

# CHAPTER - ONE

## INTRODUCTION

### 1.1 General Background

Tax is the largest source of public revenue of the modern governments. It is the internal source of national income. Tax is the legal duty of every citizen of a country to pay honestly. In the present day, a government has to spend a lot of money to fulfil its responsibility towards its people. The responsibility may be either for security, for health, education or other developmental activities. To meet the growing public expenditure, the government has to manage its funds from internal as well as external sources. External sources of funds are foreign grant and loans. Such external sources are uncertain, inconvenient, and not good for healthy development if there is heavy dependent on them. The government imposes tax on the people to repay the external debt, as a consequence of which the capacity or people to work to save decline.

The term "tax" defined as a liability to pay an amount to the government. It is a compulsory contribution to the national revenue from the taxpayers according to law. It is used for common interest of the people. The taxpayer could not get direct personal benefits. The tax can be classified in two types. They are; 1) Direct tax 2) Indirect tax. A Direct is a tax paid by a person on whom it is legally imposed. In Direct tax, the person paying & bearing tax is same. It is not shift able to others. For examples; Income tax, property tax & Gift or prize tax are direct tax. Similarly, Indirect tax means that tax which is imposed on one person but partly or wholly paid by another. In Indirect tax, the person paying & bearing tax is different. It is shift able to others person.

There is a global trend of tax reforms. So, the global trend should be encouraged Nepal to change its tax system for meeting the worldwide scenario. But, there is no compulsion to flow in the world flood. A tax system should be structured depending on the countries own economic and social condition or tax reform should be as per the industrial and trade situation of the country but minimum

adjustment or reforms must be made to meet the global changes. Thus, we cannot route back to the global trend it ultimately should be followed.

Developing countries try to mobilize internal source. So the government should be trying to reform tax policy and strategy. Nepal also has changed its policy and strategy to achieve more internal resources by replacing sales tax in to Value added tax (VAT). Since late 1960s and now this tax has become one of the main stays of the tax system in over the world 130 countries. In south Asia Pakistan adopted a VAT in 1990 and Bangladesh and Silence have since 1991 and 1995 respectively. Also in India, VAT is adopted in restricted form called; modified value added tax (MOD VAT) with effect from 1986.

In Nepal, Value Added Tax (VAT) was introduced on 16 November 1997. This Tax was levied in place of the manufacturing level, Sales Tax, Hotel Tax, Contract Tax & Entertainment Tax. However, it could not be implemented fully until the Fiscal Year (F/Y) 1998/99 due to the political instability and strong opposition from the business community. VAT replaces the old sales Tax, the Contract Tax, the 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 Custom duties and Income Tax depends to a great extent upon the effectiveness of VAT, it is expected to help enhance revenue collection .The VAT is broad -based Tax as it covers the value added to each commodity by a firm during all stages of production and distribution. It is a modern Tax system to improve the collection of taxes, to increase efficiency and to lessen tax evasion. It is also regarded as the backbone of income Tax system in Nepal.

Value added tax is a tax imposed on the value added in each economic activity from production to consumption. It means VAT is charged to value addition done to prepare the final product. Business people only collect the VAT as a mediator so that don't bear its burden. In conclusion, VAT should be the most essential choice for the developing countries as an ingredient of their tax reforms because it is the most improved from of sales tax and revenue enhancement and economic efficiency. It is an important instrument for the mobilization of internal resources. VAT is an improved form of sales tax. It is not a genuinely new form of taxation but merely a sales tax administered in different form. Under VAT system,

consumer knows the amount they are paying in form of VAT. VAT is more transparent and account based tax system. Thus, tax reform and adoption of a VAT is integral part of whole Tax system in present situation.

## **1.2 Statement of the Problem**

A government has to spend a lot of money to fulfil its responsibility towards its people. The responsibility may be either for security or special service economic development or other development activities. So government expenditure is rising. To meet the growing public expenditure the government has to manage its funds from internal as well as external sources. Such external sources are uncertain, inconvenient and not good for healthy economic development if there is heavy dependent on them. It is better to mobilize internal sources rather than with beggar's eye to the donors. Taxes are the important sources of public revenue and major fiscal Policy instrument have an important role in increasing rate of capital formation and they're by achieving and high rate of economic growth. Nepal is facing the serious problem of resource append high dependency on foreign loan. Cutting expenditures on development work infrastructure and social services will not be just for a country crawling towards development. So, higher resource mobilization through taxes remains to be the best option.

Nepal on the basic of Gross national product (GNP) per capital has come down early at the last position of backward. Despite more four decades of landed development, the Nepalese economy is persistently suffering from general poverty stagnation. The low-income people of Nepal suffered from economic humiliation ever before then they are suffering today and this has led to several economic VAT registrants' political disturbances in the country. Tax reform and adoption of VAT is important fiscal phenomenon. The adoption of VAT as a substitute of existing sales taxes is expected to improve the Nepal's tax system in various ways. The Sales Tax is expected to improve in the Nepalese tax system has too many cause. They are; the sales tax System is very narrowly based and less productive, it is also putting much pressure on economic activity by its distortion characters and it has cascading effect. By contrast, a VAT has broad-based tax, it is based on self-assessment system and provides the facility of tax credit as well as tax refund, increases the revenue elasticity and it avoids cascading effect existed in sales tax

and contains catch-up effect (perhaps it is the most charming feature of VAT). Similarly, it has also some merits. Such as; less chance of tax evasion, simple to administer, transparent & minimum burden to consumers, mass participation of taxpayer and it is based on value added not on total price. So, price does not increase as a result of VAT. It is expected that the VAT would contribute more than 40 percent of country's total revenue. It is the reality shown in developed countries.

VAT is a new experiment in Nepalese tax system. So that, so many problem and difficulties has to face in primary phase of implementation. They're no conducive environment for execution the concept of VAT. The tendency of unnecessarily troubling taxpayers must be stopped to ensure a friendly atmosphere at various tax collecting offices. The Major problem associated with VAT is lack of knowledge. In Nepal most of the Taxpayers are unknown about the VAT. The billing systems also confuse for the Taxpayer. The billing system is lacking. Most of the Businessman is not showing VAT in Bill to their customers. If they did, they are charged extra amount in the Name of VAT. The general concept is that, VAT increases the prices of commodities and serves.

In Nepal, resources mobilization is still poor that does not cover the growing expenditure. Because of deficit financing and external loan, the Economy has to face the resource Gap debt trap problem. It is widening continuously with the increment of total expenditure in respect to total revenue collection. Taxation is not sole receipt of government but it is considered as one of the most important part of government receipts. It plays a important role in domestic resources mobilization.

- ) What is present provision and status of VAT in Nepal?
- ) What are the problems and prospects of VAT?
- ) What is the contribution of VAT on revenue mobilization?

### **1.3 Objectives of the Study**

The main objective of this study is identifying problem and prospect of VAT in Nepal. The specific objectives of this study are:

- To analyze present provision and status of VAT,
- To analyze the problems and prospects of VAT,
- To analyze contribution of VAT on revenue mobilization

### **1.4 Significance of the Study**

Nepalese government has already been implemented VAT for achieving ultimate objective of economic development and acceleration growth rate of economy through expanding. During the last 11(Eleven) years of VAT implementation, government has made a great effort to make VAT more effective and productive. However, VAT was subject of a strict opposition from the business community in initial stage of implementation. Letter there were some correction in VAT rules and regulation and then slowly business community accepted the system and further demanded it to extend the retail level so that all the businessman firms will be treated equally. In such situation, internal resource mobilization should be strengthened to overcome resource gap problem. The experience shows that successfully implemented of VAT will have positive impact on the economy. For strengthening internal resource mobilization of Nepal, the government has already adopted VAT administration and policy, according to the reform policy and programmed noted in the eight five-year plans.

Nepal has adopted VAT since 16 November 1997 which the following objectives:

- Expanding the base of tax i.e. bringing more goods and services under the tax net.
- Export formation.
- Reducing economic in efficiencies.
- Acceleration of the development peace throws more resource mobilization.
- Evolving a simple and transparent tax system

Despite more than 10 years of VAT implementation, many Nepalese people are unknown about various aspects of it. This study basically concentrates on administrative structure of VAT, the importance of VAT to improve internal

resource mobilization, existing problems of VAT in Nepal and provided effective suggestion to making VAT effectiveness.

In this regard, this study carries a great significance to mobilize additional resources through improved and successful implementation of VAT and hence make the country self -dependent to some extent instead of the rapidly persisting resource gap.

### **1.5 Limitations of the Study**

All research study has been lunched to solve a particular research problem. It requires various kinds' data, materials and other relevant information, which may not sufficient to the researcher.

- The study only covers the time period from 2002 to 2011 the rational for choosing this period is mainly for the simplicity of analysis is data itself.
- Primary and secondary data both are going to be used so the validity and reliability may depend on the goodness of these data.
- Primary data by questionnaire is collected from Kasowati only.

### **1.6. Organization of the study**

This study has been categorized into five chapters. Prior to the body of the thesis, several pages of preliminary materials such as title page, Viva-voce sheet, Recommendation, Declaration of the researcher, Acknowledgements, Table of contents, List of tables, List of figures and Abbreviations used have been included.

#### **Chapter One: Introduction**

The first chapter is introduction which includes background of the study, Introduction of Value Added Tax, statement of the problem, objectives of the study, needs and significance of the study, and limitations of the study.

#### **Chapter Two: Review of literature**

The second chapter is Review of literature which refers reviewing the research or other related published or unpublished literature, articles published in

different economic journal, bulletin, dissertation papers, magazines, newspapers and websites in the related area's study, so that all possible relevant past studies, their conclusion findings and recommendation can be known through review of literature. The purpose of literature review is to find out what research studies have been conducted in one's chosen field of study, and what remains to be done. In other words review of literature is basically a stock taking of available literature in the field of research. It supports the research to explore the relevant and time facts for the reporting purpose in the field of study. In the course of research view of the existing literature would help to check the chances of duplication in the present study. This one can find what studies have been conducted and what remains to go with. In brief this chapter includes conceptual framework and review of related studies

### **Chapter Three: Research Methodology**

The third chapter is Research Methodology. In order to achieve the objective of the study, appropriate research methodology has been adopted. It is purely explorative cum descriptive study. It includes the introduction, research design, nature and sources of data, data analysis tools, sampling procedure and definition of some key terms. The main objective of the study is to analyze, examine, highlight and interpret situation of VAT implementation, problem and prospects in Nepal. Research methodology refers to the various sequential steps to be followed and adopted by a researcher in studying a problem with certain objectives in view.

### **Chapter Four: Presentation and Analysis of Data**

The fourth chapter comprises presentation and analysis of data. This is the main and key chapter of research study. In this chapter sources of data are primary and secondary, which are presented in appropriate form. Analysis and interpretation of data have been performed thereafter. From this analysis and interpretation major findings have been deduced.

### **Chapter Five: Summary, Conclusion and Recommendation**

The fifth and the last chapter is concerned with the output of the study in the form of summary, conclusion and recommendation. This chapter consists of summary of the major findings of the study, concluding it with major recommendations and suggestions.

## **CHAPTER - TWO**

### **REVIEW OF LITERATURE**

#### **2.1 Introduction of VAT**

##### **2.1.1 Concept**

Value added tax is a tax levied on value-added on goods and services by the business enterprises at the successive stage of production and distribution. Value added for a firm is the gross receipt from sales after subtracting all expenditure in goods and services purchased from other firms. Looking from one angle value added by a firm is the sum total of incomes paid out by firm to factors employed and value is added by processing or handling these purchased items which its own labour force and its own machinery, building or other capital goods.

Clear concept can be attained through an example. Let's consider the case of sugar production. A farmer produces sugarcane and sells it to the miller. Miller adds value in the process of changing sugarcane into sugar. All the expenditure including profit made by the miller constitutes the value added of that miller. Miller sells his products that are sugar to the wholesaler who, in turn, sells to the retailer with an increasing value. Ultimately sugar is sold to the consumer with the some additional value. Thus, at each stage of production and distribution value is added and sum total of all sum value added exactly equals to the final sales value of the sugar.

VAT, like other sales taxes in classified as an indirect tax because it is paid by business firm to the government and shifted to the purchasers of the product rather than being collected directly by the government fro the purchases. Goods and services constitutes base of VAT and it is shifted forward to consumer. A basic characteristic of VAT is that deduction is permitted of tax paid on purchases of goods purchased for direct resale and material and parts physically incorporated in to good to be sold.



### **2.1.2 Origin and Development**

Value added tax is a major breakthrough in the field of taxation. It is regarded as a process of tax reform in many countries in the world. Such widespread popularity has become one of the most astonishing phenomena of public finance. The evolution of VAT is the most astonishing phenomenon of public finance. The evolution of VAT is the most significant event in the history of commodity taxes and the speed with which the VAT has spread over other taxes in modern times (Shoup 1988:139).

In this connection, Germany introduced a multistage sales tax to mobilize resources for war finance during World War I. After the war, the German government wanted to reform the tax as the existing tax caused rapid price rises and so on, a commission was set up under the leadership of Wilhelm Van Siemens which proposed for the first time in 1919 for Germany to replace the existing multistage sales tax by value added tax. The improvement consisted in the subtraction of previous outlays from taxable sales with the result that the tax base of each firm would be reduced to the value, which is added to the product. (Sullivan 1965:12) But the government hesitated to introduce a totally new tax system because there might originate various practical problems.

Before the introduction of VAT, sales tax was the main source of revenue mobilization. In the developed countries revenue mobilized through sales tax followed custom duties. While imposing tax on sales, there was a debate as to what stage of sales tax is imposed and to which communities up to modern days as well, value added tax is considered a major breakthrough because it is a revised version of sales tax.

After World War II, the Japanese government wanted to reform the existing traditional tax system and formulated a committee under the chairmanship of Kan. Shoup. In 1949, the committee recommended value added tax in the place of

turnover tax. But Japanese government also hesitated to introduce VAT because it was a new concept and no person was known about the new tax regime.

VAT took almost 85 years to mature. In 1954 France was the first country to introduce value added tax. But the tax was introduced only up to wholesale level. The new tax remained only in France up to 1959 and it spread all over the world from 1960.

As the experience shows VAT still has not become a perfect substitute for other taxes like excise duties, special consumption taxes etc. This further implies that VAT has not caught the fancy of the intent as it is claimed in theory. In underdeveloped countries VAT is less neutral and less comprehensive. Therefore, these countries are facing the problem of tax administration, tax evasion and high cost of collection.

## **2.2 Types of VAT**

There are several bases to classify the different types of VAT. However, the classification of VAT on the basis of the treatment of capital goods is much important. Considering the treatment of capital goods, the following classification has been made in broad sense.

### **A. The consumption Type:**

Under this type of VAT discrimination is done with respect to capital or consumable goods. Whatever is purchase for the use of business is treated at par. This implies that full credit of inputs is provided. It is indeed the most superior form of VAT and is universally practiced. Since no discrimination between capital and other consumption is made this system is natural and does not lead to alternation or substitution between methods of production.

## **B. The income type:**

When capital goods used for methods of production are not deductible but only a portion relevant to particular period is allowed to deduct and the remaining portion is carried over for the next period, then it is termed as income types of VAT. Under this method the capital equipment are divided over a period on the basis of their useful life. Such methods are called depreciation. Since the tax base equals to Private personal income under this method, it is called as income type of VAT. This type of VAT is fraught with some difficulties as well face in calculating income for a particular period. AS a result many countries do not practice these types of VAT.

Depreciation = Net investment + consumption = Net national product.

## **C. 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 deduct 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 fevers international production. Neutrality of tax is not satisfied in this method therefore it has not practicable ground. It is suggested to impose the tax on consumption and gross investment in this variant. Finally gross national product becomes the base of this variant. It creates a substantial discriminative for saving, investment and capital-intensive production.

The base 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 = Gross investment + Consumption both the income and GNP variant do not include the purchase of capital goods from the tax base in the year of purchase. But the income type includes the depreciation from the tax base in the subsequent years while GNP type does not treat as so. The GNP type of VAT is less practicable because it is biased to labor incentive technique. The income types also rare in practice because it includes 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 includes investment from any tax burden. Furthermore the consumption variant is more uncreative 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 others, it has widely accepted and successfully implemented in VAT system.

## **2.3 Principal of VAT**

There are two principles in the case of international trade under the VAT system. One is taxing all domestically produced goods and services including exported and exempting imported and second is taxing all imported good and exempting all exported goods and other principles are as follows :

### **2.3.1 Origin Principle**

Under this principle, goods and services produced in a country are taxed at the place where they are produced or rendered, irrespective of whether they are consumed there or not. It implies that all exports are taxable and all imports are non-taxable. Where there is border and Cross-country trade this principle gives preference to imported goods services over domestic production. Countries with international boundaries prefer not to have this principle while taxing.

### **2.3.2 Destination Principle**

Under this principle, goods and services are not taxed at the place where they are produced or rendered. The tax is imposed at the place where they are actually consumed. Alternatively all imports are taxed while all kinds of exports are tax-exempt. The main benefit of this principle is that, it non-discriminate between import and internal production. This is the most popular form of principle adopted by a large of countries. This lends support for exportation, many countries are eager to boast export therefore they follow this principle. The equal treatment provided for imports and domestic production fulfils the criterion of tax criterion of tax being neutral.

