

ECONOMIC POLICY NETWORK

Policy Paper 32

STUDY FOR THE MEASURES OF TAX COMPLIANCE HABIT AND LEAKAGE CONTROL

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Inputs from various stakeholders during interactions at Advisory Committee meetings, and the regional workshop in Birgunj, Parsha District organized by the EPN Focal Unit have been incorporated in the report.

Foreword

Economic Policy Network (EPN) initiated in August 2004 is an undertaking of the Government of Nepal with an Asian Development Bank (ADB) Technical Assistance (TA) to develop and institutionalize an open, responsive and result oriented economic policy formulation process based on sound economic analysis and dialogues with the partnership of public and private sector, academia, and independent professionals, to support and consolidate the Government's economic policy reforms on poverty reduction strategy. The initial focus has been in the areas of macroeconomic management; trade, investment and employment; infrastructure development; and tourism, agriculture, and regional development through four thematic advisory committees chaired by the secretaries of the respective implementing ministries, and guided by a high-level steering committee. The present study is an outcome of the initiative under the Advisory Committee for Economic Policy on Macroeconomic Management chaired by the Secretary of the Ministry of Finance.

This report has dwelt upon the existing legal provisions to check tax leakages and its implementation status. A critical appraisal of tax related earlier legal instrument has also been carried out. The importance of tax education, accounting knowledge, motivation for revenue staff and tax payers are also reviewed. The report has identified some legal, institutional, administrative and policy constraints and has suggested improvement in institutional structure of tax administration, revenue police and monitoring activities. The recommendations are the outcomes of consensus reached among major stakeholders through various consultations and the EPN workshop. I hope the findings and recommendations will be helpful for policy makers for future reforms.

I would like to thank Mr. Banshidhar Ghimire for carrying out the study. I also thank all those who have provided inputs for the report during the interactions, the advisory committee meetings, and the EPN regional workshop held in Birjunj. The work of the Advisory committee for macro economic management is to be commended for selecting the issue and for following through with the study. I would also like to appreciate the entire EPN team for their hard work. Last but not least, I would like to thank the ADB for supporting this initiative.



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I believe that revenue leakage control needs multidimensional measures including enforcement of ethical standards on employees and tax payers. Implementation of the measures suggested in the study will help policy makers and implementing officers to facilitate compliance and enforce laws.

Acronyms

ACA	– Association of Chartered Accountants
CA	– Chartered Accountant
ICAN	– Institute of Chartered Accountant Nepal
CCI	– Chamber of Commerce and Industry
CIAA	– Commission for Investigation of Abuse of Authorities
COS	– Customs Offices
DG	– Director General
DOC	– Department of Customs
DRI	– Department of Revenue Investigation
EPN	– Economic Policy Network
FAD	– Financial Administration Division
FNCCI	– Federation of Nepal Commerce and Industry
NRB	– Nepal Rastra Bank
FY	– Fiscal Year
GATT	– General Agreement on Trade and Tariff
GDP	– Gross Domestic Product
GOV	– Government of Nepal
IMF	– International Monetary Fund
IRD	– Inland Revenue Department
IROs	– Inland Revenue Offices
IT	– Income tax
LAN	– Local Area Network
MOE	– Ministry Education
MOF	– Ministry of Finance
MOGA	– Ministry of General Administration
MOHN	– Ministry of Home Affairs
MoICS	– Ministry of Industry, Commerce and Supplies
MLD	– Ministry of Local Development
MOLJ	– Ministry of Law and Justice
PAN	– Permanent Account Number
RASTF	– Revenue Administration Structural Reform Recommendation Task Force
RATC	– Revenue Administration Training Center
TIA	– Tribhuvan International Airport
UNDP	– United Nations Development Program
VAT	– Value Added Tax
WAN	– Wide Area Network
WTO	– World Trade Organization

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Executive Summary

Nepal's main source of public expenditure financing is revenue. Internal and external borrowings, external grants and printing notes are also used to finance deficits. The contribution of revenue in annual budget is around 68-70 percent. Out of total revenue, the share of tax revenue is around 77 percent. The revenue/GDP and tax/ GDP ratios are about 13 percent and 10.6 percent respectively, but the expenditure/GDP ratio is around 18 to 19 percent. For last five years the revenue and expenditure gap varied in between 5.5 percent to 7 percent. The fiscal deficit is about 3 percent. These facts prove that the collected tax is not enough to meet public expenditures.

The study is primarily focused on review of present status of tax compliance and tax leakages, appraisal of legal provisions and instruments of enforcements, indicators of tax compliance and remedy of tax leakages, improvement of institutional structures of tax administration identification of policy, legal institutional and administrative constraints. The summary of findings is presented in policy matrix as stated in terms of reference.

In this study, tax compliance means voluntary compliance of tax laws by taxpayers without any effort from action by tax administration. Non-compliance with tax laws is that attempts by taxpayers to maximize income, current or life time by minimizing the tax liability. Usually this is done by taxpayer through evading and avoiding taxes. Tax evasion and avoidance both result in the leakages of revenues which should have been deposited to treasury. Tax evasion is fully illegal action while tax avoidance is not considered illegal.

In order to formulate policies about leakage control, there are two types of taxable capacities one is the degree of taxation beyond which productivity effort and efficiency as a whole begin to suffer and another is the tax potentials of different taxes within the prevailing tax rates and tax system with cent percent voluntary compliance by taxpayers. Potential collection with full compliance minus actual collection is leakage.

Existing situation of tax leakages in Nepal is very alarming. The estimated evasion is more than 40 percent of taxable capacity. The survey conducted jointly by a donor agency and FNCCI showed annual smuggling of NRs. 33.50 billion for the FY 2003-004. This is about 42.55 percent of the official trade of NRs 78.74 billions. The average customs rate for the year is 10.7 percent. Applying this rate, the amount of customs revenue leakage is estimated to be about NRs. 3.58 billion. This figure is about 25 percent of the customs revenue collected during the year. Similarly the loss in value added tax from the same smuggling is about NRs. 3.71 billion. The amount is about 42 percent of the VAT collected from import during the year. Assuming the same level of smuggling from Tibetan border and Tribhuvan International Customs point revenue leakages would be about NRs. 330 millions and NRs. 120 millions respectively. The smuggling before and after the survey is assumed to have remained in the same level. Because no concrete policy and administrative actions has been taken since the time by the Authorities.

Regarding the VAT, the potential tax base is estimated from the figure of consumption plus capital formation. By laws, the activities related to agriculture, electricity, finance, land and building and medical services and goods are generally non-taxable. Therefore, whole amount related to such activities has been reduced to arrive at potential tax base. Using that base and rates of the year the leakages estimated varies from 38 to 42 percent.

Tax compliance should also be considered in terms of registration, return filing, entry from proper customs points and tax payments within given time frame by laws. For income tax and VAT. Out of the registered tax payers only around 72 percent and 35-37 percent have filed their returns for income tax and VAT respectively. For VAT, during the year 2000-2001, the percentage of non-filer was only 6.6 percent and for the year 2004-05 the figure has been increased up-to 28.3 percent. The percentage of debit return has decreased to 33.2 percent from 35.4 percent.

The annual average growth rate of income tax collection was about 20% before the enforcement of new Income tax Act. The annual average growth rate has declined to about 10%. Similarly, the trend of growth of average amount of tax paid by each taxpayer has been reduced while the annual growth of tax registrants is around 25 percent. This scenario shows four types of non-compliances. First non-registration, second non-filing, third delay filing and the fourth is under reporting of income/sales/production/import.

The VAT was introduced to replace the sales, hotel, entertainment and contract taxes. The average growth of VAT registration for last (2001-005) five years is 13 percent. The annual average growth rate of sales tax and other tax collection before the imposition of VAT was about 23 percent. After the imposition of VAT the growth rate has declined to about 15 percent. This is because of the reduction in tax rate about 22% and credit given for extended period for the stocks under sales tax regime.

Prevailing tax related laws have made various anti-leakage provisions to minimize the non-compliance and to maximize the tax collection. These provisions are related to additional fee, fine, fine-plus imprisonment. There are special provisions for anti-leakage activities in Corruption Control Act. But these provisions are not properly handled and implemented. Similarly, many anti-leakages provisions of Revenue Investigation and Leakage Control Act, 1995 also have not been used properly. In addition, legal provisions made under the Excise and Alcohol Control Act 1974, especially the provisions for penalties, are also being implemented only in few cases. For excise purpose Band roll system has been replaced by sticker system, which has not been well managed. So it has not been very effective to control leakages of excise tax. From the excise, the revenue leakage is estimated to be more than Rs. 2 billion.

Income Tax Act 2002 contains several anti-leakage provisions including prosecution in court for tax evasion. During last five years, the provision of 100 percent fine and imprisonment up to two years has not been implemented.

The penalty provisions of the Customs Act 1962 have not been implemented perfectly. In average cases, the major provisions related to search, seizure and raids in location of suspected place/store where smuggled goods are stores, arresting the persons on reasonable ground of suspicion of possessing smuggled goods and acts of auctions of the confiscated or seized goods without the owners has been implemented. But very few absconded persons/smugglers have been arrested later. Similarly, the provision of purchase of under valued goods has been implemented in few cases.

The most of anti leakage provisions made under the Land Revenue Act, 1977 (Malpot Ain) have not been used for long time. Since the land revenue was assigned to local bodies as their revenue sources, the auctions of land, on the ground of revenue deferred, have almost stopped. Mostly, the land registration fees are raised on the basis of fixed valuation of land of

different localities and in many cases fixed values on which registration fees are paid, are lower than real transactions values.

Against all provisions and existence of many weaknesses for effective tax compliance and proper control of leakages, the tax system inherits policy, legal, institutional and administrative constraints. For example, income tax is said to be more comprehensive and more complicated than the previous Act. The VAT has only one rate and threshold provisions which has been making it difficult to widen tax base and ensuring the competitiveness of markets near Indian borders. Excise is under administered and needs reactivation. Manpower is not sufficiently trained. Interdepartmental transfer has minimized professional development. There is less coordination with local bodies and inter department. The tax potential indicators have not been developed. Because of only by the using of such indicators, the increase or decrease of tax collection from potential sectors can be measured and calculated.

Due to absence of continuous monitoring of potential tax collection with actual tax collection, absence of economic intelligence of business activities and employees, inadequate verifiable statistics of import export and domestic transactions, adequate of reform in laws to make compliance easy and non compliance difficult, insufficient supervision and inspection of tax collection centers and their documents by leakage control concern authorities, lack of periodical review of rate structures, absence of capacity of administration to developing technical standard especially for the control of leakages in excise tax, insufficient enforcement of ethical codes for businessmen and employee, inadequate bureaucratic commitment, unavailability of adequate technical know how in employees, absence of performance indicators of each level of employee, insufficient training to enhance employees' capacity to control leakage, inadequate tax education management, inadequate laboratory facilities for customs and excises, less automation of functions which can be automated to enhance capacity of subordinate. It is usually felt that the reward and punishment system is not being performance based.

Recommendations

To overcome all these constraints and shortcomings, the following measures are recommended:

1 Policy recommendation

The tax payers and politicians at different level charges that the tax is unjust on the ground that the tax causes the increase in price of consumer goods and it limits the ability to spend. Thus to justify the taxation the government should set goals of over all fiscal policy. The Government should decide the overall level of public spending and should set level of public debt. The fiscal policy should be as an adjunct to monetary policy. The policy of taxation should be based on redistribution of income and wealth. The tax system must be the integral part of public welfare systems. The spending of public purse should be directed to encourage the economically desirable activities. The balance should be maintained between state and citizen's activities through taxation policy.

- (a) Policy measures on taxation:** To expand tax base, the threshold of VAT should be revisited as taxation policy. But at the same time, the principle of single rated VAT need to be reconsidered in the context of Indian VAT System that has three rates

excluding the zero rates. The reconsideration of single rate is also necessary to widen tax base to electricity and other services applying lower rates. Establish the desk to study the revenue assignment to municipality to compensate them for local development tax which will stop to be collected at customs point as part of elimination of other duties and charges (ODC). Make arrangement to take cooperation of local bodies to control illicit distillation and sales of alcoholic products without license. Impose local development tax on sale below the threshold to equalize tax burden between registered and unregistered traders.

- (b) Measures for compliance and fraud controlling:** The preventive measures should be given priority over punitive measures while tackling fraudulent activities. This should be the principle of legislation and enforcement. Fraud can be curbed by making tax laws less complex and leaving less scope for subjective decision. The fraud control policy should focus on two issues (a) first try to make optimal use of information technology, (b) Secondly, to promote the tax compliance and focus on effective tax payer inspections by pyramid based mechanism. Establish separate investigation unit and investigate tax payers who fall in high revenue risk area. Start criminal proceeding against the offenders. MOF need to set annual target of investigation to DRI in different field such as customs, income tax, VAT and excise.

2 Recommendation on Legal reforms

The tax laws should be amended to make simple and predictable. The complexity in legal system is an incentive to tax avoidance. The complex business transaction is more difficult to legislate too. The complex taxes are more difficult to administer properly. To remove the complexities of laws following measures are suggested:

- (a) For the amendment of customs Act 1962:** Existing Customs Act and Rules are not compatible to WTO system. These shortcomings are being the breeding ground for Valuation Frauds. To make the Customs Laws compatible with International Standard it is essential to amend as recommended in the Report of Mr. S.D. Mazumdar (UNDP consultant for preparing Customs Valuation Manuals). Besides his suggestion there is the need to incorporate revenue leakage control provisions in Customs Act about classification and post clearance audit. The customs laws should make provisions of Revenue police for border patrolling to control smuggling.
- (b) For the amendment of Income tax Act 2002:** To make the tax system simple and understandable the tax Acts should be revisited keeping in view of the tax compliance. The list of shortcomings, ambiguities and inadequacies should be prepared and the focus should be made to make the Income Tax Act simpler. The effective tax law requires shift compliance's goal from mere enforcement to more proactive approaches that encourage voluntary compliances. However, the weaknesses of income tax mentioned in chapter IV need to be overcome.
- (c) For amendment of Leakage Control and Investigations Act 1995:** In the present situation, DRI is using delegated power as per Customs Act and VAT Act. The Revenue leakage control and Investigation Act should be amended to make tax compliance effective and fraud risky. In order to make DRI functions more effective, they should be allowed to file cases of corruption and revenue leakages to special courts as CIAA does. The delegated power of customs and tax officer contradicts the

functions of investigation and assessment. In the existing situation, if the delegated power is exercised by the investigating officer, firstly, he should decide that the elements of evasion are not present in the case and only after that he can make additional assessment. The Revenue investigation and control act should be amended to accommodate all necessary powers needed for investigation.

3 Recommendations for Institutional reforms

The tax institutions should be developed in modern organization and management principles. Keeping this in mind, the followings measures are suggested.

- (a) **Revisiting the institutional structure of Revenue organizations:** There is the need of restructuring the tax institutions as per the recommendations of the study headed by Madhukar Shamsar JBR and RASTF, 2006. The institutional reformer should keep in mind that the tax collection cost should be minimized and functions of top management and field level organization should be specified. The investigation and control agencies need to coordinate their activities and by establishing institutional mechanism for exchange of information between different agencies. Improvement is needed in the structure of IRD and IROs. Reactivating excise administration within IRD structure is difficult. Therefore, it is necessary to establish independent sub-directorate within IRD by giving all powers of director general to the head of sub-directorate in the matter of excise. This should be made by making amendment in Excise Act and Income Tax Act. In field offices, separate full-fledge sections under direct control and supervision of sub-directorate should be established. Alternative of this will be establishment of separate department of excise and field offices under the department. The service centers of IRD or IRO are not functioning as they were expected to function. In order to reduce administrative burden of IROs and also to reduce the cost of tax payment to taxpayers, assign collection functions of house and land rent and presumptive income tax to local bodies and make arrangement to share revenue.
- (b) **Establishment of Revenue Board:** The transfer of employee from one department to another and lack of coordination between departments, Ministries, Leakage Control Authorities demand certain level of autonomy in revenue administration. For this purpose, autonomous revenue board is necessary. The board should be headed by revenue secretary and it should consist of expert members of each field of taxes including excise and local tax.
- (c) **Developing institutional efficiency:** In order to increase the institutional efficiency, job manuals are needed for tax payer's services, taxpayer's survey, investigation and audit. The geographical and functional responsibilities should be clarified in procedural manuals. The recruitment, transfer and departmental action and firing policy in revenue services should be rationalized to create good working environment. It requires forming different sub-groups for customs, excise, audit investigation, tax payer's survey, collection and computer and statistics in revenue group. It is equally necessary to stop transfer of technical manpower and annual transfer by the Ministry of Finance in the way to discourage professional efficiency of officers and other employees.

- (d) **Automation and information system:** The process of automation in tax administration can contribute to service delivery and generate cost saving benefit. The revenue leakage can be controlled through the use of automated data. In the field of Customs it is necessary to automate all aspect of work with the use of WAN and LAN. In the same manner income tax and excise administration's functions should be automated by establishing central information system and necessary sub-systems. Make decisions on technology policy for revenue administration as a whole.
- (e) **Establishment of Revenue intelligence and risk management units and rationalization of sub-Customs offices:** The intelligence is essential for both preventive and repressive actions. So, the intelligence unit and risk management unit are necessary in each tax administration. The sub customs offices should be rationalized and they should be developed as border patrolling posts. Now the pattern of border trade has changed because of the development of transportation system in both sides of the border. Some of the sub-customs offices do not have well road connected and there is no border sub-customs office at the place where there is good road connection. India has been pressing for limiting the number of sub-customs offices. The need of sub-customs office is felt to promote border trade. Therefore, it is necessary to rationalize sub-customs offices in the way to make balance between border trade facilitation and limitation of sub-customs offices as well as reactivate the customs offices, presently inactivated offices, where more feasible.
- (f) **Monitoring mechanism:** To ensure tax compliance and control revenue leakage, the monitoring system should be designed taxpayer-wise, tax-wise and office-wise. The periodical monitoring reports are necessary to evaluate the performance of each office and the employees. In order to monitor the property of employee and tax payers, establish economic intelligence unit in DRI in collaboration with central public relation department.
- (g) **Infrastructures of institutions:** Most of the Revenue institutions are deprived of modern infrastructure facilities. The field offices of DRI, Customs and revenue investigation unit have no proper physical infrastructures. Customs Warehouse, yards and other infrastructures for transit trade should be developed as per regional standard.

4 Administrative reforms

The major function of tax administrations is collection of tax. The tax administration systems should be designed to ensure;

- Continuous monitoring of potential tax collection with actual tax collection,
- Develop information system horizontally and vertically,
- Make automation in Ministry Department and field offices through LAN and WAN,
- Develop and use the working Manuals with international standard,
- Create social environment to develop ethical code and include professional and business ethic in the school curriculum,
- Revise indicators of performance, separate office indicators and official's performance indicators,
- Incorporate and redesign the functional division as mentioned above and as recommended by Revenue Task Force,

- Bring joint-secretaries working up-to departmental level to revenue sub-group for specialization,

5 Other recommendations

The tax evasion is known as the inevitable market reaction. It can be controlled only applying multi-dimensional approaches. It demands the cooperation of politicians, business communities and citizens as a whole. The following activities will help to increase tax compliance;

- Develop co ordination mechanism in customs offices,
- Prepare tax potential indicators and such indicators need to be based on tax, economic sector and geographical region-wise,
- Consolidate inter and intra information exchange systems between the offices and departments and other agencies i.e. CIAA and NVC for controlling the leakage by using modern technology,
- Make regular visits and surprise visit to check the transactions in business premises and also to check the behavior of revenue officials,
- Develop mechanism of monitoring the property as well as expenditure of the employees
- Start social awareness program to make the communities aware of negative impacts of tax evasion and effective use of collected taxes,
- Formulate attitude change plan,
- Prepare Informative and understandable citizen Charter for each office and keep and convey that to the visitors to tax office.

Revenue leakage is affecting not only revenue collection. It is also affecting national economy and equity. Therefore, an honest effort to control leakage is necessary. However, in the presence of different constraints even an honest effort is not likely to successful to curb cent percent revenue leakages.

Chapter I

Introduction

1.1 Background

Nepal's main source of financing public expenditure is revenue. External debt/development assistance, internal debt and deficit financing have different kinds of limitations. Taxes are levied to finance public expenditure and they are payments which do not represent a consideration for specific services. To meet such need, taxes are imposed by a public authority on all those who fulfill the criteria of laws have the payment obligation. The unpleasant feeling of suffering for an uncompensated loss of economic power as a result of the compulsory levy with no entitlement to a consideration has a greater influence on the behavior of the individual than the awareness created by the necessity of levying tax by the government. The consequence is that every community on which taxes are imposed endeavors to escape from the fiscal burden placed on it and the restriction created by taxation. There are various ways and means of doing this some produce desired result, while others do not. It is also possible to overshoot the mark or to end up by being questioned by leakage control authorities. However, everywhere in the world, there are problems related to revenue leakages. History shows that Nepal seems have been facing the problems of revenue leakages before and since Rana Regime. Noted economic historian Mahesh Chandra Regmi states "for instance the amount assessed at Birgunj was Rs.6120 while not more than Rs. 4673 were collected at Chisapani. Leakage of customs revenue in Nepal, India trade in the central border thus amounted to approximately one fourth of the total amount".

