

Income Taxation in Nepal: Analysis of Structure and Problems

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DEGREE OF MASTER OF ARTS (M.A.)**

**In
ECONOMICS**

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Date: 2064-09-15

LETTER OF RECOMMENDATION

Mr. Lokendra Bhandari has written a dissertation entitled "**Income Taxation in Nepal : Analysis of Structure and Problems**" under my supervision on a partial fulfillment of the requirements for the Degree of Master of Arts in Economics. I Forward it with recommendation for approval.

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APPROVAL LETTER

We certify that this dissertation entitled "**Income Taxation in Nepal : Analysis of Structure and Problems**" submitted by *Mr. Lokendra Bhandari* to the Central Department of Economics, Tribhuvan University, in partial fulfillment of the requirement for the Degree of MASTER OF ARTS in ECONOMICS has been found satisfactory in scope and quality. Therefore, we accept this thesis as a part of said degree.

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CHAPTER I

INTRODUCTION

1.1 Background of the Study

The study of tax under public finance is also called government finance. Governments need revenue to carry out activities and need revenue to implement activities. Such activities are included in the government annual budget. Budget is the composition of revenue and expenditure. The main sources of revenue are a) taxes b) non-taxes c) foreign loan d) domestic as well as foreign borrowing. The tax is an important source of revenue.

A tax is a compulsory levy payable by an economic unit to the government. A tax is a generalized exaction, which may be levied upon individuals, groups of individuals, or other legal entities.

The base of a tax is the legal description of the object with reference to which the tax is payable. For example, the base of an excise duty is producing, packing or processing of a specific good; the base of an income tax is the income of the assets defined and estimated in terms of certain rule laid down for this purpose. The base of each tax has to be defined legally and it determines the tax liability of individual taxpayer.

Income tax is usually made on an annual basis and law has to decide whether income would be taxed on the basis of accrual or receipt.

The main objective of the modern government of any developing country is to improve living standard of its people through the development process. In order to achieve the goal every government launches different economic, social, cultural and other development activities. For example the government needs various types of resources that is man, machine, materials etc... one of the most essential things is enormous financial resources. However, the internal resources are more preferable for sustainable economic development.

Every country needs resources to develop the country and maintain security. Resources can be mobilized from two sources, internal and external sources. Internal sources include public borrowing, government bonds, surplus on public undertakings and taxation, external sources consist of foreign aid, grants and loan.

Such external sources are uncertain, inconvenient, and not good for healthy development, if there is heavy dependence on them. It better to mobilize internal sources rather than looking with beggars eye to the donors.

Developing countries are trying to mobilize their internal sources of finance necessary funds for regular and development activities. Nepal is also doing it. But Nepal's experiences show that it is mobilizing internal resources with limited success. Internal sources are better than external sources because it is sustainable and less risky.

Nepal faces a number of problems connected with economic growth like removal of poverty and inequalities on the one hand and on the other there is the additional problem of chronic unemployment and regional disparities also.

Continuous borrowing to raise the necessary public funds is not good. It reduces the liquidity position of the government and increases inflation. Governments have to impose higher taxes to repay the interest and the borrowed sum.

The use of internal sources seems better for financing public revenue in developing countries. Tax is the main component of internal sources. Different forms of tax are Value Added Tax (VAT), Income Tax, Customs Duties, Excise duties and others.

A tax is a compulsory contribution to government made without reference to a particular benefit received by taxpayer.¹ Taxpayer does not expect any return for his tax paying. It is neither an exact amount nor a penalty for any legal offense.

¹ R. Good (1984). Government Finance in Developing Countries, New Delhi, TataGrow Hill, India.

Taxes are divided into two distinct types: direct tax and indirect tax. On the basis of impact and incidence of tax. Income tax is the main constituent of direct tax now a days. It has been considered as the one of the major elements of tax revenue. For this reason; developed countries like USA, UK, Japan etc. collect substantial part of their revenue by income tax but developing countries like Nepal still has been unable to maximize the collection of income tax.² The importance of income tax has increased day by day and in the 19th century it has not only remained a source of revenue for emergency, but also has become a regular source of income for government.³ In fact, income tax system has been originated recently as an internal source to strength the source of tax, for economic growth of a country and meets the slogan of economic revolution by searching additional sources of revenue.

Every country needs resource for fulfilling the government expenditure. To supply the expenditure tax is playing vital role where income tax is also contributing it. In the world first income tax was introduced in the UK in 1799. Prime minister Willam had imposed tax to the public to provide necessary funds for French revolutionary war. It was called war tax also. It has been regularly imposed after 1842. In India, it was started from 1860 in early days an income tax liability was calculated at flat rate. But from 1909 it has been calculated according to the progressive rate.

Government of Nepal introduced for the first time in Nepal in 1960 (2017 BS), it was known as “Business Profit and Remuneration Tax”, which was governed by the Business Profit & Remuneration Tax Act 1960. According to the Act only business profits and remuneration income were subjected to taxes. But this act was narrow and vague. So this was replaced by Income Tax Act, 1962 (2019 BS). This act was an extension of the previous Tax Act. It has 29 sections; where as previous Act had 22 sections. This Act had tried to define the different headings of income such as business income, income from house and land rent, remuneration profession and occupation income, income from

² Hari Prasad Marahatta, (1980). Fundamental of Nepalese, Income Tax, Kathmandu, P.2.

³ Ashok Kumar Saxena, (1986). Income tax Law & Practice, Law Agency Allahabad, P. 2.

insurance agency etc... the objective of the “Income Tax Act” was to reduce unequal distribution of wealth with social justice and to establish tax paying habit in the people. This income Tax Act remained till 1974.

The “Nepal Income Tax Act 1962 was replaced by new Income Tax Act 1974 (2031BS). There are 66 sections in this Act and it is more specified tax law. There are provisions of self-assessment and carry forward of losses for three years. This Tax Act was amended 8 times respectively in 1977, 1981, 1985, 1986, 1989, 1991, 1992 and 1993.

New income tax act 2058 is implemented from 04-04-2001. This Act replaces the income Tax Act 2031 and other act related to income tax. There are various additional provisions in the new act.

1.2 Statement of the problem

Economic development is the prime concern of every nation of the world. Underdeveloped countries are facing serious problems in the process of economic development. Nepal is also not an exception to this condition. The majority of people have not been able to get even basic facilities. The government wants to fulfill the basic needs of the people and accelerate development activities one at a time. Thus, every nation of the world is accomplishing various activities to fulfill these objectives. It needs huge amount of capital. Despite the various measures adopted by government to boost up revenue collection there is still a substantial resource gap between expenditure and revenue. The rate of government is exceeding the rate of growth revenue almost every year. In other words Nepal has been facing persistent budget deficit from the beginning of her development phase. External deficits, currency depreciation, inflationary pressure, rising interest rate which may cause crowding out effect and reduce in economic growth are the consequences of the budget deficits. The mobilization of revenue has not increased to the level on which the level and speed of our expenditure is raising. Rising the government revenue helps to overcome the serious bottleneck of resource gap in the process of economic development program. In

this context, taxation can be taken as means for resolving this problem by mobilizing additional resources form domestic sources.

Nepal, one of the least developed countries in the world, has growth rate 2.3 of real GDP (2004/5 CBS). Nepal's GDP per capita is \$240 (2005 HDR), one of the poorest in the world impling the scarcity of resources for the development process. Thus the role to taxation has promised to provide the infrastructure for the development process and to provide the social services to the poor people, whose volume is dominant in country's demographic structure.

In Nepal after the rise of democracy, deliberate planning process began only after 1956 (2031 BS) and the huge amount of revenue was required for the process of economic development, a lot of capital was needed. Where first budget was brought in 2008 BS. To fulfill the planning expenditure and for the process of economic development a lot of capital was needed. In this process of generating more revenue, Nepal Government (NG) introduces direct and indirect tax system in the country. Similarly to strengthen the existing revenue departments various rules and regulations has been enforced. During this period, income tax was introduced from 2016 BS.

There is high resource gap in our budget. It means our budget is called deficit budget. The expenditure is higher than our revenue and foreign aid. The gap is fulfilled by internal and external loans. In every budget, it is reality. This is the main economic problem of Nepal. Tax and non-tax revenue is the major source of the internal revenue where tax is paying more vital role than non-tax revenue. In tax revenue, indirect tax is playing more vital role than direct tax. It means Nepal's tax structure is mainly based towards indirect taxes.

The experience of the developed countries clearly indicate that tax may be one of the major development for the increament of internal revenue but in Nepal its contribution has not increased significantly during 40 years.

It is mentioned above that there is significant resource gap in Nepalese finance. The gap between income and expenditure is increasing. Therefore the resource gap has been a serious bottleneck of the process of economic development of

developing nations like Nepal. To increase the government revenue it is very necessary to raise its source of revenue. Although there are various sources of government revenue, the tax revenue is the major important source.

Nepal is facing a problem of scarcity of resources for development activities. Few rich capture major economic source and they are under taxed either because of tax evidence or evasion and most of poor people suffer from commodity tax.

In the context of the discussion of the problem taken for the above studies, the research questions are as follows.

1. What is the income tax structure of Nepal?
2. Does income tax in Nepal really contribute to the generation of revenue?
3. What are the problems of resource mobilization and resource gap in Nepal?

1.3 Objectives of the Study

To increase the internal revenue of government income tax plays a vital role. The specific objectives of this research are as follows:

-) To analyze the tax structure of income tax in Nepal,
-) To explore the new avenues to make income tax more effective; and
-) To find out the problems and weakness of income tax system in Nepal.

1.4 Significance of the Study

Nepal is an agro-based developing country with low speed in industrialization process. There are only a limited number of corporate bodies and their economic performance is very dismal. So, there is need to growth and development of corporate sector in our nation. The government needs huge amount of fund to spend on daily expenses as well as development activities. Every year, Nepalese government has been presenting deficit budget, there is increment in source gap. Most of the development activities depend on bilateral

and multi lateral grants and loans. The nation is hardly bearing the burden of the loan and the internal source of revenue is not sufficient even to meet the ordinary expenses. In this context, the easy and long lasting way to increase revenue to strengthen the internal source is through income tax. Thus, the contribution of income tax on government revenue and its impact on fulfilling resource gap has been chosen as a relevant topic for the study.

Government prepares the budget to operate the daily works, to develop the country and maintain security. Budget depends upon internal and external resources where internal source is better than external source because it is safe and sustainable in internal source tax play vital role. It means government can't go a head towards development with out sound tax system and implementation of it.

Among the taxes, income tax is one major components of direct tax system. There are many possibilities for extension of income tax in Nepal. The developed countries of the world have proved the issue because income tax is playing major role in their national revenue.

This study explains the role of income tax in Nepal, this study has provided a meaningful suggestion to the Nepal government to increase the revenue from income tax in Nepal. This study will be useful to economists, planners, tax officers, tax administrators, government and other interested person about the corporate sector in internal resource and the problem and prospect of corporate sector. It will also provide the information about trends and projection of income tax.

