AN ANALYSIS OF TAX STRUCTURE
IN NEPAL

A Thesis
Submitted to the Central Department of Economics,
Tribhuvan University, Kirtipur, Kathmandu, Nepal,
In Partial fulfillment of the Requirements for the Degree of
MASTER OF ARTS
In
ECONOMICS

By
Bhavana Puri
Roll No. 238/063
Central Department of Economics
Tribhuvan University, Kirtipur
Kathmandu, Nepal
2011

LETTER OF RECOMMENDATION

This thesis entitled **"An Analysis of Tax Structure in Nepal"** has been prepared by **Bhavana Puri** under my supervision. I hereby recommend this thesis for examination by the Thesis Committee as a partial fulfillment of the requirements for the Degree of Master of Arts in Economics.

…………………………………..

Mr. Nirmal Kumar Raut

Lecturer

Date: 10th Nov., 2011

APPROVAL LETTER

We certify that this thesis entitled **"An Analysis of Tax Structure in Nepal"** submitted by **Bhavana Puri** to the Central Department of Economics, Faculty of Humanities and Social Sciences, Tribhuvan University, in partial fulfillment of the requirements for the Degree of MASTER OF ARTS in ECONOMICS has been found satisfactory in scope and quality. Therefore, we accept this thesis as a part of the said degree.

Thesis Committee

Prof. Dr. Rudra Prasad Upaddyay ……………………………………….
Head of the Department

Mr. Baburam Karki ……………………………………….
External Examiner

Mr. Nirmal Kumar Raut ……………………………………….
Thesis Supervisor

Date: 2068/08/01

ACKNOWLEDGEMENTS

Inspiration plays a vital role. Here, I am greatly indebted to my respected teacher Nirmal Kumar Raut, lecturer at Central Department of Economics, whose inspiring suggestions and guidance help me to prepare this thesis. Likewise, I express my deep sense of respect to Prof. Dr. Rudra Prasad Upadhyay, Head of the Central Department of Economics for his inspiring suggestion in the completion of this study.

I am also thankful to my respected teacher, Mr. Subash Khatri and Mr. Khagendra Katuwal who provided me ideas and materials for this study. Similarly, I am also grateful towards all the teachers of the Central Department of Economics who directly or indirectly helped me in the course of my Study.

I feel great pleasure to acknowledge Inland Revenue Department, Ministry of Finance and Nepal Rastra Bank for providing me thesis material as well as logistic and moral support to carry out this study.

Especially, my thank goes to my brother Surya Kumar Puri, my friends Kalpana Parajuli, Durga Paudel, Parbati Gurung, Amir Khatri, Nabin Rai, Sunita Sharma for their extensive support and constant encouragement with valuable suggestion and technical support during the course of this Study.

Finally, I take this opportunity to remember my father Damber Singh Puri and my mother Shanti Puri for being there in each and every steps of my life with lots of love, understanding, moral support and constant care.

Bhavana Puri

November 2011

TABLE OF CONTENTS

LIST OF TABLES

LIST OF ABBREVIATIONS

@	At the rate
CEDA	Center for Economic Development Association
GDP	Gross Domestic Product
GNP	Gross National Product
IMF	International Monetary Fund
LDCS	Less Developed Countries
MST	Manufacture Level Sales Tax
PAN	Permanent Account Number
RST	Retail Level Sales Tax
SAFTA	South Asian Federation of Trade Agreement
T.U.	Tribhuvan University
UNDP	United Nations Development Programme
VAT	Value Added Tax
WST	Wholesales Level Sales Tax
WTO	World Trade Organization

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Economic development has been one of the most popular slogans in almost all the developing countries all over the world. Similarly, achievement of high rate of economic growth rate, reduction of income disparities and poverty and improvement of living standard of people are some of the development strategies towards which most of the government's efforts have been directed in developing countries. It is known that government needs more revenue for overall economic development and state welfare. Besides this, for meeting day-to-day expenditure, government also requires some sources of income, these are the challenging tasks, which demand increasing necessity of regular expenditure in general and development expenditure particular. However, resource mobilization is very low, compelling the government to depend on foreign assistance heavily (Parajuli, 2009). Development expenditure has been dependent almost entirely on foreign aid. We know, external assistance is uncertain, inconvenient and not good for healthy development. Foreign aids are not bad for economic development of the nation, but the experience of most of the developing countries shows that there are negative effects of increasing international grants and loans to finance and the public development activities. Thus, the government should depend on its own resources for generating revenue to spend these regular as well as development activities.

Government collects revenue from tax and non-tax sources. Tax is key source for revenue mobilization. Tax is a compulsory contribution, as prescribed by law, to the government for a common benefit upon the residents of the state. Taxes are major fiscal policy instrument and important government policy tools have an important role in increasing the rate of capital formation and thereby a high rate of economic growth can be achieved. Increase in taxes may be directed to increase in saving through the postponement of consumption. To increase in saving as available for making useful and productive investments. Taxation may also play a dual role. On the one hand, taxation may be used to make the maximum volume of resource available to the public sector. On the other hand, taxation may be used to promote useful investment in the private sector and to prevent the resource from being dissipated over speculative and unproductive investment as well as over lavish and luxuries consumption. Thus, taxes in developing countries are the severe means of raising revenue (Uprety, 2004).

There are two ways to raise tax either by indirect tax or direct tax. Tax is a direct one when the incidence and impact are on the same person e.g. income tax. Indirect tax simply implies that a tax in which the burden or incidence of tax does not directly fall on the taxpayers but shifts towards other persons and the real income are affected indirectly e.g. Value Added Tax, custom duties etc.

In least developed countries like Nepal, role of indirect tax is seen to be more important and VAT is the most important innovation of the second half of the twentieth century, which is considered as an effective means to collect revenue as a reformed sales tax of indirect tax system. The Value Added Tax is recent origin in the field of taxation. The concept of VAT was developed for the first time by Dr. Wilhelm V. Siemens in Germany in 1919. The concept of VAT was developed further in 1949 by a tax mission in Japan headed by Prof. Carls S. Shoup, the tax however remains as only a topic of academic interest until 1953. In 1954, France introduced VAT covering the industrial sector. The tax was however limited up to the wholesale level. By the end of 1960s only eight countries including France, Brazil, Germany, Netherlands, Sweden etc. had introduced VAT. Since then VAT has been introduced by at least one country each year.

The concept of VAT in Nepal was introduced in early 1990s. Government of Nepal indicated its intention to introduce VAT in the eighth plan, subsequently the finance minister declared to introduce a two- tier sales tax system to make the base of implementing VAT from the fiscal year 1992/93. A VAT task force was created in 1993 under the financial assistance of USAID in order to make necessary preparation for the introduction of VAT. The VAT task was force to prepared the draft of VAT legislation.

The parliament of Nepal Enacted "Value Added Tax Act – 1995 (2052)", Subsequently VAT regulation was made in 1996; the act was passed in 1995. Its implementation was delayed due to political instability and strong opposition from business community. VAT with single rate of 10 percent has been fully implemented with its effect from 16 November, 1997. It has replaced sales tax, hotel tax, contract tax and entertainment tax. VAT is a new tax system for Nepal, it has been justified in the light of government fiscal imbalance and need for extra revenue mobilization through an efficient tax system. The government of Nepal has been increased VAT 10 percent to 13 percent effecting from 15 February, 2004. Its name (Value Added Tax) implies, a tax in the value added to a commodity or service.

1.2 Statement of the Problem

Despite more than five decades of planned development efforts, Nepalese economy is victimized by poverty, income inequality and unemployment. Nepal is in 138th position among 169 countries. The low income leads Nepalese people under vicious circle of poverty. GNP per-capita income is just around 476 US$. The number of population living below, the poverty line is 25.4%, political scenario has changed, but economic system is traditional, needs and aspirations of people have been risen tremendously, but economic growth is poor (3.54%) and unable to support and fulfill the needs of people (Economic Survey, 2010).

The economic performance of the country in major areas is also disappointing. The economic growth rate is not going to support the increasing population. Basic macro economic indicator of Nepal shows that Nepal's economic performance is not satisfactory. The widening resource gaps- revenue expenditure gap, saving investment gap, import-export gap of the country has further affected the economic stability of the country.

The ever increasing government expenditure and limited sources of revenue have lead the country to several fiscal crises over many years. The share of foreign aids in development expenditure is more than 50 percent. The burden of foreign debt is increasing year by year (Kharel, 2011).

The persisting budgetary deficits and increasing dependency on foreign assistance for financing deficits present a dismal picture of country's prospects. The design of taxes in Nepal is so poor and defective; those revenue raising instruments have very disappointing performance. The weak performance of taxes in raising revenue is the major factors in Nepal's low tax GDP ratio. Nepal's tax structure is less productive. The major defect of Nepalese tax system is very narrow base, mainly because the larger proportion of GDP originating from the agricultural sector remains out of tax net. Similarly, other problems are low contribution of direct taxes, low voluntary tax, compliance, very weak tax administration, wide spread tax evasion, burdensome legal and administrative procedures etc.

The scope of direct tax through income taxes and property taxes are rather limited because of the low administrative expertise and large scale of tax evasion. On the other hand, the rates of indirect tax like import tax and excise duties are also gradually being lowered because of trade liberalization policy. In this situation, only revenue raising device may be tax on internal transaction of goods and services.

In this situation, there is no alternative way of VAT in the place of existing sales tax system, which is less productive and narrow base. The problem is that most of the general public doesn’t know the concept of VAT even that businessmen have not clearly understand it. In such situation, government should abolish that sort of problem and make VAT remarkable.

1.3. Objective of the Study

1. To review the Nepalese tax structure.
2. To provide some recommendations for making VAT effective and efficient.

1.4 Significance of the Study

VAT can play an important role in the process of development in developing countries like Nepal which needs higher revenue to fulfill various responsibilities. If it is properly implemented VAT provides various financial needs. For the successful implementation of VAT co-ordination between government and business community is needed.

VAT is the modern form of sales taxation. It has been implemented since 1997 in Nepal. There is need of deeper and wider study about VAT in Nepal. In this context, many empirical and theoretical studies have been conducted to examine the various problems and prospects of VAT in Nepal. The study will be directly beneficial to policy maker, private sector, researcher and general people. Policy maker will be able to identify the areas needed for improvement It will help the re-searcher to carry out their research a step ahead about VAT.

