CHAPTER – ONE
INTRODUCTION

1.1 Background

All the nations of this globe need various resources for their developmental and welfare activities. For the economic development of a country, taxation seems to be the most effective way of mobilizing internal resources. The objectives of any tax system are to make funds available for economic development, to maintain reasonable economic stability in the face of long-term inflationary pressure and short run internal price movements, to reduce inequalities, which brings productive efficiency and bring about justice & political stability in a country.

As developing countries have several challenges in collection of tax. On the other side, there is question mark on its proper utilization. So we should conduct study and develop the new system of taxation and its scientific implementation, which can be easiest, cost effective, acceptable and transparent on its procedures.

Certainly, economic development depends on multiple causes. The pace of economic development is different from nation to nation. In developing countries like Nepal, the government policies are always targeted to achieve high rate of economic growth, reduction of income disparities, reduction of poverty and unemployment. But government becomes unable to achieve the above-mentioned fundamental target of economic determinants. There are many reasons for the failure of government in developing countries. Among them, the most important reasons are lack of capital formation, low investment, low income, low productivity and low sharing of resources.

For achieving the stability, the government has to expedite its activities through effective mobilization of resources. The other main thing is that the government should reduce the economic inefficiency by using favorable monetary and fiscal policies. Monetary policies help for contractions and expansion of money supply and handling the inflation to the economy.

Fiscal policies play the vital role in increasing the rate of capital formation, resource mobilization, price stability, and reduction in economic inequality and promote the employment opportunities. This, in turn, helps to achieve high rate of economic growth. Tax policy, being one of the major instruments of fiscal policy, its main objective is to collect the revenue and other objectives are economic development, establishment of welfare state, promote the equal distribution system of income, production and consumption, creation of favorable environment of employment and investment and control of illegal production and consumption. Those are the main determinants of economy. So we can say, "Taxation is the backbone of the national economy."

The tax revenue includes two types of taxes: direct and indirect. Direct taxes are more familiar and have a dominant role in the developed countries rather than in developing countries. Direct taxes are the means and tools of generating savings and promoting capital formation. Direct taxes are income tax, property tax, business profit tax, land revenue etc.

Indirect taxes have a dominant role in the whole tax structure of developing countries like Nepal. Most of the revenue is being raised from indirect taxes, because it is easy, less expensive and convenient method to a developing economy. Indirect taxes are excise duty, import and export tax under custom duty, value added tax, sales tax, entertainment tax, road tax, air flight tax, vehicle tax, etc. In any developing economy, indirect taxes occupy a most important means to finance. Among the indirect taxes, value added tax is the pivotal one.

The Value Added Tax (VAT) is a comparatively new tax. Wilhelm Von Simons first recommended this tax in 1919 for Germany to replace, multistage sales tax, in order to avoid the undesirable effects, particularly, cascading and vertical integration of the sales tax.

The value added tax is similar to the national sales tax. VAT is levied on the value added by each firm through its production and distribution activities. Value added for a firm is the value it adds to its purchases of inputs from other firms before selling them to others.

To achieve the objectives of national economic development through revenue mobilization, Nepal introduced VAT in 1997. Although there were many contradictions regarding its introduction and consequence, VAT is a scientific tax system, which is the most popular and transparent system applied throughout the world, was inevitable. From the past experiences of VAT, Nepal should show the clear picture of its inching further as well. The challenges, which came forward in these years, must be guiding the coming activities regarding the use and implementation of VAT.

In Nepal, Value Added Tax (VAT) was introduced on 16 November 1997. This tax was applied in place of the sales tax, hotel tax, contract tax and entertainment tax. However, it could not be implemented fully until the FY 1998/99 due to political instability and strong opposition from the business community.

VAT replaced the old system of sales tax, contract tax, hotel tax and entertainment tax. It has been designed to collect the same revenue as the four taxes it replaced. Since the collection of both custom duties and income tax depend to a great extent, upon the effectiveness of VAT. It is expected to help enhance revenue collection. VAT is a broad based tax as it also covers the value added to each commodity by a firm during all stages of production and distribution. It is a modern tax system to improve the collection of taxes, to lessen tax evasion. It is also regarded as backbone of income tax system in Nepal. The current threshold for VAT registration is Rs. 2 million for goods, 1 million for service and mixed transactions (goods and services) and ten thousand for importers. Those vendors whose annual turnover is below the threshold can, however, register voluntarily.

There is a persistent increase in the number of VAT registrants. It has crossed 59,000 and is increasing rapidly. At the time of conversion from the then existing sales tax to VAT, a total of 2045 taxpayers were converted as VAT registrant. As the taxpayers are increasing, the amount of revenue collection and the level of tax compliance are improving today.

VAT is a tax imposed on the value-added to goods and services consumed in Nepal and exported outside. The tax is based on the principle that each producer or distributor adds value in same way, to the materials they have purchased and it is this added value that is taxed at each stage of the production and distribution chain. There is the presumption that VAT is shifted forward completely to the consumer. In the VAT system, producers, distributors and people providing services collect VAT on the products or services sold or provided.

The difference between the VAT collected on the sales and the VAT charged on purchase or import determine the amount registrant must remit or the amount that may be claimed as credit or refund. In other words, if the tax on sales is more than the tax on purchase, the dealer/ businessman remits the difference; if the tax on sales is less than the tax on purchases the dealer may carry forward this credit to the next month or claim refund. Registered businessman is obliged to collect and remit VAT on his taxable transactions.