1.2 Objectives

Objective of the study is to identify the causes of non compliance with the tax law by tax payers, inability of tax officers to enforce tax laws to control tax leakages and recommend suitable policy instruments to increase compliance to control leakage of tax revenue.

1.3 Rationale

There are three principal ways of financing a given deficit. The first option which is being used in Nepal is borrowing from foreigners as official development assistance or loan. The process is straight forward through the borrowings from foreigners additional resources are made available at the disposal of GON. Against the inflow from loan proceeds, local currencies are created which government may spend.

The second way of financing the deficit is through domestic borrowing. Through this route, the government obtains cash balance all ready held by residents to exchange for debt instruments; usually Treasury bill. There is no immediate increase in money supply. Since, there is merely a change of hands from private resident to the government. A major disadvantage of this alternative is that the government effectively substitutes its own spending for that of private sector crowding out takes place. The competition for funds with the private sector drives up interest rates which in effect discourages private investment.

.Domestic debt has to be paid in the future either by increasing taxes or by cutting expenditure to create surplus to pay debt. Unless and until, the debt is monetized, there may be no inflationary pressure. But the shorter is the term of the debt, the sooner the decision

will have to be made whether to roll it over or to pay through money creation or increased taxes. For this reason, higher mobilization of resources through taxes is important because lack of funding may result in the under provisions of public goods like education, health, infrastructures that needed to develop different sectors of economy.

Existing situation of Nepal's financing public expenditure seems to be the mixture of all the sources mentioned above. The contribution of revenue in annual budget is around 68-70 percent. Out of total revenue, the share of tax revenue is around 77 percent. The revenue/GDP and tax/ GDP ratios are about 13 percent and 10.6 percent respectively, but the expenditure/GDP ratio is around 18 to 19 percent. For last five years of revenue and expenditure gap varied in between 5.5 percent to 7 percent. Against the situation of conflict in country and low increment in capital expenditure, the fiscal deficit has not been reduced less than 3 percent. All these facts prove that the volume of collected tax is not enough to meet public financing. Since the level of tax compliance is lower than potential so it needs to develop and apply proper leakage control mechanism. It is necessary to promote tax compliance habit of existing tax payers and bringing potential taxpayers in tax net.

Nepal has been making attempts to reshape economic structures to enhance international competitiveness. For this, free trade areas are planned to expand and when free trade area become fully operative that role of customs revenue will progressively decline in importance. Therefore, direct and indirect domestic taxes need to be made more efficient and high yielding.

According to Syed M. Ahsan, not only from the view point of financing public expenditure but also to reduce negative impacts of tax leakages, the control of tax evasion and avoidance is necessary. Negative impacts of tax evasion and avoidance on economy are as follows:

- **Losses of economic efficiency:-** An economic consequence of tax evasion is directly related to the losses of economic efficiency. Evasion and avoidance result on changes in general behavior brought about by tax distorted general prices of commodities and services.
- **Cost of non compliance to evaders:** Expenses incurred to carry out evasion activities and in follow-up efforts to prevent detection and conviction.
- **Cost of investigation to authorities:** Resources cost on the enforcement side including investigation and punishment.
- **Additional Compliance cost to honest tax payers:** Additional compliance cost borne by honest tax payers in terms of record keeping etc in view of the possible investigation.
- **Honesty loses and evader win:** Tax evasion may drive some firms out of business as they are unable to compete with owners that successfully avoid taxes such possibilities may be unwillingly aided by a deliberate government policy to lower taxes or no tax to small firms.
- **Increase in inequity:** - Tax avoidance and evasion increase inequity as opportunity of evasion and avoidance is not equally available to all.

1.4 Scope and Limitation

This study covers major taxes; customs, value added tax, income tax and excise. Leakages of other taxes and non tax revenue have been deliberately left because of the time constraints. The scope of the study is:

- a. Existing leakage control provision of different Acts and their implementations,
- b. Appraisal of leakage control provisions of different time periods,
- c. Indicators of compliance,
- d. Administrative, institutional, legal and other constraints in tax compliance and enforcement of tax laws,
- e. Recommendation of policy instruments to control leakages, and

Because of time constraint, the study has not gone beyond the areas of customs, income tax, VAT and excise.

1.5 Methodology

- a. Data used in the study are secondary sources published and non-published.
- b. Analysis of published and unpublished research materials.
- c. Literature review of the published and non-published research materials, papers presented in national and international seminars, conferences and workshops.
- d. Meeting with policy makers, tax payers, accountants and other stakeholders.
- e. Feedback of the workshops.

1.6 Organization of the Report

The report is divided in nine chapters. Chapter I represents the introduction. Chapter two is related to review of present status of tax compliance including taxable capacity and potentials as well as modus operandi of tax evasion. Chapter third has comprised the legal provision to check tax leakages and its implementation status; fourth chapter is related to appraisal of legal instruments including acts concern to income, customs, VAT, excises and land revenue related taxes. Chapter five has explained about the indicators of tax compliance and remedy of leakage. Similarly, chapter six is concern to compliance activities, chapter seven has explained about improvement of institutional structures and monitoring. Chapter eight is related to identification of various constraints and final chapter comprises the suggestions for improvements and conclusions.

Except these chapters, the report consists of executive summary, policy action matrix, two annexes and reference of materials used in the study.

Chapter II

Review of Present Status of Tax Compliance

Every tax whether that is levied directly or indirectly or on income or on property or on expenditure has to be paid by individuals. Even corporate tax is indirectly paid by the shareholder of the company. Therefore, it is necessary to know the causes and motive of tax evasion and avoidance by individuals. As Professor Syed M. Ahsan, there are different reasons for tax evasions. Some of the reasons mentioned are as follows;

- a. **"Rationality:** It is said that Rational Tax evaders want to maximize expected net income after taxes and penalties or utility thereof, under this premises, to pass up any gainful evasion opportunity would simply violate the axiom of choices, and hence irrational. However, to the extent that rational taxpayers are risks averse, namely that they prefer a sure alternative to a risky one of equal expected value, the more risk averse will evade less that the less risk averse.
- b. **Psychological:** There is a feeling in many quarters that individuals differ in the sense of stigma attached to evasion and any follow up investigations or charges and penalties. The survey of attitude literature also discovers that evasion is more among those who feel that they pay an unfairly high level of taxes. Resistance to pay taxes has been argued to reflect the tax payers doubt that public revenue has a "visible and concrete social or national objective". Tax payers' views on this subject would vary presumably depending on his income and wealth level as well as their political orientation.
- c. **Administrative and legal aspects:** Complex tax code can add to the burden of compliance with the tax law and encourage evasion. However, this is probably true of marginal cases. Powers of the wealthy to block tax measures or to fight administrative procedures in dealing with evasion may create a bad morale on the general population. Based on Latin American experience, Herschel believes that knowledge of wide spread corruption and conspicuous life style of senior policy makers in the country may signal the mismanagement of public funds and hence induce resistance to comply with tax laws.
- d. **Role of specific taxes:** Evidently the scope for evasion depends on specific tax instruments and how taxable base is defined. The later may also dictate collection procedures. Income tax would be difficult to enforce one estimate in 1986 cited by Ahmad and Stern on the evasion of personal income tax in Pakistan indicates that over 60 percent of total income was not reported to the tax authorities. Some of the variables influencing tax evasions are;
 - The effectiveness of enforcement parameters like taxpayers survey audit investigation etc.
 - Simplicity of tax structure, fine and penalty system.
 - Acceptance of the tax system.
- e. **Motive of Tax Evasion:** In view of the fact that magnitude of tax evasion depends on financial strength of perpetrator, it can be established that the motive for the majority tax evasions is excessive desire for enrichment. It is proved experience that the higher the income the greater the incentive for tax evasion.

- f. **Poverty and unemployment in border area:** In some cases, poor are used to smuggle goods, for example, high level of unemployment in border areas induced individuals to smuggle goods and evade customs duties and other taxes collected at customs. And there may be traders who involve in evasion and avoidance activities due to likely failures of their business and other individuals with marginal income who are not able to meet their expenses from their earnings. Otherwise the motive of tax evasion is excessive enrichment.
- g. **Tax Evaders are not named:** Cases of big avoidance is planned and implemented with the help of lawyers and auditors. Persons committing breaches of tax laws in Nepal has not been described as criminals. In international tax literature, they have been described as "white collar criminals" and evasions and avoidance acts as "white color crimes". Since they are not named they are not de motivated to evade or avoid taxes.

2.1 Taxable Capacity

To formulate plan or measures of compliance and revenue leakages control, it is necessary to estimate how much is evaded how they are evaded and who the evaders are? Therefore, it is necessary to estimate taxable capacity or tax potential. Taxable capacity is an important element for imposing taxes. It measures to what extent taxes can be imposed without creating any harm to the external competitiveness of domestic economy. Over taxation reduces the international competitiveness of the country and under taxation makes government and local bodies unable to provide essential services like health, education and infrastructures needed to gear up economic development of the country. Most of the economist and official claim that Nepal is under taxed country in the South Asian region in comparison to the GDP tax ratio. It is not clear whether increased revenue collection is the effect of development or the economic development is the effect of higher rate of revenue collection.

2.2 Potential Collection and Actual Collection

For the purpose of estimating tax compliance habit, it is necessary to estimate potential collection which would be achieved, if there were the situations of cent percent voluntary compliance of tax laws and tax rates. Collection capability is the amount of tax collection under the existing system with optimum verification effort by tax administration. Therefore, potential collection is higher than collection capability and collection capability is higher than actual collection. The difference between potential collection and actual collection is tax evasion. The gap between potential collection and collection capability is the policy related leakage and the gap between collection capability and actual collection is related to administrative capacity.

2.3 Tax Compliance Habit, Tax Avoidance and Tax Evasion

Adequacy of tax systems has two tools -(i) improve the collection capability and (2) improve the efficiency of tax system. "The measures for tax compliance habit and leakage control" have to deal with both of the tools. Increasing collection capability deals with the rates, the broadening of the tax base, degree and time of penalty and other sanctions. Tax compliance habit will be evaluated under the existing rates and the leakage control provisions. Compliance parameter such as timely registration, timely submission of returns, and accuracy of returns and magnitude of the voluntary declaration of sales income, production and value of goods, debit returns, credit returns, zero returns are used to evaluate the level of compliance.

As general and professional perception, tax compliance means voluntary compliance of tax laws by taxpayers without any effort or action by tax administration. However, the magnitude of voluntary compliance differs from country to country and time to time in the same country. Non compliance with tax laws is that attempts by taxpayers to maximize income current or life time by minimizing tax liability. For the purpose of analyzing compliance, non-compliance by taking advantages of the existence of loopholes in the tax laws is called tax avoidance and under reporting of taxable transaction of import and export, income/sales and production as well as exaggeration of expenditure by illegal ways are known as tax evasions. Tax evasion and avoidance both result in the leakages of revenues which should have been deposited in government treasury. People regard tax evasion as fully illegal action and tax avoidance has been regarded as legal and even as a part of maximize earning by tax planning. Regarding the tax compliance habit, everybody including tax payers acknowledge the need for levying and paying taxes, but at the time of payment many people do not like, for instance the status of registration of income tax payers and return submitted by them has been presented in table 1 that shows the magnitude of non compliance in terms of filing returns has gone up-to 64.6 percent.

Table 1 : Status of Registration and Return Filing of Income Tax in Nepal (2001-2004)

Descriptions/FY	2001/2002	2002/2003	2003/2004	2004/2005
Registered taxpayers	1,59824	176085	166699	195498
Percentage increase/ decrease	-	10.2	-5.3	17.3
Voluntary tax compliance	74705	48041	67889	69138
Percentage of tax payers and registered returned filed	46.7	27.3	40.7	35.4

Source: Revenue Administration Structure Reform Taskforce, 2006,

The above table shows that the rate of tax compliance is not satisfactory. The percentage of returns filed was 46.7 percent in the year 2001/2002. The percentage decreased to 35.4 percent in the year 2004/2005. The level of non-compliance increased from 53.3 percent to 64 percent.

Table 2: VAT Registration and Compliance (2001-004)

Descriptions/ FY	2001/002	2002/003	2003/004	2004/005
Number of Tax payer registered in VAT	25149	29872	34174	39776
Percentage increase/decrease in registration	19.3	18.8	14.4	16.4
Filed Returns	21473	26099	25049	28525
Percentage of returns	85.4	77.3	72.3	70.7
Number of non filers	3676	6773	9125	11251
Percentage of non filers/increased	----	84.2	34.7	23.3
Percentage of non-filers	14.6	22.7	26.7	28.3

Source:-Revenue Administration structure Reform Task force, 2006

Above table shows that in the years 2002/003, 2003/004 and 2004/005, the VAT registration have been increasing. But, the trend in VAT compliance is decreasing. During the year 2001/2002, the compliance rate of VAT was 85.4 percent and it decreased to 70.7% for the year 2004/2005. The percentage of non-filers increased from 14.6% to 28.3% during the same period. Thus the percentage of non compliance is increasing in terms of measurements of compliance on the basis of voluntary filing of tax returns by taxpayers.

2.4 Variables Affecting Tax Evasion and Avoidance

Tax administration's efficiency relates to the increment of enforcement to reduce evasion for which it has the power of assessment, reassessment, imposing fees, fine and penalty. Some variables that determine the collection capability of the taxes and at the same time provide loopholes for evasion and avoidance are as;

- **The tax rates:** High tax rates may persuade some individuals to non compliance. Therefore, it would be counter productive and the people complain that VAT rate of 13 percent is very high and it has induced evasion and has diverted trade from official routes to non official routes.
- **The broadness of the tax base:** Limitation of tax base is another important factor which effects collection capability. The tax base of VAT has been limited due to several exemptions like agricultural products, electricity and others. The exemptions are so large, the collection will never likely to be near final consumption/expenditure. Situation with income tax is also similar. Impact of exemption on Tax Administration and Tax Collection are negative and it has been positive for tax evasion. In addition the exemptions have provided several facilities for non compliance.

2.5 Customs Evasions

A survey of smuggling in Nepal India border has estimated the figure off smuggling of about Rs. 33.50 billion. There is no reason to believe that the percentage of smuggling from Tibet Autonomous Region of China is less than that from India. There is also an international airport (TIA) as smuggling point. The survey in Nepal India border was jointly conducted by a donor agency and FNCCI. The official import during the period is Rs.78.74 billion and the smuggling is 42.5 percent of the official trade. The average customs rate of the year is about 10.7 percent. At that rate the customs revenue leakages is estimated about Rs. 3.58 billion which is about 25 percent of the revenue collected. Leakages of customs revenue results in the leakages of other taxes and duties collected at customs. For example, from the same smuggling the leakage of VAT is estimated to be about NRs. 3.71 billion which is about 42 percent of VAT collected from import. Assuming the same level of smuggling from Tibet the revenue leakage can be estimated to be NRs. 330 millions. It is very difficult to estimate revenue leakages from airport customs. Assuming the same level of smuggling, the customs revenue evasion from the airport customs can be estimated to be NRs. 120 millions. However, this is not likely to be the complete picture of revenue leakage from customs. Since the complete picture is not possible to draw on the base of available literatures. Some indicators of smuggling can be drawn from consumption also. For example, annual consumption of gold in Kathmandu valley is about 16 tons but official import of gold is almost negligible. Similarly high value stones are not imported by paying customs duties but these commodities are purchased by consumers in shops located in main markets of the country. This used to happen when there were quantitative restrictions. Thus, to some extent, it is possible to make estimate revenue leakage from gold. But it is not possible to estimate revenue leakage from high value stones and some other commodities.

2.6 Value Added Tax Evasion

Value Added Tax was imposed in 1995 by abolishing sales tax, hotel tax, entertainment tax and contract tax. In table no.3, the tax base of VAT has been estimated by adding consumption and capital formation. This is the maximum tax base therefore non taxable and

tax exempted items of national income has been deducted to compute estimated tax base. In reality all of the exempted items are not tax free. Tax is exempted at the stage of sale not at the stage of production. Therefore, input tax is collected on inputs of the exempted goods. Some of the deducted items are agriculture, electricity, finance land buildings. The tax rate in the beginning years was 10 percent and in the middle of the FY 2004/2005, the rate has been increased at 13 percent. Potential tax base, collection percentage, actual collection and leakage are given in table 3:

Table 3: Present Status of Estimated VAT Evasion

Year	Tax base (Rs)	Potential collection percentage	Rs. in crores	
			Actual collection percentage	Leakage %
2000/2001	19312	10	6.2	3.8
2001/2002	20437	10	5.8	4.2
2002/2003	13735	10	6.1	3.9
2003/2004	15699	10	6.0	4.0
2004/2005	15957	10 & 13-11.5	7.3	4.2

The figures in the table 1 show the magnitude of leakage varying in each year. In the year 2000/2001, the leakage was 38 percent and it registered to 42 percent for the year 2001/2002 and 2004/2005. The above table does not show the good picture of tax compliance. The increase in the percentage of non filers means either the business has been closed or the tax payer is willfully delaying to submit tax return and pay taxes. "It is said that any delay in disclosing the true tax base would also be an example of evasion behavior since this strategy if successful would lower the present value of the tax due."

Filing credit returns has decreased but not to the extent expected. Still the number of percentage is very high. Filing debit return has decreased that means people making payment in the value added portion of the tax has decreased. The increment in zero return is the sign of increased in the number of tax exempted registration of traders and thereby more refunds.

2.7 Income Tax Evasion

Due to unavailability of reliable data of income distribution it has made difficult to estimate the base for income tax. In addition various exemptions in incomes and increased limit of exemptions such as exemptions of agricultural income, increase in the amount of non taxable income up to Rs. 1,00,000/ for individual and Rs. 1,25,000/ for family also has made to compute the proper base of income taxes. Economist and Administrator claim that Nepal is under taxed country of the South Asian region. This hypothesis is probably logical for individual and corporate income tax. For example, TANZI and Burger and Stern's estimates of the countries below the per capita income of US \$ 349/ and 360 are as follows:

Table 4: Potential Collection of Income Tax in Developing Countries

Estimates of	Total Income Tax % of GDP	Individual Income Tax % of GDP	Corporate Income Tax % of GDP
TANZI'S	2.6	1.1	1.5
Burgess and Stern's	3.6	1.4	2.2

The above table shows that individual and corporate income tax will have to be 2.6 and 3.6 percent of GDP as mentioned by the authors respectively. As mentioned in the Revenue

Administration Structural Reform Recommendation Task Force (RASTF) 2006, during the year, 2000/001 income tax as percentages of GDP plus import in Nepal was 1.7 percent. But the ratio has decreased to 1.5 percent in the year 2004/2005. This tendency is against the general belief that as per capita income increases income tax increases more than proportionately. Nepal's existing level of income tax collection is below than both of the studies. Therefore, it is essential to make an estimate of potential collection and compare that with actual collection.

On the basis of income and family size of the population, the potential tax can be calculated. According to statistical pocket book published by Central Bureau of Statistics-2004, population of Nepal is 22.7 million and family size is 5.45 number and the numbers of families are 41,74,374. According to the second living standard survey, the richest 20 percent of the family earn Rs. 156,486/ annually. Family size of the richest family is 4.3 members. Agricultural income is only 25 percent of total income of the rich families. If agricultural income is reduced from the total income of the family will come down to Rs. 1,17,365/. This amount is below the non taxable level of income Rs. 125,000/.

Per capita income of 10 percent of the richest family is Rs. 57,145/, while multiplying this amount by average family size the family income will be about Rs. 2,45,000/. After adjustment of agricultural income by 25 percent, the income will be about Rs. 184,000/. If the tax is calculated on individual base the tentative tax will be about Rs. 8,850/. In such way, the estimated tax potential will be about Rs. 36943117000/. This figure is higher than existing level of collection.

Per capita expenditure of the rich 20 percent family is Rs. 42,236/. By adding consumption of 4.3 person, we get the figure of Rs. 1,81,614/ and if we deduct 25 percent of agricultural income, we get Rs. 1,36,211/ which is above the taxable limit of income and the amount of tax paid by each family will be Rs. 1,681/. The consumption of 10 percent of the family is Rs. 62,037/, assuming consumption as proxy of income total income of a family will be Rs. 2,66,759/. Deducting agricultural income of 25 percent from the total income, we get taxable net income about Rs. 2,00,000/ (in round figure). The number of assessment unit in this bracket of income will be 4,17,437/. The amount of tax after family exemptions of Rs 1,25,000/, will be Rs. 11,250/. The total tax from this section of family will be Rs 4,69,61,66,250/. Another 10 percent of the households will pay Rs 70,17,11,000/ and total of both will be Rs. 5,39,78,77,000. Income tax of individual (including tax on interest the amount) collected in the year is Rs. 2,90,98,00,000 that is about 53.91 percent of the total capacity, thus, the amount of estimated evasion will be Rs. 2,48,80,77,000/ which is about 46.09 percent of the capacity. Thus, in terms of expenditure, the potential income tax collection will be about 1.14 percent of GDP. However the actual collection of FY 2003/04 is about 0.61 percent of GDP and estimated leakage is about 0.52 percent of GDP. But in the view of this study income is easy to hide than expenditure. Therefore, tax potential of rich family has to be estimated on the basis of expenditure.

