

AN EVALUATION OF THE NEPALESE INCOME TAX SYSTEM

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1. Introduction

This paper intends to trace how the Nepalese income tax system was evolved over the years. It also seeks to bring out the main issues of the existing system and recommends some policy measures. Considering these objectives, the paper is divided into five sections. The introductory section is followed by a section that presents the major developments in the income tax system. The Third Section analyses the main problems of the existing system and the Fourth Section deals with some reform measures. The last section contains concluding remarks.

2. Evolution

2.1 Inception

While the idea of introducing income tax in Nepal originated in the early 1950s, it could not be introduced until 1958 mainly due to political instability. This tax was introduced by the first elected Government in 1959. The underlying reasons for the introduction of income tax were to generate more revenue to finance development activities and to help achieve social justice.

The tax was introduced on an experimental basis on business income and salaries, which are easier to assess than other forms of income such as agricultural income. After about 3 years' experience with this tax, it was extended in 1962 to income from all other sources. Several sources of income, however, were exempted from income tax over the years. For example agricultural income was excluded from the income tax net in 1966/67. This source was made liable to income tax again in 1973/74 but was exempted from income

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tax in 1977/78. Since then no attempt has been made to levy income tax on agricultural income.

Dividend income has been kept out of the tax net except for a short period. In 1986/87, dividends distributed by public limited companies and corporations subject to the corporate tax were made liable to tax. A 20 percent withholding tax was levied on such dividends at the time of the distribution of dividends. The withholding tax was credited against the individual income tax payable on total income including dividend income. The withholding tax on dividends was abolished in 1987/88 while dividend income was still fully subject to tax at the shareholders' level. A partial relief was granted to dividends in 1988/89 when the taxable position was reduced to 15 percent of dividend income keeping 85 percent out of the tax net. This system also existed in 1989/90. Dividend income has been fully exempt at the shareholders' level since 1990/91.

Interest income obtained from investment in development bonds issued by the Government was exempted from income tax from 1965/66 to 1991/92. While export income has been excluded from income tax coverage since 1988/89. Similarly, several allowances provided to the employees have been exempted from income tax over the years.

2.2 Separation of Corporate, House Rent and Interest Taxes from Individual Income Tax

Initially, corporate income tax was combined with the individual income tax and the same rate structure was fixed for both taxes for many years. Such a system would be understandable perhaps in an economic situation where the number of public corporations was limited and private companies were family-owned and family-managed. But the situation changed over the years. The number of public enterprises increased and several public and private limited companies were created. Moreover, the progressive rate structure of corporate tax was undesirable since it encouraged business enterprises to split into different units to take advantage of lower rates. Further, as the shareholders, who ultimately get the benefit of the profit of the companies or corporations, fall in different income groups progressive rates cannot be justified on the same grounds (i.e. ability to pay) as for individual income tax.¹ So, government corporations and public limited companies listed on the Nepal Stock Exchange have been subject to a separate flat rate corporate income tax since 1986/87. Corporate tax was extended to private limited companies in 1993/94. The

¹ George E. Lent, "Corporation Income Tax Structure in Developing Countries", *IMF Staff Papers*, Vol. 24, 1977, p. 737.

rate of corporate income tax was 40 percent from 1986/87 to 1991/92 and has been 35 percent since 1992/93.

Initially, house and land rent was subjected to the income tax. However, a separate tax called house rent tax was levied on this type of income from 1965/66 to 1967/69, and between 1974/75 and 1977/78. House rent has again been taxed separately since 1991/92. This tax is levied on all income obtained from the renting out of land and buildings. It is mandatory to withhold the tax at the rate of 15 per cent which is, in fact, the final tax.

Similarly, interest was subject to individual income tax until 1976/77. But a separate interest tax was levied on this type of income in 1977/78. Since then, the tax has undergone considerable changes. Now this tax is levied on interest income from all types of deposits at a bank or finance company. Exempt from this tax are provident fund deposits, provident fund deposited at a bank in the name of employees, deposits of the village development committees, municipalities and district development committees, and deposits of a non-profitable educational, social or religious organization. This tax is withheld by the bank concerned at the rate of 5 percent at the time the interest is paid to depositors.

