Personal Income Tax Compliance Behaviour in Kathmandu Valley

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Abstract

This article aimed to explore whether factors such as tax awareness and knowledge, the perceived fairness of the tax system, its complexity, tax rates, and income levels influence the compliance behavior of registered personal income taxpayers in the Kathmandu Valley. A theoretical framework was employed to test hypotheses based on responses gathered from a survey of these taxpayers. Data collection was carried out using a purposive judgmental sampling method, and questionnaires were distributed as part of a descriptive and analytical research design.

The collected data were analyzed using least squares regression and SPSS 26.0. The results indicated that personal income tax compliance, the dependent variable, was significantly and positively influenced by five key factors: tax awareness and knowledge, fairness of the tax system, complexity of the tax system, tax rates, and income level. The findings also revealed that taxpayers often lack sufficient technical knowledge and perceive the tax system as overly complex. These factors—along with tax awareness, fairness, complexity, tax rates, and income level—are thought to contribute to taxpayer non-compliance.

To enhance tax compliance, the study recommends that the government should focus on improving public services, increasing awareness about the benefits of paying taxes, and educating the public on compliance measures. Additionally, conducting regular audits can act as a deterrent to non-compliance. Future research could investigate the impact of social and referral groups on compliance behavior, as social norms and ethical values may offer further incentives for tax compliance.

Keywords: *Tax Awareness and Knowledge, Fairness of the Tax System, Complexity of the Tax System, Tax Rates, Income Level, Tax Compliance*

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Introduction

Taxpayers' ethical values play a crucial role in shaping their compliance decisions. Individuals with stronger ethical beliefs tend to exhibit more favorable attitudes toward tax compliance, as they view it as a responsibility or obligation that must be respected. Ethical beliefs are therefore key factors in improving compliance, particularly among individuals in the informal sector. When taxpayers perceive tax evasion as unethical, compliance levels tend to increase (Ameyaw, B., Oppeng, A., et al., 2016). Noncompliance with income tax laws is a longstanding issue, with even Plato commenting on this phenomenon over 2,500 years ago (Tanzi & Shome, 1990). Despite its long history, the issue of tax compliance gained minimal attention until the last few decades (Richardson & Sawyer, 2001).

Tax compliance refers to the fulfillment of ethical obligations and the observance of tax laws. Roth, Scholz, and Witte (1989) define compliance as taxpayers filing all necessary documents and tax returns on time, accurately reporting their tax liability according to the Revenue Code, regulations, and court rulings in effect at the time. Similarly, James and Alley (2002) describe tax compliance as the willingness of individuals to follow the spirit and letter of tax laws without the need for enforcement actions. In this study, tax compliance is defined as the timely and accurate filing of all necessary tax returns, with the tax due properly reported under the relevant tax regulations at the time of filing. Among various definitions, Roth et al.'s (1989) concept of tax compliance is preferred (Saad, 2011).

Papp and Takáts (2008) also concluded in their study that lower tax rates tend to increase tax compliance. Saad (2011) further suggests that a taxpayer's knowledge and the complexity of tax laws influence their perception of compliance. Moreover, taxpayers' positive views on the fairness of the tax system contribute to their favorable attitudes toward compliance.

The government of Nepal has implemented various measures to increase voluntary compliance with income tax laws among personal taxpayers. These measures can be categorized into requirements and deterrents. The requirements assign certain enforcement powers to the Inland Revenue Department, while penalties are imposed as deterrents for non-compliance.

There remains a significant gap between the income tax that should theoretically be collected from those engaged in economic activity in the Kathmandu Valley and the actual amount collected. Non-compliance among taxpayers and potential taxpayers is one of the primary contributors to this tax gap. Factors such as income level, occupation, age, gender, tax literacy, perceived fairness of the tax system, peer pressure, tax evasion, tax avoidance, tax complexity, the likelihood of detection and penalties, and tax rates have all been linked to non-compliance.

Based on these findings, the research hypotheses for this study propose that tax awareness and knowledge, tax fairness, tax complexity, tax rates, and income levels have a significant impact on tax compliance behavior.

