Evolution, Current Problems, and Possibilities for Reform of the Nepalese Tax System (Ⅱ)

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5. Needs and possibilities for tax reform

The analysis of the structure and operation of the Nepalese tax system indicates that the Nepalese tax system does not satisfy the criteria of a good tax system, viz. simplicity, revenue productivity, elasticity, economic efficiency, and equity. Poor tax administration has further distorted the Nepalese tax system to a larger extent. It is, therefore, necessary to rationalize the structure and operation of the Nepalese taxes and strengthen tax administration. Further, tax reform has become inevitable in Nepal due to the changes which are taking place in economic policies including tax policy in the SAARC region, especially India. Moreover, the domestic situation is also favourable for economic reforms, including tax reform. People have been expecting changes since the reinstallation of a multi-party political system in 1990 ; policy makers are now in the mood and position to bring about reform ; and reform measures are likely to be endorsed by the Parliament given the favourable political climate, since the Government is now formed by a single party which has a majority in the Parliament to pass the laws.

In the light of this domestic and international situation, the Government has already initiated a programme of economic liberalization. Now the emphasis is on the development of a more open and market-oriented economy. To this end, the Government introduced new industrial and commercial policies in 1992. The main thrust of these policies is to deregulate the economy so that the private sector can flourish. Tax policy needs to be streamlined accordingly. Tax changes, of course, have been effected annually, but they have in no way been part of any long-term tax policy. So now is the time to launch a comprehensive tax reform programme.

The long-term objective of the tax reform programme should be to adopt an ideal tax system probably with a few broad-based, low rate, and simple taxes. Many countries have introduced a broad-based value added tax (VAT) in place of a multiplicity of commodity taxes, which varied considerably in their structure and operation. Such a move has allowed many tax administrations to concentrate on a single tax with fewer rates and exemptions and now taxpayers need only go through a few formalities. This has reduced the work of both parties to a great extent. Further, few exemptions and a uniform (or few) rate(s) are attractive from an economic point of view since they are likely to cause less distortion in the economic activities. Such a tax interferes very little with the economic decisions of both the producers and consumers. Moreover, in many countries, this tax has succeeded in generating more revenue than the taxes it replaced. Similarly, a comprehensive income tax levied on global income with a few, low rates and fully assessed on the actual profit is the ideal one. As such a tax treats all sources of income equally, it not only improves equity and efficiency but also makes the tax system simple. It is also desirable to have a net wealth tax covering all tangible and intangible property.

The Nepalese economy, however, is not yet sufficiently developed to make such ideal taxes feasible. These taxes would be very complex at this stage in Nepal. Taxpayers may not understand such taxes, and the administration may not be able to implement them. To elaborate this point, the Nepalese economy is basically a rural, agricultural economy. Farmers are scattered all over the Himalayan kingdom. Most of them are illiterate, do not keep any records of their farming and have very small farms. Farming is done primarily for subsistence, nothing is marketed. Agriculture - the source of livelihood for more than 80 percent of the total population - is a way of life. Moreover, it is also difficult to levy tax on big farmers because of the lack of adequate records.

The Nepalese business sector is also not well organized. In terms of number, small vendors dominate the business sector. Like farmers, they are illiterate and do not keep any records of their business. They are scattered throughout the mountain areas. Small market places do exist all over the country but, on administrative grounds, in certain districts it may not be worthwhile to set up even one tax office to cover all the market places located within a particular district. Due to the geographical position and undeveloped modern transport facilities it would not be possible for tax officials to have any physical access to many market places. This all means that a conventional income tax, a broad-based VAT and a comprehensive net wealth tax do not seem to be feasible at this stage. In all cases, such taxes, if introduced, would remain largely unenforced, which would cloud their future and compromise the Government. The unfortunate honest people and/or those who are under the scrutiny of the tax officials would be penalized. This would then destroy respect for the tax laws and also for the Government itself, and the procedure may ultimately turn out to be very costly for both the Government and society.

There is thus a long way to go before a theoretically sound tax system could be adopted in Nepal, nevertheless this should remain as a long-term ideal goal. In the short and medium terms, it would be desirable to adopt some less sophisticated measures which are relatively easy to understand and administratively less demanding and thus could be assimilated by the tax administration. For practical reasons, central level commodity and income taxes should be limited to the large market places ; local bodies may be more effective for taxing activities carried out in the small and remote areas. It also makes good administrative sense for some vendors, sources of income, commodities or transactions to be kept outside the tax net. Some sources of income might be taxed separately while, other sources might be brought under some special regime. The implementation of such "second best" or may be even "third best" measures would, however, make it ultimately feasible to introduce the "first best" measures in the long run. So Nepal should adopt the following strategy to reform its tax system :

5. 1 Formulation of a comprehensive tax reform programme

A comprehensive tax reform package should be designed with the aim of establishing an ideal tax system over the years. During this period, both fiscal experts and the private sector should be consulted widely. It must be remembered that the co-operation of, not the confrontation with, the private sector is required for the success of a tax system. A careful assessment of alternative measures should be made and *ad hocism* should be avoided. Not all reform measures, however, can be implemented at one time. So they should be phased over a period of time. Short-term deviation should be avoided unless it is strongly justified on administrative grounds or to cope with some sort of emergency situation. Such a strategy has the following advantages over the existing system of introducing tax changes on a piecemeal basis.

