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Taxation of Income in Nepal

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Abstract

Over the study period, (1980-81 to 1996-97) rate structure of Personal Income Tax has gone down from 7 to 2. Compared to the finding of other scholar (G.R. Agrawal), the buoyancy and elasticity coefficient of Nepalese Income Tax has also declined significantly from 2.18 to 1.11 and from 2.01 to 0.53 respectively. It reflects that number of exemptions and deductions have eroded the tax base. Though the rate structure of Personal Income Tax was progressive, it has violated equity consideration. Hence a new rate structure has been proposed to maintain equity.

It was only in the fitness of things that, being so close to man, property served as the object of taxation for thousands of years since recorded history. The process of transition from property to other criteria measuring prosperity gained immensely accelerated momentum by industrial revolution, through, of course, the process began with the commercial development of the days preceeding industrial revolution in European countries. While older forms of property began giving way to newer and newer forms of financial and physical assets, income also began acquiring the dominant role as the indicator of well being. With the passage of time, the ancient taxation of property became both less fashionable and less productive. Income emerged as a welcome substitute for property as a tax base, and subsequently it was accepted as the most representative index of economic or social status and of fiscal capacity. The relative welfare position of individuals began to be measured in terms of their incomes and thus the tax on income became respectable both among the ranks of economists and of policy makers.

The personal income tax as against consumption taxes began to be considered the most equitable tax. It was felt that consumption taxes imposed on manufacturing, wholesale or retail sales, did not permit adjustment to family size, nor could they be an effective instrument of progressive taxation.

While progression could have been achieved by limiting the tax base to a relatively small set of luxury items, this would have limited greatly the revenue raising ability of consumption taxes. If, on the other hand, a large tax base was retained by taxing more or less all consumer goods, the resulting burden distribution would be regressive. Thus the search for progression had to be met by the income tax.

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The rise of egalitarian philosophy, in particular, and the social philosophy, in general, has been the main driving force behind the rise of progressive taxation of income. The historical association between income and progressive taxation, as against consumption and regressive taxation, was mainly responsible for the rise of income taxation.

In Nepal, income tax on 'Business, Profit and Remuneration' was introduced by the Finance Act, 1959. In the very next year, the then parliament introduced Business Profit and Remuneration Tax Act 1960. In fact, Income Tax Act, as such, was for the first time introduced in Nepal in the year 1962. At present, the relevant statute is the Income Tax Act, 1974. Under section 2(a) of the present Act, income is defined as 'cash or in kind earned or obtained from the sources mentioned in section (5). Under section (5) of the Income Tax Act, 1974 income is classified in five types, namely, income from agriculture, income from industry, trade, profession or occupation, income from remuneration, income from house and land rent and income from other sources.

Classificatory analysis of data commences with the year 1980-81, since data for earlier years was not made available by Department of Taxation, Ministry of Finance Nepal. Similarly, the year 1996-97, constitutes the last year of the period of study as the reliable data containing finalise statistics for subsequent years was not available. Though attempt has been made to update the data wherever reliable statistics are easily available. Statutory rates of income tax and its burden on different income slabs have been analyzed covering the period 2000-2001. Similarly, revenue collection from income tax has also been updated.

An overview of revenue and expenditure trends of the Government of Nepal shows that during the period under study, resource-gap, in absolute terms, has steadily gone up from Rs. 1673.1 million in the year 1980-81 to Rs. 20350.2 million in the year 1996-97. As percentage of GDP, it increased from 6.3 in 1980-81 to 7.55 in the year 1996-97. Whereas resource mobilization within the country, as a percentage of GDP, had gone up from 0.41 in 1980-81 to 1.97 in 1996-97, revenue collection from income tax had gone up from 0.58 to 1.53 only. To a student of fiscal matter and their social impact, it is natural for such questions to arise in the mind as to whether the corrective of the tax instrument was intrinsically deficient or that the tax design was immaculate but its enforcement went haywire. The present study is the outcome of such questions. An attempt, therefore, is made in this study to find answers to the following sets of questions.

1. Is Nepalese income tax system of automatic responsive type? If it is so, to what extent? If it is not, why it is not? And to what an extent is it being corrected through discretionary tax changes?

