

CHAPTER I

INTRODUCTION

1.1 Background of the Study

Economic development of the country depends on the various factor and for the achievement of the economic growth, government should focus on the tools such as reduction of income disparities, poverty alleviation, high employment rate and the improvement of the living standard of the citizen. Government introduces the fiscal policy for the achievement of the desired target that moves the country forward in the path of economic development. For the accomplishment of the above target, government should collect the revenue in various forms and government should mobilize those collected revenue in the productive sector for the economic growth. Revenue plays a vital role in the country for development of a country.

To accomplish its objective, government needs to mobilize a lot of internal resources to fulfill its responsibility towards its nation and people. In developing country like Nepal, there is a necessity for raising a larger volume of funds for the development and administration expenses (Kumar, 2011). Revenue collection in Nepal is a challenging task in itself, which demands increasing necessity of regular expenditure in general, and development expenditure in particular. However, government relies heavily on foreign assistance because of inefficient resource mobilization. Development expenditure has been dependent almost entirely on the foreign aid. External assistance is uncertain, precarious, inconvenient and not conducive to the healthy and overall development. Experience of the most of the developing countries shows that there are negative effects of increasing international grants and loans to finance the public development activities. Thus the government should depend on its own resources for generating revenue in order to finance these regular and development activities. The government can collect revenue from taxable and non-taxable sources. Tax is a key source for revenue generation and mobilization (Kumar, 2011).

Tax is a compulsory contribution by the citizen to the government. In other words tax may be defined that it is a reliable source to increase revenue of government for the

use of public benefit for the overall development of the economy.

Tax can be classified as Direct and Indirect. Direct Tax comprise of Income Tax, Property Tax, Land Tax, Vehicle Tax, etc. These taxes are directly imposed on a person or an organization that bears tax burden ultimately. Indirect Taxes are levied on the supposing that the persons or organization first collect on to pay can transfer the burdens to other e.g., Entertainment Tax, Hotel Tax, Contract Tax, Value Added Tax (VAT), Education Tax, etc. In the act tax word of Dalton “An Indirect Tax is imposed on one person but paid partly or wholly by another”. VAT falls on the group of indirect taxes.

The concept of VAT was first developed by ‘Dr. Wilhelm Von Siemens’ for Germany in 1919. But Carl S. Shoup, an American Professor suggested this Value Added Tax in 1949 to use in Japan. However, it was applied first in France in 1954. VAT has been spreading rapidly since the 1960s and now this has become one of the main stays of the tax system in over the world covering around 130 countries.

In Nepal VAT has come into consideration to replace indirect taxes like as Sales Tax. For this propose a mission was established in August, 1993 A.D. for study, suggestion and implementation process about VAT. But the process of VAT could start since 1995, on worlds only when the parliament pass VAT Act and declared its enactment from November 16, 1997. Value Added Tax also called as a goods and service tax (GST) because it is charged on goods and Services. VAT with single rate of 10 percent has been decided to implement with effecting from 1997, but due to some problem it was only implemented from 1997. But HMG Nepal has increased it to 13 percent with effect from 2004.

VAT is the recent innovation in the field of taxation. It is the tax imposed on value added by business firm on goods and services at the successive stages of production and distribution. Value addition on a commodity or services is simply the excess of sales value over business purchases by a business entity. During the successive stages of production and distribution processes, business enterprises add value to their purchase by processing or handling them by own machinery, building or other capital goods. VAT is considered as one form of sales tax. It is the multiple stage tax which has grown as heterogeneous of turnover tax and retail level sales tax. Thus, VAT is the multistage sales tax which is levied on the value added of business

enterprise at different stage of production and form of old sales tax.

To meet the financial requirement of the government, taxation has become one of important sources of resource mobilization and also helpful in income redistribution and economic stability. The taxation is the function of economic development to combat inflation, alleviate poverty, reduce the gap between rich and poor, narrow the size of revenue expenditure, promote the national economy, mobilize the domestic resources for economic development and save the domestic economy.

There is predominant role of indirect taxes, specially import duty and sales tax in Nepalese structure. Income tax and other indirect taxes did not seem to play effective role in revenue generation because of their inefficient operation. Sales tax, however, provided a considerable bulk of revenue, but it suffered from its very narrow base and cascading and pyramiding effects, creating distortions without generating potential amount of revenue. The VAT has been considered as an attractive alternative to exist as an indirect tax system spreading around the world at a speed which is unmatched by any of other tax in the modern time (Shoup, 1990). Although it is the youngest form of taxation innovated in first decade of the twenty century. It has been emerging as a main element of the worldwide tax reform, in every attempt of tax reform VAT is gaining the primary preference.

The direction and tax reform in developing countries established that, among other things, the VAT is the most important choice and ingredient of tax reform. The tax reform and adoption of a VAT is, therefore essentially connected with the efforts of many underdeveloped countries to achieve the goals of economic development. Since, the VAT is one of the component of indirect taxes developed in the past, is probably the best tax system that had never been at the top of the tax system. VAT may be adopted by developing countries with no extra difficulties. VAT is an important instrument for mobilization of internal resources, and mobilization of internal resources decrease the pressure of VAT in economic activities. Since VAT is an indirect tax, no one can deny because of its illuiveness and taxpayers don't feel direct burden of in developing country in Nepal. Indirect tax is a major source of the tax revenue in Nepal. It covers about 80 percent of tax revenue. Major heading of indirect tax is custom duty and excise duty. In fact custom duty and excise duty are a kind of narrow based sales tax. Custom duty is followed by sales tax (now it is called VAT) in case of contributing in indirect tax revenue. The tax reform and adoption of

VAT is, therefore, essentially connected with the efforts of many underdeveloped countries to achieve the goal of country's economic development. Value added tax system is designed to address various problems associated with the conventional sales tax system.

VAT is the most important innovation of the 20th century. It is a scientific tax system, which was first introduced in 1954 in France. It has been spreading all over the 1960's and now this tax has become one of the mainstays of the tax system in over 145 countries. In Nepal VAT has come into consideration to replace of old indirect taxes. It was introduced on 16th November, 1997. It is a modern tax system intended, when fully operational, to improve the collection of taxes, to increase efficiency and to lessen tax evasion. VAT will replace the existing Sales Tax, the Contract Tax, the Hotel Tax and the Entertainment Tax. It has been designed to collect the same revenue as the four taxes it replaces. VAT is the supplementary of sales tax, entertainment tax, contract tax and hotel tax. It is believed 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. The self-policing and catch up effect of VAT has turned out to be the rationale of the VAT system.

VAT is the transparence tax system that is based on the taxpayer's transition. VAT is not only transparent in it but also demands transparency in other tax system as well. Unless such environment is created, VAT cannot be implemented effectively. VAT is the youngest member of the sales tax member of the sales tax family, which is broad based. Since the base of the VAT is extensive, under this tax resume more revenue can be collected through lower rates. The effective implementation of this tax can help in reducing the rates of custom duties and income tax along with reducing smuggling of imported goods and hence improves that balance of payments, reduces the unintended distortions, services horizontal equity in a greater degree and makes the tax system simple and natural.

Tax is a compulsory contribution made to government by its citizen according to some general rules. Without reference to any special benefit, which said contributors are expected to produce. In other words tax may be defined that it is a reliable source to increase revenue of government for the use of public benefit.

To conclude, VAT has been 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, which leads to revenue enhancement and economic efficiency. VAT, being a multi-point tax, provided a number of opportunities to the Government to gain access to the revenue. It is an important instrument for the mobilization of internal resources. There is tremendous scope for increasing the revenue from VAT. The tax reform with adoption of VAT is, therefore essentially connected with the efforts of many underdeveloped countries as one of the major elements of tax revenue to achieve the goal of country's economic development (Shrestha, 2008).

1.2 Statement of the Problem

Nepal as developing country, effective mobilization of the revenue collection is very important for the upgradation of the economy as GDP per Capita of Nepal is very low. GDP per Capita of Nepal is 752 US Dollar, which is lowest among the SAARC Countries (MoF, 2015). The GDP Value of Nepal represents 0.03 percent of the world economy. This shows that the Tax as a instrument of the Fiscal Policy helps to maintain the economic development through its effective mobilization. Economic Growth of the Country can be measured by the GDP, GNP per Capita, Employment rate, Inflation, Poverty rate. And the above mentioned factors are possible with the mobilization of the revenue collected through various form of TAX. Among the various tax, VAT is one of the most important and effective techniques to collect more revenue for the economic development. Introduction of VAT in Nepal triggered hot debate about its merits and demerits in the Nepalese Economy. There are various issues as well as challenges regarding VAT System in Nepal.

This research study helps to answer the following questions:

- What are the challenges being faced by the government and taxpayers in VAT collection ?
- What are the efforts made by the government to collect VAT ?
- What are the opportunities of VAT collection in Nepal ?
- What are the current trend and contributions of VAT on GDP, Total Revenue and Tax Revenue ?

1.3 Objectives of the Study

The general objective of the study is to analyze challenges and opportunities of VAT in Nepal. But the specific objectives of this study are as follows:

- To analyze the challenges being faced by the government and taxpayers in VAT collection,
- To study the efforts made by the government to collect VAT,
- To identify the opportunities of VAT collection in Nepal,
- To find out the trend and contributions of VAT on GDP, Total Revenue and Tax Revenue.

1.4 Significance of the Study

VAT is a recent system in the arena of tax administration. This paper will assess critically the performance of VAT in Nepal since its inception to date, focusing basically on four aspects of it, viz, (i) Collection and reporting of VAT, (ii) Problems faced by the taxpayers and (iii) Actions required to be taken, and (iv) Trend and contribution of VAT on Nepalese economy. So, this study will be beneficial in terms of viewing the current taxation scenario and will be helpful for administration for the effective and efficient implementation of the vat system minimizing the evasions and possible loopholes and may bring positive impact in overall tax system (Koirala, 2010).

Nepal has adopted VAT since November 16, 1997. In the present situation of Nepal, tax reform and adoption of VAT as a substitute of existing sales taxes is expected to improve the Nepal's tax system in various ways. The sales tax system is very narrowly based and less productive. It is also putting much pressure on economic activities by its distorted character. By contrast, VAT would broaden the tax base and increase the revenue elasticity. Hence the main focus of the study is to find out how VAT is superior to sales tax and what is its share in the Gross Domestic Product (GDP), thereby showing a substantial change between the two periods i.e. before implementation of VAT and after its implementation. The study also critically assess the administration of VAT in Nepal, analyzing the lapses and problems with necessary measure for improvement.

It is helpful in

- Analyzing the challenges being faced by the government and taxpayers in VAT collection,
- Identifying the efforts made by government to collect VAT,
- Identify the opportunities of VAT collection in Nepal,
- Examining the trend and contributions of VAT on GDP, Total Revenue and Tax Revenue.

1.5 Limitations of the Study

- Secondary data has been used in this study and therefore the results depend on the reliability of secondary data.
- It is not a complete study of the whole tax system in Nepal.
- The period of data analysis has been taken from FY 2004-05 to 2014-15.

1.6 Organization of the Study

The study is divided in six different chapters. The first chapter introduces the background of the study, statement of the problem, objectives of the study, significance of the study and limitations of the study. The second chapter reviews some books, articles, publications of governments, etc. The third chapter deals the research methodology. The fourth chapter highlights the historical background of VAT in Nepal. The fifth chapter analyzes the challenges and opportunities of VAT in Nepal. Finally, the last chapter covers overall summary of findings, conclusion and recommendations.

CHAPTER II

REVIEW OF LITERATURE

2.1 Introduction

Tax is a compulsory contribution to the government from a person without exception of special benefit. In a broader sense, there are two types of tax. One is Direct Tax and another is Indirect Tax. Property Tax, Gift Tax and Income Tax etc. are examples of Direct Tax. The person on whom it is legally imposed directly pays it. On the other hand, Value Added Tax, Hotel Tax, Entertainment Tax, Education Tax, Custom Duty and Excise Duties are the example of Indirect Tax. It means that Indirect Tax is imposed on one person who paid the tax liability by collecting it from customer by adding it to the goods and services sold or distributed. Thus, Indirect Tax is indirectly collected from the general public or ultimate or final consumer.

VAT is the best form of the Indirect Tax which is imposed on value added amount in different levels of production and distribution of goods and services. It is the most important tax innovation of the second half the twentieth century and the speed with which the VAT has spread around to the world is unmatched by that of any other tax in the modern time. The VAT being a tax on value added, created by a business entity and imposed at every stage of business process, is different than other kinds of tax. In this sense, the same value added is never taxed twice that is cumulative effects do not occur. In practice, the VAT is collected from producer and distributors at many points and treated as multiple stage commodity tax. The tax base for VAT is the value added in production and distribution rather than the value of sales only.

VAT is the improved and modified form of the traditional sales tax and avoids cascading effect existed in sales tax. Value added at each stage of the production and distribution activities. The stage may be import, manufacturing, wholesale and retail. Value added is sale value minus purchase value or conversion cost plus profit. Conversion cost may include wages, interest, rent, depreciation, other expenses & overhead and taxes excluding VAT and income tax. Generally, the tax base (value added) can be directly ascertained from the following equation.

$$\text{Value Added (Tax Base)} = \text{Sales} - \text{Purchase}$$

$$\text{Value Added (Tax Base)} = \text{Conversion Cost} + \text{Profit}$$

Where,

$$\text{Conversion Cost} = \text{Wages} + \text{Interest} + \text{Rent} + \text{Depreciation} + \text{Overhead} + \text{Other Expenses} + \text{Taxes Excluding VAT.}$$

2.2 Review at International Level

According to economy watch website, Value Added Tax, popularly known as ‘VAT’, is a special type of indirect tax in which a sum of money is levied at a particular stage in the sale of a product or service (www.economywatch.com/business-and-economy/vat.html).

Value Added Tax, or Goods and Services Tax (GST), is tax on exchanges. It is levied on the added value that results from exchange. It differs from a sales tax because a sales tax is levied on the total value of the exchange. For this reason, a VAT is neutral with respect to the number of passages that there are between the producer and the final consumer. A VAT is an indirect tax, in that the tax is collected from someone who does not bear the entire cost of the tax. To avoid double taxation on final consumption, exports (which by definition, are consumed abroad) are usually not subject to VAT and VAT charged under such circumstances is usually refundable (www.en.wikipedia.org/wiki/Value_added_tax).

Shoup (1969) has considered that Value Added Tax as the latest and most probably the final stage in historical development of general sales tax, imposed on the value added by the business firms. He explains VAT as the difference between sales proceeds and the cost of the materials etc. purchased from other firms, which is the base of a VAT.

Value Added Tax, popularly known as ‘VAT’, is a special type of indirect tax in which a sum of money is levied at a particular stage in the sale of a product or service, (www.economywatch.com/business-and-economy/vat.html)

Goode (1986) has suggested that among the advantages of the value added tax are its broad coverage and relative neutrality. Goods and services are subject to the same effective rate of taxation except where a deliberate decision is made to discriminate through the rate structure or exemption. The author regards VAT as the most

important tax innovation of the second half of twentieth century.

