

CHAPTER - I

INTRODUCTION

1.1 Background of the Study

Nepal, the country of Mt. Everest and the birth place of Lord Buddha located in the world map in the South Asia with an area of 1,47,181 sq. km. and 2,64,94,504 population (CBS, 2011). Nepal is suffering a long political conflict. It is in a transition period of facing several challenges.

Economic development, which implies to maximize the welfare of the people and efficient allocation of resource is the important concern and target of the most of the government policy in the developing countries. Achievement of high rate of economic growth, reduction of poverty and improvement of living standard of the people are some of the development strategies of the government of developing countries. Despite these strategies and efforts, the condition of the developing countries has not been improved yet. Since many of them are still suffering from vicious circle of poverty. In these developing countries, the sources of revenue are limited because the economy depends upon traditional system of agriculture and industry.

The revenue collection yield through imposing various kinds of taxes like direct tax and indirect tax on the economic activities is an over-riding function of the government. The government generally, imposes taxes to carry out the public expenditure to establish the equitable society through social welfare activities. It is indispensable to any government to keep balance between the taxation mechanism and public expenditures therefore maintaining the peace of revenue growth to fulfill the

government expenditure is prominent task of government and it can be achievement only by the effective implementation of prevailing taxes system in the country (Bhandari, 2011).

Among the various kinds of taxes the value added tax is one which has been expanding throughout the world more rapidly than other types of taxes. The value added tax is itself a good tax system having the feature like broad based tax system. Indirect tax, the burden lies on the consumers, self assessment system avoiding the cascading and pyramiding, maximize the revenue mobilization and self-polishing and catch up effect.

Furthermore, it is indispensable to promote the export, to maintain transparent accounting system and to minimize illegal activities in business. The stimulate the country's economy at large along with high revenue collection. In sum up the efficiency and fairness of VAT system became the motivation factor for country to introduce it on their tax administration. Therefore, more than 140 countries have been implemented the value added tax around the world excluding USA.

In this line, the government of Nepal introduced a modern tax system – the Value Added Tax (VAT) in 1997. The sales tax, entertainment tax, contract tax and hotel tax were replaced by the value added tax. At the time of introduce of this tax, it was assuming that this tax will be one of the main taxes of the government revenue. But due to the political turmoil in the country and problem of effective implementation. It could not be as it was assumed. However after implementing VAT, the government of Nepal has been continuously making its efforts to stream line the VAT as the main source of revenue through the reform of tax administration. But the prominent question

regarding to its effective implementation in Nepal is always remained unanswerable.

Government of Nepal has decided to adopt VAT by VAT act 1996. It was fully implemented from 17th August 1999 with 10 percent of manufacturing level sales tax (MST). While partially initialized from 16th November 1997. Firstly, the VAT has been changed at 14th January 2004, with 13 percent and rate made 13% VAT, VAT Act 1996 has made from sum provision of exemption and zero-rating on some basic goods and service.

1.2 Statement of the Problem

Nepal is a developing country, where most of the people live under poverty line. Nepal is poorest country in the south Asia, Human which is 0.46 percent. The problems instead of being solved, are rather depending and worsening. Economic development is considered as basic needed for very welfare state to fulfill the aspiration of its people. (HDR, 2013)

But Nepal is a developing country facing development challenges to promote the life standard of its 25 percent of citizen surviving below the poverty line under such condition. Nepal is facing a serious problem of resources gap and depending of foreign aid and loan. (CBS, 2011)

In this way the sharply increasing burden of foreign debt, the nation is failed down under debt trap. Although the every increasing government Expenditure and limited sources of revenue. It has led the country to savere fiscal crisis over the year. Government expenditure is increasing day by day wile there is no an equivalent increasing in government revenue. Such an unable growth in revenue and expenditure. It has resulted in massive revenue expenditure gap or budgetary deficits

in the country. To avoid defect budget, VAT should be an instrument tools. Because most of the tax system has structured from 1960's where government tax revenue was mostly dependent on land tax. Later the share of tax revenue to non-tax revenue to non-tax revenue slowly increased.

The poorly desired classical type of tax system is one of the challenges of Nepal for mobilizing the maximum volume of resources. There are certain limitation in reforming the various taxes in Nepal. The tax structure is highly dominated by in directed taxes. The share of direct taxes is declining from initial year from 1983/84 and which is sharply declines in 2008/2009 with the contribution of only 15.4 percent. In fact declines share of direct tax structure signifies stagnant. Condition of the economic and tax structure. In the Nepalese sales tax suffered from very low tax base.

Cascading/ pyramiding effect and distortion effect and distortion effect but VAT is confided as the best form of sales tax having much merit like self policing catch of effect, broad base, nature etc. So VAT should be implemented in proper way. Which would be optimal solution of the resource gap and high dependency on foreign loan. After 1992/93 the condition of tax structure is slowly improved but not satisfactory. The research questions are as follows:

-) How can the historical background of VAT examines,
-) How can the analyze the administrative problem of VAT,
-) How can the evaluate effectiveness of VAT,
-) How can consider the possioble impacts of the economy.

1.3 Objectives of the Study

The general objective of the study is to examine the various issues to implement a VAT in Nepal and its options to the government, if it will be implemented in properly and successfully in the country.

The specific objectives of the study are as follows:

-) To examine the historical background of VAT,
-) To analyze the administrative problem of VAT,
-) To evaluate effectiveness of VAT,
-) To consider the possible impacts of the economy.

1.4 Significance of the Study

This study is not only for the study if VAT literature moreover, it helps to fulfill the knowledge gap and also help to study on acute problems of VAT economy that the resource gap. VAT may be an effective instrument of mobilizing internal resources more efficiently at present in Nepal, where as Nepal has become of WTO, SAFTA and BIMSTEC. After the full implementation of these economic treaties. The international trade would be more liberalized. The present reveue resources of Nepal. Custom duties would not be able to beer the revenue patentability. In these context internal revenue resource is most o the country, which achieved easily through VAT. So that is why? The significance of the study is more relevant in the present context.

1.5 Focus of the Study

This study will cover an area of VAT and its role of public budget of the government of Nepal and its issues and options for the economy.

1.6 Methodology of the Study

Secondary as well as primary sources of data are used to fulfill the effectiveness of the study. To fulfill the objectives of examining historical background of VAT, secondary sources of data and information related to VAT are derived from books, booklets, articles, journals, magazines, , research paper, dissertation, etc.

The secondary data include the data from national accounts of Nepal, annual survey of manufacturing establishments in Nepal, statistical yearbook, etc. CBS, economic survey and Budget speeches of various years, publications of NRB, economic reports etc, are used as secondary data. The source of such of kind of data also include the publications of CEDA, APPROSC, etc.as the abroad sources. The data from world development report, annual report of economic data social surveys of Asia and the pacific, statistical indicators for the Asia and the pacific and UNO, etc. are basically quoted. beside these information, facts, evidences. etc. are collected from other related sources, publications, books, newspapers, research publications, book, newspapers, research publications.

While estimating the base and revenue potentiality of VAT, the base has been calculating according to the structure designed by VAT – Act 1996 and at regulation 1997. To estimate the base of VAT, national income in numerous adjustment have been calculated by the GDP accounts method and then after allowing for the exemptions from the sectors accounts of GDP, net VAT base have been made by treating exports and capital formation as credit, and important and the use of exempted inputs by manufacturing sector as debit

To find out the opinion of the respondents representing different groups related to VA, and opinion survey techniques through administered questionnaire, personal interviews as well as telecommunication would be contacted. Thus, in considering the various options of VAT, a general forecast would be made on the basis of various information, evidence, facts and relatives as well as experiences of foreign country.

1.7 Limitations of the Study

The study covers the (1997 - 2013) period of 16 years mainly based on secondary data. The availability of data is the main factor of making the study limited. On the other hand, the methodology followed in this study is designed by the next sophisticated technology. So the limitation can be summarized as follows:

- i. VAT is the primary process of implementation or no event has matured so, this study is basically limited in theory.
- ii. Due to the non-availability of data, the effective technologies may not be used for VAT calculation.

1.8 Organization of the Study

The study is divided into six different chapters.

The first chapter introduces the background of the study. The second chapter reviews some related literature. The third chapter clarifies the conceptual background of VAT. The fourth chapter analyzes VAT in the Nepalese context. The fifth chapter examines the issues and options for the applicability of VAT in Nepal. The sixth chapter summarizes the findings, conclusions and recommendations.

CHAPTER – II

REVIEW OF LITERATURE

2.1 Introduction

Tax reform is one of the seriously raised convened of any country's fiscal system. There are several studies and experiments on VAT, as a major instrument on tax reform since last half century but few efforts have been made on the topic concerning Nepal. Wherever studies have made are descriptive rather than analytical. Although most of the UDCs efforts in lat half-century is one tax reform in the periphery of VAT.

W.V. Siemens first recommended VAT in 1919 AD for Germany to replace the umsatzsteuer (multistage sale tax) in order to avoid the undesirable effects, particularly cascading and vertical integration forthe later tax. The concept of VAT was developed further in 1949 by tax mission to Japan led by Prof. Carks. Shoup recommended the fuk kchi – zei (VAT) for Japan in order to avoid the undesirable and unintended effect of he Japanese enterprises and turn over taxes is placed at that time. Thus the concept of VAT was emerged in Germany and enhanced and developed the structure in Japan and France practically levied in first time 1954 A.D. (Adhikari, 2006)

2.2 Overview of Previous Studies

Shoup (1990), considers VAT in his famous book 'public finance' as a final stage in a historical development of sales tax which is imposed on the value added by the business process. Value added is the difference between sales procceds and the cost of material etc. purchased by firms. Which is the tax base of a VAT. A firm adds value by processing or handling this purchased items with its labour force and its own

machinery, building or other capital goods. He has classified the following three types of VAT.

i. Gross product types of VAT (in closed economy) in this types of VAT, purchases from other firm that are deductible from sales excludes purchases of capital goods, e.g. machinery, furniture, building, vehicles and no depreciation is allowed to deduct from VAT base. The base of VAT will be gross national product.

$$\text{GNP} = \text{C} + \text{I}$$

$$= \text{W} + \text{P} + \text{D}$$

Where C = consumption

P = Net profit after depreciation

I = Investment and

D = Depreciation

He argues these types of VAT because of this relatively unimportant in practice.

ii. Income types of VAT (enclosed economy) in this type net national income (NNI) is the base of VAT where depreciation is allowed to deduct from VAT based by not permitting deduction of capital goods purchased from other. The aggregate base of tax will be

$$\text{NNI} = \text{C} + \text{I} - \text{D}$$

$$= \text{W} + \text{P}$$

iii. Capital exemption type of VAT: He distinguished the wage and

consumption types of VAT under capital exemption in closed and open economy.

In Open Economy

) Wage type of VAT considering imports and exports, destination as well as origin principle the base of VAT under destination principle import is broken into wage element and profit element. But the tax base of wage type of VAT will be the wage paid in the country which ever principle is adopted.

) Consumption type of VAT: Assuming there are two country world and if both countries wishes to exempt. Value added in producing capital goods or in accumulating inventory in the year investment and the formula of tax base will “sells less all purchases” couple by tax liability (rebate) in negative value added. And under the concept of origin principle of VAT world:

$$C + I = W + P - D (X - m)$$

$$\text{i.e.} = W + P + D - I$$

$$= C + X - m$$

Next in destination principle case, the base of VAT will be,

$$= W + P - I$$

$$= C - X + m \dots\dots\dots (ii)$$

In closed Economy

) Wage type of VAT: In the two sector economy (i.e. labor and capital) the aggregate base of this type of VAT for any given year becomes an amount corresponding to wage paid, where wage plus profit including interest equal to net national income. In this type, VAT base will be

$$\begin{aligned} YP &= C + I - D + p \\ &= W \end{aligned}$$

Where,

$$YP = \text{NNP (Net National product)}$$

) Consumption type of VAT this type of VAT deducing the full value of capital goods or Exempt capital goods or exempt capital goods purchased from other form but it does not allow to deduct depreciation from the value added. The taxable base of this tax is $W + P + D - I$. Which is equal to consumption expenditure © or $W + P + D - I = C$, where, Net national income rewards to factors equal to net national product.

He states that the consumption type of VAT is most superior to amongst three and his main conclusion about VAT are:

) VAT has the strong capacity of growing tax in the field of taxation.
) VAT is neutral and revenue productive but some what regressive and complex tax. So it may become challenging for developing countries.

-) If demand is elastic in the open economy there remains the possibility of exporting some of tax to non-resident factor owner.
-) Differentiate incidence of the income type of VAT is presumably progressive, since the tax includes in the value added the net return from investment but “incidence of the VAT itself: without reference to some other tax is meaningless.”

He reached the conclusion with the VAT is superior even then retunes sales tax for benefit consumer in depressed areas by differential tax rates.

2.3 International Context

Shoup (1969) in his book has explained value added tax as the latest and probably the final stage in a historical development of taxation. Which is based on goods and services. VAT is imposed on the value added; the difference between the sales proceeds and the cost of the purchases from other firms. VAT is superior to the turn over tax, the manufacture and the whole sales taxes as it eliminates the uneven impacts of these taxes. A comprehensive VAT will have favourable impact on the economy and easy to administer. But it is inflationary in nature. Comprehensive consumption type of VAT is equivalent to a retail sales tax in its purchase from except that the latter does not offer an option between the destination principles.

(Shoup) explains a comprehensive VAT that all economic activities from the earlier stage of farming mining right through the retail level. Among the types of VAT, he preferred consumption types of VAT and tax credit method for computation. VAT has more revenue productivity and transparent because of its self-enforcing feature. In addition, VAT can reduce its regressivity by providing zero rate and exclusion of transaction below certain threshold.

Lent (2001) shows in his article the tax structure of seven developing countries and the different adaptations that have been made to VAT concept. Those countries are Brazil, Ecuador, Ivory Coast, The Malagasy Republic, Morocco, Senegal and Uruguay. In these countries covering of taxable base varies substantially from one country to another. The tax generally do not apply to farm sales. Sometimes exclude services and do not always extend to the retail state or even to we whole-sale activities.

The study shows the share of the VAT revenue in total government tax revenue in 1968 – 70 ranged between 10 percent and 30 percent. In only two of the seven countries. Ecuador and Uruguay has the revenue less than about 20 percent of total tax revenue. Revenue elasticity of the VAT seems less than unity in Brazil. In all countries for which information is available of the VAT apparently resulted in higher revenue then did the yield of the preceding tax.

Due and Friendleander (1997) in his book states that in their empirical work “Government finance”, VAT is most critical among other sales tax because it has broader coverage and it offers great revenue potentiality as compared other type of sales taxes. “Value Added” is the tax base defined as the difference between the sales of firm’s product and the sum of the amounts paid by the firms. On the ground of revenue potentiality and equity (regressively) it is related to sales taxes. On the other part of the coin advantages or good features of VAT is major source of revenue. But its administrative complexities are excess burden in developing countries.

2.4 National Context

Khadka (2006), in his research paper proposed structure, operation and administrative set up of a VAT for Nepal and necessary steps to be taken for its early introduction in its proposed structure, the coverage of VAT should be made as broad as possible covering all business transactions. Exemptions should not be granted unless there is a specific reason to do so, such as administration and equity. Zero rating should be limited to exports and tax rate should be single in order to avoid complications and inefficiencies in collection.

The proposed operation of VAT requires that the tax payers above a threshold limit should be registered; the vendor should issue an invoice for each sale, keep a clear account of his purchases and sales (separate account for zero rated, exempted and positive rated goods) and VAT liability should be calculated on its taxable sales; tax credit method should be used as a method of computation of the tax and tax payment and refund period should be of one month. The present sales tax and the excise department should be restructured drastically and training should be provided including the operation of computer system. A VAT implementation team including experts and persons from every field should be set up. A detailed preparation should be considered as a prerequisite for the introduction of VAT. A comprehensive VAT education program must be launched to educate the taxpayers.

Tiwari (1990) in his article states that VAT is considered as the most growing trend in the field of taxation. Discussing the merits of VAT, the reasons for its growing attraction in the world are; VAT is one of the best modern taxation theories. It will raise considerable revenue and sustain it. It is effective to control price rises and reduce tax evasion.

Discussing the development of tax in Nepal, the author focuses the problems of Nepalese sales taxes such as administrative inefficiencies, very large number of small tax payer with no record keeping and issuing the invoice and sales tax concentrated only on important manufacturing level.

Gautam (2006) talked about the contribution of VAT in government revenue and problem faced by it. He has used different types of questionnaire to various ranked employees. The researchers used both primary and secondary data and have reached to the following conclusion.

VAT is a kind of indirect tax which is found to be superior to any other tax system for recollecting the internal revenue. The import VAT revenue is higher than internal VAT revenue. Poor management is also cause of ineffective resource mobilization. The growth rate of registrants is increasing. It shows the implementation status is satisfactory but due to the lack of transparency in business activity, weak cross checking mechanism, transition manipulation practice conclude that many potential taxpayer are out of VAT. The price change on goods and service may create double problem for tax payers.

Pathak (2013) in his study report has analyzed issues and effectiveness of value added tax in Nepal has is clear that the tax most essential of the government related. The conclusion is that presence of VAT entirely depends on its implementation aspect.

Ahamad & Stern (2007) in his article suggest the tax reform to India through the paper "Alternative sources of government revenue: Illustration from India 1979/ 80" after analyzing the Indian tax system by

employing the advanced and sophisticated tools and techniques. there was a very considerable taxation of intermediate goods in India shows the evaluation of "effective taxes". Inputs of some goods were taxed more than 20 percent, and on the average the taxation of inputs arose mainly due to federal excises on domestic production, is the major important things of tax system. Other major notable points is that the exports were also taxed at 6 percent through input taxation. The rebates to the exports as a remission of domestic taxation were clearly insufficient.

There is the supporting of income inequality in the social marginal cost (SMC), of raising revenue was highest for federal excises followed by state sales tax and import taxes respectively. Similarly the SMC of raising revenue from cereals, food items, fuel and light was the highest and SMC of raising revenue from milk and dairy, clothing and other non food items was the lowest income tax preferable to raise an extra amount of revenue rather than to use commodity taxes. For strong income inequality, the argument for income tax is very strong. Cereals become very unattractive as a source of revenue and import duties represent the most desirable general sources of extra indirect tax revenue. The paper also suggests that a move to a VAT at uniform rate would have adversely affected the poorer section of the Indian society. Given the non-distorting effects of VAT on production however, there might have well advantages in considering a non-uniform VAT supplemented by selective excises and tariffs.

The famous pair modern economists Musgrave and Musgrave (1996), in their book "Public Finance in Theory and Practices" Suggests that in among three types of VAT, i.e., GNP, Income and consumption types, the least types is of for practical consideration for both efficiency and equity criterion and tax based on consumption similar to the retail sales tax

especially for the poor countries. The invoice method for calculation is more preferable and advantages of the value added approach.

Describing the problem of VAT states that "A sales tax may be imposed in either single or multiple stage form. If latter is implemented in the value added (rather than turnover) sense, it is equivalent form the economists' point of view to a corresponding single stage tax. At each stage the value of product is increased and these price rise accordingly, which is the Valued Adde – the tax base."

Among the two types of alternatives i.e VAT and retail sales tax (RST), posing the same tax base, which one is more preferable? This string difference in their opinion are analyzed as:

-) Number of taxpayer is less under the RST than under VAT. Therefore the tax administration is feasible in RST than VAT.
-) The exclusion of capital goods is more effective in VAT system than under RST.
-) VAT constitutes self- enforcement in invoice system for calculating tax liability than under RST.
-) VAT constitutes problems in such countries like USA, which have authority of tax calculation posed by the state level.

