Tax Evasion and its Control in Nepalese Context

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Abstract

Nepal's public revenue is obtained through taxation, which has assumed an important role in the government contributing to various types of public good and investment on infrastructure and social welfare. Even though a succession of tax system and administration reforms have been carried out, the problem of noncompliance has persisted with detrimental effects on revenue generation as well as on long run fiscal sustainability. The weaknesses with the system despite its structural improvement are weak enforcement mechanisms, administrative lacunae, cumbersome tax procedures and poor technology usage along with increased refusal among taxpayers to repose faith in public institutions. Against this background, in this study we try to investigate the antecedents of tax evasion in Nepal and its containment purpose. It also explores alternative approaches that might be more practicable and applicable for improving compliance by way of similarly improved tax performance. Based on the extant theoretical and empirical literature, official government documents, and evidences from international comparative case studies of tax evasion in this article provides authorities in Nepal with a range of instruments that might be effective in dealing with problems of tax evasion. The strategy is based on a well-balanced three-pronged programmer encompassing more rigorous enforcement, simplification of the tax system and greater digitization of tax administration as well as better information education communication for taxpayers. Room is also created to address administrative incompetence and behavioural handicaps in getting people to conform, a piece of political chapter on fairness and transparency with respect to the spending of public money. Closing administrative loopholes and synchronizing the incentives for voluntary compliance, can produce significant improvements in revenue performance, the study argues. Ultimately, by building an efficient and transparent tax system that is also easily comprehended and accepted by citizens, Nepal may be better placed to develop and sustain inclusive and sustainable economic development. Tax is a foundation of nation building but there is massive tax gap because of the enormous scale of tax evasion in Nepal. This paper examines structural origins of tax evasion in Nepal, combining administrative and socio-economic perspectives

Introduction

Taxes are used to invest in the shared priorities of our country, including health care, education and infrastructure. In Nepal, taxes contribute more than 80% of total revenue, according to the Move's Economic Survey 2023/24. This represents a big chunk of the country's income overall. In any event, the capacity of the country to afford its development goals was seriously compromised by the long-standing problem of tax evasion, which also made for a widening distinction between those compelled (by force) to pay taxes and those willing to do so.

Personal and Corporate tax evasion refers to the situation where individuals or businesses knowingly file false returns, fail to report income, overstate deductions or underpay taxes. In contrast, the related term tax avoidance is the legal utilization of the tax regime to one's own advantage, to reduce the amount of tax that is payable by means that are within the law. Evasion is an out-and-out breakage of tax laws and carries all kinds of nasty ramifications such as fines or jail time, while avoidance doesn't break any law at all, but possibly enjoys the benefit of what's legal. (Ahmed & Rider, 2019; Kemal, 2014)

Since all the cash orientated industries, such as retail trade, hospitality and some segments of professional services with much of undetected informal sector were found to have significantly higher odd of committing such crime. One source of tax evasion is the informal sector, which has been estimated to be approximately 35% of the economy (Asian Development Bank, 2003) and rely on taxes. Outside the legacy finance system, transactions are more difficult to monitor and police.

VAT, PANs and online tax filing are some of the new components of Nepal's tax system in recent decades. But little headway has been made due to administrative lacunae, insufficient enforcement and the constant distrust of taxpayer. IRD, for example, notes that of the reasons why actual efficiency in VAT collection falls despite increasing registration to VAT is under-declaration and fraudulent invoicing.

Around the world, people are coming to understand that tax evasion is a governance problem, not just a financial one. He also proposes that the general level of evasion is associated with declining trust in institutions, lower voluntary compliance and unfair competition. In Nepal, they are compounded by a culture of parallel economy, lack in implementation and political unrest.

Hence, tax evasion in Nepal can only be understood through a multi-faceted analysis. It's someone's job to stop and take a look at how a society operates, the psyche of the

taxpayer, the (in general) mechanics of bureaucracies, and yes even economics in relation to it all. Evidently simplification of the tax administration, taxpayer service enhancements and assurance that value could be attributed to the public goods secured from projects financed through taxation are universal tools in the drive towards sustainable compliance. (Allingham & Sandmo, 1972).