2.3 Increasing Dependence on the Presumptive Basis

Another noticeable development in the field of income taxation is the increasing use of the presumptive basis in the case of income where it is difficult to make an income tax assessment in accordance with the actual income and expenditure of the taxpayer. Under the Income Tax Law of 1962, 90 percent of the gross income from house and land rent, income accruing from investments, professions etc. was considered as the net income for income tax purposes. In the case of a timber contract with a foreign contractor, 15 per cent of the contract amount has been considered as the net income since 1974/75. Similarly, in the case of goods imported from countries other than India, the net income had been presumed between 1983/84 and 1992/93 to be 8 to 30 per cent of the value stated on the import licence, depending upon the nature of the goods. In the case of distilleries producing country liquor under a minimum guarantee system where the tax is not assessed on the basis of the accounts, 25 per cent of the minimum guarantee amount or excise, whichever was higher, was considered as the net income between 1982/83 and 1991/92. The corresponding figure has been 33 per cent since 1992/93.

In the case of foreign airline corporations operating air services in Nepal, tax is levied at the rate of 5 per cent on the total turnover arising in Nepal, while the corresponding rate

is 3 per cent in the case of foreign airline corporations doing business in Nepal other than operating an air service.

The presumptive basis was extended further in 1993/94 when an annual presumptive tax was levied on rented vehicles, small shops, and small contractors. The following types of entrepreneurs having up to Rs 450,000 annual turnover or Rs 45,000 net income but who have remained outside the tax net in the past have been given an option to pay an annual income tax of Rs 1,000:

(a) retail grocers, (b) retail rice shops, (c) cold drinks stores, (d) butchers (e) fruit and vegetable shops (f) photocopying services, (g) secretarial services, (h) tailoring, (i) laundering, (j) hair dressing, (k) electronic repair services, (l) welding and grill making, (m) workshops without machinery and other similar shops.

Small contractors whose contract amount does not exceed Rs 1 million are taxed at the rate of 1 per cent on ration contracts and 2 percent on other contracts. This tax is withheld by the contract awarding party. Similarly, presumptive annual tax is levied on rented vehicles and temporarily registered vehicles.

There is a separate scheme for small taxpayers having an annual income below Rs 60,000. They are not subject to normal procedures i.e. they are not required to report their actual income for the purpose of income tax assessment. In such cases, assessment is made by a committee composed of a tax officer, customs officer, excise officer, and representatives of the village development committee or municipality and the local Chambers of Commerce and Industry. Small taxpayers can fulfil their tax obligations by paying 20 percent more in taxes than in the previous tax year.

2.4 Progressive Rate Structure

Graduated rates of income tax were introduced from the very beginning. Under this system, net income is divided into different bands which are subject to progressive rates. The first slice of income, known as the basic allowance, has been exempt from the tax from the very beginning. Such an allowance was Rs 7,000 for all types of taxpayers in 1959/60. It was raised over the years and is now Rs 25,000 for individuals and Rs 35,000 for married couples and families. The higher slices of income are subject to progressive rates. Initially, there were 10 different rates, ranging from 5 to 25 percent. These rates were raised over the years to maintain vertical equity and generate additional revenue. The highest marginal rate ever levied was 60 per cent on income over Rs 540,000 in 1975/76. The greatest number

of tax rates was 12 in 1964/65. Since 1988/89, there has been a trend to reduce the level and number of tax rates. Now there are three rates, i.e. 10, 25 and 35 percent.

2.5 Move from Joint Taxation to Individual Taxation

From the very beginning, the Nepalese income tax has treated the family as a tax unit. Under this system, tax is levied on the joint income of the family, i.e. the income of the spouse and dependents are added to the income of the head of the family for tax assessment. A change was effected in the Nepalese income tax system in 1977/78 when the system of joint taxation was replaced by a system of individual taxation in cases where both husband and wife are salary/wage earners and these salaries/wages are their main source of income. When the tax liabilities of husband and wife are calculated separately, they cannot claim the married couple's basic allowance; instead, each of them is entitled to an individual's allowance. This means that when couples are taxed separately, their combined basic allowance becomes higher than that of the married couple's allowance and their income is subject to lower marginal rates, leading to a decline in their total tax bill. This is an incentive for secondary earners to take up paid employment. The system of individual taxation has also made withholding more simple and accurate since final tax liability depends only on the income of the individuals.²

It must be noted that unearned income of spouses is still subject to joint taxation. In other words, when one of the spouses has income other than employment income, the tax is levied on the joint income of the family. Such a provision is desirable to avoid the possibility of revenue loss from the deliberate transfer of assets or income among family members.