Tait (2001) in his book, focuses about the important of VAT. The study mainly deals with the policy concerns on the basic illustrations of some theoretical as well as empirical proofs. Major conclusions drawn are;

- i. The VAT is for the buoyant base of revenue, maintaining neutrality and efficiency in taxation.

- ii. It is preferable that the VAT should cover all stages of production to the retail level and the services.
- iii. VAT simply changes relative prices but not the over all price increase.
- iv. Single rate VAT with no zero rate and few exemptions proves regressive but it should be evaluated on the basis of proofs relatively less regressive than others.
- v. Retails sales tax is the alternative for the VAT.

A VAT expert of Nepal Khadka (1998) in his book analyze the VAT system in this region, Probably, he is the person of first observer of VAT aboard and the firstly proposed VAT for Nepal with micro study of Nepalese economy and tax system. He states "VAT is the most recent innovation in the field of taxation, which is levied on the value added of goods and services, and is shifted towards completely to the consumers."

The major beauty of VAT its neutrality of efficiency, more equitable than other forms of sales tax except retail sales tax. It avoids the problems of cascading or pyramiding, advantageous to exemption of exports, revenue productive, self-policing nature in administrative point of view. It is very complex and troublesome and difficult to operate. Among these goods and bad features, he states "VAT should be introduced in Nepal." The main objective of the study "to examine the structure and operation of VAT in the Asian pacific countries", which also explores the possibility of introducing VAT in Nepal. He lastly developed a VAT proposal for Nepal. He concludes mainly as following.

- a. VAT is theoretically accepted and it is natural with respect to production and distribution as well as consumer choices.

- b. The broad base of VAT makes more revenue productive as well as horizontally equitable.
- c. Even though it is complicated to administer, it provides self-policing nature and the catch up effect facilitates the tax administration.
- d. Asian pacific nations, China, Indonesia, Korea, New Zealand, Philippines and Taiwan have operated VAT from 1989, where VAT has been introduced as a part of large-scale tax reform program. Some exceptions in China, all have adopted the consumption type of VAT with tax credit method for computation of VAT base. The New Zealand VAT system is perhaps the purest in the world

However, the study is not fully devoted to Nepal, and lacks empirical study in Nepal. He lastly concludes with some recommendations for Nepal.

- a. Nepal, at the current period of study time there are one and half dozens of taxes which are governed by separate laws, own structures, operational system but very few of these taxes such as custom duties, sales tax, excise and income tax provide some volume (block) of the revenue. The tax effort is very low; the tax system is very inelastic i.e. inequitable, narrow base with multiple rat and wide exemption leads to inefficiency.
- b. VAT itself is not inflationary; it is desirable for Nepal several points of views.
- c. There is an urgent necessity for rationalization of tax system. Although rationalization comprises of a series of measures. VAT is considered in this respect.

- d. VAT should be seen a long term and major step for the rationalization of tax system, which would required a long preparatory period.
- e. Any hasty decisions regarding the introducing the VAT should be avoided.

A high level task force headed by Prof. Madan Kumar Dhahal (1995) to review Nepal's tax system has made some recommendations for a VAT in Nepal. In his report the task\ force recommends a VAT in place of existing sales tax and small service based taxes as a long-term tax reform measure. The report has emphasized the introduction of VAT in Nepal as follows:

- a) Broaden tax base and increases the tax revenue.
- b) Make the tax system transparent and elastic.
- c) Prevent tax evasion.
- d) Make the tax system efficient, and
- e) Encourage exports.

The report has also emphasized that there are some other factors to be considered seriously before implementing a VAT. They are:

- a. Price level,
- b. Equity,
- c. Nature of tax payers,
- d. Small taxpayers.

The report recommends some necessary preparation to be undertaken before implementing a VAT . such as drafting a law, developing an efficient and capable administration, a functional pattern is recommended. The other recommendations of the task force are:

development of an effective tax refund system, measures to increase self compliance, taxpayer's services,. And computerization of the administration, research and development, and different types of presume administration system extensive taxpayer's education program, etc.

Khadka (2006) in his paper focuses on the proposed structure, operation and administrative set up of a VAT for Nepal and necessary steps to be taken for its early introduction. In its proposed structure the coverage of VAT should be made as broad as possible covering all business transactions. Exceptions should not be granted unless there is a specific reason to do so, such as administration and equity. Zero rating should be limited to exports, and tax rate should be single in order to avoided complications and inefficiencies in collection.

The proposed operation of VAT requires that the tax payers above a threshold limit should be registered; the vendor should issue and invoice for each sales, keep a clear account of his purchases and sale (separate account for zero-rated, exempted and positive rated goods) and VAT liability should be calculated of is taxable sales; tax credit method should be use as a method of computation of tax and the excise department should be structured drastically to administer a VAT. Officer level posts should be increased considerably and extensive training should be provided including the operation of computer system. A VAT implementation team including experts and persons from every field should be set up. A detailed preparation should be considered as a prerequisite for the introduction of VAT. A compressive VAT education program must be launched to educate the taxpayers.

A study made by Nepal Chamber of Commerce (1997a) to analyze the possible effects of VAT in Nepalese economy make some observation.

The observations are:

- a. Adverse effects on price level.
- b. Increase in the price of imported goods would hit the import business and re-export of imported goods leading to a decline in the revenue from import tax.
- c. The account-keeping requirement of VAT would increase the tax compliance cost and cost of doing business, it would adversely affects the smaller trades.
- d. Adverse effects on domestic production due to abolition of protection policy under VAT.
- e. VAT would be unjustifiable on social ground, it would aggravate the income distribution,
- f. Negative effects in revenue collection, and
- g. Chances of failure of a VAT in Nepal are great because the present administration is incapable for handling a VAT. The study concludes that a VAT in Nepal should be implemented on experimental base to know its pros and cons and after that a full VAT might be considered.

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

- a. Government machinery is not capable for implementing a VAT.
- b. The business community has no confidence in the administration because it has failed to implement many other taxes effectively and fulfill its own commitments even previously.

- c. VAT will hamper genuine trade and, as a consequence, illegal trade will prosper. Rising in the price of domestic products will make them less competitive. Import and re-export of imported goods will get a negative impact leading to decline in government revenue.
- d. VAT will inhibit the growth of newly developing trade and industrial activities in the country.
- e. The modern account keeping system required the VAT is difficult to keep. This will raise the costs of doing business.
- f. There will be a sharp price rise if a VAT is introduced, consumers will be badly affected due to price rise. Nepalese markets in border area will dry up due to VAT.

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

Ministry of Finance (2005) published a report entitled. “The Report of the Taxation System Re-observation Task Force,” after studying six months by the member of VAT task force. It mainly analyzed the magnitude of the Nepalese tax system and recommended various measures of tax reforms. The study is highly academic and it depends upon theoretical bases, which covers less empirical findings in Nepal.

The study concludes, “There is no possibility of any other great measure to introducing a tax rather than introducing VAT in Nepal.” The major findings of the study are as follows:

(a) The need of VAT in Nepal:

-) To increase revenue collection by broadening the tax base.
-) To make the tax system more buoyant,

-) To discourage the tendency to tax evasion,
 -) To make the tax system efficient,
 -) To promote the exports.
- (b) The existing tax system of Nepal generates less amount of revenue, so alternation of the system should be searched. In this context, the VAT appears as the best alternatives.
- (c) Some aspects for consideration of VAT are, price level, equity, the condition of taxpayers and small vendors.
- (d) A special consumption tax on luxuries should be introduced as a supplementary tax for the VAT.
- (e) In the Nepalese concern there must consists detailed preparation before implying VAT, which are:
 -) Making choice of the types of VAT,
 -) Define the exemptions and determine the structure of VAT,
 -) Choosing the best method of computation,
 -) Giving taxpayers information,
 -) Developing the existing administrative system.

Efficiency, flexibility, administrative feasibility and equity in sacrifice are the major guided traditional principle to design any tax. The modern theories of welfare economic also concentrate the major principles of efficiency and equity. In the real sense, as a reform of indirect tax, most of the efforts on VAT were held only on the theoretical background. No empirical study is yet made about revenue potential power of vast in Nepal.

Subedi (1997) in his thesis concludes that since the existing tax system is not efficient in raising adequate revenue, and it is above distortion, inequitable and give incentives for tax evasion. The finding of the study emphasizes the need for the reform of entire tax system. To reform the tax system. It is desirable and necessary to move towards VAT and improve the administration. A VAT in Nepal expands the coverage of tax; removes distortion effects of the existing taxes and will have a minor effect on prices. Empirically, VAT is also found to be the best alternative for reducing the inefficiencies and introducing neutrality, fairness, productivity and transparency in the tax system. A VAT, however, would rise the regressively of the tax system.

According to the study, the most important problem for implementing a VAT is administrative inefficiency. The present sales tax administration is not capable for handling a VAT. Other problems associated with the applications of VAT are:

- a. No account keeping system,
- b. Lack of awareness of VAT in taxpayers.
- c. Lack of co-operation and believes in between government and private sectors.

The full advantage of VAT cannot be achieved with extending it to the retail level but the extension of VAT o retail level is impossible and impracticable in Nepalese context.

The study suggests that a moderate single rated VAT is desirable. If the VAT is implemented well, it will generate 1.5 to 2.5 fold more revenue that existing sales tax. But, however, the study concludes a VAT in Nepal may not be a hen with golden eggs and it is not a Panacea for curing all ills; it requires actives efforts and commitments for all sides.

CHAPTER- III

CONCEPTUAL BACKGROUND OF VAT

3.1 Introduction of VAT

3.1.1 Origin, Concept and Development

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

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

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

The modern VAT first implemented in France in 1954 with the name Aure. La ValeurAdout'ee (VAT) in place of French production taxes.

French VAT was designed by Maurice Laure, was an officer in the French Ministry of Finance. Maurice Laure is regarded as a father of modern VAT, covered industrial sector and latter extended to wholesale level.

At the beginning of sixth decades of last century, VAT has taken a giant leap in its history. Some French colonial countries such as Ivory Coast (1960), Senegal (1961) as well as other developing countries of Africa and South America like Brazil (1967), Uruguay (1968), Equator (1970), Bolivia (1973) replace their turnover taxes by VAT in French model 1954. “Financial and Fiscal Committee of the European Union (EU) has recommended adopt VAT to its member countries to replace their existing multistage sales taxes in 1962 (1976:65). Vietnam has established a new record in Asian nations to adopt a broad base VAT in 1973. South Korea introduced VAT in 1977. Similarly China in 1984, Indonesia in 1985, Taiwan in 1986, Philippines in 1988, Japan in 1989. Thailand in 1992 and Singapore in 1994. In the SAARC region, India introduced modified VAT (MOD VAT). The MODVAT has been designed to avoid the cascading effects and the tax was extended in later year. The classical type of VAT was first introduced by Pakistan in 1990, followed by Bangladesh (1991) and Sri Lanka in 1995 in SAARC region. Nepal could not remain isolated from VAT so partially adopted since 16th Nov 1997 and full implemented from 17th Aug, 1999. While early preparation has been made with the commencement of 8th Five Yearly Plan (1992-97) and experimental basis was announced from 1992/93 budget with a two-tier sales tax system on some selected items.

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

3.1.2 Meaning and Concept

Vat is similar to the retail sales taxes because the tax of VAT and the retail sales tax on consumer goods and services are identical. Retail sales tax (RST) is imposed only at the final stage while VAT is imposed at each stage of production and distribution. The operation of VAT and its counterpart RST can be visualized as below under the assumption of tax rate 10 percent.

Table No. 111-1
A Process of Tax-Credit Consumption VAT VS RST

Pro.& Dis	VAT Regime				RST Regime		
	Purchase Price	Sales Price	Value Added	VAT	Purchase Price	Sales Price	Sales Tax
Primary Pro.	0	200	200	20	0	200	-
Manufactures	200	1000	800	80	200	1000	-
Wholesalers	1000	1200	200	20	1000	1200	-
Retailers	1200	1300	100	10	1200	1300	130
Total				130			130

Source: Estimated Arbitrary Figures during the Study.

As, shown in the above table, Value Added Tax (VAT) is a tax collected in various Stages of business process on the basis of value added. Example shows both tax provide same figureRs. 130.

VAT is t multistage tax, which has grown as a hybrid of turnover tax and the retail level sales taxes (Khadka, 1998). It is levied on the value added

of business enterprises at each stage of production and distribution process. The tax base is 'Value Added' during the successive stages. VAT is similar to a turnover tax because both are imposed at each stage in the business process. Turnover tax is imposed on value at each stage while VAT is imposed only on value added at that stage, which is the basic difference to them. While, Vat is similar to retail level sales tax because the consumption types of VAT and RST on consumer goods and services are identical. "Vat is regarded as a comprehensive one since it covers all economic activities right through to the retail level "(Shoup; 1988: 139). Thus VAT may be extended through the retail level. In this situation, it is similar to retail level sales tax on the goods and services covered with the important difference that VAT is collected at each stage rather than being converted at the final stage of distribution (Goode,op. cit, 158). Thus VAT collected, piece meal, from all units in the production and distribution system on their respective value added (John and Due, 1976: 78).

VAT is an indirect tax. The revenue potentiality of VAT is relevant with not only the name of VAT. It depends on two aspects. Firstly, it needs an administrative to be efficient and secondly for the consumption type of VAT, the buoyancy of revenue depends on the expenditure nature of each households, in which high percentage of their income depends on purchasing goods and services generates more revenue to the government. VAT is almost regarded as the optimum form of consumption-based tax.

Value added can be calculated by two methods i.e., Addition and subtraction methods.

Addition Method: Value Added = Wage + Rent + Interest +

Profit, etc.

$$\begin{aligned} \text{Subtraction Method: Value Added} &= \text{Sales Price} - \text{Purchase price} \\ &= \text{Output} - \text{Input} \end{aligned}$$

3.2 Types (Forms of VAT)

VAT has been classified on several basics; the most important basis is how goods are treated by a VAT. “The precise treatment of deductibility of tax paid on durable capital goods is of great concern in distinguishing VAT of Various types. (Shoup,1962: 251). It can be classified into three different types:

A. Gross National Product (GNP) type of VAT

All final goods and services are taxed and capital goods purchased by a firm from other firms are not deductible from the tax base in the year of purchases. The tax is levied on both consumption and gross investment because this type of tax also covers the depreciation under the tax base subsequent years. The total tax base is equal to GNP.

GNP type: Gross investment consumption.

In this type, it is very difficult to calculate the tax base, so it is less desirable and not found in practice. This tax against some of the equity criteria that is unlikely to be used (Shoup:

1969: 70). It also creates a substantial disincentive for saving, investment and capital incentive production.

B. Income type of VAT

If annual capital depreciation is excluded from the tax base, it is called the income type of VAT. In other words, the total taxable base in income variant is equal to total GNP minus depreciation of capital. The income type of VAT can be used as substitute for income tax because total base of the tax is equal to personal income without exemptions. It is also the theoretically defective and rarely used in practice. As an exception “The income VAT has been used by Argentina and Colombia. The State of Michigan in USA used an income VAT and an approximate form in Turkey,” (Crawford; 1996:).

The aggregate base of income type of VAT is same as that for a comprehensive income tax. Such type of tax may be imposed in multistage form by taxing on net value added by each firm.

$$\begin{aligned} &\text{Income type: GNP- depreciation} \\ &= \text{Net investment} + \text{consumption} \\ &= \text{Net National Product (NNP)} \end{aligned}$$

C. Consumption Type of VAT

Under this variant of VAT, all capital goods purchased from other firms in the year of purchase, are excluded from the tax base while depreciation is not deducted from the tax base in the subsequent years. (Khadka, 1997: 2). The consumption variant allows a deduction or tax credit from its base the full value of investment goods at a time of purchase. All purchase (without miner exception) for use in production, including purchase of durable capital goods are deductible in determining tax liability in the period in which they are purchased. The base of the VAT is now defined

as the firms, gross receipts minus the value of all its purchases of intermediate (materials and goods in process) as well as its capital expenditure on plant and equipment. This type of VAT allows an adjustment for depreciation in other years (if it did so, it would be deducting the price of capital goods twice). In effect, this tax grant 100 percent accelerated depreciation, which is equivalent to exemption (Carl S. Shoup). VAT in this form is equivalent in base to retail sales tax, which exempts all purchases for business use including those of capital equipment.

Consumption Type: Total Consumption

= GNP — Gross Investment

= GNP — (Net investment + Depreciation)

The tax base of this type becomes the aggregate consumption expenditure by personal household occurs. Thus the consumption VAT exempts capital goods. Comparing the three types the consumption type of VAT is more easy to calculate. However, in some respect it needs additional administrative complexities than other kinds of sales tax. The totality of consequences is easier to track if taxes are confined to final consumer goods rather than intermediate ones (Prest and Barr, 2008).

The consumption type of Vat is being most admirable in all members of EU countries and it is becoming more popular worldwide because of its relativity feasible concept as compared to income and GNP types. This type is not also immune from the blame of anti- investment bias since it doesn't discriminate against capital-intensive techniques in favour of labor-intensive techniques as it the remaining two types.

3.3 Methods of Calculating VAT

The value added is the net tax base under the VAT system. The countable tax base is the difference between sales and purchases value by business firms and those can be completed by employing any three different methods. They are:

i) Addition Method

ii) Subtraction Method

iii) Tax Credit Method

I) Addition Method:

In this method, first value added is computed by adding all incomes generated or factor payments in the forms of wages, rent, interest and profit during the production and distribution process and then, the VAT rate is applied to the value added to get the VAT payable.

This method is rarely found in practical due to its complexity computation since, in this method VAT seeks to avoid capital goods from its base. It is practically applied in Argentina and Israel, in their selected economic activities such as banking and finance where value of inputs and outputs is difficult to measure (Cnossen, 2008).

ii) Subtraction Method

Calculation of VAT payable in this method requires a subtraction of gross purchases from gross sales of a business enterprise during a period and application of VAT rate the remainder. Under this method, the taxable base is calculated by subtraction of gross purchases from gross sales of business enterprise during a taxable period. Definitely, sales

value is greater than purchase value by its own activity of firms. In these methods, tax base is determined as a net turnover, which is obtained by subtraction the cost of materials from sales proceeds. This method is also known as a direct subtraction technique or account method. The subtraction method is the most appropriate for consumption type of VAT. However, it is simplest one but it needs a uniform rate of tax without exemption, which has lack of equity consideration of good tax.

iii) Tax Credit Method

In the tax credit method, VAT liability of a firm paid on total purchase is deducted from VAT levied on total sales, which is the net tax liability. In other words, the net VAT is calculated by deducting tax on inputs from the tax of outputs during a taxable period. i.e. $\text{Net VAT} = \text{Output Tax} - \text{Input Tax}$. For more clear tax on purchases is subtracted from the tax on sales under this method. This method is also known as the invoice method or indirect subtraction method. It is considered as a tool for self-enforcing (cross-checking) measure due to tax credit under a VAT system. While the addition method provides no means of cross checking at all and the subtraction method provides much less clear-cut guidance for cross auditing (Due, 1976: 94).

Among the three methods, the tax credit method is widely universally accepted measure. It is more successfully used in all UDCs and EU countries including Japan, South Korea and elsewhere. This method is suitable under the destination mechanism in which the tax credit chain is not broken. It is also especially useful if it is designed to reduce the rate of VAT at some stage in the business process (say raw materials) or primary stages without reducing the total tax paid on total value added. The reduced amount is maintained by equally increased tax at further

stages. This phenomenon is known as catch-up effect, which could not achieve under the addition and subtraction method.

Table III - 2

Different Methods of Calculating the VAT Liability

(VAT rate 10%) (In Rs.)

