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Fiscal Policy of Nepal in/Changed Perspective

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Fiscal policy occupies an important place in the overall economic policy of the government at macro-level. So any change in the macro-economic policy remains incomplete unless the fiscal policy of the government also is changed accordingly. The government of Nepal, after the restoration of democracy, has adopted the open and liberal economic policy and in the process it has been repealing the existing restrictive rules, regulations, laws and directives governing the economic policies one after another with a great zeal and vigour. Fiscal policy has also undergone changes to that direction through the very first budget of the multiparty democratic government. However, the speed of changes and reforms in fiscal area could not be as fast as in other areas. In fact, the first budget in this direction (1991/92 budget) could incorporate only a limited changes in fiscal policy. On revenue side, it could introduce hardly any new measures worth naming/ except some minor changes in the existing tax rate. On expenditure side, some new thinkings incorporated in the budget as to the proportion of development expenditure allocated for rural areas was increased and low priority and low return foreign aided projects were put under review. In addition to this, an avenue was open for to put a restraint on the growth of the regular expenditure, but the budget itself could not bring out any such reform measures in this regard. In fact, the government had the time constraint to do all these things which the budget speech itself has confessed.

High power Administrative Reform Commission and Pay Commission were set up to suggest the wayouts to do the pruning of the government expenditure. The implementation of the Administrative Reform Commission's Report is in the process and that of Pay Commission's Report has already been put into action. The former report is geared to reduce the expenditure while that of the latter report is to push it up. During the fiscal year 1991/92 several important and far reaching steps were taken to further open, liberalise and marketize the economy. Introduction of the system of partial convertibility of Nepalese Rupees vis-a-vis convertible foreign currency, on trade account, revision in the Industrial Policy,Trade Policy and Foreign Investment Policy are the few cases in point. As a result, almost all the items, except a few re-exportable items, were brought under the Open General Licences (OGL) system. The required foreign exchange for the import of these goods were made easily available at market rate through the commercial banks. Likewise almost all the industries, except a few, could be established without license.

On the fiscal front, however, no such serious steps were taken during the year. But budget speech was the high moment to introduce the new measures pertaining to the fiscal policy. And the Ministry of Finance, Nepal Rastra Bank and the Central Tariff

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Board were working hard to prepare proposals in order to fine tune the fiscal policy in line with the newly adopted overall economic policy.

As a result, the budget speech of the government for the fiscal year 1992/93 introduced several far-reaching fiscal measures. Tariff schedule and the income taxation were two important areas where in the path-breaking reforms were effected through 1992/93 budget. However, Sales tax and Excise duties did not see much changes . Limited but important reforms took place on expenditure side. There were not much changes and reforms in other taxes. The objective of this article is to analyse the reforms introduced in fiscal policy area by the democratic government. Since fiscal policy deals with the government expenditure and resource mobilization, one should look into both sides while analysing the fiscal policy.

Coming to Nepal's case first budget of the government did not (could not introduce much reforms in the existing expenditure process. The second budget tried to relax some rigidities contained in the expenditure process of the government. They can be summarised as follows:

- One third of the annual budget will be automatically released in the beginning of the fiscal year in place of one sixth in the past.

- The project managers will be held responsible and taken action accordingly in case of irregularities in the project instead of withholding the budget altogether.

- The foreign assistance will be accepted only in the priority areas as determined by the government instead of the projects selected by the donors.

These reforms are, by far, path-breaking but are not enough in view of the extent of reform needs. The development projects have got more and more resources but no prudent expenditure mechanism has been introduced. The possibilities of the resource misuse in the development projects are still there as before. No new mechanism has been developed to periodically monitor and review the projects. The entire responsibility has been put upon the project managers. And the integrity of the project managers have been taken for granted.

As mentioned before, only customs duties and income taxation have undergone some reforms through the second budget. These reforms have been summarized below.

Until 1991/92, there were 13 basic import tariff rates ranging from 5 percent to 200 percent. These rates were applicable to the imports from all the countries including India. On top of that, there was the system of additional import duty which was applicable to the imports only form the countries other than India. The rate structure of this additional duty ranged form 15 percent to 50 percent. This system of additional duty had discriminated against the imports from third countries. This made the third country imports quite expensive conspired to the Indian goods. The devaluation of the Nepalese Rupees vis-a vis convertible currencies and revaluation of it vis-a-vis Indian Rupee in July 1 and 3, 1991 and introduction of the system of partial convertibility of the Nepalese Rupee on March 4, 1992 also acted heavily against the imports form the third countries. This increased the imports form India substantially while reduced the imports form the third countries. This had two serious implications in the economy.Firstly, there occured a heavy pressure on the reserve of the Indian currency, on the one hand and the glut in the reserve of the convertible currencies on the other. This finally led to a situation of selling of convertible currency to finance from the imports form India. Secondly, revenue receipts from the customs duties, the largest source of the government revenue, could not increase as projected on account of the decline in the high tariff attracting imports from the third countries and increase in the low tariff bearing imports from India. This problem had been growing to a serious proportion.