1.5 Limitation of the Study

1. The study is based on secondary data. The reliability of such data has not been examined.

2. The study covers from 1991/92 to 2009/10. Since the country adopted multi-party system after 1990 which brought the waves of liberalization in country, the study takes that fact into account to select the starting period.

CHAPTER TWO

REVIEW OF LITERATURE

The history of VAT is not so long in the global contexts, several studies and experiments have been undertaken on VAT. It has been major instrument of tax reform since last four decades. But very few studies have been done on the topic concerning Nepal. An attempt has been made in this chapter to review the theory of tax as well as recent literature relating to Nepal.

2.1 Theoretical Review

Value Added Tax (VAT) is the most recent innovation in the field of taxation. It is considered as one of the most powerful tools of the fiscal policy. From the experience of VAT in several countries, many economist and policy makers have agreed on VAT is probably the best indirect tax as it gained a remarkable popularity in such a short span of time.

VAT replaces old sales tax, contract tax, hotel tax, and entertainment tax. It has been designed to collect the same revenue as the four taxes it replaced. Since the collection of both customs duties and income tax depends to a great extent upon the effectiveness of VAT. It is expected to help in revenue collection.

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

VAT is multiple sales, which has grown on a hybrid of turnover tax and retail level sales tax. It is similar to turnover tax in the sense that both these taxes are imposed at each stage in the production and distribution process. VAT is similar to the retails stage sales tax because the tax base of VAT (consumption type VAT) and of the retails level sales tax on consumer goods and services are identical. VAT, however differs from retails level sales tax in the sense that the former is imposed at each stage of production and distribution while the latter is imposed only on one stage, which is the final stage. Theoretically, VAT is broad-based as it covers the value added to each commodity by firm during all stages of production and distribution. There is the presumption that VAT is shifted forward completely to the consumers.

2.2 Types of VAT

VAT has been classified on several bases and it can be basically classified into three categories namely consumption type of VAT, income type VAT and production type of VAT. The difference among such types of VAT depends upon the treatment of capital goods purchased from other firms and the treatment of depreciation for the purpose of tax base (value added). That is why, discussion is concentrated within the treatment of these two items for all types of VAT.

2.2.1 Consumption Type of VAT

If all capital goods (investments) brought from other firms are excluded from the tax base (value added) in the year of purchase, but the depreciation is included in the tax base, it is known as consumption type of VAT. It can be expressed in the following equation:

Value-added = Wages+Intrest+Rents+Depreciation+Profit-Capital goods purchased from outside (in the year of purchase)

The above equation clearly shows that the tax base is consumption because investments are free from taxation. Under this type of VAT, investments are encouraged because it excluded from tax base. Similarly, imports are taxed whereas exports are relieved from tax. Thus, tax base for the nation under this type is equal to the domestic consumption. Nepal has adopted it with tax credit method from very beginning.

2.2.2 Income Type of VAT

Under the income type VAT, capital goods purchased from outside suppliers are included in the tax base in the year of purchase but depreciation is excluded from the tax base. The following equation is presented to make clear ideas about the tax base under it.

Value added=wages + interests + profits + capital goods purchased from outside (in the years purchase)

Or

Value added (tax base) = sales-purchase (excluding purchase of capital goods from outside in the year of purchase) - depreciation.

The above equation clearly shows that the value added is equal to the consumption plus net investment. It means the tax base for the nation is the net national income that comprises the consumption and then net investment of all firms with in the country.

2.2.3 Production Type of VAT

The production type VAT includes capital goods purchase from other firm in the tax base in year of purchase and also includes depreciation in the tax base. It can be expressed in the following equation.

Value added=wages + interests +rent + depreciation + profits + capital goods purchased from outside (in the year of purchase).

Or, Value added (tax base) =sales – purchase (excluding purchase of capital goods from outside in the year of purchase).

The above mentioned equation obviously shows that the tax is imposed both on consumption and gross investment.

This means that value added by all firms with in country constitute the gross national product (GNP). That is why; the tax base of this type of VAT is conceptually equal to the GNP. Thus, this type of VAT is also termed as gross nation product type VAT.

2.3 Methods of Computation of VAT

VAT can be computed by following three methods:

2.3.1 Addition Method

In this method, the tax base is calculated by adding the payments made by the firm to the factors of production employed in turning out the production such as wages, interest, rent, royalties and profits. This method is very close to income type of VAT that includes the reward to all the factor of production in its base because all payments made for the factors of production have to be added. It creates complexities in calculating them in practice. Virtually no country has based the additive method. However, Argentina and Israel have used it in selected economic activities, such as banking and finance, where value of inputs and outputs are difficult to measure (Due, 1976:71).

2.3.2 Subtraction Method

Under this method, cost of production is deducted from the base value. In other words, value added is determined as net turnover that is obtained by subtracting the cost of materials from sales proceed. It is much closed to consumption type VAT. Theoretically, it looks simple and easy but it is very difficult to compute especially where multiple rates of VAT exist. Problems like ascertaining tax value in an accounting period may also arise.

Above two methods are called direct methods because value added is computed directly either by adding the payments made by the firms to the factors of production or by subtracting the cost of production from sales.

2.3.3 Tax Credit Method

Tax credit method is known as indirect subtraction method or invoice method. Under this method, input tax is credited from output tax and passed into next stage up to consumption level. Tax credit method is similar, to some extent subtraction method but the major difference among two are:

a. In the earlier method, the tax base levied in the different amount of tax on sales and tax on purchase, where as in the latter method; the tax is levied on the different amount of sales value and purchase value.

b. Earlier method requires invoices, while latter does not require.

If the tax rates are same throughout the production and distribution method, all three methods, give the same result. Among the three methods of computation of VAT, the tax credit method is widely used in the world. This is because this method has several advantages over the other two methods, which are:

a. The tax liability in this method is attached to it. It is technically and legally far superior to other methods.

b. The tax calculation of value added, which is a difficult tasks, is not necessary.

c. The tax credit method creates a good audit trial making and cross-checking possible.

d. It provides an effective way to completely free product such as exports from tax and makes boarder tax adjustment easier and possible.

e. Due to its effect, undervaluation and evasion at some stages are not possible.

f. There will be no revenue loss but exemptions are granted to small firms or products.

g. Rate differentiation at different stage for administrative or other reason becomes possible under this system without reducing the total tax paid. If tax rate is reduced at earlier stage, this similarly gives rise to unequally increase tax of later stages.

Thus, the tax credit method is desirable for several reasons and has been adopted by many countries of the world. Nepal has also adopted this method to calculate VAT. Calculation of VAT revenue can be expressed as follows:

Additional method (T) = t(wages + rent +profits)
Substation method (T) = t(sales value – purchase value)
Tax credit method (T) = t(tax on sale)-t(tax on purchase)
Where,

T = VAT percentage rate

The example can be easily understood by the following imaginary figures:

Table 2.1: Method of Computation of VAT (VAT @ 13%)

Details	Stages production; and distribution			
A. Addition method	**Manufacture**	**Wholesaler**	**Retailer**	**Total**
a. wages	2400	400	200	3000
b. Rent	800	600	400	1800
c. Interest	200	100	100	400
d. Profit	600	200	100	900
e. Value added (a+b+c+d)	4000	1300	800	6100
f. VAT liability(13% of e)	520	169	104	793
B. Subtraction method				
a. Sales	10000	11300	12100	33400
b. Purchase	6000	10000	11300	27300
c. Value added (a-b)	4000	1300	800	6100
d.VAT liability(13% of e)	520	169	104	793
C. Tax Credit method				
a. Sales	10000	11300	12100	33400
b. Tax on sales	1300	1469	1573	4342
c. purchase	6000	10000	11300	27300
d. Tax on Purchase	780	1300	1469	3549
e. net VAT liability(b-d)	520	169	104	793

Source: Arbitrary estimated figures

2.4 Principle of VAT

While considering the international trade, the principles of VAT have great significance. Whenever international trade between two countries is considered, cross boarder adjustment is necessary. For the purpose of imposing VAT, principle of VAT can be divided into origin and destination principle. Choice between those two principles largely depends on the goods and the policy of nation, accession of international trade, computing methods and types of VAT.

2.5 Origin Principle

Under this principle, goods and services are taxed at the place where they are produced or rendered irrespectively, whether they are consumed or not. It implies that all exports are taxable and all imports are not-taxable. Where there is border and cross country trade, this principle gives performance to import goods and services over domestic production. Countries with international boundaries don't prefer to have this principle while taxing. But these sorts of principle may be beneficial where common trade is existed like European Union. Otherwise rest of the countries does not prefer this principle.

2.6 Destination Principle

Under this principle, goods and services are not taxed at the place where they are produced or rendered but the place where they are consumed. Alternatively all imports are taxed while all kind of exports are exempted from tax. The main benefit arising out of this is non-discrimination between import and internal production.

This is the most popular form of principle of VAT, adopted by large number of countries. This principle supports for export and many countries are eager to be best exporter, therefore, they follow this principle. The equal treatment is provided for imports and domestic production, which fulfills the criterion of tax being neutral.

2.7 Characteristics of VAT

The main characteristics of VAT can be stated as follows:

a. It is form of indirect taxation
b. It is broad based tax as it covers the value adds to each commodity by a firm during all stages of production and distribution.

c. It is substitute for sales tax, hotel tax, contract tax and entertainment tax.
d. It avoids cascading effect existed in sales tax and contains catch-up effect.
e. It is based on self-assessment system and provides the facility of tax credit and tax refund.

2.8 International Review

Shoup (1969), in his famous book "Public Finance" considered Value Added Tax as the latest and probably the final stage in historical development of general sales tax imposed on the value added by the business firm. He explained VAT as the difference between sales proceeds and cost of materials etc purchased from others firms, which is the tax base of VAT. He further added, a firm adds value added by processing or handling these purchases items with its labor force and its own machinery, bulking or other capital goods.

While talking about the types of VAT and its practicability i.e. GNP, income and consumption Musgrave and Musgrave (1976), in their book "Public Finance, Theory and Practices" had preferred the latest type of VAT as more applicable and reliable one for both efficiency and quality which was similar to the retail sales tax and seemed to be more practical for poor countries. Likewise, the invoice method for calculation was more preferable and has the advantage of the value added approach.

