard to their marital status. Under the system of individual as a tax paying unit, incomes of all earning members of a family are not pulled together but are assessed separately. So, such family enjoys more than one exemption if there are more than one earning member in any family. The progressiveness of the tax system suffers under this arrangement. Whereas under the system of family as a tax paying unit, incomes of all earning members of such family are clubbed in and is assessed as joint income. Such family obtains only a single exemption and further, the progression of the tax system also becomes more effective. So if there are more than one earning member in a family and family is a tax paying unit, then such family pays more tax both ways.

In Nepal family is a tax paying unit and so exemption is being provided on the basis of the marital status of the tax payers except for salary income. For salary income, in some cases individual has been specified as a tax paying unit.[21] This may be contrasted with India where individual and not the family is the tax paying unit for all types of income.[22]

The system of family as a tax paying unit accepts the fact that the expenditure to be incurred for the maintenance of each of these tax paying units, that is, individual, couple and family, varies. However, in some countries, the same amount of exemption limit is granted for couple without children and couple with dependent children. In case of Nepal individuals and couples without children and couples with children have been treated sometimes as three different types of units and sometimes as only two different types. The practice has varied from time to time.

The opinion of the Canadian Royal Commission on Taxation is instructive in this regard. It says that the most obvious and substantive differences between tax units that result in differences in the fraction of unit's total economic power available for discretionary use are differences

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21. Finance Act 1980-81, H.M.G. of Nepal, Ministry of Law and Justice, Nepal.

22. Income Tax Act, 1961, Government of India, pp.1.16 -1.17.

in marital status and differences in the number of dependents. So, in general, a married couple has not a similar fraction of its total economic power available for discretionary use than an unattached individual with the same total economic power. Therefore, the tax system should allocate a smaller tax to a married couple than to a bachelor with the same income."[23]

In some countries, exemption is granted for family on per head basis. The U,S.A. is one of those countries where exemption for families is granted equally on per capita basis.[24] But Canadian Royal Commission is against granting such equal amount of exemption for members of the family on per head basis because in its opinion greater expense is associated with the first child, and so a larger credit should be provided for the first child than for the additional children. But, though, it looks logical theoretically, it adds more complexities to the administration of the tax.

In England and Canada also exemption has been provided on per head basis but since costs are thought to be relatively higher for the principal income recipient in the family than for dependents, a variable exemption has been provided for

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23. Report of the Royal Commission on Taxation (Canada), op.cit., p.14.

24. Pechman, Joseph. A., op.cit., pp.70-71.

income recipient and the dependents. The tax payer and his wife are getting higher exemption than their dependents in these countries. But in almost all the developing countries where family is specified as the tax paying unit, exemption for family also is provided with on a lump-sum basis without taking the number of dependent children into consideration. Nepal itself falls in the group of such countries. This is done mainly for administrative convenience. In some countries including the U.S.A., additional exemption is provided to the aged and blind persons and exemption is different for earned and unearned income.

In this background, we will make at attempt to find out the answers to the following questions regarding the exemption limit provided under the income tax system of Nepal during the last decade from 1973-74 to 1983-84.

a. Has the poverty norm been taken into account while determining the exemption limits for various tax paying units under the income tax system of the country? or

b. Have these exemption limits been determined taking into account the prevailing per capita income of the country? and,

c. Have these exemption limits been adequately adjusted to the prevailing price levels during the period?

The case of Nepal will be compared with other countries wherever the relevant data of other countries are available.

2. <u>Income Tax Exemption Limit in Nepal</u> :

<u>Exemption Limit and Poverty Norm</u> :

National Planning Commission of Nepal has determined the poverty norm of Nepal as Rs.2 per head per day at 1976-77 prices.[25] This comes out to be Rs.60 per head per month and Rs.720 per head per annum. In other words, this is the minimum amount of expenditure (income) that is required to get the required callorie intake, of 2256 calories at 1976-77 prices. This is regarded as the dividing or the poverty line. So, if the exemption limit is being determined according to the subsistence principle, the exemption limit should always be equal to or around the poverty norm.

