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CHAPTER IX

MAIN FINDINGS OF THE STUDY AND THE RECOMMENDATIONS FOR THE TAX REFORM

1. Main Findings :

Taxation of income is an important fiscal instrument for resource mobilization because it is directly associated with the economic levels of the people. It is also equally important for mitigating the inequalities in income distribution because it is progressive in nature. It is also a useful fiscal weapon to encourage certain kinds of savings and investments by way of granting deductions and concessions while computing the tax. So this tax assumes an extremely important position in the revenue structure of the developing countries where revenue needs of the government are enormous, inequalities in income distribution are glaring and enhancement of the domestic savings and investments is extremely essential.

But at the present moment this tax does not appear to have performed so satisfactorily in almost all the developing countries. Nepal's case in this regard is even more unsatisfactory. Revenues from taxation on personal incomes and corporate profits constituted only 10.6 per cent of the total tax revenue, 8.6 per cent of the total revenue and 0.8 per cent of the GDP in 1983-84 in Nepal.

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Built-in-Responsiveness and Buoyancy :

So far as the efficiency of the existing personal income taxation as measured in terms of built-in-responsiveness and buoyancy in relation to tax base and GDP is concerned, it has come out to be satisfactory. As tax to GDP built-in-responsiveness for the periods 1973-74 to 1975-76 and 1980-81 to 1982-83 are more than unity (2.01 and 1.26 respectively). But tax to GDP built-in-responsiveness during the earlier period was high due to high tax to base built-in-responsiveness during that period and tax to GDP built-in-responsiveness during the latter period was high due to high base to GDP built-in-responsiveness during that period. Base to GDP built-in-responsiveness during the earlier period and tax to base built-in-responsiveness during the latter period were low (0.27 and 0.45 respectively).

So far as the buoyancies of the personal income taxation in relation to tax base and GDP during both the periods are concerned, they are high. But tax to GDP buoyancies during both the periods are high (2.52 and 2.76 respectively) due to excessively high tax to base buoyancies during both the periods, that is, 4.09 and 4.58 respectively. Base to GDP buoyancies are far low during both the periods, that is, 0.62 and 0.60 respectively. This means that the changes in tax structure have been focussed mainly on raising revenue from the tax base than on widening the tax base in relation to the GDP.

So, in such a situation, even though the efficiency of the personal income taxation to generate revenue in relation to GDP is reasonably good, this tax system can not mobilize considerable amount of revenue due to too narrow a tax base. So, the broadening and deepening of the tax base are essential for a growing economy like Nepal for resource mobilization.

Impact on Income Distribution :

Data show that the distribution of income is extremely uneven in Nepal. As per the survey conducted by the government, 51.22 per cent of the total sample families have been receiving only 13.19 per cent of the total income whereas 9.83 per cent of the total sample families have been in receipt of 46.81 per cent of the total income. So the progressive income tax in such a situation has an important role to play in reducing the gap between the rich and the poor. It is, of course, true that the progressive income taxation reduces the gap of income distribution only among the tax payers. In this regard, the inequalities in the distribution of income before tax among the tax payers were 0.452 and that of income after tax were 0.375 reducing, thereby, the inequalities by 0.077. This is due to the progressiveness in income taxation. The degree of progression of the personal income tax system effective during the assessment year 1980-81 was 0.389 which was responsible for reducing the inequalities in post-tax income distribution by 0.077.

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But since the income tax base in Nepal is quite narrow due to the exclusion of agricultural income, dividend income, interest income (interest from fixed deposits) etc. from the tax base, lax treatment of salary income and fixing exemption limits too high, the income tax system, however, progressive it may be, can attain only modest results in so far as vertical equity is concerned and remains defective as regards horizontal equity.

Exemption Limits :

Determination of the exemption limits, at too high a level has also made the income tax system less effective in terms of attaining distributive justice and mobilization of resources in Nepal. Taking poverty norms at current prices in the country as the basis for judging the exemption limits, these limits appear to be too high, being 10.9 times for individuals, 7.2 times for couples without children and 2.5 times the poverty norms for family in 1983-84 in Nepal.