This is crude estimate. If we correlate the evasion of other indirect taxes to income tax the figures of 46.50 percent is not so high. Individual income taxes are being paid by tax payers without being registered. For example, tax on land and house rent, interest, dividend and tax paid as final withholding is collected without assigning PAN. The IRD does not have the actual record of the people who pay the tax without PAN number.

The evasion of corporate tax which could be significant has not been estimated. For this tax declared voluntarily by corporations and the amount of tax which would be assessed need to be estimated. This cannot be done without sampling audit of selected files. This study is not mandated to audit individual files of taxpayers.

2.8 Excise Evasion

Excise Evasion has been a serious concern for Government of Nepal since the evasion of the billion rupees of excise was reported to have been evaded by only one distillery located in Parasi. Illicit distillations and sales without license are other cases of excise evasions. The stickers which are stuck in the bottle or packing of the liquors are reused several times to evade excise. False stickers were also found in the course of investigation. The amount of excise evaded has to be calculated on the basis of the volume of illicit distillation and excise evaded by licensed distilleries. It is expected that excise evasion by licensed distilleries and breweries is more than Rs.2 billion based on the assumption of the investigation of one distillery mentioned above. The magnitude of evasion by illicit distilleries and unlicensed sellers is perceived to be very high. Foreign alcohol products imported without paying duties and leakages from duty free shops and bonded warehouse has not been estimated. If we can estimate this, the amount of excise evasion is expected to very high. As alcohol and cigarettes are high duty excisable items, the risk is very high.

2.9 Modus Operandi of Tax Evasion

Generally there are two ways of implementing tax evasion decision by tax evaders. They are;

- The tax evaders cover up their actual financial situation in case this would have tax implications;
- The tax evaders produce fictitious financial situations which qualify for tax concessions. The apparent fulfillment of condition of tax concession leads either to an effective reduction in the tax paid or to a tax loan for a limited period.

The tax payers decide on these methods opting in favor of one of these two ways of evading tax. Some more details of these methods are given below;

- (a) **General falsification and deception method:** In this method, the evader corrects entries on the basis of falsified documents including fictitious business transaction. They use legal falsification method using fictitious contract i.e. preparing of fictitious employment contract, fictitious sales contract, fictitious service contract, fictitious loan contract, fictitious licensing contract and fictitious leasing contract.
- (b) **Accounting falsification method:** In this method, the evader falsifies accounting documents, prepares self made external vouchers in some cases, old vouchers are re-dated in the way which looks new to the tax auditor. The evader falsifies the amount in the books of accounts. Likewise, they falsify recording of business transaction, false dating of business transaction, false entry of document, and the evaders do not allocate transaction to an account or make incorrect allocation to account. The evader prepares two sets of accounts deliberately external and internal to manipulate taxes. The all efforts of tax evader are concentrated on profit contraction. For this purpose, the evader increases business expenses and contracts revenue. The evader does not disclose withdrawals via assets account and contracts the gross profit. To plough back undisclosed profit, they make financial and other

investment outside the company. And at the same time, they retransfer the undisclosed money for financing investment within the company. Other methods of evasions employed by evaders are transfer pricing by non resident companies, head offices expenditure, advertising activities conducted in other countries and expenditures shown in the books of permanent establishment situated in Nepal. Similarly, income earned from export of software is other means employed to evade taxes. The possibility of being a company or individual resident or non-resident in Nepal or any other country in order to minimize tax liability, the existence of under ground economy and money laundering are other loopholes of tax avoidance and evasions.

- (c) **The methods of Customs Evasions:** The methods of Customs evasions are outright smuggling, valuation fraud, classification fraud, and quality and quantity manipulation. Seepage from bonded ware house, duty free shops, and excess commodity imported under baggage rules and misutilisation of project exemption and diplomatic immunity.
- (d) **Methods of VAT evasion:** Methods of evasion of value added tax are absence of issuing proper bills to the buyers, under valuation at the customs points, fixation of low ex-factory price in internal production and further under valuation by whole seller and retailers. There is no reliable valuation data base either to control valuation fraud in import or in internal production.
- (e) **Methods of excise evasion:** Methods of excise evasion are illicit distillation, selling alcoholic products without license under reporting of production and sales, quantity and quality manipulation by not showing actual record of raw material imports, local raw materials used in production and removal of final products.

Chapter III

Legal Provisions to Check Tax Leakages and its Implementation Status

3.1 Legal Provisions in General

Prevailing laws have made various anti leakage provisions to minimize the non-compliance and to maximize the tax collection. The details of the provisions are given in concerning chapters. However, the brief summary of these provisions are produced here. These provisions are, mainly, related to additional fee, fine, fine-plus imprisonment. There is special provision for anti-leakage activities in Corruption Control Act. But these provisions are not properly handled and implemented. Similarly, many anti-leakages provisions made under Revenue Investigation and Leakage Control Act, 1995 have not been used. In many cases, instead of filing cases in the authorized court, Department of Revenue Investigation (DRI) has been exercising the power of customs officers delegated from Nepal Government through the Ministry of Finance. After delegation of such authority by the government, the Department has been working as supplementary agency of the Department of Customs (DOC) and the Inland Revenue Department (IRD). In practice, the jobs of investigation and prosecution have been minimized. In addition, legal provisions made under the Excise and Alcohol Control Act 1974, especially the pro-visions for penalties, are also being implemented only in few cases. In real practice, large numbers of shop-keepers are selling alcoholic products without license issued by Concern Excise Office. This issue has not been properly managed. Very few provisions of search, seizure and raids of Alcohol Control Act have been used to deter either illicit distillation or sale of alcoholic products without license.

3.2 Provisions of Income Tax Act

Income Tax Act 2002 contains several anti leakage provisions including imprisonment for tax evasion. The provision of 100 percent fine and imprisonment up to two years has not been implemented during last five years. Income Tax Act 1974 had similar provisions of fine and imprisonments. But it had provided the administrative as well as judicial power to tax officers. In previous Act, the burden of proof was not mentioned in the Income Tax Act; therefore, the Evidence Act used to be prevailed. But in prevailing Act burden of proof falls on tax officials. So it seems that decision makers are hesitating to make decisions. Previously, the provisions used to be implemented by tax officers by getting approval from the Revenue Tribunal. Existing Income Tax Act fully relies on taxpayers and expects 100 percent voluntary compliance and 100 percent accuracy in the assessment of tax liabilities. But the previous Act was not fully depended on taxpayers, it had some doubt in the willingness and ability of taxpayers and had provisioned for specific certification by tax registered auditors. Basically, provisions related to additional fee submitting false or confusing income statement, penalty for blocking tax proceedings, penalty for exerting undue influence, penalty for crime committed by unauthorized persons and penalty to collaborators have not been come in practice and that has not been used in the way to deter evasion and avoidance behaviors. The terminologies used in the new Income Tax Acts are not familiar to the taxpayers. Some degree of non compliance is due to the misunderstanding and debatable interpretation of the different provisions of the Act.

3.3 Provisions of VAT Act

VAT is another area of low compliance and leakages. Various anti leakage provisions made under the VAT Act 1995 have not been implemented perfectly and such provisions are mainly related to control tax leakage and increase tax compliance. For example the goods exceeding Rs.10,000/ from the traders, not having VAT registration, is not likely to be monitored due to prevailing habit in market to issue two types of bills. The tendency of issuing plain bill or not issuing any bill has not been minimized. The provisions of purchase of under value of goods and suspending the business have not been effectively implemented. Penalty provision for preparing false account or invoice and other documents have not been effectively imposed. During the discussion in workshops held in Birgunj the problem of dummy registrations of VAT were discussed and suggestions were made to scrutinize applicant before allocating VAT registration number.

3.4 Provisions of Customs Leakage Control in Customs Act

The provisions of search, seizure and raids of suspected place/store, arresting the persons on reasonable ground of suspicion of possessing smuggled goods and acts of auctions of the confiscated or seized goods are not being implemented satisfactorily. Some time goods are seized but related persons are not arrested as per the Act. The unclaimed goods are auctioned as if there were no owners. Customs authority opposed the particular statement. But it is very difficult to take it as absolute. In such cases very few absconded (persons)/smugglers have been arrested later. The provision of purchase of under valued goods has been rarely implemented. However, the continuation of smuggling is by and large the effect of high rate of duties collected at customs points which include VAT, local development fee etc. The duty exceeds 16 percent and the cost of smuggling according to estimate of participants is lower than that.

3.5 Provisions of Revenue Leakage Control Act

The anti-leakages provisions of Revenue Investigation and Leakage Control Act, 1995 also have not been used properly. Instead of filing cases in the authorized court, Department of Revenue Investigation (DRI) has been exercising the power of customs officers and tax officers, delegated from Nepal Government through the Ministry of Finance. In practice, the jobs of investigation and prosecution have been minimized.

3.6 Provisions of Land Revenue Act

The most of anti leakage provisions made under the Land Revenue Act, 1977 (Malpot-Ain) have not been used for the long time. The auctions have almost stopped since the land revenue was assigned to local bodies as their revenue sources. Mostly, the land registration fees are raised on the basis of fixed valuation of land of different localities and in many cases fixed values are lower than real transactions values.

3.7 Provisions in Excise Act, Alcohol Control Act

The Excise Act 2002 has replaced previous Band roll system by sticker system. And sticker system has not been effective to control leakages of excise. Physical control of highly taxed goods like alcohol and cigarettes has been ineffective to control the leakage. For physical control purpose, unskilled and untrained lower level employees, who lack technical as well as

legal knowledge, are being posted in the production centers. The existing provisions of fines and penalties are not being used effectively.

In market, large numbers of shop-keepers are selling alcohol products without license. Large amount of revenue leakage from excise is due to illicit distillation; this issue has not been properly managed. Very few provisions of search, seizure and raids of alcohol act have been used in the way to deter either illicit distillation or sell of alcohol products without license. The revenue leakage is estimated to be more than Rs.2 billion. Physical control of highly tax goods like alcohol and cigarettes has been ineffective to control the leakage.

Chapter IV

Appraisal of Legal Instruments during Different Time Period

There are several laws that are designed to control revenue leakage and noncompliance. The existing Acts have several provisions to control revenue leakage and these are exercised through different agencies. The Department of Revenue Investigation (DRI) works under Revenue Leakage (Investigation and Control) Act, 1995. Income Tax Act, 2002, Value Added Tax Act, 1995, Alcohol Control Act 1974, and Excise Act, 2002 are enforced by IRD. The Customs Act 1962 and Export and Import Control Act 1956 are enforced by Department of Customs.

4.1 Income Tax Act, 2002

The Act has defined the tax base, persons, residence and non residence. It has incorporated the provisions related to tax accounting, quantification and characterization, tax administration: registration, filing returns, assessment and audit, payments, fees and penalties, international taxation and agreement, capital gain based tax, rights of taxpayers, tax deductions at source and certification and review and appeal.

(a) The Base of Income Tax: As prevailing income tax system the foundation of the base is incomes derived by different sources earned by a person (natural and entity) during an income year/period. The income earned by a person (including the person that receives the income as final withholding payment and a foreign PE (permanent establishment) situated in Nepal is included for tax purposes. The system has adopted global principle for residence person and source principle for non-residence person. Similarly, for tax computation scheduler and global system are applicable. Basically, corporate tax is calculated under global form. The eligible expenses and reductions are deducted and reduced from tax payable incomes. The income tax payable by a person is calculated by applying the relevant rates mentioned in Schedule-1 of Income Tax Act, 2002 to the person's taxable income for the income-year and subtracting from the resulting amount any credit claimed by the person. Notwithstanding as mentioned above, the income tax payable by resident individual, who meets all of the mentioned conditions, is equal to the sum of the amount to be withheld under section 87 of Act by the employer from payments made to the individual during the year. Thus the taxable income of a person for an income-year is equal to the amount as calculated by subtracting reduction, if any, claimed for the year from the total of the person's assessable income for the year from each of the income heads such as business, employment and investment. The base and principle of tax differs from the previous Act in the sense that the tax liability of resident working outside Nepal have been made more ambiguous.

In addition a full-fledged self-assessment system has been implemented and the presumptive taxation and current year taxation system are strengthened. In comparison to previous Act, the scope of discretionary interpretation of the tax administration has been reduced. The Act has separated administrative and judicial responsibilities by distinguishing civil liabilities of the taxpayers from criminal liabilities. The Income Tax Act 1974 had given the space for self as well as assessment by tax officials and the tax authority was entitled to exercise administrative as well as quasi-judicial power.

(b) Sources of Incomes for tax purpose: The terminated Income Tax Act, 1974 (2031) had divided the sources of incomes in five categories, i.e. house rent income, remuneration income, income from business, industry profession and vocation, agriculture income and income from other sources. The income from agriculture was exempted. But the Income Tax Act, 2002 has divided the incomes in three categories or there are three sources of income heads: employment, investment and business.

This Act has not included the windfall gains under income tax system. But the previous Act had made the provisions of the other source of income. Tax accounting and timing, characterization of incomes, calculation of net gains from assets and liabilities, special provisions for individuals, entity and insurance and banking and retirement fund, provision of calculation of depreciation are other matters that are incorporated in existing Act.

(c) Deductions, reductions, exemptions, concessions, allowances and rebates: Previously, the exemptions and incentives were given by Income Tax Act, Finance Acts and other concerned acts and regulations. The Income Tax Act, 2002 has made certain provisions to enhance the tax compliance as of incentives to the payers. It has made the provisions in the area of deductions, reductions, exemptions, concessions, allowances, and rebates in tax rates. The prevailing Income Tax Act integrated all income tax related incentives and concessions. These can be listed below:

(i) Exempted amounts and business exemptions and concessions: Exempted amounts: The income derived by a person entitled to privileges under a bilateral or a multilateral treaty concluded between Government of Nepal and a foreign country or an international organization is exempted. Likewise the income derived by an individual from employment in the public service of the Government of a foreign country, provided that, the individual is a resident person solely by reason of performing the employment or is a non-resident person; and the amounts are payable from the public funds of the country is also exempted. Income from the employment derived by non-Nepali individuals employed by Government of Nepal on terms of a tax exemption is also out of the tax bracket. Allowances paid by Government of Nepal to widows, elder citizens, or disabled individuals are exempted incomes. In addition, income derived from an exempt organization by the way of gift, bequest, inheritance, or scholarship, except as required to be included in calculating income under the Act is tax free. Pension received by a Nepali citizen retired from the army or police service of a foreign country provided the amounts payable from the public fund of that country are treated as non taxable incomes. These provisions were not incorporated in previous Act. All of the provisions were not needed in the previous Act because all pensions were not taxable. In addition, from equity point of view, the provisions relating to tax exempted amounts are not rational. Since, the pension earned inside the country is taxable. Similarly, provisions relating to foreign based incomes may be the matters related to bilateral treaty.

Business exemptions and concessions: As Income Tax Act, the agricultural income derived from sources in Nepal during an income-year by a person, other than the income from an agriculture business derived by a registered firm, or company, or partnership, or a corporate body, or through the land above the land holding limit as prescribed in the Land Related Act, 1964 (2021) is not taxable. Similarly, the income of cottage industry is tax free with some exceptions. In addition, the incomes derived by cooperative societies, registered under Cooperative Act, 1991(2048), from

business mainly based on agriculture and forest products as specified in the Act i.e. sericulture, and silk production, horticulture are exempt from tax. Dividends distributed by such societies are also exempt from tax. Previously, these exemptions were provided by Income Tax Act, Finance Acts and special (sectoral) Acts.

Tax rebates: In case, of the special industry that provides direct employment to six hundred or more Nepali citizens during each day of the year, only 90 percent of the tax rate will be applicable.

In case, of the industry which is operated in a remote, undeveloped, or underdeveloped area, the rate of tax will be applicable at 70, 75, or 80 percent, respectively, of the rate otherwise applicable for the period of ten income-years commencing from and including the year in which the operation commences. Here the special industry means a manufacturing industry as categorized by Industrial Enterprises Act, 1992, with some exceptions of tobacco and alcohol based products. Previously this facility was provided under Industrial Enterprise Act 1992. The income of an approved retirement fund is exempted from tax. Payment from approved Retirement Fund, up to Rs.500000 or 50 percent, whichever one is higher, is tax-free payment. Others rebate provisions made by Act are:

- the income earned by an industry that is established in special Economic zone or Export Promotion zone as declared by GON under gazette notice; 50 percent tax exemption is provided,
- the income earned by an information technology based industry that is established inside the information technology park under gazette notification; 75 percent of tax is exempted,
- 25 percent tax exemption on incomes: earned by a natural person from a special industry; earned by a natural person from export business; earned by an entity from special industry as well as export business; earned by entity from infrastructure business such as tunnel; bridge, frame, ropeway, overhead bridge, road etc;
- Tax exemption by two percent point to the Companies that have listed their share and securities in stock exchange.

All the incomes earned under above said sources should be accounted separately as income earned by separate person. If any income is earned by above based activities, all seems to be facilitating by more than one facility, in such case only one facility will be provided according to their choice.

Other concessions and rebates:

- Option of election for couples to file the returns jointly or separately,
- Minimum exemption for single or spouse of a couple (Rs.100000 and Rs.125000 respectively),
- Minimum rate of 15 percent is applicable for natural person on taxable amount up to Rs.75000,
- Medical tax credit facility up to Rs.750 per annum (but this provision is not practical and tax payers are not feeling happy with this provision).
- For individual, 10 percent tax on capital gain (For the disposal more than the value of Rs.10 million),
- Remote area allowance from Rs.6000 to Rs.30000 as the location of residence,

- Pension allowance; 25 percent of minimum exemption limit,
- No surcharge or additional tax up to the taxable income of 15 percent tax bracket,
- Facility of filing presumptive tax return for individuals conducting small businesses (who have a turnover equal or lower than Rs.1.5 million or an income equal or lower than Rs.150,000),
- Tax rate for an entity and individual engaged in an industrial activities or export business as well as infrastructure business is 20 percent,
- The taxable income of an entity engaged in power generation, transmission, or distribution is taxed at the rate of 20 percent,
- The repatriated income of a foreign permanent establishment of a non-resident person situated in Nepal will be taxed at the rate of 10 percent,
- The taxable income of a non-resident person deriving income from providing shipping, air transport or telecommunication services in Nepal will be taxed at the rate of 5 percent,
- The taxable income of an entity wholly engaged in the projects conducted by any entity so as to build public infrastructure, own operate and transfer it to the Government of Nepal in the sector of power generation, transmission, or distribution for an income-year shall be taxed at the rate of 20 percent.

Thus, mentioned provisions in the tax laws, in regard to concession and rebates have resulted in the multiplicity of the tax rates and have created the inconsistency and confusions.

- (ii) **Eligible deductions:** To compute the taxable income all the expenses that are related to earn the business incomes are deductible from income. However the Act has made some statutory or special provisions regarding the expenses. As the Act the expenses can be divided in general and specific. The Section 13 and 14 (in some extent) is related to general deductions. Under this provisions all business expenses, real and related to earn income or gain, are deductible from the income earned during the year. Other expenses should be treated as the specific provisions mentioned in specific sections.

This means for the eligibility of the expenses to be deducted, expenses should be spent during the particular year; by the concern taxpayer and that should be related to attain the income of such year. If that expense does not meet any terms or conditions mentioned, the expenses will not be eligible to deduct from income. In this regard salary and wages, office expenses, business promotion expenses (except research and development expenses), repair and maintenance expenses (Except the repair of assets owned by the taxpayer) are the example of general expenses. Interest, cost of trading stock, pollution control costs, research and development costs, expenses for employment by private entities, repair and improvement costs, depreciation allowances and losses from a business or investment fall under specific deductions.

- (iii) **Facility of single PAN/registration for income tax provision:** The Income Tax Act has made the provision of permanent account number (PAN) as an identification number of taxpayer. As the Income Tax Act, IROs will issue the PAN under the delegated right by IRD. The IRD may issue the order to taxpayers to quote the PAN in any return, documents and statement. Similarly, Government may issue the order or may prescribe situations in which a person is required to show or quote their PAN for any specific matter. In other words; PAN is a unique identification number, issued to all the taxpayers throughout the country. PAN identifies each taxpayer

uniquely countrywide. PAN is allotted only once in the lifetime of a taxpayer and it is never changed. In addition the Income Tax Act has declared various rights to the taxpayers in tax administration and concern.

