

CHAPTER I

INTRODUCTION

Tax becomes the main source of revenue of the state. Value Added Tax (VAT) is the latest innovation in the field of taxation. VAT is considered as the reform tax system of the 21 century, which has already been implemented popularly in more than 150 countries in the world. VAT is multi staged; commodity and services based tax which is levied on the value added of business at different stages of production and distribution like importer, distributor, wholesaler and retailer. It is imposed on value of goods and services.

VAT is a sales tax in advanced form. It is imposed on different stages. It is the tax imposed on added value of goods and services. Added value is in the forms of profit, wages, administrative expenses etc. It is imposed on producer, wholesaler, retailer and consumer also. In some countries, including Australia, Canada, New Zealand, and Singapore, this tax is known as “goods and service tax” because it is related to both goods and services. Value added tax is one of the forms of indirect taxes too. Encyclopedia of taxation and tax policy says “Value added tax is a broad based tax on business designed to measure net generated in a country.” Being a broad based tax, it is levied on industry as well as commerce. The tax is paid by every company that handles a product during its transformation from raw materials to finished goods. The amount of the tax is determined by the amount of the value that a company adds to the goods and services it buys from other firms.

For instance, suppose that a distributor buys a P4 Computer at a cost of Rs.30, 000 and paid Rs. 3900 as VAT at his/her purchase. The distributor adds Rs. 5,000 as wages and profit, and sells the Computer to wholesaler for Rs. 39,550 with VAT [(i.e. Rs.30,000 +5,000) x 1.13]. The value- added tax is to be paid to government is Rs. 650 i.e. 13% of Rs. 5000. The wholesaler adds Rs. 2,000 as profit and sells to retailer for Rs. 41,810 inclusive of VAT. The value-added tax is to be paid to government is Rs. 260 i.e. 13% of Rs. 2,000 and the retailer adds Rs. 2000 as profit and administrative expensive and sells to the final

consumer or user at Rs. 44,070 inclusive of VAT and VAT to be paid by retailer to the government is Rs. 260 i. e. 13% of 2,000. In this way, the total value added tax at each stage of production adds to the total value of the final product. In this way we can say that all the channels before reaching the goods and services to the final user are only the mediator of VAT and ultimately the burden of VAT is to be borne by final user.

VAT is a broad based tax as it also covers the value added to each commodity by a firm during all stages of production and distribution. It is a modern tax system which enables to efficient collection system, to increase efficiency and to reduce tax evasion. It is also referred as the backbone of income tax system in Nepal.

VAT plays great role in the revenue mobilization in Nepal. The reason behind VAT system, it makes transparency in all kinds of transaction, helps to make the wide area of tax and discourages tax evasion. So it is needless to say that VAT is the most important sources of the government revenue.

Implementation of VAT was not easy in the initial days. It was a matter of great debate. Even after the enhancement of law, there were a lot of constraints and difficulties in introducing and implementing VAT in Nepal. A large number of entrepreneurs, traders and business communities were against VAT system. The initial two year of VAT implementation was very turbulent. Now it has become familiar and VAT is currently well accepted by the consumers as well as business and industrial communities of Nepal. This is account based tax system that leads to transparency and accountability on the both part of tax payers and tax collectors.

1.1 Background of the Study

The concept of VAT was introduced in 1919 by Dr. Wilhem Von Sieman in Germany. This concept was brought to replace the “Usnatzsterller” (multi stage sales tax) due to its undesirable effects, particularly cascading and vertical integration of the latter tax (MST) for the first time. The Germany knew the administrative complication of the VAT

system. So, it has the fear to implement. Therefore, the rate of *umsatzsteuer* is reduced instead of the implementation of VAT. In 1921, the America was implementing the corporate income tax. Pro. Thomas S Admas suggested the tax for the United State of America to replace the existing tax system. Until early 50s the development of VAT remained limited only in the theory.

France was the first implementer of VAT in 1954 covering only in the industrial sector. The VAT was limited to only up to whole level. But these countries limited the VAT only on import and manufacturing stage. In late 60s, VAT started to become popular. Countries like Denmark and Brazil adopted this system of tax in 1967. France, the first implementer of VAT, extended it to the retail level for the first time. And Germany also the adopted VAT in the same year. In 1969, the countries like Netherlands and Sweden also adopted VAT in their 'countries. In 1970, 1971 and 1973, Luxembourg, Belgium and Ireland introduced the VAT respectively.

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

In SAARC region, Pakistan was the first adaptor of VAT. It implemented VAT in 1990. India introduced VAT first as modified value added tax (MOD VAT) in 1996. But actually in India, VAT replaced sales tax on 4 January 2005. Though some state did not adopt the VAT (for political reasons), majority of the state embraced VAT, states like Andhra Pradesh and Maharashtra taking the lead. The Empowered Committee, constituted by Government of India, provided the basic framework for uniform VAT laws in the states but due to the federal nature of Indian constitution, States do have a liberty to set their own valuations for the VAT levied in their own territory. [*Amatya, Pokharel and Dahal, 2008:4*]

In the Nepalese context, the concept of VAT in Nepal was introduced in early 1990s. Nepal government indicated its intention to introduce VAT in the eighth plan. Subsequently the Finance Minister declared to introduce a two tier sales tax system. A VAT task force was created in 1993, under the financial assistance of USAID in order to make necessary preparation for the introduction of VAT.

1.2 Statement of Problem

In developing economies, the tax systems suffer from structural constraints with tremendous administrative and procedural complexities that lack simplicity and transparency. The tax system is said to be perfect and successful when additional revenue is mobilized without creating excess burden to the tax payers with no change in the tax rates and legal bases and with modest discretionary changes attributing to improving efficiencies in tax administration. A prime concern of the tax policy in underdeveloped countries is how best to produce adequate revenue to finance the public sector. Therefore, revenue mobilization is a challenging proposition in developing economies where a majority of the people lives in abject poverty, and the people engaged in economic activities have extremely limited taxable capacity.

Transparency, simplicity and moderately low tax rates are antidote to corruption in taxation. In terms of tax revenue ratio, the contribution of direct taxes to total tax revenue is conspicuously less as compared to the contribution of indirect taxes. Since tax structure is massively dominated by indirect taxes, there is a need to move towards direct taxes to mobilize internal resources at a much higher level. The direct to indirect tax ratio is 1:1.65 percent in Nepal (Economic Survey, 2010/11). Tax avoidance, evasion, and delinquency have also increased substantially over the years. This is one of the critical reasons, why the number of taxpayers is just 360,000 (Inland Revenue Department, 2011/12), which is 1.41 percent of the total population.

The performance and contribution of direct tax is a signal to advancement of greater scale of development. The increase in customs duties and VAT is not a reflection of success

syndrome. The tax effort ratio (TER) in Nepal is estimated to be 14.8 percent whereas tax revenue to GDP ratio is 12.6 percent in 2010/11 and 13.2 % in 2011/12. While the share of non tax is 2.3 percent of GDP. The major challenge to Nepalese tax system is how to accelerate tax effort ratio to the maximum for meeting minimum requirements for development. According to Central Bank (first six months of 2009/10), custom revenue rose by 45.1 percent. Similarly excise revenues and income tax revenue increased by 67.6 percent and 32 percent respectively compared to the previous year. At the same time non tax revenues increase by 15% percent compared to the preceding year. Of the total mobilization value added tax (VAT) grew by 43.5 percent.

In spite of various development plans made over the years with a view to alleviating poverty, Nepal is still entangled in the vicious circle of poverty. The per capita income of Nepal is estimated to be just around US\$ 735 in 2012 despite the poor performance of other sectors of the economy which was possible due to the increasing remittance. There hasn't been any satisfactory improvement in human development indicators. Nepal ranked 142' out of 177 countries on the human development index in 2007 with FIDI value 0.534 which is lower than all other South Asian countries. The country has a significant regional disparity in human development. The economic is unable to provide gainful employment to all of its rapidly growing population, which has led to migration of labor to India, Southeast Asia, and the Middle East. The economy continued to recover from the downturn in FY 2002 on the basis of improved performance in agriculture and services, though the recovery is fragile. Increased political uncertainties following the royal proclamation, imposing of emergency rule in February, complex security scenario and agriculture's continued dependence on the weather pose significant risks for higher economic growth over the short to medium term.

The economy has been adversely affected by exacerbation of the insurgency and political instability since the second half of 2001. On the one side, the growth rate of GDP is decreasing in the conflict affected economy. On the other side, the need for higher regular expenditure demands higher revenue generation in Nepal. In the context of the liberal economy, the only way is the effective implementation of indirect taxation policy. As an

effort to overcome the problem of higher resource gap, the government has improved the administration of VAT, simplified the income tax law and implemented a three years customs reform and modernization program. Even the rate of VAT has been increased to 13% from 10%. However, the contribution of VAT in revenue generation and hence the resource mobilization is not satisfactory.

- What is the revenue structure in Nepal?
- How effective has VAT proved in Nepal in revenue generation?
- What will be the impact in revenue collection at different VAT rates?

Though various researches have been conducted in this field previously, they showed controversial findings. Some of the studies concluded that VAT performance is encouraging while some other studies have considered it ineffective. In this condition, this research is more comprehensive and tries to explore the clear solution. The solution of these questions may also be guideline for the planners, tax administrators' policy maker.

1.3 Objectives of the Study

The basic objective of this study is to examine the effectiveness of VAT in revenue generation in the Nepalese economy. Special objectives of this study will be:

- To examine the legal provisions of VAT
- To examine the revenue structure in Nepal
- To assess the performance and contribution of VAT to the revenue collection.
- To analyze the implementation and practices of VAT.

1.4 Significance of the Study

Following points will high light the significance of study in the case of VAT & Tax Revenue in the context of Nepali:-

- J The nation's economy has not been better despite numerous efforts made by the government. Still our economy is heavily relies on the foreign grants and foreign loans. There exists a very acute resource gap in Nepal, which is not a good sign in the growth of national economy.
- J This implies that the question of research mobilization is a challenging task for the country and its effectiveness relies on the other financial tool that may enhance it. In this context, VAT may be an instrument for mobilizing internal resources more effective.
- J Numerous researches have been carried out on VAT abroad but very few of these are applicable in developing countries like Nepal. In Nepal, most of the efforts on VAT were directed towards the theoretical background. The study is not only for the sake of study and to fulfill the knowledge gap but also to examine the practical problems faced by VAT administration to-generate higher revenue.
- J In spite of poor administrative system on the ground of unwillingness of businessmen and tax payers, to make the revenue system more buoyant through implementing VAT is really a challenge. Therefore, the study will have great significance to policy makers, administrators, researchers and students of public finance as well. The study will be beneficial for the policy maker, private sectors and researchers as it provides idea and knowledge about VAT in illustrative data and figures.
- J Major problem of the Nepalese economy has been adversely affected by exacerbation of the insurgency and political instability since of 2062/63 BS. As resulting, the growth rate of GDP is decreasing in the conflict affected economy. VAT can be effective instrument for mobilizing internal resources and raising total government revenue.
- J The liberal economy, the only way is the effective implementation of indirect taxation policy. As an effort to overcome the problem of higher resource gap, the government has improved the administration of VAT, simplified the income tax law and implemented a three years customs reform and modernization program.

This study has stressed the problem in the VAT system also, and this will generalize this

problem to the common consumers, business persons and the tax administrators too. After acknowledging the problems, the necessity of addressing these problems will emerge, which is a good sign if that can help to inject more revenue in the economy. The commendations made in this study to address these problems may contribute as a good sign for all responsible groups. Similarly, it will help the researchers also to carry out their research a step ahead about VAT adding further more data in coming years and to analyze it with respect to the past VAT- facts. This approach of dealing with VAT-data in years to come, may trace down the benefits and the shortcomings in it. From this perspective, this study bears great significance in terms of effectiveness of VAT and its legal provision & application.

1.5 Limitations of the Study

- The major limitation of this study is resource constraints. Due to this reason, this study will be based on the secondary sources of data and no test will be done to check the reliability of published data. This study will cover only sample period from 2003/04- 2011/12
- The main emphasis of this study is to analyze trend and structure of VAT in Nepalese economy. No study will be done regarding the relationship of VAT and income tax, custom laws and other such laws, which are interrelated to VAT.
- Simply, to estimate the built-in—flexibility and sensitivity coefficient equations and graphical analysis will be done to interpret data to reach the conclusion.

1.6 Organization of the Study

This study has been organized into five chapters, the title of each chapters are as follows:

- **Chapter I: Introduction:** This includes background of the study, statement of the problems, objectives of the study, importance of the study and limitation of the study along with chapter plan.
- **Chapter II: Conceptual Framework and Review Of Literature:** This is done to know what research has been done in the related topic in previous days and what is

to be done at present or in future. In this chapter which gives the theoretical concept and review of related materials i.e. review of books, review of thesis, review of journals, newspapers, magazine , web sites etc.

- **Chapter III: Research Methodology:** it includes introducing research design, data collection, nature and source of data, data gathering procedure and statistical tools

- **Chapter IV: Data Analysis and Presentation:** It concerned with presentation and analysis of data. The data collected from various years annual report of ‘Inland Revenue Department ‘, economy survey etc. have tabulated in their sequential order and data have been described, analyzed and projected with statistical tool as well as general accounting & taxation principle.

- **Chapter V: Summary, Conclusion and Recommendation:** It deals the general idea of the study and it represents all and opinions of the research as far as possible. Summary, conclusion and recommendations are mentioned in the last chapter of the study.

Lastly, Bibliography and Appendices have been presented at the end of the thesis work.

CHAPTER II

CONCEPTUAL FRAMEWORK AND REVIEW OF LITERATURE

This chapter shows the conceptual framework of VAT in Nepal and review of the relevant previous studies, literature, found in the form of published books, articles, seminar papers, research reports etc. It will cover the study of base of value added tax and its contribution towards government revenue. Various studies are done on VAT throughout the world. And their findings are easily found on various books, research papers, seminar papers, and reports of the international institution, issues of the journal and article and so forth. In the context of Nepal, some studies related to VAT have been carried out but all of these were conducted almost before the implementation of VAT and have focused on the theoretical soundness of VAT. Here attempt has been made to review them.

2.1 Conceptual Framework

The concept of VAT was introduced in 1919 by Dr. Wilhem Von Sieman in Germany. This concept was brought to replace the “Usnatzsterller” (multi stage sales tax) due to its undesirable effects, particularly cascading and vertical integration of the latter tax (MST) for the first time. The Germany knew the administrative complication of the VAT system. So, it has the fear to implement. Therefore, the rate of unsatzsteuer is reduced instead of the implementation of VAT. In 1921, the America was implementing the corporate income tax. Pro. Thomas S Admas suggested the tax for the United State of America to replace the existing tax system. Until early 50s the development of VAT remained limited only in the theory.

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VAT in their countries. In 1970, 1971 and 1973, Luxembourg, Belgium and Ireland introduced the VAT respectively.

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2.1.1 Development and Character of VAT

VAT is of German and American parentage. Shortly after World War I, the basic principles were developed in both nations. In the 1950s there was a revival of interest in VAT in Western Europe and America. In 1940, Paul Studenski in a classic article constructed a general ethical philosophical foundation for the use of VAT. He developed and related to VAT a “cost of services variant” of the benefit principle of taxation justice. In the same year Senator O’Mahoney introduced the value added concept in proposed federal legislation.

VAT is applied at the point of sale as a percentage of the sale. It is a net turnover tax because the VAT paid on purchases from VAT-paying firms prior to the sale is deductible

from the tax liability or tax base, respectively. Basically, the tax is applied to GNP as it arises through the production process.

The Member States of the European Economic Community (EEC) are using VAT at rates which cause the tax to produce 24 to 40 percent of national government revenues (payroll taxes included). In addition, VAT is a major tax in Norway, Denmark, and Sweden; in various modified forms it has been introduced into Finland, Greece, Brazil and Mexico. It will become a major portion of the tax system of Great Britain and Ireland when they become Member States of EEC. In addition, VAT is being seriously considered by most of the governments of the industrial nations of the world.

The growth of the use of VAT owes much to the fact it possesses a new name. This made it attractive to EEC in its search for a major tax to be used by all Member States at relatively uniform rates and with relatively uniform tax bases. Also, it has turned out to be the right tax at the right time. Higher revenue demands, expanding social programs and computer accounting have contributed to VAT's acceptance. As a result, the growth of its use and favorable consideration has been swift. In a democracy VAT is a good peace tax; it is not a good war tax.

In 1965 VAT was used only by France with Finland and Michigan using modified forms. Today it is one of the world's most productive taxes and its rate of introduction is accelerating.

VAT, more than any other tax, makes the cost of government benefits a portion of the entire decision process and of the cost of consumption and production. With taxes equaling 30 to 40 percent of GNP, this becomes a very desirable characteristic for the preservation of efficiency in a market economy.

In the Nepalese context, the concept of VAT in Nepal was introduced in early 1990s. Nepal government indicated its intention to introduce VAT in the eighth plan. Subsequently the Finance Minister declared to introduce a two tier sales tax system. A VAT task force was created in 1993, under the financial assistance of USAID in order to

make necessary preparation for the introduction of VAT. [*Amatya, Pokharel and Dahal, 2008:10*]

The VAT task force prepared the draft of VAT legislation, was created in 1993, under the tax system review task force constituted by Nepalese government in 1995 under chairmanship of Professor Madan K. Dahal proposed and recommended to implement VAT in lieu of:

- (a) Sales Tax Act, 2033
- (b) Hotel Tax Act, 2018
- (c) Contract Tax Act, 2023 and
- (d) Entertainment Act, 2016

Nepalese government implemented it on 16 Nov. 1997 (Mangsir 1, 2054). However, VAT came into full operation in Feb. 1998.

In the implementation of VAT, majority of business community strongly protested against VAT and they severely criticized VAT. They said that VAT increases the cost of business; it is complicated and encourages corruption. A series of discussion were held between the government and representatives of the business community.

Thus, the business community tried till the last moment to postpone the implementation of VAT. But, government went on their schedule to implement. However, it extended the deadline to three months, and VAT became the effective tool for the collection of revenue of the government

In total tax revenue the contribution of VAT is more and attractive. There is tremendous scope for increasing the revenue from VAT. The sound implementation of VAT will obviously increase its contribution in coming days. VAT is a scientific tax system, which is most popular and transparent system. But, there are some issues or problems in VAT such as in: administration, cooperation, refund, policy etc. To overcome problems, the government should make almost all the people aware and well informed about it. Not on1 from the side of government but business must community support for the sound implementation of VAT. So VAT is a revenue productive tax.

Finally, The threshold, which was earlier said to be NRS. 4.5 million was brought down to NRs. 2 million. The current threshold for VAT registration is Rs. 2 million. Those vendors whose annual turnover is below the threshold can, however, register voluntarily. VAT rate was changed to 13 % from 10% on 15th January 2005 (Magh 1, 2061).

There is a persistent increase in the number of VAT registrants. It has crossed the 69,000 registrants. No. of VAT registrants are increasing day by day but in slow manner because every business organization wants to pay low tax to the government.

Office wise Registration Status of VAT as on 2067/68

Total Registration

Office Code	Place	No. of Registration
11	BHADRAPUR	2131
12	BIRATNAGAR	3250
13	DHARAN	1854
14	JANAKPUR	1857
15	LAHAN	1729
16	SIMARA	1193
17	BIRGUNJ	3386
18	HETAUDA	1341
19	BHARATPUR	1868
20	DHANGADBI	1883
21	MAHENDRANAGAR	1099
22	POKHARA	3564
23	LALITPUR	4170
24	BHAIRAHAWA	3322
25	KATHMANDU-3	10327
26	NEPALGUNJ	2873
27	KATHMANDU- 1	11917

28	KATHMANDU-2	6988
29	BHAKTAPUR	2809
30	KRISHNANAGAR	724
51	DANG	1368
Total Taxpayer		69653

2.1.2 Types of VAT

VAT is of different types. They are categories on several bases. The most important of them is the classification of VAT on the base of its treatment to capital goods. The VAT has typically been classified into three categories.

- The consumption type
- The income type
- The gross national product type

Nepal has adopted the consumption type multistage vat system. In other words under this system tax is levied on value added at each stage in the process of production and distribution. In this system there is a provision of input tax credit mechanism from producer to the retailer level. So, VAT is calculated indirectly using input tax credit mechanism. In which the tax payer pays vat on its value added only. In other words the registered tax collector pays tax after deducting the amount already paid input vat from the tax on sales of product or services. Because of destination based principle Nepalese VAT system has made the provision of tax free to export.

The types of VAT can be classified in several bases. The most important things to be considered for the classification of base is how capital goods are treated by VAT. From these angles, types of VAT are classified as follows:

I. The Consumption Type

This classification is considered as neutral type because under this type, no discrimination is done with respect to capital or consumable goods. It is really superior form of the VAT

because full credit of inputs, irrespective of what type of purchase is done, is provided. All capital purchased from other firms, in years of purchase, is excluded from the base while depreciation is not deducted from the tax base in the subsequent years. Investment is freed from taxation and consumption is considered as the base of tax.

II. Income Type

Under the income type, VAT does not exclude capital goods purchased from other firms from the tax base in the year of purchase whereas depreciation is excluded from the tax base in the subsequent years. In this variant, capital equipment is divided over a period on the basis of their useful life. As in consumption type, in this variant, all the purchases of the capital goods are not allowed to be deducted in the same year when it is purchased. Only a relevant portion to the particular period is allowed to be deducted and the remaining portion is carried over for the next period. The tax falls both on consumption and net investment and the conceptual tax base of this category is the net natural income. Under this method, tax base equals to private personal income. Many countries do not prefer practice of this method because it faces the same problem as we face in calculating income for a particular period. It is consistent with the origin principle of taxation where exports are taxed and imports are relaxed from the tax.