Theoretical Review of Tax Compliance

Lawan and Salisu (2017) proposed an expansion of the taxpayer compliance model by introducing an additional sensitive factor: Emotional Intelligence (EI). This inclusion aims to shed more light on how EI influences taxpayers' compliance decisions, emphasizing certain inherent traits found in individual taxpayers. They suggested an extension of the Fischer model, which would theoretically make a positive contribution to the tax compliance literature. Several theoretical concepts provide a strong foundation for understanding tax compliance, and they are as follows:

i) Classical theory of tax compliance

The A-S model of tax compliance, grounded in deterrence theory, posits that taxpayers seek to maximize the potential gains from tax evasion while balancing the risks involved. This includes the prospect of being caught and penalized by tax authorities (Sandmo, 2005). Alabede et al. (2011) found that deterrence theory primarily relies on tax audits and penalties as enforcement tools. They emphasized that this theory motivates taxpayers to comply with tax laws mainly out of fear of punishment and sanctions.

Trivedi, Shehata, and Mestelman (2005) suggested that deterrence theory frames taxpayers as making strategic decisions, weighing the economic consequences of various compliance alternatives. Verboon and Dijke (2007) further noted that the core of the deterrence model is the interaction between the likelihood of detection and the severity of penalties, both of which are intended to influence non-compliance.

Brook (2001) pointed out that while classical deterrence theory focuses on economic analysis, social and psychological factors are also critical in understanding non-compliance. Several key studies, such as those by Torgler (2002), Hasseldine and Hite (2003), and Kirchler (2007), have examined the effectiveness of deterrence in promoting tax compliance. Elffers (1999) and Braithwaite (2003) argued that deterrence is most effective when rational individuals perceive the risks to outweigh the rewards. In societies where the deterrent effect is low, compliance tends to be weaker.

ii) Theory of planned Behaviour

The theory of planned behavior suggests that individuals' actions within society are influenced by specific factors, stemming from certain reasons, and occurring in a deliberate, planned manner (Erten, 2002). Benk et al. (2011)

argue that an individual’s ability to perform a specific behavior depends on having a clear intention toward that behavior. The key factors shaping this intention include attitudes toward the behavior, subjective norms, and perceived behavioral control (Armitage & Conner, 2001). According to Ajzen (2002), these factors are influenced by behavioral beliefs, normative beliefs, and control beliefs.

Wenzel (2004a) and Braithwaite (2003) emphasized the importance of sociological and psychological factors in achieving high levels of tax compliance. In their analyses, concepts such as trust in authorities (Murphy, 2004), perceived fairness of the tax system (Wenzel, 2004), and moral considerations regarding societal norms (Frey, 2003; Wenzel, 2004b) are critical for gaining a deeper understanding of tax compliance behavior.

Empirical Review

Musgrave and Musgrave (1989) suggested that compliance behavior is influenced by factors such as the choice of appropriate technology, administrative procedures, auditing and enforcement, legal rules (penalties and the likelihood of being caught), tax structures, and administrative systems. They also emphasized that tax compliance costs should significantly exceed administrative costs.

Richardson & Sawyer (2001) highlighted both positive and negative relationships between fourteen compliance variables and personal income tax compliance behavior.

Wu and Teng (2005) concluded that the determinants of tax compliance can be divided into two categories. The first includes factors that influence the anticipated benefits and costs of tax compliance, such as marginal tax rates, inflation rates, and per capita GDP. The second category encompasses proxies for evaluating government performance, including government spending efficiency, corruption levels, and timely payments.

Ikade and Yahaya (2008) found that good governance, tax equity, and fairness have significant positive relationships with taxpayer compliance levels.

David (2010) noted that the first successful state income tax was introduced in Wisconsin in 1911, featuring improved administrative techniques that enabled more equitable tax collection. It was assumed that taxes on personal income were used solely by the government, with a fixed, proportional tax rate applied to income without any exemptions or deductions.

Alabede (2012) demonstrated a strong correlation between perceived tax service quality and tax compliance behavior. In Nigeria, public government effectiveness strongly influences compliance behavior, and the cultural diversity across regions significantly affects taxpayer behavior. Regression analysis revealed that taxpayers' financial situations also play a significant role in shaping the relationship between tax compliance behavior and its determinants.

Maxime (2012) explored the foundations of modern American public finance by examining Buchanan's claim of a positive approach in contrast to Musgrave’s normative approach to public goods. The research concluded that it is difficult to separate the positive from the normative in their theories and noted that in democratic societies, state action is shaped by collective deliberation and choice.

Sharma and Duwadi (2013) identified major compliance issues in Nepal, such as low registration rates, low return filings, under-invoicing, tax fraud, and many cases pending in the Revenue Tribunal. They suggested initiatives for improving compliance, including tax system reforms, strategic planning, organization restructuring, taxpayer segmentation studies, and enhanced enforcement strategies.

Waso (2014) found that online tax systems impact compliance levels among small taxpayers in East Nairobi, particularly in registration, filing, and payment processes.

