

CHAPTER I

SETTING OF THE PROBLEM

Socio-Economic Indicators

Nepal falls into the group of the least developed countries among the community of Nations. With an annual per capita income of U.S.\$160 in 1984 Nepal ranks 123 among 128 countries listed in the World Development Report 1986. Its economy is heavily dependent upon agriculture. Even considering 36 low-income economics whose GNP per capita as a group in 1984 was \$260, Nepal turns out to be an extremely poor country. The GNP per capita increased at a sluggish rate of 0.2 per cent during the period 1965-84 whereas that of the countries falling in this group was 2.8 per cent. The percentage of urban population was only 7 as against 23 for this group. Labour force engaged in agriculture was 93 per cent in 1980 in Nepal as against 70 per cent for the group. The share of agriculture in GDP was as high as 56 per cent in 1984 as against 36 per cent for this group. Agriculture contributed 60 per cent to its foreign trade.

Life expectancy in Nepal is only 47 years as compared to 60 among the 36 low-income countries as a group. Its population is increasing at a high rate of 2.6 per cent

per annum during 1973-84. Nepal has mortality rate of 18 per thousand. Each physician had to provide service to 30060 persons in 1981 in Nepal whereas in the 36 low-income countries as a group this figure was 5375 persons. Infant mortality rate was 135 in 1984 as against 72 for the group. We thus see that all the important socio-economic indicators for Nepal point towards the extreme state of its under-development.

The main reason for this dismal economic picture is the late start of its modernization. Its doors to the outside world were opened only in 1950^s. Before that for centuries it was an isolated land-locked country. Attempts for economic development were started only since the close of 1950^s. Country's first annual government budget was introduced in 1952 and the first development plan was formulated in 1956. But due to virtual absence of the required infrastructure for development, the pace of development was rather slow in the early years of the developmental efforts.

Table I.1

Important Socio-Economic Indicators of
Nepal and 36 Low-Income Economies

Indicator	Nepal	36 Low-Income Economies
1	2	3
GNP per capita U.S.\$ (1984)	160	260
Average Annual Growth Rate in GNP per capita (1965-84)	0.2	2.8
Percentage of urban population	7	23
Percentage of Labour Force in Agriculture (1980)	93	70
Share of Agriculture in GDP (1984)	56	36
Daily Calories supply per capita (1983)	2047	2336
Fertilizer Consumption (100 gms of plant Nutrient per hectare of Arable Land)	137	661
Life Expectancy at Birth (1984)	47	60
Annual Rate of Growth of Population (1973-84)	2.6	2.0
Mortality Rate Per 1000 (1984)	18	11
Population Per Physician (1981)	30060	5375
Infant Mortality Rate (1984)	135	72

Source : World Development Report 1986, World Bank,
 Washington D.C.

Resource Position of Nepal :

Due to the paucity of internal resources, the early development plans and government budgets were heavily dependent upon foreign grants and loans. Domestic resources were insufficient even for meeting the regular expenditure of the government during the First Plan (1956-61). During the Second Plan (1962-65) only 23 per cent, during the Third Plan (1965-70) 47 per cent, during the Fourth Plan (1970-75) 41 per cent and during the Fifth Plan (1975-80) only 33 per cent of total plan outlay were financed through domestic resources.

During the Sixth Plan (1980-85) only little more than fifty per cent of the Plan out lay was expected to be raised from the domestic sources. Thus although the reliance on domestic sources for the financing of the development plans of Nepal has been increasing, the gap between the plan needs and the domestic resources is still very large. Satisfactory growth of the Nepalese economy is crucially dependent on the mobilization of domestic resources.¹

The Table I.2 below clearly shows the government revenue and expenditure trend for the last two decades from 1964-65 to 1983-84. We find in the Table that the total

1. Agrawal, G.R., Resource Mobilization in Nepal,
Centre for Economic Development and Administration,
Kirtipur, Nepal, 1980, p.3.

government revenue increased from Rs.192 millions in 1964-65 to Rs.1008 millions in 1974-75 and to Rs.3409 millions in 1983-84, the net increase being Rs.816 millions in 1974-75 and Rs.3217 millions in 1983-84, whereas the net increase in government expenditure was Rs.1164 millions in 1974-75 and Rs.7087 millions in 1983-84. It implies that the net increase in government expenditure is more than double the net increase in government revenue in 1983-84. As a result of this much faster rate of growth of government expenditure as compared to that of revenue, the resource gap has been widening alarmingly year after year which was Rs.158 millions in 1964-65, Rs.505 millions in 1974-75 and Rs.4028 millions in 1983-84. The increase in the gap during the last 3 years from 1981-82 to 1983-84 is more striking during which the gaps have exceeded even the total revenue of the government.