On this debate, the current study would contribute in: (i) reviewing available literature related to tax evasion and its contrary; (ii) identifying reasons of evasion in case of Nepal and; (iii) establishing environment by which compliance can be achieved so that government is able to earn revenue as per expectation. The approach is descriptive of the current reality but also policy-relevant, mixing both forensic and prescriptive analysis.

The problem of tax evasion has come under close scrutiny in economic and public finance literature, especially for developing, South Asian economies. Among the early theoretical work were those by Allingham and Sandmo (1972) who developed an economic deterrence model, postulating that tax payers are rational agents and decide whether or not to evade taxes depending on the audit probability and severity of penalties. Although influential, this model was later criticised for neglecting social, institutional and psychological aspects of tax compliance.

Feld and Frey (2007) proposed the idea of tax morale, where voluntary compliance is widely contingent on public trust in government, perceived equity of taxes and quality of supply by the state. They find that an excessive use of enforcement may lead to a 'negative' motivation toward paying taxes. It is this view which has special significance for developing nations where institutional credibility is generally low.

A few studies in South Asia indicate structural reasons for tax evasion. Bird and Zolt (2015) claim that complicated tax systems, small tax bases, and ineffective administration severely limit fiscal mobilization in South Asia. Das-Gupta (2017) in the case of India observed informal sector prevalence and weak audit capability are major causes because of which digital tax administration, even though enhanced has seen limited deterrence impact. Ahmed and Rider (2019) also found that in Bangladesh, corruption and political interference dilute the efficacy of enforcement of tax laws.

In Pakistan, Kemal (2014) contends that low tax-to-GDP ratios are largely driven by extensive evasion and exemptions that benefit politically-connected groups. The research underscores that enforcement is not enough, if taxpayers are not educated and there is no simplification in tax laws. Sri Lankan research also finds that the compliance will increase if

taxpayers feel that there is transparency and accountability in tax administration (Silva & Jayawardena, 2016).

Nepal-specific literature indicates similar challenges. Inland Revenue Department's (IRD) own studies as well as independent researchers demonstrate the prevalence of VAT evasion, under-invoicing and non-registration by enterprises particularly small and medium size firms. 4.1 Tax awareness and trust in government spending The tax culture is further weakened by lack of tax knowledge and lack of trust in government use of revenues, reducing voluntary compliance (Sharma, 2018).

Recent research also underscores on the importance of digitalization and bring into view technology driven electronic filing and billing system for combating evasion with sound institutional capability support and public acceptance to power such up.

On the whole, literature shows that tax evasion in South Asia is a multifaceted problem that must be addressed through good enforcement practices, institutional reform and taxpayer service.

Literature Review

Other specializations have also written about tax evasion: policy analysis, economic theory, psychology and ethology, sociology and public administration, governance (fighting against state corruption), law and criminology. This sub-section is based on the mechanisms, drivers and control mechanism that are pertinent to Nepal's context both proliferating across the globe as well as possible inferences made with little evidence available from Nepalese data. (Feld & Frey, 2007; Silva & Jayawardena, 2016)

Theoretical Foundations

The Allingham and Sandmo (1972) economic model serves as a useful device with which to visualize tax evasion, as it interprets disciplined attitudes towards the payment of taxes in terms of rational choice. Taxpayers in this model compare the expected financial advantage of evading taxes into relation to the risk that they will be apprehended and the penalty they would face if caught. It's less likely to be avoided when the perceived punishment if you get caught outstrips whatever possible tax benefit was gained.