As for example, exemption limit should have been Rs.720 for individuals, Rs.1440 for couples and Rs.4176 for families with 5.8 members(being the family size in Nepal) in 1976-77. In fact however, the statutory exemption limit in 1976-77 was Rs.6500 for individuals, Rs.7500 for couples and Rs.8500 for families. And in 1983-84, exemption limit for unmarried individuals should have been Rs.1381 instead of Rs.15000, and

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25. <u>A Survey of Employment, Income Distribution and Consumption patterns in Nepal</u>, <u>op.cit.</u>, p.110.

for couples Rs.2762 and for families Rs.8010 instead of Rs.20,000 each. If we adjust the poverty norms to the current prices, we would be able to find out the ratio of the statutory exemption limits to poverty norms for different years. For this purpose, we have adjusted the poverty norm measured at 1976-77 prices to the current price prevalent in other years to derive the poverty norms of different years at current prices. And, finally we have calculated the ratio of the statutory exemption limits to poverty norms of different tax paying units for the whole period. The result is presented in Table VI-1.below. In the Table, we find that the ratio of the exemption limits for all types of tax paying units to poverty norms was exceedingly high.

It is seen in the Table that the statutory exemption limits for all the tax paying units was much higher than the poverty norm in all years during the period. Not only that but the multiples have tended to increase. In this also, exemption for individual was as high as 9 times the poverty norm in 1976-77 itself and as high as around 11 times in 1983-84. In other years also it was not less than 7 times the poverty norm. But for families, it was barely 2.5 times as highest in 1983-84 and 1.5 times as lowest in 1974-75. The couples were in between these two extremes. From this, it appears that the individuals have been best-benefitted and

TABLE VI.1

This means that individuals are better treated

Income Tax Exemption Limits as Multiples of the Poverty Norms in Nepal

(1973-74 to 1983-84)

This is an interesting point,

Year	Poverty Norm at Current Price (Rs.)	Individual Limit (Rs.)	Individual Ratio	Couple Limit (Rs.)	Couple Ratio	Family Limit (Rs.)	Family Ratio
1	2	3	4	5	6	7	8
1973-74	605	3000	4.9	4500	3.7	6000	1.7
1974-75	706	4500	6.4	6000	4.2	6000	1.5
1975-76	701	5500	7.8	6500	4.6	6500	1.6
1976-77	720	6500	9.0	7500	5.2	8500	2.0
1977-78	800	6500	8.1	7500	4.7	8500	1.8
1978-79	828	6500	7.8	7500	4.5	8500	1.8
1979-80	909	7500	8.2	10000	5.5	10000	1.9
1980-81	1031	7500	7.3	10000	4.8	10000	1.7
1981-82	1138	10000	8.8	15000	6.6	15000	2.3
1982-83	1300	10000	7.7	15000	5.8	15000	2.0
1983-84	1381	15000	10.9	20000	7.2	20000	2.5

Source : (a) Column 2 is derived from adjusting the poverty norm of 1976-77 by the price index of the respective years.
(b) Column 3, 5 and 7 are taken from Chapter III, Table III.1.
(c) Since poverty norm is on per head basis, column 3 is devided by column 2 to derive column 4, column 2 is multiplied by 2 to devide column 5 to derive column 6 and column 2 is multiplied by 5.8 to devide column 7 to derive column 8. The average family size is Nepal is 5.8.

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families least benefitted in terms of exemption limits compared with the poverty norm. But all the units are enjoying exemption limits at the high level of multiple of the poverty norm.

In India, exemption to tax payers is provided on individual basis. So there are no separate exemptions for unmarried individuals, couples without children and families. This was Rs.15000 for 1985-86,[26] and poverty norm at 1984 prices was Rs.1280 per head per annum and Rs.6400 per family of 5 members per annum.[27] So if the tax payer is single without spouse and without dependent children, the ratio of exemption limit to poverty norm comes out to be 11.7. If a tax payer is a couple without dependents, this ratio comes out to be 5.9 and for a family of 5 members it comes out to be only 2.3. And if there are more than one earning member in a family this ratio would come out to be much higher.[28]

It may be so due to the fact that since poverty norm is a relative issue than the absolute one, it is too low in developing countries. And it is determined only on the basis of the Calorie intake required for subsistence in the case of

26. *Finance Act, 1985*, Ministry of Finance, Government of India, p.XIV.

27. Ojha, P.D., "Trickle down Theory Does not work", *The Economic Times*," June 26, 1986, p.6.

28. Bagchi, Amresh, *op.cit.*, p.735.

are necessary also, e.g., etc. if they are included, full citing the developing countries. But the poverty norm in advanced countries is found to be much higher than that in the developing countries. In the advanced countries, the poverty norm has long ago ceased to reflect a physiological minimum necessary for survival and has become instead a minimal social standard of decency, the life-style that a particular society considers for the minimum qualification for membership[29] of that society.