Regarding the problem of VAT, Musgrave and Musgrave remarked "A sales tax may be imposed on either single or multiple forms. If the later one is implemented in the value added (rather turnover) sense, it turns to be corresponding single tax. At each and every stage the value of product is increased and this price rises according, which is the "Value Added Tax base".

Goode (1986) in "Public Finance in Developing Countries" describes VAT as the most important innovation in public finance. VAT applies to the tax imposed on the value added at successive stage of production and distribution. VAT, a sales tax on consumption is fairer than an income tax because the later results double taxation of saving is unconvincing but the former lacks the progressiveness, which serves by later.

Goode has pointed following advantages of VAT:

a. It is broad based and relatively neutral.

b. It avoids both simple cascading and cumulative taxation of goods of producers that are not physically incorporated in products.

c. Spreading the tax over the several stages of production and distribution is often considered as an administrative advantage compared with collecting it all at one stage because enterprises has less incentive to evade tax.

d. It generates the possibility of issuing information as a cross checks on compliance with other taxes particularly income taxes.

Besides these suitability of Value Added Tax is questionable for countries where small enterprises are important accounting is unreliable and administrative is weak.

Due and Meger (1988) in "Government Finance economics of the Public Sector" examine the VAT in Dominican Republic. He mentioned VAT in Dominican Republic was in effect from November 1983. However, the general reaction towards the tax hostile from the business sector from increased record keeping requirements because the commercial sector of the economy was dominated by small and medium size business. The other main objection due to the belief that VAT was responsible for increased inflation was also due to other reasons. There was a general agreement that the enforcement of the tax had not been adequate mainly because of the lack of personal. Evasion was wide spared mainly firms failed to register. While the tax has brought the additional revenue, the inadequate enforcement and failure to extend it to the commercial sector as planned and the use of makeshift, distorting system in the latter have resulted in serious failure to attain the advantage of a complete VAT. The experience of the country with the tax provides a warning to other developing countries not to attempt to use Value Added Tax extending beyond the import and manufacturing sectors without careful consideration of the ability of the whole-sale and retail sector.

In a seminar "Value Added Tax on Asia" organized by IMF/UNDP, Tait (1991) presented a paper entitled VAT policy issue structure regressively, information and export in Jakarta of Indonesia and later arrived on. The occasional Paper (88) IMF Washington D.C. edited by same author in 1991. The study concentrates on the policy concerns on the basic illustration of same theoretical as well as empirical proofs.

a. The VAT is the alternative of retailer's sales tax. However both do not can tax the unofficial business but under the reporting of sales will show up under the VAT.

b. The VAT is for the buoyant base of revenue maintaining neutrality efficiency in taxation.

c. It is preferable that it has the capacity of covering the all stages of production to the retail level and services.

d. Overall, VAT may not contribute to promote export but it makes the system easier.

e. Single positive rate VAT and few exemptions prove regressive but it should be evaluated on the basis of proofs relatively less regressive than others. It should be weighted compared to the deficits.

f. VAT, simply changes relative price but not the overall price increase tax should be deflationary.

g. VAT administration affects many components whether all are retail sales and services be taxed or how many rates are to be used, the treatment of capital goods, financial services, foods, small traders will affect the administration of VAT.

Thripathy (1992) said that VAT has distinct advantage as an instrument of resource mobilization. The tax on value represents a new technique for collecting taxes on output of economic enterprises.

If a tax on value added is imposed on sales minus the purchase of materials and also of capital expenditure items of an enterprise. According to him, in the developing countries the consumption type of Value Added Tax should be improved in every stage of manufacturing and distribution exempting. Beside its structure should be designed in such a manner that to impose a low rate of tax on food articles. The consumption type of Value Added Tax should be imposed in complete substitute of the tax on undistributed profit of companies because a large scale of evasion of tax revenue takes place in these countries with regard to sales taxation, where as the taxation of corporate profit is administratively much more convenient.

As a complete substitute for sales tax, a Value Added Tax has important advantage. This may be summed up under the following broad categories:

a) Administrative advantage
b) Promotion of economic growth
c) Instrument of planning
d) Promotion of economic efficiency and
e) Healthy effect on exports

The most important point about the Value Added Tax for developing countries is that it will constitute a dynamic part of their tax system. Besides the Value Added Tax is the most obvious of tax which vary in response to short run economic fluctuation. It can be raised or lowered as the situation demands more quickly and easily than many other taxes. Thus, the Value Added Tax can constitute an important instrument of development the finance and economic stabilization in developing countries.

2.9 National Context

Bista (1999) in his M.A. dissertation on "Value Added Tax: It's Issues and Effects" the objective of the study is to examine the importance of VAT with respect to resource mobilization and to identify the problem of VAT and its prospects in developing countries like Nepal. The study basically stands on secondary data. Data analyzing tools are simple statistical tools e.g. percentage, ratio etc. In his study, he found the following facts with respect to his objective.

VAT can mobilize the rest of revenue resources by broadening tax base and tackling all illegal business activities. Tax officers are not specialized or the professionalism is not developed on tax officers. Public awareness is low to make people aware. Paper media commitment towards VAT is weak, open boarder is the main cause of unauthorized trade and unofficial trade. He recommended the following things most necessarily to make the VAT effective. Political parties as well as leaders should show their commitment towards VAT implementation. Government should manage the necessary physical environment so that the VAT administrations can function properly and effectively. There should be good co-operation between government and business community. Talking with India should solve problem arisen by open boarder. VAT officials should be trained. These are the main recommendation made by him.

Devkota (2000) in his M.A. dissertation on "A Study on Value Added Tax Imposition in Nepal" Basic objectives of the study were to see the effectiveness of present information and communication networking in imposition of VAT. He has collected primary data to gather opinions and views relevant to study objectives. Statistical tools he used are simple as ratio, percentage, average etc.

According to him, main problems in implementation of VAT are lack of VAT education to taxpayers and low public awareness level towards VAT. Value Added Tax system has not created positive thinking to taxpayers. The customers do not have habit to collect invoices while purchasing goods and services, which is the most important part of success and failure of the VAT implementation. He also found the communication gap between government and private sector towards VAT. It seems lack of enough preparation for implementation of VAT in Nepal.

Ghimire (1998) in his M.A. dissertation entitled “Value Added Tax Key Issues in Nepal” tries to examine the various issues pertinent to VAT in Nepal. His study is based on primary data by administrating question to VAT in Nepal. Data analysis tools used in his dissertation are simple statistical tools such as average percentage, ratio etc. He has followed analytical as well as descriptive research design.

He has made confusion that the existence of small traders in large proportion raised a problem due to their low operation skill, lack of accounting record illiteracy and high compliance cost. Existence of open boarder and large amount of unauthorized trade from India to Nepal passes a great threat to the success of VAT in Nepal. Illegal imports would help to form a channel resulting in a large scale of tax evasion.

He has made some recommendations for the successful implementation of VAT in Nepal. They are strong administration education program to relevant persons, registration extensive training program to VAT personal, technical data base system, combination of various revenue teams, co-ordination of VAT department with other departments, close co-operation between government and private sector etc.

Khadka (2001) wrote that VAT is the most recent innovation in the field of taxation. It is levied on the value added of goods and services. The tax is broad based which covers the value added to each commodity by a firm during all stage of production and distribution.

The book had covered all aspects of VAT including the nature of VAT reasons for the growing popularity of VAT, development of VAT etc. This part examines all structure and operation of VAT in Asia pacific region which also explores the possibility of introducing VAT in Nepal. Probably, he is the observable person of VAT and the firstly proposed VAT for Nepal with a micro studied of economic system of Nepal.

Khanal (2000) made a dissertation entitled on “Value Added Tax Issues and Options in Nepal”, examined and opined that VAT would be an improvement over the sales tax system. Adoption of VAT in the place of sales tax would insure certain, gain though the gain may be of least amount. That is why, a move towards VAT would be ‘better’ but not an ‘ideal’ step.

He found that the major hurdles for the applicability of VAT in Nepal are the existence of larger proportion of small traders in trading activities, unfavorable business structure and impracticable administration, existence of open border and large amount of unauthorized trade from India, under valuation of imports and lack of consciousness of Tax Law of Nepal.

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

1. VAT is a kind of indirect tax which is found to be superior to any other tax system for collecting the internal revenue, contribution of VAT in total indirect tax is more and higher.

2. The import VAT revenue is higher than internal VAT revenue.

3. Poor management is also cause of ineffective resource mobilization.

4. The growth rate of registrants is increasing. It shows the implementation status is satisfactory but due to the lack of transparency in business activities, weak cross checking mechanism, transition manipulation practices conclude that may potential tax payer are out of VAT.

5. The price change on goods and services may create double problem for tax.

Silwal (1999) in his book “Value Added Tax, A Nepalese Experiences” had expressed his practical experiences about VAT. In his words “VAT is in all stages not-cascading tax system. It extends to all levels of production and distribution. Similarly, it covers all stages and services or exempting any of them renders VAT ineffective. The book gives main focus on Nepalese tax system. The book clearly analyzed why the government of Nepal introduced VAT.

He suggested that factors affecting VAT design. Poorly designed VAT accompanied by weak administration would just brain the treasury. So, almost care is necessary while designing a VAT.

According to him, the following facts were considered while designing a VAT in Nepal:

a) Tax base issues
b) Rate structure issues
c) Exemption issues
d) Threshold issues

Finally, he concluded that the introduction of VAT provides an opportunity to sweep the cobwebs, revamp and substantial part of the tax administration. In every country, where it has been implemented properly, the VAT has proved itself as revenue productive tax. However, the benefit from VAT depends upon its coverage.

2.10 Problem and Prospects of VAT in Nepal

2.10.1 Existing Problems

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 requirements, equity consideration and position of foreign trade etc. VAT with a single positive rate is desirable in developing country like Nepal. Because multiple rates make tax administration more complicated since, there is need to classify commodities into different groups according to their rates. Moreover, businessman has to keep separate record and information. In a country like Nepal, many small vendors who may not be literate and able to apply properly the different rates to various goods they sell.

VAT is considered as broad based tax, but all goods and services can not be bought within tax net, various issues play important role in determining the tax base, so timely revision of different 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.

i. The goods and services of basic need 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 full impact of such exception will not be felt by the poor.

ii. Some goods and services are exempted because of 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 negative effects on primary products.

iii. 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 transportation, sports, etc.