Cognitive and social factors were targeted in subsequent developments. The slippery slope model is characterized by two main elements of compliance: authority power (force) and legitimacy (confidence in the authority). When the citizens have confidence in the system, it is possible to speak of their voluntary cooperation; but when they do not, they rely on deterrence where about it is concern. (Bird & Zolt, 2015; Das-Gupta, 2017)

Global Trends in Tax Evasion

Businesses tax evasion that affect tax on the side of government in the world In all the countries (developing and developed) in the world, there are positive correlation between taxation and economy recovery, as it is a necessity for government to utilize resources (tax), raising revenue:e.g. "Estimates of the Cost of Crime in Australia – 2005", "Costs of Crime and Justice" (Criminal Justice Commission), Queensland police Service, Brisbane. imf. org The International Monetary Fund," (retrieved 2002-11-13) IMF estimates that middle and high income countries lose 3 %– $1 trillion, and six percent loss lower-income countries GDP every year tax evasion. While high-income countries see widespread advanced evasion and corporate profit shifting, more low-level income underreport for those in the informal sector and small-scale self-employed is found in poor countries.

But of course enforcement as sole mechanism never results in long-term compliance, we all know that. The evidence from countries like Rwanda, Estonia and Chile show that taxpayers' education, digitalization of tax administration and simplification of process bring about a massive improvement on compliance.

Statement of the problem

Although many reforms on tax policy and administration have been undertaken, the issue of tax evasion still stands as an insidious problem in Nepal. The difference between potential and actual tax revenues represents a large volume of non-compliance and evasion. Current tax schemes are usually much work in those areas of enforcement and punishment and little on structural fragility, administrative ineffectiveness, or behavior that is to make a difference as for the taxpayer's willingness cohesive. (Asian Development Bank, 2003; Sharma, 2018).

Furthermore, cash is king in a region where the informal economy remains strong, which makes it hard for tax officials to trace earnings and ensure that everybody stays onside. Political meddling, graft and poor coordination among government agencies further undermine enforcement. The consequence is that honest tax payers are over-taxed, and evators escape scot free.

This study seeks to address the following research questions:

 i. What are the major economic, administrative, and behavioral factors contributing to tax evasion in Nepal?

 ii. What mechanisms has the Government of Nepal adopted to control tax evasion?

 iii. How effective are these mechanisms in improving tax compliance and revenue collection?

Research Objective

This research focuses on the nature, causes and control of tax evasion in Nepal. The specific objectives are:

i. To find out the principal forms and techniques of tax evasion in Nepal with special reference to direct and indirect taxes.

ii. To analyze the most important determinants-economic, administrative and behavioral-that determine tax evasion.

iii. To assess the current governmental control measures and their efficacy.

iv. To compare the experience of Nepal with that of other low-income countries and its faced-off challenges.

v. To suggest practical measures to minimize tax evasion and increase of compliance in Nepal.

Methodology

Methodologies Descriptive and Analytical research design is used in this study to explore tax evasion and its control system in Nepal. This study is predominantly dependent on secondary data sourced from trusted agencies such as publications of IRD, MoF, CBS, Office of the Auditor General and other relevant academic journals/books and policy reports.

The data covers trends of tax revenue, structure of taxes, compliance drives and administrative reforms. Although qualitative analyses are relied upon to understand policy, institutional and behavioural dimensions of tax compliance issues, they complement quantitative data on trends in revenue and readiness to comply. The paper uses content analysis, trend analysis and comparative review to find significant results. (Inland Revenue Department, 2023; Ministry of Finance, 2024).

Research Design

Analytic/Descriptive The research design used in this study. It offers a fairly broad understanding of the issue using both qualitative and quantitative methods. Evaluation is primary (effectiveness of options available in force and possible improvements) as well as description (what kind and extent evasion has).

Data Sources

Two types of data sources are used:

Data original: The data were obtained through semi-structured interviews with tax official, accountant and Small Medium Enterprises (SME) owner.

Secondary data: Derived from the published documents of Ministry of Finance, Inland Revenue Department (IRD) Nepal Rastra Bank (NRB), Asian Development Bank (ADB) and International Monetary Fund (IMF) as well as related academic Journals.

Data Collection Techniques

Key informant interviews were done with stakeholders in Pokhara, Lalitpur and Kathmandu for primary data collection. Through purposive sampling, a sample which represents tax administrators, business and industry as well key financial experts was chosen to gain a range of views.

The secondary information was gathered from various sources, which included reports of economic survey and budget speeches; IRD annual report data and tax compliance & enforcement literature. (Asian Development Bank, 2023; Central Bureau of Statistics, 2023).