These registrants are entitled to recover the tax paid on their purchases. This recovery or refund is known as input tax credit. The input tax credit (ITC) is the total of the tax paid on taxable goods and services purchased in Nepal and the tax paid on taxable goods and services imported into Nepal, where VAT is paid or payable by a registrant on a purchase or on imports credit.

However, even though the purchases of goods or services may relate in part to commercial activities in certain conditions, the purchase may not get input tax credit entitlement when he sells goods or services which are tax exempt. VAT divides all goods or services into two basic categories, taxable and tax-exempt. The goods and services, which are specified as basic goods or public necessities, are tax-exempt. VAT is applicable only to the consumption of goods or services in Nepal. However, supplies made in Nepal that are exported are taxed at zero percent.

Exporters are allowed to claim input tax credit for VAT paid on purchase of goods and services relating to their commercial activities. Exports are taxed at 0% to increase export of both goods and services.

Taxpayers whose annual turnover is more than Rs 2 million for goods, 1 million for service and mixed transactions (goods and services) and ten thousand for imports are required to register in VAT compulsorily. Taxpayers who fall below this limit will be requested to register in VAT voluntarily. If the stock of the taxpayer exceeds the specified amount when the tax officer inspects the stock such taxpayer will be registered compulsory.

If the annual expense of the taxpayers on the telephone and the likes exceed Rs. 1 lac or if the taxpayer conducts the business of some specified goods such as hardware, sanitary, furniture, fixture, furnishing, automobiles, motor parts, electronics, marbles, color lab within the specified area or the

Metropolis, Sub-Metropolis or Municipality the department may force him to register in VAT irrespective of his transaction amount.

A major part of tax reform within the territory seems different stages, which are classified mainly in two different stages.

Stage before 1997:

Before the implementation of VAT, the empirical tax system was not scientific and it was poorly designed defective tax structure. The major defect can be taken as a narrow base, non transparent and could not cover the whole areas. Huge share in GDP was origination from the agriculture sector, which remains out of the tax net. The other but not minor defect to increase tax collection are low elasticity of major taxes, plethora of exemption and tax concession granted to the industrial sector, low contribution of direct taxes to the total tax revenue, low voluntary tax compliance, cumbersome legal and administrative procedures, impractical rates, very wheeled tax administration and wide spread tax evasion.

Stage after 1997:

To get a concrete achievement by reforming the existing tax system, the government of Nepal has started value added tax (VAT) from November 1997. The VAT in Nepal replaced tax existing sales tax and other small service based taxes (hotel, entertainment and contract tax). Obviously, the VAT had broadleaved the tax base and increased the revenue elasticity in the fiscal year 1996/97. The total revenue governed from hotel tax, entertainment tax, contract tax and sales tax that were replaced by VAT was 3.0% of GDP and it increased to 3.00 to 3.790% in the fiscal years 2007/08 (Economic survey 2003/2004 and fiscal year 2007/2008).

However, the issue of VAT in Nepal is still a matter of discussion, mainly the industrialists and businessmen are reluctant to pay VAT even the consumer are not aware of taking VAT invoice. Undereducated individuals are scared whether the VAT may rise prices so low voluntary tax compliance. Cumbersome legal and administrative procedures are weakening tax administration and tax evasion is still prevailing. So in this situation review of VAT implementation is necessary to increase the revenue of the government.

1.2 Statement of the Problem

Taxation is not the sole receipt of government but it is considered as one of the most important part of the government receipts. It plays an important role in domestic resource mobilization. Through taxation, resources of the private sectors are transferred to public sector for the economic development of the country. Sustainable economic development has been the prime concern of every developing nation. Nepal is a developing, agriculture-based country facing serious problem of resource gap. On account of low investment, low production and low employment opportunities has directly affected the national economy so that the target of revenue collection could not be achieved as targeted but government expenditures are increasing day by day. For maintaining the resource gap, the government has been trapped to take the loan from external or internal sources.

Tax revenue, non-tax revenue, grant and loans are various sources of government funds. Grants are based on several political considerations. In our past experience, the ratio of grant is decreasing and the amount of loan is increasing. On the other hand, grant is not the permanent source; it can never be a substitute to domestic resources and can never be a remedy too. To face these problems, government instrument has to be fully utilized specially the revenue collecting bodies.

Non-tax revenue has low base and is unable to mobilize adequate fund. Loan has to be repaid; developing countries suffer from increasing amount of repayment of loan. In this way, other sources of government fund, except tax, seem to be vulnerable and non reliable, only taxation is the major and effective source of revenue.

Keeping in view the necessity of adequate resource mobilization for meeting the increasing need of resource for development, the government of Nepal has taken the "VAT" as a base tax. On that situation, identification of the main problem of VAT and their detail examination is imperative and necessary for this study.

1.3 Objectives of the Study

The basic objective of this study is to analyze the trend of VAT in different sectors of Nepalese economy especially in revenue collection, after its implementation in Nepal. The study includes the following specific objectives:

- To analyze the tax revenue structure of Nepal.
- To find out the share of VAT in GDP, total revenue and tax revenue.
- To show the performance of sales tax and VAT in the Nepalese tax system.
- To find out the trend of VAT in Nepal.
- To identify the major issues involved in the process of its implementation.

1.4 Significance of the Study

Nepalese economy has a slow growth due to acute resources gap in Nepal. The question of resource mobilization is challenging provocation. So, VAT may be a prominent instrument to study and deserves special significance. Moreover, it is believed that this study may examine the various problems; undesirable effects, further evaluate the performance of VAT since last couple of years, the problem of Nepalese revenue system.