By looking at this Table it also appears that the spectacular growth in the government expenditure has resulted from the enormous increase in the development expenditure of the government in recent years. As the figures show that the increase in the development expenditure in 1974-75 over that of 1964-65 was little more than 4 times while it increased by little more than 5 times in 1983-84 over that of 1974-75 whereas the increase in regular expenditure in 1983-84 over that of 1974-75 was only little more than 4 times.

TABLE I.2

Government Revenue and Expenditure in Nepal

(1964-65 to 1983-84)

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Year	Total Revenue	Expenditure		Resource Gap	Foreign Sources		Internal Sources		
		Total	Regular		Total	Grants	Loans		
								Develop- ment	
1	2	3	4	5	6	7	8	9	10
1964-65	192	350	118	232	-158	147	141	6	11
1969-70	464	684	219	465	-220	251	244	8	-32
1974-75	1008	1514	547	967	-505	387	283	104	119
1979-80	1880	3471	1162	2309	-1591	1341	806	535	250
1980-81	2419	4092	1361	2731	-1673	1562	869	693	111
1981-82	2680	5361	1634	3727	-2682	1723	993	730	959
1982-83	2842	6979	1997	4982	-4138	2076	1090	986	2062
1983-84	3409	7437	2274	5164	-4028	2547	877	1671	1480

Sources : (a) Budget in Nepal (1951-52 to 1981-82), HMG of Nepal, Ministry of Finance, Revenue Administration Training Centre, Kathmandu, 1982.

(b) Budget Speeches, HMG of Nepal, Ministry of Finance, Kathmandu, 1982-83, 1983-84 and 1984-85.

N.B. : (a) Internal sources refer to domestic borrowing and deficit financing.

(b) Regular expenditure refers to current account expenditure in Nepal.

(c) Figures given in the Table are rounded up.

If we look at the sources for meeting this gap, we find that foreign sources have played major role in bridging this gap throughout the period except during recent 3 years, that is, 1981-82 to 1983-84 during which internal sources have contributed more than half of the total gap.

In foreign sources, foreign grants had been contributing lion's share till the year 1974-75. But since 1979-80 foreign loans have been increasing enormously whereas foreign grants have remained either static or even declined in terms of GDP (Table I.3) although foreign grants still exceed foreign loans except in the year 1983-84 in which foreign loans have exceeded the grants. The consistent increase in the foreign loans in financing the development provides the danger signal in terms of the problem of debt servicing in the coming years.

Sources of Government Revenue in Nepal

During the last decades from 1964-65 to 1983-84 the tax revenue has constituted more than 80 per cent of the government's total revenue in Nepal. In tax revenue, indirect taxes have contributed more than 75 per cent of the total tax revenue since the year 1974-75. Attention is invited to Table I.5 and I.6.

In terms of Gross Domestic Product (GDP) the tax revenue constituted less than 3 per cent of GDP in 1964-65, around 5 per cent in 1974-75, around 6 per cent in 1979-80

TABLE I.3

Government's Resource Gap as Percentage
of Gross Domestic Product in Nepal

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(1964-65 to 1983-84)

Year	Total Revenue as Percentage of GDP	Total Expenditure as Percentage of GDP	Resource Gap as Percentage of GDP	Foreign Sources as Percentage of GDP	Foreign Grants as Percentage of GDP	Foreign Loan as Percentage of GDP	Internal Sources as Percentage of GDP
1	2	3	4	5	6	7	8
1964-65	3.4	6.2	2.8	2.6	2.5	0.1	0.2
1969-70	5.3	7.8	2.5	2.9	2.8	0.1	-0.4
1974-75	6.1	9.1	3.1	2.3	1.7	0.6	0.7
1979-80	8.1	14.9	6.8	5.7	3.5	2.3	1.1
1980-81	8.9	15.0	6.1	5.7	3.2	2.5	0.4
1981-82	8.7	17.3	8.7	5.6	3.2	2.4	3.1
1982-83	8.4	20.7	12.3	6.2	3.2	2.9	6.1
1983-84	8.9	19.5	10.6	6.7	2.3	4.4	3.9