(a) A comprehensive tax package would make it easier to sell new tax measures than if they are levied individually on an *ad hoc* basis. Under a comprehensive tax package programme, some measures may increase the tax burden while others may have the opposite effect. Some individuals or organizations may gain from one set of measures while others gain from another set. The overall reaction by different sections of society to a tax package may be mixed. As Thirsk observes: "Comprehensive tax reform, insofar as it creates winners as well as losers, may meet with less political resistance than piecemeal tax reform. The recent reforms in Colombia, Mexico, and Jamaica seem to suggest that if everyone has both a little to gain and a little to lose from a tax reform package, political opposition to the reform will be unable to coalesce around a particular issue."[12]

It is to be noted that the sales tax has recently been extended to the wholesale level on an experimental basis. Industrialists and businessmen, however, have been opposing the extension of sales tax to the wholesale level. This means that they will strongly object to the introduction of a broad-based VAT. Such opposition could be avoided if the introduction of a broad-based VAT were accompanied by the

12) Wayne Thirsk, "Lessons from Tax Reform: An Overview", in Javad Khalilzadeh-Shirazi and Anwar Shan (eds.), *op. cit.*, p. 65.

abolition of octroi, the removal of some items from the excise tariff, a reduction in tax rates, and the simplification of tax procedures. The abolition of octroi is likely to be strongly opposed by local bodies and such a move is not desirable without making arrangements for alternative revenue sources for local bodies. The abolition of octroi should be accompanied by the transfer of land revenue, vehicle tax, and entertainment tax from the jurisdiction of the central Government to the local bodies. Under the new arrangement, the increase in the base of VAT would compensate the central Government for revenue loss due to the transfer of land revenue, vehicle tax and entertainment tax to the local bodies and the reduction in tax rates. The abolition of octroi, the deletion of some items from the excise tariff, and the simplification in tax procedures would offset any possible increase in the tax burden on industrialists and businessmen due to the introduction of VAT. Furthermore, the transfer of land revenue, the vehicle tax, and the entertainment tax from the jurisdiction of the central Government to the local bodies should compensate for the loss in local tax revenue due to the abolition of octroi. Under the new arrangement, society would be free from the hidden costs of the existing irrational commodity taxes, industrialists and businessmen would be relieved from the octroi harassment, and landowners would be free from the requirement of having to travel to the district headquarters to pay land revenue, which may be more than a day's journey away in some places. These aspects need to be made clear in order to obtain the support of the taxpayers and public for the tax reform programme.

(b) The announcement of a long-term tax strategy would minimize uncertainty among the private sector, which is very important in order to attract investment. This is because such a strategy would remove uncertainty and allow investors to make long-term plans. It is said that "other things being equal, investors are more willing to invest when the fiscal environment is relatively stable than when many tax changes are being made and then reversed".[13]

(c) The declaration of a comprehensive tax package to be implemented over a period of time would also simplify tax administration. It would reduce pressures from influential lobbies regarding the exemption or reduction in tax rates for their transactions/incomes/commodities during the time of the preparation of budget. Further, it would avoid tax-induced activities, such as the rise or fall in the volume of imports depending upon the expectation of an increase or decrease in tariffs, that often take place just before the presentation of a new budget.

5. 2 Rationalization of the structure and operation of taxes

Commodity taxes

The ultimate goal of the commodity tax reform should be to levy a single VAT in place of the sales tax, excises on several items and minor commodity taxes levied on specific services, that all vary considerably in their structure and operation. Short-term measures should be directed to achieve this goal in the long run. In fact, there has already been a move in this direction since 1992/93 when sales tax was extended to the wholesale level for a few domestic products. In

13) Zmarak Shalizi and Lyn Squire, "Consumption Taxes in Sub-Saharan Africa", in Richard M. Bird and Oliver Oldman (eds.), *Taxation in Developing Countries*, The Johns Hopkins Press, Baltimore and London, 1990, p. 360.