2.6 Shift from Itemized to Flat System of Standard Expenses

The system of calculating standard expenses in the case of employment income has also undergone changes over the years. An amount not exceeding 5 per cent of remuneration in respect of the cost of travelling to and from work and Rs 50 per month of 5 percent of remuneration, whichever was the lower, as expenses on the purchases of books and journals was allowed to be deducted as standard expenses in 1974/75. The scope of standard expenses was stretched further in 1980/81 when an amount equal to 2.5 per cent of the remuneration for the education of each child up to 2 children and contributions by an

² Charles E. McLure, Jr., and Santiago Pardo R., *Improving the Administration of the Colombian Income Tax, 1986-88*, in Richard M. Bird and Milka Casanegra de Jantschet, (eds), *Improving Tax Administration in Developing Countries*, IMF 1992, P. 141.

employee to the provident fund were also made deductible. A standard deduction system in lieu of itemized deductions was introduced in 1986/87 when 15 per cent of the amount of employment income left after deducting provident fund contributions or Rs 3,000, whichever was the lower, was considered as standard expenses. The latter figure was raised to Rs 5,000 in 1990/91 while the provision of 15 per cent was rescinded in 1992/1993.

2.7 Increasing Use of Withholding Tax

Tax on employment income, bonuses, commissions, vehicle rent, distribution of fees, consultancy fees and sub-contract income is withheld at source. In the case of employment income, the withholding tax rates are the same as the annual income tax rates calculated on the pro-rated income. A person who makes disbursement of such income subject to withholding tax must withhold tax at prescribed rates at the time of disbursement, remit it to the Government account within 15 days and submit the particulars thereof to the tax office concerned. The withheld tax is provisional and is subject to adjustment in the final tax assessment. In the case of other income, tax is withheld at different rates, ranging from 1 to 10 per cent.

In 1991/92, an advance tax was levied at the rate of 5 percent on imports with a value of more than Rs 5,000 at any one time from Tibet, and on imports, other than those for personal use under the personal Baggage and Luggage Rule, which enter through the Tribhuvan International Airport. The rate of tax under the barter trade with Tibet is 2.5 percent. The scope of this tax was extended further in 1993/94 when 5 percent of the import value determined for the purpose of import duties was levied as an advance income tax on all commercial imports, other than imports under the personal Baggage and Luggage Rule, which do not have income tax registration certificates. In the case of imports of agricultural products, food stuffs, animals, birds, eggs and meat the tax is levied at the rate of 2.5 percent.

3. Major issues

3.1 Narrow Coverage

The coverage of income tax is very narrow. Agricultural income is exempted from income tax. Capital income is treated favourably. For example, capital gains are not taxed. Dividends are kept out of the income tax net at the shareholders' level while interest on deposits from an account with a bank or finance company is taxed lightly. Although labour income is taxed more heavily than the capital income, several sources of labour income have

also been kept out of the ambit of income tax. For example, allowances such as travel allowances, foreign allowance, expenses granted to employees visiting other countries, the leadership allowance of a leader of a team visiting abroad, telephone allowances, vacation pay, pensions etc. granted to employees are all excluded from the coverage of income tax. In addition, a number of tax incentives have been provided to industries.

Omission of these sources of income from the income tax net has led to a considerable erosion of the tax base. Exclusion of agricultural income from the tax net alone cuts out about half of the GDP. Of the sources of GDP, the tax legally covers manufacturing, construction, trade, restaurants and hotels, and financial and real estate which account for one quarter of the GDP. Nevertheless, not all these sources have been made fully liable to tax; there exist several concessions, credits and rebates. This is all reflected in the low contribution, low elasticity, and the limited number of taxpayers. For example, income tax provided a revenue of Rs 1151 millions in 1992/93 which was 9.87 percent of total tax revenue and 0.70 percent of GDP. The elasticity of the income tax was only 0.44 for the period from 1974/75 to 1991/92, meaning that income tax revenue increased by only 0.44 percent for every 1 percent increase in GDP.