- (d) **The rights of tax payers:** A taxpayer with respect of paying tax under the Income Tax Act has declared the rights and such rights are to get respectful behaviour, to receive tax related information as per the prevailing laws, to get the opportunity of submitting proof in own favour in respect of tax matters, to appoint lawyers or auditors for defence, and to maintain secrecy in respect of tax matters and keep it inviolable.
- (e) **The public circulars and advance ruling:** To achieve consistency in the implementation of the Act and to make the tax administration simple and provide guidance to persons affected by the Act, including officers of the Department, the Department may issue in writing public circulars setting out the Department's interpretation in concern to the Act. The Department is liable to make public circulars available to the public at offices of the Department and at such other locations or by such other medium as the Department may determine. In addition, the Department may, upon application in writing by a person, issue to the person by notice in writing a advance ruling setting out the Department's position regarding the application to the person with respect to an arrangement proposed or entered into by the person.
- (f) **The penalty provisions:** The penal provisions are the vital parts of any Income Tax Act. It should be understood that not all taxpayers comply with tax laws voluntarily. Some may submit the returns but may not maintain accounts properly. Some may try to avoid tax obligation. So there is the universal practice to include penal provision to control non-compliance. The previous Income tax Act also had made different provisions of penal provisions for this purpose.
- **Penalty in the form of Fees and Interest:**
- ✓ Failure to Maintain Proper Documentation – Annual 0.1 percent of total turnover or Rs.1000 on the basis of monthly calculation, which one is more.
 - ✓ Failure to File Statements or Return of Income- Annual 0.1 percent of total turnover or Rs.1000 on the basis of monthly calculation, which one is more.
 - ✓ Failure to submit the Statements of Withholding Tax: - Annual 1.5 percent fees at the tax to be withhold.
 - ✓ Making False or Misleading Statements: if action is done unintentionally- 50 percent of under taxed amount; but in case the offence has been done intentionally: imposed 100 percent of under taxed amount. But still, since five years of introducing new Act, this provision of 100 percent charge has not been enforced.
 - ✓ If an instalment of tax paid by a person is less than the tax payable by the person: the person shall be liable to pay an interest at standard interest rate (15 percent per annum) for each month and part of a month.
 - ✓ Interest for failure to pay tax: A person who fails to pay tax, on or before the date on which the tax is payable, is liable to pay interest for each month and part of a month at the standard interest rate on the amount outstanding.
 - ✓ Fees for Aiding and Abetting- in case of intentional action- 100 percent of under taxed amount (Section 121).

- **In the form of offences:** Offences are dealt with in the Act in a sense of criminal offences of taxpayers as well as tax administrators. According to the Act there are two types of punishments and these are: fines, and imprisonment on conviction. Both a fine and the imprisonment are attracted to the offences such as the failures to comply, failures to pay tax, failure to maintaining documentation or filing income returns, making false or misleading statements, impeding or coercing the tax administration, offences by the authorized and unauthorized persons, aiding or abetting etc. These can be listed as:
 - ✓ a penalty of not less than Rs.5000 and not more than Rs.30000 is charged for the failure to pay tax on time,
 - ✓ a person is liable to a fine of not less than Rs.40000 and not more than Rs.160000, or an imprisonment for a term of not less than six months and not more than two years, or both for making false or misleading statement,
 - ✓ a person is liable to a fine of not less than Rs.5000 and not more than Rs.20000, or an imprisonment for a term of not less than one month and not more than six months, or both for a person who obstruct the tax officer to performance his duties and impede the enforcement of the Act.
 - ✓ Only the attempts to commit the offences referred, a person is liable to a half of the penalty (both of) mentioned,
 - ✓ any authorised person who violates the provision of the Act, that person is liable to pay a fine of not more than Rs.80000, or an imprisonment for a term of not more than one year, or both,
 - ✓ any unauthorised person collects or attempts to collect an amount of tax is liable to a fine of not less than Rs.80000 and not more than Rs.240000, or an imprisonment for a term of not less than one year and not more than three year, or both,
 - ✓ a person who knowingly aids or abets another person to commit an offence is liable to a half of the penalty that is imposed on the main offender,
 - ✓ if the offender is government official he may be liable to the full penalty that is imposed on the main offender,
 - ✓ a person is liable to a fine of not less than Rs5000 and not more than Rs.30000. for the failure to comply with Income Tax Act, and
 - ✓ the defaulter can be prevented from going outside Nepal

In case, if any person accepts in writing as having committed one or more offences, other than of a kind offences done by an unauthorised persons, the IRD may, at any time prior to the commencement of court proceedings, order the person to pay a sum of money specified by the Department. But not exceeding the amount of the fine that is likely to be imposed for committing one or more offences. While issuing the order the IRD is required to specify the offence committed the sum of money to be paid, and the date for payment. But an order issued by the IRD will be final and not be subjected to any appeal. Government of Nepal shall be a plaintiff in all lawsuits under above mentioned offences and provisions. But the Income Tax Act 2002 has not given the judicial power to the tax officials. The previous Income Act had the provisions of interest, fee and penalty and the Act had given the power to tax authorities to imposing penalties to the defaulters and offenders.

- (g) **Weaknesses of the Income Tax Act, 2002:** Against all these provisions, existing income tax related laws and system are not free from some constraints, shortcomings and weaknesses. Some of them can be listed as:

Not fully ecology based: Income tax system is fully depended on taxpayers/self assessment. The tax laws are based on full transparent economic system, scientific accounting and information mechanism as well as morale based tax payers and tax administration. But the environment is not so as assumed.

Departmental action: Section 133 of the Act has made provision for taking departmental action for not making amended assessment within the stipulated time and increase or decrease in tax liability due to the negligence of officials of the administration. The Director General is empowered to initiate Departmental Actions against the concerned employees. But, the provision of protection of official during the lawful discharge of duty is not specifically mentioned in the Act. An example of such provision is as follows; "During the discharge of their duty, the tax investigators are protected by the provisions relating to;

- (a) Self defense,
- (b) Protection against resistance,
- (c) Insult, and
- (d) Bribery charges.

Existing provisions of the section 136 of the Act is very general, therefore, inadequate to protect employees during lawful discharge of their duty.

Exclusive for tax base: For income tax purpose only three sources are incorporated. These do not include the residuals or other incomes. For example, windfall gain has been excluded from Income Tax Act. It is managed under the provision of Finance Act which administered in annual basis, temporarily. Details about the administration i.e. collection authority, procedures, penalties and legal provisions for remedy are not specified.

Inadequate provisions to control Leakages: Section 29 and section 35 state some anti-leakages and anti-avoidance measures. Section 29 specific but section 35 is ambiguous and Nepali words used in the section do not give the indication that the section is related to allow or disallow tax planning.

Comparatively more complicated: Terms used in Income Tax Act, 2002 are comparatively more complicated and more explainable. Some provisions are not enough to administer from simplicity point of view. For example no clear terms and provisions are given for assessment on the base of best judgment.

(h) **Others:** All burdens of proof the evidence has given to tax officials. The Act has made the provision of compulsory return file but it has not made the provisions of compulsory registration for income tax purpose. There is no provision of issuing notice to filing return to potential offenders. The Act is unable to make clear provisions in concern to tax exemptions of non profitable and non-governmental organization as well as retirement fund. Regarding the enforcement tax payers need to be prosecuted even to collect assessed tax, no judicial power is given to tax officials. Thus expectation of 100 percent voluntary compliance and 100 percent accuracy in the assessment of tax liabilities has broadened the size of non-compliance and tax collection gaps.

(i) **Provisions regarding transfer prices:** There are several provisions regarding transfer prices of multinational companies or foreign companies operating in Nepal through dependent agent, branch or subsidiaries. The cases of tax leakages have to be proved in

accordance with the provisions of treaties of double tax avoidance and fiscal evasions. Therefore, the cooperation of partner country is essential to prove leakage.

(j) Inadequate provisions for investigation: The law does not have adequate provisions for investigations. For example, nothing is mentioned about taking suspected evaders in the custody of government. The section 111 of the Act has been made non-compliance cheaper than compliance. In the previous Act of 1974, the defaulters could be taken into custody for 6 months for not paying the dues. Prevailing Act has made provision to file case in the district court.

(k) Appraisal of revenue productivity: Revenue productivity in terms of Tax/GDP ratio, annual growth rate before and after the 8th amendment in Income Tax Act 1974 and after the introduction of Income Tax Act 2002 are given in the comparative Revenue Productivity table/Chart under different Income Tax Regimes.

Table 5: Comparative Revenue Productivity Table/Chart Under Different Legal Regimes

Year	Amount Collection	GDP at Factor Cost	GDP Income Tax Rate	Annual change percentage in GDP	Annual change percentage income tax
1988/1989	879.6	85831	1.02	17.3	
1989/1990	932.1	99702	0.93	16.2	05.96
1990/1991	764.8	116127	0.66	16.5	- 17.95
1991/1992	885.0	144933	0.33	24.8	05.72
1992/1992	1198.6	165350	0.72	14.1	35.43
1993/1992	1921.6	191596	1.03	15.9	60.32
1994/1992	2872.3	209976	1.37	09.6	49.47
1995/1992	3573.4	239388	1.49	14.0	24.40
1996/1992	4213.2	269570	1.56	12.6	17.90
1997/1992	4898.1	289798	1.69	07.5	11.62
1998/1992	6170.0	330018	1.86	13.9	25.96
1999/2000	7426.6	366251	2.02	11.0	20.36
2000/2001	8957.4	393566	2.21	07.5	20.61
2001/2002	8934.2	406318	2.20	03.1	- 00.38
2002/3003	7863.7	457546	1.72	03.4	- 12.00
2003/2004	9510.0	474919	2.00	07.4	10.27
2004/2005	10450.0	508651	2.05	7.7	09.88

Note: GDP Tax Ratio in the table 5 is calculated on current price of factor costs of GDP and income tax revenue realized during the years.

Before the eighth amendment of Income Tax Act 1974, the tax/GDP ratio was around 1.02 percent and it came down to 0.33 percent due to instability in politics and administration. In 1989/90, the growth rate declined by 17.95 percent, then after the growth rate went up to 6.82 percent. But after the 8th amendment, the annual growth rate seems to have been stabilized at about 20 percent. After the replacement of Income Tax Act, 1974 by Income Tax Act, 2002, the revenue/GDP ratio declined and even the improvement has not moved up-to the ratio of 2001/2002. The annual growth rate has been almost negative for two years and increased and begun to grow annually by about 10 percent. However, the growth has not been able to move up-to the growth rate of 2001/2002. Environment of conflict, organizational frictions after the integration of (Income) Tax Department and Value Added Tax Department, legal, slow

growth rate in economy and destabilization might have contributed to lower rate of growth in collection.

4.2 Customs Act 1962

Customs Act is old and out dated, not friendly for present economic ecology; most of provisions are administered under annual Finance acts. The Customs Act 1962 is the product of democratic revolution of 1950. Before it there were *Sanad and Sawals* to administer Customs. To regulate the Customs matter for the first time Customs Act was promulgated in the year 1962. This Act has been amended seven times from the time it was promulgated. And perhaps, the draft for proposed eighth amendment is ready; it is expected to come in few years.

- (a) **Base of customs duty:** The base of Customs revenue is the value and volume of import and export trade. Higher the volume of foreign trade of the country the higher will be the Customs revenue. The duty evasion offence is committed by the fraudulent activities of the traders. The importers and exporters are required to fill the declaration form while exporting and importing the goods. The goods accompanied by the passenger within the limit of baggage rules may be released without filling declaration form. The agent of the owner is supposed to be the owner of the goods of his principals.
- (b) **The source of customs duty:** The Value of the goods imported or exported is the main source of the Customs duty. The customs duty is levied on the value of goods applying the rate of import or export tariffs; in exceptions for some specified goods tariffs are charged under specific tax principal. The rates of tariffs are changeable through Finance Act. To regulate and have a proper control on import and export the Customs Act enjoins certain liabilities on the traders and carriers. Thus, they have to bring in the cargo imported into the country for unloading only at specified Customs point. They must declare the goods in front of the customs officer correctly and get assessed and pay duty properly to be released from customs point. They must possess the customs clearance certificates to move to destination.
- (c) **The procedures of duty compliance and incentives:** For all goods, which are imported or exported, the importers are liable to pay customs duty. The owner of the goods should declare the goods with detail descriptions. The export and import activities are carried within the specified day and time through specified route. The Customs Act 1962 has laid down certain incentives to the compliance:
 - The GON has the right to provide duty exemption partially or fully by prior gazette notification. At the same time the government by notification may provide the facility of custom-duty free, partially or fully. The GON can provide duty free facilities by Gazette notification to any person. At present there are 28 provisions for partial exemptions and some of which contains different exemption rate for different situations. There are 24 provisions of 1 percent duty and mostly are based on the end use or type of import. Other 15 provisions are for full exemptions, particularly imported from India and Tibet. Remaining 8 provisions have provided partial exemption at different rate on the recommendation of Government authority. Out of this, 2 provisions have 1 percent duty at the recommendation of municipalities. In this way there are 77 provisions of full or partial duty exemptions.

- The Act also has made the provisions of refunds. As the provision, the paid duty by the person, who imported the goods and the same person exports, the GON may refund fully or partially.
- The GON may provide duty exemption fully or partially to the domestic products exported.
- Indian Excise is deducted from the imported duty if the import is under (Duty refundable process) DRP system.
- The Customs duty is levied on the basis of Transaction Value according to the principles and Methods of WTO Valuation Agreements (Finance Act 2006).
- The informer may get rewards and the offender may get punishment.
- The parties who feel aggrieved with the decision of Customs officer may appeal at either in Department or Revenue Tribunal.

(d) The penalty provisions: The penalty provisions are part of any laws to make them comply with the provisions made there on. Some of the importers try to avoid the customs laws. Usually, they try to declare less value to evade custom duty and some of them may out rightly smuggle goods through unauthorized route. Though, the modus operandi may differ from case to case. So, it becomes necessary to take action against those who do not comply with the customs laws. In this context the Custom Act 1962 has made certain penalty provisions as a universal practice for duty compliance leakage control. The most of the penal provisions made under Customs Act 1962 are in the form of cash penalty. The limits of penalties vary from Rs.50 to equivalent to the amount of duty evaded which depends on the degree of crime or evasion. Section 14, 15 and 15(a) of the Customs Act 1962 have made provisions of search of any premises, if there is reasonable ground. Section 16 of the Act has the provision of arresting the person committing and involving in the smuggling activities. Sections 17, 18 and 19 have laid down the provisions of detentions of arrested person, arrest of the absconded person and taking on possession of government of the confiscated goods. The Section has made clear provisions of the procedures of auctions of seized goods. Section 34 of the Customs Act has made the highest provisions of penalty up to the equal amount of the value of the goods smuggled as well as imprisonment of 5 years. It also has made the provision of the seizure of the goods confiscated for the offence of smuggling. The Customs officer on duty may order to shoot below the knee in extreme case of encountering on smuggling. Where the officer, desired to take decision of quasi-judicial nature, the officer should file the case to the chief of the customs office. In such condition the Customs officers may exercise the power as judge of district court.

In addition no vehicles can leave customs yard unless a written clearance certificate for the vehicles and goods is issued by the customs officials. The Customs officials may check any vehicle passing through.

(e) The weakness of Customs Act, 1962: Though the Customs Act seems to be very strong in comparison to others Act. The enforcement and implementation of the Act is not satisfactory. There is always public claim that the Customs authorities are not able to control smuggling effectively. In this context the list of weaknesses of the Act are given below:

- Until now, the process and methods of value declaration of imported goods are not clearly defined. Section 13 of the Act has made provision of value determination on the basis of price actually paid or payable or transaction value. Procedure of

determining value is not in the Act. However, the Finance Act, 2006 has tried to incorporate all provisions of WTO systems of Value determination.

- To control the revenue leakage and to increase the duty compliance, the enforcement provision of Customs Act is not being fully capable. The revenue leakage is increasing with the ratio of increment in informal trade in border areas and international airport.
- The provision of cent percent inspection or examination has made the customs job very difficult, in practice.
- It lacks the provision of Customs police force and the Act does not mention the provision of independent review system.
- There is no provision of risk management in concern to customs control and planning. Similarly, there is lacking the provision of monitoring and rationalizing the list of duty exemptions that is a great cause of revenue leakage.

Thus, the Customs Act and its Regulation are seems to have not able to meet the need of modern customs administration as the need of the revenue collection authority.

4.3 Value Added Tax Act, 1995

In Nepal value added tax (VAT) is administered under Value Added Tax Act 1995 and VAT Regulation, 1996. It is a tax on goods and services consumed in Nepal. The tax is based on the principle that each producer or distributor adds value, in some way, to the materials they have purchased and it is added value that is taxed at each stage of the production and distribution chain.

The coverage of VAT in Nepal is based on transfer, sales, supply, imports and exports of goods and services except some special provisions. Every persons or firms or companies who are involved in such transactions are liable to pay and collect tax. The actual coverage is structured by standard and zero rates as well as tax exempted provisions.

(a) Base of Tax: Taxable value of goods and services is the base of Value Added Tax. Value Added in each stages of production and distribution of the goods and services until it reaches the consumer's is the tax base of the VAT. Regarding the taxable goods and services Nepal has adopted two types of tax rates. One is standard rate and other is zero-rated.

Nepal has adopted "inclusive basket system" which makes broad-based tax coverage. Under this system all transactions regarding transfer, sales, supply, imports and exports of goods and services, except some special provisions where value ads exist are taxable. The Value Add Tax Act has listed exempted goods and services under schedule one. Except this provision, all value added economic transactions are taxable and tax is collected at the rate of 13 percent. This is called standard rated area.

Under the Nepalese VAT system some goods and services are, may be, taxed at zero-rate. The objective of this zero rate is to provide the relief on some goods and services under regular VAT system. The purpose of such relief is to promote export and to maintain diplomatic behaviors. Under this provision, the purchaser is allowed to credit the tax paid on inputs or purchase of goods and service concern. However, the registrants have to maintain all records regarding VAT. Supplies made outside from Nepal or exports are taxable at zero-rate. The exporters are allowed to claim input tax credits paid or payable on purchases of goods and services relating to their commercial activities. Exports taxed at zero percent include exports of both goods and services. The list of exempted and zero rated goods and

services are frequently changed by Finance Acts. The main areas of exempted goods and services are basic agricultural products, goods of basic needs, live animals and animal products, agricultural inputs, medicine, medical and similar health services, education, books, newspapers and printing inputs, artistic and cultural goods and services, air transport, vocational or professional service, postal goods and services (provided by Government), financial and insurance services, bank notes, and cheque books, gold and silver, land and building, casinos etc.

(b) The procedures of tax compliance and administration: There are certain incentives given to tax payers to make compliance with the provisions of VAT. The prima fascia commitment of the tax compliance is understood by the tax registration.

Tax registration: It is essential to have registration of all taxable producers, sellers, and suppliers. In other words a person (individuals and legal persons) who is involved in a commercial activities and the turnover exceeds the given threshold is required to register for VAT. However it is not necessary to register who deals only non-taxable goods and services. Similarly those persons who fall below than the defined threshold are not necessary to register. But the thresholds are different for various purposes i.e. Rs.200000, Rs.100000 for consultancy and Rs.10000 for transportation in specified location. In some extent these provisions have created the confusions.

Similarly, the registrant is entitled to collect VAT and utilize the facility of tax credit and refund.

Provision of deregistration: A VAT registration may be cancelled by anyone whose total taxable sales for four consecutive calendar quarters is not more than the threshold specified and who has been registered for a full fiscal year or by persons who no longer have a commercial activity. The Act has mentioned other conditions regarding the cancellation of registration. In case of corporate body, the organization is closed or transferred or collapsed, if the business is running under proprietorship and owner is died, if the partnership is dissolved or dead of any partner, if the distributor or producer stops to sale or produce taxable goods or services or if the business is registered by mistake, the it may be deregistered by the tax officer. But the de-registration process is very harassing and very few numbers have been de-registered in against large numbers of registrants have been requested for deregistration.

Self assessment: The registrants are entitled to assess or compute the tax and return the file by themselves. In this system taxpayers determine the tax liability by themselves and file the return in concern Inland Revenue Office. It is mandatory to file the return whether there is business transaction or not. But if there are no any sales, the registrant should file zero return. Voluntary registrants or who have the sales less than the threshold may file by four-monthly return.

Tax refund: The difference between the VAT collected on sales and charged on purchases determines the amount a registrant must remit or the amount that may be claimed as a refund. In other words if the tax on sales is more than the tax on purchases the person remits the difference. If the tax on sales is less than the tax on purchases the person claims a refund for the difference with 15 percent interest. But the interest will be calculated since after 60 days of the application submitted for refund. If a taxpayer has more than 50 percent of export of his gross sales, he is entitled to refund the tax immediately. However the refund process and procedures are lengthy and complicated.

Tax payment: The producers, suppliers and sellers are the agents for tax collection on behalf of VAT Department or VAT administration. If the tax return shows the debit balance the registrants should pay the tax at a bank or at concern IRO where he will receive a voucher with number as proof of payment.

Tax credit: Tax credit is a facility for taxpayer. Under this system a producer or distributor can deduct the tax paid on input or purchases from the tax collected amount. The difference amount determines the amount of tax to be remitted in treasury or claim for refund.

Zero rates on export: On export VAT is imposed on zero rates and tax paid on purchase can be credited or refunded.

Taxable price: VAT and treatment of discount and commission: Regarding the taxable price discount, commission and sales bonus are exclusive. For example, if a taxpayer sells its product in cash and he provides the trade discount or cash discount deducting from price and he shows the same in tax invoice, the net price after deducting the discount or commission is taxable.