Due and Friedlander (1977) have stated that VAT is the most critical among the sales taxes because it has broader coverage and offers great revenue potentially in comparison to other type of sales tax.

Murti (1998) has offered an explanation of the underlying theories pushing Hungary to develop a VAT system, Under the substantially changing economic condition, there was need to lift the state regulation and leave the economy to be operated by the profit mechanism. In addition to certain other factors, the development of market force required through changes in the price structures its wage content and taxation. In other words, the reform included the tax and price reform was to diminish the tax burden on the business sector, make it more uniform and simplicity in taxation and budgeting relationships. By reducing the part of taxes payable from corporate income the level of produces prices might have fallen with other portion of taxes being transformed into cost. This was going to be ensured by introducing VAT and personal income tax parallel with modifying the taxation of the business sector and system of producer prices.

Ahmand and Lucllow (1999) have identified the alternative tax reform packages on VAT for Pakistan keeping the distributional consequence in consideration. The authors have their own method for the tax reform analysis. In the first step, they describe the existing taxes and then, examine the consequences of the tax changes (and thus price changes) on households, resulting government revenue and also implications for production. They analyze and compare the consequences of different options such as the single rate VAT with selective exercise and some exemptions (Or zero rating) and multiple VAT rates. The reform with equal revenue and the reform with additional revenue as well as the production implications of tax reform are also considered. The work shows that instrument can be designed to increase revenue and at the same time, protect the poor. A value added tax supplanted with selective excises would have made Pakistan's tax system more buoyant and reduced the production distortions inherent in Pakistan's current tax system and not at the expense of the poor.

Carl (1999) has viewed that Value Added Tax as the latest and probably the final stage in a historical development of general Sales Tax, which is imposed on the "value added" by the business firms. VAT is the difference between sales proceeds

and the cost of materials etc. purchased from other firms, which is the tax base of a VAT. A firm adds value added by processing or handling these purchased items with its labor force and its own machinery, building or other capital goods.

Aujean, Jenkins and Poddar (1999) have developed a model for central and eastern European countries, on the base of the observation on the value added tax in EC and OECD countries. In this article, he states that it requires nearly complete overhaul of the tax system and in most contrives the introduction of VAT is considered a corner stone of the necessary tax reform. In addition, he describes that this form of taxation is worldwide, apart from that of transaction based, accounts controlled VAT in the market economy based on the free enterprise and pricing system. At last, he has concluded that on appropriate VAT for central and eastern European countries has proceeded from the widely agreed promise that the tax should be used almost exclusively to generate revenue for government budget in as neutral and administratively feasible manner as possible, while the income tax can be employed to achieve distribution objectives and excise and imports duties to attain allocate goals, the focus of the VAT should be on revenue.

Shome (2004) has tried to examine the extent of gain or loss to the states from the introduction of value added tax, having features of uniform design, tax credit for inputs, extension of tax base to transactions beyond the first-point sale and zero-rating of interstate trade and international exports. She stated that exclusion of services from the base would not eliminate the problem of cascading from the tax system. As manufacturing sector output was the major basis of sales tax, the estimation of impact of VAT was limited to registered manufacturing sector only. If the entire cost of tax was passed on as higher prices of output, then the result would be reduction in value of output. The effects of Introduction of VAT were classified into four parts, i.e., loss from providing input tax credit, loss from reduced value of output, loss from removal of CST, and gains from taxing second and subsequent sales within the state. With certain assumptions, she estimated the losses, gains and net impact on different states for the year 1997-98. With 15 percent rate of VAT, the impact (loss) varied from Rs. 932 crore for U.P. to Rs. 1054 crore for Maharashtra.

Narayan (2003) has noticed that something interesting. Indeed, by assuming a 100 percent collection rate and approximately a 0.6 percent rise on real GDP, if Fiji's VAT was increased by 25 percent, it resulted in about 4 percent increase in

government revenue. Nevertheless, it caused investment, real consumption and national welfare to decline.

Shahabuddin (2005) has investigated income distributional implications by applying the method developed by Alameda and Stern and using the data of household consumption expenditure and input output table, the results obtained indicate that a revenue neutral uniform VAT is regressive (relative to pre-reform situation) in its impact on the income of different households. The paper also explores the income distributional impact of an alternative policy package, and the welfare consequences of the alternative package are found to be superior to those of uniform VAT. The findings of the study suggest that, among different possible VAT schemes, a selective VAT with exemption core zero rating) and additional exercise is clearly preferable than to a complete uniform VAT if the distribution issues are of dominant concern in tax reform.

Aydin (2010) has stated that following the adoption of value added taxes by Western Europe countries, many developing countries have been giving increased attention to this form of tax as a means of rationalizing their Sales Taxes and improving their revenue."

Jantshcer and Silvani (2010) have mentioned that for effective and proper administering VAT, the emphasis should be given on registration and taxpayer's identification, invoicing and book keeping requirements and the collection function, including the role of electronic data processing.

Burgess, Stephen and Nicholas (2010) have stated that a comprehensive VAT covers value added at all the three levels of business activities, i.e., manufacturing, wholesaling and retailing. He distinguished between three types of VAT, i.e., consumption VAT, net income VAT and gross income VAT; and opined that a comprehensive VAT with consumption base, the tax credit method, following destination principle to determine VAT on international and inter-state trade flows could be an ideal commodity tax structure for India. There could be ideally two types of tax regimes in India with central and state VATs. There could be parallel central and state VATs on the same base from manufacturing to retailing or central VAT up to manufacturing stage and the state VAT at wholesaling and retailing stages. He further pointed out that VAT system with one or two rates might have to be

supplemented by special excise and subsidies to take care of the problems of equity, environment and social bads like tobacco and alcohol.

Hsiung (2011) has made an effort to assess the VAT in Taiwan, which was in effect since 1986. According to her, the VAT in Taiwan was implemented in order to increase the competitiveness of exports and improve the efficiency of business tax structure. VAT had replaced business receipt tax, stamp tax and commodity tax which constituted 28% of total tax revenue. The impact of VAT showed that the business tax revenue increased considerably although the reform were aimed to be revenue neutral. Adoption of VAT did not cause price fluctuations. Another surprising impact of VAT was that the revenue from the business income tax increased significantly immediately after the adoption of VAT. This may be attributed to the cross-checking procedure provided by VAT. As for exports, there did not seem to be a direct link between VAT and exports since exports are influenced by a number of factors. The tax fell heavily on the public sector business and they were more affected by VAT than the private sector business. Generally, it can be said that the VAT system tremendously improves the efficiency of tax collection. However, there are some rooms for improvements especially in administration. The experience of Taiwan has attested to the superiority of VAT in taxing business activities.

Choi (2012) has examined and evaluated the Value Added Tax in Korea from its introduction to its effects. VAT in peoples Republic of Korea was introduced in 1977 as a part of large tax reform with the objectives of the simplification of tax restructure and its administration, the promotion of exports, capital formation and maintenance of neutrality in indirect tax system. Introduction of VAT was also guided by revenue consideration. The characteristic of Korea VAT were of general type as had been lesser then its supporter had claimed in its favor or its opponents had feared would result from its introduction. The VAT did not have a major impact on the price increases, it showed a good impact on investment, and VAT supported exporters more than the previous tax system. One of the most controversial issues of VAT is that it is regressive in nature. Studies found that the VAT in Korea was more or less regressive with respect to income. In its overall evaluation, VAT in Korea has worked relatively well, in some case much better than its designer and taxpayers had anticipated. The VAT has broadened tax base, reduced evasion, increase revenue and solved many problems associated with previous taxes.

However, the VAT may be simple in theory; the Korea experience with VAT during last 10 years had made it clear that it was not so simple in practice. It created a host of problems that gave rise to voluminous paper work, more or less arbitrary distortions in trade and consumption and inequalities in the distribution of tax burden. The proper assessment of several problems relating to VAT including coverage, rate structure, administration, special taxpayer, co-ordination with direct taxation etc. It helps other countries to learn from Korea experience.

2.3 Review at National Level

VAT is definitely a new and modern tax as compared with other traditional tax systems. Actually, VAT is thought of being the most important tax reform in the 21st century. VAT has gain wide concern among the economist, policy maker as well as businessman in Nepal. So, there has been a lot of study in this topic in the national level as well.

Dahal (1919) has suggested that VAT is a most scientific innovative and powerful tax with built in quality of universal application for both developed and developing economies. The biggest virtue of VAT is that it is revenue buoyant and highly instrumental for resource mobilization especially in an economy with and acute shortage of resource. He further added Nepal has entered in to major global tax system with the introduction of VAT

Bhattarai and Koirala (2007) have recommended that VAT is a general consumption tax assessed on the valued add to goods and service. It is a general tax that applies in principle to all commercial activities involving the production and distribution of goods and the provision of services. It is a consumption tax because it is borne ultimately by the final consumer, it is not a charge on companies. It is charge as a percentage of price which means that the actual tax burden is visible at each stage in the production and distribution chain. It is an indirect tax, in that the tax is collected from someone other than the person who actually bears the cost of the tax (namely the seller rather than the consumer). As VAT is intended as a tax on consumption exports (which are by definition consumed abroad) are usually not subject to VAT.

Silwal (1999) has covered all the aspects of VAT. The author experience extends to all levels of production and distribution. Similarly, it covers all stages and services or

exempting any of them renders VAT ineffective.

(Khadka, 1997) has mentioned VAT is not an additional tax, but has replaced taxes such as sales tax, hotel tax, contract tax and entertainment tax that used to be levied on the sale of goods and services

Thapa (1994) has made an effort on the theoretical methodology and deal with theoretical issues. The conclusion derived was considering the present condition of Nepal facing government expenditure, low revenue effort, high dependency of foreign loan, and need of more economic growth of the economy and because of low revenue potentiality from direct taxes there is a prompt need to improve the Sales Tax of Nepal. But there is less chance to mobilize more revenue through existing form of Sales Tax. In this context, there is no any other alternative except introducing VAT in Nepal.

Karnikar (1997) has made a study with Nepal Chamber of Commerce to examine VAT in Nepalese economy in 1997. The main findings of the study were as of:

- VAT effects adversely in price level.
- It increases the price of imported goods.
- Ultimately increase the cost of production there by reduces the exports business.
- Requirement of book-keeping is complicated
- It would finally affect the small traders.
- It is untimely to implement.
- It would be unjustifiable on social ground.
- Present administration is incapable for handling VAT.
- Computerization system is not sufficient and it is new concept 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 analysis negative impact of VAT neglecting its positive impact.

Bista (2000) has focused the need of VAT for Nepal for several reasons. They are effective revenue mobilization, industrial development, story administration, transparency and avoiding all tax loopholes. VAT helps to reduce the resource gap by broadening the tax base and mobilizing additional resource by controlling tax, leakage, smuggling, unofficial trade and corruption through transparency and account based cross checking. Positive and favorable effects of VAT on all sectors can be aligned only if government can operate the VAT administration with effectively and efficiently in his dissertation, found the following findings:

- The Sales Tax system is failure to several cases: narrow tax base, inelasticity of tax rate, incapable and weak administration tax leakage, corruption and political intervention. So, the entire tax reform is needed.
- A VAT is account based, invoice based and record based: it checks the tax loopholes such as under valuation, non-recording and unauthorized trade. It discourages such issues and problems existed in the Sales Tax system.
- VAT mobilizes the additional resources and the rest of internal resources by broadening tax base and by discouraging the existing tax loopholes.
- For implementation of VAT, the public awareness level relating VAT and VAT administration should be good and it is a pre-requisite in the preparation of VAT.

VAT administration should be strong and efficient in order to implement properly. But in Nepal, VAT administration has been facing the problems like corruption, incapability, inefficiency, delaying, ineffectiveness, inadequate physical environment, unexpended employee and weak organizational set up.

Pokhrel (2005) has described VAT as the improved and modified form of the traditional sales tax and avoids cascading effect existed in sales tax. Value added at each stage of the production and distribution activities. The stage may be import, manufacturing, wholesale and retail. Value added is sale value minus purchase value or conversion cost plus profit. Conversion cost may include wages, interest, rent, depreciation, other expenses & overhead and taxes excluding VAT and income tax.

Sharma (2008) has examined several aspects of VAT administration such as its problems, constructions, possibilities, operation and other aspects. In his dissertation, he has found the following findings:

- Most of the Traders and businessman are lacked with the minimum concept of VAT. They are mainly facing pricing, billing and accounting problems.
- An adequate VAT education programs are not conducted and VAT administration has also facing lack of administrative personnel.
- The relation between government and business community is broken, which has been barrier to implement of VAT successfully.

The suggestion to the government to implement VAT successfully in Nepal were as follows:

- The government should pay attention of design the strong administration.
- The government should try to produce gazette manpower and to train them well.
- The government should launch comprehensive educational program.

At last, he concludes that VAT requires the strengthen administration for its effective and efficient implementation.

Sainju (2009) has commented the experience of VAT system in the past years reveals that the VAT system is gradually succeeding in making the revenue system of Nepal more scientific and has also been increasing internal revenue generation which is very praiseworthy. By gradually resolving the problems seen in its concept, the role of the tax administration, industrialists, businessman, and most importantly the consumers is crucial and hence their full and honest contribution is expected. The mobilization of internal revenue occupies an important role in the mission of national development. Therefore the researcher suggest, a part from the government's commitment in making a scientific and systematic tax system to make VAT more successful and effective, there is equal need for contributions from industrialist, businessmen as well as consumer as well.

From the above definitions, it is obvious that VAT is an indirect tax which is the news and significant experiment done on the modern tax system. Like its predecessor, i.e., the sales tax, VAT is also levied on the sale of goods and services (GST). 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.

2.4 Research Gap

This research helps the reviewers to find the updated and changed situations in the economy and the behaviors of the consumers and business persons towards the VAT system. VAT is becoming the backbone leading indirect tax for the strong revenue system for development of the country in Nepal. In the past, there were not enough development of information and technology and Inland Revenue Offices in different cities of the country. But now it has been improving as major revenue resource of government. For sound implementing VAT system, the government and its concerned agencies are making different plans and policies to collect the maximum revenue in the country for the welfare of the people of Nepal. Besides, VAT system is most important tool to collect the higher revenue through government agencies. So, this is the deficit between past studies and this research studies which is the important for planners, policy makers, VAT experts, economists and business scientists.

CHAPTER III

RESEARCH METHODOLOGY

3.1 Research Design

The research design followed in the study is both descriptive as well as analytical. This study analyses the trend and pattern of Value added taxation of Nepal. For this purpose, we have estimated some models. Variables that are used in this model have been explained analytically. The main variables that are used in the model are Value Added Tax and Gross Domestic Product. The variable GDP and VAT are associated with each other. The study was focused on the investigation of effect of VAT revenue to total revenue and GDP.