If any conclusion can be drawn in this regard from the cases of India and Nepal discussed above, it may, obviously, be that income tax exemption limit in developing countries, and presumably in developed countries also has no relation at all with the poverty norm prevalent in the respective countries. Exemption limits are exceedingly higher than the poverty norm. So the exemption limits in any income tax system might have been provided with any other purpose except for subsistence.

Another point of justification for this conclusion is that the continuing exemption is in practice in most of the countries rather than the initial or vanishing exemption as has been mentioned earlier. It means that assessed income up to a certain level is exempted from taxation however may be the level of the assessed income. In other words, even a millionaire enjoys the exemption where continuing exemption system is in practice. If exemption is to be provided for

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29. Scitovsky, Tibor, The Joyless Economy, Oxford University Press, 1977.

subsistence purpose, then initial or vanishing system of exemption had to be, generally, in practice under which whole of the net income is taxable including the amount previously exempted as soon as the assessed income crosses this limit. Because there is no ground to provide exemption to those who have net income in excess of subsistence level if the subsistence would have been the basis of exemption limit. The celebrated Carter Commission on Canadian Taxation also is of this view as has been quoted earlier. Moreover, the exemption limits have been provided ever since the modern income tax system came into existence at the close of the 18th century. At that time there might have been no practice of measuring the poverty norm as it is today, so the income tax exemption limit could not have been determined on the basis of the line called poverty.

Exemption Limit and Per Capita Income :

If poverty norm cannot be the basis of the income tax exemption, the per capita income of the country would provide a good dividing line between the poor and non-poor.[30] The people having income more than this national average may be called relatively rich or at least non-poor and people having income below this average may be called poor. And if income tax is a tax to be paid by relatively rich or non-poor people, then this amount of national average should be the basis of exemption

30. Bagchi, Amaresh, op.cit., p.735.

So called marriage tax.
Also interesting. But note that tax on income unit, not on per capita basis. Moreover children

limit for income tax purpose. But has it ever been so? The answer in case of Nepal is found in Table VI-2 given below.

In the Table, it is seen that the ratio of statutory exemption limit to per capita income for all tax paying units were higher in all years except for families in initial two years. Here also, exemption limit for individual was several times higher than the per capita income than for other tax paying units.

TABLE VI-2

Income Tax Exemption Limits as Proportion of Per Capita Income in Nepal

(1974-75 to 1983-84)

multiple

Same for population figure?

Year	Per Capita Income at Current Price (Rs.)	Exemption Limit as Proportion of Per Capita Income		
		Individual@	Couple@	Family@
1	2	3	4	5
1974-75	1224	3.7	2.4	.8
1975-76	1240	4.4	2.6	.9
1976-77	1184	5.5	3.2	1.2
1977-78	1296	5.0	2.9	1.1
1978-79	1427	4.6	2.6	1.0
1979-80	1474	5.1	3.4	1.2
1980-81	1670	4.5	3.0	1.0
1981-82	1854	5.4	4.0	1.4
1982-83+	1969	5.1	3.8	1.3
1983-84*	2158	6.9	4.6	1.6

+ Per Capita income is revised estimate.
* Per Capita income is estimate.
@ Ratio for individuals has been calculated by the figures of per capita income as given in Column 2, per capita income has been multiplied by two and 5.8 while calculating ratio for couples and families respectively.

Source : For per capita income-central Bureau of Statistics, National Planning Commission, Nepal.

It was as high as 6.9 times in 1983-84 and it was never less than 3.7 times in other years. For couples and families the ratio in 1983-84 was 4.6 and 1.6 respectively. In all earlier years the ratios for all the tax paying units were lower. In other words over the period of time exemption limits have tended to a larger multiple of the per capita income, thereby, eroding the tax base.

In absolute terms, if per capita income has to be the basis of exemption limit, it would be only Rs.2158 instead of Rs.15000 for individuals, Rs.4316 for couples and Rs.12,516 for families instead of Rs.20,000 each in 1983-84.

Before hastening to any conclusion, it would be useful to look at the situation prevailing in other countries. However, the recent data on statutory exemption limits of other countries excluding India are not readily available, but whatever data have been available to us, throw enough light on the case at hand. Data are presented in table VI-3.