The number of registered payers of income tax (other than wage and salaries earners) is less than 100,000. It must be noted that about one quarter of these registered payers no longer operate economic activities but their names have not been removed from the tax list because there is no practice of keeping such lists up to date.

Moreover, tax enforcement is very poor. Not all the sources brought under the tax net have been taxed fully, resulting in a gap between the legal and the actual tax base. It is believed that several potential taxpayers, particularly self-employed groups have remained out of the tax net. Further, not all taxpayers brought under the tax net file income tax returns on a regular basis and pay tax according to the current law.

3.2 Unscientific Tax Assessment

The number of taxpayers, as stated earlier, is limited. Further, the income of these limited taxpayers is not assessed on a regular basis. The number of tax assessments is much more lower than that of the number of registered taxpayers, meaning that not all taxpayers included in the tax net have been taxed effectively. There is an erratic trend in the number of tax assessment, showing the lack of a continuous and systematic effort in this area.

It is also interesting to note that, of the assessed cases, a large number of tax assessments are made on a best judgement basis. Theoretically, the best judgement method is used when a taxpayer does not submit returns or submits incorrect returns. In such cases, tax assessment is made on the basis of the negotiation between the tax officer and taxpayer which does not depend on the actual profit and loss of the taxpayer but is geared to other factors such as fulfilling the target given to the tax offices for a fiscal year. There is a general tradition among tax officers to assess a higher (or at least not a lower) amount than in the previous year. Under such a situation, a taxpayer is encouraged to influence the tax officer by bribery or other means to minimize or other means to minimize the tax liability of the income-year concerned and also to minimize his future liability.

3.3 Deviation from the Basic Principle of Income Taxation

The essence of the progressive income tax is that it should take into account the personal circumstance of the taxpayer. The Nepalese income tax system has deviated considerably from this principle. It treats different sources of income differently, resulting in an unequal tax burden upon taxpayers having equal tax paying capacity. Employees, particularly in the public sector, pay full tax on their income due to withholding tax. Self-employed people who earn more money, however, are almost out of the tax net; they pay little or no tax on their income. Although, in theory, business income is supposed to be taxed to the same extent as remuneration income, in practice, there is a possibility that this type of income may escape tax altogether or be taxed lightly due to the ineffective enforcement of the tax. Capital income is treated favourably. Tax on interest is subject to moderate tax as well.

Further, the tax is levied on a current year basis on some forms of income while on a preceding year basis on others. Under such a situation, receivers of labour income whose income is subject to withholding tax and who generally belong to the lower income groups have to pay higher real tax rates³ due to inflation than do earners of other incomes such as business income. Business income is assessed on the previous year basis and businessmen delay payments in several ways and pay less tax in real terms. Further, the tax is not implemented effectively and uniformly. Several sources escape tax. The bulk of the tax revenue is assessed under the best judgement method and on a presumptive basis. For these reasons, both horizontal and vertical equity have been damaged considerably and the Nepalese income tax is not in fact as progressive as it would appear from its statutory progressive rate structure.

³ Amalio Humberto Petrei, "Inflation Adjustment Schemes Under the Personal Income Tax", *IMF Staff Papers*, Vol. 22, 1975, p.552.

3.4 No Adjustment for Inflation

Under the individual income tax, income brackets, basic allowances, standard expenses, business expenses etc. have been expressed in money terms and, these amounts have been either not adjusted at all or only partially adjusted for inflation. As a result, they have been eroded in real terms over the years due to inflation. This may be clear from the case of the basic allowance. Despite rapid inflation, basic allowances were kept unchanged from 1983/84 to 1989/90. During this period, the GDP deflator index increased over 65 percent (the consumer price index increased almost 80 percent). The result was that the level of basic allowance for individuals was reduced from Rs. 15,000 in 1983/84 to Rs. 9,050 by 1989/90. In the case of married couples and families the volume of basic allowance decreased in real terms from Rs. 20,000 in 1983/84 to Rs. 12,067 by 1989/90. The upward revisions made in the basic allowances in 1990/91 and 1992/93 were not sufficient to bring the level of basic allowance back to the 1983/84 level in real terms, as in 1992/93, the volume of basic allowance stood at Rs. 10,398 for individuals and Rs. 14,558 for married couples and families in 1983/84 prices. No adjustment was made to the basic allowance in 1993/94. Thus, as adjustments in basic allowances have not been closely linked with inflation, the level of basic allowance has been eroded over the years. The situation is more serious in the case of other amounts where no inflation adjustments have been made at all. The consequence is that those previously exempt are now subject to tax and those who were already in the tax net have moved up into higher tax brackets without any increase in their real income. This bracket creep phenomenon increases the tax burden particularly on wage and salary earners who generally belong to the lower income groups but are, in fact, taxed more effectively than the higher income groups.

