

# CHAPTER - I

## INTRODUCTION

### 1.1 Background of the Study

VAT implies a tax on the value added to a product at each stage of its production, from raw materials to finished product. Widely employed in [Europe](#), value-added taxes have the advantage (for governments) of raising revenue “invisibly,” that is, without appearing as taxes on the bill paid by the [consumer](#). Thus, this study is focused especially on VAT as a major source of government revenue.

VAT is the most recent innovation in the fields of taxation. VAT is levied on the value added of goods and services. VAT is an improved version of sales tax. It is levied at different stages of production and distribution. It is a multistage tax, which is connected at the different stages of production and distribution; sales of both domestically produced and imported goods and services.

The concept of VAT was developed for the first time by Dr. Wilhelm v. Siemens in Germany in 1919. Maurice Lauré, Joint Director of the French Tax Authority, the Direction *générale des impôts*, was first to introduce VAT on April 10, 1954, although German industrialist Dr. Wilhelm von Siemens proposed the concept in 1919. Initially directed at large businesses, it was extended over time to include all business sectors. In France, it is the most important source of state finance, accounting for nearly 50 % of state revenues. The world is now seeping towards the 21<sup>st</sup> century. The world now has develops various new techniques, VAT likewise VAT in the field of taxation. VAT, a latest and emerging tax, is one of the successful experiences in the tax system. It isn't a one-night job. It has a long historical journey to develop form the crude concept.

The concept of VAT in Nepal was introduced in early 1990s. Nepal government indicated its intention to introduce VAT in the eighth plan. Subsequently, the finance Minister declared to introduce a two tier sales tax system 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 on USAID in order to make necessary preparation for the introduction of VAT. The VAT task force prepared the draft of VAT legislation.

Nepal adopted VAT system in 1997 in full format. The parliament of Nepal enacted "Value Added Tax Act. 2052" form 1995. VAT regulation was made in 1996 from the budget speech of 1992/93. The system was finally introduced on 16 Nov 1997 (1<sup>st</sup> Mangsir, 2054) in Nepal.

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The parliament of Nepal enacted “Value Added Tax Act, 1995 (2052)”. Subsequently, VAT regulation was made in 1995. Although the act was passed in 1995, its implementation was delayed due to due to political instability and strong opposition from the business community. VAT has been fully implemented with effect from 16 November, 1997 (1<sup>st</sup> Mansir, 2054). It has replaced sales tax, hotel tax, contract tax and entertainment tax. It has been designed to collect same revenue as the four taxes. Its replaced VAT is a new tax system for Nepal. VAT

has been justified in the light of government fiscal imbalances and need for extra revenue mobilization through an efficient tax system.

Nowadays VAT has become the major source of government revenue, its contribution to total government revenue is significant and increasing. VAT has replaced sales tax, hotel tax, contract tax, and entertainment tax in Nepal.

In the Nepalese context, the tax system review task force constituted by Nepalese government in 1995 under the chairmanship of Professor Madan K. Dahal proposed and recommended to implement VAT in lieu of sales tax, hotel and entertainment tax and Nepalese government implemented it in 16 Nov. 1997. However, VAT came into full operation in Feb.

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

Thus, the business community tried till the last moment to postpone the implementation of VAT. But, government went on their schedule to implement. However, it extended the deadline to three months, and VAT become the effective tool for the collection of revenue of the government. In total tax revenue the contribution of VAT is more and attractive. There is tremendous scope for increasing the revenue from VAT. The sound implementation of VAT will obviously increases its contribution in coming days. VAT is a scientific tax system, which is most popular and transparent system. But, there are some issues or problems in VAT such as in: administration, cooperation, refund, policy etc. To overcome the problems, the government should make almost all the people aware

and well informed about it. Not only from the side of government but business community must also support for the sound implementation of VAT. So VAT is a revenue productive tax. It also removes the misuses of sales tax and contribution to increase internal revenue and reduce foreign loans. Thus because of many features and contribution future prospects of VAT is good enough. From the past experiences of VAT in Nepal, it would show the clear picture of its incoming future as well.

Finally, the threshold, which was earlier said to be NRS. 4.5 million Was brought down to NRs. 2 million and VAT rate is changed to 13 percent from 10 percent since 15<sup>th</sup> January 2005.

VAT is a very good tax system although there are so many complication regards to this system. The successful execution of the system depends upon appropriate government policy and awareness in people.

## **1.2 Statement of the Problem**

Only a good tax system is not sufficient to make the revenue collection procedure effective, effective implementation of the system is also necessary. We discussed so many advantages of implementation of VAT system. VAT is a scientific, simple and very good tax system. However there are so many problems regarding implementation of VAT system. It has been about 13 yrs of VAT implementation in Nepal, but there are so many problems in its effective implementation. Still today, we people do not have the habit of getting invoice after we make purchases and the businessman hesitate to give invoice to the customers. There is lack of effective government programs to aware people about VAT system and encouraging people to ask bill when they made purchase. The government has closed the eyes to let the business vendor to avoid the tax. How better is the

system, if proper implementation is lacking there will be no benefit of the system. Therefore Effective implementation of VAT system is necessary in Nepal.

There are so many problems and challenges regarding implementation of VAT in Nepal. Some of them are pointed out below.

1. Awareness of General public about the regulation is quite poor. Quite a sizeable number of Nepalese buyers are found not bothered to take formal invoices of their purchase. People in business and their association too, are found having a lot of confusion on provisions of the regulation. And consequently, accounts maintained by them are found having a lot of discrepancies.
2. Entry of custom undeclared goods in the market and unauthorized trade are creating a lot of problems with respect to implementation of the regulation.
3. Regulation aspect is very poor. We find many business units in a busy city area, closed to one another, grand and fabulous but not registered with under VAT regulation on pretext that their transaction is below the threshold limit. Many registered taxpayers are found keen on following the provisions of the regulation. Monitoring process of IRD to examine whether or not taxpayers are following the provision of the regulation properly is noted not working regularly.
4. Practice of simply accepting tax returns by the concerned without any scrutiny brought for submission by registrants and absence of legal provision requiring making tax assessment of tax payers at short interval, to the practical extent, are other problems with respect to proper implementation of the regulation. Such practice is found making taxpayers carefree with their obligation subjects to the Acts. Perhaps, this is the reason for having lots and lots of taxpayer submitting zero of credit tax returns regularly, having massive tax debtors and quite a large number of taxpayers not submitting tax returns.

5. People involved in application of a system have a great bearing on successful implementation of the system. In other world having a nice and improved system alone is not sufficient to ensure its effective implementation. People engaged for making the system operational is also equally important. Though there are some talent and energetic tax officer in the VAT system, they too are made to function in the same unhealthy old working environment in the name of consolidation of tax collecting measures.
6. Tax administration has not been able to convince taxpayers as to why they need to pay tax. Thus, the situation is such that taxpayer squeezes where as tax avoider swells. In such circumstances execution of a tax Acts as desired becomes as hard as chewing an iron bread.
7. Some provisions of VAT Acts 2052 appear quite unclear, ambiguous and impractical. Section 6(2) and Section 8(2) of the Acts are examples of the statement. Some other arrangement on the Acts, which appears that they may weaken implementation of they are Section 20(1) and (4) have the Acts. Provision in the Acts for treatment of transactions as taxable and non-taxable create a lot of confusion.
8. Absence of clear cut demarcation of stages of transactions such as production, distribution, wholesale, retail etc also create problem in implementation of VAT system.

Thus, the major problem of Value Added tax can be summarized as problems of VAT billing, Narrow Tax base/coverage, Smuggling, under valuation and unauthorized trade Weak tax Administration, Weak public consciousness level, and Geographical barriers.

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

The general objective of this study is to analyze the contribution of VAT in government revenue and challenges in its implementation (in the context of Nepal).

The specific objectives of this study are as follows:

- J To sketch the historical background of VAT in general.
- J To assess contribution of VAT to total government revenue.
- J To point out the hurdles from the side of government in collecting revenues, especially VAT;
- J To assess implementation status of VAT Act 2052.
- J To identify the factors of challenges on VAT's implementation;
- J To identify the public's viewpoints towards VAT;

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

Study of VAT has the following significances:

1. This study gives the present scenario of VAT implementation in Nepal. The significances of VAT to government revenue can be known from this study.
2. This study explains the procedure of tax refund and judicial trend in tax refund, which makes people easy to know how VAT paid can be refunded with existing laws.
3. This study makes other researcher easy to conduct further research on VAT implementation in Nepal.

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

To keep the research work feasible, to keep study in track, to go according to plan, the researcher has to barricade the research from same limitations. The following are the limitations of this study.

1. No attempts have been made to examine the reliability of the secondary data.
2. For primary data collection Kathmandu Valley has been selected purposively.
3. The research study covers the period from FY 2001/02 to FY 2008/09.
4. Altogether forty respondents have been consulted in drawing the ideas in the form of primary data.

## **1.6 Organization of the Study**

This study is organized into five chapters. The overall background of the study has been included in chapter I. This chapter further contains statement of the problem and objectives of the study. An extensive review of literature in the field of financial analysts' views of financial ratio has been summarized in chapter II. This chapter begins with the presentation of review of the established theory in this field. Subsequently, the remaining part of the chapter contains the presentation of review of major studies in the area. The Research Methodology used in this study has been presented in chapter III. This chapter contains the research design, nature and sources of data, sampling procedure, tools or the models used for data analyses are provided in chapter IV. Finally, summary of the major findings and conclusion of the study are presented in chapter V.



## CHAPTER - II

### CONCEPTUAL FRAMEWORK AND REVIEW OF LITERATURE

#### 2.1 Conceptual Framework

The tax on value added in each production and services is called VAT. It is also called consumption-based tax, the traders, businessmen, producers and service providers collect the tax from the consumers and pay it to the government.

Value Added = Cost + Profit

Value added tax (VAT) is similar to a [sales tax](#). It is a tax on the estimated market value added to a product or material at each stage of its manufacture or distribution, ultimately passed on to the consumer. [Maurice Lauré](#), Joint Director of the French Tax Authority, the [Direction générale des impôts](#), was first to introduce VAT on April 10, 1954, although German industrialist [Dr. Wilhelm von Siemens](#) proposed the concept in 1919. Initially directed at large businesses, it was extended over time to include all business sectors. In [France](#), it is the most important source of state finance, accounting for nearly 50 % of state revenues.

VAT implies a form of indirect taxation. It is an improved and modified form of sales tax. It is levied on value added of goods and service at each stage in the process of production and distribution chain. These stages can be import, manufacturing, wholesale and retail. Value added for a firm is sales value minus all expenditures on goods and services purchased from other firms plus profit. The value added can be obtained by adding payments to factors of production (wages, salaries, rent, interest and profit) this value added is the base of VAT. Although VAT is eventually borne by the final consumer, it is collected at each stage of production and distribution chain (Bhattarai and Koirala, 2004: 18.3).

Personal end-consumers of products and services cannot recover VAT on purchases, but businesses are able to recover VAT (input tax) on the products and services that they buy in order to produce further goods or services that will be sold to yet another business in the supply chain or directly to a final consumer. In this way, the total tax levied at each stage in the economic chain of supply is a constant fraction of the value added by a business to its products, and most of the cost of collecting the tax is borne by business, rather than by the state. VAT was invented because very high sales taxes and tariffs encourage cheating and smuggling. Critics point out that it disproportionately raises taxes on middle- and low-income homes.

Value Added Tax (VAT) is tax on exchanges. It is levied on the value added that results from each exchange. It differs from a sales tax because a sales tax is levied on the total value of the exchange. For this reason, a VAT is neutral with respect to the number of passages that there are between the producer and the final consumer. A VAT is an indirect tax, in that the tax is collected from someone other than the person who actually bears the cost of the tax (namely the seller rather than the consumer). To avoid double taxation on final consumption, exports are usually not subject to VAT, which led to such consequences, is refunded.

Nowadays VAT has become the major source of government revenue, its contribution to total government revenue is significant and increasing. VAT has replaced sales tax, hotel tax, contract tax, and entertainment tax in Nepal.

So, VAT is a very good tax system although there are so many complication regards to this system. The successful execution of the system depends upon appropriate government policy and awareness in people.

VAT system is the major source of government revenue. In context of Nepal, external source of revenue generation is dominant which ultimately enhance the foreign dependency. Therefore effective mobilization of internal sources is necessary. Thus the study has major focus on the following points:

1. VAT could be an effective and successful to internal resource mobilization, study on the implementation has been made.
2. While conducting a research on VAT implementation, first it is better to study the legal provisions and consideration of VAT system. So, the different legal provisions of "Value Added Tax Act, 2052" have been explained.
3. VAT system has an important feature of tax refund. The procedure of tax refund and judicial trend in tax refund is studied well and analyzed.
4. The study is focus on the contribution of VAT to government revenue.

