or remain ineffective. Net wealth tax, stamp duties, and house construction tax are recent examples. On top of this, the practice of making frequent changes in the tax system on an *ad hoc* basis only serves to create uncertainty among the taxpayers. Under such circumstances it is difficult for industrialists to plan their activities properly and they lose confidence in government policy. Undesirable economic activities such as a tax-induced increase/decrease in imports etc., depending upon the expectation of an increase/decrease in tax rates, often take place just before the budget presentation. Policy makers might then have to face pressure from influential lobbies for the exemption or reduction in tax rates on their transactions/commodities etc. Frequent tax changes also create transitional costs such as start-up costs and learning costs.[11] Moreover, resources spent by both taxpayers and tax collectors on learning the old system have been wasted.

11) Richard M. Bird, "Tax Administration and Tax Reform: Reflections on Experience", in Javad Khalilzadeh-Shirazi and Anwar Shah (eds.), *Tax Policy in Developing Countries*. The World Bank, Washington, D. C., 1991, p. 41.

existing organizational pattern of the revenue administration is also inadequate. Surprise visits to taxpayers and sample checking and auditing of their books are simply not done. The inspection of field offices by the departments is carried out in a superficial way. Similarly, there is a lack of facilities to carry out laboratory tests on commodities in order to find out their nature and quality in the event of disputes between the taxpayers and tax officials regarding their classification.

There is also a lack of physical facilities in the tax offices. Generally several officials have to share a room. Under such conditions tax collectors find it difficult to concentrate on their work. There are no waiting rooms for the taxpayers or tax consultation booths. In some offices, sometimes files are wrapped up in a piece of cloth and kept in the corridors due to the lack of space and office furniture. Most work is done manually which causes delays and mistakes. Records have not been computerized except in a few cases. The database is limited : a comprehensive information system is yet to be developed.

4. 8 Lack of coherent and stable tax policy

In Nepal, tax changes have been introduced on an *ad hoc* basis, without much consideration for their feasibility and possible effects on the economy. The private sector is rarely consulted regarding the new tax proposals. In several cases even the tax administrators have not been informed about new proposals until the date of their implementation. Tax laws are formulated several months after the introduction of new taxes. The result is that taxpayers hardly ever comply with such taxes and neither do the tax administrators support these taxes wholeheartedly. Furthermore, such measures are often either reversed

Similarly, the burden of octroi is not restricted to the local area. This tax is passed on, through higher prices, to consumers, who may be residing in or outside the municipal area. Thus octroi runs counter to the principle of non-exportability, as the burden of octroi also falls on people residing outside municipal areas. Furthermore, as goods brought into a municipal area are held up at different points for the purpose of octroi it creates inconvenience to the importers and passengers and wastes time and energy and retards the growth of trade and industry.

4. 7 Weak tax administeation

The tax administration is weak. Until recently, there was in fact no specialized revenue service. Revenue personnel were drawn from general cadres without having any specific qualifications. The new entrants to the revenue administration used to be directly posted to the field offices without being given any basic training for their jobs. Moreover, it had also been the practice for revenue officials to be transferred outside the revenue administration, so their experience and special training, if any, was wasted. This resulted in a weak tax administration. Knowing this, taxpayers naturally try to take full advantage of the situation. While a revenue group was created within the Nepal administrative service in 1992/93, there is still a long way to go in order to develop a specialized revenue service.

The existing organization pattern of revenue administration is unbalanced, i. e. the responsibility and workload are not evenly distributed among the various revenue departments and the allocation of responsibility for the collection of various taxes by each department does not seem to have been made on a rational basis. In addition, the changes which occur in the fiscal year concerned are given in the Finance Act, meaning that it is necessary to consult the Finance Acts for several years back in order to know the structure and operation of the tax system. As the Finance Acts are published in the Gazette which is not widely distributed, it is difficult to collect the Finance Acts pertaining to several different years. Further, some procedural changes are brought about by means of departmental circulars which are restricted in circulation. Such changes complicate the tax system.

4. 6 Octroi is not a good local tax

Octroi, which generates about 90 percent of local tax revenue, does not satisfy most of the principles of a good local tax. For example, this tax does not satisfy the principle of autonomy which prescribes that municipalities should be given autonomy to fix tax rates within the prescribed limits according to local conditions. This is becauae variation in tax rates among the municipalities would cause reallocation of resources even when such a reallocation of resources is not justified on economic grounds. On the other hand, fixing a uniform rate of octroi in all municipalities would mean that municipalities are deprived of fiscal autonomy.

Octroi also does not satisfy the principle of accountability which emphasizes that a local tax system should assist local bodies to be accountable to their constituents through the efficient use of local revenue. This occurs when local people are aware of the tax burden and consequently are concerned with the use of the local budget. As the burden of octroi is hidden, this tax does not encourage local people to take an interest in the spending of the local bodies.

goods, he then has to send further samples of such goods. He is required to send to the department concerned weekly, monthly, quarterly, halfyearly, and annual returns showing production, sales, amount of excise tax paid, stock, etc. after having them certified by the excise personnel posted at the factory. He is required to obtain prior approval from the excise inspector posted at his factory if he wishes to remove his goods from the factory warehouse. In the case of goods subject to the self-removal procedure, he has to inform the chief of the excise office about the ex-factory price three days before the removal of goods from his factory.