1.5 Methodology

This study based on secondary sources of data. The analysis of data uses descriptive technique and some statistical tools. The data and information was collected from various sources.

1.6 Source of data

The sources of data consist of books, journals, newspapers, reports and dissertations. The major sources of secondary data were as follows.

1. Economic survey and budget speech, Ministry of Finance, Government of Nepal (MOF).
2. Report and records of Inland Revenue department, Ministry of Finance, GN.
3. Published documents of NRB, NPC.
4. Dissertations related to income tax available at the central library of T.U.
5. Newspaper, published articles different journals, souvenir and news magazines.
6. Different publications of Central Bureau of Statistics (CBS).
7. Internet, e-mail.

1.7 Tools/Processing and Analysis of Data

The analysis of the qualitative and quantitative data collected from different sources, at first, tabulated into various tables according to the topics analyzed order. Then simple statistical tools such as percentage, and rank calculated where necessary and they had been presented and analyzed in analytical way. Graphs, and Charts had also used to present the findings of the study.

1.8 Limitations of the study:

The study uses secondary data.

1. The secondary data of 16 years (1989/90-2005/06) have been taken due to democracy.
2. Main focus is give to the contribution of income tax to national revenue of Nepal.
3. For the individual taxes, only the major components of direct tax are considered.

CHAPTER II

LITERATURE REVIEW

2.1 Review Theoretical Context

A tax imposed on income base is called income tax. The basic objectives of Income tax are two fold-revenue collection & redistribution. Income tax is divided into two parts. Individual Income tax and corporate income tax. Income tax to be paid by Individual or couple or sole proprietorship firm is individual income tax where as Income tax to be paid by entity's is called corporate Income tax. In some countries, separate laws are made to deal with individual and corporate Income taxes.

As regards to Individual Income tax, some say. Income tax was Introduced in Batavian Republic of Holland in 1997. Others say, It was first introduced in 1999 in England to finance the war against France. Corporate Income tax was at First introduced in 1909 in America. Individual Income is imposed by progressive technique, i.e. higher the amount of Income, higher is the rate of tax. For the purpose of Calculating Income tax, taxable income should be derived at first, which is an amount of Income after deducting the expenses Incurred to earn the concerned income.

In Nepal, Income tax (Combination of both the Individual and corporate) provides around 21 percent of the total tax revenue. The marginal tax rate is 25 percent for individual and 20 percent industry, 30 % financial institutions and 25% other taxpayers for corporate bodies.

There are mainly two types of tax system in the world. They are direct or indirect tax. Direct tax is that type of tax, which creates the direct burden on individual. In the other words. Individuals are liable to pay tax from their personal Income. It is really paid by the same person who is legally imposed. Next method of taxation is called Indirect method of taxation. According to this method tax doesn't creates the direct burden upon an Individual. In Indirect taxation, an Individual doesn't liable directly to pay the tax. He/she pay the tax

to the third party in terms of fee, service charge, penalty, fine, VAT, sales tax, custom duty etc. Hence, it doesn't create the direct burden upon an Individual. The examples of direct taxation are income tax, vehicle tax, gift tax, house and land tax, interest tax, compact property tax etc. The example of indirect taxation are custom tariff, excise duty, sale tax, VAT, entertainment tax, hotel tax and passenger tax etc.

Taxes are compulsory levied on Individual, Firms, companies and other units for general government purpose-government with authority assigned in different laws generates with compulsion, some funds from Individuals firms, companies and other units, which generally termed as taxes. According to classical economist Adam Smith "A tax is a contribution from citizens for the support of the state"

According to classical economist Dalton, "A tax is a compulsory contribution imposed by a public authority irrespective of the exact amount of service rendered to the taxpayer in return and not imposed a penalty for any legal offence."

In classical economics tax was taken as an extra burden to people. But now time has changed and the government has to provide maximum social welfare to the people. Thus, the government has to broaden its revenue.

In Nepal, Income tax is defined as the tax levied on net income derived after deducting all allowable deductions and relieves from the total Income. Income tax is levied on the Income derived from business employment for Investment. Income tax is always levied on the net income i.e. total Income less the allowable deduction.

Tax has been one of the major source of government revenue from ancient time, however, reliable records and data about taxation of that time are not available. Tax were then levied on the merchants, travelers and farmers in the form of cash, kind or labour. On some occasions gold and agriculture products were also paid as taxes, but the nature of these taxes was temporary.

Income tax can be classified into two types: personal/Individual Income tax and corporate Income tax. Individual Income tax is modern tax, which is measure of ability to pay of any Individual. It is based on the progressive rates. Corporate Income tax is levied on business enterprises having a legal personality, direct from their owners. Tax on corporate ultimately come from the Income or wealth of Individuals. Generally, flat rate is applied to corporate Income tax. Since 1959/60, Income tax was started in Nepal. After its establishment, many Individual and institutions have studied in this subject regarding legal aspect, administrative problem, historical aspect, trend of Income tax and Income tax structure etc. They have made appreciable efforts in the field of Income tax.

It is not an easy task to perform a research study based on Income tax system because it is changing rapidly with the flow of time. In lack of sufficient review of available materials, it is a very complex problem to find detail Information about Income tax in Nepal. There are various studies carried out by different institutions and Individual's Reviews of available materials based on Income tax will certainly helpful regarding to the subject matter in the. For this purpose, various books and dissertations have been received as far as possible.

B.E.V. Sabine (1966), A history of Income tax, Tax structure open to a country to alter its level and the rate of growth through changes in the individual elements that constitute the tax structure." Economic development depends for more than is commonly recognized. On a carefully throughout and well organized tax structure (Charles Mansfield, "Tax structure in Developing countries: An Introduction." Finance and Development, March 1971, P. 37). In very poor countries, Income tax contribute between one sixth and one fifth of total tax revenue in the United states. In advanced countries Income and other direct taxes account for 60 percent of total tax revenue of the direct taxes, personal Income tax contribute 27% of total tax revenue and social security tax make 31% on average low and middle Income countries raise roughly 10% of their tax revenue through personal Income taxes. Surprisingly however the

richer Latin American countries raise a smaller share of revenue from personal Income taxes do the poor countries of sub-Saharan Africa. In constant, Latin American countries are the dominant users, within developing countries of social security tax.

Law and practice of Income tax in India (Bhagwati Prasad) 1971), July 6th edition, states that Income tax is a complicated and yet a fascinating subject both for study and practice. In view of many good work on the subject it would, however, not be out of place to list the specific features claimed for the present one. The book is in a tax book from Incorporating the income tax act 1961 and the Income tax rules (1962) with selected leading case wherever necessary.

Harley H. Hinrich (1966), has sketched a pattern of tax structure change from traditional to industrialization society. According to this pattern, non tax source and/or traditional direct taxes namely land revenue, provide most of the revenue in traditional society. As the society being to break away from old ways, taxes on international trade assume importance as the supplier of revenue. As this occurs, traditional direct taxes decline in importance. The growth of internal indirect taxes like excises and sales taxes is related to the development of domestic production, internal trade and mobilization of the economy. Modern direct taxes like personal income tax and corporate profit tax are levied when the economy reaches maturity.

2.2 Nepalese Context

Mr. Narendra Lal Kayast, present a dissertation in 1974 named "Taxation of Income and property". His studies cover the role, Importance, and historical and legal aspects of Income tax. He has concluded that the reason for the very significance contribution of Income tax to government revenue was due to the tax evasion. He has pointed out that the tax evasion as the main problem of Income tax system of Nepal. This study is very much helpful to find some relative information about Income tax in Nepal. (Kayast, 1974).

Mr. Rup Bdr. Khadka has represented a book entitled "Nepalese taxation: A path for reform." He has described the Introduction, development, existing

structure, main problems and possible direction of reform. He has Identified the major problem of Income tax and possible direction of reform. He has Identified the major problem as weak tax administration, Imbalance and Inadequate organization pattern, lack of adequate Information system lack of coherent tax policy and Inadequate organization pattern, lack of adequate Information system, lack of coherent tax policy and Inadequate physical and other facilities. (Khadka, 1994).

In a report entitled "Review of Tax System" prepared and submitted by Madan Kumar Dahal (2052) to MOF, NG covered the various issues relating to tax such as low tax elasticity higher burden of indirect tax to direct tax lack of voluntary compliance, leakage etc. The exemption of Income from agriculture sector, which is contribute 40% of total GDP, was marked as a main reason of narrow base. Including agriculture sector, Income from domestic Industries, social sector and electricity sector which contributed 52% to GDP were exempted from Income tax and only large Industries, mines contribution, trade, hotel and restaurent which contributed 48% Income to GDP were under Income tax. All the provisions made the tax base very narrow. The tax rates were unnecessary high. The tax rates were unnecessary high. Only 73,000 taxpayer's Income was demanded which was less than 1% of the economically active population. Real per capita, Income growth rate at that time was 0.3% which showed that low taxable capacity of the people. This report suggested increasing the total number of taxpayers and to Increase the percapita Income.

This study further suggest about 40% extra resource mobilization if the proposed tax policy and program were in place. This study recommended various practical ideas to wider income tax base like 20% exemption from total tax assessment might be given to make self-tax assessment effective. It suggested raising, the exemption limit of Income tax for a person to Rs. 35,000 and for family to Rs. 50,000 and exemption should be based on inflation rate.

Hari Bahadur Bhandari (1994) has dealt with the trend of Income tax collection and tax revenue as well as Nepalese tax structure along with identifying factors

to Increase tax paying habit of tax payers. He used primary as well as secondary data for the study. He found that Income tax is a suitable means of raising domestic resources and reducing the Increasing trend of fiscal deficit and external resources of financing. He identified the problems related to income tax as poor tax paying habit, – widespread to impose capital gain tax and to impose income tax on agriculture income for high class farmers. He also suggested to control tax evasion by plugging legal loopholes and effective enforcement of law. He recommended to adjust exemption limit according to the change of market price index and the number of dependent family members.

Dr. Govinda Bahadur Thapa wrote an article entitled " Practical Issue In Income Taxation" in Rajaswa. Thapa has focused that Income tax is an Important source of revenue of the modern government. This tax is not only for revenue but also for attaining equity. However being a direct tax on Income and profit, these are several practical issues to be settled before it becomes revenue productive as well as equity achiever. Defining taxable Income and tax paying units determining appropriate rate structure and method of assessment are some of such issue, which are instrumental to make the income tax system effective. This article also analysis and explain the theoretical basis to settle these issues. (Thapa, 2001)

Mr. Vidyadhar Mallik has presented this book named "Nepal Ko Adhunik Aayakar Parnali" which is fully based on newly Income tax act of Nepal. Mr. Mallik has played a vital role in the literature of modern Income tax system in Nepal by presenting the complicated provisions of new Income tax act in simplest way with sufficient illustrations where necessary.