### **2.1.1 Basic Features of the Nepalese VAT System**

The following are the main features of VAT:

- ) Self-policing;
- ) No cascading of pyramiding effect;
- ) Tax liability on transaction;
- ) Good audit trial/invoice trial;
- ) Catch up effect;
- ) Neutrality on tax;
- ) Single rate and multiple rate can be applied;
- ) Self-assessment system;
- ) Tax credit system;
- ) Wide scope

While Nepal has adopted a conventional VAT similar to that implemented over 125 countries around the world, it has injected some special features into VAT system to make it uniquely Nepalese.

Some of them are as follows (K.C., 2007).

1. The adoption of consumption type of VAT
2. The consumption of VAT through tax credit method.
3. The principle of destination.
4. The provision of exemption and zero are goods and services.
5. The application of VAT to all business turnovers through the retail stages i.e. broad base.
6. The allowance of tax credit for taxable supplies including the zero rate supply.
7. The facilities of tax refunds.
8. The use of single positive rate of 13%
9. The level of thresholds of RS 2 millions

Nepalese VAT is subjected to a standard rate of 13%, however a few transactions of goods and services are zero rated and some are exemption and threshold form VAT.

### **2.1.2 VAT as a Substitute of Sales Tax**

VAT is an improved form of sales tax. It is a substitute for sales tax, hotel tax, contract tax and entertainment tax. It is not a genuinely new form of taxation but merely a sales tax administrated in different form. The prices to be charged under VAT and sales tax do not differ. Under the VAT system, consumers know the amount they are paying in form of VAT but under sales tax system, it was not shown separately in the bill. Though both taxes are collected finally from the consumers, VAT is more transparent then sales tax VAT is levied at each stage from production to sales but sales tax is levied on only certain level of sales (Bhattarai and Koirala, 2004: 18.6).

### **2.1.3 Types of VAT**

VAT has been classified on several bases. The most important of them is the classification of VAT on the base of its treatment to capital goods. Capital goods are such goods which are used more than a year in order to serve or produce revenue goods. VAT can be classified in three categories according to the capital goods treated. They are:

1. GNP type VAT;
2. Income type VAT; and
3. Consumption type VAT (Bhattarai and Koirala, 2004:18.4).

Now, let us discuss each of them in brief.

#### **1. GNP type VAT**

When the firms are not permitted to deduct even the amount of depreciation on capital goods, the tax is imposed on GNP. The base of tax is total consumption goods plus all final product capital goods. The base of tax in GNP types = Gross investment + Consumption = GNP. Group domestic product type VAT neither excludes the purchase of Capital Goods nor the depreciation from the tax base. It means the tax is levied both on consumption and gross investment. Under this type, capital goods purchased by a firm from other firms are not deductible from the tax base in the year of purchase. It also does not allow the deduction of depreciation from the tax base in subsequent years. Tax is levied both on consumption and gross investment. The tax base on this type is gross domestic product.

$$\text{GNP type VAT} = \text{Gross Receipt} - \text{Cost of Intermediate Goods}$$

#### **2. Income type VAT**

In this case, it is not the output of the consumption goods only which is taxed but also capital goods from which depreciation is deductible. Thus, it becomes a tax on net national product and the tax base is the same as that of a personal income

tax without exemptions. The base of the tax in income types = GNP – Depreciation i.e. Net investment + Consumption = NNI (Net National Income). Income type VAT includes all capital goods purchased from other firm in the year of purchase while depreciation is excluded from the tax case. The tax is levied on both consumption and net income. Income Type VAT= Gross Receipt- cost of intermediate Goods - Depreciation. The income type VAT does not exclude capital goods purchased from other firms from the tax base in the year of purchase. This type, however, excludes depreciation from the tax base in subsequent years the tax falls both on consumption and net investment. The tax base of this type is the net national income.

### **3. Consumption type VAT**

Under the consumption type of VAT, all capital goods purchased form other firms in the year of purchases are excluded from the tax base while depreciation is not deducted from the tax base in subsequent year. Since investment is not relieved from the taxation under this variant, the base of tax is consumption. The base of tax in consumption types = Gross National Product – Gross Investment = GNP - GI = Total consumption expenditure. Under consumption type VAT, all capital goods purchased from other firms, in the year of purchase, are excluded from the tax base while depreciation is not deducted from the tax base in subsequent years. The base of tax is consumption since investment is relieved from taxation under this type. In Consumption type VAT system, VAT is not imposed on the purchase of capital goods from other forms and depreciation is not deducted from the tax base in the subsequent years. Consumption type VAT is widely used. So by the term VAT we basically mean the consumption type VAT.

**Consumption Type VAT = Gross Domestic Products - Cost of Intermediate Goods - Cost of Capital Goods**

Among three types of VAT, the consumption variant has been widely used in several countries in Europe and elsewhere in the recent years. Nepal has also adopted this type of VAT. The reason for the popularity of this type is that this variant does not affect decisions regarding investment and growth since it relieves investment techniques in favor of labour-intensive production. On the other hand, since the growth national product variant creates "a substantial disincentive for saving investment and capital intensive production "it is not likely to be a member of tax family of any country. Furthermore, the consumption variant is more attractive than the income variant from the consideration of foreign trade, because the consumption variant is incompatible with the destination principle of tax action which has been used by many countries. In the other hand, the income variant is consistent with the original principle of taxation. This is why many countries selected the consumption variant and why in this study also by VAT we basically mean the consumption variant.

#### **2.1.4 Comparison of VAT with a Sales Tax**

Value added tax (VAT) avoids the cascade effect of [sales tax](#) by taxing only the *value added* at each stage of production. For this reason, throughout the world, VAT has been gaining favour over traditional sales taxes. In principle, VAT applies to all provisions of goods and services. VAT is assessed and collected on the value of goods or services that have been provided every time there is a transaction (sale/purchase). The seller charges VAT to the buyer, and the seller pays this VAT to the government. If, however, the purchaser is not an end user, but the goods or services purchased are costs to its business, the tax it has paid for such purchases can be deducted from the tax it charges to its customers. The government only receives the difference; in other words, it is paid tax on the gross margin of each transaction, by each participant in the sales chain ([www.answers.com/topic/value-added-tax](http://www.answers.com/topic/value-added-tax)).

Sales tax is normally charged on end users (consumers). The VAT mechanism means that the end-user tax is the same as it would be with a sales tax. The main difference is the extra accounting required by those in the middle of the supply chain; this disadvantage of VAT is balanced by application of the same tax to each member of the production chain regardless of its position in it and the position of its customers, reducing the effort required to check and certify their status. When the VAT system has few, if any, exemptions such as with [GST in New Zealand](#), payment of VAT is even simpler.

A general economic idea is that if sales taxes exceed 10 %, people start engaging in widespread tax evading activity (like buying over the Internet, pretending to be a business, buying at wholesale, buying products through an employer etc.) On the other hand, total VAT rates can rise above 10% without widespread evasion because of the novel collection mechanism. However, because of its particular mechanism of collection, VAT becomes quite easily the target of specific frauds like [carousel fraud](#), which can be very expensive in terms of loss of tax incomes for states ([www.answers.com/topic/value-added-tax](http://www.answers.com/topic/value-added-tax)).

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Personal end- consumer of products and services cannot recover VAT on purchase, but business are able to recover VAT (input tax ) on the products and services that they buy in order to produce further goods or services that will be sold to yet another business in the supply chain or directly to a final consumer. In this way, the total tax levied at each stage in the economic chain of supply is a constant fraction of the value added by a business to its products, and most of the cost of collecting the tax is borne by business, rather than by the state. VAT was invented because very high sales taxes and tariffs encourage cheating and smuggling. Critics point out that it disproportionately raises taxes on middle and low income homes.

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In many developing countries such as India, sales tax \ VAT are key revenue sources as high unemployment and low per capital income render other income sources inadequate. However, there is strong opposition to this by many sub-national governments as it leads to an overall reduction in the revenue they collect as well as a loss of some autonomy.

Sales tax is normally charged on end users (consumer). The VAT mechanism means that the end user tax is the same as it would be with a sales tax. The main difference is the extra accounting required by those in the middle of the supply in this disadvantage of VAT is balanced by application of the same tax to each member of the production chain regardless of its position in it and the position of its customers, reducing the effort required to check and certify their status. When the VAT system has few if any, exemptions such as with GST in New Zealand, payment of VAT is even simpler.

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### **2.1.5 Introduction of VAT**

Value added tax is newly developed modern and scientific tax system, which is recently innovated in the field of taxation. It is hybrid taxation from the retail level of sales tax. So VAT is an advance form of sales tax. It has spread all over the world which in a short span of time. It has gained huge popularity in short period of time in a history of taxation.

In the field of taxation, VAT has been considered as an attractive alternative to indirect tax system. It has been emerging as a main element of the worldwide tax reforms although it is the youngest form of taxation innovated in the second half of the twentieth century.

Value added tax is a tax imposed on "value added" by a business firm a goods and services are the successive stage of production and distribution. Value added on a commodity or services is simply the excess of sales value over purchase by business entity. The VAT is collected from seller in the basis of their value added each stage of business process, thus the same value in never taxed twice and never produces cumulative effect.

VAT for a firm is nothing but its gross receipts from sales minus all expenditure on goods and services purchased from other firms. In the production and distribution process, a firm buys materials from other firms. This material may include principle raw materials, auxiliary raw materials, chemical, electricity, and goods such as machinery equipment, building, furniture & vehicles. The firm adds value to these purchased materials by processing of handing them with the help of its own factor of production such as labor, land, capital etc. This increase in the value of output over inputs is the value added by a firm is equivalent to its payment of wages, salaries, rent and interest plus its profit and this value added is the base of VAT.

VAT is new concept of collection revenue. Each step of goods and services are levied to tax on its added value. It covers the value added to each commodity by a firm during all stages of production and distribution and the VAT is shifted forward completely to the ultimate users.

We can able to get a clear concept of VAT through an example. Consider the case of sugar production. A farmer sugarcane and sells it to the miller. Miller adds value in the process of changing sugarcane in to sugar. Value added of miller constitutes all expenditure including profit and miller with an increased value. Ultimately sugar is sold to the consumers with some additional value. Thus, at each stage of production and distribution, value is added as sum total of all such

added value exactly equals to the final sales value of the sugar. The following table shows the simple process of calculating VAT.

In Nepal value added tax (VAT) was introduced on 16 Nov 1997. This tax was levied in place of the sales tax, hotel tax, contract tax and entertainment tax.

**Table 2.1**  
**Simple Process of Calculating Vat**

<b>Stages</b>	<b>Cost Price</b>	<b>Value Added</b>	<b>Selling price Before VAT</b>	<b>VAT @ 13%</b>	<b>Selling price After VAT</b>	<b>VAT to the Government</b>
Producer	-	-	500	65	565	65
Stockiest	500	100	600	78	678	13
Wholesaler	600	100	700	91	791	13
Retailer	700	100	800	104	904	13
Total						104

*Source: Arbitrarily Estimated Figure*

From the above table, by using a VAT rate @ 13% the producer pays of Rs.65 as a VAT to the government. The stockiest collects VAT of Rs.78 in his sales but has an input tax credit of Rs. 65 and thus remits Rs.13 to the government. Likewise, the wholesaler collects VAT of Rs.91 but deducts his input tax Rs. 78, and remits the balance of 13 to the government account. On the same way, retailer collects Rs.104 as VAT and remits Rs. 13 to the government after deduct his input tax of Rs 91. At last; the consumer will pay 104 as VAT. Finally, the government gets total revenue of 104 (i.e. 65+13+13+13) from all stages.

### **2.1.5.1 Exemption**

Exemption simply means the goods and services free from a tax justification. Under this approach goods or services is subject to exemption and input tax incurred there is not refundable. One of the other words, where a supply of a commodity or services is exempt from VAT means the condition where the traders

do not pay VAT. "The exemption, at one of the stages, may be granted only to small firm in that stages as a means of reducing administrative costs relative to revenue. Exemption of the final product may be intended not as completed exemption but only as an exemption of value added to that particular product at the final stages. The tax credit can be restricted accordingly. Such a product may be termed quasi exempt" (Shoup Carlrls S., 1969).

"Exemption means an exclusion of certain kinds of business transaction of a person (who engaged in supplying goods and services) from the tax net. An exempted person does not have to fulfill the formalities e.g. registration, keeping account, issuing invoices and filling of return which are required by VAT. In other words, an exempted person does not have to deal with the VAT administration and pay tax similarly VAT administration has nothing to do with the exempted person" (Khadka Rup Bahadur, 1997).