1993/4, the scope of the wholesale level sales tax was further extended to the wholesalers of some more domestic products and sole distributors or agents of the foreign firms or companies and their wholesalers. The tax credit method has been adopted to avoid multiple taxation. Thus, the existing sales tax already has features akin to a VAT. Nepal, however, should not make a hasty move towards a broad-based VAT. A detailed preparation should be considered as a prerequisite for the introduction of such a tax. Its structure and operational aspects would need to be designed, the administration would have to be strengthened and the taxpayers should be educated before the introduction of a broad-based VAT.

VAT Acts and Rules, including working procedures, forms, and registers to be maintained by the registered vendors, should be developed before the introduction of VAT. (It is to be noted that in Nepal it has usually been the practice to formulate tax law after the introduction of a tax.) The consumption type VAT with the tax credit method should be adopted. It should be levid on the importation and supply of all goods, other than those specifically exempt by law. In the case of services, only those services specified by the law should be taxed. Exports should be zero-rated and a few items, including unprocessed food and medicine, should be exempt. Tax should be extended right through the retail level except in the remote areas which need to be kept outside the purview of the VAT on administrative grounds. Small vendors, irrespective of their place in the production and distribution chain, should be exempt on administrative grounds. As Cnossen observes: "There is no reason why middle-size and large retailers, which may be assumed to keep adequate accounts, should not be registered ... The sole criterion for tax coverage should be the size of the firm, regardless of the stage at which it is situated."[14] The sales tax and excise administrtion should be strengthened considerably in order to make it capable of handling the VAT. A comprehensive VAT education programme must be launched to educate the taxpayers.

VAT should be supplemented by a special commodity tax levied on luxuries and socially less desirable goods, both domestically produced and imported, so that the domestic production of such goods would not get undue protection.

Considering the structure of the Nepalese economy, the poor practices of record and account keeping in the industry and trade sectors and the limited administrative capability, it would take a long time to make full preparation for the introduction of VAT. Meanwhile, a series of transitional measures need to be taken in order to rationalize the existing commodity taxes, and which will also be helpful for the smooth transition to VAT. To this end, the commodity coverage and the base of commodity taxes should be broadened through both legal and administrative measures. On the legal front, commodity coverage may be extended mainly by reviewing the exemption policy. The overall level of exemptions should be kept at a minimum. Further, sales tax should be extended gradually to the service sector.

On the administrative front, the base of commodity taxes may be widened by making the tax enforcement more effective. The valuation

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14) Sijbren Cnossen, "Design of the Value Added Tax: Lessons from Experience", in Javad Khalilzadeh-Shirazi and Anwar Shah (eds.), *op. cit.*, p. 77.

system should be improved. Taxable value should be reassessed, if it is found to have been understated which is hardly ever done at present. The creation of a price unit, a laboratory, and some technical posts in the revenue administration would help strengthen the valuation system.

Administrative restriction and quantitative bans should be replaced by protective tariffs. This is because protective tariffs encourage price-based mechanisms, thereby improving resource allocation. Protective tariffs are not free from limitations, however. So their number and level need to be reduced gradually. The number of excise rates should also be reduced and for simplicity's sake, the practice of fixing both specific and *ad valorem* rates, and whichever is the higher rate is the effective rate, should be abandoned and instead either specific or *ad valorem* rates, should be fixed, depending upon the administrative feasibility.

The operation of commodity taxes should be simplified. Both excises and sales tax are now administered by one department. So there is hardly any justification for a manufacturer to register separately for sales tax and excise purposes. The requirements for the annual renewal of the excise licence and the submission of weekly, monthly, quarterly, half yearly, and annual excise returns unnecessarily complicate tax administration. It would be desirable to unify excise and sales tax registration and returns and reduce the frequency of returns. A unified monthly and annual excise and sales tax returns system would bring down the number of returns to 13 from the existing 84 (13 sales tax returns and 71 excise returns). Similarly the annual renewal of the excise licence must be abolished. Instead, a manufacturer should be given a permanent production and sale registration number and be required to inform the sales tax and excise office about the closure of his factory within 15 days.

In the present context of simplifying the tax system, the physical control system of excise and related provisions are now less effective and relevant. Such unnecessary provisions include the requirement for a manufacturer to obtain permission from the excise officer concerned for the commencement of manufacturing, and also the sending of samples of excisable products to the concerned department to have them certified by the excise official posted at the factory of a manufacturer. Emphasis should now be placed on record-based control instead. In 1993/94, the tax credit system replaced the suspension system. It was hoped that the new system would reduce the scope for tax evasion. A swift settlement of the tax paid on inputs should be taken as the most important aspect for the success of the tax credit system.