So the tax proposals for the fiscal year 1992/93 had to incorporate measures to correct these anomalies. And the budget had also to reform the tax structure so as to make it consistent with the new macro-economic policies adopted by the government. The first target towards this direction was to slash down the high tariff wall. Accordingly, the existing basic import duties rates above 100 percent were reduced to 100 percent and the number of duty rates also were reduced from 13 to 8. The objective of this measure was to open up the economy further on the one hand and to simplify the system on the other.Another important measure taken in the area of import tariff was to drastically cut down the additional duty rates. Now the additional duty rates have been fixed at 5,10,15 and 20 percent in place of 15,30,40 and 50 percent previously. The objective of this measure was to help open the economy on the one hand and to make the imports from the third countries cheaper on the other so that Nepal's import trade is diverted towards the third countries. We should wait for some months to know whether or not these changes have been effective to produce the desired results.

One can doubt that the reduction in the additional duty, whatever drastic it might be, is by no means sufficient to divert imports from India to third countries. Because the exchange rates of Nepalese Rupee with convertible currencies' are so high that the third countries' goods become automatically expensive compared with the similar Indian goods. This is absolutely a valid point. Hence, one can argue that the difference in exchange rates between Nepalese Rupee and Indian Rupee on the one hand and Nepalese Rupee and convertible currencies on the other should be fully compensated through import duties to realise the desired result if those exchange rates can not be made comparable. To do this, the import duty rates for the third country imports should be made far more lower than for the Indian goods. If this could have been done, Nepalese imports from third countries and exports to India could have substantially increased. As a result, the pressure on convertible currencies would have increased and that on Indian currency would have relaxed. In other words, the existing situation of selling convertible currencies to finance the imports from India would have reversed . But this is simply not possible so long as the existing kind of trade relations between Nepal and India remains effective. Because the trade between Nepal and India has been currently running on preferential treatment basis and under this type of trade relations, the concessions to be given by Nepal to the imports from India should be higher than given to the third country goods. So the budget of 1992/93 has tried to its maximum possible extent through the fiscal side to rectify the distortions emerged in Nepal's foreign trade regime. However, it is likely to be far from effective because of the barrier of the type of trade relation between Nepal and India and the exchange rates of Nepalese Rupee with convertible currencies and with Indian Rupee

Another important tax, in which significant changes were effected by the budget of 1992/93 was the income tax. Until 1991/92, the tax free limit for married couple and family was Rs. 30,000/-. This limit has been raised to Rs. 35,000/- for 1992/93. Besides this until 1991/92 there were five income brackets of Rs. 10, Rs. 20, Rs.20 thousand and of the rest and their corresponding marginal tax rates were 10, 20, 30, 40 and 50 percent respectively. For 1992/93, the number of the income brackets has been reduced to three, namely, of Rs.25, Rs.40 thousand and of the rest and their corresponding marginal rates have been fixed at 15, 25 and 40 percent respectively. Previously, the highest marginal tax rates for remuneration income was 40 percent and for non- remuneration income 50 percent. Now, this rates for both types of income has been fixed at 40 percent. Hence, this change has gone in favour of non-remuneration income. The rate of corporate profit tax also has been reduced from 40 percent to 35 percent.

The reduction in the number of income brackets and the highest marginal rate of income taxation in 1992/93 is by far a positive step towards reforming the income tax structure. It simplifies the income tax administration on the one hand and enhances the incentives to save and invest on the other. This is also in line with the recent trends in income tax structure prevailing around the world. There has emerged a trend of reducing income brackets on the one hand and highest marginal tax rates on the other in order to improve the tax compliance. It has been an established fact that higher and steeply progressive rate structure of taxation encourage tax payers to evade and avoid the tax payment. Hence, these changes effected in the income tax structure in 1992/93 is absolutely in line with the liberal and market led economic policy.

However, the changes in the nominal rates of income taxation in 1992/93 look regressive because the tax rates applicable to low income brackets have been raised from 10 percent to 15 percent and from 20 percent to 25 percent while the rate applicable to top income brackets has been reduced 50 percent to 40 percent. An attempt has been made to see empirically whether these changes are of regressive nature or not and if they are, how much regressive they are ? Changes in disposable income and average effective tax rates can be used to measure the impact of tax changes in terms of progressively or regressively.

Five hypothetical non-remuneration income levels of Rs. 50 thousand, Rs.100 thousand, Rs. 500 thousand, Rs.1 million, Rs.5 million and Rs.10 million have been taken to analyses the case. Tax free income limit applicable to married couple and family has been selected . So, only the tax-free limit has been deducted from the gross income to arrive at the taxable income. Tax free income limits, income brackets and corresponding marginal tax rates effective in fiscal years 1991/92 and 1992/93 have been applied to respective income levels. And firstly tax liability has been calculated and then disposable income and the average effective tax rates have been derived and compared for each income levels between those of 1991/92 and 1992/93. The derivatives have been presented in table numbers 1,2 and 3 as follows:

Table 1

Comparison of Tax Liability

Income Level (Rs.' 000)	1991/92 (Rs.)	1992/93 (Rs.)	Change in Percentage
50	3,000/-	2,250/-	- 25.0
100	19,000/-	13,750/-	- 27.6
500	2,19000/-	173,750/-	- 20.7
1000	4,69,000/-	3,73,750/-	- 20.3
5000	24,69,000/-	19,73,750/-	- 20.1
10000	49,69,000/-	39,73,750/-	- 20.0

Note :- Tax liability is the amount of tax to be paid on respective income levels.