### **2.4 Methods of computation of VAT**

There are three basic methods by which VAT can be calculated:

#### **2.4.1 Addition Method**

Under this method value added is the total sum of the factor payments made by the business firms, which is equivalent to the gross income received by the factors of production. The tax base is computed by adding the payments made by the firms to factors of productions employed in turning out the product, such as wages, interest, rent, royalties and profits. Thus, VAT under additional method is the function of the total factor payment as given by:

$$\text{VAT} = f(\text{W}+\text{R}+\text{I}+\text{P})$$

Where,

W = wage,

R = rent

I = interest,

p = profit

### **2.4.2 Subtractions Method**

Under this method value added is determined as net turnover which is obtained by subtracting the cost of materials from sales proceeds and the procedure was used in the Michigan VAT. Value added is obtained by subtracting purchase of produced goods from the figure of sales during the period, as given in the functional form by,

$$\text{VAT} = f (S_v - P_v)$$

Where,

$S_v$  = Sales value

$P_v$  = purchase value

This method of calculating VAT is suitable for the consumption variant of VAT. It is not well suited for discrimination among types of consumer goods but it needs not any adjustment to operate correctly for imports under the origin principle. Something also happens to the addition methods. However, under the destination principle, these principles, these both methods of direct calculation cannot supply the information needed to compute precisely the export rebate or the import compensating tax when there is not uniform rate to all stages of value added of all goods and services.

### **2.4.3 Tax Credit Method**

Tax credit method is also known as the invoice method and uses an indirect subtraction technique to compute the tax liability. Value added as such never calculated at all. In this method, but the effect is exactly the same as if the figure was calculated and the tax rate applied. Since, the firm deducts the amount of the tax paid on its purchases during the period from the figure calculated by applying the tax rate to its figure of taxable sales for the period. Under this method taxpayers are allowed to subtract the taxes already paid by the supplier and passed on to them from the gross tax liability, which is levied on the total value of their sales. Thus, in contrast to the subtraction method, which deducts purchases from

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

Hence net tax liability is given by:

$$\text{VAT} = f(\text{Outputs} - \text{Inputs})$$

Where,

Outputs= tax collection from sales

Inputs = tax paid on purchases

Among the above three method of computing VAT, the tax credit method is widely favoured in the countries. The invoice method is used generally in European countries. The tax credit method is so superior to the other method in terms of application and enforcement as well as adaptability to various rates modification that is now universally employed. The methods of calculating VAT liability under the different methods are shown in the table below:

## **2.5 Structure of VAT**

The structure of Nepalese VAT is designed in VAT Act 1996. The main characteristic of Nepalese VAT is as follows:

### **2.5.1 Tax Base**

The tax base of VAT is all types of expenditure on final consumer goods. Hence the aim of VAT is to reach to the consumption expenditure making the tax base as broad as possible. The tax base of a VAT depends on its scope or coverage, which defines what kinds of goods and services or business activities are included in tax base.

It is desirable to include all kinds of goods and services or business activities in to the scope or VAT so that all consumption expenditure comes under taxable base of VAT. But all the consumption items for practical purpose are not included in

the tax base. A VAT levied on selected goods and services and economic activities are narrow based while of VAT is levied on wide range of goods, services and economic activities are broad based. A broad based VAT extends to the retail level to the manufacturing level. A Pre-retail level to the manufacture level (or wholesale level) makes the VAT base smaller.

The tax base depends upon exemption, Zero rating, tax and threshold in underdeveloped countries taxing on agriculture is not feasible from administrative point of view, similarly from equity and administrative reason only few selected services are taxed. Many goods and services are exempted which reduce the tax base and hence reduce the revenue generation through VAT.

### **2.5.2 Freeing from VAT**

Some goods and services are let free of VAT or they are not taxed. The theoretical base of VAT is largely reduced of such inclusion from the scope of VAT, freeing from VAT may be justified for three reasons.

- a. Administrative
- b. Equity and
- c. Economic

There are two or three general method of freeing from VAT exemption and zero rating under the VAT. There is a provision of keeping some goods and service beyond the tax net. Such provisions reduce VAT base and hence reduce the revenue productivity. However, such provisions are important from administrative simplicity and equity point of view in general there are three method of freeing from VAT.



### **2.5.2.1 Zero Rating**

Zero rating means a zero percent tax on goods and services. Under the current VAT act exported goods and services are zero-rated. The trader supplying zero rated goods and services is entitled to recover the net tax paid on his purchases used to make a zero rated supply. Main objective of Zero-rating is to promote specific goods and Services (e.g. exports), to give facilities for some person (e.g. tourist). But these goods and services are taxed for another purpose or person at prescribed rate.

On other hand, in the case of the dealer dealing with exempt goods and services, VAT is not levied on his sales and there is not entitled to a credit for VAT paid on his purchase or imports. An exemption is generally granted, if it is desirable to exclude a particular product or transaction on administrative grounds; i.e. traders having an annual turnover below the threshold are exempt. Such traders are not collect VAT on their sales. As tax-exempt traders they are not entitled to the input tax credit but in Zero -rating provision person has enjoyed this facility.

### **2.5.2.2 Exemption**

Exemption means an exclusion of a certain kinds of goods and services from the tax net. In Nepal, basic needs goods, and services, basic agriculture products, agriculture inputs, social welfare services, educational and culture goods and services, personal services purchase and rent of land and building, financial and insurance services, postage and revenue stamps are tax- exempt. These are tax-free goods and services. Neither tax is collected from sales nor payment of tax on purchase. There is no facility of tax credit on the transaction of mentioned goods and services.

### **2.5.2.3 Threshold**

Relating to simplification of the VAT administration, many countries provide a threshold level even for taxable supply. A threshold would keep of trades from

VAT who sells below the prescribed level. The only major difference between exemption and threshold is that, a threshold applies to taxable supply and more often than not there is an option to register voluntarily in the VAT whereas, under exemption, registration is out of question. So, any one who sells below a level of threshold, if gets in to the VAT voluntarily he/she would be getting an equal treatment to other registered taxpayer. Many countries even provide extra privilege for voluntary registration.

In case of Nepal, small traders whose annual turnover is below a certain level are not required to register on VAT. The level of the threshold varies from country to country depending up on the revenue requirement, administrative capability, level of record and accounting proficiency in the industry and business etc. Section I of the VAT Act 1995 has made a provision for setting a threshold limit and initially the level was fixed by VAT regulation.

### **2.5.3 Tax Rate**

A VAT may be levied on single rate or multiple rates various aspects such as revenue requirement, equity considerations, administrative capability, nature of product and tax payers etc. guide the choice. The lower VAT rate with higher cost of administration is not desirable because tax system will be less attractive from revenue generation and productivity point of view. The government can be very tax rate on social ground and as the part of Fiscal policy to increase / decrease spending.

Under the multiple rate VAT, there is a need of classifying commodities into different groups according to their rates so that tax administration becomes more complicated. Business persons have a liability to keep separate record and have to provide more information, while preparing their tax return. It not only creates inconvenience but also becomes unequal in effect since a dealer (business persons)

may charge different rates on the same goods sold to different buyers. Moreover a business person may charge a high rate for that product which is subjected to lower rate and vice versa. The multiple rate VAT is also economically inefficient as it provides ground of tax evasion. further there is an incentive to the producers to substitute their resources from high tax product to low tax product to save nor tax liability which causes considerable loss in government revenue and do not justify the reallocation of resources.

Nepal and its neighboring countries introduced VAT in the 1980s and 90s. Among the SAARC countries, Bhutan and Maldives have not introduced VAT in their tax system. The rate of VAT among other SAARC countries. Pakistan, Bangladesh, Sri Lanka and Nepal are 15, 15, 12.5 and 13 percent respectively. India has adopted MoD, VAT which is different from state to state. The other neighboring countries Singapore, Thailand and Japan have 3, 10 and 5 percent respectively. China has adopted multiple rate VAT which is 17 percent and 13 percent.

## **2.6 Operation of VAT**

For effective implementation of VAT, the following provisions are needed:

### **2.6.1 Registration**

This is the first step for the smoothly operation of VAT. The registration of firms subject to the tax is a master roll of taxpayers. In this process, all the vender's having a taxable business turnover are compulsory registered on VAT. Any business enterprises that have not compulsion for registration, if they desire to register can register voluntarily. However, there is no compulsion to register for the small vendors who have an annual turnover below the threshold.

The registration procedure starts with a notice to the potential taxpayers through extensive publicity campaign. Then the registration forms and distributed so that the vender will fill up to be a formal member of the taxpayer under the VAT system. Then the registration form is returned back to the Inland Revenue

Department and their coding is made. Thus registered taxpayers may be unknown about VAT in detail. So, an informative visits needs to be made and check detail whether the provided information by the taxpayers are correct or not.

If tax officer is satisfied about applicants may register them for VAT purpose. Like other registered vender's, who are registered voluntarily will be able to claim back input tax paid on their purchases, to collect VAT on their sales, to hold the collected tax until the date of it payment to the concerned tax offices. The tax-registered vendors should get a VAT registration certificate, which must be prominently displayed in the public area of his business.

### **2.6.2 Tax Invoice**

The tax invoice is a crucial document for VAT as it established the seller liability for tax and purchaser's entitlement to credit. A VAT registrant is required to issue a tax invoice whenever a transaction takes place. Invoices are the important documents for VAT control. There are two types of invoices; (i) tax invoices and (ii) abbreviated invoice.

Tax invoices established both the liability of the supplier and the amount of the deduction allowed to the registered purchaser. A VAT registrant is required to issue a tax invoice in the prescribed form whenever a transaction takes place. Only VAT registrants' taxpayers should issue a tax invoice. A minimum of three copies of each invoice must be prepared. The first copy must be given to the buyer and the vender must retain the remaining two copies. A tax officer must make these available at all reasonable times for inspection. The invoice must be used in sequential numerical order. However, they can prepare invoices with different serial numbers for branches or different sections with prior approval of the VAT office.

The abbreviated invoice is simple type of invoice for registered sales to unregistered persons, who should be considered final consumer under the VAT. VAT registrants may make an application to use abbreviated invoice and the tax officers may allow it use. In the case of sales under abbreviated invoice, VAT is calculated by multiplying the sales by the VAT quotient. The VAT quotient if

found by dividing the rate of VAT. The abbreviated invoice can issue up to 5 thousand transactions. There is restriction to cross the limit.

### **2.6.3 Books of Account**

Every VAT registered vender should be kept clear account of his activities (purchases and sales), which come into VAT base. The record of all invoices including other information such as the serial number and date of issue, of invoices the amount charges, and the VAT charged. The account should be kept in such a way that the VAT authorities are able to check the accuracy of VAT returns. Such records are kept for 4 to 6 years. So that it can be provided the tax administration if asked to check its accuracy and fairness. The period relating to the preservation of the account depends on internal audit. VAT liability should be calculated accordingly VAT account. This is, because if it is levied only on the cash basic, Taxpayers might delay payment. Small venders, public or local bodies and not profit making organization, however, may be allowed to account for their output tax input tad only open receipt or payment.

### **2.6.4 Tax Return and Payment**

A tax return is a summary of the transaction of a VAT registered business firm which consists of total purchases, total sales, input tax, output tax, tax liability etc during a taxable period. In additional to firm's name and account number the firm includes the following information:

1. Total sales including transfers form inventory to personal use of the owners.
2. Exemption Sales
3. Zero Rated Sales
4. Taxable Sales
5. The Gross Tax (Taxable Sales and Tax Rate)

6. Tax on Purchase (Exclusive of the purchase for credit allowed exempt related sales)

7. Net Tax liabilities

After filling up the tax return form, each firm requires to submit it on the tax office and pay the net tax liabilities within a specific period. There would be provision of frequent intervals, so that payment of the liabilities would be easier to the firm. Such a provision provides government revenue in a regular basis to smooth out its expenditure. General practice shows that the standard tax period is of one month. Usually VAT payment is made through bank.

### **2.6.5 Penalties**

Penalties play the important role for effective operation of VAT. Actually penalties are designed to punish the taxpayers who are not following the legal rule. Penalties are considered essential as they create an incentive to tax payers to deter evasion and non-compliance for smooth functioning and producing a full revenue potential of a VAT system. However penalty taxes became inequitable if they are imposed heavily on some defaulters but not on others, so all defaulters should treat equally.

The penalties have divided into four forms: automatic financial, automatic non-financial, criminal financial and non-financial. Some other typical devices for penalties are attachment of bank account, revocation of business certificate, seizure of property shut down of premises, temporary suspension of trading license, threat of imprisonment, criminal prosecution etc." (Alan a Tait 1998:3 19)

### **2.6.6 Audit of VAT**

The purpose of the audit is to find out, according to the law and regulation, the actual VAT liability of the taxpayers. Auditing in VAT system is a selective review of the taxpayer's books of accounts and other records including balance sheet profit and loss accounts. Main cause of auditing is to be ensured that the

major areas of purchases, sales, stock and profit or loss accounts are substantially correct or not. The purpose of VAT audit is to find out actual VAT liability of the taxpayer's. A VAT audit, which is based on the principle of self-assessment by taxpayers, may be integrated with that of income tax. However the intergraded audit is more desirable and popular. The types of a VAT audit can divide into field audit and office audit, where the former include advisory visit, verification of records and fraud investigation and the latter includes desk audit checking the return for arithmetical accuracy and completeness. The office audit is desirable to check each return for probable accuracy, as a basic for selecting account for audit.

Several activities and steps; which appear in performing the audit, are included in the audit management. Generally the audit management activities includes (Sharma, 1997:40) :

- Searching of the taxpayers who fail to register and file the return.
- Reviewing the tax returns, checking the conformity of calculation and verifying the data inputs, outputs, zero-rated goods and exemptions.
- Selecting the business unit for audit through the establishment of appropriate selection criteria and accounting to the audit capacity of the administration.
- Preparation for audit and audit result for further decision-making and auditors, allocation of tasks among inspectors and auditors, audit manuals etc.

## **2.7 VAT and Other Forms of Sales Tax**

VAT is modern and scientific tax then other form of sales tax. VAT is compared with other form tax as follows:

### **2.7.1 VAT and Retailer's Sales Tax (RST)**

VAT and RST are acceptable on theoretical grounds because both are identical in the sense of tax base. Both differ in tax collecting techniques in which VAT is collected at each stage of business process while RST is imposed only at the final stage. Each system provides the same and amount of revenue because total value

added of final goods and services are same and both are principally the destination based consumption type.

From the administrative point of view RST seems to be simple as compared with VAT because their records and audit are sufficient on keeping the single stage. And the number of taxpayer remains more under VAT than RST. RST based on the suspension principal in which tax retailers are required to register for the sales tax purchase. Thus it is meant that the RST is levied only on the sales, which is registered to sale the consumer.

VAT and RST are vertically neutral with respect to production and distribution as total tax on a given commodity depends on the final price under both systems. On the other hand VAT and RST both are able to avoid the problem of cascading effects since there is no possibility to impose on tax. Both taxes avoid the problem of pyramiding since there seems no need to apply the mark-up on the tax amount levied at earlier stages. So, consumer price increase only by the amount of tax.

RST is more vulnerable to tax evasion than VAT. RST places a heavy burden only at the retail stage. Under this tax system, the whole tax is imposed at single stage (i.e. retail level). If a retailer does not file his return under the VAT, tax collection is dispersed over the whole production and distribution process. Thus the tax burden is distributed among a large number of taxpayer who feels it less burden

some as compared to RST. VAT provides a self-policy mechanism, which is not available under RST VAT also provides a more complete audit trail than RST. As a conclusion, we can say that VAT is more preferred in developing countries but it required efficient tax administration.

### **2.7.2 Value Added Tax and Manufactures Sales Tax (MST)**

Manufactures sales tax (MST) basically covers domestic manufacturing as well as imports. This is a single stage levy. In practice manufactures and importers are required to register for sales tax purpose. Generally this type of tax is applied on sales in case of domestic product and on the import value in the case of imported goods. These types of tax is favoured in many developing countries in the sense



that it more or less avoids the cascade evil and covers more organized entrepreneurs so as to make administration easy.

In contrast, VAT avoids cascading and pyramiding effects. It does not have a negative impose on negative impact on economic growth. The tax burden also falls stepwise under a VAT system, rather than at once in an import level of sales tax. The stepwise burden would not disport economic sectors. So, they will not encourage evading tax. But if, burden is laid down at once, a very high load will depress the entrepreneurs so as in creating the tax evasion. From the above discussion we can conclude that MST is non-neutral, limited in base and encouraging various difficulties with the culmination of tax evasion. VAT proves advantageous over MST, that it has broad coverage equipped with catch up effects, eliminating cascading and pyramiding and desirable in developing countries because it is distrusted roughly according to consumer expenditure. The main disadvantage, coherent to VAT, in comparison to MST, is the large number of taxpayer with poor record keeping. But it can be covered by means of improvement in administration.

