Chapter One

INTRODUCTION

1.1 Background of the Study

In the context of new millennium, in 21st century economic development is essential for the developing country like Nepal. The developing countries are in dire need of funds to initiate development projects for national development. The role of revenue in the development of a country is not less important than role of oxygen for the existence of human body. The nation will be able to achieve maximum social welfare if it has sufficient financial resources. In this context, a government needs to mobilize a lot of internal resources to fulfill its responsibility towards its nation and people.

Equity, growth and stability have long been accepted as the major objectives of any economy. The underdeveloped countries (UDCs) have to accelerate their economic growth rates, eradicates absolute poverty, reduce inequalities and create more productive employment opportunities without affecting the ecological and environmental balances.

Being a developing country, the role of government in Nepal is still vital to build infrastructure, to provide social service and to alleviate vigorous poverty, these are challenging tasks, which demand increasing necessity of regular expenditure in various sectors. However, resource mobilization is very low compelling the government to depend on foreign assistance heavily. Development expenditure depends almost entirely on foreign aid. About 70 percent of Nepal's development budget is financed by external assistance, but external assistance is uncertain, inconvenient and not good for healthy development, if there is heavy dependency on it.

The experiences of the most of the developing countries show that there are negative effects of increasing international aid and loan to finance the public development activities. Development planners are of the opinion that a country should not heavily depend on foreign aid as it would hamper the proper utilization of internal resources and give rise to the nonchalant attitudes. More dangerously, it would give rise to the dependency syndrome, which is not a healthy signal for any country. Thus, it is better to mobilize internal resources rather than approaching foreign loans and aids.

In the developing countries like Nepal, there is a necessity for raising a larger volume of resources for financing sustained growth of public investment. It is not possible in these countries to mobilize resources by curtailing existing consumption because it is very low. Public borrowing and internal resource mobilization have also some limitations. Deficit financing is inflationary and foreign aid is not a reliable sources. Continuous use of borrowing to raise the necessary public fund is not good as it increases inflation.

Of course, the prospect of mobilizing resources through taxation is the most effective and powerful tool reserved in the hands of the government of a country. It is taxation, which gives paramount power to the government to command over economy of a country. Taxation may be utilized by the government as a tool for giving incentive to the proper growth of saving, in vestment and gross domestic product. There are several angles through which taxation could be looked upon. While some observe taxation as a mere source of incentive and growth, the other take it as a sources of incentive to the growth of industries and other sectors of the economy. In Nepal, however, the tax policy is mostly guided by the revenue consideration.

In spite of the fact that the taxation gives a great power into the hands of a government, the government should be careful and tactful in imposing taxes on the people. Taxes should never be imposed arbitrarily. Otherwise, there is always the possibility of undergoing serious hazards. The remark of Hicks in this connection is appropriate. “Tax bankruptcy was an important contributory factor to the fall of the Roman Empire. Unjust and inefficient taxes set the French Revolution a flame. An important part of the explanation of Germany's failure in the war of 1914-18 was her antiquated tax structure. Britain loosed the American-Colonies because of inefficient tax system (Hicks; 1941, 10). The government, therefore, is expected to think seriously before imposing tax on the people. It is so because a tax, if imposed, dose not has only short run but also long run direct and indirect impact on the economy.

The two types of taxation, direct and indirect, the latter is incidental to a transaction involving the expenditure rather than receipt of money by the taxpayer while direct tax falls on income. As a part of taxation, indirect tax is an instrument of fiscal policy to achieve broader objectives of stabilization, optional allocation of resources and overall economic growth.

Liberalization of international trade flows has made taxes on international trade less important by enhancing the use of domestic indirect taxes of revenue generation. The role of indirect tax is high in the developing countries because of poor tax administration to collect direct taxes, low per capita income, and evasion possibilities. It implies that there is an economic and administrative limit to the mobilization of resources through direct taxation in the developing countries. Similarly, in the case of developing countries like Nepal, Average Propensity to Consume (APC) is high. Which logically suggests possibility of mobilizing resources from existing consumption, it is possible only through indirect taxes, Indirect tax is a major source of tax revenue in Nepal, and it covers almost 72 percent of the total tax revenue. Generally indirect taxation affects many economic activities such as savings, investment, consumption, production and distribution of national income. No one can deny the importance of indirect tax in the developing countries like Nepal. Thus, as a matter of fact, more resources can be raised only through the exploitation of indirect tax.

Indirect tax, which has important share in total tax revenue, is composed of three major components: Customs Duties, Value Added Tax (VAT) and Excise Duties. Customs and Excise are old tax while VAT is new tax. VAT had gained popularity in short period of time. It is broad based, transparent and economically neutral.

VAT is the most important tax innovation on the second half of the twentieth century. It is scientific tax system, which was first introduced in 1954 in France. It has been considered as one of the major instrument of tax revenue. For this reason, 150 developed and developing countries in the world have adopted VAT till 2012. The list of some countries of that have adopted VAT is given chapter two (Literature Review). It appears to have been successful; in a member of developing countries. It has been introduced in many developing countries to meet persistent revenue demands. Following the economic liberalization policy, Nepal has also legally and administratively implemented VAT system since 16 November 1997. The government of Nepal has announced VAT as a focal instrument for domestic resources mobilization.

To conclude, VAT has been the most essential choice for the developing countries as an ingredient of their tax reforms because it is the most improved form of sales tax, which leads to enhance revenue and economic efficiency. It is an important instrument for the mobilization of internal resources. There is tremendous scope for increasing the revenue from VAT. The implementation of VAT will obviously increase its contribution in coming days. The tax reform with an adoption of VAT is, therefore essentially connected with the effort of many UDCs as one of the major elements of tax revenue to achieve the goals of country’s economic development.

1.2 Taxation and Economic Development

No problem is of greater worldwide concern today than the development, which implies maximization of people's welfare and efficient allocation of resources. In the last two decades, virtually all developing economies have placed great stress on acceleration of economic development more specifically on raising per capita real income to the level of the developed countries as quickly as possible.

Developing economies are concerned with the utilization of resources so as to accelerate the process of development and increase living standard of people. In this context, taxation has become a main source of resource mobilization to meet the financial requirements for economic development. The principal component of fiscal policy to mobilize public resources is government tax policy. Developing countries raise part of the vast financial resources required for their development needs from taxes, Taxes as major fiscal policy instruments and important government policy tools have an important role in increasing the rate of capital formation and thereby achieving a high rate of economic growth. Taxation, in the modern world, has been taken as the best effective tool for raising the ratio of savings to the national income. Thus, taxation must be viewed as an indicator of economic development.

Taxation affects economic development in two major ways by altering determinants of economic development and by permitting the financing of current government activities and governmental or government financed private investment without the undesirable effects of other methods of financing.

Taxation is used to combat inflation, reduce the gap between rich and poor, promote the national economy, mobilize the domestic resource and save the domestic economy. The role of taxation in economic development lies in its function of rising of maximum volume of resource and directing the flow of resources into useful and productive channels of investment, so that country's productive capacity is enhanced. According to Hicks, "The taxation is most important sources of financial development for both direct contributions which it can make and for its indirect effects on control and incentive and in narrowing the gap in available income." (Hicks; 1941, 5)

To analyze the effects of indirect taxation on the attainment of the goals of increasing the growth, accepted pattern of income distribution, efficient allocation of resources, and price stability, John F. Due employed a development model. According to John F. Due the model is as follows:

$\Delta Y = F(\Delta K, \Delta Y/\Delta K, t, r, v)$

Where, ΔY= Rate of economic growth or annual increase in per capita real income (Y/N).

ΔK = Rate of capital formation or annual increase in total capital stock.

$\Delta Y/\Delta K$ = Incremental capital output ratio (ICOR) or relationship between an increase in capital stock and consequent increase in output.

t = Rate of technological change or the rate of increase in new available technology which affects the quality of output that can be obtained from a given quantity of factor units.

r = Rate of increase in quantity and quality of natural resources labor and entrepreneurial activity.

v = Modification in the institutional environment.

1.3 Focus of the Study

Implementation of VAT in Nepal is still in the developing phase. The state and the business community are cooperating with each other for the effective implementation of VAT. The practice of VAT in Nepal is not free from misunderstanding between stakeholders. There seems to be a lack of complete .knowledge of VAT in the government level as well as in business community level. The theoretical study aims at the norms and the values of VAT. The international experiences regarding the implementation of VAT are imperative to Nepal in the context of her early hour’s tax reform program. Success of any program is insured by its proper implementation. Nepal should take lessons from failures cropped up and follow best practices from around the world. So, this study focuses on the practical aspects of implementation of VAT system in Nepal.

1.4 Statement of the Problem

Nepal is a least developed country. Here economy is vulnerable to minor changes due to its rugged topography, low productivity and lack of industrialization, dependence of India and landlocked situation etc. There is a global trend of tax reform. In this way, Nepal will not be independent of such changes but will certainly be influenced from such global changes. The emerged concept of globalization increases foreign direct investment (FDI) and adopted the policy of economic liberalization during the early 1990s. The social, political, and geographical constraint have impeded the overall economic development of the nation. Budget deficit is increasing day by day. The resources gap is bridged by taking foreign loan and grants. Enormous amount of debt liability is on its people's head. The macroeconomic indicators show the vulnerability of Nepalese economy. Nepal is forced to accept many such unfavorable conditions to get loan approval from various multilateral and bilateral donor agencies like IMF, WB, ADB and other similar institutions. Such donor driven tendency has some negative aspect as well.

Considering this reality the government decided to introduce VAT in Nepal from the fiscal year 2054/055 B.S. with replacement of sales entertainment tax, hotel tax and contract tax. But it could not be implemented smoothly due to the strong objection of the business community. Business community claims that VAT is not appropriate in Nepalese context it increase unnecessary tax burden to tax payers and it is difficult to administer. However, the government claims that VAT is a modern and scientific tax system. It does not increase unnecessary tax burden but carry all the taxpayers in tax criteria and it is possible to collect substantial amount of revenue through this tax system.

The major problems are as follows.

a) How to improve the Value Added Tax System in Nepal?
b) What should be done to make VAT effective?
c) How VAT can be made tax payer friendly?
d) How the contribution of VAT can be increased in total tax collection?
e) How VAT can be made the backbone of Nepalese tax system?
f) How adequate revenue can be generated to minimize the present resources gap?

Value Added Tax can play an important role in internal revenue mobilization. There is great potential of generating adequate revenue. Despite its potential, its mobilization is not being effective as it was expected before. There is several research works carried out to know the crux of the problem. No longer have they been able to get the point clearly. So, this study is proposed to explore the practicing scenario and the inherent problems in the system.

1.5 Objectives of the Study

The main objective of the study is to ponder into the theoretical knowledge of VAT and to analyze the practical aspect of the implementation of VAT in Nepalese context. The general objective of the study is to examine the various issues relating to VAT and to provide useful views and suggestion. However, the study also aims to meet the following specific objectives.

a) To analyze the history of VAT in Nepal,
b) To study the current practice of VAT in Nepal,
c) To find out the contribution of VAT in GDP, total revenue, total tax revenue and indirect tax revenue.
d) To find out revenue structure in Nepal.
e) To find out VAT collection trend in Nepal.
f) To discuss about major issues of VAT.
g) To find out status of sector wise VAT collection.
h) To make clear about VAT practices.

1.6 Importance of the Study

Value added tax is not fragile in itself. It is powerful tool of government fiscal policy. But there are scores of problems encumbering the smooth functioning of VAT. The crux of the problems lies in the implementation of VAT. VAT should not be labeled as failure in Nepal. The success and failure of VAT is largely depends upon its operational efficiency and business community's compliance with it. Business community used to claim that VAT would create many kind of negative impact. But VAT system has travelled a long way since its implementation. We have learned so much about VAT since 15 years but very limited studies have been made in the area of VAT. Now it is necessary to undertake research to find out the key areas where certain change and correction is necessary. Therefore this study will be helpful to clear the cloud of uncertainty about the effect of VAT in the Nepalese economy.

This study is beneficial for the policy makers, private sector researcher and other interested persons. Policy makers will be able to identify the areas need for improvement and for the proper implementation of VAT at present in Nepal. Private sector will be able to identify the impact of VAT on their area. They can compare the impact of tax on their business before and after implementation of VAT. They will be clearer about VAT system. Similarly, it will help the researchers to carry out their research a step ahead about VAT. Erroneous belief about VAT is misleading the business community and thwarting VAT compliance. Though not significant, this will have some worth to the stakeholders.

1.7 Limitations of the Study

The study has very limited area of investigation. It is only a part and partial analysis of VAT. Comprehensive study of VAT is not possible in this dissertation due to its certain deadline for completion. The information and data are collected from the Inland Revenue Department, Ministry of Finance. Most of the data are taken from Economic Survey and Annual Report of Inland Revenue Department.

a) Available data covers a very short period of time.
b) Due to time and resource constraints mainly secondary data are used in this study.
c) This study is largely dependent on the reliability of secondary data. The reliability of secondary data could not be tested because of time constraint.

The literature on VAT is inadequate and scattered. These all constraints have limited the boundary of the study. Despite such limitations, attempt has been made to make it useful research.

1.8 Organization of the Study

This study has been divided into six chapters. The abstract of each chapter is given below:

Chapter-1: It is the introductory part of the study. It contains the background of the study, statement of the problem, objectives, significance, limitations and organization of the study.

Chapter-2: It contains review of the literature which deals with theoretical review and review of published and unpublished materials such as Books, Journals and Research Works.

Chapter-3: In this chapter, the research methodology has been discussed about research design, nature and scope of the data, data collection procedure and presentation and analysis of data.

Chapter-4: It is the major part of the study which focuses on presentation and analysis of data. In this chapter the collection and available data have been tabulated in a systematic way and different statistical tools have been used to analysis the data.

The major findings of the study are also included in the same chapter.

Chapter-5: It is the concluding part of the study. It contains the summary, conclusion and suggestions.

The bibliography and appendix is given at the end of the thesis.

Chapter Two

REVIEW OF THE LITERATURE

2.1 Theoretical Review

2.1.1 Concept

Value Added Tax is a tax imposed in value added on goods and services by business firms at successive stages of production and distribution. Value added is the excess of sales value over purchases by a manufacturing or trading firm during a period. For example, a sales person pays 10 rupees for sliced bread and carries it to the retailer of 15 rupees he had added 5 rupees of the value to the bread. A certain percentage of tax is levied on the added value at various levels of such production and distribution. In this sense, VAT is a multistage sales tax (Subedi; 1998, 79).

Value Added Tax (VAT) is the most recent innovation in the field of taxation. It is considered as one of the forms of sales tax. Sales tax levied on the sale of goods and services, is commonly divided into three groups e.g. turnover tax, single stage tax and VAT. Turnover tax is levied at all stages of the production and distribution process, The single stage tax may be imposed at the manufacturing level or at the wholesale level or at the retail level, and the tax is known as manufacture’s tax, wholesale tax and retail tax, On the other hand, VAT is imposed on the value added at each stage of production and distribution. VAT is a multistage tax, which has grown as a hybrid of turnover tax in the sense that both these taxes are imposed at each stage of production and distribution process. VAT, however, differs from the turnover tax as the latter is imposed on total value at each stage while the former is imposed only on value added at that stage. VAT is similar to the retail stage sales tax because the tax base of VAT and of the retail level sales tax on consumer goods and services are identical. VAT, however, varies from retail level sales tax in the sense that the former is imposed at each stage of production and distribution.

