

CONTRIBUTION OF VAT IN TAX REVENUE IN NEPAL

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LETTER OF RECOMMENDATION

The Thesis entitled **CONTRIBUTION OF VAT IN TAX REVENUE IN NEPAL** has been prepared by **Sudina Subedi** under my supervision in 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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Date: 22/11/2073 B.S.

APPROVAL LETTER

The Thesis entitled **CONTRIBUTION OF VAT IN TAX REVENUE IN NEPAL** by **Sudina Subedi** has been accepted as a partial fulfilment of the requirements for the Degree of Master of Arts in Economics.

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Sudina Subedi

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ABBREVIATIONS/ACRONYMS

CBS	Central Bureau of Statistics
CA	Chartered Accountant
CEDECON	Central Department of Economics
DANIDA	Danish International Development Agency
DG	Director General
EC	European Countries
EU	European Union
FY	Fiscal Year
GDP	Gross Domestic Product
GNP`	Gross National Product
HIID	Heyward Institute for International Development
IMF	International Monetary Fund
IRD	Inland Revenue Department
IRO	Inland Revenue Office
MODVAT	Modified Value Added Tax
MoF	Ministry of Finance
NCC	Nepal Chamber of Commerce
NCCI	Federation of Nepal Chamber of Commerce and Industry
GON	Government of Nepal
NRB	Nepal Rastra Bank
SAARC	South Asian Association for Regional Cooperation
SAFTA	South Asian Free Trade Agreement
T.U.	Tribhuvan University
USAID	United States Agency for International Development
VAT	Value Added Tax
WST	Wholesale Level Sales Tax
WTO	World Trade Organization

CHAPTER I

INTRODUCTION

1.7 Background of the Study

The term 'Value Added Tax (VAT)' can be defined as a tax levied (on the value created) at each stage in the process of production and distribution of a good or service. These stages can be import, manufacturing, dealers, wholesalers and retailers etc. For example, a large paddy collector from the local farmers pays a percentage on the paddy it sells to a miller. The miller then pays the same percentage (less what the paddy collector paid) on the rice (processed paddy) which it then sells to a hotel. The hotel likewise pays the same percentage (less what the paddy collector and miller paid) on the food it serves to its guest. Proponents of a VAT claim it is transparent as each person or company along the supply chain has an incentive to ensure that every other person or company pays the VAT, and thus reducing the likelihood of tax evasion and avoidance. They also argue that it is more straightforward than other taxes (which it replaces) because there are virtually no exemptions or loopholes. It is based on value added principle.

Tax is collected by government to meet the need of budget. Among the various types of tax, the sales tax is one of the major sources. VAT is the most scientific system of sales tax. In the early days, the tax from the consumption and production is collected as sales tax. But now, it is almost completely replaced by the VAT. The concept of VAT was introduced in 1919 by Dr. Wilhelm Von Siemens in Germany. This concept was brought to replace the "Usatzsteuer" (multi stage sales tax) due to its undesirable effects, particularly cascading and vertical integration of the latter tax for the first time (Shah, 2012). The Germany knew the administrative complication of the VAT system. So, it has the fear to implement. Therefore, the rate of unsatzsteuer is reduced instead of the implementation of VAT. In 1921, the America was implementing the corporate income tax. Pro. Thomas S Admass suggested the tax for the United State of America to replace the existing tax system. Until early 50s the development of VAT remained limited only in the theory (MoF, 2015/16).

France was the first implementer of VAT in 1954 covering only in the industrial sector. The VAT was limited to only up to whole level. But these countries limited the VAT only on import and manufacturing stage.

In late 1960s, VAT started to become popular. Countries like Denmark and Brazil adopted this system of tax in 1967. France, the first implementer of VAT, extended it to the retail

level for the first time. And Germany also adopted VAT in the same year. In 1969, the countries like Netherlands and Sweden also adopted VAT in their countries. In 1970, 1971 and 1973, Luxembourg, Belgium and Ireland introduced the VAT respectively.

In Asia, Vietnam was the first country to introduce this most scientific tax system. The country adopted VAT in 1973. The trend being VAT popular was increasing all over the world. In 1977, 1984, 1985, 1986, South Korea, China, Indonesia and Taiwan introduced VAT respectively. Similarly, VAT was introduced by Philippine in 1988, Japan in 1989, Thailand in 1992 and Singapore in 1994 (wikipedia.org/wiki/Value-added_tax).

In SAARC region, Pakistan was the first adaptor of VAT. It implemented VAT in 1990. India introduced VAT first as modified value added tax (MOD VAT) in 1996. But actually in India, VAT replaced sales tax on 4 January 2005. Though some state did not opt for VAT (for political reasons), majority of the state embraced VAT, states like Andhra Pradesh and Maharashtra taking the lead. The Empowered Committee, constituted by Government of India, provided the basic framework for uniform VAT laws in the states but due to the federal nature of Indian constitution, States do have a liberty to set their own valuations for the VAT levied in their own territory. (Khadka, 1989).

Nepalese ancient tax system was based on Vedas, Smritis and Purans. Directives propounded by Yagyabalka, Chanakya were main sources of taxation system. In Nepal, Value Added Tax Act was enacted by 1995 and started to implement only at 16 November, 1997. Value Added Tax Act repealed four different Tax Act such as Sales Tax Act, Hotel Tax Act, Contract Tax Act and Entertainment Tax Act. VAT replaces the old Sales Tax, Contract Tax, Hotel Tax and Entertainment Tax. It is believe that successful implementation of VAT will helps to generate customs duties and income tax also and it is expected to enhance the revenue collection and it is closely associated with the GDP. This Act classifies good and services under three category they are Vat able goods and services, exempted goods and services and zero rated goods and services. It is applied at a single rate (presently 13%, initially 10%) based on addition of value of the goods and services at each stage in the process of supply and delivery of goods and services.

Since then second amendment have already been made on Value Added Tax Act, 1995, and 8th amendment have been made in the Value Added Tax Rules, 1997. Various directives have been issued by the concerned authority to implement the VAT in Nepal.

1.8 Statement of the Problem

Nepal is an underdeveloped country facing development challenges to promote the living standard of its citizens who are living below the poverty line. Though, Nepal has kept high priority from its Eighth Five Year Plan, 25.2 percent people are still below the poverty line. Under such condition, Nepal is facing a serious problem of resource gap. Hence, it has to depend on foreign grants and loans. Such dependency may solve the present financial crisis of the country but it may leave unexpected problems in future. High inflation rate, unemployment rate, high corruption in the financial sector, political instability, unjustified and unmanaged agricultural sector are the few examples that have been deteriorating the growth of economy. Thus, revenue mobilization is great challenge for the sustainable development of the national economy.

The economic growth of Nepal is very slow. It has not been in the direction of sustainable development with revenue generated from its internal sources. So, government should concentrate on increasing public revenue. Since, taxation in the modern world has been taken as the most effective tool to raise the public revenue, proper taxation policy has to be implemented by the country in order to increase the capital formation and achieving the high rate of economic growth. VAT should be the most essential choice for the most developing countries as an ingredient of their tax reforms because it is the most improved form of sales tax and revenue enhancement and economic efficiency. The policy and strategy can be made with a thorough analytical study of various financial data from the past to the present.

Some key questions are as follows:

-) What is the trend and contribution of VAT to the Tax Revenue in Nepal?
-) Are existing policies of VAT effective to meet the target of revenue collection?
-) What are the major problems and prospects of VAT in Nepal?

1.9 Objectives of the Study

The general objective of this study is to analyze the contribution of VAT to the tax revenue collection in Nepal. However, the specific objectives of this study are as follows:

-) To examine the trend and analyze the contribution of VAT to the Tax Revenue in Nepal.
-) To assess policies related to VAT to meet the target of revenue collection.

-) To identify the major problems and prospects of VAT in Nepal.

1.10 **Significance of the Study**

Developed countries implemented VAT and its possible components after the discussion and analysis of many years at the top level. There are a lot of researches done on VAT in developed countries as well as developing countries which has accepted VAT as a major tool of their fiscal policy. Every country has implemented VAT as per the need and feasibility of its own economy. The researcher could not afford implementing VAT just as a copy-way that other countries had implemented earlier.

This study discusses a lot about the contribution of VAT in total revenue; assess the policies of VAT and existing problems of VAT in Nepal. The nation's economy has not been better despite lots of efforts in it. Still our economy is heavily relied on the foreign grants and loans. There exists a very acute resource gap in Nepal which is not a good sign in the growth of national economy. This implies that the question of resource mobilization is a challenging task for the country and its effectiveness relies on the other financial tool that may enhance it. In this context, VAT may be an instrument for mobilizing internal resources more effectively.

-) This study is significant for the VAT policy makers for reformation of the tax system.
-) It is important for researchers, readers and businessman to know conceptual framework of VAT as it provides idea and knowledge about VAT through illustrative data and figures by highlighting the contribution of VAT on the tax revenue of Nepal.
-) It encourages civil society and political parties to work for the successful implementation of the VAT.

1.11 **Limitations of the Study**

The following are the main limitations of the study.

-) VAT was implemented in Nepal from 1997. But this study due to lack of time and monetary constraints, only includes the data from FY 2001/2002 to FY 2013/14.
-) This study is based on the published secondary data and information and no attempts have made to examine the reliability and authenticity of the data.

1.12 **Organization of the Study**

This study has been divided into six chapters.

Chapter I: Introduction

This chapter includes background of the study, statement of the problem, objectives of the study, significance of the study, limitations of the study and organization of the study.

Chapter II: Literature Review

This chapter includes relevant literature from review of some books, papers, articles and thesis related to the subject matter of the study.

Chapter III: Research Methodology

This chapter covers the detail framework of the study such as research design, nature and sources of data, data collection procedures, data processing procedures, variables used in the analysis

Chapter IV: Theoretical Background of VAT

This chapter contains evolution of VAT, types of VAT, methods of computation of VAT, structure of VAT and operation of VAT.

Chapter V: Data Presentation and Analysis

This chapter comprises data presentation and analysis of data. Secondary data collected from various sources have been presented in tables and diagrams. The data have been analyzed by using different mathematical tools.

Chapter VI: Summary, Conclusion and Recommendations

This chapter is the last chapter, which is concerned with the output of the study in the form of summary, findings and recommendations.

At the end of the study, references and appendices have also been incorporated.

CHAPTER II

REVIEW OF LITERATURE

Value Added Tax (VAT) is a broad-based tax as it covers the value added to each commodity by a firm during all stages of production and distribution. It is a modern tax system to improve the collection of taxes, to increase efficiency and to lessen tax evasion. It replaces the old Sales Tax, Contract Tax, Hotel Tax and Entertainment Tax. It is considered as one of the most powerful tools of the fiscal. From the long experience of VAT in several countries, many economists and policy makers have agreed on as VAT is probably the best in indirect tax. It is outstanding that it gained such a remarkable popularity in such a short span of time. It is also regarded as the backbone of income tax system in Nepal.

2.1 Review at International Level

Tax reform to strengthen the country's fiscal system has become one of the seriously raised concerns in many developing countries in this modern time. The adaptation of VAT in a country's tax system is the outcome of an attempt to reform the existing tax system in almost all developing countries since 1960's. W.V. Siemens first recommended VAT in 1919 for Germany to replace the 'Multi-stage Sales Tax' in order to avoid the undesirable effects, particularly cascading the vertical integrating, for the later Tax. Despite of serious consideration by the German Government, it was decided to reduce the rate of 'Multi-stage Sales Tax' instead of applying VAT. The concept of VAT developed further in 1945 by a tax mission to Japan. This mission recommended the Fuka-Kachi-Zehi (VAT) for Japan in order to avoid the undesirable and unintended effects on the Japanese enterprise and turnover taxes in place at that time. Various studies are done on VAT throughout the world and their findings are found on various books, research papers, seminar papers, and reports of the international institution, issues of the journal and article and so forth. This study has been made to review these literatures.

Lent, Casanegra and Gueraeld (1973) have stated that the most important feature of VAT in such countries is its' conceptual basis such as taxable base (value-added), exemption, treatment of small traders etc. Problems of VAT depend on the administrative capacity in the developing countries. Economic and social atmosphere also plays vital role to make comprehensive tax base of VAT. A VAT applied only through the production or wholesale stage does not generate the advantage of non-interference with market process to the same extent as one that covers other all sectors of economy including retailing and services.

Developing countries have limit range of VAT based by excluding the most troublesome sectors (Farmers, entailers etc.) because they have their own difficulties.VAT produces between 10 to 30 percent of government revenue of seven developing countries. The revenue of VAT is expected to increase at faster rate than the rate of growth of the economy. There are fundamental difficulties in VAT operation administration in developing countries. The problem is the treatment of small tax payers which includes large numbers of retailers, service enterprises and farmers. It is not possible to construct a mode of VAT in developing countries on the basis of laws enacted in those countries. Value-adding technique has greater precision in elimination the 'cascading' if there exists the remission of taxes on exports and is less subject to tax evasion.

Singh (1996) has stated that administration of VAT does not require firms to calculate Value Added Tax. VAT is administered by invoice method. He found the merits of VAT as neutral and efficient resource allocation, neutral between different goods and services, neutral between business, neutral between different types of production and distribution. Since neutrality is important and neutrality is produced in goods is possible in VAT system because it does not distort any one of the above.

The author has explained that VAT at single rate with exemption of food stuffs, farmers, housing, finance, health, education, charities, newspaper, books and periodical may be levied in such a way as to make the entire system of taxes, benefit the goods to deal more progressively and the cross audit features of VAT this facility to reduce tax evasion and demerits. VAT may raise price at the time of replacement. Author further stated that VAT being complex tax, individual and small firms so not maintain proper records. Accumulation of inventory is likely to higher smooth tax payment. Regarding the VAT in developing countries, the main requirements to introduce VAT are described as: (a) Ability to administer VAT, determines the feasibility. (b) Small business and compliance are also other problems which should be created very carefully in developing countries while introducing VAT. (c) Successful introduction of VAT depends largely in previous experience of multistage sales tax or general sales tax.

Lekhi (1995) has addressed that VAT as its name implies, is a tax in a value added to a commodity or a service. It means that the value added tax is imposed on the value that business firms add to the goods and services that is purchased from other firms. It also adds value by processing or handling these purchase goods with its own labour force or machinery, building or other firms. However, the value added tax belongs to the family of

sales tax. A value added tax is a tax not on the total value of the commodity being sold, but on the value added to it by the last trader. The trader, therefore, is not liable to pay a tax on gross value but on the net value, i.e. the gross value minus the value of the commodity purchased from the other firms. In this way, value added tax implies a tax, which is paid by all sellers of goods and services.