The table shows that the proportion of the income tax exemption limit for a family with two children to per capita income is generally less than one in advanced counteies. The proportion varies from 0.3 in Australia and West Germany to 0.7 in Japan, whereas in developing countries the proportion is exceedingly high. It is as high as 7.8 in India, 6.7 in Pakistan and 6.6 in Nepal. The reason for this may be that

Must report Bangladesh. Because equally poor neighbour

SAARC Countries?

TABLE VI-3

Income Tax Exemption and Per Capita Income of Selected Countries (As of 1977-78). — for individual / couple / married? multiple

S. N.	Country	National Currencies	Exemption Limit	Per Capita Income	Exemption Limit as Proportion of the Per Capita Income
1	2	3	4	5	6
1.	Australia	Dollar	1790	6336	0.3
2.	Canada	Dollar	5120	8941	0.6
3.	Denmark	Kroner	21600	53894	0.4
4.	France	Franc	15200	35392	0.4
5.	W.Germany	Deutsche Mark	6058	19517	0.3
6.	Japan	Yen	116000	1641173	0.7
7.	England*	Sterling Pound	1815	3615	0.5
8.	The U.S.A.	Dollar	4700	10630	0.4
9.	India ==	Rupee	Individual 12000	1536	7.8
10.	Malaysia	Ringgit	2000	2398	0.8
11.	Pakistan	Rupee	13500	2016	6.7
12.	Singapore	Dollar	4500	4000	1.1
13.	Srilanka	Rupee	4800	913	5.3
14.	Thailand	Baht	14000	8796	1.6
15.	Nepal	Rupee	8500	1296	6.6

* As of 1979-80;
== As of 1980-81;

for family

Source : Bagchi, Amresh, op.cit., p.734.

Has done well in relation to comparable countries.

per capita income is too low but income tax exemption is too high in developing countries and vice versa in the case of advanced countries. So, though it may be said conclusively from Table VI-3 that the proportion of exemption limit to per capita income is less than one in advanced countries and more than one in developing counteies, the variation among them does not allow us to conclude that the income tax exemption forms some particular multiple of per capita income in both types of countries. Rather it is as similar as the relation between exemption limit and poverty norm. On the basis of this it may be stated as a conclusion that income tax exemption is being determined neither on the basis of poverty norm nor on per capita income not only in Nepal but all over the world. It might have been determined randomly or by looking at the limits prevailing in other countries at the most, while introducing the tax system first of all and since then it has been continuing till now with minor adjustments from time to time.

Higher exemption limits in developing countries seem also to be on the ground of administrative consideration and ever rising prices. Tax administration in these countries is not as efficient as in developed countries. Further, the tax compliance ratio also is not satisfactory.

Inflation and Income Tax Exemption :

On whatever ground the exemption limit might have been determined in the initial stages we have been taking it for granted. But whether the exemption limits in real terms have been maintained in the face of rising prices over the period is a matter of everyone's concern. This is because as nominal incomes rise with inflation, tax payers are pushed up into higher rate brackets, even though their real income does not change. Not only this, the persons who were below the exemption limit previously cross this limit and become liable to income tax because of rise in money income due to inflation. Thus a household with constant real income finds itself paying a higher tax.[31] In other words, the persons who are already paying tax move into higher rate brackets and pay more tax and the persons who were just below the exemption limit and hence were not paying tax, cross this limit and become liable to tax even without any change in their real income due to inflation. So it results in hardship to the people if this erosion of real disposable income is not adequately compensated from time to time. And one important way to do it, is the scaling-up of the exemption limit in accordance with the rate of inflation.

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31. Musgrave, R.A. and Musgrave, P.B., The Public Finance in Theory and Practice, op.cit., p.386.

So, here we examine the case of Nepal as to whether the exemption limit has been adequately adjusted to inflation or not during the period from 1974-75 to 1983-84. In other words, whether the exemption limit in real terms prevalent during 1973-74 has been maintained during this period or not. For the purpose, we have deflated all the nominal exemption limits of later years to 1972-73 price index on the basis of which exemption limit for the year 1973-74 is determined. So the price index lags behind exemption limit by one year. Another reason behind this lagging is that income of 1972-73 is taxed only in 1973-74. So price index of 1972-73 is applicable to the tax structure of 1973-74. Then we have taken the proportion of the exemption limit prevailing during these years as deflated to 1972-73 prices to the exemption limit prevailing in 1973-74. This gives us the measure of indexation where a measure of 1 might be treated as signifying full-indexation, a proportion of less than 1 as indicative of under indexation and more than 1 of over-indexation.