He criticized the Nepalese tax system as scattered provision of tax concessions holidays and benefits. He prepared a long list of tax exempt earning activities such as foreign source income of a resident person retirement benefits, capital gains and so on and urged to impose tax on all those income earning activities

which are out of tax net to bring fairness, neutrality, effectiveness, efficiency and horizontal equality in the society. (Mallik, 2003)

Rajendra Dulal (2004) found in his study that, Because of the increasing gap between expenditure and revenue collection. Nepal has to heavily depend upon both the external as well as Internal dept to meet the budget deficit unfortunately, the dependency is increasing which is undesirable for economy.

This scenario emphasis for the mobilization of the internal revenue to the optimum level. His study further shows that the share of non tax revenue was about 24 percent in 2002/2003. This shows that the tax has been major source of revenue mobilization.

The contribution of Income tax to direct tax has increased significantly since its introduction. The contribution of Income tax to total revenue was 7.8% in 1975/76 and in 1999/00 it was 14.5%. Thereafter it has increased some what fluctuating. Within income tax the share of corporate tax was 49% that of individual was 42%, house and land tax was 9% and interest tax was 5.3%.

The Income tax rates and slabs have been changed radically in recent years. Rate structure of Income tax has been changing continuously since its contribution in 1959/60. Under new Income tax act 2002, Individual Income tax is levied with low rates of 15% and 25% under the new Income tax act; the corporate income tax is levied with single rate of 25%. For bank & financial Institutions the rate is 30 percent of taxable Income.

In a developing economy taxes are used to attain many objectives; raising revenue is only one of them. In order to facilitate compliance and collection, a tax system must be administratively feasible. The other requirement of a good tax system is that it must spread its burden equitable. It must also avoid misallocation of resources which means that the pattern of production, trade, consumption, saving and Investment must not be upset. There are the requirements which a good tax system must satisfy and they are to be considered in any tax reform. But all these aims can rarely be satisfied simultaneously, so tax reform is a matter of trade offs.

The major problem in taxation is "who bears the tax". Traditionally, it has been advocates that the incidence of an indirect tax is largely shifted forward, and that of a direct tax is on these on whom it is levied. The process of the transfer of tax is known as 'shifting' of the tax, while the settlement of the burden on the ultimate taxpayer is known as "incidence". The Incidence of the tax is generally measured by the reduction in real Income that result from the imposition of that tax. This incidence of tax has far reaching implication for distributions of Income of wealth.

Income tax in developing nation has been regarded as instrument of growth and social justice. Experience in most of the developing countries, including Nepal, has show that Income tax has not success in achieving either of many goals because only a small part of national Income comes under the preview of Income tax. In Nepal, indications are that income tax has not played a significant role in reducing the inequalities of Income and wealth.

CHAPTER III

ANALYSIS OF THE STRUCTURE OF INCOME TAXATION

3.1 The Structural of Income Taxation

The Income tax is a fairly general tax. The system of income taxation in Nepal has forty-five years of history. During this period, exercises with four income tax Acts were formulated with numerous tax rates and exemption limit schedules. The trend and contribution of income tax revenue has also become matter of interest.

The structure of income tax is studied on the basis of following area:

-) General trends of income tax revenue as percentage of GDP, total revenue, direct tax revenue. It covers the past 17 years (From 1990 to 2006)
-) Structure analysis of income tax revenue From 1997 to 2006)
-) The trend of exemption limits and tax rate during the last 47 years.

3.2 Structure of Total Revenue

Total revenue in Nepal is composed of tax revenue and non-tax revenue. When the government of Nepal presented first national budget in 1951/52, the revenue structure was typically that of traditional economy with 73 percent of government receipts coming from non-tax source and land tax, out of 73 percent, the share of non-tax revenue was 43 percent. In 1960' the share of non-tax revenue declined drastically because of the increasing contribution of indirect tax on foreign trade. In 2005/06 the share of non-tax revenue is 20.13 percent of total revenue as compared with 21.57 percent in 1989/90. On the other hand, the share of tax revenue of the initial period of the study (FY 1989/90) was 78.43 percent of the total revenue and declined to 77.29 percent in fiscal year 2004/05. But increase in 2005/06 at 79.58 percent which is presented in the following table and graph.

Table 1: Structure of Total Revenue

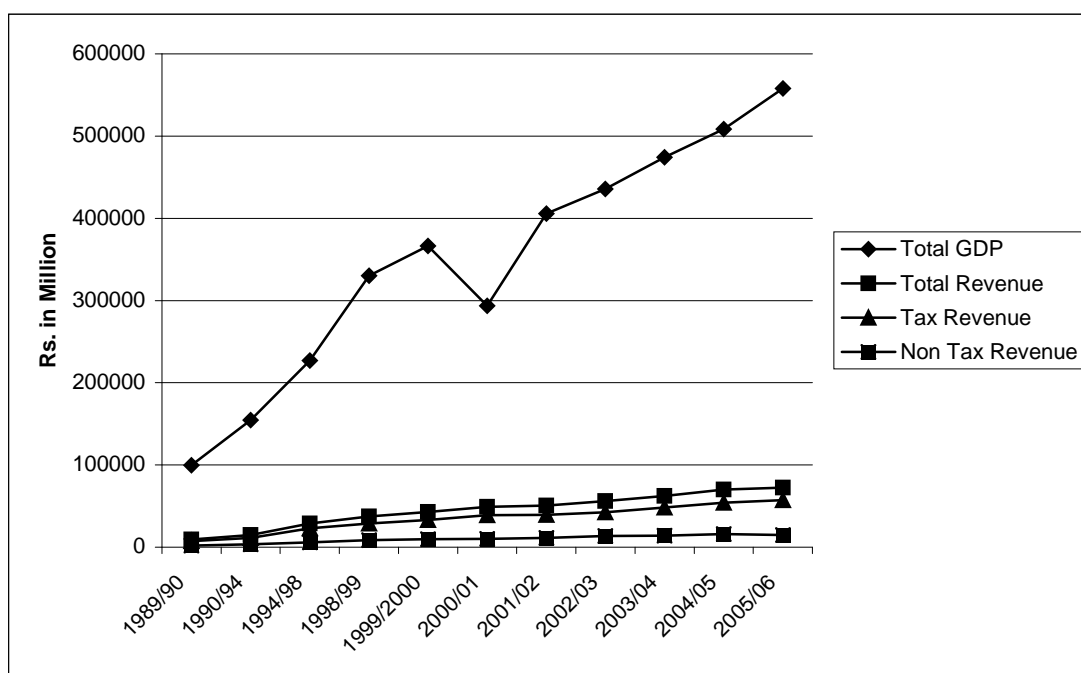
Rs. in Million

Fiscal Year	Total GDP	Total Revenue	Tax Revenue	Tax Revenue as percent of Total Revenue	Non Tax Revenue	Non-Tax Revenue as Percent of Total Revenue
1989/90	99702.0	9287.9	7284.1	78.4	2003.8	21.6
1990/94	154501.5	14743.05	11271.6	76.2	3471.45	23.8
1994/98	227183.0	28944.9	22919.67	79.2	6025.22	20.8
1998/99	330018.0	37251.0	28753.0	77.2	8498.0	22.8
1999/2000	366251.0	42893.8	33152.5	77.3	9741.3	22.7
2000/01	293566.0	48893.6	38865.0	79.5	10028.6	20.5
2001/02	405632.0	50445.6	39332.2	77.9	11113.4	22.0
2002/03	435531.0	56229.8	42587.0	75.7	13642.8	24.3
2003/04	474242.0	62331.0	48175.7	77.3	14155.3	22.7
2004/05	508651.0	70112.8	54104.9	77.2	16017.9	22.8
2005/06	557870.0	72282.1	57427.0	79.5	14855.1	20.6

Source: NRB Quarterly Economic Bulletin of Various Years

From the above table, it can be concluded that the contribution of tax revenue on total revenue is fluctuating from 73 percent to 81 percent. So the tax revenue contributes about three four of the total revenue. This indicates that tax revenue has the significant role in total revenue. The structure and contribution of tax revenue is shown graphically as follows:

Figure 1: Structure of Total Revenue



3.3 Structure of Tax Revenue

Tax revenue is composed of direct and indirect tax. There has been simultaneous increase in direct tax, indirect tax and the total tax revenue in absolute term. In 1989/90, the amount was Rs. 1369.8 million, Rs. 5914.3 million and Rs. 7284.1 million respectively and during the period of 17 years, these amount became Rs. 13961.5 million, Rs. 43465.5 and Rs. 57427.0 million. The basic reason for increment was due to the expansion of tax base and rates.

Despite the absolute increment of direct tax during the study period, its share in total tax revenue is in fluctuation trend. In 1989/90, its share was 18.8 percent amounting Rs. 1369.8 million which decreased to 16.5 percent amounting Rs. 1827.35 million in the period from 1990/91 to 1993/94. After that, it has increased continuously and reached to 26.95 percent amounting Rs. 10599 million in 2001/02 which is the highest share during the study period. In 2002/03, it decreased and reached to 23.73 percent amount Rs. 10105.8 million. And again in 2005/06 it started to increase and reach 24.31 percent, amounting 13961.5. Hence, the share of direct tax to total tax revenue is in

between 15 to 27 percent during the study period. The contribution of indirect tax in 1989/90 was 81.2 percent amounting to Rs. 5914.3 and reached to 83.95 percent amounting to Rs. 9431.75 million in the period from 1990/91 to 1993/94 and then it started to decrease and reached to 73.05 percent amounting to Rs. 28733 million in 2001/02. In the fiscal year 2002/03 it again increased and reached at 76.27 percent amounting 32481.2 million. But from 2003/04 it decreased and reached 75.69 percent amounting 43465.5 percent in 2005/06. This implies the significant role in tax revenue. From the following table, we can see that there is the greatest reliance on indirect tax and it needs to shift towards the direct tax. The structure of total tax revenue has shown in the following table no 2.

Table 2: Contribution of Direct and Indirect tax to Total Tax Revenue

Rs in million

Fiscal Year	Total GDP	Total Tax Revenue	Total Direct Tax	Percentage of Direct Tax to Total Tax Revenue	Total Indirect Tax	Percentage of Indirect Tax to Total Tax Revenue
1989/90	99702.0	7284.1	1369.8	18.8	5914.3	81.2
1990/94	154501.5	11271.6	1827.35	16.5	2431.75	83.95
1994/98	227183.0	22919.67	4907.8	21.27	18011.9	78.67
1998/99	330018.0	28753.0	7296.8	25.4	21456.2	74.6
1999/2000	366251.0	33152.5	8554.3	25.8	24598.2	74.2
2000/01	293566.0	38865.0	9769.7	25.1	29095.3	74.9
2001/02	405632.0	39332.2	10599.0	26.9	28733.2	73.1
2002/03	435531.0	42587.0	10105.8	23.8	32481.2	76.3
2003/04	474242.0	48175.7	11901.9	24.7	36273.8	75.3
2004/05	508651.0	54104.9	13061.3	24.1	41043.6	75.9
2005/06	557870.0	57427.0	13961.5	24.3	43465.5	75.7

Source: Calculations Based on Quarterly Economic Bulletin Published by NRB (2006)

3.4 Contribution of Total Revenue, Tax Revenue, Direct Tax and Indirect Tax as Percent of GDP

The contribution of total revenue on GDP has increased from 9.32 percent to 13.78 percent as compared with 1989/90 to 2004/05. But the contribution of total revenue to GDP decreased in the fiscal year 2005/06 12.91 percent as compared to the fiscal year 2004/05. Thus, the contribution of total revenue on GDP is increasing in slower pace.