VAT is supposed to be neutral in the form of production and commercialization. VAT is simpler as compared to other indirect taxes. There is less possibility of evasion of tax in VAT. The VAT encourages the exports of the country. It is easy to investigate the large size of the firms. It is based on the cross check and cross audit. VAT being levied and collected in small fragments at different stages of production and distribution, it is burdensome. It leads to efficiency. It avoids cost-casting effect. It encourages investment. Burden of tax is shared by all factors of production like wages, interest, rent and profit. Thus it encourages productivity.

Musgrave and Musgrave (1976) have suggested that in among three types of VAT i.e. GNP type, Income type and Consume type of VAT is for practical consideration for both efficiency and equity criterion and tax based on consumption similar to the retail sales tax especially for the poor countries. The invoice method for calculation is more preferable and advantageous to the value added approach. They have explained the VAT's problem by stating, 'a sales tax may be imposed in either single or multiple stage form. If latter is implemented in the value added sense, it is equivalent from the economists' point of view to corresponding single stage tax. At each stage, the value of product is increased and these sales price rise accordingly, which is the 'value added'. Although retail-level sales tax (RST) and VAT poses the same tax base, the strong difference between VAT and RST are analyzed as:

1. Under the retail tax the number of taxpayers is less than under VAT.
2. The exclusion of capital goods is more effective in VAT system than under RST.
3. Invoice system under VAT than under RST constitutes self-enforcement features, which the latter one lacks.
4. VAT constitutes problem in such countries, which have authority of tax collection posed by the state level.

Due (1976) has examined VAT by the paper entitled "Value Added Tax in Developing Economies" in the book "Taxation and Development" on the contribution of UN in 1976.

The study has both theoretical and implemented parts in detail as well as in its nature and history. The theoretical and implementation aspects of VAT according to him are as follows:

VAT is regarded as a sales tax to overcome from the demerits of turnover tax; VAT is entitled acceptable for the sales tax in comparison to other of sales taxes. The most important requirements for the successful operation of a VAT are its' universality and simplicity. VAT implies more than one stage in business process, therefore it has distinctive feature of fractional impact without cascading effects. The major criteria recommended for the evaluation of the tax in UDCs, are acceleration of economic growth, optimal use of available resources, an acceptable pattern of income distribution, reasonable price stability, avoidance of foreign domination of the economy and political stability.

The lawyers related to tax jurisdiction should draft the tax law. A computer system is basic need for VAT operation. The same personnel administration of sales tax should be utilized to VAT operation. Registration of the business firms should be operated in great care. Tax returns may be filed at relatively frequent intervals. Inspections should be operated separately by the related careers. Crosschecking is best solution.

2.2 Review at National Level

Khadka (1998) has described the theoretical background and the development of VAT in Nepal. Preparation and status of VAT are also addressed in this book. Since it is the collection of the published papers, the government has already addressed many recommendations provided earlier. Different aspects of VAT have also been analyzed in his book entitled "The Nepalese tax system". In his own words "Tax compliance is very poor in Nepal and different taxes are not being fully paid as per the law. There is an advantage of the situation. There is lack of coordinating approach and long-term strategies. Several tax measures were introduced in 1997/98 without any consideration and their possible effect".

Khadka (2002) has concluded that the number of VAT registrations was 4959 in the first year of VAT implementation against 2045 sales tax registrations, which has increased almost to 27000 by mid November 2002. This indicates that there has been substantial increase in the tax base in terms of number of taxpayers. VAT refund system has also becoming gradually effective. As there was no belief of taxpayers on the refund mechanism, no taxpayers applied for the refund on the first fiscal year of VAT implementation. But after publicity regarding the tax system, the trust of the taxpayers regarding this process gradually increased. Then, they started applying for the refund. The refund amount increased to RS 1710 million FY

2001/02 from RS. 70 million in FY 1998/99 of the total returns, the share of credit, debit and zero returns was 39 percent and 24 percent respectively at the end of the fiscal year 2001/02.

Bista (1999) has suggested that VAT is applicable and feasible in Nepal in order to reduce the resource gap by mobilizing additional resource to meet the estimated revenue collection by broadening the tax bases to control the tax leakage, smuggling, unofficial trade and corruption through transparency account based cross checking, although Nepal has many issues, problems and constraints relating administration, politics, economy and society. If the government operates the VAT administration with effectiveness and efficiency; the effect on VAT in all sectors will be positive and favorable.

Subedi (2004) has stated the following major points in his dissertation:

VAT is superior to any other types of sales tax, while comparing VAT with other form of sales tax such as economic efficiency, supporting economic growth, excess burden, equity norms, simplicity of administration and price stability. Due to lack of experts, skill manpower in the VAT administration on the auditing system which is one of the most important parts is not effective. The prospect of VAT entirely depends on its implementation aspect. VAT has bright prospect in Nepal only when it can be implemented in a successful way further. The successful featuring depends upon the strong, fair, capable, honesty and efficient administration, strong political commitment, cooperation between private and government sector etc.

Silwal (1999) has addressed that VAT is in all stages non-cascading tax system. It extends to all level of production and distribution. Any discrimination in taxing goods or services or exempting any of them renders VAT ineffective. He suggested that factor affecting VAT design also take into consideration. A poorly designed VAT accompanied by weak administration would just drain the treasury, so almost all cases are necessary while designing a VAT. According to him, Tax base issue, Rate structure issues, Exemption issues and Threshold issues were considered while designing a VAT in Nepal. Finally, he reached a conclusion that introduction of VAT provides an opportunity to sweep away to cob-webs and revamp a substantial part of the tax administration. In every country where VAT has been implemented properly, it has proven itself as a revenue productive tax. However, benefit from VAT depends upon its coverage. In an article "Effect of VAT on revenue: a pre and post VAT appraisal" visualizes a scenario of Nepalese economy. In general, he analyses VAT very precisely after its implementation in particular. The performance of VAT in the first 15

months (November 1997-January 1999) is mixed. The first three months of the information was considered to be a grace period. There were only 3000 million of taxpayers on which 2045 were the converted ones from the sales tax. About 400 million worth of stocks of sales tax were carried over from old system.

At present, the total registrations are just over 79000 which only 4 percent contributes to 80 percent of interval VAT collection. Further segregation of internal collection reveals that 20 percent collection is coming from Nepal Telecommunication Corporation, 40 percent from excisable producers, producers like cigarettes, beers and liquor manufacturers and their distributors and only 40 percent from the other traders and industries. Thus, the accumulated credit in the system by the end of the 15 months was around one billion rupees.

Karnikar (1997) has analyzed the possible effects of VAT in Nepalese economy. The main findings of the study report were that it affects adversely in price level. Increase in the price of imported goods and ultimately increase the cost of production, thereby reducing the exports business. Requirement of bookkeeping is complicated. It would finally affect the small traders and would be unjustifiable on social ground. Present administration is incapable for handling VAT. Computerization system is not sufficient and it is new concepts for the tax administration.

The study report suggested for a partial VAT on some commodities. It was in favor of phase wise implementation of VAT. The study analyzes negative impact of VAT neglecting its positive impact.

A study made by Nepal Chamber of Commerce (1997a) has analyzed the possible effects of VAT in Nepalese economy makes some observation.

The observations are:

-) Adverse effects on price level.
-) Increase in the price of imported goods would hit the import business and re-export of imported goods leading to a decline in the revenue from import tax.
-) The account-keeping requirement of VAT would increase the tax tax compliance cost and cost of doing business, it would adversely affects the smaller trades.

-) Adverse effects on domestic production due to abolition of protection policy under VAT.
-) VAT would be unjustifiable on social ground; it would aggravate the income distribution.
-) Negative effects in revenue collection, and
-) Chances of failure of a VAT in Nepal are great because the present administration is incapable for handling a VAT. The study concludes that a VAT in Nepal should be implemented on experimental base to know its pros and cons and after that a full VAT might be considered.

Nepal Chamber of Commerce organized a national wide discussion programme on VAT. According to report of the discussion programme (NCC, 1997 b) the various views expressed about VAT in Nepal may be summarized as follows:

-) Government machinery is not capable for implementing a VAT.
-) The business community has no confidence in the administration because it has failed to implement many other taxes effectively and fulfill its own commitments even previously.
-) VAT will hamper genuine trade and, as a consequence, illegal trade will prosper. Rising in the price of domestic products will make them less competitive. Import and re-export of imported goods will get a negative impact leading to decline in government revenue.
-) VAT will inhibit the growth of newly developing trade and industrial activities in the country.
-) The modern account keeping system required the VAT is difficult to keep. This will raise the costs of doing business.
-) There will be a sharp price size if a VAT is introduced, consumers will be badly affected due to price size. Nepalese markets in boarder area will dry up due to VAT.

It is concluded that it is not possible to implement a VAT in Nepal and if implemented, it will have adverse effects on the economy.

2.3 Research Gap

In this way, various books, papers, dissertations, reports, articles, journals and other reference material have been reviewed while preparing the dissertations. But there are not sufficient study conducted in such particular topic that “Contribution of VAT in Tax Revenue of Nepal.” In Nepal, most of the studies were related with theoretical aspect. The previous researchers were not able to explain the research gap but this study is focused to review the research gap in Nepal and it is concluded that there is a huge research gap. Beside this, the country is also facing the increasing burden of foreign loan. They have not shown the number of dept return filler, credit return filler and zero return filler. Beside this the revenue performance of VAT is not properly studied. Only the limited challenges for VAT implementation are explained. In this study, area of challenges for effective VAT implementation is studied. They are not explaining the rules and regulations of VAT. Such special studies have not conducted yet, so this study is different from other related studies. VAT is being an important factor to government tax revenue so that its real situation and exact contribution of GDP, total revenue and tax revenue are also found out which is made for effective VAT implementation in Nepal.

There are lots of researchers on VAT in abroad but very few of these are concerned about countries like Nepal. So, the studies are mainly focused on contribution of VAT in tax revenue and National income of Nepal. Beside this, the study will be beneficial to the policy makers, revenue department, and student of tax, private sectors and researchers. It will provide the clear concept, ideas as well as knowledge to that person who are interested and want to gain knowledge of VAT system. Similarly, it will be equally helpful to the researchers who carry out their research work.

CHAPTER III

RESEARCH METHODOLOGY

3.1 Research Design

For this study, exploratory and descriptive research designs have been applied. This research design has been flexible and open to all possible ideas that might help to explore new ideas. Research is the way or plan that specifies the sources and types of information relevant to the research problem, specifies the approach which will be used for the relevant data collection and analyze the collected data. It helps the researcher to find answer of the problem and control the errors over the study. Although there are many types of research design, critical evaluation and logical description have been done in a research topic to evaluate problems and prospects of VAT in Nepalese context.

3.2 Nature and Sources of Data

In this study the secondary data is used. The secondary sources of data are the information desired from books, journals, newspapers, reports and dissertations etc. The major sources of secondary data are: budget speeches and economic survey, Ministry of Finance, publication of Center for Economic Development Association (CEDA), Tribhuvan University, and records of department of taxation, dissertations related to VAT available at central library of T.U. Publication of VAT projects, economic review and indicators from Nepal Rastra Bank etc. and other relevant data related to this study.

3.3 Data Collection Procedures

This study is totally based on the secondary data and information. These data and information are analyzed in a simple way by explanatory method. So, the sources of data are as follows:

-) Publication of Ministry of Finance, Inland Revenue Department and Nepal Rastra Bank,
-) Budget speeches of various Fiscal Years, Economic surveys, Report of Various Task-Force of the Government of the Government of Nepal,
-) VAT Act and VAT Rules of Nepal Government,
-) Articles, journals, reports and related websites.

3.4 Data Processing Procedures

The data and information collected from secondary sources are collected, edited, classified, tabulated and analyzed. Tables and graphs are used to discuss and explain these data and information. On the basis of the findings from this analysis, the steps needed to be taken from all the responsible parties have been recommended.

3.5 Presentation and Analysis of Data

Collected data have been categorized on the basis of nature and its different simple and complex tables. Most of the data have been presented in tables and some are in diagram i.e. time series. Ms-Excel has been used for the analysis purpose.

3.6 Variables Used in the Analysis Process

- GDP** : Gross Domestic Product is the total final output of goods and services produced in the country's territory by residents and non-residents, regardless
- VAT** : Value Added Tax is broad based tax as it also covers the value added to each commodity by a firm during all stages of production and distribution.
- Indirect Tax** : The tax revenue on customs consumption and production is known as indirect tax.
- Direct Tax** : Direct tax is composed on income and capital,
- Total Tax** : Total tax is the sum of direct and indirect tax.

CHAPTER IV

THEORETICAL BACKGROUND OF VAT

4.1 Evolution of VAT

Value Added Tax (VAT) has been regarded as one of the most important fiscal innovation of modern times. The evolution of VAT is the most significant event in the history of commodity taxes and the speed with which the value-added tax has spread around the world is unmatched by that of any other tax in modern tax. (Shoup, 1988,139). The rise of Value Added Tax is unparalleled tax phenomenon (Tait, 1988, 31).

VAT has originated as an alternative to multistage turnover or cascade type of taxes. The VAT has also been used to replace the single stage manufactures; wholesale or retail level sales taxes. It avoids the demerits of turnover taxes and retail level sales taxes.

The concept of VAT emerged in 1919, when a German industrialist Carl Von Siemens proposed the tax to replace the multistage sales taxes (Umsatzsteure) in Germany. In 1949, the Shoup Tax Mission to Japan headed by Prof. Carl .S. Shoup recommended a VAT, the fuka-kachi-zei for Japan to minimize the defect of running turnover tax. In the mean time, the manufacturers' sales tax in Argentina and Brazil took a partial value added in 1935 and 1948 respectively when manufacturers were allowed to pay tax on the excess of sales over purchase.

The modern VAT first implemented in France in 1954 with the name Aure. La Valeur Ajout'ee (VAT) in place of French production taxes. French VAT designed by Maurice Laure, was an officer in the French Ministry of Finance. Maurice Laure is regarded as a father of modern VAT, covered industrial sector and latter extended to wholesale level.