1.5 Methodology of the Study

The data needed in this study are collected from the secondary sources and when necessary and possible are used primary sources. Various information required for this study is derived from the information and discussion with different businessmen, consumers and tax administrators. Observation method is also applied as it played a supporting role in the study.

The secondary database is national data of government publications, Ministry of Finance, the publication of Central Bureau of Statistics, Customs Department, Inland Revenue Department and other reports. Finance Ministry's official data, newspapers, articles of Rajaswa journal and research publications etc. are also considered. For the functional scenario of VAT, the necessary data of information is taken from the Inland Revenue Department.

- The study is based on Inland Revenue Department's VAT Revenue considering secondary data.
- The study is based on simple ratio analysis.
- The study is analytical and explanatory type of research.

- The study shows the performance of VAT by using standard deviation model.
- The accuracy of second data is not examined.

1.6 Limitation of the Study

The study might be covered vast area. But the study has the following limitations:

- This study has covered the period of seventeen years F/Y 1991/92 to 2007/08 and for the analysis the data of VAT is taken from FY 1997/98 to 2007/08.
- The study is based in the secondary data. So the reliability of the study depends largely upon the reliability of the secondary data.
- Limited statistical tools and techniques are used.
- This is not a comprehensive study.
- There is time and resource constraint.

1.7 Organization of the Study

The study is divided into five major chapters: Chapter I, the introducing chapter, which spotlights on the various aspects of the study including the role of taxation in economic development. Chapter II covers theoretical and historical background of VAT and its commencement in Nepal. This Chapter observes the review of literature too. Chapter III describes research methodology. Chapter IV is the main body of research, which gives evaluation, trend, and comparison with other discipline and revenue structure after implementation of VAT as well as key issues of VAT after its introduction in Nepal. Chapter V comprises findings and recommendation of the study.

CHAPTER -TWO
THEORETICAL AND HISTORICAL BACKGROUND OF VAT AND REVIEW OF LITERATURE

2.1 Theoretical Background of VAT

2.1.1 Introduction

Value Added Tax (VAT) is the most need innovation in the field of taxation. It is considered as one of the most powerful tools of the fiscal policy. From the long experience of VAT in several countries many economists, as well as, policy makers have reached in the conclusion that VAT is probably the best in indirect tax. It has gained huge popularity within the short span of time.

VAT is, as the name itself suggests, imposed on the value-added portion in different stage of sales. It is modern and scientific form of sales tax. Ultimately, the real and final burden of tax is shifted towards the consumer who consumes goods and enjoys the services. As goods and services are shifted in the process of production and distribution, one after another stage, the tax is also jointly shifted simultaneously.

There are different types of Sales tax viz: turnover tax, called the single stage tax is levied at the only one stage of the production and distribution process. It may be imposed at either manufacturing level or wholesale level or at the retail level. According to the stage of its imposition it is called as manufacture tax, wholesale tax or retail tax.

Multiple tax, as turnover tax, is levied at different stage of production and distribution process. VAT falls in this category of multiple stage tax. It is turnover tax in the sense that it is levied in the production and distribution process. VAT ultimately differentiates from the turnover tax as the latter is imposed on the total value, while former is imposed only on value added portion, particularly at that stage. Similarly, VAT is similar to manufacture tax, wholesale tax or retail tax in the sense that, as mentioned earlier, VAT follows all the stages in the process of sales. VAT is also called as goods and service tax (GST).

Whatever we call, VAT is a newly entrant family member of indirect tax. It is imposed on the value added. The increments in value of output over input are the value added. The value added for the firm is the gross receipt from sales minus all expenditure on goods and services purchased by firms.

The VAT is levied on value that adds to goods and services they purchase. This tax is imposed on value addition of all taxable products. This is collected on each stage in the production and distribution process. The VAT is imposed to generate a neutral tax that would provide substantial revenues without reducing the effectiveness and efficiency of the market system. Suggestions for introducing VAT were first made in the United State of America (USA) in 1911. It was first implemented in national level in France in 1954.

In March 1996, the House passed legislation to introduce VAT in Nepal. It got effective from 16 November 1997 (2054.08.01 B.S.). The VAT is believed to be improvement over other types of indirect taxes. Prior to the introduction of VAT, there were several independent domestic taxes on goods and services. Some major are: sales tax, hotel tax, contract tax and entertainment tax. Among them sales tax was the most important source of revenue before its replacement.

The some major advantages claimed by the supporter of VAT are as follows:

- It reduces distortion of trade and consumption due to the broad base and uniform basis of taxation.
- It is better instrument for managing the economy.
- It helps to promote exports and improving the balance of payments.
- It places an equal burden on both imports and domestic products.
- It places a proposition burden of tax from production level to retail level.

There are also some shortcomings; the major can be identified as follows:

- It creates dual economy due to the threshold concept.
- It increases the price to the final consumers, as it is not simple in practice as advocated in theory.
- The administrative cost is relatively high.
- The final consumers feel higher burden of tax.
- The billing enforcement of the VAT is not easy as advocated by the VAT experts.
- It is regarded as regressive nature of tax.
- It creates a lot of problem in practice.