III. Gross National Product Type

Under this method, the purchase of capital goods are neither deducted from the tax base in the year of purchase nor the depreciation is allowed to be deducted from the tax base in the subsequent years. As no input tax on the purchase of capital goods is allowed in this variant, it discriminates among the techniques of production and finally favors international production. Neutrality of tax is not satisfied in this method; therefore, it has no practical ground. It suggests imposing the tax on the consumption and gross investment in this variant. Finally Gross National Product becomes the base of this variant.

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

Consumption Type:

Gross National Product — Gross Investment = Total Consumption Expenditure

Income Type:

Gross National Product - Depreciation.

=Net Investment + Consumption =Net National Product

Gross National Product Type:

Gross Investment + Consumption = GNP

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

To carry out the research on ‘*Value Added Tax in Nepal*’ (Focused on GDP and Total Revenue)’ the nature of data, the sources of data and the statistical tools are as follows.

2.1.3 Objectives of VAT

1. To increase in government revenue.

2. Developing stable source of government revenue.
3. To make the tax system more transparent.
4. To avoid cascading effect.
5. To reduce tax evasion practices.
6. To increase in export.

2.1.4 Basic Features of Nepalese VAT System

The type of VAT adopted by Nepal is conventional similar to that implemented over 150 countries around the world, it has injected some special features in to vat system to make it uniquely Nepalese. The following are the main features of the Nepalese VAT system:

The adoption of consumption type of VAT because VAT is finally borne by the consumer

- The consumption of VAT through tax credit method
- The principle of destination.
- The level of threshold is Rupees 2 million.
- The facility of tax refund.
- The application of VAT to all business turns over through the retail stages.
- The rate of Vat is single and positive @ 13%..
- The provision of exemption and zero rate for the goods and services.
- The allowance of tax credit for taxable supplies including the zero rate supply.
- Small entrepreneurs are exempted to register in VAT office.
- Self assessment system.

2.1.5 Legal Aspects for Registration and Cancellation of VAT in Nepal

Registration of VAT

VAT is subject matter of law, for this registrant is most. The criteria for the registration in any business are based on annual taxable turnover or transaction of more than 2 million rupees.

Small vendors those who do have less than 2 million annual turnovers may also registered their business voluntarily.

Cancellation of the Registration

A VAT registration may be cancelled if one's total taxable sales for four consecutive calendar a quarter is not more than 2 million rupees and who has been registered for a full fiscal year or by persons who no longer has a commercial activity because of bankruptcy, receivership, or cessation of the business.

The obligations of the VAT registrant are as follows:

- Submit VAT return and pay the collected VAT amount within the 25 day of the following month.

- Provide tax invoice to their customer.

- Maintain purchase and Sales Book separately for the VAT purpose.

- Keep their VAT record for a period of 6 years

- Inform the Inland Revenue Office of changes to the business including new address, telephone number or a reorganization of a partnership within 15 days.

- Put their Certificate of Registration in the premises where customers may easily see and read it,
- Allow tax officers to enter the business to examine the business records and the stock on hand.
- Most business will require only minor modifications to their record keeping. In order to complete his VAT return a taxpayer will need to ensure that his books and records provide.
- The amount of VAT paid on purchases.
- The amount of VAT collected on sales.
- A method of distinguishing between taxable and exempt sales.
- The time the goods and services were supplied and Evidences those goods were exported, if any

A taxpayer must keep the records of a purchase book, a sales book and a VAT account. The purchase and sales book should include the following things.

- The invoice number
- The invoice date
- The customer's name and PAN number in the sales book
- The taxable value, and
- The amount of VAT

2.1.6 Administrative Review and Offences of VAT

Administrative Review

A tax collector who is not satisfied with the Tax Assessment made by Tax Officer may submit an application to the director of IRD (Inland Revenue Department) for review within 30 days from the time of receiving such decision. IRD bound to furnish their verdict within 60 days from the filing of application and IRD fails to do then collector may submit their appeal to the revenue tribunal.

Offences

Following acts are considered offence and fine and penalty will be imposed.

- No registration within 90 days from the commencement of the Act.
- No publication of registration certificate within the business premises publicly.
- Not giving information regarding transfer of location or area of business to the authority within 15 days from 'such transfer.
- Not issuance of bill.
- VAT collection without registration.
- Not filing of tax statement as per the prescribed period.
- Any kind of cheating forgery or fraudulent transaction.
- Creating obstacle to the tax officer during the inspection of business transaction.

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

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

Calculation of Tax Included in Price

When VAT is collected (as it is in Western Europe) step-by-step through the economic process, the amount of tax directly included in any product or service can be accurately calculated at any stage. Nevertheless, complications still arise-particularly in the area of services.

The difficulties of making an accurate calculation of this type with the conventional turnover tax were a major reason for the BEGs decision to introduce VAT as a replacement. Because company profits are uncertain until the end of the year, and the profits to be allocated to a particular good or service are even more uncertain, the corporate profits tax is very badly suited for use in making refunds on exports or collecting border taxes on imports.

2.1.7 Tax Harmonization

The treatment of VAT and other indirect taxes on the basis of destination and the corporate income tax and other direct taxes on the basis of origin is an integral part of European taxation literature and of the GATT understandings. Although this position rests on the general incidence conclusions mentioned at the start of this review it also has a legal and an economic-political base.

British opinion commenting on international tax neutrality has concluded it is not obtainable through application of the destination principle to direct taxes as well as indirect taxes. This situation makes international harmonization of direct tax legislation much more necessary than harmonization of indirect tax legislation. It is also true the harmonization task is much more difficult.

A true tax union, the apparent goal of the EEC, means that indirect taxes will be levied on the basis of origin and ER-IT is eliminated. However, it is believed by some that all the goals of the EEC can be met without eliminating ER-IT between Member States and, therefore, uniform VAT rates are not required. The desirability of harmonization of indirect taxes under the rules of ER-IT has frequently been considered in relation to the use of VAT by EEC.

It is not only the manner in which taxes are collected and their relative rates that affects economic interrelations as formal and informal tax and economic unions develop. The manner in which taxes are spent is also influential. Two & countries collecting the same

portion of national income with identical taxes, but with quite different public expenditure patterns, would still not have economically neutral fiscal systems. For example, high social security expenditures may induce labor to go where productivity is relatively low to enjoy the advantages of liberal social security benefits.

A general indirect tax such as VAT possesses international monetary characteristics. It has been frequently suggested that an increase of VAT rates is the equivalent of a devaluation of the currency. Also, VAT can be used to change the general liquidity of the economy through changes in collection and refund practices.

The German economic literature had always seen international and domestic economic adjustment opportunities in changing the portion of VAT refunded on exports or collected on imports. The introduction of VAT as a common tax for the Member States of EEC eliminates ER-IT on trade among themselves. In doing this it also introduces a new ER-IT hurdle for nations outside of EEC stimulus for nations.

2.1.8 Principles of VAT

There is no doubt that VAT is levied on consumption and consequently final burden of the tax is shifted to the consumers. In the age of globalization and liberalization, the world has been narrowed as a small village. Goods and Services can be provided broadly either domestically or by importing from other countries. When two countries are involved in trade, the analysis of cross border trade agreement should be exercised with cordial bilateral approach and becomes necessary. To impose VAT in the economy, the following two principles of VAT have to be considered clearly.

I. Original Principle

In this principle, tax is levied at the place, where it is produced or rendered irrespective of whether they have been consumed or not. In this principle, preference is given to imported goods or services over domestic production because all exports are treated as taxable where as all imports are treated as non-taxable. This sort of

principle may be beneficial where common trade exists like European Union; otherwise rests of the countries do not prefer this principle.

II. Destination Principle

Contrary to the earlier, under destination principle, tax is imposed at the place where it is consumed irrespective of where it is produced or rendered. Neither has it preferred imported goods or services nor the domestic goods or services. Equal preference is given to both imported and domestic products. In this ground, it is assumed to be a neutral principle and with the purpose to boost the exporting goods, many countries prefer to apply this principle of taxation.

2.1.9 Working Nature of VAT

VAT is a tax imposed on the value added to goods and services consumed in Nepal or exported outside. The tax is based on the principle that each producer or distributor adds value, in some way, to the materials they have purchased and it is this added value that is taxed at each stage of the production and distribution chain. There is the presumption that VAT is shifted forward completely to the consumer.

In the VAT system, producers, distributors and people providing services raise VAT on the products or services sold or provided. The difference between the VAT collected on sales and the VAT charged on purchases determines the amount a registrant must remit or the amount that may be claimed as a refund.

In other words, if the tax on sales is more than the tax on purchases, the dealer / businessman remits the difference. If the tax on sales is less than the tax on purchases, the dealer may carry forward this credit to the next month.

2.1.10 Laws governing VAT in Nepal

The Value Added Tax Act, 2052 and Value Added Tax Regulation, 2053 are the basic laws of the VAT, whereas, any Act should not contradict with the provisions of

Constitution and judicial interpretation also plays the vital role to interpretation and The other tax related Acts like Fiscal Act are also related with VAT.

The VAT Act came into force with the objective, as stated in the preamble, Whereas, for increasing revenue mobilization by making effective the process of collecting revenues required for the economic development of the country, it is expedient to impose a value added tax on all transactions including the sale, distribution, delivery, importation, exportation of goods or services and to collect revenues effectively by regulating the process of collection.

Essentials of VAT

Essential elements are divided in 7 parts; on VAT can be charge or imposed without fulfilling all requirements.

Supply

“*Supply*” means the act of selling, exchanging and delivering any goods or services, or the act of granting permission thereto or of contract thereof for a consideration; A broad-based VAT is designed to bring within its charge every kind of economic transaction, subject to limited exceptions. This is normally achieved by drafting a very broad provision imposing VAT on an extremely wide range of business transactions and then removing by specific exception any transaction that is not to be liable.

Goods or Services

“*Goods*” means any kind of property whether movable or immovable, “*Services*” means anything other than goods;” Transactions are usually stated to be within the scope of VAT if they are “*supplies of goods or services.*” These terms are given extremely wide meanings that go significantly beyond the usual meanings of “*supplies,*” “*goods,*” and “*services*” in most languages. The aim is to bring within the charge all economic activity.

VAT laws usually contain a definition of a “*supply of goods*” or “*goods*.” It is felt, in the light of the formal presentation above, that the better practice is to offer a definition of a “supply of goods.” Again, the definition needs to avoid being too closely related to any definition of a similar concept in the commercial or consumer law of the state. This is because the scope of the VAT rule will usually be wider than the scope of the commercial law.

For Consideration

“*Consideration*” means anything to be received for money, goods, services or value; A supply is made for payment, consideration, or compensation if the taxable person making the supply receives, or is entitled to receive, payment for the supply. For this purpose, it does not matter in what form the payment is made. An exchange of goods is a supply for payment or consideration by both parties to the bargain, as is a supply of goods in exchange for the provision of services by the person receiving the goods. In addition, it does not matter who makes the payment. It will usually come from the person receiving the supply, but the source is irrelevant. Therefore, some laws make it clear that all forms of payment are to be included as payment or consideration for the supply, even if this includes grants made by public authorities or other third parties.

The concept that a supply is within the scope of VAT only if there is payment or consideration for it follows from the fundamental nature of the tax as one imposed on the value added by a transaction. If a supply does not result in gain for the supplier, directly or indirectly, then no value is added in making the supply. By contrast, the same reasoning argues that the consideration should include all forms of payment received by the supplier, in cash or in kind, whenever and however paid, and regardless of who pays them. This definition is usually used as the definition of the taxable value of the supply, that is, the amount on which the VAT is imposed. Both, efficiency and fairness therefore argue for a comprehensive definition

Other than Exempt Supply

Goods or services supplied; imported; exported in and from the Kingdom of Nepal; tax shall be levied on the taxable value of every transaction. Notwithstanding anything contained no tax shall be levied on the transactions of goods or services set forth in Schedule 1, of VAT Act.

Supplied by Taxable Person

“*Person*” means any individual, firm, company, association, institution, partnership firm, cooperative, joint business, religious endowment, or fund; and the term also includes any government body, any religious organization charitable trust or similar other bodies and branches or sub branches there engaged, with or without the objective of profit, in taxable transactions. “*Registered Person*” means any person who is registered for ‘transactions pursuant to Section 10

A person within the scope of VAT is usually described as a taxable person; this terminology avoids the confusion caused in some states by calling such persons “*taxpayers.*”

Supplied within and outside the Nation

There are two conflicting principles on which the territorial scope of a VAT can be based: the origin principle and the destination principle. As these names suggest, the origin principle charges a transaction, only part of which occurs within the jurisdiction, if the transaction originates or is created within the state and the destination principle charges the transaction if it is destined for consumption in the state. For example, if goods are exported from state A to state B, then state A will charge the transaction if it has an origin-based VAT, and state B will charge if it has a destination-based VAT. For services, it may in practice be harder to determine where the service is provided, or where it is consumed. ‘Subject to that practical problem, an origin-based tax will concentrate on the state of origin of the person supplying the service, while a destination-based tax will charge supplies consumed in the state.

Except otherwise provided, a Value Added Tax shall be imposed on the following transactions:

- Goods or services supplied into the nation;
- Goods or services imported into the nation;
- Goods or services exported outside the nation;
- On the Business Activities of that person

The unique nature of the VAT is its potential scope in identifying and taxing the economic contribution to added 'value made by any economic operator in connection with any activity' of a business or commercial nature. A charity that supplies goods to beneficiaries without payment, or for a token fee, is not acting as a business, where the running of an art gallery to which free admission was granted was accepted as outside the scope of VAT. By contrast, it will be hard for an ordinary commercial company, a partnership, or a landlord to argue that payments they derive from their activities are anything other than economic. An interesting example of a marginal case is the suitably named in decision, which established that shooting (and equally hunting and fishing) one's own land with one's own friends contributing to one's costs is not always an economic activity.

Tax invoice System

VAT is invoice based tax system. Role of tax invoice is more important in VAT system. Section 14 of VAT Act, 2052 and rule 17 and 18 of VAT Regulation, 2053 stipulates about tax invoice system. The "*VAT invoice*" should be clearly written in front page of the tax invoice bill that should be given to the customer. Three copies of tax invoice is must in which one copy is for buyer, one copy is for office record and the third copy is for VAT office purpose whenever needed.

Tax credit, being a fundamental feature of VAT system, the amount of tax which has to be paid by seller and tax credit of buyer will be clear if the VAT invoice system is brought into regular practice. VAT system creates the situation to mention real price in VAT invoice while purchasing goods and services. Similarly, VAT invoice system minimizes the low invoice and high invoice problems gradually.

Tax Administration

In the process of execution of VAT in 2052, the Department of Excise Duty and Sales Tax was converted into Department of VAT. From 2058, Department of Tax and VAT has been changed into Inland Revenue Department. Tax being a serious and technical subject administration of tax should be competent, active and service oriented. Taking this into account Inland Revenue Administration is an action oriented organization. Honest, competent and high moral professional organization is inherent part to make the succession of VAT system. But expected result is not accomplished yet from the VAT administration, which has burden to implement VAT Law and Regulation. Large number of proficient manpower in tax administration is still in scarcity. Voluntary taxpayer has not got the opportunity to pay tax with due respect even today.

Appeal System

Tax administration is the main organ to put into effect the VAT law. If tax law is not enforced properly, taxpayer has to pay more or less tax. If low rate of tax is collected government has to lose revenue and if high rate of tax is collected that will be unjust for taxpayers. Considering the undesired situation as mentioned above, tax law stipulates the provision of appeal system. Every taxpayer has right to appeal against the decision of tax officer. In regard to VAT, appeal system comprises of administrative appeal and judicial appeal.

Case Laws on VAT

In respect of VAT as prevailed provision, taxpayer can file an application in Inland Revenue Department against the decision of tax officer under administrative appeal. If that appeal is not decided within 90 days or if that application decided within 90 days and the taxpayer is not satisfied with the decision then he can appeal at the Revenue Tribunal. If the decision of Revenue Tribunal is also unsatisfactory then concerned unsatisfied party might file an application at the Supreme Court for appeal permission. The ultimate interpreter of VAT matter is the Supreme Court.

The interpretations of court relating to the law and matters are plays the vital role on the development of justice as well as law and order. Because of new implementation there are no case is find decided by the Supreme Court. However, the Revenue Tribunal has decided more case on this regard. Some of them play the significant roles to develop the VAT as an effective method of revenue collection.

2.1.11 Tax Liability should not base on Assumption

The tax office cannot assess the tax liability on the basis of proportion of a month or months. Assessment should be based on fact and evidence. In principle, the VAT is imposed on actual transaction, cannot be assess or impose on assumption.

In the case of *Shailendra Malla MD, of Sarbada (P) Ltd v. Department of VAT*; by nature of business, breakage should be write-off, imposition of interest and fine in assumption of sold item is unjust. Interest and fine shall impose till the decision is made.

In another case, *Padma Jyoti partner of Bhajuratna Bikri Kendra v. Department of VAT*; the tribunal shall not entertain the assessment done by the computer whether tax return filled by the tax payer.

Direct and Indirect Taxes

Although GNP is equal to GM (National Income plus depreciation and indirect taxes) the taxation of one rather than the other divides taxes into a sharp dichotomy. Taxes using GNP are levied on transactions, and taxes on GM are levied on persons. Using this definition in this area where there is much difference of opinion, transaction-based taxes are indirect taxes, and person-based taxes are direct, taxes. Taxes provide governments with control over resources for their use, and decrease the quantity of goods and services that can be purchased by the private economy. In the case of indirect taxes, prices are increased so less can be purchased. Under a direct tax, after-tax incomes are decreased so less can be purchased-and maybe is less. On the face of it, direct taxes place a continuous downward pressure on prices of private goods while stimulating

leisure. On the other hand, indirect taxes appear to place a persistent upward pressure on prices and stimulate saving. When one digs a little deeper this apparent difference becomes blurred. Some researchers believe it is impossible to assume offhand that sales taxes are shifted forward. It is also true that many commentators on the American wage negotiations of 1967 observed what might be called the announcement effect of income tax rate increases being proposed in Congress.

VAT as used by the EEC Member States is of the invoice consumption variety. The legislation of all Western Europe users of the tax provides for the more or less immediate deduction from the firm's VAT liability of the VAT included on the invoices of all purchased goods and services.

The income type VAT of the literature would permit the VAT tax base to be reduced by the amount of depreciation that takes place during the year, like the income tax. The extent that these two different approaches to VAT affect the incidence of the tax has not been directly considered in the literature. Rather, the discussion has been around whether VAT of the consumption type is equivalent to a proportional consumption tax, and VAT of the income type is equivalent to a proportional income tax. These analyses, and there have been others, in trying to establish VAT equivalence have proven to be somewhat sterile efforts to relate the different to the familiar.

The third type of VAT makes no allowance for capital purchases or depreciation. This is called the gross product type. The consumption type VAT has been favored by those wishing to stimulate investment, economic growth, and tax simplification. The characteristics of the income type VAT cause more stable revenues while providing an equal treatment of all costs.

2.1.12 VAT Introduction Considerations

While introduction of a major new tax to replace old taxes or to provide additional revenues is considered, a need develops to know how the economic position of particular taxpayers will be affected. Both in the US and the UK, VAT has been considered as a tax to provide revenues that would permit a reduction of the rate of the corporate income tax.

Obviously, a development along these lines would reduce the relative tax burden of high corporate profit industries. The low and no-profit “inefficient” corporations would have to pay more taxes. To avoid the imposition of new taxes on no-profit corporations, it has been suggested that these firms, at the start, be exempted. The impact on saving of a switch away from the corporation income tax toward the use of VAT can be analyzed in relation to income levels of dividend receivers and the withholding of profits, and therefore savings, of corporations.

If direct taxes other than the corporate income tax, i.e., personal income, payroll and property taxes, are replaced with VAT, the relative burdensomeness of taxes of the high savers and the large users of real estate’s are lightened. Also, the amount of tax evasion is decreased, and therefore tax acceptance is improved. VAT can be a very prolific revenue raiser without acquiring the evasion propensities created by high rate income, property and retail sales taxes.

VAT, administered as it is in Europe and calculated on each invoice, becomes a deduction from tax liabilities of all purchasers down to the final consumer. Therefore, failure to pay AT by a seller increases the taxes owed by the purchaser of the good or service .This gives VAT a high built-in anti-evasion character. The collection of a high percentage of selling price through use of a single stage tax develops evasion problems that VAT avoids. It is also true that the introduction of VAT will reinforce the administration of the personal income and the corporate profits taxes. Because prices are more likely to rise from the introduction of a new tax than to fall when an old tax is removed, the introduction of VAT requires compensatory actions. For example, welfare benefits of various types could be improved. For this to be possible, VAT rates at introduction must be set to bring in revenues in excess of those provided by the taxes replaced.

The British studies of VAT emphasize the administrative problem •as being serious. The administrative difficulties increase substantially with the introduction of varied rates and the coverage of small establishments Michigan tax officials found their use of a variety of VAT called the Business Activity

VAT did not create unusual tax administrative problems. In Germany the major administrative problems have arisen from the quasi investment tax on all additions to fixed assets. The rates of this tax are scheduled to decline until eliminated. The changeover from the German turnover tax to VAT was remarkably smooth. The more serious administrative problems of The Netherlands were largely due to inexperience in the application of taxes at the retail level. The administrative problems arising from the introduction of VAT in an underdeveloped nation may be more serious.