A. Addition Method	Stage of production and distribution			
	Manufacturer	Wholesaler	Retailer	Total
a. Wages	1200	200	100	1500
b. Rent	400	300	200	900
c. Interest	100	50	-	150
d. Profit	300	100	50	450
e. Value Added (a+b+c+d)	2000	650	350	3000
f. VAT liability (10% of e)	200	65	35	300
B. Substraction Method				
a. Sales	5000	5650	6000	16650
b. Purchases	3000	5000	5650	13650
c. Value Added (a-b)	2000	650	350	3000
d. VAT Liability (10% of c)	200	65	35	300

C. Tax Credit Method				
a. Sales	5000	5650	6000	16650
b. Tax on Sales (Cross tax)	500	565	600	1665
c. Purchases	3000	5000	5650	13650
d. Tax on Purchases	300	500	565	1365
e. Net VAT Liability (b-d)	200	65	35	300

The above table shows that every seller calculates the gross tax by applying the tax rate to his total sale and from gross tax he subtracts or credits the tax paid on his purchases to get net amount payable. If tax credit chain would not broken, the total amount of tax paid by all the sellers in the example is equal to the amount of tax if same rate was applied to the final price of the product.

All the three methods of computing of VAT are not in common use. The addition method is appropriate for income type of VAT, which, in its base, includes the rewards to all factors including interest and profit. Since income type of VAT is not much used. Calculating of VAT using this approach is a complex and difficult procedure, which increases administrative burden. For consumption type of VAT, the subtraction method is appropriate one. But as addition method, this method is not of common use as administrative difficulties in its calculation are also true as in addition method. Therefore, the refinement of subtraction method the tax credit method is of universal use. The tax credit method is original

EU model, which is adopted as a method of tax calculation by almost all the countries all over the world.

There are some advantages of the tax credit method over the other two methods. They are:

- i. The tax liability in this method is attached to the transactions that make it technically and legally superior to other methods.
- ii. Calculation of tax is easier than other two methods because calculation of value added, which is a difficult task is not necessary in this method.
- iii. The tax credit method creates a good audit trail and cross checking possible.
- iv. It provides an effective way to completely free any product such as exports from tax makes broader tax adjustment easier and possible.
- v. Due to 'Catch-up effect' under valuation and evasion at some stage is not possible.
- vi. There will be no revenue loss due to exemption granted to small firms or product. For example, agricultural sector is exempted and if industrial sector uses inputs from agricultural sector, the inputs bring no credit with them that means the agricultural sector also comes under tax base.
- vii. Tax rate differentiation at different stages for administrative or other reason becomes possible under this system without reducing the total tax paid. If the tax rate is reduced at earlier stages, this simply gives rise to an equally increased tax at later stages.

3.4 Terminologies used in VAT

Terminologies, which have specific meaning, are used in the process of VAT studying. They are:

) VAT

The short form of Value Added Tax is VAT. It is a tax based on goods and services, and is an improved form of sale taxes. The vat is levied on the value added on goods and services at each stage in the process of production and distribution. (VAT Project, 1996: 1).

) Input Tax

An input tax is a credit or a refund claimed by a registrant for the VAT paid or payable on any taxable input that used in the course of commercial activity. Input tax is central to the operation of a VAT system. It enables the recovery of tax incurred in the production and distribution process by the registrant before tax is charged on the sale of goods and services to the final consumer (VAT Department, 1997: 1).

) Tax Credit

Under VAT, whenever a registered person pays VAT for any taxable business materials or services, the business can get a credit for the VAT paid in the form of an input tax credit. The input tax credit includes the tax paid on his purchase of stock, raw materials, semi- processed goods and overheads provided by the firms that are used to make taxable goods or taxable services. At the end of each month, each registered person must complete a VAT return. On the return, the registered person totals the tax paid and the tax collected for the month and deducts the tax paid on purchases from the tax collected on sales. In the case where the tax

paid exceeds the tax collected, the business receives an input tax credit which can be used to reduce its tax in the following month.

) **Tax Refund**

The situation for a tax refund arises when the amount of input tax is higher than the amount of output tax. Such a situation generally arises in the case of exports because exports are zero rated in order to relieve them from burden of VAT. In Nepalese context, the taxpayer may apply to the VAT office for refund. If the tax payer is a regular exporter with more than 50 percent of his sale exported or has had more input tax than output tax for a continuous period of at least 6 months, and interest will be paid on refund where payment is made more than 60 days after the claim is filed (VAT Act and Regulations VAT Department, Bhadra, 2054: 29-31). Such a provision would help to settle accounts for each taxable period. However, it is necessary to examine returns in the case of large and abnormal claims. This is a prudent requirement in any VAT system.

) **Zero-Rating**

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

) **Exemption**

Exemption means that the transaction is not required to pay tax on sale. He is however, not allowed any credit for tax paid on inputs. It simply means the goods and services freed from a tax jurisdiction. Under this approach, goods and services are subject to exemption and input tax inquired there is not refundable. Exemptions are mainly given by some purposes such as (i) for basic need goods or services, (ii) social welfare ground (iii) reducing complexities in administration and (iv) goods and services purchased by the head of the state or foreign ambassadors, representatives and counselors. It must be pointed out that exemptions and zero-rating are not the same and one. Exemptions are granted to entities such as small firms or firms producing or rendering specific products or services. Exempted firms don't have to pay the VAT on their output although their inputs may still be subject to the VAT for which they are unable to claim any credit without filling tax returns.

) **Threshold**

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

) Cascading I Pyramiding Effect

Cascade tax is such tax ‘under which the tax applies to the selling price at each point of sale, from the initial production of materials to the final sale to the consumer (John F. Due, 83).’“It is tax on the gross value of the goods including the element of taxes paid at earlier stage. Such effect of tax is called cascading effect. Due to the cascading effects of sales tax, price level is increased higher than the amount of tax paid by the traders. Such effects is called pyramiding effects of tax. According to Carl. S. Shoup, the chief reason for applying the value added technique is to prevent cascading, that is, to avoid taxing any ingredient of the final product more than once.

) Self-Policing Technique

VAT is a new improved form of sale tax based on invoices and computer system. The whole transaction of the economy from production to consumption is recorded in each step of the transaction. That is why, tax evasion and cheating is considered to be minimum in comparing to other forms of taxes.

3.5 Operation of VAT

) Registration

The initial and necessary step towards VAT operation is registration of vendors who are legal taxpayers. All the firms and traders selling taxable goods and services and having an annual or periodic turnover above a specific limit should register in VAT office before collecting of VAT. Voluntary registration is allowed for other small traders and firms whose periodic turnover is below the limit.

Extensive publicity campaign is to be done at first to notify' potential taxpayers before the procedure of registration is made. Registration forms are distributed along with prudential and procedural guidance; after the forms returned, review of filled in forms and their coding is made. There after brief educational visit is to be done to newly registered taxpayers. The educational visits also help the registrants to understand the procedures and solve the problems.

) VAT Numbers

A unique VAT number must be assigned to each taxpayer for identification. It is desirable that VAT number should become the taxpayer identification number (TIN) which covers the all types of taxes and taxpayers including VAT and those not liable to VAT. A TIN is a code to identify taxpayers. Each taxpayer must have a single unique TIN. The TIN has two objectives: (i) To facilitate computer applications, such as detecting stop filers; and (ii) To help cross-check information on taxpayers compliance, for example, the selective cross checking of sales and purchase among VAT taxpayers.

After providing VAT number, registration certificate is issued to all taxpayers. Each taxpayer should display his VAT registration certificate at his business place so that the inspectors and consumers know whether the vendor is registered or not.

) Master File

The advancement of computer system and use of TIN number has given rise to master file system in which the master file of each registrant is prepared in computer in tax headquarters. A master file contains all the information pertinent to taxpayers including TIN. This system makes an

efficient control of tax collection possible.

3.5.2 Invoices

Each registered vendor must issue an invoice to each taxable sale. Invoices are the initial documents for VAT control. It is through invoices the tax liability of a taxpayers and purchaser's right to claim a credit is established. There are two types of invoices: (i) Tax invoices — issued to VAT taxpayers, and (ii) Final consumer invoices issued to unregistered persons.

i) Tax Invoices

Tax invoices are issued to the sales to registered taxpayers because the registered taxpayers can claim the credit of the tax on their purchases through the help of tax invoices. Generally, 3 copies are made, two of them first and one is given to the purchaser and the seller for his own record. The purchaser uses the original first copy to tax credit.

ii) Final Consumer Invoices

This type of bill is given to final consumer who is, may or may not register in VAT. Much information like name, address of purchasers may be omitted in final consumer invoices and final price may be shown including tax rather than showing VAT and price changed separately. Only a copy of such invoice may be issued and sells of such type is entered into the sales book.

3.5.3 Books of Account

Every VAT registrant is required to maintain an adequate and clear record of his all transactions. The record must be in sufficient detail to show the taxpayer to calculate correctly the amount of VAT he has to pay

and can reclaim, and to complete the necessary returns. Such records are kept for fairly long time (4-6 years generally) and made available to the administration on request to check its accuracy and fairness.

3.6 Processing of VAT

The collection of VAT is an ongoing process includes distribution of tax return forms filing of returns and payment of VAT and the processing of returns.

) Tax Return Forms

Tax return forms are the preprinted forms the taxpayers have to fill and submit every tax period. The forms contains following informations:

- a) Total sales (including personal use of owners)
- b) Exempted sales,
- c) Zero-rated sales,
- d) Taxable sales: $a - (b + c)$
- e) The gross tax (Taxable Sales x Tax Rate)
- f) Tax on purchases, and
- g) Tax due (The Net VAT): e-f

) The Filling of Returns and Payment of VAT

Each taxpayer should return complete tax return form and tax due till the end of each tax period. A month is standard tax period; however, more than a month may be in case of small traders. The tax return forms is in 3 copies, the original is kept with taxpayers then the first copy is submitted

to tax office and the last is submitted to bank if taxpayer pays at the bank.

Usually, payment of VAT is made at banks. Collection of VAT through banks is a sort of ‘privatization’ in tax collection. Since they are used for receiving payments and handling money, using banks to collect VAT has generally been successful.

) Processing of Returns

After the return VAT form, the processing of VAT begins in which validation, batching arithmetical check, posting and balancing accounts. Tax returns are stored carefully.

) Tax Credit and Refund

Tax credit is the most distinguishing feature of VAT. Taxpayers are appealed to credit the tax shown on their purchase to calculate the tax credit, gross tax is calculated from the total sales during of tax period, then the tax shown on the purchases during the same tax period is subtracted from the gross tax and the taxpayers is allowed to pay the rest-the net amount. However, no credit is allowed for the tax paid on inputs used in the production of outputs that are exempted. If tax paid on purchases excess tax collected on sales of any tax period, the taxpayer is allowed to carry over his credit to subsequent tax periods until it is absorbed by the tax liability of the taxpayers.

The refund of tax arises in the situation when there is an excess of tax credit over VAT liability. The situation arises only when goods are zero-rated. If goods are zero-rated, the suppliers of zero-rated items are not allowed to collect any tax on their final sales or exports. However, they are allowed to claim back the tax on their purchases if there is any tax. Authorities must refund the tax with in a specific period when such claim is attained.

) VAT Enforcement

For the purpose of VAT enforcement, various techniques have been used. The most important is the requirement of adequate record keeping and maintaining it for a long time. And the VAT administrations have to be enriched with a clear vision and mission with adequate will power. Much legislative power is granted to tax officials to inquiry, size, and check, such suspected fraud cases. In addition to that, the tax officials are powerful to assess or reassess the tax liability of a VAT payer when they suspect traders may have misreported their tax liability or when returns are not presented at all.

) Penalties

Penalties are designed to punish taxpayers for their any VAT offences and to recoup the revenue losses due to miss-functions of taxpayers. Penalties are necessary for deterring evasion and non-compliance for smooth functioning and producing a full revenue potential of a VAT system. Some of the VAT offences liable to penalties are failure to register, not to issue invoices and keep accounts, fraud report, fraud invoices and accounts, unauthorized action, etc.

) Audit of VAT Management and Methodology

VAT audit is a selective review of the taxpayer's books and records including year-end statement, balance sheets and profit and loss accounts to ensure that the major areas of purchases, sales and stocks are substantially correct, not that the taxpayer has filled a perfect return. The purpose of the VAT audit is to find out according to the law and the regulations, the actual VAT liability of the taxpayers (Tait, 1988: 290). Every audit may be divided into two types, so VAT audit also divided

into two. One is on site and the next off site audit, the former is based on verification of records and fraud investigation and also advisory. The later is based on taxpayers' reports on office.

Audit management activities include:

- i. Searching for the taxpayer's, who fail to register and file the returns,
- ii. Reviewing tax returns checking the conformity of calculations and verifying the data inputs, outputs, zero rated goods and exemption
- iii. Selecting the business units for audit through the establishment of appropriate selection criteria and according to the audit capacity of administration
- iv. Preparation for audit and audit performance
- v. Reporting audits discussing about audit results and processing the results for further discussion making, and
- vi. Staffing, training, controlling over inspectors and auditors, allocation of tasks among inspectors and auditors, audit manual, etc.

) Use of Computers

Computer is supposed a recent mechanism for modern VAT operation, which provides a greater efficiency at lower costs. The use of computers' facilities and maintenance of master file system, which is an essential element of VAT operation for efficiency, monitoring, administration and controlling departmental policies. It has also facilitated the tax collection system as a whole.

3.7 Aspects of Administration

Administrative aspect is more important in a VAT system. The success of VAT, in fact depends upon the capability for administering it. This is because VAT would bring large number vendors, including retailers into tax net. This means that the number of person who will have obligations to file returns and pay tax will increase drastically. This will give rise to a voluminous payer-works in detail with large number of taxpayers under a rather complicated operation system, which demands a large, integrated and efficient administrative set up.

All administrative aspects of VAT are designed to increase the ‘voluntary compliance’ by the taxpayers. in addition to collection activities such as checking and processing of returns, a swift detection of stop-filers and non-filers, broad audit coverage, inspection and levying appropriate penalties are important aspects of VAT administration. Some of the basic requirements for successful administration of VAT are an appropriate taxpayer identification system; a simple VAT return form which does not request information that can not be processed on timely fashion: an effective taxpayer assistance programmed; a reliable electronic data processing system, which provided accurate and timely information; systems for cross-checking information in VAT return with information from other sources to detect under reporting an enforcement system that applies different strategies to different kinds of non-compliance; and finally, a sound and effectively applied penalty system. The very nature of VAT demands a functional type of organizational structure and office oriented personnel system (Khadka, 2006: 138). We discuss the two main aspects of VAT administration; the organization structure and staffing.

) Organizational Structure

The first issue regarding the organizational structure of VAT is which department should run the VAT. The previous sale tax and excise department has been changed into VAT department at first and latterly income tax department and VAT department merged into Inland Tax Department controlling under the Ministry of Finance.

) Staffing

The policy implementing key tools is staffs in any department. The total staffs may be divided into office and field staffs. The office personal consist of (i) The director or chief of the office and an assistant if necessary.(ii) The head of the divisions of the office.(iii) Senior review auditors. (iv) Senior enforcement and collection personnel to deal with hard core delinquents.(v) Legal officers. (vi) Personnel providing information to firms. (vii) Computer personal, and (viii) Filling clerks and stenographic personal. The field personal consists of (i) Auditors, (ii) Inspectors, and (iii) Enforcement personal.

CHAPTER IV

VAT IN NEPALESE CONTEXT

4.1 EARLY HISTORY OF VAT

The first intention to move towards VAT may be found in Eighth Plan (1982; 97). The government had planned to adopt a VAT replacing the existing defective sales taxes. A partial VAT was imposed on experimental- basis through 1992 budget: when the government introduced a two tier sales tax on some nine selected items (beer, biscuits, cigarettes, noodles, quality liquors, soft drinks, vegetables, ghee and woolen yarn). In addition to the manufacturers, the dealers and distributors of these items were; required to register and pay tax on the sales of these items. They were also allowed to credit the tax that was paid by the manufacturers against the tax on their sales. The scope of two tier sales tax: system was further expanded to include five more items (cement, iron rods, paints, plain and corrugated sheets and soap) in 1993. Besides, the sole distributors, wholesalers of foreign firms or companies were also required; to register and collect tax on their sales (Khadka, 1996: 134).

The process of the introduction of VAT gained momentum when the government set a Task Force under the *Sales TAX and Excise Department* in September ;1993 for making necessary preparations prior to the introduction of VAT.; Meanwhile; the Tax System Review Task Force, 1995 was Setup in the leadership of Prof. Madan Dahal in January 1994 recommended a VAT and some serious attempts to be undertaken for its introduction. The government finally expressed its commitment to introduce a VAT from April 1997 in its 1995-96 budget.

4.2 NEPALESE CONTEXT

4.2 VAT PREPARATION

In order to make necessary preparations for the introduction of VAT, the ; VAT Task Force performed various activities. The financial help for introducing a; VAT was provided by USAID and technical help to this regard provided by Harvard institute for international development, USA. The VAT preparatory activities by the Task Force are briefly explained as follows:

1. It prepared a draft of VAT law and held interactions with the private sector on the purposed VAT law. After much exercise the VAT law was finally passed by the Ninth Session of the Parliament in 1995. VAT regulations were also prepared by the Task Force. After much discussion, it finally ratified by the government in 1997.
2. The Task Force held various discussion programs with businessmen, administrators, tax persons, journalists, accountants, auditors and 'the like in order to make the VAT known to them. More than 100 such programs were held from 1995 to 1997 in major cities of the country.
3. Leaflets, booklets and VAT introductory brochures were prepared and widely circulated among the related persons e.g. potential taxpayers. tax officials and other interested persons.
4. Under The Task Force, a VAT project was established to undertake the various technical preparations like drafting of law. regulations

and operating manuals; computer development; designing and providing training. designing various forms, etc. Experts from Harvard Institute for International Development are working in the project.

5. The *Sales Tax and Excise Department* was change to Value Added Tax department in August 1996. The sales tax rate was unified to single rate of 15 percent in the same year.
6. A study about the administrative requirements for a VAT was undertaken by the Task Force. A functional type of organizational set up was recommended and approved by the government. The VAT administration was restructured beginning from July 1996 according to the functional', needs/ Many sections, subsections and officer level posts have been created and have been being fulfilled.
7. Training of different types was designed and being provided to the various level officers. Some officers were sent to abroad in order to take special training. The training for computer operation, tax refund, tax audit, investigation, return processing have been being provided.
8. Several materials for educating the taxpayer and the general public have been designed, published and circulated. Twelve different brochures covering various aspects of VAT have been punished and distributed among the potential taxpayers. In addition, small booklets, leaflets and pamphlets have also been distributed among the general public. Talk programs on television regarding VAT are shown. Lately, various advertisements regarding VAT have been flown in the print media. Various posters have been designed and stuck in the public places.

4.3 SALIENT FEATURES

Nepal is adopting a general consumption type VAT based on destination principle. It would be levied on the value added of each taxable sale right from manufacturing to retail level. It would be computed through tax credit method. The taxable value is sales value exclusive of tax. Other salient features of the VAT in Nepal are, briefly, explained as follows:

4.3.1 Coverage

Nepal has adopted consumption-type VAT using tax credit method. Under this system, the tax is levied on all types of goods and services both imported and domestically produced except those specially exempted by the law. It extends right from the manufacturing / import level to retail level. It covers all kinds of goods and services unless they are specifically exempted. Goods of basic necessity and certain services are exempted from VAT.

4.3.2 Exemption And Zero-Rating

Sales by farmers, agricultural inputs, financial, educational and other social services, unprocessed foods, kerosene, health services etc. are exempted from VAT. All exports and goods supplied in foreign currency are zero-rated.

4.3.3 Rate Structure

The VAT rate was single 10 percent other than Zero-rate for exports. Nowadays it has changed into 13 percent by 2005. The rate is fixed by the finance Act. Zero-rating increases the burden considerably on the taxpayers and the tax administration due to the requirement of

maintaining books of accounts, submitting returns and refunding the tax levied on the inputs of Zero-rate items. So, in Nepal, zero rating has been limited to the exports only.