Data Analysis plan

We use those same series, from the data in the tax revenue statistics and evasion estimates, to run a descriptive analysis with them (simple averages) or used qualitative comparisons of two values when they belong to different periods (some calculated as percentages, others as ratios). In qualitative interview data, thematic analysis has been applied to examine emergent themes, perceptions and recommendations.

Scope and Limitations

Based on case studies in the largest cities and small towns of Nepal, the paper asks about tax evasion in general throughout the land.

The analysis is specific to Nepal, but the same can be applied to other developing countries as well. There are a few limitations to keep in mind; the fact that interviews provide self-reported data introduces bias, and it is hard to get an accurate number regarding the loss of revenue through evasion since you can't see it.

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Conceptual Framework

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This study is theoretically based and empirically supported by available literature on tax evasion in developing countries specifically South Asia. It posits that FLET in Nepal is not a unilateral phenomenon, but rather the end product of economic situation, administrative strength and tax-payer attitude. The combination of these determinants affects the extent to which tax compliance occurs and government policies are a mitigating factor. (Ahmed & Rider, 2019; Kemal, 2014).

Figure 1

Conceptual Framework of Tax Evasion and Its Control in Nepal
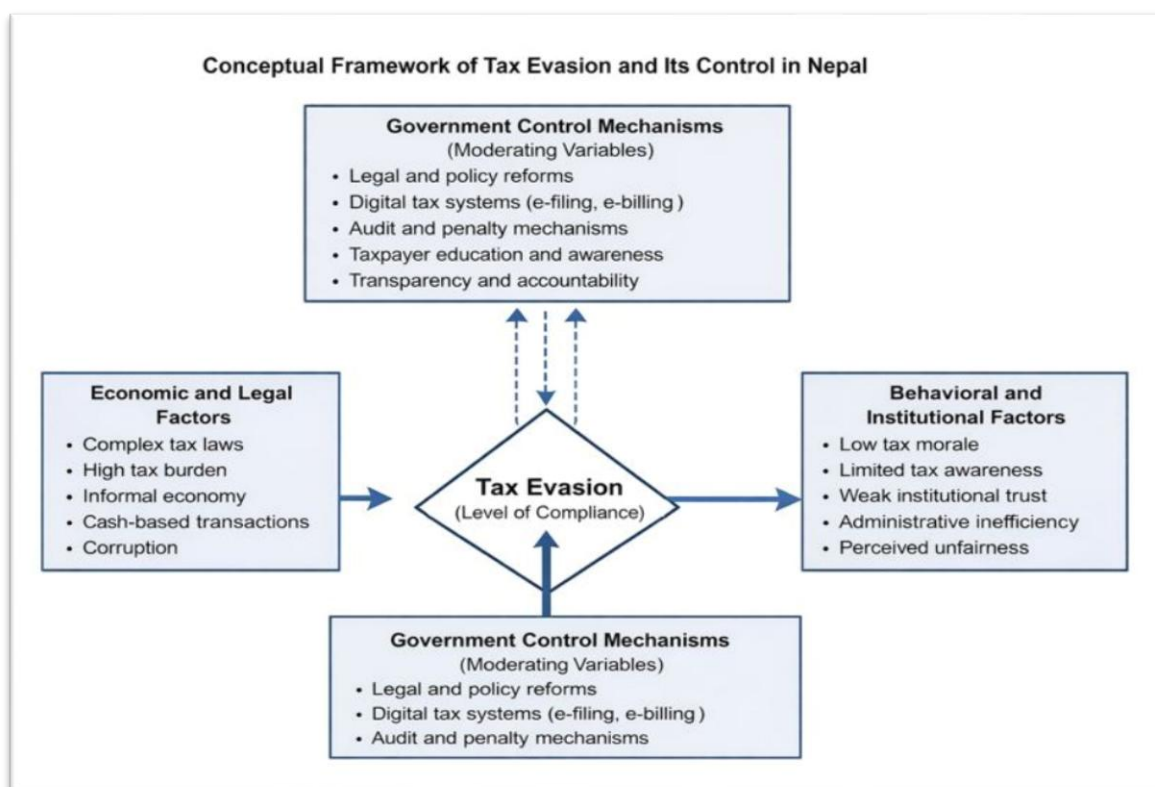
Source: Author

Definition of Variables Used in the Conceptual Framework

Economic & Legal factors:

- Complex Tax Laws: Complex tax laws are the sum of overly convoluted tax rules and processes that make it hard for taxpayers to understand which contribute to increasing unintentional errors and in most cases obliges willful tax noncompliance.