3.2 Nature and Sources of Data

Secondary data were collected in order to achieve the real and factual result of any research. This study used secondary data collected from the official and unofficial sources. The official sources of data were collected through annual reports, different books and publications such as:

- Reports, articles and dissertations on the concerned subject.
- Documents of National Planning Commission.
- Annual report of Inland Revenue Department.
- Central Bureau of Statistics.
- Nepal Rastra Bank.
- Various books written by tax officers and scholars.
- Publications, Budget Speeches and Economic Survey of various fiscal year of Ministry of Finance (MoF), the Government of Nepal.
- Newspapers, such as, Gorkhapatra, the Rising Nepal, Kantipur Daily, and so on.
- Publications of various VAT Department.
- Websites

The collected data through secondary sources have been tabulated in different ways according to the requirements of the study.

3.3 Tools and Techniques of Data Collection

Various statistical tools have been used in order to get the meaningful result. For the purpose of analysis, following simple statistical tools are used:

- Simple average
- Simple percentage
- Graphs, charts and diagrams
- Trend analysis

3.4 Presentation and Analysis of Data

In the process of presentation and analysis of the data, collected data from secondary sources has been first processed for tabulation and analysis purpose. The research covers the study from FY 2004-05 to 2014-15.

CHAPTER IV

THEORETICAL BACKGROUND OF VALUE ADDED TAX IN NEPAL

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, 1998:139). The rise of Value Added Tax is an unparalleled tax phenomenon.

4.1 Background of VAT in Nepal

The framework of the Nepalese VAT system is specified in the VAT Act and Regulations. The VAT system is also governed to some extent by the Finance Act, 1999. Some procedural matters relating to VAT are also introduced through operating manual. The government also has introduced some notifications relating to the VAT system. Similarly, the VAT Department has issued several circulars on various procedural matters from time to time.

4.2 Types of VAT

There are several bases for classifying VAT. In practical sense, the types of VAT can be classified on a threefold basis on the ground of treatment of producer's goods. The precise treatment of deductibility of tax paid on durable capital goods is of great concern in distinguishing VAT of various types. "Capital goods" includes any assets that will not be used up entirely within the tax year of purchase. (i.e. Machinery, Building, Equipment, Furniture, Vehicle etc.) Goods from the tax base.

The classification of VAT on the basis of the treatment of capital goods is much important. Considering the treatment of capital goods, the following classification has been made in broad sense.

a) Gross National Product (GNP) Type of 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 of gross domestic product is:

$$\text{Base of VAT} = \text{GNP} = C + I_g$$

Where,

C = Consumption

I_g = Gross investment.

b) The Income Type of VAT

Under the Income type of VAT capital goods purchased from other firms are not deducted from the tax base, however, the depreciation in the subsequent year is allowed to deduct from the tax base. Similarly, it requires that an excess of year-beginning inventory over year end inventory to be deducted (Shoup, 1969:252). So the tax base in this type of VAT is the consumption plus net Investment. In aggregate sense that tax base is equal to net national Income.

In this type,

$$\text{Base of VAT} = \text{NNP} = C + I_n$$

Where,

C = Consumption

I_n = Net Investment

c) The Consumption Type of VAT

All capital goods purchased from other firms in the same tax year are allowed to deduct from the sales value while calculating base under the consumption type of VAT. Although the depreciation is not deducted from the tax base. A tax on the incremental Value Added in the production of consumer goods is referred to as the consumption type of VAT. The consumption VAT restricts the burden of tax to the final consumption goods and exempts capital goods. In national accounts term the base of consumption type of VAT is,

$$\text{GNP} = I_g$$

Or,

$$\text{GNP} - (I_n + D) = C$$

Where,

D = Depreciation

Among those three types of VAT, the Consumption Type of VAT has been widely applied in several countries like Europe and Elsewhere in recent years including

Nepal. The reasons for the popularity of this type are that this variant does not affect decisions regarding investment and growth since it relieves investment from any tax burden.

4.3 Methods of Calculating VAT

Musgrave and Musgrave (1959) has described the methods of calculating VAT through the following three methods:

a) Addition Method

This method is also known as the Direct Value Added Computation method. Under this method the tax base is obtained by adding the incomes produced by the firm. In other words the tax base is computed by adding the payments made by the firms to the factors of production employed in turning out the product such as Wages, Interest, Rent, Royalty and Profit. This method is appropriate for the income type of VAT that includes in its base in regards to all factors.

b) Subtraction Method

Under this method, Value Added is determined as net turnover which is obtained by subtracting the cost of materials from sales proceeds. Thus, VAT is levied on the amount which is derived by subtracting purchase from sales. This method for the consumption type of VAT, no account is needed to be taken of capital goods produced within the firm and no inventory accounting is required.

c) Tax Credit Method

This method is also known as the Invoice Method. Under this method tax is levied on the Total Value of Sales and Tax Payers are permitted to deduct from their gross tax liability the taxes already paid by their suppliers and passed on to them. Thus in contrast to the subtraction method, tax on purchase is subtracted from the tax on sales under the credit method, Under this method, excess of input tax over the output tax is refundable or can be claimed as a tax credit generally, Value added tax is not to be included in the base.

4.4 Basic Features of VAT in Nepal

VAT is an indirect tax that is imposed on different goods and services on the basis of value added of value added amount in different stages of production and distribution. It is not a genuinely new form of taxation but merely a sales tax administered in different form, although it is eventually born by the final consumer. VAT is collected at each stage of production and distribution chain. The main features or characteristics of VAT as follows:

- It is an Indirect Tax.
- It is based on Value Added.
- It is a Broad-Based Tax.
- It avoids Cascading and Pyramiding.
- It has the Self-Policing and Catching up Benefits.
- It provides the facility of Tax Credit and Tax Refund.
- The consumption of VAT through tax credit method.
- The Principle of Destination.
- The level of threshold is Rupees 5 million.
- The application of VAT to all business turns over through the retail stages.
- The rate of Vat is single and positive @ 13%.
- The provision of exemption and zero rate for the goods and services.
- The allowance of tax credit for taxable supplies including the zero rate supply.
- to register in VAT office.
- Self-assessment system.
- Small entrepreneurs are exempted

Nepal has adopted a consumption type VAT system since 1997. Under this system, tax is levied on value added at each stage in the process of production and distribution. More specifically speaking, value added is never calculated directly; but the same result is obtained indirectly through the input tax credit mechanism, i.e. VAT is levied on output and a credit is allowed for the full amount of the tax paid on the business input, including

capital goods at previous stages. The end result is that each and every VAT registrant pays VAT on its value added only.

- **Scope**

VAT is based on the destination principle. It is levied on the goods and services where the place of supply is in Nepal and importation of goods and services into Nepal. Exports of goods and services are zero-rated. This means that the tax base is domestic consumption. VAT is a broad-based tax, which applies to all business turnovers through to the retail stages, with a few exceptions. It is levied on a large number of goods and services other than those specifically exempt by law, particularly on administrative and social grounds.

- **Rates**

VAT for a fiscal year is levied at a single positive rate as specified in the Financial Act made for that year. Goods and services are either taxed at the standard rate of 13 percent or they are taxed at zero percent. Those taxed at the standard rate includes all goods and services except those which are specified as taxed at zero percent or tax exempt. A few transactions or goods and services are zero-rated, which are given in Schedule 2 of the VAT Act. Like Schedule 1, which is related to exemptions, the government, without a parliamentary approval, also can change Schedule 2.

- **Zero Rating**

Zero-rating means some items are taxed at zero rates. This further means that no VAT is payable on them, but they are otherwise regarded as taxable. Therefore, a registered person making zero-rated sales may take full credit for the VAT paid on the taxable inputs to his business. At present, the following supplies are zero-rated (A study on VAT in SAFA Countries, 2005):

- Export of goods.
- Goods or stores taken on board an aircraft, provided that the goods are taken on board an aircraft on flight to a destination outside Nepal for delivery to another country and fuel is used by the aircraft on a flight to a destination outside Nepal.
- Goods that have been shipped for use as stores on a flight to a destination outside Nepal.
- Imports of goods and services' by accredited diplomats.

Some special features in VAT system of Nepal are specified as follows:

- The adoption of consumption type of VAT.
- The computation of VAT through tax credit method.
- The principle of destination.
- The provision of exemption and zero rate goods and services.
- The application of VAT to all business turnovers through the retail stages i.e. broad base.
- The allowance of tax credit for taxable supplies including the zero rate supply.
- The facility of tax refunds.
- The use of single positive rate at 13 percent.
- The level of threshold of Rs. 5 millions.

- **Coverage**

VAT is a tax on goods and services consumed in Nepal. The tax is based on the principle that each producer or distributor adds value, in some way, to the materials they have purchased and it is this added value that is taxed at each stage of the production and distribution. The coverage of VAT in Nepal is based on transfer, sales, supply, import and export of goods and services except some special provisions. It is levied on the value added at each stage of the production or distribution. Every persons or firms or companies who are involved in such transaction liable to pay and collect tax. The actual coverage is structured by the standard and zero rates as well as tax exempted provisions. In other words, tax coverage is guided by tax invoice system. VAT is administered by invoice method.

- **Standard Rated Areas**

Nepal has adopted “Inclusive Basket System” which means board-based tax coverage. Under this system, all transactions regarding transfer, sales, supply, imports and exports of goods and services, where value added exists are taxable, except some special provisions. The Value Added Tax Act 1995 has made provision for exempted goods and services under special law. Unless this provision, all the value added

economic transactions are taxable and tax is collected at the rate of 13 percent. This is called standard rated area.

- **Zero Rated Areas**

Under the VAT system some goods and services are, or may be, taxed at zero-rate. The objective of this zero rate is to relieve some goods and services from taxation working under regular VAT system and net for the purpose of promoting and encouraging export and maintaining diplomatic behaviors. Under this, purchaser is allowed to credit the tax paid on inputs or purchase in concern. Supplies made in Nepal that are exported are taxable at zero-rate. Exporters are allowed to claim input tax credits for VAT paid or payable on purchases of goods and services relating to their commercial activities. Exports taxed at zero percent (0 percent) include exports of both goods and services

- **Exempted Goods and Services**

Under VAT system all goods and services are divided into two basic categories: taxable and tax-exempt. Exempted goods and services are included in Schedule 1, which is given at the end of the VAT Act. This schedule can be changed by the government and does not require parliamentary approval.

Goods and services are either taxed at the standard rate of 13 percent or they are taxed at zero percent. Those taxed at the standard tax include all goods and services except those that are specified as taxed at zero percent or tax-exempted. According to VAT Act 1996, the purchaser will not pay VAT on tax-exempt goods and services and the supplier is not allowed input tax credits on purchases related to the following goods and services.

- **Taxable Value**

VAT is levied on the taxable value of each transaction, which is the total price charged by the seller (including all- related charges). The taxable value does not include the VAT itself, and takes into account any price adjustments (such as discounts or rebates) in effect at that time of the sale. Adjustment that becomes necessary after the time of sale (such as for goods returned) is to be made in subsequent determination of the tax or credits. The taxable value of a transaction is the price paid, which is also consideration for the goods or services, by the recipient to the supplier, provided that the supplier and recipient are independent of each other. The price charged must include all related expenditure borne

by the supplier. In the case of imported goods, the tax base is the sum of import value, freight, transport costs, insurance, commission, import duties plus any charges paid by the importer.

In the case of a transaction taking place between associated persons, or goods being exchanged or bartered, or at any time when the value declared is lower than the prevailing market value, the taxable value of the transaction shall be the market value of the goods or services, which shall be taken as the consideration in money agreed between independent sellers and buyers for the supply of goods or services. If a tax officer is satisfied that the declared value is substantially below the market value, he may determine the value of the disputed transaction to the best of his ability.

Tax Credit

- **In case of taxable supply**

Under this system VAT registrants making taxable supplies, including the zero rated supplies, are entitled to claim input tax credit. It is, however, allowed to the extent that the purchased/imported goods and services are used for goods and services sold in taxable transactions, including exports. Since, only VAT registrants are allowed to claim input tax, small vendors falling below the registration threshold and not registered for VAT are required to pay VAT on their purchases but cannot claim an input tax credit.

- **In case of Mixed Supply**

A person involved in mixed transaction (i.e. making both taxable and tax-exempt transactions) is entitled to claim input tax credit on the purchases related to the making of taxable sales only, but not purchases related to his exempt sales. The VAT registrant is allowed to claim the tax on purchases which he can clearly identify as being for taxable sales. A VAT registrant will have overheads, such as diesel or telephone charges or stationary, which will be used by both his taxable and his exempt sales. A VAT registrant is authorized to claim a proportion of his input tax. The proportion to be claimed is the proportion that his taxable sales bear to his total sales.

- **Partial Credit**

Some goods are used for both the purpose of the business and for personal use. In such cases, it is very difficult to ascertain the proportion used in the taxable and tax-

exempt transactions. These include such items as computers and cars. In these cases, only partial input tax credit can be taken. For example, 40 percent of input tax credit may be claimed on airplanes and automobiles and 60 percent may be claimed on computers.

- **No Credit**

With certain goods and services, it is very difficult to ascertain whether they have been used for the purpose of the business or for personal use. These include such items as business entertainment, beverages, alcohol or alcohol mixed beverages, such as liquor and beer, and light petroleum (petrol) fuel for vehicles. In these cases no input credit can be taken.

- **Administration of VAT**

In general the prime goals of VAT administration are to promote voluntary compliance and to promote the VAT revenue by effective, efficient and economic way. Identification of tax payers, tax registration, processing of returns, tax audit, assessments, collection, credit, refund and control of stop filers are main functional areas of tax administration. In the Nepalese periphery, Ministry of Finance is the main responsible body for collecting financial resources and managing the public expenditure. Department of Customs, Revenue Administration Training Centre, Department of Revenue Investigation and Inland Revenue Department are the responsible bodies of Ministry of Finance. Inland Revenue Department (IRD) is currently responsible for the administration of all types taxes. Likewise the department is also responsible for monitoring the non-tax revenue of the Government. Under IRD there are 21 Inland Revenue Offices through the country. These offices and department jointly administer the VAT as well as income taxes. The Government of Nepal has the authority to appoint Tax officers in required numbers. Similarly, the jurisdiction of a Tax officer should also be prescribed by the Government

- **Registration**

Suppliers of taxable goods and services are required to register under the VAT Act and collect this tax. It is, however, not necessary for them to register if they deal with only tax exempt goods and services. Similarly, small vendors falling below the registration threshold are also not required to register for VAT. The existing level of threshold is Rs.5 million. In the case of imports, traders having annual commercial

imports below Rs.200,000 are not required to register. Traders dealing with the mixed supply also will have to register only when the transaction of taxable supply exceeds the registration threshold. However, vendors falling below the registration threshold can register voluntarily. VAT administration had allocated a TPIN (taxpayer identification Number) consisting of nine digits to registered taxpayer with a view to process data in computer. All the records of taxpayer are stored in the computer in database format. As the computer processed all the data of taxpayer, it has become an integral part of VAT administration. Before that all the records are kept manually.

- **De-registration**

The organization is de-registered from VAT under following conditions:

- In the case of an incorporated body, if the incorporated body is closed down, sold or transferred, or if the incorporated body otherwise ceases to exist.
- In the case of a partnership firm, if it is dissolved.
- In the case of individual ownership, if the owner dies. If a registered person ceases to be engaged in taxable transactions.
- If person is registered in error.