4.3.4 Tax Credit and Refund

Credit of tax on purchase of all taxable goods is provided against the tax on sales of such goods. However, no tax credit is provided of the tax on the purchases of drinks (soft and hard), fuel used in vehicles and entertainment expenditure. A partial tax credit is provided of the tax on the purchase of aero planes, automobiles and computers. Full credit of the tax on the purchases of kinds of capital goods is provided against the tax on produced by such goods. There is a provision of tax refund if tax credit exceeds tax liability. The tax refund arises in the case of exports becomes exports are Zero-rated and if there is any domestic tax levied on exportable items it should be refunded to the exporters.

4.3.5 Treatment of Small Enterprises

The small enterprises like small firms, small traders, artisans, etc. are exempted from the VAT. For this purpose any seller of taxable goods having less than 3 millions annual turnover (the threshold limit) is exempted i.e. he is not required to fulfill any formality regarding VAT.

4.3.6 Taxpayers Formalities .

Each seller of taxable goods having annual turnover above the threshold limit should register for Vat purpose. The tax payer should issue an invoice of each taxable sale, prepare a debit and credit note, maintain the record of his all transaction, fill tax return and submit tax return to the tax office and pay tax till the end of each tax period.

4.3.7 Operation

The base of VAT is the value added by each firm through its production and distribution activities. The value added, however is not calculated directly, but the exact result is obtained by levying tax on total sales and deducting tax on purchases from tax on sales. The operation of VAT would be fully computerized with master file and Taxpayer Identification Number (TIN) system. The administration would provide specialized operation such as processing of returns, tax refund. checking and auditing, fraud detection. etc.

4.3.8 Administration

The previous *Sales Tax and Excise Department* has been changed into Value-Added Tax Department but now days it has changed into In-land Tax Office. This would administer VAT. The administration has 177 district offices in major industrial towns and a head office at Kathmandu.

4.4 NECESSITY

It is necessary to introduce VAT in Nepal for many reasons. It has become necessary to reduce the number and the level of tax rates. broaden the tax base and make the tax system more transparent in line with liberal economic policies introduced in recent years. VAT is the best option to meet these objectives. VAT will bring the Value Added at the wholesale and retail levels under the tax net and will make easier to le tax on the service sector. Broadening the tax base will make it possible to further reduce the rate of other taxes, including ~.,come tax and import duties, there by making the tax system economically more efficient. Vat will improve the efficiency, competitiveness of domestic products in the

international market by relieving expo from internal commodity taxes. Furthermore, as VAT will be levied only on Value Added, inputs will be relieved from taxation, meaning that double taxation will be eliminated under VAT. As VAT will be levied right through the retail level, increase in the value of taxable commodities during the process of production and distribution would be reflected in the tax revenue which will make the tax system more elastic.

4.4.1 Broaden the Tax Base

VAT will broaden the base of the Nepalese tax both legally and administratively. Legally, VAT will bring the value added at the wholesale and retail levels under the net-and will make it easier to levy tax on the service sector. VAT will broaden the base administratively as well, as it will minimize the problem of understatement of import value / ex-factory price due to the "catch up effect". Under the VAT ' understatement of taxable value at the import / manufacturing point would be corrected on subsequent sales since the credit for taxes paid on purchase would correspondingly lower. Further, there may not be an incentive for VAT registered vendors to buy goods from those importers/ manufacturers who have undervalued their goods since they will not be able to obtain input tax credits. As Vat provides invoice and audit trail, it makes tax evasion more difficult. Furthermore, as VAT would be levied right through to the retail stage. Tax payer will think that they might be caught at a later stage if they evade tax at an earlier stage.

As VAT will be levied right through to the retail level, increases in the value to taxable commodities during the process of production and distribution would be reflected by increasing in the tax revenue which will make the-tax system more elastic.

4.4.2 Promote Economic Growth

Broadening the tax base will make it possible to reduce the rate of other taxes. Including income tax and import duties. Thereby it makes the tax system economically more efficient. VAT will improve the efficiency and competitiveness of domestic products in the international market by relieving. exports from internal commodity taxes. Furthermore, as vat will be levied only on value added, inputs will be relieved from taxation, meaning that double taxation will be eliminated under VAT. VAT will improve the competitiveness of the domestic products in other ways as well. It is to be noted that the existing sales tax system discriminates against domestic products. Some of the current sales tax administration policies effect is to provide more control over domestic goods than over imports. The VAT makes the controls equal for domestically produced and imported goods.

4.4.3 Establish a Fairer Tax System

It is necessary to introduce VAT to make the Nepalese tax system fairer. The existing commodity tax system encourages smuggling and under-valuation, resulting in a discrimination against those goods, which are not smuggled and/or under-valued. Further, the import/manufacturing level sales tax discriminates against those goods that generate a higher value added at an earlier stage or stages. This is also true, as stated earlier, in the case of domestic products. The tax system has also become discriminatory due to the lack of its effective implementation.

As VAT makes smuggling and/or under-valuation more difficult and less attractive, the tax is likely to be levied more uniformly on all taxable commodities. Further, VAT will place an equal burden on all goods and

services irrespective of their proportion of value added at different stages. The tax will also be fairer due to its wider coverage, uniform rate and effective enforcement. As VAT will help strengthen the over-all tax system, it will make the Nepalese tax system fairer. ,

4.5 RECENT DEVELOPMENT OF VAT

The VAT was initially scheduled to be effective from April 1997- registration for the VAT was to begin from the third week of April before the actual collection is started form the third week of July, 1997. The government was preparing according to the schedule. Meanwhile, the private business sectors, which did not fully agree with VAT from the beginning. became very active for its immediate reaction to the implementation of VAT. A nationwide discussion program hosted by Nepal Chamber of Commerce was held among traders. businessmen. industrialists, and their representative associations in March, 1997 in order to collect the business community's attitude towards the new tax. All the members of business community showed their hostile attitude towards the tax and their general meeting unanimously passed a slogan of "No VAT". At the same time, a study made by Nepal Chamber of Commerce recommended that the VAT was not suitable for Nepal and it was not appropriate to implement in haste. It also recommended that a partial VAT on some selected commodities should be tried on experimental basis.

After that a? direct confrontation was started between the pro-VAT side, (the government) and anti-VAT side (the business community). The business community started an organized opposition against VAT. They threatened to disobey the government if the VAT was implemented. They also called `bandh'. street demonstration, etc. in the protest against VAT. The government could not defend the business people. The government

seemed rather weak in its arguments in the favor of VAT. The preparations made by the government for the introduction of VAT proved to be illusory. The preparations were very weak, insufficient and superficial. At last, the government came under the violent pressure of business community and postponed the implementation of VAT until November, 1998 in order to make full preparations and resolve the unsolved issues.

In 1997-98 budget, the government announced a 20 percent sales tax rate for the non-registered importers against the 10 percent rate for registered ones. This was clearly a step towards the introduction of VAT. This caused much resentment on business circle and business people very actively opposed it. In August 1997, the government issued a notice that the VAT would be implemented from the third week of November 1997. A Final battle was started between the government and the business community regarding the VAT. The business community called several programs in the protest against VAT. There were several 'bandh' programs and businessmen did not open L/C and stopped imports. They did not release their merchandise from the customs. Meanwhile, the business community splitted into two part's, a major part headed by Federation of Nepal Chamber of Commerce and Industries came to support the tax. Finally, a point of compromise between the pro-VAT and anti-VAT sides was reached when the government set up a Task Force including .the representatives from the private business sectors. It was agreed not to start any procedures for implementing VAT unless the Task Force resolves the basic issues preparing a good environment for the implementation of the new tax. However, the government did not allow any flexibility in its schedule and registration for the VAT is started from the third week of November 1997 whereas the actual collection of VAT is actually started from the third week of February 1998.

CHAPTER V

ISSUES AND OPTIONS IN THE APPLICABILITY OF A VAT IN NEPAL

Value Added Tax is a superior tax with many good features as well as theoretical merits. But it would be wrong to pursue one to believe that the VAT is the best tax, which has no drawbacks. Like other taxes, the VAT may be problematic if accompanying factors are unsuitable. The actual implementation of VAT in many developed as well as developing countries shows that the VAT is bound to fall well 'short of the theoretical ideas; there are many difficulties in applying the full VAT principle to reality. The VAT is not free from practical drawbacks and controversial elements arising a number of problems.

One of the most important controversies as regards VAT is whether the tax is applicable to a country. The applicability of VAT depends on administrative capability, stage of economic development, and other special factors. In-the context of Nepal, the main issue of implementing VAT is its applicability issue. Implementing a VAT in Nepal may arise a host of practical difficulties making the VAT inappropriate or less applicable. Problems may also rise further as the side effects of implementing the VAT.

The main purpose of this chapter is to provide an ex-post evaluation of the success of a VAT in Nepal by examining the various applicability issues of the tax: And to suggest some options that could be helpful to fiscal planners to make the VAT effective and successful. The approach mainly followed for the analysis is "viewing the tax from the side of taxpayers"

6.1 SMALL TRADERS

The challenge of the small traders is one of the most prominent issues of the applicability of a VAT in Nepal. The trading activity of the country is dominated by small traders, which include most of the retailers, artisans craftsmen, street hawkers and seasonal traders. They are scattered throughout the country including rural and remote areas, which makes it difficult to bring them into tax net and govern administratively. But bringing the small traders, which include most to the retailers into VAT net is essential for many reasons.

The VAT is collected right from the manufacturers and the collection process is completed only when the retailers collect the entire amount of tax from the answers. The inclusion of retailers makes crosschecking before the retail stage feasible because there is a sale and purchase records, and the retailers claim credit or his purchase. Inclusion of the retailers is also important for widening the tax base and increasing revenue yield. On the other hand, if retailers are excluded; evasion is made easier (by adjusting margins between wholesale and retail activities) for a sector that represents and substantial element of the total value added in the economy and more significant revenue loss may result. It also requires higher tax rates to derive the same revenue (Tait, 1988:110). It is, therefore, very essential to include the small traders or retailers into the coverage of VAT to achieve the theoretical as well as practical advantages of the tax.

The inclusion of all small traders into the coverage of VAT is, however, virtually impossible because of the administrative and tax compliance problems. For a VAT, the tax administration and taxpayers must meet

some essential pre-requirements and reach a certain level of ability. The inclusion of all small traders into the coverage of VAT arises many problems for both tax administration and small traders themselves. For the tax administration, the problem is how to handle the small traders as taxpayers with minimum cost and adequate efficiency. The problem of small traders as taxpayers is how to comply with the VAT with no additional burden and bad effects on them. If it is for this reason, the effectiveness or success of VAT depends on how far the small taxpayers are handled with relative ease.

The root cause of the problems of small traders is the problems of record - a basic prerequisite for a VAT. Small traders are engaged in making transactions with no systematic - written records: goods and services are freely sold or purchased with no invoice issued and entry in account books. The small traders keeping no records are the function of many factors. Firstly, small traders are the traditional type of businesses with no practice of record keeping. Secondly, most of them are illiterate and ignorant about modern record keeping. Thirdly, their scale of operation is usually so small that there is no need of record keeping. Fourthly, the important factor is small traders are self-employed business where family members are engaged in making purchases and sales, and there is no need for issuing invoices and keeping record of their each purchase and sale.

Even though there is no practice of record keeping by small traders, it is important to consider whether they are able to maintain the essential records required by the VAT if they are asked to do so. In the VAT, the taxpayers are, as a minimum required to record and file their all purchase invoices, sequentially number sales invoices, normal accounting record,

and a VAT account in a readily retrievable fashion. They have to submit the tax return every tax period. But most of the small traders are illiterate in Nepal. Seeing the level of literacy and knowledge about record keeping, the small traders can hardly be expected that they would be able to keep records. Rather, their scale of operation is very small, small turnover, low margin and low profit. Their scale of operation and income do not permit them to make any special expenses for tax purposes, such as hiring an extra manpower, devoting extra time and incurring stationary and other costs. The continual process of record keeping, filing tax return, paying tax, dealing with the administration, and suffering administrative hassles would be a big cost for the small traders, which may ultimately lead them to close their doors or find a way to escape the burden of tax totally.

Problem equally arises also in the administrative front. Inclusion of small traders into the tax net of VAT would result in an all at once and considerably increases in the number of taxpayers. It cannot be expected that such a weak tax administration of Nepal would handle the situation. The number of taxpayers may alone be a headache of the administration. Further, registration, accepting returns and their verification, taxpayers' service, control of evasion, inspection auditing, etc. pose many problems for efficient administration of the entire tax system. Even if the administration is an efficient one, the control of such a large number of taxpayer which is fairly dispersed throughout the country in small market and town, seasonal markets, village shops and markets in remote areas are a formidable task for the administration.

J **Granting Exemption**

The administrative as well as tax compliance problems of small taxpayers have made it necessary to derive various ways to deal with the small traders. Among them, perhaps, the best possible device for Nepalese context is granting exemption to the truly small traders. This method was originally practiced by European countries and later has been used by several other developing countries.

Exempting small traders includes fixing a threshold limit indicated by a specific amount of annual turnover, exempting the traders whose annual turnover is below the threshold limit and requiring all other traders to comply with the regular VAT system. Fixing a threshold limit is, however, an important issue in designing a VAT in Nepal. There is no idea how to fix and what criteria to follow in fixing the threshold limit. One criteria to this purpose may be that the threshold limit should be fixed in such a way that all the larger businesses including larger retailers are included into the tax net so that there is no substantial loss in revenue. But fixing the threshold limit in such a way becomes arbitrary in several respects, and it does not serve the desired objective of fixing it.

The tax administration does not have any records or data of the larger businesses and their annual turnover. It is difficult to know that what the annual turnover of the so-called larger businesses is. The businesses themselves do not keep any exact record of their annual sales and, if they do keep, they would not reveal it. It is also very difficult to know whether the "larger" businesses are defined by the threshold limit do really fall into the taxable businesses. Any arbitrary figure fixed as threshold limit is bound to be too low or too high. There is no certainty that traders above

the threshold limit or so called "larger" traders can easily comply with the requirements of VAT with no extra costs or burden on them.

Fixation of an arbitrary threshold limit may have further undesirable results. Since the administration does not have the records or estimates of the number of potential taxpayers above the threshold, the number of legal taxpayers above the threshold limit may be so large that handling them may become beyond the capability of existing administration. This may lead to a state of anarchy in the tax system. Many legal taxpayers may fail to register, many of the registered taxpayers may fail to file the tax return and pay tax, many of the taxpayers who make return may fail to make correct return, administration may fail to check verify the return_ cross check, detect the non filers. inspect and audit in large scale: and. tax evasion may be large and wide spread.

Adoption of any other way other than granting exemption of the treatment of small traders is neither feasible nor provide attraction at least in the initial years of the introduction of the VAT in Nepal.

J **Taxpayers' Identification**

Even though the threshold limit is fixed either by employing any criteria or by arbitrary manner, problems still remain as how to identify the businesses whose annual turnover is above the threshold limit. In the case of existing taxpayers under sales tax and other businesses who keep systematic record of their transactions. there may not be any problem. But in the case of businesses. those who have become new taxpayers, the problem is really tough. As VAT would bring many of the retailers into tax net, it would be very difficult to know which of the trader is legal

taxpayer and liable to register under the VAT. There would be no strong evidence to show that one should register, and tax administration cannot compel them to register without any evidence or record. Voluntary registration cannot be expected since there may not be any strong incentive for all traders to do so.

It is most possible that many of the legal taxpayers would try to escape from the VAT. They would not show any actual record even if they have. Instead, they would show a false record underreporting their turnover. They would pretend to have a small business, circumscribed by losses. Many of the legal taxpayers would, therefore, be able to avoid registration.

Another notable fact is that traders are dispersed in main markets, sub-markets, etc. The traders making turnover above that threshold limit may pass unnoticed because they are in inner and narrow streets or far from the main market areas or in rural or sub-urban areas or they have smaller looking unattractive stores. By contrast, the traders in main market areas, with small but attractive stores would catch more attention of tax persons even though their turnovers are below the threshold limit.

) Further Implication's

Challenges are not settled yet even though the threshold is fixed, and all the legal taxpayers have been identified and brought into the tax net. There exists a large inconsistency and challenges are further arising. Due to exemption granted to the small traders, two kinds of traders (taxed and exempted) exist in practice introducing some sort of discrimination. The traders who are registered have to comply with the VAT: they should

challenge invoice of their' each sale showing the amount of VAT paid by the consumers. Keep systematic accounting records of their all purchases and sales, they have to file monthly returns and make VAT payment. For, this they would have to devote extra time, incurs extra expenses (perhaps hire an accountant install a computer or incur at least stationary costs). Moreover, they would be subject to frequent inspection by tax inspectors, checking and auditing by the tax inspectors. Their goods would be a bit costly; they would have to quarrel with the consumers who do not want to receive bills and pay VAT. But he exempted traders. who may be existing by their sides and selling same types of goods. would have to do none of these formalities done by the registered traders. Besides. the unregistered traders would sell relatively cheaper goods because their sales escape tax at least by their own margin. The consumers might be reluctant to go the registered shops not only because they have to pay higher prices for goods but also because they may be hostile to the VAT and reluctant to pay any extra amount as tax. In such a way. VAT favors the exempted traders and discriminates against registered ones.

A trader who h-as just reached the threshold limit incurring all compliance costs and other problems. whereas another trader whose turnover is slightly lower than the first mentioned trader and. therefore, below the threshold limit is let free of all the costs and problems seems clearly discriminatory. It is difficult for a registered trader to compete with an unregistered one because competition does not occur on equal footing. In high competition, the registered traders would have to pay VAT and incur other tax compliance 'expenses by cutting off their profit margins, which would badly hit their business. In such a situation the

registered traders have only two choices: one is to split their businesses and go below the threshold limit for which they may use illegal means: others to close the door.

Medium scale self employed retailing or other business activities would be worst hit by the VAT. There are four problems that medium scale trading activities would face under the system of VAT. They are:

- (1) The prices of their sales would be relatively higher than that of exempted sellers. This would lower their competitive position in the market. They would lose more consumers also because they change VAT, which may not be digestible to the consumers having low level of civic consciousness.
- (2) They would have to incur various costs for tax compliance and devote extra time for VAT.
- (3) They would have to give a fine clearance to income tax as well because VAT registered traders would also attract income tax personnel due to the availability of clear records of their businesses.
- (4) They would be subject to inspection and checks by tax inspectors. audit trails, suspicion by administration and more other administrative burden and hassles. Tax officials may tease them threaten them and take unnecessary advantages from them.

Under these circumstances. the medium scale VAT registered traders. on the one hand would have to compete with the exempted traders existing by their sides and bearing neither of the problems listed above and on the

other hand. with the big business houses having large scale of operation, economy of scale and who can maintain the tax compliance with low, reasonable cost and relative ease. The market conditions would not allow the medium scale traders to shift the tax compliance costs forward, and backward shifting would make it impossible for them to stand in the market.

Further consequences of such problems may be split in businesses and establishment of dummy businesses. Traders may employ other illegal means to escape from VAT, such as bribing the tax officials. Problems of such traders may broaden the scope for illegal activities and corruption.

Issues and options

1. Small traders should be exempted initially. Other ways of treating small traders may be adopted after some years of experience _with VAT.
2. Before fixing a threshold limit a survey of the number and turnover of new (potential) taxpayers should be conducted. After estimating the number of potential taxpayers and their annual turnover, the threshold limit should be fixed. at the point so that the number of additional taxpayers could be handled by existing administrative strength with relative ease and efficiency. The threshold limit can be lowered in the following years as the administrative capability gradually increases.
3. To fix the threshold limit, it would be better to follow the administrative approach. For this, first, the administrative capability should be assessed as how many new taxpayers can be

dealt with existing administrative power. After that, following opportunities 2, the number of additional taxpayers that are likely to come under VAT and their turnover should be assessed. The threshold limit should be fixed at the point where administratively required number of taxpayers is equal to the actual number.