A manufacturer has to register for sales tax purposes and is required to file a monthly return within one month of the end of each month and an annual return within one month of the expiry of the year. He is also required to obtain an income tax certificate which is, like the excise licence, to be renewed annually. He has to file an income tax return within three months after the end of the income year relating to his previous year's income. He also has to go through several formalities in connection with the refund of the deposited octroi. Similarly tax officials have to deal with the same taxpayers several times in connection with various taxes. Such multiple sets of taxes lead to a "complex and multiple relationship between trader and government"[10] and increase both administrative and compliance costs considerably.

Changes in the structure and operation of various taxes are frequently made by the Finance Act. However, generally only those

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10) Allan A. Tait, *Value-Added Tax : International Practice and Problems*, Washington, D. C., International Monetary Fund, 1988, p. 16.

judgement method and on a presumptive basis rather than on actual profit.

4. 5 Complicated procedures

The Nepalese tax system has become unnecessarily complicated. Taxes are levied under different names which are paid by some taxpayers in various capacities. For example, a manufacturer has to pay (1) import duties on the imports of raw materials etc. as an importer, (2) sales tax on the imports/purchases of the industrial materials as a sales tax registered vendor, (3) excises on his products as a producer, (4) sales tax on the sale of his products as a seller, (5) [he may have to pay] octroi in the form of a deposit on goods in transit through a municipality, other than the municipality where his industry is located (This deposit is theoretically refunded when the materials are taken out the jurisdiction of the municipality concerned), (6) final octroi twice (once on the import of raw materials at the entry point of the municipality where his industry is located and once on his finished goods at the entry point of the municipalities - other than the municipality where his industry is situated - where he sells his products), and (8) income tax as an earner of income thorough these activities.

The manufacturer has to go through several formalities. For example, he has to obtain an excise licence, to be renewed annually, for the manufacture of excisable goods and obtain permission from the excise officer concerned for the commencement of manufacture of those goods. When production begins, the manufacturer has to send samples of his products to the department concerned to have them certified by the excise officer, and, in the event of any change in such for both sets of commodities. Further, these taxes favour imported goods over domestic products since they do not cover distributional expenses and the profit margins of importers.

Not only commodity taxes, but also the Nepalese income and property taxes are considered to have become inequitable. For example, the Nepalese income tax treats different sources of income differently, resulting in an unequal tax burden upon taxpayers having equal tax paying capacity. Employees, particnlarly in the public sector, pay full tax on their income due to withholding tax. Self-employed people who earn more money, however, pay little or no tax on their income. Although, in theory, business income is supposed to be taxed to the same extent as remuneration income, in practice, there is the possibility that this type of income may escape tax or be taxed lightly due to the ineffective enforcement of the tax. Capital income is treated favourably: capital gains and dividends are exempt, interest is taxed lightly, and house and land rent income is separately taxed. Even if the rates for individual income tax and rent tax are the same, the tax favours house rent due to the application of lower marginal rates on higher income from this source.

Further, income tax is levied on a current year basis on some forms of income but on a preceding year basis on others. In such a situation, receivers of labour income whose income is subject to withholding tax have to pay higher real tax rates due to inflation than do earners of other types of income such as business income. Business income is assessed on the previous year basis and businessmen delay payments in several ways and pay less tax in real terms. Several sources escape tax altogether. The bulk of the tax revenue is assessed under the best to the refund of taxes levied on the input of exports due to the lack of a simple and well-functioning duty drawback and excise refund system. Cascading/pyramiding effects further make it difficult to refund the exact amount of taxes levied on exports. These factors make domestic products less competitive in the international market.

Furthermore, the exemption of several commodities, sources of income, and property and the existence of differential rates cause reallocation of resources from taxed to untaxed areas or from highly taxed to lightly taxed areas. High tax retes bring further economic distortions. In short, even in the absence of empirical evidence, there are *a priori* reasons to believe that the Nepalese tax system creates substantial distortions within the economy.

4. 4 Inequity

Commodity taxes predominate in the Nepalese tax system. These taxes are generally considered vertically inequitable since they do not take into account the personal circumstances of taxpayers : they fall on all spending equally, meaning that lower income groups, who spend a proportionately large part of their income on consumption, have to pay a higher percentage of their income in the form of tax, as compared with higher income groups. As the major commodity taxes are collected at an early stage in the production and distribution process these taxes are judged to have become horizontally inequitable as well. This is because these taxes put a higher burden on commodities that generate proportionately higher value added at the tax impact point than on their counterparts that generate higher value added below the tax impact point. This is so even when the statutory rates are the same price when they are taken for sales purposes into the areas of other municipalities. Moreover, octroi is likely to be levied more than once on the finished goods. For example, goods imported via air arrive first in Kathmandu and are taxed by the Kathmandu Municipality. Then the small vendors from different parts of the country buy these goods from the importers and take them to sell in their respective areas. When these goods arrive in these places they are taxed yet again at the entry point by their respective municipalities. Octroi is levied on the tax inclusive price. There is no system to adjust the octroi paid earlier, in this case to the Kathmandu Municipality. Any attempt to do so would be impractical at the local level at this stage. Thus there is a tax on tax, resulting in a cascading effect. One of the consequences of cascading is that the tax-induced rise in prices is higher than the amount of tax.