### **2.7.3 Value Added Tax and Wholesale Level Sales Tax (WST)**

Simply speaking, the wholesale level sales tax (WST) means the taxation on sales to retailers by wholesaler. In underdeveloped country, wholesalers are more organized than the producers and retailers. Thus it is easy to implementing in practice and more meritorious than MST in the sense that it covers value added by wholesalers. Wholesaling goods are carried directly from producers or importers. But in many countries, there is no provision of separately registers. Making the provision of separate registered as domestic enterprises and imports can enlarge the volume of taxable base. Which makes WST more suitable too? As a theme WST can be levied in two ways i.e. WST impose on wholesale enterprise and accompanies with manufacturing or retail system. On the ground of revenue potentiality, Value added tax provides more revenue than WST but as compared with MST, wholesaling enterprises lie somehow greater than MST compared to VAT. For the administrative formalities like calculating tax base cross checking and auditing, refund procedures etc are less under the WST system. Furthermore,

WST is easy to handle since it needs only to watch on sales point of wholesalers. On the basis of this reasoning WST is argued to be superior. The inclusion of new items i.e basic necessities would make VAT more vertically inequitable than MST and WST as it will be levied at uniform rate however, the imposition of VAT on services. Which the higher income group largely consumes would have opposite effect. Despite these few merits of WST, we cannot ignore the contradictory and bad effect of WST in practice, which puts the demerits of VAT, in shadow. If manufactures or importers encourage direct sell to retailers or consumers then the revenue will be nil. The problems should be more serious when for the two kinds of goods having same qualities and price whereas distribution process is different. Suppose one commodity (say A) supplied from producer to wholesaler and wholesaler to retailer successively but the other commodity (say B) is supplied directly from producer to retailer or to consumer, then definitely the price of 'B' becomes for below than 'A' due to the WST. In this case, the commodity 'B' cannot compete with 'A' in the market. Such a vast alternation compels the producer of commodity 'A' to close down his production. Thus WST is on neutral among the production and distribution process as well as consumer choices. But in contrast, it is notable that VAT does not create such discrimination because VAT is levied in every stage of business process.

Thus, WST encourages manufactures or importer to sell directly to the retailers so that product remains beyond the tax net. This results a loss in the revenue on the other hand, it discriminates against those products by means of competitive advantage, which bear the tax burden favouring those firms, and product, which do not bear the tax burden. In contrast, VAT does not create such discriminations since it is levied at every stage of production and distribution and tax evasion is also more difficult. Thus VAT is neutral among the process of production and distribution.

## **2.10 VAT in Nepal**

### **2.10.1 Evolution**

VAT is a member of sales tax family. In 1997, it replaced the existing sales tax, contract tax, entertainment tax and hotel tax. But among the replaced taxes, sales tax is the most important. So, evolution of VAT is the evolution of sales tax. Sales tax was first introduced in 1965 by Finance Act 1965, and in 1966, sales tax act was implemented. Initially the tax was imposed at retail level. In 1968, the base of sales tax was reduced up to wholesale level and again to manufacturing/import level in 1974. This tax was converted into VAT in 1997.

#### **Retail Level Sales Tax (RST)**

Retail level sales tax was introduced in 1965. Under this system, all the retailers were required to register for sales tax purpose. They had to add the value of product by imposing it on sales. Billing system was required so that each copy of bill could be verified by the tax office. The retailers had to submit monthly and annual records to the tax office.

Manufacturers and wholesalers were also required to register for sales tax purpose. They had the obligation to keep records of their sales. Moreover, they had to submit their account of sale to the tax office on monthly and annual basis. To avoid multiple taxation, the transaction between two registered vendors was out of tax net, meaning the tax was levied only on the sales of registered retailers to final consumers.

#### **Wholesale Level Sales Tax (WST)**

Retail level sales tax created many problems, so it was replaced by wholesale level sales tax in 1968. Under wholesale level sales tax system only the manufacturers and wholesalers were required to register. The tax was levied on the sales of

wholesalers to retailers and retailers consumers. This tax net is more convenient because wholesalers are more organized and the number is manageably small so that tax administration is easier.

However, Nepalese trade sector was very small and the wholesalers were also small, unorganized and was not capable of keeping proper account. Further not much was done for the operation of this tax. As a consequence, problems associated with RST persisted in this system also. Not issuing bills, under billing and fake import in the name of fake firm became more acute.

### **Import/ Manufacture Level Sales Tax (MST)**

Due to problems in the operation of WST, the tax base was further reduced in 1974 to the level of import and manufacturing. Under this system only manufacturers and importers were required to register for the tax purpose. Some manufacturers were out of tax net if they were cottage industrialists. Moreover, the transaction between two registered firms was out of tax net.

The MST tax gained some features of VAT in 1985 when an advance sales tax system was introduced. Under this system, sales tax registered firms were required to pay the advance sales tax on inputs which were credited against the tax on output. The new system helped to check leakage to some extent but it complicated the tax system and led to harassment to taxpayers by the tax officials as well. Value added element was further extended in the sales tax system in 1992/93 when two -tiers system was introduced in the case of some selected domestic products. Under this system besides manufactures, dealers and distributors of some selected items such as beer, biscuit , and noodles were required to register for sales tax purpose and to collect tax on their sales. The two-tier system was expected not only to broaden the tax base but also to discourage the malpractice of selling taxable goods at artificially lower prices.

## **2.10.2 Reasons for the Adoption of VAT in Nepal**

Nepal introduced VAT for several reasons, which are

### **(A) Revenue Enhancement**

The base of MST was narrow. The large number of exemptions granted on socio-economic ground and weak tax administration aggravated the problem (Khadka, 2000: 71). Some taxes like land revenue, house tax vehicle tax etc have to be transferred to the local bodies to make these bodies financially autonomous. The relative share of custom duties has been decreasing due to the reduction on import tariffs in line with the adoption of liberal economic policies and with the membership of WTO. After the implementation of proposed SAFTA, the problems will be more acute. Therefore, Nepal will have to become less dependent on international trade taxes and small services taxes for its revenue in future.

In the context, there was no option but to implement VAT in Nepal. VAT has a broader base, which can meet the growing need of nation. VAT system not only broadens the base by formulation a Modern tax on wider coverage of goods and services but also increases transparency of tax administration. So, with a small rate of tax, very high yield of revenue can be generated.

### **B) Broaden the tax base**

VAT will be broadening the base of the Nepalese tax both legally and administratively. Legally, VAT brings the value added at the wholesale and retail levels under the tax net and makes it easier to levy tax on the service sector. VAT broadens the base administratively as well as it minimizes the problems of understatement of import value/ ex-factory price due to the "catch up effect". Under the VAT any understatement of taxable value at the import/ manufacturing point would be corrected on subsequent sales since the credit for taxes paid on purchases would be correspondingly lower. Further, there may not be an incentive

for VAT registered vendors to buy goods from those importers/ manufactures who have undervalued their goods since they will not be able to obtain input tax credits. As VAT provides an invoice and audit trail, it makes tax evasion more difficult. Furthermore, as VAT would be levied right through the retail stage, taxpayers will think that they might be caught at a later if they evade tax at an earlier stage.

As VAT will be levied right through the retail level, increases in the value of taxable commodities during the process of production and distribution would be reflected by increases in the tax revenue which make the tax system more elastic (Khadka 1997;78)

### **C) Tax Reform**

The tax reform programme is directed by the political, economic and social condition of country. The objectives of such programmes are mainly economic in nature. The major objective of tax reform programmes are: to increase revenue collection, to make the tax system efficient, neutral and buoyant, to attain equity, and to make tax system simple and transparent.

In order to achieve these objectives, the tax reform programmes after the 1970s were directed toward the introduction of VAT, reduction of the tax rate and broadening the tax base and enhancing administrative efficiency. Such overall reform is done only through a package program in which adoption of VAT is a major component.

### **D) Removing the Problems of Sales Tax**

There were many problems associated with the implementation of import/manufacturing level sales tax. Firstly, the MST was levied on the profit margin of the manufacturers but not the profit margin of importers. It discriminated against domestic products. Secondly, the importers favored under

valuation of importers goods as there was no provision of invoice system, credit method and tax refund mechanism which plays a crucial role on cross checking and checking of under valuation Thirdly, the import/manufacturing level sales tax had cascading and pyramiding effect. Moreover, the registered vendors had no compulsion to keep their account, which lowered not only sales tax but also income tax as well. Hence, the defective sales tax discouraged domestic production in one hand and lowered the collection of tax from sales tax along with income tax and custom duties on the other. Therefore, to overcome such conditions, modern, efficient, fair, transparent, broad based, neutral and simple tax system was necessary which was no other than VAT.

#### **E) Administrative Efficiency:**

The tax system of Nepal seriously lacks administrative efficiency. The administration is indifferent and corrupt. The widespread use of discretionary measures and lack of transparency in day to day administration resulted into arbitrary tax assessments, harassment of genuine taxpayers and opportunities for corruption. Taxpayers complain that tax officials give their approval only when they raise the prices. So, the reduction on price level was not possible because the taxpayers had to pay high tax on previously determined high prices even through the market price was low.

Since the implementation of VAT allows transparency at all levels, enhances tax compliance and is based on transaction value, administrative efficiency in tax system will be ensured. As the success of any tax system depends entirely on administration, "the introduction of VAT provides opportunity to sweep away the cobwebs and revamp a substantial part of the tax administration." (Tait, 1991; 1)

## **F) Promote Economic Growth**

Broadening the tax base will make it possible to reduce the rate of other taxes, including income tax and import duties, thereby making the tax system economically more efficient. VAT will improve the efficiency and competitiveness of domestic products in the international market by relieving exports from internal commodity taxes. Furthermore, as VAT will be levied only on value added, inputs will be relieved from taxation, meaning that double taxation will be eliminated under VAT. VAT will improve the competitiveness of the domestic product in other ways as well. It is to be noted that the existing sales tax system discriminates against domestic products. Some of the current sales tax administration policies effect is to provide more control over domestic goods than over imports. The VAT makes the controls equal for domestically produced and imported goods. (Khadka; 1997:78).

### **2.11 An Outline of Nepalese VAT System**

#### **2.11.1 Characteristics of Nepalese VAT**

The Nepalese government has implemented VAT since 1997. This VAT has the following basic characteristics.

- The adoption of consumption type of VAT.
- The computation of VAT through tax credit method.
- The principle of destination is adopted.
- The provision of exemption and zero rated goods and services.
- The application of VAT to all business turnovers through the retail stages i.e., broad base.
- The allowance of tax credit for taxable suppliers including the zero rated supply.



- The facility of tax refund.
- The use of positive rate of 13 percent.
- The level of threshold of Rs. 2 million.
- Extensive and excellent information about the new tax provided to the public and business firms.

### **2.11.2 Structure of Nepalese VAT**

#### **A) Coverage of VAT**

VAT is levied on both good and services. Some and services are exempted from the net because of administrative difficulties associated with implementation. Moreover, necessary are exempted on socio- economic grounds. All the other goods and services are under the net of VAT

Nepalese VAT is implemented on destination principle. Therefore, there is a provision of zero rate for export promotion. Only exported items have to be included in zero rate but other items are also zero rated which is responsible for administrative complexity.

#### **B) Exemptions**

Theoretically, VAT can be levied on all goods and services. However, in practice, some goods and services in tax exempt due to administrative, social and excess credit reasons. The exempted transactions are not subject to tax but no credit facility is allowed for tax paid on inputs. So, exemptions are the exclusion of certain goods and services from the tax net.

The list of exempted goods and services may be different from year to year and are provided in the appendix of VAT act. In Nepal following goods and services have been tax exempted.

- Goods and services of basic needs which includes rice, pulses, flour, fresh fish, meat, eggs, fruits, flowers, edible oil, piped water, wood fuel, and kerosene.
- Basic agriculture products are also tax-exempted, for example, paddy, wheat, maize, millet, cereals, and vegetables.
- The expenses of buying goods and services required to grow basic agriculture products are tax-exempted. These include live animals, agriculture inputs including machinery, manure, fertilizers, seeds, and pesticides.
- Social welfare services including medicine, medical services, veterinary services and educational services.
- Goods made for use of disabled persons.
- Transport Services.
- Personal services are also tax exempt. These are the services provided, for example, by professionals, by actors and other entertainers, people charging for academic and technical research and computer services.
- Exemption from tax is also extended to the purchase and rent of land and buildings.
- Financial and insurance services.
- Postage and revenue stamps, banknotes, cheque book.

### **C) Threshold**

Relating to simplification of the VAT administration, many countries provide a threshold level even for taxable supply. A threshold would keep of trades from VAT who sells below the prescribed level. The only major difference between exemption and threshold is that, a threshold applies to taxable supply and more often than not there is an option to register voluntarily in the VAT whereas, under exemption, registration is out of question. So, any one sells below a level of

threshold, if gets in to the VAT voluntarily he/she would be getting an equal treatment to other registered taxpayer. Many countries even provide extra privilege for voluntary registration.

#### **D) Zero Rating**

Under the VAT some goods and services are taxed at a zero rate. The objectives behind the introduction of zero rating are to relieve some goods and services completely from taxation. Zero rated items technically remain within the tax net so a purchaser is allowed to credit him input tax. It is generally levied in the case of exports, which need to be free completely from internal commodity taxation. But zero rating increases the burden considerably on the part of both taxpayers and the tax administration due to the requirement of maintaining books of account, submitting returns and refunding the tax levied on the inputs of zero items.

#### **E) Tax Rate and Base**

The base of tax is the Value added of each transaction in various stages of production and distribution. VAT is based upon actual transaction value but because of lack of transparency in Nepalese economy, tax base is determined by net receipts. So, Nepalese system of discounted price causes some problem in the implementation process of VAT.

In order to make tax system simple and transparent, single rated VAT is becoming more popular. Some countries accepted reduced rate so that tax concessions can be provided without any distortions. Long list of tax-exempts make tax system complex which is not desirable from social justice and broad based tax regime point of view.

## 2.12 Review of Related Literature

(Tiwari 1990), in an article started that VAT is considered as the most growing trend in the field of taxation (VAT is the recent innovation in the field of taxation in the present world) rather than others type of taxes.

Discussing the merits of VAT, the reasons for its growing attraction in the world are:

- ❖ Vat is the best on the most modern theories.
- ❖ It will raise consideration revenue and sustain it.
- ❖ It is effective to control price raise and reduce tax evasion.

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

Before introducing VAT, following things should be considered.

- ❖ Keeping in mind the increment of the number of tax payer in a VAT system, it is necessary to collect prepared records of potential value added tax payers.
- ❖ A separate administration unit of VAT in necessary.
- ❖ Computer use should be introduced to assist administration.
- ❖ The rate system of VAT should be single one and if more, dual rates 10% to 15% will be appropriate.
- ❖ Agricultural products, basic necessities and other similar goods and exports should give exempted. Necessary forms of ledgers should be improved this should be simple and coverage should also be extended to services such as electricity consumption and telephone services.

- ❖ Studies should be operated on the aspects such as need of this tax, effects and targeted tax payers, according to studies policy should be prepared and after a preparation period it will be appropriate to take 3 or 4 years for introduction of VAT.
- ❖ The rate of customs and excise duty should be adjustment most of the taxable goods under excise duty should be transferred under VAT and specific excise duty on luxuries.

(Silwal,1988)started that most of the developing and developed countries are now engaged in the study of VAT very seriously and most of the economists of this country has realized that the VAT the only source of tax revenue, which has very high tax potential among the existing tax systems it will not be an exception for Nepal. VAT is set to be consumption tax where the consumption of taxable goods and services will ultimately pay the tax if any goods become spoiled before consuming will not be liable to tax the feature of VAT are started as follows.

- ❖ Input tax credit (tax paid on earlier stages).
- ❖ Compulsory invoice system (for its good operation).
- ❖ Wide tax coverage (covering retailing service and others)
- ❖ Possibilities of tax evasion and cheating are also minimize pointing out the problems of VAT in Nepal. The author recommended some necessary conditions which should be full filled before introducing VAT. They are:
- ❖ Change in the organization of the tax administration to monitor handle and make supervision of VAT, a task force for necessary preparation for it is recently needed.
- ❖ Development of personnel administration and providing them training.
- ❖ Sufficient information system about VAT should be developed and introduced. Public awareness is the most important condition.
- ❖ Choice of the tactics and polices should be developed.

This study concludes that there is no condition of waiting for a long period of time to introduce VAT in Nepal.

Bista (1999) in his research entitled, "Applicability and feasibility of VAT in Nepal". He has found the followings;

- The sales tax system is failure to several cases: narrow tax base, in-elasticity of tax rate, incapable and weak administration, tax leakage, corruption and political intervention. So, the entire tax reform is needed.
- A VAT is account based, invoice based and record based; it checks the tax loopholes such as under evaluation, non-recording and unauthorized trade. It discourages such issues and problems existed in the sales tax system.
- VAT mobilized the additional resources and the rest of internal resources by broadening tax base and by discouraging the existing tax loopholes.
- In VAT system, tax refund and threshold, two provisions are necessary for the effective implementation of VAT. But, they are two gates of possible mal-practice and tax evasion for the effective implementation of VAT in Nepal; these gates should be closed by conducting strict monitoring system and by operating the punishment section of VAT enactment.

Khadka and Shukla (1999) made a study present status and the future prospects in domestic indirect taxes in India. India will have to depend more on indirect taxes in the foreseeable future. Because of the continuing trend to lower the rates of customs duties in view of the liberal economic policies, there is no likelihood of increase in revenue from customs duties. This means more revenue will have to be generated mainly through the domestic indirect taxes. i.e. the excise duties at the central level and at the state level. For this reason and also for the overall reforms of the indirect taxation, the conversion of these taxes in to some form of VAT has become an attractive alternative. Various tax reform committees of India have recommended moving towards VAT instead of other tax system. According to the Chelliah committee, the ideal solution would be to have a single VAT at the central level reaching down to the retail stage in replacement of most indirect taxes other than protective duties and sumptuary excise duties the central excise, the state excise, the municipal octroi, the goods and passengers tax and the

electricity duty while sharing the proceeds of VAT among the three levels of government.