Sources : Calculated from Table I.2 and I.4.

and since then it has contributed a little more than 7 per cent (Table I.7). Direct tax revenue has constituted less than 2 per cent of the GDP during the whole period till 1982-83. Indirect taxes constituted less than 2 per cent of GDP in 1964-65 and continuously kept on rising to around 4 per cent in 1974-75 and to around 5.5 per cent towards the close of the period under review. From this, it becomes clear that indirect taxes have played pivotal role in the revenue expansion.

Revenue from Income Tax:

The share of personal income taxation is around half of one per cent of the Gross Domestic Product during the larger part of the period. Its share when combined with corporate taxation was 0.3 per cent in 1974-75 whereas the share of the personal income taxation alone was 0.6 per cent in 1983-84 (Table I.7).

In terms of total revenue, the share of income taxation including corporate taxation was 4.7 per cent in 1974-75 whereas in 1983-84 the share of this tax was 6.6 per cent and corporate tax revenue was 2 per cent (Table I.5).

In terms of total tax revenue also, the share of the personal income taxation combined with corporate taxation was 5.6 per cent in 1974-75. Personal income taxation constituted 8.2 per cent and corporate tax constituted 2.4 per cent of the total tax revenue in 1983-84 (Table I.6).

However, income tax has occupied an important place in direct tax revenue in recent years. Until 1974-75 land revenue used to constitute the largest share in direct tax revenue but since 1981-82 personal income taxation alone constitutes little more than 31 per cent of the tax revenue whereas the share of land revenue has declined to only 11.4 per cent of direct tax revenue in 1982-83 and 10.9 per cent in 1983-84.

Although from the study of the Tables from I.4 to I.7 as mentioned above, it appears that income tax revenue constitutes rather small share in the revenue structure of Nepal, if we look at the growth rate of the revenue from different taxes we find that the revenue from this tax has been increasing at the highest rate as compared to any other single tax, direct or indirect over the period. For instance, revenue from this tax increased by 787 per cent in 1974-75 over that of 1964-65 and by 519 per cent in 1983-84 over that of 1974-75 (Table I.4) which are the highest rates of growth for both the periods as compared to those obtained for any other single tax. So, since the taxation on income is directly related with the over all development particularly with the economic growth of the country, it contains highest revenue potential in the growing economy like Nepal.

Government Revenue in Developing Countries :

It is, of course, well known that the developing countries mobilize proportionately far less revenue from the

TABLE I.4

Sources of Government Revenue in Nepal
(1964-65 to 1983-84)

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Year	GDP at Current Price	Total Revenue	Total Tax Revenue	(Rupees in Millions)										Non-Tax Revenue
				Total	Indirect Taxes	Direct Taxes			Total	Personal Income	Corporate Income	Land Revenue	Other Taxes	
1	2	3	4	5	6	7	8	9	10	11	12	13	14	
1964-65	5602	192	151	98	83	14	-	54	5	-	43	5	41	
1969-70	8768	464	411	283	194	38	51	129	20	-	88	21	53	
1974-75	16571	1008	843	639	329	120	191	205	47	-	91	67	165	
1979-80	23351	1880	1529	1224	608	215	401	304	63	38	64	139	351	
1980-81	27307	2419	2036	1596	816	242	538	440	101	43	105	191	383	
1981-82	30988	2680	2211	1728	825	306	597	483	152	38	84	209	468	
1982-83	33761	2842	2421	1836	761	366	709	585	185	55	67	278	420	
1983-84	38184	3409	2737	2029	826	432	771	708	224	67	77	340	672	
Percentage variation in 1974-75 over 1964-65	196	425	459	552	294	761	-	282	787	-	110	1190	297	
Percentage variation in 1983-84 over 1974-75	130	238	224	218	151	261	305	246	519	-	-15	406	308	

Sources : (a) For GDP - Central Bureau of Statistics, HMG of Nepal, Kathmandu.