4. The data of the turnover of the businesses those are not under the present sales tax can be found from a number of sources. The existing income tax and import tax records are the most important sources for that. Besides, information may be found from advertisements, business yellow pages, department of 'Industries and commerce, trade licenses; registration in various trade associations, records with business organizations, etc. In addition to these, field survey can be conducted to estimate the correct number of potential taxpayers.
5. Businessmen, various trade groups, and their associations and organizations should be consulted and their opportunities should also be considered in fixing the threshold limit.
6. In lowering the threshold limit in future, the revenue generation from small traders should be weighted against the administrative costs in handling them and an optimal point should be reached. It is because the very small traders like small retailers are not very significant from revenue point of view, omitting the smaller ones does not make any larger difference in revenue collection.
7. It would be advisable to require the traders who have fixed location but are not registered as taxpayers to submit a provisional

statement of their annual turnover and expected future turnover. The provisional statement submitted by the traders may be very useful in lowering the threshold limit and identifying the taxpayers in future.

8. Sellers of some specialized items such as cement, furnishing materials and services, electric goods, electronic goods, watches, beverages, PCOs, photo goods and services, etc. who issue invoices of their products and who are able to maintain records should be compulsorily registered regardless of their turnover after some years of experience with VAT. Coverage of such goods should, be increased annually.
9. Another method for treating the small traders may be to require all the traders having fixed shops. Such traders should be given a special registration number and be required to take invoice of their each purchase and keep the invoices in a file. The tax inspectors should be made able to check their purchase invoices against their stocks. Such taxpayers should be required to submit their purchase records to the tax office every six months. A turnover tax or VAT may be levied on such traders by adding certain mark-up to their purchases. This method may be used to abolish the tax preference to the 'Small traders after some years of experience with VAT and such trader may ultimately be treated as regular VAT payers.
10. There is another method that can be adopted for abolishing the tax preference to the small traders after some years of experience with the VAT. This method includes the application of a higher rate or the application of same rate after adding a certain mark-up when

the wholesalers or dealers sell goods to the unregistered traders. The unregistered traders may be given special identification numbers.

11. To increase registration, the registration program should be launched as a campaign. Strong notices for the registration should be widely disseminated with strong warning of penalty for non-registration. If any case of non-registration is found, this should be severely treated with greater publicity among other traders so that it may act as a deterrent to others.
12. Simple accounting system should be devised for the small taxpayers. Tax return forms should be simple, they should not demand the information that cannot be easily calculated and that is not necessary.
13. Incentives for the taxpayers should be devised as far as possible. Small traders may be supplied account books and purchase books free of cost if they demand. Tax rebate of a certain percent of their tax liability may be allowed as compensation to the compliance cost of the taxpayers.

6.2 BUSINESS STRUCTURE AND PRACTICES

Value Added Tax is considered not ideal for all developing countries. One of the basic causes for such consideration is that the business structure and practices in many underdeveloped countries is not modernized, which makes a VAT inapplicable or unsuitable to those countries. Considering an economy where larger sector of economic activity is not monetized, where barter system is more prevalent, where

self employed' small scale agriculture is dominant, any modern tax like VAT has a very limited use in such an economy. According to Carl Shoup, a country is better to rely in other forms of sales tax other than VAT where foreign trade plays a minor role; retail trade is fragmented among very small sellers; vertical integration of producers, manufacturers, wholesalers and retailers: basic accounting is not widespread. Shoup also suggests that if the fragmentation of retailers is the only feature discouraging use of VAT. Single stage taxes might be superseded by a pre-retail VAT one that covers all firms except retailers (Shoup, 1988:151).

Well-developed market structure and distribution channel are necessary for the applicability of a VAT. Further, accounting and literacy come to forefront. The state of helplessness portrayed by the lack of accounting records and literacy has persisted in the evaluation of third world tax system for the best part of 40 years (Terkper, 1994: 22). The degree of compliance and cost of administration also depends on whether businesses are accustomed to keep good accounting records, on share of business activities carried out by small businesses and on the existence of modernized distribution system.

The Nepalese business structure and practices, which are not so modernized, becomes an important challenge as whether it is suitable for the applicability of VAT? The lack of systematic record keeping in many parts of the Nepalese economy would make administration difficult and evasion easy. Controlling the illegal activities becomes almost impossible in a situation where the distribution channel not fully or even largely modernized. The problems of large informal and traditional type of

business and other economic activities should not be underestimated and they should have a due solution before implementing a VAT in Nepal.

- **Business Structure**

The problems of implementing a VAT due to the, underdeveloped business structure and pattern have been summarized below:

- i) A VAT is an account-based system. It cannot be applied unless the business enterprises keep systematic records of their purchases and sales and issue invoices of their sales. In Nepal, a large portion of business activities are concentrated in the informal sector, where traders do not issue invoices of their sales and do not keep systematic records of their transactions. It is, because, the trading activity is dominantly shared by small and medium scale traders. Almost all of such trading entities are self-employed where family members are engaged in making transactions. Keeping account and issuing invoices is felt not necessary as all the purchases and sales are handled by the owners themselves and transactions are made in small scales. Consumers also do not insist on taking bills of their purchases. Another reason for not keeping accounting record is illiteracy and lack of knowledge about modern record keeping. Many of the traders are not able to keep systematic records by themselves and they also cannot hire an accountant for that purpose since their small scale of operation does not permit him to do so.
- ii) The distribution channel is not well-developed and specialized in Nepal. Goods are not always supplied in a same established

pattern. Manufactures sometimes sell goods directly to the retailers or consumers also. A same person sometimes acts as an importer, wholesaler and retailer and also as an industrialist-cum-trader. There is no clear line. which divides the various stages of the distribution of goods. For example, it is difficult to distinguish a wholesaler or a retailer as the same person performs the both jobs. A same person performing several jobs poses serious problems in determining or checking his purchases, sales, trade margins, value added and tax liability. This may further arise several technical as well as practical difficulties in the operation and enforcement of VAT giving chances to the creation of loopholes for the leakage of revenue.

To illustrate this point, let us assume that a businessman acts as an importer, exporter and producer. He imports and produces goods and sells in the market. He exports some portion of his products. In the case for imports, his valued added may be lower but in the case of his own produce, his value added may be higher: In this situation, the traders may mix up some of his manufactured items with his imported items, show low value added and lower tax liability. The tax officials, those are not efficient ones may find it very difficult to segregate which of his sales are imported and which are his own products. Further, the businessman may overstate his exports and fraudulently claim additional money to be refunded.

As there are many difficulties in extending the VAT to the retail level (explained in small trader's problems), limiting VAT to the

pre-retail level also arises numerous problems as retailers and wholesalers cannot be distinguished.

- iii) As indicated earlier, most of the business activities particularly retail trade is concentrated in the hands of small traders. There are a larger number of petty vendors, street hawkers and seasonal traders. Extending VAT to cover such small traders is almost impossible. Exempting small traders excludes a large portion of retailing activity from VAT base, which is undesirable.
- iv) Nepalese business sector is also not well organized. Small traders who dominate the business sector are scattered throughout the country- in rural, mountainous and remote areas. There exist many small market towns and seasonal markets all over the country. It is very difficult for the tax administration to have a physical access to each market place. It may not be possible and worthwhile to set a tax office in each of the market place. A tax office located in the district headquarter cannot control all of the trading activities in the district. In some districts, it is difficult to set even a tax office due to geographical conditions, lack of transport and communication facilities, high cost, etc. Implementation of a VAT in such an environment may be a very difficult task.
- v) There is no fixed pricing system in the market: price varies from market to market, shop to shop and from day to day. Prices of some products especially of imported goods are determined by bargaining. There is also a frequent price fluctuation. But for a VAT to be applicable there should be uniform price of the products in the market. Otherwise, the profit margins and value added of

different sellers would appear different which is very suspicious for taxpayers. Some sellers selling the products with high prices and some with lower prices would create many doubts and pose many difficulties to the administration for its verification. Varying price would create the scope for the dishonest traders to show the prices of their sales lower than they are actually sold in and lower their tax liability.

J **Business Practices**

The prevailing business practices unsuitable for VAT in Nepal are summarized below.

- i) Trade between Nepal and Tibet is based on barter system. There is no purchase invoice of goods from Tibet. Difficulties arise to levy VAT since VAT is based on an actual invoice price.
- ii) Credit sales are prevalent in a large part of business activities. Traders supply goods collected money after the goods are sold by their purchasers. But in a VAT, an invoice must be issued showing VAT when the goods are handed over to purchasers. It means that the VAT liability is created when goods are handed over and the tax should be collected in tax office within a month. Selling goods in credit and paying VAT in cash would be inconsistent for the taxpayers and this would hamper their trade to the extent they supply goods in credit. If a provision is made in VAT regulation for the sale in credit, it would create a scope for a delayed VAT payment because each taxpayer would try to show that he has sold in credit and get interest benefit of the tax he has collected actually.

iii) Problems also arise in the case of sale in loss, damaged goods and returned goods. In some cases, traders have to sell goods even in loss because of rapidly changing market conditions. Similarly, if the goods are damaged, they are sold in loss. In both situations tax liability is lower than tax credit and condition of tax refund arises which sounds surprising. If the sale in loss is not recognized in tax rules, it would be unjustifiable. and if it is recognized. it would create further problems such as creating loopholes for tax evasion. burden on administration. Some dishonest traders would try to show that they have sold in loss and claim tax refund or high tax credit.-Due to the absence of effective tax machinery, such a practice cannot immediately be investigated and checked. The authorities would have to verify the sales in loss. This would on the one hand. be very burdensome and raise the tax compliance cost of the genuine taxpayers. On the other hand, would provide a way for tax evasion, corruption and other malpractice both dishonest taxpayers and tax officials.

Further, goods once sold may be returned due to trade reasons. How to deal with the returned goods, which already bear VAT, is another practical issue in the operation of a VAT in Nepal.

iv) Prices of some goods are highly flexible at present. Because of high competition traders sometimes sell goods with very low margin and consumers highly benefit. But under VAT, prices tend to be rigid because of a fixed mark-up allowed or prevalent. Traders cannot so goods at lower prices even if they wish to do so. But they may have to sell at lower price than allowed because of

high competition. To compensate this, the traders may hide some of their turnover.

- v) In VAT, value added by a trader is a trend make-up or a margin, which is more or less fixed. But for some traders, the operation cost of their trading may be higher because they incur some special expenses. For example, specialized lighting system in their shops, furnishing cost, packaging cost, high rent, etc. Such expenses are not recognized in a VAT and the trader cannot cover such expenses by shifting them to the consumers. If the traders add these costs to the price of their sales it would show higher value added, higher profit and higher income tax liability as a consequence. Since their additional special expenses are not recognized, the traders would hide some of their sales and evade tax to cover their special expenses.
- vi) Problems are also created by mixed sales. Many traders sell both VAT-able and non-VAT-able goods from a single shop. They may sell both goods at a time. This creates a problem for separating the taxed and non-taxed goods. It may also make difficult to determine the annual turnover of traders in taxable goods.

Issues and options

1. After the threshold limit is fixed, it would be better to increase the coverage of VAT by extending the tax to the traders of some specialized items regardless of their annual turnover.
2. Voluntary registration should be encouraged through devising various incentives to the taxpayers. Such incentives may include

purchases by governments only from registered sellers. tax rebates, as compensation to compliance cost. etc. Incentives should also be provided to the consumers to take invoices of their purchases. Incentive to the consumers may include public awareness programs on media, a monthly, lottery system in the tax invoices, etc.

3. Simple tax return forms and simple accounting system should be granted to the small taxpayers.
4. After some years. the tax preference to small traders should be abolished either by treating them as special taxpayers or by adding a mark-up to the sales to the unregistered traders.
5. A technical database should be prepared, revised and updated in regular way for the administrative purpose. The technical database should include import prices, manufacturing prices and market retail prices of the various products and also their prices at different trading stages, transportation costs to various places, change in prices. quality differences, etc.
6. Care must be taken while dealing with a less clear or unspecialized business like a manufacture-cum-trader or a wholesaler-cum-retailer. A complete investigation should be made if there appears any suspicion in such cases.
7. Sale in credit should not be allowed. Sale in loss should be partially allowed. A detailed inquiry should be made if any case of serious damage or loss is reported. Small damage and loss should not be allowed for.

8. It would be better to require the importers and manufacturers to fix the maximum retail price of their sales so that misappropriation may be reduced due to more transparency in business activities.

6.3 TAX ADMINISTRATION

The saying that tax administration is tax policy in developing countries also hold true in Nepalese context. Administration issues are the most important issues of the applicability of a VAT in Nepal. The success and effectiveness of a VAT in Nepal. depends on the extent the administration is strong enough and capable for an effective operation of the tax.

It is often seen that when there is a talk of any new tax or tax reform. the various merits of new tax are emphasized in loud voice whereas its administrative aspect is often overlooked. Tax reforms are emphasized such that they would work wonders if properly implemented, but will fall apart or produce poor or perverse results if poorly administered. But there is all likelihood that such reforms are poorly administered and fell to achieve what is desired. Taxes on personal expenditure and wealth. European style value added taxes. elaborate taxes on the potential income of agricultural land-such cleaver ideas tend to come crashing to earth when put into place with usual inadequate administration in poor countries (Bird, 1990: 266). It, means that any tax in developing countries should be designed in such a way that it can be administered with existing administrative capability. In this regard, Shoup suggests that in a developing country. still at an early stage of development where most business activity is fragmented among small firms, a turnover tax may be preferred on administrative grounds: if only retail trade fragmented. the value added technique may be applied in a less than comprehensive

manner to affect only imports manufacturers, extractive industries and perhaps wholesalers. This kind of VAT may be planned as temporary measure to be expanded to the retail sector within a few years, if all goes well (Shoup, 1988: 149).

The administrative difficulties seem to be the greatest hindrance for the feasibility of VAT in The VAT as a modern and complex tax cannot be implemented without an efficient and modernized administrative set up. In the absence of technically competent, Honest and dedicated administration, the VAT, though it may be a good proposal, cannot be brought into being. But the tax administration in N--pal is very weak reflecting the condition of the country itself. What is worse is the existing sales tax administration, which is planned to administer the VAT; is most neglected and weakest of all. In such a situation, the expected smooth working of VAT becomes really a myth.

The various aspects of administrative ability are examined in the following subsections.

J Past Experience and Credibility

It is crucial to examine the ability of Nepalese revenue administration in terms of whether the administration has been successful in handling various taxes in the past. The past record of the administration may be a mirror to see what may happen in a VAT in future. Past records show that the revenue administration has mostly failed to fulfill the administrative requirement for various taxes and the expected outcomes of various taxes relating changes remained only on paper. Due to its past records, the administration has lost its credibility and it is very questionable that

future would not be so.

One of the most striking examples of administrative inability in the past is the failure of self-assessments system (SAS). which was a modern a highly praised system. Even if the government has given some incentives (e.g. 3 percent rebate for accounting cost) nobody voluntarily went to the tax office and pay tax. The main cause of the failure of SAS is weak implementation and administrative hassles. The taxpayers who voluntarily complied with the SAS had to face bitterness with the tax personnel. The taxpayers were treated badly in the tax office. Though it was a self-assessment system, the assessment made by taxpayers was never approved and their accounting records were not verified. Such a bad treatment to the taxpayers caused much resentment and taxpayers did not co-operate with the system.

Some other existing taxes have not effectively been collected. Rent tax is now levied with 15 percent but it is never collected effectively. Many people do not even know if there is a rent tax. Similarly, the collection form existing house and land tax is less than 50 percent of the total estimated.

Another striking example may be found with income tax collection. Despite the last 50 years of collection experience and much of the government's attention focused on streamlining the income tax administration, there is no expected progress; the income tax administration is still a poor, backward and ineffective one. Many bad tendencies appeared in the past in the collection of income and other taxes. The taxpayers had to establish a relation with the tax personnel in the tax office to pay their tax liability. Taxpayers were often badly treated

and many times taxes were forcefully collected. The tax officers' power of making arbitrary decisions was widely misused and taxpayers were made helpless.

The government has also failed to fulfill its commitments made in the past. One of such commitment was duty draw back. It was said that duty would be refunded within 60 days, but businessmen complain that even after three years it has not been refunded yet.

Due to its failure of effective implementation of various taxes and fulfillment of commitments in the past, the revenue administrative lost its credibility. However, the credibility is an important factor for the implementation of a new tax and its effectiveness. No amount of tax reform, rationalization or simplification can substantially improve tax compliance unless there is substantial improvement in public perception regarding the efficiency, technical competence, integrity and ability of tax authority to relentlessly pursue and punish tax evaders without political or other interference (Government of India, 1991:126). If the taxpayers do not have any faith in administration and think that the new scheme is not likely to succeed, it has a very bad implication for a new tax and its effectiveness. Regarding its past records, it is very much doubtful that the administration would better implement a modern and complex tax like VAT.

) Preparation

The question of preparation also assumes greater importance especially for increasing implementing capability of the administration. Widespread and in depth preparation is necessary for a successful implementation of

the VAT in a country. In terms of complexity of development, the demand for human resources and the impact that it will have on society the implementation of VAT can rank as one of the most significant development projects undertaken by a country. It will certainly be one of the most demanding projects managed within the revenue services and if mismanaged could seriously disrupt the operation of entire department (Holland, 1991 a: 18). For this reason, the aspect of preparation should not be underestimated.

But we have a bitter reality that many government policies in Nepal are implemented without proper consideration and preparation. This has often been one of the causes of the failure of such policies. Regarding VAT, the case is more or less same. The preparation for a VAT is very weak. The government also does not seem serious about it. The responsible persons in the government and its department badly suffer from the lack of knowledge, motivation and responsibility. For example, the government set a Task Force for making necessary preparations for the introduction of VAT. But the Task Force could not show its existence and role for making such preparations. It is said that the Task Force did nothing except holding few meetings.

Introduction of the VAT needs a fresh start. But the government is still suffering from old mentality. It is moving on the surface. No serious in depth attempts have been made for solving the grass-root problems. There is only a lecture system- preparation is confined only to giving lectures.

Many challenges regarding the design of VAT and its implementation have not been solved. No satisfactory way is devised for the treatment of

small taxpayers. Threshold limit is arbitrarily fixed. Precautionary measures have not been taken to lesson the possible adverse effects of VAT. No criteria are developed for the identification of taxpayers and bringing them into the tax net. The problem how to increase tax compliance and prevent evasion in the VAT remains the same. The administration seems giving no attention the development of a good information system, technical database and inspection and audit system.

A one sided preparation or preparation only by the government is not sufficient for VAT. Preparations by the businessmen who are the tax collectors and preparations by the ' consumers are equally important. The consumers and businessmen should be equally prepared mentally and physically for a VAT Preparation- whatever there is - is limited to the government's side. Taxpayers and consumers are given no attention. Consumers are fully ignorant and they are not made conscious about the new tax.

The role of private sector is important in making preparation for a VAT. But the private sector is somewhat neglected in the decision-making and policy formation process. The private sector is never taken into confidence regarding VAT. The involvement of private sector in the formation of rules and regulations and in solving basic issues is neglected. Instead, a situation of a direct confrontation with the private sector is created. The negligence and non-involvement of private sector in VAT implementing process may have serious consequences.

J **Capability**

The challenge of administration mainly centers on the administrative capability of implementing a VAT. Unless the administration is strong enough to administer the tax the theoretical merits of the VAT do remain only on paper. Administering a VAT is possible only when the administration has achieved a certain level of efficiency. Besides the high level of efficiency achieved by the administration the capability for administering a VAT efficiently is the function of a number of factors. One group of factors includes the , structure of VAT and another group of factors is external factor such as economic environment and business structure. These groups of factors are discussed elsewhere; here we consider the factors which are specific to the tax administration.