The firm adds value to these purchased materials by processing or handing them with the help of its own factor of production, such as labors, land, capital etc. (Shoup; 1969, 251). This value of output over inputs is the value added by the firm. In other words, looked at form and angle, value added of a firm is the sum total; of the incomes paid out by the firm to factors employed. This means that value added by a firm is equivalent to its payment of wages, salaries, rent and interest plus profit, and this value added is the base of VAT.

Let us suppose that a producer has imported raw materials at the rate of Rs. 50 from a foreign country to manufacture some goods. The producer then used the raw material to prepare a finished product and sold it to a wholesaler at Rs. 100, the wholesaler then sold it to retailer at Rs. 130 and the retailer sold to the consumer at Rs. 150. Then for the purpose of VAT, the value addition at the import level is Rs. 50, in the production level is Rs. 50, at the wholesale level is RS. 30 and retail level Rs. 20. These amounts and the basis for VAT and when applied at the rate of 10 percent, the VAT amount will be Rs. 5, Rs. 5, Rs. 3, and Rs. 2 at import level, production/manufacturing level, wholesale level and retail level respectively, amounting to total VAT of Rs. 15.

Table No. 1

Example

Computation of VAT Payable

Production/ Distribution Level	Sales Price	Value Addition Collected	Tax Collected from Sales @10% (Assumed)	Tax Incurred on Purchases	Actual VAT to be Paid to the Government
Importer	50	50	5	0	5
Producer	100	50	10	5	5
Wholesaler	130	30	13	10	3
Retailer	150	20	15	13	2
Total					15

2.1.2 Historical Background

VAT is the youngest member of the sales tax family. In 1919 Dr. Wilhelm Von Siemens first purposed the concept of this tax in Germany. During the First World War, the Germany Government introduced Umsatssteuer (A multiple stage sales tax) as a temporary measure to mobilize the much needed resources. During the First World War, since the revenue generated through this system was encouraging the government did not abolish the system even after the war was over. But under this tax system tax was levied on the tax inclusive total sales price at each stage in production and distribution process and thus the problem of cascading and vertical integration staled becoming evident that German economy deprived of the benefit of specialization and economy of scale. To resolve these problems Dr. Siemens proposed tax to be levied only on the value addition at each stage of the production and distribution process. The German government debated a lot on this and held many discussions but since this was a very new concept government was not confident about its implementation aspect. Hence, instead of adopting this new system it took measures to reduce the negative impacts of the multi kevel sales tax system by reducing the tax rates.

The concept of VAT was developed further in 1949 by a mission assigned to purpose reforms in the tax system of Japan under the chairmanship of Professor Carls Shoup. The mission recommended the adoption of VAT to replace the prevailing enterprise and turnover tax rather that was causing undesirable and unintended distortions. To implement this tax serious discussion were held and although even the law was passed by the parliament owing to the newness of this tax and the lack of knowledge regarding its implementation, like in Germany, it was not implemented in Japan either. No country adopts this tax system until 1954. Up to this time, VAT remained a topic of academic discussion.

After three and half decades of the evaluation of the concept of VAT France introduced VAT in 1954 at the wholesale level in the industrial sector. Up to 1959, this tax was confined to the boundary of France. In 1960 this tax was adopted by the Ivory Coast, in 1961 Senegal followed it and in 1967 Brazil and Denmark adopted this tax system. There after many countries started adopting this tax.

In the process of establishing the European community (EU) in 1960s, the policy to adopt a standard tax system for the members of the community was also adopted. In this context, it was decided that all member countries of the EU should adopt VAT by replacing their various types of indirect taxes. Since it become, a precondition to adopt VAT to become a member of EU. The member countries started to introduce VAT in to their tax systems and gradually this become the standard tax system of the European countries.

Nepal introduced VAT in 1997 for several reasons. One of the important reasons was to develop a stable source of revenue by broadening the tax base. Nepal had been generating bulk of its revenue from import duties. This became possible because of the restrictive economic policies adopted by India until the beginning of the 1990s. Indian tourists were attracted to buy goods imported from third countries in the Nepalese market. These goods also used to be deflected to India by both the Indian and Nepalese traders. The scope of this type of trade, however, had been decreasing due to the opening up of the Indian economy since the early 1990s. There had been a drastic reduction in the import tariff, quantitative restrictions and licensing system in India since 1991. As a result, the volume of the third country import in the Nepalese market meant for the Indian buyers had been shrinking. Further, Nepal reduced its import tariff in line with the liberal economic policies adopted since 1992/93 and in line with the customs duties reform-taking place around the world generally and in India particularly. Consequently, import duties will be less important in the future than they were in the past. The process had begun as relative position of import duties decreased from 37 per cent in 1990/91 to 34 per cent in 1996/97. Furthermore, Nepal had to reduce custom duty to remain within the South Asian Association for Regional Co-operation (SAARC) region after the implementation of the South Asian Free Trade Agreement (SAFTA); this meant Nepal would have to become less dependent country on international trade taxes for its revenue.

The base of the domestic trade had been going narrow as well since the share of the total economy that flows through market channels was relatively small. The potential tax base became even smaller as sales tax used to be collected at the import/manufacturing point. The large number of exemptions granted on socio-political grounds and weak tax administration only aggravated the problem.

It is necessary to introduce VAT in Nepal for many reasons; broadening the tax base, reducing the tax rates, promoting economic growth and making the tax system transparent, fairer and less distortion.

2.1.3 Types of VAT

The types of VAT are determined based on treatment of capital goods of a firm. Input tax paid for capital goods is allowed to credit from the output tax or not, is the fundamental question in the study of types of VAT. If allowed, it can be credited fully or based on depreciation in the second question regarding the differentiation of VAT. The types of Vat are as follows. (Khadka; 1989, 2)

2.1.3.1 Consumption

Under the consumption type, VAT of all capital goods purchased from other firms, in the year of purchase, are excluded from the tax base while depreciation is not allowed for deduction from the tax base in the subsequent years. Since investment is relieved from taxation under this variant, the base of tax is consumption types of VAT. As exports are relieved from tax while imports are taxed the base of this tax becomes identical to the base of retail sales tax on consumer goods and services.

Consumption type of VAT is more popular and accepted widely in the world. Investment is free from the tax burden, export is tax free and import is taxed, it is easy from the point of view of tax administration too. Nepal has also adopted the consumption types of VAT system, the most popular type of VAT in the world. A registered person can credit the tax paid in the purchase of goods and services from the tax collected in the sales under the prevailing laws of Nepal (VAT Act-1995, 17.1).

2.1.3.2 Income

The income type of VAT does not exclude capital goods purchased from other firms form the tax base in the year of purchase. This variant, however, does exclude depreciation from the tax base in the subsequent years. Moreover, under this system, an excess of year-end inventory over starting inventory is included in tax base while excess of starting inventory over year-end inventory is excluded (Shoup; 1969, 252). The tax falls both of consumption and net investment, and the conceptual tax base of this variant is the net national income. For this reason a comprehensive VAT of the income variety is equivalent to a flat rate integrated tax on corporate and personal income, with no exemptions or deductions other than those needed to measure income.

2.1.3.3 Gross National Product

Under this variant, Capital goods purchased by firm from other firms are not deductible from tax base in the year of purchases. This variant does not allow the deduction of depreciation from the tax base in the subsequent years. Hence, the tax is levied both of consumption and gross investment and the conceptual tax base of this variant is gross domestic product.

Thus, the variants of VAT differ depending upon the treatment of capital goods. The consumption variant excludes all capital goods purchased from other firms in the year of purchase from the tax base, but makes no allowance for depreciation from the tax base in the subsequent years. Both the income and the gross national product variants do not exclude the purchase of capital goods from the tax base in the year of purchase. These two variants differ in that the income variant excludes the depreciation from the tax base in the subsequent years while the gross national product variant dose not do so. Among these types of VAT, the consumption variant has been widely used in several countries in Europe and elsewhere in the recent years. The reasons for the popularity of these types are that this variant dose not affects decision regarding investment and growth since it relieves investment from any burden of tax. Since the tax does not discriminate against capital intensive techniques in favor of labor intensive techniques, there is no need for a firm to switch over form capital to labor intensive methods. Hence, the tax is neutral regarding the techniques of production. On the other hand, the gross national product variant offends of against some of the consensus equity criterion that it is unlikely to be widely used. If an asset with a life of, say, seven months is purchased in the period January to May of a calendar tax year, it is deductible; if it is purchased after first June it is not deductible. To full consistent, no deduction should be allowed for purchases that go to increases the year no offset against sales should be allowed for a drawing down of inventory. This tax therefore, puts heavy pressure on firms to use methods of production that do not require capital assets and that do not involve frequent year to year fluctuations in physical volume of inventories (Shoup; 1969, 251). Since the gross national product variant creates a substantial disincentive for saving, investment and capital intensive production. It is not likely to be a member of the tax family of any country.

Forther more, the consumption variant is more attractive then the income variant from the consideration of foreign trade. This is because the former variant is compatible with the destination principle of taxation, which has been used commonly by several countries. Under this principle, the tax base is consumption; hence exports are relieved from taxation, while imports are taxed. As explained later on, export can be relieved completely from VAT under the consumption variant. On the other hand, the income variant is consistent with the original principle of taxation, where the goods are taxed in the country of production; and hence exports are taxed while imports are relieved from the tax. Because of the nature of the income variant, it is difficult to make exports tax free completely.

The consumption variant, thus, have several advantages over the income and the gross national product variants. That is why many countries selected the consumption variants.

2.1.4 Methods of Computation of VAT

The registrant is responsible to levy the VAT and deposit to the government. Registrant is said unpaid tax agent of government. Now tax liability calculation is a crucial part of the VAT system. Taxpayers have to calculate his tax liability and deposit to the concerned authority under the VAT system, which is known as self-assessment system. Therefore, the policy of tax base or method of computation of tax is necessary to make clear by the country adopting the transparent tax system, the VAT system.

The specific modalities on how the tax base is established and the liability computed will influence the administration of the VAT. VAT is levied on the sum total of value added by a firm in due course of production and distribution. There are three methods of computation of VAT. (Khadka; 1989, 5)

2.1.4.1 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 income produced by the firm. In other words, the tax base is computed by adding the payments made by the firm to the factors of production employed in turning out the product, such as wages, interest, rent, royalties and profits.

This method is appropriate for the income type of VAT that includes in its base the rewards to all factors. (Shoup; 1969, 246)

2.1.4.2 Subtraction Method

Under this method, value added is determined as net turnover, which is obtained by subtracting the cost of material from sales proceeds. Thus, VAT is levied on the amount, which is derived by subtracting purchases from sales (Khadka; 2001, 6). Advocate of the subtraction method argue that the compliance costs are lower. This method is appropriate for the consumption variant of VAT.

2.1.4.3 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 taxpayers 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, which deducts purchases from sales and levies taxes on the difference, tax on purchases is subtracted from the tax on sales under the tax credit method.

The credit method is almost universally preferred at least for the comprehensive VAT. In fact, it is clearly a necessity if multiple rates are used. A firm pays tax based upon its sales value and claims a deduction for the VAT paid upon its supplies of goods and services, In this case, the tax paid on inputs serves as an important record and not the specific value of purchases, this tax is then credited against taxes due to the sales made by the enterprises.

2.1.5 VAT and International Trade

Trade across the border of the country is directly influenced by the decision of any revenue system. VAT is also concerned in relation to the international trade. In the case of international trade, a country applying VAT or preparing to apply VAT two alternatives appears to be serious. They are taxing all domestically produced goods exempting all exports or taking all the imports and making exemption for all exports goods and services to the foreign country. Two principles are found regarding international trade in the system.

2.1.5.1 Origin Principle

The origin principle advocates the theme that “Tax all goods and services where they are originated or produced and relive those goods from taxes, which are all imported from aboard.” A country applying this principle “Taxes all export and free all imports” (Subedi; 1998, 10). VAT is charged in the country where goods are originated and goods imported are free of VAT under this principle. Export is taxable and import is relieved from tax liability under the origin principle. Addition, subtraction and tax credit these three methods of computation of VAT can be applied equally under this system but tax credit method is not suitable because tax rate of importing country needs to compute. Export is discouraged under the origin principle due to equal tax burden as domestic supply.

2.1.5.2 Destination Principle

The approach, which taxes imports and frees exports, is known as the destination principle of VAT. Under a destination principle of VAT, all exports are allowed to free tax and all imports subject to tax. Under the basic destination rule tax would be collected at import and the firm would receive credit for this tax and a refund when the products are exported (Subedi; 1998, 100).

2.1.6 VAT Free Arrangement

Under VAT regime there is some provision keeping some special goods and services or transaction beyond the tax base. Such provision makes the tax administration simple and promotes equity among taxpayers. There are three provisions from freeing from VAT. They are: Exemption, Zero rating and Threshold.

2.1.6.1 Exemption and Zero Rating

Exemption and zero rating are two popular method of escaping from VAT. Exemption and zero rating are not the same method they are different to each other. The transaction of tax-exempted goods and services remains outside the preview of VAT. The exempted goods and services are kept outside the formalities of VAT system. VAT is not collected on tax exempted goods and services. If the transaction of certain goods and services are zero rated tax is levied then such goods and services or transaction are kept within the preview of VAT. The dealing in such transaction has to be registered under VAT and fulfill all other formalities that are applicable to other registrants. Such registrants have to collect VAT at the rate of zero percent on their sales and can deduct the tax incurred on their purchases. This means that the zero rated goods and services are taxable but the rate is zero and the registrant should follow all formalities of VAT. On the tax exempted goods and services the output tax can not be collected and the input tax can not be claimed but on the zero-rated goods and services a zero-rated tax is levied which actually is equivalent to zero and the input tax can be claimed. This means that in the zero rated goods and services VAT is not levied on sales but the VAT paid on purchase can be claimed. If it is administratively difficult to apply VAT on certain goods and service, exemption is given where as zero rating is applied on certain transaction if they are necessary to free from tax net.

2.1.6.2 Thresholds

Small business having annual turnover up to certain amount are not required to register under VAT. The amount fixed for this purpose is known as thresholds. To keep small business firm outside the tax preview thresholds has been specified under the VAT system. The wholesaler, retailer, dealer or producers who sell taxable goods and services below the thresholds level do not have to be registered under VAT and neither do they have to collect VAT on their sales. Thus, thresholds is a kind of exemption, which is based on the amount of the transaction but on the kind of goods and services. Therefore, the thresholds must be set based on the nature concerned and the status of education and record keeping at various levels of business firms.

2.1.7 Some Legal Aspect of VAT

2.1.7.1 Imposition of Value Added Tax

According to Clause 5 of VAT Act 2052 the following transactions are imposed with VAT except if otherwise mentioned in the Act.

a) Goods and services supplied in the territory of Nepal.
b) Goods and services imported in the territory of Nepal.
c) Goods and services exported outside the territory of Nepal.
d) VAT is imposed on transaction value.
e) VAT is not imposed on exempted goods and services which are mentioned in schedule one of VAT Act.