- **Invoicing**

VAT is an invoice-driven system. Under this system, each registrant is required to issue a tax invoice or an abbreviated invoice. A VAT registrant is required to issue a tax invoice in the prescribed form whenever a transaction takes place. The format is prescribed in the VAT regulations, which requires the following information:

A sequential identifying number.

- The date of the transaction.
- The date of issue of the invoice, if different from the date of the transaction.
- The name, address and TPIN of the vendor.
- The name, address and, where applicable, TPIN of the buyer.
- The type of transaction (e.g. sale, hire, rental or exchange).
- A description to identify the goods or services supplied. The quantity of the goods or the extent of the service for each description.

- The rate of VAT and the amount payable, excluding VAT, for each description of goods or services.
- The value of any goods or services provided in part exchange.
- The total amount payable, excluding VAT.
- The rate and amount of any discount offered.
- The total tax charged.
- The total amount charged, inclusive of VAT.

A minimum of three copies of each invoice must be prepared. The first copy must be given to the buyer and the vendor must retain the remaining two copies. These must be made available at all reasonable times for inspection by a tax officer. The invoices must be issued in sequential numerical order. However, the invoices can be prepared with different serial numbers for branches or different sections (such as restaurants, bars, laundry, etc., in the case of hotels) with prior approval of the VAT office.

- **Accounting**

VAT registrants are required to maintain purchase and sales books and list all sales and purchases in these books. They are also required to prepare a VAT account.

- **Purchase Book**

VAT registrants are required to maintain an account of their business purchases for VAT purpose. They have to record of purchases by invoice. At the end of each accounting period VAT registrant must total the amount of taxable purchase/ imports, tax exempt purchase/imports and the tax paid on purchases/imports.

- **Sales Book**

Similarly, VAT registrants are required to maintain account of their sales for VAT purpose. Like purchases, sales also are to be recorded per invoice basis. At the end of each accounting period VAT registrants are required to total the amount of taxable (standard-rated and zero-rated) and tax exempt sales they have made in the period and the tax collected on sales. If they make both taxable and exempt purchases and sales they are then required to calculate the proportion of input tax they are entitled to the tax period.

- **VAT Account**

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

All documents and accounts relating to the business must be retained for a period of six years.

- **Submission of Return**

A VAT registrant must complete a VAT return and submit it to the concerned VAT office within 25 days of the month following the end of the accounting period. In the case of compulsory registrants, it is necessary to submit VAT return every month but the voluntary registrants have to submit returns on a trimester basis. The head office is required to submit tax returns for the transactions carried out by it and its branches and sub branches, if any. There are no special rules, for example for seasonal business or others. Even if there is no transaction, it is necessary to submit a zero return. Returns could be debit returns, credit returns or zero-returns. There is no need to attach purchase and sales invoices or any other documents relating to the tax with the returns. If a taxpayer does not submit return within stipulated time, he will be subject to a penalty of 0.05 per cent of payable tax per day or Rs. 1000, whichever is higher.

- **Tax Assessment**

VAT is a self-assessed tax. Taxpayers determine their tax liability themselves and pay tax. Under this system, a taxpayer determines his tax liability and files his return to the VAT office. However, not all taxpayers may file their return and- pay tax within the specified time. Similarly, not all taxpayers may file the correct returns and pay correct amount of tax.

- **Penalty**

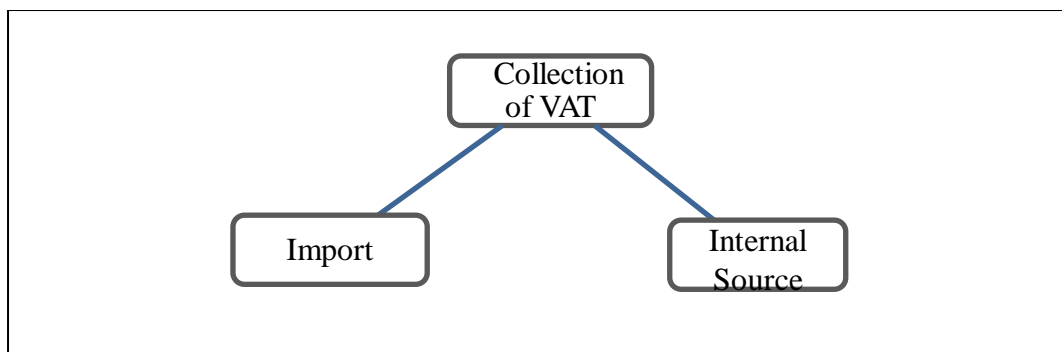
Penal provisions have been made for any non-compliance. For example, a vendor will be required to pay liable tax plus up to Rs.10,000 or a 10 percent of payable tax, whichever is higher, if he fails to register before the commencement of his business. Penalty for non-issuance of invoice is Rs.500 each time whereas the corresponding figure for failure to keep the required information in account is up to Rs. 10,000 each time. Similarly, a taxpayer who has committed fraud or tax evasion will be charged with a penalty not exceeding 100 per cent of the amount of tax, or six months jail, or both.

- **Collection of VAT**

There are two sources of VAT collection one is from Import and other is from internal sources. While importing the goods from outside country VAT is charged on the goods imported. This VAT is input tax credit for the company. The source of VAT is shown in the figure 4.1

Figure 4.1

Collection Process of VAT



In the figure 4.1, it is shown that collection of VAT is from internal source and import source. When the goods are reached on the Nepal border, there is a custom office where the goods are valued and accordingly VAT is charged. This import VAT is input tax credit for the company. The other is from Internal source which includes local purchases of goods and services from the VAT registered shop which is also input tax credit for the company and sales of goods and services which is Output tax credit of the company. The note should be made that only the company who are registered in VAT can deduct the output tax credit from input tax credit. If the company is not registered, they cannot claim their input tax credit which they collect from purchase of goods and services.

CHAPTER V

CHALLENGES AND OPPORTUNITIES OF VAT IN NEPAL

5.1 Role of VAT in Government's Revenue

The total VAT revenue of Nepal in 2014-15 increased by 15 percent to Rs. 118.49 billion; revenue accounts for 104 percent of the annual target on Local Collection. The expansion of economic activities as an upshot of timely budget announcement has mainly contributed to such growth in the revenue. Moreover, increase in PAN number holders, growth in imports, and control in the revenue leakages and reforms in tax administration. The increase in was due to growth in imports, investigation into taxpayers' involvement in fraud VAT bill issuance and reforms in VAT administration.

Of the total revenue in 2014-15, VAT constituted the highest, i.e., 31.57 percent followed by income tax (24.85 percent), customs duties (20.98 percent) and excise duties (15.04 percent). In FY 2014-15, 18.98 percent files the Debit VAT return, 44.03 percent files credit VAT returns 25 percent files Zero return. The amount payable by taxpayer to government in FY 2014-15 was Rs. 22.7 billion and return from government amounts to Rs.5.05 billion. In FY 2014-15, the credit amount is 5.22 times more than the debit return amount. This situation is not good for the Tax administration. The government should analyze the situation and administers the case with the best possible means.

Between the two sources of VAT, import VAT occupies the significant place. It is more than 200 percent in compare to VAT from internal trade and services from past to the date i.e. the ratio is 33:67. The ratio of collection from internal sources and import is almost constant from the beginning. Internal VAT in 2014-15 from Production, Sales, Tender, Tourism and others are: 33, 23, 17, 4.17 and 23 percent respectively .

The contribution of VAT to GDP is 5.58 percent over the study period which is low as compared to the other countries.

5.2 Challenges Faced by Government to Collect VAT

Lot of problem is faced by Nepal government to collect VAT during or over the VAT implementation period. Resistance from the business community, ignorance of general people and the lack of full support and commitments from the politicians and government official forced the authority responsible for implementation VAT to make compromise on various aspects of VAT which has weakened the process to its implementation right from the beginning the culture of doing business without maintaining proper books of account has made implementation VAT difficult in Nepal.

The problem is further intensified due to lack of culture of issuing and receiving bill at the point of sales and purchases, non-adherence to standard norms and codes of doing business, negative behavior of tax official and of sense of accountability in the government and political parties. It is a big problem faced by the government in collection of VAT.

On one hand, there are problem associated with billings where the businessperson do not issue invoice or issue incorrect invoices and, on the other hand, there are problems related to valuation at the point of import and production. In addition, more problems originate when every official or employee interpret the act, rules, letters and circulars on a discretionary manner. Additional problems have emerged in its implementation due to our geographical structure, lack of education, unauthorized and unorganized business due to the open boarder in the bordering market etc. this tax system does not seem very effective despite VAT having completed around twelve years in operation. And this id due to the political situation of the country, the lack of good co-amongst VAT, customs and other taxes, lack of the practice of issuing and demanding correct invoice amongst the individual and business sector, the lack of a system of maintaining accounts and the attitude of some employees and some tax payers.

There are many challenges the government has been facing to collect VAT. Those challenges are related with the following:

a) Billing System

The major problem associated with VAT is the lack of compliance on the part of businessmen with the billing requirements. They hardly issue bill to customers, though it is mandatory under the VAT Act. They do discourage the customer for

demanding bill by charging extra money on it. Issue of an invoice is a must under VAT system. Likewise, it is the responsibility of the consumer to ask for the invoice, however, at the retail level. On one hand, consumer are not interested in asking for an invoice as they consider it useless and wastage of time, on the other hand, retailers are under no pressure to issue an invoice. Thus at the retail level, evasion is most likely to take place because crosschecking is not possible at this level. Even the registered ones may not be interested to obtain invoice; they can omit some of their transaction from the books of account. Low valuation of imported goods at the customers is another major obstacle facing the government and is the root cause of the failure of the billing system.

b) Under Invoicing Practices

One of the challenges lying ahead of VAT collection and VAT implementation is the rampant practice of under invoicing.

In Nepal, a Majority of goods are imported and the imports are allowed to enter the country only after paying custom duty at the specified rate. Depending upon the price of the goods imported, less or more custom duty has to be paid and as a result, other taxes are affected. Therefore, if an invoice with a less amount is made and goods are imported, then less custom duty has to be paid. This practice of making invoices with fewer amounts on imported goods so as to evade customs along with other taxes is called under invoicing. Once the goods enter the country by undervalued billing, the VAT revenue along with custom duties are evaded and this cannot be caught up in later stages of distribution if similar undervalued billing continues to take place.

c) Tax Refund

To impact confidence among the tax payers on the VAT system, the VAT administrators should not neglect the tax refund aspect. Though the VAT Act prescribes a fairly simplified procedure for this, in reality, it is quite different. There have been widespread complaints regarding the system of tax refund. The tendency is to set off cash refunds against future earnings even when cash refund is due. This is of particular concern to tax payers at the time of capital investment or at the time of declining business environment. The number and volume of refund claims made so far as found to be still very low compared to the potential refund number and amount.

d) Open Boarder

Nepal shares an open boarder with India and Tibet, which encourages large volume of smuggling business. Most of the imports are made through the secret ways without having to pay custom duties and VAT. Open boarder gives two kinds of incentives: one Nepalese consumer living in boarder town often go directly to India boarder to purchase cheaper goods and other the products from India are brought for trading purpose through giving rise to a large amount of unauthorized trade. This is the most serious problem in front of the government of Nepal.

e) Geographical Structure

Geographical condition of our country has created an important issue about the VAT implementation and revenue collection. Mainly three sets of problems have been arisen due to the geographical condition.

- i. In many district of Nepal there is no transportation development to these areas. In these areas, the means of transportation is air but the cost of manual or air transport is very high due to maximum freight costs which increase the cost of goods and VAT is higher in the remote areas than other developing areas.
- ii. There are small scale business activities in the remote areas. The revenue collection from such areas would be a negligible amount as compared to collection cost. Therefore, the high collection cost does not permit VAT to be applicable in same of the districts in Nepal.
- iii. Controlling and collecting VAT in far and remote areas is not easy due to the lack of transportation and communication etc. it is difficult to control the many functions of VAT likes inspection, audit, tax refund' penalty hearing appeals in the remote areas due to the lack of adequate tax office.

f) Non-Cooperation between the Government and Private Sector

Government policies in Nepal are often formed and implemented without a due consideration and preparation. With regard to VAT the government never took the private sector into confidence. Private sector is not much involved in designing the VAT structure rules, regulation and solving the wide range of issue. On one hand, the private sector is actively opposing the implementation of VAT, at least, at present. On

the other hand, the government is firm to implement the new tax. Such a divergence would lead to many undesirable consequences which would make the VAT an unsuccessful.

The VAT structure, rules and regulation formed without consulting and discussing with the private sector are likely to become unpractical and non-operational. International experience also shows that the VAT is less likely to be effective or successful where the private sector does not fully co-operate with government.

g) Registration

Some business, especially small traders who are liable to register, may not register themselves as tax payers. It is administratively very difficult to discover all the legal tax payers under the VAT because of the threshold limit. Tax evaders may take a good advantage of this difficulty. Further, non-compliance of the tax from the registered tax payers may also occur due to administrative weaknesses.

h) Tax Evasion

The large amount of illegal trade and other established tax evading practices pose a great challenge to a VAT in Nepal, Most of the tax evasion occurs at the import level. The existence of long open boarder, weak and easily corruptible tax administration are the major factor facilitating tax evasion. There are several possible ways and forms of tax evasions in VAT in Nepal. These are:

- i. Non-registration.
- ii. Sellers don't report their sale to the tax authority.
- iii. UN recorded trade.
- iv. Dummy business.
- v. Smuggle goods supply by the channel of exempted business.

i) Threshold

From the very beginning the debate about its threshold is going on and without visible sign of any consensus reached about it. If threshold isn't permitted in VAT, small retailers should also be included in this system. That's why all concerned, no matter whether they are big of small businessmen of industrialists need to be registered themselves. It is impractical to think that thousands of taxpayers will be managed

properly the light of the fact even ten to twelve big customs are not controlled properly. On the other hand, it is quite difficult to justify the decision to bring very small retailers in VAT net from administrative, legal or even revenue perspectives. According to the critics of VAT threshold, illegal importing is encouraged, as it is quite easier to sell these illegal items through them.

j) Account Keeping

Nepalese retailers lack the habit of maintaining proper accounts of their transactions. But in VAT system, tax payers need to issued invoices and transaction accounts and VAT audit need to be maintained. One of the reasons of the ineffectiveness of VAT is the absence of proper maintenance of transaction accounts. This is also a most serious problem for government for better collection of VAT and better implementation of VAT.

k) Tax Administration

Nepal's tax administration is no effective all around. Wide spread use of discretionary measures and lack of transparency manifest in day to day administration it has resulted into arbitrary tax assessments, harassment of genuine tax payers and provide opportunities for corruption. It is, therefore necessary to effective change in all aspects of taxation (i.e. policy, law, procedures and administration in order to implement tax reform in meaningful way).