Some of the basic requirements for successful administration of a VAT are as follows:

An appropriate taxpayer identification system, a simple VAT return form which does not request information that can not be processed untimely fashion: an effective tax payer assistance program; a reliable electronic data processing (EDP) system, which provides accurate and timely information; systems for cross-checking information in VAT returns with information for other sources to detect underreporting; an enforcement system that applies different strategies to different kinds of non-compliance; and, finally, a sound and effectively applied penalty system. However, the present administrative short of these basic requirements, the administrative structure designed to meet some of these requirements becomes non functional as there is a severe lack of knowledge experience

and efficiency.

The lack of adequate personnel training is one of the weaknesses of the tax administration in Nepal that adversely affects the efficient administration of the whole tax structure, especially the implementation of any new tax scheme. The problem is more serious for a VAT as VAT is a new concept for Nepal and there is a severe dearth of knowledge about the concept, working and operation of the VAT. Efficiency comes from skilled manpower, proper management, honesty and dedication. But all of these factors are severely lacking in present administration. Administrative management is often motivated -by political and money consideration. Even competent; dedicated and honest tax officials- and it is amazing how many of them there are - can seldom do their jobs properly, for lack of political support on the one hand and minimum resources needed on the other. Frequent political interference and undue transfers further reduce efficiency of the administration.

VAT has a very complex operation relative to the present sales tax. It includes a large number of taxpayers, many of whom are difficult to deal with, and this alone is the vast additional burden on the administration. Further, the administration has to be very clever in controlling the tax collection such as identifying non-filers, underreporting; and excess credit claim, over refunding and other various tax frauds. The failure of effective tax control leads to wide spread drainage in tax revenue. Such an effective controlling demands greater expertise and capability, which is rare in present administration due to the lack of proper planning, training and experience.

An effective inspection and audit system is very much required for

preventing revenue leakages in a VAT system. But this function is severely limited by the scarcity of capable and trained personnel. As much of the administrative work would be devoted to the daily problems of collection, appeals and other matters, only a small portion of trained personnel would be free for inspection and audit work. The present trend show that the inspection and audit by many of the tax officials would be guided by the money making concerns due to the absence of tight control and supervision of the staff.

The self-policing mechanism of VAT, which is expected to improve the, administrative capability, is not workable in our context. It is effective only in an economy where the levels of distribution are many and traceable, the record and accounting system is well developed, and auditing is carried out in a large scale. None of these conditions are satisfied in Nepal. where the channels of distributing are limited and less traceable, in several cases commodities are sold by the producer, directly to consumers; the record and account keeping system is very poor even among big vendors; tax auditing is not carried out by the tax administration; and taxable value is not reassessed even if it is found to have been underestimated considerable (Khadka, 2004: 90). Under these circumstances if poorly administered, a VAT would invite several •ill tendencies in Nepal. It may lead to an anarchy in Nepalese tax system.

J **Corruption**

The applicability of a VAT in Nepal is further hindered by the existing wide spread corruption in the tax administration. Not only is the tax administration, the whole political system corrupt in Nepal. We can see many corruption charges even against government ministers daily in

newspapers and such charges get tacit consent as there is seldom refusal of such charges. Corruption as an existing reality in Nepal has become an obstacle to country's economic development. Corruption is politically protected and institutionalized from top to bottom level. If the country is sea, of corruption, as some are, the tax administration will not be as island of incorruptible, and it is foolish to pretend it is (Bird, 1990: 266). Nepalese tax administration also inevitably reflects to a large extent the nature of country itself.

The whole administrative set up in Nepal is full of corruption. It is frequently complained by all that there is no work without bribe. How to make money is main work motive of many government employees from top to bottom. Revenue administration is even notorious to this regard. Many businessmen said the tax officials often taught them how to corrupt them and evade tax. It is also said that there is a strong nexus between smugglers, and high-level government officials. They bring goods from various trade entries to Kathmandu by bribing police, employees of municipalities and-politicians and share the large profit.

The Corrupt nature of tax officials may well be seen in the sharp competition among them to get transferred to the departments like income tax and customs where there are more direct contacts with the taxpayers and chances, of collusion with them are also more.

The corruption would greatly reduce administrative efficiency in the VAT. In addition adoption of a VAT would broaden the scope for corruption and malpractice leading to a substantial leakage of revenue. After all. if the tax implementing agency is itself corrupt and itself brings malpractice, there is no solution and everything goes wrong.

Issues and options

1. A high level VAT implementation team with a close co-operation with government departments should perform the task of implementing the VAT. The VAT implementation team should be a very active and effective one. It should include the 'representatives of various sectors with special preference to business organizations.
3. Tax administration should be kept away from political intervention and any sort of influences from the outside. Capable persons should be selected in the leadership of tax administration.
4. To increase the capability of administration training of tax personnel should be kept on the topmost priority. Training should be designed for various levels and purposes. General training for all and specialized training for particular persons and foreign training should be designed and provided. Foreign tax tours may be helpful in this case. Tax manuals and directions should be prepared specially and circulated among tax personnel.
5. A good working environment should be created in the administration. Reward and punishment system should be made effective. Tax officials should be encouraged to do better by providing them incentives like quick promotion: foreign training; etc. Tax officials should be well paid.
6. Taxpayers should be provided better services. Tax persons should be polite cooperating and quick in their works. A proper respect should be paid to the taxpayers. The taxpayers who are found

honest- and cooperative with the administration should be honored publicly. Such a program would raise the status of the taxpayers and establish their separate identity in the society. This may be conducive to increase tax compliance.

7. The use of discretionary power such as raid power by the tax officials should be limited. Tax officials should not be allowed to use such power unless there is a strong case to do so. Tax officials should always try to behave with the taxpayers on equal footing.
8. Tax collection and payment activities should be made transparent. Rules and regulations should also be made simple and unambiguous. The limitation of discretionary power and transparency in tax rule and tax collection activities would reduce the chances of malpractice.
9. There should be strong supervision of the tax persons who work in the field. Any misdeed should severely be punished.
10. A good co-ordination of the VAT department with the other tax departments should be established to facilitate cross checking of records to tax matters. A coordinated tax audit program carried out by both. VAT and income tax departments are very much desirable.
11. There should be a proper co-ordination of the activities between local VAT offices and head office. Duties should be clearly divided between local tax offices and the head office. A proper balance should be maintained in the working of VAT offices at the central and local level.

12. There should be a fully computerized operation with master file management and a single TIN. The TIN should be required to use for other purposes like bank accounts; purchase of capital, shares, etc.
13. Investigation branch should be highly strengthened and detection' should be made Very effective. A system to derive information from a number of sources should be developed.
14. Tax audit should be carefully planned. The audit campaigns carried out annually have a very little effectiveness in detecting substantial tax evasion. Their shock or surprise element is lost, unless they are done only in a small number of cases and are continuously carried out to through detection. No detection can be justified unless it results in the detection of substantial tax evasion and the case leads to successful prosecution of the guilty persons. To this purpose, the administration should have adequate expertise in this regard.
15. Extensive auditing should be carried out in larger businesses where revenue risk is higher. A general audit and desk audit should be designed for small businesses.
16. Collection of VAT through banking is an attractive opportunity to reduce the chances of administrative harassments on taxpayers and collusions between tax payers and tax officials.
17. A large publicity campaign should be launched before implementation of VAT. The publicity campaign should aim at educating both taxpayers and general public. The publicity program should include advertisements and information through

mass media, free distribution of pamphlets, booklets, etc. public discussion program; program and films on the television, etc. The goal of publicity campaign should not only be to disseminate the knowledge about the tax but also to make the people mentally prepared to accept the tax.

18. The cases of corruption and bribing should be strong controlled by an effective monitoring and evaluation system. Reward and punishment should be a main "motto" of operating the tax administration.

6.4 OPEN BORDER AND UNAUTHORIZED TRADE

Open border issues assume greater importance for the success of VAT Nepal. The long open border of Nepal with neighboring countries creates many problems for the tax system of Nepal due to the free movement of people and a large amount of unauthorized trade through the border.

) The Open Border Situation

Nepal has long open border with its both giant neighboring nations India and China. With China the open border is not a serious problem due to geographical inconveniences caused by mountain area. There is no easy pass through the border and level of illegal trade because it is negligible. However, the problem is alarming between India and Nepal, because there is no legal ban or passport system. People of India and Nepal; may easily enter into each other's nation. People of both countries often go to the border, towns of other country to buy goods because there is no need to pay customs duty for the goods brought for personal use. Goods

brought for commercial purpose' have to go through customs and pay customs duty as well as sales tax. ;

Since goods from India or imports from India have to pay import and sales tax,. The Indian products become dearer in Nepal as compared to Indian market. This gives two kinds of incentives: one is Nepalese consumers living near the Indian boarder go directly, to Indian boarder to purchase cheaper goods and second is goods from India are brought for trading purposes through smuggling giving rise to a large amount of unauthorized trade.

J **Level of Unauthorized Trade**

Although there is no any measurement of unauthorized trade between Nepal and ;India, it is generally agreed that such trade in the boarder area is considerab4. Many businessmen have claimed that only a little amount of goods from India come through custom. Some of them went as far to say that 90 percent of goods from India come via illegal channel. Others opined that the level of illegal trade is two or threefold than legal trade. It may be said that level of illegal trade is in large amount or say, equal to the legal trade.

To prove the level of illegal trade, there is no strong evidence as such. However, some observation may be made:

1. Corruption and bribery are wide spread and generally accepted phenomenon in Nepal. Tax department especially customs department is notorious for this. A sharp competition may be seen among tax officials to be posted to a customs point. It is generally seen that the officials who have once posted to the customs point

have buildings in towns. It is unbelievable to say that a customs officer has: not a cushy residence in a city. On the other hand, some businessman engaged in import business has changed to millionaire overnight. These are all attributed to the existence of large-scale corruption, bribery and unauthorized trade.

2. During the 1989-90, trade impasses between India and Nepal. India had sealed borders, and no Indian goods were legally allowed to Nepal. Nevertheless, there was no reduction of the supply of Indian goods to the Nepalese markets.
3. One of the main points of opposition of the businessmen opposing VAT is that VAT is not feasible due to open border with India and illegal import from India. They say if VAT is implemented they cannot compete with illegally imported goods or goods brought without repaying any tax. It has an implication that they are now able to compete which means they are also engaged in illegal, trade to compete with others. The illegal trade being impossible under VAT, their business dries. As the businessmen best know about the business situation, this is a strong evidence of the existence of large amount of illegal imports from India.
4. In Nepalese markets on border, the Indian goods may be found at the same prices as; in Indian border markets. It is possible only when goods are brought without going through customs.

Unauthorized trade is very much organized and systematic in the border area. There are many organized groups active on the both sides of the borders and these groups are responsible; for illegally supplying goods

from India to Nepal and Nepal to India. Trucks of goods are supplied without any hindrance. Some inhabitants of the boarder area are doing it as their profession. As they are accustomed with and aware of every situation, unauthorized trades more sophisticated than it is thought to be.

There are different forms of illegal imports. These are (a) hiding, (b) underreporting (c) under invoicing, (d) manual supply, (e) bribing, (f) luggage, etc.

The problem of illegal trade is great in Nepal. The government has not so far been able to tackle the problem, instead of being decreased, is ever increasing as there has been often said that there is an alleged contact of smugglers with high level government officials. The problem will not come to an end unless corruption is abolished in the country.

) Implications for a VAT

The existence of open boarder and unauthorized trade is a great threat to a VAT in Nepal. It would have many bad implications for the business activities as well as tax system in Nepal. Mainly, there would be two kinds of implications of the open boarder and illegal trade if VAT were implemented. Firstly, there is a possibility that the: level of illegal imports would decrease after the adoption of a VAT in Nepal. It is because there is a danger of being discovered when the goods imported illegally are sold through taxable channel. VAT registered vendors would not dare sell goods which bear no tax. To the extent VAT prevents illegal trade. Indian goods would be dearer in the Nepalese markets due to the :full imposition of import duty and VAT. Nepalese consumers living near the boarder area would prefer rather to go across the boarder than to buy

in local markets. This tendency would show for Indians in the Nepalese trade and revenue collection may not increase.

Secondly, it is most possible that the level of unauthorized trade remains the same even after the, VAT. It is possible due to the existence of exempted trade and weaknesses of tax administration. The goods brought through illegal channel may be marketed through small exempted shops. Even the registered traders may sell the illegally brought goods secretly without issuing invoice and showing in record. The illegal imports is unrecorded and such trade is difficult to catch by the administration. The administration is itself very poor and corrupt. Such administration can hardly be expected that it would be able to prevent such malpractice.

If illegal trade remains the same even after VAT, the genuine trade in Nepal would adversely affected and parallel economy would develop further in Nepal. The illegal trade would repeal legal trade and whole trade would tend to be illegal and black economy would develop further. This would also raise corruption, bribery and other malpractice.

It would be very difficult for the tax administration to check this, as the unrecorded trade does not have any purchase records. The self-policing feature of VAT and catch-up effect also would not work. Therefore, the open boarder and unauthorized trade is a great threat to the success of VAT in Nepal. Unless the administration is sufficiently story to check these problems. The possible merits claimed for a VAT would remain only on; paper.

Issues and options

1. Honest officials should be posted to the costumes points.; Boarder

patrolling to control the illegal activities in the boarder should be increased and made effective.

2. Tariffs should be reduced to discourage illegal imports. Tariffs should be reduced in Nepal due to this India also reduces them.
3. There should be a joint action by both Indian and Nepalese authorities to control illegal trade in the boarder area. Any action to prevent illegal trade should be closely co-ordinate with that of Indian authorities' actions.
4. The tendency of Nepalese consumers going to Indian, market should be discouraged.
5. Physical checking of warehouses and business inventories should be: increased to detect smuggled goods. Physical checking of lorries carrying goods ;on the roads would be highly effective for preventing smuggling. Secret information by the public about any tax fraud should be encouraged.

6.5 IMPORT VALUATION

The existing system of import valuation is an obstacle to the implementation of VAT in Nepal. Under the present system, the import duty is collected according a fixed price list of various goods prepared and periodically reviewed by the central valuation committee under the tax department for import duty purposes. The prices of goods determined for import duty purpose is considerably low than actual import prices, since imported goods are valued from only 15 to 50 percent of their actual prices.

The present system of under valuation provokes two sets of problems under a VAT. Firstly, since the value of imported goods is low the importers would pay low custom duty as well as VAT. When the goods enter into the market, they would be sold at their actual price - far higher than the price on which import duty and VAT is paid at the import stage. The consequence of this is that the profit margin of the importers would appear very large and there would be a considerable increase in their income tax liability. Secondly, if the goods were valued at their actual prices, the import duty as well as VAT on the goods would increase considerably leading to a sharp rise in the prices of imported goods.

The importer would be trapped between the two problems described above. If they let their goods undervalue, their income tax liability would increase sharply and they would be unable to pay such an unreal and undue increase in income tax. They would rather like to value their goods at actual price and let the price of their imports rise sharply upward.

J **Further Consequences**

The rise in import; duty and VAT liability and consequent increase in the prices of imported goods after a VAT in Nepal would have much further implication.

Firstly, 'rise in the ; tax liability of imported goods at import point would provide an incentive for illegal imports and tax evasion. Since a large amount of goods are coming form illog4l channel even at present. The imposition of VAT would add more attraction to it.

Secondly, ;import trade is likely to be hit by the adoption of a VAT. Huge

increase in the tax liability of goods would lead to a sharp rise in their prices, which in turn would decrease the demand for imported goods and import trade would dry. The decrease in import trade would further have an adverse effect on country's revenue collection because import duty is the most productive source of government revenue in Nepal.

However, it may be argued that the rise in the price of imported goods would not decrease revenue; collection: It is because the rise in price would decrease only the volume of imports, not the value of imports. Decrease in the volume of imports; and consequent decrease in revenue collection would be compensated by the equal increase in tax liability due to actual (high) evaluation of imports if the consumption expenditure devoted to imported goods remains the same before and after the price rise. If the demand for imported goods is highly elastic more than a unit, the rise in the prices of imported goods would have an adverse impact on country's revenue collection.

Thirdly,, the rise in the prices of imported goods would have a further negative impact on country's revenue collection. It is agreed by all that Nepal's huge amount of imports is not for its own use; about 70 percent of imported goods are re-exported to India through unauthorized trade., May be the figure is incorrect but it is true that a large amount of imported goods are re-exported to 'India. The rise in the prices of imported goods would make the re-exports to India not possible since India is also lowering import duties on foreign goods. This would further reduce the import volume of Nepal leading to a fall in the collection of revenue form import tax and VAT.

Issues and options

1. Import should be actually valued. An accurate and timely data of the price of all kinds of commodities prevailing in local and international markets should be maintained. '
2. Along with the actual valuation import duties should be reduced in such a way that there is no substantial increase in the tax burden on imports.
3. A close co-ordination should be established between customs and VAT department.

6.6 EQUITY

Equity is an important, perhaps the most important issue of VAT in its design and implementation. It is due to the fact that VAT is always alleged to be a regressive tax. The VAT as a consumption tax, falls more heavily on the poor than on the rich, as the former spend a larger proportion of their income on consumption than the latter. The regressiveness of VAT is also empirically tested and proved in many countries having a VAT. Some of the empirical evidences include Choi (1983) for Korea, Aaron (1981) for Europe, Ahmad and Stern (1987) of India, Ahmad and Ludlow (1989) for Pakistan and Hossain (1995) of Bangladesh. Such a regressiveness of the tax is not justifiable on social and economic grounds, and opposite of the basic principles of taxation.

Voices against the VAT have also been raised in Nepal for the tax being inequitable. However, such voices are often very weak or not so strong that they may compel the policy makers to correct the regressiveness or

prevent it from being implemented. People who are really poor and who would have bad impact of the inequitable tax are not able to raise their voices against the tax because they have very low level of consciousness about government policies and state matters. The authorities or policy makers do not feel necessary to correct such problem because it does not strike their interest. Political parties may have an interest to raise it as political issue but such possibility has very less chance since such matter is not easy to put into propaganda and attract people.

The repressiveness of VAT may have a long-term effect than an immediate reaction. It may cause frustration among the low-income people and increase the level of poverty in long term. VAT is also against the existing poverty alleviation policy of government.

Issues and options

1. Excise duty and special consumption tax could be levied on certain commodities along with the VAT.
2. Essential goods and services should be exempted. The exemption should be reviewed from equity point of view, later, the technique of zero rating rather than exemption should be employed to relieve essential goods and services totally from the VAT.
3. After some year, VAT rate should be differentiated with higher rates on luxury goods and lower rates on essential goods.
4. The government expenditure programs should be improved in such a way that the poor get more benefits than the rich.

6.7 TAX EVASION

The large amount of illegal trade and other established tax-evading practices pose a great challenge to a VAT in Nepal. Most of the tax evasion occurs at the import level. The existence of long-open border and weak and easily corruptible tax administration are the major factor facilitating tax evasion.

Sales tax at present; is levied at the manufacturing level or factory door, where tax evasion is difficult. Nevertheless, tax evasion frequently occurs even in the present sales tax system. The present tax evading practices involve - no-registration; no-compliance; under invoicing of sales; establishment of artificial sales depots and supplying goods at artificial lowered prices to the distributors having a close relationship with the manufacturers; transferring some of the manufacturing activities to the dealers or distributors; underreporting of sales; selling directly to the retailers or consumers, etc. in addition. Direct tax evasion by bribing the tax authorities also occurs.