Manufacturing level taxes cause contraction in the operation of firms as these taxes give an incentive to push as much activity and cost as possible beyond the tax impact point in order to reduce tax liability. Further, octroi encourages the establishment of industries in the big cities as it protects the products of these industries that are produced and consumed locally. Thus, octroi affects decisions concerning the location of industries, leading to an uneconomic use of resources. Further, as vehicles are stopped at several points for the purpose of octroi it creates inconvenience to importers, wastes time and energy, and increases the cost of production. As the free flow of traffic and trade is hindered, this interferes with the growth of trade and industry.

Further, the existing commodity tax system has had an anti-export bias. It has not been possible to implement the legal provisions relating the total tax system was 1.17 while of major taxes, viz. import duties, income tax, sales tax, and excises the buoyancies were 1.32, 1.31, 1.24, and 1.21, respectively, meaning that tax revenue has largely been increased through discretionary measures during the period under review.

4. 3 Inefficiency

Major commodity taxes are largely collected at the import/manufacturing point. These taxes, levied at an early stage in the production and distribution process, have cascading/pyramiding effects. Normally, sellers apply a mark-up percentage in their tax inclusive selling prices, resulting in a rise in consumer prices in excess of the amount of the tax, i. e. the consumer prices rise not only by the amount of the commodity taxes but in excess of the tax because of the pyramiding effect of commodity taxes. The cascading effects add fuel to the flame. To elaborate further, machinery, equipment and spare parts, raw materials, auxiliary raw materials and chemicals are subject to import duties, licence rates and premiums. Although under the existing excise system, goods produced by a domestic industry which are produced with domestic raw materials and used by another domestic industry as inputs are exempt from the excises on the recommendation of the concerned department, in fact this is hardly followed in practice, resulting in fact in excise on excise. Thus the Nepalese excise has become a cumulative levy.

Octroi is cumulative as well. It is levied on industrial materials at the gates of the municipality where the industry which uses them is situated. Finished goods are again subject to octroi on the tax inclusive only 7.83 percent in 1991/92 which was lower than that of many other developing countries. Tax revenue, which constitutes three quarters of the total public revenue, grew by an average annual rate of 15.58 percent between 1974/75 and 1991/92. This growth is in part because of inflation. In real terms, tax revenue grew only by 6.84 percent during this period. This growth is inadequate in relation to the growth of public expenditure and the public sector has been facing a resource crunch. The composition of tax revenue is lopsided. The Government relies heavily on commodity taxes for its revenue. In 1950/51 commodity taxes provided only 25 percent of total tax revenue while the contribution of property taxes was 75 percent ; income taxes were not then in existence. This position has changed radically over the years. Now commodity taxes provide more than 80 percent of the total tax revenue of the central Govrnment while property taxes provide less than 7 percent. The remainder, about 10 percent, is obtained through income taxes. The structure of the local taxes is more unbalanced than that of the central taxes. Commodity taxes provide almost all local tax revenus. Unlike in many countries, property taxes provide negligible revenue at the local level in Nepal.

The Nepalese tax system is inelastic. The elasticity of the total tax system was only 0.48 during the period 1974/75 to 1991/92. The elasticities of individual taxes were rather divergent, ranging from 1.32 of contract tax to −0.95 of export duties. Of the major taxes, the elasticities of sales tax, import duties, excises and income tax were 0.77, 0.65, 0.60 and 0.44, respectively.

The total tax system as well as most of the individual taxes were found to be buoyant during the period under study. The buoyancy of fully, resulting in a gap between the legal and the actual tax base. For example, it is believed that several potential payers of income and property taxes have remained outside the tax net ; house roof tax and net wealth tax have remained almost unenforced.

This has been reflected in the low number of taxpayers. For example, in 1989/90, the number of registered payers of individual income tax (other than wage and salary earners who contributed 5.5 percent of total income tax revenue in 1989/90), corporate income tax and house rent tax was only 70,810 which was less than 1 percent of the total economically active population (age group 15-60). It must be noted that about one quarter of these registered payers are no longer engaged in economic activities but their names have not been removed from the tax list because there is no practice of keeping such lists up to date. Furthermore, not all taxpayers brought under the tax net are taxed effectively.

Income tax assessment is highly subjective and the base of customs duties, excises and sales tax is believed to have generally been understated. The tax administration does not have the resources to reassess such understated values. It may be noted that in 1991/92, the average total import tariff was only 9.85 percent compared with the nominal rates, which generally ranged from 30 to 165 percent. Similarly, the average sales tax rate on imports was only 3.82 percent compared with nominal rates which ranged from 5 to 40 percent in 1991/92.