This study suggest that in pure economic terms, it would be desirable to levy a full fledged VAT extending right through the retail level in place of the central excise, state sales taxes and local level octopi.

Khakda in his book entitled "VAT in Nepal" has described the theoretical background and the development of VAT in Nepal. Preparation and status of VAT has also addressed in this book. Since it is a collection of his published papers, many recommendations provided earlier has already addressed by the government. Being a researcher and a VAT advisor, he has spent a lot of time in preparatory work of VAT and has played a significant role in formulating the tax policy. He is continuously attached in research of tax policy from the inception of VAT in Nepal.

Different aspects of VAT had also been analyzed in his book entitled "The Nepalese tax system". In this own words Tax compliance is very poor in Nepal and different taxes ware not being fully paid the law. There was a lack of transparency and both the tax payers and tax collector take and due advantage of the situation. There was a lack of coordinate approach and long-term strategy. Several tax measures were introduced in 1997/98 without any consideration and their possible effects.

Khadka in his book The Nepalese tax system reviews of the Nepalese tax administration points out the needs to introduce VAT in Nepal. The main reason to introduce VAT was to development a stable source of revenue by broadening the tax. In the near future, the revenue from custom duties will diminish because of the enactment of SAFTA and WTO agreement in such situation broad based internal tax system is required.

The sales tax was narrow based and most of the sales tax was collected from custom/manufacturing points. The huge exemption made on socio economic ground resulted on weak tax administration and low yields of revenue. Moreover delegation of taxing authority to the local bodies to make them financially also caused low performance of central taxes. In such condition, the author stresses on the proper implementation of VAT in Nepal. But VAT is not great panacea because there are many hindrances on the implementation of VAT, most of the business vendors do not want to be registered under VAT. Cross checking has not been possible and under valuation is dominating. So in conclusion the writer suggest that VAT will generate more revenue in the days to come when it becomes fully operation, (Khadka, 2000}

khadka in his book entitled "VAT and its relevancy to Nepal" has briefly tried to cover almost all the theoretical aspects VAT especially the introduction to VAT, the types of VAT (consumption, income and gross national product) methods of computation to VAT (addition, subtraction, and tax credit) the evolution of VAT. Comparison of VAT with other forms of sales tax, the reasons for its adoption and VAT preparation in Nepal and so on, (Khadka, 1997).

He define VAT is the most recent innovation in the field of taxation. It was levied on the value added goods and service. Theoretically, the tax broad based as it covers the value added to each commodity by firm during all stages of production and distribution.

By comparing VAT with manufacturing level sales tax (MST) had argues that VAT would have a broad base than the existing MST because VAT would be levied on retail level also and it brings more goods and services under its tax net than the MST. There are so many challenges to implement VAT in Nepal. VAT system demands better tax administration does not seem so good. That's why, it is necessary to reorient tax administration in the light of modern administration



reorient action and taxpayers education will not be adequate for the success of VAT in Nepal. It needs an overall tax reform packages, which is very helpful for the implementation of VAT.

A high level task force (1995) outlined the following reasons to adopt VAT in Nepal.

- ❖ To broaden the tax base and increase tax revenue.
- ❖ To make the tax system transparent and elastic.
- ❖ To prevent tax evasion
- ❖ To make the system efficient and
- ❖ To encourage export.

After analysis the various aspects of tax structure and the position of the economy, the report finally recommended the following aspects to be incorporated before adopting VAT in Nepal.

- ❖ A functional organization pattern.
- ❖ Development of effective tax refunds system.
- ❖ Measure to increase self-compliances.
- ❖ Tax payer's service and tax education.
- ❖ Computerization of the administration.

A study made by Nepal chamber of commerce (1997a) to analysis the Possible effect of VAT on Nepalese economy make some observation. The observations are:

- ❖ Adverse effect on price level,
- ❖ Increase in the prices of imported goods would hit the import tax,
- ❖ The account keeping requirements of VAT would increase the tax compliance cost and cost of doing business, it would adversely affect the small traders,

- ❖ Adverse effects on domestic production due to the abolition of protection policy under VAT,
- ❖ VAT would be unjustifiable on social ground; it would aggravate the income distribution,
- ❖ Negative effects on revenue collection and
- ❖ Chances of failure of a VAT in Nepal are great because the present Administration is incapable for handling a VAT.
- ❖ The study concludes that a VAT in Nepal should not be implemented in haste. A partial VAT on some commodities should be implemented on experimental basis to know its pros and after that a full VAT might be considered.

Nepal chamber of commerce (1997 b) organized a nation wide discussion program on VAT. According to a report of the discussion program (Nepal chamber of commerce, 1997) the various views expressed about VAT in Nepal may be summarized as follows:

- ❖ Government machinery is not capable for implementing a VAT.
- ❖ The business community has no confidence in the administration because it has failed to implement many other taxes effectively and fulfil its own commitment seven previously.
- ❖ VAT will hamper genuine trade and as a consequence, illegal trade will prosper. Rise in the prices of domestic products will make them less competitive. Import and re-export of imported goods will get a negative impact leading to decline in government revenue.
- ❖ VAT will inhibit the growth of newly developing trade and industrial activities in the country.
- ❖ The modern account keeping system required by the VAT is difficult to keep. This will raise the costs of doing business.

- ❖ There will a sharp price rise if a VAT is introduced; consumers will be badly affected due to price raise. Nepalese markets in boarder area will dry up due to VAT.

Laudari (2001) In his dissertation analysis the problem and prospects of VAT in Nepal, basically on the theoretical aspect. He stated that in the current status of decreasing revenue from custom duties due to the liberal economic policies, importance of VAT is growing for resource Product (GDP) is mobilization. The contribution of VAT in tax revenue and gross domestic product is growing. While the contribution of other tax; replaced by VAT is gradually declining. From the field survey, the study concludes that the VAT having positive effect the national economic growth. Majors' problems associated with the VAT system to business houses are account keeping and billing.

From the field survey, the study concludes that VAT will have effect on economic growth major problems associate with the VAT system to business houses are account keeping and belling. Weaknesses of VAT administration are lack of motivation service minded attitude and dishonesty in VAT officers. VAT system, the best and advanced fiscal tool in theoretical sense, could not yielding the expected returns in Nepal because of the lack of strong and honest tax administration, lack of motivation and service minded attitude among tax officials, lack of the cooperation of business community lack of co-ordination between tax collectors and taxpayers, lack of strong political commitment and weak public consciousness.

Adhikari (2003), in his book “Value Added Tax In Nepal: Theory and Practice” deals with the theoretical concept of VAT which includes historical background, objectives merits and demerits of Vat, Introduction of VAT system in Nepal, different terminologies associated with VAT, Tax Administration System and legal provision made for the VAT implementation in Nepal and Value Added Tax rule 1997 and Value Added Tax Act 1996.

Adhikari (2003) published a book named "Modern Taxation in Nepal: Theory and Practice". This book has been divided into five parts. In his first part, he described the theoretical aspect of tax. In second part, he described the Income Tax Act 2058. In third part, he described about Value Added Tax (VAT). In

fourth part, he described property tax / house and compound tax in Nepal. At last in fifth part he described wind fall tax and other provision.

Nepal Tax Journals (2004) published news about taxation. In this news they include lack of taxpayer education program, taxpayer do not have fully knowledge about positive aspects of tax laws. The news was stressed that taxpayers are accepting income tax act, 2058 as a compulsory law.

Chudali (2004), presented a dissertation named "*Effectiveness of Nepalese Tax policy on Various Business Sectors*". He had described various short coming of the tax system and policies. His main objectives of the study were as follows:

- ) To analyzed the nature of the existing Nepalese tax policy.
- ) To know the tax system of various business organization.
- ) To find out the reaction of organization regarding Nepalese tax policy.
- ) To draw specific finding and conclusion of Nepalese tax policy.
- ) To make recommendations for the Nepalese tax policy.

Similarly, his major findings were as follows:

- ) The Income Tax Act, 2058 should be revised which simplified language and ambiguity should be removed. The goods that are taxed once should be remarked so that double taxation should be avoided.
- ) There should be clear and strict rule for reward and punishment. The person who conceals tax should be properly identified and given punishment. Tax authority should build up monitoring body for proper evaluation of the tax collection.
- ) Entrepreneurs have indicated that tax officials are full of corruption so Government should correct its bureaucracy. It should update its traditional and monotonous for tax collection which has encouraged corruption.
- ) Very sensible and service oriented business which provide basic requirement like health education and communication should be given tax exemption or subsidy so that these facilities can be available for all level.

- )] Nepalese tax system should be based on Nepalese economy rather than developed countries.

The Kantipur daily (2005) published news about Income Tax and VAT. The news presented the terms used in Income tax and VAT is not clear. There is not friendly business environment between taxpayers and government. Similarly, the vocabularies used in tax act are very ambiguous and difficult. Monthly journal published by federation of Nepalese Chamber of Commerce and Industries (FNCCI), (2005) named "Byabasaik Aacharan". In the journal, tax expert Pandey and Bajracharya presented different aspects of Nepalese tax system.

Bhattarai & Koirala (2006) in their book named "Tax Laws and Tax Planning" describes the income tax system in depth. This book includes the separate chapter of Value Added Tax. It describes VAT practice in Nepal with several theoretical as well as with examples. This book specifically designed for the study of MBS 2nd year under Tribhuvan University. However, the book has not mentioned about the legal provisions.

Bhandari (2006), submitted a dissertation named "Tax Knowledge of Taxpayers in Nepal". His major objectives of the research work are as follows

- )] To find out the present position of taxation knowledge of taxpayer's in Nepal.
- )] To find out the present scenario of implementation of VAT system.
- )] To examine the effectiveness of VAT system.

His major finding was as follows:

- )] To increase income tax knowledge of taxpayer related information should be published regularly.
- )] Special taxpayer education program necessary for employees and small taxpayers.
- )] Professor researcher, taxpayers, tax experts should be taken while making tax policy.

- ) The school as well as campus level curriculum should include tax related education so that taxpayer education programs can be more effective.

Gairhe (2009), submitted a dissertation “A Study on Problems In VAT Implementation in Nepal“. His major objectives for the research work are

- ) To review the Resource Gap in Nepal with a view to examine VAT revenue collection.
- ) To analyze the problems of VAT implementation that have been faced in Nepal.

His major findings of his research are follows:

- ) Tax revenue has greater share than non-tax revenue in total revenue structure where VAT revenue has average contribution which is in increasing trend
- ) People are not aware about the benefit of VAT, so different campaigns must be held out to make people aware of VAT system for its successful implementation in Nepal.

Gautam (2009), presented a dissertation entitled “Taxpayers & Their Awareness towards Business Taxation: A Case Study of Baneshwor Area”. The main objectives of this thesis work are:

- ) To know view of taxpayer about business taxation and their awareness
- ) To find out the effectiveness of business taxation in Nepal

Similarly, his major findings are as follows:

- ) Most of the peoples have knowledge about income tax, VAT & Custom duty. But current Tax & VAT rate is high which must be reduced.
- ) VAT is superior to sales tax.
- ) Major problems of VAT are lack of public awareness, ineffective tax administration etc.

Karn (2011), submitted a thesis entitled "VAT Administration And Its Effectiveness In Nepal". The major objectives of the research work are as follows:

- ) To evaluate & identify the problems of VAT faced by the public.
- ) To evaluate the success of VAT administrations to collect VAT.
- ) To assess the contribution of VAT on economic indicators.

Similarly, the result of the research work is presented below:

- ) VAT results in rise in prices.
- ) The successful implementation of VAT is measured through collection of VAT.
- ) The collection of VAT is carried out successfully by the government.

Pant (2012), has submitted thesis entitled "VAT Compliance in Nepal: Its Structure And Determinants". The main objectives of his research work are as follows:

- ) To examine the structure of VAT in Nepal.
- ) To analyze the factors affecting VAT compliance in Nepal.
- ) To provide measures improving the collection of VAT.

Similarly, the major findings of his research work are:

- ) The government should concentrate more on introducing various discretionary measures rather than broadening the VAT base by reducing the tax-exempted goods & service.
- ) Under billing system is prevailing in the market which lowered VAT amount.
- ) Political instability is a major factor affecting VAT compliance.

### **2.13 Research Gap:**

With reference to above review of related literature of a level in the concern field of VAT, this study chiefly focused prospects and problems on VAT. The country has experienced the VAT about the decade and these days various study has been conducted on Nepalese VAT system regarding problems and prospects in Nepal. Though, the topic of this research work is also similar to the previous research work but it is found that in previous researches, the research is mainly focused only on secondary data but here the researcher have taken the primary data from the reliable source i.e. the annual report of MOF for fiscal year 2011/12. Here, it is tried to found out the awareness of VAT system, prospects and its problems. Various researches have been undertaken on the VAT system in Nepal, with regard to its problems and prospects. The secondary data has been taken from the annual report of MOF for the fiscal year 2011/12. To concerned variables are composition and contribution of VAT in GDP and total revenue, total tax revenue, total indirect tax. For that various statistical tools as well as percentage revenue custom duties, taxes are built to measure the interrelationships of the concerned variables of the concerned area.



## **CHAPTER-THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

The main objective of this research is to analyze and interpret the issues present status of VAT in Nepal. VAT is being applied instead of import/manufacturing level of sales tax, entertainment tax, hotel tax and contract tax. So, it should be sound and effective value added tax system results the increasing rate of indirect tax on tax structure as well as national revenue at satisfactory and reasonable level. Therefore the main concentration of this study is on the role of value added tax, VAT structure, VAT coverage and planning, organizing and administrative requirement. However, the major focus on different issues, present practice and future prospects of VAT to implement effectively in Nepal.

The problem of delaying tax assessment, tax evasion and avoidance etc may be solved through efficient management system. After performing analytical system on this subject matter, it tries to recommend for tax administration to execute policy of VAT effectively. To achieve these objectives a research methodology has been designed in this chapter.

#### **3.2 The Research Design**

Research design is the plan structure and strategy of investigation conceived so as to obtain answer to research equation and to control: A research design is purely and simply the framework or plan for the study that guides the collection and analysis of the data. The main objective of this study is to analyze and evaluate the problem and prospects of vat in Nepal. This study follows the analytical and descriptive research design. To complete this study following design and format

has been used. First of all the information and data are collected. The important information and data are selected. In analysis part interpretation and comments are also made wherever necessary. Result and conclusion are given after analysis of data recommendation and suggestion is also given. The design has been adopted from previous research work.

### **3.3 Source of Data**

The study is based on primary data and secondary data. The data are collected from the published by National Planning Commission (NPC) world Bank (WB) Nepal Rasta Bank (NRB) Economy Survey 2010/11 MOF, July.

### **3.4 Method of Data Collection**

Data in social sciences are based on our sense observation, which include all forms of perception used in recording responses as though they impinge upon our senses. In short, all the relevant information that can be expressed in numerals has been treated as data in this study. This study is based on primary data and secondary data. The data collected from various Budget speech of HMG/N, ministry of finance Economic survey. The gross domestic product (GDP) to be taken from Economy survey HMG/N ministry of finance. During the study period (2002/03 to 2011) will be taken from national account publication of CBS and other related. Beside these publications of CEDA, Nepal Rastra Bank, etc has been used to collect necessary data and information.

### **3.5 Methods of Analysis**

This study was based in descriptive and analytical methods for the presentation and analysis of data. At the time of presentation and analysis of primary and secondary sources data, were edited and processed. Table, Graph, Diagram, simple percentages and time series analysis are used for the purpose of presentation and analysis of data.

## **CHAPTER -FOUR**

### **THEORETICAL ANALYSIS OF VAT**

#### **4.1 Public Expenditure and Revenue**

##### **4.1.1 Public Expenditure**

Public expenditure is an important part of government which plays a crucial role expands large scale of economic activities and for peace building security and social welfare. Prior to FY 2010/11, government expenditure used to include two types of expenditure: regular expenditure and development expenditure. However, FY 2010/11 onwards the Nepalese government started following international practices of expenditure classification and reclassified the government expenditure into recurrent expenditure, capital expenditure and principal repayment. Before the introduction a new classification principal repayment used to be a part of regular expenditure, "Prior to the early 2000s regular expenditure accounted for about one third of expenditure while development expenditure was about two thirds of total public expenditure. The regular expenditure increased rapidly and exceeded the development expenditure during 2002/03. Not only in terms of volume but also in the share in total expenditure" (Khadka, 2005:147)

Since a large part of revenue is spent on regular expenditure, there has been very little revenue surplus (i.e. revenue min regular expenditure). Revenue surplus provides a small part of total development expenditure. The situation has been come even more critical in recent years. This situation needs to be changed in order to avoid possible Fiscal crisis. (Khadka, 2005:148)

**Table 4.1****Ratios of Government Expenditure and Revenue of GDP (In Current  
Producer's price)****Rs. in ten million**

Fiscal year	Government Expenditure (A)				Revenue (B)	Difference between A and B
	Recurrent	Capital	Principal repayment	Total		
2002/03	5209.05	2235.61	955.95	8400.61	5622.98	2777.63
2003/04	5555.21	2309.56	1079.49	8944.26	6233.10	2711.16
2004/05	6168.64	2734.07	1353.33	10256.04	7012.27	3243.77
2005/06	6701.78	2960.66	1436.48	11098.92	7228.21	3870.71
2006/07	7712.24	3972.99	1675.23	13360.46	8771.21	4589.25
2007/08	9144.69	5351.61	1638.69	16134.99	10762.25	5372.74
2008/09	12773.89	7308.90	1883.41	21966.20	14347.45	7618.75
2009/10	15101.91	9023.77	1843.23	25968.91	17994.58	7974.33
2010/11	17029.54	10784.75	1722.05	29536.34	19981.90	9554.44

**Source: Economy Survey, 2011/12: MOF July, 2012.**

From the table it is clear that the government's liabilities to repay debt have been increasing in term of GDP. It actual value is increasing very rapidly. The different between the government expenditure and revenue is decreasing due to the incapacity of government expenditure and revenue is decreasing due to the incapacity of government to make capital expenditure for development activities.