Someone may claim that the ratio of compliances in the VAT has been small though as has been loud, it should have been improved over the indirect tax it replaced. The base of VAT is broad. It permits more precise and broader adjustment. Taxpayers have now familiarized themselves with VAT. Revenue consideration since its introduction, VAT has become a major source of revenue in the country. VAT yield was 26095.6 million rupees in 2006/07, which is 36.7% of tax revenue. Its average annual growth rate is 13.2% during six year (2001 to 2007) whereas 10.6 % annual growth in total tax revenue. The government relies mainly on indirect taxes, which account for more than 73% of total tax revenue in 2006/07. The relative importance of indirect tax has been high and there has been now significant change in their importance before and after the introduction of VAT. The share of VAT has been increasing in the tax revenue. It has increased from 31.8% to 36.7% within seven years. It is believed that burden of VAT is still low. VAT in a percentage of GDP has been all-out for 3.6% in fiscal years 2006-2007.

Table 2.1

Revenue from VAT

S .No.	Fiscal Years	VAT	Total Revenue	VAT-Tax Ratio
1.	2000/01	12382.40	38865.10	31.80
2.	2001/02	12267.30	39330.60	31.20
3.	2002/03	13459.70	42587.00	31.60
4.	2003/04	14478.90	48173.00	36.00
5.	2004/05	18885.40	54104.70	34.90
6.	2005/06	21610.70	57430.40	37.60
7.	2006/07	26095.60	71126.70	36.70
Average Annual Growth Rate		13.20	10.60	00.00

Source: Economic Survey 2007/08, MoF

Generally the VAT is implemented on the destination principle. Under this principle, VAT is imposed on the value added of all taxable products that are consumed domestically. Exports are relieved from VAT. But imports are taxed in this principle. The destination principle is regarded as effective in ensuring that traded products contain no VAT elements of exporting countries.

2.1.2 Evolution

Historically, the VAT has emerged as an alternative to defective multistage turnover tax or cascading type of taxes. VAT was introduced in attempts to improve the existing shortcomings of the sales tax.

As an improvement of the turnover tax Dr. Wilhelm Von Simons firstly introduced VAT for Germany in 1919. It was advance over existing turnover tax by employing the concept of subtraction of previously outlays from taxable sales.

Similarly, Professor Thomas A. Adams recommended the sales tax with a credit or refusal system. The Shop mission also proposed it for the reconstruction of the Japan's economy in 1949. Suggestion proposed and recommendation was gradually rising so far for implementation of VAT but a single country till 1953 didn't introduce it. France became the pioneer country in the history of taxation by adopting tax. 'Surla Value Ad Joutee" in the place of the then French production taxes. This move of France became the first step in the field of VAT. Maurice Laurel, an officer in the France ministry of finance designed the VAT for France. The Ivory Coast, French colonial country, followed the France in adopting VAT in 1961. Since the sixties, VAT has been spread over the world very quickly and widely. Upto 1968, it was covered to the industrial sector and to the wholesale level only. VAT was implemented fully in 1968.

Different countries of the globe started adopting VAT one after another. This tax system became a popular worldwide measure to bring about tax reforms and its adoption soon gathered global momentum. This fact can be justified by the increase as follows the number of countries that adopted this tax.

Year	Countries that have started adopting VAT
1954	France
1960	Ivory Coast
1961	Senegal
1967	Brazil, Denmark
1968	Germany, Uruguay
1969	Netherlands, Sweden
1970	Ecuador, Luxembourg, Norway
1971	Belgium
1972	Ireland
1973	Austria, Bolivia, Italy, United Kingdom, Vietnam
1974	Argentina, Chile, Columbia, Costa Rica, Nicaragua
1976	Honduras, Israel, Peru
1977	Korea, Panama
1980	Mexico
1982	Haiti
1983	Dominican Republic, Guatemala
1984	China
1985	Indonesia, Turkey
1986	Morocco, New Zealand, Niger, Portugal, Spain, Taiwan
1987	Grenada, Greece
1988	Hungary, The Philippines, Tunisia
1989	Japan, Malawi
1990	Iceland, Kenya, Pakistan, Trinidad and Tobago
1991	Bangladesh, Benin, Canada, Jamaica, Mali, South Africa, Egypt
1992	Algeria, Armenia, Azerbaijan, Cyprus, El Salvador, Estonia, Fiji, Kazakhstan, Kyrgyzstan, Russia, Tajikistan, Thailand, Turkmenistan, Ukraine, Uzbekistan, Moldova

1993	Burkina Faso, Czech Republic, Paraguay, Poland, Rumania, Georgia, Slovak Republic, Venezuela
1994	Bulgaria, Finland, Lithuania, Singapore, Western Samoa, Madagascar, Nigeria
1995	Gabon, Ghana, Switzerland, Zambia, Malta, Mauritania, Togo, Latvia
1996	Albania, Guinea, Uganda
1997	Barbados, Congo Republic, Nepal
1998	Croatia, Mongolia, Sri Lanka, Tanzania, Vanuatu
1999	Cambodia, Cameroon, Mozambique, Netherlands Antilles, Papua New Guinea, Slovenia
2000	Australia, Chad, Macedonia, Namibia, Sudan
2001	Rwanda
2002	Lebanon and so on…………………..

Source : Inland Revenue Department, *Value Added Tax, Four Years of Implementation 2058*

India, our nearest neighboring country to the south, implemented MODVAT in place of VAT to design to correct and avoid the disadvantage of input taxation in the field of excise duty. India has shown its in-depth will to external MODVAT to VAT in different stages and sectors. A lot of preparation had been made, a deadline for the adaptation of VAT in different stages had been announced frequently but due to federal system and lack of cross stage arrangements it has not been made realized till now. Pakistan, Bangladesh and Sri Lanka, other members of SAARC also implemented VAT in their respective country in 1990, 1991 and 1998 respectively. As VAT is broad based tax and more revenue productive; more than 125 countries have adopted it in their respective countries.