VAT has not been introduced as a major tax in an area placing major reliance on direct taxes and using only selective excise taxes, e.g., UK or the US .Until this is done, one cannot with assurance state the problems envisaged will be realized and Introduced under the right conditions VAT would improve the fiscal and economic climate of the UK. *[Source: Gerald (2004:32Page)]*

2.1.13 Impacts of Use of VAT

A considerable portion of American writing relative to VAT has been concerned with introducing VAT as a replacement for the corporate income *tax*. This has also been the case with earlier discussions of British writers. The UK later reduced this emphasized and it never really existed on the continent.

Economic Stabilization

One aspect of the consideration of VAT as .a replacement for the corporate profits tax is VAT's greater revenue stability. It would reduce the built-in economic stabilization impact of the American federal fiscal system. The sensitivity of corporate profit levels to fluctuations in economic activity and the high rate at which they are taxed makes the intensive use of this tax base a major contributor to what is called desirable cyclical fiscal instability. Observation of this type of fiscal policy has caused a number of fiscal analysts to conclude built-in fiscal instability may not be desirable. It seems to prevent full use of resources, and to promote a non-stabilizing government expenditure policy. In the long run, VAT can more than likely make a greater contribution to an automatic stabilization policy than can the corporate income tax.

Another apparent economic stabilization advantage of VAT lies in its greater effectiveness in reducing consumption expenditures. These expenditures can be reduced by a given amount through a smaller increase of VAT rates than of Personal income tax rates. It is also true a broad based tax such as VAT is more effective as a general regulator of demand while having less effect on the cost of living than narrow based excise taxes.

Economic Growth and Investment

The impact of VAT on economic growth of developed and also developing nations are another aspect of the relative desirability of using VAT to replace the corporate income tax or, perhaps, of introducing VAT as an additional tax. The UK study of VAT in 1963 and early 1964, and other “*economic growth*” related analyses of tax systems were stimulated by the “unsubstantiated” claims that the use of transaction taxes, generally, was an important cause of the relatively rapid economic growth of Continental Western Europe. Indeed, the findings of the studies demonstrated that economic growth on the Continent was more rapid than in the UK and America. On the other hand, the causes identified did not fully support the position that the more rapid rate was due to lower profit taxes and higher transaction taxes on the Continent.

The most careful study of causes of American economic growth found the domestic demand for industrial capital to be weak. This situation could be causally related to high US corporate profit taxes. The relatively low American profit and interest rates prior to 1965 led to an outflow of American Savings’ to Europe. Savings invested abroad do not stimulate American income growth (multiplier effect tends to be less) as much as domestic investment. VAT, by stimulating exports and retarding imports, expands domestic investment of savings. It is generally believed British economic growth is closely related to exports. The UK international competitive position would be improved by replacing the corporate income tax with VAT.

The consideration of the relationship of VAT to investment and economic growth broadens inevitably into the general consideration of the difference in the impact on investment, of incomes and profit taxes compared with excise and transaction taxes. As was mentioned

above, the discussions of VAT are also concerned with the difference in treatment of capital goods under the income type and the consumption type VAT.

Under the income type VAT the base is prevented from including capital goods twice (once when produced, and again as a cost of further production for sale) by providing for depreciation deductions from the taxable base. Under the consumption type VAT full allowance is made at the time of capital good purchase. The consumption type VAT treats the purchase of a capital good exactly like the purchase of steel, coal or what have *you*. Where the so-called “buffer rule” is used, tax refunds are not paid, and a tax credit is instead carried forward to be applied to future VAT liabilities.

2.1.14 VAT as a State Tax

The American tax advisory group to Japan in 1949 and 1950 recommended VAT as a prefectural tax. The international economic advantages of the tax were not recognized and VAT was not recommended as a national tax. This American recommendation was a revival of American interest shown in VAT during the 1930s.

In 1953 Michigan enacted BAT which belonged to the VAT family. The tax was repealed in 1967. The base of the tax was profits before taxes plus payroll and depreciation of fixed assets other than real estate. Interest, rent, and taxes other than those measured by net income were excluded from the base. During its life it was the subject of considerable tax literature, much of it related to administration. Proposed legislation in West Virginia in 1968 and 1970 provided for a “true,” rather than a truncated version of VAT such as BAT of Michigan. An analysis of the proposal concludes the tax turns out to be a business tax based on the benefit principle. The Michigan experience with BAT demonstrated the revenues from the tax to be more stable than from a corporate income tax. VAT collected relatively more from manufacturing and retailing than from other industry grouping.

Because Federal income taxes of both the individual and corporate variety are high, tax sharing through deduction of state taxes from Federal taxable income is important. VAT is not deductible by consumers under present Federal legislation or IRS Regulations but is deductible by businesses. This is the same situation that exists with state corporate income

taxes. Because of prevailing tax incidence beliefs and ease of tax burden identification, a stronger case can be made for deduction of VAT from Federal taxable individual income than for deduction of corporation income taxes. *[Source: Gerald (2004:46Page)]*

2.1.15 Exemptions/Non- exemptions of VAT

VAT divides all goods and services into two basic categories, taxable and tax-exempt. Goods and services are either taxed at the standard rate of 13 percent or they are taxed at 0%. Those taxed at the standard rate include all goods and services except those, which are specified as taxed at 0% or tax-exempt.

Tax-exempt Goods and Services

The purchaser will not pay VAT on tax-exempt goods and services and the supplier is not allowed input tax credits on purchases related to the following goods and services:

EXEMPT GOODS AND SERVICES AS PER VALUE ADDED TAX LAWS OF NEPAL:

Group 1

- (a) Basic agricultural products Rice, wheat, maize, barley, millet, buckwheat, lentils, flour, semolina, grits, grams, beans, and similar basic, unprocessed agricultural food products and their residues.
- (b) Green and fresh vegetables, fruits, fresh eggs, and similar unprocessed agricultural products (apart from those consumed by hotels, restaurants, bars, guest houses, cafeteria, and other similar enterprises).
- (c) Unprocessed cash crops (e.g., sugarcane, cotton, cardamom, ginger, dried ginger, jute, unprocessed tobacco sold by farmers, tea leaves, orthodox tea produced by using organic fertilizers, coffee seeds, oil-extractable food items such as soybeans, peanuts, mustard seeds, sunflower seeds, sesame seeds and their residue.

- (d) Herbs (including their extracts)

Group 2

Goods of Basic Necessity

- a) Unprocessed mustard oil
- b) Drinking water supplied openly by tankers and taps
- c) Fuel wood and charcoal
- d) Kerosene (apart from aviation fuel)
- e) Salt

Group 3

Livestock and their products

- (a) Goats, lambs, sheep, yaks, buffaloes, boars, pigs, rabbits and other similar livestock; their fresh milk (including pasteurized milk), yogurt, and other unprocessed, raw varieties.
- (b) Cows, buffaloes, lambs, and their fresh milk (including pasteurized milk) and yogurt.
- (c) Ducks, cocks and hens, turkeys, partridges and similar fowl and their fresh meat, other unprocessed varieties, and eggs.
- (d) Fresh or dried meat (unpacked)

Group 4

Agriculture related products and equipment

- (a) The seeds of crops and plants listed in Group 1
- (b) Fertilizers, chemical fertilizers, and products used for treating the soil

General equipment used for agricultural work

- i) Hand equipment used for digging or cleaning the soil and for cutting wood, twigs, etc (apart from hand saws)

ii). Small hand equipment used for separating the grains and cleaning the husk (dehuskers)

iii) Hand equipment used for cutting animal fodder and the plough

(c) Chemical pesticides used exclusively or primarily in crops

(d) The following items used in agricultural work

- Tractor
- Cultivator
- Hairo
- Leveler
- Equipment used for cutting animal fodder
- Thresher
- Fishing net
- Readymade cages to keep fish
- Fish incubator

- Pumping pipe of up to 8 horsepower and its hose pipe of up to 30 meters

(e) The utensil in which hens are given drinking water, the box in which chicks are kept.

(f) Specified ingredients used in animal feed and feed supplement

Group 5

Medicines, medical treatment and other health services

(a) Surgical and medical services provided by Government owned health organizations

(b) Human blood, ingredients contained in the human blood, and vaccines

(c) Human and animal parts and tissues used in medical research

- (d) Medicines used for treating animals and people and family planning products
- (e) Equipment/material made for and solely appropriate for use by the disabled
- (f) X-ray films and oxygen gas used for medical treatment
- (g) Medical raw materials imported or bought by a medicine industry as per the limit specified by the Department of Drug Management.

Group 6

Education

Research work carried out in schools and universities

- (a) Commercial or professional training courses and refresher training courses organized without profit motive.
- (b) Educational services provided by schools and universities.

Group 7

Books, newspapers, printed material, and printing and publishing

- (a) Books, newspapers, magazines, and periodic publications
- (b) Newsprint paper

Group 8

Culture, arts and craftsmanship related services

- (a) Fine arts, sculpture, architecture and similar handicrafts and related services
- (b) Cultural programs
- (c) Entry fees to libraries, museums, art museums, zoos and botanical gardens

(national parks)

Group 9

- (a) Passenger transport and goods transportation services
- (b) Air travel, non-tourist transport (apart from cable cars), and goods transportation services (apart from transportation of goods related to supply)

Group 10

Commercial or professional services

Institutional or personal services provided by artists, sportspersons, writers, designers, translators, and interpreters.

Group 11

Miscellaneous goods and services

- (1) Postal service (only those operated by the Government)
- (2) Services related to transportation or handing over of letters, money and parcels various services related to services required for transportation or handing over of letters, money and parcels Postal stamp.
- (3) Financial and insurance services
 - Bank notes and cheque books
 - The printing and releasing of Nepalese notes
 - The supply of bank notes into Nepal from outside Nepal
 - Cheque book
- (4) Gold and silver Gold, gold coins, and gold ornaments Silver and silver coins (apart from readymade silver goods and ornaments)

- (5) Electricity
- (6) Raw Wool
- (7) Battery-operated three wheeler and its chassis and battery
- (8) All machinery and equipment used for the production of bio gas, solar, and wind energy on the recommendation of the Alternative Energy Centre.
- (9) Aero planes, helicopters, fire brigades, and ambulances
- (10) Products made of jute.
- (11) Only those industrial machineries on which a maximum of customs duty is levied, as per Part 84 of the Customs Tariff.
- (12) Woolen carpets and their cutting, dying, washing and knitting.
- (13) Aluminum, copper, and bronze scrapes, blocks, sheets, and readymade utensils.
- (14) Cotton saris, lungi (wrap around), dhoti (for male and female), petani, and gamcha (small cotton towels)
- (15) Cotton thread
- (16) Woolen thread (apart from artificial and acrylic) used to knit handmade sweaters in the country
- (17) Goods received as donation in any natural calamities or for philanthropic purposes with permission from the Ministry of Finance of Government of Nepal.

Group 12

Building and land

Purchase, sales and renting of houses and land (apart from services provided by commercial enterprises such as hotels, guest houses, etc)

Group 13

Betting, casinos, and lotteries

- (1) Activities related to providing services to enterprises engaged in betting and gambling
- (2) Lotteries

ZERO RATING GOODS

Goods or Services payable at zero rate:

1. Goods or services purchased or imported by His Majesty King, Her Majesty Queen, His Majesty Crown Prince, and other members of the Royal Family.
2. Export of goods:
 - (a) Goods exported outside the Nepal
 - (b) Goods shipped for use as stores on a flight to an eventual destination outside the Nepal; or
 - (c) Goods loaded for use as stores on aircraft to a destination outside Nepal or as merchandise for sale by retail or supplied to persons in the course of such a flight.
3. Export of services
 - (a) A supply of services by a person resident in the Nepal to a person outside the Nepal and having no business establishment, agent, or legal representative acting on his behalf in the Nepal.
 - (b) Where goods are supplied on a here or loan basis by a registered person resident in Nepal to a person resident outside the Nepal
4. Imports of goods and services by accredited diplomats
5. Medical industries can get zero rate facility, if they intended
6. Local purchase from those which were provided exemption from sales tax as per the agreement made previously.

2.1.16 VAT Fraud and Evasion

Like all taxes, VAT is subject to evasion. For example, traders may fail to register for the tax, they may under-report sales or, where different goods are subject to tax at different rates, they may reduce their tax payments by misclassifying sales into the category subject to a lower rate (or zero rate) of tax. In some respects, the particular structure of VAT may reduce its exposure compared with other systems of sales taxation. In particular, the gradual commutation of the tax at each stage of the chain of production and distribution may reduce the amount of tax at stake at each stage, and hence the gains to be made from making untaxed sales.

It was quite shocking to reflect on the Transparency International (TI) report released on June 11, 2012. As per the anti-corruption index for the year 2011, Nepal has claimed the 143rd position among 180 countries listed—it was 138th the previous year. It was also observe that political instability, lawlessness, nepotism and lack of accountability have mainly characterized this. Unfortunately, corruption has not only dominated governance at all levels, but also that an anticorruption agenda has not become a political and social priority of Nepal.

Corruption, as a great socio-political and economic evil of our society, has been the biggest obstacles to justice, democracy and overall national development.

The nation has been cheated by corrupt leaders and some privileged groups. Ironically, the government's inability to collect taxes has virtually strengthened the black income machinery or black economy in a significant manner, and the economic scenario is dwindling. Therefore, campaigns have to be accelerated to get back stolen assets from the tax dodgers.

VAT offers distinctive opportunities for evasion and fraud, especially through abuse of the credit and refund mechanism. Revenue may be lost through exaggerated claims for credit for VAT paid on inputs to production. Moreover, the opportunity exists for outright fraud through the construction of business activities with the sole purpose of defrauding the exchequer, because some categories of business can be entitled to net

refunds of VAT from the revenue authorities. These can include firms selling predominantly zero-rated goods while claiming credit for significant amounts of VAT paid on standard-rated production inputs. While zero-rated domestic sales can create opportunities of this sort, the main point of vulnerability in the current system arises because of the VAT zero-rating of exports.

Under a VAT, they may or may not issue an invoice. If they do, the customer, if registered for VAT, may seek the corresponding credit. The ultimate success of the evasion then depends on the inability of the revenue authorities to discover that more VAT invoices have been issued but not declared by their issuer. For sales to final consumers or exempt businesses, however, there is no gain from issuing an invoice, since no credit would be available: common examples include personal services

(Home decoration, building contractors working for private customers and so on) for which value added at the final stage is usually large relative to VAT-able inputs. Sometimes, the customer is aware that the sale is made without VAT, and may share some of the gains (or believe that they do so).

Some fraud has been doing by the businessmen, which are as follows:

) VAT collection by issuing the VAT bill in lower prices

This may be possible through false accounting (under-reported sales). In Nepal this system of VAT fraud is commonest in most of the business firm.

In the context of Nepal, almost all business firms have kept two sets of account for their advantage. 1st sets of account are for their actual transactions i.e. for their internal purpose. In this sets of account they records actual transactions of their firm. And 2nd type of account book is for tax purpose i.e. they show that sets of book in Inland Revenue Department. In this type of book they show lower sales revenue than actual sales. What I mean to say that they sold goods without VAT bill. In such a way business firm has been cheating the revenue of nation.

) **Conceal the stock**

If the VAT representative came to check the transaction and their stock, the businessmen try to conceal their real transactions and stock. The businessmen keep their stock far away from their shop because the VAT representative could not find the stock. In this way, the VAT evasion and fraud has been growing among the businessmen.

) **Failure to register**

The commonest cases under the VAT are relatively small businesses operating near to the level of turnover, at which registration becomes compulsory, that fail to register, saving both the VAT for which they would be liable and VAT compliance costs. It may be able to evade income taxes as well as VAT. Once again, firms selling to final consumers (or to other unregistered businesses) are likely to predominate in this group.

) **Misclassification of commodities**

When traders have sales that are liable to tax at different rates, or some of which lie outside the scope of the tax (exempt items under the VAT), they may reduce their liability by exaggerating the proportion of sales in the lower-taxed categories.

) **Omission of self-deliveries**

Goods or services produced by the business and consumed by the proprietor or employees, in principle taxable, may not be declared. Generally, however, this is a relatively unimportant category in more developed economies where agriculture, for which this can be a real issue, is less significant. And a VAT with a relatively high registration threshold will exclude many of the smaller businesses for which this is likely to be more of a risk.

) **Tax collected but not remitted**

This may be possible through false accounting (under-reported sales), by engineering bankruptcy before tax is paid, or in other ways. More particularly, the ‘missing trader’ frauds involve registered businesses charging their customers VAT but disappearing before paying tax to the authorities.

) **Imported goods not brought into tax**

If tax is not levied at the border, then there is a potential gain from purchasing imported goods bearing no tax and then reselling them in the home market.

2.1.17 Sources of VAT information about Practices in Nepal

Reviewing the existing practices of VAT reveals that the government’s emphasis is largely on meeting revenue growth targets. The country has failed in sustaining minimum growth rate by establishing link between revenue generation and expenditure management. For making policy adjustments, a regular enquiry in the changes in revenue and expenditure structure and their impact at the household level is necessary. After each policy announcement, the government is found to revert back because of pressures from vested interest groups and politicians. There are several references some of which include, withdrawal of Education Service Charge, charges on Crude Palm Oil, and helplessness to control leakages in customs and VAT. Presently, the pressure is mounting from boulder exporters.

Most retailers avoid giving invoice. Often, it is reported that supermarkets use software to record different set of transaction for VAT. Besides this, credit claim or refund claim is made for which there is no VAT return submission by the seller. In some of the purchases by foreign offices from Nepali market, the examinations reveal, that traders do not keep VAT payment records while claiming VAT refund. The reason VAT is increasing is largely because of the proper compliance by institutional organizations such as Nepal Telecom, Nepal Oil Corporation and other public companies. The VAT office

complain members of Nepal Chambers collectively pay peanuts as VAT, but all of them collect in full from the customers.

There have been several cases of misuse of stickers by alcohol producers. Under-reporting of production is another problem by manufacturers who show losses most of the times. The input-output ratio analysis by Internal Revenue Department is very poor.

There is under-reporting of profits by using different accounting techniques. During investigations, it has been found that non-formal, non- corporate sectors keep two sets of books of accounts.

VAT exemption list is too long and there is pressure to make it even longer. Exemption in VAT may assist taxpayers to also under-report incomes. The MOF has a defined Revenue Exemption Policy for exercising discretionary authority granted by law and is used for medical, emergency relief, educational and other relevant purposes. The review of such practices can also provide some clues on leakages for strengthening revenue administration.

Nepal's economic condition does not allow it to waste scarce resources, the way it had been doing in the past. Every rupee of government expenditure should be used as efficiently as possible. We must examine the link between government expenditure and revenue with the progress and stability of private sector economy. Therefore, to achieve the lofty ideals stated in the manifesto of political parties, an effort to develop revenue policy is needed that can ensure high levels of employment and income.

2.2 REVIEW OF LITERATURE

The research and study based on VAT in Nepal is not an easy task to perform as a whole. Because, time to time, the concept and rules are changing rapidly. VAT revenue is directly affected by national and international environment also. In Nepal there is no long history of VAT. But it does not mean that the history of it is very short. It is not easy task to collect all the information about VAT in Nepal. Reviews of available materials, based on VAT, are helpful regarding to the actual subject matter in the tax system and its actual condition in Nepal. For this study, various books, articles, thesis etc have been reviewed as far as possible. The main and important books and dissertations reviewed for the study are as follows:

2.2.1 Review of the Books/Reports

- **Agrawal (1992)** has started the new phase of Nepalese tax system study from the widely explained research work “*Resources mobilization for development; the reform of tax system in Nepal*” published by Center for Economic Development and Administration (CEDA) in 1992. He presented details about income tax and VAT in Nepal. His study analyzing vividly about role of tax system from legal aspect and administrative aspect, role of income tax and VAT for resource mobilization and other important facts. Dr. Agrawal has given his second contribution towards income tax in 1994 through his report “*Resource mobilization in Nepal*”. He has focused his efforts towards the new dimension in the side of Nepalese tax system. His study is the first comprehensive scientific study on the taxation in Nepal. His facts and figures are very helpful to find out the condition of taxation in Nepal at that time. He had identified the major problems of income tax and VAT system as inefficiency of tax administration and tax evasion though other many have been also shown. Various mathematical calculations have been shown as per capita burden of income tax, buoyancy coefficient of taxation, elasticity coefficient, etc. His study may be the first comprehensive scientific study on the field of taxation

- **Dhakal (2059 B.S)** has presented a course book based on the syllabus of BBS third year and MBS second year, “*Income tax and house and compound tax: law and practice with VAT*”. He had described historical aspect of income tax and VAT and its legal provisions relating to tax with mathematical expression. His book is more useful to know about general information and provisions made under “Income tax, VAT act 2052”.

- **Adhikari (2007)** has written on his book ‘*VAT system in Nepal*’. The then His Majesty Government, first of all, expressed the view of introducing VAT by Eighth Plan. Initially the document mentions the statement to convert the import and manufacturing level sales tax into VAT. Finance Act 1992 introduced the two-tier sales tax for nine items as the base for introducing VAT. Finance Act 1994 extended it for some additional items. The government formulated a VAT Tax Force in 1993 in financial and technical assistance of *USAID*, which drafted the VAT documents to formulating the legislation. The Parliament pass VAT Act in 1995 (2052). However the opposition political party and business community opposed the implementation of VAT. They expressed the view that the infrastructures were in sufficient and preparation was incomplete to implement the VAT effectively. Thus Government could not get political consensus regarding the implementation of VAT. In such environment the government introduced VAT system in 1997, (2054) from November 16, 1997. Although, the VAT act was passed in 1995 and the VAT regulation was approved in 1996. *Danida* provided technical assistance to implement the VAT in full phase. VAT replaced the existing Sales Tax, the Contract Tax, the Hotel Tax and the Entertainment Tax.