Zero percent tax on goods 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 is 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 Finance is the apex body of 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, lacks of proper training, political intervention, 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 without PAN. So the attitude of general public towards tax administration is negative. The tax officials have to work in co-operation, there is no possibility of run away the defaulter next tax payer provide improper bill to customer and evade tax in a large scale.

d. Problem Related to open Border and Unauthorized trade

The other important problem is unauthorized trade and open boarder. People of both countries- Nepal and India are free to enter into each other's boarder, any goods and no paying customs for personal use. Beside that unauthorized trade is very much in the boarder area. There are many organized groups active in both sides of the boarder and these groups are responsible for illegal supplying of goods from India to Nepal and Nepal to India.

2.10.2 Prospects of VAT

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 with acute shortage of resources.

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

On the other hand, there is less possibility of collection of huge amount of income tax because of low per-capita income of Nepalese people, therefore VAT is found one alternate. Because of all these factors, 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 fulfill the revenue requirement of the government. If multiple VAT rate is implemented with adequate preparation and study, the revenue collection trend will increase 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 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 within tax preview i.e. taxing all commodities including zero-rated goods and taxing agricultural products etc. and the exemption should be limited.

c) Reducing the Threshold Level

VAT is not applicable to all transaction. 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 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. Collection of all vendors will have to bring under VAT net; this is possible 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 will not possible to implement VAT effectively. Therefore, it is common to keep threshold level as low as possible. The threshold level should be fixed based on the administrative capacity, the capacity to maintain accounts in the industry and commercial 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 vendor having annual transaction less than Rs.2 million is many times more than the vendors having annual transaction above than Rs. 2 million. So, it is necessary to review the present threshold level.

Behind this, there is a huge prospect of revenue mobilization through improving tax laws and regulation, improving institutional and infrastructure development. Further more, tax friendly environment can be created by the government provoking education; information and knowledge to the tax payers.

2.11 Conclusion

VAT is a modern and transparent tax system. It is less distorted and more revenue productive. That is why; this tax has become a popular topic for tax reform and has been spreading all over the world since late 1960s. In the process of economic liberalization and globalization, VAT makes the tax system flexible. Majority of the statements utter that VAT is the latest innovation in the field of tax system.

CHAPTER THREE

RESEARCH METHODOLOGY

Research is a systematic and organized effort to investigate a specific problem that needs a solution. This process of investigation involves a serious of well through out activities of gathering, recording, analyzing, and interpreting the data with the purpose of finding answers to the problem. Thus, the entire process by which we attempt to solve problems or search the answers to questions is called research (Wolf and Pant, 2002).

Research methodology descries the methods and process applied in the entire study. In other words, research methodology is a systematic process to approach any research problem to and explore it objectively.

3.1 Research Design

Research is the way or plan that specifies the sources and types of information relevant to the research problem, specifies the approach which will be used for the relevant data collection and analyze the collected data. It helps the researcher to find answer of the problem and control the errors over the study. Although there are many types of research design, critical evaluation and logical description have been done in a research topic to evaluate problems and prospects of VAT in Nepalese context.

3.2 Nature and Sources of Data

In this study the secondary data is used. The secondary sources of data are the information desired from books, journals, newspapers, reports and dissertations etc. The major sources of secondary data are : budget speeches and economic survey, Ministry of Finance, publication of Center for Economic Development Association (CEDA), Tribhuvan University, and records of department of taxation, dissertations related to VAT available at central library of T.U.

Publication of VAT projects, economic review and indicators from Nepal Rastra Bank etc. and other relevant data related to this study.

3.3 Variables Used in the Analysis Process

GDP: Gross Domestic Product is the total final output of goods and services produced in the country's territory by residents and non-residents, regardless

VAT: Value Added Tax is broad based tax as it also covers the value added to each commodity by a firm during all stages of production and distribution.

Indirect Tax: The tax revenue on customs consumption and production is known as indirect tax.

Direct Tax: Direct tax is composed on income and capital,

Total Tax : Total tax is the sum of direct and indirect tax.

3.4 Presentation and Analysis of Data

Collected data have been categorized on the basis of nature and its different simple and complex tables. Most of the data have been presented in tables and some are in diagram. Ms-Excel has been used for the analysis purpose. In this study simple, multiple percentage, histogram, bar-diagram and trend line have been used to present the facts and information.

CHAPTER FOUR

VALUE ADDED TAX IN NEPAL

4.1 A Brief Historical Background of VAT in Nepal

The concept of Value Added Tax is originated from Germany in 1919. At the mean time, Dr. Whelm Von Simons developed the philosophy and principle of Value Added Tax by recommending it for Germany to replace the turnover tax (multistage sales tax) and to avoid the problems of cascading effect. Professor Thomas S. Adams recommended Value Added Tax for the USA in 1921. A detailed structure of Value Added Tax was designed for Japan in 1949 to replace the existing enterprise and to turnover taxes. Due to the new concept and fear of its complicated nature, these countries could not introduce Value Added Tax immediately. France introduced Value Added Tax for the first time in 1954. Ivory Cost introduced the Value Added Tax in 1960. While Senegal adopted it in 1961, Denmark and Brazil implemented in 1967.

Among the SAARC countries, India introduced MODVAT (Modified Value Added Tax) in 1986 for manufacturing products in order to correct excise duty Pakistan, Bangladesh and Sri-Lanka adopted Value Added Tax in 1990, 1991 and 1998 respectively.

In Nepal the concept of introducing Value Added Tax was developed along with the Eighth Plan (1992-1997) when the government indicated its intention to convert the import/manufacturing level sales tax into Value Added Tax in that document of plan. Preparation of VAT was initiated in September 1993 when VAT Task Force was created in the sales tax and excise department in order to make the necessary preparation for the introduction of Value Added Tax. A VAT steering committee was also formed to evaluate and monitor VAT preparatory activities. After the deep study on various aspects relating to the structure an operation of VAT, the task force prepared the draft of VAT law in 1994. It was discussed in depth at several stages with in the taskforce with concerned parties. After reviewed by the steering committee the draft was sent to various business group for their comments. Although, the business community did not provide any written comment on the draft, the private sector opposed to the implementation of Value Added Tax.

Due to the disagreement of private sector and political instability in these days, the government did not indicate its commitment to introduce Value Added Tax. They expressed the argument that the infrastructure and preparation where insufficient to implement the Value Added Tax effectively. In September 1995, along with the formation of coalition government, committed to introduce Value Added Tax in the same Fiscal Year 1995/96. The VAT bill was presented to the parliament on December 1995 as per parliamentary process, it was referred to the finance committees (a parliamentary committee) and the committee returns the bill to the parliament on same month together with its report for amendments to a few provisions. The lower house of parliament passed the VAT bill on same month while upper house of parliament passed it on January 1996. The royal seal was provided to Value Added Tax act 1995 on 21 March, 1996. For the effective implementation and administration of VAT, the government established one VAT department in center and seventeen VAT offices in different districts by changing the name of sales tax and excise department and its offices as Value Added Tax department and Value Added Tax office respectively in 16th July, 1996. The Government has issued VAT, in 24th March, 1997.

Since the strong opposition from the business community and political parties, the government could not enacted VAT laws immediately and made a provision in section 1.2 act and section 1.2 of the rule that the laws shall come into force on such date as government may specify by notification published in the Nepal Gazette. In this way, the implementation of Value Added Tax was postponed for some time although the act was already provided Royal Seal. The act, finally came to force as the government specified the date of implementation of VAT by publishing in the Nepal Gazette on 16 November,

1997. However, it could not be implemented in full phase until the Fiscal Year 1998/99 due to political instability and strong opposition from the business community after the compromise with business community; the government has implemented Value Added Tax in full phase since 17th July, 1998. It has been introduced as an improved indirect tax for the replacement of the sales tax. It also replaces hotel tax, entertainment tax and contract tax and has been supported to collect the same revenue as the four taxes it replaced. Nowadays, Value Added Tax is administered through Inland Revenue Department and Inland Revenue Offices as Department of Value Added Tax and Department of Taxation are merged as Inland Revenue Department since 17th July, 2001.

Nepal has adopted broad based consumption type Value Added Tax with credit method. This means, the tax base is domestic consumption only. Some social welfare services, educational goods and services, cultural goods and services etc. are exempted from tax. VAT with single rate of 10 percent has been increase to 13 percent with its effect from 15, Feb., 2004.

4.2 Need for Tax Reform

Nepal introduces VAT in 1997 for several reasons. One of the important reasons is to develop a stable source of revenue by broadening the tax base. Nepal has been generating bulk of its tax revenue from import duties. However, due to the opening of the Indian economy since the early 1990s there has been drastic reduction in the import tariffs quantitative restriction and licensing system in India since 1991. Further, Nepal has reduced its imports tariff inline with the liberal economic policies adopted since 1992/93 and in line with the customs duties reforms taking place around the world. Consequently, import duties will be less important than they were in the past. The process has already begun as the relative position of import duties decrease from 37 percent in 1990/91 to 34 percent in 1996/97. Furthermore, Nepal will not be in position to levy import duties on trade that takes place within the SAARC region after the implantation of the SAFTA. This means that Nepal will have to become less dependent on international trade taxes for its revenue, which is also desirable from economic resource allocation point of view.

The base of the domestic trade taxes has been narrow since the share of the total economy that flows through market channels is relatively small. The potential tax base become even smaller as sales tax used to be collected at the manufacturing point.

The large numbers of exemption granted on socio-political grounds and weak tax administration only aggravated the problem. The narrow tax base has been eroded further due to compliance weaknesses that have tolerated the understatement of import price and smuggling. Since the sales tax was not levied at the stage of manufacturing point, there was no possibility of capturing the evaded tax at a point further down the trade channels. It has also been necessary to transfer some of the national level taxes, as land revenue, house tax, land tax and vehicle tax to the local bodies, in order to make them financially more autonomous. This means that there is no choice but to introduce VAT in Nepal to generate the revenue required to improve its deterioration macro-economic performance.