At the beginning of sixth decades of last century, VAT has taken a giant leap in its history. Some French colonial countries such as Ivory Coast (1960), Senegal (1961) as well as other developing countries of Africa and South America like Brazil (1967), Uruguay (1968), Equator (1970), Bolivia (1973) replace their turnover taxes by VAT in French model 1954. "Financial and Fiscal Committee of the European Union (EU) has recommended adopting VAT to its member countries to replace their existing multistage sales taxes in 1962 (1976:65). Vietnam has established a new record in Asian nations to adopt a broad base VAT in 1973. South Korea introduced VAT in 1977. Similarly China in 1984, Indonesia in 1985, Taiwan in 1986, Phillipines in 1988, Japan in 1989, Thailand in 1992 and Singapore in 1994.

In the SAARC region, India introduced modified VAT (MOD VAT). The MODVAT has been designed to avoid the cascading effects and the tax was extended in later year. The classical type of VAT was first introduced by Pakistan in 1990, followed by Bangladesh (1991) and Srilanka in 1995 in SAARC region. Nepal could not remain isolated from VAT so partially adopted since 16th Nov 1997 and full implemented from 17th Aug 1999. While early preparation has been made with the commencement of Eighth Five Year Plan (1992-97) and experimental basis was announced from 1992/93 budget with a two-tier sales tax system on some selected items.

Now, with the 80 years of history, VAT has been heartily adopted by more than 100 countries with the arrival of last decade of previous century. VAT has spread its roots in rapid acceleration all over the world.

4.2 Types of VAT

The types of VAT are determined on the basis of treatment of capital goods of a firm. Input tax paid for capital goods is allowed or not is the fundamental question in the study of types of VAT. There are three types of VAT, they are:

-) Consumption types
-) Income type
-) Gross National Product (GNP) type

a. Consumption Type VAT

Under consumption type VAT, all capital goods purchased from other firms, in the year of purchase, are excluded from the tax base while depreciation is not deducted from the tax base in subsequent years. The base of tax is consumption since investment is relieved from taxation under this type.

b. Income Type VAT

The income type VAT does not exclude capital goods purchased from other firms from the tax base in the year of purchase. This type, however, excludes depreciation from the tax base in subsequent years. The tax falls both on consumption and net investment. The tax base of this type is the net national income.

-) Human resource managements
-) Capital Goods

J Financial Statement

c. GNP Type VAT

Under this type, capital goods purchased by a firm from other firms are not deductible from the tax base in the year of purchase. It also does not allow the deduction of depreciation from the tax base in subsequent years. Tax is levied both on consumption and gross investment. The tax base of this type is gross domestic product.

Consumption type VAT is widely used. So, by the term 'VAT' we basically mean the consumption type VAT.

These bases of VAT under various categories may be shown as:

$$\begin{aligned}\text{Consumption Type} &= \text{Gross National Product} - \text{Gross Investment} \\ &= \text{Total Consumption Expenditure}\end{aligned}$$

$$\begin{aligned}\text{Income Type} &= \text{Gross National Product} - \text{Depreciation} \\ &= \text{Net Investment} + \text{Consumption} \\ &= \text{Net National Product}\end{aligned}$$

$$\text{Gross National Product Type} = \text{Gross Investment} + \text{Consumption}$$

Both the Income and GNP variants do not exclude the purchase of Capital goods from the tax base in the year of purchase. But the income type excludes the depreciation from the tax base in the subsequent year while GNP type does not treat as so. The GNP type of VAT is less practicable because it is biased to labour incentive techniques. The income type VAT is also rare in practice because it excludes the depreciation from the tax base in the subsequent years. Both types of VAT are theoretically defective and practically difficult to implement. It has just academic value. The consumption type of VAT is most popular and widely recognized by almost all the countries. It does not affect decision regarding investment and growth since it excludes investment from any tax burden. Furthermore, the consumption variant is more lucrative from the point of view of tax administration as well as from the consideration of foreign trade. As several advantages have incorporated in consumption theory, in comparison to other, it has been accepted and successfully implemented. (www.answers.com/topic/value-added-tax).

4.3 Methods of Computation of VAT

VAT can be computed by adopting three different methods. These are (a) Addition method, (b) Subtraction method, and (c) Tax-credit method. These methods can be used to arrive at the VAT liability.

a) Addition Method

This method is based on the identification of value –added which can be estimated by summation of all the elements of value-added (i.e. wages, profits, rent and interest). This is in line with the income method of calculating national income. In this method, all the payments made for the factors of production have to be added, it creates complexities in calculating them in practice. Virtually no country has used the additive method; however, Argentina and Israel have used it in selected economic activities, such as banking and finance, where value of inputs and outputs are difficult to measure.

b) Subtraction Method

This method estimates value-added by means of difference between outputs and inputs [i.e. $T = t(\text{output} - \text{input})$]. This is also known as product approach and has further variants in the way subtraction is attempted from among (i) direct subtraction method, (ii) intermediate subtraction method and (iii) indirect subtraction method. Direct subtraction method is equivalent to a business transfer tax whereby tax is levied on the difference between the aggregate tax –exclusive value of sales and aggregate tax-exclusive value of purchases. Intermediate subtraction method is based on deduction value of purchases from the aggregate tax-inclusive value of sales and taxing the difference between them.

Above two methods are called direct method because value added is computed directly either by adding the payments made by the firm to the factors of production or by subtracting the cost of production from sales.

c) Tax Credit Method

The indirect subtraction method entails deduction of tax on inputs from tax on sales for each tax period, [i.e. $t(\text{output}) - t(\text{input})$]. This method is also known as tax credit method or invoice method. In practice, most countries use this method and employ net-consumption VAT.

Though the tax credit method is similar, to some extent, to subtraction method but the major differences among two are:

) In the earlier Method, the tax base is levied in the ‘difference amount’ of tax on sales and tax on purchase, where as in the latter method; the tax levied on the ‘difference amount’ of sales value and purchase value.

) Earlier method requires invoices, while the latter does not require.

If the tax rate were same throughout the production and distribution method, all the three methods should give the same result. Among the three methods of computation of VAT, the tax credit method is widely used in Europe. This is because this method has several advantages over the other two methods, which are:

) The tax liability in this method is attached to the transaction that makes it technically and legally far superior to the other methods.

) The tax calculation of Value Added, which is a difficult task, is not necessary.

) The tax credit method creates a good audit trail making the cross checking possible.

) It provides an effective way to completely free any product such as exports from tax and makes broader tax adjustment easier and possible.

) There will be no revenue loss due to exemption granted to small firms or products.

) Rate differentiation at different stages for administrative or other reason becomes possible under this system without reducing the total tax paid. If tax rate is reduced at earlier stages, this simply gives rise to unequally increased tax rate at later stages.

Thus, the tax credit method is desirable for several reasons and has to be adopted by many countries of the world. Nepal has also adopted this method to calculate VAT payable. Calculation on VAT revenue (T) can be expressed as following for the above mentioned three different types.

Additional Method (T) = t (wages + rent + profit).

Subtraction Method (T) = t (sales value – purchase value).

Tax Credit Method (T) = t (tax on sale)- t (tax on purchase)

Where, t = VAT percentage rate.

4.4 Structure of VAT

a) Coverage

Vat is the improved version of sales tax. So the coverage of VAT should be as broad as possible. Unlike retail sales tax, it should be levied on the value added at each stage of production and distribution. Each person carrying on taxable business or transaction should be made liable to VAT. Larger be coverage of VAT, greater will be the revenue collected. Therefore, the coverage of VAT should be made as broad as possible.

b) Exemption

Exemption simply suggests to an exclusion of a certain kinds of business transaction or a person form the tax net. If the objective of the government is to make the vendor free from the responsibilities for registering and paying tax, but do keep some tax on the final purchaser, exemption is a suitable measure. If it is desirable to keep certain goods or services or transactions are not subject to tax but no credit is allowed for tax paid on inputs. Exemptions, thus implies the exclusion of certain goods and services form the tax jurisdiction. For example, if exports are exempt exporters are not required to register under VAT. They do not need to collect VAT on their outputs and cannot claim for input tax credit.

c) Zero-Rating

“Zero-rating” means that a trader is not only exempted from payment of VAT on his sales but it also allowed getting refund for any taxes paid on his outputs. It means zero percent tax rate on goods and services. If any goods or services are zero-rated, the input tax or tax paid on purchases is creditable or refundable. Theoretically, zero rating is applied to ensure for freeing tax truly. Zero rating is applicable for certain goods and services only because it increases the burden considerably on the part of both tax payers and the tax administration due to the requirement of maintaining books of accounts, submitting returns and refunding the tax levied on the inputs of zero-rated items (Khadka, 1997:59).

d) Rates

It is desirable to levy VAT with a single positive rate in order to make the VAT system simpler. This is because multiple rate tax administration is more complicated. Under multiple rated VAT, there need to classify commodities into different groups according to their rate. Businessman has to keep separate record.

Multiple rates make tax system inefficient from the economic point of view. It gives an incentive to the producer to divert their resources higher rated to lower rated goods and services to save the tax payment. Similarly, it stimulates a consumer to divert their resources from higher rated to lower rated commodities. Thus, multiple rates create scope for tax evasion. On the other hand, a single rate makes VAT very less costly, easy to comply with and easy to administer.

e) Threshold

Small traders whose yearly turnover is minimum than a limit are not required to be registered on VAT. The limit amount is known as threshold, which may be changeable in every fiscal year. The level and threshold is different from country to country depending upon the revenue requirements, administrative capability, level of record and accounting proficiency in the industry and business sector, etc. According to VAT Act 1985 (Nepal), the minimum transaction threshold was NRs. 1 millions, later it adjusted to NRs. 2 million by Economic Act 2054. Recently it has further raised to 3 millions.

4.5 Operation of VAT

a) Registration

The initial and necessary step towards VAT operation is registration of all vendors carrying on taxable business. However, registration must not be mandatory for small vendors having an annual return below the threshold.

b) Deregistration

A VAT registration may be cancelled by anyone whose total taxable sales for four consecutive calendar quarters is not more than 2 million rupees and who has been registered for a full fiscal year or by person who no longer has a commercial activity because of bankruptcy, receivership, or cessation of the business, death and so on.

c) Obligations of VAT Registrants

VAT registrants are required to:

-) Submit VAT return and pay tax within the 25th day of the following month.
-) Provide their customers with a tax invoice.
-) Maintain Purchase Book, Sales Book, and VAT account.
-) Keep their VAT records for a period of 6 years

-) Inform the IRO of changes to the business including new address, telephone number of a reorganization of a partnership within 15 days.
-) Put their certificate of Registration in the premises where customers may easily see and read it,
-) Allow tax officers to enter the business to examine the business records and the stock on hand.

d) Invoicing

Invoices are the initial documents for VAT control and are the most essential under VAT system. Every registered producer or vendor is required to issue an invoice for each taxable sale. There are two types of invoices:

i. Tax invoice

The tax invoice will require the name and address of the seller and purchaser, the seller's PAN number and invoice number, the date of transaction and description of the sale including the number of items purchased, the unit of each item and notion of any discounts.

The tax invoice must be prepared in three copies and clearly identified as a tax invoice. The original copy is to be given to the purchaser; the second copy is to be retained for audit purpose while the bottom copy is for use by the seller in preparing a record of transaction.

ii. Abbreviated invoice

This is the simple type of invoice for registered sales to an unregistered person, who should be considered a final consumer under the VAT system. VAT registrants may make an application to use an abbreviated invoice and tax office may allow its use subject to certain conditions.

The following information must be recorded on the abbreviated invoice:

-) An identifying number issued in sequential order.
-) The name, address and the registration number of the vendor.
-) The date of transaction.
-) A sufficient description to identify the goods or services supplied.
-) The total amount of money paid, including VAT.

In case of sales made under the abbreviated invoice, VAT is calculated by multiplying the sales by the VAT quotient. The VAT quotient is found by dividing the rate of VAT by 100 plus the rate of VAT.

e) Books of Account

Every VAT registrant requires keeping records of all the invoices either received or issued, including the serial number and date of issue. In general, VAT liability is determined on the basis of the accounts kept by the tax payers himself. The record should be kept in such a way that VAT authorities are able to check the accuracy of the VAT returns. Such records are kept fairly for long time generally 4 to 6 years. In general account must be maintained on the accrual basis. Vat liability should be calculated accordingly. This is because if it is levied only on the cash basis, taxpayers might delay payments. VAT registrants are required maintain purchase and sales books and its list of all the sales and purchase in the corresponding book. They are also required to prepare for a VAT account.

i) Purchase Book

VAT registrants are required to maintain an account of their business purchase for VAT purpose book refers to the account of the VAT registrant, which includes all the transactions for business purchase. The record must be kept on the basis of invoice. At the end of the each accounting period, the VAT registrant must total the amount of taxable purchases/imports; tax exempt purchase, imports and tax paid on purchase/imports.

ii) Sales Book

Similarly, VAT registrants are also required to maintain an account of their sales for VAT purpose. Sales book is also an invoice –based account. At the end of each accounting period VAT registrants needs to total the taxable account (standard and zero rated) and tax-exempt sales, they have made in that period and tax collected on sales. If they make both taxable and tax exempt purchase and sales, they are required to calculate the proportion of input tax they are entitled to the tax period.

iii) VAT Account

VAT registrants are also required to maintain the VAT account. It is monthly summary of taxable purchases and sales and VAT paid on purchases and changed on sales.

iv) Tax Credit and Tax refund

Tax payers (vendors) allowed deducting their input tax from output tax. This is known as tax credit or tax invoice method of tax computation. The refund is the difference of gap between output tax and input tax, when the amount of input tax is higher than the amount of output

tax. Such a situation generally arises in the case of exports because exports are zero-rated and in order to relieve them from burden of the VAT tax refund takes place. Here output tax means tax amount which is collected on sales and input tax means paid amount on purchases. The taxpayer may apply to the Inland Revenue office for a refund only if taxpayer is a regular exported with more than 50 percent of his sales expected or has more input than output tax for a continuous period of at least 6 months.

f) Administration

Administration means the management of affairs. Its organization should be strong and reached to the grass root level so that policies and programs of government can be well functioned to grass-root level. VAT administration is responsible for setting operational guidelines, program development and evaluation, design of forms and instructions, statistical analysis, budget development and resource allocation.