Another example of unnecessary excise concerns sugar and molasses, which are subject to 1 percent excises. These items are also subject to sales tax at the rate of 10 percent. However, the sales tax rate is reduced by 80 and 50 percent, respectively, on domestically produced and imported sugar. It would be desirable to abolish excises and levy only the full sales tax on these products.

The central and local level vehicle taxes should be unified and levied at the local level. Entertainment tax should be transferred from the central level to the local level. The transfer of these taxes and the land revenue, as discussed below, from the central level to the local level should serve as the alternative for the octroi which needs to be abolished.

Income tax

As in the case of commodity taxes, a consistent effort should be made to expand the scope of income tax. As the agricultural sector accounts for about half of the total GDP, it is desirable to extend income tax to agricultural income. It must be remembered that a large part of the national budget is spent on agricultural sector. It is considered that the large farmers have benefitted more than the small farmers from public investment and subsidies granted to the agricultural sector. Further, the prices of land and its products have been increasing. So a tax on agricultural income would be justified. It is true that such a tax cannot be made very effective in the near future, but a start should be made so that agricultural income could be taxed in same way as non-agricultural income in the long run. For practical reasons, a very simple presumptive basis, probably per unit of land, could be adopted. Further, as such a tax would penalize the unproductive use of land, it would induce landowners either to use their land more productively or to sell it to the really needy. Further, as farmers would require cash to pay tax it would lead to an improvement in the marketing of agricultural products.

As land revenue offices maintain a land cadastre which gives information concerning the location, type, identification number, and ownership of each plot of land in their respective areas of jurisdiction, the implementation of such a presumptive tax on agricultural income should not be very difficult. Such records are, however, maintained on a district basis. Some landowners own land in more than one district and the total area of land owned by these landowners all over the country is not known. Further, the land has still not been surveyed in

23 of Nepal's 75 districts (this, however, should not be a problem since only the land in remote areas is yet to be surveyed and this type of land is likely to remain out of the tax net in any case). Furthermore, the extension of income tax to agricultural income would demand a large administrative set-up, which would simply not be possible with the existing resources of the Tax Department. While the Land Revenue Department has a relatively large number of staff, these officials would require a tremendous amount of training to handle income tax since income tax administration is more complicated than that of land revenue. The fact of the matter is that a detailed process of preparation is necessary before introducing even a relatively simple presumptive tax on agricultural income. Until then, land revenue should be made as effective as possible to serve as a proxy for an agricultural income tax.

The exemption of allowances granted to employees on account of travel, telephone and contingency and the sum allowed to an employee by his employer to meet business-related expenses, which are not verified by receipt, should be included in the taxable income. A withholding tax on dividends may be taken as a desirable long-term goal, if not an immediate one. The scope of tax incentives may gradually be reduced. Industries may be granted non-tax incentives instead. They should be allowed to carry forward their losses for 5 years. New taxpayers may be identified from the existing sources and a detailed survey of traders, professionals and so on should be conducted.

Some sort of presumptive method should be adopted in the case of small taxpayers and certain professionals. For this purpose it is necessary to call on the services of a group of experts to fix some objective criteria on the basis of certain indicators such as imports, purchases, turnover, number of employees, consumption of fuel and electricity etc. This method would allow tax officials to enroll some taxpayers on the tax list who would otherwise remain outside the tax net. They might be given the option to be taxed under the normal tax regime, instead of by the presumptive method. The ultimate objective should be to bring small taxpayers and professionals into the purview of the normal tax procedures.

Withholding tax should be extended to sources of income such as honorariums and payments made to professionals such as accountants, architects, auditors, carpenters, lawyers, mechanics, plumbers etc.

Consistent efforts should be made to make income tax assessment more objective and the existing practice of assessing income tax largely on the basis of the best judgement of a tax officer should be avoided. Tax officials should examine the tax returns with a positive attitude and should assess income tax, as far as possible, on the basis of returns submitted by the taxpayers. Taxpayers also should believe that in this changed context their returns will be accepted at face value and should co-operate with tax officials by submitting correct returns. Besides, several incentives, such as a special allowance, the right to claim accelerated depreciation, to carry forward losses for a longer period than others, special deductions etc., might be extended to those taxpayers who keep proper records and books of account and file accurate returns. It would also be desirable to publish a list of honest and high taxpayers to encourage accurate tax returns. Further, it is necessary to gradually develop a self-assessment system which would reduce the scope of the collusion between taxpayers and tax officials and, on occasion, the harassment of the former by the latter.