Hire purchase sales system and VAT Collection: Under the hire purchase system purchaser will pay the price value of sold goods in various installment and the supplier should collect VAT when buyer does pay the cash as agreed installments under agreed sales scheme. If there is no any written agreement or sales scheme, the tax should be collected at the time of issuing sales invoice or transfer of goods.

Partial use of goods and tax credit: The VAT Act and Regulation also has provided the facility of tax credit on partial use of goods or expenditure. If a producer purchases some raw material and he uses the material to make both taxable and non-taxable goods. If it is possible to identify the used proportions, the producer is entitled to claim tax credit in extent of proportion used for the production of taxable goods, which one is earlier.

Second hand goods and treatment of VAT: Regarding the business of used goods, laws have made separate provisions. Under this provision for the calculation of VAT, the taxable value will be calculated by deducting the purchase from sales. However the taxpayer is not entitled to credit the tax paid on purchase of those second hand goods purchased for resale.

Right of taxpayers: The taxpayer is the person who involves in taxable economic activities. The VAT Act has provided various rights to taxpayers such as tax credit, tax refund, getting information, administrative review, appeal etc.

Previous sales tax related Acts had not provided the he facility of tax credit, tax refund and other facilities as prevailing act.

(c) Provision of fee and penalties: Interest and Fee: If a registrant fails to pay the any tax during the period prescribed by law or on and before 25th day of next month of tax period, the registrants is liable to pay additional amount of 10-percent/per annum as additional fee. But this fee can be dismissed by Director General (DG) of IRD. In case where, the taxpayer fails to pay any tax to be paid under VAT Act, he is liable to pay interest in due amount at the rate of 15 percent per annum. The taxpayer is also liable to pay interest in the case of appeal to tribunal against tax officer's decision. Regarding the penalties, there are two types of penalties; one is penalty in the term of money and other one is non-economic or not in monetary term. In monetary term the penalties are imposed:

- for failure of registration- Rs.10000 for every tax period and collection of tax,
- for failing to use or mention the registration number-Rs.1000 for every turn,

- for failing to display registration certificate-Rs.1000 for every turn,
- on non-issuing the invoices- Rs.5000 penalty for every turn plus collection of tax,
- for collection of tax by non-registrants-collection of tax plus 100 percent penalty,
- for failing to keep the accounts up-dated Rs.10,000 for every turn,
- for obstruction to visit of tax officers-Rs.5000 for every turn,
- for failing to mention the information such as date and amount of sales, registration number of buyer (if it is registrant)- up to Rs.5000,
- for failing to keep certified purchase and sales books- Rs.10,000,
- for failing to preserve the accounts up to 6 years- up to Rs.5000,
- for failing to file return in due time- 0.05 percent of tax or Rs.1000 (for every tax period) which one is less,
- for under-invoicing-Rs.2000 for every bill/invoice or penalty, up to 100 percent of tax which one is less,
- for preparing falls accounts, documents or invoices- penalty, up to 100 percent of tax or imprisonment up to 6 months or both,
- for evasion of tax- penalty, up to 100 percent of tax or imprisonment up to 6 months or both,
- in case of under-invoicing- penalty, up to 100 percent of tax or imprisonment up to 6 months or both,

Similarly, every taxpayer is liable to keep the accounts in defined format. Otherwise tax officer may audit the transactions and may impose the penalty.

(d) Weakness in VAT system: Previously hotel tax, sales tax, contract tax and entertainment tax were administered by separate Acts. In 1995, VAT was introduced in Nepal, it replaced other acts and all taxes were incorporated under VAT Act. It is proved experience that VAT is a scientific and modern tax system. It is assumed that it is broad based that has higher enforcement capacity and higher deepening power. But in Nepal, the implementation experiences are not so very strong. Policy inconsistency and frequently change in laws is one of the remarkable shortcoming. Revenue leakage has not been controlled as desired. The mechanism is not functioning properly. The weaknesses, by experience, can be listed as:

- less implementation of suspending the business, blocking accounts, possessing anti legal activities related properties and penalty provisions for preparing false account or invoice,
- Weak mechanism of billing enforcement activities,
- Inadequate monitoring provisions.

Previously, under sales tax system, bills/invoices related to hotel and entertainment tax were used after stamped by the concerned tax office. The contract tax used to be deducted at source on contract amount and contract tax used to be certified by the concerned office/officer. At the time of making assessment of income tax of the concerned contractor, the contract amount and contract tax was reconciled by the tax office/officer. But the prevailing VAT related laws has made the provisions of compulsory billing as format specified by IRD, asking for tax invoice/bill by purchaser, goods purchased and transported for commercial purpose in specified location exceeding the value of Rs.10,000 should be accompanied by tax invoice/bill, compulsory registration for VAT for the locations of activities specified by the Department and issuing order by Department for using cash machine and computer.

But the provisions made under various laws have not been effectively implemented. For example the goods exceeding Rs.10000 thousands from traders, not having VAT registration, is not likely to be monitored due to prevailing habit in market to issue two types of bills. The tendency of issuing plain bill or not issuing any bill has not been minimized. The provisions of purchase of under value of goods and suspending the business have not been effectively implemented. Penalty provision for preparing false account or invoice and other documents have not been effectively imposed.

Appraisal of VAT in-terms of revenue productivity: The following table shows the rate of growth before and during the VAT regime.

Table 6: Productivity of Sales Tax and other Taxes/VAT:

FY	Amount of Collection	GDP at Factor Cost	VAT GDP RATIO	Growth Rate of Tax Collection
1988-1989	1290.0	85831	1.50	
1989-1990	1533.0	99702	1.53	18.82
1990-1991	1817.7	116127	1.56	18.57
1991-1992	2618.6	144933	1.81	44.02
1992-1993	3217.4	165350	1.95	22.89
1993-1994	4397.8	191596	2.27	36.68
1994-1995	5720.6	209976	2.72	30.07
1995-1996	6117.1	239388	2.55	6.94
1996-1997	6783.2	269570	2.51	10.88
1997-1998	6881.9	289798	2.37	1.56
1998-1999	8765.9	330018	2.15	27.38
1999-2000	10259.7	366251	2.80	17.02
2000-2001	12382.4	393566	3.14	20.7
2001-2002	12267.3	406318	3.02	-00.1
2002-2003	13459.3	457546	3.08	9.12
2003-2004	14478.9	474919	3.05	7.58
2004-2005	18885.4	508651	3.71	13.02

Source: Economic Survey 2003/04 and 2005/06.

The above table shows that average revenue growth for five years before VAT was about 23 percent and after VAT introduced, the average growth rate for five years has come down to 15.56 percent. The average rate of tax before VAT was about 12.75 percent. Therefore, the growth rate of VAT is not unsatisfactory.

Moreover, tax credits on declared stock were given for longer period of time. It is not essential to consider the revenue productivity after the increase of VAT rate from 10 to 13 percent. The increment of rate might have induced non-compliance and evasion which was raised by businessmen and administrators in the workshop held in Birgunj.

4.4 Excise Act, 2002

(a) **Concept and tax base:** Excise is the levied on goods and services consumption of which need to be discouraged by the state from the view point of patronage. Similar view has been taken to environmental hazards and consumption of non-renewable natural resources. The base of excise is the volume and value of excisable goods that are produced internally or imported. The excise duty and the Excise Act is administered and enforced by IRD and concern IROs. The objective of this Act is to impose and collect the tax on production, import

and services. As the Acts at least 43 items of goods are taxable. As the Act, excisable goods and services refer to the goods and services on which excise duty is applicable as per the Act and the prevailing laws including Finance Act. The goods imply both movable and immovable assets. Similarly, the service implies any other items that cannot be categorized as goods. Without taking the license as per Excise Act, nobody can undertake the production, import, sales or storage of excisable goods or provide excisable services.

For goods, it is levied on the base of price on the production or import. On production, excise duty is levied at the price taken at the time and place when a producer sells excisable goods to a wholesaler, or the price fixed by the IRD based on the cost of production. On imports, it is levied on the amount that is estimated at the time of levying customs duty. But if the goods to be imported are also produced in Nepal and if the Department has established a price of that good, the excise duty is levied on the basis of which ever is higher between the price established by IRD and the price based on importation. For the purpose of excise duty recovery, IRD can carry out a reassessment or an additional assessment if deemed necessary. In connection of the revenue structure of excise the tobacco and alcoholic based goods covers around 90 percent of excise based revenue.

(b) The procedures of duty compliance, facilities and incentives: This act has made the provisions of various facilities and incentives:

- **Tax credit facility:** The duty paid on purchase of services or goods for the purpose of trading or resale or export, production can be credit or deducted by collected duty.
- **Tax exemption:** The goods exported outside the country and goods sold by duty free shop (including bonded warehouse are not taxable. But the bank guarantee is necessary to utilize such facility. The Act has imposed the excise on vehicles, but ambulance, dead human body carriers and auto-rickshaw powered by the battery are non taxable.
- **Self removal facility:** with some exceptions of the products related to tobacco and alcoholic; rest of excisable goods can be issued under self removal system.
- **Appellate:** If any license holder feels to aggrieve by the decision of authority, may file the appeal to the Revenue Tribunal.

(c) Fees, penalties/punishments and other provisions as the part of enforcement Instruments:

(i) **Fees:** For delay payment late fee is chargeable at the rate of 0.5 per day on due amount.

(ii) **Penalties and punishments:**

- **If the responsible person withholds the information or denies providing assistance:** can be imprisoned for three months or charged a fine of Rs.10 thousand or both as the nature of offence.
- **If the excise duty is evaded, hidden or cheated:** punishment in the form of confiscating the amount along with a fine based on the amount or one year imprisonment or both.
- **If the excisable goods are produced or imported without license:** punishment in the form of confiscating the amount along with a fine based on the amount or one year imprisonment or both.
- **If a person prepares false accounts or forged documents and commits an offence:** punishment in the form of confiscating the amount along with a fine based on the amount or one year imprisonment or both.
- **If the offences mentioned above are attempted or instigated:** punishment, applicable by half of that of the real offence.

- Utensils used directly or indirectly in the offence, and the tools, machinery, equipment including vehicles used in the production of the goods and services are confiscated. But if the person has used rented vehicle without the permission of the vehicle owner in committing the offence then the vehicle will not be confiscated but the owner will be charged a fine of Rs.25000 and depending on the nature of the offence the driver can be imprisoned for up to three months or charged a fine of Rs.15000 or both. In case whether, if a vehicle has been registered as rented vehicle but it is found to be used by the vehicle owner then the vehicle can be confiscated.
- ***If any person commits the following offences:*** a fine, charged of Rs.5 thousands to Rs.15 thousand;
 - if the goods are sold or stored without license,
 - if the excisable services are provided without license,
 - if actions are done against the act and rules

Others: Freezing, auctioning, or selling of assets: if officer finds valid reasons,

- ***Cancellation of License:*** if the terms and conditions have been violated or it is observed to be detrimental to public welfare.
- ***Search, seizure and raids:*** If any individual, firm, company, or organization is found to be engaged in the production, import, sale or collection of excisable goods or has been providing excisable services without taking a license or if information regarding the evasion of excise duty is obtained by the authority. He can be investigated, goods can be seized and persons can be arrested (premises, house, land, vehicles or places associated with that academy and suspected person to have committed the offence).
- Providing rewards to other who provides information or clues regarding the offences.

(d) Weakness in excise administration: In one hand the coverage of the excise has been extended. Few years ago, only few items were excisable, i.e. nicotine based and alcohol based products. Presently, not only those goods fruit juice and vehicles are also taxable and scope has been expended. But the revenue organization is not capable to administer the excise Act and rules properly as extended activities. The excise has been excluded from the main stream of the revenue administration. Manpower is not perfectly trained as the technicality of excise administration. For excise purpose Band roll system has been replaced by sticker system and sticker system has not been very effective to control leakages of excise tax. Physical control of highly tax goods like alcohol and cigarettes has been ineffective to control the leakage. For physical control purpose unskilled and untrained lower level employees, who lacks technical as well as legal knowledge, are being posted. Excise Administration is lacking a clear vision, mission and goals.

4.5 The Revenue Leakage (Control and Investigation), 1995

It is desired objective of enforcements of laws is remarkable increase in revenue. By a particular revenue concern organization, the preventive and punitive activities are performed to achieve such desired goals. Before the formulation of Revenue Leakage (control and investigation) Act 1995, the Revenue Leakage control authorities used to take action under the Customs Act 1962, the Export and Import Control Act 1956, and previous Corruption Control Act 1960. The provisions of both former Acts were used to control smuggling and unauthorized trade and the later was used to control corrupt activities of Customs official.

The Revenue leakage (control and investigation) Act has made different provisions to control revenue leakage.

4.6 Delegation of Authority to DRI

The penal provision of Revenue Leakage (Investigation and Control) Act 1995 is not sufficient to enforce the penal provision made under the Income Tax Act, Customs Act, and Excise Act and other tax related laws. Regarding this, to strengthen the enforcement activities, the Government of Nepal has delegated the certain provisions of Customs Act and other tax acts to Revenue Investigation Department. It is noted that Section 4 of Revenue Leakage (Investigation and Control) Act 1995 has clearly pointed the circumstances of deemed leakages in revenues. In addition, the Act also has made provision of arresting the suspicious person on the ground of revenue leakage activities. Thus, the Department of Revenue Investigation is only the investigating authority; however it is not authorized to decide as other courts in concern to take actions against the fraudulent activities. Regarding the action, after detail investigation it may file case in District Court with the consent of attorney general. In the process of investigation, the investigating officer may detain the person arrested on the charge of revenue leakage up to 45 days with the approval of District Judge. In concluding version, the existing organizational structures and the insufficient provisions in the Act have made the effective enforcement difficult

4.7 Alcohol Control Act 1974 and Less Use of Anti Leakage Provisions

The Act also attempt revenue leakage control in the area of Alcohol production, distribution and sale. There are many penal provisions in the Act however, the enforcement is very weak. Some of weakness is listed below:-

- the penalties provisions have been implemented only in few cases,
- Sticker system has not been managed properly so it has been less effective to control leakages,
- Physical control of highly tax goods like alcohol and cigarettes are being ineffective to control the leakage,
- Deputation of unskilled and untrained lower level employees has increased the chance of leakage.

As report appraised the situation in previous chapter, in market a large numbers of shop-keepers are selling alcohol products without permission. Very few provisions of search, seizure and raids of Alcohol Control Act have been used for illicit distillation or sell of alcohol products without license.

4.8 Land Revenue Act, 1977 (Malpot Ain) and Provisions for Compliance

The land Revenue Act has made provisions of levying the land tax as well as the registration fees. The valuation of the land is made in annual basis for the registration purpose. The Value of the land is the main base of levying the registration fee on sale of the land. There is the absence of real transacted value of land. The major factors of revenue leakage can be listed:

- the auctions have almost stopped,
- the land registration fees are raised on the basis of fixed valuation, and
- In many cases fixed values are lower than real transactions values.

Chapter V

Indicators of Tax Compliance and Remedy of Leakages

5.1 Basic Indicators of Tax Compliance

The basic indicator of the tax compliance is the comparison of taxable capacity of the residence with the actual tax collection. The tax compliances are measured using various common and different indicators for different taxes. For example, compliance of VAT is measured by using VAT/GDP ratio, VAT Revenue Ratio, VAT/Tax revenue ratio, gross domestic product plus import VAT ratio, gross domestic consumption /VAT ratio, increase in numbers of tax payers, number of return filers, number of debit and credit returns, number of "zero" returns, number of unsettled returns, cost of collection, numbers of tax payers registered. For income tax, compliance is measured in-terms of tax/GDP ratio, individuals in different income slab and their tax ratio, per capita tax payment.

Estimation of tax potentials need to be continuously reviewed because changes in economic activities result in the change of potential tax collection and actual tax collection depends upon elasticity. The preparation and review of tax potential indicators need continuous monitoring of economic activities of different sectors and geographical regions. Similarly, comparing of potential collection with actual collection, performances of offices and employees are also need to be continuously evaluated. Other indicators, such as controlling efforts of illegal activities, the magnitude of increase or decrease in under ground economic activities and enforcement of ethical codes also need to be monitored to increase compliance. Furthermore, to estimate potential collection of income tax, the pattern of income distribution and the pattern of consumption also need to be monitored. The pattern of income distribution is used to estimate tax paying capacity of the income tax payer. Consumption pattern is used to estimate potential collection of value added tax and excise. The detail of estimates based on income and expenditure has already been stated in Chapter II.

5.2 The Comparison of Tax Revenue in Percentage of GDP with South Asian Countries

GDP indicates the total economic production of the country. The experiences of South Asian countries show that if tax revenue ratio is higher in percentage of GDP, tax compliance can be said to be satisfactory. If the percentage is lower, it shows the possibility of tax leakages and non compliances. The following table shows the comparison of tax GDP ratio of Nepal with other South Asian Countries:

Table 7: The Tax Revenue as the percentage of GDP in South Asian Countries (2001/2002)

Countries	Tax revenue	Income Tax	VAT	Excise	Customs	Others
Bangladesh	7.7	1.4	3.9	0.1	1.9	0.1
Bhutan	11.1	5.9	4.6	0.4	0.1
India	16.0	3.2	...	3.2	1.9	...
Nepal	9.6	2.2	2.8	0.9	3.2	0.4
Pakistan	12.1	3.8	5.7	1.3	1.3	...
Sri Lanka	15.0	2.5	6.7	3.3	2.1	0.4

Source: Next Steps in Tax Reform Nepal (IMF FAD 2003)

The above table shows that the countries having the higher percent of tax in GDP are collecting revenue in better way than the countries with lower tax/GDP ratios. The international comparison need to be evaluated considering the factors like the magnitude of exemption in income tax and zero-rate as well as degree of exemption in VAT and customs and the degree of monetization of the economy. The tax/GDP ratio has been discussed in chapter II. The annual comparison of tax/GDP ratio is given below:

**Table 8: Tax/GDP Ratios
Comparison of the Tax/GDP Ratios
(FY 2001/2002-2004/2005)**

Description/ Years	NRs. in millions			
	2001/002	002/003	003/004	004/005
Customs duty	12658.8	14236.4	15554.8	15701.6
Excise	3807.0	4785.1	6226.7	6445.5
VAT	12267.3	13459.7	14478.9	18885.4
Land registration	1131.0	1414.3	1697.5	1799.2
Income /property, profit tax	9463.7	8691.5	10215.1	11272.6
Total tax	39330.6	42587.0	48173.0	54104.7
GDP(at current price)	406318	457546	474919	508651
Tax / GDP ratio	9.6	9.3	10.1	10.6

Source: Economic Survey 005/006 MOF Nepal

In south Asian countries, Sri-Lanka has highest ratio. Except Bangladesh, Nepal has lowest tax/ GDP ratio. This ratio is not encouraging and this figure gives chance of suspicion of leakage of tax revenue since last four years the tax /GDP ratio has not changed substantially.

5.3 Tax Expenditure Ratio

The Expenditure is the capacity of the Government to spend for public money. The capacity of spending money comes from the internal resources as well as the external borrowings. There is limitation on external source and borrowing. As mentioned in chapter one of this reports the country cannot borrow beyond certain/mandated level. Thus it should ultimately depend on the internal revenue. The following table shows the percentage of revenue in total expenditures.

**Table 9: Revenue/Expenditures Ratios
Tax Expenditure Ratios
(FY 2001/2002-2004/2005)**

Descriptions/Years	Rs. in millions			
	001/002	002/003	003/004	004/005
Expenditures	80072.2	84006.1	89442.6	102560.4
Tax	3933.06	42587.0	48173	54104.7
Percent in Expenditures	49.1	50.7	53.9	52.6

Source: Economic Survey 005/00, MOF Nepal

As the figures mentioned in the table 9, out of the tax revenue for the year 2001/002, the contribution of revenue is not more than 49.1 percent. For the following years, it has covered 50.7, 53.9 and 52.6 percent respectively. However, such a little increment is not due to

remarkable tax increase, in reality, it is due to lower amount spent on development sectors. Thus, the ratio of tax revenue and expenditure varied during those years in between 39.1 percent to 52.6 percent.

Table 10: Indicator showing Tax paid by each tax payer

SN	FY	VAT Rs	Income Tax Rs
1	2000/2001	5,71,000.00	
2	2001/2002	4,75,000.00	56,000.00
3	2002/2003	450,000.00	46,000.00
4	2003/2004	424,000.00	57,000.00
5	2004/2005	475,000.00	53,000.00

Source:- Revenue Administration Structural Reform Recommendation Task Force, 2006

If we go through the table above, the number of the registration of VAT and income tax both are increasing but the amount of tax paid by each tax payer is decreasing. This may be interrelated as declaration of sales and income may have been under declared to that extent compliance in terms of tax payment by each taxpayer is decreasing

Other Indicators: Import/export volume and particularly import tax ratio, increase/decrease in the numbers of taxpayers making tax payment in legally stipulated time, filing tax returns, collection cost to government and compliance cost to tax payers and taxpayer-friendly system and procedures are other familiar indicators.