4.6 Assessment of the Policies related to VAT

Nepal implemented VAT in 16 November, 1997 after passing VAT Act of Nepal in 1995 and VAT rule in 1996. Because of the strong opposition of the business community government of Nepal, it has to work out with the rule again and again. For example, in an original VAT Act, threshold limit was determined to Rs. 1 million. Finance Act 1997 increased it to Rs. 2 million and again, the changed Finance Act 1998 increased it to Rs. 3 million just after eight months of its implementation. First amendment in VAT Rules 1997 was done only to further increase the threshold limit to Rs. 4.5 million. This amendment was again replaced by the Finance Act 1999/00. The threshold limit again lowered to Rs. 2 million. Thus, it can be seen, as the threshold limit has been a much debated issue in Nepalese context. VAT bill was passed in March 20, 1995 and VAT regulation was approved in January 27, 1996 by the cabinet. Finally, VAT was introduced in November 16, 1997. From that date, VAT replaced Sales Tax Act 1967, Hotel Tax Act 1962, Contract Tax Act 1967 and Entertainment Tax Act 1961. Legal provisions related to VAT are listed below:

a) VAT ACT 1996AD

i. Bill made to Impose and Collect Value Added Tax Preambles

Whereas, for increasing revenue mobilization by making effective process of collecting revenues required for the economic development of the country, it is expedient to impose a value added tax on all transactions including the sale, distribution, delivery, importation, exportation of goods or services and to collect revenues effectively by regulating the process

of collection. Now, therefore, parliament has made this act in the twenty fourth year of the rule of His Majesty King Birendra Bir Bikram Shah Dev.

ii. Imposition of Value Added Tax (Section 5)

Under this section, VAT is imposed on goods and services supplied, imported into the Kingdom of Nepal and exported outside of Nepal. Tax shall be levied on taxable value of every transaction. No tax shall be levied on the transactions of goods or services set forth in schedule 1, provided that any tax applicable on such goods or services at the time of purchase.

iii. Assessment of Tax and Collection

There is compulsion for registered person to assess and collect tax at the taxable value. People who are outside the Kingdom but receipts the services in Nepal also has to assess and collect tax at the taxable value in accordance with the Act and Rules there under.

iv. Exemption for Small Vendor (Section 9)

A person having a transaction below the threshold should not need to register. But he can register if he wishes voluntarily. So, voluntary registration states often allow those who are not required to be registered voluntarily. Person can get registered number after the completion of registration process.

v. Registration (Section 10)

Three months (90 days) are given to the person engaged in any transaction from the commencement of this Act. Every person has to fill up the prescribed form for registration. A unique register number is given to such person in time with the registration certificate. After the registration he can display attested copy by the tax officer in different places of his transaction. This number is applicable for all types of transaction then-after. A person should inform the tax officer within 15 days of any changes in the information pertaining to the applicable for registration as required under sub-section 1 and 2.

vi. Cancellation of Registration (Section 11)

There are three main conditions for the cancellation of VAT registration. The first case is where a person has been registered for VAT properly, but where the registration is no longer appropriate. This will occur where a person was required to register because the person's business activities exceed the threshold but where, subsequently, the person's level of business activities has declined to below the threshold. The second case is where the person

has ceased to carry on business activities. The final case is where the person has been registered by mistake or by misrepresentation on the part of the person.

vii. Invoices to be issued Except Otherwise Prescribed (Section 14)

Every registered person is required to issue an invoice to the recipient, in the process of supplying any goods or services. It's a duty of recipient to obtain invoice. The specimen of any invoice is prescribed in the VAT Act.

viii. Unregistered Person not to collect Tax (Section 15)

Unregistered person is not needed to issue an invoice or other documents showing the collection of tax. If he collects tax, the tax collected shall be assessed and collected from him.

ix. Accounts of Transaction to be Kept (Section 16)

There are four conditions in this section. First deals about up to date accounts of his transaction. These accounts should be available for inspection to tax office upon his request. Second deals the content of accounts, in which date and value of transaction and registered number of party if any should be included. Thirdly, registered person may use authorized sells and purchase book and lastly every tax payer should preserve the accounts of transactions for a period as prescribed.

x. Tax Offset (Section 17)

A registered person can offset the amount of tax he has collected against the tax paid or tax due in importing or receiving goods and services related to his own taxable transactions. No offset or only partial offset is given in the case of aeroplanes, automobiles, computers and high priced other items as prescribed in Act. Offset is given only in the following conditions:

-) Must be a registered person
-) Should provide essential documents

xi. Assessing VAT(Section 20)

Where a taxable person has not made a return for a period for which a return should have been made, the tax authorities should be given reserve powers to impose an obligation on the taxable person to pay VAT to the tax authorities.

xii. Tax Collection (Section 21)

Each tax payer has to pay tax within a specified period. If it has not been paid within the specific period, the tax officer, on the approval of the Director General may collect the tax by using any of the following methods:

-) Offsetting the amount, if any is refunded to the tax payer.
-) Seizing the assets (movable and immovable) of the tax payer.
-) Selling the parts or full assets at a time or in a series.
-) Deduction of amount is made from a corporate body owned by HMG/N or local bodies.
-) Deduction of amount from tax payer's bank account.
-) Deduction of amount from the third parties.
-) Withholding imports, exports and other transaction of the tax payer.
-) Under the subsection and it is stated that tax shall not be collected in past years from the date the tax was assessed.

In exercise of the power conferred by Section 41 of the Value Added Tax Act, 2052 (1996) then His Majesty Government has framed the following rules; Value Added Tax Rules, 2053 (1997).

b) VAT RULES, 2053 (1997)

i. Application for Registration (Rule 3)

Any person engaged in any transaction at the time of the commencement of the Act shall submit an application for registration to the concerned tax officer, in the format as set forth in Schedule-1 within 90 days of the commencement of the Act. A person intend to engage in any transaction after the commencement of the Act shall submit an application for registration to the concerned tax officer, in the format as set forth in Schedule-1 prior to the commencement of such transaction. In the case of partnership, the application must be submitted along with the details of the partnership in the format as set forth in Schedule-2.

ii. Investigation into Application (Rule 4)

The tax officer may ask for additional documents for the process of registration. It shall be the duty of the applicant to submit such additional details and documents to the concerned tax officer within seven days of such demand. In case of a registrant which is not required to be

registered as set forth in sub-section (3) of Section 10 of the Act, the concerned tax officer shall give a notice setting out that he is not required to be registered, to the applicant within seven days of the receipt of the application.

iii. To Grant Certificate of Registration (Rule 5)

The concerned tax officer shall, if he deems it proper to register, upon making investigations pursuant to Rule 4 into the application submitted for 2 registration pursuant to Rule 3, register the transaction which the applicant has carried out or intends to carry out the transaction and grant the certificate of registration bearing Registration number as well in the format as set forth in Schedule-3 to the applicant, without thirty days of the date on which the application was submitted.

iv. Entrepreneur Carrying out Small Transaction Need not to be Registered (Rule 6)

Any person carrying out transactions not exceeding one million rupees within the last twelve months as set forth in Section 9 of the Act need not have registered his transactions. Provided that any person who imports into the Kingdom of Nepal goods valued at one hundred thousand rupees or more per annum for commercial purposes shall have to register his transactions. But he can register voluntarily after completing the procedures of investigation.

v. Cancellation of Registration Process (Rule 12)

In case the registration of any registered person be cancelled due to the conditions referred to in sub-section (1) of Section 11 of the Act and such a registered person or his successor in the event of his absence submits to the concerned tax officer an application, setting out the conditions for cancellation of registration, accompanied by the Tax Return referred to in Schedule -11 as well as the payable tax amount, for the cancellation of registration, within thirty days of the date on which the condition for cancellation of registration occurred, or the concerned tax officer is satisfied that the registration of a registered person in existence of the conditions set forth in sub-section (1) of section 11 is to be cancelled; he (the tax officer) shall cancel the registration of such person, upon getting him to pay the remaining tax amount, and give notice thereof to the concerned registered person or his successor and the department.

vi. Tax Invoices (Rule 17)

Mainly there are two conditions relating to tax invoices. At the time of supplying any goods or services by a registered person, he shall give tax invoices to the recipient. Three copies of

tax invoices are essential, and the original copy is given to the recipient, the second copy to be separately recorded so that it can be produced as and when asked for by the VAT office and the third copy are recorded by the registered person for the purpose of his transaction.

vii. Abbreviated Tax Invoices (Rule 18)

To conduct retail sales of any goods and services, he should take permission from tax officer by submitting application. Then after he can use abbreviated tax invoices. When low priced goods are sold in large quantities abbreviated tax invoices is used expressing the names grossly. A registered person who gives an abbreviated tax invoice to the recipient should maintain records thereof as below:

-) To prepare and maintain a duplicate copy of the original invoice,
-) Where a transaction has been carried out by maintaining a duplicate of the roll, the total thereof must be calculated and maintained every day,
-) To maintain records of the value, including tax, of each transaction.

There is provision of cancel the permission granted if registered person is found not to have maintained the records required to be maintained necessary documents to the tax officer.

viii. No Need to Give Tax Invoices

A person who carries out transactions of used goods of a value exceeding ten thousand rupees, need not issue a tax invoice in such cases where the selling price is less than the buying price of the goods supplied by him.

ix. To Submit Tax Return of Tax Period (Rule 26)

For the purpose of tax return a registered person should submit to the concerned tax officer the tax return of one-month tax period according to the Bikram Era, within 25 days of the expiry of that period. The tax period of a taxpayer who has registered voluntarily may be fixed at four months. But the registered person is liable in the tax expiry period of 25 days.

x. To Require to Submit a Tax Return through the Heir or Legal Representative (Rule 27)

In case any registered person dies or becomes mentally or physically incapacitated to submit the tax return, the tax officer may, considering him to have supplied the goods or services till the day preceding his death or becoming mentally or physically unable, require his or legal representative to submit a tax return for that period.

xi. To Submit a Tax Return Individually or Jointly (Rule 28)

There is a provision of tax payment jointly or superlatively. The conditions are listed below:

-) Any taxpayer becomes incapable to submit a tax return or he dies; his heir or guardian,
-) Any taxpayer is a legal person, any director, executive chief or any employee appointed by the management, on behalf of such a taxpayer,
-) In case any taxpayer is a legal person and such legal person is dissolved or liquidated by the liquidator.

In other circumstances other than those mentioned above, the person concerned with the tax payer and prescribed by the tax officer.

xii. Tax Officer May Assess Tax (Rule 29)

If a tax officer does not satisfied with the documents of the tax payers he may asses the tax liability. The concerned tax payer is given a time limit of seven days to submit evidence in his favor against the tax assessment order issued by the tax officer. If tax is not collected, an order including description of additional charge is issued.

xiii. To Pay Tax, Additional Fees and Interest Amount (Rule 30)

The concerned tax payer shall deposit the tax, additional fees and the interest amount referred to in the tax assessment order within seven days of receipt of such an order to the concerned Tax Office.

xiv. Procedure of Sending Notices of Tax Assessment Order (Rule 31)

If the order is sent by tele-fax, telex or other similar electronic devices installed at the address of such taxpayer or such order is delivered to himself or at his office or through registered post to his address, it shall be deemed to have been duly delivered. In case of order not received by the taxpayer he should inform tax officer.

xv. Assessment and Recovery of Tax Collected by an Unregistered Person (Rule 32)

Unregistered person having collected tax should assess and recover within seven days of the issue of the tax assessment order.

xvi. To Submit a Tax Return Prior to Filing Appeal (Rule 34)

Prior to filing an appeal by a tax payer against a tax assessment order made, he must submit his tax return of that period to the concerned tax officer.

xvii. Time –Limit for Applying for Remission of Additional Charges (Rule 36)

For the remission of the additional charges, an application shall be submitted to the Director General within thirty days of the expiry of time-limit prescribed for payment of tax. But additional charges should grant if an application is not submitted within the time-limit.

xviii. Tax Assessment Period (Rule 37)

While calculating the period in case a petition has been filed with any court in regard to tax and a stay order has been issued, the period shall be calculated by deducting the period until which the petition is decided.

xix. Time –Limit for Collection of Tax (Rule 38)

While calculating the time-limit, in case an appeal has been filed, the period from the date of filling such appeal to the date of decision shall not be included.

xx. Application to be Submitted (Rule 43)

For the deduction of sales tax application should be submitted to the tax office in the format prescribed by the Act and Rules. And for a claim to deduct Sales Tax or tax, the concerned tax payer must also submit invoices of payment of Sales Tax or tax and other documentary evidence within 15 days of registration. In absence of the documentary evidence tax shall not be made. If such deduction are already made then it can be rejected and take necessary action against such tax payer. But if the application is accepted the tax payer may deduct such taxes.

xxi. Provision regarding or Services to be Supplied within the Kingdom of Nepal (Section 56)

While purchasing or acquiring the goods or services on which tax of value of ten thousand rupees is payable at a time within the Kingdom of Nepal by His Majesty Government or the association, organization or office owned by His Majesty Government or constitutional bodies, such goods or services shall be purchased or acquired only with a registered person.

Since the process of VAT accounts begin from the issuance of invoices, a provision has been made under Section 14 of Act for registered person to issue an invoice to the buyer while selling goods or services and for the buyer to receive the invoices, Rule 17 deals the regulation of the section.

CHAPTER V

DATA PRESENTATION AND ANALYSIS

5.1 Introduction

Value Added Tax (VAT) is the most recent innovation in the field of taxation. It is considered as one of the most powerful tools of the fiscal policy. From the long experience of VAT in several countries, many economists and policy makers have agreed on as VAT is probably the best indirect tax. It is outstanding that it gained such a remarkable popularity in such a short span of time.

Vat replaces the Old Sales Tax, Contract Tax, Hotel Tax and Entertainment Tax. It has been designed to collect the same revenue as the four taxes it replaced. Since the collection of both customs duties and income tax depends to a great extent upon the effectiveness of VAT, it is expected to help in enhancing revenue collection.

VAT is a broad-based tax as it also covers the value added to each commodity by a firm during all stages of production and distribution. It is a modern tax system to improve the collection of taxes, to increase efficiency and to lessen tax evasion. It is also regarded as the backbone of income tax system in Nepal.

5.2 Magnitude of Government Revenue

Total Revenue of Nepal can be decomposed into tax revenue and non-tax revenue. Tax revenue contributes about three quarters of total revenue while non tax revenue represents about one quarter of total revenue. This is shown in the figure 5.1.