4. 2 Less productive and inelastic

The Nepalese tax system is not productive. Tax to GDP ratio was example, a number of commodities are exempt from customs duties and sales tax on various grounds, including equity. Sales tax is mainly collected at the import/manufacturing point while value added at the wholesale and retail levels remains outside the tax net. Similarly, agricultural income, capital gains, dividends, and several allowances granted to employees are exempt from the income tax. From 1977/78 to 1992/93 land revenue was almost exempt for all landowners in those areas where the land survey had not been completed and for those landowners who held less than 1.5 *Bigha* in the *Terai* region and less than 20 *Ropani* in other areas. The scope of the net wealth tax is limited mainly to the property of an individual or an organization in 16 specified urban areas. Property in other areas is subject to this tax only when the owner has taxable property in one of the 16 specified urban areas. Further, it is not levied at all on gold and silver ornaments for personal use (there is no limit for exemption), nor on land of less than 10 *Bigha* in the *Terai* and the inner *Terai* region, less than 20 *Ropani* in Kathmandu Valley and less than 60 *Ropani* in the hilly areas, industrial machinery, equipment, warehouses and compounds, shares and debentures invested in domestic companies and corporations, and treasury bills issued by the Government.

In addition, cottage industries are exempt from excises, sales tax, and income tax and a large package of tax incentives are available for other industries in the form of tax holidays, tax rebates, tax credits, and additional expenses and depreciation. All this means that the statutory tax is smaller than the potential tax base.

Moreover, tax enforcement is very poor. Not all commodities, sources of income, and property brought under the tax net have been taxed value determined for the purpose of registration fees is used for other areas. In the case of properties other than house and land, the value as of 16 July of each year is used for the purpose of assessing the net wealth tax. Property owned by a person in different parts of the country is first valued separately. Then the value of all property is added together in order to assess the tax. The tax unit is the family, defined as husband, wife and children. The net wealth up to Rs. 1 million is exempt, the next 1 million is subject to Rs. 300 and the slices of net wealth above this figure are taxed at progressive rates ranging from 0.05 percent to 1.50 percent.

Registration fees are levied on the transfer of property whether by sale or gift or endowment. The base of registration fees is the value of the property concerned. Tax rates are fixed on both a lump sum and an *ad valorem* basis in some cases (such as Rs. 75 plus 1 percent of the sale value on property deals of up to Rs. 2,000) and only as a percentage of the value of property in other cases. The rates for gifts and endowments are lower than the rates for sales. Also, higher rates are fixed for urban areas than for rural areas.

4. Major issues with the existing Nepalese tax system

The existing Nepalese tax system is defective. Major issues related to its structure, operation, and administration are outlined below.

4. 1 Narrow tax base

The base of the Nepalese tax is narrow, legally as well as administratively. On the legal front, several commodities, services, transactions, sources of income or property are kept outside the tax coverage. For charged at a flat rate of Rs. 2 per *Kitta* (parcel of land, irrespective of its size) in those districts where land has yet to be surveyed. Land revenue is collected directly by land revenue offices in 62 districts where the land survey has been completed and through middlemen in other districts.

Local development tax is collected by land revenue offices from landowners at the rate of 10 percent of land revenue. As this tax is earmarked for local development, tax proceeds are transferred by the land revenue offices directly to the district development committees concerned.

Municipalities are authorized to levy a house roof tax on each house in their area of jurisdiction. The rate ranges from Rs. 50 to Rs. 3,000 in the case of concrete houses and Rs. 5 to Rs. 200 in the case of mud houses, depending upon the size, type, structure, and compound of the house and the availability of facilities such as drinking water, electricity, roads, sewage and telephone services.

The net wealth tax is levied on net wealth owned by an individual or an organization in 16 specified areas. Property in other areas is subject to the tax only when it is owned by an individual or an organization having taxable property in one of the 16 specified areas. For the purposes of valuation, houses are divided into 4 categories based on construction materials, and the average value per square foot to be applied to each type of house has been fixed. Depreciation rates range from 0.75 to 3.00 percent a year and are applied for 25 to 100 years, depending upon the type of construction of the houses. In the case of land, valuation is made according to the method fixed by the local committee appointed for this purpose in the urban areas and the

The interest tax is levied on interest income from all types of deposits, other than those specifically exempt, at a bank or finance company. The tax is withheld at a rate of 5 percent by a bank or finance company at the time the interest is paid to depositors.

Municipalities are authorized to levy a professional tax on business enterprises under their area of jurisdiction. This tax, as it stands today, cannot be classified as an income tax in the strict sense since tax liability depends upon the nature of the profession, instead of upon the level of income. Under the existing system, business enterprises are divided into different groups according to their nature for tax purposes, and maximum and minimum flat rates are fixed for each group. Municipalities can fix rates within these limits according to local conditions. This tax could gradually be developed as an income tax and could be based on turnover or capital of a business enterprise.