2.1.3 **Principle of VAT**

There is no doubt that VAT is levied on consumptions and consequently final burden of the tax is shifted to the consumers. In the ages of globalization and liberalization, the world has been narrowed as a small village. Goods and services can be provided broadly either by domestically or by importing from trade, their might be a question of borders. Whenever international trade between two countries is considered, cross border adjustment is necessary for the purpose of imposing VAT, principle of VAT can be divided into following two categories.

Origin Principle

Under this principle, tax is levied at the place where it is produced or rendered, irrespective of whether they are consumed or not. In this principle, preference is given to imported goods and services over domestic production because all exports are treated as non-taxable. Those sorts of principle may be beneficial where common trade is existed, like European Union, otherwise rest of the countries do not prefer this principle.

Destination Principle

Contrary to the earlier, destination principle is imposed at the place where it is consumed irrespective of where it is produced; neither it protects imported goods or services nor the domestic goods or services. Equal preference is given to both imported as well as domestic product. In this ground, it is assumed as neutral principle of taxation. For the purpose of boosting exports, many countries prefer to apply this principle of taxation.

2.1.4 Types of VAT

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

I. Consumption Type

This classification is considered as natural type because under this type no discrimination is done with respect to capital or consumable goods. It is really a superior for the VAT because full credit of inputs, irrespective of what type of purchase is done. Under this type, all capital goods purchased from other firms, in the year of purchase, are excluded from the tax base while depreciation is not deducted from the tax base in the subsequent years. Since investment is relieved from taxation, the base of tax is consumption. As exports are relieved from tax while imports are taxed, the base of this tax becomes identical to the base of retail sales tax on consumer goods and services.

II. Income Type

Under the income type, VAT does not exclude capital goods purchased from other firms from the tax base in the year of purchase whereas depreciation is excluded from the base in the subsequent years. Moreover, under this system an excess of year-end inventory over starting inventory is included in the tax base while an excess of starting inventory over year-end inventory is excluded. The tax falls both on consumption and next investment and the conceptual tax base of this category is the net national income. In this variant, capital equipment are divided over a period on the basis of their useful life. Under this method, tax base equals to corporate, personal income, with no exemptions or deductions. It is consistent with the origin principle of taxation where exports are taxed and imports are relieved from the tax.

III. Gross National Product Type

Under this method, the purchase of capital goods is neither deducted from the tax base in the year of purchase, nor the deprecation is allowed to deduct from the tax base in the subsequent years either. Hence the tax is levied both on consumption and gross investment and the conceptual tax base of this variant is gross domestic product. As no input on the purchase of capital goods is allowed in this variant, it discriminates among the techniques of production and finally favors international production.

Neutrality of tax is not satisfied in this method; therefore it has not practicable ground. It is suggested to impose the tax on consumption and gross investment in this variant. Finally Gross National Product becomes the base of this variant. It creates a substantial discrimination for saving, investment and capital-intensive production.

The base of VAT under various categories may be shown as follows:

Consumption Type : Gross National Product – Gross Investment = Total Consumption expenditure

Income Type : GNP – Depreciation = Net Inv + Consumption = Net National product

Gross National Production type : Gross Investment + consumption = GNP

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

2.1.5 Methods of Computation of VAT

Method of computation of VAT also plays a unique role for the successful implementation of VAT. The specific modality of the tax base is established and computed which will influence the administration of VAT. Broadly, VAT can be computed by following three methods:

(i) Addition method:

In this method, the tax base is calculated by adding the payments made by the firm to the factors of production employed in turning out the production such as wages, interest, rent, royalties and profit. This method is very close to income type of VAT that includes payments made to all the factor of production in its base. Because of all the payments complexities in calculating them it is impractical. Virtually no country has used the addition method, although Argentina and Israel have used in selected economic activities, such as banking and finance where value of input and output is difficult to measure.

(ii) **Subtraction method:**

Under this method, the cost of production is deducted from the sales. In other words, value added is determined as net turnover that is obtained by subtracting that cost of materials from sales proceeds. It is very close to consumption type of VAT. Theoretically, it looks simple and easy of VAT computation, problems like ascertaining tax value in an accounting period may also arise.

(iii) **Tax credit method**

Tax credit method is known as indirect subtraction method or invoice method. Under this method input tax is credited from output tax and passes into next stage up to consumption level. Tax credit method is similar, to some extent, to subtraction method but the major difference among two is:
In the earlier method, the tax is levied in the difference amount of tax on sales and tax on purchase whereas in the latter method, the tax is levied on the difference amount of sales value and purchase value. Earlier method requires invoice while latter does not require. If the rates were same throughout the production and distribution methods, both methods would give the same result otherwise it wouldn't be.

Alan A. Tait has identified four main advantages of this method over the other two methods. They are:

- Easy to calculate tax liability of transaction
- Good audit trail

- Account based system
- Carry forward of credit

Calculation of VAT revenue (T) in different methods may be expressed as follows:

Addition method: T =t (wages + rent + interest + profit)

Subtraction method T = t (sales value- purchase value)

Tax credit method : T= (tax on sale) – (tax on purchase)

Above expression will be clearer from the following illustration.