Lawan and Salisu (2017) concluded that emotional intelligence is a new determinant influencing tax compliance and proposed an extension of the Fischer model to include emotional intelligence in tax compliance literature.

Shukor (2020) determined that there is a relationship between the effectiveness of public governance, tax compliance behavior, tax ethics, and education. However, there was no significant link between future tax costs and compliance behavior.

Kehelwalatenna and Seyza (2020) found a positive relationship between moderating variables and independent variables in increasing tax compliance behavior. They also emphasized the importance of strengthening tax

awareness programs to enhance the positive impact of tax rates, fines, and penalties on taxpayer compliance.
Alam (2020) concluded that institutional, individual, and other non-economic determinants positively impact tax compliance behavior, while socio-psychological and economic drivers have a negative impact. The study also noted a moderate effect of individual drivers and a substantial positive link between tax compliance and institutional, socio-psychological, economic, and other non-economic factors.
Tiwari (2021) found a positive relationship between tax awareness, attitudes toward tax, peer influence, and government incentives with tax compliance. The study revealed that taxpayers' awareness and perceptions significantly affect the compliance behavior of rental taxpayers in Pokhara, where non-compliance persists due to the low cost of non-compliance.

Research Framework:

Philosophically, this study adopts both realist and nominalist worldviews. A realist perspective posits that universal truths exist as real, tangible, and measurable entities, independent of our perception. In practical terms, income tax policy can be effectively implemented if it is clear, unambiguous, consistent, and coherent. As the administrative capacity and skills of the tax authorities improve, the proper execution of income tax policies becomes more achievable.
The researcher employed models from Jackson and Milliron (1986) to conduct this study, recognizing that the factors examined are interconnected. These variables can be categorized into dependent and independent variables, which are used to analyze their relationships and impacts on tax compliance behavior.
TC= f (TK + FTS + CTS + TR + LI)

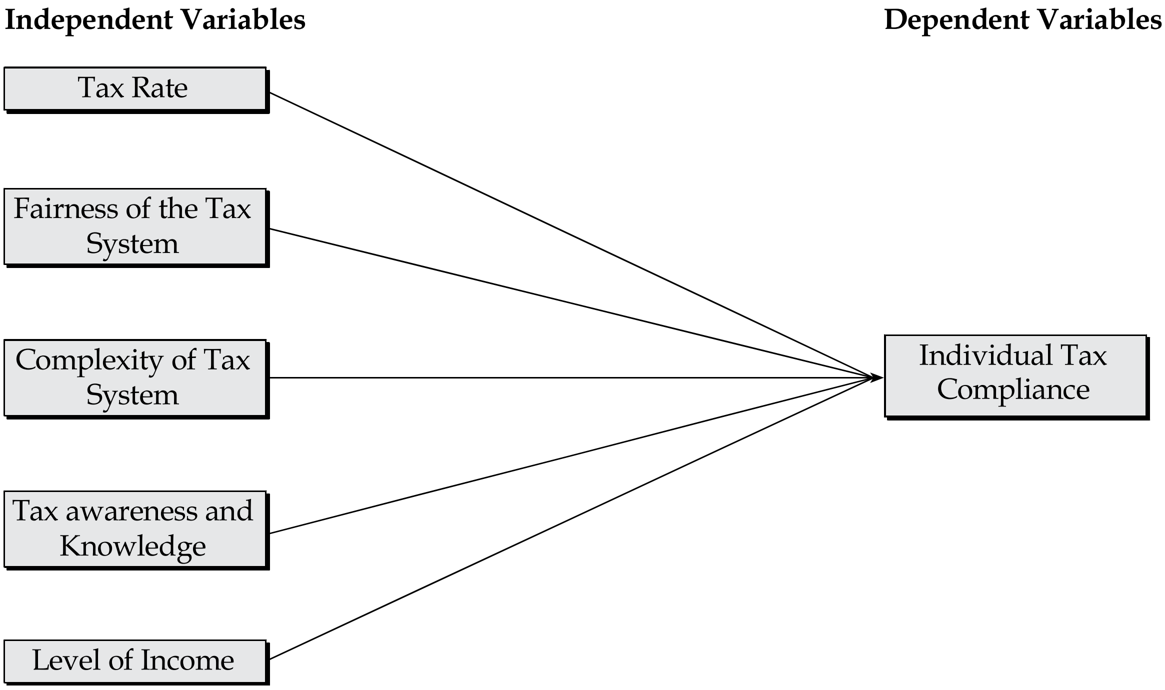

Figure : Conceptual Framework

Source: Researcher's Design (2023)

Data and Research Method:

Researchers might choose from the quantitative, qualitative, or mixed methods research approaches when designing their study methodology (Creswell, 2003). The ontological and epistemological perspectives of the researcher typically have an impact on the inquiry paradigm that is used in their research. These convictions reflect the researcher's worldview and attempts to comprehend it. Positivism and constructivism are the two ideologies that are most at odds with one another. As a result, constructivist researchers typically use qualitative techniques, while positivist researchers typically use quantitative techniques. The alternative paradigm is a mixed-method approach that combines constructivism and positivism (McKerchar, 2010).