Above table shows that the changes in the income tax structure in 1992/93 have reduced the tax liability of all the income levels at varied rates .The largest decline (27.6 percent) in the tax liability has taken place in the income levels up to Rs. 100 thousand. And the decline is at low rate in the income levels above Rs. 100 thousand. For the income levels up to Rs. 10 million the decline is lowest. But the comparison of the tax liability before and after tax changes can clearly suggest us whether certain tax changes have progressive or regressive implications. Only comparison of after tax income and average effective tax rates before and after the tax changes can tell us whether certain tax changes are of progressive or regressive nature. So, here tax liability before and after tax changes have been calculated to derive the after tax income and average effective tax rates.Changes in Disposable income has been presented in Table-2 below.

Table 2

Comparison of Disposable Income

Income Level (Rs.' 000)	1991/92 (Rs.)	1992/93 (Rs.)	Change in Percentage
50	47,000/-	47,750/-	1.6
100	81,000/-	86,250/-	6.5
500	2,81,000/-	3,26,250/-	16.1
1000	5,31,000/-	6,26,250/-	17.9
5000	25,31,000/-	30,26,250/-	19.6
10000	50,31,000/-	60,26,250/-	19.8

Note:- Disposable income is derived by deducting tax liability from respective gross income levels.

This table shows that the change in income tax structure in 1992/93 is regressive because the disposable income, that is post tax income has increased at low rate in low income levels it has increased at quite high rate in upper income levels. Similar is the result from the change in average effective tax rate point of view as presented in Table -3 below

Table 3

Comparison of Average Effective Tax Rate

(in percentage)

Income Level (Rs. ' 000)	1991/92	1992/93	Change in Percentage Point
50	6.0	4.5	- 1.5
100	19.0	13.7	- 5.3
500	43.8	34.7	- 9.1
1000	46.9	37.4	- 9.5
5000	49.4	39.5	- 9.9
10000	49.7	39.7	- 10.0

Note:- This rate is the percentage of tax liability to each gross income level.

Table 3 also shows that the change in income tax structure in 1992/93 is of regressive nature. Because the average effective rate of income taxation has declined as a result of the changes in income taxation by only 1.5 percent in low income levels while it has declined by 10.0 percent in high income levels. So, it is empirically proved that the changes effected in the income tax structure in 1992/93 are of regressive nature.

CONCLUSION

This fiscal policy measures taken by the democratic government through its first two budgets deserve appreciation at least in terms of direction. But they are quite inadequate in terms of the desired results. On expenditure side, control of expenditure has been tried to achieve only through the wage and salary which constitutes only 29.6 percent of regular and 6.7 percent of the development expenditure. But, other headings where the possibility of leakage of resources is equally high, have been left untouched. On revenue side only customs duty and income taxation have been reformed. But the reform in the customs duty has been far from rectifying the anomalies contained in the foreign trade regime. This reform neither could boost the imports from the third countries nor enhance the revenue collection. Reforms in income taxation in line with what is prevailing around the world today, is by far a welcome step. However, it has been at the cost of revenue. No serious steps have been taken to compensate the revenue loss caused by the tax reforms.

Sales tax and excise duties have seen only negligible changes. In terms of revenue, both the taxes are extremely important accounting for around 29 percent and 14.4 percent of the total tax revenue respectively. Self- removal mechanism after the payment of excise duties has been introduced under excise duties in case of 16 industrial productions. And the factory-posted excise officials have been withdrawn from these factories. This is also a welcome step. However, one should not be that much sure about the scruples of the industrialists. Likewise, two tiers of sales tax system have been introduced on 9 industrial products. This is also undoubtedly a welcome step towards finally introducing the value-added tax. However, the start is too humble. Hence, it is insignificant in terms of revenue mobilization. In the same way, half-hearted approach has been taken in respect of the property taxation. Land revenue has been left untouched. This is not only this year, but it has remained so since last two and half decades. In such a situation, bringing agricultural income into the tax net cannot even be thought of.

As a result of the inability of the government to introduce new and bold measures to mobilize as much domestic resources as possible, around 70 percent of the development expenditure has been proposed to be financed through the foreign sources. This is not the happy situation for the country like ours which has already borne the debt of around Rs. 90 billion. The past tradition of banking its development expenditure upon foreign assistance could not be broken even by the democratically elected government. So much remains to be done in the area of fiscal policy if it has to be made consistent with the overall macro-economic policy.

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