- High Tax Burden: High tax burden leads to higher tax rates and compliance costs which in turn compel taxpayers to hide their income so as not to pay taxes.

- Informal Economy:The grey economy refers to economic activities which are outside the jurisdiction of government regulation and taxation, so these electronic transactions escape tax as well.

- Cash-Based Transactions: Paperless economy transactions will be those exchange of goods and services where records or evidence cannot be maintained in physical form so it is likely to generate more black money.

- Corruption: Corruption is the abuse of public office either by tax officials or taxpayers that undermines enforcement and motivates noncompliance.

- Behavioral and Institutional Factors

- Low Tax Morale: Tax morale is low, meaning there is little sense of a moral obligation to pay tax honestly.

- Limited Tax Awareness: Tax awareness limitation is the insufficient awareness about tax laws, processes and responsibilities among taxpayers.

- Weak Institutional Trust: Low institutionalized trust means that the taxpayers do not trust state institutions and don't think that the money is spent in an efficient way.

- Administrative Inefficiency: Administrative inefficiency includes delay, blockages and lack of capability in tax administration resulting in ineffective operation.

- Perceived Unfairness: Perception of unfairness comes in when taxpayers feel that the tax system is not fair or biased, which can sap voluntary compliance.

Dependent Variable:

- Tax Evasion (Level of Compliance): Tax evasion is the act of illegally escaping the imposition of taxation which violates tax laws, and low compliance.

Moderating Variable (Government Control Mechanisms):

- Legal and Policy Reforms: Institutional and policy changes involve tax law and regulation reforms designed to simplify administration, improve compliance.

- Digital Tax Systems (E-filing, E-billing): Digital taxation systems are technology driven methods of recording the transactions, minimizing the human element and bringing more transparency in the tax administration.

- Audit and Penalty Mechanisms: Audit/penalty institutions are devices to reduce tax evasion via inspection, investigation, and punishment.

- Taxpayer Education and Awareness: Educating the taxpayer Taxpayer education programmes also aim to raise levels of tax awareness and voluntary compliance.

- Transparency and Accountability: Transparency and accountability result in an open tax administration system by these means created and provide for the responsible utilization of public monies, thus fostering trust from taxpayers.

Results and Discussion

By 20% (IRD, 2023; MoF, 2024). But it's still less than ADB's projected potential. One could guess that if rampant tax avoidance, evasion and underreporting were substantially reduced, Nepal's RIR should have ranged between 25-28% as predicted by ADB.

Tax evasion is believed to cost at least 400–500 billion NPR per year, or about 6-8% of GDP, reports IRD. Particularly common is VAT evasion. Let F.Y. 2022/23 pull a similar rabbit out of a hat plinth. Contributions from VAT amounted to 27% of the total tax

revenues, however there had been an assumed compliance gap in respect of VAT which was approximately 30%' implying that the difference between potential and actual collected amount was still significant.

Table 1

Estimated Revenue Loss from Tax Evasion in Nepal (FY 2022/23)

Tax Type	Estimated Potential Revenue (NPR billion)	Actual Revenue Collected (NPR billion)	Estimated Evasion Loss (%)
VAT	350	245	30%
Income Tax (Corporate & Individual)	280	210	25%
Excise Duty	150	120	20%
Customs Duty	180	150	17%
Total	**960**	**725**	**24%**

Source: Author's calculations based on IRD and MoF 2023 data.