Positivism is an approach that views the world through the lens of objective realism, suggesting that knowledge is generated through deductive reasoning, where a precise and systematic process is followed. Positivists prefer to collect quantitative data using objective research methods, such as structured interviews, experiments, and closed-ended questionnaires. These methods allow researchers to identify and measure behavioral patterns, leading to the creation of social facts that govern society. As a result, positivist researchers typically employ quantitative methods like surveys and experiments in their research design.

Regression analysis, a set of statistical procedures, is used to examine the impact of independent variables on dependent variables. This study utilizes a multivariate regression analysis approach. The primary model used in the research is as follows:

$$PITCB = \alpha + \beta 1TAK + \beta 2FTS + \beta 3CTS + \beta 4TR + \beta 5LI + E \text{......................} (1)$$

Where PTC = Personal Income Tax Compliance Behaviour, TAK = Tax Awareness and Knowledge, FTS = Fairness of Tax System, CTS = Complexity of Tax System, TR = Tax Rates, LI= Level of Income, E = Error Term, $\beta 1$, $\beta 2$, $\beta 3$, $\beta 4$, $\beta 5$ = Coefficients, Prior Expectation = $\beta 1, \beta 2, \beta 3, \beta 4, \beta 5 > 0$

This is the major important chapter of the study. In this chapter, the data related to the study has been tabulated, presented, analyzed and interpreted. The reliability of the study depends upon the data available and sources of data.

Results and Discussion:

In this study, the explanatory variables include income level, tax rates, fairness of the tax system, complexity of the tax system, and tax awareness and knowledge. The dependent variable, tax compliance, is represented by both attitude and intention. It is reasonable to assume that a statistically significant relationship exists between these two sets of variables. The objective of this section is to explore the nature and extent of the relationships between various combinations of these variables. To identify these relationships, regression analysis has been employed.

Regression analysis is a statistical method used to examine whether a significant correlation exists between two or more variables. It offers a range of techniques for modeling and analyzing relationships between a dependent variable and one or more independent variables. This section focuses on understanding the degree of interconnectedness between the variables in the study. The model summary table provides insight into the strength of the correlation between the independent variables and the dependent variable. The multiple correlation coefficient, or R, reflects the linear relationship between the observed and predicted values of the dependent variable, with a higher R value indicating a stronger connection.

Table 1

Model Summary of Dependent Variables and Independent Variables

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.885a	.783	.780	.21594	1.865

a. Predictors: (Constant), Income Level, Tax Rate, Tax Awareness and Knowledge, Complexity of Tax System, Fairness of Tax System

b. Dependent Variable: Tax Compliance

Source: Field Survey Results, 2023

The values of R and R^2, as shown in Table 1, illustrate the influence of the independent variables on tax compliance. The simple correlation R-value is 0.885, indicating a significant relationship between the variables. The adjusted R^2 for the regression model is 0.783, meaning that 78.3% of the variation in tax compliance is explained by the regression equation, which includes five explanatory variables. The remaining variation can be attributed to other external factors not included in the model. Additionally, the Durbin-Watson test result for the dependent variable is 1.865, suggesting a positive autocorrelation within the model.

Table 2

ANOVA Analysis

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	63.586	5	12.717	272.716	.000b
	Residual	17.627	378	.047		
	Total	81.213	383			

a. Dependent Variable: Tax Compliance

b. Predictors: (Constant), Income Level, Tax Rate, Tax Awareness and Knowledge, Complexity of Tax System, Fairness of Tax System

Source: Field Survey Results, 2023

Table 2 presents the ANOVA analysis, which assesses the overall significance of the regression model. The explained sum of squares is 63.586, while the residual sum of squares is 17.627, leading to a total sum of squares of 81.213. The model is deemed significant, as the p-value is 0.00, which is less than the alpha level of 0.05.

