

# A Note on Capital Gains Tax for Nepal

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The capital gains tax is direct, and its incidence is progressive. In its essence the income tax discriminates against earned income, hence the capital gains tax mitigates a bias distorting resource allocation. What is equally important, the capital gains tax may constitute a significant source of fiscal revenue.

The imposition of a capital gains tax must, nevertheless, be approached with caution, and requires an in-depth technical study. Nepal has a history of attempts to impose taxes that, after a brief period, had to be eliminated because of administrative difficulties or because of excessive resistance. A capital gains tax is difficult to administer and it may be highly unpopular, and it would be most unfortunate if it were to meet the fate of the house construction tax, the road and bridge maintenance tax, and the tax of interest, to cite just three examples of failure. It is also a question whether the administrative effort required to put into effect a capital gains tax could not, more fruitfully, be directed at the improvement of collection of one of the existing taxes.

The remarks that follow were written after close consultation with Dr. M.K. Dahal of Tribhuvan University, whose help is gratefully acknowledged. Their purpose is to outline the possibilities as well as the difficulties of collecting a capital gains tax, and to identify some major issues that call for further study.

## THE TAX BASE

Given the structure of property holdings, the capital tax should, for the present, be confined to realized appreciation in the value of land and of buildings. In practice the application of the tax would be largely confined to Kathmandu Valley where rapid urbanization results in significant appreciation of real property values.

## THE TIME FRAME

In many countries short-term capital gains are taxed more heavily than gains on property held for long periods of time. However, to simplify the procedure we suggest that the tax be applied uniformly to gains realized on property held for five years or less, and that no tax be applied for property held for longer periods.

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## TAX RATE

To avoid excessive resistance and widespread tax avoidance, the capital gains tax should be quite moderate, and it should not surpass 20 percent or at most 25 percent of the realized capital gain net of registration fees.

## ADJUSTMENT FOR CHANGES IN THE GENERAL PRICE LEVEL

The tax should be imposed on the real appreciation of the value of assets, and not on nominal appreciation caused by changes in the general price level. It is, therefore, recommended that, for tax purposes, the amount of the capital gain be deflated by the change in the consumer price index for the relevant period.

## TAX ASSESSMENT

If a capital gains tax is to be successfully collected, it is imperative that the value of the property being sold be ascertained with reasonable accuracy. Undervaluation of property values to reduce the payment of land and house taxes and of registration fees appears to be, unfortunately, quite widespread. The imposition of a capital gains tax would give yet more incentive to undervalue property.

It is therefore imperative that the property valuation mechanism be strengthened. Appraisals are in principle, to be carried out every five years; in practice, however, they often lag by ten years or more. As a consequence, landlords, especially in the urban areas, pay only a small fraction of the land tax which they would have to pay were their property appraised at current market value.

## CLOSING A LOOPHOLE

Under current rules properties with areas of less than 3,000 feet<sup>2</sup> are not subject to the land and house tax. In urban areas this exemption applies to structures with quite substantial value. To broaden the base of the land tax, and also of the capital gains tax, if the latter is instituted, this exemption should be modified in an appropriate fashion.

## TAX COLLECTION

The capital gains tax, being a direct tax, is normally collected in conjunction with the income tax. In Nepal, however, only some 1 percent of the population pays income tax, and the collection rate appears to be far from satisfactory.

The task of collecting the capital gains tax would impose an additional burden on income tax collectors., and to avoid this imposition we would like to propose a simpler, albeit somewhat unorthodox administrative arrangement.

Capital gains on real property are realized when the property is sold, at which time the registration fee is collected. We propose therefore, that the capital gains tax be determined and collected together with the registration fee. Since, at present there is no coordination between the Tax Office and the Registration Duty Department, such an arrangement would require an administrative change and, perhaps, special legislation.

#### CONCLUDING REMARKS

Administrative weakness is the biggest obstacle to the success of a capital gains tax. The first, essential step is to improve real property assessment and to reduce the loopholes. Such measures would, by themselves, result in the payment of higher land and house taxes and of higher registration fees. Improved administration could also increase the yield of the house rental tax.

With proper assessment and better tax enforcement fiscal revenues would rise, and the burden on the taxpayers would correspondingly increase. Rather than to impose new taxes, which, in the absence of administrative improvements are bound to yield little revenue, it may thus be warranted to direct the major effort in the direction of improved enforcement of the existing tax system. These, and other, considerations should be given close attention by tax experts.

## BOOK REVIEW

Amatya, D.B. (1987); Perspectives in Regional Problems and Regional Development in Nepal (New Delhi: Sterling Publishers), pp. xii + 106, price Rs. 100.00 (I.C.)

The book under review is a worthwhile addition to the occasional publications on Nepalese economy. The book is, nevertheless, more organised and meaningful than the author's previous publication on Nepalese fiscal issue, published a year before the publication of the present book. Further, an appropriate foreword and recommendation of the book by the stalwart of Nepalese regional planning, Dr. Harka Gurung, is definitely encouraging.

The book, though could have been organised in fewer chapters, has eight chapters. A brief background of regional problems and issues, few of the development models in brief and a comprehensive remark on geography, population and pattern of migration are the highlights of the first three chapters. The next three chapters present various indicators showing regional inequalities and problems, mentions their evolution and deals with the relevance of growth models in the Nepalese context. They are followed by a chapter on an appraisal of regional plannings and regional development strategy in Nepal. The last chapter is on a couple of alternative models of regional development recommended for Nepal.