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

1. Goods and services of basic needs which include rice, pulses, flour, fresh fish, meat eggs, fruits, flowers, edible oil, piped water, wood fuel etc.
2. Basics agricultural products are also tax-exempt for example paddy, wheat, maize, millet, cereals and vegetables.
3. The expenses of buying goods and services required to grow basis agricultural products are tax-exempt. This includes live animals, agricultural, inputs including machinery, manure, fertilizer and pesticides.
4. Social welfare services including medicine, medical services, vegetarian services and educational services.
5. Goods made for the use of disabled persons.

6. Educational and cultural goods and services such as books and other printed materials, radio and television transmissions. Artistic goods, cultural programmes, non-professional sporting events and admissions to educational and cultural facilities.
7. Air transport.
8. Personal services are also tax-exempt. These are services provided, for example, by actors and other entertainers, sportsmen, writers, translators and manpower supplier's agents.
9. Financial and insurance services.
10. Postage and revenue stamps, bank notes, cheque books.

#### **2.1.5.2 Zero - Rating**

Zero rating means taxing goods or services with zero rates. If zero rating is granted for a particular goods, the goods is technically taxable and the tax payer (supplies of goods) is required to fulfilled all the formalities like that of a regular tax payers with of difference that the supplier of zero rated goods is not required to pay tax and he is allowed to claim back the tax, if any one purchases. For example if experts are zero rates, the expert is able to get the refund of the tax on his purchase, which he has used for producing the export items (Shoup Carls S., 1988).

Zero rating is an actual rate of VAT against which credit for VAT paid and inputs can be claimed and thereby a full rebate obtained. So zero-rating a VAT rate has a rate of zero percent, which is imposed on selected goods and services. It is nothing, except a tax-free provision of VAT especially for the selected goods and services.

In most of countries exports are zero rated so that the exporter is able to get the refund of the tax on his purchased, which he has used, for producing the

exportable items. As zero rated items of transaction are within the tax net, although effectively they don't attract any VAT, a purchaser will obtain a repayment of input tax borne in his purchase of goods and services, meaning that zero rated items or transaction if the objective to full exempting. Zero rating is also desirable tax to the poor either not at all or relatively less than well to do. If the zero rates are applied only at the first stages, the tax credit methods work satisfactorily, there is no over taxation (Shop Carls S., 1969). A zero rates goods do not bear any tax at all while and exempted goods may bear a tax element in its price. Further, differentiation between these two aspects is based on the administrative work. Business enterprises concerned with the Zero-rated goods and services are the formal member like all other VAT registered members and hence they have to fulfill the entire formalities associate with the VAT operation. But business enterprises having the transaction of only exempted goods and services have no concern with VAT administration.

### **2.1.5.3 Threshold**

Threshold is a point at which an indexation provision becomes operative. Thus, threshold is a VAT of an upper limit beyond which VAT system is in operation. The traders which have low level of transaction will have a lower revenue yield relative to the compliance cost and either they are capable to fulfill all the formalities of VAT. Further, it will create administrative complexity if all the small vendors are registered in VAT. In such a situation, threshold is also an important provision of VAT, which keeps the small vendors beyond the tax net. Thus, threshold is a kind if exemption, which is based in the amount of the transaction but not on the kinds of goods and services. So threshold must be said on the basis of the production and the distribution system in a country concerned and the extent of education and record keeping at various levels of volume among business firms.

#### **2.1.5.4 Tax Rate**

Rate means positive rate excluding zero rate. Design of tax rate structure is an important aspect of the VAT. The design of rate structure is chiefly influenced by revenue requirement, administrative simplicity efficiency, type of products, tax burden etc. however, the entire requirement can no be achieved simultaneously as one may be contrasting to another.

On the basis of the statistical picture given by those countries adopting: - "VAT as a fiscal instrument with the differential VAT rate in the world". Theoretically and practically, the rate of VAT may be diversified in to two rates. They are:

#### **2.1.5.5 Single VAT Rate**

In simple, single VAT rates means a VAT of which tax rate is fixed only at one number. In other words, if tax rate in VAT is fixed at less than two tax rates for all level including the wholesaler, the producer and retailer. It is said to be single tax rate. For example, suppose if tax rate is 15% it fixed for all level of VAT purposes. The fixed VAT rate is then, known as only single VAT rate. In practice, almost countries of the world favored single VAT rate rather than multiple VAT rates, because it has many merits. Firstly, its singularity brings simplicity, VAT administration side. Secondly, its simplicity reduced the cost of VAT administrative operation. Thirdly, it is easily understandable to the customer, the trader and others. Fourthly, for transparency, it makes easy for record keeping and account will be minimum due to the effectiveness of VAT administration which is stimulated by single VAT rate.

#### **2.1.5.6. Multiple VAT Rate**

Differential VAT rate makes tax burden to higher incomes class more than to lower income class so that the vertical progressive may be stored in thee society.



The gap between the higher income class and the lower income class may distort the economy. Therefore, it should be multiple for the sound economy.

1. Differential VAT rate discourages luxurious life and unproductive expenditure, and encourages social welfare for the lower income class by imposing two different VAT rates.
2. Since multiple VAT rates enlarge its tax coverage by including all kinds of goods and services, the estimated revenue level may be collected. The higher ratio of revenue collection supports the additional development activities.
3. To implement the policy of production especially for domestic products for industrialization, differential VAT rate is suitable instrument that is applied for "discourage imported goods and encourages domestic goods." So, differential VAT rate is protective umbrella for domestic goods.

#### **2.1.5.7 Imported Goods Taxed**

The VAT act schedule I lists imports which are tax-exempt. Some of these include prescription drugs. Basic, groceries, medical devices and agricultural products. Most imports however are fully taxable at customs point. There after these are treated on the same basis as domestically produced goods. The VAT in imported goods is collected by custom. It is calculated on the dutiable value of the goods, in other words on the value of the goods including transportation, insurance, freight and commissions plus any duty or other taxes payable on the goods. The value for the duty of the goods is determined in accordance with the valuation provisions contained in the Customs Act. Registrants may claim input tax credit for the VAT paid on imported goods used in their commercial activities.

#### **2.1.5.8 Exports Goods Taxed**

VAT is applicable only to the consumption of goods and services in Nepal. However, supplies made in Nepal that are exported are taxable at 0%. Exports are allowed to claim input tax credits for VAT paid or payable on purchase of goods

and services relating to their commercial activities. Exports taxed at 0% include exports of both goods and services.

#### **2.1.5.9 Obligations of VAT Registrants**

VAT registrants are required to:

- J Submit VAT return and pay tax within the 25<sup>th</sup> day of the following month
- J Provide their customers with a tax invoice
- J Maintain purchase book, sales book, VAT account
- J Keep the VAT records for a period of 6 years.
- J Inform the IRO of changes to the business including new address, telephone number or a reorganization of a partnership within 15 days.
- J Put their certificate of registration in the premises where customers may easily see and read it.
- J Allow tax officers to enter the business to examine the business records and the stock on hand.

#### **2.1.5.10 Books of Account**

Every VAT registrant requires keeping records of all the invoices either received or issued, including the serial number and date of issue. In general, VAT liability is determined on the basis of the accounts kept by the taxpayers himself. The record should be kept in such a way that VAT authorities are able to check the accuracy of the VAT returns. Such records are kept fairly for long time generally 4 to 6 years. In general account must be maintained on the accrual basis. VAT liability should be calculated accordingly. This is because if it is levied only on the cash basis, taxpayers might delay payments. VAT registrants are required maintain purchase and sales books and its list of all the sales and purchase in the corresponding book. They are also required to prepare for a VAT account.

### **a. Purchase Book**

VAT registrants are required to maintain an account of their business purchase for VAT purpose purchase book refers to the account of the VAT registrant, which includes all the transactions for business purchase. The record must be kept on the basis of invoice. At the end of each accounting period, the VAT registrant must total the amount of taxable purchases/imports; tax exempt purchase, imports and tax paid on purchase/imports.

### **b. Sales Book**

Similarly, VAT registrants are also required to maintain an account of their sales for VAT purpose. Sales book is also an invoice-based account. At the end of each accounting period VAT registrants needs to total the taxable account (standard and zero rated) and tax-exempt sales, they have made in that period and tax collected on sales. If they make both taxable and tax exempt purchase and sales, they are required to calculate the proportion of input tax they are entitled to the tax period.

### **2.1.5.11. VAT Account**

VAT registrants are also required to maintain the VAT account. It is monthly summary of taxable purchases and sales and VAT paid on purchases and changed on sales.

### **Tax Credit and Tax Refund**

Taxpayers (vendors) allowed deducting their input tax form output tax. This is known as tax credit or tax invoice method of tax computation.

The refund is the difference of gap between output tax and input tax, when the amount of input tax is higher than the amount of output tax. Such a situation generally arises in the case of exports because exports are zero-rated and in order to relieve them from the burden of the VAT tax refund takes place. Here output

tax means tax amount which is collected on sales and input tax means paid amount on purchases. The taxpayer may apply to the Inland Revenue office for a refund only if the taxpayer is a regular exported with more than 50% of his sales expected or has more input tax than output tax for a continuous period of at least 6 months.

### **Auditing**

Auditing is the universal method for the control of VAT and prevention of tax evasion. The purpose of the VAT audit is found out according to the law and regulation, the actual VAT liability of the taxpayers.

### **Administration**

Here, administration leads VAT administration. Administration means the management of affairs. Its organization should be strong and reached to the grass root level so that policies and programmes of government can be functioned to the people. VAT administration is responsible for setting operational guidelines, programme development and evaluation, design of forms and instructions, statistical analysis, budget development and resource allocation.

## **2.2 Reviews of Related Studies**

Carl S. 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 firms. He explained VAT, as the difference between sales proceeds and the cost of materials etc. purchased from other firms, which is the tax base of a VAT. He further added, a firm adds value added by processing or handling these purchased items with its labour force and its own machinery, building 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 and

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 did have 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 than turnover) sense, it turns to be equivalent to a corresponding single tax. At each and every stage the value of product is increased and this price rises accordingly, which is the "value added - the tax base."

John F. Due made detail analysis of VAT by means of paper entitled "Value Added Taxation in Developing Economies" published in the book "Taxation and Development Edited by N.T. Many and published by Praeger publishers on the contribution of UN in 1976. The study contained theoretical and implementation aspects of VAT in developing countries. In the real sense, it was the additional theoretical base for VAT which applied and made useful theoretical methodology and made useful recommendations for its implementation.

The major findings derived by the author are as follows:

- i. VAT is regarded as sales tax.
- ii. The distinctive feature of the VAT is that of 'fractional' impact with out cascading effects, since, the tax applies at multi-stages but only to value-added.
- iii. Criteria recommended for evaluation of the tax in developing countries:
  - a. Acceleration of economic growth
  - b. Optimal use of available resources
  - c. An acceptable pattern of income distribution

- d. Reasonable price stability
  - e. Political stability
  - f. Avoidance of foreign domination of the economy.
- iv. VAT is entirely acceptable form of sales tax in comparison to other forms of sales taxes (especially to overcome from the disadvantageous of turnover tax).
  - v. The most important requirements of successful operation of VAT are its universality and simplicity.
  - vi. This portion covers the details of the implementation aspects of VAT.
    - i. The tax law should be drafted by the lawyers related to the tax jurisdictions.
    - ii. If VAT is being replaced for another form of sales tax, the same administrative organization and personnel can be utilized and training should be provided.
    - iii. Registration of the business firms should be operated in great care.
    - iv. Tax returns may be filed at relatively frequent intervals.
    - v. A computer system is the basic need of VAT operation.
    - vi. Inspections and audit should be operated separately by the related careers, crosschecking is the best option.

In the paper entitled "Value Added Tax in the Republic of Korea" Choir Kwang judged the impact of VAT in Korea. The government of Republic of Korea introduced general type of VAT of European model in 1977 with the objective of simplification of tax restructure and administration, the promotion of exports, capital formation and maintenance of neutrality in indirect tax system. The government spent a good number of years for preparation and became success to convey the message that the adoption of VAT benefited the business community in Korea. It showed a good impact on the investment. In its overall evaluation, the VAT has broadened tax base, reduced evasions, increased revenue and solved major problems associated with the previous tax system.

Besides the positive impact stated above, the Republic of Korea experience with VAT had made it clear that it was not so simple in practice. It created more or less arbitrary distortions in trade and consumptions and inequalities in the distribution of tax burden.