2. Which of the tax instruments was intrinsically deficient? To what an extent these deficiencies have been remidied in the past?

3. Is structure of exemptions riddled with loopholes, inequities and arbitrary expedients? If it is so, then, to what an extent, they have eaten into the potentialities of revenue raising components of income tax.

For measuring buoyancy and elasticity of income tax, the following formula is used.

$$Lny_t = Lna + blnx_{t-1} + U_t$$

For the adjustment of discretionary change, the Proportional adjustment method as propounded by Prof. G.S. Sahota is used.

$$IT_t = \frac{AT_t \pm RT_t}{AT_{t-1}} X\ IT_{t-1}$$

Where,

IT_t = Adjusted or net tax yield at time t.
IT_{t-1} = Adjusted or net tax yield of previous year (t-1)
AT_t = Actual tax yield at time t.
AT_{t-1} = Actual tax yield at time t-1.
RT_t = Actual discretionary changes at time t.

Extent of Taxpayer relief

Blanket exemption limit above which tax liability is attracted has undergone very frequent changes over the period under study. It occurred in the years 1981-82, 1983-84, 1990-91, 1992-93, 1997-98, 1998-99, 1999-2000 and 2000-2001. In each time, exemption limit was raised for each category of assesses viz. the unmarried individual and married couple and family. Analysis of the exemption limit vis-à-vis poverty threshold indicates that over the period under study, scaling-up of exemption limit did not match the poverty-threshold-norm at-all. Even then, it was observed that for all tax-paying units, the statutory exemption limit had steadily declined over the period but not at the same rate and in the same proportion. Moreso, it was also found that scaling-up of exemption limit over the period had not been fully indexed to neutralise the impact of inflation. But when seen the prevailing exemption limit in terms of multiple of per capita income for individuals, it was found that over the period, it had steadily declined from more than 3 times to less than 2 times. Almost the same trend was observed in the case of couple and family as tax-paying units.

As compared to the present prevailing exemption limit in most of the comparable developing countries, it was found that it was, generally in the range of 2.5 to 3 times of per capita income for individuals. The present exemption limit in Nepal is no exception to the trends which have been observed in almost all the comparable developing countries.

Structure of Income Tax

Facts and tendencies in respect of the following for the period 1980-81 to 2000-2001 were examined:

(i) The changing pattern of rate structure of personal income tax;
(ii) Maximum marginal tax rates and the income on which these rates apply;

(iii) Changes in rates, statutory average rates and statutory effective burden and,

(iv) The impact of larger availing of the plethora of deduction, relief's, allowances and exemptions.

Similar investigations were carried out in respect of data and available information pertaining to the corporate income tax. An example only, of the kind of results reached regarding personal income tax, the following three are cited here:

(1) Analysis of average rate of tax and burden on the selected income levels reveal that variations in average rates of tax in income range of Rs. 5,000 to 50,000 were much higher over the period under study than variations found in higher income ranges. This indicates that changes in rate structure along with recasting of slabs had made a greater dent into the income held in the range of Rs.5,000 to Rs. 50,000.

(2) Structure of exemptions and deductions were found to be riddled with loopholes, inequities and arbitrary expedients. Faculty and non-rational layout of exemptions and deductions and under-reporting of income continue to 'kill off' much potential revenue from income tax.

(3) Going beyond the consideration of the effect of the exemptions, the rate structure, itself, had been such as to place a nominal burden on the assessees on the higher income brackets. It was observed than index of sacrifice on income levels above Rs. 3,00,000 was lower as compared to what it was on income levels below Rs. 3,00,000. This establishes the fact that rate structure, as it prevails today, is not equitable.

Revenue Aspects

A low yield from income tax has been a matter of common knowledge ever since they were levied in Nepal. Income tax revenue, as percentage of GDP, registered a level beyond one percent only after 1993-94. Revenue yield from personal income tax, as percentage of GDP, has gone up from 0.37 to 0.75 during the period starting from 1980-81 to 1988-89 but there-after it, as percentage of GDP, has gone down continuously and reached a low level of 0.39 in the year 1995-96. Although, it registered an advance after 1995-96 and reached a level of 0.67 in the year 1998-99.