3.5 Defective System from the Perspective of International Taxation

Some anomalies exist under the existing income tax system from the perspective of international taxation. For example, dividends have been fully exempt at the shareholders' level in the case of both resident and non-resident taxpayers, *inter alia* to attract foreign investment. But such a provision may not be effective in attracting foreign investment unless the country of residence of a non-resident taxpayer exempts the dividend income derived from Nepal. Only a very few countries, including France and the Netherlands, have such a provision. Many countries, including Germany and United Kingdom, have adopted the tax credit system, i.e. they levy tax on worldwide income of their resident taxpayers and allow taxpayers to credit tax from their total tax liability on the tax paid abroad. Under such a condition, foreign investors have to pay full tax in their home country on the tax exempt dividends in Nepal. Thus the Nepal Government loses revenue but the foreign investor

does not gain any advantage; the amount of tax forgone by the Nepalese Government would simply be transferred to the Government of the country of residence of a foreign investor. This also applies to other sources of income which are either exempt or lightly taxed in Nepal.

Unilateral reliefs provided to attract foreign investment are not effective in any way. Foreign investment is made for long period. Foreign investors are not assured by the unilateral reliefs which, they fear, can be lifted any time. Tax treaties, however, do give assurance to the foreign investors regarding tax provisions and incentives. Nepal has not yet completed such treaties with its trading partners except with India. Lack of the Mutual Agreement Procedure, advance ruling, clarity, frequent changes in the tax system and the predominance of arbitrary decisions, such as assessment made on the basis of best judgement of a tax officer are all serious hindrances to attracting foreign investment.

4. Possible Direction for Reform

Given Nepal's level of economic development and the state of its record and account keeping system, tax administration and tax consciousness, a drastic re-tuning with the aim of achieving vertical equity and raising substantial revenue from income tax does not seem to be feasible at this stage. However, a persistent effort has to be made in order to strengthen the income tax system in the long run.

4.1 Extension of Coverage

Attempt should be made to bring the agricultural income under the income tax net. Similarly, the scope of exemptions, deduction, rebate etc., should be reduced. Allowances granted to employees on account of travel, telephone, contingency and the sum allowed to an employee by his employer to meet business-related expenses, which are not verified by receipt, may be included in the taxable income.

It is believed that tax incentives, as elsewhere, have not been effective in achieving their intended objectives in Nepal. They have, at best, encouraged the establishment of parasite-type industries or trade-type activities at the cost of government revenue and scarce administrative resources. Their outright abolition, however, would create an unfriendly atmosphere in the private sector which is also not desirable. So it is necessary to adopt measures which will boost the confidence of the private sector with respect to government policy and which will be effective in attracting investment.

Under the existing income tax system, industries are not allowed to carry forward losses incurred during the tax holiday period and, in other cases, they are allowed to carry forward losses only for 2 years. In fact, industries should be allowed to completely offset their losses in order to attract investment. This can be done by allowing the carry-forward or carry-back of losses. The problem is that carry-back of losses requires re-opening past returns⁴ which makes it administratively complicated. Further, sometimes there may be a need for the reimbursement of tax⁵. So the system of carry-back of losses does not seem attractive on an administrative grounds. However, all industries should be allowed to carry forward their losses for 5 years.

Further, non-tax incentives such as direct subsidies and the provision of adequate infrastructure may prove to be more effective than tax incentives. So with the development of non-tax incentives, the scope of tax incentives may gradually be reduced.