3. 3 Property taxes

The existing property tax system encompasses 5 taxes, viz. land revenue, local development tax, house roof tax, net wealth tax, and registration fees. Of these, land revenue is levied on each parcel of land. It is based on Iand area, traditionally divided into 4 categories, related to land productivity, in the rural areas and 6 categories, related to commercial importance, in the unban areas. The land units which serve as a bssis for fixing land revenue rates are *Bigha* or *Katha* in the Terai region and *Ropani*[9] in other areas. However, land revenue is

9) 1 *Bigha*=1.6 acres, 20 *Katha*=1 *Bigha*, 20 *Dhur*=1 *Katha*, and 20 *Kanwa* =1 *Dhur* while 1 *Ropani*=0.12 acres, 16 *Ana*=1 *Ropani*, 4 *Paisa*=1 *Ana*, and 4 *Dam*=1 *Paisa*.

percent flat rate tax is levied on income earned by expatriate persons, companies, or firms on account of loans, technical know-how, technology, information, formulae or other such services provided to industries, factories or companies established within Nepal.

Corporate income tax is levied at a flat rate of 35 percent. However, the rate is 5 percentage points lower than the normal rate for industries which are listed on the Nepal Stock Exchange and which have distributed a minimum 15 percent of shares to more than 100 persons. A corporation may select either the straight-line or diminishing-balance method of depreciation. Several tax incentives in the form of tax holidays, rebates and additionl depreciation and expenses are granted to attract investment.

House rent taxes are levied at both the central and local levels. The central level house rent tax is levied on income obtained from the renting out of land buidings ; there is no tax on imputed rental income from owner-occupied housing. Although this is an independent tax, tax rates and the level of basic exemptions are the same as that of the individual income tax. The basic allowance is granted either under the individual income tax or the house rent tax, depending upon the situation of a particular taxpayer, and a taxpayer who is not entitled to the basic allowance under the individual income tax is also not permitted such an allowance under the house rent tax. It is mandatory to withhold the house rent tax at prescribed rates at the time of the payment of rent.

The local level house rent tax is levied on the income derived from the letting out of land, houses, shops, garages, warehouses, sheds, factories or ponds at a rate not exceeding 5 percent of the rent.

15 to 38 percent for cinemas located in different areas) of total seat capacity and the number of shows. An entertainment tax of Rs. 15,000 per month is levied on touring movie shows, while in the case of public video shows, the tax is levied at the rate of 100 percent of the ticket price.

Hotel tax is levied on hotel bills and payable by the customers. The amount of tax is to be stated on the invoices. The tax is levied at graduated rates which vary according to the class of hotels, i. e. 10 percent for ordinary hotels, 12 percent for 1- and 2-star hotels, and 13, 14, and 15 percent for 3-, 4-, and 5-star hotels, respectively.

3. 2 Income taxes

At present there are 5 types of income taxes, viz. individual income tax, corporate income tax, house rent taxes, interest tax, and business and profession tax. The individual income tax is currently levied with three progressive rates ; 15 percent for the first Rs. 25,000, 25 percent for the next Rs. 40,000, and 40 percent for income over Rs. 65,000. A basic allowance of Rs. 25,000 for individuals and Rs. 35,000 for married couples and families is exempt from the tax. Tax on employment income, bonus, commission, vehicle rent, distribution of fees, consultancy fees and sub-contract income is withheld at source. In the case of employment income, the withholding tax rates are the same as the annual income tax rates calculated on the pro-rated income. In the case of other income, withholding rates are flat but vary for different sources of income. The withheld tax is credited against the final tax liability for those taxpayers who submit an income tax certificate at the time of the receipt of income and is a final tax for others. A 20 is imposed on the import of diesel and petrol to be used for vehicles. The rate is 20 paisa per litre and tax is collected at the customs point together with customs duties.

Air travel tax is levied on a per ticket basis. The current rate in the case of domestic flights originating in the *Terai*[7] area is Rs. 50 and Rs. 20 in other cases. However, in the case of helicopters, the rate is Rs. 75 irrespective of the origin of the flight. The air travel tax on domestic flights is waived in the case of foreign tourists who buy tickets with foreign currency. In the case of international flights, the tax rate is Rs. 500 when the flights are destined to the South Asian Association for Regional Conference (SAARC)[8] countries and Rs. 600 in the case of other countries. Non-Nepalese citizens have to pay an additionl Rs. 100.

The contract tax is levied on the value of contracts exceeding Rs. 10,000 which are negotiated for work undertaken in Nepal for profit. The rate of tax is 5 percent and withheld at the same rate from each contract payment by the party awarding the contract.

Entertainment tax is levied on entrance to cinemas, circuses, dance halls, opera, theatres, etc. In the case of Kathmandu Valley, this tax is charged on each ticket sold with the levy graduated according to the class of ticket. The existing rates for dress circle, balcony, special, first class, second class and third class are Rs. 8.00, 6.75, 5.50, 3.00, 1.75, and 0.50, respectively. In the case of cinemas outside Kathmandu Valley, the tax is levied on the basis of a specified percentage (which varies from

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7) The *Terai* is the plain in the southern part of Nepal.

8) Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka are members of this conference.

the case of goods that are exempt from customs duties, sales tax and excises, or subject to specific customs or excise duties or brought in without a proper invoice, the value for the purpose of octroi is fixed by a committee chaired by the municipal mayor. The rate of octroi is 1 percent of value thus determined and the tax is collected at the municipal gates.

A health tax is levied on the production of cigarettes at the rate of 1 paisa per stick. Revenue generated through this tax is earmarked for the activities relating to the prevention and treatment of diseases such as cancer, tuberculosis, and other similar diseases.

Of the service-based taxes, vehicle taxes are levied both at the central and the local levels. The central level vehicle tax is levied on all types of vehicles including three-wheelers and motorcycles. Tax rates are fixed annually on a per vehicle basis. In the case of private cars, jeeps, vans and motorcycles, tax rates are further linked to the cylinder capacity of vehicles. Additional rates are also levied on diesel-operated cars, jeeps and vans.

In addition, the municipalities are also allowed to levy an annual vehicle tax on vehicles registered in the area of their jurisdiction as well as an annual or a per entry tax on vehicles that enter municipal areas but are not registered there. Maximum and minimum rates are fixed for each type of vehicle so that municipalities can use their discretion in setting vehicle tax rates according to local conditions.

Highway tax and road-bridge maintenance tax are also levied at the central level. The highway tax is levied on all types of fourwheeled vehicles passing through Naubise and along other specified highways. The rate is Rs. 25 per vehicle per time. Road-bridge maintenance tax purchases, however, is credited against tax on their sales.

The base of sales tax on imports is the sum of value of the imports determined for the purpose of import duties and the amounts of import and countervailing duties. In the case of registered vendors, the tax is levied on the actual sale price when the goods are sold to other registered vendors and on the actual buying price by retailers in the case of sales to non-registered vendors. This price includes the cost of production and the profit margin of the seller and discount, if any. Registered vendors are required to issue bills of each sale and they have to record the amounts of sales tax on their bills. In the case of sales to registered vendors, it is necessary to record the sales tax register number of the buyers.

Sales tax rates, as usual, are fixed on an *ad valorem* basis. At present there are only two rates, i. e. 10 and 20 percent, depending upon the nature of goods. The rate of sales tax on telephone and related services is 20 percent and non-life insurance premiums 10 percent.

Another tax levied on goods is the octroi, which is under the jurisdiction of the local governments. This is levied on goods brought into a local area in commercial quantities for commercial, professional or industrial use. Goods brought in for daily consumption and raw materials, machinery and equipment to be used in the industries of national priorty are exempt.

In the case of imported goods, the base of the octroi is the total of the import value determined for the purpose of import duties, the amount of import duties and the sales tax. In the case of domestic products, it is the sum of the ex-factory price, excises and sales tax. In imports from India. The same base applies to countervailing duties subject to *ad valorem* rates, while some countervailing duties are levied on physical amounts. Rates of import duties are fixed on an *ad valorem* basis. Currently, there are seven bands of import duties (i. e. 5, 10, 20, 30, 40, 60, and 110 percent). Countervailing duties are levied at the same rates as excises on domestic products, as described below.

Export duties are levied on a few items such as logs, firewood, plywood, stone, magnesite, sand, etc. for environmental protection and ecological conservation. Rates of export duties are largely fixed on a specific basis although a few items are subject to *ad valorem* rates, which are levied on FOB prices. An export service charge of 2 percent is levied on exports of other items that are not subject to export duties.

Excises are currently levied on adout 20 manufactured goods. The base of excises is the volume of production or ex-factory price, which includes the cost of production and normal profit of the manufacturer, or both depending upon the excise rates. Excise rates are largely fixed on an *ad valorem* basis and vary considerably from commodity to commodity, ranging from 1 percent on sugar to 150 percent on high quality liquor. Some items are subject to specific rates. For a few goods the rates are fixed on both a specific and an *ad valorem* basis and whichever is the higher is the effective rate.

Sales tax is levied on a large number of products, imported as well as domestically produced. It is mainly collected at the import/manufacturing point. It is also levied at the wholesale level on some selected domestic products and on sole distributors or agents of the foreign firms or companies and their wholesalers. Tax levied on wholesalers' unenforced. *Panchayat* Development and Land Tax was introduced only by a few municipalities (and village bodies). As this tax was levied haphazardly and the tax proceeds were not used efficiently, the tax became unpopular and was suspended in 1979/80. The tax was reintroduced by two municipalities in 1989 but was abolished in April 1990 together with the abolition of the Panchayat system.

The local tax system was changed considerably in 1988 when tax rates of house roof tax, house rent tax, octroi and business and professional tax were increased considerably, tax procedures, mainly relating to octroi, were clarified and non-legal charges collected together with the octroi were abandoned. The local tax system was marginally revised in 1993.