In this manner we have calculated the indexation for the period of the years from 1974-75 to 1983-84 for individuals, couples and families. The result is presented in Table VI-4 below.

In the Table we find that exemption limits for individuals and couples have been over-indexed significantly throughout the period. But this limit for families has been under-indexed in

TABLE VI-4

Income Tax Exemption Limit and Degree of Indexation in Nepal

(1973-74 to 1983-84)

Year	Consumer Price Index 1972-73=100	Exemption limit at Current Price(Rs.)			Exemption limit at 1972-73 Prices(Rs.)			Degree of Indexation			Degree of under/over Indexation		
		Indi-vidual	Couple	Family	Indi-vidual	Couple	Family	Indi-vidual	Couple	Family	Indi-vidual	Couple	Family
1	2	3	4	5	6	7	8	9	10	11	12	13	14
1973-74	100.00	3,000	4,500	6,000	3,000	4,500	6,000	1.00	1.00	1.00	0	0	0
1974-75	118.20	4,500	6,000	6,000	3,807	5,076	5,076	1.27	1.13	0.85	.27	.13	-0.15
1975-76	138.00	5,500	6,500	6,500	3,985	4,710	4,710	1.33	1.05	0.78	.33	.05	-0.22
1976-77	137.00	6,500	7,500	8,500	4,744	5,474	6,204	1.58	1.22	1.03	.58	.22	.03
1977-78	140.70	6,500	7,500	8,500	4,620	5,330	6,041	1.54	1.18	1.01	.54	.18	.01
1978-79	156.40	6,500	7,500	8,500	4,156	4,795	5,435	1.38	1.06	0.90	.38	.06	-0.10
1979-80	161.80	7,500	10,000	10,000	4,635	6,180	6,180	1.54	1.37	1.03	.54	.37	.03
1980-81	177.60	7,500	10,000	10,000	4,223	5,631	5,631	1.41	1.25	0.94	.41	.25	-0.06
1981-82	201.40	10,000	15,000	15,000	4,965	7,448	7,448	1.65	1.65	1.24	.65	.65	.24
1982-83	222.40	10,000	15,000	15,000	4,496	6,745	6,745	1.50	1.50	1.12	.50	.50	.12
1983-84	254.00	15,000	20,000	20,000	5,905	7,874	7,874	1.97	1.75	1.31	0.97	.75	.31

Source : For Price index -

a. Quarterly Economic Bulletin, Mid October 1983 to January 1984, Nepal Rastra Bank, Kathmandu, p.40.

b. Economic Survey, 1984-85, H.M.G. of Nepal, Ministry of Finance, Kathmandu, p.61.

Note : a. Columns 3,4 and 5 are taken from Chapter III, Table III.1 .

b. Columns 6,7 and 8 are derived by deflating the respective statutory exemption limits at current prices to the price levels of 1973-74 (1972-73).

c. Columns 9,10 and 11 are derived by deviding the respective figures of columns 6,7 and 8 by respective exemption limits of 1973-74.

d. Columns 12,13 and 14 are derived by deviding the respective figures of latter years of columns 9,10, and 11 by the figures of 1973-74 of the same columns 9,10 and 11.

e. Price index of respective earlier year is applied to the exemption limits of latter year to make the price index and exemption limits comparable.

four out of ten years. In the remaining six years also, the over-indexation is far less for families than for individuals and couples. So the increase in exemption limits during the decade has benefitted the individuals most and families least. In other words, the individuals and couples have been provided with higher level of exemption limits in real terms throughout the period as compared to that in 1973-74 whereas the families have been provided with lower level of exemption limit in real terms in four out of ten years as compared to that in 1973-74. This may not be the result of deliberate action on the part of the government. This is rather the consequence of the adjustment of exemption limits on adhoc basis without taking its end result upon the various tax paying units into consideration.

To conclude the chapter, it may be stated that income tax exemption limit has been determined neither on the basis of the poverty norm nor on the basis of the per capita income. It must have been, perhaps, randomly determined while introducing the income tax system in the country. And this has been continuing till now and will be continuing in the days to come with some adjustments from time to time in the face of inflation. But such adjustment also seems to have been made basically in line with the original design resulting, thus, in benefitting individuals and couples more and causing harm, sometimes, to families. Here then, there is scope for a scientific formulation of the exemption limits, which appear to be on the high side.