In the book "Government Finance in Developing Countries", Richard Goode (1986), described VAT as the most important tax innovation of the second half of the 20<sup>th</sup> century and it was classified as a form at sales tax as consumption. The tax applied to the value added at production and distribution; that is, sales precede less purchase of material input and certain services.

Due and Meyer (1988) examined the VAT in Dominican Republic. Ignoring the hostile reactions of business sector, labour union and even political parties. Vat was introduced in 1983 in Dominican Republic. The increased record-keeping requirement became the main issue in the medium and small sizes business dominated economy of Dominican, also the belief that VAT was responsible for the inflation become another obstacle, but the inflation was due to other reasons. There was general agreement that the enforcement of the tax hadn't been adequate mainly because of lack of personnel. Evasion was wide spread, many firms failed to register. The overall evolution of the tax in the country, therefore remained rather negative. While the tax has brought additional revenue, the inadequate enforcement and failure to extend it to the commercial sector as planned, and the use to making shift, distorting system in the latter have resulted in serious failure to attain the advantage of complete value added tax. The experience of the country with the tax provides a warning to other developing countries not to attempt to use a value added tax expending beyond to import and manufacturing sectors without careful consideration of the ability of the wholesale and retail sector to operate the tax, and general attitude of these sectors towards the tax.

In a seminar "Value Added Tax on Asia" organized by IMF/UNDP, Alan A. Tail (1991), presented a paper entitled "VAT policy issues: structure, regressively, inflation and exports" in Jakarta (Indonesia) and later arranged on the occasional paper (88) IMF Washington D.C. edited by the same author in 1991, mainly concerned on the policy issue of VAT by illustrating some theoretical as well as empirical proofs:

1. VAT provides new buoyant revenue based and improves tax system in terms of neutrality and efficiency.
2. Experience broadly shows that VAT contributes from 12 percent to 30 percent of revenue in most countries representing above 5 to 10 percent of gross national product.
3. VAT is alternative of retailer sales tax. However both do not fully tax the unofficial business but the under reporting of sales value will show up under the VAT.
4. It is preferable that VAT has the capacity of covering all the stage of production to the retail level and the services.
5. VAT simply changes relative prices but not the overall price increase. Tax increase should be deflationary.

Lastly, at least if VAT cannot promote exports world, it makes the system easier. A VAT administration is affected by the decisions regarding: whether all retail sales are included, should services be taxed, choice of proper rates and the treatment of capital goods, financial services, food, small traders.

HMG (1995) formed a high level task force to review Nepal's' tax system, headed by Prof. Dr. Madan K. Dahal. It made 'very useful recommendations for implementing VAT in Nepal. The report suggested VAT instead of existing sales tax and service based taxes like hotel, entertainment, contract tax as a long-term tax reform.



It emphasized the VAT in Nepal to:

- a. Increase the tax revenue by broadening tax base;
- b. Make the system more transparent and elastic;
- c. Prevent tax evasion; and
- d. Make the tax system more efficient and promoting export more easily.

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

- ) A functional organization pattern.
- ) Development of effective tax refunds system.
- ) Research and development.
- ) Extensive taxpayer's education programme.
- ) Computerization for calculating VAT operating and administration
- ) Measure to increase self compliance

Dahal, Madan Kumar (1996), in his article "A few words about VAT" has written "VAT is a most scientific, innovative and powerful tax with built-in quality of universal application for both developed and developing economies. The biggest virtue of VAT is that it is revenue buoyant and highly instrumental for resource mobilization especially in an economy with an acute shortage of resources." He further added, Nepal has entered into a major global tax system with the introduction of VAT. VAT is an account-based tax that leads to transparency and accountability both as the part of taxpayers and collectors. Open border, non-magnetized economy, non-issuance of invoice etc. are major problems that would marginalize the prospects for resource mobilization in Nepal. This calls for introducing stringent regulations to deal with the delinquency of tax, maintaining

records properly and improving efficiency of VAT administration. The success of VAT will have significant bearing on the economy of Nepal."

Nepal Chamber of Commerce (1997), in a study analyzed the possible effects of VAT in the Nepalese economy. Dr. Puspa Raj Karnikar headed the team. The main findings of the study are as follows:

- ) VAT effects adversely in price level;
- ) It increases the price of imported goods;
- ) The account keeping requirements of VAT would increase the tax compliance cost and cost of doing business that would affect the small traders adversely;
- ) Ultimately increases the cost of production and hence reduces the export business;
- ) It would be unjustifiable on social ground; and
- ) Because of inefficient revenue administrative VAT cannot implemented successfully. So it is untimely to implement VAT.

The study report suggested for partial value added tax (VAT) on some commodities. It was in favour of phase-wise implementation of VAT. The study analyzed negative impact of VAT ignoring its positive impact.

Gyawali, Achyut [*Himalayan Times* (Nepali)] in February 20, 2000 in his article "VAT and its implementation" pointed out major issues. The major findings of his article are pointed as:

- ) The businessperson of VAT exempted goods and having transactions below threshold need not register in VAT.
- ) Business firms having transactions below threshold with the business of taxable goods are volunteer to register in VAT.

- ) The businessmen and industrialists transfer the collected amount of VAT to government, so they are the mediator.
- ) The level of awareness of general customer needs to be increased they must know about VAT whether it rises prices of commodity or not, whether they are paying VAT to exempted goods or to non-registered businessmen.
- ) If consumer pay VAT to non-registered businessmen it is worthless since non-registered businessmen cannot collect VAT. If they collect VAT there is a provision to pay double amount of collection as punishment.

Rup Khadka (2000) entitled "*The Nepalese Tax System*" examined and evaluated the value added tax in Nepal from its introduction to its impact on the economy. He covered the reasons for adopting VAT, basic features, operation of VAT, VAT implementation, revenue performance, existing problems of VAT, future strategy, including various data and illustrations.

The book points out following reason for the introduction of VAT in Nepal:

- ) The first and important reason was to develop a stable source of revenue by broadening the tax base.
- ) Nepalese tax system is massively dominated by custom duties but the contribution of custom duties has been decreasing due to reduction in import tariff in line with the liberal economic policies adopted since 1992/93 and in line with the custom duties reform taking place around the world since the early 1990s.
- ) It was necessary to introduce VAT in Nepal to generate revenue required for improving its deteriorating macro-economic performance.
- ) The adoption of VAT was also essential to establish an account-based modern transparent tax system.

Nepalese VAT possesses some basic features as mentioned in this book, they are pointed as:

1. Nepal has adopted a consumption type of VAT.
2. VAT is based on the destination principle.
3. VAT is a broad-base tax.
4. VAT is levied with a single positive rate of 10%.
5. Exports of goods and services are zero-rated.
6. Some goods and services are exempted from VAT.

The level of registration threshold is fixed at Rs. 2 million.

Regarding the revenue performance, Khadka was optimistic in affirming that VAT would generate more and more revenue in the days to come when it was fully operational.

Pointing out the existing problems of VAT in Nepal, the author stated "It is not easy to implement a broad-based VAT in the present Nepalese context where smuggling and under valuation are common and the amount of unauthorized trade is considered to be very significant. This type of trade does not come in the tax net. Since VAT tries to dismantle this type of trade, it is not easily acceptable by those traders who are involved particularly in unauthorized cross-boarder trade. It has also been common to grant many exemptions and incentives under various taxes, including the sales tax system. VAT intended to abolish them, which was necessary to broaden the tax base and rationalize the tax system."

Narayan P. Silwal (2002) in his book *"Value Added Tax: A Nepalese Experience"* had covered all aspect of VAT. In writer's word "VAT is an all stages non-cascading tax system. It extends to all levels of production and distribution. Similarly, it covers all stages and services. Any discrimination in taxing goods or services or exempting any of them renders VAT ineffective." The book gives main

focus on Nepalese tax system. The book clearly analyze why the government of Nepal introduced VAT. HMG announced retail level sales tax at the rate of 10% covering a whole range of goods and services. There was no procedural law to administer it. When RST introduced in Nepal, literacy level was just meager and billing and record keeping was fanciful. In this situation, required revenue could not take place, which in turn into the development expenditures. So that a modern, efficient and neutral tax like VAT was therefore preferred to free from past difficulties.

The writer expressed a version by borrowing HMG declaration that - "Major changes must be made in order to make tax administration fair, efficient and effective. The hostility, harassment and corruption that currently exist between the tax office and the business community must end if Nepal is to have a modern tax system. The business wants the system changed and willing to pay a reasonable tax but they want the system transparent and fair."

Narayan Silwal suggested that a poorly designed VAT accompanied by weak administration would just drain the treasury. So utmost care is necessary while designing a VAT. According to him the following fact were considered while designing a VAT in Nepal.

- ) Tax base issues
- ) Rate structure issues
- ) Exemption issues and
- ) Threshold issues

Finally the author reached in a conclusion that the introduction of VAT provides an opportunity to sweep away the cobwebs and revamp a 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 form VAT depends upon its coverage.

Dr. Roop Jyoti in an article "Problems in VAT Implementation" published in June 15, 2003 in Deshantar magazine, tried to describe the problems of VAT and they are pointed as:

- ) Weak in billing system.
- ) More and unnecessary goods and services are in the area of exemption.
- ) Potential taxpayers are ignoring registration.
- ) Unsatisfactory tax-return.
- ) Delay in tax-return processing.
- ) Increase in unpaid tax amount.
- ) Discussion about the threshold.

Finally, Dr. Jyoti concluded that all these problems of VAT are avoidable. Strong and smooth administration could avoid these problems and VAT should be effective to generate more and more revenue.

### **Research Gap**

The country has experienced the VAT about a decade but very few studies have been conducted on the topic of VAT in Nepalese context. Above all researchers have conducted in different sense either in worldwide coverage or in particular case of any country. Furthermore they were related only with the theoretical aspect. In this study, the researcher has tried to evaluate Nepalese VAT with respect to resource mobilization. This study also analyses problems emerged in VAT with special reference to legal aspect and prospect of VAT.

## **CHAPTER - III**

### **RESEARCH METHODOLOGY**

#### **3.1 Concept of Research Methodology**

The research study focuses particularly on the mobilization of resource through VAT, its laws and regulations and problems and prospects. So the materials of information relating VAT taxation and its various theoretical aspect, empirical results and experiences are taken in the way of this study for its good picture. Actually this is a review of VAT since its conception, decisions, preparation, implementation and results achieved till now. On the basis of survey and by administering the questionnaire and by collecting the published quantitative and qualitative data, this study has tried to analyze and describe the results of the survey which has been supported by both primary as well as secondary data.

#### **3.2 Research design**

To achieve the stated objectives of the study, the study of VAT Act 1996 made for descriptive research whereas analytical research has been carried out In terms of role of VAT in generating government revenue in Nepal. For an empirical research an opinion survey has been conducted. The options of various hundred respondents associated with distinct denominations (groups) i.e. tax administrators, tax experts and tax payers were collected through structured questionnaire with reference to VAT system of Nepal, major problem of VAT system, remedy to minimize corrupt practice existed in Nepalese VAT administration, a use of ineffectiveness of VAT administration, the important factor for effectiveness of VAT including necessary suggestion for achieving effectiveness of VAT in Nepal.

### 3.3 Population and Sample

In order to benefit this research work, 50 sample sizes is selected out of total population from Kathmandu city. Persons included in the sample are carefully selected. The respondents have been divided into four groups. The following table shows the group of respondents and the size of samples.

**Table 3.1**

**Groups of Respondents and Size of Samples from Each Group**

<b>S.N.</b>	<b>Group of respondents</b>	<b>Sample size</b>
1	Tax experts	5
2	Tax officers	5
3	Businessmen\ traders	10
4	Consumer	20
<b>Total</b>		<b>40</b>

### 3.4 Nature and Sources of Data

Primary as well as secondary data have been collected in order to achieve the real and fact result. All the possible and useful data and views as far available have been collected. The major sources of data are as follows:

#### 3.4.1 Primary Data

The major tool used for the collection of primary data is distribution of a questionnaire to a response of persons. A set of questionnaire was developed and distributed to the selected forty respondents in order to get accurate and actual information. The questionnaire was distributed to four tax groups.

#### 3.4.2 Secondary Data

The secondary sources of data are the information derived from books, journals, newspapers, reports and dissertations etc. The major sources of secondary data are: economic survey of various fiscal years and budget speeches, Ministry of Finance, publication of CEDA, Tribhuvan University, reports and records of



department of taxation, Ministry of Finance, dissertation related to VAT available at Central Library of T.U., publications of VAT projects, publication of VAT department and other relevant records and data related to this study.