Taking per capita GNP at current prices as the basis for judging these limits also, the limits come out to be 6.9 times the per capita GNP for individuals, 4.6 times for couples without children and 1.6 times for families in 1983-84 in Nepal.

Adjustments for Inflation :

The examption limits for different tax paying units have not only been fixed excessively high in comparison to poverty norms and per capita income, but they have also been over-adjusted to the rate of inflation over the period of time. The over-adjustment for individual was 0.97, for couple without children it was 0.75 and for family it was 0.31 in 1983-84. It means that different tax paying units have been enjoying more tax-nil limit in subsequent years than what they had enjoyed in 1973-74 in real terms. So the trend of over-indexation of tax-nil limits in the face of inflation has eroded the tax base considerably in Nepal.

Under the progressive taxation, inflation results in an increase in tax liabilities due to bracket-creeping even without change in income in real terms. So the government adjusts tax structure by way of lowering the marginal tax rates, increasing the width of income slabs, raising the tax-nil limits and increasing the proportion of the personal allowances to neutralize the adverse effect of inflation and to maintain the level of tax burden. The present study shows that the adjustments of tax structure have more than neutralized the effect of inflation over the period. The average tax rates in real terms for all income levels were lower in 1984-85 as compared to 1975-76. But the distribution of benefits of the adjustments in tax structure has been uneven for different real income levels. The middle income groups, namely, Rs.15,500 to Rs.35,500 have benefited the least while the upper income groups have reaped greater benefits.

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Corporation Tax :

Corporation tax has extremely insignificant place in the revenue structure of Nepal. The revenue from this tax constituted 2.4 per cent of tax revenue, 2.0 per cent of total revenue and 0.2 per cent of the GDP in 1983-84. And whatever revenue has been raised from this tax, more than 95 per cent has been raised from only the public enterprises. Private enterprises are almost non-existent in Nepal. And the tax system for corporate sector has also not been formulated in line with the usual norms of this tax prevalent in other countries. The rate structure of corporation tax applies to firms and partnership firms in Nepal except surcharge as against the usual practice of grouping these firms under personal income taxation in other countries. On the other hand, the firms enjoy the tax-nil limit granted to personal income tax payers whereas the partnership firms have been denied the benefit of this limit. The rate structure of corporation tax is more progressive than the rate structure of personal income tax while the usual practice in other countries is that the corporations are taxed at flat rate. And this tax has not been used as a fiscal instrument to promote savings and investments in any desired area of corporate sector.

2. Recommendations for Reform of the Income Tax System in Nepal :

On the basis of the findings of the present study as mentioned above, Income tax system of Nepal requires substantial reforms to make it effective in terms of resource mobilization, distributive justice and promotion of savings and investments. We propose the following reforms.

Widening of the Tax Base :

Under the widening of the tax base we consider the following seven areas : (1) Treatment of Agricultural Income; (ii) Salary Income; (iii) Interest Income; (iv) Dividend Income; (v) Scientific Adjustment of Exemption Limits; (vi) Adjustment for Inflation; and (vii) Tax Paying Units. The recommendations in these regard are made to widen the tax base.

Treatment of Agricultural Income :

Agriculture has a predominant place in the economy of Nepal. Largest share of developmental expenditure has gone to this sector in every successive development plan. But this sector has not contributed to the public revenues in a commensurate manner. Land Revenue is the only source of revenue from this sector. And since land revenue is not directly associated with the income originating in this sector, it is an inelastic source of revenue. It is therefore found that the share of land revenue in the total tax revenue of the government is declining year after year. But making agricultural sector to contribute more revenue to the government by way of taxing its income on par with non-agricultural income is a very complicated task.