Hypotheses Test Results

Based on the calculation of the relationship among the explanatory variables, the summary of the hypotheses test results can be presented as follows:

Table 3

Results of Hypotheses Test

S.No.	Alternative Hypotheses	Tools and Method Used	Accepted/ Rejected
1	States that have tax awareness and knowledge significantly affect tax compliance behaviour.	Correlation	Accepted
2	The tax fairness of tax system has a major impact on tax compliance behaviour.	Correlation	Accepted
3	Tax compliance behaviour is significantly impacted by the complexity of the tax system.	Correlation	Accepted
4	The tax rate has a major impact on tax compliance behaviour.	Correlation	Accepted
5	The level of income has considerable impact on tax compliance behaviour.	Correlation	Accepted
6	Tax awareness and knowledge, tax fairness, tax complexity, tax rates and level of income have a substantial impact on tax compliance behaviour.	Regression	Accepted

Source: Field Survey Results,2023

Table 3 demonstrates that the hypothesis testing results, using correlation and regression analysis, provide empirical evidence that factors such as tax awareness and knowledge, fairness of the tax system, complexity of the tax system, tax rates, and income levels significantly impact tax compliance. All alternative hypotheses proposed by the researcher are supported by these findings.

Discussion

This study provides valuable insights into the tax compliance behavior of individual income taxpayers in Nepal and supports earlier research with evidence specific to Nepal. The primary aim was to explore how various factors affect tax compliance among Nepalese personal income taxpayers.

The literature review identified five key factors influencing tax compliance: tax awareness and knowledge, fairness of the tax system, complexity of the tax system, tax rates, and income level. The study's participants included small- and medium-sized business owners in the Kathmandu Valley, as well as government officials, public enterprise employees, bankers, auditors, academics, and university lecturers.

The research objectives and questions were effectively addressed, with SPSS results providing robust support for the hypotheses tested. The findings align with those of Meaza Wudeneh (2018), Atul Raj Pandey (2020), Mohd Rizal Palil (2010), and Rawlings Peter Osebe (2013), who also found that tax awareness and knowledge, fairness of the tax system, complexity of the tax system, tax rates, and income level significantly affect tax compliance behavior.

The study supports the work of Amankwaah Eric, Abina Solomon, and colleagues (2019), who emphasized the importance of socioeconomic status and tax knowledge in both enforced and voluntary tax compliance. It also aligns with Kanbiro Orkaido Deyganto's (2018) findings, which identified gender, age, tax knowledge, simplicity of the tax system, perceptions of fairness, awareness of penalties, likelihood of being audited, and perceptions of tax rates as significant predictors of tax compliance attitudes.

Furthermore, this research is consistent with T.G. Damayanthi Swarnathilaka Jayawardane and Kelvin Low (2017), who identified tax rates, audit likelihood, simplicity of the tax code, and detection likelihood as primary factors influencing tax compliance in Sri Lanka. It also resonates with Sinnasamy et al. (2015), who concluded that tax rates, penalties, tax equity, and peer pressure influenced tax compliance in Malaysia. Finally, Walsh (2012) proposed five main determinants of tax compliance—deterrence, norms, objectivity, public confidence in tax administration, and tax complexity—which agree with the findings of this study.

Conclusion

This study aims to examine how individual taxpayers' tax awareness and knowledge, as well as factors like the fairness of the tax system, tax complexity, tax rates, and income level, impact their ability to comply with tax laws. The findings reveal that these characteristics—tax awareness and knowledge, fairness and complexity of the tax system, tax rates, and income level—significantly influence taxpayers' compliance behavior.

The results indicate that tax compliance is affected by a range of factors, including taxpayers' characteristics, the tax code, tax administration, and the broader economic and political context. For Nepal to achieve higher levels of voluntary tax compliance, several key issues must be addressed promptly. These include inadequate awareness and knowledge of tax laws among taxpayers, low tax morale, a disconnect between public spending and taxpayer preferences, skepticism about efficient public expenditure, poorly designed tax administration and systems that fail to meet taxpayer expectations, lack of government transparency and accountability, and insufficient tax advocacy and education by government agencies.

The government's current methods of tax collection are inefficient, and voluntary compliance cannot be effectively achieved without comprehensive tax laws, appropriate tools, and active efforts by tax inspectors. Addressing these issues requires regulations that emphasize legitimacy and social engagement.

The findings of this study offer valuable insights for governments aiming to reduce tax evasion and can serve as a benchmark or model for improving tax systems in other developing nations, like Nepal. Ultimately, this research provides clear evidence that factors such as income level, fairness of the tax system, complexity of the tax system, tax rates, and tax awareness and knowledge significantly impact individual tax filing behavior.

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