Nepal has already witnessed a widespread resentment and nationwide demonstration by the traders on the eve of the introduction of VAT all those oppositions were not directed against the VAT but against customs and income tax administration. Since the implementation of a VAT renders transparency at all level and enhance. Experiences have proved that however, good a tax policy would be what matters is its administration. So that the government of Nepal have tries to build up sound tax administration in order to effective VAT collection.

l) Political Instability

The government of Nepal has been facing the problem of political instability since introduced of VAT in this country. Changing of government frequently create many problem on VAT collection also. Because difficult governments have different attitude and their own views that directly affect VAT collection, regulation, and implementation.

5.3 Opportunities Made by the Government to Collect VAT

It is not that, the government of Nepal does not have the option doing nothing for the collection of VAT, from the earlier period to till now. In the very beginning when the businessmen worked to have old sales tax exemptions restored, a VAT as a single stage levy; a geographical and higher threshold, etc. The government conceded several of their demand on the pledge that from the next fiscal year the VAT would be implemented enacting the VAT law, a continuation of the old sales tax system, reduces rate for few domestic products were the major concessions allowed by the government. It was also agreed that a joint task force were to be formed to look into the matters relating to the registration aspects of retail shops. Since the beginning of VAT until now, the government has made maximum efforts to collect VAT.

In May 2000, an interaction program was held. Many politicians and parliamentarians were invited to this program. For the first time, in Nepal, there was not argument against VAT as such and discussions on the issue of its proper implementation because the overriding concern. Proper implementation, transparency, fairness and service minded organization were key issue discussed during this problem.

Similarly, the Inland Revenue Department and the DANIDA organized a VAT project program on the occasion of four year completion of VAT IN Nepal. This article reviewed the problems, challenges and achievements made until the merger of the two former departments, namely the Department of taxation and the VAT Department, into the Inland Revenue Department, into the Inland Revenue Department in April 2001. This conference organized to more completion of four years of VAT did conclude with the note, that through VAT in it was acceptable to legitimate business, the practical aspect, concerning application of laws and rules into action showed considerable scope for improvement.

The efforts made by the government concerned to VAT collection can be describe as in the following points:

a) Effective Tax Administration

The new administration in the VAT Department was organized along functional lines. The purpose was to have a function-based responsibility under which it would be easy to monitor the performance and also facilitate the establishment of a professional organization in a relatively short span of time. The function structure is also supposed

to be held established accountability and to reduce collusion the tax payers and tax officers. Setting up a functional VAT administration become easy because of the startup staffs were mostly fresh entrants into the revenue service. The foundation of the tax design is quit modern and extensive training was imported and core groups formed in specific function areas. To improve Administrative capability, effective implementation VAT Act, law, rules and regulation different training and seminar was organized by help of RAS project, OECD, DANIDA, JICA for employees and tax payers.

b) Public Awareness

The extended period was a blessing in disguise for every one who was engaged in the implementation process of the VAT. Some more training information campaigns, meeting, etc. were held to convince people about the introduction of VAT. Massive education programs were carried out across country. Over hundreds of talk programs were organized for cross section of the society businessmen, journalist etc. during 7 years of VAT implementation, government have made many efforts to collection VAT, A number of tax payer awareness campaigns have been lunched. A huge number of information folders has been produced and distributed; massive tax payer information has been published in the newspaper and aired through radio and television. Signboard, books, articles, pamphlets and so many others information concerned with VAT was produced and published across the country.

c) Incentive and Penalties System

The government have many incentives and penalties introduced, to make VAT effective and to collect more revenue, those businessmen have not necessary registration whose business transaction is under threshold, concession for 1.2 million of import from India and Tibet without the VAT certificate, no compulsory invoices for unregistered traders, a reduction tax deducted at source, a revision in the book value of systems, tax refund system etc. an incentive has been provided by the government to business community.

Similarly, besides the above incentive and facilities provided to business community. There are provisions of penalties for the faulty businessman. The government has defined fault as to the transaction such as non-applied for the registration before transaction started, misused of registration number, non-issuing of bills, non-keeping

of account, not included the particulars appointed of account, user of false account or invoice etc. the government can penalize to the business according to their fault.

d) Launching Special Package Program

The government of Nepal had effort made of launching special package programs also made effective collection. Under this special package programs the government has decided to award 25 Commercial Important Persons (CIPs) annually. Giving by the latest decision, president of Federation of Nepal Chamber of Commerce and Industry (FNCC) and Nepal Chamber of Commerce (NCC) too will be designated as ex-officio Commercially Important Persons (CIPs). The new announcement has been made by following the recommendations of the private sector.

Similarly, the government has reputed 10 persons as commercially important person from banking, financial and production oriented area service and banking area operating in the outside the Kathmandu Valley and highest tax payer person of the Nepal. The commercially important person can use extra commercially important person lounge, trafficking from Tribhuvan International Airport. This program introduced by the government is very fair. By this kind of program taxpayers will be enthusiastic.

e) Improved Billing System

Success of VAT system hinges on how the billing habit will be improved in future, billing system is the life blood of VAT collection.

However, the government or tax administration does not have done more practiced on improving billing system. It is not that, they don't have done anything about this regards, but how much they have done is not enough. Sales billing remains the key factor for true implementation of VAT system. So that the government has been spent millions rupees to educate the mass about billing system. And lateral entry system in the market has also operated. Formal billing must be made compulsory to all taxable supplied.

f) Tax Refund

Tax refund is important policy issued by the government for tax payer. After it became clear that refund is reality, claims started to be made, in order to ease the refund process; two strategies were adopted for regular exporters a refund verification

mechanism was introduced whereby VAT would be refunded in 30 working days. For the rest, the VAT rule of 60 days prevailed, but the implementation was not that easy.

By the above description, it is clear that the government has made a lots of efforts about vat collection. Tax administration has given primary priority since its introduction.

5.4 Trend of VAT Collection over the Study period

Revenue mobilization in Nepal was slow for a long time. It was not more than 12% of GDP; all the known and required reform measures were implemented in custom duties, excise duties, sales and income tax. The reform packages advised by the World Bank and IMF were implemented. Even than the pace of revenue mobilization was slow. It led to the search of another tax system. In a sense, it was quit natural as in the World and especially among developing nations, the success story of VAT was very popular. The rate of revenue mobilization, in especially those countries under VAT regime, was encouraging. Within a short span of time more than 120 countries adopted this tax system though Nepal was still to enter into this regime. In the backdrop of the failure of all known measures to increase revenue, it was quite natural to expect that VAT would enhance revenue collection and this was exactly the case when VAT was first introduced in Nepal.

VAT is a most scientific, innovation and powerful tax with built in quality of universal application for both development and developing economies. The biggest virtue of VAT is that it is revenue buoyant and highly instrumental for resource mobilization especially in an economy with actuate shortage of resources. Now VAT rate is increased from 10 percent to 13 percent has comprehensive based including goods and services, is consumption based, and has a reasonable threshold that renders VAT administration practicable. Nepalese VAT system has already comes a long way and that it should experience further revenue productivity in the future.

In spite of preliminary resistance, VAT is currently well received by the consumer as business and industrial communities of Nepal, for this is account based tax that lead to transparency and accountability both on the part of tax payers and tax collectors.

5.4.1 Trend Analysis of VAT Collection

In spite of preliminary resistance, VAT is currently well received by the consumer as business and industrial communities of Nepal. It is an account based tax that lead to transparency and accountability both on the part of tax payers and tax collectors. Trend of Nepalese VAT collection is in increasing trend over the study period from 2004-05 to 2014-15, which is shown in table and figure below:

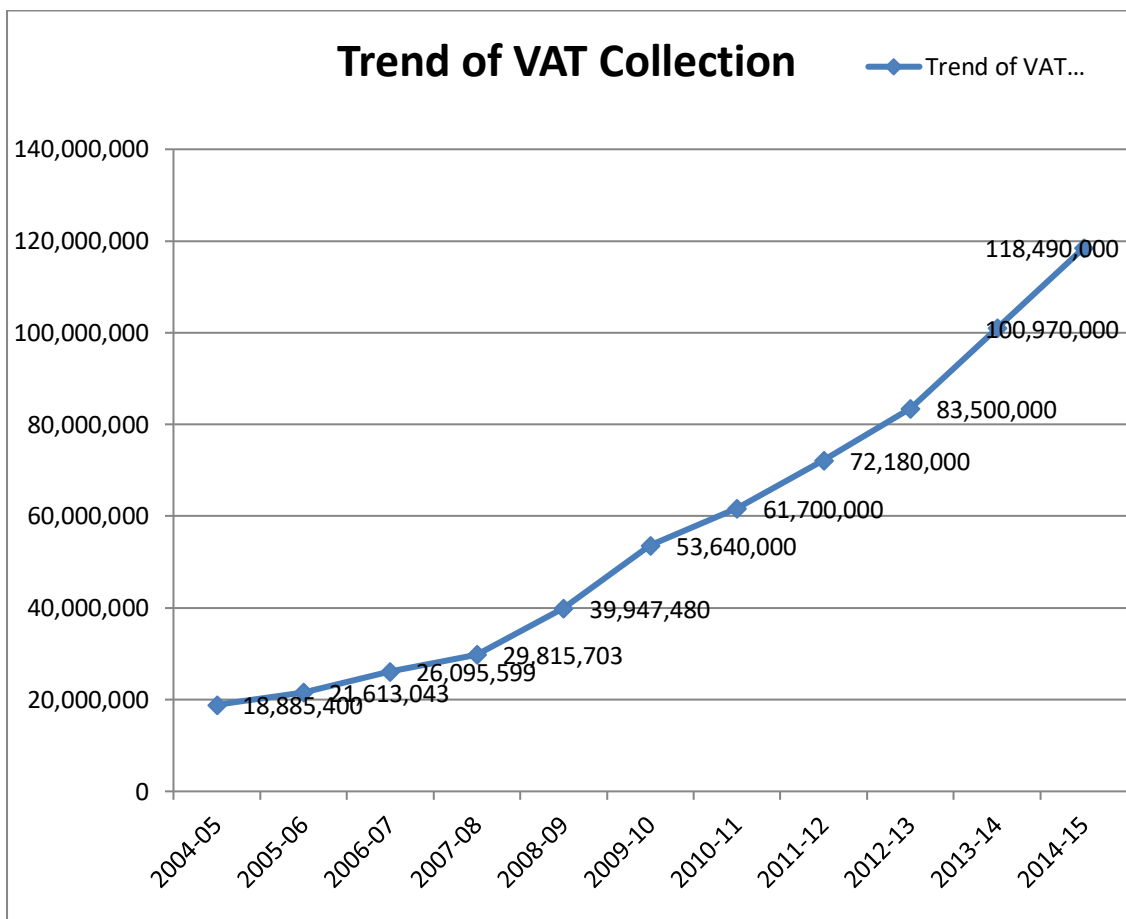
Table 5.1
Trend of VAT Collection

(Rs. In '000)

Year	Trend of VAT Collection	Increasing Percentage
2004-05	18,885,400	
2005-06	21,613,043	14%
2006-07	26,095,599	21%
2007-08	29,815,703	14%
2008-09	39,947,480	34%
2009-10	53,640,000	34%
2010-11	61,700,000	15%
2011-12	72,180,000	17%
2012-13	83,500,000	16%
2013-14	100,970,000	21%
2014-15	118,490,000	17%

Source: Various Annual Report, Inland Revenue Department, Ministry of Finance, GoN

Figure 5.1
Trend of VAT Collection



Source: Table 5.1

Table 5.1 and figure 5.1 shows that VAT revenue collection was increasing trend from FY 2004-05 to 2014-15 there was fluctuation in percentage change over the year. Tax collection increased to 34.00 percent in the FY 2009-10 & 2010-11 and it decreased to 17 percent in the FY 2014-15. The net VAT revenue collection in the taken first FY 2005-06 was Rs.18,885,400.00 thousand. Highest increasing percentage of VAT revenue collection was in the FY 2008-09 & 2009-10, which was 34 percent. Average increased percentage is 19 percent over the study period. Last 10 years trend of VAT collection shows increasing growth in VAT revenue collection. It is more obvious that revenue collection through VAT would also not be the exception since there is a lot of instability in political situation as well as in economic trends.

5.4.2 Estimated Trend Analysis of VAT Collection

A time series depicts the relation between two variables, one of them being time. One of the most commonly used method is the Least Square Method ($Y = a + bx$) which is employed here to measure the trend for further prediction of the VAT revenue for the next fifteen years from the FY 2015-16 to 2029-30 to estimate whether there may be increase in the VAT revenue collection. Future amount of VAT are predicted on the basis of the data of the previous year.

The parameter of time series analysis for the further prediction of VAT revenue, a and b, where a is the Y interception or the computed trend figure of y variable when $X=0$ and b represent the slop of the trend line or the amount of change in Y variable that is associated with a changeable of one unit in x variable. The x variable in time series represents time and Y represents GDP and VAT revenue.

For predicting the amount of GDP, the parameter of the analysis, are as follows:

$$Y_c = -21485824565 + 10722378.58x$$

Where,

$$a = -21485824565 ,$$

$$b = 10722378.58$$

Using the last 11 years trends it is an attempt to project the growth and size of next 15 years. For forecasting trends of VAT revenue collection of future 15 years regression method of forecasting has been used. These values have been obtained by applying the above methods as shown in annexure I.