The contribution of tax revenue on GDP is also increasing. In 1989/90, the share of tax revenue was 7.31 percent, which was increased to 10.63 percent in 2004/05, but reduced in 2005/06 as 10.29 percent. In 1989/90, the contribution of indirect tax and direct tax was 5.93 percent and 1.37 percent respectively which have increased to 7.79 percent and 2.50 percent in 2005/06.

Table 3: Total Revenue, Tax Revenue, Direct Tax and Indirect Tax as Percent of GDP

Rs. in million

Fiscal Year	Total GDP	Total Revenue as % of GDP	Tax Revenue as % of GDP	Direct Tax as % of GDP	Indirect Tax as % of GDP
1989/90	99702.0	9.32	7.31	1.37	5.93
1990/94	154501.5	9.48	7.23	1.14	6.06
1994/98	227183.0	11.49	9.10	1.93	7.17
1998/99	330018.0	11.29	8.71	2.21	6.50
1999/2000	366251.0	11.71	9.05	2.34	6.72
2000/01	293566.0	12.42	9.88	2.48	7.39
2001/02	405632.0	12.44	9.70	2.47	7.22
2002/03	435531.0	12.91	9.78	2.19	7.59
2003/04	474242.0	13.19	10.20	2.37	7.83
2004/05	508651.0	13.78	10.63	2.56	8.07
2005/06	557870.0	12.91	10.29	2.50	7.79

Source: CBS, Quarterly Economic Bulletin Published by NRB, Different years

The contribution of income tax on GDP is increasing gradually. It had contributed 0.93 percent in 1989/90, which was increased to 2.03 percent in 2005/06. Within direct tax, income is in the leading role to now.

3.5 Structure of Direct Tax

In Nepalese tax structure, the major components of direct taxes are income tax, land tax and house and land registration tax. Until the fiscal year 1993/94 vehicle tax was considered as direct tax and since 1997/95 budget speech, it has been classified under the indirect tax. The share of the major components of the direct taxes are given in table no 4.

Table 4: Structure of Direct Tax, and Their Share as % of GDP

Rs. in million

Fiscal Year	Total GDP	Total Direct Tax	Income Tax (Rs.)	Income Tax as % of Direct Tax	Land Tax Rs.	Land Tax as % of Direct Tax	House and Land Registration Rs.	House and Land Registration as % of Direct Tax
1989/90	99702.0	1369.8	922.9	67.37	73.5	5.37	373.4	27.25
1990/94	154501.5	1827.35	1137.6	61.01	72.67	4.35	617.07	34.61
1994/98	227183.0	4907.8	4147.92	78.90	16.02	0.37	993.8	20.71
1998/99	330018.0	7269.8	6300.5	86.34	0.8	0.01	995.5	13.64
1999/2000	366251.0	8554.3	7421.2	86.75	117.7	1.38	1015.4	11.87
2000/01	293566.0	9769.7	9153.9	93.7	8.0	0.08	607.8	6.22
2001/02	405632.0	10599.0	8903.6	84.00	14.4	0.13	1121.3	10.58
2002/03	435531.0	10105.8	8132.2	80.47	0.1	0.001	1414.2	14.00
2003/04	474242.0	11901.9	9504.0	79.85	0	-	1697.5	14.26
2004/05	508651.0	13061.3	10456.0	80.05	0	-	1799.2	13.78
2005/06	557870.0	13961.5	10933.5	78.31	0	-	2180.3	15.62

Source: Quarterly Economic Bulletin Published by NRB, Different years

Income tax occupies largest share in the direct tax and that the percentage share of this component in the fiscal year 1989/90 was 67.37 percent amounting to Rs. 922.9 million. It's share decreased over next four years and reached to

61.01 percent in the period of 1990/91 to 1993/94. After that it started to increase and reached to 93.7 percent in 2000/01 which is the highest share during the study period. From 2001/02 it again started to decrease and reached to 79.85 percent in 2003/04. Again it increased for only one year, reached 80.05% in 2004/05. But in 2005/06 it again decreased at 78.31%.

Land tax, which comprised 5.37 percent of direct tax even in 1989/90, contributed only 0.001 percent in 2002/03 and zero in 2003/04 to 2005/06. The share of land tax was decreased sharply due to the rise in the relative importance to indirect taxes and income tax and large exemptions granted under the land revenue system. Since 1996/97, land revenue collection authority has been transferred to local government. Thus land tax has made a negligible contribution to the revenue structure of Nepal.

The share of house and land registration fluctuated year to year. Its share in 1989/90 was 27.25, 34.61 percent in the period of 1990/91 to 1993/94, 6.22 percent in 2000/01, 14.26 percent in 2003/04 and 13.78 percent, 15.62 percent in 2004/05 and 2005/06 respectively.

3.6 Trends in Income Tax

Until 1993/94, income tax revenue was divided into corporate income tax, individual income tax, and remuneration. After 1993/94, the income tax revenue was divided into four groups i.e. corporate income tax, individual income tax, house and land rent tax and interest tax. Corporate tax is collected from government corporations, public and limited companies, partnership firms. Individual tax is collected from remuneration, industry, and profession or vocation. Interest tax is collected from banks or finance companies that pay interest on all type of deposits and the house rent tax is levied on income obtained on renting house and land in urban areas. Since 2002/03, interest tax and house and land tax are included in investment income tax. The structure and trend of income tax revenue is given in the following table.

Table No. 5 Structure of Income Tax (From 1996/97 to 2005/06)

Rs. in Million

Fiscal Year	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
Sources of income tax										
A) Corporate income Tax	2693.3	2936.8	3462.2	4439.6	6026.4	4355.3	3752.3	4935.3	5454.5	5617.8
– Government corporation	1231.1	1317.8	1526.5	2198.9	2968.0	1769.2	1251.0	2056.6	1331.1	195.8
– Public limited company	858.4	925.1	1155.0	1337.4	1924.3	1410.2	1235.1	1531.3	2467.6	3405.6
– Private limited company	603.8	693.8	780.7	903.3	1134.1	1176.0	1166.7	1239.8	1527.3	1703.0
– Income from other institute	-	-	-	-	-	-	99.5	107.6	128.1	313.4
B) Individual income tax	1136.1	1562.2	2184.3	2317.6	2402.1	3732.4	3050.7	3262.6	3555.0	3729.9
– Remuneration	168.1	322.2	396.5	451.5	597.3	835.4	12490	1392.9	1678.2	1771.1
– Industry, business profession	968	1240	1787.8	1866.1	1804.8	2897.0	1801.7	1869.7	1876.8	1958.8
C) Investment income tax (income from other sources) (House and land rent tax, dividend, tax, interest tax etc.)	388.8	509.6	654.0	664.2	725.4	815.9	1321.5	1291.9	1425.9	1546.6
Total (A+B+C)	4218.2	5008.6	630.5	7421.2	9153.9	8903.6	81245	9489.8	10435.4	10894.3

Source: Annual Report of Various Years, I.R.D., and Quarterly Economic Bulletin of NRB, 2006, Economic Survey, 2005/06.

Table no 5, we can see that the aggregate amount of corporate income tax gradually increased up to 2000/01 but decreased in 2001/02 and again started to increase it increased in 2003/04 to 2005/06 but it was lower than 2000/01 within corporate income tax, government corporation had contributed about half percent up to 2000/01, but then after it had decreased. The corporate income tax plays the vital role in contributing to income tax.

The contribution of individual income tax to the total income tax is in increasing trend. Its share in 1996/97 was Rs. 1136.1 million which increased up to Rs. 3732.4 million in 2001/02. It decreased to Rs. 3050.7 million in 2002/03 and it again increased to Rs. 3729.9 million in 2005/06. Within individual income tax, the contribution of remuneration income tax is continuously increasing up to the end of study period but its contribution is less than industry, business, and profession.

The contribution of investment income tax is also increasing trend. Its contribution was Rs. 388.8 million in 1996/97 which was increased up to Rs. 1546.6 million in 2005/06.

Table no. 6 Components of Income Tax and their Share (From 1996/97 to 2005/06)

Rs. in million

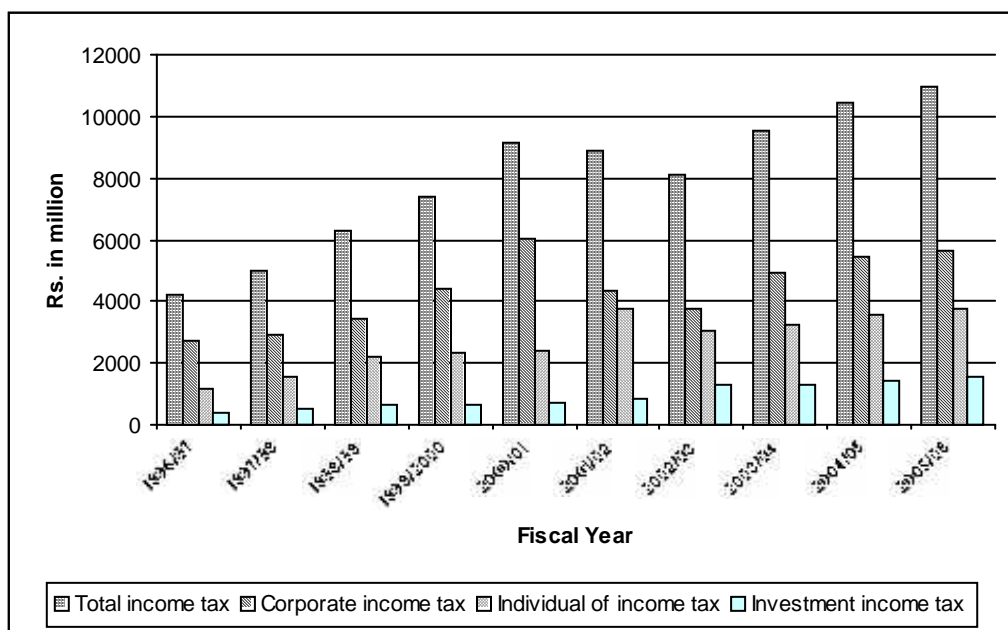
Year	Total income tax	Corporate income tax	Percent of total income tax	Individual of income tax	Percent of total income tax	Investment income tax	Percent of total income tax
1996/97	4218.2	2693.3	63.85	1136.1	26.93	388.8	9.22
1997/98	5008.6	2936.8	58.64	1562.2	31.19	509.6	10.1
1998/99	6300.5	3462.2	54.95	2184.3	34.67	654.0	10.3
1999/2000	7421.2	4439.6	59.82	2317.6	31.23	664.2	8.95
2000/01	9153.9	6026.4	65.83	2402.1	26.24	725.4	7.92
2001/02	8903.6	4355.3	48.92	3732.5	41.92	815.9	9.16
2002/03	8132.2	3752.3	46.14	3050.7	37.14	1321.5	16.25
2003/04	9504.0	4935.3	51.92	3262.6	34.32	1291.9	13.60
2004/05	10456.0	5454.5	52.17	3555.0	34.00	1425.9	13.64
2005/06	10933.5	5617.8	51.40	3729.9	34.11	1546.6	14.15

Source: Quarter Economic Bulletin of Nepal Rastra Bank and Annual Report of Various Years, Inland Revenue Department.