The author further focused on the coverage of VAT to which says that VAT is a tax on goods and services consumed in Nepal. The tax is based on the principle that each producer and distributors adds value, in same way, to the materials they have purchased and it is this added value that is taxed in each stage of the production and distribution chain. Similarly, author has dealt with the various provisions of VAT act regarding the standard rate as well as zero rated areas.

The author has listed the merit of VAT as

- Less chance of VAT evasion
- Easy for administration
- Simple and single stage tax
- Less tax burden on consumer
- Encouragement to investment and export
- More neutrality
- More efficient tax

Similarly the demerits of VAT system are

- Possibility of inflation
- Relatively complex
- Increasing in management cost
- It is neutral but not perfectly neutral

➤ **Kandel (2009)**, the writer of this book has written about the “*VAT system of Nepal and Practices*”. VAT is considered as one of the forms of sales taxation. It is divided into three groups i.e. turnover tax, single stage tax and VAT. Turnover tax is levied at all stages of the production and distribution process, the single stage tax may be imposed at the manufacturing level or at the wholesale level or at retail level and the tax is known as manufacturer’s tax, wholesale tax and retail tax. On the other hand, VAT is imposed on the value added at each stage of production and distribution;

In regard to the types of VAT the author has categorized into three heads.

- The consumption Type
- The Gross National Type
- The Income Type

The author has dealt with the Nepalese provisions regarding VAT

- **Jenkins and Kuo (2010)** the writer, of this book has written about on “*A VAT Revenue Simulation Model for Tax Reform in Developing Countries: A case study of Nepal*”. References and further reading may be available on his book and articles. To view references and further reading you must purchase this book.

In this book, they developed a model to simulate policies and revenues for a value-added taxes (VAT) system in countries that have an indirect tax system containing sales, excise taxes, and tariffs. An application of the model is carried out for Nepal, which introduced the VAT to replace its sales tax system and rationalize its excise and tariff systems. The study shows that, in a developing country, tax policies that might seem very realistic and politically noncontroversial are likely to yield a very narrow tax base. If a government of a developing country wants to rely more on the VAT over time, it must move aggressively to broaden the base and enhance compliance.

2.2.2 Review of the Journals Articles

- **Kwang Choi (2008)**, the writer’s paper entitled “*Value Added Tax in the republic of Korea*” outlined the experience of VAT in his country. He declared that the VAT did not have a major impact on the price increase. It showed a good impact on the investment. Studies found that the VAT in Korea was more or less regressive with respect to income. In its overall evaluation, the VAT has broadened tax base, reduced evasion, increased revenue and solved major problem associated with previous taxes. The study has drawn the following major conclusions:
- The Korea government and the public were fully prepared for adoption of VAT in 1997.
 - The government succeeded to convey the message that the adoption of VAT benefited the businessmen in Korea.
 - VAT enjoys a positive reception from taxpayers.
 - There was no serious problem of tax evasion.

Besides the positive effects stated above, few realistic problem were also realized in Korea. VAT possessed a corresponding increase in tax administrative work. Administrative and compliance cost substantially increased.

- **Carl Shoup (2010)** in his article titled “*The Value Added Tax and Developing Countries*” (The World Bank Research Observer, Vol. 3, No. 2, (July, 2010), pp. 139-156) writes about the comprehensive value added tax (VAT), now a principal source of revenue for some forty countries, was nowhere to be found only thirty years ago. This article analyzes the reasons for this dramatic change and weighs the advantages and disadvantages of the VAT for developing countries. It points out the choices a government instituting a VAT must make with respect to taxing all final products or only consumer goods, and it offers suggestions on how to treat exports and imports, how to compute the VAT payable, whether to use “exemption” or “zero-rating” approaches, and whether to have one or various tax rates. For countries with a fragmented retail trade the VAT may apply only to wholesale and earlier stages. The article draws no general conclusions on the suitability of the VAT for developing countries, because these countries differ so widely.

The writer says the speed with which the value added tax has spread around the world is unmatched by that of any other tax in modern times. Thirty years ago there was no comprehensive VAT anywhere. Two countries, Brazil and France, had been experimenting with a restricted VAT. Today, the comprehensive VAT is found in some forty countries, most of them in Europe and Latin America. The restricted form of VAT is used by twenty more countries, chiefly in Africa. In 1988 value added tax is scheduled to be introduced, apparently in comprehensive form, in two such disparate economies as Hungary and Tunisia.’ However, there is no value added tax in Australia, Canada, Japan, or the United States (except for the state of Michigan). The comprehensive value added tax first appeared in Brazil in 1967, when the Brazilian states adopted it to replace their turnover taxes. Late that year Denmark imposed it to replace a wholesale sales tax. From the beginning, therefore, the comprehensive VAT appeared practicable for both industrial and developing economies.

He writes the VAT has not been introduced, usually, to add to a country's tax revenue. Instead, it has chiefly replaced other types of sales tax that were deemed to have serious defects, defects not to be found in the VAT. Foremost among these defective taxes is the turnover tax, levied as a percentage of sales, not just value added. This turnover (or cascade) tax puts pressure on the economic system to reduce activity at the earlier stages, manufacturing, for example, and expand it at the last stage, retail. The turnover tax thus favors the kind of good that is sold in a luxurious shop with a high mark-up, say, a jewelry store or one selling expensive clothing, relative to goods sold in low-margin operations such as supermarkets or by mail order. The value added tax, in contrast, is neutral in this respect. Such economic neutrality is generally considered desirable.

Moreover, equity is an issue. Under a turnover tax, the rich consumer is taxed more lightly than the poor consumer, because the former buys more of the lavishly retailed goods, the latter of the supermarket types of goods. Turnover taxes have two other serious defects. One is that they encourage vertical mergers between business firms. If the miller and the bakery merge into one concern, total turnover tax decreases, since one stage of sales has been eliminated. Total VAT, in contrast, remains unchanged. The value of milling and the value of baking are still each taxed just once; the only difference is that the tax is collected from one firm, not (in sections) from two.

Finally, a turnover tax tends to inhibit growth by taxing capital goods, if not directly then through taxation of materials and other inputs entering into the production of such goods. The VAT can be shaped so that it reaches only consumption goods. In several countries the VAT has replaced, not a general turnover tax, but a manufacturer's sales tax or, less commonly, a wholesaler's sales tax. These taxes have a much smaller base than the VAT, so a higher tax rate is needed to raise the same revenue and a higher rate provides more temptation for tax evasion. Both taxes favor value added at retail, and the manufacturers tax favors it at wholesale as well. With both taxes it is somewhat more difficult to ensure that the tax strikes only consumption goods, not capital goods, than under the VAT. The VAT has also replaced a retail sales tax, but in only two

countries, Sweden and Norway. It did so chiefly because it was considered more likely to ensure exact exemption of all exports. The value added tax has not been substituted for the income tax, corporate or personal, anywhere except the state of Michigan in the United States. In the United States some business executives have occasionally urged such a substitution, chiefly on the grounds that the VAT exempts exports and taxes imports, while the income tax does neither, so that a change would improve the balance of trade. This argument is a rather weak one.

Why do almost all the VAT countries use the consumption type rather than the income type? Probably because virtually all of them also levy an income tax proper, usually both on corporations and on individuals; to impose an extra tax on income would be to overdo the taxation of income as against consumption. A desire not to tax income heavily as compared with consumption may imply a desire to encourage growth by using a substantial part of the year's economic activity to add to the stock of capital equipment

Another reason for not relying entirely on taxation of income is that such taxation changes the terms on which an individual makes a choice between consume now and waiting to consume (somewhat more) later. The advantage to be gained by waiting is decreased by an income tax, which takes away part of the interest and profit from saving and investing. With a consumption tax, the ratio of consumption later to consumption now is left unchanged. Unless there is some good reason for thus changing the ratio, neutrality is to be preferred.

Regarding the suitability of VAT in developing countries he says that the value added tax is not ideal for all developing countries. Consider those where

- (a) Foreign trade plays a minor role,
- (b) Small-scale agriculture is important,
- (c) Retail trade is fragmented among very small sellers,
- (d) Vertical integration of producer, manufacturer, wholesaler, and retailer (or with any two or three of these stages) is unlikely to be induced by a turnover tax,

- (e) Discrimination against investment goods is not considered harmful,
- (f) Basic accounting is not widespread, and
- (g) Efficient and impartial tax administration has not yet been achieved.

A country with, say, three or more of these seven features may do better to rely on a simpler turnover tax, despite its defects, or on a single-stage tax at the manufacturing or wholesaling level. If the fragmentation of retailers is the only feature discouraging use of a VAT, single-stage taxes might be superseded by a pre-retail VAT, one that covers all firms except retailers. Less venturesome still is a VAT applied only to transaction within a single stage: manufacturing, for example. The choice of a VAT over other taxes is especially difficult when a country has some of the seven elements listed above, but combined with the opposites of the other elements. For example, a fragmented retail structure often coexists with a large foreign trade sector, or the potential for tax-induced vertical integration may be high in a country that has not yet achieved an efficient and impartial tax administration. The choice between a turnover tax and a VAT then becomes a matter of subjective weighting of the pros and cons. accordingly; no generalization seems justified on the suitability of the value added tax for developing countries as a group.

- **Keen and Lockwood (2010)** conducted a research on the “*value added tax: Its causes and consequences*”. In this paper they explore the causes and consequences of the remarkable rise of the value added tax (VAT), asking what has shaped its adoption and, in particular, whether it has proved an especially effective form of taxation. It is first shown that a tax innovation, such as the introduction of a VAT, reduces the marginal cost of public funds if and only if it also leads to optimizing government to increase the tax ratio. This leads to the estimation, on a panel of 143 countries for 25 years, of a system describing both the probability of VAT adoption and the revenue impact of the VAT. The results point to a rich set of determinants of VAT adoption, and to a significant but complex impact on the revenue ratio. The estimates suggest, very tentatively, that most countries which have adopted a VAT have thereby gained a more effective tax instrument, though this is less apparent in sub-Saharan Africa.

2.2.3 Review of Previous related Thesis

- **Khanal (2009)** the submitted a thesis entitled “*Value Added Tax (VAT) and its revenue potentiality in Nepal*” to the Central Department of Economics which was conducted. His study was entirely based on the secondary data. The tax revenue and other related data were collected from budget speeches of government in various years, economic surveys and various publications of NRB and CBS. Besides these, the publications of CEDA, APROSC, NRB etc had been used to collect necessary data and information. The time period taken for the study was from fiscal year 2000/02 to FY 2008/09. The data had been analyzed by using various mathematical tools such as percentage, ratio, mean, splicing etc. Along with these, double log linear model was used to estimate the elasticity and buoyancy coefficient. Main objectives of thesis conduct regarding the “*Value Added Tax (VAT) and its revenue potentiality in Nepal*” are follows

Objectives of Study Carried out for

- ❖ Examining the trend and structure of VAT in Nepal,
- ❖ Estimating the potentiality of revenue yield from VAT and
- ❖ Suggesting appropriate policy recommendations.

His Major Findings from Thesis are

- ❖ He concludes that taxation is an instrument for resource mobilization and that would help to bridge revenue-expenditure gap. Due to high growth of government expenditure and slow increase in government revenue, resource gap is ultimately created in our economy. This trend of revenue- expenditure gap shows that Nepal has been undergoing several fiscal crises. The permanent solution to this situation is the domestic resource mobilization through properly designed tax system.
- ❖ He reiterates that the value added tax has been considered as an attractive alternative to existing sales tax system which has been quickly 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 acceptance rate.

- ❖ He also adds that VAT is not totally immune from the fault of regressive nature. Single positive rate creates repressiveness with respect to expenditure but not necessarily with respect to incomes. Moreover, from the administrative point of view, VAT cannot be more attractive than other kinds of sales tax. In spite of the administrative complexity, to maintain the equity norms, exemptions and zero rating are principally proposed. But such provision makes the tax base limited. As a result, the primary goal of VAT “to induce revenue by means of broad coverage with low rates” is violated.

In his view, 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 discrimination 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 exemption and zero-rating techniques help to reduce the repressiveness. In this way, VAT has somehow more equity nature as compared to other kind sales taxes. The other major basic criteria of a good tax i.e. self-policing nature can be easily found in VAT system.

His paper states that the share of tax and non tax revenue comprises the average ratio of 77.95 and 22.04% during the study period. The ratio seems to be stable within the whole 16 years time. The contribution of total tax revenue from indirect tax has continuously declined and direct taxes have continuously increased which can be satisfactory trend of revenue collection. Indirect tax still plays predominant role with 77.95 average contributions of total tax revenue, and especially by 32.92 and 33.71% contributing an average ratio by sales tax or VAT and custom duty respectively. Among the sub-sectors of indirect tax, all are in declining tendency except sales tax or VAT.

His paper points out that after implementing VAT, Nepalese economy is suffering from price rise. Surprisingly the price has simultaneously increased in both exempted and taxed commodities. Thus the causes of inflation might be businessmen rather than VAT.

The elasticity and buoyancy coefficient of selected taxes of Nepal seemed to be very low, which indicates the greater need in increasing the resource mobilization. The elasticity coefficient less than unity indicate the inelastic nature of Nepalese taxation. The predominance of indirect tax, especially sales tax/VAT and custom duties with regressive nature is also less than unity i.e. inelastic. By the estimated value of 5%, GDP growth rate of 2008/09, there is no possibility to raise the revenue from sales tax/VAT greater than in 2007/08 as revenue in 2008/09. However the buoyancy coefficients also seemed higher than elasticity. This indicates that government has concentrated more on introducing various discretionary changes rather than broadening the tax base. Due to inelastic and buoyant nature of Nepalese tax system, the deficit financing or resources gap is increasing every year.

- **Adhikari (2009)** prepared a thesis entitled “*The role of Value Added Tax in Nepal*” with the main objective of examining the trend of VAT in Nepal. He also described the share of VAT to total tax revenue and its ratio to gross domestic product. His study focused on the role of VAT, structure of VAT, projection of VAT, legal aspect of VAT act, and problems of VAT in Nepal. The major problems of VAT identified by him are evasion of VAT at high level, delay in assessment, normal role of VAT, lack of public information, complicated acts and other defects of existing VAT acts.

Objectives of Study are

- ❖ Highlight role of VAT in context of Nepal, and its legal aspect.
- ❖ Examining the trend of VAT in Nepal
- ❖ Ratio share contribution of VAT in Government Revenue Collection and GDP
- ❖ Explain the need of VAT for country development process

Major Findings from his thesis are

- ❖ To increase the revenue of government that VAT law should be clear and practical

- ❖ Nation Should be determined scientific method for accounting assessment and collection of VAT
 - ❖ Widening tax coverage, easy and simple procedure of tax payment
 - ❖ Knowledge and awareness about VAT should be carried to all VAT payer
 - ❖ Evasion of VAT must be checked to contribute taxes to the economic growth of Nepal.
- **Baral (2010)** prepared a thesis entitled, ” *Resource mobilization through VAT in Nepal*” which was conducted in order. This research study had focused particularly on the mobilization of resource through VAT, its laws and regulations and problems and prospects. The study followed the analytical cum descriptive research design which had been supported by both primary as well as secondary data.

Basic Objectives of Study of thesis,

- ❖ To analyze the trends in composition of VAT in Nepal,
- ❖ To examine the laws and regulations of VAT and
- ❖ To analyze the problems and prospects of revenue mobilization through VAT in Nepal

Finally, he makes conclusion, recommendations and Major Finding from study of Thesis are

- ❖ There he stated that VAT, a latest innovation in the field of taxation, is being preferred by many countries of the world, is superior over sales tax system. In the total tax income VAT plays a major and attractive role because of its merits. The business community in the earlier days of VAT implementation opposed VAT showing the cause that VAT would increase price level. And even after a decade of Vat implementation consumers complain that the businessmen charge more price without following the act of VAT.

- ❖ Any tax system may not provide the expected yield when there exist tax evading 100 loopholes. Evasions of tax not only loses the revenue but also creates economic distortions, market imperfections etc. However tax- evading practice is a general phenomenon in any country and it cannot be solved perfectly but it must be minimized as far as possible. Generally, business enterprises are more responsible for tax evasion but it is not true all the time. There are other group such as consumers, tax administration, for their direct or indirect benefit may be supporting, or encouraging business enterprises for tax evasion.
- ❖ Corruption is one of the most dangerous obstacles in the path of effectiveness of Vat. Therefore, the administration should be very watchful to prevent any kind of malpractice, fraud and tax evasion. Almost care should be taken to prevent any kind for biding and corruption. Tax officials should be effectively monitored.

Nepal has adopted single rated VAT replacing the sales tax that was of 15%. Likewise, other taxes i.e. contract tax, Entertainment tax, Hotel tax was not below 15% on average. But VAT rate is subject to 13% rather it was at the rate of 10% till 15th January 2005. Due to broader base and coverage, it has been expected to have greater revenue yield on percent rate structure.

- **Prasad (2010)** submitted a master's thesis on "*Introduction of Value Added Tax in India States*" How has the revenue performance been?" In his thesis his findings and recommendations were, a majority of Indian states replaced the existing sales tax system with Value Added Taxes (VAT) with effect from April 2005. This policy paper analyzes the revenue performance of states which implemented VAT from April 2005 in comparison with those which implemented it later. It considers all the major general category states with the exception of Delhi and Goa. There were also several variations among states which implemented VAT. This paper then explains possible reasons for variations which include factors like number of prevailing VAT rates, exemptions, inclusion of inputs in the concessional rate category, and differences in definitions of commodities and state tax legislations.

Objectives of Study from Thesis Conduct

- ❖ The study uses differenced regression analysis to analyze the differences between the VAT and non-VAT states.
- ❖ Expressed objective of increasing state government revenues,
- ❖ Improve VAT revenues of states and better achieve the objectives of VAT introduction

Major Findings From his thesis are

- ❖ Study shows that there was actually a reduction in the rate of growth of revenues of VAT states compared with the non-VAT states.
- ❖ His paper recommends a freeze on the list of VAT exempted commodities, precise and uniform definition, across states, for key items like ‘capital goods’ and ‘industrial inputs.
- ❖ Removal of inputs from the concessional rate of 4%, and careful monitoring of refunds as well as the impact of the low threshold limit for VAT registration.

- **Sharma (2011)** in his thesis titled “*Contribution of VAT on government revenue in Nepal*” tries to analyze the composition of VAT in different sectors of economy and its contribution to the total revenue collection after its introduction in Nepal.

The basic objectives of his study were

- ❖ To review theoretical aspects of VAT and analyze its contribution to government revenue,
- ❖ To examine the VAT as an instrument for internal resource mobilization,
- ❖ To identify the major problems with VAT collection in Nepal and finally

He states that the study was undertaken to observe how VAT was contributing to the total revenue of the country. For this study, exploratory and descriptive research design had been applied. Hence, this research had been conducted without any formal research design. It had been made flexible and open to all possible ideas that might help to explore new ideas.

He has discussed various opinions and theories from numbers of writers in the Review of Literature Section and the theoretical analysis of VAT has also been explained. The theoretical analysis is mainly focused on the principles of VAT, its type, methods of computation and legal provisions of VAT. He has included the various data such as GDP, Total Revenue, Tax Revenue, Indirect Tax Revenue and emphasized the interrelationship of all these with VAT in Nepal for the period of ten years from 2002/03 to 2010/11. He also explains the resource mobilization through VAT in Nepal in his dissertation. He has tried to identify the existing problems with VAT in Nepal. He analyzes the multiple problems relating to VAT from consumers, businesspersons and administrative system. Finally, he makes conclusion and recommendations.

Major Findings of Thesis are

- ❖ The government of Nepal has been facing the resource gap in Revenue Expenditure because of the increased government's expenditure surpassing the increased government's revenue.
- ❖ The government's expenditure is from the revenue, foreign loan, foreign grants and public borrowing. The foreign grants and foreign loans are conditional, uncertain, inconvenient, and dependent upon donors. It is not a good symptom for the national economy.
- ❖ The utilization of internal sources such as tax and non-tax sources can be the measure to narrow down the revenue expenditure gap. The non-tax revenue source cannot be used effectively as a revenue raiser because most of these sources are levied not for revenue purposes. So, Tax Revenue plays a very important role for the revenue collection Nepal.

The tax revenue is composed of direct tax and indirect tax. Direct tax also plays a pivotal role in generating the government revenue but for the country like, Nepal, where the per capita income is so low and rural agriculture being the main base of the economy, the drastic increase in revenue through income tax is not possible. The situation is also not favorable to raise the rate of direct taxes. Therefore, the only way to consider for the

sustainable revenue growth of the country is the indirect tax. Indirect tax can be divided into two categories; these are: commodity tax on foreign trade (customs), an internal commodity tax on goods and services.

The customs played a substantial role for the revenue generation in Nepal in the past but its present and future appears not as good as comparing to its past contribution. It is because Nepal has reduced its import tariff in line with the liberal economic policies adopted since 1992/93 and in line with the custom duties reform-taking place around the world in general and particularly in India. The entry to SAPTA and WTO of the country also played a role for the decreasing revenue collection through customs. This further enhances the necessity to rely on the internal commodity tax on goods and services for the revenue collection.

2.3 RESEARCH GAP

With reference to above review of related literature of a level in the concern field of VAT, this study chiefly focused on vat i.e. contribution of vat in government treasury. For that various accounting and statistical tools as well as regression models are built to measure the interrelationships of the concerned variables of the concerned area.