These values are shown in table and figure below:

Table 5.2

Estimated Trend of VAT Revenue Collection for Future 15 Years

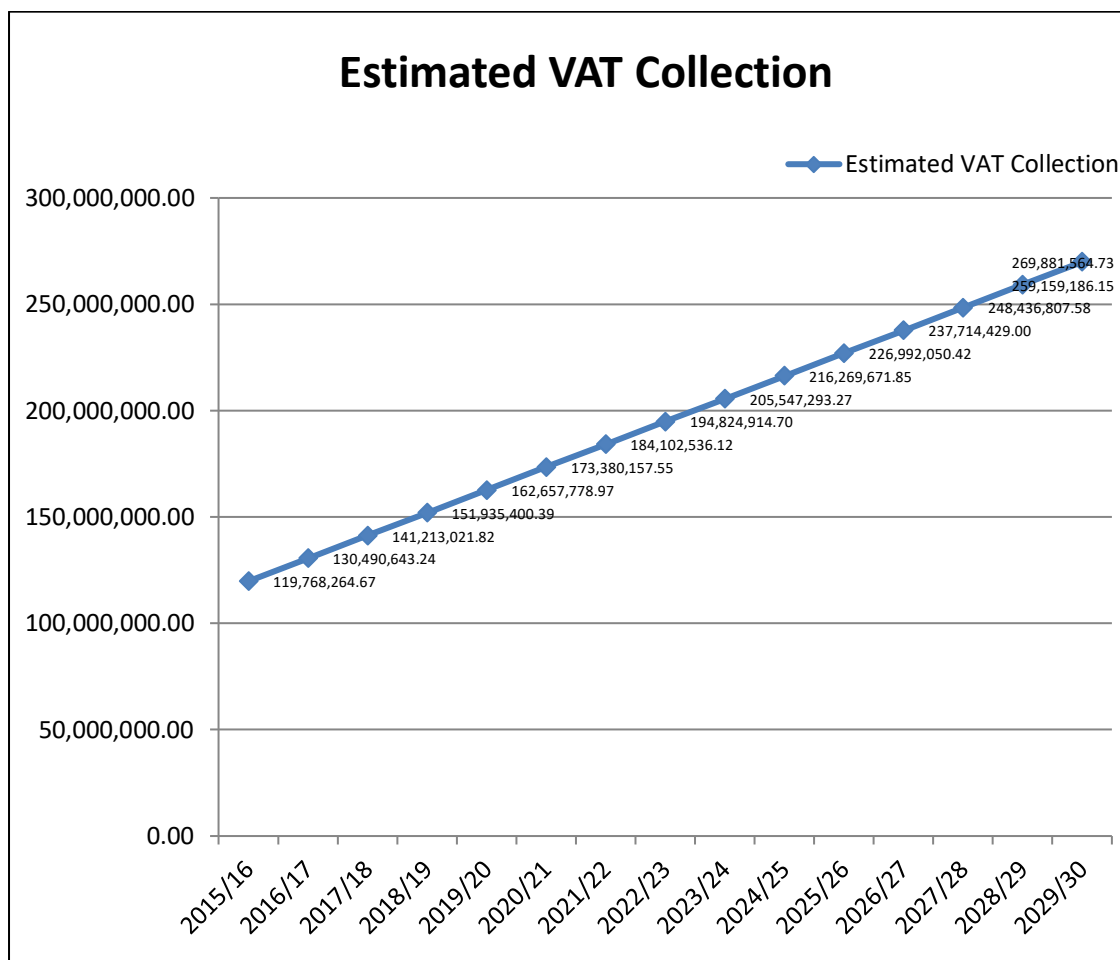
(Rs. In '000)

Year	Estimated VAT Collection	Increasing Percentage
2015-16	119,768,264.67	-
2016-17	130,490,643.24	9%
2017-18	141,213,021.82	8%
2018-19	151,935,400.39	8%
2019-20	162,657,778.97	7%
2020-21	173,380,157.55	7%
2021-22	184,102,536.12	6%
2022-23	194,824,914.70	6%
2023-24	205,547,293.27	6%
2024-25	216,269,671.85	5%
2025-26	226,992,050.42	5%
2026-27	237,714,429.00	5%
2027-28	248,436,807.58	5%
2028-29	259,159,186.15	4%
2029-30	269,881,564.73	4%

Source: Annexure I

Figure 5.2

Estimated Trend of VAT Revenue Collection for Future 15 Years



Source: Table 5.2

Table 5.2 and figure 5.2 shows trend of forecasted figure of 15 years of VAT collection. Future trend of VAT revenue collection is in increasing trend but increasing percentage will be in decreasing trend. In FY 2016-17, VAT revenue collection will be Rs. 130,490,643.24 thousand and increasing percentage will be 9 percent, after five year i.e. FY 2021-22 VAT revenue collection will be Rs. 184,102,536.12 thousand and increasing percentage will be 6 percent. After 14 year i.e. FY 2029-30, VAT revenue collections will be Rs. 269,881,564.73 thousand and increasing percentage will be 4 percent. Forecasted figure of 15 years shows increasing growth in VAT revenue collection. The trend shows VAT revenue collection is increasing in diminishing rate.

5.4.3 Composition of VAT Revenue

VAT Revenue is classified into Import Revenue and Inland Production Revenue. VAT collection from Inland Production and Import are shown separately as in table and figure below:

Table 5.3
Composition of VAT Revenue

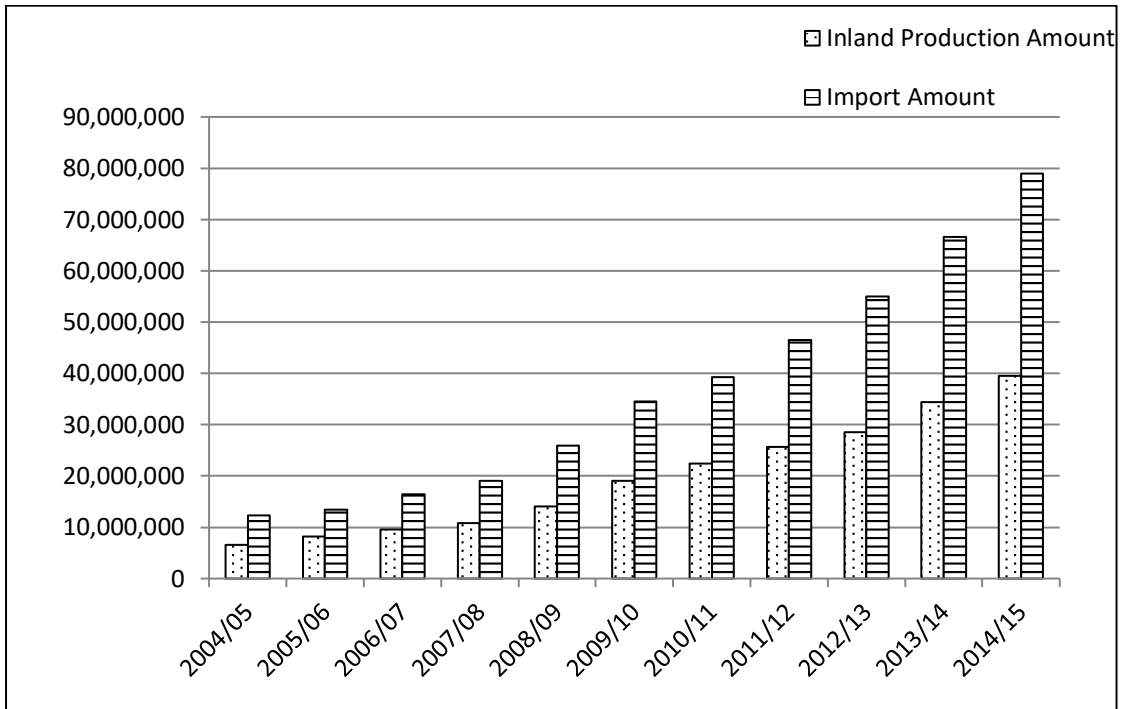
(Rs. In '000)

Year	Total	Inland Production		Import	
		Amount	% Increases	Amount	% Increases
2004-05	18,885,400	6,614,973		12,270,427	
2005-06	21,613,043	8,150,502	23%	13,462,541	10%
2006-07	26,095,599	9,631,330	18%	16,464,269	22%
2007-08	29,815,703	10,808,241	12%	19,007,462	15%
2008-09	39,947,480	14,023,658	30%	25,923,822	36%
2009-10	53,640,000	19,100,000	36%	34,540,000	33%
2010-11	61,700,000	22,390,000	17%	39,310,000	14%
2011-12	72,180,000	25,640,000	15%	46,540,000	18%
2012-13	83,500,000	28,490,000	11%	55,010,000	18%
2013-14	100,970,000	34,400,000	21%	66,570,000	21%
2014-15	118,490,000	39,550,000	15%	78,940,000	19%

Source: Various Annual Reports, Inland Revenue Department, Ministry of Finance, GoN

Figure 5.3

Composition of VAT Revenue



Source: Table 5.3

The Table 5.3 & figure 5.3 shows the VAT collection trend during the study period was increasing trend but it was not in satisfactory level. The portion of VAT collection on Import is higher than VAT collection on Inland Production. Actual VAT collection from Inland production was not reach expect level.

5.5 Contribution of VAT in Government Revenue

The income of the government through all sources like taxes, fees, fines/penalties, donation etc. is called government revenue or public revenue. Public revenue may be divided into two main headings: Tax Revenue and Non-Tax Revenue. Tax Revenue contributes about three quarters of total revenue while Non-Tax Revenue represent about one quarter of total revenue at the central level.

5.5.1 Composition of Tax and Non- Tax revenue

The composition of Tax Revenue and Non-Tax Revenue in the FY 2014-15 is shown in table and figure below:

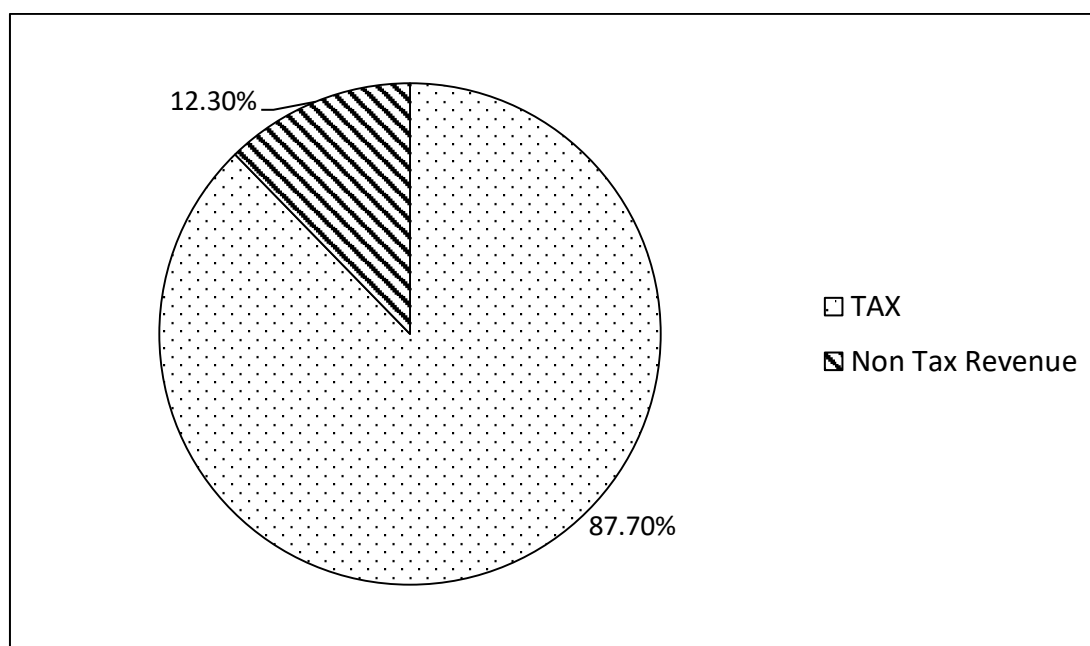
Table 5.4
Composition of Total Revenue

Particulars	Amount	Percentage
Tax	355,940,000,000.00	87.70 %
Non Tax	49,900,000,000.00	12.30 %
Total Revenue	405,840,000,000.00	100 %

Source: Annual Report, Inland Revenue Department, Ministry of Finance, GoN , Year 2014-15

Figure 5.4
Composition of Total Revenue

(Rs. In '000)



Source: Table 5.4

Table 5.4 figure 5.4 show the composition of Nepal’s total revenue, which constitutes Tax and Non- Tax Revenue from the FY 2014-15. Share of Tax Revenue has always been greater than the share of Non- Tax Revenue. In FY 2014-15, the share of Tax and Non Tax revenue was 87.70 percent and 12.30 percent respectively.

5.5.2 Contribution of Tax Revenue to GDP

VAT plays vital role for revenue generation. The share of VAT in the total revenue is shown in table and figure below:

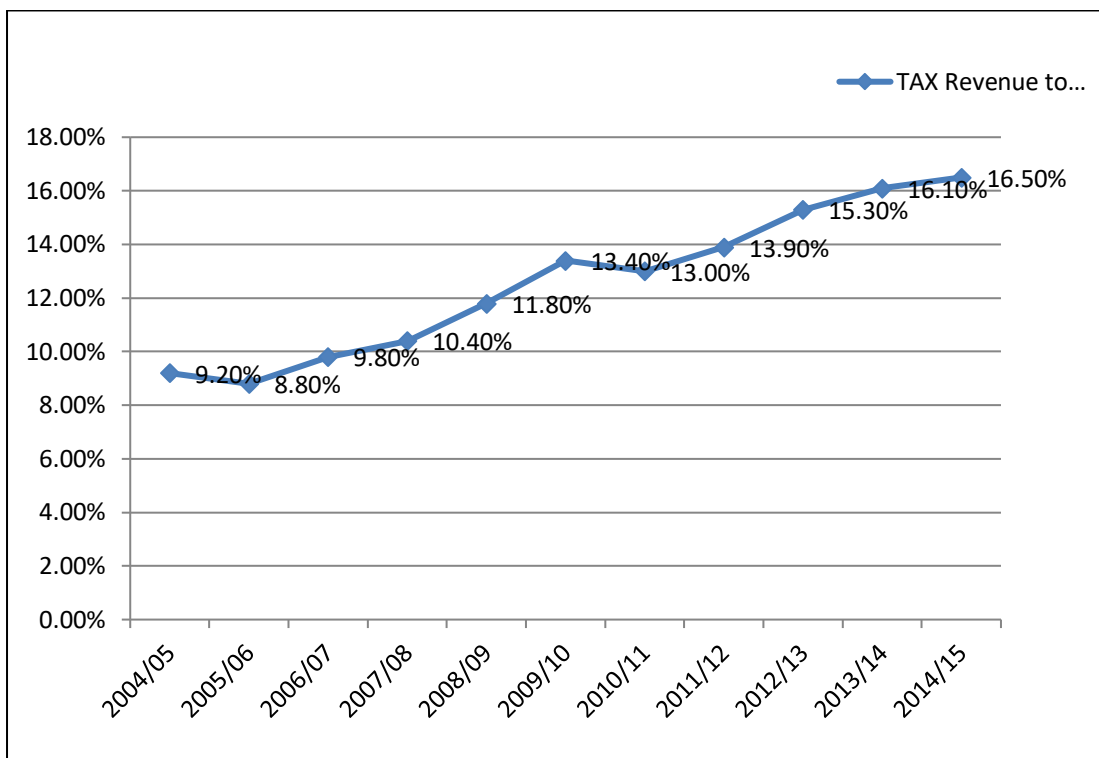
Table 5.5
Contribution of Tax Revenue to GDP

Year	TAX Revenue to GDP(%)
2004-05	9.2%
2005-06	8.8%
2006-07	9.8%
2007-08	10.4%
2008-09	11.8%
2009-10	13.4%
2010-11	13.0%
2011-12	13.9%
2012-13	15.3%
2013-14	16.1%
2014-15	16.5%

Source: Various Annual Reports, Inland Revenue Department, Ministry of Finance, GoN

Figure 5.5

Contribution of TAX Revenue to GDP



Source: Table 5.5

Table 5.5 and figure 5.5 shows the contribution of VAT on GDP is in increasing trend. The contribution of VAT on GDP was 9.2 percent in FY 2004-05 which is in increasing trend and thus has reached upto 16.5 percent in FY 2014-15. This shows VAT has played a significant role in GDP of the country. The trend of contribution of tax revenue on GDP over the study period was not constant. In some years it is in increasing trend whereas in some years it is in decreasing trends. From the FY 2010-11 the contribution of Tax revenue on GDP is in increasing trend but it is not in satisfactory level.