Remedy of Leakages: The increased frequency of audit, quality of audit, increased probability of detection and disciplining of corrupt and incompetent officials are some of the modes of remedies. This concept has been formulated as follows;

"The probability of detection (P) depends upon the reported income (x) the amount of bribe (b) and the total level of discipline (d) thus the detection technology has been stated as :

$$P \times x < 0 \quad P_b = 0 \quad \text{and} \quad P_d > 0$$

Present practice of not auditing small enterprises may have tax leakages implications of contracting transactions to remain below the level of turn over prescribed in the Act. Therefore, audit program should be made in the way to cover micro enterprises. This will create the impression that they are not immune to auditing, if they are found whole of their past will be investigated. To make audit effective, supervision and selection of the enterprises worthy of tax audit need to be made systematically. Tax payers need to be classified according to turn over or profit or other criteria. For example, on the basis of turn over tax payer may be classified as large, medium, small and ultra small. The audit frequency for them may be determined four years for large six years for medium, 8 years for small and 10 years for ultra small. If found evasion in the audit whole of their past must be investigated according to law or making provision in law. Maximum number of audit needs to be prescribed. For example large tax payers 8, medium tax payers 15, small 30, ultra small 50 or as deemed appropriate by IRD. Points should be given to every audit and performance of the auditors should be evaluated on the basis of audit and investigation. Further study and training is needed to make audit more efficient.

This study does not have time to work out details. Suggestions for improvement has been made in chapter IX which is likely increase the administrative capacity and discipline of the employee.

Chapter VI

Compliance Activities, Educations, Accounting Knowledge and Motivations

6.1 Compliance Activities

Compliance activities begin with registration and filing for the purpose of income tax, value added tax (VAT) and excise returns in stipulated time. It also requires the calculation of accurate tax liability filing return including documents required and payment of taxes in time. These compliance activities are necessary for tax payers to fulfill their own tax obligations. Other tax related compliance are withholding of taxes of other taxpayers on behalf of tax office and depositing the amount in revenue accounts. In Chapter V, compliance levels using different indicators have been reviewed. The modern tax system has adopted a shift in the compliance paradigm. The concentration is shifted from solely on enforcement to proactive approaches that encourage tax compliance side by side. The income tax and VAT had started registering taxpayers differently than previous income tax registration and sales tax registration. Previously, the tax administration used to be operated by tax wise departments; such as Excise Sales Tax, Customs and Taxes. In the process of administration reform, Excise and Sales Tax Department were merged and converted into Value Added Tax Departments. In the year 2002 (2058), the Department of Value Added Tax and Department of Taxes were merged and new Department was named Inland Revenue Department (IRD). After the integration of tax administration, the tax payers are given the single PAN number with the objective of facilitating tax payers for tax compliances. The automation on VAT system was also designed to promote voluntary compliance. Within the IRD income tax and excise are still not fully automated. However, a portion of the customs administration has been automated. There is no built in system of compliance which ensures that all functions of tax administration are being operated in the way that they should have been. In the absence of automation, many functions of customs, excise and income tax administration are being operated manually. In this situation, there are many possibilities of non compliance.

6.2 Tax payers' Educations Services

Revenue administrators used to think that when laws are enacted everybody is obliged to fulfill legal liabilities. After several years of experience Government thought that participation of stakeholders in decision making would be important to make them accept changed policies and also to educate them about Government policies in common forums in mass level. In this process Government began to form tariff board before the budget presentation in legislatures. Taxpayers Associations especially Chamber of Commerce and Federation of Chambers of Commerce and Industries began to demand more participation and more say in formulating Revenue Policies and permanent Revenue Consultative Committee was formed with the membership from Chamber of Commerce, FNCCI and other private sectors and Government officials and academicians.

After the formation of Revenue Advisory committee, the participation and policy making process became institutionalized. This has resulted in educating taxpayers directly and indirectly. Each year before the preparation of the Budget, the committee conducts

consultation with business communities and organizes meetings frequently to discuss revenue related aspects. Post budget seminars are also held to educate the taxpayers about the changes made in the policy, procedures and the tax rates.

In addition, before PAN registration, the taxpayers or their representatives are informed and advised about the systems of tax compliance. For this purpose, the tax offices have established the taxpayer service section/desks. The tax department publishes the tax brochures and makes available to taxpayers. The departments use print media as well as electronic media to educate the tax payers.

The training programs are arranged to the tax officials as well as to the tax auditors. The training to the tax payers' employees has become effective. There are private sectors institutes to train the tax payers' staffs. Knowledge of tax laws and procedures helps taxpayers to comply with law and calculate tax liability accurately. Tax compliance depends on the economic ethic of private as well as government officials.

6.3 Accounting Knowledge and Training

Since Nepal adopted the hybrid of traditional and modern accounting system. Before establishing ICAN, there was no professional training institute for accountants. After the enactment of Chartered Accountants Act 1996 (205), ICAN has been established and it operating professional training to accountant and award certificate of professional competency (CA, ACCA etc). Before that University educated academic accountants and others with long experience in accounting practice used to functions as accountants and auditors. Auditing license used to be given by Auditor General's Office. Now the license for auditing is given by the institute ICAN. It has the responsibility of formulating and implementing accounting and auditing Standard. Other universities including Tribhuvan University are also supplying accounts graduates to the market. GON is also conducting practical accounting training to the officials as well as the other persons. Tax auditors are trained on the principles of taxations and systems of accounts. The Revenue Administration Center conducts various types of tax related training for Government officials.

The Department of Customs is providing training to the customs official on Customs Valuations and goods classifications. The Revenue Administration training Center conducts training to the Customs Agents. These training programs have not been sufficient. International experts have commented that at this stage of knowledge, it would be very difficult to implement WTO valuation system.

There is the need of adequate training to operate Customs Control Activities. Post entry verification, select cargo for physical examination on the basis of risk management technique and post clearance audit in Customs Administration are examples of such activities. The administrators of the futures will be knowledge administrator and the business persons will be knowledge bearer with adoption of modern technology. The use of super electronic highway will help to boost service provisions over the next few years in the contemporary world Thus, Nepalese tax administration should be properly trained to be able to adopt advanced technology in order to combat non compliance and revenue leakage.

6.4 Motivation to Employees

People's general perception is that employees are motivated to work under the Ministry of Finance. But all are not equally motivated to achieve their best in the job assigned to them.

Employees' preferences to work under the Ministry of Finance originate in their desire to work in the area of their study, to get more opportunities in terms of foreign training and other could be the desire of quick enrichment. Even after quick enrichment, the probability of the detection and prosecution is low. The rate of conviction is lower than the rate of prosecution. There is no such thing as naming and faming. Some instances of naming and faming have not been exemplary in all respects. For example, people chosen for awarding medals and for civil service awards were not recognized as the best performers in their field.

It is taught in the Universities that people attempt to fulfill their basic needs and climb up to other needs up to self actualization. The observed behavior in revenue administration till now is that they are continuously making attempts to fulfill basic needs. The 'satisfied need is no longer motivator' do not seem to be valid in revenue administration. Instead, 'there are people who never grow beyond certain levels and whose total life style is geared towards the satisfaction of lower level needs seems to prevail. A recent Survey of attitude made by RSTF 2006 showed findings contrary to these beliefs. The findings exhibited that 27 percent of the respondent regarded adequate training, 25percent reward and punishment, 20 percent promotion on the basis of performance, 15 percent increased in salary and 11percent responded that certain percentage of collected revenue should be given as reward.

The observation of many literatures on other aspects of employees' behavior has been noted below:

- Promotion of persons who should not have been promoted from the known facts of his performance.
- Withholding promotion of a person who should have been promoted from all the known facts of his performance.
- If good performers are continuously ignored without any reward and rewarding persons performing badly from all source of knowledge, known as bad performer.
- Somebody being continuously posted in the area regarded as difficult and less attractive without mentioning reasons or faults.
- Somebody being continuously posted in places regarded as best but performance indicators showing negative performance.

People in revenue administration prefer to work in the sectors which have public relation in their day-to-day or annual work. Audit, inspection and clearance works are regarded very attractive. The functions related to collection and statistics, file management, and taxpayer survey are assumed less interested areas. It can be quoted that the following tasks are regarded as less attractive:-

- The job of statistics and collection are regarded as non-creative, boring and the repetition of the same job. They think that the task as unappreciated by departmental or office head.
- Tax payers survey and collection section do not have public relation like audit section of IRO and duty assessment section of customs. Despite being deprived of the advantages of public relation, they regard their job without any challenge and less importance. The employees posted in that section do not feel that they have been recognized and given serious responsibility. They do not even feel as enlargement of their job.
- If people are working in tax payer's survey, collection and statistic feel that their friends working in duty assessment and audit are working for achievement,

recognition, growth, challenge of job, increase in responsibility and job enlargement, the people working in the tax payers service, collection and statistics may be motivated to work contrary to this they feel that they have been deprived of opportunity. Thus, it might have caused frustration to most of them. The audit section may also, in many offices, have not been functioning as expected by IRD. For example, it was found audit section became unable to make assessment of revenue risky file within the stipulated time of four years. The procedures of selection are 75 percent of revenue risky file by IRD and 25 percent by IROs. Nobody was in the position to justify that un-audited files do not have revenue risk than the audited files. In order to complete audit of all files within four years, employees deputed in taxpayer's service section and collection sections are also involved in auditing in the way to reconcile the interest of all. This shows the people posted in the audit do not have high level of productivity or they are not motivated to the high level.

6.5 Motivation to Tax Payers

The major objective of tax administration is to promote effective compliance with tax obligation that originates from tax systems. Such effective compliance should be spontaneous the tax administration must induce the tax payer to comply through two types of actions, by facilitating or motivating compliance in every possible way and likewise by effectively combating noncompliance by enforcement. In order to encourage the taxpayers to file accurate returns and pay taxes voluntarily, it is necessary that they understand the importance of taxation, recognize their responsibility and understand the tax laws and accounting system. At the time of auditing and examining the accounts of tax payers the tax officers should take opportunity to deepen the taxpayer's knowledge of tax laws and encourage voluntarily compliance. To motivate voluntary compliance for return filing and paying tax, it is necessary to the tax administration to ensure that all tax payers fulfill their tax obligation. Inaccurate returns are examined and corrected and strict measures are taken in the case of tax evasions.

The procedures of tax compliance should be easy. The tax returns forms should be simple and easy to fill with income and expenditures details. The language of the laws should be simple to understand. The tax payers should be well informed about the visible economic benefit of tax compliance such as—law and order situation, judiciary system, increased infrastructures for doing business, efficiency and effectiveness in public expenditures, and participation in policy making process. In Nepal, among these motivating factors only few are visible.

Chapter VII

Improvement of Institutional Structures of Tax Administration, Revenue Police and Monitoring

7.1 Improvements in Institutional Structures

In Nepal, the idea of taxing income in modern form was originated in the year 1950 with the establishment of democratic system in the country. Attempt was made to introduce income tax on basic salaries but it could not be materialized due to political instability in the country. The elected Government introduced income tax on business income and salaries in the year 1959. The tax coverage was extended with the promulgation of Income tax Act 1962. The income tax was levied to all incomes derived from different sources. There was a provision to capture income from any sources. Since the introduction of Income tax Act 1974, incomes were categorized in five groups. But the agriculture income was kept outside of tax net for most of the periods, except in some years tax on agriculture income was imposed by Finance Acts. Income Tax used to be assessed on the income of the previous year till 1997/98. Since 1998/1999 the concept of levying the income tax on current year was introduced. In the new system tax payer is required to pay income tax in three installments on the basis of latest tax return or the estimated income of the current year, whichever is higher. The development history of income tax shows that the tax was assessed officially when it was originated. In the year 1991/1992 a self-assessment system was introduced. Income Tax Act 2002 has made provision of purely self-assessment system. The tax officials may amend assessment or jeopardy assessment only.

Like wise VAT was introduced replacing the Sale Tax, Hotel Tax, Contract tax and entertainment taxes. It was introduced in November 1997 as a new tax as according to VAT Act 1995. Initially, the enforcement of VAT was full of debates. There were many disputes on VAT implementations in the critical circumstances and resistance of tax payers'. Finally, VAT founded its base and is being implemented. However, it has not been able to broaden the tax base as desired. The reluctance of businessmen to provide VAT bill is the crux of the problem of successful VAT enforcement. The improvement programs of VAT were broadening the tax base, development of functional administration, computerization enforcement and tax credit and refund.

In the same way The Customs Act 1962 has been amended several times to make customs compliance effective. The area of Customs Valuation became fragile for non compliance. The section 13 of Customs Act 1962 (with amendment of 1997) tried to make provisions of Transaction Value as a basis of value determination for customs purpose. The subsequent Finance Act has improved the provisions of Value determination as per the principles laid down in GATT/WTO system. Nepal, as the member of WTO, has committed to implement the GATT/WO valuation system by 2007.

In spite of the different tax laws, The Revenue leakage Control and Investigation Act is another improvement. A separate department has been established to combat with revenue leakage and smuggling control. However, the effectiveness of the functions is questioned time to time.

Organization: The current organization is comprised of departments under the Ministry of Finance and the departments are Customs, land revenue, revenue investigation (intelligence). The revenue training center is similar status as department. Revenue Tribunal is first appellate court to appeal against the decisions of customs, tax and excise officers. The exception is income tax Act which permits administrative appeal. The administrative appeal has to be accompanied with the deposit of 33 percent. DG of IRD makes decisions on administrative appeals. Large numbers of administrative appeals are pending with the DG of IRD.

Under DOC, IRD and DRI, Field Offices are located in the different part of the country. Each of these offices is led by different ranks of officers, subordinate staffs and others.

The works of income tax and value added tax is divided in functional base i.e. taxpayers' service, audit/investigation and collection. Excise is administered on tax type by IRD and IROs and the department of customs is also by its nature is administered on tax type. But inside customs related organizations some works are divided on functional basis.

Functions of tax administration: From the legal design of the tax procedures the functions emerged are tax payers' service, registration, collection, audit, declaration, enforced collection, administrative review, tax rebating and judicial review.

In the organization of internal Revenue Offices all of the above functions are not discreet. For example, enforced collection is a matter of prosecution in district courts. Investigation functions are being diluted. This has further weakened the enforced collection. Regarding this the experience of other countries and continent are lesson based. About functional division in "Latin American Tax Administrations have not been able to achieve satisfactory standards in most of the functions identified above, despite much effort. Tax administration neither had at the outset of the decade, a current account and accurate accounting nor adequate managerial evasion control capacity." Regarding the use of courts for enforced collection "Gradually due to inefficiency of judiciary procedural laws empowered tax administrators to fulfill the functions of judges of collection."

Our situation is not much different from those quoted above in evasion control as well as enforced collection. Forget about the efficiency of judiciary. Our experience shows that we have not been able to prosecute offenders even under the Acts which give power of judge to tax officers and excise officers. DRI is another example of inadequate capacity to prosecute tax evaders.

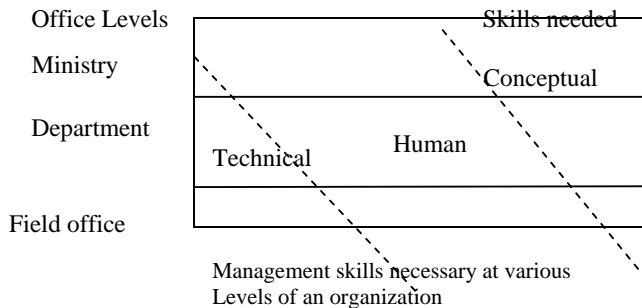
Different studies have been contributed to improve tax compliance and revenue leakage control and that are the high level Administration Reform Commission 1991, Tax systems Review Task Force 1995, Fiscal Reform Task Force 2002 and Revenue Administration. Studies made under the leadership of ex-Finance Minister Madhukar Shamsher JBR, and Structure Reform Recommendation Task force 2006 had recommended improving the tax compliance and revenue leakage control systems.

The Ministry of Finance has sole responsibilities for formulating policies and plans of revenue collection. The three departments including their field offices are responsible for enforcement. IRD has altogether 22 tax offices including large tax payers' office. IRD has 925 officials to administer the tax systems (Income Tax VAT and Excise). Likewise the DRI has four regional Investigation unit offices having 170 officials to perform the investigation

and leakage control activities. In customs administration there are all together 174 customs offices including 29 main custom offices, 142 sub customs offices, 1 foreign post office custom office, 1 International Air port customs house and 1 Dry port Customs office. All these institutions are working in the areas of compliances and leakage control. The Revenue Administration Structural Reform Recommendation Task force has recommended the changes in the structures of existing organization of each department to make the revenue compliance activities effective. Since, as the Task Force, the audit and investigation activities of IRD and the investigation and smuggling control activities of DOC and Revenue Leakage control activities of DRI have not been effective as expected by the Ministry.

Ministry has not been able to coordinate the functions of Revenue Departments and to coordinate the functions of leakage control authorities. The tax payers are complaining that they have to pay double tax on house rent and some other taxes and they have to go to municipalities as well as IRO to complete their tax obligation. The road barrier created by local bodies has made hassles in export and import of goods from one place to customs points. This has also raised the cost of export and import. Therefore, coordination with Ministry of Local Development is felt necessary. The transfer of employee from one department to another and lack of coordination between departments, Ministries, Leakage Control Authorities and demand certain level of autonomy in revenue administration. For this purpose, autonomous revenue board is necessary. The board should be headed by revenue secretary and it should consist of expert members of each field of taxes including excise and local tax.

Level of Office and qualification: Revenue division of Ministry of Finance is headed by revenue secretary. The department heads are transferred from the General Administration. The chief tax administrators or customs administrators are also posted from the administration group of general civil service. The jobs of field offices are mostly technical nature and are related to accounting, auditing, assessment, valuation, classification etc. The generalists are not expected to know these jobs in depth and thereby directing, controlling and commanding their subordinate in relation to their performance. A chart indicating the responsibility of field, department and Ministry is relevant to quote here:



The above chart reveals that the Ministry is concerned in policy matter rather than transfer and day-to-day operation. The department is concerned for the management of employees in field level and concerned to set the target and get it fulfilled and it also supplies policy input to the Ministry. Therefore, departments are bridging between implementation and policy matters. Field offices are, technically, implementing agencies and they need technical knowledge and expertise. For this reason the post of chief administrators and director general and deputy general grouped in general administration does not meet the principle of work specialization. Considering the fact, the former Civil Service Act and Revenue Group

Division Rules had made provisions of grouping these posts within Revenue Administration Group.

7.2 The Revenue Police

The origination of Customs patrolling unit was started since 1966 as a smuggling control force. The force was deputed under local administration as border patrolling unit. The customs patrolling work could not be performed effectively through this arrangement. So the patrolling force was deputed again under Customs administration. The manpower in the patrolling force was 275. The force was again mobilized under Zonal commissioners and the number of the additional temporary revenue patrolling force was increased to 475. The central link of the patrolling force was Revenue investigation Division of Ministry of Finance. After the Democratic Revolution of 1989 the Zonal commissioner system was abolished and the patrolling job was carried by the Revenue Investigation Division of Ministry of Finance. The need of establishing of a separate Revenue Investigation Department for the purpose of controlling the Revenue leakages was felt and established in 1995 the patrolling force was transferred to Customs offices and to the new department. Until now there are 30 Customs patrolling staffs in different customs point and 37 personnel's in Department of Revenue Investigations. In the year 2000 to control smuggling the government deputed Nepalese Army personnel. But the system also could not work perfectly and the job was handed over to the armed police force. In addition, until now the Revenue departments have not equipped with their own enforcement police force. The Revenue Administration Structures Reform Recommendation Task Force has recommended the establishment of Revenue Security force under Ministry of Finance.

7.3 Monitoring Activities

Existing monitoring system is focused mainly on revenue collection. In reality the collected amount is a concern for office chief, Director General, Secretary and even the Minister. There is no monitoring system to estimate how much has been left uncollected. This type of monitoring system has minimized the role of enforcement and less initiative is taken by officials to force or induce people to make compliance. Existing monitoring of collection and other revenue activities are:

- Sending daily and monthly statement of collection,
- Other statements as prescribed by financial administration, regulation and departments,
- Central monitoring unit located in MOF deals mainly with complains related to misdeeds of officials,
- Periodical meetings of departmental chiefs in MOF monitor collection activities under different departments and different sources,
- Sometimes departmental and office chiefs are directed to fulfill the collection gaps in their areas.

To monitor the enforcement of the different department there is the need of Central Information System at Ministry level and at the same time at department level. The central level information system will collect information related to income tax, VAT, excise and customs valuations and classifications. The information will be made available to Revenue Departments and at the same time to other investigation agencies. It is necessary to develop

the information system horizontally and vertically. The notable inadequacy of Revenue administration is information sharing with each other.

7.4 Ongoing Reforms

Tax reform is a continuous process unless the situation takes dramatic turn, the reform measures need to be taken from the base of ongoing reforms. Every Revenue Departments are undertaking reform measures. This situation shows that they are reform mongers and do not like to stay in existing situation. The followings are some of the reform measures mentioned by DG's in the discussion and the meeting with officials of IRD and IRO sector number 3.