VAT system is needed for revenue purpose as an attentive tax system to import tariffs. At the same time, the VAT system promotes the interchanges of information between other tax systems, particularly trade taxes, as customs information is required. It determinates the validity of input tax. VAT should not only be an effective instrument to generate substantial revenue at customs points, but also helps streamline tax policy in general. VAT has natural link with the income tax. Currently, the main basis of the income tax assessment in the case of importers is the information supplied by the customs. But only a fraction of such information reaches the tax administration. VAT will provide the information on imports, local sales and input cost that can be used to assist in the effective implementation of the income tax.

Besides, it is necessary to introduce VAT for several other reasons. The manufacturing level sales tax discriminated against the domestic products viz. imports because the profit margins of the manufactures were included under the base of this tax depends upon the final price irrespective of the promotion of value added at different stages in the process of production and distribution. Further, VAT can be applied anywhere in the economic with out leading to a cascading because it employs a credit mechanism. It also relives exports completely free from the burden of taxation through the zero-rating of exports and the refund system for excess credit.

The implementation of VAT in Nepal is also expected to establish an account-based modern transparent tax system. Manufacturing level sales tax is not levied on the actual selling price but on the national sales value, which included to ex-factory price import value and the amount of excises/ imports duties. This means that the determination of the sales tax base invaded the problems associated with the determination of the base of the excise of import duties. In the case of domestic product, sales tax registered manufactures were required to get their price approved by the tax officials. In the case of excisable items, manufacturing has not only to get their ex-factory prices but also dealer, wholesale and retail level prices approved by the exercise authorizes . There is a possibility of either collusion or harassment prices negotiated between tax officials and taxpayers. There is general lack of administrative capability to determine the taxable value in realistic way.

4.3 Structure of VAT in Nepal

4.3.1 Coverage

Nepal has adopted a broad based consumption type VAT using the tax credit method. Under this system, tax is levied on all types of goods and services, both imported and domestically produced except those specifically exempted by law. It is desirable to make the commodity coverage of VAT as wide as possible. So, all goods and services should be brought into the VAT net unless there is strong justification for their exclusion. In the case of service, there are different practices, however, in developing countries like Nepal, the service sector is rather unorganized and not many services seem to be attractive from the revenue point of view. That is why; some economist recommended a selective approach rather than an integrated approach in the cases of service.

4.3.2 Exemption

While it is desirable to make the coverage of VAT as broad as possible, there are reasons to exempt some transactions from this tax, particularly on administrative grounds. For example, it is not desirable to waste scare administrative resources in chasing after very small vendors who are unorganized seasonal and illiterate and do not keep any record of their business. They are scattered all over the mountainous country. It will be extremely difficult to bring them in to VAT net and the revenue gain may not be substantial. So, small vendors having on annual turn over upto the level of threshold may be exempted from the VAT. The exempted goods and services in the context of Nepal are:

a. Basic agricultural products,
b. Goods of basic necessity,
c. Livestock and their product,
d. Agriculture related equipment,
e. Medicine, medical treatment and other health services,
f. Education,
g. Books, newspaper, printed materials, and publishing,
h. Culture, arts and craftsmanship related services etc.

4.3.3 Zero Rating

Zero rated areas consist of certain goods and services that are taxed at the rate of zero percent. The objective behind the introduction of zero rates is to relive some goods and services completely from taxation. It means that VAT is not levied on zero rated goods or services, but they are regarded as taxable goods or services. Zero rating is definitely a better method than exemption. It is generally levied in the case of exports, which need to be free completely from internal commodity taxation.

Zero rating, however, increases the burden considerably on the part of both at payer and tax administration to the requirement of maintaining books of accounts, submitting return and refunding the tax levied on the inputs of zero rated items. So, in Nepal, zero rating should be limited to the exports and some international services only.

4.3.4 Rates

VAT can be levied both with single positive rate or multiple rates. Generally, VAT with single positive rate is desirable in order to make VAT system simple, because multiple rates make tax administration more complicated under this system. There is need to classify commodities into different groups according to their rates. Moreover, in a developing country like Nepal many small vendors, who may not be sufficiently literate, sell a number of commodities. They may not be able to apply properly the different rates of various goods they sell.

Multiple rates make the tax system inefficient from the economic point of view. It gives incentive to producers to divert their resources from higher rated to lower rated industries to save on tax payment. The multiple rates create scope for tax evasion that may result in considerable revenue loss.

On the other hand, single rate makes VAT less costly, easy to comply and easy to administer.

4.4 Operation of VAT

4.4.1 Registration

The provision of registration is mentioned in the section 10 Value Added Tax act, 2052. According to this section, every vendor already engaged in any transactions of the time of commencement of Value Added Tax is required to apply for the registration with in 90 days from the commencement of the act. Similarly, every person wishing to engage into transaction after the commencement of the act is leaguered to apply for registration prior to beginning to engage in such transaction. However vendors involving in business of goods and services that are free from Value Added Tax need not register for the purpose of this tax. It means vendors having taxable goods and services are required to register their transaction to IRD. But, small vendors failing below the prescribed transaction are not compulsorily required to register for Value Added Tax. For this purpose, Value Added Tax laws have prescribed the level of registration threshold. The existing level of registration threshold is Rs. 2, million of annual transactions.

4.4.2 Tax invoices

VAT registrant must issue VAT bill while selling for supplying goods or services. Such bill is known as tax invoice. The tax invoice require the name and address of the seller and the purchaser, the seller's PAN number and invoice number, the date of transaction and description of the sale including the number of items and mention of any discounts given. The tax invoices is a crucial document for VAT as it establishes the seller's liability for tax and the purchase entitlement to credit. It is however, not necessary to specify the format and content of the tax invoice, taxpayers may be allowed to prepare format of tax invoice according to their requirement.

Tax invoice must be prepared in three copies- the first copy should be clearly identified as tax invoice. The original copy is to be given to the purchaser, the second copy for audit purposes and the last copy is use by the seller while preparing record of the transaction.

Tax officers may grant permission for a VAT registrant to issue abbreviated invoice for retail sales below the value of Rs. 5000. The chief difference between the two taxes invoices are that on abbreviated invoice does not require the name and address of the purchaser. The registrants have the right to request detailed tax invoice, as they will not be able to claim input tax credits with abbreviated invoices. IRD may order tax payer to issue invoices by using cash machine or computer. The procedure in such case shall be as prescribed by the General Director of IRD. It will have anytime access to the database of the tax payer.

4.4.3 Accounting

Value Added Tax is levied on value added at each stage of selling and distribution activities of taxable goods or services. It is taxed on the basis of transaction of taxable goods and services. The effectiveness of VAT depends upon the record and accounting of the transition. So, the VAT registrant requires to keep clear accounts of their transactions of purchase, the registrant person has to maintain records of the following information, document and details:

a. Information as per VAT account,
b. Records relating to trade accounts cash receipts and payments,
c. Tax invoices and abbreviated tax invoices issued by registrants,
d. Tax invoices and abbreviated tax invoices received by registrants,
e. All document relating to his imports and exports,
f. Books of purchase and sales.

The VAT account is a monthly summary showing the course of the figures of viewed in the VAT return. All the registered taxpayers are required to maintain following accounts:

a. Purchase Book,
b. Sales Book,

c. A VAT Accounts.

a. Purchase Book

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

b. Sales Book

Similarly, VAT registrants are required to maintain account of their sales are also to be recorded for invoice basis. At the end of each accounting periods, VAT registrants are required to total the amount of taxable and tax collect on sales. If they make both taxable and exempt purchase and sales, they are then required to calculate the proportion inputs tax, they are entitled to the tax period.

c. VAT Account

It is a monthly summary of taxable purchase and sales and VAT paid on purchase and sales.

4.5 Evolution

VAT is a member of sales tax family. In 1997, it replaced existing sales tax, contract tax, entertainment tax and hotel tax. Sales tax was firstly introduced in 1965 and in 1966, sales tax act was imposed at retails level in 1968, the base of sales tax was reduced up to wholesale level in 1994. 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 by billing system was required so that each copy of bill could be verified by the tax office. Retailers had to submit monthly and annual record to the tax office.

The tax was introduced without any preparation neither the tax officials nor the taxpayers were familiar with this kind of tax as the number of retailers was very high but illiterate.

Wholesales Level Sales Tax (WST)

Retail Level Sales Tax created many problems, so it was replaced by wholesale level sales tax in 1968. Only the manufactures and wholesalers were required to register. The tax was levied on the sales of wholesalers to retailers and retailers to consumers. This tax, in average, is more convenient because wholesalers are more organized and the number is manageable. So that tax administration is easy.

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 manufactures and importers were required to register for the tax purpose. Some manufacturers were out of the tax net if they were cottage industrialists.

4.6 Reasons for the Adoption of VAT in Nepal

Nepal introduced VAT for several reasons which are:

a) Revenue Enhancement

The base of manufacture level sales tax (MST) was narrow. The large number of exemptions granted on socio economic grounds and weak tax administration aggregated the problem (Khadka, 2000: 71). Some taxes like land revenue, house tax, vehicle tax, etc. has 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 the SAFTA, the problem will be more acute. Therefore, Nepal will have to become fewer dependants on international trade and small service taxes for its revenue in future.

b) Broaden the tax base

VAT will be broadening the base of Nepalese tax both legally and administratively. Legally, VAT brings the value added at the wholesales and retail level 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 problem of under statement of import due to the "catch up effect". Under the VAT any under statement of taxable value at the 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 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 stage if they evade tax at an earlier stage (Khadka, 1997).

c) Tax Reform

The tax reform programmers are directed by the political, economic and social condition of the country. The major objectives of tax reform programs are mainly economic in nature. The major objectives of tax reform programs are to increase revenue collection, to make the tax system efficient, to make tax system simple and transparent.

d) Removing the Problem of Sales Tax

There were many problems associated with the implementation of manufacturing level sales tax. Firstly, the manufacture level tax was levied on the profit margin of the manufactures, but not the profit domestic products. Secondly, the importers favored under valuation of imported 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. 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 hand. Therefore, to overcome such conditions, 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 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 price even though the market price was low (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 product in the international market by revealing exports from internal commodity taxes. Further more, as VAT will be levied only on value added, imports will be relieved from taxation, meaning that double taxation will be eliminated under VAT. VAT will improve the competitiveness of the domestic products in other ways as well. It is to be noted that the existing sales tax system discriminates against domestic products. The VAT makes the equal control for domestically produced and imported goods (Khadka 1997, 78).