The share of corporate income tax on total income tax was 63.85 percent in 1996/97, which decreased to 54.95 percent in 1998/99. In 1999/2000, it started to increase and reached to 65.83 percent in 2000/01. In 2001/02, it again started to decrease and reached to 46.14 percent in 2002/03. But from 2003/04 it again started to increase and reached at 52.17 percent in 2004/05. In 2005/06 the

share of corporate income tax on total income tax is 51.40 percent, less than previous year. Hence, the share of corporate income to total income tax was not consistent but it contributed about half percent or more of total income tax. Similarly, the share of individual income tax to total income tax was also fluctuating year to year. In 1996/97, it had contributed 26.93 percent on total income tax, which increased continuously since two year and reached to 34.67 percent in 1998.99. From 1999/00, it started to decrease and reached to 34.67 percent in 1998/99. From 1999/00, it started to decrease and reached to 26.24 percent in 2000/01. In 2001/02, it upsurged and reached to 41.92 percent. Then after it again started to decrease and reached to 34.00 percent in 2004/05 But in 2005/06 it again up surged and reached at 34.11 percent. The contribution of investment income tax was also fluctuated. Its contribution amount was increasing continuously but share was not increasing continuously. Its share in 1996/97 was 9.22 percent, which increased over next two year and reached to 10.38 percent in 1998/99 but it again started to decrease and reached to 7.92 percent in 2000/01. From 2001/02 it again increased to 16.25 percent 13.60 percent in 2003/04 was the decreased percent of share. In 2004/05 and 2005/06 it is respectively 13.64% and 14.15%. The components of income tax and their contribution in total income tax has been shown graphically as follows:

Figure No. 2 Components of Income Tax and their Percentage (From 1996/97 to 2005/06)



3.7 Contribution of Income Tax in Nepal

Nepal has late started in practicing of income tax. First of all, income tax was imposed in 1959/60 A.D. as business profit and remuneration tax. In 1962, the first Income Tax Act was enacted which replaced the business Profit and Remuneration Tax Act, 1959. After the introduction of new Act, the share of income tax is increasing continuously. The role of income tax in the economic development of Nepal will be very clear, if we review the magnitude and share of income tax on GDP, total revenue, total tax revenue, and direct tax revenue.

The contribution of income tax on various revenue for the study period is given in the following table no. 7.

Table no. 7 Contribution of Income Tax on Different Revenue Heads

Rs. in million

Fiscal Year	Income tax	Income Tax as percent of total GDP	Income Tax as percent of total revenue	Income Tax as percent of tax revenue	Income Tax as percent of direct tax
1989/90	922.9	0.93	9.94	12.67	67.37
1990/94	1137.6	0.71	7.51	9.82	61.01
1994/98	4147.92	1.53	13.32	16.82	78.90
1998/99	6300.5	1.91	16.91	21.91	86.34
1999/2000	7421.2	2.03	17.3	22.39	86.75
2000/01	9153.9	2.33	18.72	23.55	93.7
2001/02	8903.6	2.19	17.65	22.64	84.00
2002/03	8132.2	1.87	14.46	19.10	80.47
2003/04	9504.0	2.01	15.25	19.73	79.85
2004/05	10456.0	2.06	14.91	19.33	80.05
2005/06	10933.5	1.96	15.13	19.04	78.31

Source: NRB Quarterly Economic Bulletin (2006/07) CBS 2006

Income tax was increased about 11 folds in 2005/06 as against in 1989/90. Total income tax in 1989/90 was Rs. 922.9 million and increased to Rs. 10933.5 million in 2005/06. In the study period, income tax was the fourth source of revenue from 1989/90 to 1992/93 and since then it has been the third largest share of tax revenue in Nepal.

The share of income tax to total direct tax was 67.37 percent in 1989/90 which regularly decreased and reached at 61.01 percent in the period of 1990/91 to 1993/94 and then after it was continuously increased and reached at 93.7 percent in 2001/01. After 2000/01, it again started to decrease and reached at 78.31 percent in 2005/06. In overall, it is increasing continuously and is main source of direct tax.

The share of income tax to total revenue was 12.67 percent in 1989/90 which decreased to 9.82 percent in the period of 1990/91 to 1993/94. After then it has increased up to 2000/01. Its contribution to the total tax revenue was 23.55 percent in 2000/01. After 2000/01, it again started to decrease and reached to 19.04 percent in 2005/06. In overall, its share in total tax revenue is also increasing. Similarly, its share on total revenue and total GDP was 9.94 and 0.93 percent respectively in 1989/90, which decreased to 7.51 and 0.71 in the period of 1990/91 to 1993/94. After its share increased up to 2000/01. In 2000/01 its share 18.72 percent of total revenue and 2.33 percent of total GDP, which is the highest contribution during the study period. Then it again started to decrease and reached to 15.13 percent and 1.96 percent in 2005/06.

From the above table, we can say that the income tax is one of the main source of direct tax in Nepal. But the contribution of income tax to the total tax revenue is still lower than the developed countries. Nevertheless, income tax is most likely to surpass the custom duties in future and will be the second largest source of revenue and the first largest source will be VAT.

3.8 Income Tax Rate and Exemption Limit

Rate structure of income tax has been changing continuously since its introduction in 1959/60. Since 1959/60 to till now, there are national records of

highest and lowest income tax rate. In 1963/64, the lowest income tax rate was 4 percent and in 1975/76, the highest income tax rate was 60 percent, which are not repeated till now. From the introduction of income tax, tax rate is charged on different brackets. In 1975/76, the income tax rate for personal income was 10 percent to 60 percent for 7 different brackets. From 1998/99, the income tax rate for personal income tax is 15 percent and 25 percent (except special industry conducted by individual) for two different brackets. It shows that there is a trend of reducing the number of brackets and tax rates.

Now, individual income tax is levied with two rates i.e. 15 percent and 25 percent. For individuals, who have Rs. 120000 income or Rs. 1200000 turnover from any kind business in metropolitan or sub-metropolitan cities, municipalities and other areas in Nepal are subject to pay Rs. 2000, Rs. 1500, and Rs. 1000 as an annual flat rates respectively.

The income tax rate for partnership firms, corporation and non resident was 15 to 60 percent in 5 different brackets in 1975/76. Now, it is 30 percent for bank and financial institution and 25 percent for partnership, corporation and non-resident with a single rate.

For every year, Finance Act prescribes the exemption limit for individual, family, and couple. Above the exemption limit, different income tax rate have been levied. The exemption limits indifferent years are shown in the following table no 8.

Table no. 8 Exemption Limit in Nepal (1959/60 to 2005/06)**In Rs.**

Fiscal Year	Individual	Couple	Family	All tax payers
1959/60-1962-63	-	-	-	7000
1963/64-1964/65	-	-	-	6000
1965/66-1966/67	-	-	-	5000
1967/68-1976/74	3000	4500	6000	-
1974/75	4500	6000	6000	-
1975/76	5500	6500	7500	-
1976/77-1978/79	6500	75000	8500	-
1979/80-1980/81	7500	10000	10000	-
1981/82-1982/83	10000	15000	15000	-
1983/84-1989-92	15000	20000	20000	-
1992/93-1996/97	20000	30000	30000	-
1997/98	25000	35000	35000	-
1998/99	30000	40000	40000	-
1999/2000	40000	50000	50000	-
2000/01	50000	60000	60000	-
2001/02	55000	75000	75000	-
2002/03	55000	75000	75000	-
2003/04	65000	85000	85000	-
2004/05	80000	100000	100000	-
2005/06	100000	125000	125000	-

Source: Finance Acts of Various Years, MOF, G/N.

The table no 8 shows that there was only one exemption limit for all individual taxpayers from 1959/60 to 1966/67. After 1967/68, individual taxpayers were categorized into 3 heads i.e. individual, couple and family. From the FY 1967/68 to 1978/79, exemption limit was different for each three categories. But after 1979/80 to till 2005/06, the exemption limit of couple and family is

same. This shows that the exemption is given only for two categories i.e. individual and family or couple. Above the exemption limit of individual income, different sets of tax rates are charged for different brackets. The following table no. 10 shows the rates for individual income tax in Nepal.

Table No. 9 Rates of Personal Income Tax in Nepal (1975/76-2005/06)

In Rs.

Fiscal Year	Brackets (Over exemption Limit)							
	1	2	3	4	5	6	7	8
1975/76	5000 7%	5000 10%	10000 20%	10000 30%	10000 40%	500000 55%	Balance 60%	-
1980/81	5000 5%	5000 10%	10000 15%	20000 20%	20000 30%	30000 40%	Balance 50%	-
1985/86	5000 10%	5000 15%	10000 20%	15000 25%	15000 30%	30000 40%	200000 50%	Balance 55%
1990/91	10000 15%	15000 20%	20000 35%	25000 40%	3000 45%	Balance 50%	-	-
1995/96	40000 10%	25000 20%	Balance 30% (a) 33% (b)	-	-	-	-	-
2000/01 to 2003/04	75000 15%	Balance (25%)	-	-	-	-	-	-
2004/05	80000 15%	100000 25+1.5%	-	-	-	-	-	-
2005/06	100000 15%	125000 25+1.5%	-	-	-	-	-	-

Source: Finance Acts of Various Years, MOF, G/N., Economic Report of NRB 2005/06.

a) Remuneration b) Other

From the above table no 9, it is clear that the rates for individual income tax in Nepal were different for different brackets. In 1975/76, the tax rate for personal income was 7 to 60 percent for 7 different brackets. In 1985/86, the brackets were increased to 8. But after 1985/86, the number of brackets and rate of individual income tax decreased till now. In 2005/06 there is 15 percent rate of

Rs. 100000 for individual of 125000 and 25 percent for compare. The individual operating special industry, will enjoy tax concession on both rates.

Similarly, income tax is levied for partnership firms, corporation and non residents. In the case of these, exemption limit is not given. Tax is levied on the income after deducting expenses. The rates and brackets approved for different years are given below:

Table No. 10 Income Tax Rates for Partnership Firms, Corporation and Non-residents (1975/76-2005/06)

In Rs.