A current payment basis should be adopted in the case of income not subject to withholding tax. This would prevent the fall in revenue in real terms due to inflation, would improve horizontal equity by taxing all sources of income on the current year's income, would be convenient to the taxpayers since they have to pay on the current year's income, and would minimize the tendency to make deliberate delays in payments. Rough adjustments should be made in line with the rate of inflation in the level of basic allowance, deductions etc., fixed in money terms, in order to minimize the effect of inflation on income tax. An avoidance of double taxation treaty should be completed with the major trading partners of Nepal in order to attract foreign investment and technology. In general, dividends should be taxed, at least in the longer run. However, special tax treatment of dividends such as exemption or a lower tax rate on dividend income may be considered on a country-by-country basis, depending upon the tax treatment of dividends in the country of residence of foreign investors. A resident taxpayer may be taxed on his worldwide income.

The above-mentioned measures, particularly the extension of income tax to agricultural income, dividends, allowances and fringe benefits combined with a reduction in tax incentives, would gradually broaden the base of income tax. This would make it possible to reduce the tax rate, improve equity and efficiency and lead to an ideal tax system. Gradually interest tax and house rent tax could be integrated into the individual income tax, and other sources subject to the presumptive method could be brought within the normal tax regime

Property taxes

As property taxes satisfy most of the criteria of a good local tax system, these taxes should be developed as major sources of local tax revenue. House roof tax should be strengthened particularly through the development of a detailed records regarding the size, type, structure, location, date of construction, compound etc. of each house in the municipal area concerned. Land revenue should be transferred from the central level to the local level and tax proceeds may be shared by the village development committees/municipalities and district development committees. Of the local levels, village/municipality seems to be the appropriate levy point for land revenue. This would provide a relatively stable tax base for each local body. The tax base is localized and the tax burden is largely limited to local residents. It would also reduce the compliance costs of landowners since they would not have to go to the district headquarters to pay tax, which in some cases may be a day's journey away. Further, as the tax proceeds would be used in activities directly benefitting local taxpayers, this system would help improve taxpayers' compliance. Furthermore, large numbers of local people would be connected with the local bodies who would take an interest in the local budget. It must be noted that at present land revenue is collected by the land revenue offices of the central Government but 75 percent of the proceeds are transferred to the district development committees. The transfer of tax levying authority to the local bodies would avoid the need to transfer land tax proceeds from the central to the local bodies and thus reduce the cost of collection. Further, as local bodies may be run by different political parties, a local land tax system would damp down politically motivated opposition towards the efforts to raise the rates of land revenue which aim to make them more meaningful.

However, the central goverment should continue to maintain records of house and land ownership for various reasons, including the inadequate administrative capabilities of the local bodies which may not always exercise their authority properly. The land revenue offices of the central government should prepare the records of ownership of land in such a way that it would be possible to trace the total amount of land owned by an individual in different parts of the country.

Although in theory a net wealth tax is very attractive for several reasons, including equity and strengthening income tax administration, the enforcement of this tax is frustrating and its future does not seem to be very promising if it continues to be managed as it has been up till now. The tax would inevitably result in horizontal inequity if it remains largely unenforced. This is because only the unfortunate honest people and/or those who are being closely monitored by the tax officials would be penalized. This would compromise honesty and destroy the respect for tax laws. It is, therefore, desirable to undertake an in-depth study regarding the prospects and constraints of the net wealth tax in Nepal.

In the field of registration fees, it is necessary to make the valuation more realistic and tax should be levied only on the buyers of property, not on both buyers and sellers. Tax rate should be reduced from the current rate of 14 percent to, say, around 5 percent at first and then down further to 3 percent. In the case of the resale of a house and land within 5 years, a registration fee of about 5 percent of sale value could be levied on the sellers as a proxy for capital gains tax. This would curb speculative transactions concerning houses and land, thereby discouraging unproductive investment in real property and controlling its prices.

5. 3 Strengthening tax administration

The Nepalese tax reform should also focus on administrative reform. It is said that tax "structure and administration are interdependent and tax reform must take both aspects into account."[15] It must be remembered that mere formulation of tax measures is not an end in itself: they have to be implemented successfully. This explains the need for improvement in tax administration. Casanegra's observation, "In developing countries tax administration is tax policy"[16], is quite relevant in the present Nepalese context where there is much scope for reform in the existing taxes through an improvement in tax administration. New measures, even the most modest, would require an improvement in tax administration as well. For example, the presumptive method has been prescribed in cases where normal tax procedures are just not impossible. However, even the "presumptive taxes require a considerable amount of administrative input if they are to be based on realistic and objective criteria".[17] Another relatively easy

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15) Richard M. Bird, "Tax Administration and Tax Reform: Reflections on Experience", in Javad Khalilzadeh-Shirazi and Anwar Shah (eds.), *op. cit.*, p. 39.