The tax evasion under the existing sales tax indicates that tax evasion would largely increase rather than decrease after the adoption of VAT. It is because the chances for tax evasion; are many under the VAT than at present. A VAT brings a large number of taxpayers; into tax net and the tax liability would be distributed among many less' sophisticated and difficult to control groups like traders, which include a large number of retailers. Due to weak implementation and poor administrative capability, tax evasion would be widespread, considerable and difficult to control after the adoption of VAT.

Tax evasion under the VAT is found easier as also shown by international experience. Estimates of tax evasion range from 2 - 4 percent of revenue foregone (the United Kingdom) to 40 percent (Italy) (Tait, 1988: 304). The so-called "built-in-checking" "self-policing mechanism", "catch-up-effect", etc. feature of VAT which are often claimed to be preventive to tax evasion are illusory or overrated advantages of VAT. Experience of European and other developing countries shows, that it is not the simple self-enforcing tax that some of its less sophisticated advocates have suggested (Aaron, 1981:2). The matching of sales against purchases is a formidable task in practice where much of the administrative efforts are directed to other essential functions. Most of the evasion occurs at the retail stage because at the retail stage the consumers have no incentives to be sure that the tax have been paid at the previous stages and, in addition, tax payers have a common interest in avoiding the tax altogether (Mansfield, 1990: 139). The "built-in-self enforcement" mechanism is largely a myth rather than a reality. '

There are several possible ways and forms of tax evasion in VAT. Let us now discuss the most possible or typical ways of tax evasion that may occur under the system of VAT in Nepal. ;'

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

2. **Suppressing sales:** This is one of the most common ideas to evade VAT. Under this form, the sellers do not report some of their sales to the tax authorities. The method has a limited use as substantial underreporting becomes suspicious. As a varied form of this method, the seller may suppress sales price or value added of their sales. This kind of tax evasion involves a secret collusion between the sellers and purchasers to under invoice the price per unit of merchandise for tax purposes. Substantial under invoicing is, however, impossible because the market prices of most commodities are well known, and a ridiculously low declared price is likely to provoke a thorough investigation. In the case of goods whose prices fluctuate frequently and largely, such malpractice is possible.

Under invoicing of sales may also take the form of quality differentiation of the sales. For example, the price of a Jean's pants ranges from Rs.500 to Rs.2000 in the market. A seller selling a jeans pant may actually set it in Rs.2000 but he may issue an invoice of only Rs.500 and he may persuade the purchaser to accept it by allocating some of the benefit to him. This kind of tax evasion is difficult to control:

Retail services are particularly prone to evasion through under reporting. European experience shows that in traders such as decorating, carpentry, plumbing, and gardening where taxable inputs are small and value added is high evasion by small operators is common. The consumer is offered lower price and the sale is not reported. Frequently cash sales evade both VAT and income tax (Tait, 1988: 311).

3. **Unrecorded trade:** In the form of tax evasion just mentioned above, substantial amount of evasion through suppression of sales or value added does not seem feasible as any business must add his margin to his purchases, otherwise his tax quality may appear lower than the tax credit he may claim. But tax evaders may easily overcome this problem. At the first attempt, they may not show their record of some purchases and claim no credit, thus preserving an acceptable value added. If the first attempt does not work or is not attractive, a very attractive and feasible way is through unrecorded trade. Unrecorded trade in Nepal is the most possible way of large large-scale tax evasion under the VAT.

It is evident that there is a large amount of illegal imports within the country. smuggled goods have neither purchase nor sale records, they are entirely in the black market and it is not possible to detect them except by physical verification of stocks. Such goods may be purchased and sold with full trade value added but without any invoice or record. Traders acting in this activity may even collect VAT from the consumers by issuing fake invoices and pocket a large amount of profit. This kind of practice is more attractive since the tax evaders are able to evade not only the VAT but also income tax. The authorities can check inventories and warehouses stocks to catch this evasion. However, such searches are time consuming, expensive and annoying to honest traders.

Due to weak administration, a channel of unrecorded trade or underground economy may be developed and make strong creating a large amount of revenue loss in this system of VAT. Some

manufacturers also may allow some of their products to the unrecorded black market channel. Manufacturers would try to sell their products directly to the consumers or exempted retailers.

4. **Dummy Businesses:** Tax evaders may use the technique of supplying goods through nominees or dummy businesses below threshold limit. They may establish dummy stores in secret places and supply goods from such stores without any record and invoices. Dummy stores may be sued to supply smuggled goods. business firms may also establish fake business units below threshold limits and do some part of their business activities in their names. There may be frequent appearances; and disappearances of disguised firms. Firms, which enjoy tax exemption, may act for larger firms by handling some of the products of taxed firms as their own products.
5. **Use of Exempted Businesses:** This way may be followed with relative ease. Smuggled goods and the goods having higher value added at the retail level may be supplied through the exempted channel. A registered trader may establish many exempted store and supply a large amount of goods from those stores:
6. **Exaggerated Tax Credit and Refund Claims:** This form of tax evasion involves the following devices.
 - a. Tax evaders may use the invoices from unregistered suppliers to claim credit. The tax authorities may be defrauded if the tax evader pretends that he or she has a purchase invoice with VAT number or creates an imaginary VAT number.

- b. If a business is engaged in selling both taxed and exempt goods and services, he may easily divert some of the taxed inputs use in producing exempt items as a credit against the tax on his taxed sales.
- c. There may be many cases of credit claimed for purchases that are not creditable. For example, credit claimed for telephone, automobile, etc. for business purposes but in fact used in non-business purposes.
- d. The exaggerated credit and refund claims may also take a form of inflating the claims to deduct VAT paid at earlier stages. Tax evaders: may fabricate fake invoices for the purchases that were never made. There may be a business to invent and print false invoices for sale to those; wishing to defraud the revenue (Tait, 1988: 307).
- e. A more complicated, but more remunerative (and riskier), device to claim fake refunds is when a new business is started, because then the authorities could expect VAT deductions to exceed VAT liability since there would be large purchases of capital equipment and raw materials (Tait, 1988: 307). Such business may disappear before a time for an audit.
- f. There is another possibility of false export claims and over-invoicing of exports by using fake devices. For this purpose there may, appear some bogus businesses that are involved in fabricating fake expo4 invoices and claim VAT rebates on goods that have never been entered into transactions. After sometimes, when there is a danger of being discovered, they may disappear.

7. Other Forms Of Tax Evasion

- a. Traders, especially small traders use some of their stocks for their self- consumption and they may omit the self-consumption from the records.
- b. Tax evaders may create artificial losses by showing damages or sales in loss and lower tax liability or claim tax refund.
- c. Tax evaders may use two kinds of invoices one for giving to the purchaser (consumers) and other for tax office or record creating a scope for misappropriation.

Issues and options

1. Increasing administrative efficiency is the most desirable and effective way of preventing evasion. There should be greater control of tax collection; inspection and auditing system should be performed with greater expertise; and penalty should be well designed and highly publicized. Reduction of the tax rates, incentives for the payment of the tax and increase in the tax consciousness of the people are some other ways to reduce tax evasion.
2. Tax returns should be carefully checked by experienced officers and processed in computer. Tax personnel must exercise utmost vigilance with respect to artificial schemes devised by the dishonest taxpayers. Similarly, tax refunds should be closely monitored against any kind of fraud.
3. Tax administration should be computerized to make a large amount

of processing of returns and across checking or purchases against sales feasible. A strong technical database should be built and maintained to make detection and checking effective.

4. A moderate tax rate should be designed at the initial stage of the introduction of the VAT. Considering the fact that higher rate may provide an incentive for tax evasion.
5. There should be a good co-ordination and co-operation between the VAT and other revenue departments to prevent revenue leakages.
6. Each taxpayer should always be put in the danger of anytime investigation. There should be a surprise or shock element in such investigation without providing any chance for dishonest taxpayers to plan and embezzlement. Businesses should be randomly selected for auditing and a through investigation should be made in suspect causes.
7. A mobile unit to investigate any malpractice and secret hidden businesses should be set: up. The members of such unit to detect any fake cash memos may do random spot checks of accounts. Occasional purchases by mobile tax officers and random collection of cash memos given to the consumers for later checking against the books of account may be attempted. Spot-checking of consumers at market places, hotel premises may also be attempted to find whether the sellers invoices.
8. University students may be hired on part time basis to carry out fiscal inspections (such as a Bolivia). It is because the tax personnel may easily be corruptible and they are also experienced

in designing a malpractice. Fiscal inspections; carried out by fresh men/women would be more effective.

9. Greater emphasis should be place on physical stock verification of inventories against invoices; this should be used only in suspect cases because it would be highly annoying to honest taxpayers. Physical checking in trucks carrying goods on roads would be highly effective to protect illegal goods being supplied.
10. High penalty should be imposed if a guilty is found VAT offences,; penalties and criminal prosecution should be well advertised through the media so that it would act as a deterrent to other. Public notices and boards should be put on market areas warning the people for not taking invoices or involving in any kind of misdeeds.
11. Collection of VAT through banks is found to be effective in many countries. In addition to congestion caused by the taxpayers in tax officer, there ma be "give and take" between the taxpayers and tax inspectors leading to a great deal corruption. The possibility of "negotiations" between the taxpayers and tax officials can be reduced it the banks are used to collect the VAT for the banks merely act as collection agents.

6.8 OTHER TAXES

Adoption of VAT would have a substantial impact on the collection of other taxes particularly income tax and import duty. Since VAT brings transparency in business activities clearly showing the amount of purchases, sales and profit margin, the income tax liability of each VAT

registered person can easily be determined. VAT records facilitate the detection of possible fraud in income tax payment - a most possible case at present. Income tax in Nepal is now levied on the turnover of businessmen not in their actual incomes. But the income tax, which is levied on turnover, is very high, as most of the businessmen can not pay such a large income tax liability, they mostly show their turnover very low hiding a substantial amount of it and lower their income tax liability. However, this is not possible under VAT system. So the effective implementation of VAT would clearly reveal the actual turnover of businessmen leading to a substantial increase in income tax collection. Similarly, VAT would have a favorable impact on the collection of import duty by actual valuation of imports.

A positive impact on the collection of other taxes after the adoption of VAT is expected and desirable. Nevertheless, if the increases in the liability of other taxes is substantial and unexpected, the all at once and substantial increase in tax burden may not be bearable by the economy and this would retard most of the business activities of the country. Such an unexpected increase is also difficult to handle by the administration.

Issues and options

1. The rates of import and income taxes should be reduced with the introduction of VAT so that there is no substantial increase in tax burden on the economy in VAT regime.
2. A package program for the tax reform, which involves all the major taxes, is most desirable in Nepalese case. The tax rates of all major taxes should be changed simultaneously without disturbing the country's economic and fiscal system.

6.9 TAX CONSCIOUSNESS OF THE PEOPLE

VAT is a transparent tax in which every consumer can see his own tax liability in his each taxable purchase. The consumers know how much money they are paying to the government as tax. This kind of transparency, in some respects, is helpful for increasing public awareness making people more conscious about their rights and duties. Such transparency, however, is problematic in some respects, especially when people have low civic consciousness and they do not feel that they should pay to the government. This may develop a hostile attitude of the people towards the tax giving a way to tax leakage.

The working of VAT lies on the assumption that each consumer takes an invoice of his purchase. Before the purchase stage by consumers, the purchaser may have an interest of obtaining invoices of his purchase ensuring that all tax has been paid so that he could claim tax credit to be subtracted from the tax on his sales. But consumers do not have such an interest. Cross checking of sales against purchases is also not possible at the retail stage. A possible case after the adoption of the VAT in Nepal may be that low conscious people do not demand any bill of their purchases facilitating to tax evasion by the traders.

Another possible case under the VAT may be that consumers who do not want to pay tax would bargain with the sellers to get the prices of their purchases reduced. The seller would agree to this on the condition that the consumers do not demand any invoice of their purchases. Therefore, there may be collusion between the sellers and purchasers not to issue invoices and evade tax.

Some of the consumers may have a hostile attitude towards the tax (and also to the government and they would not want to pay even a penny to the government. Such consumers would not prefer to go to the VAT registered shops, although they have to pay even a larger price: than the tax inclusive price. The VAT would cause several frequent quarrels between the sellers and purchasers on tax matters.

Issues and options

1. A well-planned publicity campaign aiming at both taxpayers and general people should be conducted before the implementation of VAT. People should be educated about the characteristics of the new tax as well as about the new requirements with which taxpayers and general public would have to comply with. The tax education programme should describe the operation and affects the new tax. The dissemination of information should be relied heavily on newspaper, television, radio, and through trade associations. The VAT guidebooks should be published and distributed among the taxpayers.
2. Interaction programmes about VAT may be conducted among a certain sections of people like factory worker student, government employees, etc. Talk programmes about the new tax should be conducted in electronic media before the implementation of VAT.
3. Notices should be issued to the public urging them to take invoices of their purchases. Such notices should include warnings against any malpractice. Besides, random checks in it the market places may be conducted occasionally.

4. Incentives, like monthly lottery in VAT invoices, are another desirable option for increasing people's co-operation in taking invoices.

6.10 CO-OPERATION BETWEEN THE GOVERNMENT AND PRIVATE SECTOR

There should be a close co-operation between the government and the private sector as one of the basic requirements for implementing a VAT in any country. But there is a wide gap between the government and private sector as regards to the implementation of a VAT in Nepal. The private sector is actively opposing the implementation of VAT, at least, at present. The government on the other hand, is firm to implement the new tax. Such a divergence would lead to many undesirable consequences, which make the VAT at Government policies in Nepal are often formed and implemented; without a due consideration and preparation. With regards to VAT the government never took the private sector into confidence. Private sector is not much involved in designing the; VAT structure rules and regulation, and solving the wide range of issues.

Preparation of the private sector is not going on equal pace with the government. The private sector is somewhat neglected from the VAT implementation process.

The absence of active participation of the private sector in the VAT implementation process is not a good symptom for the success of VAT. The rejection of the tax by the private sector would make it an unpopular tax. Tax compliance and co-operation with the administration would be lower under such an unpopular tax. The VAT structure, rules

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

Issues and options

1. The government should take the private sector in confidence. The private sector should be persuaded to co-operate with the government. A point of compromise should be sought if there is any dissimilarity of thinking. Any direct confrontation should be avoided.
2. Insufficient communication between the government and organizations of taxpayers and consumer groups damages the prospects for close co-operation. The communication between the government, taxpayers and consumer groups should not be broken. Special committees should be formed including the representative from various sectors and groups. To make the VAT operational and workable the tax authorities must learn business structures and practices so that VAT procedures could be made suitable to commercial procedures. For this, tax authorities should consult the business associations and trade groups like small retailers. It is tactful for the authorities to acknowledge that they have much to learn about business practices, and the interchange of ideas can mean that the form of VAT presented to the government contains the best of the combined views of the revenue authorities and the trade organizations (Tait, 1988: 109)

6.11 GEOGRAPHICAL ISSUES

The existing geographical condition of the country and difficulties created by such conditions would create several problems for the applicability of the VAT in Nepal. There arise mainly three sets of problems due to geographical conditions:

- (i) Many districts of Nepal are not within the access of transport. Some of the districts are connected by very poor means of transport and some others; are not connected by motor transport. Supplies to these areas are made by porters, animals and air transport. But the cost of manual or air transport is very high. Due to high 'transportation cost, value added of the goods supplied to these areas becomes very large at distribution stage. Application of VAT in such areas as other easily accessible areas means the consumers of the remote areas bear much higher burden of the VAT than the consumers of other accessible areas. This is clearly inequitable; and is unjustifiable for any reason.
- (ii) There is a small scale of business activities in those remote hilly, and mountain areas. For the collection of the VAT in those areas, it is necessary to incur some essential expenses like a building, certain staff, computers, etc. But the revenue collection in such areas would be a negligible amount as compared to the collection cost. Moreover, the business activities scattered throughout the hilly and mountain areas: in small markets, towns, seasonal markets, village shops, and mobile shops pose a great difficulty in identifying taxpayers and their, control. Some areas are such that it is not worthwhile- to set even a tax office in a district. Therefore,

the high collection cost does not permit VAT to be applicable in some of the districts in Nepal.

- (iii) Controlling VAT in far and remote areas is not easy. In VAT system the function of collection, taxpayer's assistance and other small functions are done by local offices, whereas inspection, audit, hearing appeals, tax refund, and penalty falls within the function of higher level offices or regional or central offices. But due to the lack of transport, communication and easy access, it is not possible for high level offices to perform these functions. It would also be impossible for the taxpayers to come to the center for getting tax refund, appealing, etc,

Issues and options

1. The districts which are not connected by motor transport should be excluded from the VAT
2. Later, lower rated VAT or a special turnover tax may be levied on the selling of goods in remote areas.

6.12 POLITICAL ISSUES

Any government policy, especially when it is related with the effects on general public is very much likely to be a political issue. VAT in Nepal is likely to be a political issue since it is connected with the loss or gain of the entire people including the consumers, traders and businessmen. Before implementing such a large project, the government, political parties and, their leaders would like to secure their political interest and nobody would like to take a risk of being a cause of the suffering of the people.

There are some factors, which would make VAT a political issue in Nepal. The most important is that the tax may be the cause of increased price level. Since VAT is perceived to have a direct link with increased price level. The introduction of VAT would be unpopular among people and this, in turn, would make the government unpopular. Political parties always seeking to secure their vote bank would take step back under such condition. The regressivity of VAT is another issue. Unlike price effect the regressivity of VAT would not directly provoke people's reaction, however, it would sooner or later leave a hostile feeling among people. In political front also, such issue would be prominently raised to attract people's attention.

Further, a VAT would make people feel that they are paying money to government in their every purchase and, people would be politically more conscious than before. People would like to see whether the government is spending money for their best interest. When people are antagonistic to government, when they feel that it is wasting their money; taxes are likely to be even more unpopular than usual (Bird, 1990:263). The failure of government in making useful expenditure as it is a usual case in Nepal, peoples' hostility towards the government and the political system would increase. This would have further undesired implications.

VAT would be major part of Nepalese fiscal structure, the failure of which would have serious consequences. International experiences so that taxes are cause of the fall of many governments and political instability. If VAT cannot borne by the country, or if it possibly fails it would lead to the disturbance of the whole political as well as economic set up of the country.

Issues and options

1. There should be a political consensus among all the parties regarding VAT. VAT should not be made a political football. The power to change the tax rate and exemption should be snatched away from the hands of the government so that irrational governments would not be able to please certain interest groups close to them.
2. Attention should be paid to government expenditure program: The government must curtail the unproductive lavish expenditures. People should directly benefit from the government expenditure and people should not be made feel that the government is not doing well - it is wasting the many collected from them or looting them.
3. There should be strong political commitment and actions to prevent corruption at high level.

6.13 POSSIBLE RISKS

There may be some risk involved with the adoption of VAT in Nepal. What happen if the tax fails'? What happens if revenue collection declines? The possible failure of VAT may be due to administrative failure and inapplicability of VAT to the present economic business structure. Administrative weaknesses may lead to anarchy in tax system, the administration being not able to control the taxpayers and ensure that tax is paid in fair manner. The economic environment and business structure of the economy is such that the VAT :is: not fully workable. If VAT fails, it would have severe consequences in the Nepalese fiscal

system. It would be practically impossible to move back to sales tax and there is no any other alternative source of revenue.

Another possible risk is that the VAT may raise less revenue than estimated. This may happen due to the fall in imports; adjustment in business activities - a large part of business activities going below threshold limit; low tax rate; credit provided to the tax on purchases of industries; over refunding; fraudulent claim of tax credit and widespread tax evasion. The decline of revenue collection would be another shock to Nepalese fiscal system.