(b) For revenue figures (i) Budget in Nepal (1951-52 to 1981-82), op.cit.

(ii) Budget Speeches, op.cit.

N.B. : (a) Till 1976-77, Corporate tax revenue was included in personal income tax revenue.

(b) Figures given in the Table have been rounded up.

TABLE I.5

Revenues from Selected Tax and Non-Tax Sources as Percentage

of Total Revenue of the Government of Nepal

(1964-65 to 1983-84)

Year	Total Tax Revenue	Indirect Taxes				Total	Direct Taxes			Non-Tax Revenue			Total
		Total	Customs	Excises	Sales Tax		Personal Income	Corporate Income	Land Revenue	Other Taxes			
1	2	3	4	5	6	7	8	9	10	11	12	13	
1964-65	78.4	50.5	43.3	7.2	-	27.9	2.7	-	22.4	2.7	21.6	100.0	
1969-70	88.6	60.9	41.7	8.2	11.0	27.7	4.2	-	18.9	4.6	11.4	100.0	
1974-75	83.7	63.3	32.6	11.9	18.9	20.3	4.7	-	9.0	6.6	16.3	100.0	
1979-80	81.3	69.1	32.3	11.4	21.3	16.2	3.4	2.0	3.4	7.4	18.7	100.0	
1980-81	84.1	66.0	33.7	10.0	22.2	18.2	4.2	1.8	4.3	7.9	15.9	100.0	
1981-82	82.5	64.5	30.8	11.4	22.3	18.0	5.7	1.4	3.1	7.8	17.5	100.0	
1982-83	85.2	64.6	26.8	12.9	25.0	20.6	6.5	1.9	2.3	9.8	14.8	100.0	
1983-84	80.3	59.5	24.2	12.7	22.6	20.8	6.6	2.0	2.3	10.0	19.7	100.0	

Source : Calculated from Table I.4

TABLE I.7

Revenues from Selected Tax and Non-Tax Sources as

Percentage of the Gross Domestic Product of Nepal

(1964-65 to 1983-84)

Year	Total Revenue	Tax Revenue	Indirect Taxes				Total	Direct Taxes		Land Revenue	Other Taxes	Non-Tax Revenue
			Total Customs	Excises	Sales Tax	Personal Income		Corporate Income				
1	2	3	4	5	6	7	8	9	10	11	12	13
1964-65	3.4	2.7	1.7	1.5	0.2	-	1.0	0.1	-	0.8	0.1	0.7
1969-70	5.3	4.7	3.2	2.2	0.4	0.6	1.5	0.2	-	1.0	0.2	0.6
1974-75	6.1	5.1	3.9	2.0	0.7	1.1	1.2	0.3	-	0.5	0.4	1.0
1979-80	8.1	6.5	5.2	2.6	0.9	1.7	1.3	0.3	0.2	0.3	0.6	1.5
1980-81	8.9	7.5	5.8	3.0	0.9	2.0	1.6	0.4	0.2	0.4	0.7	1.4
1981-82	8.6	7.2	5.6	2.7	1.0	1.9	1.6	0.5	0.1	0.3	0.7	1.5
1982-83	8.4	7.2	5.5	2.3	1.1	2.1	1.7	0.5	0.2	0.2	0.8	1.2
1983-84	8.9	7.2	5.3	2.2	1.1	2.0	2.0	0.6	0.2	0.2	0.9	1.7

Source : Calculated from Table I.4

domestic sources than the developed countries. Economists all over the world have reached this conclusion on the basis of empirical studies. As we see in Table I.8 below, the advanced countries mobilized on an average 37.8 per cent of GDP during 1978 to 1981. But mobilization of internal resources in some of the Asian developing countries as percentage of GDP is far less than that of the advanced countries. Malaysia had mobilized the highest percentage of resources (30.2 per cent) whereas the total revenue of the government of India was below 20 per cent and that of Nepal was below 10 per cent. This shows the magnitude of effort required by Nepal on the resource mobilization front. In the same way, Nepal mobilized only 6.7 per cent of the GDP by way of taxation as compared to 9.9 per cent by Burma and 15.9 per cent by India.