2.1.7.2 VAT Registration

According to Clause 10 of VAT Act 2052 it is necessary to register the business before starting for the purpose of VAT but it is not necessary to register the business of exempted goods and services.

2.1.7.3 Cancellation of Registration (Clause 11, VAT Act 2052)

There are three main condition of VAT deregistration. The first case is where a person or firm has been registered for VAT properly, but where the registration is no longer appropriate. This will occur where a person was required to register because the person's business activities exceed the threshold but where, subsequently, the person's level of business activities has declined to below the threshold. The second case is where the person has ceased to carry on business activities. The final case is where the person has been registered by mistake or by misrepresentation.

2.1.7.4 VAT on Imports (VAT Rules 2053, Section 9)

The collection of VAT on imports of goods at Custom point is so important. According to VAT Rules 2053, Rule No. 48, there is provision of imposing VAT on imported goods or services at the prevailing rate in Nepal.

2.1.7.5 VAT Invoices (VAT Regulation 2053, Section 4)

A VAT invoice is an invoice, till roll print, or other document that is issued by as taxable person who makes a taxable supply and that records the supply and the amount of VAT payable on it. In an invoice-based VAT system, invoice is the proper part of the procedure for imposing and enforcing the VAT. The requirement of invoice to be issued is a special feature of VAT.

2.1.7.6 VAT Returns (VAT Act 2052, Clause 18)

There is a standard return form, so that taxable persons should know precisely what is required for VAT return filing. The businessman should know the sales amount, VAT collected on sales (Debit), purchase amount, VAT paid on purchase (Credit) and exempted sales and purchase. The difference amount between the Debit and Credit should be deposited in revenue account of government.

2.1.7.7 Payment of VAT (VAT Act 2052, Clause 19)

The business which is registered in VAT should file the VAT return in specified time. The Debit VAT amount should be paid within 25 days after the expiry of tax period.

2.1.7.8 Assessment of VAT (VAT Act 2052, Clause 20)

If a business firm try to evade VAT by under invoicing, loose billing, transaction without billing or any means the Tax Officer can assess VAT with penalty under clause 20 of VAT Act 2052.

2.1.7.9 VAT Periods (VAT Regulation 2053, Section 6)

The standard period is calendar month; often, taxable person with small levels of taxable turnover is allowed to use longer periods of bi-months and four months.

2.1.7.10 Tax Credit (VAT Act 2052, Clause 17, and VAT Regulation 2053 Rule 39 to 44)

Where the input tax credit for any VAT period exceeds the output tax collected, there is excess of VAT credit or of deductible input tax. As a direct result, the taxable person will pay no VAT to the tax authorities for that period. In such cases the tax authorities use that excess to offset future obligations.

2.1.7.11 VAT Refund (VAT Act 2052, Clause 24-25, and VAT Regulation 2053 Rule 45)

According to the rules and regulations VAT paid on purchases is refunded to the tax payer on the following basis.

a) Export
b) Continuous credit more than 6 months
c) Diplomatic Refund

2.1.8 Issues and Strategies

Value Added Tax system entered into the 1.5 decade of its implementation in Nepal. Even today, the implementation of VAT is not proceeding at a desired path. It is facing several problems in operation. One of the basic merit of VAT i.e. revenue productivity through a broad coverage is not yet realized in Nepal. VAT that has been in operation for the last fifteen years is still facing a number of challenges owing to poor administrating and lack of good faith and irregularities, among other issues, have posed a great problem.

"It is not easy to implement a broad based VAT in the present Nepalese context where smuggling and under valuation are common and the amount of unauthorized trade is considered to be very significant." (Khadka; 2000, 84).

2.1.8.1 VAT Billing

Since VAT is based on bill system, the issuance of proper bill is very important for the successful implementation of VAT. In other words, the success of VAT depends on bill issuance by traders and compulsory receipt of bill by customers. In Nepal, however, the widespread practice of not issuing VAT bill while selling goods is still an implement in the effective implementation of VAT, paralyzing government commitment to develop VAT is a backbone of revenue collection. Even after 1.5 decade of implementation of VAT, consumers are unaware of the significance of billing system. The culture of asking for bills while purchasing goods has not developed so far despite government's commitment and efforts. Due to the lack of public awareness about billing system, few people ask for bill of their purchases.

The proper issuance of bills has remained a major bottleneck. The revenue generation is not meaningful because the potential revenue is severally lacking due to the non operation or ill operation of billing system in most of the registered firms. Businessmen registered in Inland Revenue Offices holding VAT certificate, fulfill just formalities but avoid issuing bill for every transaction. Most of the firms do not issue bills. They issue parallel bills, loose bills and make parallel accounts one for the tax purpose and the other for business purpose. Consumers too are not much interested in taking bills since VAT amount is added if they demand for bill. If any consumer asks for bill for his/her purchase, they would charge thirteen percent more as VAT on top of the price. Then, general consumers do not ask for VAT bill, either they take cash memo or a purchase note. The people, who debate for VAT bill, feel harassed.

Furthermore, the major problem associated with VAT is the lack of compliance on the part of businessmen with the billing requirements. Businessmen hardly issue bill to consumers though it is mandatory under VAT Act. If customers insisted, they would charge extra money. Such practice has discouraged the customers to demand VAT bill. Similarly, low valuation of imported goods at the custom is another major obstacle if the successful implementation of VAT and is the root cause of the failure of the billing system. If this provision could not take place in practice, the effectiveness of VAT always remains questionable. Until the bills are not issued, VAT can not be effective. This is the greatest challenge of VAT in Nepal.

2.1.8.2 Narrow Coverage

The base of VAT is narrow, both legally and administratively. For example, agriculture, the biggest sector, is outside VAT net. Exclusion of agriculture sector alone cuts the tax base by almost 33 percent of GDP.

An attempt was made to limit the number of exemptions under VAT until the introduction of VAT, but the number of exemptions increased substantially after the implementation of VAT. Most of the exemptions are politically motivated and given under some pressure. Almost 70 percent of the economic activities brought under VAT net are also not tapped effectively due mainly to the lack of strong political commitment and weak tax administration. This has been reflected if the low number of taxpayers and low revenue collection.

2.1.8.3 Weak and Traditional Tax Administration

The general impression is that the administration is weak, traditional, indifferent, inefficient and corrupt. The amount paid by the taxpayers never goes to treasury to the full extent due to leakage. Tax payment is based on negotiations resulting in huge corruption with increasing tax avoidance and evasion. However, it is obvious that corruption originates at the top and politicians protect the malpractices and irregularities of tax officials, Moreover, poor training, low status, poor salaries and poor equipment characterize the tax administration. Tax officials are not given specialized training on various aspects of taxation. There is lack of adequate auditors, treaty negotiators and trained personnel on various aspects of taxation. Since many officials lack proper knowledge of taxation and experience in tax administration, many tax matters are not being handled in a proper way. There is also a system of performance based evaluation of the officials for promotion to higher levels. Under these circumstances, another most serious problem for implementing VAT in Nepal is the administrative inefficiency. Qualified, intelligent, competent, knowledgeable and well-trained manpower are necessary for handling this system efficiently. It is, however, difficult to find tax officials having such qualities. The budget of Inland Revenue Offices has not been increased even after the many fold increase in the activities of this administration after the introduction of VAT. Due to the weak tax administration, there are big gap between the legal tax system and its actual operation. For example, tax invoice adopted under VAT is more in name than practice. Several retailers either do not issue invoices or issue improper invoices.

2.1.8.4 Lack of Coordinated Approach and Long Term Strategy

The study of the development of the Nepalese tax system indicates that there has been a lack of coordinated approach and long-term strategy. Several tax measures have been introduced on an ad-hoc basis without much consideration of their possible effects.

While VAT was scheduled to be implemented from November 16, 1997, the sales tax system was changed drastically in mid July, only for four months i.e. until the introduction of VAT. Under the new system, in addition to manufacturer's dealers, wholesalers, and retailers having an annual turnover exceeding Rs. Two million and imports with annual commercial imports exceeding Rs. 10,000 were required to register and obtain a registration number. Since the tax administration and taxpayers were not informed about the new system. In FY 1998/99, the government decided to implement VAT in a full-fledged manner but at the same time introduced several new measures. However, measures were not appropriate at a time when the government had planned to implement a full-fledged VAT. International experience indicates that government dose not proposes any new taxes during the initial stages of VAT implementation.

Similarly, the lack of coordination between concerned departments along with Ministry of Finance has been a serious problem. A glaring example could be Ghana where VAT system had been withdrawn because of the lack of such coordination among the government agencies. In our country, experiences show that there is no proper coordination between Inland Revenue Department and other relevant institutions such as Custom Department, Department of Revenue Investigation and Ministry of Finance. To insure proper coordination, the relation between Inland Revenue Department (IRD) and Ministry of Finance should be intimate. DANIDA- VAT project in its progress report of that period has underlined that the implementation of VAT in Nepal depended on a very few persons.

2.1.8.5 Traditional and Complex Procedures

When the new tax VAT has been adopted, tax procedures have not been adjusted fully in line with the new development. Traditional practices continue to work. Some procedures and forms, which were designed under the controlled regime, have not been revised. Traditional mentality of tax officials only makes the matter worse. Rationalization of the tax structure and simplification of tax procedures can not carry much significance if the tax officials continue to work in a traditional way. Similarly, the importance of the training is not also given due attention.

2.1.8.6 The Use of ICT in Tax Administration

In recent years Inland Revenue Department is using various tools and techniques of Information Technology such as some software like Protax, Mismatch, E-filing of VAT and IT tax returns, RAS, ETDS, EPAN, Personal EPAN, IRD Website, EMIS and so on. But still it is necessary to use the latest ICT techniques such as SMS Push mailing. Notice Board Service, Tax Calculator software for everyone. Tax Apps (Just like Turbo tax Apps of America) and so many innovative ideas based on modern technology to improve and simplify the tax administration.

2.2 Review of Literature

Tax Law Design and Drafting is an International Monetary Fund publication edited by Victor Thuronyi. This book deals with the drafting and designing of different tax laws. The value added tax is also discussed in chapter six. This particular chapter, VAT, has been dealt by David Williams. The article confers standard practices on VAT in the international context. It begins with the general introduction on VAT. The present status of VAT, its terminologies, economic implication, territorial scope, charges to VAT, and its principle of non-discrimination are covered in the introduction section. Then it proceeds into the definition of taxable person under VAT along with the provisions regarding the registration, VAT numbers, cancellation of registration, and voluntary registration. The third section deals with the definition on the supplies of goods and services and the condition for the business transactions to come under the scope of VAT. The fifth section comments about the exemption of VAT and its implications in the economy. The next part ponders over the valuation of goods and services. The payment of VAT in the world is also discussed. Finally, the article concludes with the administrative management of VAT. (IMF; 1996)

VAT in Nepal is a collection of published articles.. Dr. Rup Bahadur Khadka, an expert of VAT in Nepal, writes this book. The first paper gives a general introduction to VAT. The second paper which was written at a time when the draft VAT law was under-development outlines the purposed structure and operation of VAT and the administrative structure to run this tax. The third paper provides an overview of the VAT system, while the forth paper describes mainly the reasons to introduce VAT in Nepal. The fifth paper basically points out the preparation made for the political, economic and administrative complications appeared in the course of VAT implementation. The sixth chapter presents the existing status of VAT implementation and the major impediments that needed to be removed for the smooth running of VAT. The last paper analyzes the Indian domestic indirect tax system and presents views of various committees and individual on VAT in India. (Khadka; 2001)

VAT and Its relevancy to Nepal is a collection of different articles published and written by Dr. Rup Bahadur Khadka. The articles specially deal with the general introduction of VAT on the eve of the introduction of VAT in Nepal. He has compared the VAT with the sales tax in use before the introduction of VAT. Nepal had the experience of implementing import/manufacturing level sales tax; wholesale level sales tax and the retail level sales tax. The Multistage Sales Tax (MST) had a narrow base and suffered from the cascading effects. It also discriminates against the domestic products in relation to imports because the profit margin of the manufacturer is included under the base of this tax but not the profit margin of the importer. The wholesale level sales tax was operating in Nepal before VAT. The WST also suffers from the similar shortcomings. The wholesalers used to create fake distribution channels to evade tax. The retail level sales tax is neutral with respect to methods of production and distribution and does not suffer from the problem of cascading effect. But the whole tax is at stake if retailer does not file his return because RST places a heavy burden only at retail level. (Khadka; 1997)

Nepalma Mulya Abhibriddhi Kar: Siddhanta ra Byabahar is a collection of different articles published in various newspapers and written by Dr. Rup Bahadur Khadka during 2051-2054. The main objective of this book is to bring public awareness regarding the implementation of VAT. It cites the example of India, China and Bangladesh where VAT had been already introduced. It has made an attempt to justify the rational for introducing VAT in Nepal, the legal, procedural and structural aspects of VAT are also covered in the book. The success story of Singapore and failure story of Ghana and their implication to Nepal are delineated in the study. (Khadka; 2054 B.S.)

Value Added Tax: Four Years of Implementation is a compilation of articles contributed by various experts on VAT in Nepal on the occasion of four years of completion of implementation of VAT in Nepal. This is a publication of Inland Revenue Department and VAT-Project edited by Dr. Rup Bahadur Khadka. It compromises of twelve main articles along with some comments provided by the various persons.

Mr. Shakti Prasad Pandit, Under Secretary at the MOF, writes the first article, “VAT Accounts Audits.” He emphasizes for a visit to a tax payer’s premises, if any irregularity resulting in tax evasion is found while conducting a tax audit, then the tax officers assesses the tax amount that has been evaded. Mr. Lal Mani Joshi, Deputy Director General of IRD, writes the second article, “Tax Credit and Tax Refund Process under the VAT System.” The tax refund process appears to rather lengthy in his opinion. He disclosed that there has been an increase in the amount refunded each year. The third article, “VAT Assessment, Penalties and the Appeal Procedure” is written by Mr. Ratna Raj Bajracharya, a senior practicing chartered accountant. He opines that the requirement of VAT registration for marginal entrepreneurs is not very much conductive for the growth of cottage and small industries as well as marginal entrepreneurs. The forth articles, “Value Added Tax: A Retrospection” written by Mr. Nawaraj Bhandari, Director of IRD, describes the mounting enthusiasm and zeal of the staff to the support of MOF, VAT Department (then) and the DANIDA VAT Project.

The fifth articles, “Implementation of VAT in Nepal: An Evaluation” is written by Dr. Govinda Bahadur Thapa, the director of Foreign Currency Exchange Department of NRB. The article points towards the weaknesses inherent in the Value Added Tax system in Nepal. He is critical to the timing of the introduction of VAT in Nepal. He strongly denounces the existence of an unstable government at the time of introduction, which forced the government to accept many compromises in this regard. He makes critique on the lack of serious consideration to the impact of smuggling from the long open boarders with India and Tibet. The lack of highly motivated tax administration and proper accounting system are also impeding the functioning of VAT in Nepal. The sixth article, “Value Added Tax in the University Curriculum” is written by Dr. Pushpa Kandel, Lecturer at the Saraswati Multiple Campus, TU. He opines that an uncoordinated working atmosphere with the government and the universities, blowing their own trumpets, is not going to benefit the nation in any way. The seventh article, “Value Added Tax: The Road Ahead” is written by Mr. Madhu Kumar Marasini, Director at the IRD, advocates for increasing publicity campaigns based on Radio, TV, FM programs because they are popular in the cities where most of the tax payers reside. He also advises for sudden inspection of goods on the road to check tax evasion.