### **3.5 Data Collection Procedure**

As stated above, data have collected from both primary and secondary sources. Primary data have collected through administration of a questionnaire to responsive persons. A set of questionnaire was developed and distributed to the selected respondents in order to get a accurate and actual information, interviews, informal dialogues and discussions with the concerning scholars have used to some extent with the concerned persons. And secondary data have been collected from different published documents, budgets speech, previous studies, previous research articles, consultant's reports etc.

### **3.6 Data Processing and Analysis**

Processing means a series of operations on data in a research, so as to obtain desire outcome. Analysis means the categorizing, ordering, manipulating and summarizing of data to obtain answers to research questions. The collected information have compiled and tabulated in different headings. These data have to be patronized and graphed into different way so as to make research understandable even at a glance.

### **3.7 Tools for Analysis**

To make research objective, find to accurate result and practicable, different tools are used. The information received in different aspect of VAT from primary and secondary sources was first processed for tabulation and analysis. For the purpose of analysis generally simple statistical tools have been used which are simple percentage method, ranking method, graphs, charts, diagrams, etc.

## **CHAPTER - IV**

### **PRESENTATION AND ANALYSIS OF DATA**

#### **4.1 Revenue Structure of Nepal**

Even after the introduction of planned development, Nepal has been facing growing resource gap rapidly. This need has specially pronounced the urgency in domestic resource mobilization. But in developing nation like Nepal, portions of foreign grants and loans are increasing and have produced bitter experiences. The repayment of principal and interest has produced burden and has decreased resource for the social welfare activities and no doubt that the existence of government proofs by the activities of government which enhance the economic and social status of the people. In order to perform such social oriented programs, government needs huge amount of resources. Such type of economic revenues is collected from internal and external sources. Total revenue is comprised up of total tax revenue and total non-tax revenue. Tax revenue consists of customs, taxes imposed upon consumption and production of goods and services, taxes as property and income etc. And non-tax revenue is composite of fees, fines, penalties, dividend, interest, sales of goods and services and other miscellaneous receipts.

In developed economy economic like USA, UK etc. direct tax pays a leading role for the internal resource mobilization where as in developing countries like Nepal, indirect tax pays pioneering role by dominating direct tax. In general, how much direct tax can mobilize the internal resource shows the magnitude of economic development. But in the context of Nepal, indirect taxation is the principle source to general revenue. So, to divert the economy in the channel of development, it is necessary to increase the share of direct tax, ultimately decreasing the share of

indirect tax. Therefore, the attention should be focused on the sufficient resource mobilization through direct taxation.

Direct tax is actually paid by the person on whom it is imposed legally 32. By definition, direct tax is a charge imposed by governmental authority up to property, individual or transaction to raise money for public purpose 33. Direct tax is a levy by the government on the income and wealth received by households and business enterprise in order to raise revenue and as an instrument of fiscal policy. Direct tax is so called because it is normally assumed that the real burden of payment falls directly on the person or the business enterprises immediately responsible for paying them and can be passed on to anybody else. Direct tax is progressive so far as the amount paid varies significantly according to the income and wealth of the taxpayer.

With very limited tax base and narrow coverage, direct tax in Nepal seems too less effective to mobilize the domestic resources. Although it is an inevitable instrument of the fiscal policy and hence, it must be designed and practiced properly. In general, revenue productivity of the direct tax goes on increasing as the economy of the countries grows over time. If the economy growth increases, per capita income per annum of the country will automatically raise. In depth it means that he possesses the ability to pay direct tax. Thus, the magnitude of direct tax goes up and substitutes in the place of indirect taxes magnitude. So higher magnitude of the direct tax indicates to the less developed or developing country and hence country need to accelerate the growth path to substitute the share of direct tax is less than other developing economies like Pakistan, Bangladesh, etc. Thus, it lies as a minor source of tax revenue source of Nepal. Direct tax in Nepalese economy is composed of different taxes namely income tax, land tax, property tax, wealth tax, interest tax, and tax on registration.

In the current situation, income tax is one of the major sources of direct tax. Nepal is levying four different types of income tax. Its categories are individual income tax, corporate income, tax, house rent tax and interest tax. On the other side, property tax is another major direct tax. It includes land revenue, Bhumikar, house and land registration and house and land tax. The average largest share in the direct tax is occupied by income tax.

The major component, of indirect tax in Nepalese tax structure constitutes custom duty, excise duty, sales duty, sales tax/ VAT and context tax. Custom duties are composed of mainly import duties. Other component of indirect tax like entertainment tax, hotel tax and other tax contribute very nominal share because they are included in VAT.

Like tax revenue, non-tax revenue is another source of the government revenue in the structure. It is not imposed compulsory by public authority to the tax payers. Fees, fines, penalties, dividend interest, sales of goods and service etc are the bases of non tax revenue. The composition of non tax revenue in Nepalese tax system is of the following factors such as charges, fees, fines, forfeitures, receipts from sales of commodities and services, dividends, royalty, sales of fixed assets, principle and interest payment etc. "While there is some scope of generating more revenue through the operational performances, these sources can not be used effectively as a revenue raised since most of these sources are levied not for revenue purposed."

#### 4.1.1 Composition of Tax Revenue

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

**Table 4.1**  
**Composition of Tax Revenue**

(Rs. in million)

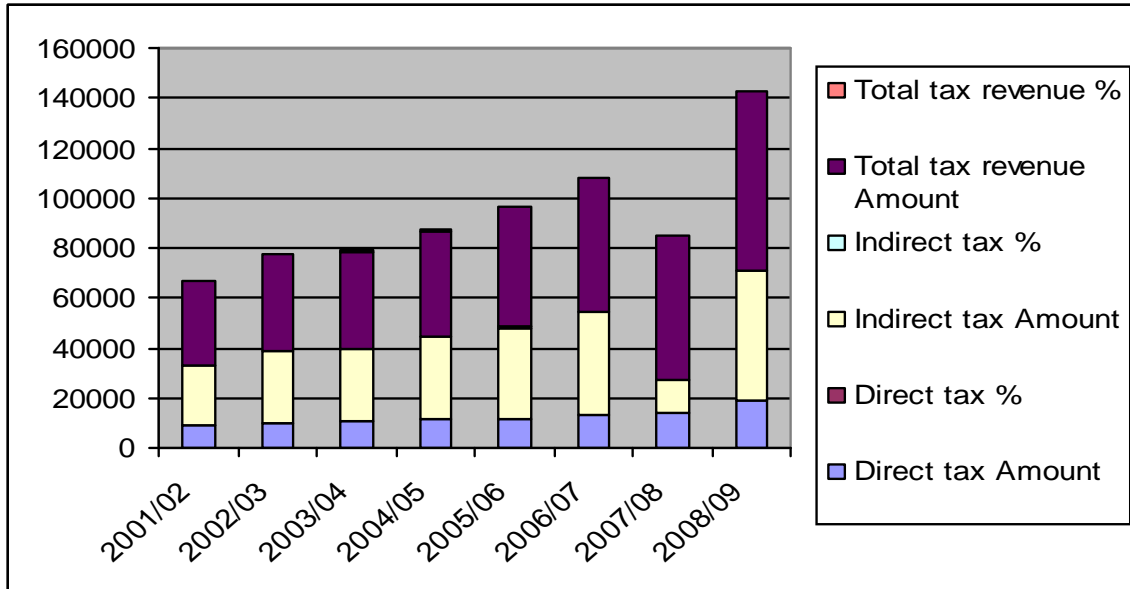
FY	Direct tax		Indirect tax		Total tax revenue	
	Amount	%	Amount	%	Amount	%
2001/02	8951.5	27	24200.6	73	33152.1	100
2002/03	10159.4	26.14	28705.7	73.85	38865.1	100
2003/04	10597.5	26.94	28733.1	73.055	39330.6	100
2004/05	11799.3	27.72	32486.7	72.27	42566.0	100
2005/06	11895.5	24.69	36264.5	75.30	48160.0	100
2006/07	13071.8	24.16	41032.9	75.83	54104.7	100
2007/08	13968.1	24.32	13461.9	75.67	57430.0	100
2008/09	18980.3	26.66	52187.7	73.33	71168.0	100

*Source: Economic Survey of Various Fiscal Years*

From the above data we can conclude that in developing countries like Nepal indirect tax plays a vital role in revenue generation. Direct tax has been drawn least in the FY 2006/07 (24.16) and the greatest value reached in the FY 2004/05 (27.72 %). Similarly, indirect tax has the lowest indication in the FY 2004/05 (72.27 %), and the highest value reached in the FY 2006/07 (75.83 %)

We can present the above data in the following bar diagram:

**Diagram 4.1**  
**Composition of Tax Revenue**



#### 4.1.2 Tax GDP Ratio in Nepal

The tax GDP ratio has been shown in table 4.2, the table shows rather disappointing scenario of tax GDP ratio for the study period. In FY 2001/02 the ratio is 9.05 which has increased to 13.23 in FY 2002/03, and again it slightly decreases to 9.72 in 2003/04 and 2004/05, 2005/06, 2006/07, 2007/08 and 2008/09 is 9.77, 9.69, 10.14, 8.78 and 9.78 % in GDP respectively.

**Table 4.2**  
**Tax GDP Ratio in Nepal**

(Rs. in million)

FY	GDP	Total Tax Revenue	% of GDP
2001/02	366251	33152.1	9.05
2002/03	293566	38865.1	13.23
2003/04	404482	39330.6	9.72
2004/05	435531	42566.0	9.77
2005/06 <sup>R</sup>	496745	48160.0	9.69
2006/07 <sup>P</sup>	533538	54104.7	10.14
2007/08	654055	57430.0	8.78
2008/09	727089	71168.0	9.78

*Source: Economic Survey and Budget Speeches of Various Fiscal Years*

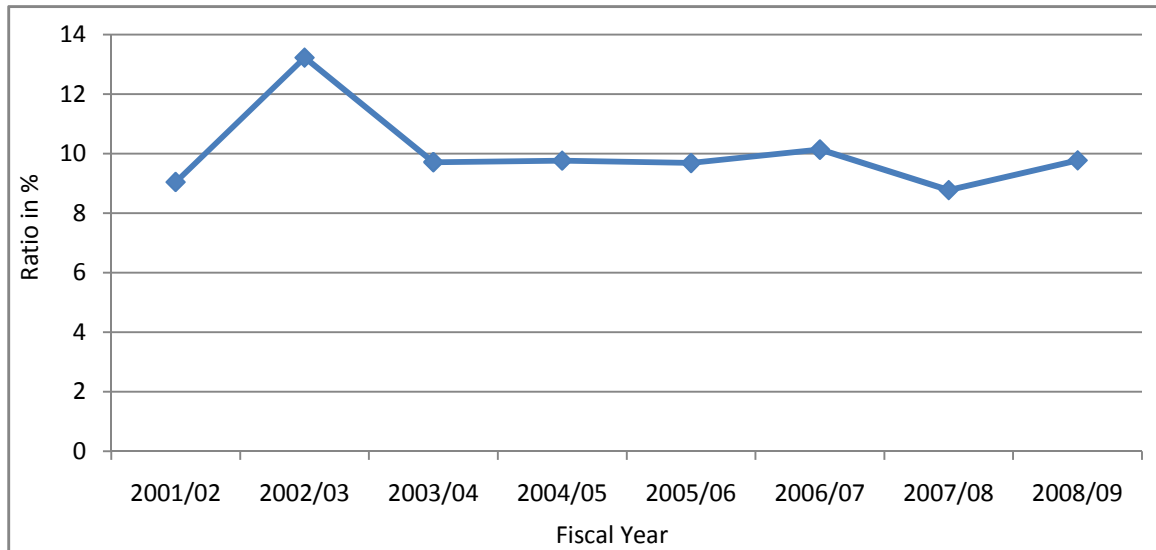
Where,

R = Revised estimate

P = Preliminary estimate

The above table can amicably be presented in the following line diagram:

**Diagram 4.2**  
**Tax GDP Ratio in Nepal**



#### 4.1.3 Contribution of VAT in Total Revenue

The following table shows the contribution of VAT in total revenue.