The planning history of Nepal has always shown a disparity between planned target and actual achievement with the regional disparity remaining distinct as ever, while the concept of regional planning and development still is incomprehensible. In the Nepalese context, the basic problem is the disparity between natural regions, but the regional policy attempts at reducing the inequalities among the broader development regions. In other words, the programmes and projects are initiated in development regions without due regard to the locational feasibility. Gurung, in 1969, proposed a framework of regional development for the integration of diverse regional economies along the selected North-South growth axes. The idea of such planning region is well conceived for the disparity among natural regions will be considered well. Unfortunately, there is still a reluctance in its implementation and still remains in the appendix of fourth plan.

The subject matter of the book, according to the author, is to deal with the evolution of regional problems, their implications in terms of existing development models and an evaluation of the growth pole concept as applied in Nepal. In dealing with the evolution of regional problems, the author concludes that the geographic, ethnic and cultural factors are equally important in explaining the emergence of the regional inequalities in Nepal.

Regional development models, that have been reviewed by the author are the spacial equilibrium model, the export base model, the Hirschman and Myrdal model and the interventionist or growth pole concept. The spatial equilibrium model has been dismissed in the Nepalese context as the migration of unskilled labour from hills to lowlands and negligible capital flight from rich to poor regions would not generate regional

development and the neo-classical factor mobility assumption is taken as too weak to explain the emergence of regional problems in Nepal. The export base model, on the other hand, is not relevant as it widens the regional inequalities in Nepalese situation.

The author seems to be more at home with Hirschman and Myrdal model. Besides the historical and socio-cultural factors mentioned by Hirschman, the author adds that the political factor such as the concentration of development activities in Central and Eastern development regions during Rana regime should be taken into account in explaining regional problems of Nepal. Finally the author reviews the growth pole model similar to the one that is implemented in Nepal since 1975 as a model of regional planning and which has undergone different stages of confusion with unproductive results in hand.

The chapter on an appraisal of regional planning and regional development strategy in Nepal is, perhaps, the meaningful exposition made by the author in the context of the prevailing confusion regarding regional planning and development policy in Nepal. The proposed regional development strategy for Nepal with a series of North-South growth axes or development corridors linking the diverse regions has definitely aroused the interest of the planners and intellectuals. But the test of pudding lies in eating. The proposal was dropped without any further actions. The outbreak of development regions, in the fifth five year plan, for spatial planning in Nepal incorporated the concept of growth pole or growth center. Eventually, in the respective context of resource endowment, it seemed difficult to identify natural growth center and planned growth center. Further, perhaps, as a result of large involvement of foreign aid, the Nepalese plans suffered from a high degree of external influence. In this context, there would be an improper identification of priority areas where the investment packages are to be delivered. The author seems to support what Hirschman thinks '...the external economies due to the poles, though real, are consistently overestimated by the economic operators.' Then he sets out to point out the numerous weaknesses of this concept which make it inappropriate to the economy like that of Nepal. Further, the flaws in regional development policy are pointed out with the findings that the piecemeal solutions like IRDP to solve regional problems are not only uneconomical but also do not lead to 'spread effects' to generate inter-regional development.

The author proposes two alternative models for Nepal in the concluding chapter. He feels that the regional planning itself has become an obstacle to economic development of Nepal and suggests that the government as a matter of policy should discard the regional planning, especially in industrial sector. So, as a first alternative approach, regional planning holiday is suggested which in fact is no model. This line of thought can be entertained only when the government accepts a virtual failure of the spatial development strategy.

The second approach after Hirschman, on the other hand, is an affirmation of the validity of the growth center or growth axis approach. Hirschman agrees that in the geographical sense, growth is necessarily unbalanced. In analyzing the process of unbalanced growth, an advance at one point sets up pressures, tensions and compulsions toward growth at subsequent points. But if all of these points fall within the same privileged growth space, the forces that make for transmission of growth from one region to another will be weak. Thus the author is of the view that effort should be made to concentrate on development activities in EDR and CDR, and eventually other regions will follow as a result of 'herd instincts' and 'demonstration effect.' But the arguments against this concept, in the first place, is as all governments regardless of their democratic character desire and need support from all sections of the country, the temptation is strong to scatter the investment effort far and wide. Secondly, as the foreign funds play an important role in the development activities of Nepal, the external influence will have its say in the development activities of lagging regions. Thirdly, in view of the government's sense of distributive justice, and compelling considerations of equity and national cohesion, there will always be an attempt to promote development of backward areas.

Of course, the author and Hirschman himself argues that as the development starts at the growing points, the increased internal revenue collected from privileged places will be used to invest in the infra-structural facilities of the backward regions and, with higher degree of mobility, there will be an encouragement to set up industries and developmental activities in the backward regions. The author at this juncture has failed to perceive that the infrastructural development does not necessarily manifest growth as experienced in the past planning periods of Nepal. We should not, however, forget the resource realities and how far the Hirschman approach will have its say depends upon the resource base of the region. One should not neglect to consider, as have been neglected by the Nepalese planners and policy makers until now, the resource base and economic structures of different regions of Nepal while recommending any strategy for regional development. Gurung, in foreword of the book, rightly points out that the socio-economic indicators mentioned by the author would have been more meaningful if they have been examined on the basis of ecological/geographical regions rather than on the basis of development regions which are functional divisions. However, one also agrees that through intellectual exercises, as have been done by the author, that we may arrive at some credible perception of regional policy in Nepal.

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