Fiscal Year	Brackets (Over exemption Limit)							
	1	2	3	4	5	6	7	8
1975/76	10000 15%	10000 25%	10000 40%	500000 55%	Balance 60%	-	-	-
1980/81	5000 5%	5000 10%	10000 15%	20000 20%	20000 30%	30000 40%	Balance 50%	-
1985/86	5000 10%	5000 15%	10000 20%	15000 25%	15000 30%	30000 40%	200000 50%	Balance 55%
1990/91	10000 15%	15000 20%	20000 35%	25000 40%	30000 45%	Balance 50%	-	-
1995/96	33% in total	-	-	-	-	-	-	-
2000/01 to 2003/04	30% (a) 25% (b) 20% (c)	-	-	-	-	-	-	-
2004/05 TO 2005/06	30% (a) 25% (b) 25% (c)	-	-	-	-	-	-	-

Source: Finance Acts of Various Years, MOF, G/N. Economic Report of NRB 2005/06.

a) for bank and financial institutions

b) Others (including partnership firms)

c) For special industry (manufacturing industry other than liquor and tobacco)

The table no 10 shows that the income tax rates for partnership firms, corporation and non resident were different for different slabs in the earlier

year. But after 1995/96, the rate and bracket became uniform. This shows the progressive tax in earlier year and flat rate in recent year. The income tax rates in 1975/76 was 15 to 60 percent with 5 brackets. But in 2005/06 the tax rate was only 30 percent for bank, finance company and financial firms, 25 percent for other (including partnership firm) at a flat rate on taxable income and 25 percent for special industry.

3.9 Income Taxation in Nepal: An analysis of Provision Related to Income Tax Concession, Exemption and Deduction

Income tax Act, 1974 was replaced by Income tax Act, 2002. Income Tax Act 2002 has classified the income into following 3 heads.

- a) Business Income
- b) Employment Income and
- c) Investment Income

The Act had defined the income heads as follows:

- a) **Business:** Business means any industry, a trade, a profession, or the like isolated transaction with a business character and includes a past, present, or prospective business.
- b) **Employment:** Employment includes a past, present and prospective employment.
- c) **Investment:** Investment means an act of holding or investing one or more assets of a similar nature that are used in an integrated fashion but excludes:
 - Act of the holding of assets, other than non-business chargeable assets, primarily for personal use by the person owning the assets or investing amount on such assets or
 - Employment or business.

For the calculation of net income of these three income heads, Act has clearly mentioned the incomes or amounts which are taxable and non taxable

(concession, exemption) and expenses, which are allowed for deduction and not allowed for deduction. For the computation of net income and taxable income, the Act had made the following provisions.

3.9.1 Income from a Business

Income Tax Act, 2002, section 7, has clearly mentioned the incomes or amounts which are included while computing the income from business. They are:

- A person's income from a business for an income year is the person's profits and gains from conducting the business for the year.
- The following amounts should be included while calculating a person's profits and gains from conducting a business for an income year:
 - Service fees including commission, meeting management or technical services fees.
 - Amount derived from the disposal of trading stock.
 - Net gains from the disposal of the person's business assets or liabilities of the business.
 - Amount of excess depreciation on the disposal of the person's depreciable assets of the business (i.e. capital gain from pool disposal of depreciable assets).
 - Gifts received by the person in respect of business.
 - Amounts derived as consideration for accepting a restriction on the capacity to conduct the business.
 - Amounts derived that one effectively connected with the business and that would otherwise be included in calculating the person's income from an investment (i.e. amount derived from subletting vacant rooms of a house rented for official use).
 - Other amounts required to be included on tax accounting or quantification, allocation and characterization of amount of dealings

between an entity and a beneficiary of general insurance business. For example, amounts to be included due to change in accounting method, transfer pricing, recovery of bad debts, compensation received etc.

Incomes Excluded from Business Income

The following amounts are excluded while calculating a person's profits and gains from conducting a business:

- Amounts exempt under section 10.
- Taxation of dividend under section 54.
- Dividend distributed by a controlled foreign entity at the end of the year under section 69 and
- Final withholding payments.

3.9.2 Income from an Employment

Income Tax Act, 2002, section 8, has clearly mentioned the income or amounts, which are included while computing income from employment. An individual's income from an employment for an income year is the individual's remuneration from the employment of the individual for the year. For the purpose of computing income from an employment, the following amounts (income) received by him in respect of any employment of services rendered by him in any year of income shall be included:

- Any wage, salary, leave pay, overtime pay, fees, commission, prizes, gifts, bonuses and other facilities.
- Any personal allowances, including any cost of living, dearness, subsistence, rent entertainment, and transportation allowances.
- Any payments for reimbursement of costs incurred by the individual or an associate of the individual.
- Any payments for the individual's agreement to any conditions of the employment.

- Any payments of redundancy or loss of termination of the employment.
- Retirement contributions, including those paid by the employer to a retirement fund in respect of the employee, and retirement payments.
- Other payments made in respect of the employment.
- Other amounts as given in chapter 6 of the Act, i.e. perquisites and any gains due to change in tax accounting require to be included.

In the above provisions, there is a provision of loss of employment. But the provision had not clarified the meaning of loss of employment. On the other hand, retirement contributions are nothing else than the product of sacrifice of oldness of employment. These are the bases for living standard of oldness of employees. So it does not give good information to the taxpayers (employees). Dearness allowance is given to meet the living standard of employees. It is not lawful to include in taxable income.

Income Excluded from Employment Income

The following amounts are not included while computing the income from employment.

- Amount exempt under section, 10 and final withholding payments.
- Meals or refreshments provided in premises operated by or on behalf of an employer to employer's employee that are available to all the employees or similar terms.
- Any discharges or reimbursement costs incurred by the individual:
 - i) that serve the proper business purposes of the employer.
 - ii) that are or would otherwise be deductible in calculating the individual's income from any business or investment.

Payments of prescribed small amounts, which are so small and thus unreasonable or administratively impractical to make accounting for them (only upto Rs. 500) at once expenses may be stationary, gift, tea/coffee

expenses, emergency medical expenses are pointed by Internal Revenue Department.

3.9.3 Income from an Investment

Section, 9 of ITA, 2002, has defined the income received from an investment for income tax purpose. For the purpose of computing income of any person from an investment for an income year is the person's profits and gains from conducting the investment for the year and there shall included.

- Any dividend, interest, natural resources payment, rent, royalty, gain from investment insurance, gain from an unapproved retirement fund, or retirement payment made by an approved retirement fund derived in respect of the investment.
- Net gains from the disposal of the persons non-business chargeable assets of the investment.
- Excess amount of incomings over the depreciation basis including outgoings on the disposal of depreciable assets of the investment of the person's. (Depreciable basis includes the depreciation amount, expenses made on the depreciable assets).
- Gifts received by the person in respect of investment.
- Retirement contributions, including those paid to a retirement fund in respect of the person, and retirement payments in respect of the investment.
- Amounts derived as consideration for accepting restriction on the capacity to conduct the investment.
- Other amounts required to be include on tax accounting, or quantification, allocation and characterizations of amounts of transaction between any entity and beneficiary or general insurance business.

In the above provision, Act has included the amounts derived as consideration for accepting a restriction on the capacity to conduct the investment, it is

fruitful to the investment who receive the compensation against restriction. But it will not be possible to implement, if the act does not clarify the nature of restriction, cause of imposing restriction, process of compensation-computing the entity, which give compensation.

Non-Includable amounts on Investment Income

The act has mentioned the amounts, which are excluded in computing income from an investment under section 9 (3). They are:

- Exempt amount under section 10.
- Taxation of dividend under section 54.
- Dividend distributed by a controlled foreign entity at the end of the year under section 69 and final withholding payments and
- Amounts that are included in calculating the person's income from any employment or business.

3.9.4 Concession and Exemption of Income Tax

Income Tax Act, 2002, has mentioned the concessions and exemption amounts. They are described in the following section.

A. Exempt Amounts

The following amounts are exempted from tax under section 10, Income Tax Act, 2002.

- i) Amounts derived by a person entitled to privileges under bilateral or a multilateral treaty concluded between Nepal Government (NG) and a foreign country or an international organization.
- ii) Amounts derived by an individual from employment in the public service of the government of foreign country.

Provided that:

- a) The individual is a resident person solely by reason of performing the employment or is a non-resident person and

- b) The amounts are payable from the public funds of the country.
- iii) Amounts derived from public fund of the foreign country by an individual who is not a citizen of Nepal as referred to in paragraph (iii) or by a member of the immediate family of the individual.
- iv) Amounts derived by an individual who is not a citizen of Nepal but employed by Nepal Government on terms of a tax exemption.
- v) Allowances paid by NG to widows, elder citizens, or disabled individuals.
- vi) Amounts derived by way of gift, bequest, inheritance or scholarship except as required to be included in calculating income from business, employment or investment.
- vii) Amounts derived by an exempt organization by way of:
 - a) Gift, donation.
 - b) Other contributions that directly relate to the exempt organization's function, whether or not the contribution is made in return for consideration provided by the organization. For example, subscription fee received by a club is exempt from tax.
 - c) Pension received by a Nepal Rastra Bank as per its objectives.
- vii) Pension received by a Nepal citizen retirement from the army or police service of a foreign country provided the amounts are payable from the public fund of that country.

In the above section, pension amount received by Nepalese people being retire from the service by army or police of foreign country is exempted from income tax. It restricts the objective of raising more revenue of government because some of them receive more amount than the exemption limit approved by the government.

Exempt Organization

Exempt organization means the following entities:

- A social, religious, educational or charitable organization of public character registered without having profit motive.
- An amateur sporting association on formed for the purpose of promoting social or sporting amenities not involving the acquisition of gain.
- A political party registered with the electric commission.
- A village Development Committee, Municipality or District Development Committee.
- Nepal Rastra Bank
- Nepal Government.
- The prescribed entity that has been issued with a personal ruling under section 76 stating that it is an exempt organization.

Income Tax Act has mentioned the organizations, which are tax-free (exempt organization). Act has exempted social, religious, educational or charitable organization of a public character registered without having profit motive. In the case of non-transparent private business like boarding schools, NGO's or other entities, where profits are earned, but for the sake of tax planning, is called retained earnings or something else. So they are tax free. It is not food symptom of tax administration.

B. Business Exemptions and Concessions

The following business exemption and concessions are mentioned in section 11 of Income Tax Act, 2002.

- i) An agricultural income derived from source in Nepal during an income year by a person, other than the income from an agriculture business derived by a registered firm, or partnership or a corporate body, or through the land about the holding ceiling as prescribed in section 12 of Land Act 1964, is exempt from income tax.