The concerned variables are composition and contribution of VAT in GDP and total revenue, total tax revenue, total indirect tax.

Most of the developed countries like USA, UK, Japan, and Italy etc are able to collect major portion of their revenue through VAT but in context of Nepal, is still have been unable to collect adequate revenue from VAT. Share of VAT to the revenue structure is very low in comparison to other countries. This study is focused on contribution of VAT in the government revenue and on analyzing the problem behind its facts and finding measures to overcome the problems associated with VAT tax systems as to raise its contribution towards public revenue

Here are some research gaps that have not been concluded in previous thesis studies. So, this thesis has attempted to highlight the real condition and contribution of VAT in the

government revenue of Nepal from 2003/04 to 2011/12. Specially, this study can answer the following:

- ❖ To examine the revenue structure of Nepal
- ❖ To examine the legal provisions.
- ❖ To assess the performance and contribution of VAT in the revenue collection.
- ❖ To analyze the implementation and practices of VAT done by the VAT Registrants
- ❖ The proportion of VAT for government revenue.
- ❖ To study the trend of VAT collection in Nepal.

These are some research gaps that have not properly study in previous submitted thesis. So, Main purpose of this thesis is to highlight these gaps and loops holes of VAT system in Nepal.

CHAPTER III

RESEARCH METHODOLOGY

This chapter presents the methodology of the research which describes the research design, the method of data collection, reliability of instruments selected or constructed and statistical tools and procedures used in the analysis.

This study is undertaken to observe as how VAT is contributing to the total revenue of the country. For this study, explanatory and descriptive research design has been applied. Hence, this research has been conducted without any formal research design. This research has been flexible and open to all possible ideas that might help to explore new ideas.

3.1 Research Design

This study is carried out on the basis of descriptive and analytical research design. The descriptive research design will be used for the purpose of conceptualization and description of the problem. The analysis has given the revenue potentiality of VAT and the actual mirror of the economy.

Firstly, it is collected secondary data from books, company profiles, progress report & magazines. Secondly, collected primary data through the method of small interview, to collect the information for my thesis.

The data used in this thesis are

Primary Data

Primary data are the original data collected during the thesis preparation. This data is collected for meeting the specific objectives of study. The data is collected with direct interaction of the stakeholders. These data are not previously existed in the origination. Primary data is collected through formal and informal interviews and specially observation of the researcher.

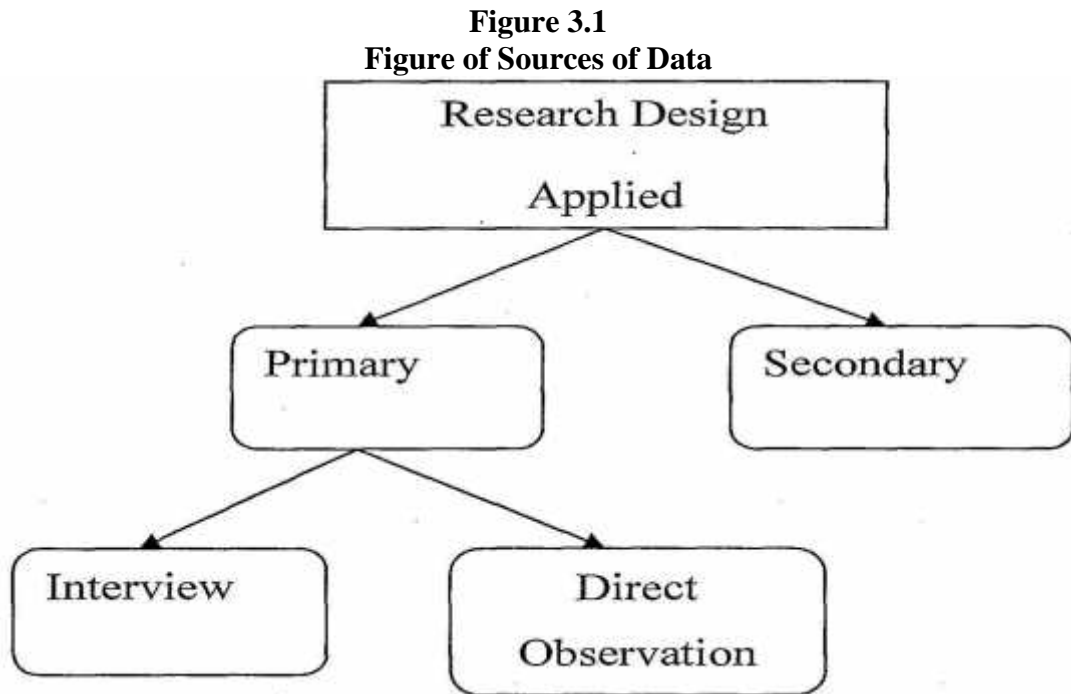
Secondary Data

Secondary data are the published data; record etc. the primary data became the secondary data when the person other than researcher uses the data. Secondary data were thoroughly studied for the fieldwork purpose. There is nominal use of this data in this thesis. The data was mainly collected by secondary source.

3.2 Nature of Data

The study is mainly based on the secondary data and information. These data and information are analyzed in a simple way by explanatory research design method. The time period taken for the study will be from fiscal year 2003/04 to FY 2011/12. Rationale for choosing this period is mainly availability of data itself.

3.3 Source of Data



I. Primary Data

Formal and informal interview (questionnaire Method) with concern people for primary data. Field visit for observation.

Table 3.1

Respondent schedule of Primary Data observed

Respondent/Concern Person	No. of Total Observation	No. of Total Response received
VAT Payer (Businessmen)	35	30
Consumer(Public)	25	20
VAT Expert	3	3

II. SECONDARY DATA

The major sources of secondary data are as follows:

- Publications of Ministry of Finance (MOF) The Government of Nepal (Budget speeches of various Fiscal Years, Economic surveys, Report of Various Task-Force submitted to MOF)
- Publications of Inland Revenue Department (IRD) (Various Annual Reports, VAT Acts and Rules, Brochures on various aspects of VAT, and various co-publications of IRD and VAT Projects)
- Reports and Publications of FNCCI and NCC
- Various Journals of CEDECON, TU
- Economic surveys and various publications of NRB and CBS.
- Newspaper, Magazine, journals, souvenir, internet websites etc. related to income tax.

- Dissertations related to income tax, available at central library, T.U. and other library.
- Other published and unpublished relevant record, data, reports, journals and articles on the related subject etc.

Basically secondary data from fiscal year 1987/88 to 2002/03 is used for this research study.

3.4 Statistical Tools

The data and information are tabulated and analyzed. Ratio, percentage and estimated data are used to discuss and explain these data and information. The assumed data are also used in few cases to verify and explore the working nature of VAT. Bar diagrams and chart have also been used to illustrate the findings. On the basis of the findings from this analysis, the steps need to be taken from all the responsible parties have been recommended.

3.5 Data Processing

The data collected from above mentioned sources will be directly tabulated so as to meet the requirement of the study. While shaping the data into tabulated form proper attention will be given not to let the chances of error.

Most of the data will not be in the readymade form. Hence the data will be processed by using relevant statistical tools.

3.5.1 Tools, Techniques and Tests

Concepts like regression analysis, hypothesis testing has been employed along with presentation tools like pie chart, bar diagram, ratios etc. SPSS (Statistical Package for Social Science) and Excel programme has been used to used to analyze the collected data

CHAPTER IV

DATA ANALYSIS AND PRESENTATION

4.1 Revenue Structure of Nepal

Revenue of the government plays a crucial role in the fiscal policy. It also plays an important role in the process of economic development and in reducing the burden of external debt. The total revenue of government of Nepal is collected from tax and non-tax sectors. The tax revenue is compulsory sacrifice of the people, which can be divided into two components direct and indirect taxes. The revenue collected from charges, fees, fines, dividends, royalty, receipts from sales of commodities and services, principles and interest payment etc. are the non-tax revenues and revenue from sales tax and other kinds of service based taxes are indirect tax revenue.

Adequate revenue generation can provide required funds for the development work of the country. In this respect, the tax structure has vital role in development. Government has introduced various taxes mainly to raise revenue. The trend and composition of tax revenue in the recent and VAT's role in the internal resource mobilization and its effectiveness will be discussed and analyzed here. Total Revenue of Nepal can be decomposed into Non-tax Revenue and Tax Revenue

4.1.1 Non-Tax Revenue

Non-tax revenue is not imposed compulsorily by public authority to the people. Non-Tax revenue represents about one quarter of the total revenue and Tax revenue contributes about three quarters of total revenue. The tax revenue comes from direct taxes and indirect taxes and

The non-tax revenue comes as forms of fees, fines, penalties, dividends interest, and sales of government property, donations, and gifts and so on. There is some scope for generating more revenue through the improvement of non-tax source particularly by

improving political image, operational performances and proper identification of priority sectors. The table 1 shows the contribution of the non-Tax Revenue and Tax revenue to the GDP and to the total Revenue of the country from 2003/04 to 2011/12

Table 4.1

Magnitude of Revenue Collection in Nepal

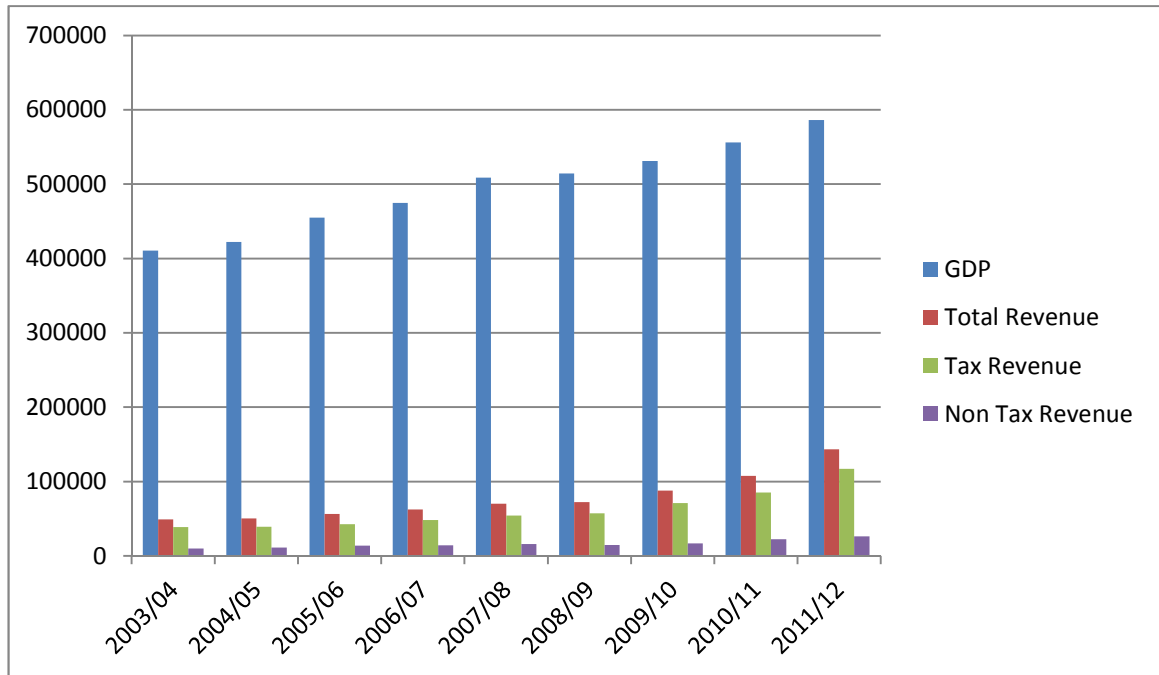
Amount in million

FY	GDP	Total Revenue		Tax Revenue			Non Tax Revenue		
		Amount	% GDP	Amount	% GDP	% of T.R	Amount	% GDP	% of T.R
2003/04	410789	48893.60	11.90	38865.10	9.5	79.5	10028.5	2.4	20.5
2004/05	422301	50445.5	11.90	39330.60	9.3	78.0	11114.9	2.6	22.0
2005/06	454935	56229.8	12.40	42587.00	9.4	75.7	13642.8	3.0	24.3
2006/07	474919	62331.00	13.12	48173.00	10.1	77.2	14158.0	2.9	22.7
2007/08	508651	70122.70	13.78	54104.70	10.6	77.1	16018.0	3.1	22.8
2008/09	514460	72282.08	14.05	57427.00	11.2	79.4	14855.1	2.9	20.6
2009/10	530890	87712.08	16.52	71126.73	13.4	81.1	16585.4	3.1	18.9
2010/11	555850	107546.50	19.35	85025.27	15.3	79.1	22521.2	4.1	20.9
2011/12	586234	117051.90	24.47	117052	19.97	81.5	26422.6	4.5	18.5

Sources: Economic Survey and annual reports of Various Fiscal years.

Figure 4.1

Magnitude of Revenue Collection in Nepal



The above table 4.1 shows that in the composition of total revenue, tax revenue, has dominant role because the figures which total revenue of Rs 38865.10 M, 39330.60M, 42587.00M in FY 2003/04, 2004/05 and 2005/06 respectively, where 79.5%, 78% and 75.7% is contributed by tax revenue and remaining by the non tax revenue and in FY 2006/07 the contribution of tax revenue is Rs. 48173.00 million and started to increased upto the FY 2009/10 and decreased in FY2010/11 and also increased in FY 2011/12 where total revenue is 117502 million and 81.58% has been contributed by total tax revenue and remaining by the non tax revenue.

The contribution of total revenue to GDP is increased to till date i.e. in FY 2003/04, total revenue on GDP is 11.90% and increased to 24.47% in FY 2011/12

4.1.2 Tax- Payers registration on VAT

The numbers of sales tax registrants were converted into VAT registrants from 16th Nov. 1997. Those taxpayers, who do the taxable transaction of VAT above threshold, are

required to compulsory register in VAT. But those vendors, who have transaction below the threshold level, are not compulsory required to register. However, if they are interested they can go into VAT. Table 4.2 show the numbers of VAT registrants.

Table 4.2

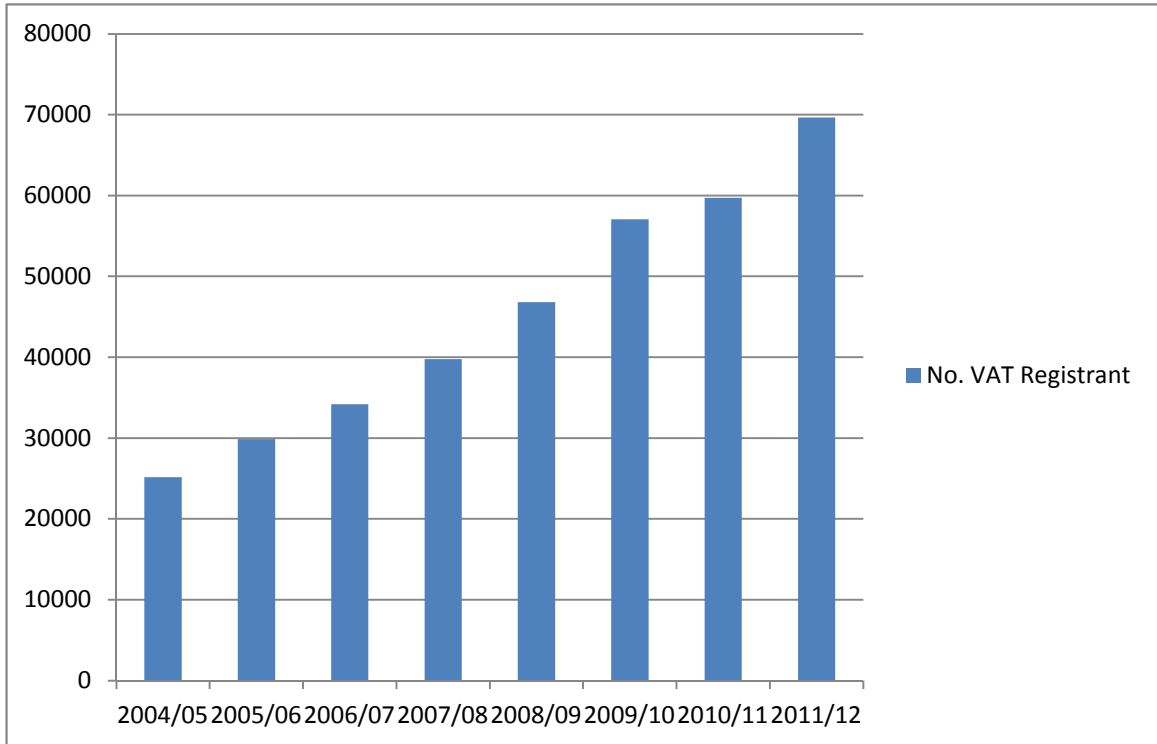
Numbers of VAT Registrants

Fiscal Year	No. of registrants	Percentage Change
2004/05	25150	-
2005/06	29872	18.78
2006/07	34174	14.40
2007/08	39776	16.39
2008/09	46831	17.74
2009/10	57072	21.87
2010/11	59707	4.61
2011/12	69653	16.67

Source: Economic survey and annual reports of various fiscal Years.

Figure 4.2

Number of VAT Registrants



The above table 4.2 shows that the numbers of registered tax payers were less in the initial stage but the number has significantly increased in all later years. It was only 25150 in the FY 2004/05 but now reached to 69653 in the FY 2011/12. Thus, the number of registrations on VAT is in increasing trend. It indicates that registrant trend is going on good track and sound ward. Table 4.2 also shows that the businessmen are interested to come into VAT and problems are going to minimizes. To effectively handle the increasing number, in future there should be improved information technology and registration process

4.1.3 Composition of Tax Revenue

The following table 4.3 shows the composition of tax revenue and the share of direct and indirect tax in total tax revenue:

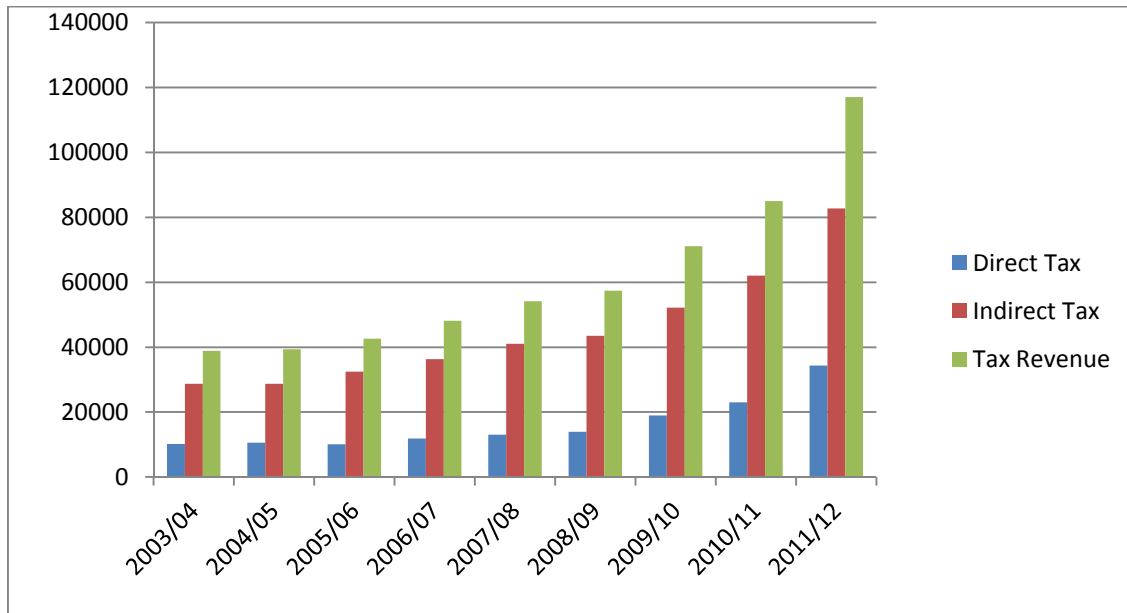
Table 4.3
Composition of Tax Revenue

Amount in Million

FY	Direct Tax		Indirect Tax		Total Tax Revenue	
	Amount	%	Amount	%	Amount	%
2003/04	10159.40	26.15	29135.25	73.85	38865.10	100
2004/05	10597.50	26.95	29292.78	73.05	39330.60	100
2005/06	10105.80	23.73	33040.70	76.27	42587.00	100
2006/07	11912.60	24.73	36961.01	75.27	48173.00	100
2007/08	13071.80	24.17	41839.38	75.83	54104.70	100
2008/09	13961.48	24.17	43465.52	75.69	57427.00	100
2009/10	18980.30	26.69	52146.43	73.31	71126.73	100
2010/11	23006.46	27.06	62018.81	72.94	85025.27	100
2011/12	34320.74	29.32	82731.167	70.68	117052	100

Sources: Economic Survey and annual reports of Various Fiscal years.

Figure 4.3
Composition of Tax Revenue



The table 4.3 shows the tax revenue is composed of direct and indirect tax revenue. The tax on customs, consumption and production is known as indirect tax whereas direct tax is imposed on income and capital. In Nepal's Revenue collection, the contribution of Indirect tax has always been very high and significant. Its contribution to the GDP is also commendable and praiseworthy. The same fact is depicted by the table given above. From the above table, the share of indirect tax on tax revenue is significantly higher than direct tax. In FY 2003/04 the share of indirect and direct tax to total tax revenue was 73.85 % and 26.15 % respectively. When we look at the figures of FY 2011/12, the shares of indirect and direct tax to total tax revenue are 70.68% and 29.32% respectively. From the above data we can conclude that in Nepal indirect tax has been playing a crucial role in revenue generation.