5.5.3 Share of VAT revenue in Total Tax Revenue

The percentage of contribution of VAT revenue in total revenue for the FY 2014-15 is presented in table and figure below:

Table 5.6

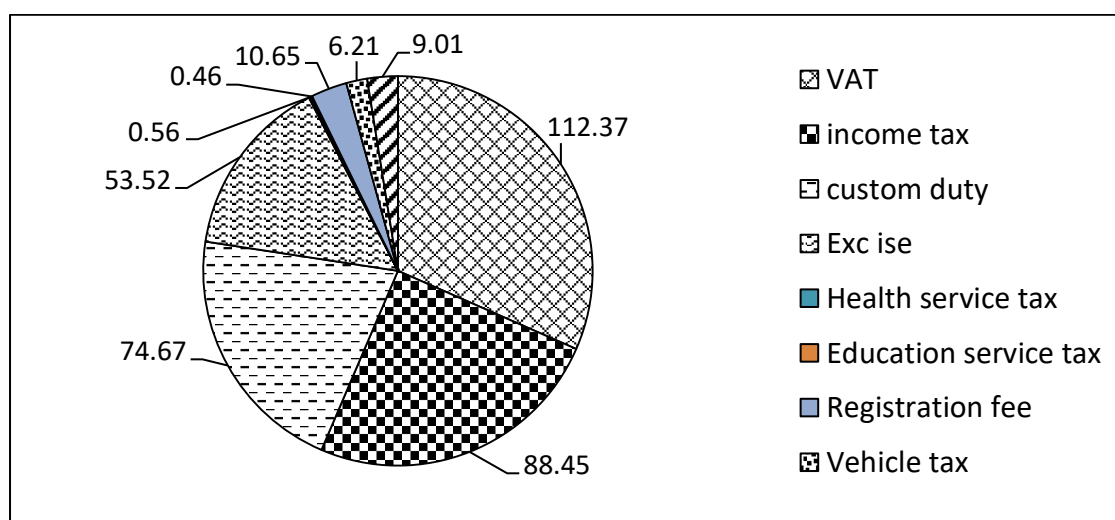
Share of VAT Revenue in Total Revenue

Tax Revenue	Amount in Rs.	Contribution %
VAT	112.37	31.57
Income tax	88.45	24.85
Custom duty	74.67	20.98
Excise	53.52	15.04
Health service tax	0.56	0.16
Education service tax	0.46	0.13
Registration fee	10.65	2.99
Vehicle tax	6.21	1.74
Other tax	9.01	2.53
Total	355.90	

Source: Annual Report, Inland Revenue Department, Ministry of Finance, GoN, Year 2014-15

Figure 5.6

Share of VAT Revenue in Total Revenue



Source: Table 5.6

Table 5.6 and figure 5.6 shows the contribution of VAT in total tax revenue. Contribution of VAT on Total Tax revenue is 31.57 percent. Thus, VAT has a significant contribution on total tax revenue collection.

5.5.4 Contribution of VAT in Total Revenue

Percentage of contribution of VAT revenue in total revenue is presented in table and figure below:

Table 5.7

Contribution of VAT in Total Revenue

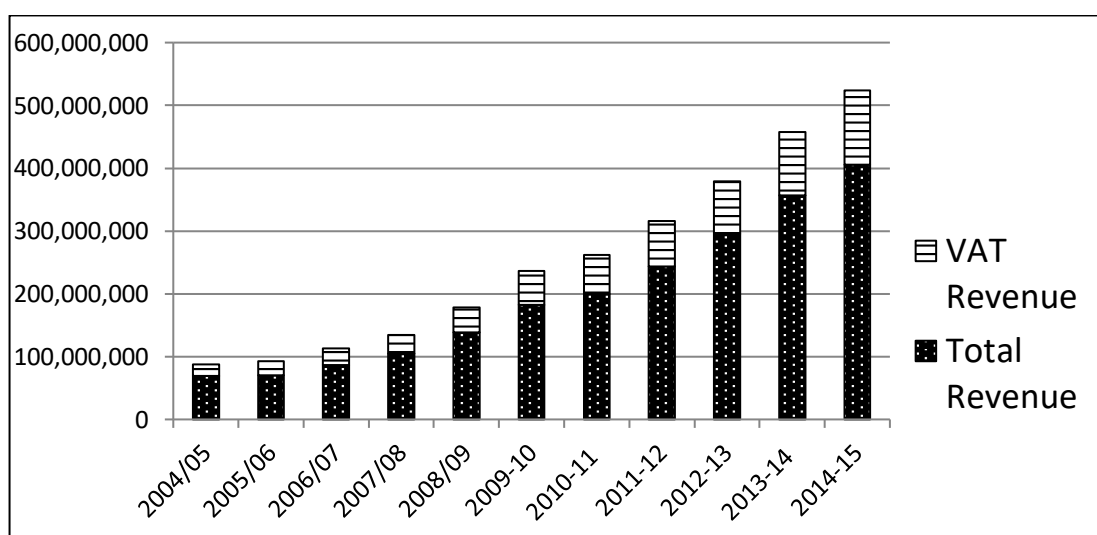
(Rs. In '000)

Year	Total Revenue	VAT Revenue	Contribution of VAT on Total Revenue
2004-05	68,875,063	18,885,400	27.42%
2005-06	70,768,468	21,613,043	30.54%
2006-07	86,686,005	26,095,599	30.10%
2007-08	104,939,301	29,815,703	28.41%
2008-09	138,371,954	39,947,480	28.87%
2009-10	182,370,000.00	53,640,000.00	29.41%
2010-11	199,810,000.00	61,700,000.00	30.88%
2011-12	243,920,000.00	72,180,000.00	29.59%
2012-13	296,010,000.00	83,500,000.00	28.21%
2013-14	356,850,000.00	100,970,000.00	28.29%
2014-15	405,840,000.00	118,490,000.00	29.20%

Source: Various Annual Reports, Inland Revenue Department, Ministry of Finance, GoN

Figure 5.7

Contribution of VAT to Total Revenue



Source: Table 5.7

Table 5.7 and figure 5.7 clears that share of VAT revenue in total revenue lies between 27.42 percent to 30.88 percent in last 11 years of history. In FY 2009-10 contribution of VAT in total revenue was 29.41 percent. It was increasing trends till FY 2013-14. In FY 2014-15 the VAT revenue was 29.19 percent on total revenue. The contribution of VAT revenue on total revenue has higher contribution on total revenue collection over the years of study period.

5.5.5 Contribution of VAT on GDP

Percentage contribution of Value Added Tax in GDP is presented in table and figure below:

Table 5.8

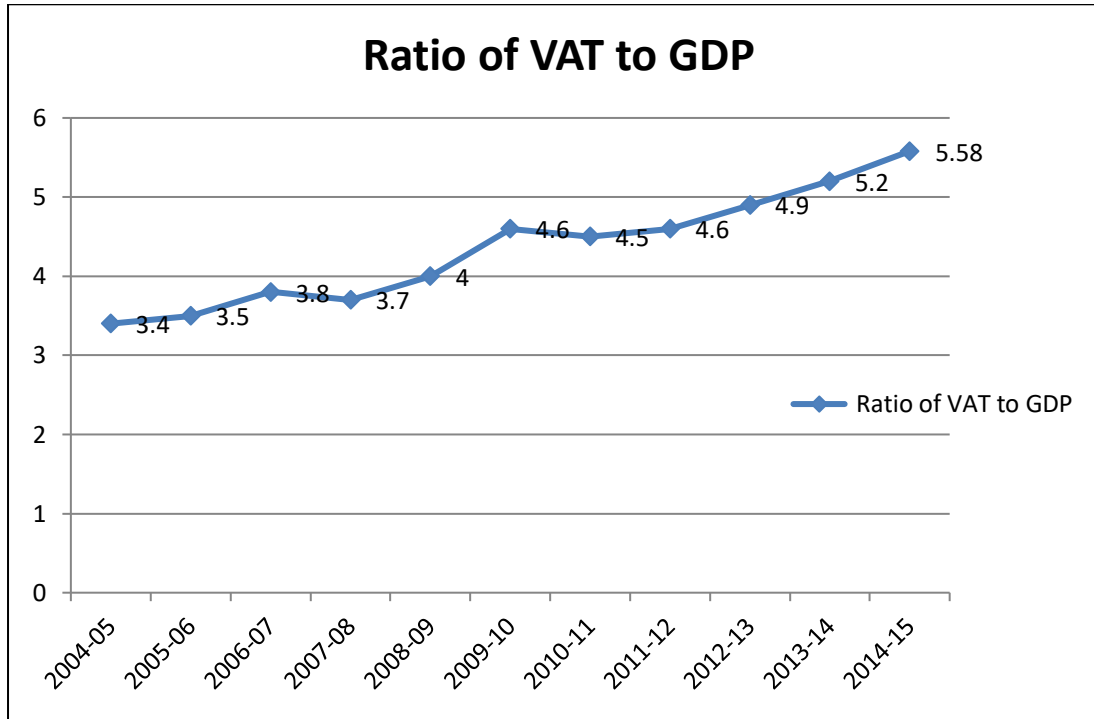
Contribution of VAT on GDP

Year	Ratio of VAT to GDP
2004-05	3.4
2005-06	3.5
2006-07	3.8
2007-08	3.7
2008-09	4
2009-10	4.6
2010-11	4.5
2011-12	4.6
2012-13	4.9
2013-14	5.2
2014-15	5.58

Source: Various Annual Reports, Inland Revenue Department, Ministry of Finance, GoN

Figure 5.8

Contribution of VAT on GDP



Source: Table 5.8

Table 5.8 and figure 5.8 shows contribution of VAT in GDP. In FY 2007-08 contribution of VAT in total GDP was 3.7 percent. It was in increasing trends till FY 2014-15. In FY 2014-15, Contribution of VAT on GDP has increased upto 5.58 percent on total GDP. Trend of contribution of VAT revenue on GDP of the study period was not constant. In some years it is in increasing trend whereas in some years it is in decreasing trends. From the FY 2010-11 contribution of VAT revenue on GDP is in increasing trend but it is not in satisfactory level.

5.6 Consistency between Planned and Actual Revenue Collection from Value Added Tax (VAT)

Consistency and variability between planned revenue collection and actual revenue collection from VAT is presented in table below:

Table: 5.9

Planned and Actual Revenue Collection from VAT in Different Years

(In Rs. millions)

Fiscal Year	Target Revenue Collection from VAT	Actual Revenue Collection from VAT	Revenue Collection Percentage
2004-05	16950	18885	111.41
2005-06	23650	21613	91.38
2006-07	26463	26095	98.6
2007-08	29651	29815	100.55
2008-09	41000	39700	96.82
2009-10	51560	54920	106.5
2010-11	67370	61680	91.55
2011-12	72740	72180	99.2
2012-13	88950	83500	93.87
2013-14	103050	100960	98
2014-15	118730	118490	99.8

Source: Various Annual Reports, Inland Revenue Department, Ministry of Finance, GoN

Table 5.9 clears that consistency between planned and actual revenue collection is not so satisfactory in FY 2010-11 and FY 2012-13. In the comparison of target or planned revenue collection, the percentage of actual revenue collection is in increasing trend and it was achieved as per target in recent years.

CHAPTER VI

SUMMARY OF FINDINGS, CONCLUSION, AND RECOMMENDATIONS

6.1 Summary of Findings

A large amount of government revenue comes from taxation in Nepal. More than 75 percent of government revenue comes from taxation whereas the contribution of non-tax revenue is less than 25 percent in Nepalese tax structure for long period of time. The contribution of tax revenue was expected to increase after the implementation of VAT. But implementation of VAT could not increase the contribution of tax revenue on total revenue significantly. Some of the summary of findings are as follows:

- VAT has been implemented in Nepal in order to generate more revenue, but the efficiency of the Nepalese VAT administration is not satisfactory and not up to the expectation of the government revenue, however, VAT shares a significant proportion to the total revenue.
- Number of taxpayers registrants under VAT has been increasing year after year. The ratio of registrants in VAT is increasing sharply year by year. The number of registrant in FY 2013/14 is 684,552.00 which is increase by 17,506.00 in FY and reached upto 765,605.00 in the FY 2014-15. Number of taxpayers cancelling their registration under VAT is also generally in the increasing trend, though this has reduced in some years in comparison to previous year.
- The status of Non-filers is not also satisfactory. In the FY 2014-15, it had increased up to 24.20 percent in the FY 2014-15. But the trend seems to be fluctuating. There is never a constant proportionate increase.
- In Nepal, collection of VAT has been classified as imports and Inland Production, out of which collection from imports has significant share i.e. Rs. 78,940 million in the FY 2014-15 as compared to Inland Production contribution amounting to just Rs. 39,550 million or just 33.38 percent of the total VAT revenue in the same fiscal year. This surely indicates that there is a heavy dependence on imports rather than domestic products.

- The contribution of VAT to GDP is just 4.64 in an average of 8 years. The contribution of VAT to GDP reached 5.58 percent in the FY 2014-15.
- Hopefully, an average share of VAT revenue in total tax revenue is pretty good, i.e. just about 29.26 percent which simply indicates that VAT though implementation wise, faring very poorly, is still emerging as the important source of revenue generation.

6.2 Conclusion

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 percent (now changed to 13 percent) and exports are subject to rate of zero percent. 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. 5 million) are not required to register under the VAT system.

The contribution to government revenue is significant. Since, VAT is a broad based tax system; it is obvious that it should contribute significantly to the revenue. The contribution to revenue has the increasing trend. However, the share of VAT in GDP is very low. The most of the share of VAT is contributed from import. Nowadays, VAT from domestic products is in increasing trend.

VAT has now reached the adult form but there are so many challenges that are need to be solved to make the system more effective. The lack of proper billing system, smuggling and undervaluation, weak performance of tax administration, low level of public consciousness, rampant corruption, political instability, geographical barriers, open boarder and unauthorized trade, narrow tax base, lack of coordination between custom office and VAT related offices etc. are the major challenges of VAT implementation. Improvement is necessary in such area.

Value Added Tax puts greater significances in revenue mobilization in Nepal. The Reason behind this is that VAT system is transparent with broad tax base and discouraging tax evasion. So, it is necessary to say that VAT is the most important source of the government revenue. VAT is a most scientific, innovation and powerful tax system with built in quality of universal application for both developed and developing economies. VAT system makes it possible to broaden the tax base, eliminate the tax evasion and cascading, create an investment friendly environment and finally to increase the government revenue. This is a matter of great pride that Nepal has entered into a major global tax system with the introduction of VAT. However there are several issues in VAT system in Nepal, which can be explained below;

- VAT as a major instrument and important policy tools have an important role towards increasing the rate of capital formation and also achieving a high rate of economic growth.
- VAT is expected to occupy an important part of Nepal's revenue in a country with a narrow basis for revenue to assume this tax which is based on consumption and imposed at all stages of production and distribution due to catch-up self-policing feature the VAT system is more effective.
- In Now days developing as well as developed countries in the world have increasingly focused their attention towards reforming the tax system by standardizing and improving the poorly designed Tax structure in order to mobilize high volume of resources for the development purposes and make the economy healthy and efficient in this sense the successful implementation and effective structure of VAT system to contribute the government revenue of Nepal.
- Adoption of VAT system for Nepal is both compulsory and necessary .The globalization and recent trend of trade and tax system has affected the Nepalese economy .As Nepal is one of the member of WTO, it is necessary to decrease the custom duty and excise duty. Consumption based tax is only an alternative to more revenue which directly helps to increase domestic resources for development works.