The next article, “Value Added Tax and the Practice of Issuing and Receiving Invoices in the context of Market Economy” is written by Vidyadhar Mallik, Director General of the IRD. He believes that if market runs in a fair manner, the market principle will bring “Welfare to many, happiness to many.” He clearly points out the weaknesses on the part of the government, the business community and the general public. This tax system deserves concerted effort of all stakeholders. The business community may use cash machines and inexpensive billing software. They can develop the habit of quoting the price inclusive of VAT and remind customers to take invoice by displaying notices. He urges for black listing and transparency on the part of the business community. Customers can inform the tax authorities about the fraudulent transactions. The tax administration should increase surveillance and consumer’s education level. The ninth article entitled, “Value Added Tax in Nepal: Analysis and Suggestion” is written by Dr. Roop Jyoti, a leading industrialist of Nepal. He suggests that the practice of under invoicing should be discouraged and at the same time the custom duties must be gradually decreased.

The next article, “Value Added Tax, The Concept, International Experience and Its Application in Nepal” is written by the editor himself. In this article, Dr. Khadka’s attempts are to give the knowledge about VAT to the general public. He has also included the current developments and the status of VAT in the Nepalese as well as international context. He believes that despite different huddles, VAT implementation is becoming more effective. Lene Bandix, in “Four Years of Value Added Tax in Nepal” has simply assessed the implementation of VAT in Nepal and has lots of hope in VAT. The final Article entitled, “Value Added Tax: Its

Past, Present and Future" is written by Mr. Narayan Prasad Silwal, former Director General of VAT Department. He points out the lack of ownership after the formation of the Inland Revenue Department. (IRD/DANIDA Report; 2001)

The International Monetary Fund Staff Papers, July, 1993 contains an articles entitled **"The Value Added Tax in Developing Countries"** by George E. Lent, Milka Casanegra, and Michele Guerard. It analyses the position of VAT in seven developing countries; Brazil, Ecuador, Ivory Coast, the Malagasy Republic, Morocco, Senegal and Uruguay. As per the study, a substantial part of the revenue in developing countries is derived from imports. A VAT with multiple rates and many exemptions present greater difficulties for administration and compliance than does a single rate tax with few exemptions. VAT imposes greater discipline by reason of its self-checking features and it is also self-correcting, it can catch up the tax which is escaped at a previous stage. In this respect, it has some advantage in reducing the risk of revenue leakage. (IMF Staff Paper; 1973, 318-327)

The same journal in March-1973 has an article entitled, **"The Brazilian State Value Added Tax"** by Michele Guerard. The state tax reform was prepared in 1965, along with a general reform of the entire Brazilian tax system. Brazil introduced VAT in the name of Impasto Sobre Artculacao De Mercadori as with effect from January 1, 1967. It remained basically a sales tax, and it was still intended that it can be fully shifted forward to the purchaser at each successive transaction. The tax in each stage was levied at a uniform rate on all commodities, with few exemptions. The Brazilian experience shows that the VAT technique can be adopted with no great difficulty within the conditions in some developing countries. (IMF Staff Paper; 1973, 91-102)

An article, **"Mulya Abhibriddhi Kar Maujdat Ghosanale Ubjaeka Prashnaharu"**, published in the Rajaswa and written by Mr. Ram Prasad Mainali prescribed remedial actions for the smooth operation of the VAT. He emphasizes on proper billing system, political commitment, motivated staff, public awareness, technological improvement, effective audit, online data system and reduced thresholds. (Rajaswa; Baishakh, 2060 B.S., 37-42)

Kwang Choi in his research paper entitled "**Value Added Taxation in the Republic of Korea"**, he has examined and evaluated the VAT in Korean Economy. VAT was introduced in Korea in 1997. The main objectives of introduction of VAT in Korea are simplification of tax restructure and its administration to promote exports, capital formation, maintaining neutrality in indirect tax system. VAT has neither so negative nor so positive effect on the economy of Korea. VAT did not have major impact on price level. It has positive impact on investment and export. In Korea the VAT has broadened tax base, reduce evasion, increased revenue and solved many problems associated with previous taxes.

The Korean experience of VAT during seven years had proved that VAT is not as simple as in practice as it is in theory. It creates a lot of problems that give rise to voluminous paper work more or less arbitrary distortions in trade and consumption and inequalities in the distribution of tax system. (Economic Bulletin for Asia and Pacific Region; 1983, 72-84)

Allen A Tait in his paper entitled "**VAT Policy Issues: Structure, Regressive Inflation and Exports"**, he has mainly raised the policy level issues about VAT. The main conclusions of the study are as follows:

❖ VAT provides a new tax base and improves tax system in terms of neutrality and efficiency.

- ❖ VAT contributes from 12 percent to 30 percent of revenue in most countries representing about 5 to 10 percent of gross national product.
- ❖ VAT is more complicated then other sales taxes from administrative point of view.
- ❖ Collecting VAT and paying refund make it complicated than other sales tax.
- ❖ The study compares VAT and retail level sales taxes on several respects and concludes:
- ❖ Neither retail sales tax nor the VAT can tax the unofficial and black transaction and both are open to evasion by under recording sales. However, under valuation is more difficult in VAT.
- ❖ A comprehensive VAT with only few exemptions and without zero rates makes it more regressive.
- ❖ If VAT is replaced to get equal tax yield relative price may be increased and it will have deflationary effect rather than inflationary, if net revenue is raised. **(**IMF Staff Paper; 1991, 115-131)

Hamada Koichi in his paper entitled, **"Broadening the Tax Base in Asian Countries"**, he has explained that VAT is a useful tax that is considered to have little discretionary effect on resource allocation and to encourage capital accumulation. Nevertheless, VAT is not completely neutral to resource allocation and generally is regressive to income distribution. If one tries to make it less regressive by excluding food and necessities from taxation then one will hurt the neutrality even more. Many Asian governments implemented tax reforms based on the introduction of VAT. Generally, the revenue enhancing objective of tax reforms seem to have been fulfilled. VAT has a regressive characteristic, but it's possible harms should be compared with the damage from inflation that might occur without the implementation of revenue raising devices including the imposition of VAT of increasing rate. (Asian Development Bank Review; 1999, 13-18)

Basanta Raj Khanal in his thesis paper, "**Value Added Tax Issues and Options in Nepal"**, he has assessed the feasibility of VAT as an alternative to sales tax in Nepal and to consider the possible effects of VAT on the socio-economy of Nepal. The study follows analytical and descriptive research design. The study finds that: VAT was appeared in Nepal as an alternative of sales tax. There were many problems associated with sales tax. One of the major problems of sales tax was its narrower tax base. Adoption of full-fledged VAT replacing the sales tax has largely broadened the tax base. The increased tax base would make the tax system more productive and elastic. Adoption of VAT would be helpful in removing the production distortions and other undue pressures on economic activities caused by the inherent defects of sales tax. The VAT would also remove the unfairness of the sales tax system and would increase the competitiveness of Nepalese products. The VAT would not be more regressive from revenue point of view it is equally unattractive from administrative point of view. A number of problems arise regarding the administration of a VAT in Nepal. As a modern tax VAT demands highly capable administration which is seriously lacking in Nepal.

The study recommends that VAT should be designed and implemented in such a way that it could fully work with the available administration under the present business and economic environment. A commodity-wise particular VAT is not appropriate. It will create many problems in VAT system. Exemption and thresholds should be designed with close co-operation between private sector and government in the process of VAT implementation. For that there should be good communication between these two parties. (Khanal; 2000)

Arjun Dhakal in his thesis paper, "**VAT and Its Revenue Potential in Nepal"**, he has analyzed the different aspect of Nepalese VAT system being focused on revenue potentiality. The main objective of this research was to examine the historical background of the VAT, analyze the Nepalese tax structure and estimate the potential of revenue yield from VAT. The major findings of this study are:

- Nepal has adopted the destination based consumption type VAT operated through the tax credit method.
- Nepal has followed the destination principle to adjust the international trade.
- The primary reason for growing popularity of VAT is its broad coverage without distorting economic efficiency.
- The stepwise collection of VAT discourages the evasion of VAT.
- VAT has some how equity nature as compared to other kinds of sales tax.
- Exemption and zero rating reduce the regressiveness of VAT however, it makes the administration complex.
- VAT is more efficient tax to avoid the cascading and pyramiding effects.
- VAT is not immune from the fault of regressive nature. Single positive rate creates regressiveness with respect to expenditure but not necessarily with respect to incomes.
- From the administrative point of view VAT can't be attractive alternative to other kinds of sales tax.
- Due to administrative complexity as well as maintain the equity norms, exemption and zero-rating are principally purposed that such provision makes the tax base limited.

The recommendations of the study are:

- ❖ VAT should be extended through retail as a bulk of tax performance to generate more revenue.
- ❖ The important sectors of VAT offices like as tax refund, tax audit taxpayer’s service, investigation, and return processing and registration should be separated for successful operation.
- ❖ The existing destination based consumption type of VAT operation through the credit method should remain continuous.
- ❖ Consumer should be aware for taking invoice for every taxable purchase by comprehensive advertisement program.(Dhakal; 2001)

Raju Laudari in his thesis paper, **“VAT in Nepal: An Analysis of Its Problems and Prospects”**, he has analyzed the problems and prospects of VAT in Nepal. The importance of VAT is increasing as the source of government revenue at the time of decreasing the role of custom duty. After implementation of VAT system in 1997, contract tax, hotel tax, sales tax and entertainment tax had been replaced by it. Looking at the contribution of these replaced tax in tax revenue and gross domestic product the contribution was gradually increasing before the implementation of VAT.

The conducted field survey shows that there will be improvement in revenue mobilization due to VAT system. The causes of this claim are theoretically VAT system is transparent; it broadens the tax base and discourages tax evasion. According to the survey the main problems for business house are account keeping and billing and the weaknesses of VAT administration are lack of motivation and service oriented attitude among the officials, lack of honesty in VAT officers. The view of most of the respondents was that the VAT system played positive effect in nation’s economic growth.

The study recommended the following aspects:

- Tax related information should be published through different media and tax education program should be launched.
- There should be close co-operation between the private sector and government in due VAT implementation process.
- Strong tax administration should be designed to implement VAT properly.
- Tax monitoring system should be established and launched properly.
- Under invoicing of sales should be minimized. (Laudari; 2001)

Babu Ram Karki in his thesis paper, **“Resource Mobilization through Value Added Tax in Nepal”**, he has analyzed resource mobilization aspect of VAT. He concluded that VAT was expected to have high revenue productivity due to its broad base coverage, elimination of economic distortions caused by sales tax system, elimination of cascading and pyramiding effects, creation of competitive business environment, strengthen the foreign trade etc. Other aspect of VAT such as transparency and catch-up effect were expected to fulfill after implementation of VAT, but could not get expected results. The contribution of VAT revenue as percent of GDP remained less than 3 percent after implementation of VAT and the performance does not show improving. This indicates that there is still many challenges and efforts to make the VAT success.

Theoretically VAT is a modern and in general the best form of sales tax. But all its negative and positive aspect mostly depends upon the implementation aspect. The administrative capacity of the authority, the level of awareness of the general public and taxpayer, honest and loyal tax collectors, nature and status of the development etc. are the prerequisite to make the VAT effective. The revenue elasticity of VAT also points out that the VAT revenue is not self corrective and there needs more efforts from the tax authorities to make the VAT suitable according to the nature and status of the Nepalese economy.

The recommendations of the study are as follows:

- A strong commitment from the grass root level to the top level is essential to make the VAT success.
- A strong and fair administration is the most crucial for the proper implementation of VAT.
- Monitoring system of VAT should be effective to reduce the tax evasion. (Karki; 2003)

2.3 Research Gap

In the context of tax reform it is absolutely important to make the implementation of VAT effective as soon as possible. About one and half decade have already been passed since VAT came into operation but very few studies had undertaken on the topic of VAT implementation and revenue mobilization in the Nepalese context. In this study, the researcher tries to evaluate Nepalese VAT system in correspondence with revenue mobilization of the country and tries to assess the impact of VAT on government revenue in Nepal. There is only few research works conducted in this topic. But such VAT related research work has not provided appropriate solution about the effective implementation of VAT system in Nepal. Other researchers have provided general recommendation only. But in this research, it has been tried to fulfill such research gap. For better implementation of VAT, the recommendation should be specific. Researcher wants to eliminate research gap exist in the past and explore the in-depth information which could be helpful for better implementation of VAT. So, this study would be fruitful for those interested persons, parties, scholars, businessmen, students, teachers, civil society and government officials academically and policy perspectives.

Chapter Three

RESEARCH METHODOLOGY

3.1 Conceptual Framework

This study is undertaken to examine the various problems and issues relating to VAT and analyze its implications while implementing VAT in Nepal. Therefore the major concentration of this study is to analyze the implication of VAT and its implication on revenue mobilization in Nepal. To perform analytical study and to achieve these objectives a research methodology has been design in this chapter. The study is based on secondary data. Mainly the secondary data have been collected from Inland Revenue Department, Economic Survey of various years. Other necessary data and information have been collected from books, booklets, articles and magazines written by tax officers and scholars. The collected data and information have been tabulated and different statistical tools such as time series, simple average and percentage have been used to analyze the collected data. The results have been expressed in the form of description.

3.2 Research Design

Most of the data and information are concerned with the past phenomenon of the performance either they are numerical or opinions. So, this study is based on historical data. After the collection of past data and experience this study uses its own procedure. Therefore this study has followed descriptive research design.

3.3 Sources of Data

In order to achieve the result of this research secondary data have been collected from different sources.

Source of Secondary Data

The secondary data of this research were collected from the following different sources:

- ❖ Published and unpublished reports, articles and dissertations on the concerned subject.
- ❖ Publications, budget speeches and Economic Survey of various fiscal year of Nepal Government, Ministry of Finance (NG/MOF).
- ❖ Published documents of National planning Commission (NPC).
- ❖ Publication and annual report of Inland Revenue Department (IRD).
- ❖ Different publication of Central Bureau of Statistic (CBS).
- ❖ Various books written by tax officers and scholars.

3.4 Methods of Collecting Secondary Data

The major secondary data relating to VAT is collected from Protax (the name of software which is currently operating all over Nepal to manage VAT procedure based on online system) data base of Inland Revenue Department, Lazimpat, Kathmandu. For this purpose I requested to the Deputy Director General of IT Division to provide data. The staff of IT Division provided me the required data through E-mail. Some data relating to Diplomatic VAT Refund are available from Refund section of IRD. The received E-mail are in crude form so I can not present in Appendix.

The data relating to GDP and revenue collection are taken from Economic Survey of FY 2011/12 published by Ministry of Finance, Government of Nepal. The related data table are provided in Appendix.

The data and information are taken from available reliable sources for the authenticity of study and the sources are given in relevant places.