Revenue yield from corporate income tax, over the period under study, shows that it, as percentage of GDP, was always less than 0.3 percent during 1980s. During 1990s, particularly after 1993-94, it, as percentage of GDP, increased continuously and reached a level beyond one percent. Yields from House and Land rent tax and interest tax were always less than 0.6 as percentage of GDP throughout the period under study.

Buoyancy coefficient of income tax for the period 1980-81 to 1996-97 works out to 1.11. After the restoration of multi-party democracy in Nepal, buoyancy coefficient of income tax works out to 1.71 for the period 1990-91 to 1996-97. Whereas buoyancy coefficient before the restoration of democracy covering the period 1980-81 to 1989-90 was 1.15.

The over-all elasticity of Nepalese income tax, for the period 1980-81 to 1996-97, works out to 0.53. This clearly indicates that structure of income tax in Nepal is not much responsive. Elasticity coefficient before the restoration of democracy in Nepal was 0.35 covering the period 1980-81 to 1989-90 but it rose to 1.21 after the restoration of multi-party democracy in Nepal.

When judged against the buoyancy and the elasticity estimates of income tax in Nepal as worked out by other scholars for the period 1967-68 to 1975-76, it was disturbing to note that buoyancy and elasticity co-efficient of income tax for the latter period starting from 1980-81 to 1996-97 had declined significantly from 2.18 to 1.11 and from 2.07 to 0.53 respectively. The virtual decline in the buoyancy and elasticity coefficients occurred despite of increase in national income and enhancement of base of income tax over the period under study. In fact, in none of the plans covered under the present study, the buoyancy and elasticity estimates could reach near to the estimates of other scholars for the earlier periods. Causes for sluggishness in the responsiveness of income tax may be identified, in the very beginning, in yield-loss from three sources. Over the period, exemptions and deductions had eaten substantially the potentiality of revenue raising of income tax. Faulty and non-rational layout of exemptions and deductions and under-reporting of income continued to kill-off revenue raising potential of income tax.

A related, although different, was the issue of the manner in which different incentive provisions, which were incorporated to give a boost to industrial development, had eaten into the tax base. Apart from 15 year income tax holiday for investment in electricity, Industrial Enterprises Act, 1992 has given either tax holidays or granted a rebate at the rate of certain percent of the income tax on 14 items under section 15 and 4 items under section 16. Total number of income tax payers in Nepal is still less than one percent of the total population. Revenue from income tax collection is still less than 2 percent of GDP. Administration of income tax in Nepal has resulted in a number of problems which are reflected in an ever-increasing number of arrears of assessment, too much pending cases before the Revenue Tribunal and mounting arrears of collection at the end of the each financial year. In fact, cumulative delinquency, in absolute terms rose from Rs. 189.4 million in the year 1980-81 to Rs. 3077.0 million in the year 1997-98. Percentage of delinquency to the total tax to be collected was as high as 62.2 percent in the year 1991-92. But after the restoration of Multi-party democratic system in Nepal, it began to decline steadily and for the year 1997-98, total tax to be collected was nearly 41 percent. In fact, mounting arrears over the period under study, has assumed serious proportion and this, in itself, speaks eloquently much about the efficiency of tax administration in Nepal.

On the basis of the aforesaid observations and findings, the following suggestions are given to overhaul the structure of income taxation in Nepal.

Personal Income Tax

Any scheme of reforms with regard to personal income tax must necessarily proceed by acknowledging the violation caused to the principle of equal treatment of equals by the plethora of exemptions and deductions. Apart from the revenue loss caused by wide variety of incomes which qualify for exemptions, there is further impact in terms of increasing regressivity of the manner in which exemption are availed of by the taxpayers in the higher income brackets.

Under the present Income Tax Act, 1974, extra one month salary received for Dashain expenses, remote area allowances, travel expenses, foreign allowances, leadership allowances, medical expenses, payment in lieu of home and sick leave etc. along with remunerations received in kinds such as housing, car, telephone services etc. are completely exempted. While some of the expenses and allowances may justifiably be exempted on other considerations but, nonetheless, it is also true that income tax base is unduly eroded causing revenue loss on the one hand and on the other violating seriously the principle of equal treatment of equals. At least, extra one month salary received for Dashain expenses and allowances such as remote area allowance and leadership allowance can be made taxable through suitable amendment in the Income Tax Act, 1974.