- Customs Department has been conducting training program in the area of valuation, working manuals in Nepali are under preparation. Preparations are also going on to introduce WAN and LAN with the assistance of ADB. Customs modernizations and reforms action plans is also one of the major reform initiated by the government which is still continuing in second stage. As a part of the reform, the customs code of conduct was introduced. The performance indicators of each customs offices and IRD also were developed and are still being implemented with positive outcomes.
- Department of Revenue Intelligence has been conducting training program in the area of risk management, papers collected at barriers from transporters and others has been computerized and sent to Internal Revenue Offices.
- IRD has begun computerized collection system which is very significant. The existing accounting system is very old and it is very difficult to verify payments made by tax payers.
- The IRD has initiated the reconciliation process of tax withheld by different withholding agencies. On the completion of the process, this will help tax payers to get tax clearance certificates without having to collect the proofs of withholding from different withholders. This will also result in the behavior of withholders to keep withheld tax with them without depositing the amount in the revenue account.
- The process is underway to open bank counters in all the three offices under IRD in Kathmandu valley. This will result in the reduction of cash transactions in the offices and meetings of tax payers with the employees of the tax offices.
- Decisions have been already made to issue temporary E-PAN registration through the organizations of tax payers like Chamber of Commerce in center and others in local levels. This will encourage tax payers to get registered and get PAN.
- Income Tax Act is being continuously attempted to make simple and effective. For example, provision has been made to deposit 33 percent of the disputed amount to apply for administrative review. This is expected to discourage tax payers to apply for administrative review without genuine reasons.
- For the effective implementation and enforcement billing system, the process is underway to make the use of cash machine compulsory for specified VAT registered traders.
- As a process of ongoing reform, Ministry of Finance has initiated to develop large tax payer office and ICD Birgunj as model revenue office based on performance. Employees will be receiving additional remunerations of 200 percent of their basic salary if the revenue target is exceeded adequately.

Despite of all ongoing reforms the tax compliance has not been increased adequately and as a consequence the revenue leakage has increased. This shows that the doses of reforms have

been less than needed. Because for the modernization of tax administration the following elements are essential:

- Modern Acts and regulations,
- Modern tax organizations,
- Motivated and well trained human resources,
- Modern, scientific and information based technologies,
- Information based and quick decision making procedures,
- Change friendly management,
- Positive attitudes and high morale,

There is the absence of all or some of the elements in ongoing reforms. Therefore, this study has tried to analyze institutional improvement, legal situation and other aspects of tax compliance.

Chapter VIII

Identification of Policy, Legal, Institutional and Administrative Constraints

Against all provisions and existence of many weaknesses for effective tax compliance and proper control of leakages the tax system is surrounded by so many legal, institutional, administrative and policy constraints. For effective policy formulation, knowledge of taxable capacity and tax potential capacity is necessary. Economic analysis functions of MOF do not specifically mentions about this. Strong political will is essential for the successful enforcement and implementation of tax laws. Income tax laws have been amended seven times within the period of less than five years. This shows the inadequate political commitment and inconsistency in Policy.

Similarly, lack of continuous monitoring of potential tax collection with actual tax collection, economic intelligence of business activities and employees, verifiable statistics of import export and domestic transactions, reform in laws to make compliance easy and non compliance difficult, supervision and inspection of tax collection centers and their documents by leakage control concern authorities, periodical review rate structures, developing technical standard especially for the control of leakages in excise tax, enforcement of ethical codes for businessmen and employee, bureaucratic commitment, availability of adequate technical know how in employees, performance indicators of each level of employee, sufficient training to enhance employees' capacity to control leakage, adequate tax education management, adequate laboratory facilities for customs and excises, automation of all functions which can be work a developed system and culture of proper participation in decision making to enhance capacity of subordinate and to be understand as partly involvement them accordingly are other constraints found in revenue system. Further, it lacks a reliable and performance reward and punishment system.

8.1 Legal Constraints

The present Income tax Act is more comprehensive and, less simple. The complexity becomes as an incentive to tax avoidance. As a response to complexity of tax law the tax liabilities are reduced by the tax payers. The terminologies used in the Income Tax Act are not familiars to the tax payers. The Nepali version of the Act is more complicated to understand. Thus the ambiguity, complexities and inadequacies in income tax Act, are major constraints. Other constrains are the frequently change in law without enough home work and impact study, and misunderstanding and debatable interpretation of the Act. The excise Act lacks development and incorporation of technical standard especially for the control of leakages .The Customs Act 1962 (with amendment) has been amended seven times but still it is unable to meet the need of the time. Some degree of non compliance is due to the misunderstanding and debatable interpretation of the different provisions of the Act.

Efficient legal design and efficiency of operation: Efficient legal design and efficiency of operation are interrelated and is as given in the following table:

Table 11:

<p>Efficient Legal Design Efficient legal designs provide an environment prone for internal and external efficiency.</p>	<p>Win-Win situation.</p> <p>Design leads to efficient administration. Internal efficiency is improved because system operations flow smoothly and the design has built-in safeguards to reduce risks.</p> <p>Compliance cost is low because the system establishes rational and well structured storing and reporting obligations, which are in general natural by-products of a sound accounting setting.</p> <p>Compliance cost is further reduced by enforcement which induces better compliance.</p>	<p>Win-Loss Situation.</p> <p>Poor management of a good design.</p> <p>Compliance cost goes up, as compliance goes down.</p>
<p>Inefficient Legal Design Inefficient legal design determines hard to administer environments. Lack of accountability breaks the integrity of the system.</p>	<p>Loss-Win situation.</p> <p>Compliance cost is high and unnecessary. Reporting requirements may be beyond the acceptable limits or nonexistent. But management is able to reduce it without a loss.</p> <p>Internal efficiency may be impossible because of the rules governing substantive and procedural aspects of tax. Processes are not standardized and vulnerability of the system is high; however, managers enforce.</p>	<p>Loss-Loss situation.</p> <p>Poor management of poor design.</p> <p>This is probably a common situation.</p>

Source: Jaime Vazquez-Caro, Senior Tax Administration Specialist, The World Bank. (Paper presented in the Inter-American Center of Tax Administration in 1966 in Italy)

The Nepalese situation of Income Tax Design can be compared with the above table and can be said that legal design was poor. There is the situation of poor management and still the managers are enforcing it.

8.2 Policy Constraints

The inconsistency in the policy is the result of political indifference and lack of adequate mind application in the legislation brought for policy changes. In most of the cases, the politicians for political gain manipulate the tax policy and system and use to blame others for bad result. There is lack of clarity in fiscal vision and goals in macro level. The tax administration lacks of adequate autonomy. The threshold limit has induced trends of splitting business. The policy lapses the provision to develop the professionals to provide better career opportunities to such professionals. There is less consideration of economic activities and volumes in the country while formulating tax policy. The tax/GDP ratio is lower in comparison to Asian and other countries as mentioned in other chapter of this report. The compliance cost is high that why there is non-compliances too. There is inadequate reform in laws to make compliance easy and non compliance difficult. The periodical review of organization and rate structure has been less effective. The policy of single rate of VAT

has made difficulties in widening VAT base. Similarly, the exemption list also has narrowed the base and has created inequity. The rate can be said to be regressive and also uncompetitive with the neighboring Indian markets.

Similarly, present income tax system is not likely to fulfill the objective of redistribution of income. It seems like less equitable than previous tax regimes. Individual income tax rates of Nepal are not progressive in comparison to other South Asian Countries. The option given to the income to the husband and wife to select between single or separate assessment has resulted in the splitting of income tax base of family. This has resulted in the discrimination against the single earner with family. Only 75 thousand of the income is taxed at minimum rate of 15 percent and rest of the income is taxed by applying 25 percent flat rates. Thus, the tax rate is as equivalent to proportionate tax rate and it does not have the distributive justice.

8.3 Administrative Constraints

The revenue administration is not adequate to discharge all the functions of tax administration as stipulated in existing laws. Since there are many shortcomings in administrative functioning's of Revenue administrations. The various reports of reforms on Revenue Administration have stated that administrative settings are not well designed. The administrative structure has been changed to functional in income tax and VAT. Customs and excise and non-tax revenue are being administered in traditional tax type organization system. The policy of limiting offices has resulted in the situations where tax payer does not have easy access to tax administration. Similarly, the tax administration also does not have easy access to taxpayers.

The systems of Revenue leakage control is also not well designed as per international standards. There is the absence of economic intelligences. The systems of intelligence ought to be based on effective information. The Revenue administration has not designed effective data base for the purpose of economic intelligences. Thus, the Revenue administration is not able to carry effective investigation to control revenue leakage for tax compliance in the absence of information inventory.

The Revenue administration is not equipped with well prepared working Manuals for different taxes and investigation systems. The Finance Ministry has developed ethical code for the employees of Revenue group. Likewise the FNCCI has developed the business ethics. The ethical codes are on the paper and there is no application of such ethics in practice. The business and professional ethic are not taught in any educational institutions. The social environment is favorable to illegal earnings.

Revenue collection is one of the most important functions of modern tax administration that needs adequate degree of expertise. The revenue officials are expert in one of their field. They are transferred from one department to other and sometimes from outside that leads them to be jack of all master of none. Annual transfer of employees from peon to joint secretary has made professional competence irrelevant. Departmental heads have very little say to in those transfers, and to some extent, they are frustrated to find customs officers or tax officers and other trained employees interchange in their department leading inefficiency both of the offices.

In the absence of bureaucratic commitment, the numbers of noncompliance is increasing. Such situation may discourage those taxpayers who regularly pay taxes. Performance indicators of office have been developed in Tax and Customs administration but performance

indicators of officers and employees have not been developed. Performance of office does not reflect the same level of performance of all officers and the employees. In one hand, the prescribed standard indicator does or does not reflect the performance rightly has not been appraised. In other hand there is absence of effective use of these indicators to appraise performance of office. These indicators are developed and prescribed only to measure the performance of offices. The performance of individual employees is not measured by existing indicators. Thus, there is the lack of performance indicators to measure the performance of all level of employees. This makes difficult to depute official on the basis of performance contract. A recent experiment has been made in large taxpayer office and ICD Birgunj giving allowances on the basis of performance indicators. If the system is found to be productive and distortion free the system should be expanded to other offices too.

The revenue administration is lacking minimum infrastructures such as office buildings, testing labs, warehouses, open yards and sheds. The computers hardware and software are also not available to all offices. The system of automation has not been completed. Automation of partial functions of Customs and tax administration has not been able to control revenue leakages.

The work in tax administration is divided functionally with the exception of excise tax which is not justifiable principally and practically. The dual system of job division tax wise and function wise is a constraint on compliance of excise laws. In principle excise related laws as other tax laws stipulate some functions. But the administration is not designed to verify that all stipulated functions are complete. Practically this is not justified because there is no adequate coordination to oversee the result of leakage of excise with the leakage of VAT and income tax.

The smuggling control is a major function of customs administration. There is inconsistency in customs patrolling systems. Sometimes it was carried by customs, sometimes by local administration and sometimes it was controlled by Nepalese army and at present the function is carried by armed police. The border patrolling is a major activity of smuggling control and tax compliance which is getting less priority in reform measures.

8.4 Institutional Constraints

Ministry of Finance is solely responsible for the revenue matters and is regarded as the organization responsible for tax reforms. There are three departments and their field offices to collect tax and control revenue leakages. IRD was created by integrating Value added tax department and of income tax department. The offices were also integrated without considering managerial capacity and other aspects of organizational design. No, organization and management surveys were made before integration and amalgamation of filed offices which were brought down to 22 offices from previous number of 39. Now it has been observed Kathmandu, Biratnagar and Birgunj exceeds the number of tax payers which can be handled by one office due to the work load and working procedures. All the official functions need to be done 100 percent except audit and investigation. For example, every return submitted by taxpayer has to be filed and recorded, every collection need to be entered in books of accounts or computer program. All applications for administrative review, exemption and rebates need to be decided. Therefore, the size of office is important. Some of IROs are big enough and officers are finding it difficult to manage. The managerial capacity seems low to manage big organization. The functional division of work is not transparent about the investigation function and audit function dilutes each other.

The tax administration has been designed by crossing the principle of span of control. For example one Chief tax officer has to supervise nine tax officers. As management norms the general span of number of manpower to be controlled by the supervisor is six. The study headed by Madhuker Samsheer JBR has also suggested reducing the number of tax officers working under one chief tax officer.

The tax officials are more attracted in audit function than other functions and there is the psychological pain to work in taxpayer service and tax collection sections. Excise administration is handled by lower staff in office level and particularly in production centers. The tax administration is institutionally under organized in some place and over organized in others. For example, we can quote sub-customs offices which are more in numbers and the service centers of tax office which are less than required.

The employees of IRD, DOC and DRI have been trained many times but they are not enthusiastic to improve ability with technical know how. This trend shows that either the training is inadequate or the employees are not sufficiently motivated to put learned principles and procedures in practice in their field of operation. The training programs are mostly designed to train in the field of audit, valuation and other procedures of tax administration. Nothing has been heard about the training on search, seizure and raids.

There are many studies that have suggested reforming the revenue group keeping in view the tax compliance and leakage control. The advancement of modern information technology has pushed us to adopt the modern systems. Our Tax administration could not internalize the information technology for the purpose of tax compliance and leakage control. It is well understood by contemporary world that information technology must work in the functional areas in promoting voluntary compliance. It can be done by making it as easy as possible for clients to deal with tax offices. The information technology allows the clients easy access, both to retrieve information and request services and to comply with legal requirements. Nepalese tax administration does not easily and effectively internalize with modern information's technology in the service of tax payer. Although IRD has inaugurated allotment of temporary/permanent account number on line in collaboration with Nepal Chamber of Commerce, Kathmandu. Even in allotting permanent account number it is necessary to take precautions against probable distortion.

The tax compliance and revenue leakage control activities have not been institutionalized. The departments and their offices are lacking with revenue intelligence units. All taxpayers are not risky from the view point of revenue leakage. Existing organizational structure is not adequate to exercise revenue leakage control on the systematic basis of risk management and selectivity in inspection and audit functions. There are no central and local risk management units in Revenue Departments and local offices.

The Finance Ministry has a central monitoring unit. It is not functioning as desired by the policy makers. The tax departments also possess monitoring arrangement but this arrangement is also not very effective. The operation of central monitoring unit mostly depends upon complain filed voluntarily by citizens or aggrieved persons and report submitted by offices. It is not systematic as ongoing process.

The transfer of technical manpower has badly affected the running of computer program. The investigating capacity of DRI is limited due to the lack of the well trained human resources.

The tax, and customs investigation function are also suffering from low capacity of investigation. There are deficiencies in training systems. The training programs still could not enhance the enforcement of laws.

The infrastructures in customs houses are inadequate. The low level of physical facilities causes negative impact in transit trade too. There are 143 sub-customs offices the presence of which is not rationalized. Sub-customs offices were open to facilitate border trade. Now the pattern of border trade has changed because of the development of transportation system in both sides of the border. Some of the sub-customs offices do not have well road connected and there is no border sub-customs office at the place where there is good road connection. India has been pressing for limiting the number of sub-customs offices. The need of sub-customs office is felt to regulate the border trade.

8.5 Other Constraints

There are other constraints which can not be forgotten at the time of analyzing in this study. The tax avoidance is an inevitable business reaction in the market. Besides the above mentioned constraints there are few other shortcomings which are given below:

- ❑ There is a little co-operation with other operating agencies and Customs like immigration, security, quarantine, narcotics unit and other related stakeholders.
- ❑ There is absence of institutional mechanism to compute tax potential indicators to determine the revenue leakage.
- ❑ There is no built in mechanism of exchange of information inter-departments and between investigating agencies.
- ❑ There is the provision of sudden visit/surprise visit/friendly visit/checking and inspections in VAT administration but these provisions are not effectively implemented and are not visible as in other area of tax administration.
- ❑ It lacks of departmental mechanism to monitor property of employees and property of tax payers.
- ❑ There is absence of social awareness programs.
- ❑ There have inadequate and ineffective moral education to change attitude towards illicit earning.
- ❑ Reliable performance base reward and punishment system has not been established.
- ❑ The practice of making participatory decision is not visible in departmental as well as in local level. There is no such thing as coordination through consultations and in departmental as well as Ministry level.
- ❑ The citizen charter can be seen in each field offices but the implementation is not effective.

Chapter IX

Suggestions for Improvements and Conclusion

The control of tax leakage depends on the effective measures of tax compliance. The complexity of legal systems and unpredictable procedures are major contributing factors of non compliance. The administrative and institutional hurdles are also irritating factors to taxpayers. In a democratic society taxation is understood as over-riding private ownership of property. So to convince the people there should be the clear provision of legislation. The present study tries to recommend certain measures to tax compliance and leakage control.

9.1 Policy Recommendation

The politician at different level charges that the tax is unjust on the ground that the tax causes the increase in price of consumer goods and it limits the ability to spend. Thus to justify the taxation the government should set goals of over all fiscal policy. Government should decide the overall level of public spending and should set level of public debt. The fiscal policy should be as an adjunct to monetary policy. The policy of taxation should be based on redistribution of in come and wealth. The tax system must be the integral part of public welfare systems. The spending of public purse should be directed to encourage the economically desirable activities. The balance should be maintained between state and citizen's activities through taxation policy.

- (a) **Policy measures on taxation:** The threshold of VAT should be revisited as taxation policy to expand tax base. But at the same time, the principle of single rated VAT need to be reconsidered in the context of Indian VAT System which has three rates excluding the zero rates. The reconsideration of single rate is also necessary to widen tax base to electricity and other services applying lower rates. Establish desk to study the revenue assignment to municipality to compensate them for local development tax which will stop to be collected at customs point as part of elimination of Other Duties and Charges (ODC). Make arrangement to take cooperation of local bodies to control illicit distillation and sales of alcoholic products without license. Impose local development tax on sale below the threshold to equalize tax burden between registered and unregistered traders.
- (b) **Measures for compliance and fraud control:** The preventive measures should be given priority over repressive action when tackling frauds. This should be the principle of legislation and enforcement. Fraud can be curbed by making tax laws less complex and leaving less scope for it. The fraud control policy should focus on two issues (a) First; try to make optimal use of information technology. (b) Secondly, the policy should focus on effective tax payer inspection making inspection pyramid to promote tax compliance. Establish separate investigation unit with small number of experts and investigate tax payers who fall in high revenue risk categories. Start criminal proceeding against the offenders. MOF need to set annual target of investigation to DRI in different field such as customs, income tax, VAT and excise.

9.2 Recommendation on Legal Reforms

The tax legislations are not simple and understandable as mentioned in preceding chapters. The tax laws should be amended to make simple and predictable. The complexity in legal system is an incentive to tax avoidance. The complex business transaction is more difficult to legislate too. The complex taxes are more difficult to administer properly. To remove the complexities of laws following suggestions are made.

- (a) **Recommendation for the amendment of Customs Act 1962:** The Customs Act and Rules are not compatible to WTO systems. These shortcomings are being the breeding ground for valuation frauds. To make the Customs Laws compatible with international standard it is essential to amend as recommended in the Report of Mr. S.D. Mazumdar (UNDP consultant for preparing Customs Valuation Manuals). Beside the recommendations of Mazumdar, there is the need to incorporate revenue leakage control provisions in customs Act about the classification and post clearance audit. For the purpose of controlling of smuggling, legal provision should be made for establishment of and administration of Revenue police for border patrolling.
- (b) **Recommendation for the amendment of Income tax Act 2001:** To make the tax system simple and understandable the tax Acts should be revisited keeping in view of the tax compliance. The list of shortcomings, ambiguities and inadequacies should be identified and the focus should be made to make the Income Tax Act simpler. Present Income Tax Act, particularly the provisions of burden of proof on tax officers make enforcement efforts of tax officers difficult. The effective tax law requires shift compliance's goal from mere enforcement to more proactive approaches that encourage voluntary compliances. However, the weaknesses of income tax mentioned in chapter IV need to be overcome.
- (c) **Recommendation for the amendment of Leakage Control and Investigations Act 1995:** In the present situation, DRI is using delegated power as per Customs Act and VAT Act. The Leakage Control and Investigation Act is not sufficient to combat with tax frauds. The Revenue leakage control and Investigation Act should be amended to make tax compliance effective and fraud risky. In order to make DRI functions more effective, the Department should be allowed to file cases of corruption and revenue leakages to special courts. It will be reasonable on the ground that CIAA has been filing the cases to special courts. It is inequitable to file cases by one agency to special court and by other agency in district courts. The delegated power of customs and tax officer contradicts the functions of investigation and assessment. In the existing situation, if the delegated power is exercised by the investigating officers, they should first decide that the elements of evasion are not present in the case and only after that they can make additional assessment. The Revenue Investigation and Control Act should be amended to accommodate all necessary powers needed for investigation.

9.3 Recommendation for Institutional Reforms

Institutional development is integral part of tax policy. The tax institutions should be developed in modern management principles. For the institutional reforms followings measures are suggested.