While it is worthwhile to concentrate on taxpayers already in the income tax net, there is also a need to identify new taxpayers. "Simply getting income earners registered as taxpayers is the first step in effective tax administration; therefore, using all possible sources to establish a taxpayer master list has to be the most important task of a developing country's tax administration".⁶ Potential taxpayers may be found from existing sources such as records maintained for the purposes of excises, sales tax, property taxes, surveys conducted by the Central Bureau of Statistics and other organizations, and advertisements made in magazines and newspapers etc. Auditors, barbers, consultants, doctors, lawyers, tailors, taxi owners etc. are registered with some agencies, so their information may be obtained from the relevant organizations. Further, information can be obtained by conducting a detailed survey of traders, professionals and so on. However, small vendors who have hardly any taxable income after taking account of all business and personal expenses and basic allowances should not be brought under the tax net as they may involve more administrative efforts than possible revenue gains.

⁴ Charles E. McLure, Jr., "Analysis and Reform of the Colombian Tax System" in Malcolm Gillis (ed.), Tax Reform in Developing Countries, Duke University Press, Durham, 1989, p. 52.

⁵ Carl S. Shoup, "Retrospective on Tax Missions to Venezuela (1959), Brazil (1964), and Liberia (1970)", in Malcolm Gillis (ed.), op. cit., p. 269.

⁶ Richard K. Gordon, Jr., "Income Tax Compliance and Sanctions in Developing Countries", in Richard M. Bird and Oliver Oldman (eds.), Taxation in Developing Countries, The Johns Hopkins University Press, Baltimore and London, 1990, p. 457.

4.2 Improvement in Tax Assessment

Consistent attempts should be made to encourage taxpayers to file proper returns and assess income tax on the basis of normal procedures. Tax officials should examine the tax returns positively, i.e. they should help taxpayers in correcting small mistakes on tax returns if they are not intentionally made for the purpose of tax evasion and assess income tax on the basis of the returns submitted by the taxpayers. Taxpayers also should believe that in this changed context their returns will be accepted at face value and should co-operate with tax officials by submitting correct returns. In other words, there should be a tacit understanding between the tax collectors and taxpayers.

It would be desirable to provide incentives to those who keep proper records for tax purposes. In Japan, the "blue" return system, recommended by the Soup Mission in 1949, proved to be very effective in developing the habit of proper record keeping among taxpayers. Taxpayers filing a blue return are given several privileges including special allowances, deductions, the carry-forward or carry-back of losses. This system has also been adopted by other countries. In Nepal also, similar incentives might be extended to those taxpayers who keep proper records and books of account and file accurate returns. It would also be desirable to publish a list of honest and high taxpayers to encourage accurate tax returns. Enterprises benefitting from tax incentives should also be required to maintain standard accounts.

Further, it is necessary to develop a self-assessment system which would reduce the scope of the collusion between taxpayers and tax officials and, on occasion, the harassment of the former by the latter. The success of a self-assessment system depends upon the voluntary compliance of the taxpayers who are required to keep an adequate account of their incomes and expenses, compute net income, determine the amount of tax, submit a return to the tax office and pay the tax within the stipulated time. It is, therefore, necessary to launch a comprehensive tax education programme regarding the operation of the self-assessment system for the potential taxpayers. It is equally important to train tax officials in auditing methods and sample auditing should be made an integral part of the income tax administration. Furthermore, penalties prescribed for non-compliance should be implemented effectively.

4.3 Use of Presumptive Method

It is desirable to adopt some sort of rough and ready method⁷ in the case of such small taxpayers and liberal professionals such as accountants, auditors, barbers, consultants, doctors, lawyers, nurses, painters, tailors, writers and so on. In such cases, it is necessary to fix some objective criteria by a group of experts on the basis of certain indicators on the basis of purchases, number of workers, imports, use of raw materials or components, and consumption of fuel and electricity, gross sales or receipts. This method would allow tax officials to enrol some taxpayers in the tax list who would otherwise remain out of the tax net and check tax evasion at a relatively modest cost⁸. They might be given an option to be taxed under the normal tax regime.

4.4 Extension of Withholding Tax

As the withholding tax reduces the work of the tax administration, extends the coverage of tax, improves compliance, reduces the scope of tax evasion, and prevents a fall in revenue in real terms due to inflation, the withholding tax introduced on several sources of income in 1993/94 should now be strictly implemented and its scope should be extended to other sources of income such as honorariums, and payments made to liberal professionals such as lawyers, accountants, auditors, architect, plumbers, carpenters, mechanics etc.