Financial savings

As example only, at present, premium (not exceeding 7 percent of the insured amount) on the life insurance policy of the employees or the actual premium paid (whichever is less) is completely deductible from total income under section 26 of Income Tax Act, 1974. To any shrewd observer, it is clear that this provision has an element of regressivity and can erode the tax base substantially. This observation is true at least in case of those taxpayers who had other sources of income and are in high income brackets. They can pay high premium on their life insurance policies and deduct the whole of all premium from their total income. This ubiquitous nature of exemption violates the principle of horizontal equity.

In addition to the deduction of life insurance premium, deposits in the provident fund up to 10 percent of the salary of the employee is completely deductible from the total income. Besides, deposits up to 10 percent of the salary under Citizen Investment Trust, is again deductible from the total income, in case total income earning of an employee is less than one hundred thousand rupees.

Needless to stress that small savings, in the form of life insurance premium and contribution to provident fund and/or to citizen Investment Trust, are exempted to boost the saving in the economy. But the manner, in which these provisions were availed in the past, has resulted in the loss of revenue and had, indeed, not given an additional incentive to save more. In order to increase rate of saving in the economy, it is better to introduce a system of rebate on total saving. Instead of deducting all small savings from total income of the employee, what is required is to reduce the total tax payable of the employee at a rate of, so to say, 20 percent of the total savings in a given financial year. This will give additional incentive to the taxpayer to save more. More so, base of the income tax will not be unduly eroded.

Rate Structure of Personal Income Tax

As the question of alteration in the rate structure of personal income tax is approached, it becomes necessary to emphasize certain observations which may easily be lost sight of. Analysis of rate structure shows that average tax burden on higher selected income levels had declined. More so, another important observation which must be kept in mind is the fact that the level of sacrifice in paying the tax has not been same for all taxpayers. In fact, index of sacrifice, at the rate applicable in the financial year 2000-2001, has declined on income levels above Rs. 3,00,000. For making the sacrifice level equal for all taxpayers, rate of tax has to be such that it bears a constant relationship with the after tax income in the hands of the assessee. The suggested slab structure and corresponding rates are derived on the presumption that the index of sacrifice, irrespective of income levels, must remain the same.

The following formula is used for making the sacrifice level constant.

$$\frac{t}{y\,(1 - t/100)} = k.$$

where 'K' is a standardized tax fraction (or index of sacrifice) and is continuously maintained constant all along the income levels. In this 'Y' is personal income and 't' is the effective tax rate.

By applying this formula, effective tax rates at each level of income is obtained keeping the value of 'k' at 0.00007. For selected income levels, the effective tax rate are as follows:

Recommended Tax Rates compared with Present Rates

(Percent)

Income Level	Recommended Tax Rate	Existing Tax Rate 2000-2001
150,000	9.50	7.5
200,000	12.28	11.8
250,000	14.89	14.5
300,000	17.35	16.2
350,000	19.68	17.5
400,000	21.87	18.4

If these effective rates are accepted, the corresponding converted slab rates would be as follows.

Income Level (Rs.)	Rate of Tax (without any surcharge)
75,000-150,000	20 percent on amount in excess of Rs. 75,000
150,000-300,000	15,000 + 25 percent on amount in excess of Rs.150,000
300,000 and above	52,500 + 30 percent on amount in excess of Rs. 300,000

Corporate Income Tax

Most important of other direct taxes is the corporate income tax which treats corporation as independent legal entities. These corporations pay taxes on their incomes which are actually profits of the corporations and not of the individuals who are shareholders of the company.

The for most principle in corporate taxation is that the rates of tax which applies to corporate income must not exceed maximum marginal rate of tax as applicable to individuals. Since the suggested maximum marginal rate of tax for individuals is 30 percent, there is no need to increase the present corporate rate of tax beyond 30 percent.