If there is increase in government expenditure it is due to increase in the debt repayment and the need for recurrent expenditure to finance security and social welfare.

#### **4.1.2 Public Revenue**

The income of the government through all sources like taxes, fuel, donation etc. is called public revenue. Public revenue may be divided into tax and non tax revenue.

##### **4.1.2.1 Tax Revenue**

Nepalese tax revenue generates from two resources -direct tax and indirect tax. Direct tax includes income tax, land revenue, land registration Fee, Property tax etc whereas indirect tax includes VAT, custom duty and excise duty etc. In Nepalese tax revenue share of indirect tax is larger than the direct taxes. The contribution of direct tax in total tax revenue is about countries like USA, UK and other developed countries, the contribution of direct tax in Nepal is very low.

**Table 4.2**  
**Contribution of Direct Tax and Indirect Tax Revenue**

**Rs. In ten Million**

Fiscal Year	Total tax Revenue	Direct tax Revenue	Direct tax % of total tax revenue	indirect tax revenue	Indirect tax % of total tax revenue
2002/03	4089.6	1088.19	26.61	3001.41	73.39
2003/04	4817.3	1191.26	24.73	3626.04	75.27
2004/05	5410.47	1307.18	24.16	4103.29	75.84
2005/06	5743.04	1396.81	24.32	4346.23	75.68
2006/07	7112.67	1898.03	26.69	5214.64	73.31
2007/08	8515.55	2308.77	27.11	6206.78	72.89
2008/09	11705.19	3432.07	29.32	8273.12	70.68
2009/10	15629.49	4175	26.71	11454.49	73.29
2010/11	17277.76	4865.51	28.16	12412.25	71.84
Average	8922.34	2406.98	26.42	6515.36	73.58

**Source: Economy Survey, 20011/12: MOF July, 2012**

The average direct tax revenue, indirect tax revenue and total tax revenue is 2406.98,6515.36 and 8922.34 rec. Percentage of Direct tax and indirect tax on total tax revenue is 26.42 and 73.54. Being an underdeveloped country most of the Nepalese people live in the level of subsistence and all their income is spent out on consumption there could be a reason that direct tax is not producing more revenue than indirect tax.

#### 4.1.2.2 Non Tax Revenue

Non tax revenue comes in the form of fees, fine, penalties, dividends, interest, Sales of goods and services, While there is some scope for generating more revenue through the rationalization of non-tax sources, particularly improvement in pricing policies and operational performances these sources are lived for purpose other than revenue generation. It is therefore, necessary to make every effort to generate more revenue through taxes. Which are levied on commodities, income and properties, since non tax revenue source cannot be used as an effective instrument of revenue mobilization.

**Table 4.3**

**Relatives Share of Non Tax Revenue and Tax Revenue on Total Revenue**

**Rs. In ten Million**

Fiscal Year	Total Revenue	tax Revenue	% of tax revenue	non tax revenue	% of non tax revenue
2002/03	5453.89	4089.60	74.99	1364.29	25.01
2003/04	6233.10	4817.30	77.29	1415.80	22.71
2004/05	7012.27	5410.47	77.16	1601.80	22.84
2005/06	7228.19	5743.04	79.45	1485.15	20.55
2006/07	8771.21	7112.67	81.09	1658.54	18.91
2007/08	10762.25	8515.55	79.12	2246.70	20.88
2008/09	14347.45	11705.19	81.58	2642.26	18.42
2009/10	17994.58	15629.49	86.86	2365.09	13.14
2010/11	19981.87	17277.76	86.47	2704.11	13.53

Average	10864.98	8922.34	80.45	1942.64	19.55
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**Source: Economy Survey, 2011/12: MOF July, 2012**

The average total tax revenue, tax revenue and non tax revenue is 10864.98, 8922.34, and 1942.64. The average percentage of tax revenue and non tax revenue on total tax revenue is 80.45 and 19.55.

## **4.2 Nepalese Taxes**

Taxation is the internal part of total government revenue. It is also the pillar of the fiscal policy. It contributes more than seventy percent to the total revenue. In this situation the tax structure stands as a mirror of the Fiscal Policy. In the Nepalese government revenue, tax revenue dominates non-tax revenue. The relative share of non-tax revenue is about 20 percent and that of tax revenue is about 80 percent. As the non- tax revenue is not the regular source of revenue; they are providing a significant part in Nepalese government revenue.



**Table 4.4**  
**Composition of Tax Revenue**

**Rs. in ten Million**

<b>Descript ion</b>	<b>02/03</b>	<b>03/04</b>	<b>04/05</b>	<b>05/06</b>	<b>06/07</b>	<b>07/08</b>	<b>08/09</b>	<b>09/10</b>	<b>10/11</b>
Customs duties	1278. 32	1555. 48	1570. 16	1534. 40	1670. 76	2106. 24	2679. 29	3515. 08	3571. 16
Tax on domestic producti on of goods and services	1723. 09	2070. 56	2533. 13	2811. 83	3543. 88	4100. 53	5593. 83	7939. 41	8841. 10
Taxes on income property and profits	1027. 41	1021. 51	1127. 26	1178. 70	1672. 68	2014. 70	2909. 74	3623. 89	4508. 26
Tax and land revenue	60.78	169.7 5	179.9 2	218.1 1	225.3 5	294.0 7	522.3 3	551.1 1	357.2 5

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The customs duties and tax on domestic product of goods and services are of indirect nature while the taxes on income, property and profits and tax on land revenue and registration are direct taxes. If we compare the two types of taxes, the revenue generated by indirect taxes is larger than direct taxes. So, the burden of taxation falls on the poor people and the tax system is somehow regressive.

Is somehow regressive

The contribution of VAT, custom duties, excise duties, income tax is described in the following subsection. These are the major sources of revenue, which generate more than 50 percent of tax revenue and 75 percent of total revenue.

#### **4.2.1 Customs Duty**

The custom duties of the study are decomposed of,

- a) Import Duties
- b) Export Duties
- c) Indian excise refund and other.

Import duties are levied on goods imported into Nepal while export duties are levied on goods exported from Nepal. Under India Nepal trade treaty 1995, as amended from time to time; those India products which are subject to excise will be refunded by Indian government if those products are directly imported into Nepal. Custom duties are the traditional sources of tax revenue in Nepal, which contribute about one third of total tax revenue. In the past, while internal sources of revenue were not developed and the government has adopted the closed economic

system, custom duty was the single largest sources of tax revenue. But recently, due to the WTO and SAFTA provisions along with liberalization and external sector, the relative share of custom duty to the total tax revenue has been decreasing and it is now the second largest sources of internal revenue.

**Table 4.5**

**Custom Duty as Percentage of Total Tax Revenue**

**Rs. In ten Million**

<b>Fiscal Year</b>	<b>Custom Revenue</b>	<b>Total tax revenue</b>	<b>Custom duty as a % of total tax revenue.</b>
2002/03	1278.32	4089.6	31.26
2003/04	1555.48	4817.3	32.29
2004/05	1570.16	5410.47	29.02
2005/06	1534.40	5743.04	26.72
2006/07	1670.76	7112.67	23.49
2007/08	2106.24	8515.55	24.73
2008/09	2679.29	11705.19	22.89
2009/10	3515.08	15629.49	22.49
2010/11	3571.16	17277.76	20.67
Average	2164.54	8922.34	25.95

**Source: Economy Survey, 2011/12: MOF July, 2012.**

The relative share of custom duties on total tax revenue had increased from FY. 2002/03 to FY 2003/04. In 2003/04 the share of custom duty on total tax revenue was 32.29 percent which had 31.26 percent in 2002/03. But its share to total tax revenue remained at 29.02 percent in FY 2004/05 and it had decreased to 20.67 percent in FY 2010/11. Previously it was single largest source of revenue but from the FY 2010/11, it has been the first largest source of revenue.

**Table 4.6**  
**Composition of Custom Duties in FY 2010/11**

**Rs. In ten Million**

<b>Items</b>	<b>Custom duties</b>	<b>% of total custom duties one item</b>
Export	35.77	1.00
Import	3148.03	88.15
Indian Excise refund	283.18	7.93
Other	104.18	2.92
<b>Total</b>	3571.16	100.00

**Source: Economy Survey, 2011/12: MOF July, 2012.**

In case of composition of custom duties it is dominated by the import duties levied on the import of goods and services. This condition shows Nepal's reliance on internal goods and services for domestic consumption. The export is exempted for increasing the competitiveness of Nepalese firms in the international market. So it has a relatively small contribution.

#### **4.2.2 Excise Duties.**

Excise duties are one of the traditional sources of tax revenue in Nepal. In the past, these duties were levied on agricultural as well as industrial products. They are imposed in the commodities, which are socially harmful and undesirable.

Excise duties are fourth largest source of tax revenue in Nepal. The relative share of excise duties is decreasing in the recent years because only socially harmful products are subject to tax and government has adopted a policy to cut down the number of goods to level excise. The rate of excise ion increasing year by year with Nepal’s entry into WTO and SAFT, the revenue from customs duties is decreasing in this context, there is possibility of increasing excise duty.

- Excise are levied to generate revenue as well as to achieve some socioeconomic objectives. These deities are generally levied on tobacco products alcoholic beverages and some luxury goods. This duties is lived to discover age the consumption of those goods. Alcoholic beverages and cigarettes contain more than 80 percent of the revenue generated through excise.

**Table 4.7**  
**Contribution of Excise Duties in Total Tax Revenue**

(Rs. In ten Millions)

<b>Fiscal Year</b>	<b>Excise Revenue</b>	<b>Total tax revenue</b>	<b>% Excise Revenue on total tax revenue:</b>
2002/03	372.12	4089.6	9.10
2003/04	622.67	4817.3	12.93
2004/05	644.59	5410.47	11.91
2005/06	650.76	5743.04	11.33
2006/07	934.32	7112.67	13.14
2007/08	1118.96	8515.55	13.14
2008/09	1622.09	11705.19	13.86

2009/10	2430.61	15629.49	15.55
2010/11	2654.29	17277.76	15.36
Average	1227.82	8922.34	12.92

**Source: Economy Survey, 2011/12: MOF July, 2012.**

The average excise revenue and average tax revenue is 1227.82 and 8922.34. The average percentage of excise revenue on total tax revenue is 12.92.

#### **4.2.3 Income Tax**

The income tax of Nepal is a composition of tax from public enterprises, private corporate bodies, individual remuneration and interest tax. Individual income tax is levied on every individual who was taxable income. Individuals and proprietorship firm pay this tax. The profit of corporation falls on the category of corporate income tax. Income tax is the major source of government tax revenue, which is levied to achieve certain economic and social goals such as broadening the people's choices, equal distribution of income wealth and property in the economy etc. Higher the share of income tax on the total tax revenue, higher will be efficiency and effectiveness of the tax system.

**Table 4.8**

#### **Contribution of Income Tax in Total Tax**

**Rs. In Ten Million**

Fiscal year	Total tax Revenue	Income tax	% Income tax on total tax revenue.
2004/05	3886.51	915.39	23
2005/06	3933.06	890.36	22.63

2006/07	4258.70	813.22	19..09
2007/08	4817.50	950.40	19.72
2008/09	5410.47	1045.60	19.32
Average	4461.25	922.99	16.93

**Source: NRB Quarterly Bulletin -2010 mid October.**

Income tax which is a major sources of direct tax in Nepal, contributes about 20 percent of total tax revenue. Total number of income tax payers in Nepal is still less than 1 percent of the total population. Revenue from income tax collection is still less than 2 percent of GDP (Nepal, 2007) this shows the high three should for income tax and widespread poverty.

#### **4.2.4 Value Added Tax**

- VAT is levied on all goods and services unless specifically exempted by the law, and collected at the different stage on the process of production and distribution. VAT is a member of sales tax family. The introduction of VAT replaced existing sales tax, hotel tax, entertainment tax and contract tax in 1997.
- In the context of Nepal, to see the effect on vat in price, many think should be considered firstly, VAT is not additional tax on the existing tax, it is tax imposed instead of existing sales tax, hotel tax, entertainment tax and contract tax. During implementation of VAT, the existing sales tax was reduced from 15 to 10 percent and adjustment made in customs duty and income tax. VAT has been exempted on basic necessary goods and services. If VAT is imposed on goods which were exempted from sales and other taxes, the increment in price of goods is likely.

- Business with annual turnover of less than 2 million are not required to register for VAT, goods exempted for VAT include primary agriculture products. Goods of primary needs, livestock's and their products, agricultural, materials, medicine and health services, education paper and cultural services. VAT is not levied on goods for export.

**Table 4.9**

**VAT Revenue as the percent of GDP**

**Rs. In Ten Million**

<b>Fiscal year</b>	<b>GDP</b>	<b>VAT Revenue</b>	<b>% of VAT on GDP</b>
2002/03	46032.5	1345.97	2.92
2003/04	50069.9	1447.89	2.89
2004/05	54848.5	1695.00	3.09
2005/06	61111.8	2365.00	3.87
2006/07	67585.9	2642.30	3.91
2007/08	75525.7	2965.19	3.93
2008/09	90930.9	4100.00	4.51
2009/10	106088.1	5156.00	4.86
2010/11	124642.3	6737.16	5.41



Average	75203.96	3161.61	3.93
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**Source: Economy Survey, 2011/12: MOF July, 2012.**

As shown in table 4.10 the share of VAT revenue as percent of GDP was 2.92 percent in FY 2002/03. This figure was below 5 percent in 2000/2001 and increased to 5.41 percent in 2010/11. In the earlier years of the implementation of VAT, Share of it on GDP is low due to the lower rate of new tax regime and opposition from the business communities. Percentage of vat on GDP is decreasing in increasing trend.

#### **4.2.5 Comparison of VAT and custom Duty**

On the tax composition by individual taxes customs and VAT are two major sources of tax revenue in Nepal of the total revenue in Nepal. Of the total revenue mobilization of the last nine years

**Table 4.10**

#### **Comparison of VAT and Customs Duty**

**Rs. In Ten Million**

Fiscal Year	Total Tax revenue	Customs duty	Custom duty % of total tax revenue	VAT	% of VAT on total revenue
2002/03	4089.6	1278.32	31.26	1345.97	32.91
2003/04	4817.3	1555.48	32.29	1447.89	30.06
2004/05	5410.47	1570.16	29.02	1695.00	31.33
2005/06	5743.04	1534.40	26.72	2365.00	41.18
2006/07	7112.67	1670.76	23.49	2642.30	37.15

2007/08	8515.55	2106.24	24.73	2965.19	34.82
2008/09	11705.19	2679.29	22.89	4100.00	35.03
2009/10	15629.49	3515.08	22.49	5156.00	32.99
2010/11	17277.76	3571.16	20.67	6737.16	38.99
Average	8922.34	2164.54	25.95	3161.61	34.94

**Source: Economy Survey, 2011/12: MOF July, 2012.**

In above table 4.11 maximum tax revenue is Rs. 17277.76 in fiscal year 2010/11 in the beginning year minimum of total tax revenue than increasing trend of the study period. In the FY 2002/03, 03/04, 04/05, 05/06, 06/07, 07/08, 08/09, 09/10 is Rs. 4089.6, Rs 4817.3, Rs. 5410.47, 5743.04, Rs. 7112.67, Rs. 8515.55, Rs. 11705.19 and Rs. 15629.49 ten million respectively total tax revenue. The custom duty is also increasing trend of the study in the F/y 2002/03 is Rs. 1278.32 ten million and of custom duty which is minimum in the study period. In the fiscal year 2010/11 is Rs. 3571.16 ten million of custom year. Some of year custom duty increase high different rate and some of year was increase low different ratio. Percentage of custom duty on total tax revenue is fluctuating trend. In the beginning year decreasing trend and F/y 2003/04 is increasing i.e. 32.29% than the decreasing rate of the study period. The fiscal year 2010/11 is 20.67% which is minimum % of custom duty on total tax revenue.

#### **4.2.6 Contribution of VAT in Revenue Generation**

The introduction of VAT in Nepal was designed to replace sales tax, hotel tax, contract tax and entertainment tax. VAT was launched in Nepal with the objectives of broadening the tax base, eliminating cascading effect of sales tax, and creating an investment friendly tax system in the country. The main objectives of VAT is to develop a simple and modern tax system with an exemption of expert

and basic goods from taxation and finally to increase the base of revenue collection.