Table 5.1

Magnitude of Government Revenue

(Rs.in billion)

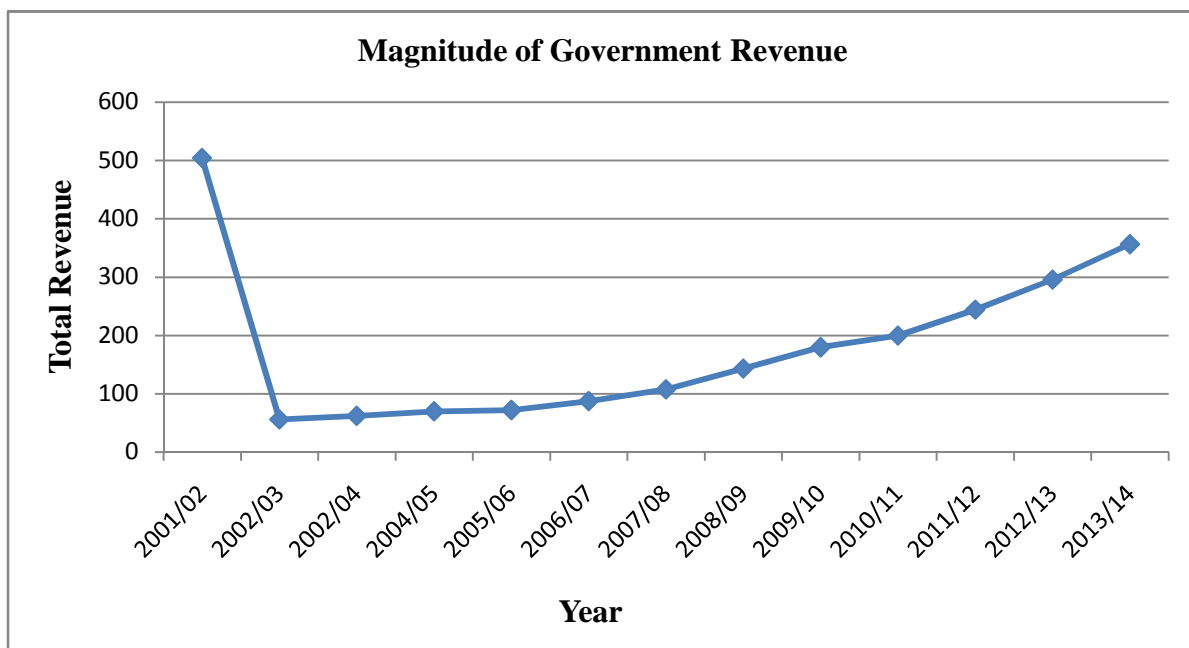
Fiscal Year	Total Revenue	Increment (percent)	Tax Revenue			Non-tax Revenue		
			Amount	Increase (%)	% of contribution	Amount	Increase (%)	% of contribution in Govt. Revenue
2001/02	504.4	3.17	39.33	1.2	77.97	11.12	10.94	22.03
2002/03	56.23	11.47	42.58	8.26	75.72	13.64	22.73	24.26
2002/04	62.33	10.85	48.17	13.13	77.28	14.16	3.78	22.71
2004/05	70.12	12.50	54.10	12.31	77.15	16.02	13.14	22.84
2005/06	72.28	3.08	57.43	6.16	79.45	14.85	-7.28	20.55
2006/07	87.71	21.35	71.13	23.86	81.10	16.59	11.67	18.91
2007/08	107.62	22.70	85.15	19.71	79.12	22.47	35.46	20.88
2008/09	143.47	33.31	117.05	37.46	81.59	26.42	17.61	18.42
2009/10	179.94	25.42	156.29	33.52	86.86	23.65	-10.49	13.14
2010/11	199.82	11.05	172.77	10.54	86.46	27.04	14.33	13.53
2011/12	244.37	18.23	211.72	18.39	86.63	32.65	17.18	13.37
2012/13	296.02	17.44	259.21	18.32	87.56	36.80	11.27	12.44
2013/14	356.62	16.99	312.44	17.03	87.61	44.17	16.68	12.39
Average	148.23	15.96	125.18	16.91	81.88	23.04	12.07	18.11

Sources: Economic Survey FY 2014/15

Table 5.2 shows that the share of tax revenue is 81.88 percent and non-tax revenue is 18.11 percent in average from FY 2001/02 to 2013/14 which reflects that a major amount of government revenue is collected by tax revenue in comparison to non-tax revenue. Non-tax revenue has very low share in government revenue. It shows that total revenue increased by 3.17 percent in FY 2001/02, 11.47 percent in FY 2002/03, 10.85 percent in FY 2003/04, 12.50 percent in FY 2004/05 but had very low increment 3.08 percent in FY 2005/06. However, it increased remarkably by 21.35 percent in FY 2006/07, 22.70 percent 2007/08, and 33.31 percent in 2008/09. Again the rate of increment became 25.42 percent in FY 2009/10 and 11.05 percent in 2010/11. It again increased to 18.23 percent in 2011/12 and 17.44 percent in FY 2012/13 and 16.99 percent in FY 2013/14. The fluctuation in the revenue may have occurred due to the political instability in the country. Though there is variation in increments of revenue, revenue collection is going in positive way after the implementation of the VAT system.

Figure 5.1

Magnitude of Government Revenue



Source: Based on Table 5.2

5.3 Composition of Direct Tax

Direct tax is actually paid by a person on whom it is imposed legally. The impact or the money burden and the incidence are on one and the same person. For the study direct tax has been divided into four parts income tax, vehicle tax, land tax and others tax.

Table 5.2
Composition of Direct Tax

(Rs in Billion)

Fiscal Year	Tax Head				Total Amount	Percentage Head			
	Income	Land	Vehicle	Others		Income	Land	Vehicle	Others
2001/02	8.91	1.13	0.56	0.00	10.6	84.06	10.66	5.28	0.00
2002/03	9.68	0.61	0.43	0.16	10.88	88.97	5.61	3.95	1.47
2003/04	9.24	1.69	0.70	0.27	11.9	77.65	14.20	5.88	2.27
2004/05	10.16	1.80	0.81	0.31	13.08	77.68	13.76	6.19	2.37
2005/06	10.37	2.18	0.85	0.56	13.96	74.28	15.62	6.09	4.01
2006/07	15.03	2.25	0.99	0.69	18.96	79.27	11.87	5.22	3.64
2007/08	17.31	2.94	1.07	1.77	23.09	74.97	12.73	4.63	7.67
2008/09	25.14	5.22	1.85	2.10	34.31	73.27	15.21	5.39	6.12
2009/10	31.28	5.51	2.42	2.53	41.74	74.94	13.20	5.80	6.06
2010/11	38.87	3.57	3.02	3.19	48.65	79.90	7.34	6.21	6.56
2011/12	30.49	2.94	9.12	1.32	43.87	69.50	6.70	20.78	3.00
2012/13	37.06	0.37	8.96	1.60	47.99	77.22	0.77	18.68	3.33
2013/14	45.42	2.85	10.32	2.00	60.59	74.94	4.70	17.03	3.30
Average	22.22	2.54	3.16	1.27	27.61	77.43	10.18	8.54	3.83

Sources: Economic Survey FY 2014/15

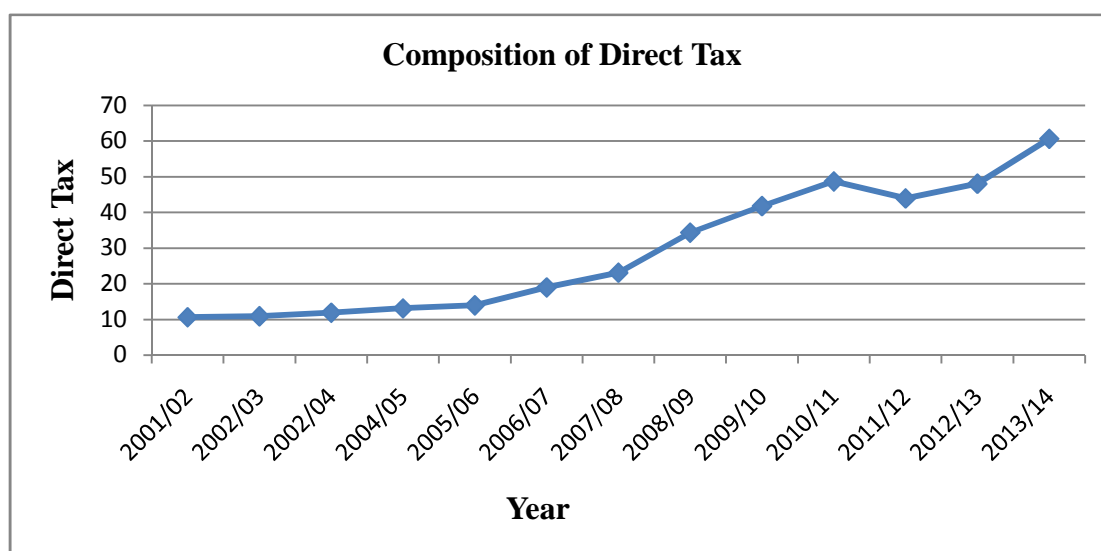
Table 5.3 shows that the share of income tax was 84.06 percent, share of land tax was 10.66 percent, and share of vehicle tax was 5.28 percent while the share of other tax was nil of total

revenue in FY 2001/02. The share of income tax increased to 88.97 percent, land tax increased to only 5.61 percent in FY 2002/03. The share of income tax slightly decreased to 77.65 percent, land tax increased to 14.20 percent, vehicle tax increased to 5.88 percent and other taxes increased to 2.27 percent in FY 2003/04. From FY 2004/05 to 2005/06 the share of income tax, vehicle tax goes on decreasing but land tax and other taxes goes on increasing. Again in FY 2006/07 share of income tax increased but rest others decreased. From FY 2007/08 to 2008/09 the share of income tax, other taxes go on decreasing but land tax and vehicle tax go on increasing. From FY 2009/10 to 2010/11 the share of income tax, vehicle tax go on increasing but land tax goes on decreasing. The share of income tax, land tax and other taxes decreased to 69.50 percent, 6.70 percent and 3 percent but vehicles tax increased to 20.78 percent in FY 2011/12. Again in FY 2012/13 income tax and other taxes increased to 77.22 percent and 3.33 percent whereas land and vehicle tax decreased to 0.77 and 18.68 percent. The share of income, vehicle and other taxes decreased to 74.94 percent, 17.03 percent and 3.30 percent but the land tax increased to 4.70 percent

Figure 5.2

Composition of Direct Tax

(In Rs. Billion)



Source: Based on Table 5.3

5.4 Composition of Indirect tax

Indirect tax is imposed by one person but is paid either partly or wholly by another person. In case of indirect taxes, the impact and incidence on tax are on different persons. A sales/value added tax, excise duty or customs duties are indirect tax because the trader, manufacturer,

consumer, or buyers shift burden forward. The developing countries like Nepal, due to low per capita income; the share of indirect taxes is ore in comparison to direct tax. For the comparison purpose taxes from contract, hotel and entertainment have been included in sales/ value added tax because after adaptation of VAT all these taxes are replaced.

Table 5.3
Composition of Indirect Tax

(Rs. in Billion)

Fiscal Year	Indirect Tax			Total Indirect Tax	Percent of Indirect Tax		
	Custom Duty	VAT	Excise Duty		Custom Duty	VAT	Excise Duty
2001/02	12.65	12.27	3.81	28.73	44.03	42.71	13.26
2002/03	12.78	13.46	3.77	30.01	42.59	44.85	12.56
2003/04	15.55	14.48	6.23	36.26	42.88	39.93	17.18
2004/05	15.70	18.88	6.44	41.02	38.27	46.03	15.70
2005/06	15.34	21.61	6.51	43.46	35.30	49.72	14.98
2006/07	16.70	26.09	9.34	52.13	32.04	50.05	17.92
2007/08	21.06	29.81	11.19	62.06	33.93	48.03	18.03
2008/09	26.79	39.70	16.22	82.71	32.39	48.00	19.61
2009/10	35.15	54.92	24.31	114.38	30.73	48.02	21.25
2010/11	35.71	61.66	26.54	123.91	28.82	49.76	21.42
2011/12	40.90	70.93	30.01	110.56	36.99	64.15	27.14
2012/13	54.32	83.41	36.23	129.27	42.02	64.52	28.02
2013/14	64.12	101.10	45.41	157.71	40.65	64.10	28.79
Average	28.21	42.18	17.38	77.86	36.97	50.75	19.68

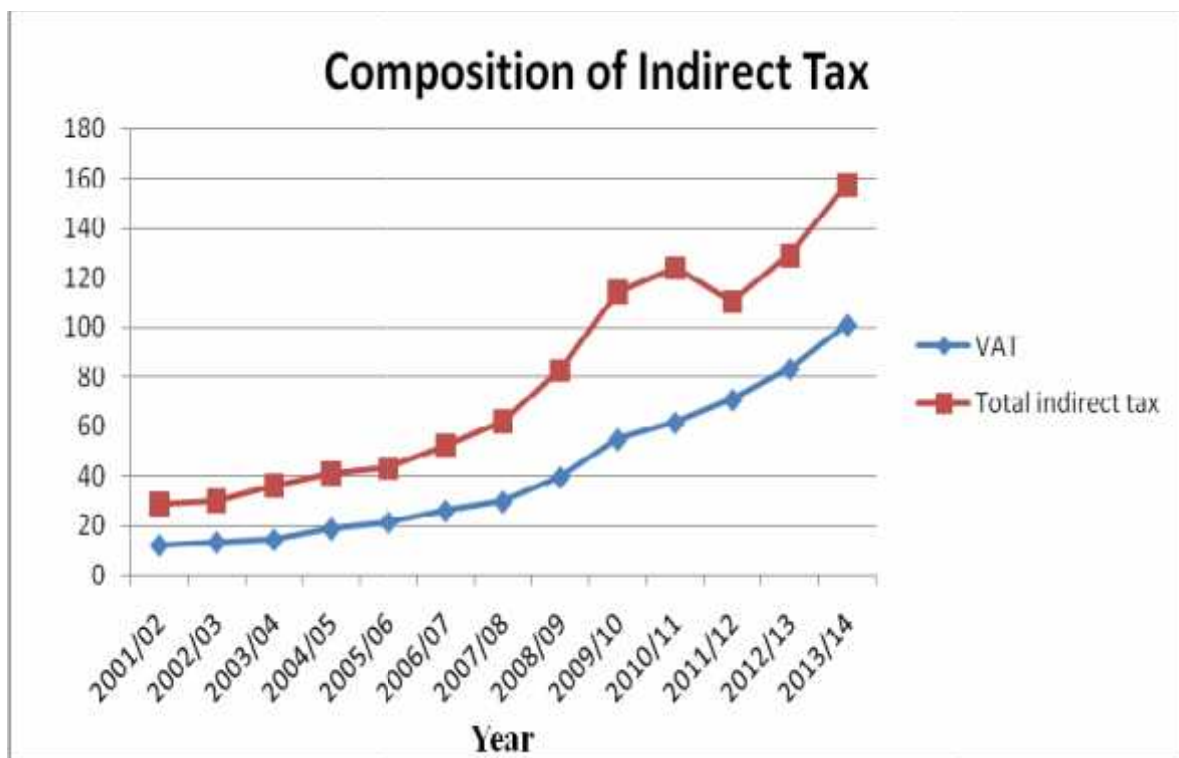
Sources: *Economic Survey 2014/15*

Table 5.4 shows that in FY 2001/02 the share of custom duty, sales/VAT, excise duty and other in indirect tax was 44.03 percent, 42.71 percent and 13.26 percent respectively. It is observed decreased till FY 2010/11 and again it increased in FY 2011/12 and started decreasing till FY 2013/14. Custom duty is decreased from continuously from FY 2004/05 to 2010/11. It may be due to less international trade of the country as well as political instability. The share of VAT increased from FY 2001/02 to 2002/03 but slightly in FY 2003/04. Then

again share of VAT increased from FY 2004/05 to 2006/07 but decreased in FY 2007/08 and 2008/09. Again VAT increased from FY 2009/10 to 2012/13 and slightly decreased in FY 2013/14. The excise duty was 13.26 percent in FY 2001/02 but decreased in FY 2002/03 again increased in FY 2003/04 but goes on decreasing till FY 2005/06. After that the share of excise duty kept on increasing till FY 2012/13 and again decreased in FY 2013/14. This shows that VAT collects more revenue than other taxes. However, there is no substantial increase in VAT which might be the lack of upgrading of VAT collection system.