The authorities should be full aware of any kind of risk associated with VAT and all alternative measures should be used to avoid any undesirable situation. ;:

CHAPTER- VI

SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS

6.1 Summary of the Findings

Taxation is an instrument for resource mobilization and that would help to bridge revenue-expenditure gap. Due to growing role either of government expenditure or inflation, then the rate of revenue growth, resource gap is ultimately created in our economy. This trend of revenue expenditure-gap shows that Nepal has been undergoing through a several fiscal crisis and rather than reformed tax structure it was leading a debt-trap' situation. These facts justify that ultimately the permanent solution to uplift this situation is the only domestic resource mobilization technique by properly designed tax system.

In this connection, the value-added tax has been considered as an attractive alternative in existing sales tax system, spreading around the world. Furthermore, VAT has been emerging as a main element of the worldwide tax reform, which could be justified by its world wide implemented rate.

In Nepal, sales tax was introduced at first in 1965/66 through the retail level. Coming to the beginning of 90th century, sales tax seem unattractive due to the narrow tax base, creating cascading effects, high burden on domestic products and inefficiency, etc. In, this background, VAT has been getting a chance to introduce in Nepalese tax system. : Theoretically, VAT has broad based as it covers the value added to each goods and services by a firm during all stages of production and

distribution. As the nature of indirect tax, burden of the VAT can be presumably shifted forward to the consumer. France first introduced VAT in 1954 and then the route was followed by Ivory Coast in 1960, secondly. More than 100 economies in the world have successfully adopted a full VAT during the last five decades. Nepal has adopted the destination based, consumption type VAT operated through the tax - credit method. The tax: credit method is considered as a tool for cross-checking measure under VAT system.; In this way, VAT is said to be a self - policing ' in nature. To adjust the international trade, Nepal has followed the destination principle.

The primary reason for growing popularity of the VAT is its broad coverage without distorting economic efficiency. VAT also plays the neutrality role on the methods of production and distribution as well as consumer choices, which is the basic need for a good tax system.; Furthermore, the stepwise collection of VAT does not encourage tax evasion. VAT is considered vertically neutral because the tax liability cannot be reduced by changing the method of production and distribution. However, it is very difficult to define an equitable distribution of the burden through VAT but exemptions and zero-rating techniques help to reduce the regressivity. In this way; VAT has somehow more equity nature as compared to other kinds of sales taxes. The other major basic criterion of good tax i.e., self-policing nature can be easily found in VAT system. However, tax evasion is a universal phenomenon, thus our goal must be bounded just to reduce the tax evasion as far as possible.

Perhaps, VAT is most efficient tax to avoid the cascading and pyramiding effects. VAT can also effectively reduce capital goods as well as export

form their tax base. So, VAT ensures the tax on consumption and should encourage investment price stability and supporting economic growth are other notable merits of VAT.

Besides these, VAT is not totally immune from the fault of regressive nature. Single positive rate creates regressively with respect to expenditure but not necessarily with respect to incomes. Moreover, from the administrative point of view, VAT cannot be attractive alternate to other kinds of sales tax. Due to administrative complexity as well to maintain the equity norms, exemptions and zero rating are principally proposed but such provision makes the tax based limited. As a result, the primary goal of VAT "to induce revenue by means of broad coverage with low taxes" should violate.

After implementing VAT, Nepalese economy is suffering by price hike; surprisingly the price is simultaneously increased in both exempted and taxed commodities. Thus, the inflation invites by businessmen, but not by VAT. Some findings are as follows:

6.2 Findings

Taxation and economic development are two closely interrelated concepts since taxation has an important role in country's economic development. In recent decades, many developing countries around the world have begun to focus their attention on reforming their poorly designed defective tax structures as an integral, part of their development efforts. Such reforms have broken some older leanings and established some new trends and axioms. One of such trends is the increasing acceptance of a VAT as an important part of their tax reform programs.

Nepal has been undergoing through a severe fiscal crisis due to limited; sources of revenues and increasing government expenditures. The trend of revenue expenditure gap shows that it is even likely to increase-in future leading the country ;to' a debt trap situation. In the wake of such a crisis, Nepal is planning to adopt a VAT. A number of issues come up with the consideration of a VAT in Nepal. Such issues generally involve: Is a VAT better alternative than the present sales tax? What are the issues in the applicability of a VAT or what are the practical problems of implementing a VAT in Nepal? What is the revenue potential of a VAT and what should be the 'appropriate tax rate? What would be the effects of VAT on the economy and other areas concerned? Such issues should carefully be considered and resolved before the VAT is actually implemented.

) VAT as an Alternative to Sales Tax

The present sales tax system is associated with many problems. One serious defect of present sales tax is its very narrow tax base. Due to the narrow tax base, the sales tax is n t productive and elastic. Besides, the sales: tax system is putting much pressure on economic activities due to its distortion characters such as taxation of inputs, cascading and pyramiding effect, high burden on domestic industries, unfairness in the ; treatment of domestic products in relation to imports, etc. The sales tax administration is also very weak and neglected; rules and regulations are often one sided,; discretionary, arbitrary, non-transparency and unpractical; and tax assessment system is arbitrary. Moreover, the tax system is suffering form lack of clear-cut long - terni policy directives; the frequently changing tax rates, irrational exemptions and rate;

reductions granted by the government from time to time, and this has further complicated the tax system.

Adoption of a full-fledged VAT replacing the sales tax would largely broaden the tax base. In the case of imported goods, the tax base in VAT would increase about three fold of the present sales tax base. The increased tax base would make the tax system more productive and elastic. Adoption a 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; the VAT would increase the competitiveness of Nepalese products. The VAT would not be more regressive than the present sales tax system.

While VAT seems more attractive from revenue and economic efficiency point of it appears equally unattractive from administrative point of view. A number of programs arise regarding the administration of a VAT in Nepal. As a modern tax. VAT demands highly capable administration, which is severely lacking in Nepal. The present administrative set up does not seem efficient enough to administer a VAT with illo extra difficulty. Though a better tax the VAT may be, it would have very poor results than what is expected mainly due to administrative weaknesses.

In the overall evaluation, a VAT would be an 'improvement" over the present sales tax system. Adoption of a VAT in the place of sales tax would incur certain "gain", though the gain may be a least amount. That is why, a move towards VAT would be a "better" but not and "ideal" step. It is because the allegedly overemphasized theoretical advantages of VAT would crash down on earth when it comes to reality due to the absence of

a "good" environment for the applicability of the tax.; Thus, one biggest problem for implementing a VAT in Nepal is its applicability. The applicability issues assume greater importance and demand a very careful: examination as well as solution before the implementation of a VAT in Nepal.

J **Applicability of a VAT**

There are several challenges in the applicability of a VAT in Nepal. The first and most important issue is the administrative issue. Lack of administrative capability is the greatest problem of implementing a VAT in Nepal. The tax administration in Nepal - the revenue administration in general and sales tax administration (which would also administer VAT) in' particular - is very backward, inefficient and corrupt. The administration would not function properly as it is lacking some essential requirements for administering a VAT, that include skilled and ~ experienced manpower; honesty and dedication in tax personnel; good working environment; an effective information system, etc. Further, other basic requirements for AT like a carefully planned effective audit and inspection system; computerized operation: an effective system of checking and processing of returns and fraud detection; effective control of the tax credit and refund; and, an effective taxpayers identification system are not effectively and adequately developed. The administration would not function properly due to the lack of political support and due to frequent interventions and influences from the outside. The administration has also lost its credibility because it failures to administer various tax changes efficiently in the past. Preparation for VAT by the government is also clearly inadequate. Instead of resolving basic practical

challenges, it is moving on the surface. In many cases, preparation is limited to giving only lectures. The easily corruptible tax persons create another big problem. If the administration is it corrupts, nothing better can be expected everything would go wrong. Such an administration would not effectively administer a full-fledged VAT, which also covers retailers. It cannot also be expected that such an administration would be changed overnight.

Following tax administration,, the second biggest problem for the applicability of a VAT is posed by country's underdeveloped business structure, practices, and distribution system. A VAT has a limited scope in Nepal where a: large part of business activities are concentrated in a rather unorganized sector; where business activity is fragmented and small traders dominate the trading activities; where distribution system is not modernized, not well channelized or specialized and not fully traceable; where basic accounting is not prevalent; where illiteracy is widespread; and where much of the trading activity are of self employee traditional type. Under these circumstances, degree of compliance would be lower, administrative difficulty and evasion easier.

Special problems come up due to the existence of small traders in large proportion. As many; of the small traders can not fully comply with the requirements of a VAT due to their low scale of operation, lack of accounting records, illiteracy and high compliance costs; the problem arises how to treat them without no substantial revenue loss and extra; burden on small traders. How to fix a threshold limit to exempt the truly smaller ones is; practically very difficult. Moreover, the more challenging problem is how to identify the traders who fall above the threshold limit.

Identifying all the legal taxpayers and bringing them into tax net is a formidable task. Further, the tax preference to the exempted traders complicates the situation. The existence of both taxed and exempted traders in practice would badly affect the medium scale registered traders since they would have to compete with the smaller exempted trades on the one hand ? and with larger trading houses with economy of scale on the other. In this situation, the medium scale registered traders would either close their doors or use illegal means such as, unrecorded sales, establishment of dummy businesses, disguised closing or businesses, splitting up of businesses, supplying through nominees, bribing and corrupting tax officials, etc. to avoid the tax burden.

Due to the existence of a large proportion of small traders in trading activities, unfavorable business structure and practices, and weak administration, there would be anarchy in the tax system. Many of the legal taxpayers would fail to register; many of the registered taxpayers would fail to make tax returns, and many of the taxpayers who make returns would fail to make correct returns; tax administration would fail to verify the returns and detect fraud, tax compliance would be low and not correct due to the weaknesses in enforcement, and tax evasion would result in large scale.

The existence of open boarder and a large amount of unauthorized trade from India to Nepal poses a great threat to the success of a VAT in Nepal. The illegal imports from India would help to form a channel of unrecorded trade or black market channel resulting in large-scale tax evasion. Because the tax administration is not strong enough to check the situation, the scope for illegal trade and tax evasion would not decrease

even after the adoption of a VAT. The implication of unrecorded trade is that the genuine traders would be adversely affected and illegal trade would ultimately repeal the legal trade.

The existing under-valuation of imports is another big obstacle for implementing a VAT. The VAT would raise the prices of imported goods leading to a fall in import trade. As import trade dries, revenue collection from imports would also decline.

The existing tax evading practices and corrupt nature of tax administrators implies that a VAT would broaden the scope for corruption and bribing. Corruption and bribing would facilitate illegal activities resulting in a large-scale revenues leakage.

Special problems are posed by the other taxes - import taxes and income tax. A VAT may unexpectedly cause an all at once and considerable rise in the liability of other taxes. The unexpected rise in tax burden is difficult- to handle administratively and bear economically.

Divergent views expressed by the government and private business sectors regarding VAT and communication gap between the two sides damages the prospects for a successful implementation of a VAT since a close co-operation between the two sides is an essential pre-requisite for a successful implementation of VAT.

There are several other challenges, which are not favorable for a VAT. One of them is the low tax consciousness of the people. Further, equity assumes greater importance and the VAT would get less favor for being a regressive tax. Besides, geographical and political issues create other problems. In addition to these, there are some risks associated with the

VAT, such as decline in revenue collection from VAT and possible failure of the VAT itself.

Considering the various issues in the applicability of a VAT in Nepal, it can be said that VAT is not "fully" applicable to Nepal. A VAT is bound to have poor results than expected due to the various applicability problems.

7.3 CONCLUSION

The characteristics of the UDCs and thus of Nepal are general poverty; low income, low saving, low investment and capital formation, low productivity, and again low income and general poverty. It is, therefore, the dictum that "a country is poor because it is poor" holds so true in the case of developing countries.

However, a country is poor not only because there is general poverty in physical assets but also because there is general poverty in the thinking. The poverty in the thinking of such countries is reflected in their poor efforts made for their economic development. Poor thinking means poor planning and policy, formation. Such poor planning and policy formation is often very poorly implemented generating very poor results. This is how a poor country remains poor. Let the dictum be codified that "a country which is poor would remain poor simply because it does not have enough political and economic wisdom to come up out of the swamp of poverty." A poor country thinks poor, acts poor, achieves poor and therefore remains poor;

Showing in that perspective, the implementation of VAT in Nepal would have very poor result than expect due to poor planning and poor

implementation. Nepal's whole political and administrative set up is very weak, backward, ill committed and corrupt. Inefficiency prevails everywhere. There is a severe lack of skilled, honest and dedicated persons in key positions. Working for money or corruption is widespread in political as well as in administrative fronts. Where corruption enters from front door, honesty and efficiency escapes from back door. On the other side, people are less conscious and ;very backward. They are badly crushed by a heavy load of poverty, illiteracy and ill health. People cannot play a decisive role for the country's progress.

Under these circumstances, any policy change would not yield the desired results. The implementation of VAT is not likely to yield ideal results. Lack of seriousness of the government, poor planning and implementation, backward and inefficient administration. and underdeveloped economic and business structure would make the tax fall short of the various results that are generally expected from the introduction of VAT: in Nepal. Though a better tax the VAT may be, it would not be really a better tax in Nepalese context because the general characteristics of the country could not allow it to be so.

However, there is no reason for being so pessimist that everything would happen worso rather, there is a need to be more serious about the situation and conscious efforts should be made for the country's better future. For that enough intelligence should be acquired breaking the wall of poverty in thinking.

7.4 RECOMMENDATIONS

The following are the recommendations made in this study:

1. A Value Added Tax should be adopted in Nepal as an important measure of reforming the present tax system. Before its implementation, the various issues pertinent to VAT should be considered seriously' and be resolved. Since there is low level of administrative capability and unfavorable economic and business environment in Nepal, the VAT in Nepal should be designed and implemented in such a way that it may fully work : with the available administration under the present business and economic environment. The VAT is not fully applicable to Nepal mainly attributing to administrative backwardness and underdeveloped economic business structure of the country. There is need for an option to be followed for its adoption. Such option alternative way should avoid any kind of risk or future accidents associated with VAT.
- 2) Instead of adopting a full-fledged VAT from the beginning, the implementation of a VAT in Nepal should go in phases. It is because adopting ;a full-fledged VAT without proper experience, adequate administrative capability, and suitable business pattern and practices, would invite several disorders in the tax system. This would deteriorate the whole revenue structure.
- 3) For the phase-wise implementation of VAT, first an appropriate schedule should be formed. In the first phase. VAT should cover ; only import manufacturing level. In the second phase (preferably in

following year), the VAT should be extended to cover the distributors or dealers of various products including foreign goods. In the third phase, wholesalers and semi-wholesalers should be included into the tax net. In the fourth phase, retailers should be included into the coverage of VAT. In this way, VAT should be implemented in three or four phase (the second and third phases or third and, fourth phases may. be mingled together for three phases). The time duration for the full implementation of VAT should be 3 years (minimum),to 5 years ;maximum). No flexibility should be allowed in the timetable, it should strictly, be followed.

- 4) The phase-wise implementation of VAT has certain merits. Firstly, ; there would be no need to increase the administrative capability all at once, which is almost impossible. Secondly, the administrative requirements for handling the VAT could properly be assessed facilitating a more easy expansion of VAT. Thirdly, the 'administrative skills and efficiency would gradually be achieved. The administration would gain more expertise and experience to ;deal with the taxpayers and control the tax. Fourthly, new taxpayers could properly be identified and tax evasion would be minimized. Fifthly, any : risk factor associated with the tax could be minimized. In short, the' phase-wise implementation would help to minimize the various administrative problems and, at the same time, it would facilitate a successful implementation of a VAT in Nepal. On the other side, the phase-wise implementation would reduce the organized opposition against VAT, and it would increase the acceptability of the tax. Similarly, the problems caused

by other taxes and import valuation could gradually be minimized.

- 5) A commodity wise implementation of VAT should never be tried because it would arise many difficulties and complications in the operation! of tax leading to an ultimate failure of the tax. Such a partial VAT has no possible merits; instead, it would cause many disorders in the tax system.
- 6) In fixing the threshold limit or to bring an additional number of taxpayers into the tax net the administrative approach rather than any arbitrary method should be followed: In doing so, first the administrative capability for handling an additional number of taxpayers and the additional number of potential tax payers should properly be assessed. It is desirable to conduct a survey of the potential taxpayers and their annual turnover for VAT purposes. The threshold limit should be fixed in a point so that the additional number of taxpayers is equal to the administratively required number of taxpayers, and the administration could identify the additional taxpayers.
- 7) Tax preference to the exempted traders should gradually be eliminated. Some other methods of treating the small retailers should be devised and implemented after some experience with VAT. One way for eliminating tax ~preference may be a commodity-wise expansion of VAT. In this method, sellers of some specialized items should be required to register compulsorily regardless of their annual turnover.

- 8) Special incentives of various kinds should be devised for increasing registration and compliance with VAT. In doing so, small traders should especially be encouraged.
- 9) A technical database including all information about traders and trading activities should be prepared timely and periodically. Such database should be updated and reviewed periodically.
- 10) The implementation and other various activities regarding VAT should be performed by a high level VAT implementation team. Such team should have a well representation from the private business sector and consumer groups. It should also include tax experts, technical persons, legal persons, etc. The team should work in a close co-operation with the government departments.
- 11) There should be a close co-operation between the private sector and government in the VAT implementation process. The various issues pertinent 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. The private sector should always be taken into confidence. There should be a well communication and exchange of ideas between the two sides.
- 12) The VAT administration should be kept free from any sort of intervention or influence from the outside. Honest and capable persons should be selected for the key positions. Training of the tax personnel should be kept at the topmost priority. A good working environment should be created inside the administration. Reward and

punishment system should strictly be followed as a major guideline of conducting administration. Tax officials should !closely be monitored for any kind of misdeeds. There should be a close co-ordination or collective functioning by VAT and other tax departments with regards the enforcement of VAT as well as other taxes. The VAT administration' should be computerized with master file and TIN systems. An investigation branch should be created under the VAT department and made very active. VAT auditing should be carefully planned and performed. A system of paying taxes through banks should be developed as soon as possible.

- 13) Taxpayers should be provided better services with due regard and honor to them. Tax officials should behave with the taxpayers on equal footing. Many discretionary powers of the tax officials should be limited making them rational.
- 14) An extensive publicity campaign aimed at both taxpayers and general public should: be launched. People should be well educated about the new tax before its implementation.
- 15) Import tariff should be reduced along with the actual valuation Borders should effectively be controlled to prevent the illegal There should be a boarder tax adjustment between Nepal and India. Warehouse checking and highway checking should be practiced effectively to prevent any kind of illegal trade.
- 16) A tax reform package including all major taxes is most desirable in Nepal. Such a package should make simultaneous changes in all major taxes so' that there is no substantial increase in the total tax burden on the economy.

- 17) A special consumption tax on luxury items should be levied along with the VAT to increase the equity aspect of VAT. After some years, the VAT rate should be differentiated with the higher rate on luxurious goods and; lower rate on essential goods. The districts, which are not connected by easy transport, should be exempted initially from the VAT and a special tax like a general turnover tax may be considered later. To reduce the repressiveness of VAT, the government expenditure programmes should be corrected favoring the poor.
- 18) The administration should be very watchful to prevent any kind of malpractice, fraud and tax evasion. Utmost care should be taken to prevent any kind of bribing and corruption. Tax officials should effectively be monitored.
- 19) The authorities should be very serious to prevent any kind of price rise associated with VAT. Statutory provisions, extensive tax education, official monitoring and close co-operation with the private sector are some of the measures to prevent price rise. A special powerful price-monitoring unit should be constituted for the purposes of controlling any "undue" price rise due to VAT. Besides, tight monetary and wage policy should strictly be followed.
- 20) A moderate, rate of VAT should be designed initially. The VAT must be an equal revenue reform. The initial rate of VAT covering the retail trade should be 7-8 percent (since 6.5 percent rate is the equal revenue reform).

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