At present, earnings of financial institutions such as banks, insurance companies and other non-bank financial companies, are taxed at the rate of 30 percent. But, for other public enterprises, public and private limited companies, and partnership firms, rate of corporate income tax at present, is 25 percent. It is suggested that the rate of corporate income tax should be raised to 30 percent for such companies also.

At present, basic industries such as, energy, mineral, construction, agro and forest based industries are taxed at the rate of 20 percent. For accelerating the rate of over-all economic development of the country, it is necessary to give fiscal concessions in the form of lower rate of tax to such industries. Therefore, increase in the rate of corporate tax is not desirable.

Industrial Incentives

The present corporate tax system contains a variety of incentives which tend to reduce the effective rate of corporate taxation. Apart from 15 year income tax holiday for investment in electricity, the Industrial Enterprises Act, 1992, has given either tax holiday or granted a rebate at the rate of certain percent of the income tax on 14 items under section 15 and 4 items under section 16. In the context of suggested rate of corporate income tax, there is a need to establish a scale of relative desirability of their continuance or otherwise.

At present, cottage industries (based on traditional skills and using local raw materials including carpet and handicrafts making, leather, textile and clothing and Jewelry) irrespective of the size of the industry receive an infinite tax holiday. Sales tax, excise duty and income tax are not levied on cottage industries. At least, cottage industries which are engaged exclusively in commercial production and whose earnings are more than Rs. 75,000/- per year can be brought into the ambit of corporate taxation after giving initially six years of tax holidays.

Under section 15(d) of Industrial Enterprises Act, 1992, industries (other than cigarettes, bidi, cigar, chewing tobacco, khaini industries and industries producing other goods of a similar nature utilizing tobacco as their basic raw material, industries producing alcohol or beer and saw mill and catechu industries) using 80 or more than 80 percent of indigenous raw materials in their products and employing all manpower from among Nepali Citizens are granted a rebate at the rate of 10 percent of the income tax. Effective enforcement of this provision requires vigilant and efficient tax administration. As example only, flour mills which were using imported wheat and not fulfilling the mandatory provision of using more than 80 percent of indigenous wheat, were also granted a rebate at the rate of 10 percent of the income tax. Since vigorous enforcement of this provision in other industries is also very much difficult, repeal of section 15(d) is suggested.

Similarly, under section 15 (r) of the Industrial Enterprises Act, 1992, any industry which provides direct employment to 600 or more than 600 Nepali citizen round the year is granted, in addition to other facilities, an additional income tax rebate at the rate of 10 percent in that year. Since effective verification of number of employment in each industry in each financial year is difficult to made, repeal of this provision is suggested.

Administration of the Tax

After the restoration of Multi-party democratic system in Nepal, revenue from both personal and corporate income tax showed a buoyancy never seen before. As percentage of GDP, revenue from income tax rose from 0.58 percent in the year 1980-81 to 1.53 percent in the year 1996-97. Yet there are certain pitfalls in the administration of the tax. Total number of income taxpayers are still less than one percent of the total population. Problems of arrears has demonstrated serious gaps and delinquency. There is considerable scope for raising the yield of income tax further, particularly, through revamping of tax administration and securing better compliance. Strengthening of tax administration deserves earnest consideration.

To file income tax return by the salaried person is not mandatory under the Nepalese Income Tax Act, 1974. Tax deducted at source does not include income earned from other sources. Unless there is a provision for compulsory filing of return, loss of revenue, in case additional income from other sources are not honestly disclosed, can not be easily ruled out. Compulsory filing of returns will not only increase the number of income tax assessees but also will act as a deterrent on dishonest tax payers.

A number of complications can be found regarding the procedure of income tax collection in the Income Tax Act, 1974. As a result, negotiated tax settlement has become common practice in Nepal.

A system of priorities in the scrutiny of important cases should be introduced. At least, files of taxpayers having large revenue potential must be completed by the end of the financial year. The income tax officer should make a through study of the case and wherever required, instructions may be obtained by the Department of tax before finalising the case. This would considerably reduce the number of appeals to the Department of Tax or Revenue Tribunal Court. Frequent changes in jurisdiction and frequent transfer of officers should be, as far as possible, avoided. Care should be taken to deploy adequately trained inspectors and ministerial staff in field tax offices.

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