Table: 2.2

Computation of VAT in Different Methods

S. No.	Description	Importer	Manufacturer	Wholesaler	Retailer
1.	Purchase value	5000	7000	10,000	12,000
2.	13 % of tax on purchase	650	910	1300	1560
3.	Wages	800	1200	800	400
4.	Rent	600	800	600	300
5.	Interest	300	600	300	200
6.	Profit	300	400	300	100
7.	Sales value (1-3+4+5)	7000	10,000	12,000	13000
8.	13% tax on sales	910	1300	1560	1690
9.	VAT liability in				
9.1	Addition method 13% of (3+4+5+6)	260	390	260	130
9.2	Subtraction Method 13% of (7-1)	260	390	260	130
9.3	Tax credit Method (8-2)	260	390	260	130

For the purpose of calculation of VAT, the purchase value at the point of import is shown zero. From the above illustration it is clear that if the tax rate is same throughout the production and distribution method, the VAT amount to be paid is same in all the methods. Only calculation procedures are different. Finally all the burden of tax falls on consumer. In this example, the consumer has paid Rs. 1690 for VAT. The government collects the same amount not only by one stage rather than different amount from different stages of production and distribution i.e. Rs. 650 at the custom point in advance and Rs. 260 from the importer, Rs. 390 from the manufacturer, Rs 260 from wholesaler, Rs. 130 from retailer.

2.2 Procurement of Vat In Nepal

2.2.1 Development of VAT in Nepal

In the eighties, various countries, to maintain a sound economic condition, adopted various types of economic reform programs were at the heart of worldwide policies. Nepal was also no exception to the global phenomena. The Nepalese government revealed its intention for the adaptation of various reform programs to promote market-oriented economy in the Eighth plan document. In a process to reform tax policy, it had mentioned that some time in the mid-plan period, VAT would be introduced in the country. Before that VAT was completely unknown word to the general people of Nepal. After restoration of democracy in 1990, the new government took a number of measures to liberalize the trade, investments and financial system.

Subsequently, the then state minister of finance announced, in his FY 1992/93-budget speech that, VAT, on domestic production would be applied on an experiment basis from the fiscal year 1992/93. A two-tier sales tax system (manufacturer/importer and wholesaler) was in function at that period.

Under this system, dealers and distributors of nine selected items were required to register for sales tax purpose and collect tax on their sales. It was extended further to five more items in 1993/94. Only the amount of tax paid to manufacturers was allowed for credit. Further, sole distributors or agents of the foreign firm or companies and their wholesalers were also required to register for the purpose of collection of sales tax.

The preparations for the introduction of VAT in Nepal commenced in September 1993. For this purpose, a Steering Committee and a Task Force were formed. The financial assistance for the preparatory work to introduce VAT was provided by the United State's Agency for International Development (USAID) and the technical assistance by the Harvard Institute of International Development (HIID). The members of the VAT Task Force and the consultants from Harvard University carried out the following preparatory works :

- Preparation of a VAT law;
- Launch taxpayer education program;
- Create an appropriate organizational structure and personnel system;
- Organize training and
- Initiation of computerization process.

The task force was fully devoted to accomplish preparatory works. Due to political instabilities and frequent changes in the priority for the implementation of VAT, The task force could not continue its Job. The VAT task force was dismantled.

The then minority government formed after the mid-term election appointed a Tax System Review Task Force, which recommended introducing VAT. There was again a change in the government and it showed as earlier, a firm commitment to introduce VAT. It allocated budget for the study of VAT that had already been transferred to other projects. As a consequence, technical assistance for the implementation of VAT continued. After all, the DANIDA supported the VAT project. It is continuously supporting till now.

As a part of preparatory work, the VAT Act was passed in 1995 by the parliament. The Government in 1996 approved VAT regulations. In the same year, the Department of Sales Tax and Excise were renewed as the Department of value added tax (VAT). After a year, the ministry of finance approved nine values of manuals. Furthermore, VAT task force organized various discussion and interaction program related to VAT in different parts of the kingdom. Various introductory brochures were published and distributed to the potential taxpayers, businessmen and the administrative staffs.

The VAT was initially scheduled to be effective from July 1997. The government had planned to register the potential taxpayer in VAT from this period.

In support of VAT, the government decided to rationalize the tax structure by reducing the rate of income tax, sales tax and custom duties in advance. The VAT was supposed to replace the Sales Tax, Hotel tax, the Entertainment Tax and the Contract Tax. For this purpose, the VAT task force was conducting its work in accordance with the schedule. Meanwhile, the private sector of business field opposed the movement policy on adoption of VAT. Nepal Chamber of Commerce held a nationwide discussion program among business communities. Most of the business community showed their unwillingness to the VAT that was scheduled to be operated from two month later. Business community protested the decision of the adoption of VAT with the slogan "No VAT!". Issue of VAT created a conflict between the government and the private sector. Confrontation continued for a long time. Accepting the increasing pressure of business sector finally government decided to extend the date of application for four month. The government also announced the effective date as November 16, 1997. With a view to make easy for the functioning of VAT the government made an arrangement in the budget for F/Y. 1997/98 to convert the Hotel tax into the Sales tax. The rate of the sales tax reduced from 15 percent to 10 percent. Further, the rate and the slab of income tax and customs duty were also lowered. The government took a heavy revenue risk by revising the rate and structures of various taxes without prior demand of the taxpayers.

Whatever reasons were laid for the postponement of effective date of VAT, the preparation time got a very valuable time for the preparation of VAT. The government and its associated body tried to convince the business community in favor of VAT. It was really a very hard work to implement VAT without the full cooperation of business community. The VAT project, Ministry of Finance as well as Department of VAT devoted to implement VAT in the extended period for making friendly relations by providing more training, information campaign, meeting, talk program and interaction program between different groups of people.

In the meantime, the business community also divided into two groups. Generally, industrialists were in favor of VAT whereas, trading group was against the VAT. Despite heavy protest by trading group, the government implemented the VAT from the scheduled date of November 16, 1997.