- The structure and the trend of Nepalese VAT system improving and increasing continuously. It shows that there is better improvement and making effective policy or administration part .But it is not sufficient to reach the economic goal of the nation.
- In spite of VAT is a major instrument to achieve the high rate of economic growth, there are many challenges and problems on the successively implementation on VAT system in Nepal. The main problems and challenges are; lack of suitable policy of government, ineffective billing system, existence of open boarder large amount of unauthorized trade, lack of coordination of VAT department and traders, lack of public awareness etc.
- Lastly, this research try to shows that the structure and challenges of VAT system in Nepal and also find out that the broad base and uniform basis VAT is a better instrument for managing the economy, promote the exports and improving the balance of payments.

However, there are several issues in the applicability of VAT in Nepal. One of the key issues is administrative capability and situation which definitely are of great importance for the effective implementation of VAT in Nepal. Actually VAT was introduced in Nepal in an ambitious hope to increase the revenue and particularly stop the leakage made through other forms of taxes. But history has shown that the government has already tried many reforms in the field of taxation but no alternative have effectively materialized because it lacked proper planning and in other words leading to administrative failure. Indeed, this is true in the case of VAT also, Nepalese businessmen are generally found to avoid the frequent contacts with the tax officials because they are widely known for unofficial benefits. Even in the administrative area, there is a widespread corruption. From the survey, it is clear that it is difficult for the customers to get the job done by officials without sufficiently bribing them. There is also a red tapism everywhere. So, for the government, administrative capability and transparency are the serious concerns.

The number of registrants are increasing but the tax collection has not been satisfactory when compared to the number of registrants. Public awareness is very low. The salesmen are not used to issuing bills and the consumers to receiving them. Undervaluation and smuggling of goods are mostly found. The problem seems to be

aggravated by the government's increasing the VAT rate to 13 percent which immensely discourages the customer in demanding bills on their purchases. Truly, recent increment in VAT rate has a fairly negative influence on general people. Their viewpoint is to broaden the tax base instead of increasing the tax rate. Tax rate has been increased time and again for nothing, but this does not get reflected in real revenue mobilizations. Rates should be continued for a long time for transparency and must be incorporated in VAT Act itself. So, the government has to pay serious heed in increasing the tax base instead of increasing the tax rates. International experience tells us that the gradual lowering of duties or tax rate is an effective tool in achieving the desired goals rather than increasing it. Periodical policy has also been obstacles for its speedy enforcement, and a major hurdle that has hurt revenue generation. Excise duty is an important source for VAT, but it has not been effectively administered. Custom officials are more worried on customs duty than VAT collection. Widespread leakages are normal practices due to lack of professionalism, integrity, technically competent, and international orientation. Tax auditors have been auditing without basic knowledge and academic background. As it is weakly enforced, many sectors are out of tax net. Taxpayers complain that the procedures are complicated and time consuming during the decision-making process.

The current modality of the raffle tickets has been designed so as to seize the original bills from eighty percent of taxpayers, who pay only twenty percent of revenue. The system is not new; many countries have already tried with the lottery system, and failed gaining from it. It means, we have no valid mechanism to bring potential payers into net, and no valid mechanism has been developed on bringing them into the tax net. A bold vision, evolutionary leadership, efficient bureaucrats, honest taxpayers plus collectors and graft-free society are the invisible infrastructures required. So all must think from a long-term perspective rather than weighing up immediate pros and cons. The Inland Revenue Department must come up with a forward-moving process, concrete action plan and policies to cope with the global challenges in order to accelerate the reform process.

6.3 Recommendations

On the basis of research, the following corrective measures are recommended for higher Government Revenue from VAT in Nepal:

1. A proper co-ordination between IRD and MOF should be established. Unpractical Acts, Rules and Regulations should be amended.
2. The tax administration should be very watchful to prevent any kind of malpractice, fraud and tax evasion. Utmost care should be taken to prevent any kind of bribing and corruption. Tax officials should effectively be monitored.
3. Taxpayers, customers are clearly ignoring the VAT system and taking it for granted. They have lack of proper knowledge about computation of tax liability, taking invoice or bill on their purchases. So, emphasis should be given in educating the tax payers. The issuance of proper bill for every taxable sells must be made mandatory.
4. The success of VAT system is not only the success of the IRD, but also the success of nation as a 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 created among general public, non-governmental and government organization.
5. Government has been providing tax refund facility to business organization and foreign diplomacy and foreign aided project. Tax refund is one of the sources of tax leakage. Therefore, tax authority should manage tax refund facility properly.
6. Research and investigation should be conducted on various issues, such as the effect of VAT on price, economic growth, investment and measures for solving VAT problems should be recommended by the expert group. VAT law needs to be reviewed on the basis of experience gained so far.
7. The accounting system should be transparent. Taxpayers should be encouraged to register their business voluntarily. Instead of forcefully coercing tax payers, providing various facilities to them can increase VAT compliance. The tax administration can select genuine business persons and reward them.

8. Border administration should be effectively controlled to prevent the illegal trade. Warehouse and highways checking should be done effectively to prevent any kind of illegal trade.
9. The problem of under invoicing too a great extent can be solved by the reduction in the rates of custom duties and increase in the exemption limit of income tax. Accurate invoicing is likely to take place only if the government pays heed to the pleas of the taxpayers.
10. VAT collection on import is remarkably higher than domestic production. Government should take effective steps to encourage domestic production. Lots of efforts should be made to reestablish a functionally well-organized organization where the tasks are carried out in a modern, effective, efficient, transparent and service-minded manner.
11. However, not only in Nepal but actual implementation of VAT in many developed as well as undeveloped countries show that many difficulties in applying VAT, and could not collected revenue as expected. The less collection of VAT revenue seems the lack of proper implementation so that the government has to be trying to emphasis on the effective VAT Implementation. There are certain points which may be useful in order to do effective implementation and collection of VAT in Nepal that are as follows:
 - a) Increase the administration capability.
 - b) Developed potential taxpayer identification.
 - c) Provide incentive for traders.
 - d) By launching special educational programs and penalty.
 - e) Developed simple accounting system for traders and so on.

Most of the national economic activities are dependent upon agriculture and large portion of GDP coming from agricultural sector remains out of the tax net. Thus VAT should also be levied on agriculture sector with sufficient exception for generating more tax revenue. This will increase VAT/GDP ratio.

REFERENCES

- Aujean, M., Jenkins, P., & Poddar, S. (1999). A new approach to application of VAT to public sector bodies. *International VAT Monitor*, 10 (4), 120-130.
- Aydin, B. (2010). Cyclicalities of revenue and structural balances in South Africa, *IMF Working Paper 10/216*. Washington, DC: International Monetary Fund (IMF)/The World Bank.
- Bhattarai, I., & Koirala, G.P. (2006). *Income taxation in Nepal with tax planning and VAT*. Kathmandu: Asmita Publisher.
- Bista, R.B. (2000). *VAT in Nepal: Theory and practice*. Kathmandu: Ratna Pustak Bhandar.
- Burgess, R., Stephen, H., & Nicholas, S. (2010, February). Value-added tax options for India, *International Tax and Public Finance*, 2(1), 109-141.
- Carl, S.S. (1969). *Public finance*. London: Wildfield and Nicholson.
- Carl, S.S. (1978). *VAT and developing countries*. London: Wildfield and Nicholson.
- Choi, W.J. (2012, August). Value added tax in the Republic of Korea, *IMF Working Paper 74*.
- Dahal, M.K. (1996). *Tax system: Revenue tax force in report*. Kathmandu: Ministry of Finance (MoF)/Government of Nepal (GoN).
- Dhakal, S. (2003). *Problems and prospects of value added tax in Nepal* (Unpublished master's thesis). Tribhuvan University, Central Department of Economics (CEDECON), Kitipur, Kathmandu.
- Due, J.F., & Carrie, M. (1988). *Government finance economics of the public sector*. New York (NY): Wang Praeger Publishers.
- Due, J.F., & Friedlander, A.F. (1973). *Value added taxation in development*. Washington, DC (USA): N.T. Wang Preeger Publication, Inc.
- Goode, R. (1986). *Government finance in developing countries*. New Delhi: McGraw Hill Co. Ltd.
- Hossain, S.M. (2005). *Public finance in open economies*. Cambridge, Massachusetts: Harvard Institute for International Development, Harvard University.

- Hsiung, B. (2011). *The modern VAT*. Ernst and Young (Ed.). 1995. *VAT and sales taxes worldwide: A guide to practice and procedures in 61 countries*. New York (NY): John Wiley & Sons.
- Jantshcer, M., & Silvani J. (2010, January). *Analysis of tax and trade incentives for foreign direct investment: The case of Vietnam* (Unpublished doctoral dissertation). Cambridge, Massachusetts: Kennedy School of Government, Harvard University.
- Jenkins, G.P., & Khadka, R.B. (1998). Value added tax policy and implementation in Singapore. *International VAT Monitor*, 9(2), 40-50.
- Khadka, R.B. (2001). *Value added tax: The concept on international experience and its application in Nepal*. Kathmandu: IRD/ DANIDA Report.
- Khadka, R.B. (2001). *VAT and its relevancy*. Kathmandu: Ratna Pustak Bhandar.
- Koirala, K. (2010). Value added tax in Nepal: A critical assessment of its performance. *The Journal of Nepalese Business Studies*. Kathmandu.
- Kumar, J. (2011). *A study on productivity and implementation of Value Added Tax in Nepal* (Unpublished M.B.S. thesis). Faculty of Management, Tribhuvan University, Kirtipur, Kathmandu.
- MoF/GoN (2014). *Economic Survey, FY 2014/15*. Kathmandu: Ministry of Finance (MoF)/ Government of Nepal (GoN).
- Murti, M.N. (1998, March). Value added tax in a federation: commodity tax reforms in India, *Economic and Political Weekly*, 30(11), 579-584.
- Musgrave, R.A. (1959). *Public finance in theory and practice*. London: McGraw Hill, Kogakusha Ltd.
- Narayan, A.R. (2003). *The taxable capacity of a Fiji: Taxation and economic development*, (chapter-1). London: Z-Books, Frank Cass.
- Pokhrel, S.P. (2005). *Value added tax in Nepalese context. Mirmire (Banker's Club)*. Kathmandu: Taleju Publication.
- Sainju, P.K. (2009). *Sales taxation in Nepal*, Kathmandu: Ratna Pustak Bhandar.
- Shah, R.K. (2012). *VAT in Nepal*. Kathmandu: Heritage Publishers & Distributors Pvt. Ltd.

- Shome, P. (2004). On the elasticity of developing country tax system. *Economic and Political Weekly*, XXIII (34).
- Shoup, C. (2010, July). The value added tax and developing countries. *The World Bank Research Observer*, 3(2), 139-156.
- Shoup, C.S. (1969). *Public finance*. London: Oxford University Press.
- Shoup, C.S. (1988). Value added tax in developing countries, *Research Observer*.
- Shoup, C.S. (1990). Choosing among the tiers of VAT. Malcolm Gills, Carls Shoup and Gerardo Sciate (Eds.). *Value added taxation in developing countries*. Washington, DC: The World Bank.
- Shoup, C.S. (1996). *Public finance*. London: Weidenfeld and Nicolson.
- Shoup, C.S. (2005). *Public finance: Value added accounting and reporting VAT*. New Delhi: Kanishka Publishers, (pp. 361-368).
- Shrestha, S.M. (2008). *A study on VAT: Implementation, problems and its effectiveness in the Nepalese economy* (Unpublished M.B.S. thesis). Faculty of Management, Tribhuvan University, Kirtipur, Kathmandu.
- Silwal, N.P. (2000). *Value added tax: A Nepalese experience*. Kathmandu: Mrs. Indu Silwal, Sheela Printers.
- Silwal, N.P. (2008). *Value added tax: A Nepalese experience*. Kathmandu: Mrs. Indu Silwal.
- Thapa, G.B. (1994). Value added tax in Nepalese context. *Mirmire (Banker's Club)*. Kathmadu: Nepal Rastra Bank (NRB).
- Retrieved from [http:// www.economywatch.com/ business-and-economy/vat.html](http://www.economywatch.com/business-and-economy/vat.html).
- Retrieved from [http:// en.wikipedia.org/wiki/Value_added_tax](http://en.wikipedia.org/wiki/Value_added_tax)
- Retrieved from [http:// www.economywatch.com/ business-and-economy/vat.html](http://www.economywatch.com/business-and-economy/vat.html)
- Retrieved from [http:// www.ird.gov.np](http://www.ird.gov.np)
- Retrieved from <http://www.mof.gov.np>

Annexure I

Year (X)	VAT Collection (Y)	Increasing percentage	
2004-05	18,885,400.00	0%	
2005-06	21,613,043.00	14%	
2006-07	26,095,599.00	21%	
2007-08	29,815,703.00	14%	
2008-09	39,947,480.00	34%	
2009-10	53,640,000.00	34%	
2010-11	61,700,000.00	15%	
2011-12	72,180,000.00	17%	
2012-13	83,500,000.00	16%	
2013-14	100,970,000.00	21%	
2014-15	118,490,000.00	17%	
2015-16	119,768,264.67	1%	
2016-17	130,490,643.24	9%	
2017-18	141,213,021.82	8%	
2018-19	151,935,400.39	8%	
2019-20	162,657,778.97	7%	
2020-21	173,380,157.55	7%	
2021-22	184,102,536.12	6%	
2022-23	194,824,914.70	6%	
2023-24	205,547,293.27	6%	
2024-25	216,269,671.85	5%	
2025-26	226,992,050.42	5%	
2026-27	237,714,429.00	5%	
2027-28	248,436,807.58	5%	
2028-29	259,159,186.15	4%	
2029-30	269,881,564.73	4%	

Y=A+B*X	
A	-21485824565
B	10722378.58

Average increase= 19%

Y15/16=21485824565+10722378.58*2016
Y16/17=21485824565+10722378.58*2017
Y17/18=21485824565+10722378.58*2018
Y18/19= 21485824565+10722378.58*2019
Y19/20= 21485824565+10722378.58*2020
Y20/21= 21485824565+10722378.58*2021
Y21/22= 21485824565+10722378.58*2022
Y22/23= 21485824565+10722378.58*2023
Y23/24= 21485824565+10722378.58*2024
Y24/25= 21485824565+10722378.58*2025
Y25/26= 21485824565+10722378.58*2026
Y26/27= 21485824565+10722378.58*2027
Y27/28= 21485824565+10722378.58*2028
Y28/29= 21485824565+10722378.58*2029
Y29/30= 21485824565+10722378.58*2030