16) Milka Casanegra de Jantscher, "Administering the VAT", in Malcolm Gillis, Carl S. Shoup, and Gerardo P. Sicat, *Value Added Taxation in Developing Countries*. The World Bank, Washington, D. C., 1990, p. 179.

17) Vito Tanzi and Milka Casanegra de Jantscher, *Presumptive Income Taxation: Administrative. Efficiency, and Equity Aspects*, IMF Working Paper No. 87/54, International Monetary Fund, Washington, D. C., August 1987, p. 15.

measure suggested earlier is withholding tax. This also requires close monitoring. As Silvani observes: "It is well to remember that every time a tax is withheld it becomes necessary to monitor not only the withholding agent to make sure that the amounts withheld are actually turned over to the treasury but also the 'withholdee' to verify that only the amount withheld, and no more, was deducted from the tax owed."[18)]

Nepal had adopted the ring system for a long period under its sales tax. Under this system sales tax registered vendors were not required to pay sales tax on the import/purchases of their raw materials etc. However, several firms imported materials for use as inputs but sold them instead. So this system was recently replaced by the tax credit system. Under this system sales tax registered vendors are required to pay sales tax on the import/purchase of their inputs but they are allowed to credit this input tax against their output tax. The success of this system depends upon the prompt settlement of the input tax which requires an efficient tax administration. Other measures such as a broad-based VAT and conventional income tax would require a very strong tax administration.

Further, "tax systems become more complicated as the economy evolves into a complex set of market structures".[19)] Nepal has now adopted an open economic policy which, *inter alia*, aims to attract

18) Carlos A. Silvani, "Improving Tax Compliance", in Richard M. Bird and Milka Casanegra de Jantscher, *Improving Tax Administration in Developing Countries*, International Monetary Fund, Washington, D. C., 1992, p. 293.

19) Roy Bahl and Jorge Martinez-Vazquez, "The Nexus of Tax Administration and Tax Policy in Jamaica and Guatemala", in Richard M. Bird and Milka Casanegra Jantscher (eds.), *op. cit.*, p. 101.

domestic and foreign investment. It is also necessary to complete avoidance of double taxation treaties with major trading partners and to implement them effectively to attract foreign investment. For this, tax personnel, at least a few, are required to acquire knowledge of how to draw up an avoidance of double taxation treaty, the tax systems of the trading partners, and the principles of international taxation. The tax administration will have to deal with complicated issues such as transfer pricing, thin capitalization, treaty shopping etc. with the establishment of multinational corporations. All this means that the tax administration has to be improved by all means available.

Reforms in tax administration may encompass reform in organization, personnel, training, administrative equipment, and facilities.

It is necessary to establish a system of internal tax audit and staff monitoring in order to make both tax officials and taxpayers more careful in fulfilling their jobs/duties and to discourage collusion, delinquency, and tax evasion. The Revenue Investigation Department may be made responsible for a joint audit for all revenue departments. A professional staff of auditors and investigators should be developed in this department. Although it would not be possible to carry internal audit on a large scale in the beginning due to the lack of adequate and trained personnel, a modest start should be made with areas where evasion is a particular problem. The Revenue Investigation Department also should include a mobile squad that is well-equipped with means of transportation and communication and which should be authorized to conduct surprise visits of the premises of suspected tax-evaders and to follow suspect carriers *en route* and make checks on their goods. In the light of the increasing number of new taxable items, it is equally necessary to set up, at least, a common laboratory in the revenue administration in order to find out the composition, quality, and nature of taxable goods, particularly when there is a dispute between taxpayers and tax collectors regarding the composition and classification of goods.

A suitable working environment should be created through, *inter alia*, creating adequate office space, furniture etc. Adequate metal detectors and X-ray machines should be installed at the Tribhuvan International Airport Customs Office to facilitate the flow of inspection and to counteract smuggling and the border patrol should be well equipped with means of transportation and communication.

It is necessary to regroup the taxes to be administered by each revenue department in the interests of efficiency. In this context, commodity based taxes such as air travel tax, contract tax, and hotel tax should be transferred from the Tax Department to the Sales Tax and Excise Department. Entertainment tax and vehicle tax should be transferred to the local bodies. As all revenue departments could be called tax departments, the name of the Tax Department should be changed to Income Tax Department.

Special attempts should be made to develop the recently established revenue group as a specialized group of competent, experienced, capable, and motivated personnel. Some technical posts should be created and low level posts such as non-gazetted level class III and IV should be abolished. Allowances etc. should be increased for the revenue officials in order to reduce temptation for corruption and make this service attractive. An effective system of reward and punishment should be established. As most officials now included in the revenue group lack specialized training, they should be given comprehensive training on various aspects of taxation in a phased manner. It should be made obligatory for new employees to obtain a comprehensive pre-service training before they are assigned particular jobs. Similarly, revenue officials should be given inservice training from time to time in order to expose them to new ideas and techniques. The Revenue Administration Training Centre should be strengthened considerably. Personnel with a sound education and a good career record should be posted to this centre to train revenue personnel in an effective manner. The local tax administration should be strengthened as well.