Due to the adoption of liberal and open market economy for the membership of WTO, contribution of custom duties in government revenue will diminish. In this context, internal revenue generation capacity has to be increased. Government has adopted VAT as major sources of revenue.

When VAT was introduced in 1997, VAT was thought to be the single largest source of revenue but until 2010/11 the custom duties has remained the single largest source. From 2010/11 the share of VAT in revenue is the highest.

**Table 4.11**

**Contribution of VAT Revenue in Total Revenue and Total Tax Revenue**

**Rs. In Ten Million**

Fiscal Year	Total Revenue	Total Tax Revenue	VAT Revenue	VAT revenue as % of total tax revenue	VAT Revenue as the % of total Revenue
2002/03	5453.89	4089.6	1345.97	32.91	24.68
2003/04	6233.10	4817.3	1447.89	30.06	23.23
2004/05	7012.27	5410.47	1695.00	31.33	24.17
2005/06	7228.19	5743.04	2365.00	41.18	32.72
2006/07	8771.21	7112.67	2642.30	37.15	30.12
2007/08	10762.25	8515.55	2965.19	34.82	27.55
2008/09	14347.45	11705.19	4100.00	35.03	28.58

2009/10	17994.58	15629.49	5156.00	32.99	28.65
2010/11	19981.87	17277.76	6737.16	38.99	33.72
Average	10864.98	8922.34	3161.61	34.94	28.16

**Source: Economy Survey, 2011/12: MOF July, 2012.**

In the study period, the share of VAT revenue is increasing in both relative and absolute terms. It has stood only 23.23 percent of total revenue in the year 2003/04 and increased to 33.72 percent in 2010/11. Moreover, the contribution of VAT revenue to total tax revenue has also increased from 30.06 in the FY 2003/04 to 41.18 percent in 2005/06.

### **4.3 Analysis and presentation of primary data**

#### **4.3.1 Knowledge about VAT system**

Knowledge of VAT is the most important question for businessman and consumers as if they don't know about the VAT system; the implementation of VAT would be supposed to be weak. So I tried to know about the peoples view. The following table shows the awareness gain by consumers and businessman in the present situation. Here the response given by the consumers and businessman on the question asked "**Have you ever heard about the VAT system?**"

**Table 4.12**  
**Knowledge about VAT system**

S.N	Group of Respondents	Sample size	Yes	No	Only by listening
1	Businessman	10	8	0	2
2	Consumers	15	7	3	5
Total		25	15	3	7
Percentage		100%	60%	12%	28%

*Source: field survey 2012*

The table shows that the most of the respondents (60%) do have the knowledge about VAT system. Among them (28%) have only a little knowledge about VAT where as 12% of them do not know about it. This show that the government authorities are not successful to lunch the better public awareness program of VAT system to the general public.

#### **4.3.2 Registration of business on VAT**

We asked the respondent's businessman as they had their business got registered on VAT or not. The table below shows the answer of respondents on the question being asked "**Have you get your business registered on VAT?**"

**Table 4.13**  
**Business registration on VAT**

<b>Respondent type</b>	<b>Response</b>	<b>No. of respondent</b>	<b>%</b>
Businessman N= 10	Yes	7	70%
	No	3	30%

*Source: field survey 2012*

The above table shows that the bigger % (70%) of the businessmen have got their business registered on VAT whereas only 30% do not have their business on VAT registration.

#### **4.3.3. Purpose of business registration on VAT**

This question is asked to find out the reason why businesses should be registered on VAT of among the various reasons which force the businesspersons to go to the tax Office. This would help the planner to find out the best and easy way for the businesspersons to register on VAT. On question asked to businessman "**What is the purpose of registering your business on VAT?**"

**Table 4.14**  
**Purpose of business registration on VAT**

Respondent type	Response	No. of respondent	%
Businessman N= 10	Because of threshold limit	3	30%
	Because of compulsion nature	6	60%
	To help government in revenue collection	1	10%

*Source: filed survey 2012*

The data in the table shows that 60% businessman register their venture under VAT net due to legal compulsion as 60% businessman marked on legal compulsion. Since the need of the VAT registration should be self-initiated, the trend should be developed for self-motivation for registration. The sad news is that only 10% (only 1 businessman among 10) want to help the government. And 30% get their business registration because of threshold limit as the threshold limit for Nepal is Rs. 2 million for VAT registration.

#### **4.3.4. Problems on VAT registration**

It is very crucial that the process of VAT registration should be easy and encouraging. after registration too. To solve the problems of business persons is a main responsibility of government for the smooth functioning of the system.

**Table 4.15**  
**Problem on VAT registration**

<b>Respondent type</b>	<b>Response</b>	<b>No. of respondent</b>	<b>%</b>
Businessman N= 10	Don't have sufficient knowledge about VAT system	2	20
	The office personnel do not provide the required assistance and guideline	5	50
	The laws and rules are not clear	2	20

	Difficulties in maintaining the specified accounts	1	10
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*Source: field survey 2012*

The table above shows the problems to be faced while getting registration on VAT by the businessmen. The findings in the above table shows that the Tax office couldn't provide the required guidelines and assistance so that the business person wills to get their ventures get registered. On the question asked "What are the major problems of registration process?" to 10 businessmen 50% (5 businessmen) said that the tax offices do not provide the required guidelines while 20% thinks that they don't have sufficient knowledge about VAT system and 20% thinks that the laws and rules are not clear. Therefore, government should correct the system wherever is possible and give training as well as incentive for the tax officers. Government should also punish hard to those who are abusing their authority for vested interest.

#### **4.3.5. Is present VAT rate appropriate?**

Government increased VAT rate from 10% to 13%. This is done to increase the tax revenue in the national coffer. But the impact is not good enough as compared to expected. Therefore, government revised some provisions in the recent financial ordinance 2006. So, it is important to know whether the current rate Ok or not. If not what should be done? So the question is being asked "**Is present VAT rate is appropriate?**" and the obtained result is shown in the table below:

**Table 4.16**  
**Appropriation of Present VAT rate**

<b>S.N.</b>	<b>Group of Respondents</b>	<b>Sample size</b>	<b>Yes</b>	<b>No</b>
1	Tax Experts	5	5	0
2	Tax Officials	10	10	0

3	Businessmen	10	8	2
4	Consumers	15	9	6
Total		40	32	8
Percentage		100%	80%	20%

*Source: Field survey, 2012*

The above table shows the result that among the total respondent's 80% (32 respondents) answers that the present VAT rate is appropriate while 20% (8 respondents) says it is not appropriate. Though the Tax experts and Tax officials says that it is appropriate rate but the government should be very much serious while deciding the VAT rate as it should be convenience to the businessmen and consumers.

#### **4.3.6. Books and records**

After registering the business on VAT the businessmen must follow the rules and regulations prescribed as and law also includes recording the transaction in the books of accounts in a prescribed manner. The books of accounts must be maintained after registering it by tax officers. For this, a question is asked to the businessmen **“What books & records must be maintained for recording the transactions?”** and the result obtained is presented in the following table:

**Table 4.17**  
**Books of accounts**

<b>Respondent type</b>	<b>Response</b>	<b>No. of respondent</b>	<b>%</b>
Businessman N= 10	Purchase book	0	0
	Sales book	0	0
	VAT account	2	20
	All of above	8	80



*Source: Field Survey, 2012*

From the above data, it shows that for recording the business transaction of VAT registrants, the businessmen must maintain purchase book and sales book along with VAT account as prescribed by the laws and rules as 80% of our respondent businessmen answered according to it while 20% replied for VAT account.

#### **4.3.7. What should be included in purchase and sales book?**

While maintaining the purchase and sales book, certain procedure must be fulfilled i.e. Transactions must be recorded in a prescribed manner. For to know more about this, a question “**What should be included in purchase and sales book?**” is asked to our respondent businessmen and the obtained result is presented in the following table:

**Table 4.18**

#### **What should be included in purchase and sales book?**

<b>Respondent type</b>	<b>Response</b>	<b>No. of respondent</b>	<b>%</b>
Businessman N= 10	Invoice number	2	20
	Invoice date	2	20
	Taxable value	1	10
	Customer and Supplier name with PAN no.	5	50

*Source: filed survey, 2012*

The data presented in the above table discloses that 50% respondents answered that while maintaining the books of accounts the name of customer and supplier with their PAN no is the must concern while 20% of them replied with invoice

number and 20% of them with invoice date as 10% of them have a view point of taxable value.

#### **4.3.8. VAT plays as a means to increase government revenue**

Many people don't have sufficient knowledge about the VAT and they don't know how VAT affects the price of the commodity. Here, I've tried to find out the personal thought of the persons so that the appropriate result is determined. In the question asked **“Do you think VAT plays as a means to increase government revenue?”** the answer obtained is showed in the table below:

**Table 4.19**

#### **VAT as a means to increase government revenue**

<b>S.N.</b>	<b>Group of Respondents</b>	<b>Sample size</b>	<b>Yes</b>	<b>No</b>	<b>I don't know</b>
<b>1</b>	Tax Experts	<b>5</b>	<b>5</b>	<b>0</b>	<b>0</b>
<b>2</b>	Tax Officials	<b>10</b>	<b>10</b>	<b>0</b>	<b>0</b>
<b>3</b>	Businessmen	<b>10</b>	<b>7</b>	<b>3</b>	<b>0</b>
<b>4</b>	Consumers	<b>15</b>	<b>7</b>	<b>5</b>	<b>3</b>
Total		<b>40</b>	<b>29</b>	<b>8</b>	<b>3</b>
Percentage		<b>100</b>	<b>72.5</b>	<b>20</b>	<b>7.5</b>

*Source: Field survey, 2012*

The table displays that 72.5% of the respondents are of the opinion that VAT plays an important means to increase government revenue while 20% believes that it is not a mean of revenue collection and 7.5% of them do not know about it.

#### 4.3.9. Does VAT increase the price of commodity?

It is found in the previous research also that consumers do not ask for invoices while making purchase due to afraid of increase in the price of goods and services. Every one wants to pay less which is the nature of consumers worldwide. By not taking invoice if the goods is found cheaper then why to take bill is a common thought. In the question asked “does VAT increase the price of commodity?” the given table shows the obtained answer.

**Table 4.20**  
**VAT increase the price of commodity**

S.N.	Group of Respondents	Sample size	Yes	No	I don't know
1	Tax Experts	5	0	5	0
2	Tax Officials	10	0	10	0
3	Businessmen	10	2	8	0
4	Consumers	15	5	8	2
Total		40	7	31	2
Percentage		100	17.5	77.5	5

*Source: field survey 2012*

Above table shows that 77.5% of the total respondents have negative opinion towards raising the price of commodity due to VAT where 17.5% of them says that price raises due to the VAT of the commodity and among them 5% replied they do not know about it. The main backbone of VAT system is billing system. The main problem identified by various previous studies is fall under weak billing system. Most of the sales and purchases are not billed that in low price-called low invoicing. Therefore this affects the whole system of taxation. Here also effort is made to identify the current situation of perfect invoicing.

#### 4.3.10. Do you ask to issue VAT bill on purchase?

The main backbone of VAT system is billing system. The main problem identified

by various previous studies is fall under weak billing system. Most of the sales and purchases are not billed that are in low price-called low invoicing. Therefore this affects the whole system of taxation. Here also effort is made to identify the current situation of perfect invoicing.

An analysis of the result of the past showed that the ration of revenue to the GDP was 9 to 11% before the implementation of VAT has not gone beyond 15%. Even the tendency of tax evasion has not declined after the implementation of VAT. There is feeling that tax evasion has increased because VAT and income tax can both be evaded if a vendor is able to issue false invoices during sales and hence the tendency to issue invoices has further declined. The inability to get purchase invoices from the businessmen and consumers while purchasing goods from the market proves this point. On the question asked “**Do you ask to issue VAT bill on purchase?**” the following result is found:

**Table 4.21**  
**Issue of VAT bill on purchase**

S.N.	Group of Respondents	Sample size	Yes	No
1	Businessmen	10	8	2
2	Consumers	15	5	10
Total		25	13	12
Percentage		100	52	48

*Source: Field survey, 2012*

From the above table, it is obtained that 80% (8 businessmen) ask to issue Vat bill on their purchase and only 20% don't ask whereas from the consumers it is only 33% ask to issue bill and 67% don't ask to issue to. So this shows that businessmen are more alert to have ask of bill while consumers are not aware of it.

#### **4.3.11. Issuing of VAT bill on every sales**

From the above data, we found that businessmen ask issuing of bill on their

every purchase made but here we also want to know about the issuing of bill on their every sales so that consumers right can be protected. So we asked the respondent business person a question “Do you issue VAT bill on every sales?” The result obtained is showed below in the following table:

**Table 4.22**  
**Issue of VAT bill on every Sale**

<b>Respondent type</b>	<b>Response</b>	<b>No. of respondent</b>	<b>%</b>
Businessman N= 10	Yes	3	30%
	No	3	30%
	Yes if only consumers ask	4	40%

*Source: Field survey, 2012*

From the above table, it is found that 30% of the businessmen issue bill and 30% of them don't issue while 40% of them issue only if consumer ask them to issue bill. This shows that though the businessmen are aware of billing system but they are ignoring it to issue to the consumers. So the government should make the consumers

#### **4.3.12. Government utilizing the collected revenue**

VAT was introduced in Nepal to get revenue mobilization and to avoid the problems of existence tax system. As Vat is the best system to get greater revenue productivity from VAT is not satisfying as it has been expected. But it has generating refundable amount of revenue since it was implemented in the country. On the question asked to the respondents **“What do you think, government is utilizing the collected revenue in a proper way?”** the following result is obtained:

**Table 4.23**

**Government utilizing the collected revenue**

<b>S.N.</b>	<b>Group of Respondents</b>	<b>Sample size</b>	<b>Yes</b>	<b>No</b>	<b>I don't know</b>
1	Tax Experts	5	5	0	0
2	Tax Officials	10	10	0	0
3	Businessmen	10	4	6	0
4	Consumers	15	4	7	4
Total		40	23	13	4
Percentage		100	57.5	32.5	10

*Source: Field survey, 2012*

Table shows that most of the respondents (57.5%) argue that revenue collection from VAT has been utilizing in a proper way while 32.5% believe that it has not been utilizing in a satisfactory way and 10% of them are unknown about the fact. Though 100% of Tax experts and 100% of Tax officials say that it has been utilizing in a best possible way but only 40% of businessmen and 27% (round figure) of consumers believe that but 60% of businessmen and 47% (round figure) of consumers do not believe it as 26% of consumers are unaware about the fact.

**4.3.13. Major problems of present VAT system**

Though it has been trying for the successful implementation of VAT, it has to tackle the various difficulties and problems are to be faced. So here, we have tried to find out some of the major problems in the effective implementation of VAT system in Nepal so a question “**What are the major problem of present VAT system?**” is asked to tax experts and tax officials and the finding is presented below:

**Table 4.24**

**Major problems of present VAT system**

<b>S.N.</b>	<b>Group of Respondents</b>	<b>Sample size</b>	<b>Unawareness of computer system to the normal persons</b>	<b>Registration process</b>	<b>Billing system</b>	<b>Tax refund process</b>
1	Tax Experts	5	1	0	3	1
2	Tax Officials	10	3	0	6	1
Total		15	4	0	9	2
Percentage		100	26.67	0	60	13.33

*Source: Field survey, 2012*

The table shows that 60% respondents think that billing system is the main problem of VAT implementation system in business sector. Out of 60% of the respondents, 60% of tax experts and tax officials focused on billing system. Similarly, 20% of tax experts and 30% of tax officials believe that it is due to the lack of awareness of sound computer system to the public while 20% of tax experts and 10% of tax officials says it is due to the refund process. Billing is the main problem of present vat system because the seller has various products including VAT and non-VAT. Consumers also don't know the items which is vat able and which is not. Customers will buy all the items, so in this case billing products and real market products where grey market products will not make any impact on VAT and real market goods will impact on VAT and stock. So in this case, billing is the problem and main problem is grey market.

**4.3.14. Major weaknesses of VAT implementation**

To know the exact position of VAT in Nepal, a research with legal provisions, rules and regulations, registration, different problems, weakness and so on other is being held relating to the VAT implementation. So to find out the major weakness

on VAT implementation a question “**What are the major weakness of VAT implementation?**” is been asked to the tax experts and officials and their answers relating to it is presented below in the following table:

**Table 4.25**

**Major weakness of VAT implementation**

<b>S.N.</b>	<b>Group of Respondents</b>	<b>Sample size</b>	<b>Lack of trained manpower</b>	<b>Weak administration</b>	<b>Unconscious taxpayer</b>	<b>Weak economy</b>
1	Tax Experts	5	2	0	2	1
2	Tax Officials	10	3	1	5	1
Total		15	5	1	7	2
Percentage		100	33.33	6.67	46.67	13.33

Source: Field survey, 2012

Table shows that unconscious taxpayer is the major weakness having for the effective implementation of VAT i.e. 46.67% respondents. Similarly, 33.33% of them believes it is due to lack of trained manpower in the organization while 6.67 says it is due to weak administration and 13.33 thinks of weak economy.