4.1.4 Composition of Indirect Tax

Indirect tax is imposed on one person but it is paid either partly or wholly by another person. In case of indirect taxes, the impact and the incidence of tax are on different persons. A sales tax, a custom duty and an excise duty are indirect taxes. Before the implementation of VAT, contract tax, hotel tax, entertainment tax were indirect taxes. The sales tax in the form of VAT came into existence having merged hotel tax, entertainment tax, and contract tax in it in 1997. In Nepal's Total Revenue collection and total tax revenue collection, the contribution of Indirect tax has always been very high and significant. The major components of indirect tax in Nepalese tax structure constitute: custom duty, excise duty, sales tax/VAT, contract tax etc. Custom duties are composed of import duties and export duties. Other components of indirect tax: entertainment tax, hotel tax and other tax contribute very nominal share because they are included in VAT since 1997. The indirect taxes are mainly of two types. These are Commodity tax on foreign trade (Customs) and Internal commodity tax on goods and services. The internal commodity tax on goods and services are Excise duty and VAT. Excise duties are one of the traditional sources of tax revenue in Nepal. In the past these duties used to be levied on agricultural as well as industrial products. They are now levied on a few industrial products. Now, these duties are levied on the domestically manufactured goods only. However, indirect taxes can broadly be divided into two parts:

- i. Custom duties

ii. Taxes on consumption and production

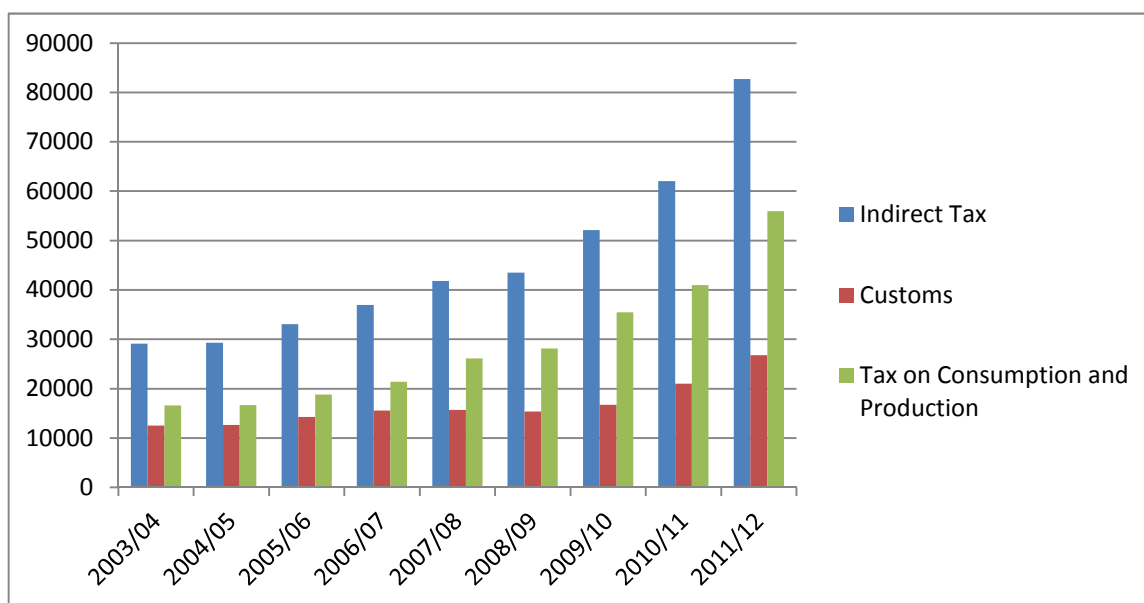
Table 4.4
Composition of Indirect Tax

Amount in Million

FY	Indirect Tax Amount	Customs		Tax on Consumption and Production	
		Amount	%	Amount	%
2003/04	29135.25	12522.06	43.08	16583.19	56.92
2004/05	29292.78	12658.75	43.21	16634.03	56.79
2005/06	33040.70	14236.39	43.09	18804.31	56.91
2006/07	36961.01	15554.794	42.08	21402.31	57.92
2007/08	41839.38	15701.55	37.53	26137.82	62.47
2008/09	43465.52	15343.67	35.30	28121.84	64.70
2009/10	52146.43	16707.64	32.04	35438.78	67.96
2010/11	62018.81	21034.60	33.92	40984.21	66.08
2011/12	82731.167	26792.84	32.39	55938.32	67.61

Sources: Economic Survey and annual reports of Various Fiscal years.

Figure 4.4
Composition of Indirect Tax



The above table 4.4 clearly shows that the custom takes very important place in the composition of indirect tax,

According to the table, in FY 2003/04 total indirect tax revenue is Rs. 29135.254 million among which custom contributes 43.08% and tax on consumption and production contributes 5 6.92%. The tax on consumption and production increases continuously and reaches 67.96% in FY 2009/10. Contribution of tax on consumption and production reaches 66.08% in 2010/11 and it is reached to 67.61% in 2011/12. From above table we can conclude that tax on consumption and production and customs was in fluctuating trend.

4.2 Performance and Contribution of VAT to the revenue collection

Here we will try to analyze the performance and contribution of VAT in revenue generation using available data from various sources.

4.2.1 TAX / GDP Ratio

The relationship between tax and GDP is known as a tax—effort ratio and the relationship between total revenue and GDP are known as revenue effort ratio. The Tax /GDP ratio is the indicator of the utilization of Taxable Capacity, which depends on the ability of people to pay or the ability of the government to collect. In Nepalese context, the tax / GDP ratio seems to be very low and it is marginally increasing during the study period. The tax / GDP ratio has been shown in table below.

Table 4.5
Tax/ GDP Ratio in Nepal

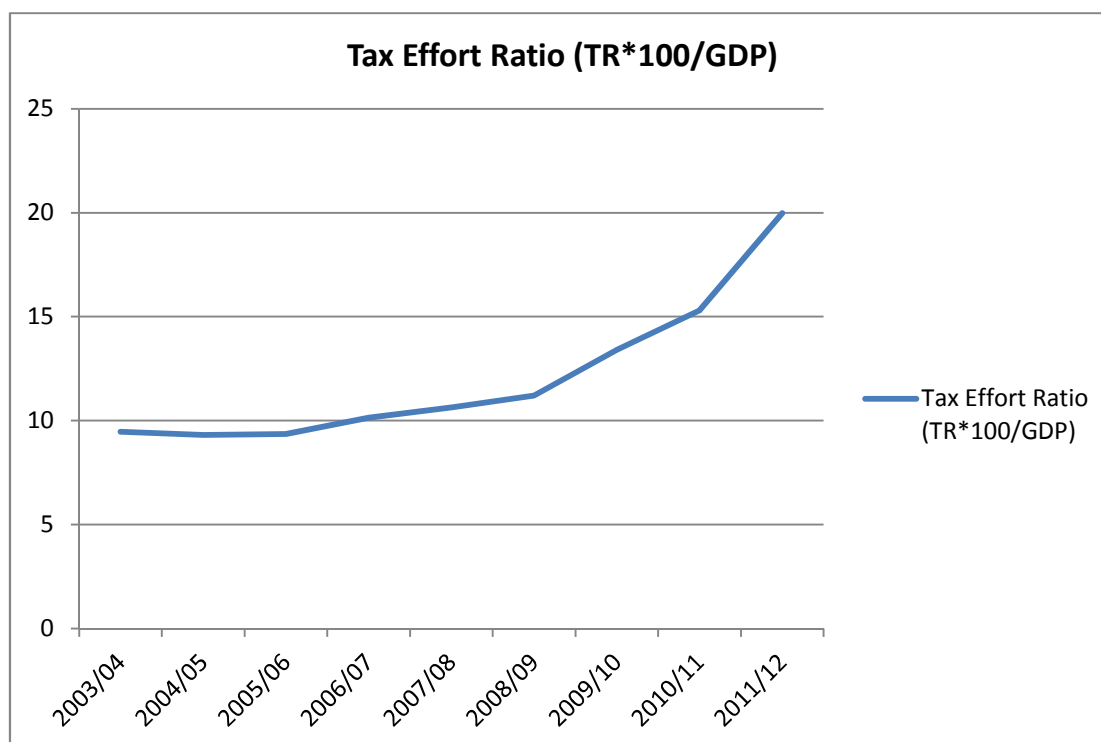
Amount in Million

FY	GDP	Total Tax Revenue	Tax Effort Ratio (TR*100/GDP)
2003/04	410789	38865.10	9.46
2004/05	422301	39330.60	9.31

2005/06	454935	42587.00	9.36
2006/07	474919	48173.00	10.14
2007/08	508651	54104.70	10.63
2008/09	514460	57427.00	11.2
2009/10	530890	71126.73	13.40
2010/11	555850	85025.27	15.30
2011/12	586234	117052	19.97

Sources: Economic Survey and annual reports of Various Fiscal years

Figure 4.5



The above table and figure 4.5 shows an increase in tax effort ratio at a snail's pace at the beginning of the study period. Tax effort ratio in FY 2003/04, 2004/05, 2005/06, 2006/07, and 2007/08 was 9.46%, 9.31%, 9.36%, 10.14% and 10.63% respectively and reached 19.97% in FY 2011/12. It shows that tax effort ratio is in increasing trend.

4.2.2 Composition and contribution of VAT to GDP and Total Revenue

VAT has been considered the best scientific tool to address the nation's taxation component and to create a positive opportunity to enhance the growth of economy in the country and resource mobilization. It came into existence since 1997, November 16 replacing the then existing tax such as hotel tax, entertainment tax and contract tax. With lots of constraints and obstacles on its way since its birth in Nepal, VAT has so far left a good approach to the taxpayers in the country and has been paramount to the country's revenue collection. The biggest virtue of VAT is that it is revenue buoyant and highly instrumental for resource mobilization especially an economy with an acute shortage of resources.

4.2.3 Composition of VAT

VAT is composed from VAT from domestic product and imported product. Its actual data of various years are given below.

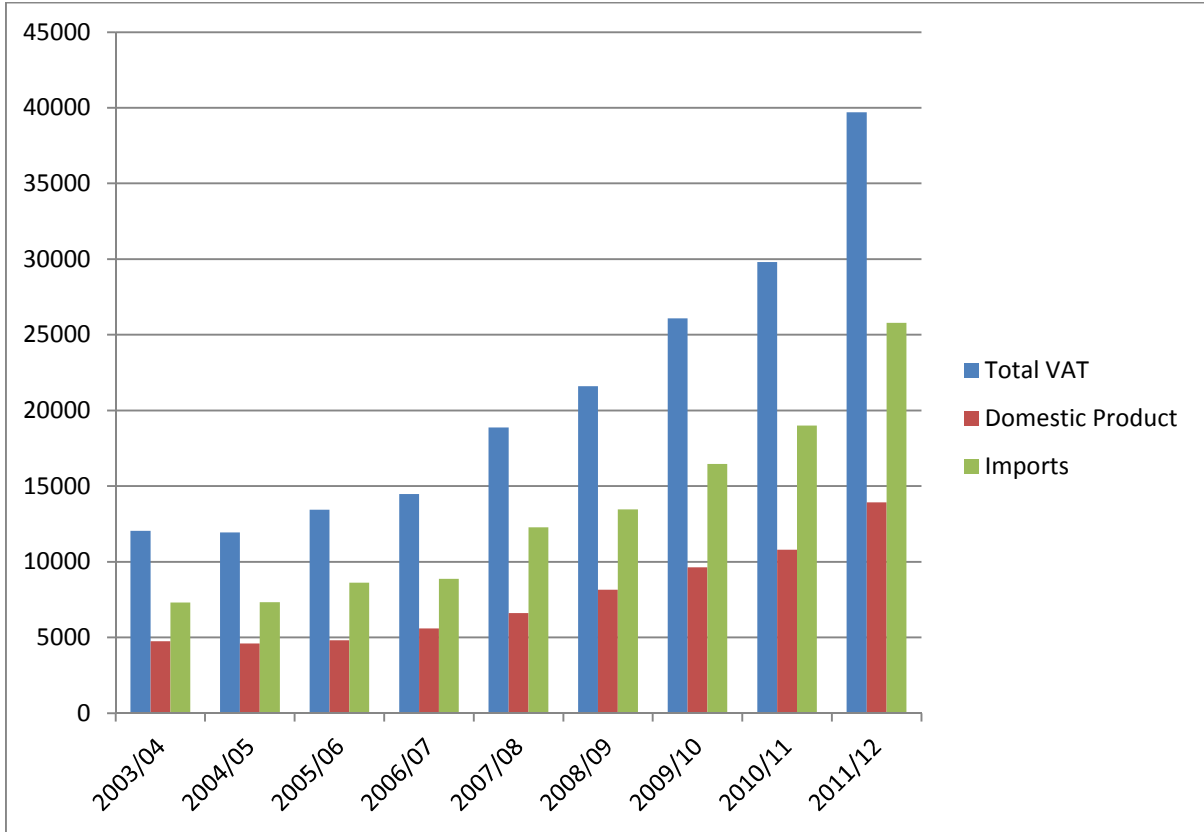
Table 4.6
Composition of VAT

Amount in Million

FY	Total VAT	Domestic Product		Imports	
		Amount	%	Amount	%
2003/04	12050.00	4744.72	39.38	7303.03	60.61
2004/05	11947.95	4608.37	38.37	7339.58	61.43
2005/06	13449.12	4819.61	35.84	8629.51	64.16
2006/07	14478.89	5604.12	38.71	8874.77	61.29
2007/08	18885.40	6614.97	35.03	12270.43	64.97
2008/09	21613.04	8150.50	37.71	13462.54	62.29
2009/10	26095.599	9631.33	36.91	16464.27	63.09
2010/11	29815.703	10808.24	36.25	19007.46	63.75
2011/12	39700.92	13918.49	35.06	25782.43	64.94

Sources: Economic Survey and annual reports of Various Fiscal years.

Figure 4.6
Composition of VAT



The above table and figure 4.6 shows the composition of VAT in Nepal. VAT from Import Product is higher than the VAT from Domestic Product. In fiscal year 2003/04, 2004/05, 2005/06 the VAT collection from Domestic Product were Rs. 4744.72, Rs. 4608.37 and Rs. 4819.61 whereas from import goods were Rs. 7303.04, Rs. 7339.58 and Rs. 8629.51 respectively. VAT collection trend in both domestic products and imported product were in decreased in 2004/05 and afterwards it was started to increase. This trend continues to till date. In fiscal year 2011/12, the VAT from domestic product was Rs. 13918.493 and from imports Rs. 19007.462.

4.2.4 Contribution of VAT to GDP and Total Revenue

The table 4.7 shows contribution of VAT to GDP and total revenue.

Table 4.7**Contribution of VAT to GDP and Total Tax Revenue***Amount in Million*

FY	GDP	Total Tax Revenue	VAT		
			Revenue	% of GDP	% of Total Tax Revenue
2003/04	410789	48893.60	12050.00	2.9	24.59
2004/05	422301	50445.5	11947.95	2.8	23.71
2005/06	454935	56229.8	13449.12	2.9	23.93
2006/07	474919	62331.00	14478.89	3.0	23.23
2007/08	508651	70122.70	18885.40	3.7	26.93
2008/09	514460	72282.08	21613.04	4.2	29.90
2009/10	530890	87712.08	26095.599	4.9	29.75
2010/11	555850	107546.50	29815.703	5.4	27.66
2011/12	586234	117051.90	39700.92	7.5	37.57

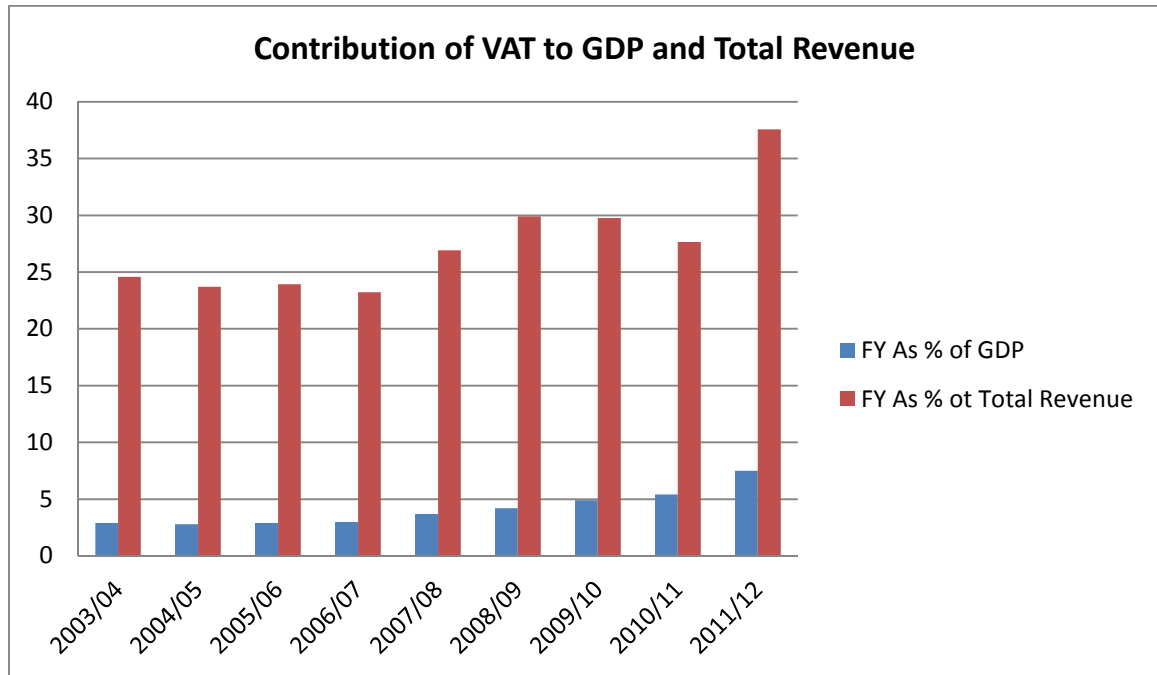
Sources: Economic Survey and annual reports of Various Fiscal years

The above table and figure 4.7 shows that the contribution of VAT to GDP and total tax revenue percentage of contribution of VAT to GDP reached to 7.5% in FY 2011/12. Percentage of VAT contribution in GDP were 2.9%, 2.8%, 2.9% 3.0%, 3.7%, 4.2%, 4.9% 5.4% in FY 2003/04 to 2010/11.

From the above analysis we conclude that percentage of contribution of VAT to GDP were in fluctuating trend.

Likewise, contribution of VAT in Total tax revenue had reached to 37.57% in FY 2011/12 from 23.23% in FY 2006/07 and contribution of VAT in total Revenue were 24.59%, 23.71%, 23.93%, 23.23%, 26.93%. 29.90%, 27.66% and 37.57% in FY 2003/04 to 2011/12. This analysis proved that the collection of VAT has been in increasing trend.

Figure 4.7



4.2.5 Contribution of VAT to Total Tax Revenue

The percentage contribution of VAT revenue to total tax revenue is presented in the table below

Table 4.8

VAT Revenue as a Percentage of Total Tax Revenue

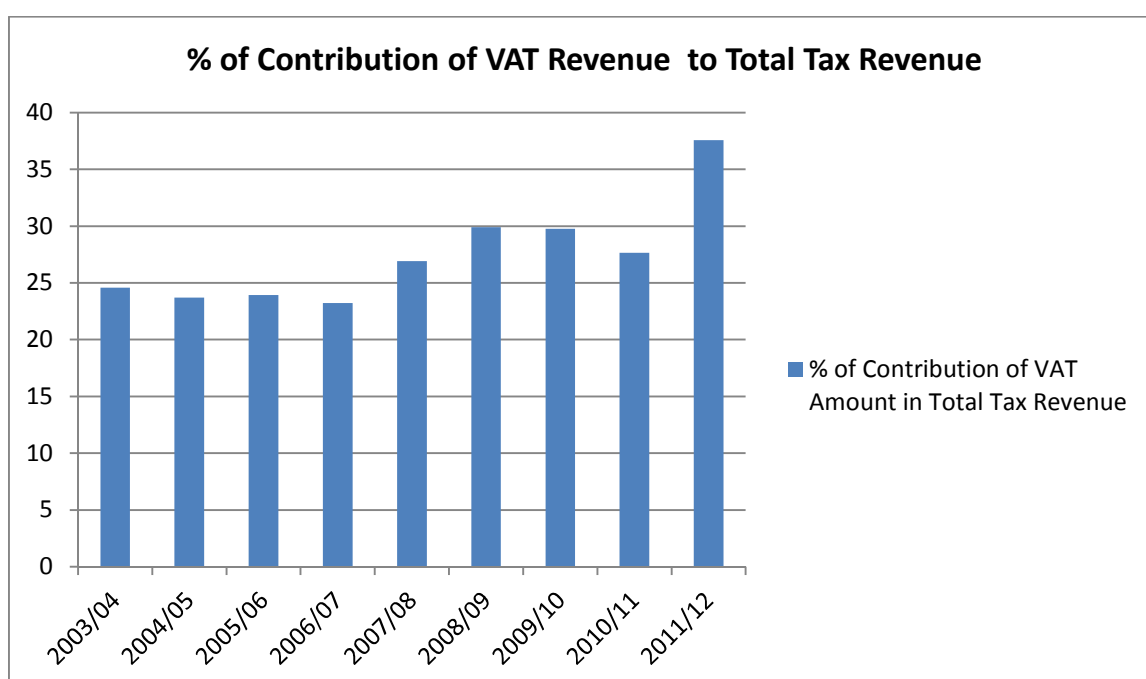
Amount in Million

FY	Total Tax Revenue	VAT	% Contribution of VAT In Total Tax Revenue (TTR)
2003/04	48893.60	12050.00	24.59
2004/05	50445.5	11947.95	23.71
2005/06	56229.8	13449.12	23.93
2006/07	62331.00	14478.89	23.23
2007/08	70122.70	18885.40	26.93

2008/09	72282.08	21613.04	29.90
2009/10	87712.08	26095.599	29.75
2010/11	107546.50	29815.703	27.66
2011/12	117051.90	39700.92	37.57

Sources: Economic Survey and annual reports of Various Fiscal years

Figure 4.8



According to above table and figure 4.8 shows the VAT Revenue as a Percentage of total tax revenue. In FY 2003/04, contribution of VAT to total tax revenue was 24.59%. Likewise, in FY 2004/05, 2005/06, and 2006/07 were 23.71%, 23.93% and 23.23% respectively. Contribution of VAT to total tax revenue was in fluctuating trend and reached up to 29.90 % in FY 2008/09 and decreased to 29.75, 27.66% % in FY 2009/10, FY 2010/11 and finally it had increased to 37.57 % in FY 2011/12.