Nepal itself tried taxing agriculture thrice in the past, but no attempt could last for more than four years. Here, it should be noted that Nepal is not the only country where taxing agricultural income could not succeed. The problem of taxing agricultural income is equally pronounced in every country. India is an important case in point where agricultural income is out of income tax net despite having several studies and academic discussions on the issue. Even the advanced countries including the U.S.A. have found this income most difficult to tax. So at this stage we do not propose for bringing the agricultural income into the scope of income tax. But keeping the revenue requirements of the government and distributive justice in mind we propose that some additional revenue could be raised by levying tax on certain type of incomes originating in agriculture as follows:

a. The rent in cash or kind received by the non-tiller land lords may be taxed as non-agricultural income. This is no doubt that most of the rentier land lords belong to the top land holding class. And they have been living luxurious life on the unearned rent from their rented out lands. The value of rent so received may be integrated into the total income of the land lords for tax purposes. The rental income may be easier to ascertain than the owner tiller's income because verification of expenses is not required for such incomes. The number of such landlords would not be large to pose an administrative problem. The operational procedures may be evolved easily with the help of District Land Revenue Offices to which all the records of landownership belong.

b. Another way of taxing agricultural income may be the tax on income arising from plantations. This may include tea plantation, sugarcane plantation, large scale orchards, jute and ginger farming; etc. There are several such plantations in Nepal and they can be a source of revenue.

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Salary Income :

It has been discussed in Chapter IV that the salary income has been treated in extremely lax manner and even the field tax offices have not maintained any records regarding the salary income for tax purposes. Such a lax treatment of salary income has contributed to the further erosion of aggregate income tax base in Nepal. In a growing economy like Nepal where the activities of the government and the magnitude of private sector are expanding rapidly, salary income should constitute an important source of government revenue. So we propose that salary income also should be treated as strictly as incomes from other heads. For this, up-to-date records of at least officer level employees in public as well as private sector should be maintained and should be assessed regularly.

Income tax Act has defined the perquisites provided by the employer as remuneration income. But the Act has not specified the types of perquisites to be included in the remuneration income. Due to this, perquisites are being ignored altogether while computing income of the salary earners. Accomodation facility or allowance is an important case in point. So the Act should clearly specify the perquisites which are to be included in the salary income and should also be put into practice.

Interest Income :

Interest from saving deposits is being included into the total income as income from other sources but interest from fixed deposits is being taxed separately in Nepal. Such differential treatment of interest from different types of savings has also caused the erosion of the tax base on the one hand, and has blunted the progressiveness of the tax system on the other. So we propose that such tendency of making the income tax system schedular instead of unitary should be discontinued and interest from fixed deposit should be integrated into the total income for income tax purpose. Such integration is essential in terms of revenue as well as distributive justice.

Dividend Income :

Dividend income is tax exempt in Nepal as has been discussed earlier. This is an unusual case in taxation. The usual practice elsewhere is that dividend income is included in the total income of the shareholders for personal income tax purpose. Promoting the investments in equity shares might be the objective of such exemption of dividend income. But this is not an ideal way of promoting the investment. People who have invested in fast growing and profit making companies have reaped large benefits without contributing any revenue to the government. There are other ways of promoting the investments in the desired field of economic activities which will be discussed later on. Here, we propose that the practice of exempting dividend income from taxation should be abolished and this should be integrated into the total income of the shareholders for income tax purpose.

Scientific Adjustment of the Exemption Limits :

Exemption limits have been determined several times higher than the poverty norms and per capita income prevalent in the country as has been discussed in chapter VI of this study. The individuals have been most benefited and the families least benefited from the present structure of the exemption limits as we saw earlier. The subsequent adjustments in these limits to neutralize the effect of inflation have been far more than the rate of inflation. So fixing the exemption limits too high and over-adjustment for inflation have contributed to the erosion of tax base on the one hand, and fixing them on ad hoc basis has resulted in the uneven distribution of tax adjustment benefits on the other. So we propose that the exemption limits should be restructured taking the poverty norms or per capita income into consideration. The exemption limits should not be too high in relation to poverty norms or per capita income. And difference among the tax paying units should be determined on the basis of the estimated living costs involved in each tax paying unit. And the limits should be adjusted only in line with the rate of inflation.