An integrated information system regarding the tax base, rate, taxpayers, tax collection etc. should be developed. Coordination and automatic flow of information among the revenue departments should be established. The use of computers should be extended gradually. A single taxpayer identification number capable of identifying the taxpayers in connection with each tax may be taken as an long-term ideal goal.

The analysis of the tax base, rates, collection, and implications of tax measures, revenue forecasting, and preparation of tax proposals must be done in a regular way. The creation of a permanent Tax Advisory Commission would probably prove to be effective to carry out such functions. This unit would require the service of dedicated personnel having a thorough knowledge of both the theoretical and practical aspects of the whole tax system. This unit may be assigned the job of monitoring the tax reform program closely. As Silvani observes: "The key ingredient in bringing about change is having a team of men and women with will and the political authority needed to see the changes through. If significant success is to be achieved, it is essential to have a group of officials with an iron will and even obsessed by the idea of modernizing."[20]

Firm and consistent political determination is required for comprehensive tax reforms, including administive reforms.

5. 4 Improving tax compliance

In Nepal the level of voluntary tax compliance is very low for several reasons. As stated earlier, most of the vendors are very small and illiterate. They do not keep even minimum records for any purpose. They find it difficult to comply with the tax due to their lack of understanding of the tax system and the absence of any record required for the preparation of tax returns. Further, in general, tax consciousness has yet to be developed among the Nepalese people. Even the big vendors or other individuals who are in a position to comply with the tax without difficulty still hesitate to pay tax. This might be due, *inter alia,* to the low penalties for non-compliance. Because of the lack of a tax auditing system in the revenue administration, there is a very low probability of detecting the evaded tax. Statutory rates of penalty for non-compliance are very low and even these low rates are generally not used in cases of need. Several monetary penalties for non-compliance have been fixed. Maximum limits were fixed many years ago when the value of money was many times higher than at present. Inflation had eroded their deterrent effects. So it is necessary to increase the limits substantially.

Penalties and interest rates are charged for late payments. Penalties

20) Carlos A. Silvani, *op. cit.,* p. 300.

associated with delayed payment of certain taxes are given in Table 1.

Table 1 : Penalties for delays in tax payment

	Income Tax	Sales and Entertainment Taxes
1.	First 3 months 3%	Up to 1 months 5%
2.	First 6 months 5%	Up to 2 months 10%
3.	First 9 months 7%	Up to 3 months 15%
4.	More 9 months 7%	More than 3 months 15%

The above-mentioned penalties are not effective to deter delays. The fact that, in the case of income tax penalty rates go down with longer delays in paying taxes only encourages further delays. For example, let us suppose there are three taxpayers A, B, and C and the tax due for each is Rs. 1,000. Of them, A pays his tax dues within one month, B within four months, and C nine months. In such cases, A has to pay a penalty of Rs. 30, B has to pay Rs. 50, and C has to pay Rs. 70, meaning that the rate of penalty is the lowest for C. These penalties are not adequate to deter delays in payments in a situation where banks charge interest of 15 to 21 percent and moneylenders as high as 36 percent. Consequently, delays are widespread, resulting in the reduction in the real value of tax revenue. Penalties and charges for delays in payment should be at a higher level than bank interest rates.

Delinquent taxes and penalties are not indexed, interest rates charged for late payment are lower than bank interest rates. The tax administration is weak and taxpayers take advantage of this situation. Complicated tax procedures, tax evasion, corruption etc. only add fuel to the flame. There is a lack of a systematic and constant effort on the part of the tax administration to increase the level of voluntary compliance.

The tax administration should, therefore, make special efforts to raise the level of voluntary tax compliance. In the words of Silvani: "The goal of tax administration is to foster voluntary tax compliance".[21] To this end, the tax administration should launch a comprehensive tax package to boost the level of voluntary tax compliance. Such a package should include both promotive and regulatory measures. Promotive measures should help facilitate tax compliance, while regulatory measures would discourage non-compliance.