Figure 5.3

Composition of Indirect Tax



Source: Based on Table 5.4

Table 5.5 shows that in FY 2001/02 the share of custom duty, sales/ VAT, excise duty and other in indirect tax was 44.03 percent, 42.71 percent and 13.26 percent respectively. It is observed that the share of custom duty decreased in FY 2002/03, increased slightly in FY 2003/04 but after that continuously decreased till FY 2010/11. Custom duty is decreased from FY 2001/02. It might be due to the less international trade of the country as well as political instability. The share of VAT increased from FY 2001/02 to 2002/03 but slightly in FY 2003/04. Then again share of VAT increased from FY 2004/05 to 2006/07 but decreased in FY 2007/08 and 2008/09. Again VAT increased from FY 2009/10 to 2010/11. The share of excise duty was 13.26 percent in FY 2001/02 but decreased in FY 2002/03 again increased in

FY 2003/04 but goes on decreasing till FY 2005/06. After that the share of excise duties has kept on increasing from FY 2006/07 to 2010/11. This shows that VAT collects more revenue than other taxes. However, there is no substantial increase in VAT which might be the lack of upgrading of VAT collection system.

5.5 Share of VAT in GDP

Gross Domestic Product is the total market value of all final goods and services produced in a country in a given year, equal to total consumer, investment and government spending, plus the value of exports, minus the value of imports. So the share of VAT in Gross Domestic Product is shown in the following table.

Table 5.4

Share of VAT in GDP

(Rs. In Billion)

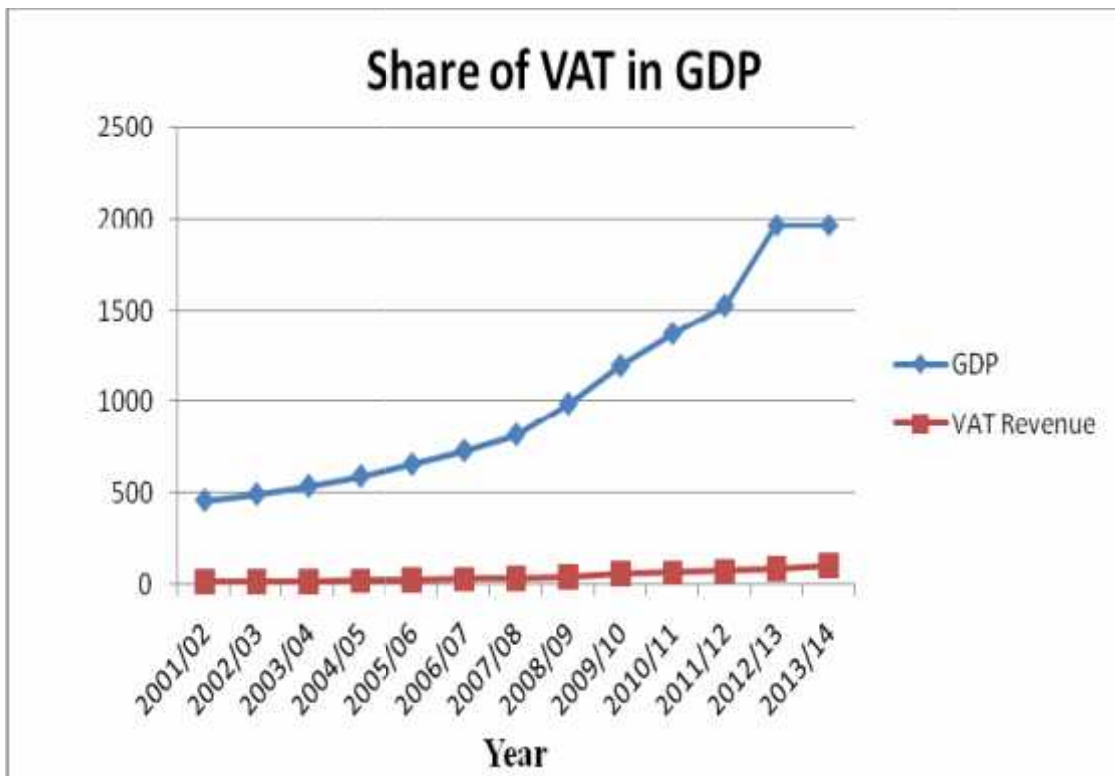
Fiscal Year	GDP	VAT Revenue	Percent of GDP
2001/02	459.4	12.27	2.67
2002/03	492.2	13.46	2.73
2003/04	536.8	14.48	2.70
2004/05	589.4	18.88	3.20
2005/06	654.1	21.61	3.30
2006/07	727.8	26.1	3.59
2007/08	815.7	29.8	3.64
2008/09	988.3	39.7	4.01
2009/10	1193.7	54.9	4.59
2010/11	1369.4	61.7	4.50
2011/12	1527.34	70.93	4.64
2012/13	1964.54	83.41	4.24
2013/14	1964.54	101.1	5.14
Average	1021.78	42.18	3.76

Sources: Economic Survey FY 2014/15

Table 5.5 shows that trends of VAT revenue to GDP are increasing from FYa 2001/02 to 2002/03 but slightly decreased in 2003/04. Since 2004/05 the VAT revenue is continuously increasing till 2009/10 but slightly decreased in 2010/11. Again it increased in 2011/12 and slightly decreased in 2012/13 and again it increased in 2013/14. This shows that there is positive impact of VAT after its implementation. However the amount of the VAT collection would have been more if there was better cooperation of the businessman, tax authorities and awareness level of consumers.

Figure 5.4

Share of VAT in GDP



Source: Based on Table 5.5

5.6 Share of VAT in Total Revenue

VAT is one of the several sources of the total revenue. The contribution of VAT in total revenue is shown in table no. 5.6.

Table 5.5**Share of VAT in Total Revenue****(Rs. In Billion)**

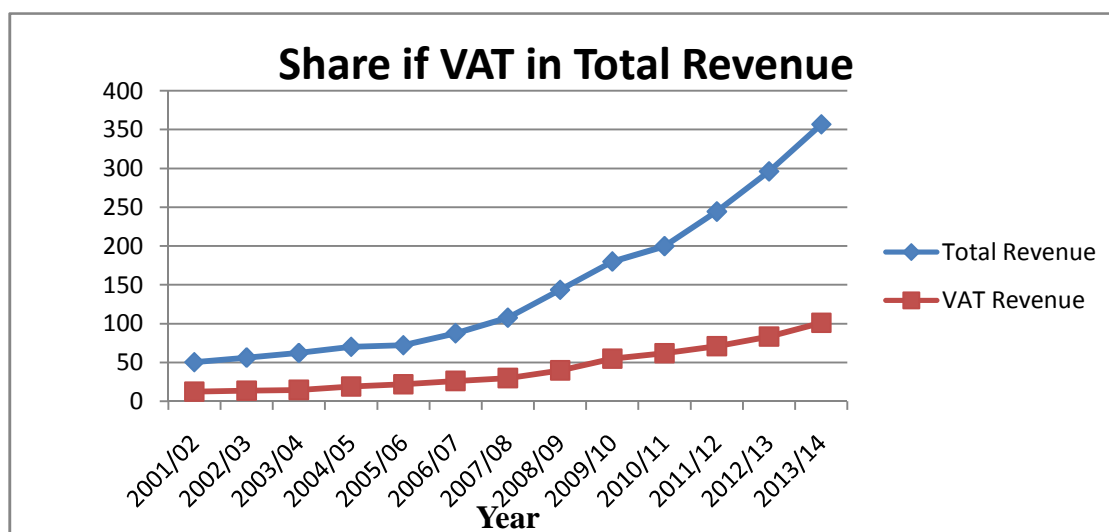
Fiscal Year	Total Revenue	VAT Revenue	Percent of Total Revenue
2001/02	50.44	12.27	24.32
2002/03	56.23	13.46	23.94
2003/04	62.33	14.48	23.23
2004/05	70.12	18.88	26.93
2005/06	72.28	21.61	29.90
2006/07	87.71	26.1	29.75
2007/08	107.62	29.8	27.70
2008/09	143.47	39.7	27.67
2009/10	179.94	54.9	30.51
2010/11	199.82	61.7	30.88
2011/12	244.37	70.93	29.02
2012/13	296.02	83.41	28.17
2013/14	356.62	101.1	28.34
Average	148.23	42.18	27.71

Sources: Economic Survey 2014/15

Table 5.6 shows that in 2001/02 the share of VAT revenue with respect to total revenue was 24.32 percent but after that goes on decreasing till 2003/04. The share of VAT increased to 26.39 percent in 2004/05 but again goes on decreasing till 2008/09. Again the share of VAT increased in 2009/10 and 2010/11. Again the share of VAT decreased from 2011/12 to 2013/14. This trend concludes that VAT has remarkable share in total revenue of Nepal.

Figure 5.5

Share of VAT in Total Revenue



Source: Based on Table 5.6

5.7 Share of VAT in Total Tax Revenue

There are several sources of total tax revenue. Among them the contribution or the share of VAT in total tax revenue is examined from the table 5.7.

Table 5.6

Share of VAT in Total Tax Revenue

(Rs in Billion)

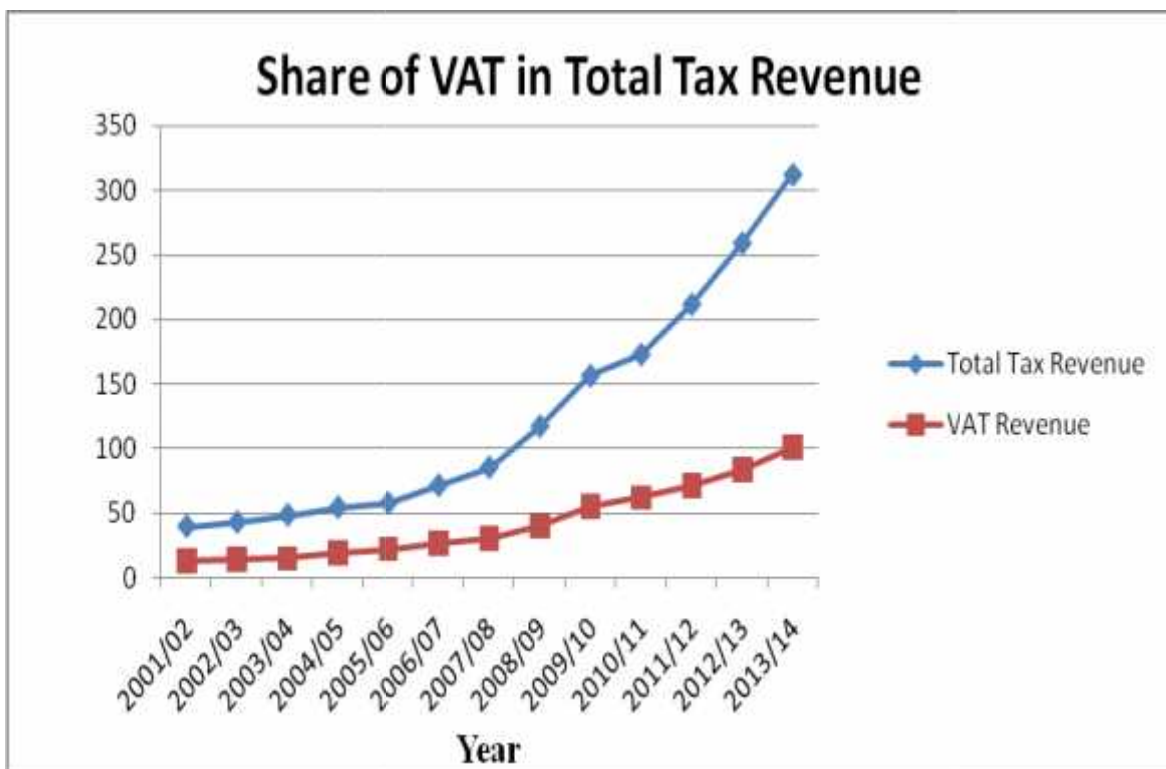
Fiscal Year	Total Tax Revenue	VAT Revenue	Percent of VAT in Total Tax Revenue
2001/02	39.33	12.27	31.19
2002/03	42.58	13.46	31.61
2003/04	48.17	14.48	30.06
2004/05	54.10	18.88	34.91
2005/06	57.43	21.61	37.63
2006/07	71.13	26.1	36.69
2007/08	85.15	29.8	35.01
2008/09	117.05	39.7	33.91
2009/10	156.29	54.9	35.12
2010/11	172.77	61.7	35.71
2011/12	211.72	70.93	29.02
2012/13	259.21	83.41	28.17
2013/14	312.44	101.1	28.34
Average	125.18	42.18	32.87

Sources: Economic Survey 2014/15

Table 5.7 shows that the share of VAT revenue with respect to total tax revenue was 31.19 percent in fiscal year 2001/02 and increased in 2002/03 but slightly decreased in 2003/04. In fiscal year 2004/05, the share in of VAT revenue was increased to 34.91 percent again increased to 37.63 percent in fiscal year 2005/06. The share of VAT slightly increased to 36.69 percent in 2006/07 but decreased till 2008/09. It again increased to 35.15 percent in 2009/10 and to 35.71 percent in 2010/11.