CHAPTER FIVE

AN ANALYSIS OF NEPALESE TAX STRUCTURE

Like in any other country, the government of Nepal needs revenue to conduct the functions of an independent state or country. A modern democratic government has to perform various social welfare programs, besides its regular activities. For this purpose, government collects revenue. These are tax revenue and non-tax revenue. These both sources are subjects to non-repayment and their sum constitutes the government or public revenue. For under developed country like Nepal, the role of taxation in the process of economic development is considerably significant. In this way, tax structure stands as a mirror of the government as well as ability of the people to pay the tax, is the major factor of designing the tax structure. For underdeveloped country like Nepal, the role of taxation in the process of economic development is considerably significant. In this respect, the tax structure has vital role in development.

5.1 Share of Tax and Non-tax Revenue in Total Revenue

Nepal is one of the developing countries so in Nepal, the contribution of tax revenue used to be almost 80 percent and non tax revenue almost 20 percent. The shares of tax revenue and non-tax revenue in total revenue have been shown in the following table:

Table 5.1: Share of tax and Non-tax revenue in Total Revenue

Rs. in billions

FY	Tax Revenue		Non-tax revenue		Total revenue	
	Amount	%	Amount	%	Amount	%
1991/92	9.87	73.08	3.63	26.92	13.51	100
1992/93	11.66	76.98	3.48	23.02	15.14	100
1993/94	15.37	78.50	4.20	21.50	19.58	100
1994/95	19.66	79.90	4.94	2.10	24.61	100
1995/96	21.66	77.68	6.22	22.32	27.89	100
1996/97	24.42	80.41	5.94	19.59	30.37	100
1997/98	25.93	78.75	6.99	21.25	32.93	100
1998/99	28.75	77.18	8.49	22.82	37.25	100
1999/00	33.15	77.28	9.74	22.72	42.89	100
2000/01	38.86	79.48	10.02	20.52	48.89	100
2001/02	39.33	77.96	11.11	22.04	5.44	100
2002/03	42.58	75.73	13.64	24.27	56.22	100
2003/04	48.17	77.28	14.15	22.72	62.33	100
2004/05	54.10	77.15	16.01	22.85	70.12	100
2005/06	57.43	79.45	57.43	79.45	14.85	100
2006/07	71.12	81.09	16.58	18.91	87.71	100
2007/08	85.15	79.12	22.46	20.88	107.62	100
2008/09	117.00	81.58	26.42	18.42	143.47	100
2009/10	155.99	87.81	21.69	12.19	177.98	100

Source: Economic survey 2009/10

The above table shows that in composition of total revenue, tax revenue has dominant role because the table shows in FY 1991/92 total revenue Rs. 13.51 billion where 73.08 percent is contributed by tax revenue and remaining by not-tax revenue. Tax revenue slightly increased up to the year 2009/10 except in years 1995/96, 1997/98 and 2002/03. This tendency is continuous and in FY 2009/10 total revenue is Rs. 177.98 billion and 87.81 percent has been contributed by total tax revenue and remaining by non-tax revenue. It is clear that tax revenue has dominant role in Nepalese economy.

5.2 Composition of Tax Revenue

The following table 5.2 shows the composition of tax revenue and the share of direct and indirect tax in total revenue.

Table 5.2 : Composition of Tax revenue

Rs. in billions

FY	Direct Tax		Indirect Tax		Total Tax Revenue	
	Amount	%	Amount	%	Amount	%
1991/92	1.59	16.15	8.28	83.85	9.87	100
1992/93	2.03	17.45	9.62	82.55	11.66	100
1993/94	2.85	18.57	12.51	81.43	15.36	100
1994/95	3.12	16.52	15.81	83.48	18.94	100
1995/96	4.65	21.48	17.01	78.52	12.66	100
1996/97	5.34	21.86	19.08	78.14	24.42	100
1997/98	6.18	23.85	19.75	76.15	25.93	100
1998/99	7.51	26.48	20.86	73.52	28.38	100
1999/00	8.59	27.01	24.20	72.99	33.15	100
2000/01	10.15	26.14	28.70	73.86	38.86	100
2001/02	10.59	26.94	28.73	73.06	39.33	100
2002/03	10.10	23.72	32.48	76.28	42.58	100
2003/04	11.91	24.72	36.26	75.28	48.87	100
2004/05	13.07	24.16	41.03	75.84	54.10	100
2005/06	13.96	24.32	43.46	75.68	57.43	100
2006/07	18.98	27.07	51.12	72.93	70.10	100
2007/08	23.08	27.11	62.06	72.89	85.15	100
2008/09	34.32	29.32	82.73	70.68	117.05	100
2009/10	41.46	26.57	114.53	73.43	155.99	100

Source: Economic Survey FY 2009/10 and various years' budget

Total tax revenue is composed of direct and indirect tax revenue. The tax revenue on customs, consumption and production is known as indirect tax whereas direct tax is composed on income and capital. From the above table, the share of indirect tax is significantly higher than direct tax. From the above data, we can conclude that in developing countries like Nepal, indirect tax play a vital role in revenue generation, which is not good for healthy economy.

5.3 Composition of Indirect Tax

Indirect tax is a popular approach concerning taxation, which implied in the world is a very effective fiscal policy adopted specially for the optimum level of resource mobilizing with the principle of more gain from the taxpayers. In short, indirect tax is imposed on one person but it is paid partly or wholly by another person, so the impact and incidence of tax are in different person. In Nepalese tax system; indirect tax can be broadly divided into two parts:

a. Custom duties,
b. Taxes on consumption and production.

The following table 5.3 shows the composition of indirect tax:

Table 5.3: Composition of indirect Tax

Rs in billions

FY	Indirect tax	Customs		Tax on Consumption and production	
		Rs	%	Rs	%
1991/92	8.28	3.35	40.56	4.92	59.44
1992/93	9.62	3.94	40.98	5.68	59.02
1993/94	12.51	5.25	41.99	7.26	58.03
1994/95	15.81	7.01	44.38	8.79	55.61
1995/96	17.01	7.32	43.07	9.68	56.93
1996/97	19.08	8.30	43.53	10.77	56.47
1997/98	19.75	8.50	43.04	11.24	56.96
1998/99	20.86	9.51	45.60	11.71	56.40
1999/00	24.20	10.81	44.68	13.38	55.32
2000/01	28.70	12.55	43.72	16.15	56.28
2001/02	28.73	12.65	44.02	16.07	55.95
2002/03	32.48	12.78	39.35	17.23	53.05
2003/04	6.26	15.55	42.89	20.70	57.11
2004/05	41.03	15.70	38.26	25.33	61.74
2005/06	43.46	15.34	35.30	28.11	64.70
2006/07	51.12	16.70	32.67	35.43	69.32
2007/08	62.06	21.06	33.93	41.00	66.07
2008/09	82.73	26.79	32.38	55.93	67.62

Source: *Economic Survey FY 2009/10*

The above table shows that the custom takes important place in the composition of indirect tax, although, it is continuously decreasing. Similarly in 1991/92 total indirect tax is 8.28 billion among custom contribution 40.56 percent and tax as consumption and production contributes 59.44 percent. It increases continuously and reaches 67.62 percent in FY 2008/2009. The main reason of increasing tax on consumption and production is due to implementation of VAT. And, the contribution of custom has been declined because Nepal decreases the custom duties drastically according to WTO agreement.

5.4 Share of VAT Revenue to Gross Domestic Product (GDP)

Gross domestic product is the total final output of goods and services produced in the country's territory by residents and non-residents, regardless of its collection between domestic and foreign claims. The VAT /GDP ratio measures the consistency of the growth of VAT revenue with the corresponding growth in Gross National Product. This is an indicator of the utilization of taxable capacity. Normally, the growth of VAT revenue mobilization in line with the growth in GDP is desirable for the rapid economic development of a country. The collection of VAT revenue is more reliable than the direct tax revenue, non-tax revenue, which facilitates the process of economic planning and development in the country. VAT has been introduced in Nepal to increase the contribution towards revenue generation. The contribution of VAT revenue in GDP is shown in below table 5.4:

Table 5.4: VAT Revenue as percentage of GDP

Rs in billions

FY	GDP*	Sales Tax/ VAT revenue	% of GDP
1991/92	149.48	2.84	1.90
1992/93	171.47	3.43	2.01
1993/94	199.27	4.69	2.35
1994/95	219.17	6.03	0.27
1995/96	248.91	6.43	2.58
1996/97	280.51	7.12	2.54
1997/98	300.84	7.12	2.36
1998/99	342.03	8.76	2.56
1999/00	379.48	10.27	2.70
2000/01	441.51	12.38	2.80
2001/02	459.44	12.26	2.67
2002/03	492.23	13.45	2.73
2003/04	536.74	14.47	2.69
2004/05	589.41	18.88	3.20
2005/06	654.08	21.61	3.30
2006/07	727.82	26.09	3.58
2007/08	815.66	29.81	3.65
2008/09^{R}	991.31	39.70	4.00
2009/10^{P}	1182.68	54.89	4.64

Source : Economic Survey FY, 2009/10.

* Gross domestic product p=preliminary; r=revised

As shown in table 5.4, the share of sales tax/VAT in GDP is 1.90 percent in FY1991/92, it has decreased in FY1994/95, FY 1996/97 and FY 1997/98 it is in increasing trend and FY2008/09, share of VAT in total GDP is 4.04 percent which is revised data. Similarly, in FY2009/10 contribution of VAT in GDP is 4.64 percent, which is preliminary data.

VAT GDP ratio is a measure to check whether the nation generating revenue properly or not. It is said that for LDCs the country must collect revenue at 5% of GDP.