**Table 4.3**  
**Contribution of VAT in Total Revenue**

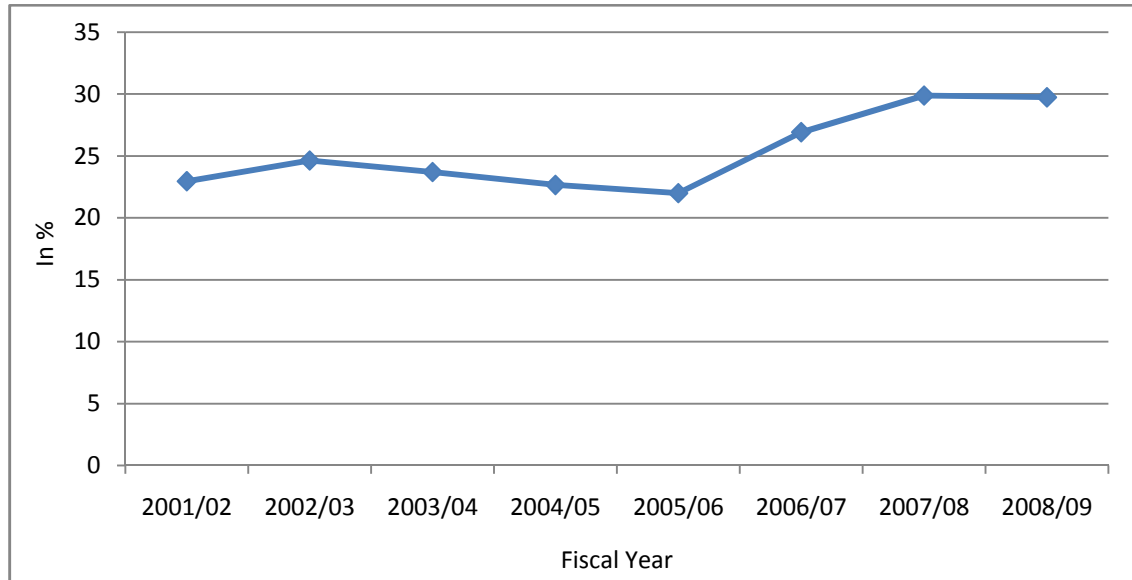
(Rs. in million)

FY	Total Revenue	VAT Revenue	% of VAT Revenue
2001/02	42893.7	10259.7	22.97
2002/03	48983.9	12382.4	24.64
2003/04	50445.6	12267.3	23.71
2004/05	56229.8	13459.7	22.67
2005/06	62302.6	14478.9	22.01
2006/07	70122.7	18885.4	26.93
2007/08	72279.1	21610.7	29.89
2008/09	87712.1	26095.6	29.75

Source: Budget Speeches of Various Years

In the Table 4.3, the lowest percent of VAT revenue is of 2005/06 (22.01); and the highest is of 2007/08 (29.89 %). It shows the increasing trend of the VAT revenue. We can present the above data in the following pie diagram also:

**Diagram 4.3**  
**Contribution of VAT in Total Revenue**



#### 4.1.4 Contribution of VAT in Total Tax Revenue

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

**Table 4.4**  
**Contribution of VAT in Total Tax Revenue**

(Rs. in million)

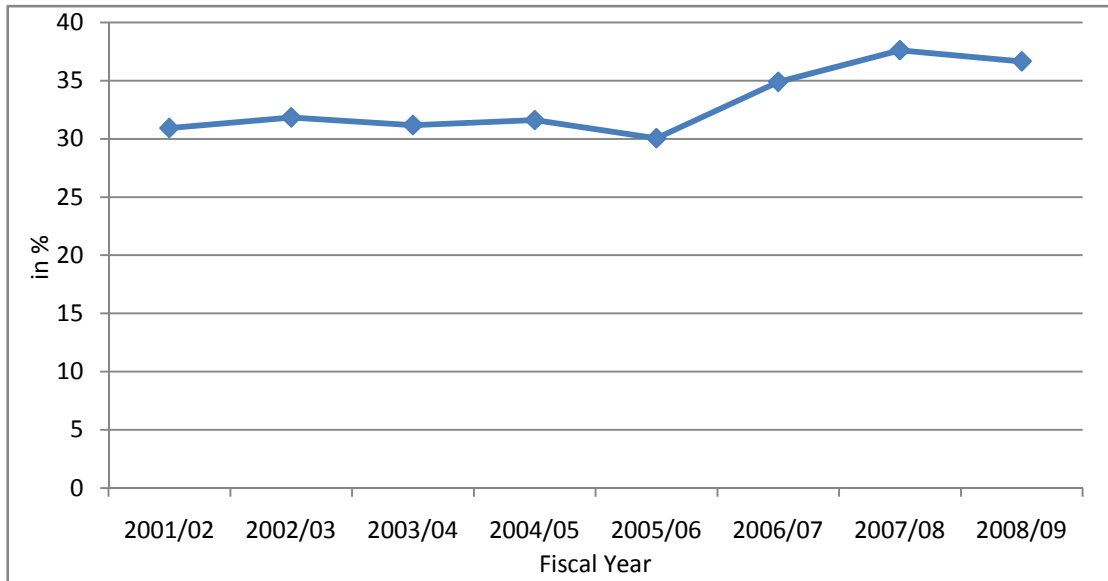
FY	Total Tax Revenue (Rs.)	VAT Rs.	Contribution of VAT in total tax revenue %
2001/02	33152.1	10259.7	30.94
2002/03	38865.1	12382.4	31.85
2003/04	39330.6	12267.3	31.19
2004/05	42566.0	13459.7	31.62
2005/06	48160.0	14478.9	30.06
2006/07	54104.7	18885.4	34.90
2007/08	57430.0	21610.7	37.62
2008/09	71168.0	26095.6	36.66

*Source: Budget Speeches of Various Fiscal Years, MOF*



As indicated above table, the lowest contribution of VAT in total tax revenue is of the FY 2005/06 (30.06); and the highest is of 2007/08 (37.62 %). Hence the contribution of VAT in total tax revenue is more and attracting further; it is in increasing style.

**Diagram 4.4**  
**Contribution of VAT in Total Tax Revenue**



#### 4.1.5 Share of VAT in Total Indirect Tax

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

**Table 4.5**  
**Share of VAT in Total Indirect Tax**

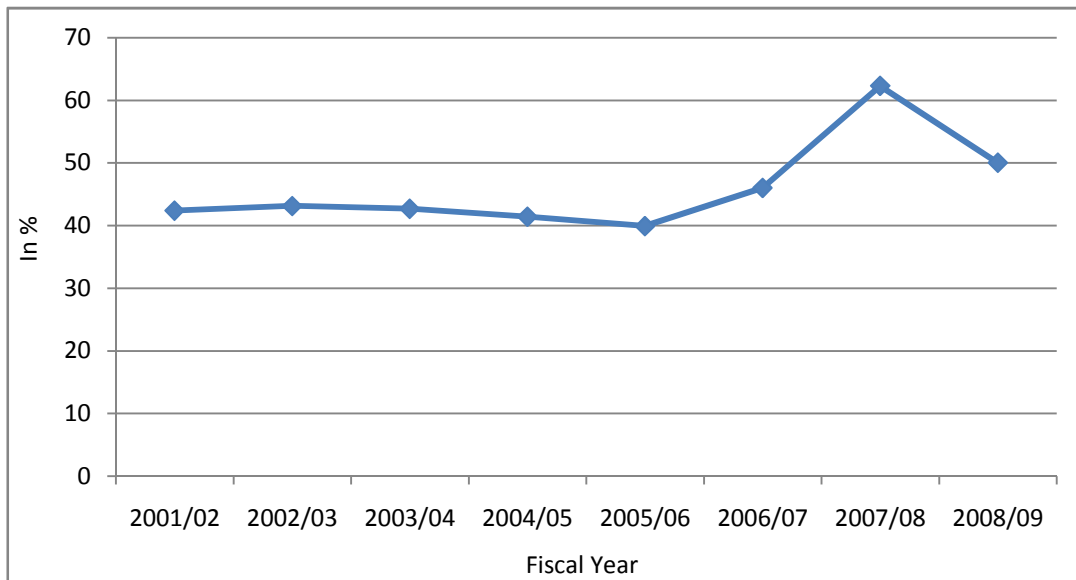
(Rs. in million)

FY	Total Indirect Tax	VAT Revenue	Percentage of VAT Revenue
2001/02	24200.6	10259.7	42.39
2002/03	28705.7	12382.4	43.13
2003/04	28733.1	12267.3	42.69
2004/05	32486.7	13459.7	41.43
2005/06	36264.5	14478.9	39.92
2006/07	41032.9	18885.4	46.02
2007/08	13461.9	21610.7	62.29
2008/09	52187.7	26095.6	50.03

Source: Budget Speeches of Various Years

The table shows that the contribution of VAT in total indirect tax revenue is more and attractive. According to the table 4.5, the lowest contribution of VAT is of the FY 2005/06 (39.92); and the highest contribution is of 2007/08 (62.29). The trend of the VAT is fluctuating from 2001/02 to 2008/09.

**Diagram 4.5**  
**Share of VAT in Total Indirect Tax**



#### **4.1.6 Share of VAT in Total GDP**

As shown in the table 4.6, the share of VAT in GDP is 2.80 in FY 2001/02, it has increased to 4.21 in 2002/03 and slightly decreased till 2005/06. Then again, it has slightly increased till the FY 2008/09.

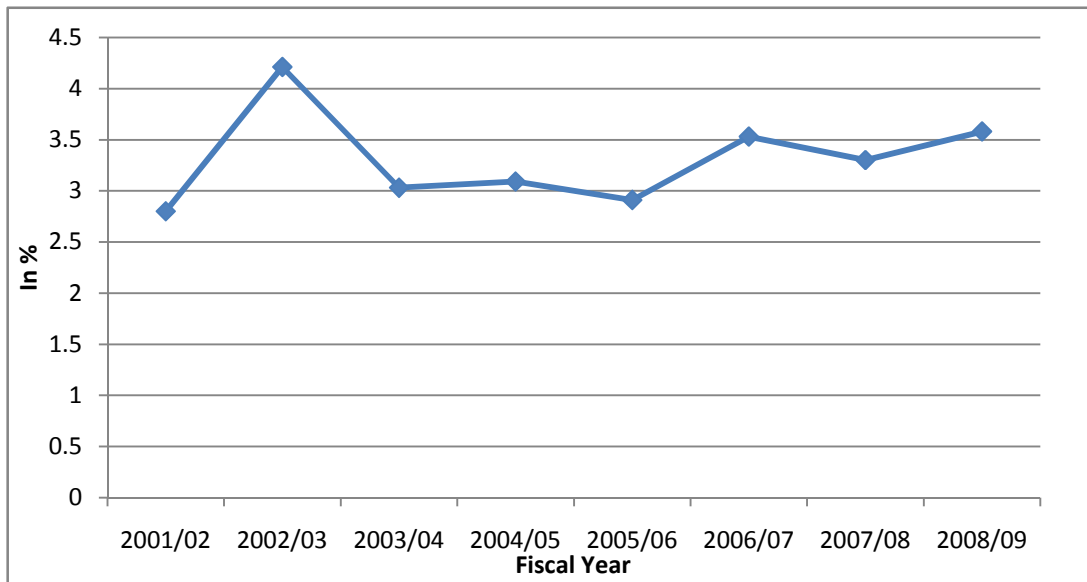
**Table 4.6**  
**Share of VAT in Total GDP**

(Rs. in million)			
<b>FY</b>	<b>GDP</b>	<b>VAT revenue</b>	<b>% of VAT revenue</b>
2001/02	366251	10259.7	2.80
2002/03	293566	12382.4	4.21
2003/04	404482	12267.3	3.03
2004/05	435531	13459.7	3.09
2005/06	496745	14478.9	2.91
2006/07	533538	18885.4	3.53
2007/08	654055	21610.7	3.30
2008/09	727089	26095.6	3.58

*Source: Economic Survey and Budget Speeches of Various Fiscal Years*

The table can also be presented in the following line diagram:

**Diagram 4.6**  
**Share of VAT in Total GDP**



#### **4.1.7 The Composition of VAT Revenue**

The revenue collection from VAT can be divided into two major components as domestic and imports. The current trend show that about one third of total revenue

comes through domestic products and two third form imports the following table shows the trend in composition of VAT revenue.