Table I.8 also shows the poor state of income taxation in Nepal. India raised on an average 18.4 per cent of total revenue by way of taxes on income and profits during 1980-82. Sri Lanka and Thailand mobilized 15.4 per cent and 19.8 per cent respectively of the total government revenue by way of the same tax during the same period while Nepal appeared to have mobilized only 6.3 per cent of the total government revenue through income taxation.

Such a low tax/GDP ratio is attributable to the predominance of the subsistence economy in Nepal where modern economic activities such as industry, trade, urbanization, etc.

Report the 5 countries that are below Nepal in per cap. inc. and report neighbouring poor countries, e.g., Bangladesh, India, Pakistan, Afghanistan.

TABLE I.8

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Total Government Revenue and Tax Revenue
as Percentage of GDP and Taxes on Income
and Profits as Percentage of Total Revenue
of Selected Asian Countries
(1978 to 1981)

Country	Total Government Revenue as Percentage of GDP	Tax Revenue as Percentage of GDP	Income Tax Revenue as Percentage of Total Revenue
1	2	3	4
Average of Advanced Countries	37.8	32.9	38.7
Burma	16.0	9.9	2.9
India	19.2	15.9	18.4
Malaysia	30.2	-	-
Singapore	25.4	16.8	32.4
Srilanka	22.7	21.0	15.4
Thailand	15.0	13.6	19.8
Nepal	8.2	6.7	6.3

Source : Average calculated on the basis of data given in Government Finance Statistics Year Book, International Monetary Fund, 1984, pp.69-70 and p.40.

N.B. : The figures given in column 4 refers to the period 1980-82.

are much less developed even as compared to the other under-developed countries. Considerable part of the economic activities is still to be monetised and large part of the

commodities do not at all pass through the market. But it does not mean that whatever tax potential exists in Nepal has been fully tapped. The remarks of Dr. R.J. Chelliah for the developing countries that "though many sources of revenue might have been tapped, the system of taxation generally have not been built on sound principles suited to the requirements of rapid economic growth"² holds true with even greater force in ^{the} case of Nepal. ✓

Buchanan and Ellis have pointed out that "while neither ideal equality nor optimum yield may be expected of the tax systems in many countries, the improvement of the revenue systems throughout the underdeveloped world offers one of the greatest unexploited instruments of economic progress."³

Looking at the magnitude of revenue requirements and low tax potential in the developing countries, the cardinal task before them appears to be tapping whatever tax potential exists in these countries if they have to achieve the acceptable rate of growth. But the challenge is formidable. ✓
Because the empirical studies have shown that " a 2.5 per cent

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2. Chelliah, R.J., Fiscal Policy in underdeveloped countries, George Allen and Unwin, India, 1969, p.54..
 3. Buchanan, N.S. and Ellis, H.S., Approach to Economic Development, Twentieth Century Fund, New York, 1955, p.333.

of national income shifts into the government sector for every \$100 gain in per capita gross national product (GNP) in the course of economic development."⁴ And achieving gains of \$100 in per capita GNP in developing countries may take decades. So raising tax/GDP ratio is easier said than done.

But whatever may be the case, Nepal should leave no stone unturned to raise tax/GDP ratio particularly of income tax/GDP ratio in order to keep pace of economic growth with other Asian countries as other Asian developing countries including India, Srilanka and Thailand have been able to achieve on resource mobilization front. For example, India even as early as 1950-51 was mobilizing 1.45 per cent of the GDP at factor cost by way of personal income tax and 0.4 per cent by way of corporation tax. As compared to India of 1950-51 Nepal of 1983-84 was mobilizing only 0.6 per cent of GDP by way of personal income tax and 0.2 per cent by way of corporation tax. In 1950-51, India's agricultural base was not very different from that of Nepal in 1983-84. Though, of course, the corporate sector in India was more developed. It would thus be clear that taxation of income and profits in Nepal have a vast potential.

4. Hinrichs, H.H., A General Theory of Tax Structure Change During Economic Development, Law School of Harvard University, Cambridge, 1966, p.3.