Figure 5.6

Share of VAT in Total Tax Revenue



Source: Based on Table 5.7

5.8 Share of VAT in Total Indirect Tax Revenue

There are several sources (excise duties, custom duties etc.) to collect indirect tax revenue. Among them, the share of VAT in indirect tax revenue collected in different years is shown in the table 5.8.

Table 5.7**Share of VAT in Total Indirect Tax Revenue****(Rs. In billions)**

Fiscal Year	Total Indirect Tax Revenue	VAT Revenue	Percent of VAT in Total Indirect Tax Revenue
2001/02	28.73	12.27	42.71
2002/03	30.01	13.46	44.85
2003/04	36.26	14.48	39.93
2004/05	41.02	18.88	46.03
2005/06	43.46	21.61	49.72
2006/07	52.13	26.09	50.05
2007/08	62.06	29.81	48.03
2008/09	82.71	39.70	48.00
2009/10	114.38	54.92	48.02
2010/11	123.91	61.66	49.76
2011/12	110.56	70.93	64.1
2012/13	129.27	83.41	64.52
2013/14	157.71	101.1	64.10
Average	77.86	42.18	50.75

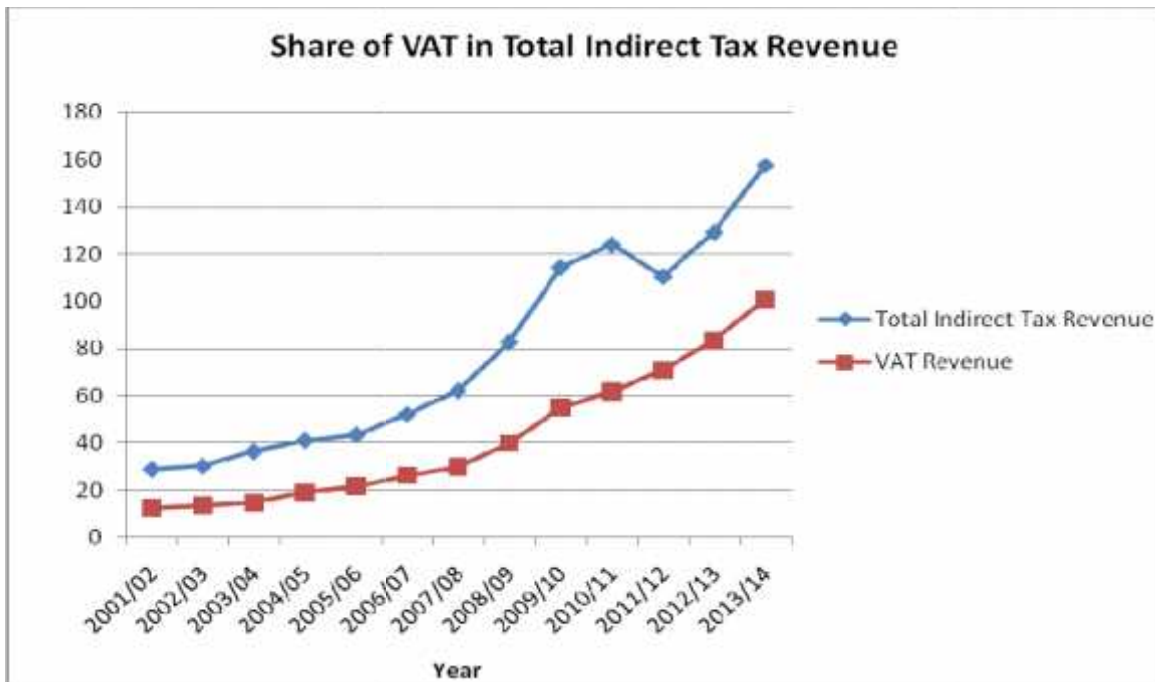
Sources: Economic Survey 2014/15

Table 5.8 shows that share of VAT revenue to total indirect tax revenue was 42.71 percent in fiscal year 2001/02 and increased to 44.85 percent in 2002/03 but decreased to 39.93 percent in 2003/04. The share of VAT goes on increasing from 2004/05 to 2006/07 but started decreasing from 2007/08 to 2008/09. Again share of VAT increased to 48.02 percent in 2009/10 and 49.76 percent in 2010/11. In 2011/12 and 2012/13 it increased to 64.1 percent and 64.52 percent and slightly decreased to 64.10 percent in 2013/14.

Though the revenue collection through VAT is positive but it is not collected as per the expectation of the government due to the loopholes of administration, fraud of businessman and lack of awareness of people. So, VAT can be made as the main source of revenue collection if there is better cooperation of government agencies, private sectors, civil society and general public in Nepal.

Figure 5.7

Share of VAT in Total Indirect Tax Revenue



Source: Based on Table 5.8

5.9 Problems of VAT in Nepal

VAT has already entered its seventeenth year of implementation and various problems have been noticed during this period in Nepal. There are substantial problems that have affected its worthiness of implementation. Businessmen, consumers and tax administrators are all tangled with the weak side of VAT's implementation and its administrative processes. The legal incapability, institutional structure, computer system, rational thoughts towards VAT, trustworthy behavior from all parties involving in VAT and so on are the few examples that have engulfed the VAT system in a negative tangled web. Therefore it has been essential to analyze the problems in its implementation and ongoing processes regarding to VAT and find out the measures to diminish them. Current problems existing in VAT are as follows:

(a) Consumers Unwillingness for VAT paying

The consumers are confused and agitated as the government has not been able to give confidence to the public that the tax paid amount will be properly utilized. Since the leakage in financial system in Nepal having lots of loopholes with immense corruption, people have been adamant to rely on if the money they have paid as VAT would really go the taxation department or not. The consumers also do not know which shop would give VAT invoices and which shop would not. The consumers know that no actions will be initiated by the

administration when VAT invoices are not issued even in a place, where VAT invoices should be made (Joshi, 2001).

(b) Defective Organizational Structure

The organizational structure of tax administration is defective. This type of tax such as VAT department creates tax department, tax department, customs department and various field offices are created under each department. There are 17 offices under VAT Department and 29 main custom offices and 143 sub-customs offices under the custom department. Most of these offices deal with the limited numbers of taxpayers and collect a nominal amount of revenue but different types of tax offices exist in the same area. The physical conditions of most of these offices are not satisfactory. There is not even adequate space in many offices. Lack of furniture, photocopies, computers etc has been common so far. Taxpayers are required to visit different offices in connection with various taxes. They also have to know about the different procedure related to different taxes. This increases their compliance cost. On the other hand, tax official have to deal with the same taxpayers different items in connection with different taxes. This does not only increase the administrative cost of collection but also opens the scope for corruption and harassment. This works as a hindrance to the smooth functioning of the private sectors. Similarly, most of the revenue offices are organized in traditional line, where one officer is responsible for all function of a tax such as registration, assessment, audit and collection. It opens scope for collusion and corruption.

(c) Issuing and Receiving of Invoices

Billing system plays the vital role in the VAT implementation. On the basis of invoice, it is determined how much tax the taxpayer paid in the purchase, how much was taken from the sales, how much has to be paid to the government and how much has to be refunded. But in practice, the trend of billing system is very low in the market till date yet. In context of Nepal, some businessmen have not been issuing the invoices, some have been issuing improperly even if they have issued, while others have been stating that an additional thirteen percent has to be paid, if invoices are required. And this lack of practicing of issuing receiving invoices in the market has remained one of the obstacles to the effective implementation of VAT. However, to sort out these problems, the government initiated the policy of accepting the transaction price for the purpose of custom duties instead of the custom's separate billing evaluation. It seems to have established the proper billing system in sales, and the opportunity of self-declaration of old stock was given to the sellers with some

facilities. Similarly few programs were conducted to the tax payers and consumers in calculating the habit of issuing and receiving invoices. Despite of the government's effort to have a proper billing system and awareness messages to the customers, the practice of issuing and receiving proper invoices could not be increased due to the following reasons.

-) Importers' habit of under invoicing at the customs and issuing improper invoices while selling those goods, in order to evade the various taxes including custom duties
-) Other businessmen do not issue proper invoices; if they do not receive the proper invoices from the importers
-) Some taxpayers do not want to receive the proper invoices at the purchase due to the fear that they have to pay the income tax
-) Some consumers do not have much concern in receiving invoice
-) Custom administration does not do the purchase of post audit of imported goods that have been undervalued by preparing reference price list.
-) At present, there is legal provision to impose customs in terms of transaction price. But it is found that custom is imposed on the basis of price of custom evaluation registered as before and sometimes, it is imposed by increasing the price in Adhoc basis.
-) Inland Revenue Administration does not make the domestic market price list necessary or the audit for taxation.
-) Inland Revenue administration does not conduct the sufficient monitoring and follow of the market to check whether or not invoices are being issued and whether they are being issued properly.
-) The taxpayers can also issue the computer bill, but they tend to erase large amount of transaction with the objective of tax evasion, it is due to the lack of developed mechanism to control the transaction entered in computer.
-) The provision to have the stamp of tax officer in the invoice while referring the stock of goods, costing Rs 10,000 at one time, is experienced to be problematic.
-) The trend of not invoicing or under invoicing found in the sales and distribution of domestic production or services. And under invoicing in initial stage of production or

sales of services causes under invoicing in successive stages of sales and distribution too

(d) The Large Number of VAT-Exempted Goods and Services

The numbers of VAT exempted goods and services are still large. This large number of exemption works against the principle of VAT and this leads to loss of revenue, transparency, neutrality and efficiency of VAT system and revenue leakage controlling mechanism. It further leads to the unnecessary complication of the tax system. The exemption does not seem justifiable except in the case of administrative complications, since VAT is based on the consumption and used only for revenue collection in the world (Joshi, 2001).

(e) Large Numbers of Non-Registered Potential Taxpayers Promoting Unhealthy Competition

Many potential taxpayers have not been registered yet. It is believed that non-registered taxpayers are not more in Kathmandu. In one hand, there is the large number of potential taxpayers while on the other hand; the illegal import under invoicing is great. As a result, the honest taxpayers who are within the VAT net have to do unfair competition with other sellers. If such trend extends, the honest and registered taxpayers will have the problem to continue e-transaction. In such condition, the policy to make tax system transparent, basing on transaction cannot be successful.

(f) Unsatisfactory Status of Tax Returns

The present status of tax return is not satisfactory. In total returns, credit returns are found to have been high. Credit return is natural in some extent due to the nature of VAT but large number of credit return shows unhealthy situation. Not-billing or under invoicing, ineffective patrolling of IRD, and ineffective tax audit in market are the causes of large number of credit return. Likewise present number of zero return is also large. The small contractors also registered in VAT to involve in the contract with the government's offices, most of them present zero returns. That is why the percentage of zero return is large. Out of the registered taxpayers, about 15 percent tax payers do not submit their file in due time.

(g) Delay in Tax File Procession

Tax file entry and procession do not seem to happen in time. And the discipline to precede the right file has not been maintained. As a result, the number of suspended file has unnecessarily increased. Likewise, taxpayers, who do not submit their file in due time are not

informed in time and computer tax assessment has not been made in time regularly. Due to the increasing number of taxpayers, the problem is likely to increase.

(h) Frequent Disputes Concerning the Thresholds

In an original VAT Act, threshold limit was determined to Rs. 1 million. Finance Act 1997 increased it to Rs. 2 million and again, the changed Finance Act 1998 increased it to Rs. 3 million just after eight months of its implementation. First amendment in VAT Rules 1997 was done only to further increase the threshold limit to Rs. 4.5 million. The Finance Act 1999/00 again replaced this amendment. The threshold limit again lowered to Rs. 2 million. Thus it can be seen, as the threshold limit has been a much debated issue in Nepalese context. Some consider that the existing threshold is too low and should be increased while others consider that the registration should be reduced or remove. If the threshold is too high, a majority of the businessmen may not come under the VAT net and under such circumstance; it will simply not be possible to implement VAT effectively. Therefore, it is common to keep the threshold as low as possible. If a VAT threshold is not established, even small vendors will have to be brought under the VAT net. If the threshold is abolished, then the thousands of small vendors will have to register for VAT and it will be hard to control the large number of taxpayers in a country. Bringing very small vendors under the tax net cannot be justified from revenue, administration, or equity points of view. It is for this reason that all the countries keep vendors outside the tax net through a medium of a threshold and this factor is equally relevant in the context of Nepal.

(i) Provision on Refunding to Tourists

There are no provisions to refund the VAT levied on the goods purchased by the tourists. So the burden of tax to some extent has fallen in export as well.

(j) Open Border and Unauthorized

There is not only measurement of authorized trade between Nepal and India. It is generally agreed that such trade in the border area is considerable. Many businessmen have claimed that only a little amount of goods from India comes through customs. One of the main points of opposition of the businessmen opposing VAT is that, it is not feasible due to open border with India and illegal imports from India. They are saying that they cannot compete with illegal imported goods or goods brought without paying tax and imported goods by paying minimum custom duties. Unauthorized trade is very much organized in systematic in the border area, there are many organized groups active on the both sides of border and these

groups are responsible for illegal supplying goods from India to Nepal, Nepal to China and China to Nepal.