Table 1 contrasts potential and actual tax revenue estimates which shows a very large tax evasion in Nepal. Given the expectation rate, NPR 725 billion was received against estimated potential of NPR 960 billion with evasion loss of about twenty four percent. Among other tax heads, value added tax is showing maximum evasion in 30% followed by income tax at 25%, where authorities collected NPRs 245 billion against a prospective amount of NPRs 350 billion and NPRs 210 billion out of the potential revenue generation of NPRs 280 respectively. The least evasion loss is showed in customs duty with 17 per cent, as it could recover NPR 150 billion from the potential NPR 180 billion; while excise duty has a relatively better compliance ratio of 20 per cent (NPR130 billion out of NPR150 billion). In short, the table suggests that in terms of revenue leakage, VAT and income tax are relatively the main culprits, indicating need for focused towards effective tax administration and compliance efforts in Nepal.

Discussion

To this should be added banknotes printings. There are financial motives for evasion, Other institutional deficiencies and reduced social trust in Nepal-all contribute to ongoing tax evasion. The other two counter attitude measures are the exposure of community benefits, transparency of tax dollars and services that are responsive to taxpayers.

The infrastructure around systems enabling technologies such as e-filing, e- invoicing and data interfacing with customs is nudging behavior with a mind-set shift in tax payers and training of tax officers.

The formal tax base increased due to Nepal's tax reforms in the recent years but unless we bridge this compliance gap, the country will have meager opportunities for expanding revenues. (Rather, as is clear from international experience, administrative reform and the empowerment of civil society are necessary for the long-term success of reforms.)

Conclusion

Tax evasion in Nepal is not about few numbers but rather complicated, involving mistrust on government, institutional capacity and larger economy. There have been significant headway in broadening the tax base and adoption of systems like PANs, electronic filing, partial e-invoicing etc but there is lot remaining at compliance end. Revenue loss from leakage amounts to 6-8% of GDP a year, which makes it that much harder for the government to finance vital public services and build infrastructure.

Ineffective administration, informality being power, unwillingness to pay taxes and minimum intrusion by the politicians have been identified as some of the reasons for persistence of tax evasion. There are measurable gains to be made in tech-enabled compliance (at least for most), straight answer taxes, clear public spending — like we have seen in Rwanda, Georgia and Chile.

What Nepal requires is a two-modal strategy: one aimed at improving administrative enforcement using modern technology and risk-based audits, and the other to increase taxpayers' trust by developing open government principles and engaging with clients in an expeditious manner. If "it" isn't both a behavioral and a technical problem, well, small changes probably aren't going to yield large results.

Implications

These findings are of significant implications for the Nepalese policymakers, tax administrators, taxpayers and future researchers.

Policy Implications

The research indicates that tax validation behavior of Nepalese people cannot be effectively managed by enforcement measures alone. Policymakers should work to simplify the tax code and reduce complexity that adds unnecessary burdens. Law reforms should have as their objective a just, open and certain tax system which the taxpayer is encouraged to comply with voluntarily rather than through intimidation.

Administrative Implications

For tax policy, the results underscore the importance of building institutional capacity within the Inland Revenue Department. The effectiveness of enforcement could be improved by more efficient digital tax systems, higher audit quality and less political interference. Efficient and accountable administration are essential to win the confidence of taxpayers and eliminate opportunities for corruption.

Implications for Taxpayer Awareness

The paper highlights the effectiveness of taxpayer education and information facilities. Greater tax literacy can help taxpayers to know what their entitlements and obligations are, limiting unintentional non-compliance. Sensitisations can also provide an environment of trust and citizenship behaviour towar ds tax payee.

Economic Implications

By looking the other way when citizens cheat on their taxes, governments stand to collect a great deal more revenue that can be spent instead on public services—education, health care, infrastructure etc. Enhanced tax compliance also fosters a level playing field, facilitates the formalisation of business and contributes to sustainable economic growth in Nepal.

Implications for Federal Governance

In Nepal's federal structure, successful control of tax evasion may increase the fiscal space for provinces and local units. Effective own-source revenue results in better service at local level and also separates a district from reliance on central government's finance transfer.

Implications for Future Research

The paper offers analytic and theoretical foundation for empirical work in this area. This research can be developed further by collecting the primary data, industry wise study and comparative analysis among provinces of tax compliance behavior in Nepal.

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