Objectives of the Present Study :

Mobilization of the internal resources, tax as well as non-tax appears to be the cardinal problem before the government of Nepal as we look at the alarming magnitude of the expenditure-revenue gap. It may even result in the slowing down of the pace of development if the gap is not bridged to a considerable extent through the internal sources. But there lies limited scope to raise revenue to any considerable extent through indirect taxes considering their effects on prices and also on equity grounds.

In direct taxes also, taxing agricultural income does not seem to be administratively viable. Land revenue has been relatively declining and inelastic. Though revenue from urban house and land tax has been increasing at faster rate in recent years, it can not constitute a major instrument of mobilization of resources. Therefore, though taxes on income and profits form small share in the total revenue at present, it would appear that they should bear a larger share of responsibilities to finance development in Nepal. Since income and corporation taxes are directly related to the growth of the economy, it should be possible to extract revenue at a significant rate through these taxes.

Mobilization of the resources to finance development should not be the only goal of the tax system. Tax system as an important fiscal instrument should also be able to attain

equity. Emergence of the modern industry, business, profession or vocation paves avenue for greater inequalities in the societies. And indirect taxes can by no means go to that extent to redress inequalities as the progressive direct taxes. In some cases indirect taxes even aggravate inequalities rather than to mitigate them. So in this respect also progressive personal income taxation can go a long way to redress inequalities in the society.

Taking these issues into consideration, this study is primarily concerned with the following objectives.

- a. To discuss the evolution of the income tax system in Nepal;
- b. To examine the various aspects of the income tax system currently effective in Nepal;
- c. To measure the responsiveness of the income tax revenue to the changes in national income in Nepal;
- d. To examine the pros and cons of the corporate tax system in Nepal along with its revenue productivity;
- e. To make an attempt to establish the theoretical basis of determining the basic exemption limits granted under the income tax system on the basis of these limits prevalent in Nepal during the last decade.
- f. To measure the impact of inflation upon the personal income tax payers of different income levels during last decade along with the measurement of the effects of the compensatory measures taken by the government from time to time;

- g. To measure the redistributive impact and degree of progression of the income tax system of Nepal;
- h. To propose various measures for the reformation of the income tax system of Nepal.

The Nature and the Sources of Data :

Since this study deals, mainly, with the government revenue, the data required for this, are available in government publications with a few exceptions. The required data have been taken from the following sources:

1. Budget in Nepal (1951-52 to 1981-82), H.M. Government of Nepal, Ministry of Finance, Revenue Administration Training Centre, Kathmandu, 1982;
2. Statistical Abstract; H.M. Government of Nepal, Ministry of Finance, Department of Taxation, Kathmandu, 1984.
3. Economic Survey, H.M. Government of Nepal, Ministry of Finance, Kathmandu, (Several years);
4. Budget speeches, H. M. Government of Nepal, Ministry of Finance, Kathmandu, (Several years);
5. Finance Acts, H.M. Government of Nepal, Ministry of Law and Justice, Kathmandu, (Several years);
6. Quarterly Economic Bulletin, Nepal Rastra Bank, Kathmandu, (Several issues);

7. A Survey of the Employment, Income Distribution and Consumption Patterns in Nepal, H.M. Government of Nepal, National Planning Commission, Kathmandu, 1977.
8. Government Finance Statistics Year Book, International Monetary Fund, 1984.
9. International Financial Statistics Year Book, International Monetary Fund, 1983.
10. A Review of Central Budget 1986-87, Centre for Monitoring Indian Economy, Bombay, February, 1986.
11. World Development Report 1986, World Bank, Washington, D.C.
12. Besides these, the present study required data on assessed income and tax demand for the estimation of elasticity and buoyancy of the tax revenue and also for the measurement of the redistributive impact of the income tax structure. These data are not available in any publication in Nepal but are being recorded in the ledgers in the Department of Taxation in Kathmandu. So, we copied down these data from those ledgers on the basis of the sampling of 10 per cent of the total income tax assessments for six years from 1973-74 to 1975-76 and from 1980-81 to 1982-83. Data pertaining to four field tax officers were not available even in those ledgers. So, we have collected them from the respective field offices visiting the places personally.

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