Various facts have been collected from published and unpublished articles, booklets, magazines provided by Inland Revenue Department, Ministry of Finance and various national and international agencies such as CBS, OECD, IMF, WTO etc.

3.5 Classification and Editing of Data

The data collected by different techniques were classified according to their nature or characteristic and edited. In editing necessary data are arranged accordingly. The data are classified according to the characters and attributes.

3.6 Data Processing Procedure

The collected data through secondary sources were tabulated in different ways according to the requirement of the study. Then the data of various years are compared on the basis of average, ratios, and trend analysis.

3.7 Procedure for Presentation and Analysis

The processed data are presented in table and analyzed in descriptive manner to show the actual situation. The description is given following the table so that it will be easy to understand. At the end of chapter four all analysis is gathered under major findings.

Chapter Four

PRESENTATION AND ANALYSIS OF DATA

4.1 Structure of Tax in Nepal

The main source of revenue mobilization in Nepal is indirect tax. This is an indication that Nepal is a developing country. Developed countries rely more on direct tax for domestic resource mobilization. VAT is one of the vital elements of indirect tax. VAT played vital role in economic development of Nepal.

4.1.1 Total Revenue Structure

Every government needs revenue to conduct different functions of the country. Nepalese government also needs revenue to conduct different welfare activities of the country. A modern democratic government has to perform various social welfare programs, besides its regular activities. For this purpose government collect huge amount of revenue, and satisfy stakeholder of the country and suppose to be a good government. There are two categories of sources of government revenue through which the government collects revenue. They are tax revenue and non tax revenue. Tax revenue is the sum of custom duty, excise duty, VAT, corporate and personal income tax, property tax, interest tax, business income hold by government, royalties, and sales of fixed assets, interest and dividend received form corporations. In this way the sum of tax and non tax revenues constitute the public revenue. These revenues are actual public income of the state.

However, the government has other sources of revenue, which are subject to repayment such as loan, from bilateral and multilateral agencies. However grants are not repaid. These sources are only desirable to meet the fiscal deficit. Both tax revenue and non tax revenues are equally important for the government. Based on the structure of economy, the government determines the structure of tax revenue and nontax revenue. In capitalist economy the ratio of tax revenue is generally higher than nontax revenue and in socialist economy (where most of the business is operated by government) the ratio of non tax revenue is generally higher than tax revenue.

In Nepalese economy amount of tax revenue is generally higher than that of nontax revenue. In Nepal, the contribution of tax revenue is round 85%. The table presented below shows the structure of total revenue of the country.

Table No. 2

Structure of Total Revenue

(NRs. In 10 Million)

FY	Total Revenue	Tax Revenue		Non Tax Revenue	
		Amount	Percentage	Amount	Percentage
2002/03	5622.98	4258.69	75.73	1364.29	24.26
2003/04	6233.10	4817.30	77.28	4115.80	22.72
2004/05	7012.27	5410.47	77.15	1601.80	22.85
2005/06	7228.20	5743.04	79.45	1485.16	20.55
2006/07	8771.30	7112.70	81.09	1658.60	18.91
2007/08	10762.25	8515.55	79.12	2246.70	20.88
2008/09	14347.45	11705.19	81.58	2642.26	18.41
2009/10	17994.58	15629.49	86.85	2365.09	13.15
2010/11	20100.00	17182.00	85.48	2918.00	14.52
2011/12	24414.00	20636.00	84.53	3778.00	15.47

Source: Economic Survey FY2011/12, Table2.2Ka, 2.3Ka,(Page No. 14,15), Ministry of Finance, Government of Nepal.

The above table demonstrates the structure of total revenue of the government after implementation of VAT of latest ten years. The contribution of tax revenue on total revenue in year 2002/03 is 75.73 per cent. It is slightly increased up to the year 2006/07 except year 2004/05. In year 2011/12 it reached to 84.53 per cent. On the other hand, the contribution of nontax revenue on total revenue is 24.26 per cent in 2002/03, which is decreasing and reached to 15.47 per cent in year 2011/12. Therefore, the above data proves that the tax revenue is in increasing and nontax revenue is decreasing year by year.

4.1.2 Structure of Tax Revenue

Tax is the compulsory contribution made to the government treasury by the public. Tax is levied either directly on income or indirectly on consumption of goods and services. Indirect tax is collected mainly from customs and the consumption of goods and services. Supremacy of indirect tax is one of the important features of the developing economics. The propensity to consumption is higher in developing countries due to their marginal income. The significant level of marginal saving results the poor level of the collection of direct tax. The heavy reliance on indirect taxation in Nepal is justified on the administrative ground.

Nepal is not in condition to generate adequate revenue from direct tax. Agriculture is the main occupation of the Nepalese people but it is tax free. The industrial development is very primitive in Nepal. Its contribution is very low in the GDP which is decreasing year by year. The per capita income of the Nepalese people is extremely low. In Nepalese economy the contribution of direct tax is very poor, it is around 28 per cent of total tax revenue and contribution of indirect tax is remarkably higher than direct tax, it is around 72 per cent of total revenue. The table bellow shows the structure of total tax revenue.

Table No. 3

Structure of Total Tax Revenue

(NRs. In 10 Million)

FY	Total Tax Revenue	Direct Tax Revenue		Indirect Tax Revenue	
		Amount	Percentage	Amount	Percentage
2002/03	4298.69	1010.57	23.73	3248.12	76.27
2003/04	4817.30	1191.26	24.72	3626.4	75.28
2004/05	5410.47	1307.18	24.15	4103.29	75.85
2005/06	5743.04	1397.81	24.33	4346.23	75.67
2006/07	7112.70	1898.05	26.67	5214.70	73.33
2007/08	8515.55	2308.77	27.10	6207.55	72.89
2008/09	11705.19	3420.07	29.32	8273.12	70.68
2009/10	15629.49	4175.00	26.72	11454.49	73.28
2010/11	17277.76	4865.51	28.16	12412.26	71.84

Source: Economic Survey FY2011/12, Table 2.2Ka, (Page No. 14), Ministry of Finance, Government of Nepal.

The above table shows the share of direct tax on total tax revenue of the government. The contribution of direct tax revenue is very low. Contribution of direct tax revenue in the year 2002/03 is 23.73 per cent and there after gradually increase and reached to 26.67 per cent in the year 2006/07. But in the year 2010/11 it increased to 28.16 percent. Increasing ratio of direct tax means economy is developing. On the other hand contribution of indirect tax revenue is also in decreasing order. Although, value added tax belongs to indirect tax family, introduction of this tax does not increase the share of indirect on total tax revenue. The tax experts always say that implementation of VAT help to catch income tax and other direct taxes due to its transparency characteristics. This claim of the tax experts might come true. The amount collected as direct tax and indirect tax are in increasing order.

Table No. 4

Percentage Increase of Direct and Indirect Tax Revenue as Compared to Previous Year

(NRs. In 10 Million)

FY	Direct Tax Revenue		Indirect Tax Revenue	
	Amount	% increased	Amount	% increased
2002/03	1010.57	-	3248.12	-
2003/04	1191.26	17.88	3626.4	11.63
2004/05	1307.18	9.73	4103.29	13.16
2005/06	1397.81	6.93	4346.23	5.92
2006/07	1898.05	35.86	5214.70	19.98
2007/08	2308.77	21.63	6207.55	19.03
2008/09	3420.07	48.13	8273.12	33.27
2009/10	4175.00	22.07	11454.49	38.45
2010/11	4865.51	16.54	12412.26	8.36

Source: Economic Survey FY2011/12, Table 2.2Ka, (Page No. 14), Ministry of Finance, Government of Nepal.

The above table shows the increasing ratio of direct tax revenue in year 2003/04 it was 17.88 per cent. It is quite satisfactory, but where after the incremental ratio of direct tax revenue is in decreasing order up to year 2005/06 and again started to grow. In the year 2006/07 the increasing ratio is 35.86 per cent. It is also positive sign. On the other hand, the incremental ratio of indirect tax revenue is also satisfactory is initial two years but thereafter it increases in decreasing order in the year 2005/06. And, in the year 2009/10 it increased to 38.45 percent and in 2010/11 it is increased just by 8.36%. But it indicates positive trend.

4.1.3 Structure of Direct Tax Revenue

The structure of direct tax revenue is given in the following table.

Table No. 5

Structure of Direct Tax Revenue

(NRs. In 10 Million)

FY	Total Direct Tax	Land Revenue And Registration		Tax on Property, Profit and Income	
		Amount	Percentage	Amount	Percentage
2002/03	1010.57	141.43	13.99	869.14	86.01
2003/04	1191.26	169.75	14.24	1021.51	85.76
2004/05	1307.18	179.92	13.76	1127.26	86.24
2005/06	1397.81	218.11	15.60	1178.70	84.40
2006/07	1898.05	225.35	11.87	1672.70	88.13
2007/08	2308.77	294.07	12.13	2014.70	87.27
2008/09	3420.07	522.33	15.27	2909.74	84.73
2009/10	4175.00	511.11	12.24	3623.89	87.76
2010/11	4865.51	357.25	7.34	4508.26	92.66

Source: Economic Survey FY2011/12, Table 2.2Ka, (Page No. 14), Ministry of Finance, Government of Nepal.

The data mentioned in the above table clearly shows that the contribution to total direct tax from land revenue and registration fee and tax on property, profit and income. The figure of land revenue and registration fee is moving in downward trend. The percentage of land revenue and registration fee in the year 2002/03 is 13.99 and next year the percent of same tax is 14.24, whereas 7.34 percent is collected in the year 2010/11. On the other hand, the revenue from property, profit and income shows the upward trend. In the year 2002/03, the contribution of income tax is 86.01 percent on the total direct tax. This is decreased in the year 2003/04 and it is in slowly increasing trend. Later in the year 2010/11 this tax is increased and reached to 92.66 percent.

4.1.4 Structure of Indirect Tax Revenue

The term indirect tax in this study refers to three categories of taxes like Custom duties, VAT and Excise duties, which contributed about 70 to 76 percent of the total tax revenue in the study period. Custom duties collection could not increase proportionately in the later years due to the liberal economic policy of Nepal. Excise duties also could not play major role in indirect tax family. So that VAT is such tax, which grasps the fertile place in the indirect tax revenue.

Table No. 6

Structure of Indirect Tax Revenue

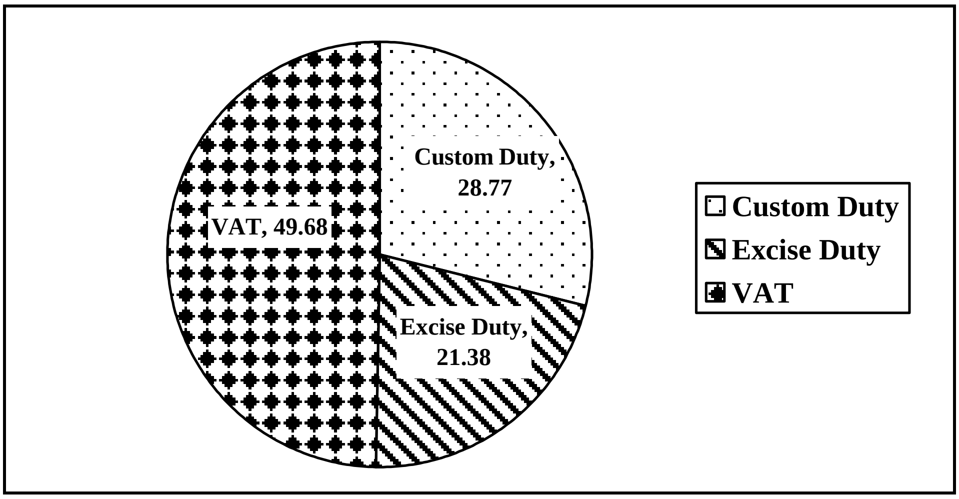
(NRs. In 10 Million)

FY	Total Indirect Tax	Custom Duty		Excise Duty		VAT	
		Amount	Percentage	Amount	Percentage	Amount	percentage
2002/03	3248.12	1423.64	43.82	478.51	14.73	1345.97	41.45
2003/04	3626.04	1555.48	42.89	622.67	17.17	1447.89	39.94
2004/05	4103.29	1570.16	38.26	645.59	15.73	1888.54	46.01
2005/06	4346.23	1534.40	35.30	650.76	14.97	2161.07	49.73
2006/07	5214.70	1670.80	32.04	934.32	17.91	2609.56	50.05
2007/08	6207.55	2106.24	33.95	1118.96	18.02	2981.57	48.03
2008/09	8273.12	2679.29	32.38	1622.09	19.60	3970.09	47.98
2009/10	11454.49	3515.08	30.68	2430.61	21.21	5492.09	47.94
2010/11	12412.26	3571.16	28.77	2654.29	21.38	6166.36	49,68

Source: Economic Survey FY2011/12, Table 2.2Ka, (Page No. 14), Ministry of Finance, Government of Nepal.

Figure No. 1

Structure of Indirect Tax Revenue (FY 2010/11)



The above table indicates about the structure of indirect tax revenue. The contribution of custom is in between 29 to 44 percent. This is decreasing year after year. In the fiscal year 2002/03 the contribution is 43.82, but in the year 2010/11 the contribution is only 28.77 percent. The contribution of excise duties is in between 14 to 21 percent. This is also in increasing trend as demand of such goods is inelastic. On the other hand VAT is in increasing trend. The contribution of VAT in indirect tax is in between 41 to 50 percent. In the year 2002/03 the contribution is 41.45 percent and in the year 2006/07 it reached 50.05 percent and slightly decreased. In 2010/11 it reached 49.68%. It is clear that VAI is the backbone of revenue of Nepal. These statistics shows that the future of VAT is bright and its contribution is very important to indirect tax.

4.2 Analysis of Different Practical Aspect of VAT

VAT system was implemented in Nepal with the objective of introducing a modern tax system to make revenue collection scientific and assist to development of the country. The implementation of VAT in Nepal has completed 15 years and running in 16th year of operation. This tax was implemented due to the absence of clarity regarding the tax.

Business community opposed it. However, with the passage of time clarity has emerged and hence this tax is being implemented in a smoother manner. Prior to the implementation of this tax the revenue was collected through the medium of levying sales tax, contract tax, hotel tax and entertainment tax. There were frequent complaints regarding tax leakage. Further the imposition of sales tax as each level of transaction made the burden of tax high and if imposed only in the initial stage then the value added during the distribution process would be out of the tax net. Forth more the different rates of the sales tax had promoted tax evasion and hence the country had to face many difficulties. VAT was implemented by replacing and integrating the sales tax, hotel tax, entertainment tax and contract tax in order to bring the value addition at each level of transaction into the tax net to broaden the tax base.

4.2.1 VAT on GDP

Gross Domestic product is the total final output of goods and services produced by the country's economy, within the country's territory, by residents and non-resident, regardless of its collection between domestic and foreign claims. The VAT/GDP ratio measures the consistency of the growth of VAT revenue with the corresponding growth in gross domestic product. This is an indicator of the utilization of taxable capacity. Normally, the growth of VAT revenue mobilization in the line with growth in GDP is desirable for the rapid economic development of a country. The collection of VAT revenue is more reliable than the direct tax revenue which facilitates the process of economic planning and development. VAT is also compatible with open market economy. The following table clearly shows the ratio of VAT with GDP at current price.