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Adjustment for Inflation :

It is a well-accepted fact that the progressive income tax structure should be adjusted for inflation from time to time to prevent the bracket-creeping from taking place but such adjustments should be so carried out as to maintain intact the tax burden in real terms and the tax benefits to result from such adjustments should be evenly distributed among the tax payers of different income levels. But the tax structure has been over-adjusted for inflation over the period on the one hand, and adjustment benefits have not been evenly distributed on the other as we discussed in chapter VII of this study. This has cost the government some revenue. So we propose that adjustment for inflation should be made after calculating the likely effects of such adjustments before hand in terms of maintaining the tax burden in real terms and distribution of such benefits. The practice of adjustment on ad hoc basis should be discontinued.

Tax Paying Units :

The current personal income tax system in Nepal has three different tax paying units, namely, unmarried individual, couple without children and family. This has been done so for the purpose of granting the exemption limits. But the couple and family have been provided with the similar exemption limits since as early as 1979-80. So such artificial distinction between couple and family which does not serve any practical purpose should be scrapped and there should be only two taxpaying units, namely, individual and family. And exemption limits should be granted accordingly. As we have seen the partnership firms are taxed as corporations. This should be discontinued and the partners should be either taxed as individuals or as registered firms.

Introduction of New Taxes to Supplement Income Tax System :

Next we consider introduction of related taxes to strengthen the income tax system. Income tax system becomes effective in terms of revenue generation and equity only when all the sources that add to the economic power of the people are made liable to pay tax. Taxing incomes from some sources and exempting others are reasonable neither on revenue ground nor on the ground of equity. So we propose the introduction of the following new taxes to supplement the income tax system which would be useful for revenue purposes as well as for equity. These are the tax on capital gains, wealth tax and estate duty.

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Tax on Capital Gains :

Although the existing Income Tax Act of Nepal has included the 'gains' into the incomes from Industry, Business, Profession or vocation, the Act has not elaborated and specified the term 'gains' any further. Nor it has given any procedure to compute the gains for tax purposes. So, in practice, it appears that income from gains has remained altogether ignored. As a result of this there might have been leakages of revenue of not insignificant amount. So we propose that capital gains should be made a separate head for income tax purposes and every monetary receipt arising from the gains from capital assets transactions should be made chargeable to tax. For the purpose, the profits or gains arising from the transfer by way of conversion by the owner of a capital asset into ? or its treatment by him as stock-in-trade of a business carried on by him should be made chargeable to income tax. Since this tax will be new for both

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the tax authorities as well as for the tax payers, the capital assets chargeable to tax on their gains should be clearly identified, exemptions and deductions should also be clearly specified. And computational procedures should be made simple.

Wealth Tax :

Incomes as regular flow of cash are taxed whereas accumulated income, that is, wealth, has remained untaxed under the existing tax system of Nepal. This also has resulted in the revenue loss to the government on the one hand, and has also defeated the equity aspect of the whole tax system on the other. So far, only urban house and land are being taxed among several other forms of wealth. All other forms of wealth have remained completely untaxed. Such blanket exemption of wealth from taxation must have cost a considerable amount of revenue to the government. And from equity stand point also such exemption can, by no means, be justified. So we propose that a separate tax on wealth should be introduced in Nepal. All forms of wealth should be clearly specified for tax purposes and procedures of valuation of wealth should be made simple. Some types of wealth may be granted exemption and exemption limit may be fixed relatively high in the initial stages and the rates of taxation should be moderate.

Estate Duty :

Inheritance is yet another source by which economic power of a person is enhanced without making any effort.