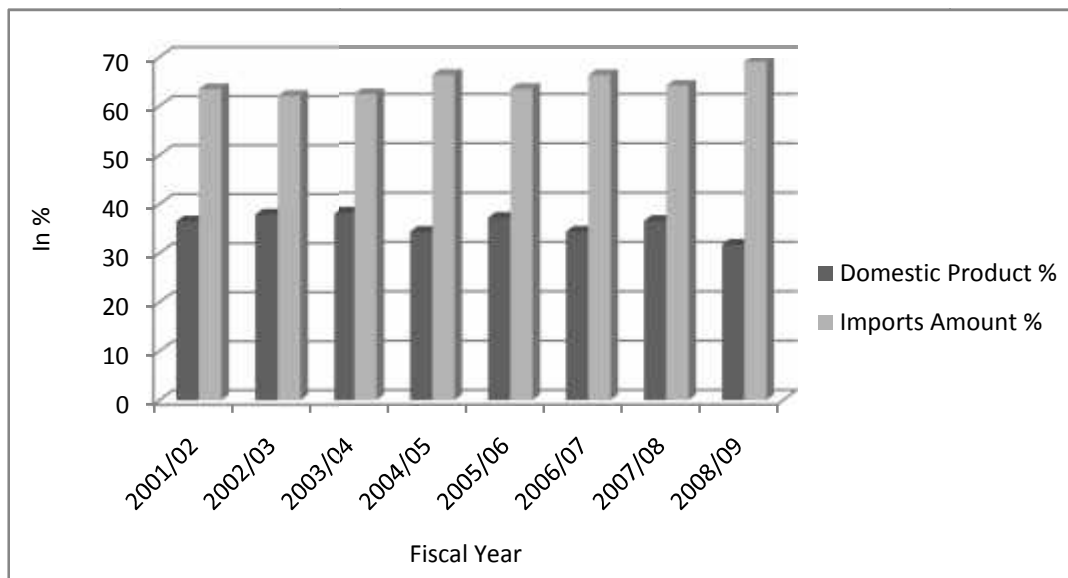
**Table 4.7**  
**Composition of VAT Revenue**

(Rs. in million)

FY	Total VAT Revenue	Domestic Product		Imports Amount	
		Amount	%	Amount	%
2001/02	10259.7	3744.7	36.50	6109.8	63.50
2002/03	12382.4	4698.6	37.90	7349.2	62.10
2003/04	12267.3	4665.5	38.00	7296.6	62.00
2004/05	13459.7	4588.8	34.10	8157.8	65.90
2005/06	14478.9	5348.9	36.94	8366.3	63.075
2006/07	18885.4	6445.9	34.13	12299.1	65.86
2007/08	21610.7	7845.8	36.30	11744.6	63.69
2008/09	26095.6	8213.6	31.48	13626.1	68.52

*Source: Budget Speeches of Various Fiscal Years*

**Diagram 4.7**  
**Composition of VAT Revenue**



In fiscal year 2001/02 to 2008/09 the share of domestic products and imports in total VAT revenue, the lowest was in the FY 2008/09 (31.48 %), and the highest is

of 2003/04 (38 %). And, in imports, the lowest is of the FY 2003/04 (62 %) and the highest is of the FY 2008/09 (68.52 %). This shows that, wherever the import is higher, the value of domestic products is lower and vice versa.

What the figure shows is that the share of imports in total VAT has been declining continuously, whereas share of domestic products has been increasing.

## 4.2 Analysis of Primary Data

**Table 4.8**  
**Knowledge about VAT**

a) Sufficient Knowledge b) No knowledge c) Only listening d) Little

S.N	Group of Respondents	Sample Size	A	B	C	D
1.	Tax experts	5	5	0	0	0
2.	Tax officers	5	5	0	0	0
3.	Businessmen	10	10	0	0	0
4.	Consumers	20	10	2	5	3
Total		40	30	2	5	3
Percentage		100 %	75 %	5 %	12.5 %	7.5 %

*Source : Field Survey, 2010*

Table 4.8 shows that most of the respondents (75 %) have the knowledge about VAT. Yet, the government authorities are found weak as they could not launch public awareness programmes to the general public. Some general public (12.5 %) have only listening about VAT, without the thorough knowledge on its major substance and implication.

**Table 4.9**  
**VAT Paid to Whom?**

a) Government    b) Businessmen    c) I don't know

S.N	Group of Respondents	Sample Size	A	B	C
1.	Tax experts	5	5	0	0
2.	Tax officers	5	5	0	0
3.	Businessmen	10	10	0	0
4.	Consumers	20	11	7	2
Total		40	31	7	2
Percentage		100 %	77.5 %	17.5 %	5 %

*Source : Field Survey, 2010*

Major portion of the sampled respondent (77.5 %) are of the opinion that VAT will be paid to the government. Yet, another larger portion (17.5 %) is of the opinion that VAT will be paid to businessmen. This shows that 17.5 % don't exactly know the source and the end of VAT.

**Table 4.10**

**Challenges Being Tackled in Implementation of VAT in Nepal**

a) lack of awareness rules and education    b) Selfish motive of the private sector  
d) Self motive of the personal    d) Loose mechanism of the government    e) All of above

S. N	Group of Respondents	Sample Size	A	B	C	D	E
1.	Tax experts	5	0	3	2	0	0
2.	Tax officers	5	0	3	2	0	0
3.	Businessmen	10	3	1	1	3	2
4.	Consumers	20	4	1	2	3	10
Total		40	7	8	7	6	12
Percentage		100%	17.5 %	20 %	17.5 %	15 %	30 %

*Source : Field Survey, 2010*

Table 4.10 displays that most of the respondents think that all the four alternatives are required for proper implementation of VAT. Yet, 20 % of the respondents think that selfish motive of the private sector is the main challenge.

**Table 4.11**  
**View at Billing System**

a) Possible   b) Impossible   c) Most Implemented   d) I don't know

S.N	Group of Respondents	Sample Size	A	B	C	D
1.	Tax experts	5	2	0	3	0
2.	Tax officers	5	3	0	2	0
3.	Businessmen	10	3	2	4	1
4.	Consumers	20	6	3	6	5
Total		40	14	5	15	6
Percentage		100%	35 %	12.5 %	37.5 %	15 %

*Source : Field Survey, 2010*

Table 4.11 shows that 35 % of the total respondents are positive on the proper billing system. It also shows that 15 % don't know what the billing system is. Most of the experts (60 %) are of the opinion that billing system have mostly been implemented.

**Table 4.12**  
**Price Rise Due to VAT System**

a) Yes          b) No          c) I don't know

S.N	Group of Respondents	Sample Size	A	B	C
1.	Tax experts	5	0	5	0
2.	Tax officers	5	0	5	0
3.	Businessmen	10	8	0	2
4.	Consumers	20	8	5	7
Total		40	16	15	9
Percentage		100 %	40 %	37.5 %	22.5 %

*Source : Field Survey, 2010*

Table 4.12 displays that 40 % of the respondents are of the opinion that price will be raised due to VAT system. 37.5 % believe that price will not be raised due to VAT system. In fact, VAT will increase the price of the commodities because it is indirect tax and that tax will be collected by the customers and paid to the government by the business people.

**Table 4.13**

**Tax Burden of VAT to the Tax Payers**

a) Higher    b) Lower    c) Normal    d) Zero    e) I don't know

S.N.	Group of Respondents	Sample Size	A	B	C	D	E
1.	Tax experts	5	0	0	1	4	0
2.	Tax officers	5	0	0	3	2	0
3.	Businessmen	10	4	0	4	2	0
4.	Consumers	20	1	1	6	7	5
Total		40	5	1	14	15	5
Percentage		100 %	12.5 %	2.5 %	35 %	37.5 %	12.5 %

*Source : Field Survey, 2010*

Table 4.13 displays that 37.5 % respondents are of the opinion that there will be nil burden to the tax payers due to VAT system. 25 % experts are of the opinion that burden will be normal to the tax payer. 2.5 % respondents think that burden will be lower to the tax payers. 40 % of the businessmen think that burden will be high. It shows that the people who are indulged in illegal business, they feel burden of tax because they are afraid of showing all the transactions of the firm to the government and finally as if they have to pay more tax.



**Table 4.14****Sufficiency of Current Legal Provisions and Rules of VAT in Nepal**

a) Yes      b) No      c) Moderate      d) I don't know

S.N	Group of Respondents	Sample Size	A	B	C	D
1.	Tax experts	5	3	0	2	0
2.	Tax officers	5	2	0	3	0
3.	Businessmen	10	0	7	3	0
4.	Consumers	20	5	5	5	5
Total		40	10	12	13	5
Percentage		100%	25 %	30 %	32.5 %	12.5 %

*Source : Field Survey, 2010*

Table 4.14 displays that out of 30 % of total respondents, 70 % businessmen are strongly opposing the present legal provisions. It is a pathetic that out of 12.5 % of the respondents, 25 % consumers do not know at all about the legal provisions of tax. 30 % of the total respondents are of the opinion that present VAT system is not sufficient and thus should better be improved.

**Table 4.15****Suggestion offered for the better implementation of VAT in Nepal**

S.N	Group of Respondents	Sample Size	Government should follow hard and fast techniques, rules and mechanisms	Mass awareness should be exercised	Every citizen should think that it is their duty to involve in the state action	Transparency and e-governance should be followed
1.	Tax experts	5	19	20	21	20
2.	Tax officers	5	20	20	19	19
3.	Businessmen/ traders	10	20	15	12	15
4.	Consumers	20	36	16	18	30
Total		40	95	71	80	84
Percentage		100%	29 %	21.5 %	24.24 %	25.45 %

*Source : Field Survey, 2010*

Table 4.15 displays that highest portion of the respondents (29 %) are of the opinion that government should follow hard and fast techniques, rules and mechanisms. Mass awareness has received least priority (21.5 %) among the four alternatives. Tax experts and officers have not so much discriminated among the four alternatives.

**Table 4.16**

**Main Problems of Present VAT System in Business Sector**

a) Registration b) Account Keeping c) Billing System d) I don't know

S.N	Group of Respondents	Sample Size	A	B	C	D
1.	Tax experts	5	0	0	5	0
2.	Tax officers	5	0	0	5	0
3.	Businessmen	10	3	1	5	1
4.	Consumers	20	0	0	12	3
Total		40	3	1	27	4
Percentage		100%	7.5 %	2.5 %	67.5 %	10 %

*Source : Field Survey, 2010*

Table 4.16 shows that 67.5 % respondents think that billing system is the main problem of VAT system in business sector. Out of 67.5 % of the respondents, 100 % experts and tax officers focused on billing system. Yet, 10 % respondents have nil knowledge about the problems of VAT system.

Billing is the main problem of present vat system because the seller has various products including VAT and non-VAT. Customers also don't know the items which is VAT-able and which is not. Customers will buy all the items, so in this case billing will be the problem. Again, for the seller they have to keep all the gray market products and real market products where grey market products will not make any impact on VAT and real market goods will impact on VAT and stock. So in this case, billing is the problem and main problem is grey market.

**Table 4.17****Major Weaknesses of VAT Administration**

- a) Lack of expert    b) Lack of trained man power    c) Lack of physical structure  
 d) Weak economy    e) I don't know

S.N	Group of Respondents	Sample Size	A	B	C	D	E
1.	Tax experts	5	0	4	0	1	0
2.	Tax officers	5	2	3	0	0	0
3.	Businessmen	10	5	5	0	0	0
4.	Consumers	20	3	13	2	1	1
Total		40	10	25	2	2	1
Percentage		100 %	25 %	62.5 %	5 %	5 %	2.5 %

*Source : Field Survey, 2010*

Table 4.17 concludes that lack of trained man power is the main weakness of VAT administration. Out of 62.5 % of the respondents, 80 % of the experts focused on lack of trained man power. 25 % of the respondents are of the opinion that lack of expert is also another major weakness of VAT administration.

**Table 4.18****Efforts Needed to Make VAT Effectively Successful**

S. N.	Group of Respondents	Sample Size	Strengthen and improve VAT administration	Train and educate the citizen about the value of tax paying	Improve VAT law and regulations	Launch public aware-ness programmes
1.	Tax experts	5	21	21	19	21
2.	Tax officers	5	17	21	21	21
3.	Businessmen	10	20	15	12	15
4.	Consumers	20	32	22	14	27
Total		40	90	79	76	84
Percentage		100%	27.35 %	24 %	23.10 %	25.53 %

Table 4.18 shows that all the four alternatives are of almost equal value to make vat effectively successful. Yet, strengthening and improvement of VAT administration has deserved highest priority (27.35 %) to make VAT effectively successful. Second priority goes on to launching public awareness programmers (25.53).

**Table 4.19**  
**Major Challenging Problems of VAT System**

<b>S.N.</b>	<b>Group of Respondents</b>	<b>Sample Size</b>	<b>Smuggling and Under-valuation</b>	<b>Lack of proper billing</b>	<b>Legal provisions</b>	<b>Mass awareness</b>
1.	Tax experts	5	22	21	13	18
2.	Tax officers	5	17	21	21	21
3.	Businessmen	10	28	32	27	30
4.	Consumers	20	29	20	27	25
Total		40	96	94	88	94
Percentage		100%	25.80 %	25.26 %	23.65 %	25.26 %

Table 4.19 shows that all the four alternatives deserve almost equal and importance. Yet, lack of mass awareness and lack of proper billing have deserved higher priorities both (25.26 %).