Table No. 7

VAT to GDP Ratio

(NRs. In 10 Million)

FY	GDP	VAT	Percentage	Remarks
2002/03	49223.13	1345.97	2.73	
2003/04	53674.89	1447.89	2.69	
2004/05	58941.16	1888.54	3.20	
2005/06	65405.45	2161.07	3.30	
2006/07	72782.90	2609.56	3.59	
2007/08	81565.80	2981.57	3.66	
2008/09	98805.30	3970.09	4.01	
2009/10	117190.50	5492.09	4.67	
2010/11	136943.00	6168.00	4.50	

Source: Economic Survey, FY2011/12, Table 1.1, 2.2Ka, (Page No. 1,14), MOF/GON

The above table shows the increasing trend of VAT on GDP. In the fiscal year, 2002/03 the VAT revenue was 2.73 per cent of GDP that reached to 3.20 per cent in the year 2004/05. This ratio reached 4.5 in the year 2010/11. It can be concluded that the increasing trend of VAT to GDP ratio is satisfactory. It is also going to meet to international standard as mentioned above in table if its growth trend remains continuous.

4.2.2 VAT on Total Revenue

The composition of tax and non tax revenue is called total revenue. Income tax, Value Added tax, Custom Duties, Excise Duties, Rent tax, Interest tax, Education Service tax, Health Service tax are the tax revenue. On the other hand Fees, Royalties, Penalties are non tax revenue. In the present context tax revenue hold 85 percent of total revenue. As well as in total revenue structure VAT plays strong role.

Table No. 8

VAT on Total Revenue

(NRs. In 10 Million)

FY	Total Revenue	VAT	Percentage	Remarks
2002/03	5622.98	1345.97	23.93	
2003/04	6233.10	1447.89	23.22	
2004/05	7012.27	1888.54	26.93	
2005/06	7228.20	2161.07	29.89	
2006/07	8771.30	2609.56	29.75	
2007/08	10762.25	2981.57	27.70	
2008/09	14347.45	3970.09	27.67	
2009/10	17994.58	5492.09	30.52	
2010/11	19982.00	6168.00	30.87	

Source: Economic Survey FY 2011/12, Table 2.2Ka, 2.3Ka, (Page No. 14, 15), Ministry of Finance, Government of Nepal.

The data mentioned in the above table clearly shows that the contribution of VAT on total revenue is very important. In the year 2002/03 the contribution of VAT on total revenue is 23.93 per cent. It reached 30.52 and 30.87 per cent in the year 2009/10 and 2010/11 respectively. The increasing scenario of above data shows that VAT is the major wing of the total revenue.

4.2.3 VAT on Tax Revenue

Tax revenue is the backbone of nation building. In our country VAT, Income tax, Custom and Excise Duties are the main sources of tax revenue. Among above taxes, VAT is new but scientific tax system. It is based on the sales of goods and services. Year by year the contribution of VAT on total tax revenue collection is increasing.

Table No. 9

VAT on Total Tax Revenue

(NRs. In 10 Million)

FY	Total Tax Revenue	VAT	Percentage	Remarks
2002/03	4258.69	1345.97	31.60	
2003/04	4817.30	1447.89	30.05	
2004/05	5410.47	1888.54	34.90	
2005/06	5743.04	2161.07	37.62	
2006/07	7112.70	2609.56	36.68	
2007/08	8515.55	2981.57	35.01	
2008/09	11705.19	3970.09	33.91	
2009/10	15629.49	5492.09	35.13	
2010/11	17182.00	6168.00	35.90	

Source: Economic Survey FY 2011/12, Page No. 14-15, Ministry of Finance, Government of Nepal.

The above mentioned data express that the position of VAT on total tax revenue. In the year 2002/03 the portion of VAT on total tax revenue is 31.60 per cent. It reached 34.90 in the year 2004/05 and 37.62 in the year 2005/06. Then it goes down. In the year of 2009/10 ratio is 35.13 and it increased to 35.90% in 2010/11. In general, the contribution of VAT on total tax revenue is growing up.

4.2.4 VAT on Indirect Tax Revenue

VAT is main source of indirect tax. It holds significant role in indirect tax generation in Nepal. It is increasing year by year.

Table No. 10

VAT on Indirect Tax Revenue

(NRs. In 10 Million)

FY	Total Indirect Tax Revenue	VAT	Percentage	Remarks
2002/03	3248.12	1345.97	41.43	
2003/04	3626.04	1447.89	39.93	
2004/05	4103.29	1888.54	46.02	
2005/06	4346.23	2161.07	49.72	
2006/07	5214.70	2609.56	50.04	
2007/08	6207.55	2981.57	48.03	
2008/09	8273.12	3970.09	47.99	
2009/10	11454.49	5492.09	47.94	
2010/11	12412.26	6166.36	49.68	

Source: Economic Survey FY2011/12, Page No. 14-15, Ministry of Finance, Government of Nepal.

The data given in the above table shows that the status of VAT on indirect tax. In the year 2002/03 the contribution of VAT on indirect tax is 41.43 per cent. The percentage increased and reached 50.04 in the year 2006/07. But later, its contribution is limited around 48 percent. In 2010/11 it reached to 49.68%. The statistical data open the fact that the contribution of VAT on indirect tax is very important.

4.2.5 VAT on Direct Tax Revenue

Direct tax occupies an important place in revenue generation. In the Nepalese context income tax, land tax, property tax, wealth tax, tax on registration, vehicle tax and others are the direct tax. But VAT is an indirect tax. The comparison between VAT and direct tax revenue is given below.

Table No. 11

VAT on Direct Tax Revenue

(NRs. In 10 Million)

FY	Direct Tax Revenue	VAT	Percentage	Remarks
2002/03	1010.57	1345.97	133.18	
2003/04	1191.26	1447.89	121.54	
2004/05	1307.18	1888.54	144.47	
2005/06	1396.81	2161.07	154.71	
2006/07	1898.05	2609.56	137.48	
2007/08	2308.77	2981.57	129.14	
2008/09	3420.07	3970.09	116.08	
2009/10	4175.00	5492.09	131.55	
2010/11	4865.51	6166.36	126,74	

Source: Economic Survey FY2011/12, Page No. 14, Ministry of Finance, Government of Nepal.

The statistical data given in the above table points out that the position of VAT on direct tax revenue. In the year 2002/03 the status of VAT on direct tax is about 133.18 per cent. It reached 144.47 per cent in the year 2004/05 and 154.71 per cent in the year 2005/06, highest since its operation. Later, in 2010/11 it is around 127 percent. The above statistical data shows the positive scenario of VAT on direct tax revenue.

4.2.6 Direct and Indirect Tax Revenue as Percentage of GDP

Direct tax is such tax whose burden can not be shifted from one person to other person. Direct tax contributes a lot in national exchequer in the developed world. Collection of direct tax is the measurement of the prosperity of an economy. So, developing economies like Nepal should strive for enhanced revenue mobilization through direct taxation. Indirect tax also plays significant role in revenue generation.

Direct tax to /GDP ratio clearly indicates the level of economic development of a country. Indirect tax/GDP ratio has increased after the implementation of VAT in 1997 because the VAT has mobilized more revenue than sales tax. The ratio of direct and indirect tax revenue on GDP has been demonstrated in following table.

Table No. 12

Direct and Indirect Tax Revenue as Percentage of GDP

(NRs. In 10 Million)

FY	GDP	Direct Tax	Percentage in GDP	Indirect Tax	Percentage in GDP
2002/03	49223.13	1010.57	2.05	3248.12	6.59
2003/04	53674.89	1191.26	2.21	3626.04	6.75
2004/05	58941.16	1307.18	2.21	4103.29	6.96
2005/06	65405.45	1396.81	2.13	4346.23	6.64
2006/07	72708.90	1898.05	2.61	5214.70	7.17
2007/08	81565.80	2308.77	2.83	6207.55	7.61
2008/09	98805.30	3420.07	3.46	8273.12	8.37
2009/10	117190.50	4175.00	3.56	11454.49	9.77
2010/11	136943.00	4865.51	3.55	12412.26	9.06

Source: Economic Survey FY 2011/12, Page No. 1, 14, 15, Ministry of Finance, Government of Nepal.

The above mentioned statistical data shows the percentage of direct and indirect tax on GDP. In the year 2002/03 on the GDP contribution of direct and indirect tax is 2.05 percent and 6.59 percent respectively. Similarly, in the year 2010/11 the ratios are 3.55 percent and 9.06 percent. The above statistical data shows that the contribution of indirect tax revenue on GDP is stronger than the direct tax revenue. Contribution of both taxes is increasing year by year.

4.2.7 VAT from Internal Collection and Import

VAT is levied on both domestically produced goods and service and imported goods and services. Nepalese economy is agro based economy. More than 66 per cent of the people are farmer here. Most of the farming is unorganized. Agricultural production through unorganized sector is exempted from VAT. Most of the products and services are consumed here is imported from India and third country. Thus, import generates more VAT revenue than domestically produced goods and services. The statistical analysis of domestic and import VAT revenue is given below.

Table No. 13

VAT from Internal Collection and Import

(NRs. In 10 Million)

FY	Total VAT	VAT from Internal Collection		VAT from Import	
		Amount	Percentage	Amount	Percentage
2002/03	1345.97	481.96	35.80	864.01	64.20
2003/04	1447.89	560.41	38.70	887.48	61.30
2004/05	1888.54	662.43	35.07	1156.11	64.93
2005/06	2161.07	815.74	37.28	1346.33	62.72
2006/07	2609.56	963.99	37.13	1646.57	62.87
2007/08	2981.57	1080.82	36.25	1900.74	63.74
2008/09	3970.09	1391.84	35.05	2578.24	64.94
2009/10	5492.09	2037.98	37.10	3454.10	62.89
2010/11	6168,00	2239.00	36.00	3929.00	64.00

Source: Annual Report FY 2010/11, Page No. 43, IRD.

The above table shows the statistical figures of VAT collection. In year 2002/03 the domestic collection of VAT is about 35.80 per cent and the collection from import is about 64.20 pre cent. The figure of domestic and import collection of VAT reached 37.13 and 62.87 per cent in the year 2006/07. Similarly, in the year 2010/11 the internal collection is reached 36 per cent and import collection is reached 64 per cent. This figure shows the increasing order of domestic collection and decreasing order of import collection of VAT revenue. The ratio is near about 35/65 on internal and import collection of VAT.

4.2.8 VAT Collection from Internal Source in the Year 2010/11

There are many internal sources in VAT collection. The major sources are production, sales, contracts, tourism and other services. VAT collection on internal sources in the year 2010/11 is given bellow.

Table No. 14

VAT Collection from Internal Source in the Year 2010/11

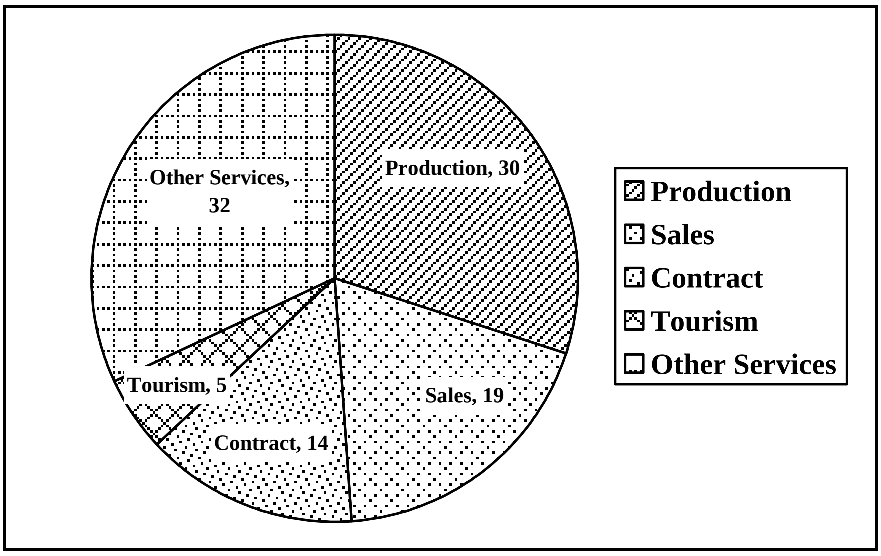
(NRs. In 10 Million)

S.N.	Headings	Amount	Percentage	Remarks
1.	Production	677	30	
2.	Sales	425	19	
3.	Contract	312	14	
4.	Tourism	112	5	
5.	Other Services	713	32	
	Total	2239	100	

Source: Annual Report FY 2010/11, Page No. 47, IRD.

Figure No. 2

VAT Collection from Internal Source in the Year 2010/11



The above statistical table shows the VAT collection from internal sources in the year 2010/11. In this year 32 per cent of VAT collected by other services area. The above figure shows that the other services, production, sales and contract are the major internal sources of VAT collection in the year 2010/11.

4.2.9 Taxpayer Registration Status

Taxpayers are sources of revenue. The basic registration process of taxpayers is to get Permanent Account Number (PAN). Permanent Account Number is the identification of taxpayer. Taxpayer gets only one PAN in his whole life. The same taxpayer can be registered into Value Added Tax according to VAT act, 2052.

Table No. 15

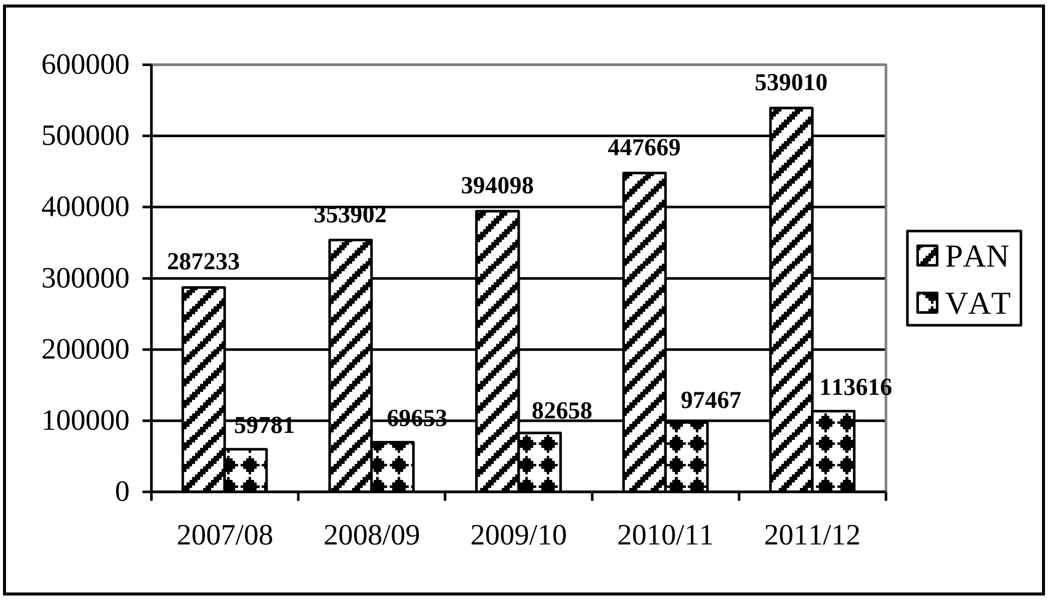
Trend of PAN and VAT Registration

FY	PAN		VAT	
	Number	Increased %	Number	Increased%
2007/08	287233		59781	
2008/09	353902	23	69653	17
2009/10	394098	11	82658	19
2010/11	447669	14	97467	18
2011/12	539010	20	113616	17
Average		**17**		**18**

Source: Protax Data Base, Data is taken at 2069/5/15 B.S. from IRD.