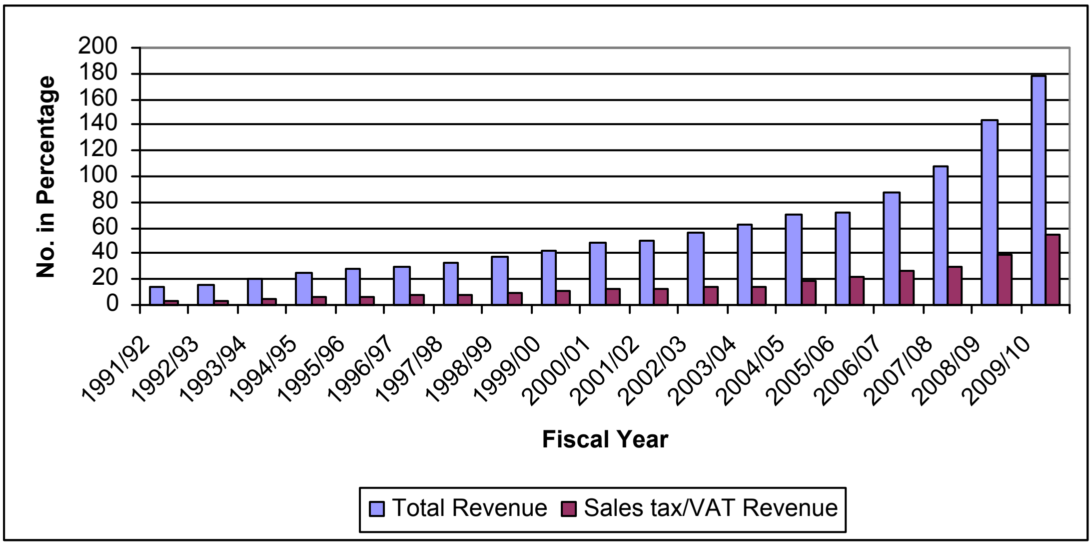
Table 5.5: Share of VAT Revenue in Total Revenue

Rs in billions

FY	Total revenue	Sales tax/VAT Revenue	% of total revenue
1991/92	13.51	2.84	21.02
1992/93	15.14	3.43	22.69
1993/94	19.58	4.69	23.96
1994/95	24.68	6.03	24.50
1995/96	27.89	6.43	23.05
1996/97	30.37	7.12	23.46
1997/98	32.93	7.12	12.62
1998/99	37.25	8.76	23.53
1999/00	42.89	10.25	23.91
2000/01	48.89	12.38	25.32
2001/02	50.44	12.26	24.31
2002/03	56.22	13.45	23.93
2003/04	62.33	14.47	23.22
2004/05	70.12	18.88	26.93
2005/06	72.28	21.61	29.89
2006/07	87.71	26.09	29.75
2007/08	107.62	29.81	27.70
2008/09	143.47	39.70	27.67
2009/10	177.98	54.89	30.84

Source: *Economic Survey FY 2009/10*

This data can be shown in the diagram also, which is presented below:



Source: Based upon table 5.5

Form above table demonstrates that the structure of sales tax/VAT revenue in total revenue. The contribution of sales tax/VAT on total revenue in FY 1991/92 is 21.02 percent. On an average contribution of sales tax, VAT on tax revenue is 25.13 percent. This table shows slightly increase in every year except FY 1995/96, FY 1997/98, FY 2001/02 and FY 2007/08. In FY 2009/10 the contribution of sales tax/VAT on total revenue is 30.87 percent, which is very high in our economy. The contribution of VAT on total revenue is not increasing in expected amount. This shows that VAT is only superior in theoretical aspect than sales tax, which is proved from above data.

5.5 Share of VAT Revenue in total tax Revenue

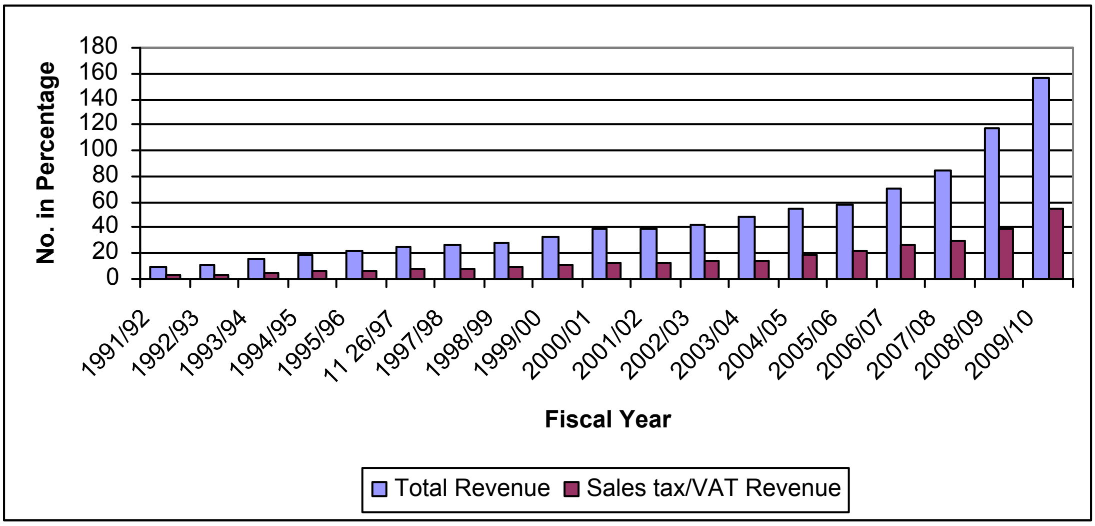
The contribution of VAT revenue to the total tax revenue has been presented in the following table 5.6.

Table 5.6: Sales tax /VAT Revenue as percent of Total Tax Revenue

Rs in billions

FY	Total tax revenue	Sales tax/VAT revenue	% of total tax revenue
1991/92	9.87	2.84	28.76
1992/93	11.66	3.43	29.48
1993/94	15.36	4.69	30.53
1994/95	18.92	6.03	31.84
1995/96	21.66	6.43	29.68
1 996/97	24.42	7.12	29.17
1997/98	25.93	7.12	27.45
1998/99	28.38	8.76	30.88
1999/00	33.15	10.25	30.94
2000/01	38.86	12.38	31.85
2001/02	39.33	12.26	31.19
2002/03	42.58	13.45	31.60
2003/04	48.17	14.47	30.05
2004/05	54.10	18.88	34.90
2005/06	57.43	21.61	37.62
2006/07	70.10	26.09	37.22
2007/08	85.15	29.81	35.01
2008/09	117.05	39.70	33.91
2009/10	155.99	54.89	35.19

Source: Economic Survey, FY 2009/10 and various years' budget.



Source: Based upon table 5.6

As indicated above table, VAT revenue was 28.76 percent of total tax revenue in FY 1991/92. During the study period of 19 years, the percentage trend of VAT revenue to total tax is in fluctuation. Sometimes, it increases in small portion and it is slightly decreases. The hide and seek continues and it will be 35.12 percent at FY 2009/10. In case of VAT contribution to total tax revenue is also not satisfactory as expected amount because there is lack of consumer unawareness about VAT.

4.7 Composition of VAT Revenue

VAT is levied on both domestically produced goods and services; and imported goods and services. Nepalese economy is based on agriculture. More than 60 percent people are farmer and farming traditionally. Agriculture production through unorganized sector is exempted from VAT. Most of the products and services are imported from neighboring countries. Thus, import generates more VAT revenue than domestically produced goods and services. The composition of VAT revenue collection from imports and exports are shown in a table 5.7:

Table 5.7: Composition of VAT Revenue

Rs. in billions

FY	Total VAT Revenue	Domestic Product		Imports	
		Amount	%	Amount	%
1999/2000	10.259	3.725	37.80	6.129	61.20
2000/01	12.382	4.744	39.38	7.303	60.62
2001/02	12.267	4.609	38.52	7.354	61.48
2002/03	13.459	4.831	35.89	8.628	62.11
2003/04	14.478	5.604	38.71	8.874	61.29
2004/05	18.885	6.614	35.03	12.270	64.97
2005/06	21.610	8.150	37.72	13.462	62.28
2006/07	26.095	9.631	36.91	16.464	[63.09
2007/08	29.815	10.808	36.25	19.007	63.75
2008/09	39.700	13.918	35.06	25.782	64.94
2009/10	54.896	20.341	37.05	34.555	62.95

Source: Budget speeches of various fiscal years

For the composition of VAT revenue covered the study from FY 1999/2000 to 2009/10 due to lack of the data.

In fiscal year 1999/2000, the share of domestic products and imports in total VAT was 37.80 percent and 61.20 percent respectively, whereas, in fiscal year 2000/2001 share was 39.38 percent and 60.62 percent respectively.

Likewise, in FY 2001/02, 2002/03, 2004/05, 2005/06, 2006/07, 2007/08, 2008/09, 2009/10, the share of domestic product and import was 38.52 percent and 61.48 percent, 35.89 percent and 64.11 percent, 38.71 percent and 61.29 percent, 35.03 percent, 37.72 percent and 62.28 percent, 63.09 percent 36.25 and 63.75 percent 35.06 percent and 64.94 as well as 37.05 percent and 62.95 percent.

The VAT revenue has been increasing gradually in absolute term, but the increasing rate is much disappointing and decreasing. The maximum rate is in 2009/10. Among various responsible factors such as ineffective billing system, under valuation of goods and services, etc, the negative growth rate of economy following the deteriorating peace and security remained the prime factor for small rate of growth of VAT revenue collection.

CHAPTER SIX

SUMMARY OF MAJOR FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

6.1 Summary of Major Findings of the Study

On the basis of preceding chapter data presentation and analysis, some important findings of the research has been presented in summary as follows:

1. The VAT system that has been implemented in Nepal has completed 13 years of its operation and enters into 14 years. Due to various complexities and problems, this tax system has not been able to achieve the expected level of success.

2. Theoretically, VAT is superior to sales tax in many of its form. As it was abolished already, there is no possibility to compare it with VAT now, so, only theoretical superiority is established.

3. A large amount of government revenue comes from taxation. More then 75 percent of government revenue comes from taxation, whereas, the contribution of non-tax revenue is less than 20 percent in Nepalese tax structure. The contribution of tax revenue was expected to increase after the implementation of VAT, but implementation of VAT did not increase the contribution of tax revenue on total revenue significantly.

4. VAT has been implemented in Nepal in order to generate more revenue, but the efficiency of the Nepalese VAT administration is not satisfactory and not upto the expectation of general people.

5. More revenue can be generated through VAT by widening its coverage. The small traders, which fall on the threshold limit could not have brought into VAT system as yet, they should be registered. The revenue can only

increase by discouraging tax evasion. There is wide range of practice of evading tax.