4.5 Introduction of a Current year Basis

A current payment basis, or an advance payment system should be implemented effectively in the case of incomes not subject to withholding tax. This will prevent a fall in revenue in real terms due to inflation. Further, such a system would be more equitable than the previous year basis because, under the former system, the tax is levied on the current year's income derived from all sources of income, while under the latter system tax is withheld at source on the current year's income in the case of some sources such as wages, salaries, commissions etc. but on the previous year's income in the case of others. Thus the current year basis fits more with the withholding system than with the previous year's basis. Furthermore, because taxpayers will have to pay tax on the current year's income, it will be more convenient for the taxpayers and minimize the tendency to make deliberate delays in payments.

⁷ The presumptive method, however, should not be adopted as a general rule as is being applied to the importers, including big importers. Larger taxpayers should be required to keep detailed accounts and be taxed under the normal procedure.

⁸ World Bank, *Lessons of Tax Reform*, 1991, p. 39.

4.6 Inflation Adjustment

Inflation-induced distortions across periods can be insulated or minimized either by discretionary measures such as a periodic revision in the amounts of allowance, expenses etc. fixed in monetary terms in line with the rate of inflation and/or reduction in tax rates or through indexation. The latter can again be done in various ways. "The most simple approach is probably to inflate all income borders (including the one which defines the basic exemption) by as many percent as the price index has increased and then apply the existing tax rates in the new income brackets"⁹. Even such a simple indexation method would invite complications, at this stage in Nepal. Apart from administrative complications, indexation reduces the automatic redistribution of incomes¹⁰, and erodes the responsiveness of income taxes. As indexation precludes the Government from increasing revenue in a relatively painless way¹¹, it may not be an attractive measure for politicians. From a practical point of view it is desirable to make some rough adjustments in income taxes through discretionary measures in order to minimize the effect of inflation.

4.7 International Perspective

It is necessary to conclude tax treaties with the major trading partners of Nepal in order to attract foreign investment and technology. This is because tax treaties provide a favorable investment climate for foreign investors by providing assurance to them regarding various tax provisions. Tax treaties would also help the exchange of information between the contracting states. Completion of tax treaties would also lead the domestic tax laws to gradually come in line with the standard international tax practice.

5. Concluding Remarks

The Nepalese income tax system has undergone considerable changes since its introduction in 1959. Several experiments have been made regarding its types, coverage, rates, allowances, tax unit, tax assessment and so on. Currently, income tax system encompasses four taxes viz, individual income tax, corporate income tax, house rent tax and interest tax.

⁹ Lars Mattheissen, "Recent Trends in Personal Income Taxation in Sweden", *Finanzarchiv*, Vol. 33, 1974/75, p. 301.

¹⁰ *Ibid.*, p. 302.

¹¹ Oliver Oldman and Richard Bird, "The Transition to a Global Income Tax: A Comparative Analysis" *Bulletin for International Fiscal Documentation*, Vol. 31, (1977), p. 443.

The Nepalese income tax system suffers from several problems. The tax base is quite narrow; several sources of income including agricultural income have been deliberately excluded from the income tax net while the sources of income brought under the tax net have not been effectively tapped. The tax assessment system is unscientific; the tax is largely assessed under the presumptive or best judgement basis and the income of many taxpayers is not assessed on a regular basis. Tax assessment is made by tax officials on the previous year's income. The result is that the income tax system is less revenue productive, is inefficient, and has become less effective in taking account of the personal circumstances of the taxpayers, thereby damaging both vertical and horizontal equities considerably.

The income tax needs to be strengthened both for revenue and socioeconomic purposes. It is to be raised through broadening the base, an effective enforcement and better tax compliance.

There is a scope for broadening the coverage of this tax, legally and administratively. Currently exempted sources of income should be gradually brought under the tax net and those included in the tax net should be taxed effectively and uniformly. Consistent attempts should be made through both promoter and regulatory measures to encourage taxpayers to adopt proper account, file proper returns and assess income tax on the normal procedures and enhance the level of voluntary tax compliance. The previous year basis of assessment should be replaced by the current year basis and a self-assessment system should be developed gradually in place of the official assessment system. The tax system should be made growth-oriented through measures including complete carry-forward of losses (including tax holiday period losses), completion of tax treaties with major trading partners and grant of incentives in a very simple and easy way.