Figure No. 3

Trend of PAN and VAT Registration



The above figure shows the taxpayer registration status of VAT. In the year 2007/08 there is 287233 taxpayers registered in tax net. They have got permanent account number. Among them 59781 taxpayers are registered in VAT system. In the year 2009/10 the PAN registrants increased by 11 percent and VAT registrants increased by 19 percent. In 2011/12 PAN registrants increased by 20% and VAT registrants increased by 17% compared to previous year. The average increasing percentage is 17 of PAN and 18 of VAT. This statistical scenario shows that the registrant's number of taxpayers is increasing year by year in PAN and VAT net. Beside this in recent year individuals who are earning remuneration and house rent income are registered in tax system. They can get personal e-PAN which is Web based PAN registration system. Till the end of 2011/12 there are 2,74,696 personal taxpayers and it is rapidly increasing.

4.2.10 Status of VAT Return Filer

The return filling is the main component of VAT system. The taxpayer can submit their return in monthly, bimonthly and trimester basis. There is the provision of penalty due to the late filing of the VAT return. So the taxpayer must be aware about the submission of their return in the tax office on time.

Table No. 16

Status of VAT Return Filer as on Ashad End

FY	Total	Total Return Filer		Debit Return Filer		Credit Return Filer		Zero Return Filer		Other	
		Num.	Per.	Num.	Per.	Num.	Per.	Num.	Per.	Nu	Per.
2002/03	29872	2309	77.3	7178	31.06	9553	41.36	5972	25.8	396	1.72
2003/04	34174	2504	73.2	8483	33.87	9625	38.42	6783	27.0	158	0.63
2004/05	39776	2852	71.7	9470	33.20	1026	36.00	8272	29.0	514	1.80
2005/06	46831	3363	71.8	1044	31.07	1288	38.30	1013	30.1	163	0.48
2006/07	52965	3675	69.4	1155	31.43	1370	37.29	1113	30.2	363	0.99
2007/08	59775	4233	70.8	1238	29.27	1565	36.98	1428	33.7		
2008/09	69653	4818	69.1	1393	28.92	1789	37.14	1635	33.9		
2009/10	82433	5688	69.0	1622	28.51	2078	36.54	1988	34.9		
2010/11	97467	6647	68.2	1875	28.21	2525	37.99	2246	33.7		
2011/12	11361	7465	65,7	2007	26.89	3127	41.89	2330	31.2		

Source: Protax Data Base, Data is taken at 2069/5/15 B.S. from IRD.

The above mentioned statistical figure shows the status of VAT return filer. In the fiscal year 2002/03 77.32 per cent taxpayer of VAT who submitted their return. Among them, 31.06 per cent are debit return filer, 41.36 are credit return filer, 25.85 are zero return filer and 1.72 per cent is other return filer. After that fiscal year the total return filer percentage is in decreasing order. The debit return filers are decreasing and credit return filers are increasing year by year. The percentage of zero return is in increasing order year by year. The above data shows that the incremental scenario of non filer in VAT system. This scenario is so much alarming for successful implementation of VAT system.

4.2.11 Status of VAT Non Filer

In VAT system, the tax payer must file their return on timeframe. But cent percent taxpayers do not submit their tax return. In terms of VAT, that kind of taxpayers who missed to return file is called non filer. It is the major administrative burden too. Deregistration and close of business are the facilities given to the taxpayer who close their business.

Table No. 17

Status of VAT Non Filer as on Ashad End

FY	Total Taxpayer	Non Filer	
		Num.	Per.
2002/03	29872	6773	22.67
2003/04	34174	9125	26.70
2004/05	39776	11251	28.29
2005/06	46831	13198	28.18
2006/07	52965	16208	30.60
2007/08	59775	17443	29.18
2008/09	69653	21469	30.82
2009/10	82433	25546	30.99
2010/11	97467	30994	31.80
2011/12	113616	38963	34.29

Source: Protax Data Base, Data is taken at 2069/5/15 B.S. from IRD.

The above statistical table explains about the non filer of VAT return. In the year 2002/03 non filer is 22.67% and in 2011/12 it is 34.29% It shows the compliance rate is decreasing. The status of non filer is going to be serious problem year by year.

4.2.12 Status of Total VAT Returns

The status of total VAT returns shows that the ratio of Debit, Credit and Zero returns on the total returns received in the VAT system of Inland Revenue Department.

Table No. 18

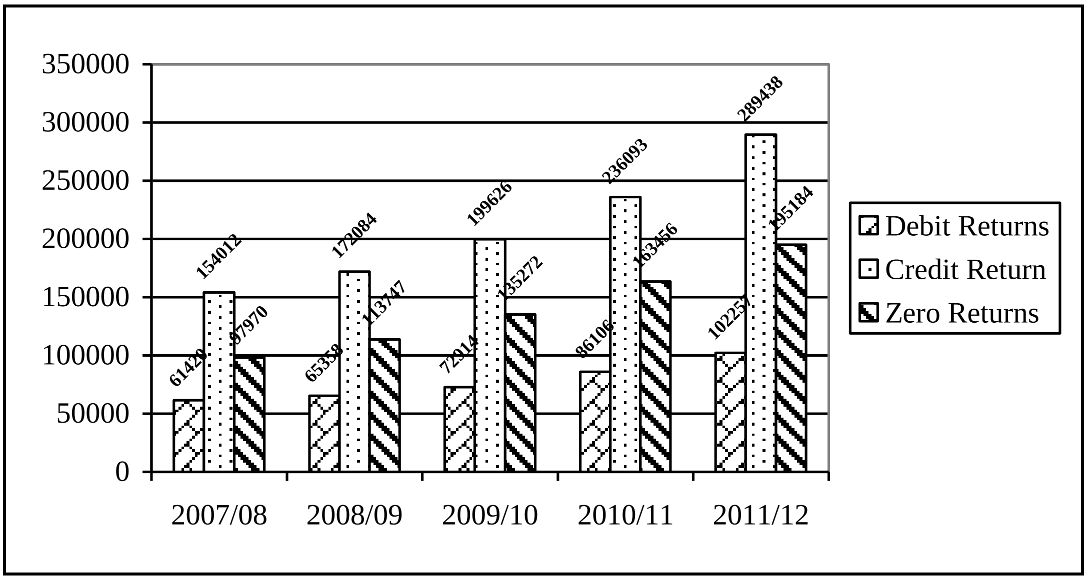
Status of Total VAT Returns

FY	Debit Returns	%	Credit Return	%	Zero Returns	%	Total Returns
2007/08	61420	19.60	154012	49.14	97970	31.26	313402
2008/09	65358	18.61	172084	49.00	113747	32.39	351189
2009/10	72914	17.88	199626	48.95	135272	33.17	407812
2010/11	86106	17.73	236093	48.61	163456	33.66	485655
2011/12	102257	17.42	289438	49.32	195184	33.26	586879

Source: Protax Data Base, Data is taken at 2069/5/15 B.S. from IRD.

Figure No. 4

Status of Total VAT Returns



The above data shows that the ratio of Zero return filer is increased by 2% from 2007/08 to 2011/12 while the Debit return filer decreased by 2.18% in the same period. The ratio of Credit filer is remained around 49% but it is also in increasing trend. It shows that the enforcement level of tax administration is so much weak and the self compliance level of tax payer is decreasing year after year. It is weak part of VAT implementation in Nepal.

4.2.13 VAT Refund Status

A VAT registrant tax payer can deduct the tax paid in purchases from the tax collected from sales of goods and services and if the tax paid in purchases exceeds the tax collected from sales can adjust the difference amount in the tax to be paid in the following month. If the credit can not be adjusted for six consecutive months, there is the provision to get refund of the exceeded amount. This provision is also provided to the diplomatic mission and export. Tax refund is very important aspect of VAT; it must be made simple, easy and systematic. The VAT refund scenario of study period is given in the following table.

Table No. 19
VAT Refund Status

(NRs. In 10 Million)

FY	Total Refund Amount	Diplomatic Agency		Export		Continuous 6 Months	
		Amount	Percentage	Amount	Percentage	Amount	Percentage
2002/03	141.76	13.64	9.60	122.40	86.30	5.72	4.10
2003/04	222.91	26.08	11.7	181.33	81.30	15.50	7.00
2004/05	275.32	14.57	5.30	236.85	86.00	23.90	8.70
2005/06	442.83	14.4	3.50	332.70	74.00	95.73	22.00
2006/07	402.57	20.25	5.00	290.00	72.00	92.94	23.00
2007/08	273.23	12.33	4.51	217.71	79.68	43.19	15.81
2008/09		Na		106.13		184.33	
2009/10	234.91	27.27	11.61	120.81	51.43	86.83	36.96
2010/11	406.60	52.74	12.97	172.84	42.51	181.02	44.52
2011/12	507.11	53.27	10.50	184.87	36.46	268.97	53.04

Source: Protax Data Base, Data is taken at 2069/5/15 B.S. from IRD.

Diplomatic Refund Data of 2008/09 can not be found from IRD Data Base.

The given analytical data discloses that the refund status of VAT. The diplomatic agency claimed 4.51 to 12.97 per cent amount of the total refund within the whole study period. In the year 2002/03 the export refund claim is 86.30 per cent of the total amount. This per cent is 86 and 72 in the year 2004/05 and 2006/07. The export refund decreased drastically in last two years, it is 42.51% in 2010/11 and 36.46% in 2011/12. The refund category of continuous six months is 4.10 per cent in the year 2002/03, 8.70 percent in the year 2004/05 and 23 per cent in the year 2006/07 respectively. The continuous refund increased drastically and reached 53.04% in 2011/12. In the recent years the continuous refund is in increasing and export is in decreasing trend. The diplomatic refund is unstable according to these data.

4.2.14 VAT Collection and Refund Status

VAT is the main source of revenue generation. To collect VAT is the major function of tax administration. But some of the collected amount of VAT will be refunded to the tax payer according to the VAT laws and regulations. The ratio of collection and refund of VAT must be narrowed down.

Table No. 20

Total VAT Collection and Refund Status

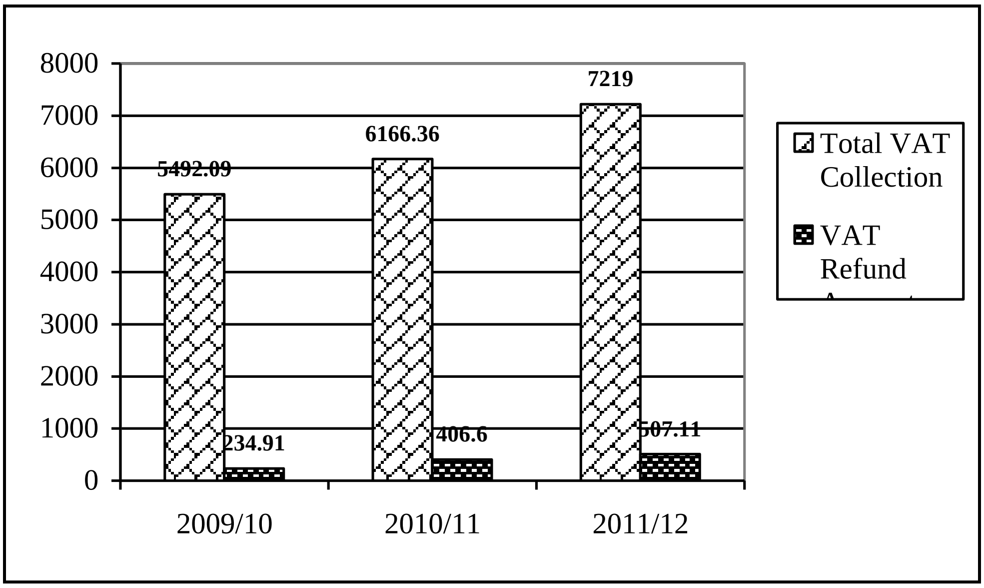
(NRs. In 10 Million)

FY	Total VAT Collection	VAT Refund Amount/%		Remarks
		Amount	Percentage	
2002/03	1345.97	141.76	10.53	
2003/04	1447.89	222.91	15.39	
2004/05	1888.54	275.32	14.57	
2005/06	2161.07	442.83	20.49	
2006/07	2609.56	402.57	15.42	
2007/08	2981.57	273.23	9.16	
2008/09	3970.09	Na		
2009/10	5492.09	234.91	4.28	
2010/11	6166.36	406.60	6.59	
2011/12	7219.00	507.11	7.02	

Source: Annual Report (IRD, MOF), Protax Data Base IRD. Diplomatic Refund Data of 2008/09 can not be found from IRD Data Base. So total refund data of FY2008/09 is unavailable.

Figure No. 5

Total VAT Collection and Refund Status



The above mentioned statistical data shows that the status of total collection and refund of VAT. In the year 2002/03 10.53 percent of total collected amount was refunded. The percentage of refunded amount was 20.49 per cent in the year 2005/06 and 15.42 per cent in the year 2006/07 respectively. Now it is 7.02% in 2011/12. In recent years the amount of refund is increasing and the percentage is decreasing.

4.2.15 Internal VAT Collection and Refund Status

Internal VAT Collection and Refund Status shows that the volume of refund with relation to VAT internally collected from the internal market system. The VAT collected on import at custom point is ignored for this analysis.

Table No. 21

Total Internal VAT Collection and Refund Status

(NRs. In 10 Million)

FY	Total Internal VAT Collection	VAT Refund Amount/%		Remarks
		Amount	Percentage	
2002/03	481.96	141.76	29.41	
2003/04	560.41	222.91	39.78	
2004/05	662.43	275.32	41.56	
2005/06	815.74	442.83	54.29	
2006/07	963.99	402.57	41.76	
2007/08	1080.82	273.23	25.28	
2008/09	1391.84	Na		
2009/10	2037.98	234.91	11.53	
2010/11	2239.00	406.60	18.16	
2011/12	2565.00	507.11	19.77	

Source: Annual Report (IRD, MOF), Protax Data Base IRD. Diplomatic Refund Data of 2008/09 can not be found from IRD Data Base. So total refund data of FY2008/09 is unavailable.

The above data analysis shows that the volume of refund is significant. It was 29.41% in FY 2002/03 where as it increased to 54.29% in FY 2005/06 which is the highest ratio in the study period. In 2011/12 the total refund amount 19.77% of total internal VAT collection. So it should be closely monitored to control manipulation and corruption.

4.3 Major Findings

On the basis of analysis of data of this research, the main findings are presented in the following points.

4.3.1 The VAT system that has been implementing in Nepal has completed more than one and half decade of its operation. Due to various complexities and problems this tax system has not been able to achieve the expected level of success.