Even after the adoption of VAT, the days were not easy as expected. Trading businessmen were completely against the VAT whereas industries were in favor of VAT with heavy concession on various taxes. Government announced all the concessions without prior plan in budget speech, four month before the date of VAT implementation, which could not motivate the businessmen. The businessmen enjoyed the facilities provided by the government for the successful enforcement of VAT, but contrary to that they continued to protest against VAT.

Political situation was also volatile. Government was in a pressure to quit. Businessmen were against VAT; industrialists were in favor of further concession in tax regime that was against the principle of VAT. VAT administrators were not fully aware of this system. Due to various reasons VAT could not function as expected. The business community demanded the continuation of all exemptions and incentives granted under the sales tax system.

Businessmen were also very furious at the function of control of local tax, FNCCI, the apex body of business community, decided on February 4, 1998 that they would not sit for negotiations with the government regarding the implementation of VAT unless the government scrap posed out control.

On March 1998, the government and the private sector reached an agreement regarding the modalities of the implementation of VAT, exemption of industrial machinery and tractors, soft behaviour towards the retailers, acceptance of the bill value in import point, set up a committee in order to review the VAT law and establishment of permanent revenue board were the main agreement. Since most of the agreed points were not implemented, the businessmen again began to oppose VAT. A series of discussion took place before the presentation of the F/Y 1998/99 budget. The demand of businessmen was increasing considering the volatile political situation of the country. The government requested for the agreement but the businessmen rejected the proposal and did not sign in agreement. Even though the government addressed few issues that were raised by the businessmen.

Finance Bill 1998 incorporated following changes:

- The threshold was increased to Rs. 2 million.
- Cottage industry got relief from the registration in VAT.
- Special arrangement was provided to settle the old stock of businessmen.
- The rate of interest was reduced to 15 percent from 18 percent per year.
- Tax officer were empowered to issue a tax assessment if taxpayer cannot justify the reason for under invoicing.
- Firms, companies and industries are required to issue serially numbered invoice with their name and address.
- The VAT administration, may inspect with prior approval of the DG of the VAT Department the books of accounts of unregistered vendors in connection with VAT, and may penalize if the books of accounts are not maintained properly.
- The list of exempted items increased.

Despite above mentioned provisions, the government also announced the several measures in the field of income tax, customs duty and revenue investigation with a view to rationalize tax structure in accordance with VAT principle. Provision of some curative measures provided for the simplification of tax collection intimidated businessmen more than attraction. They continued to oppose the VAT system with vigor. Finally, both parties agreed not to implement the provisions provided by the Finance

Act until they reached an agreement. Ultimately, both parties agreed on 39 points on September 1998. Most of the agreement was in connection with the further exemptions and concessions in various fields of VAT as well as other taxes. Few of them were in adverse direction of VAT principle.

As per agreement the government also amended the VAT Regulation increasing the threshold of Rs. 4.5 million from 2 million. Importers having import from India and Tibet up to Rs 1.2 million were also relieved from the registration in VAT.

VAT administration had allocated a TPIN (Taxpayer Identification Number) consider of nine digit registered taxpayer with a view to process data in computer. It was developed as per international standard. Last digit was for checking the accuracy of the number, which is called check number. All the records of taxpayer are stored in database of computer. As computer processed all the data of taxpayer, it has been an integral part of VAT administration. Before that all the records were kept manually.

In accordance with the purpose of integrating VAT and Tax Department into one Department from coming year a provision was made in Finance Act, 1999 that "A PAN (Permanent Account Number) will be allocated to the registrant of income tax from the coming fiscal year'. For this purpose a "Taxpayer Service Center" was established under the Department of Tax. It commenced its work from the November 16, 1999. Technical Assistance was provided by a project jointly handled by GTZ and Department of Tax. PAN was also similar to TPIN. Those taxpayers who had already received the TPIN will be converted to PAN with same number. The service of this center was only confined to nine offices of Kathmandu valley.

Issuance of PAN was accessed to all the taxpayers of the country from December 16, 1999 after the establishment of Inland Revenue Department

(IRD). For the simplification of management of data, a database computer system has been developed since the inception of VAT in Nepal.

With a view to provide all the services from the same window and to make effective mobilization of internal resource, the government decided to integrate the Department of VAT and Department of Tax. The Department of VAT merged into Department of Tax on April 2000. Through the budget speech of F/Y 2000/01, the government announced to establish Inland Revenue Department from July 2000.

Before the merger, there were 17 offices under the VAT Department and 41 offices under the Tax Department to cover the whole country. All those offices merged together and established 21 offices on the basis of including geographical region, number of taxpayer, taxpayer services and potentially of tax collection.

Out of them, four offices were classified into "A" class, two into "B" class, five into "C" class, five into "D" class and five into "E" class. Officials and staffs were recognized according to its workload. The newly established department administers the following taxes from the same window:

- Income Tax (Individual and corporate income tax, Remuneration income tax, interest tax, Rent tax, Dividend tax etc.).
- Value Added Tax
- Excise Duty
- Non-tax (Divided, principal and interest payment, royalty, charges and fees.)