- ii) Income derived by cooperative societies, registered under Cooperative Act 2048, from business mainly based on agriculture and forest products such as sericulture and silk production, horticulture and fruit processing, animal husbandry, dairy industries, poultry farming, fishery, tea gardening and processing, vegetables seeds processing, bee-keeping, Honey production, rubber farming, floriculture, and production and forestry related business such as lease-hold forestry, agro-forestry, cold storage established for the storage of vegetables, and business of agricultural seeds, insecticide, fertilizer and agricultural tools (other than machine operated) and rural community based saving and credit cooperatives are exempt from tax. Dividends distributed by such societies are also exempt from tax.
- iii) Any person operating special industry during the whole income year is taxed as follows:
 - a) If the industry is providing direct employment to 600 or more Nepalese citizens throughout the whole year, 90 percent of the applicable tax rate (20 percent) is applied for the year.
 - b) The industry operating in remote, undeveloped and under developed area will have to pay 70 percent, 75 percent, and 80 percent of the applicable tax rate (20 percent) respectively up to ten income years commencing from and including the year in which the operation commences.
 - c) If both exemptions are availed to the same special industry for same income, only one exemption is available as per the selection made by the industry.
 - d) The income received under business exemptions and concessions should be calculated separately assuming that these incomes are received by separate person. That is, income received under business exemptions and concessions should be separated from other general business and investment incomes.

- e) If the assets used by the special industry were used previously by another person operating the similar type of special industry, the ten year for the latter will be counted from the period of such use by the another person previously.
- iv) An individual working in a remote area is entitled to a rebate up to a maximum of Rs. 30000 by way of additional basic exemption. The exemption limit specified in Rule 38 of ITA, 2002 is under:

Area A Rs. 30000

Area B Rs. 24000

Area C Rs. 18000

Area D Rs. 12000

Area E Rs. 6000

Now, basic exemption is:

Individual Rs. 100000

Couple and family Rs. 125000

Clarification - for the purpose of this section

- "Agricultural business" means the business of producing crops from public or private land or deriving rent from a tenant using land.
- "Remote area", "undeveloped area", and "underdeveloped area" have the meaning in Annex-3 of Industrial Enterprise Act (IEA) 1992.
- "Special industry" means a manufacturing industry as categorized in Section II of the IEA, 1992, other than an industry producing cigarette, bidi, chewing tobacco, Khaini, or other goods of similar using tobacco as the basic raw materials, or alcohol, beer, or other goods of a similar nature.

In the above section, there is a provision of exemption of tax from agricultural income other than income from an agricultural business derived by a firm, or

company, or partnership, or a corporate body or through the land above the holding ceiling as prescribed in Land Act 1964. But the provision of taxing on agricultural income of agricultural business is not clear on itself. On the other hand, exclusion of agricultural income from tax net alone cuts out about half of the GDP.

There are various provisions about exemption and concessions. Some concessions granted to achieve certain objectives are not effective. Tax concessions encourage the establishment of industries in certain areas but they vanish or change names, ownership or place the business when the tax concession period expires. On the other hand, the concession or incentives provided to special industries are not energetic. For this kind of concession, no body will be encouraged to open the industry in remote area. For the purpose of industrial development of remote area, a separate incentive should be provided. But the new Act is also unable to do so.

C. Donation/Gift to Exempt Organization

Section 12 of ITA, 2002 has mentioned the provisions of donation or gifts given to exempt organization. The provisions are:

- i) A person may claim to have their taxable income for an income year reduce by donation/gifts made by the person during the year to an exempt organization, that are approved for the purposes of this section by the department.
- ii) Notwithstanding subsection (i), reductions allowed to a person under subsection (i) for an income year shall not exceed whichever is lower between Rs. 100000 or 5 percent of the person's taxable income for the year calculated without a deduction for gift referred to in subsection (i) and ignoring the limitations in 17 (2) and 18 (2).
- iii) Notwithstanding subsection (i) and (ii), Nepal Government may prescribe, by a notification in the Nepal Gazette, as to allow full or partial deduction at the time of assessing a person's income of the

expenses incurred for special purpose, or the expenses of gift given by the person.

- iv) Donation made to Pashupati Area Development Trust (PADT) and Lumbini Area Development Trust (LADT) is deductible upto Rs. 50 lakh.
- v) Any profit making entity can claim deduction for donation in the year of parliamentary election paid out of its profit before two months from the date of parliamentary election, to the approval National Political Parties up to Rs. 50 lakh.

From the above provisions (i) and (v), it is clear that the donation given to political parties is allowed for deduction. But it is not able to address the voice of people of 'transparency of donation amount given by businessman to political parties'.

Similarly in the above provision (iii), there is a provision of special purpose. But the act has not defined 'what is the special purpose?'

CHAPTER IV

PROBLEMS OF INCOME TAX

4.1 Narrow Coverage

The base of Income tax is extremely very low. Agriculture the largest sector of Nepalese economy is out of tax net. The coverage of income taxes is very narrow. Agriculture income is exempt 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, 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, medical allowances, 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.

4.2 Tax assessment system is not scientific

In Nepal tax collection is based on negotiation. But it is not suitable that tax is collected form negotiation. Government should make fixed rules and regulation and apply them effectively to collect tax.

4.3 Inefficient administration

The tax administration of Nepal is not efficient is the net working system is not so strong. The administration personnel are also falling in corruption. They are corrupted.

4.4 Poor data base and information system

This is one of the biggest problem of Nepalese tax system. Nepalese tax administration do not have enough Information about actually how much tax

payer here in Nepal? What is the actual Income status of Nepalese people? Due to lack of poor data base, there is greater possibility of tax evasion. Therefore, there should be reliable records of accounting for the proper implementation of Income tax.

4.5 Rates are relatively higher

In Nepal tax rates are relatively higher, it can not include the largest amount of tax payer in tax system, if the rates are little bit lower it can involve the highest amount of person in tax system, it help to generate the government revenue more effectively.

4.6 Difficult to Charge the tax on Dual used commodity

There are many dual used commodities, which requires a good judgment either brings it under the tax net or exempt it from taxation. For example, consider the example of a farmer and its mini truck. If the farmer use the truck for further Income generating purpose, in this time, no doubt, he should pay tax/ his income is to be checked through taxation. But if he use this truck for his own agriculture purpose or traveling with his family, there would not be any Income. And this time, his property should be taxed free. So, how do the government charge the tax from such kind of dual used commodities, is the great problem of our country.

4.7 Deviation from the basic Principle of income taxation

The essence of a progressive income tax is that it should take into account the personal circumstances of the taxpayer. The Nepalese income tax 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.

4.8 Long time-lag

Since 1980/81, tax payers have been required to pay an advance income tax. An advance in tax in Nepal is different from, paying taxes in advance in other countries. In Nepal, a taxpayer is supposed to file a return that indicates his income and he is, supposed to pay tax on this income. This is called an advance tax even though it is paid three months after the close of the fiscal year. Later, a tax officer himself. This is his final tax. As most taxpayers indicate no or very little profit, they do not have to pay much advance tax; the tax liability is thus, increased by the tax officers when an assessment is made, assessment takes a long time, in some cases 3 or 4 years.

Further, the lag in the collection of income tax is rather long. A taxpayer has to pay the final tax due within 35 days after the receipt of the notice of assessment. If the taxpayer is not able to pay within the stipulated period, he must file for an extension within 35 days of the notice of assessment and after the payment of any penalties. The tax officer may allow an extension of up to 9 months. Although fees are charged for late payments they are not adequate to deter delays in payments.

4.9 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, *utter 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.

Further, due to the exemption of dividend income or other income under the domestic tax laws, Nepal's bargaining power will be weak during the time of negotiating avoidance of double taxation treaties with its trading partners.

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. Moreover, there is also a lack of anti-avoidance measures, such as transfer pricing, treaty shopping, and thin capitalization which will be important as the number of foreign enterprises increases in the country.

4.10 Lack of Cost-benefit Analysis of Tax Expenditure

Tax expenditure is special form of budgetary expenditure. Increasing the efficiency of tax expenditure requires a cost benefit analysis. However, no cost benefit analysis on tax expenditure is currently being conducted in the country. In creating tax expenditure policies, the government has neither considered their effectiveness and efficiency, nor has it contemplated their cost. The government has not set tax expenditure policy on an empirical basis, but in a subjective way based on anticipated benefits but without an assessment of the requisite cost. In the end, these tax expenditures can cause not only great revenue losses but also loss in economic efficiency.

4.11 Structural Imbalance in the application of Tax expenditure policies in the tax system

Tax expenditure policies are applied directly and indirectly to reduce tax liabilities. Direct tax expenditure policies have the advantage of simplicity and certainty. For example, tax exemptions, deductions and refunds are direct form of tax expenditure policies applied indirectly that is, by reducing tax liabilities have the advantage of flexibility. For example, tax offset and accelerated depreciation are indirect form of tax expenditure. In general, direct tax expenditures increase taxpayers' incentive to evade taxes and facilitate rent-seeking, in contrast, indirect tax expenditures increase taxpayer's incentive to adjust their havior and their production activities. Thus, in tax expenditure policy development, indirect forms of tax expenditures and preferable. There methods have been used is countries with well-established tax expenditure system.

4.12 New Avenues for the Successful Implementation of Income Tax

Income tax can be a major revenue source only if certain pre-requisition or condition are fulfilled. These are:

4.12.1 Existence of predominantly monetized economy

This means that every economy activities should be monetized. Higher the economy to be monetized, greater will be the possibility to introduce new taxes. Due to the lack of pre dominant monetized economy list Developed countries like Nepal have not been able to properly mobilized resources through direct taxes.

4.12.2 A high standard of literacy

If the society is highly literate, voluntary compliance will be high. They also realized why they should pay taxes.

4.12.3 Large degree of voluntary compliance

Voluntary compliances means voluntarily dis-cloement of income and paying taxes according to the rule. If voluntarily compliance is, a great amount of resources can be mobilized through Income taxation.

4.12.4 Reliable record of accounting

In the absence of reliable records of accounting, one cannot actually calculate the Income of Individuals. There is greater possibility of tax evasion. Therefore, there should be reliable records of accounting for the proper implementation of Income tax.

4.12.5 Absence of wealthy or comprador class in the policy making

If there is wealthy of comprador class, they act in their self interest. Their activities go against the proper implementation of Income tax and government can not mobilize resources through Income taxation.

4.12.6 Honest efficient administration

Honest and efficient administration is needed for any tax, but minimum acceptable standards appear to be higher for Income taxes than for many other levies. Difficult as the task of establishing a satisfactory administration may be, it is probably the condition for successful Income taxation that can be met most quickly. The expert, nevertheless, must guard against the assumption that a tidy organization chat and political staffing assure good administration Nor can he be confident that the best attainable administration will eliminate obstacles to heavy reliance on Income taxes.

4.12.7 Improve the tax administration

In order to improve tax administration the following should be done:

-) every tax administration must get the message that honesty is honored and rewarded, while corruption get punished.
-) given the resource constraint, resource made available to a tax department must be used in a cost efficient way.
-) tax payer must get the message that tax evasion would be punished.