This transfers the accumulated economic power from one generation to another maintaining thereby the level of affluence of the family. So such transfer of affluence should be taxed whenever the transfer takes place after the death of wealth owner on both revenue as well as on equity ground. But no such tax exists so far in Nepal. Under the existing system, the only charge to be paid at the time of transfer of wealth is the transfer charge which is insignificant as compared to the value of property so transferred. So neglect of transfer of economic power by this way must have cost considerable amount of revenue to the government on the one hand, and equity has severely suffered on the other. So here we propose the introduction of the 'Estate Duty' in Nepal. The necessary operational procedures for this could be evolved once the will to introduce the tax finds its way.

By supplementing the income tax system by the new taxes as proposed, the tax system can be expected to be effective in terms of resource mobilization as well as in terms of distributive justice. The loopholes contained in the tax system would be considerably plugged.

Besides reorganization of tax base and introduction of new taxes, restructuring of existing income tax system also has important bearing on mobilizing the resources effectively. In this regard we propose the following changes.

Income Slabs and Tax Rates :

Presently there are nine income slabs including tax-nil slab in the income tax system of Nepal. And the marginal rates range from 10 per cent to 55 per cent. Since the number of income slabs is more for middle income level, the tax system is more progressive for this level. The progression does not increase as income level rises higher and higher. So the average tax rates rise faster in the middle income levels than in the upper ones. In view of this, the number of the income slabs are being reduced elsewhere in recent years. For example, the income slabs were reduced to five including tax-nil slab in 1985-86 in India. And there is also a trend to reduce the highest marginal tax rate to 50 per cent. This is in view of the fact that the higher marginal tax rates are often associated with the tendency to avoid and evade tax payment. So we propose that the income slabs should be reduced from nine to six inclusive of tax-nil slab and the highest marginal tax rate should be reduced from 55 per cent to 50 per cent. This would ease the administrative burden to some extent and would also help to improve the tax compliance ratio.

Deductions for Savings and Investments :

The existing income tax system of Nepal has granted some personal allowances to salary earners as discussed in Chapter VII but no such specific allowances have been provided to the non-salary earners. The premium paid on life insurance is deductible to a certain limit. The expenses made or donation made for religious or philanthropic purposes are also deductible to a certain limit as has been discussed in chapter III. Among the allowances granted to both types of income earners only the proportion of salary deducted for Provident Fund and premium paid on Life Insurance are intended to promote long-term contractual savings. Since the allowance for Provident Fund is confined only to the salary earners, it has limited scope for promoting savings among other groups. With respect to investment, the tax system has not granted any deduction except investment on government bonds. So the income tax system in Nepal has not been utilised as a fiscal instrument for promoting savings and investments. In view of this, we propose that some sort of a national saving scheme should be evolved and saving to a certain amount made in such schemes should be made deductible for all types of income earners. In such cases the principal amount of saving and interest thereon could be made tax free. The provision could be designed in such a way that the low and middle income groups can reap more benefit from it than the upper income groups. The similar scheme should also be evolved to promote investments by firms. Such provisions would help government to mobilize more resources on the one hand, and encourage low and middle income groups to form the saving habits on the other.

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Reforms of the Corporation Tax :

The tax on corporate profits in Nepal has several unusual features as has been discussed in chapter VIII of this study which are not found in similar tax system in other countries. So, in this regard we propose the following reforms:

i. The firms and partnership firms which are treated as corporate bodies for tax purposes should be taken out of the corporate sector and should be included in the personal income tax system. And the exemption limit, income slabs, and marginal tax rates of personal income taxation should be applied to them.

ii. The existing progressive rate structure of corporation tax should be scrapped and corporate profits should be taxed at a flat rate as is the case elsewhere. The flat rate may be made different from public and private companies and industrial enterprises and non-industrial enterprises. The rate of corporation tax should not exceed 50 per cent.

iii. The corporation tax also has not been utilised as a fiscal instrument to channelize the investment into desired areas. So we propose that deduction of certain proportion of investment made in installing the new plants or machinery should be granted to at least industrial enterprises in line with the investment allowance granted under the Indian income tax system. Such provision would provide entrepreneurs, tax free amount to some extent for investment in industrial enterprises.