Promotive measures

A well-designed education programme for taxpayers should be launched. "The education must be in the nature of why government needs taxes, how the laws are determined, and how a responsible citizen participates in the system."[22] This programme should also provide information to the taxpayers about where, when and how much tax is to be paid. Tax consultation booths should be created at all major revenue offices in order to provide assistance to the taxpayers. Taxpayers also should be informed through the mass media at times when payments are due. Tax news bulletins should be published regularly and distributed to the potential taxpayers. Tax procedures should be made simple, clear, and transparent so that taxpayers will understand the tax system more easily and tax compliance will be enhanced. It must be remembered that "As laws get more complex and far-reaching, people know that they cannot be effectively followed, and respect for all laws fails."[23] All procedures relating to taxes admin-

21) Carlos A. Silvani, *op. cit.*, p. 274.
22) Robert A. LeBaube, "comments", in Richard M. Bird and Milka Casanegra de Jantscher (eds), *op. cit.*, p. 308.
23) Richard K. Gordon, Jnr., "Income Tax Compliance and Sanctions in

istered by each revenue department should be compiled and published at the beginning of each fiscal year by the department concerned. The preparation and distribution of tax tables and tax manuals with practical examples would also help to encourage voluntary compliance. These procedural simplifications would not only raise the level of voluntary compliance but would also minimize disputes between taxpayers and tax officials and reduce the level of appeal that causes wastage of resources to both taxpayers and the Government. Honest taxpayers should be rewarded for their honesty. To this end, a list of honest and high taxpayers should be published every year.

Regulatory measures

Tax laws should be enforced effectively. "Taxpayers are not likely to meet their obligations fully when the tax system is seen to be unfair and the tax administration is thought to be corrupt or inept or both."[24] Effective and honest tax administration is important not only to provide competent guidance to the taxpayers and to make accurate assessmets, but also to inspire confidence in a strong tax administration among taxpayers and make taxpayers careful to comply with tax law; sufficient well-trained and honest tax collecting personnel would help to boost tax morale.[25] The tax administration should make every effort

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Developing Countries" in Richard M. Bird and Oliver Oldman (eds.), *op. cit.*, p. 459.

24) Charles E. McLure, Jr., and Santiago Pardo R., "Improving the Administration of the Colombian Income Tax, 1986-88" in Richard M. Bird and Milka Casanegra de Jantscher (eds.), *op. cit.*, p. 143.

25) Horst Zimmermann, *Development of the Tax System in the Federal Republic of Germany since 1980*, a paper presented at the workshop for the Federal Ministry of Finance, Mexico, D. F., 27 September 1988, p. 10.

to register all potential taxpayers. It should issue notices to the taxpayers who do not submit returns within the stipulated time. Tax returns should be checked and taxpayers should be informed about any mistakes. As tax audit increases the possibility of detection of evaded tax, it is very effective in raising the level of voluntary compliance. Swift action should be taken to collect delinquent taxes.

Non-compliance should be discouraged through an effective system of penalties. Several monetary penalties for non-compliance have been fixed. Maximum limits were fixed many years ago when the value of money was many times higher than it is at present. So it is necessary to increase the limits substantially. Further, the existing penalties for late payment of income tax seem to be irrational since instead of discouraging delay in payments, they encourage such delay, so they need to be revised. Penalties should be implemented effectively so that the cost of non-compliance will be higher than that of compliance. It must be remembered that "... the effect of penalties will be felt only if they are applied ... The public must witness the serious attempts of the administration to punish tax evasion. In general, it is important that the tax administration present the image, to the greatest extent possible without losing credibility, that compliance is substantial."[26] Such an action is necessary "so that taxpayers who are complying do not change their behavior as a result of observing those who evade."[27]

6. Concluding remarks

The Nepalese tax system has undergone considerable changes over

26) Richard K. Gordon, Jnr., *op. cit.*, 1990, p. 457 and 461.
27) Carlos A. Silvani, *op. cit.*, p. 287.

the years: existing taxes have been revised several times, new taxes have been introduced, and a few taxes have been abolished after a short trial. Despite numerous *ad hoc* revisions, the possibility for improvement remains since the Nepalese tax system is unnecessarily complex, distortive, inequitable, and inelastic and does not produce adequate revenue. Thus it is necessary to rationalize the tax system considerably. However, considering the weak tax administration, the poor record and account keeping system in industry and trade, the low level of literacy, the low level of tax consciousness among the people, an agriculture-based and predominantly rural economy, few and less demarcable channels of distribution, the predominance of unorganized and family-held business, and last but not least physical difficulties in reaching the potential taxpayers, drastic measures cannot be adopted at once even if they are important on theoretical grounds to rationalize the tax system. There is a long way to go before a theoretically sound tax system could be adopted in Nepal, but this should be a long-term ideal goal. To this end, a comprehensive tax reform programme should be launched. Reform should be phased. Some less sophisticated measures which are relatively easy to understand and administratively less demanding may be adopted in the near future. Tax administration has to be improved and both promotive and regulatory measures are going to be necessay to boost the level of voluntary tax compliance.