4.3.2 A large amount of government revenue comes from taxation. Around 85 percent of government revenue comes from taxation where as the contribution of non tax revenue is around 15 percent in present Nepalese tax structure. The contribution of tax revenue is in increasing order and the nontax revenue is in decreasing order year by year. It is the positive symptoms for the revenue generation.

4.3.3 In Nepalese tax structure indirect tax is more important than direct tax from the point of view of revenue generation. Its contribution on total tax revenue is around 72 percent and the direct tax is around 28 percent. Direct tax is the progressive tax system that equalizes the distribution of income and property among the people in the society but Nepalese government is unable to collect sufficient revenue from this source. The study concluded that the collection of the direct tax is in increasing order and indirect tax collection in decreasing order year by year.

4.3.4 The increasing trend of both direct and indirect tax is satisfactory in recent years and the increasing rate of indirect tax in year 2009/10-2010/11 is 8.36 percent where as the incremental ratio of direct tax is 16.54 in the same period. The statistical result indicates the progressive trend.

4.3.5 In the direct tax families the tax on property, profit and income occupied 92.66 percent place and the tax on land revenue and registration hold 7.34 percent place in 2010/11. It shows that the income tax is the backbone of direct tax.

4.3.6 VAT, Custom and Excise duty are the main sources of indirect tax. It is found that VAT holds around 50 percent and other taxes hold remained parts. VAT, Custom and excise duty grasp the vital role in total indirect tax collection. The statistical result point out that the future of VAT is brightening and its contribution is very important to indirect tax.

4.3.7 VAT, which belongs to indirect tax, occupied an important place in indirect tax. Its contribution in total indirect tax is about 50 percent. Till 2003/04 the contribution of custom duty was more than the contribution of VAT after then the contribution of VAT is higher than the contribution of custom duty in indirect tax revenue structure of Nepal.

4.3.8 VAT contributes around 4.5 percent of GDP in Nepal. The contribution of VAT on GDP in year 2002/03 was 2.73. Its contribution on GDP in year 2009/10 reached to 4.67 percent. It can be concluded that the contribution of VAT in GDP is growing up year by year.

4.3.9 Contribution of VAT in total revenue is near about 30 percent. It reached 30.87% in 2010/11. So it is in increasing order year by year. It shows that VAT is the major wings of total revenue.

4.3.10 VAT is the strongest pillar of total tax revenue. In the latest study year VAT hold around the 36 percent. It is in increasing order year by year. In general, the conclusion made that the contribution of VAT on total tax revenue is growing up.

4.3.11 The findings of this study open the fact that the contribution of VAT on indirect tax is very important. It holds around 50 percent amount in total indirect tax revenue collection. The scenario of VAT on indirect tax is upgrading year by year. It is the positive scene in the revenue generation.

4.3.12 The comparison between VAT on direct tax revenue also pointed out in this study. This analytical figure shows that the collection of VAT is more than direct tax revenue. VAT occupied around 127 percent in comparison to the direct tax in 2010/11.

4.3.13 The ratio of direct and indirect tax on GDP is 3.55% and 9.06% respectively in the year 2010/11. The ratio of indirect tax revenue on GDP is strongest than the direct tax revenue. The ratio on GDP of both taxes are increasing year by year.

4.3.14 Import generate more VAT revenue than internal sources. Thus import is the main base of VAT in Nepal. The study shows that increasing order of domestic collection and decreasing order of import collection of VAT.

4.3.15 Other service sector is the major internal source of VAT collection in the year 2010/11. Production sector is the second major source of this tax. Sales, Contract and Tourism are other internal sources of the VAT.

4.3.16 The registrant’s number under PAN has been increasing year by year and its number has reached 539010 at the end of 2011/12. On the other hand the number of taxpayer register under VAT has also been increasing year after year but their increasing ratio in latest year seen unsatisfactory. The total number of registrant under VAT reached to 113616 in the same year. This research shows that the registrant's number of taxpayers is increasing thoroughly in both PAN and VAT net. The number of personal PAN reached to 274616 at the end of 2011/12.

4.3.17 In the result of this study, more than 34 percent of taxpayers do not submit their VAT return at the end of 2011/12. But in the year 2002/03 this figure shows only around 23 percent. In total VAT returns received in 2011/12 the percent of Debit, Credit and Zero returns are 17.42, 49.32 and 33.26 respectively. This shows that the Credit and Zero returns are collapsing the whole self regulated VAT system. An alarming point to note here is that during the last five years the Zero returns are increased by 2% where as in the same time the Debit returns are decreased by 2.18%. The ratio of Credit returns remains almost constant. It conveys the great challenges to tax administration.

4.3.18 Tax refund facility is provided to business person, diplomatic and foreign aided projects and continuous 6 month credit. Total amount of tax refund in the year 2002/03 was Rs.141.76 million. Now it is Rs.507.11 million in 2011/12, which is 3.58 times in 10 years period of time. In 2002/03 the ratios of Diplomatic, Export and Continuous refund were 9.60%, 86.30% and 4.10%, where as these ratios are 10.50%, 36.46% and 53.04% respectively in 2011/12. This shows that the refund is shifting from Export to Continuous Credit. It is not good gesture because it shows that the situation of declining of export trade. The volume of refund is increasing year by year so it should be closely monitored to control corruption and manipulation.

4.3.19 The ratio of total VAT Refund compared to total VAT Collection was 10.53% in 2002/03, now it is 7.02% in 2011/12. VAT Refund to total Internal VAT Collection ratio was 29.41% in 2002/03 now it is 19.77. This data shows that the ratio of Refund is decreasing the volume of refunded amount is increasing. So there should be refund monitoring system in IRD to control and manage the VAT refund process.

4.3.20 There are various problems and issues relating to implementation of VAT. VAT billing, fake billing, narrow coverage, weak and traditional tax administration, mass usage of ICT technology in tax administration, lack of coordinated approach and long complex procedures are challenges for proper implementation of VAT system in Nepal.

Chapter Five

SUMMARY, CONCLUSION AND SUGGESTION

5.1 Summary

In this thesis there are six chapters. Chapter one is introductory chapter which highlights the importance of tax for economic development of country. It also sheds light on the objectives of the fiscal policy. The good taxation policy can drive the economy into right path.

Chapter two is concerned with the theoretical aspect of VAT. The concept of VAT developed by Dr. Wilhelm Von Siemens in 1919 in Germany, but practically implemented in France in 1954. VAT is a form of sales tax which is imposed on goods and services according to law on value addition occurred in the transaction.

In chapter three various books, journal’s, articles and research work are reviewed. According to the review generally the economic impact of VAT is regressive. It is difficult to implement and administer the VAT system. In the context of Nepal there are various problems in VAT system such as transaction without billing, under invoicing and low level of compliance etc.

Chapter four is about research methodology. This research is based on secondary data mostly available from Inland Revenue Department and Ministry of Finance. The descriptive research design is used to make the thesis precise for the general reader outside the field of taxation.

Chapter five is the main part of this thesis. The major findings are summarized in the following paragraph.

The ratio of VAT on GDP is around 4.5%, on Total Revenue 30.87%, on Total Tax Revenue 36.90%, on Total Indirect Tax Revenue 49.68% and on Total Direct Tax Revenue 126.74%. VAT from internal collection and import is 36% and 64% respectively. Major source of internal collection of VAT is Other services such as VAT on hotel services etc. and Production which covers 32% and 30% respectively. The Debit return filer are decreasing and Zero return filer are increasing. The ratio of the Credit return filer are somehow stable. The VAT refund amount is increasing but the ratio of refund compared to VAT collection is decreasing.

The above result shows that the weak position of VAT implementation in Nepal. In sixth chapter some recommendations are suggested. The recommendations should be taken seriously and implemented carefully to make VAT successful in Nepal..

The importance of the VAT is growing because of the downsizing of the custom duty. So the implementation of VAT should be improved by collective effort of all stakeholders.

5.2 Conclusion

VAT is modern accounting based tax system. It is transparent and the tax is levied on goods and services. VAT was implemented in Nepal before fifteen years with so many confusions, but now so many confusions are being cleared. Yet there are so many problems such as fake billing, loose billing, under invoicing, increasing number of zero returns, decreasing number of debit returns, large number of credit returns (around 49%), large volume of informal trade, unwillingness to register in VAT and low level of collection from internal sources. So VAT is not fully successful yet though it has travelled fifteen years of implementation.

Some suggestions are given for making VAT successful in Nepal.

5.3 Suggestions

On the basis of research, the following corrective measures are recommended for the better and effective implementation of VAT and to establish it as the main source of revenue generation of the country and for development of the economy.

5.3.1 A proper coordination between IRD, Custom Department, Revenue Investigation Department, Ministry of Finance and other concerned governmental and non-governmental agencies should be established. Unpractical Acts, Rules and Regulations should be amended. VAT law needs to be reviewed on the basis of experience gained.

5.3.2 Effective and mass based Taxpayer's Education is the backbone for broadening tax base and solutions for the ignorance of taxpayer. So that emphasis should be given to tax payer education and make it more effective and accessible. A publicity campaign must be initiated to make the buyers and sellers aware of the long-term benefit of billing system through miking hoarding boards, pamphlets, interaction programs as well as by using all the materials and methods including FM Radio and TV Channels.

5.3.3 To make the market monitoring and investigation system effective, more surveillance must be kept of premises that are risky while monitoring the market.

5.3.4 The exiting exemption and zero rating list is rather long. Exemptions and zero rating have impact not only on revenue collection but also on economic efficiency and revenue administration. Thus, the existing exemptions and zero rating in VAT must be revised.

5.3.5 A reasonable threshold (down from the current Rs. two million), wide range of supplies under the tax net would be an appropriate strategy for immediate future.

5.3.6 For the successful implementation of VAT system, the role of mass media, Radio, TV, and Newspaper should be enhanced. Emphasis should be given on mass media rather than distribution of booklets and written forms to taxpayers. So, an environment of consciousness towards VAT system should be created covering general public, non-governmental and governmental organization.

5.3.7 Computer system and networking program through online service must be expanded and linked so as to make the work simple and easy. Networking between IRD and Custom Department should be developed.

5.3.8 The existing destination based consumption type of VAT operation through the tax credit method should remain continuous.

5.3.9 Tax refund is the very important aspect of VAT; it must be made simple, easy, systematic and decentralized. It is essential to make the tax refund system efficient and effective in practice. There should be a separate Refund Management Information System (RFMIS) in IRD.

5.3.10 Number of taxpayers who registered in VAT net is increasing year after year. It should be needed to better management. Special incentives should be provided to small business person to increase registration trend.

5.3.11 On the other hand, the number of taxpayers who cancel the registration is also increasing order. Therefore tax authority should investigate why these taxpayers cancelled their registration. There should be close cooperation between the private sector and government sector for the successful implementation of VAT.

5.3.12 Providing various facilities to VAT registrants can increase VAT compliance. The tax administration can select genuine businessmen and reward them.

5.3.13 VAT collection in import is remarkably higher than domestic production, such high dependency on import is not good signal for the government therefore authority should take an effective step to encourage domestic production.

5.3.14 The absence of the return filling is crucial problem in VAT system. To reduce the cost of collection and compliance costs, increasing the existing tax period of one month to two month should be considered for some special business. Some incentive should be given to encourage E-filling habit of tax payers.

5.3.15 It is necessary to encourage the use of cash machine, gradually, initiating the compulsory use of cash machine, billing on the basis of nature of the business and the transaction location, developing billing software and making is freely available to the vendors. Making sure that statistics can not be changed in the billing and account software being used in the market by checking them.

5.3.16 Make attempts to win the trust of industrial and trade organizations as well the as professional community. The success of VAT depends upon the honesty and transparency.

5.3.17 To make the market monitoring system effective, immediate legal steps must be taken against those who do not give invoices and give under valued invoices. Using all the rights vested by the Finance Act and VAT Act, the culprits must be penalized, their goods must be bought and auctioned or the tax liability must be established as per the law after completing the investigation process.

5.3.18 From the equity consideration, it is bitter to differentiate the VAT rate with the higher rate on luxuries goods and lower rate on essential goods. However rate differentiation should be considered only when business community is performing VAT well and VAT administration is capable to handle the situation without much difficulty and any distortions in the economy.

5.3.19 There should be a close cooperation between the private sector and government in the VAT implementation process. The various issues concerning to VAT should be resolved through broad discussions and consultations with the private sector. The private sector should always be persuaded to actively participate in the VAT implementation process. Any contradictory situation and direct confrontation should carefully be avoided. There should be a well communication and exchange of ideas between the two sides.

5.3.20 Some commercial agricultural productions such as tea, coffee, bamboo (commercial transaction for construction purpose) etc. could be brought in VAT net.

5.3.21 Tax authority should do continuous effort in order to develop the taxpayer's positive attitude towards VAT system.

5.3.22 Data handling system of IRD should be improved. Some statistician should be employed to upkeep each and every data of IRD.

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Appendix

Some Countries which Started Adopting VAT

Year	Country that have started adopting VAT
1954	France1
1960	Ivory Coast
1961	Senegal
1967	Brazil, Denmark
1968	Germany, Uruguay
1969	Netherlands, Sweden
1970	Ecuador, Luxembourg, Norway
1971	Belgium
1972	Ireland
1973	Austria, Bolivia, Italy, UK, Vietnam2
1974	Argentina, Chile, Columbia, Costa Rica, Nicaragua
1976	Honduras, Israel, Peru
1977	Korea, Panama
1980	Mexico
1982	Haiti
1983	Dominican Republic, Guatemala
1984	China3
1985	Indonesia, Turkey
1986	Morocco, New-Zealand, Niger, Portugal Spain, Tiwan
1987	Grenada, Greece
1988	Hungary, The Philippines, Tunisia
1989	Japan, Malawi
1990	Iceland, Kenya, Pakistan, Trinidad, Tobago
1991	Bangladesh, Benin, Canada, Jamaica
1992	Algeria, Armenia, Azerbaijan, Cyprus, ET Salvador Estonia, Fiji, Kazakhstan, Kyrgyzstan, Russia, Tajikistan, Thailand, Turkmenistan,

	Ukraine, Uzbekistan, Moldova
1993	Burkina Faso, Czech Republic, Paraguay, Poland, Rumania, Georgia, Slovak Republic, Venezuela
1994	Bulgaria, Finland, Lithonia, Singapore, Western, Samoa, Madagascar, Nigeria
1995	Gabon, Ghana4, Switzerland, Zambia, Malta5
1996	Albania, Guinea, Uganda
1997	Barbados, Congo Republic, Nepal
1998	Croatia, Mongolia, Srilanka, Tanzania, Vanuatu
1999	Cambodia, Cameron, Mozambique, Papua New Guinea, Slovenia
2000	Australia, Chad, Macedonia, Namibia, Sweden
2001	Rwanda
2002	Lebanon

Source: VAT Four Years of Implementation (Page No. 98)
IRD and VAT Project (2001)

1 VAT was implemented fully in 1968.

2 VAT was abolished soon after its implementation and re-introduced in 1999.

3 VAT was first introduced only in selected provinces on selected goods but since the achievement was not satisfactory it was implemented fully in 1994.

4 VAT was abolished after three months of its introduction in 1995 and was re-introduced again in 1998.

5 VAT was introduced in 1995 and was abolished after a change in the government in 1997 and it was re-introduced in 1999.