(k) Practical Inconveniency of Tax Refunding System

Tax refunding system is not convenient in practice. If the tax payer has paid more tax in purchases than that has been collected in sales that exceeded amount should be refunded in VAT system. In case of the export, it is refunded immediately. In case of local salesman, it can be adjusted in tax to be paid in the following month. If the credit cannot be adjusted for six consecutive months, there is provision to get a refund of the exceeded amount. Export permit-card and LC or bill of entry and certificate of payment clearance are required to verify the exporting. Likewise, purchase invoice and import permit card are required to verify the tax paid in purchase. Presently, except in the case of Tibet, production certificate is asked to export the goods in other countries. Now it has been found that the bill of entry is not asked in the case of export to Tibet, according to which, there is provision of refunding tax, after verifying the certificate of tax paid on export and import or sales. But in practice, it is not so because in some cases, it is found that VAT personals refund without inspecting the tax refunds made up to the period of the refund claim and they refund without checking the value added and recovery ratio.

(l) Increasing Outstanding Amount and Total Tax Credit Amount

Both the tax outstanding amount and tax credit amount are increasing every year. The increasing amount of outstanding has left adverse effect in the revenue collection. In public finance, not depositing collected tax from the customers in government revenue is a serious crime. The international experiences show that the taxpayers are likely to misuse the tax credit but it has not been estimated in Nepal yet. However, the dishonest taxpayers might be caught in upcoming days. If the controlling mechanism is not developed by the VAT administration-expanding audit and investigation activities in order to identify and remove such artificial credits, it cannot be totally trusted that some of the numbers are not fabricated because of taxpayer's aim to reduce tax liability by submitting artificial credit files.

5.10 Prospects of VAT in Nepal

VAT is desired to achieve the goals of neutrality, revenue productivity, fairness and transparency etc. It is modern and effective tax system, which checks the loopholes, such as under valuation, non-recording and unauthorized trade. It discourages such issues and problems existing in the sales tax system. That's why VAT is considered to be the best fiscal

tool for revenue mobilization, especially in an economy with acute shortage of resources.

On the other hand, there is less possibility of collection of huge amount of income tax because of low per-capita income of Nepalese people, therefore VAT is found one alternate. Because of all these factors, Nepal has already adopted broad based consumption type VAT, using tax credit method. Despite the preliminary resistance, VAT is currently well received by customers as well as the business and industrial communities. There has been made a progress in revenue mobilization. The prospects of VAT for the revenue mobilization can be outlined as;

a. VAT Revenue Mobilization at Various Rates

The present rate of VAT in Nepal is low, so the revenue mobilization from VAT could not take momentum. The performance of VAT has been criticized²⁵ by comparing it with sales tax because it could not fulfill the revenue requirement of the government. If multiple VAT rate is implemented with adequate preparation and study, the revenue collection trend will increase more goods and services come under VAT net.

b. Revenue Mobilization by Broadening VAT Base

To meet the growing expenditure of the government, it is necessary to increase the revenue mobilization through broadening the tax base. The base of VAT can be broaden by including the value addition that takes place at all sector and level of economic activities, within the preview of tax. In the present Nepalese context, the base of VAT can be broaden by bringing all goods and services and all sectors within tax preview i.e. taxing all commodities including zero rated goods and taxing agricultural products etc. and the exemption should be limited.

c. Reducing the Threshold Level

VAT is not applicable to all transaction. An annual threshold of Rs.2 million in transaction has been specified for this purpose. But still there is strong argument that the present threshold is high. Because of high level of threshold only limited business vendors are registered, which is providing scope for the sales of smuggled or undervalued goods. Collection of all vendors will have to bring under VAT net; this is possible at low level. Although, it seems administratively difficult and socially unacceptable, it will be one way of giving the VAT revenue momentum. If the threshold level is too high, a majority of the businessmen may not come under the VAT net and under such circumstances will not possible to implement VAT effectively. Therefore, it is common to keep threshold level as

low as possible. The threshold level should be fixed based on the administrative capacity, the capacity to maintain accounts in the industry and commercial sector, the need for revenue etc. 26 Because of fragmented, self-subsistence economic structure and unorganized business sector, it is assumed that the number of business vendor having annual transaction less than Rs.2 million is many times more than the vendors having annual transaction above than Rs. 2 million. So, it is necessary to review the present threshold level.

Behind this, there is a huge prospect of revenue mobilization through improving tax laws and regulation, improving institutional and infrastructure development. Furthermore, tax friendly environment can be created by the government provoking education; information and knowledge to the tax payers.

CHAPTER VI

SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS

6.1 Summary of Findings

This study is attempting to analyze the contribution of VAT in tax revenue in Nepal, assess the policies of VAT and problems of VAT in Nepal. The base of VAT is the value addition that takes place during process of production and distribution. Since this tax is based on consumption, the burden of this tax has to be done by the consumer. VAT is based on consumption; the burden of tax has to be borne by the consumer.

VAT is based on self-assessment system. Under this system, a tax payer is required to keep a proper account of his all business transaction. Therefore, the returns files by the tax payers by assessing their tax liability have to be accepted by the tax administration not only in principle but also in practice. VAT has done away with administrative procedures such as taking approval of price for purpose of sales tax, submission of annual statement of accounts tax assessment by the tax officers stamping of invoices, submission of invoices to the tax office along with the tax returns, etc.

Summary of findings are as follows:

-) In the Nepalese context, VAT was implemented in 16 Nov. 1997 when the tax system review task force headed by Prof. M.K. Dahal proposed and recommended to implement VAT. The structure of Nepalese VAT is designed in VAT act 2052. Its coverage is defined with reference to both taxable transactions and taxable persons. The base of VAT is the value added by each firm through its production and distribution activities. According to VAT act 2052 the tax rate is 10% (now changed to 13%) and exports are subject to rate of zero %. There are certain cases such as exemptions and zero ratings under which commodities are tax free. A taxpayer is allowed to deduct the tax paid on purchase for his business from the collected on sales. This deduction is known as an input tax credit. Under the Nepalese VAT system, there is a provision for the refund of VAT. Such a situation arises in the case of zero rated supplies such as export. Small vendors having an annual turnover of certain amount (Rs. 2 million) are not required to register under the VAT system.
-) Comparing VAT with other forms of tax, it is so far superior on many grounds such as economic efficiency, revenue productivity and administrative simplicity. However

retail level and wholesale level both will generate equal revenue with similar coverage and rates if VAT can be implemented effectively along with its different provisions like exemption, threshold, zero-rating. Avoidance of pyramiding and cascading effects and providing cross auditing, self policing and catch up effects are the most favorable features of VAT which make it superior even than retail sales tax. VAT has crossed its sixteenth years of implementation. Lack of understanding between government, political parties and the private sectors create some hurdles in the beginning period of VAT implementation. Hence, there was minimal tax awareness, improper tax accounting system, smuggling, under-valuation etc which leakages tax.

-) Nepalese VAT is a consumption type and the method used for calculation of VAT is tax credit method. The VAT is subjected to destination principle, the current threshold limit is two million and it is subject to flat rate of thirteen percent with zero percent rates on the administrative complexity and equity consideration.
-) The overview of Nepalese VAT system from FY 2001/02 to 2013/14 shows that VAT contributes 5.14 percent of GDP, 28.34 percent of total revenue, 28.34 percent of total tax revenue and 64.10 percent of total indirect tax. The gap between actual VAT and its potential is large and widening every year because of the lack of proper practice of invoicing, inefficiency of tax authorities, irresponsible consumer, ineffective implementation of threshold, improper monitoring of zero rates goods, lack of coordination between custom and VAT offices, increasing corruption, poor information system and lack of transparency. It is expected that skilled manpower, well computerized system, honest businessman, responsible consumers, rule of law, clear plan and policies and transparent government with enough commitment to its duties will certainly enrich the successful implementation of VAT which will solve the problems of tax evasion and its undervaluation. Hence the country will collect enough revenue for the development activities of the country.
-) Though the trend of total revenue collection in Nepal shows the continuous increase over the period, the resource gap of the government seems to be increasing more. The share of tax revenue is significantly higher 87.61 percent of total revenue whereas the non tax revenue is 12.39 percent of total revenue in FY 2013/14. The share of indirect tax is always dominant from the very beginning period. Indirect tax is composed of custom duty, excise duty, Sales tax/VAT etc. But among them the share of VAT is more. VAT contributed 64.10 percent of total indirect tax in FY 2013/14.

6.2 Conclusion

Nepal has implemented VAT since 16th November, 1997. VAT act, rules and regulations have been set up in the line of international standard. The implementation of VAT is a great jump from the traditional tax system but several things are still lacking to be done for the successful implementation of VAT in Nepal. This study discusses various features of VAT such as its contribution in revenue, administrative policy and its computation and the existing problems in VAT. Unless the problems in VAT are addressed rationally, the potential of revenue collection would not match with the practical revenue collection. So these problems are needed to minimize continuously up to its diminishing level. After that having technological assistance and logical addition in multiple components of VAT, it can really help to resource mobilization of the country by heavily generating the increased-revenue collection in the country. The following recommendations have been made to make VAT effective and more efficient for business communities, tax-administrators, the common consumers, and other stake holders who have interest in the VAT policy.

The narrow tax base system of the previous sales tax failed to generate the minimum required amount of revenue because it included only the import and manufacturing unit. To reduce this problem Nepal introduced VAT in 1997 as the part of national tax reform. The biggest virtue of VAT is that it is revenue buoyant and highly instrumental for revenue mobilization especially in an economy with acute shortage of resources.

The trends of revenue collection show that there will be higher potentiality in VAT revenue if the government pays higher attention in VAT by blocking the loop-holes of leakage for effective resource mobilization. After analyzing VAT and total revenue, VAT and total tax revenue and VAT and indirect tax revenue, we can conclude that that VAT has contributed a significant percentage in total revenue, total tax revenue and total indirect tax revenue because they have higher positive relationship.

It can be concluded that the revenue collection trend is progressive through VAT in Nepal. It is found that the percentage of VAT in total GDP is almost constant due to inability of the government to manage open border, ineffective tax administration, and dishonesty of businessmen. The single positive rate of 13 percent should be changed into multiple rates to collect more revenue from different sectors. Further, the successful implementation depends on the strong, fair, capable administration. Thus, VAT can be entrenched as an integral part

of the Nepalese tax structure in the long-run if the issues mentioned above are taken seriously and solved accordingly.

6.3 Recommendations

Since the implementation of VAT is a great jump from the traditional tax system to a modern one, several things are still lacking for the successful implementation of VAT in Nepal. In such situations, following recommendations have been made to make VAT effective and more efficient on the basis of findings and conclusions of the study.

-) Nepalese policies are directed by the politicians. The bureaucrats do whatever their political leaders call for. Most of the politicians are motivated by their own benefits and hence, defective policies are likely to be made. Due to political interference, policies are not so effective to generate VAT revenue as it was expected during the initial implementations. Thus, political interest highly influences economic policies.
-) Political commitment is one of the most essential phenomenons for the success of government policies. This is true for VAT implementation as well. The leader shows their commitment but intentionally nobody has strong will power to make VAT system successful and more effective. There is a lack of proper cooperation and coordination between government and opposition parties. Hence, government should create favorable political environment for effective and successful implementation of VAT.
-) The success of VAT system is not only the success of the IRD, but also the success of nation as whole. The role of general media, radio, TV, newspaper plays an important one. Emphasis should be given on mass media. Awareness towards VAT system should be crated among general public, non-government and government organization.
-) Many businessmen having taxable capacity are beyond tax net. So the enforcement should be made more effective and voluntary compliance should be encouraged. The level of voluntary compliance could be raised through a set of promotion and regulatory measures including positive and service minded attitude of tax officials, rationalization of tax administration simplification of tax procedures and forms, strengthening tax administration, conducting audit and investigation in an effective manner and panelizing those who break the rules. The procedures regarding

registration, collection, interest, penalty, audit and appeal should be simplified and improved.

-) There should be close cooperation between the private sector and government sector for the successful implementation of VAT. Both sectors should always be taken into confidence by each other. Business sector participation in policy making is necessary to increase the VAT revenue for government.
-) The threshold of Nepalese VAT is relatively high because most of the retailers are beyond the tax net, but their contribution on total trade is significant. As threshold and tax, refunds are two possible gates of tax evasion, auditing investigation and monitoring systems should be made simple and effective; and the period of refund should be minimized. It is recommended to minimize the threshold limit to Rs. 1 million.
-) There should be the initiative from VAT administrators to win the trust of industrial and trade organizations as well as professional community. The success of VAT depends upon the honesty and transparency of members of tax administration.
-) The market monitoring system should be more effective, immediate legal steps must be taken against those who try to escape from VAT net by using any means or methods.
-) The exemption list is very long. The exemptions are mainly due to administrative complexity and equity consideration. Agriculture sector is entirely exempted on administrative grounds while many other exemptions are due to vested interest of the politicians. Some basic needs are out of tax net in order to introduce progressiveness in the tax system. But the long list of exemptions is not desirable under a broad based tax regime. Moreover, they are the main loopholes to evade tax. Further, they reduce economic efficiency. So, the exemption list should be shortened gradually, so that in the long-run all transactions fall under VAT net.
-) The existing long open border is the main cause of smuggling and under valuation in the border area. Under valuation in custom points not only reduces revenues from both custom duties and VAT, but also creates dissatisfaction in the domestic market. Hence, it helps to develop smuggling economy in the long-run. So, open border should be regulated to a greater extent. Moreover, customs department and Inland Revenue Department should act in coordinative manner. Actions of revenue investigation department should be strengthened.

-) The VAT refund system must be made more effective in order to refund the tax without delay. The practice of credit refund must be controlled by employing a proper mechanism.
-) Lack of proper billing that is supported, encouraged and forced by the smuggling and under valuation in the border side and lack of public consciousness, is the most challenging problem. Therefore, customs administration should be close cooperation with VAT administration. Moreover, education programs should be initiated to educate consumer about billing system.
-) Computer networking system is necessary. The existing computer system should be revised and an integrated computer network with Customs Department, Department of Tax and Ministry of Finance should be established for information and operation of this system. More improvement is needed in the present communication system.
-) Inefficient staffs lacking practical and specialized training are the serious problem. So, providing training to such staff is highly essential such as e-training.
-) The consciousness consumer program and the conscious seller program will be effective in Kathmandu valley. These programs should be launched and extended all over the country.

So, at last, the government needs full cooperation with the Tax Administration, the taxpayers and businessmen as well as consumers in its efforts to generate more revenue. VAT must be made successful and depends upon honesty, faith and morality of tax officials and business people. Therefore, it is time to action and improvements for effective and successful operation of VAT in Nepal for future perspectives as well as present needs of economic development.

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