# **CHAPTER - V**

## **SUMMARY, CONCLUSION AND RECOMMENDATIONS**

### **5.1 Summary**

Value added tax is a tax imposed on "Value added" by business firms on goods and services at the successive stages of production and distribution "value added" on a commodity or services is simply the excess of sales value over purchases by a business entity. VAT is multiple stage commodities and service based one of the best form of sales tax.

The VAT has been considered as an attractive alternative to existing indirect system, spreading around the world at a speed which is unmatched by any other tax in the recent time. It is the youngest form of taxation innovated in the second half of the twentieth century; it has been emerging as a main element of the world wide tax reforms. Since Nepal is severely defeated by the problems of fiscal deficits, resource gap and foreign debt servicing, VAT was conceived as an effective neutral and more productive tool for mobilizing domestic resources.

The VAT is collected from sellers on the basis of their "value added" at each of the stages of business process, thus the same value is never taxed twice and never produces cumulative either. Burden of the VAT is presumably shifted forward to the consumer. The optimum base of VAT is gross national product. The VAT firstly launched in France in 1954 however it was introduced by German industrialist Carl F. Van Siemen.

In the Nepalese context, VAT was implemented in 16 Nov. 1997 when the tax system review task force headed by Prof. M.K. Dahal proposed and recommended to implement VAT. The structure of Nepalese VAT is designed in VAT act 2052.

Its coverage is defined with reference to both taxable transactions and taxable persons. The base of VAT is the value added by each firm through its production and distribution activities. According to VAT act 2052 the tax rate is 10% (now changed to 13%) and exports are subject to rate of zero %. There are certain cases such as exemptions and zero ratings under which commodities are tax free. A taxpayer is allowed to deduct the tax paid on purchase for his business from the collected on sales. This deduction is known as an input tax credit. Under the Nepalese VAT system, there is a provision for the refund of VAT. Such a situation arises in the case of zero rated supplies such as export. Small vendors having an annual turnover of certain amount (Rs. 2 million) are not required to register under the VAT system.

Among the various type of VAT, gross national product type, income type and consumption type, the later one excludes capital goods from its base, thus do not penalize investment and growth. It is considered to be neutral regarding the methods of production and administratively feasible. Three principal methods, ensuring the VAT base are additions subtraction method and invoice or tax credit method. The invoice method is more popular in the world. VAT paid on total purchases minus VAT paid on total sales by a firm is the net VAT liability under this method. While addition method adds factor products and sales value minus purchases under the subtraction method. The tax credit method is considered as a tool for cross-checking measures under the VAT system. In this sense, VAT is said to be self-policing in nature to adjust international trade VAT uses one of the two principles i.e., origin or destination principle. In Nepal, consumption type, tax credit method VAT based on the destination principle with single positive rate of 13% is in practice.

Nepal introduced VAT system for several reasons. It was necessary to introduce such a tax to develop a stable source of revenue, to broaden the tax base, to

promote economic growth to generate revenue required for improving its deteriorating macro economic performance, to establish an account based modern transparent tax system, to make the tax system more scientific to gain the confidence of donors, and to make the Nepalese tax system effective.

In the empirical study, the analysis has been done about VAT on the basis of information collected from experts, tax officers, businessmen, and consumers. The tool basically used is questionnaire. The questions were asked to 40 different individuals related to this field. Empirical as well as theoretical analysis shows that VAT is superior to other types of sales tax. Not only that, most of respondents have also viewed VAT as best instrument for resource mobilization, bright future and discouraging illegal business. Similarly, most of the respondents (especially tax experts, VAT officers), argued that billing problem, open border, administrative incapability as haunting problem. They also discussed about legal provisions, choice between single or multi-rated VAT, behavior of tax personnel, rate of VAT, need of public awareness programmed etc.

Nepal introduced VAT system because of several reasons. It was necessary to introduce such a tax system to develop a stable source of revenue to broaden the tax base to promote economic growth, to generate revenue required for improving its deteriorating macro economic performance, to establish an account based modern transparent tax system, to make the tax system more scientific, to gain the confidence of donors and to make the Nepalese tax system effective.

In the previous days of VAT implementation it had to face so many protests. It had become very difficult to convince people and business vendors about the effectiveness of VAT. The IRD conducted many programmes to aware people about its applicability and proved that VAT is not extra burden to people but is the modified form of sales tax which reduces the tax burden by removing cascading

effects of sales tax. It has been about 13 years of VAT implementation and now people are now aware of VAT. However, it has not reached that position where it would have been. Number of VAT registrants is increasing per year. But there is still a need of effective programmed to bring the large number of potential business vendors under the VAT registration.

The contribution to government revenue is significant. Since, VAT is a broad based tax system; it is obvious that it should contribute significantly to the revenue. The contribution to revenue has the increasing trend. However, the share of VAT in GDP is very low. The most of the share of VAT is contributed from import. Nowadays, VAT from domestic products is in increasing trend.

VAT has now reached the adult form but there are so many challenges that are need to be solved to make the system more effective. The lack of proper billing system, smuggling and under valuation, weak performance of tax administration, low level of public consciousness, rampant corruption, political instability, geographical barriers, open boarder and unauthorized trade, narrow tax base, lack of coordination between custom office and VAT related offices etc are the major challenges of VAT implementation. Improvement is necessary in such area.

## **5.2 Conclusion**

Value Added Tax puts greater significances in revenue mobilization in Nepal. The Reason behind this is that VAT system is transparent with broad tax base and discouraging tax evasion. So, it is necessary to say that VAT is the most important source if the government revenue. VAT is a most scientific, innovation and powerful tax system with built in quality of universal application for both developed and developing economies. VAT system makes it possible to broaden the tax base, eliminate the tax evasion and cascading, create an investment friendly environment and finally to increase to government revenue. This is a matter of



great pride that Nepal has entered in to a major global tax system with the introduction of VAT.

Adoption of VAT system for Nepal is both compulsion and necessary. It cannot curtail its development projects for which more revenue is required. The globalization and recent trend of trade and tax system has affected the Nepalese economy also. As Nepal is one of the members of WTO, it is necessary to decrease the custom duty and excise duty. Consumption based tax is only an alternative to more revenue which directly helps to increase domestic resources for development works. One of the bases of the Nepalese tax system is VAT. There is no doubt in the fact that VAT in long run will help to make Nepalese economy stronger. In this sense, the successful implementation of VAT system has a greater significances as well as importance in Nepal.

VAT was introduced as a part of the national tax reform program. But VAT system in Nepal from its inception has been facing innumerable problems, which curtail its merits and effectiveness. Its process has been slow initially due to opposition from the business community and subsequently to administrative problems. Even after its full fledge implantation in 1999; the system has not been taken a considerable pace due to administrative inefficiency. Despite preliminary resistance, VAT has been largely accepted by the taxpayers as well as business communities of Nepal, and relied upon by the government as an important tool for mobilizing the revenue needed to finance public expenditure.

However, VAT is gradually moving towards its goal. In the empirical analysis most of the experts and tax officers are satisfied with the functioning of VAT in Nepal.

The biggest virtue of VAT is that it is revenue buoyant and highly instrumental for resource mobilization especially in an economy with acute shortage of resources. Despite preliminary resistance, VAT is currently well received by the customers as well as the business and industrial communities. The taxpayer's education campaign and the Lucky draw scheme conducted by the IRD with objective of uplifting the level of awareness among the concerned stakeholders of the society are praiseworthy. The implementation of VAT in Nepal is an excellent lesson for other countries to study when considering the reform the indirect tax system. There has been made a progress in revenue mobilization and the infrastructural has been already prepared. No strong voice against VAT has been heard today. VAT compliance is taking momentum at a satisfactory level. There has been a positive change in the deeds of tax administrators.

### **5.3 Recommendations**

There are some vital problems in implementation of VAT system as mentioned in previous chapter. These problems are quite challenging to the concerned authorities from the point of view of their financial performance. Thus, it is very, very important that we find some effective troubleshooting of the above problems and execute them with full force. Now, Question may arise as to what might be the solution of the above problems.

#### **5.3.1 Some Useful Recommendations on Administrative Reform for Better Implementation of VAT in Nepal**

1. Unproductive, corrupted, inefficient staff lacking practical and specialized training is a serious problem. So, providing training to such staff is highly essential.
2. Taxpayers, customers are ignorant about VAT system. They have lack of proper knowledge about computation of tax liability, taking invoice of their

purchases. So, emphasis should be given to taxpayer education. The issuance of proper bill for every taxable sells must be made mandatory.

3. Providing various facilities to VAT registrants can increase VAT compliance. The tax administration can select genuine businessmen and reward them.
4. There should be close cooperation between the private sector and government sector for the successful implementation of VAT system.
5. VAT collection on import is remarkably higher than domestic production, such high dependency on import is not good signal for the government therefore authority should take an effective step to encourage domestic production.
6. Special incentives should be provided to small business person to increase registration trend.

### **5.3.2 Some Useful Recommendations on Legal Reform for Better Implementation of VAT in Nepal**

1. The existing exemption and zero rating list is rather long. Exemptions and zero rating have on impact not only on revenue collection but also on economic efficiency and administration. Thus, the existing labyrinth of exemptions and zero rating in VAT must be avoided from tax act.
2. A reasonable threshold (down form the current Rs. 2 million), wide range of supplies under the tax net would be an appropriate strategy for immediate future.
3. Government has been providing tax refund facility to business organization and foreign diplomacy and foreign aided project. Tax refund is one of the sources of tax leakage. Therefore, tax authority should manage tax refund facility properly.

4. As per the equity principle of taxation, the government may apply different rates of VAT to luxury good and essential goods. There is injustice in levying more tax on conspicuous consumption.
5. VAT laws should be effectively implemented.

# APPENDIX-I

## Questionnaire

Dear Sir/Madam,

Kindly allow me to introduce myself as a student engaged in a research work on "**VAT in Nepal: Challenges in Its Implementation**" for the fulfillment of my dissertation for the Master's Degree in Tribhuvan University, Kathmandu.

I humbly request for yours valuable comments, views, suggestions and information on this issue which would prove very useful for my study. That's why I request you to fulfill the following questionnaire.

I hope for your kind cooperation and assure you that whatever information you provide me will solely be utilized in research work.

***A study on Value Added Tax in Nepal and Challenges in Its Implementation***  
***Questionnaire:***

Name of respondents: .....

Office/organization: .....

Business.....

Consumer.....

1) Do you know about VAT?

a) Yes      b) No      c) Only listening      d) little

2) To whom VAT will be paid?

a) Government      b) Businessmen      c) I don't know

3) What challenges do you face in implementation of VAT in Nepal?

- a) Lack of awareness rules and education b) Selfish motive of the private sector  
 c) Selfish motive of the personnel d) Loose mechanism of the government

4) What is your view about billing system?

- a) Possible b) Impossible c) Most implemented d) I don't know

5) Will price rise due to VAT system?

- a) Yes b) No c) I don't know

6) What do you think about the tax burden of VAT to the taxpayer?

- a) Higher b) lower c) Normal d) Zero e) I don't know

7) Do you think that current legal provisions and rules of VAT is sufficient in Nepal?

- a) Yes b) No c) Moderate d) I don't know

8) What suggestion will you offer for the better implementation of VAT in Nepal?

S. N.	Efforts Needed to Make Better Implementation of VAT	Likert-Type Scale				
		1/20 %	2/40 %	3/60%	4/80 %	5/100%
1	Government should follow hard and fast techniques, rules and mechanisms					
2	Mass awareness should be exercised					
3	Every citizen should think that it is their duty to involve in the state action					
4	Transparency and e-governance should be followed					

If any, please specify .....

[Note that 1 represent lowest value and 5 represents highest value]

- 9) What are the main problems of present VAT system in business sector  
 a) Registration    b) Account keeping    c) Billing system    d) I don't know

- 10) What are the major weaknesses of VAT administration?  
 a) Lack of expert    b) Lack of trained manpower    c) Lack of physical structure  
 d) Weak economy    e) I don't know

11) What kinds of effort are needed to make VAT effectively successful?

Please give your perception about VAT on the following sub-categories:

S. N.	Efforts Needed to Make VAT Successful	Likert-Type Scale				
		1/20 %	2/40 %	3/60 %	4/80 %	5/100%
1	Strength and improve VAT administration					
2	Trained and educated effort					
3	Improve VAT laws and regulation					
4	Public awareness Programmes					

If any, please specify.....

12) What are the major challenging problems of VAT system?

Please give your perception about VAT on the following sub-categories:

S. N.	Major Challenging Problems of VAT	Likert-Type Scale				
		1/20 %	2/40 %	3/60 %	4/80 %	5/100%
1	Smuggling and under valuation					
2	Lack of proper billing					
3	Legal provisions					
4	Mass awareness					

If any, please specify.....

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