**4.3.15. What are prospects to be taken to make VAT effective**

In order to know the most important factor for effectiveness of VAT in revenue collection in Nepal, respondents were requested to express their view about the most important factor for effective of VAT in Nepal. So a question “**In your opinion what are prospects to be taken to make VAT effective?**” has been raised to the respondents to express their view. The view of the respondents is shown in the following table:



**Table 4.26**  
**Prospects to make VAT effective**

S.N.	Group of Respondents	Sample size	Increase Public awareness	Develop information technology	Develop skilled manpower	Improve in threshold limit	Effective reward and punishment system
1	Tax Experts	5	3	1	1	0	0
2	Tax Officials	10	4	3	2	0	1
Total		15	7	4	3	0	1
Percentage		100	46.67	26.67	20	0	6.66

Source: Field survey, 2012

The above table shows that a 46.67% respondent wants to increase public awareness programme so that VAT can be effectively adopted while 26.67 believe that it can be effectively implemented by developing information technology where 20% of respondents says it can be fulfilled by developing skilled manpower by providing different trainings to the tax officials and persons. Similarly, 6.66% says it can be done by providing effective reward system to the businesspersons so that they are motivated in the system while punishment should be given to the persons who are in the evasion of VAT where 0% believe it can't be made effective with the improvement in threshold limit.

### **4.3 Existing Problems**

- Nepalese VAT system is based on invoice method. The success of this system depends on invoice issuance by traders and compulsory receipt of invoice by purchase. Due to the lack of public awareness about this system very few people ask for invoice for their purchase.

- Businessmen registered in VAT office holding VAT certificate fulfill just formalities but do not issue invoice for his/her purchases, they would be answered that they will be charged 13 more as VAT on top of the price. Thus, general consumer do not ask for VAT invoice, either they ask cash memo or purchase note.
- Business firms still continue making parallel dummy invoices. They ask more for general consumer but show little amounts in VAT office, which is a serious problem.
- Fake billing in the market is another major challenge. Actually inserted of improving, the condition of billing is degrading day by day. If the billing system is not improved and right step is not taken, just involving our self on the accusation to each other, this tax system seems to have the negative impact on revenue collection.
- The most serious problem for implementing VAT in Nepal is the administrative inefficiency. Qualified, intelligent, competent, knowledgeable and well educated manpower is necessary for handling the system efficiently. The department emphasized on theatrical aspect of vat but the department must think about the practical problem.
- The tax administration is traditional, weak and inefficient. It has not been able to implement the tax act and regulation properly, resulting in a big gap between the legal provisions and their actual implementation.
- Tax procedures are traditional, complex and not transparent. For Example, taxpayers are required to go to the bank to pay tax and collect vouchers and go to the tax offices to submit return. This process is unnecessarily lengthy.

- The base of Vat has been limited due to large exceptions, which is also unnecessarily complicates tax administration and sets in inefficiency in the VAT system.
- There is a lack of positive attitude and motivation among most of the tax officials. Due to the lack of services minded attitude tax officials do not handle taxpayer's problems seriously.
- There is a lack of detailed introductory training programme for the new entrants in the tax administration. Sometimes tax officials are directly posted their work place without brief introductory on the job training.
- The monitoring aspect of the government side is becoming weak.
- Business community says that more power has been given to tax officials but in practice tax officers own lee power with the more liberalization on tax system.
- While tax audit has been initiated after the implementation of VAT, the audit function is week both in terms of quantity and qualities. Selection is not made on the basic of risk criteria. There is a practice to select all taxpayers' above certain level of turnover for audit. This practice may encourage large taxpayers to split their business. If the business people do this, some activities of them will be out of tax net due to the small amount of transaction made by the firm.
- A small number of business firm are selected for VAT audit. A large number of business firm are exempted. That's why, they are free to show their transaction as they like. Consequently, we find them minimizing their size.
- VAT Act has a provision of taking hold of transaction, and stock property of those who do not pay VAT in time. However, lack of the implementation of this provision has regularly increased the amount of arrears.

- There is also a lack of an impartial, effective and efficient appeal system. Revenue tribunals take a very long time to settle the cases.
- There is a controversy in Nepal with regard to the multiple or single rate of VAT. Some people are of the view that the VAT rate should be multiple having a minimum of three rates including zero. But the tax administration opposes this on the ground of administrative difficulties. The logic of advocating multiple rates is that high and is causing tax evasion. It is making difficult to bring lots of exempted items within tax net.
- The exemption facility is working as a problem for creating distortion in the economy. There are more than 50 items under the exemption list under which VAT uses to be hidden. By using the umbrella of exempted items, taxpayers are evading the tax also on non-exempt items.

#### **4.4 Current Efforts to make VAT Effective**

VAT is collected in retail level. That is why catch up effect cannot be achieved until its implementation is not effective in this level. In this condition, it has not been the backbone of revenue. Through the attempts in the past have improve it in policies and structural aspects, its implementation up to the retail level has not been effective as desired. To make it effective up to the retail level the following additional efforts have been made:

- PAN number extension program launched.
- Tax assistant provided for the taxpayers for advice.
- Tax board that states the type and level of the taxpayers transactional made essential to be in every shop.
- Exemption of conscious consumer program and increase the prizes for the conscious consumers.

- Initiation of conscious seller programme to award the sellers who provide invoices the consumers.
- Provision for simplified bank account for retailers.
- Provision of declaring bill while handing over the stock of goods.
- Initiation of common determination between seller, buyers and tax administration in the use of bill.
- Provision of effective market monitoring system.
- Provision of stock declaration with expenditure claim in income tax and credit discount in VAT.

#### **4.5 Problems for Revenue Mobilization**

##### **a. Structural Problems**

VAT can be levied on single rate or multiple rates. The choice may depend upon economic nature of a country such as: Revenue requirement, Equity consideration, and position of foreign trade etc. Vat with a single positive rate is desirable in a developing country like Nepal because multiple rates make tax administration more complicated since: there is a need to classify commodities into different groups according to their. Moreover businessman has to kept separate records and information. In a country like Nepal, many small vendors who may not be literate may not be able to apply properly the different rates to various goods they sell.

VAT is considered as broad based tax, but all goods and services cannot be brought within tax net, various issues play important role in determining the tax base, so timely revision of deferent VAT act regarding tax base is necessary so as to increase the revenue mobilization.

The exclusion of certain goods and services from tax jurisdiction is known as exemption. There are three major areas which has brought some troubles in administration in adopting the VAT is given as:

- The goods and services of basic needs such as medical and health services, milk, not processed food stuffs, vegetable, etc are exempted with the equity consideration but this provision increases their demand and the relative prices and the fool impact of such exemption will not be felt by the poor.
- Some goods and services are exempted because o the administrative complexity, under this provision the small trades farmers and special service firms are excluded from VAT, farmers are exempted for its difficulties of proper records and financial fragility as well as to avoid the negatively effects on primary products.
- The exemption technique might be used for selected goods and services to encourage their production and consumption such as educational and medical services, cultural activities, public transport, sports, etc.

Zero percent tax on gods and services is given to relieve some selected goods and services completely from taxation, but such items are technically supposed to be remaining within the tax net. Zero rating technique is applied for the purpose of social welfare, to make export promotion and to support economic growth..

#### **b. Administrative Problems**

Effective and efficient tax administration if necessary for the proper mobilization of revenue. The value added tax is directly administrated by the Inland Revenue Administration, the Ministry of Finance; customs Administration, Revenue Investigation Administration. The Ministry of Fiancé is the apex body lf the tax administration.

Therefore for effective implementation, qualified intelligent, trained manpower is necessary and on the other hand effective monitoring is essential, but there exists traditional culture of tax administration, corruption, lack of proper training, political interference so there is big gap between legal system and its active operation.

#### **c. Problems Related with Tax Laws and Regulation.**

There is no clear provision to take legal action against the person who does transaction with put PAN so the attitude of general public toward tax administration is negative. The tax officials have to work in co-operation; there is no possibility of runaway the defaulter. Next tax payer provide improper bill to customers and evade tax in a large scale.

#### **d. Problems Relating to Open Boarder and Unauthorized Trade.**

The other important problem is unauthorized trade and open boarder. People and no paying customs for personal use. Beside that unauthorized trade is very systematic in the border area. There are many organized groups active in the both sides of the brooder and these groups are responsible for illegal supplying of goods from India to Nepal and Nepal to India.

### **4.6 Prospects for Revenue Mobilization**

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

As Nepal is a member of the WTO network, the collection of custom revenue as a major source of revenue is low.

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

#### **a. Prospects of VAT Revenue Mobilization at Various Rates**

The present rate of VAT in Nepal is low so the revenue mobilization from VAT, could not take momentum. The performance of VAT has been criticized by comparing it with sales tax because it could not fulfil the revenue requirement of the government. Recently the government has been shown its indication to implement multiple VAT system in Nepal. If multiple VAT rate is implemented with adequate preparation and study the revenue collection trend will be increases as more goods and services come under VAT net.

#### **b. Prospects of Revenue Mobilization by Broadening VAT Base**

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



### **c. Reducing the Threshold Level**

VAT is not applicable to all transactions. An annual threshold of Rs. 2 million in transaction has been specified for this purpose. But still there is strong Argument that the present threshold is so high. Because of high level of threshold only limited business vendors are registered, which is providing scope for the sales of smuggled or undervalued goods, to prevent such illegal activities and to promote revenue collection all vendors will have to bring under VAT net; this is possible by abolishing or establishing the VAT threshold at low level. Although it seems administratively difficult and socially unacceptable, it will be one way of giving the VAT revenue momentum. If the threshold level is too high, a majority of the businessmen may not come under the VAT net and under such circumstances it will not possible to possible. The threshold level should be fixed based on the administrative capacity, the capacity to maintain accounts in the industry and commerce sector the need for revenue etc. Because of fragmented, self-subsistence economic structure and unorganized business sector it is assumed that the number of business vender having annul transaction less than RS. 2 million, so it is necessary to review the present threshold level.

Behind this, there are huge prospects of revenue mobilization through improving tax laws and regulation, improving institutional and infrastructure development, improving information and technology system etc. Furthermore, tax friendly environment can be created by the government providing education; information and knowledge to the tax payer.

### **4.7 Major finding**

- ) The average total tax revenue and income tax for the study period of fiscal year 2004/05 to 2008/09 is 4461.5 and 922.99. Thus percentage of income tax on tax revenue is 16.93.

- ) The average excise revenue is 1227.82 and total tax revenue is 8922.34 and percentage of excise revenue on total tax revenue is 12.92.
- ) The average custom revenue is 2164.54 and total tax revenue is 8922.34 and percentage of custom duties on total tax revenue is 25.95.
- ) The average direct tax revenue, indirect tax revenue and total tax revenue is 24098,6515.36 and 8922.34 rec. Percentage of Direct tax and indirect tax on total tax revenue is 26.42 and 73.54.
- ) The average government expenditure on recurrent, capital and principle repayment and total expenditure is 9488.55, 5186.88, 1509.76 and 16185.19. The average revenue of GDP is 10883.77. The average different between government expenditure and GDP revenue is 5301.42.
- ) VAT and GDP are interrelated each other the average VAT revenue is 3161.61 in study period and also GDP is 75203.6 thus the average percentage of VAT on GDP is 3.93. Its shows the percentage of VAT on GDP revenue is decreasing in increasing trend.
- ) Nowadays, people are more aware of VAT so many of business are getting registration on VAT. The business registration on VAT is in an increasing trend.
- ) From the above presented data we can conclude that 80% of businessmen but only 47% of consumers have the knowledge about VAT system. This shows that general persons should be make more aware of VAT system.
- ) Most of the businessmen got their business registered on VAT due to the compulsory nature. This shows even to the present context people don't want to be in VAT system willingly.
- ) According to the businessmen, most of them say the major problem in VAT registration process is lack of sufficient assistance

and guidelines by office personnel. Tax office should regulate their staff's in accordance to it.

- ) In the question asked "Do you ask to issue VAT bill on purchase?" It is observed most of the consumers i.e. (67%) do not ask to issue invoice. Public awareness program should be lunched thoroughly.
- ) By observing the present scenario of VAT, it can be concluded that VAT has been implemented successfully and effectively in Nepal though the current legal provision and rules of VAT is not sufficient.
- ) It is found from the study that the main problem of VAT system is in its billing system though there is somehow problem in refund process too. Weakness of VAT implementation is unconscious tax payer according to tax experts and tax officials.
- ) According to the tax experts and officials, for the effective implementation of VAT system, public awareness program should be increases along with the development of information technology.
- ) Structural problems for revenue mobilization are the major problem of VAT in Nepal because of it can be levied on single rate of multiple rates. The choice may depend upon economy nature of country and time.
- ) Administrative problems are major task for implementation of VAT. To effective and efficient tax administration if necessary for the proper mobilization of revenue. The value added tax directly administer by the Inland Revenue administration, the ministry of finance custom administration revenue investigation administration.
- ) There is no clear provision to take legal action ageist person who dos transition with put pan. Show the attitude general public towards tax administration is negative.

- ) Vat is considered to be best fiscal tools for revenue mobilization, especially in an economy which acute shortage of resources on the other hand there is less possibility of correcting used amount of income tax. Because of low per capital income of the Nepalese people.
- ) The present rate of VAT in Nepal is low showing the revenue mobilization from VAT couldn't take momentum. Recently the government has been shown its indication to implement multiple VAT system in Nepal.
- ) To meet the growing expenditure of the government its necessary to increase the revenue mobilization throw broadening the tax base.
- ) VAT is not applicable to all transaction. An annual threshold of two million in transaction has been specified for this purpose. Behind this there are used prospects of revenue mobilization throw improving tax laws and regulations, improving institutional and infrastructure development, improving information and technology system etc.

## CHAPTER -FIVE

### SUMMARY CONCLUSION AND RECOMMENDATIONS

#### 5.1 Summary of Findings

Nepal has been under going through several fiscal crises due to limited sources of revenue and increasing government expenditure. The trend of gap between revenue expenditure shows that, it is even conducive to increase in future leading the country to a debt trap situation. In the wake of such a crisis Nepal has adopted a VAT.VAT is the latest innovation in the field of taxation for 21<sup>st</sup> century. It was first implemented in 1954 by the French government. Then after more then 135 countries of the world are being attracted towards this system. In Nepal, VAT was seriously considered during the first half of 1990 and came into practice since 1997. Some studies held in that period concluded that VAT was applicable to Nepal but its effective implementation through efficient administration was identified as a serious challenge. Adequate preparation suggested for its success in future.

The VAT is collected from sellers on the basic of their "value added" at each of the stage of business process. Thus the same value is never taxed twice and never produces cumulative efforts. The types of VAT are three. They are; gross national product type, income type and consumption type.

The later variant excludes capital goods from its base, and does not panellize investments and growth. It is considered to be natural with respect to the method of production and administratively feasible. There principle methods ensuring the VAT bases are: addition method, subtraction method and invoice method or tax credit method. The invoice method is more popular in the world. Nepal also applies this method. VAT paid on total sales minus VAT paid on purchases by a firm is the net VAT liability under this method. While addition method adds factor products and sales value minus purchase value under the subtraction method. The tax credit method is considered as a tool for cross checking measure under a VAT system. In this stage, VAT is said to be a self-policing in nature. To adjust

international trade VAT uses one of two principles i.e. origin and destination principle. Destination principle is more popular than origin principle.

Registration of the business vendors having taxable transaction and capacity is the first step of VAT operation in any economy. Each and every registered vendor should receive and give the bill while purchasing and selling the goods respectively. Every VAT registered person should keep book of record. Then tax return should be prepared and submitted to concerned tax office and pay the tax. Other important aspects that are required for the successful operation of VAT are enforcement, auditing computerization, penalties etc.

VAT is superior to other types of sales tax because it has many attributes. These attributes are : Economic efficiency, Revenue productivity, Supporting economic growth, No excess burden, Equity norms, Simplicity of administration, Price stability, Accounting base, Self -policing, Catch up effect if VAT can be implemented effectively along with its different provision like exemptions, threshold, zero rating, it will be more equitable. Avoidance of pyramiding and cascading effects and providing cross auditing self policing and catch up effects are the most favourable feature of VAT which makes it superior then RST.

Rate structure plays major role in efficiency and the success and failure of a tax. There is remaining discussion about single or multiple rate of VAT. In single rate, administration is simple and easy to all business entity. In contrast, it reduced tax base or can't expand the tax base. In equity concern, Single rate doesn't support the social equity because of equal rate for all goods and services that consumed rich or poor people. Multiple rate system seems quite complex but it has so many positive attributes. Such as; It broads the tax base, It Increases revenue, It accepts the social equity.

If VAT is developed as major source of revenue, there is necessary for introducing multiple rate of VAT. The survey also shows favouring multiple rate system in Nepal. Business community is also in favour of multiple rates. Revenue consultation committee is also recommended to the Government multiple rates should be implemented. The possible multiple rates may be 5% (basic goods and services), 10% (moderate goods and services), and 15% (Luxurious goods and

services). The structure of VAT in Nepal is well designed however the existing converges of exemptions is significantly broad and the threshold limit is also high which are being helpful means for tax evasion for the business community. However, a well designed structure or VAT will be nothing if the implementation is not going according and successfully.