-) in a large and growing population of tax payer it is not possible to check the returns filed by every assessee. So there is need to proceed on the basis of "Self-assessment". It means that tax authority should accept whatever is declared by tax payers on their own subject to random checks. It may not be very wise to concentrate only on "large case."
-) in order to facilitate enhancement, the following need to be done.
 - a) extension of the scheme of withholding over a wide areas such as salary, Interest, dividend and even rental Incomes.
 - b) adoption of presumptive approach in taxing the hard-to-tax group.
 - c) development of an efficient information system.

4.12.8 Others

-) Increase the extent of tax base.
-) Rationalization of tax rates compatible with SAFTA and WTO provision.
-) Self assessment system should be made more effective.
-) Improving the efficiency of the tax administration.
-) Developing an effective data and information system by using new technology.
-) Gradual elimination of exemption.
-) Introduction of voluntary dis-closurement of Income schemes (VDIS)

CHAPTER V

FINDINGS, CONCLUSION AND RECOMMENDATIONS

5.1 Findings

Because of the increasing gap between expenditure and revenue collection, Nepal has to heavily depend upon both the external as well as internal debt to meet the budget deficit. Unfortunately, the dependency is increasing which is undesirable for economy. This scenario emphasizes for the mobilization of the internal revenue to the optimum level.

The major findings of this research study are summarized

- ❑ Government revenue is the composition of external and internal revenue. Internal revenue. There is a dominant share of tax revenue in Nepalese government revenue. The contribution of tax revenue shows a fluctuating trend as it had contributed 78.43 percent in 1989/90 on total revenue but it had contributed 79.5 percent in 2005/06.
- ❑ Nepalese tax revenue is the composition of direct and indirect tax revenue. There is a dominant role of indirect tax. The contribution of direct and indirect tax revenue were 18.8 percent and 81.2 percent respectively in 1989/90, which contributed 24.3 and 75.7 percent in 2005/06.
- ❑ Among the various sources of government revenue, custom duty, sales tax (VAT), income tax and excise duty are the major sources of government revenue. Income tax revenue has occupied third position at present on the basis of contribution among these revenues. The contribution of income tax to government revenue is in an increasing trend. So the future of income tax can be highly evaluated.
- ❑ The tax/GDP ratio of Nepal is not satisfactory. It has never exceeded 11 percent. In 1989/90, the tax/GDP ratio was only 7.31 percent which

reached to 10.29 percent in 2005/06. This shows the increasing trend of tax/GDP ratio in slower pace.

- ❑ The major components of direct taxes are income tax, land tax and house and land registration tax. Among them, income tax occupies largest share. Its share in fiscal year 1989/90 was 67.37 percent and 78.32 percent in 2005/06.
- ❑ The contribution of direct tax on total tax revenue, GDP and Total Revenue is continuously increasing in slower pace. It's contribution on total tax revenue, GDP and Total revenue was 18.8 percent, 1.37 percent and 14.74 percent respectively in 1989/90, which was 24.3 percent, 2.50 percent and 19.34 percent in 2005/06.
- ❑ The contribution of income tax to the total revenue, tax revenue, direct tax and total GDP is in increasing trend. Its contribution was 9.94 percent, 12.67 percent, 67.37 percent and 0.93 percent respectively in the fiscal year 1989/90 which increased to 15.13 percent 19.04 percent, 78.31 percent and 1.96 percent in 2005/06.
- ❑ Income tax, is the composition of corporate income tax, individual income tax, and investment income tax. Corporate income tax is collected from government corporations, public and limited companies, partnership firms. Individual tax is collected from remuneration and industry, business, profession. Investment income tax is collected from dividend tax, interest tax, royalty tax, rent tax etc.
- ❑ Within the income tax there is the dominant role of corporate income tax but it is in decreasing trend, which was 63.85 percent of income tax revenue in 1996/97 but decreased to 51.40 percent in 2005/06. And the share of individual and investment income tax in the total income tax is increasing trend, which was 26.93 percent and 9.22 percent respectively in 1989/90 and 34.11 percent and 14.15 percent in 2005/06.

- ❑ The income tax rates and brackets have been changing radically in recent years. Personnel income tax rates, which ranged from 7 percent to 60 percent in seven brackets in 1975/76 was reduced to only two rates i.e. 15 percent and 25 percent in two brackets in 2005/06. In the similar vein, the corporate income tax rate has been reduced from 60 percent in 1975/76 to 30 percent (for banks, finance companies and financial firms) and 25 percent (for other including partnership firms) in 2005/06.
- ❑ In Nepal, agricultural income is exempt from income tax. Exclusion of agriculture income from the tax net alone cuts out about income half of the GDP. In the other hand, labour tax is taxed more heaving than the capital income. Retirement amount received by Nepalese people being retire from the service by army or police of foreign country is also exempted from income tax. Exemption of these sources provides loopholes for tax evasion.
- ❑ Some exemptions granted to achieve certain objectives are not effective. Tax incentive (concession) is one of the examples of this. Tax concessions encourage the establishment of industries in certain areas but they vanish or change names, ownership or place the business when the tax facility expires.
- ❑ Income tax Act has clearly mentioned the organizations, which are tax-free and is called exempt organization. Act has exempted a social, religious, educational or charitable organization of a public character registered without having profit motive.

Due to some problems like narrow coverage, unscientific tax assessment, deviation from the basic principle of income taxation, long time lag, defective system for the perspective of international taxation, weak tax administration etc. Tax revenue collection has not been implemented to the optimum level.

The Nepalese tax administration has been attempting to modify itself to meet the pressing challenge brought about by change in technology and economic policies. Some reformations have been observed with the implementation of

new tax act 2002 However, still its working procedure is traditional and the cost of administration has not been brought to the satisfactory level.

5.2 Conclusion

Developing countries like Nepal are facing serious problems in the process of economic development. Lack of sufficient financial resource is the main constraint for economic development of Nepal. A lot of funds are required to meet the objective of economic development. But Nepal is not being able to collect necessary fund. Due to poor performance on internal revenue (fund) collection and mobilization, Nepal has been heavily relying on foreign loans and grants. The dependence is increasing, which is not desirable for any economy. Thus, it is more essential to mobilize the internal fund to the optimum level.

To increase the government revenue, Nepalese government is trying to extract money from people through taxation. Tax revenue is composed of direct tax and indirect tax. But the contribution of indirect tax is higher than direct tax. Within tax, income tax is the most important source of government revenue. It is considered as a good remedy to cure growing resource gap problem in Nepal.

In Nepal, the history of income tax is not so long. It is started only on late fifties. The income tax was introduced as a trial on business profit and the remuneration income. The first elected government levied the first income tax and no specific act was made to define and to treat income tax. The first Income Tax Act was made only in 1959/60. Since then four Income Tax Acts has been implemented. From the very beginning, the concept of exemptions, concession, deductions and other forms of tax relief in income tax have emerged in Nepal. All incomes of an individual can not be taxable because the minimum cost required for subsistence can not be taxed. The exemptions, concession, deductions and other forms of tax relief are essential to encourage an individual to work more. The tax relief works as an incentive to an individual. So, the concept of exemption, deductions and tax reliefs were emerged in Nepal from the very beginning of income tax. Currently, income

tax constitutes corporate income tax, individual income tax and investment income tax. Among them, contribution of corporate sector is highest. Exemption limit and the rate of the income tax is determined according to the income level and sector wise but is not adjusted according to the inflationary situation of the country.

Income tax system of Nepal has been blamed as inefficient enough. Being various problems relating to income tax, revenue collection from income tax is low as compared to other developing countries like India, Sri Lanka, and Pakistan etc. Nevertheless, if we analyze the data relating to it, we can find out that it is neither bad nor worse but it is continuously improving. However income tax laws and administration in Nepal are to be deeply scrutinize and properly implemented. The provisions made no Act have to be mentioned clearly and language has to be made clear. Some reforms in tax administration are needed. If the problem relating to income tax system in Nepal can be solved and resources are effectively utilized then only the prospects of revenue collection from income tax will be bright and the economic development of Nepal will be achieved.

5.3 Recommendations

On the basis of the findings of the present study, the following suggestions have been recommended for a sound and effective income tax system.

(I) Extension of Coverage

Broadening the tax base has been one of the important features of the recent income tax reform in the international arena. This strategy, however, may not be as easy and effective in the present. Nepalese context as it has been in many other countries. This is because, in Nepal, broadening the coverage would mean the extension of income tax to agriculture income, capital gains and dividends, a reduction in tax incentives, and the identification of new taxpayer; neither a reduction in deductions nor the removal of exemption in the case of labour income- as has been important in many countries-would be of significant help in Nepal as the scope of remuneration income is very limited in

this country. Let us examine the possibilities for the extension of income tax to agricultural income, capital gains, dividends, etc.

(a) Including the Income from agriculture

In theory, there is a case for an income tax on agricultural income. Agriculture is the largest sector of the Nepalese economy, which accounts for about half of the GDP. A large part of the national budget is spent on the agriculture sector and prices of both land and its products have been increasing. So this sector should contribute more in the form of tax revenue. Further, a tax on agriculture is also expected, as started elsewhere, to discourage large unproductive landholdings, to curb the consumption of high income groups, and increase the case need of the farmers which encourages marketing of the agricultural products. Despite such justifications, the agriculture sector has remained almost out of the tax net for both practical and political reasons. An effective land revenue system and a refined income tax structure should be brought to cover the agriculture sector for taxation.

(b) Income from other sources:

By raising the taxation rate in capital gain, dividends to possible level and by tax incentive, the extension of coverage of tax can be enhanced.

(c) Identification of new taxpayers:

A detailed survey of traders, professionals and so on should be conducted so as to identify new taxpayers.

(II) Reform Tax Administration

More often than not, it is maintained that tax administration in developing countries is tax policy, which means until and unless policy measures are backed by corresponding administrative reforms, they are doomed to failure. This very clearly recognizes the important role of tax administration in developing countries like Nepal. Therefore, the administrative reform is critical to the success of tax policy. In view of the above and the administrative problems stated elsewhere, following measures are suggested.

- a. As the role of information is central to the success of tax administration, information collection should be consolidated. Intra-departmental as well as inter departmental networking at least among the departments within the MOF should be established at the earliest.
- b. A separate, "Research and Analysis Unit" should be established in order to find out new avenues of taxation and to find out the lapses in tax policy pursued by the government.
- c. The terms and the procedure under the act should be simplified so that even laymen could understand easily.
- d. The tax officials also need to be reoriented to implement the new act smoothly. They should be familiarized with recent innovations into the field of public administration particularly in tax administration whereby taxpayers are treated as clients. And hence, client orientation should be the thrust of the administrative reforms.
- e. New act has fully specialized the self-assessment and the taxpayers have to maintain adequate accounts of their income and expenses so that the taxable income would be easily calculated.
- f. Tax policy and administrative reforms should not be guided by the short-term goal of revenue requirements.
- g. The system of tax administration should not harass honest tax payers, rather it should convey a message to taxpayers that if they are not to report their profit accurately, there is always probability of being detected and punished.
- h. Pre-service and post-service training for officers should be carried out at regular intervals.
- i. The government should be accountable and transparent so that the taxpayers are encouraged to pay tax.