4.2.6 Share of VAT to Total Indirect Tax

The following table shows the share of VAT to total indirect tax.

Table 4.9

Share of VAT to Total Indirect Tax

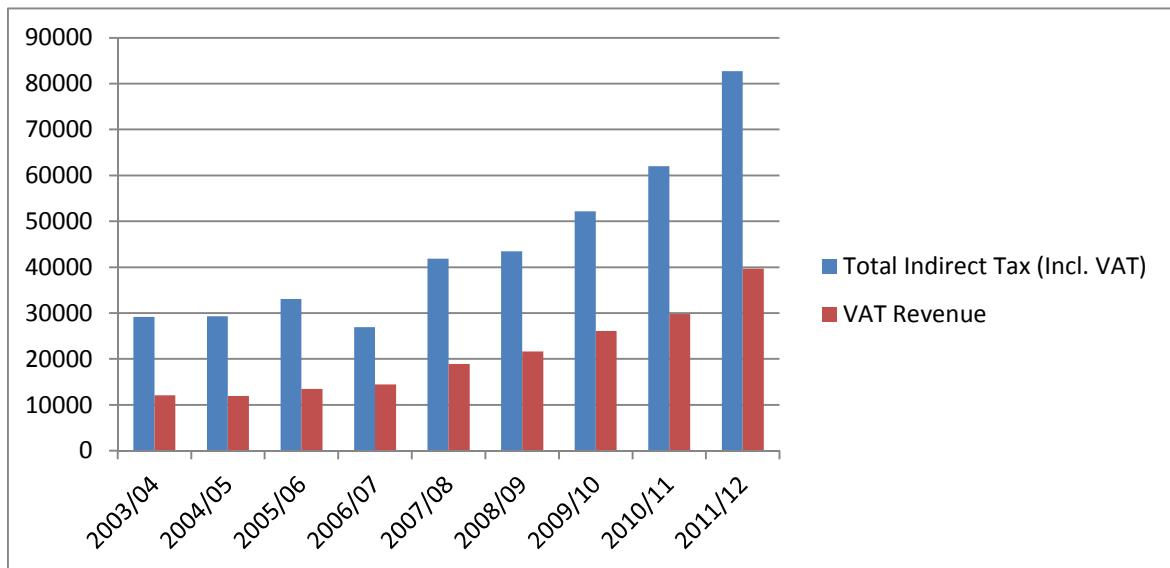
Amount in Million

FY	Total Indirect Tax (Incl. VAT)	VAT Revenue	% of VAT Revenue Share In Total Indirect Tax
2003/04	29135.25	12050.00	41.35
2004/05	29292.78	11947.95	40.84
2005/06	33040.70	13449.12	40.74
2006/07	26961.01	14478.89	39.17
2007/08	41839.38	18885.40	45.14
2008/09	43465.52	21613.04	49.72
2009/10	52146.43	26095.599	50.04
2010/11	62018.81	29815.703	47.96
2011/12	82731.17	39700.92	47.99

Sources: Economic Survey and annual reports of Various Fiscal years

Figure 4.9

Share of VAT to total Indirect Tax (Incl. VAT)



The table and Figure 4.9 show that the contribution of VAT to total indirect tax revenue has been on the rise constantly. According to the figure and table given above, contribution of VAT in FY 2003/04 total indirect tax was 41.35% and has increased up to 50.04 % in FY 2009/10. Total VAT revenue contributed 47.99% of total indirect tax revenue in the FY 2011/12.

According to above analysis, we can conclude that share of VAT to total indirect tax was satisfactory.

4.2.7 Comparison between expected and actual VAT

The following table shows the Comparison between expected and actual VAT of different fiscal year.

Table 4.10

Comparison between expected and actual VAT

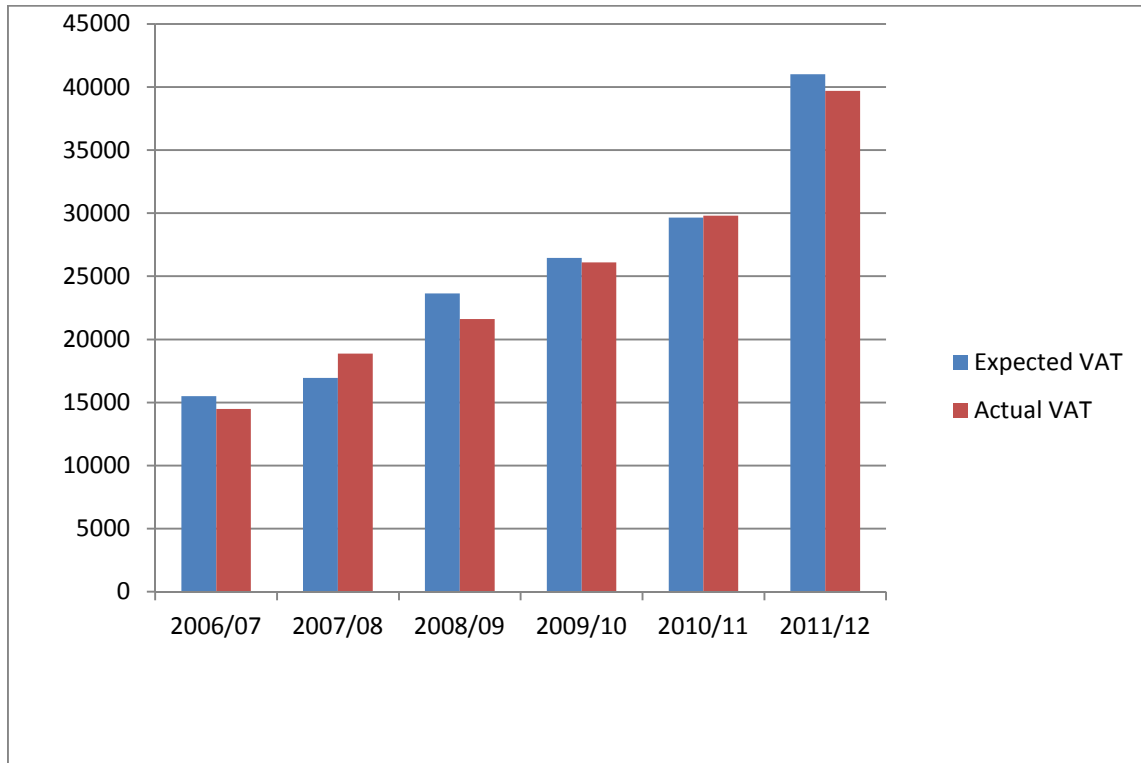
Amount in Million

FY	Expected VAT	Actual VAT	Progress %
2006/07	15504	14478.89	93.39
2007/08	16950	18885.40	111.42
2008/09	23650	21613.04	91.39
2009/10	26463	26095.599	98.61
2010/11	29652	29815.703	100.55
2011/12	41000	39700.92	96.83

Sources: Economic Survey and annual reports of various years

Figure 4.10

Comparison between expected and actual VAT



The above table and figure 4.10 shows the expected and Actual VAT collection of different years. In FY 2006/07 the expected VAT collection was Rs. 15504 million and Actual VAT collection amount was Rs. 14478.896 million. Likewise in FY 2007/08, 2008/09, 2009/10, 2010/11, and 2011/12, the Expected VAT collections were Rs. 16950m. , 23650m., 26463m. , 29652 m., and Rs. 41000 m., respectively and actual VAT collection were 18885. 4 m., 21613.043 m., 26095.599 m., 29815.702 m. and 39700.921m., respectively.

According to above data, we can conclude that actual performance of VAT collection was so-so. In FY 2007/08 and 2010/11 the actual VAT collection met the expected VAT collection or progress % of VAT collections was 111.42% and 100.55%.

4.3 Comparison of VAT Revenue Potentiality at different Rates

Under this topic, effort has been made to find out revenue potentiality of Value Added Tax in Nepal. On the basis of performance of VAT in the past years, effort the help of average increment of percentage in VAT from FY 2003/04 to 2011/12. VAT revenue has been projected up to 20% of VAT rate. It has been also assumed that existing base and threshold remains constant during the periods.

Table 4.11

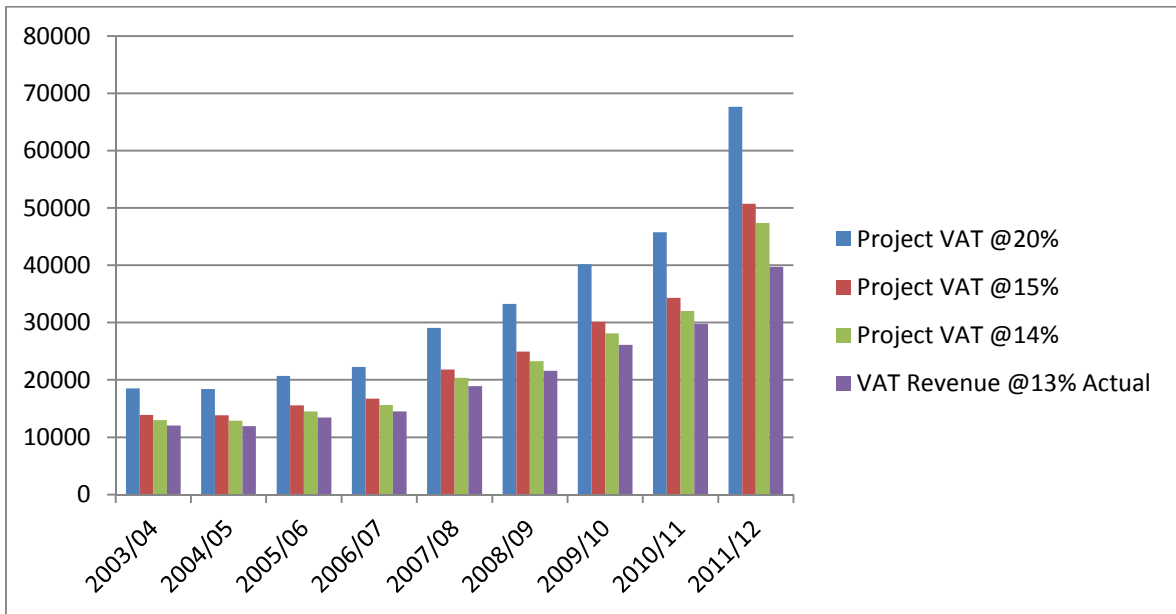
Comparison of VAT Revenue Potentiality at Different Rates

Amount in Million

FY	VAT Revenue (Actual)	% Increase in VAT	Projected VAT @ 14%	Projected VAT @ 15%	Projected VAT @ 20%
2003/04	12050.00		12974.51	13901.26	18535.02
2004/05	11947.95	-0.7	12884.28	13804.59	18406.11
2005/06	13449.12	12.5	14495.07	15530.43	20707.24
2006/07	14478.89	7.572	15592.67	16706.43	22275.46
2007/08	18885.40	30.43	20338.12	21790.85	29054.46
2008/09	21613.04	14.44	23275.54	24938.08	33250.77
2009/10	26095.599	20.74	28102.95	30110.31	40147.08
2010/11	29815.703	12.98	32030.54	34318.43	45757.91
2011/12	39700.92	47.84	47353.30	50735.68	67647.57

Sources: Economic Survey and annual reports of Various Fiscal years

Figure 4.11
Comparison of VAT Revenue Potentiality at Different Rates



The analysis of above table and figure 4.11, it can be concluded that VAT has a high trend of revenue potential. Holding our assumptions, VAT amount would be Rs. 67647.57 millions in fiscal year 2011/12. It is clear that the amount of VAT collection at higher rate would be higher.

Due to the significant contribution on all important indicators of economy and because of broad coverage, it is found that VAT has very high revenue potentiality. If the government increases rate of VAT and tax net, VAT will have more amount of revenue generation. The point at which the curve achieves its maximum is subject to much theoretical speculation. It will vary from one economy to another and depends on the elasticity of supply for labor and various other factors. It is therefore expected to vary with time even in the same economy. Complexities arise when taking into account possible differences in incentive to work for different income groups and when introducing progressive taxation. The structure of the curve may also be changed by other policy decisions, for example, if tax loopholes and off-shore tax shelters are made more readily available by legislation, the point at which revenue begins to decrease with increased taxation will become lower. Hence, we can conclude that VAT has better prospects for resource mobilization.

In above table 4.12, X represents the VAT revenue, Y represents the total revenue, u represent, the deviation taken from assumed mean of X, v represents the deviation taken from assumed mean of Y. and uv represents the multiple of u and v, $\sum uv$ represents the summation of u x v, $\sum u^2$ represents the summation of u², $\sum v^2$ represents the summation of v², r represents the correlation co-efficient, and n represents the number of observation. Karl Pearson correlation co-efficient (r) is calculated below for analysis.

Now,

$$r = \frac{n\sum uv - \sum u \sum v}{\sqrt{9(\sum u^2) - (\sum u)^2} \times \sqrt{9(\sum v^2) - (\sum v)^2}}$$

$$r = \frac{9 \times 1906941345 - 18020 \times 41510.86}{\sqrt{9(754099680.10) - (18020)^2} \times \sqrt{9(5008529976) - (41510.86)^2}}$$

$$r = \frac{16414446410}{80387.66 \times 208215.31}$$

$$r = 0.9806$$

Here is positive high degree of positive correlation between VAT revenue and total revenue.

Above calculation shows the result + 0.9806. It means there, exist positive correlation to the extent +0.9806 between the VAT revenue and total revenue deposit of Nepal.

“Correlation Coefficient value lies between -1 and +1. The following general rules are mentioned for interpreting the value of r.

- a) When $r = +1$, there is positively perfect correlation between the two variables.
- b) When $r = -1$, there is a negatively perfect correlation between the two variables
- c) When, $r = 0$, the variable are uncorrelated

- d) Nearer the value of $r + 1$, closer will be relationship between two variables and nearer the value of r to 0, lesser will be relationship.

Again,

$$\begin{aligned} P.E &= 0.6745 \times \frac{1-r^2}{n} \\ &= 0.6745 \times \frac{1-0.9806}{9} \\ &= 0.6745 \times \frac{0.0194}{3} \\ &= 0.6745 \times 0.00646 \\ &= 0.00435 \end{aligned}$$

Now. $6 \times P.E. = 6 \times 0.00435 = 0.0261$

Since, r is $> 6.P.E.$, so the value of r is significant.

4.5 Analysis of Primary Data

In process of collecting primary data, a set of questionnaire was distributed to 35 VAT payers, 25 Consumers & 3 VAT Experts out of them only 30 VAT payers, 20 Consumers and 3 VAT Experts answered properly and only these responses were kept in analysis.

1. In the question of “*Is the VAT a suitable means of raising government revenue?*”

Table 4.13

VAT as a Suitable Means of Raising Government Revenue

Option	VAT Payer		Consumer		VAT Expert		Total No. of Respondent	Total Response Percentage
	No.	%	No.	%	No.	%		
Yes	22	73.33	14	70	3	100	39	73.58
No	8	26.66	6	30	-	-	14	26.41
<i>Total</i>	<i>30</i>	<i>100</i>	<i>20</i>	<i>100</i>	<i>3</i>	<i>100</i>	<i>53</i>	<i>100</i>

The above table 4.13 shows that majority (73.58%) of respondent believe that VAT is a suitable means of raising government revenue in nation. So, only 26.41% of persons are against of it. Now, it can conclude that, VAT plays vital role to raise government revenue.

2. In the question of “*Do you issue/Receive of VAT Bill in each transaction?*”

Table 4.14**Practices of VAT Bill Issue/Receive in Transaction**

Option	VAT Payer		Consumer		VAT Expert		Total No. of Respondent	Total Response Percentage
	No.	%	No.	%	No.	%		
Yes	11	36.66	5	25	3	100	19	35.84
No	19	63.33	15	75	-	-	34	64.41
<i>Total</i>	<i>30</i>	<i>100</i>	<i>20</i>	<i>100</i>	<i>3</i>	<i>100</i>	<i>53</i>	<i>100</i>

The above table 4.14 shows that only lower number of respondent (35.84%) are practicing VAT bills while doing transaction. Most of them, (64.41%) are doing their daily transactions in without VAT bills. It concluded that, the actual VAT collection is lesser than that has to be collected. It may due to lack of knowledge or awareness about VAT.

3. In the question of “*How many set of Account book maintain in your business/firm?*”

Table 4.15**Sets of Account Book Maintain in Business/Firm**

Option	VAT Payer		Consumer		VAT Expert		Total No. of Respondent	Total Response Percentage
	No.	%	No.	%	No.	%		
1 Set	8	26.66	3	15	3	100	14	26.41
2 Set	16	53.33	7	35	-	-	23	43.39

N/A	6	20	10	50	-	-	16	30.18
<i>Total</i>	<i>30</i>	<i>100</i>	<i>20</i>	<i>100</i>	<i>3</i>	<i>100</i>	<i>53</i>	<i>100</i>

The table 4.15 shows regarding the account book maintained in their business firm, only 26.41% people has kept a set of account book in their service outlet. Whereas, 43.39% response indicates that they have been keeping 2 or more than two set of account book for different purpose. 16 people out of 53 people have not replied well. It maybe reason of not adequate knowledge about VAT or not wants to flash out actual status of account keeping. Thus, the analysis clearly shows that higher numbers of businessmen are keeping 2 set of account book for their different purpose.

4. In the question of “*Is the VAT system efficient in Nepal?*”

Table 4.16

Efficient of VAT System in Nepal

Option	VAT Payer		Consumer		VAT Expert		Total No. of Respondent	Total Response Percentage
	No.	%	No.	%	No.	%		
Yes	12	40	7	35	2	66.67	21	39.62
No	18	60	13	65	1	33.33	32	60.37
<i>Total</i>	<i>30</i>	<i>100</i>	<i>20</i>	<i>100</i>	<i>3</i>	<i>100</i>	<i>53</i>	<i>100</i>

The table 4.16 shows that most of them (60.37%) have replied VAT system is not efficiently implementing in the context of Nepal. Only few of them had given positive

response about the VAT system in Nepal. It means, the VAT system of Nepal is still not able to take proper place in Nepalese business environment.

5. In the question of “*What are the Major Problems of VAT management in Nepal? Please, choose the most suitable one?*”

Table 4.17

Major Problem of VAT Management in Nepal

Option	VAT Payer		Consumer		VAT Expert		Total No. of Respondent	% at Total Response	Rank
	No.	%	No.	%	No.	%			
Legal consideration	6	20	5	25	-	-	11	20.75	2
Less consciousness of VAT payers	12	40	9	45	2	66.67	23	43.39	1
Lack of training incentives to the employee	5	16.67	2	10	1	33.37	8	15.09	3
Lack of sufficient incentive to the employee	2	6.67	3	15	-	-	5	9.43	5
Misuse of power by Tax Administrator	5	16.67	1	5	-	-	6	11.32	4
<i>Total</i>	<i>30</i>	<i>100</i>	<i>20</i>	<i>100</i>	<i>3</i>	<i>100</i>	<i>53</i>	<i>100</i>	

The above table 4.17 shows reason of the major problems of VAT management in Nepal. Most of the respondent (43.39%) had given the common reason of it is "Less consideration of VAT payer". So, it is ranked as 1st position among the other problems. The analysis table shows that "legal consideration" and "Lack of training to the employees" is ranked to 2nd and 3rd position respectively. And finally, "Misuse of Tax Administrator" and "Lack of incentives to employee" are less preferable reason of problem, so it ranked as 4th and 5th position.

6. In the question of “*How can we increase the VAT registration habit of Nepalese businessmen? Please, choose the most appropriate option?*”

Table 4.18

Ways to Increase the VAT Registration Habit of Nepalese Businessmen

Option	VAT Payer		Consumer		VAT Expert		Total No. of Respondent	% at Total Response	Rank
	No.	%	No.	%	No.	%			
Educating tax payers	9	30	8	40	1	33.37	18	33.96	1
Simplifying tax laws	11	36.67	5	25	-	-	16	30.01	2
Penalties and fines	4	13.33	3	15	2	66.67	9	16.98	4
Reward to regular VAT payers	6	20	4	20	-	-	10	18.86	3
<i>Total</i>	<i>30</i>	<i>100</i>	<i>20</i>	<i>100</i>	<i>3</i>	<i>100</i>	<i>53</i>	<i>100</i>	

The above table 4.18 shows the possibility of increasing VAT registration habit of Nepalese businessmen as chosen by VAT payers, Costumers and VAT Experts. As per

rank order of option, 33.96% of respondent advised that most possibility of increasing VAT registration habit by “Educating tax payer”, so it is ranked at 1st position. Moreover, 2nd possible option of “Simplifying tax laws” is chosen by 30.01% of respondents. Finally, last two options are “Reward to regular VAT payers” and “Penalties and fines” are ranked 3rd and 4th position respectively, in order to increase VAT registration habit of Nepalese businessmen.