- (a) **Revisiting the institutional structure of Revenue organizations:** The Report identifies the need of restructuring the tax institutions as per the recommendations of the study headed by Madhukar Shamsar JBR and Revenue Structural Reform Task

Force 2006. The institutional reformer should keep in mind that the tax collection cost to be minimized. The functions of top management and field level organization should be specified. The investigation and control agencies need to coordinate their activities by establishing institutional mechanism for exchange of information between different agencies. Improvement is needed in the structure of IRD in central and office level. Reactivating excise administration within existing IRD structure is difficult. Therefore, it is necessary to establish independent sub-directorate within IRD by giving all powers of director general to the head of sub-directorate in the matter of excise. This should be made by making amendment in Excise Act and Income Tax Act. In field offices, separate full-fledge sections under direct control and supervision of sub-directorate should be established. Alternative of this will be establishment of separate department of excise and field offices under the department. This should be immediately because nothing has been mentioned about the reform of excise administration in ongoing reforms. The service centers of IRD or IRO are not functioning as they were expected to function. In order to reduce administrative burden of IRO and also to reduce the cost of tax payment of taxpayers, assign collection functions of house and land rent and presumptive income tax to local bodies as well as make arrangement to share revenue.

- (b) **Establishment of Revenue Board:** The transfer of employee from one department to another department and lack of coordination between departments, Ministries, Leakage Control Authorities demand certain level of autonomy in revenue administration. For this purpose, autonomous revenue board is necessary. The board should be headed by revenue secretary and it should consist of expert members of each field of taxes including excise and local tax.
- (c) **Developing institutional efficiency:** The work flow inside the institution need to be properly channeled to increase the institutional efficiency. For this purpose there is the need of job manuals for tax payer services, taxpayer's survey, investigation and audit. The geographical and functional responsibilities should be clarified in procedural manuals. To create good working environment, the recruitment, transfer and departmental action and firing policy in revenue services should be rationalized. There is the need of forming different sub-groups for customs, excise, audit investigation, tax payer's survey, collection and computer and statistics in revenue group. To encourage professional efficiency employees of all level, stop annual transfer by the Ministry of Finance without any logic.
- (d) **Automation and information system:** The information technology can help the tax administration to achieve its goal and improve efficiencies through the promotion of tax **compliances**. The process of automation in tax administration can contribute to service delivery and generate cost saving benefit. The revenue leakage control can be carried out smoothly through the use of automated data. In the field of Customs it is necessary to automate all aspect of work. In the same manner Income tax and excise administration's functions also should be automated. There is the need of central information system based on LAN and WAN to conduct monitoring activities in different levels of administration.
- (e) **Establishment of Revenue intelligence unit and risk management units and rationalization of sub-Customs offices:** Revenue intelligence is an integral part of tax administration. It cannot be ignored at any cost. The intelligence process is essential for both preventive and repressive actions. So, the intelligence unit and risk management unit are necessary in each tax administration. The sub-customs offices should be rationalized and they should be developed as border patrolling posts. There are 143 sub-customs offices the presence of which is not rationalized. Sub-customs

offices were opened to facilitate border trade. Now the pattern of border trade has changed because of the development of transportation system in both sides of the border. Some of the sub-customs offices do not have well road connected and there is no border sub-customs office at the place where there is good road connection. India has been pressing for limiting the number of sub-customs offices. The need of sub-customs office is felt to regulate the border trade. Therefore, it is necessary to rationalize sub-customs offices in the way to make balance between border trade facilitation and limitation of sub-customs offices.

- (f) **Monitoring mechanism:** The monitoring system is the focal point of enforcement of the laws and rules. The monitoring system should be designed tax payer-wise, tax-wise and office-wise to ensure tax compliance and control revenue leakage. The periodical monitoring reports are necessary to evaluate the performance of each office and the employees. In order to monitor the property of employee and tax payers, establish economic intelligence in DRI in collaboration with central public relation department.
- (g) **Developing the infrastructures for the revenue institutions:** Most of the Revenue institutions are deprived of modern infrastructure facilities. The field offices of DRI, Customs and revenue investigation unit have no proper physical infrastructures. Customs Warehouse, yards and other infrastructures for transit trade should be developed as per regional standard. The office buildings of internal revenue offices also should be developed and renovated.

9.4 Administrative Reforms

The major function of tax administrations is collection of tax. The tax administrator should be the expert implementation not the designer of policy matters. They can only advice the practical aspect of tax policy. The tax administration systems should be designed to ensure;

- Continuous monitoring of potential tax collection with actual tax collection
- Develop information system horizontally and vertically
- Make automation in Ministry Department and field offices throw LAN and WAN
- Develop and use the working Manuals with International Standard
- Create social environment to develop ethical code and include professional and business ethic in the school curriculum
- Revise Indicators of performance, separate office indicators and official's performance indicators
- Incorporate functional division in excise and redesign the functional division as mentioned above and as recommended by Revenue task force
- Bring joint-secretaries working up-to departmental level to revenue sub-group for specialization

9.5 Other Recommendations

There are other recommendations which cannot be overlooked in this study. The tax evasion is known as the inevitable market reaction. It should be controlled by joint efforts of different agencies. It demands the cooperation of politicians, business communities and citizens as a whole. The following activities can help to increase tax compliance;

- Develop co ordination mechanism in customs offices
- Develop and apply the tax wise, economic sector wise and geographical region wise tax potential indicators.

- ❑ Such indicators need to be Establish information exchange systems between different leakage control agencies using modern technology
- ❑ Make regular and surprise visit to check the transactions in business premises and also to check the behavior of revenue officials
- ❑ Develop mechanism of monitoring the property and expenditures of employees,
- ❑ Start social awareness program to make the communities aware of negative impacts of tax evasion and effective use of collected taxes,
- ❑ Formulate attitude change plan,
- ❑ Prepare Informative and understandable citizen Charter for each office and keep and convey that to the visitors to tax office.

9.6 Conclusions

Revenue leakage is affecting not only revenue collection. It is also affecting national economy and equity. Therefore, an honest effort to control leakage is necessary. However, in the presence of different constraints even an honest effort is not likely to successful to curb revenue leakages. This report has made an attempt to evaluate the existing level of compliance by making measurement of revenue leakage. The figures are only indicative not substantive.

In making suggestions, the Report has ignored an important aspect that is restructuring of state may affect existing revenue structure at center. This Study feels that it is the right to start different aspects of fiscal autonomy and equity.

Most of the suggestions are practical and can be implemented, for example, activating investigation functions is permitted by existing laws but it is not implemented in practice. The failure of imposing penalty, prosecuting tax evaders has been major cause of noncompliance. Therefore, these activities need to be carefully brought into practice. The experience of emergence of pressure groups once effective enforcement begins could not be ignored. Past experience has proved that after establishment of large taxpayers' office, the pressure groups emerged and became capable to change the limit. Similarly another pressure group emerged when inspection teams were sent to oversee the issuance of bill by retailers and the group became able to block administrative effort. This is the risk which revenue administration will always have to take care. Out of suggestions recommended, some of them are medium term and others are long term and these need to further analyzed and reformed.

Policy Matrix/Log frame

Constraints	Policy Recommendation	Activities	Indicators	Responsible Agencies	Time Frame
<p><u>Policy Constraints.</u> Inconsistency in policy, political differences and political resistance.</p>	<p>-Set goal for over all fiscal policy that based on redistribution of wealth and income equality. -Encourage socially desirable activities. -Maintain balance on public spending.</p>	<p>- Find out levels of taxes without any harm to economy. - find difference between practical capacity and potential. - Find difference between potential capacity and actual collection. -Find out difference between taxable capacity and actual tax collected and determine tax leakage. -Determine level of distribution of wealth. -Make Tax policy consistence.</p>	<p>-Consistency in policy. -Easy to formulate revenue policy. -Tentative figure of tax leakage will be identified.</p>	<p>MOF</p>	<p>Inter./L T</p>
<p>Threshold and singled rated VAT</p>	<p>-Reconsider threshold and single rate. -Create new desk for studying the replacement of Local development fees</p>	<p>-Impose alternative local development/ consumption tax to those who are below thresholds. -Impose lower rate to Water, Electricity and other public utilities. -Take Local cooperation to control illicit distillation and sale of alcoholic liquor without license</p>	<p>-Compliance increased -Additional revenue, -More transparence in activities Equalize the burden of tax between registered and non registered tax payers. Widen tax bases. -Local development fees replaced -Reduction of illicit distillation and sale without license</p>	<p>MOF, MOLD, IRD</p>	<p>Inter and Lt</p>

<u>Administrative constraints</u> Inadequate monitoring mechanism for tax compliance. Absence of economic intelligence.	-Develop system of monitoring. -Develop economic intelligence system to find out revenue leakage.	Properly implement the developed monitoring system Renovate the organizational set up. Keep surveillance of targeted group. Collect information and make investigation effective.	Increase in tax compliance. Effective investigation.	MOF/ Departments MOF/ MOHA	Immediate
Inadequate Information & data.	-Develop information system horizontally/ vertically. -Make automation in ministry, departments and field offices. -Develop WAN.	Use and operate information in assessment, audit, collection, valuation and investigation.	Leakage reduced. Increased compliance.	MOF	Immediate
Inadequate investigation system for leakage control.	-Develop effective investigation mechanism and make it regular,	Use developed investigation system effectively. Define investigation Enforce investigation.	Reduction in leakage. Increase in compliance. Increased compliance and revenue.	MOF/MOH A	Immediate
Inadequate working manuals with technical standard.	-Hire the team of experts to prepare investigation working manual. -Develop working manual with international standard.	-Use developed working manuals.	-Increased compliance. Increased revenue.	MOF/MOH A	Immediate
Inadequate use of ethical code by taxpayers and tax officials.	-Create social environment to develop ethical code. -Include business and professional ethics in the curriculum of educational institutions.	-Enforce ethical codes. -Discourage the socially unfriendly activities.	Increased compliance. Social transformation.	MOF/ MOEC/ MOIC/ FNCCI	<i>Inter/LT</i>
Inadequate bureaucratic commitment.	Develop responsive tax bureaucracy especially for the purpose of tax compliance and leakage control.	Delegation authorities to each level of tax administration. Enact the motivational activities.	-Reduced tax leakage - Increased in compliance. -Decreased complaints	MOF/ MOGA	Immediate

Generalist working as specialist	Bring joint-secretaries up-to department level in revenue group.	Amend rules of revenue sub-group	Facilitate specialization	MOF/ MOGA	Immediate
-Inadequate performance indicators as well as insufficient enforcement of performance indicators that have been developed already.	-Develop employee performance indicators. -Revise indicators. -Prepare separate indicators for office as well as officials as requirement.	-Enforce performance indicators. -Compare the performance with the figures shown in indicators.	-Employee related new indicators. -Indicator updated. -Increased effectiveness in tax administration/management.	MOF	Immediate
Inadequate infrastructures and logistics.	-Develop essential infrastructures (Office building, computers hardware and testing lab, communication network)	-Conduct needs assessment survey. -Prepare plan to develop infrastructure facilities.	-Efficiency and effectiveness of tax administration will be enhanced.	MOF	Inter
Inadequate automation.	-Assess need of information of different agencies. -Develop full automation plan. -Develop link between different investigating agencies.	Use of automated data.	Enhanced effectiveness of tax administration Reduction in tax evasion. Increased revenue.	MOF	Immediate
Lack of functional division of work in excise.	-Divide Incorporate the excise in functional division. -Redesign functional division as recommended by revenue task force.	-Administration of excise as functional division.	Harmonization in functional division. Reduction in excise leakage.	MOF/ IRD	Immediate
Inadequate customs border patrolling.	-Prepare organizational set up as recommended by revenue administration reformed task force. -Establish revenue security police force.	Enforce border patrolling properly.	-Patrolling force created. -Leakage reduced. -Compliance increased.	MOF/ MOHA	Inter.

<u>Institutional Constraints</u>	Recommended Policy Actions	Activities	Indicators	Responsible Agencies	Time frame
Inadequate clarity in responsibilities to broadening tax net	-Prepare the job manuals for taxpayer service, survey and investigation, -Clarify the geographical and functional responsibilities.	-communication and education, -orientation -follow-up	-increment in numbers of taxpayers, -additional tax payments.	MOF, IRD and IROs	Inter
Inadequate autonomy to Revenue administration	-Create Revenue Board comprising of expert members in related field and provide adequate provisions of autonomy in laws.	-Developing infrastructure and managing logistics for the operation of Revenue Board.	Effective coordination with autonomy Increased efficiency of revenue administration	MOF/ MOLJ	Inter
Absence of cooperation of local bodies	-Assign collection function of house and land rent and presumptive income tax to local bodies	-Make legal arrangement to share collected revenue from the assigned sources	-Reduced compliance cost to taxpayers -Reduced cost of collection and burden of work	MOF/ MOLJ	Inter
Absence of sub-group in Revenue Service	-Rationalize recruitment, transfer, departmental action and firing policy. -Create sub-groups to regulate transfer as per expertise. -Incorporate the class first in revenue group.	-Reconsider qualification. -Increase training duration. -Increase specialized trainings. -Bring foreign trainer to train in the new fields.	Changing structure of revenue group. Professional Development, Capacity to compete with private sector	MOF/ RATC/ DOC/ IRD/ DRI	Immediate
Inadequate attention on excise tax.	Revise the institutional structure of IRD especially create Excise Sub directorate to look after excise and sub-directorate for administrative review Create separate section in field offices by amending related laws.	Put excise in functional division and structure. -Created Excise sub directorate and sections in field offices	-Adequate attention, -Revenue yield	MOF/ MOGA/ IRD	Immediate

Inadequate Internalization of information technology.	-Make automation in all aspects of customs operation.	-Automation of functions beginning from post entry verification to release of goods.	-Minimize subjective decisions. -Minimize compliance cost. -Increased service efficiency.	MOF/ DOC/ COs	Inter.
Absence of Revenue intelligence unit	-Establish revenue intelligence unit	-Collection of information. -Forwarding information to revenue departments and offices.	-Increase in compliance. -Increase in revenue.	MOF MOGA, DRI	Immediate
Inadequate organizational structure to implement modern customs procedures.	Establish central and local risk management unit. Establish central information system.	Inspection of goods and passenger employing risk management technique. Operation of post clearance audit activities.	Increment in customs compliance. Increased revenue. Increased level of trade facilitation	MOF MOGA DOC	LT/Inter.
Ineffective monitoring	-Develop Effective Monitoring Mechanism -Use Tax wise and Taxpayers wise Periodical Reports.	-Number of Audits, -Quality of audit selection, -Hiring Specialist	Additional tax amount collected.	MOF & IRD	Inter
Transfer of technical and non technical manpower	-Stop transferring technical manpower a and inter departmental transfer of other employees	-Prepare the profile of experts in different field in each department. Retain the experts within the departments	Continuity of expertise. Enhance re-expertise. Increase productivity of experts.	MOGA/ MOF	Immediate
Inadequate Investigation capacity.	Increase investigation capacity.	-Develop investigation package and expertise in investigation. -Training program by foreign specialized in the subject like investigation.	-Increase in compliance. -Increase in revenue. -Reduction in fraud.	MOF/ DRI	Immediate
Inadequate infrastructure in customs and other revenue offices.	Develop warehousing and other physical and technical infrastructure.	Construction of warehouse in private partnership. Provision of electric filing system by customs agent or other private sector.	Increase in trade flow. Increase in efficiency. Increase in compliance.	MOF/ DOC/ Private-sector	Inter/LT

Lack of facilities to operation of transit points.	-Develop infrastructure to operate transit trade.	-Make legal provisions, Warehousing, -Other operational provision related to cargo and trade operation.	-Increment in economic activities, -More revenue collection, -Contribution to ---- National Income.	MOICS/ MOF/ DOC	LT
Lack of rationalization of sub-customs offices.	-Rationalize the sub customs offices and develop them as border patrolling post.	-Arrange training for border patrolling. -Activation of border patrolling by revenue security force.	-Reduction in smuggling.	MOF/ MOGA/ MOH	Inter.
Inadequate working manuals with technical standard.	-Hire the team of experts to prepare investigation working manual. -Develop working manual with international standard.	-Use developed working manuals.	-Increased compliance. -Increased revenue.	MOF/ MOHA	Immediate
<u>Legal Constraints</u> Absence of Modern Customs Act and Rules/ Inconsistency due to change annually.	Draft and enact customs Act and Rules incorporating essential provision of maintaining balance between Revenue protection and trade facilitation.	.Implementation of WTO valuation agreement. .Implementation of harmonized classification system. .Incorporating selected provision of revised KYOTO convention. Reduction in annual changes	-Transparent laws and procedures,. -Transparent Administration. -Reduction in subjective authority of customs administration.	MOF/ MOFJ/ DOC	Inter.
Ambiguity, Complexities and inadequacy in income tax act	-Find and list shortcomings, ambiguity and inadequacies including the provisions of burden of proof others as mentioned in chapter IV Revise and amend Income Tax act according to principles of taxation as well as practicability.	-Implementation and enforcement of amended laws.	-Simplified laws. -high compliance, -more revenue, -lower administrative and compliance cost	MOF/ MOJL/ Dts.	Inter.

Single rated VAT Act Threshold	-Identify short comings in VAT Act to amend it	-Enforcement of amended Act.	Facilitated widen tax base	MOF/ MOJL/Dts.	Inter
Inadequate Investigation & prosecution provision in Revenue Investigation Act	Identify short comings as mentioned in chapter IX to amend the Act	Enforcement of amended Act	Increased Effectiveness in leakage control	MOF/ MOJL/ Dts.	Inter
Other Constraints Inadequate cooperation with other operating agencies and Customs Offices.	Develop coordination mechanism in customs offices.	Formation of local committee of immigration customs quarantine and others.	Smooth flow of passengers. Smooth flow of goods. Cooperation to increase compliance.	MOF/ MOH/ MOAg	Immediate
Absences of tax potential indicators.	-Develop and improve tax potential indicators: -Economic sector wise. -Geographical region wise. Office and employee wise.	-Making analysis between potential and actual collection. -Estimation of degree of additional effort needed to fill gap between potential and actual collection.	-Increase in compliance effort. -Increase in revenue. -Ease in working.	MOF/ Concern Departments	Inter
Inadequate Exchange of information	-Establish automation information exchange system.	-Operation of established automation information system between different offices.	-Increase in compliance. -Increase in revenue. -Decrease in fraud and evasion.	MOF/ DRI/ DOC/ IRD	Inter.
Inadequate Sudden visit/Surprise check and inspection	Make regular and time table for regular and surprise visit/check.	-Regular visit check. -Surprise check.	Increase in compliance. Increase in revenue. Decrease in fraud cases.	MOF/ DRI/ IRD/ DOC	Immediate
Absence of Mechanism of Monitoring property of employee & traders	Develop mechanism to monitor properties and expenditure of employee.	-Review of periodic statements. -Economic intelligence work.	Enforce ethical behavior of employee.	MOF/ DRI/IRD/ DOC	Immediate

Inadequate Social awareness	Develop and promote the social awareness programs.	Execution and implementation of the social awareness programs.	Increment in compliance. Promotion in employee and business morale.	MOF/ FNCCI/ Local/ central organization	Immediate
Wrong attitude	Formulate attitude change plan.	-Inducting of moral education. -Devise visible reason for reward and penalty. -Ensuring the fair treatment in posting, transfer foreign training and other reward and punishment actions.	-Increase in compliance. -Reduce in collaborated non compliance.	MOF/ MOGA/ DOC/ IRD/ DRI/ RATC	Inter.
Absence of Transparent Citizen charter.	Prepare Informative and understandable charter.	-Providing information to the stakeholders. Regular monitoring.	-High Compliance, -Lower number of complaints	MOF and Departments	Immediate

Note: Immediate= one Year, Inter= Intermediate=up to three years, LT= Long Term= More than Three Years

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14. Dhruba Pant – Chief Customs Officer
15. Laxmi Poudyal – Chief Investigation Officer, Pathlaiya
16. Bijaya Sarawagi – Birgunj
17. Binod Gupta – Businessman, Birgunj
18. Tara Shamsher Rana – Businessman, Birgunj
19. Indu Shekhar Mishra – Birgunj
20. Navaraj Thapa – Birgunj
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25. Manihar Adhikari – Birgunj
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27. Dhruba Sharma Nepal – Birgunj

Terms of Reference:

Study Topic:

Measure for tax compliance habit and leakage control

This assignment is equivalent to effective one man month. The consultant should establish adequate interactions with various stakeholders including the government agencies while conducting the study.

Task Details:

- Review of present status
- Legal provisions to check tax leakages and its implementation status.
- Appraisal of tax related legal instruments during different time period.
- Indicators of tax compliance and remedy of leakages.
- Tax education, accounting knowledge and motivation for revenue staff and tax payers.
- Improvement in the institutional structure of tax administration, revenue police and monitoring activities.
- Identify legal, institutional, administrative and policy constraints in tax compliance and leakage.
- Suggest improvements.
- Suggest policy-action matrix (a) constraints (legal, institutional, administrative, policy and others if applicable); (b) recommended policy improvements; (c) activities; (d) indicators of achievement; (e) responsible agencies; and (f) timeframe (immediate, intermediate and long term).

The paper should include an executive summary not exceeding five pages. The consultant will have to submit a draft report to the EPN Focal Unit within 30 days from the date of assignment and present the draft at the workshop organized by the Advisory Committee and EPN Focal Unit. The final report shielded is submitted within 2 weeks of the workshop incorporating all feedbacks from the workshop. One hard and one electronic copy of the draft and final report should be submitted to the EPN Focal Unit.

Assigned to:

Responsible Ministry: MOF

Thematic area: Macroeconomic Management.