3. Recommendations for Administrative Reforms :

This is a dissertation on Economics as such the administrative reforms, though important in practice, fall outside its scope. Therefore only very briefly and in an indicative manner the administrative reforms in the Nepalese tax system are suggested to make the income taxation more effective. Our recommendations pertain to : (i) Administrative Arrangement (ii) Reform of Assessment Method, (iii) Penal Provisions, and (iv) Statistics.

Separate Department for Direct Taxation :

Currently, the existing Department of Taxation deals with Sales tax besides income tax and other minor taxes. Since Sales tax is the second largest source of government rèvenue , it must be occupying much of the attentions of this Department and income taxation must have been receiving less attention than what it deserves. And such divided attention must have some revenue implications. So we propose that the existing Department of Taxation should be split into two Departments and Sales tax should be handled by a separate Department. And the new taxes as proposed earlier would come under the existing Department of Taxation. The introduction of the proposed taxes also necessitates the separation of Sales tax from this Department. This Department could be called 'Department of Direct Taxation'.

Reforms in Assessment Method :

About 3/4 part of the total number of assessments of personal income taxation is done by applying presumptive or best-judgement method of assessment. This method of assessment is prone to evasion of tax through the clandestine agreement between the tax authorities and tax payers. Besides revenue implications, this assessment method discourages the tax payers from maintaining any accounts of their transactions. So we recommend that the maintenance of accounts which is already compulsory but is observed more in breach than in confirmation should be made effective by strengthening the penal provisions. The presumptive method of assessment should play a gradually diminishing role.

Uniform Accounting Year :

The system of following different accounting years for income tax purposes has created considerable administrative complications in the administration of tax. So we propose that such a system of following different accounting years by different tax payers or even by the same tax payer for different sources of income should be abolished. And the system of following the uniform accounting year should be introduced. Such year may be either calender year or government's financial year. In this regard the government's financial year would be more preferable. In India also, the system of following uniform accounting year has been recently proposed.

Penal Provisions :

The Act has fixed the amount of penalty for non-maintaining the books of account as per law up to Rs.5,000. The minimum amount falls within discretion of the tax officer. So there is no likelihood for tax payers to pay any substantial amount of penalty even if they violate the law when they take the tax authorities into confidence. It is therefore proposed that the penalty be made increasing proportional to the amount of assessed income involved. It means that the penalty should be made progressive.

Maintenance of Statistics :

The figures involved in the assessment of tax are useful for various types of studies and they serve over a long period important administrative objectives. So the maintenance of such information on a regular and systematic basis is essential. The system of statistical compilation is still rudimentary in Nepal. For example, there are no statistics about total income, assessed income, incomes from different occupational sources, salary incomes, types of assessees and their income brackets. So we propose that the record keeping system should be divided broadly into two parts, namely, corporate and non-corporate taxation.

The data according to the heads of income as mentioned in the Act such as income from Agriculture, Industry, Business, Profession or Vocation, Remuneration, House Rent, and Income from Other Sources should be presented under each tax paying unit. The nature of the data to be maintained should be tentatively as follows:

i. Amounts of total income;

ii. Amounts of different types of deductions separately;

iii. Amounts of assessed income;

iv. Amounts of tax demand;

v. Amounts of disposable income;

vi. Amounts of actual tax collection (The amounts of fee, charge, and penalty should be presented separately from the collection);

vii. Number of tax payers in different tax paying units under different income heads;

viii. Number of returns filed during the year;

ix. Number of returns assessed during the year;

x. Number of regular tax payers who did not furnish their returns within the given time;

xi. Number of arrears of assessment left at the end of the year;

xii. Arrears of tax collection at the end of the year.

The types of data mentioned above should be maintained in the Department of Taxation and should be published annually in a classified form or at least classified and kept in records for departmental use.

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recommendations