Implementing VAT in Nepal is not only an easy task but also a highly challenging job. The main obstacles for successful implementing of VAT are: type of business structure and their malpractice, unclear distributional channel, credit sales system, seasonal market. This aspect should be improved as the time of demand. Special problems came up due to the existence of small trades in large portion. As many of small traders cannot fully comply with the requirement of a VAT due to their low scale of operation, lack up accounting records, illiteracy and high compliance cost. A problem arises on small trades them without no substitution revenue loss and extra burden on small traders. Fixing threshold limit to exempt the truly smaller traders is only the appropriate option of this problem.

The existence of open boarder and large number of unauthorized trade from India to Nepal poses a great threat to the success of VAT in Nepal. The illegal import from India and china would help to form a channel of unrecorded trade or black market channel resulting in a large-scale tax evasion. Because the tax administration is not strong enough to check or control the situation, the scope for illegal trade and tax evasion would not decrease even after the adoption of a VAT. The implication of unrecorded trade is that the genuine traders would be adversely affected and illegal trade would ultimately repeal the legal trade.

Due to the lack of experts a skilled manpower in the VAT administration, the auditing system, which is one of the most importance part of VAT operation, is not effective. Refund system is not easy task, process oriented and delaying .So that, the businessman are getting trouble to get the refundable amount. A public consciousness level is very low. Businessmen are cheating consumers by charging high price to them in the name of VAT. They are also cheating government by not issuing proper bills in their sales and hence do not pay real VAT amount.

The geographical condition of the country and difficulties would create several problems for the effectiveness of VAT in Nepal. In the remote areas like Humla, Mugu, Dolpa etc. where the people most bear the burden of higher prices of commodities due to the following elements: A wage of porter and animal, Expensive flight rate of air cargo, time factor, food and other miscellaneous factor. In this condition, the applicability of VAT may be regressive. It adds additional burden to the remote area's people because miserable in equitable and unjustifiable. So the higher price level of commodities discourages completely the VAT. Strong administration, educational, registration program, extensive training program, technical data base system, Co-ordination of various departments (i.e. IRD, CD, RID), High level VAT implementation team, co-operation between government and private Sector, etc are essential pre-requisites for success of VAT.

We cannot easily forecast the effects of VAT on various areas. In general considerations of various effects have been made extant by using some of the existing evidences. VAT would have a favourable impact on saving, investment and production activities of the country. VAT would also increase the competitiveness of Nepalese products. The business activities of country would get certain impact from the VAT business activities would get certain re-adjustment and business structure and practices would also change. The VAT would be helpful in promoting countries exports. But import would decline due to the raise in the prices of imported goods. VAT would have positive impact on the collection of income tax and import duties. Because VAT would disclose the trading records of businessmen making them more transparent, collection of income tax would certainly increase with VAT. The VAT would put the revenue at risk. Tax liability would be distributed among more unsophisticated taxpayers like trader; there is more danger of revenue leakage.

One of the best features of VAT is its catch up effect, which makes tax evasion impossible. But this effect is difficult to achieve in practical ground because of existing channel of illegal trade and undervalued transaction and lack of administrative capability to catch and destroy the illegal channel and regulate system fairly.



## 5.2 Conclusion

It is clear that, the tax is most essential source of the government revenue. Tax can be classified as two categories; direct tax and Indirect tax. 3/4 portion of total is occupied by Indirect tax. VAT is a major source of national revenue. It covers almost 1/3 share of total revenue. Thus the conclusion is that the prospects of VAT entirely depend on its implementation aspect. VAT has bright prospect in Nepal only when it can be implemented in a successful way further, the successful featuring depends up on the strong, fair, capable, honesty, taxpayer friendly and efficient administration.

Regarding the current status of domestic resource mobilization, it is only meeting regular expenditure. Therefore, the government has to depend on foreign loan and other kinds of inflationary financing for development activities; however, both by their nature are not economically desirable in the long run. This shows the situation forcing the economy towards the fiscal crisis and the policy implication is to improve and strengthen the tax system in the nation. Taxation may be considered as the basic tool in the path of economic development for the underdeveloped countries.

Recently, developing as well as developed countries in the world have increasingly focused their attention towards reforming the tax system by realizing the poorly designed tax structure in order to mobilize higher volume of resources for the development purposes and make the economy healthy, efficient, and self dependent to a greater extent. In this respect, VAT became a point of attraction. VAT replaced existing sales tax along with contract tax, entertainment tax and hotel tax since 1997 in Nepal. VAT was expected to have a high revenue yield due to its broader coverage and base. Elimination of economic distortions caused by tax system, elimination of cascading and pyramiding effects, creation of competitive business environment, strengthening foreign trade etc were other good features of VAT that are expected to be fulfilled in real practice.

Theoretically, VAT is expected to have a revenue performance at least as much as the growth rate of GDP. The contribution of VAT revenue with respect to GDP remained 2.92, 2.89, 3.09, 3.87, 3.91, 3.93, 4.51, 4.86 and 5.41 respectively in the subsequent years of implementation. The revenue performances of replaced taxes were even higher than 3 percent, which implies less productive revenue generation through VAT. However, the trend of VAT is improving not only from revenue perspective but also from number of registration, composition of VAT returns, general thinking of people including business community.

The tax system is evaluated not from theory but by practice. Nepalese VAT is not implemented properly. Revenue potentiality of VAT with the existing structure is more than 1.5 fold of actual revenue yield. However, a large proportion of trade takes place in illegal way. VAT base may be significantly increased by redesigning the VAT structure when there will be a fair and capable administration and supported from general public and business community. This shows higher revenue potentiality of VAT in future and this is the most supporting point for the prospects of VAT in Nepal.

At the time of its introduction, it was expected that VAT will make the tax system transparent and increase collection of customs revenue and income tax revenue in the future. But in real practice, the revenue collection from other sources is also facing similar problems. No significant improvement is seen in income tax and custom revenue. In the FY 2005/06, the custom rate was reduced with the hope of increasing the VAT revenue by bringing illegal import into a formal channel, but, this hope is also dampened as recent data is not showing the intended result.

VAT is the modern and the best form of the sales tax however an implementation aspect is more important. More efficient and effective administration is the most important requirement for effective operation of VAT. Sound administration is lacking due to low morale of officials, lack of strong efficient and fair monitoring

system, close co- operation between the custom offices and Inland Revenue offices and other general aspects.

VAT being a self- assessed, invoice based and account based tax, the role of business community along-with political leaders and general consumers is more important for successful operation of VAT system. Lack of cooperation between private and government bodies and irresponsible political leaders are the matter of creating question for the prospects of VAT in Nepal.

Successful operation of VAT is extremely challenging for Nepal due to large scale of non- monetized economy, traditional business style, rugged topography, low level of public consciousness. Existing practice of smuggling and under valuation in the border areas is supporting for under invoicing. Further, all the rules and regulations are not followed in real practice, on the one hand and corruption and bribing is widespread in tax administration on the other. These factors are responsible for tax evading practices.

One of the best features of VAT is the catch up effect which makes tax evasion impossible but this effect is not achieved because of illegal trade, undervalued transactions, transactions without invoices and lack of administrative capabilities to catch and destroy the illegal channels. Once the invoices are not issued properly, the system will loose to its position. Up to now, the revenue generation through VAT is dominated by the imports, The internal trade's share on total VAT revenue is near about 40 per cent which is very small if we compare with other countries. The problems associated with custom duties are also prevalent in VAT revenue. The internal business condition is very demoralizing.

In Nepal, there are some lacunae in VAT structure and administration in which should be removed to make it a success. After Nepal's entry into WTO and SAFTA, the revenue from customs will go down. This loss should be covered from VAT. If the political conflict is settled, the burden of reconstruction of the

country should also be taken by this source of revenue. It means there is dire need of improvement in the VAT system. The problems, which have hindered in making VAT as the main stream of revenue should be solved at any cost if the government wants to generate adequate revenue from this source.

Thus, the conclusion is that the prospects of VAT entirely depend upon its implementation aspect. VAT has bright prospects in Nepal only when it is implemented in a successful way. The successful implementation depends on strong, fair and capable administration, strong political commitment, cooperation between private sector and government bodies, and regulation of open border, high public consciousness level, transparency and improvement of rules and regulations. Moreover, the structure of VAT can be developed to broaden the existing base by reducing exemptions and lowering the existing threshold. Thus, VAT can be entrenched as an integral part of the Nepalese tax structure in the long run if the above mentioned issues are taken seriously and solved accordingly.

### **5.3 Recommendations**

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

- Consumer should be made aware of taking invoices, which is their fundamental right and responsibility to the state. Even buying of appropriate goods with specified quality and quantity is possible after taking the invoice. Consumer awareness program should be launched through media, seminar, discussion etc effectively. It helps to the people to take invoices after buying goods and services.
- At present in Nepal, there is unpleasant business and political environment. VAT should be designed and implemented such a

way that it may not fully work with the available administration under the present business and political environment. This thing we should not have to forget that VAT has not been successfully implemented in some countries use to the unhealthy business and unstable political situation. So, government should try to strong commitment of above business environment and political stability.

- A value added tax should be adopted in Nepal as an important measure of reforming tax system. For its proper implementation, the various issue pertaining to VAT should be considered seriously and be resolved. Such as, low level of administrative capability, unfavourable economic and business environment, large amount of exempted
- The threshold of Nepalese VAT is relatively high because most of the retailers are beyond the tax net but their contribution on total trade is-significant. As threshold and tax refunds are two possible gates of tax evasion, auditing investigation and monitoring systems should be made simple and effective, and the period of refund should be minimized. It is recommended to minimize the threshold limit to Rs 1 million.
- There should be the initiative from VAT administrators to win the trust of industrial and trade organizations as well as professional community. The success of VAT depends upon the honesty and transparency of members of tax administration.
- The market monitoring system should be more effective, immediate legal steps must be taken against those who try to escape from VAT net by using any means or methods.
- The exemption list is very long. The exemptions are mainly due to administrative complexity and equity consideration. Agriculture sector is entirely exempted on administrative grounds while many other exemptions

are due to vested interest of the politicians. Some basic needs are out of tax net in order to introduce progressiveness in the tax system. But the long list of exemptions is not desirable under a broad based tax regime. Moreover, they are the main loopholes to evade tax. Further, they reduce economic efficiency. So, the exemption list should be shortened gradually so that in the long run, all transactions fall under VAT net.

- The existing long open border is the main cause of smuggling and under valuation in the border area. Under valuation in custom points not only reduces revenue from both custom duties and VAT, but also creates distortions in the domestic market. Hence, it helps to develop smuggling economy in the long run. So, open border should be regulated to a greater extent.
- At present in Nepal, there is unpleasant business and political environment. VAT should be designed and implemented such a way that it may not fully work with the available administration under the present business and political environment. This thing we should not have to forget that VAT has not been successfully implemented in some countries use to the unhealthy business and unstable political situation. So, government should try to strong commitment of above business environment and political stability.
- Lack of proper billing that is supported, encouraged and forced by the smuggling and under valuation in the border side and lack of public consciousness, is the most challenging problem. Therefore, customs administration should be made more effective and efficient and there should be close co- operation with VAT administration. Moreover, education programmes should be initiated to educate consumers about billing system.

- Computer linkage system is necessary. The existing computer system should be revised and an integrated computer network with Customs Department, Department of tax and Ministry of Finance should be established for information and operation of this system. More improvement is needed in the present communication system.
- Inefficient staff lacking practical and specialized training is a serious problem. So, providing training to such staff is highly essential.
- The conscious consumer programme and the conscious seller programme have proved very effective in Kathmandu valley. These programmes should be launched and extended all over the country.
- So, at last, the government needs full cooperation from the tax administration, the taxpayers and businessmen as well as consumers in its efforts to generate more revenue. VAT must be made successful and this largely depends upon honesty, faith and morality of tax officials and business people. Therefore, it is time for action and improvements for effective and successful operation of VAT in Nepal for future perspectives as well as present need of-economic development.
- To foster internal revenue policy, professional and corruption less administration should be developed. Reliable and predictable revenue policy is also required. Result oriented administration, healthy co-ordination; regular market monitoring mechanism should be developed.
- To enhance broad based tax and increase in tax compliance, taxpayer education program is needed. Habit of exchange of billing is promoted. To achieve this goal market monitoring, publicity about billing system, increase in consumer awareness, prize coupon programs should be lunched.

- Simplification of forms and proper educate them to taxpayer. Probability of tax audit is established for all taxpayer. Message should be disseminate to all taxpayer about the possibilities of cross check for all transaction. Ethical code of conduct for tax officials should be develop and strong implemented it. Business community should be involved in policy making process.



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[www.myrepublica.com](http://www.myrepublica.com)

## Appendix

### Appendix -1

#### Questionnaire for consumers

Name of Respondents:

Designation:

Office/Organization:

Occupation:

Please tick ( ) the answer of your choice or wherever appropriate put in order of preference from 1 to last number on the basis of alternatives.

1. Do you know about VAT system?

- a) Yes
- b) No
- c) Only by listening

2. Do you think VAT plays as a means to increase government revenue?

- a) Yes
- b) No
- c) Don't know

3. Is present VAT rate is appropriate?

- a) Yes
- b) No
- c) Don't know

4. Do you ask to issue VAT bill on purchase?

- a) Yes
- b) No

5. Does VAT increase the price of the commodity?

- a) Yes
- b) No
- c) Don't know

6. What do you think; government is utilizing the collected revenue in a proper way?

- a) Yes
- b) No

7. What are the major problems of present VAT system?

- a) Unawareness of computer system to normal person
- b) Registration process
- c) Billing system
- d) Tax refund process
- e) Others, if any.....

8. What are the prospects make VAT effective?

- a) Increase public awareness
- b) Develop Information technology
- c) Improve in threshold limit
- d) Effective reward and punishment system
- e) Need of training program
- f) Others, if any.....

## Appendix -2

### Questionnaire for Businessmen

Name of Respondents:

Designation:

Office/Organization:

Occupation:

Please tick ( ) the answer of your choice or wherever appropriate put in order of preference from 1 to last number on the basis of alternatives.

1. Do you know about VAT system?

- a) Yes
- b) No
- c) Only by listening

2. Have you get your business registered on VAT?

- a) Yes
- b) No

3 What is the purpose of registering your business on VAT?

- a) Because of threshold limit
- b) Because of compulsion nature
- c) To help government in revenue collection
- d) If others, please specify.....

4. What are the major problems of registration process?

- a) Don't have sufficient knowledge of VAT system
- b) The office personnel do not provide the required assistance and guidelines
- c) Difficulties in maintaining the specified accounts
- d) If others, please specify.....

5. Is present VAT rate appropriate?

- a) Yes
- b) No
- c) Don't know

6. What books & records must be maintained for recording the transactions?

- a) Purchase book
- b) Sales book
- c) VAT account
- d) All of above

7. What should be included in purchase and sales book?

- a) Invoice number
- b) Invoice date
- c) Taxable value
- d) Customer & supplier name with PAN number

8. Do you think VAT increases the price of the commodity?

- a) Yes
- b) No
- c) Don't know

9. Do you think VAT plays as a means to increase government revenue?

- a) Yes
- b) No
- c) Don't know

10. Do you ask to issue VAT bill on every purchase?

- a) Yes
- b) No

11. Do you issue VAT bill on your every sale?

- a) Yes
- b) No

12. What do you think; government is utilizing the collected revenue in a proper way?

- a) Yes
- b) No

13. What are the major problems of present VAT system?

- a) Unawareness of computer system to normal person
- b) Registration process
- c) Billing system
- d) Tax refund process
- e) Others, if any.....

14. What are the prospects make VAT effective?

- a) Increase public awareness
- b) Develop Information technology
- c) Improve in threshold limit
- d) Effective reward and punishment system
- e) Need of training program
- f) Others, if any.....



### Appendix -3

#### Questionnaire for Tax experts and Tax officials

Name of Respondents:

Designation:

Office/Organization:

Occupation:

Please tick ( ) the answer of your choice or wherever appropriate put in order of preference from 1 to last number on the basis of alternatives.

1. Could you please explain the present system of VAT in Nepal?

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2. Do you think VAT plays as a means to increase government revenue?

- a) Yes
- b) No
- c) Don't know

3. Is the present VAT rate appropriate?

- a) Yes
- b) No
- c) Don't know

4. Does VAT increase the price of the commodity?

- a) Yes
- b) No
- c) Don't know

5. What are the obligations that must be followed after registering business on VAT?

- a) Must file VAT returns on or before 25<sup>th</sup> day following the end of each month
- b) Issue VAT invoice on Sales
- c) Maintain books of accounts
- d) Keep VAT records for a period of 6 years.

6. What do you think; government is utilizing the collected revenue in a proper way?

- a) Yes
- b) No

7. What are the major problems of present VAT system?

- a) Unawareness of computer system to normal person
- b) Registration process
- c) Billing system
- d) Tax refund process
- e) Others, if any.....

8. What are the major weaknesses of VAT implementation?

- a) Manpower (lack of trained)
- b) Weak administration
- c) Unconscious tax payer
- d) Weak economy
- e) Others, if any.....

9. In your opinion what are prospects to be taken to make VAT effectiveness?

- a) Increase public awareness
- b) Develop Information technology
- c) Improve in threshold limit
- d) Effective reward and punishment system
- e) Need of training program
- f) Others, if any.....