6. Only few numbers of consumers have purchases. Customers have no habit to take bill on their purchase. This implies that there is very low public awareness and consciousness level towards VAT. On the other hand, businessmen do not want to issue bills. The businessmen have the intension of 'Malpractice' on VAT. So they don't provide bills to customers. This indicates that Government should give proper supervision and rational auditing of business account. Administrative incapability, under invoicing un-billing and lack of public awareness towards VAT are the main problems in the process of VAT implementation in Nepal.

7. In Nepal, collection of VAT has been classified as imports and domestic sources, out of which collection from imports have significant, share i.e. Rs.34.55 billion in the fiscal year 2009/10 as compared to domestic contribution, amount is just Rs.20.34 billion or 35.06 percent of the total VAT revenue in the same fiscal year. This surly indicates that there is heavy dependence of Government of Nepal on imports rather than domestic products.

8. The contribution of VAT to GDP is just 2.7 percent in an average of 19 years. The contribution of VAT to GDP reached 4.64 percent in the fiscal years 2009/10. So the VAT/GDP ratio is very low as compared to other developing countries like Nepal.

9. The contribution of VAT in total revenue is not up to the satisfactory level either in an average. It could contribute just about 30.51 percent to the total revenue in fiscal year 2009/10.

10. So far as the price to the consumer is concerned, as with the sales tax, the consumer pays the same amount to the retailer. There is no difference in consumer price, which paid for the product or service.

6.2 Conclusions

The ultimate goal of the underdeveloped countries like Nepal is to achieve the economic development and ensure the rapid rate of economic growth. It needs huge amount of investment in economic overheads and other development activities for which taxation is undoubtedly a primary source of revenue for the government. Taxation may be considered as basic tool in the path of economic development.

However, there are several issues in the applicability of VAT in Nepal. One of the key issues is administrative capability and situation which definitely dwells the great importance for the effective implementation of VAT in Nepal. Actually, VAT was introduced in Nepal in the ambitious hope to increase the revenue and particularly stop the leakages made through other forms of taxes. But history has shown that the government has already tried many reforms in the field of taxation, in the absence of alternative effective methods, lack of proper planning and in other words leading to administrative failure. Indeed, this is true in the case of VAT also, Nepalese businessmen are generally found to avoid the frequent contacts with the tax officials because they are widely known for unofficial benefits. Even in the administrative area, there is a widespread corruption as well as red taps prevailing everywhere. So, for that government, administrative capability and transparency are the serious concerns. In order to make resource mobilization though VAT, following things should be considered,

a) Administrative power and credibility,
b) Tax payer identification,
c) Registration and educational program,
e) Incentives for small traders,
f) Co-ordination with private sector,
g) Feasibility of refund system,
h) Electronic media.

Currently, while the numbers of registrants are increasing but the tax collection has not been satisfactory when compared to the number of registrants. Public awareness is very low. The salesmen are not used to issue bills and the consumers to receive them. Undervaluation and smuggling of goods are mostly found. The problem seems to be aggravated by the VAT rate to 13 percent, which immensely discourages the customer in demanding bills on their purchases.

Truly, increment of VAT rate has fairly negative influence on general people. Their viewpoint is to broaden the tax base instead of increasing the tax rate. Tax rate has been increased time and again for nothing, but this does not get reflected in real revenue mobilizations. Rates should be continued for a long time for transparency and must be incorporated in VAT act itself. So, the government has to pay serious in increasing the tax base instead of increasing the tax rates. International experience tells us that the gradual lowering of duties or tax rate is an effective tool in achieving desired goals rather than increasing it.

A bold vision, evolutionary leadership, efficient bureaucrats, honest taxpayers and collectors are the invisible infrastructure required for effective mobilization of resources. All must think from a long-term perspective rather than weighing up immediate pros and cons. The Inland Revenue Department must come up with a forward-moving process, concrete action plan and policies to cope with the global challenges in order to accelerate the reform process.

6.3 Recommendations

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 to make VAT effective and more efficient on the basis of findings and conclusions of the study.

1. Nepalese policies are directed by the politicians. The bureaucrats do whatever their political leaders call for. Most of the politicians are motivated by their own benefits and hence, defective policies are likely to be made. Due to political interference, policies are not so effective to generate VAT revenue as it was expected during the initial implementations. Thus, political interest highly influences economic policies.

2. Political commitment is one of the most essential phenomenons for the success of government policies. This is true for VAT implementation as well. The leader shows their commitment but intentionally nobody has strong will power to make VAT system successful and more effective. There is a lack of proper cooperation and coordination between government and opposition parties. Hence, government should create favorable political environment for effective and successful implementation of VAT.

3. The success of VAT system is not only the success of the IRD, but also the success of nation as whole. The role of general media, radio, TV, newspaper plays an important one. Emphasis should be given on mass media. Awareness towards VAT system should be crated among general public, non-government and government organization.

4. Many businessmen having taxable capacity are beyond tax net. So the enforcement should be made more effective and voluntary compliance should be encouraged. The level of voluntary compliance could be raised through a set of promotion and regulatory measures including positive and service minded attitude of tax officials, rationalization of tax administration simplification of tax procedures and forms, strengthening tax administration, conducting audit and investigation in an effective manner and panelizing those who break the rules. The

procedures regarding registration, collection, interest, penalty, audit and appeal should be simplified and improved.

5. There should be close cooperation between the private sector and government sector for the successful implementation of VAT. Both sectors should always be taken into confidence by each other. Business sector participation in policy making is necessary to increase the VAT revenue for government.

6. 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.

7. 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.

8. 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.

9. 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.

10. 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 revenues from both custom duties and VAT, but also creates dissertation 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. Moreover, customs department and Inland Revenue Department should act in coordinative manner. Actions of revenue investigation department should be strengthened.

11. The VAT refund system must be made more effective in order to refund the tax without delay. The practice of credit refund must be controlled by employing a proper mechanism.

12. 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 close cooperation with VAT administration. Moreover, education programs should be initiated to educate consumer about billing system.

13. Computer networking 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.

14. Inefficient staffs lacking practical and specialized training are the serious problem. So, providing training to such staff is highly essential such as e-training.

15. The consciousness consumer program and the conscious seller program will be effective in Kathmandu valley. These programs should be launched and extended all over the country.

So, at last, the government needs full cooperation with the Tax Administration, the taxpayers and businessmen as well as consumers in its efforts to generate more revenue. VAT must be made successful and depends upon honesty, faith and morality of tax officials and business people. Therefore, it is time to action and improvements for effective and successful operation of VAT in Nepal for future perspectives as well as present needs of economic development.

REFERENCES

Adhikari, C. M. (2003). *Value Added Tax in Nepal.* Kathmandu: Pairavi Prakashan.

Agrawal, G. R. (1978). Resource mobilization for development. *The Reform Income Tax in Nepal*, Kathmandu: Centre for Economic Development Aassociation, p. 21-23.

Bista, R. B. (1999). *Value Added Tax its issues and* e*ffects.* Unpublished Master's thesis, Central Department of Management, Tribhuvan University.

Carl, S. S. (1969). *Public finance.* London: Wildfield and Nicholson.

Carl, S. S. (1978). *VAT and developing countries*. London: Wildfield and Nicholson.

Choi, K. (1983). VAT in Republic of Korea. *Economic Bulletin for Asia and Pacific*. New York, p. 15-17.

Dahal, M. K. (1995). Tax system review task forces. *Report*. Ministry of Finance, HMG/N, p. 7.

Devkota, S. P. (2000). A study of Value Added Tax imposition in Nepal. Unpublished Master's thesis, Master's in Business Administration, Tribhuvan University..

Dhakal, S. (2003). Problems and prospects of Value Added Tax in Nepal. Unpublished Master's thesis, Central Department of Economics, Tribhuvan University..

Due, J. F. and Carrie, M. (1988). *Government finance* e*conomics of the public sector*. New York : Wang Praeger Publishers.

Gautam, N. (2006). *Attitude of the people towards VAT and its effectiveness in revenue mobilization.* Unpublished Master's thesis, Central Department of Economics, Tribhuvan University.

Ghimire, L. M. (1998). *Value Added Tax key issues in Nepal.* Unpublished Master's thesis, Master's in Business Administration, Tribhuvan University.

Goode, R. (1986). *Government Finance in Developing Countries*, New Delhi: McGraw Hill Co. Ltd.

Howell, H. Z. (1995). *Tax policy*, Washington D.C.: International Monitory Fund.

Kadel, P. R. (2003). *Tax laws and tax planning in Nepal.* Unpublished Master's thesis, Master's in Business Administration, Tribhuvan University.

Kanel, N. R. (2003). *Guidelines to format theses and* d*issertations*, Kirtipur: New Hira Books Enterprises, Kathmandu.

Khadka, R. B. (2001). *VAT four years of implementation.* Kathmandu: Inland Revenue Department.

Khanal, B. R. (2000). *Value Added Tax: issues and* o*ptions*, Unpublished Master's thesis, Central Department of Economics, Tribhuvan University.

Kharel, D. K. (2011). *A study on sector wise* c*ontribution of Value Added Tax in Nepal.* Unpublished Master's thesis, Central Department of Economics, Tribhuvan University.

MoF (2009). *Economic survey,* (Various Issues), Kathmandu: Singha Darbar.

MoF (2009-2010). *Budget speech,* (Various Issues), Kathmandu: Singha Darbar.

Musgrave, R. A. and Musgrave, P. B. (1970). *Public finance in theory and practice*, New Delhi: Tata Publishing House.

Parajuli, S. (2009). *Revenue policy and revenue administration*. Kathmandu: Makalu Books Publication.

Silwal, N. P. (1999). *Resource mobilization and VAT*. Kathmandu: VAT Department of Nepal.

Tripathy, R. N. (1992). *Public finance in developing countries.* New Delhi: Indus Publishing Company.

Upreti, Dambar Prasad (2004). *Value Added Tax in Nepal performance and prospects*. Unpublished Master's thesis, Central Department of Economics, Tribhuvan University.

Wolf, H. K. and Pant, P. R. (2002). *Social science research and thesis writing.* Kathmandu: Buddha Academic Publishers and Distributors Pvt. Ltd.

Websites:

http://www.imf.org
http://www.ird.gov.np
http://www.nepalchamber.org/policies/incometax.php