3. The existing structure and operation of the Nepalese taxes

3. 1 Commodity taxes

Nepal currently levies more than a dozen commodity taxes. Of the commodity taxes, customs duties, sales tax, excises, countervailing duties, octroi and health tax are exclusively levied on goods except that sales tax is levied on telephone bills and premiums for non-life insurance. Of these taxes, customs duties are the largest source of government revenue. Import duties are levied on a large number of imported goods for a revenue or a protective purpose. The base of import duties is the CIF price which is largely determined and reviewed every six months by a central valuation committee, in the case of imports from countries other than India, and every three months by the regional valuation committees of the customs officers, in the case of enforce, it was replaced in 1991/92 by a lump sum fee to be collected at the time of import/purchase from the domestic producer. In 1983/84, a house construction tax was levied on the construction of houses in urban areas. This tax was, however, short-lived. As this tax remained almost unenforced, it was abandoned in 1985/86. The newest tax is the health tax. This tax is being levied in 1993/94 on cigarettes at the rate of 1 paisa[6] per stick and revenue obtained from it is earmarked for the prevention and treatment of cancer, tuberculosis and other similar diseases.

A local tax system was initiated in 1962 when the municipalities were authorized to levy a house roof and rent tax, business and profession tax, entertainment tax, vehicle tax, and several surcharges. These taxes and surcharges, however, remained almost unenforced due, *inter alia,* to administrative difficulty. The local tax system was revised considerably in 1965 when house roof and rent tax was divided into two taxes, house roof tax and house rent tax and these taxes were simplified. Similarly, business and profession tax and vehicle tax were also simplified. Entertainment tax was abolished but the municipalities were allowed to levy new broad-based taxes, viz. octroi and *Panchayat* Development and Land Tax. Octroi was levied on goods entering the municipal area while the *Panchayat* Development and Land Tax was levied on land in place of the traditional land revenue. The latter tax was collected from both landowners and tenants and rates were based on the annual production of the main crop.

The local tax system adopted in 1965 remained largely unchanged until 1987. Taxes other than octroi and vehicle tax remained almost

6) 100 paisa equals 1 Nepalese rupee.

reinstated in 1967/68. A contract tax was introduced in 1965/66 on the value of contracts exceeding Rs. 10,000 and was withheld at the time of payment of each instalment. A road toll[5] was imposed on vehicles in 1971/72. Initially, the toll was levied on the basis of per kilometer of road travelled, but as this system was complicated and corruption prone, it was replaced in 1972/73 by a lump sum tax levied on roads according to their length. As the road toll was collected at several points, it hindered the free flow of traffic and trade, so it was abolished in 1979/80. A vehicle tax was introduced on all types of vehicles in 1972/73 and a road-bridge maintenance tax in 1982/83. The latter tax was originally levied on each vehicle at a graduated rate and collected at specified bridges. However, as this tax hindered the free flow of traffic and trade, it was replaced by a specific tax on imports of high-grade diesel and petrol to be used for vehicles and the tax is collected at customs points together with customs duties. A highway tax was introduced in 1992/93. This tax is levied on all four-wheeled vehicles passing through Naubise.

A loan tax was adopted in 1977/78. This tax was levied on bank loans. As this tax was incompatible with the growing Nepalese economy where it was necessary to promote banking activities and investment, the tax was abolished in 1980/81, after three years' trial. A local development tax was introduced in 1980/81. This tax is collected from each landowner and the tax proceeds are used in local development activities. A video tax was introduced in 1980/81 and a television tax in 1987/88. Both taxes were collected annually from the video and television owners. As the annual collection system was difficult to

5) This tax is known as road cess in Nepal.

tering several taxes, including income tax. No new sales tax unit and posts were created in this department to deal with the sales tax. So it was just not possible for such an inadequate and weak tax administration to handle the large number of vendors. On the other hand, as many of the vendors were illiterate, unorganized and very small, they found it quite difficult to comply with the tax. As a result the tax could not be managed at the retail level and was shifted to the wholesale level in 1968. Later, in 1974, for almost similar reasons, this tax was shifted again, this time from the wholesale point to the manufacturing point. Since then sales tax on imports has been collected along with the import duties and in the case of domestic products the tax has been levied on the sales of manufacturers who are registered for sales tax purposes. Sales tax was extended to the wholesale level to a limited extent in 1992/93 when the tax was also levied on the wholesale dealers' sale of a few domestic products. The scope of the wholesale level tax was widened still further in 1993/94 by bringing a few more domestic products and sole distributors or agents of the foreign firms or companies and their wholesalers under the coverage of the wholesale level sales tax.

Several minor taxes have been included in the Nepalese tax system over the years. Air travel tax[4] and hotel tax were introduced in 1960/61. Air travel tax was originally levied only on the passengers of international flights but was extended to the passengers of domestic flights in 1974/75. Hotel tax, levied on the value of the hotel bill, was abolished in 1964/65 on the ground that this tax would have an adverse effect on tourism and foreign exchange earnings, but it was

4) This tax is known as air flight tax in Nepal.

and interest were taxed separately under the house rent tax and interest tax headings and several sources of income, including agricultural income, were exempt from income tax. On the other hand, foreign investment tax was merged with the income tax in 1969/70. Corporate income tax was separated from the individual income tax in 1986/87 when government corporations and public limited companies listed on the Nepal Stock Exchange were subjected to a flat rate corporate tax. This tax was extended to private limited companies in 1993/94.