7. In the question of “Do you believe that VAT Evasion is still being practiced in Nepal?”

Table 4.19

Practices of VAT Evasion in Nepal

Option	VAT Payer		Consumer		VAT Expert		Total No. of Respondent	Total Response Percentage
	No.	%	No.	%	No.	%		
Yes	21	70	16	80	1	33.33	38	71.70
No	9	30	4	20	2	66.67	15	28.30
<i>Total</i>	<i>30</i>	<i>100</i>	<i>20</i>	<i>100</i>	<i>3</i>	<i>100</i>	<i>53</i>	<i>100</i>

The above table 4.19 clearly shows that, Level of VAT evasion practices in Nepal is higher as per observation made. Majority if respondent (71.70%) have said “yes” in response of this question. It means that VAT evasion is still being practiced in Nepal. Only 15 people out them are not believed that VAT Evasion is still practices in Nepal.

8. In the question of “What are your suggestions for eradicating VAT evasion? Please, choose appropriate option and rank the order?”

Table 4.20

Suggestion for Eradicating VAT Evasion

Option	VAT Payer		Consumer		VAT Expert		Total No. of Respondent	% at Total Response	Rank
	No.	%	No.	%	No.	%			
Controlling illegal business activities	1	3.33	-	-	-	-	1	1.88	7
Giving knowledge about VAT	7	23.33	5	25	1	33.33	13	24.52	1
Rewards to the tax evasion finders	2	6.67	1	5	-	-	3	5.66	6
Penalties and fines to VAT evaders	3	10	3	15	-	-	6	11.32	5
Simplifying tax laws	7	23.33	3	15	-	-	10	18.86	3
Timely assessment of tax	4	13.33	3	15	1	33.33	8	15.09	4
By cross checking the business activities	6	20	5	25	1	33.33	12	22.64	2
<i>Total</i>	<i>30</i>	<i>100</i>	<i>20</i>	<i>100</i>	<i>3</i>	<i>100</i>	<i>53</i>	<i>100</i>	

The above table 4.20 shows the appropriate suggestion for eradicating VAT evasion in Nepal, 24.52% respondents have chosen the suggestion for it is “Giving knowledge about the VAT” to all VAT payers and businessmen. So, it is ranked as 1st position. As per the primary data analysis, “By cross checking the business activities” and “Simplifying the tax laws” are also ideal suggestion for eradicating VAT evasion which was suggested by them, so it is ranked as 2nd and 3rd position in the analysis. Similarly, 15.09%, 11.32% and 5.66% of respondents had chosen the appropriate suggestion for eradicating VAT evasion by doing “Timely assessment of tax”, “Penalties and fines to VAT evaders” and “Rewards to tax evasion finders”. So, it is ranked 4th, 5th and 6th position in the order of total suggestions. And last one suggestion is ranked as 7th position in the rank order,

9. In the question of “*The rate of VAT had risen from 10% to 13%? Is this favorable to you?*”

Table 4.21

Response towards VAT Rate Raised

Option	VAT Payer		Consumer		VAT Expert		Total No. of Respondent	Total Response Percentage
	No.	%	No.	%	No.	%		
Yes	12	40	13	65	3	100	28	52.83
No	18	60	7	35	-	-	25	47.17
<i>Total</i>	<i>30</i>	<i>100</i>	<i>20</i>	<i>100</i>	<i>3</i>	<i>100</i>	<i>53</i>	<i>100</i>

The above table 4.21 shows the response regarding to condition of VAT rate raise from 10% to 13%. Only 5.66% of response is higher response for favorable than unfavorable. It means, limited people are willingness to pay VAT at any rate.

10. In the question of “*Do you have any complication in paying VAT?*”

Table 4.22

Complication in Paying VAT

Option	VAT Payer		Consumer		VAT Expert		Total No. of Respondent	Total Response Percentage
	No.	%	No.	%	No.	%		
Yes	19	63.33	12	60	-	-	31	58.49
No	11	36.67	8	40	3	100	22	41.51
<i>Total</i>	<i>30</i>	<i>100</i>	<i>20</i>	<i>100</i>	<i>3</i>	<i>100</i>	<i>53</i>	<i>100</i>

The above table 4.22 clearly shows that most of respondent (58.49%) have replied that they have faced the several complications and problems while paying VAT. In other side, 41.51% respondents have satisfied with present VAT paying system of Nepal.

4.6 Major findings From Secondary Data

On the basis of above analysis and data presentation, many important findings can be drawn. Major findings of this study are as following

- A) As other developing countries in the world, Nepal has been suffering from resource constraint, mass poverty, rapid growth of population, dependence on agriculture, subsistence living standard etc. In Nepal, the source mobilization is still poor that does not cover the rapid growing expenditure. There is serious resource gap and fiscal gap in Nepalese economy. Nepalese government expenditure is increasing at the faster rate than the increasing rate in revenue.
- B) Income VAT is one of the most important and suitable sources of government revenue. Thus, no. of VAT registrant of Nepalese businessmen is increasing day by day. No of VAT payer more than 360,000 in Nepal at end of last year.
- C) Government revenue is the composition of external and internal revenue. Tax and non-tax revenue are the sources of internal revenue. Among of them VAT plays a vital role for raising government revenue.
- D) The composition of total revenue constitutes tax and non-tax revenue. The share of tax revenue has always been greater than the share of non-tax revenue. The average share of tax and non-tax revenue for the period of 2011/12 was 81.58 % and 18.48% respectively in total revenue collection. Contribution of tax revenue is very much important in revenue mobilization of Nepal. For the meeting of the increasing trend of government expenditure, tax revenue has been placed as a major source of government revenue of Nepal.
- E) Tax revenue is the principle source of the government revenue, however its' contribution is differs significantly in different countries. Nepalese tax structure is dominated by indirect tax revenue The amount of direct tax was Rs 10159.400 million in the fiscal year 2003/04, which covered 26.15% of total tax revenue, and

it is increased and has reached to Rs. 34320.739 million in the fiscal year 2011/12, except in the fiscal year 2005-2008. Similarly, The amount of indirect tax was Rs 28705 million in the fiscal year 2003/04, which covered 73.85 percent of total tax revenue, and it is increasing each year and has reached to Rs. 82731.167 million in the fiscal year 2011/12, which covered 70.68 % of total tax revenue.

- F) The collection trend of VAT is increasing every year is good increasing trend. On the other hand, VAT on Domestic Product and VAT on Imported product has also increasing trend since 2003/04 to 2011/12. It was Rs. 4744.72 million, Rs 7303.04 million for VAT on Domestic product and imported product respectively in the fiscal year 2003/04 and continuously increased to until reached Rs. 13918.493 million And Rs. 64.94 million in the fiscal year 2011/12 of VAT on Domestic product and VAT on Imported respectively. The contribution of VAT to GDP and Total revenue is increasing day by day.
- G) The average contribution of VAT in total tax revenue, indirect tax revenue and GDP, which was 37.57% 47.99%, 7.5% in FY 2011/12, which shows that trend of Collection of VAT, is increased since last few years.
- H) The average numbers of VAT payers are increasing in each year and it will be high in future.

4.7 Major Findings from Primary Data

- VAT is suitable means of raising government revenue, but the context of Nepal; it is not effectively implemented, so, Government should be formulated effective strategic plan and policies to look after the favorable environment for VAT payer so, it will inspire to the large no of VAT payer to contribute for nation by paying regular taxes.
- Due to lack of proper knowledge about VAT in Nepal, VAT payers, consumers are not willing to pay VAT for the country. Most of Them have no idea about issue and receive about VAT bill while doing transaction in market. It helps to encourage those VAT evaders, and it leads to them to VAT evasion in highly. That should be immediately control and raise the government revenue by VAT, which will be retrieving by government or nation in term of different development process for us
- It has been shown on primary data analysis, that most of respondent tries to hide the about account keeping in their business. Very few have response about account keeping system in their business on actual basis. As result, it can conclude that due to the weakness of VAT system in Nepal, most of VAT payers are not keeping proper account keeping for VAT purpose. Some of businessmen have kept 2 or more than 2 set of account book in their business outlet for different purpose. That thing should be monitored by VAT office and VAT officer while cross checking the business. These types of practices are being used in Nepalese market. That's why; VAT system is not efficient and effective in Nepal.
- In the question of Major problem of VAT Management in Nepal, most of respondent have replied that “less consciousness of VAT payers” and “legal consideration of Nepal” are main causes of the problem. Even, VAT payers have not any idea that why they are paying VAT and taxes? What are the benefits of Paying VAT? How and where to pay VAT? These types of legal process and other things should be cleared out by VAT office.

- Possibility of increasing VAT registration habit of Nepalese businessmen by giving knowledge about VAT to them. Educating about benefits, need of VAT for us. Then after, only simplify the tax laws of Nepal, it will inspire to Nepalese businessmen for doing compulsory VAT registration habit before starting any business and the results, VAT revenue collection will be raised as expected.
- Respondent gives suggestion, that firstly, simplifying the tax laws of Nepal, which assists to motivate all the VAT payer or Tax payer to pay VAT/Tax time to time.. Government should make favorable environment, provides some subsidies, concession and others thing, etc. and next suggestions is spread the knowledge, education about the entire tax payer, so that, they can understand the importance, significance of paying VAT. And then only, rewards to regular VAT payer and other things. This leads to increase habit of Nepalese businessmen about compulsory VAT registration before doing any business in Nepal.
- Most of the respondent had believed that VAT evasions are still practices in Nepal. Government could be not achieve target government revenue until these types of VAT evasion is exist in Nepal. So it should be minimized as soon as possible.

Others basis tax evasion are still practices in Nepal

- VAT Evasion and Vat Fraud activities are practices by VAT evader
 - Failure to registration of VAT in VAT office while doing business
 - VAT collection by issuing the VAT bill in lower price rate of commodities.
 - Misclassification of Commodities
 - Omission of Self deliveries
 - Tax collected but not remitted
 - Imported goods are not brought into tax boundaries
 - Conceal the stock
- Giving knowledge about VAT, cross checking the business activities, simplifying the VAT laws, timely assessment of Tax are the ideal suggestion for eradicating tax

evasion. These types of things should be directly monitored by VAT office, which will be best tools to raise government revenue and effective to reduce and eradicating VAT evasion level in Nepal. Both, Government and VAT office should manage to provide certain rewards for those, whoever helping to find out and inform about the VAT evaders and determine the strict policy and charged penalties and fine for VAT evaders, so that, from the next time, these type of people will be discouraged and not to dare to do this shameless thing again.

CHAPTER V

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Summary

Taxation is an instrument for resource mobilization and that would help to bridge revenue-expenditure gap. Due to rapid growth of government expenditure or inflation and slow rate of revenue growth, resource gap is ultimately created in our economy. This trend of revenue expenditure-gap shows that Nepal has been undergoing several fiscal crises. These facts point out that the permanent solution to overcome this problem is through domestic resource mobilization in efficiently designed tax system.

In this connection, the value added tax has been considered as an attractive alternative to 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 worldwide acceptance rate.

In Nepal, sales tax was introduced at first in 1965/66 through the retail level. In the beginning of 19th century, sales tax seemed unattractive due to its narrow tax base, creating cascading effect, high burden on domestic product and inefficiency etc. In this background VAT has been introduced in Nepalese tax system. Theoretically, VAT has broad base as it covers the value added to each goods and service by a firm during all stages of production and distribution. As an indirect tax, burden of the VAT can be presumably shifted forward to the consumer.

More than 150 countries in the world have successfully adopted a fully fledged VAT during the last five decades. Nepal has adopted the destination based, consumption type VAT by using tax-credit method. The tax credit method is considered as a tool for cross-checking measure under VAT system. In this way, VAT is considered 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 discrimination 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 exemption and zero-rating techniques help to reduce the repressiveness. In this way, VAT has somehow more equity nature as compared to other kinds of sales taxes. The other major basic criteria of a 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.

Besides these, VAT is not totally immune from the fault of regressive nature. Single positive rate creates repressiveness with respect to expenditure but not necessarily with respect to incomes. Moreover, from the administrative point of view, VAT cannot be attractive compared to other kinds of sales tax. In spite of the administrative complexity, to maintain the equity norms, exemptions and zero rating are principally proposed. But such provision makes the tax base limited. As a result, the primary goal of VAT “to induce revenue by means of broad coverage with low rates” is violated.

A review of Nepalese tax structure reveals a clear picture about the Nepalese revenue in study period. The contribution of VAT revenue from indirect tax has continuously declined and direct taxes have continuously increased. It can be a satisfactory trend of revenue collection. Among the sub-sectors of indirect tax, all are in declining tendency except sales tax or VAT.

After implementing VAT, Nepalese economy has been suffering from price hike. Surprisingly the price is simultaneously increased in both exempted and taxed commodities. Thus the causes of inflation might be businessmen rather than VAT. Out of the total tax revenue, the share of the VAT is 37.57 percent of total tax revenue and

7.5 percent of the GDP. Among the indirect taxes, VAT and custom duty are the two major sources while income tax is one of the major sources for direct tax.

Due to some problems like narrow coverage, weak tax administration, defective tax system for the perspective of international taxation, unscientific tax assessment, long time lag, deviation from the basic principle in income taxation etc. VAT revenue collection has not been implemented to the optimum level.

5.2 Conclusion

Theoretically, Value Added Tax is the attractive alternative of sales tax on the ground of revenue productivity, equity norms, supporting economic growth without economic distortions, export promotion, price stability and neutrality on production and distribution etc. Further, the hypothesis of 'self-policing' or 'cross-checking' channel without cascading and pyramiding effects has made the VAT 'mile-stone' in the history of reforming of the indirect tax system.

Empirically, it is found that VAT has high revenue potentiality. Even the broad coverage of VAT would generate more revenue without addressing the equity norms. But it would be noted that, achieving both efficiency and equity objectives simultaneously is difficult. On the other hand, the provision of special consumption duty on luxurious goods and some exemptions and zero-rating techniques for basic needs helps to decrease the regressive nature.

Practically, it is found that the value added Tax is hot milk in mouth due to inefficient tax administration. However, there is no definite course about the degree of the reform. Since the judgment of achieving the degree of goal should be evaluated by comparing with previous situation as well as demonstration effect of international atmosphere. In Nepalese context, VAT is suitable both theoretically and empirically but the practical aspect is extremely weak. Thus in itself the introduction of the value added tax is not really a tax reform. The reforms in VAT have higher implication in Nepalese economy. Finally, VAT evasion and fraud has been growing among the businessmen. One common

thing done by the most businessmen to cheat the VAT is they are registered in PAN (Permanent Account Number) saying our annual turnover is not more than 2 million and they do their business freely. But in reality their annual turnover are more than 2 million.

5.3 Recommendations

The following are some major recommendations which should be considered by the tax authorities while reforming the VAT system in Nepal.

-) The success of VAT system is not only the success of the Inland Revenue Department, but also the success of nation as a whole. The role of general media, radio, TV, newspaper etc. is crucial. So, an environment of consciousness towards VAT system should be created covering general public, non-governmental and government organization.
-) Taxpayers, customers are ignorant about VAT system. They lack proper knowledge about computation of tax liability, taking invoice of their purchases. So, emphasis should be given to taxpayer education. The issuance of proper bill for every taxable sells must be made mandatory.
-) Providing various facilities to VAT registrants can increase VAT compliance. The tax administration can select genuine businessmen and reward them.
-) The government should check the culture of impunity. The tax officers should be forced to properly follow the code of conduct. At the same time, the fraudulent activities of the business communities should be penalized and they should be obliged to follow the rules and regulation by timely enforcement of laws.
-) The important sections of VAT offices like tax refund, tax audit, tax payers' services, Investigation return, processing and registration should be separately established for successful operation of VAT.

- J Income tax, custom laws and other such laws are interrelated to VAT. Thus these existing laws should be revised for the proper implementation of VAT.
- J The existing destination-based consumption type VAT using the tax credit method should be continued.
- J The accounting should be transparent and VAT officers should control auditing as far as possible.
- J Under the existing organization, there is the lack of inspection, auditing and enforcement of tax laws. The same personnel organizations of sales tax and excise offices are not appropriate and adequate for the successful implementation of VAT. Thus first of all, it is necessary to design a well-trained and skilled functional organizational pattern.
- J There should be close co-operation between the private sector and government sectors for the successful implementation of VAT. Both sectors should always be taken into confidence by each other.
- J However the administrative cost threshold has inverse relation. Thus the threshold limit should be gradually decreased to gain efficiency of administrative power. Similarly, the coverage of VAT should be extended into service based sectors.
- J Even if it is desirable to levy VAT with a single positive rate in order to make the VAT system less costly, the special consumption duty should be levied for luxury goods.
- J Even if VAT has higher revenue potentiality government is not able to collect more than 37.57 % of possible revenue potentiality 2011/12. Thus the tax authorities should be made aware of the main challenges of revenue collections tax evasion, illegal trade and corruption due to weakly designed

tax collecting system. Thus, to improve this situation, following steps should be taken

-) Issuing invoice for every taxable sells must be made compulsory.
-) The open boarder should be managed by controlling the border side secret business it is also necessary to make custom administration more strong and efficient. For the demonstration effect, reward and punishment should be established.
-) Authorized business should be penalized for the illegal and unrecorded business. Taxed commodity cannot compete in free market with illegally imported commodity. This violates first the principle of 'Self-policing' or 'self enforcement' channel of VAT and then invites the economic distortions. The extent of evasion is the inverse function of change of detection and degree of penalization, which is virtually nonexistent in Nepal.
-) The authorize administration should supervise the market in indirect way so that the businessmen could not realize that they are being supervised.
-) The government should know the culture of tax evasion and fraud and should take complete necessary action by without any financial and non-financial benefit from the businessmen.
-) The administration should control the illegal business activities operated with in the country.
-) The government should give penalties and fines to VAT evaders.
-) The administration should make provision of rewards to the tax evasion finders.

However, there is no definite course about the degree of tax reform. Thus the implementation of VAT by superseding sales, hotel, and entertainment and contract taxes is only the partial reform that can not address the equity aspects. Every businessmen and non businessman should be given awareness about the VAT. Our VAT act and rules are excellent but it is not fully applied in the practices due to the inefficient VAT administration. So, first of all VAT act should be fully applied within the businessmen to collect the expected VAT revenue.

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Appendix 1

Questionnaire

I would like to introduce myself as the student of Shanker Dev Campus, Tribhuvan University, M.B.S (final year). In order to fulfill the partial requirement of master degree in management, I am conducting a research work entitled “**Value Added Tax in Nepal: Legal Provisions, Practices and Contribution to Government Revenue.**”

(Please tick your answer in the following questions, if the question is provided with alternative, put in order of preference from one to last number.)

1. In your opinion, is the Value Added Tax (VAT) a suitable means for raising government revenue?

i) Yes:

ii) No:

2. Do you issue/Receive VAT bill in each transaction?

i) Yes:

ii) No:

3. How many sets of account book did you maintain?

i) 1 set

ii) 2 set

iii) N/A

4. Is the VAT system efficient in Nepal?

i) Yes:

ii) No:

iii) No Idea:

5. What are the major problems of VAT management in Nepal? Please, choose the most suitable one?"

- a) Legal Consideration ()
- b) Less consciousness of VAT Payers ()
- c) Lack of training incentives to the employee ()
- d) Lack of sufficient incentives to the employee ()
- e) Misuse of power by Tax Administrator ()

6. How can we increase the VAT registration habit of Nepalese businessmen? Please, choose the most appropriate option?"

- a) Educating taxpayers. ()
- b) Simplifying tax laws. ()
- c) Penalties and fines. ()
- d) Reward to regular VAT payers. ()

7. Do you believe that VAT evasion is being practiced in Nepal?

Yes:

No:

8. What are your suggestions for eradicating VAT evasion? Please, choose appropriate options and rank the order?"

- a) Controlling illegal business activities ()
- b) Giving knowledge about VAT ()
- c) Rewards to the tax evasion finders ()
- d) Penalties and fines to VAT evaders ()
- e) Simplifying tax laws ()
- f) Timely assessment of tax ()
- g) By cross checking the business activities ()

9. The rate of VAT had risen from .10% to 13%, is this favorable to you?

- i) Yes:
- ii) No:

10. Do you have complications in paying VAT?

- i) Yes:
- ii) No:

4.4 Statistical Analysis (Correlation Coefficient)

Researcher analyzed the relation between VAT revenue and total revenue. For this researcher used correlation co-efficient for VAT revenue and total revenue.

Table 4.12

Calculation of Correlation Co-efficient

Fiscal year	VAT Revenue (X)	Total Revenue (Y)	$u=X-18885.40$	$v=Y-70122.70$	u^2
2003/04	12048	48893.6	-6837.4	-21229.1	46750038.76
2004/05	11964	50445.5	-6921.4	-19677.2	47905777.96
2005/06	13460	56229.8	-5425.4	-13892.9	29434965.16
2006/07	14479	62331	-4406.4	-7791.7	19416360.96
2007/08	18885.4	70122.7	0	0	0
2008/09	21613.04	72282.08	2727.64	2159.38	7440019.97
2009/10	26095.6	87712.08	7210.2	17589.38	51986984.04
2010/11	29742.64	107546.5	10857.24	37423.8	117879660.4
2011/12	39700.92	117051.9	20815.52	46929.2	433285872.9
Total			18020	41510.86	75409968