Urban house and land tax was levied on houses and adjacent land in urban areas. Urban areas were specified by the Government through gazette notification. This tax was initially levied in big cities such as Kathmandu, Biratnagar, Birganj etc. and was gradually extended to other areas. The base of the tax was capital value which used to be fixed by an *ad hoc* committee appointed by the Government for each urban area. The tax was levied with progressive rates. As the base of this tax was not much different from the base of the net wealth tax, introduced in 1990/91, there was no rationale for one agency to levy two separate taxes on the same base. So urban house and land tax was repealed in 1992/93.

Another important event in the evolution of the Nepalese tax system was the introduction of sales tax in 1965. This tax was initially levied at the retail level. It was, however, introduced without proper knowledge of its operation and without even minimum preparation. The Tax Department, was then in its infancy (established in 1959) with a limited number of inexperienced personnel, was made responsible for the administration of this tax. This department was already administhe form of tax went into the pockets of the middlemen rather than into the Government's coffers. Furthermore, since authority to collect tax was given to many middlemen it was inevitable that tax collection was practiced in different ways in different parts of the country. The existence of such different systems of taxes in different areas was neither logical nor rational.

From 1951 onwards, successive Governments made attempts to rationalize the existing taxes and introduce new taxes, including income tax. However, success was limited until the late 1950s. Practices prevailing under the *Rana* regime continued to influence the development of the Nepalese tax system even after the demise of that regime. The Excise Act was enacted only in 1958 in order to consolidate the existing different excise rules, regulations, and procedures applicable to different areas and to make the excise system uniform throughout the country. Customs procedures could be unified only after the enactment of the Customs Act in 1962. These taxes were refined and strengthened over the years.

The foundation of a modern tax system was laid by the first elected Government in 1959 when income tax, urban house and land tax and foreign investment tax were introduced and a surcharge on land revenue was levied.[3] The income tax was first introduced on an experimental basis on business income and salaries and in 1962 it was extended to income from all other sources, including agricultural income. Income tax was thus levied on a global principle but over the years it has evolved along different lines as incomes from house rent

3) Rup Bahadur Khadka, "Nepal: A Survey of the Tax System", *Bulletin for International Fiscal Documentation,* Vol. 43, No. 3, 1989, p. 136.

1950s. Land revenue, customs duties, and excises were in existence in 1951 when a multi-party democratic political system was introduced in place of the autocratic *Rana* regime.[2] These taxes were governed by different Sanad Sawal (tax laws) each designed for a specific tax for a particular area ; there was no standard tax law applicable throughout the country. Further, these taxes were *collected through* the middlemen. In the case of land revenue the middlemen system gradually became a hereditary system, while in the case of customs duties and excises a licence for the collection of tax in a particular area was granted by auction to the highest bidder for a specified period of time.

The reasons behind the introduction of the middlemen system were probably that the *Rana* rulers did not like to be involved in the revenue administration and wanted to collect the maximum revenue with the minimum effort. Moreover, effective tax administration was not possible with the then limited number of revenue personnel available. It is also true that the middlemen system possessed some advantages. Under this system, the Government knew in advance the approximate amount of revenue that would be gathered in a given period of time. Besides, as the Government was not involved in tax collection, very few persons were required to work in tax administration, resulting in lower administrative costs to Government.

The middlemen system, however, suffered from a number of limitations. Under this system there was the possibility that the middlemen would collect more tax revenue from taxpayers than the existing law required. Thus, a portion of money paid by taxpayers in

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2) The *Rana* family held power and established a hereditary Prime Minister for 104 years beginning in 1846. This era is known as the *Rana* regime.

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

Rup Bahadur Khadka[1]

1. Introduction

This paper aims to review the development of the Nepalese tax system, to examine its existing structure and operation, to analyse its current problems and to recommend policy measures to improve this system. To this end, the paper is divided into six sections. The introductory section is followed by a section that traces the evolution of the Nepalese tax system. This section brings out all major developments in the tax system, particularly since the 1950s. The third section examines the existing structure and operation of various taxes. The fourth section analyses major problems of the Nepalese taxes and the fifth section sets forth proposals for reform. The last section contains concluding remarks.

2. Evolution of the Nepalese tax system

Very litte is known about taxation in Nepal in the period before the

1) Dr. Khadka is associated with the Revenue Administration Training Centre, Ministry of Finance, Nepal. This article is a part of his larger study entitled "Nepalese Taxation : A Path For Reform". He is extremely grateful to Professor Horst Zimmermann of the Marburg University, Germany, for his insightful comments, to the Alexander von Humboldt Foundation for their financial support, and to the Marburg University and the International Bureau of Fiscal Documentation, Amsterdam for their excellent institutional facilities.