2.2.2 Legal Provision of VAT in Nepal

First of all, the Eighth five-year plan (1992/93-1996/97) considered a policy of adopting VAT. On July 11, 1993 the Finance Ministry announced in its budget speech for 1993/94 that VAT would be introduced within a year or two. In the process of the adaptation of VAT in Nepal, a VAT steering committee and a VAT task force were formed in September 1993. After its formation, it made a draft for VAT legislation, conducted the taxpayer education programme, and recommended the organization structure and necessary personnel. It also made an effort to instill and develop an effective computer system. Nepal Government had initially scheduled to register taxpayer for VAT within the ninety days from the first day of the new year of Nepali calendar in 2054. After completing the registration work by the end of F/Y 1995/96, the government had expected to start the collection of VAT from the first day of the fiscal year 1997/98. Government's intention to adopt VAT was announced in the budget speech for the fiscal year 1996/97. But the newly formed government postponed the date of implementation of VAT till 16th November 1997.

VAT Bill was passed on March 20, 1995 by parliament. VAT Regulation was approved on January 24, 1996 by the cabinet. Finally, VAT was introduced on November 16, 1997. From this date, VAT replaced the Sales Tax Act, 1967, Hotel Tax Act, 1962, Contract Tax Act, 1967 and Entertainment Tax Act, 1961.

Value Added Tax Act, 1996 and Value Added Tax Regulations, 1997, administer Nepalese VAT system. VAT Act, 1996 consists of forty-four sections and two schedules. Similarly, VAT Regulations, 1997 consists of eleven chapters, sixty-three rules and twenty-one schedules.

The corresponding Finance Act has frequently changed various provisions incorporated in Act and Regulation. In an original VAT Regulation, the threshold limit was determined to Rs. 1 million. First amendments in VAT Regulations, 1997 were done only to further increase the threshold limit to Rs. 4.5 million. This amendment was again replaced. The threshold limit was again lowered to Rs. 2 million. In this way, threshold limit has been a major database issue in Nepalese context.

Nepal has adopted a consumption type VAT. Under this system, tax is levied on value added at each stage in the process of production and distribution. It is levied on output and credit is allowed for the full amount of tax paid on purchase at previous stage. It is based on destination principle. The law in schedule 1 of VAT Act, 1996 provides a list of exempted goods and services. Exports of goods and services are zero-rated as per schedule 2 of Act. Though threshold limit has been changed frequently, but by large it is fixed at Rs. 2 million. The threshold has been revised on 2009 as 2 million for goods, 1 million for services and mixed transactions (goods and services). Rate of VAT has been fixed at single rate, which was ten percent till January 13, 2005 and thirteen percent afterwards.

It will be unnecessary to detail all the provisions provided by the VAT Act and regulations in this study. It might be beneficial to describe it briefly.

i) Registration

Registration is the preliminary process of VAT system. Threshold limit for the registration is fixed at Rs. 2 million, 1 million for services and mixed transactions (goods and services). All the taxpayers whose taxable transaction is above the threshold are compulsory required to register in VAT. VAT is levied on goods and services. Person whose taxable turnover is below the threshold is considered as small vendors. A special privilege is provided to small vendors from the requirement of registration and filing the tax returns. But they are not kept outside from the VAT net if they voluntarily want to register.

ii) Deregistration

Criteria and process of deregistration must be as simple as registration for the effective implementation, otherwise, without easy exit system none wants to come in the net. Only huge number of registrant does not satisfy the objective of VAT. Inland Revenue Offices may be able to cancel the registration of registered person in any one of the following cases:

- In the case of an incorporated body, if the incorporated body is closed down, sold or transferred or if the incorporated body otherwise ceases to exist;
- In the case of an individual ownership if the owner dies.
- In the case of a partnership firm, if it is dissolved;
- If a registered person avoids to be engaged in taxable transaction; and
- If a person is registered in error.

Person who is willing to deregister should provide the information prescribed in schedule 11 of VAT rules, 1997. No one is permitted to deregister before the completion of a year of its registration.

iii) Tax Base

Provision of the tax base is the major part of VAT system. Though VAT is considered as a broad based tax, all the goods and services can't be brought within the purview of tax-net. Various issues play important role in determining the tax-base. VAT Act, 1996 has provided the authority to impose on all goods and service as mentioned below:

- Goods or services supplied into the territory of Nepal.
- Goods or services imported into the territory of Nepal.
- Goods or services exported outside the territory of Nepal.

It is based on taxable value of every transaction. Considering the administrative difficulties and social desire, a list of exemption for tax has also been provided in the schedule of VAT Act, 1996. List of exemption changes the tax-base in general. The taxable value does not include the VAT itself since it is refunded. The amount of all the expenditures related to transition and distribution which was born by a supplier in connection with the transaction, and the amount of profit and excise and all other taxes but except VAT itself are incorporated in taxable value. It does not include the amount of discount, commission and other similar commercially related grants on value in supplying goods or services. The taxable value of any goods or services exchanged or bartered, including transportation, insurance, freight, commission of agents and other person plus other taxes are also included in the taxable value for imported goods.

As system required, all the exports have been relieved completely from the burden of tax through zero-rating.

iv) Tax Period:

For the purpose of submission of return and amount of tax, taxpayer has been classified broadly in the following tax period:

Monthly tax period

Person who is statutory bound to register in VAT fall in this category. The taxpayer whose turnover is above the threshold i.e. Rs. 2 million is automatically fallen in this period.

Trimester Tax Period

The taxpayer whose taxable turnover is below the threshold but registered in VAT voluntarily, falling in this period. All the small vendors who have registered voluntarily are entitled to get special facility of four month period for the submission of return and due amount to tax officer.

Finance Act, 2001 had also provided a bimonthly tax period facility only to business of Hotel and tourism sector if they seek for the same.

v) Invoicing:

Every registrant is required to issue a tax invoice to the recipient in supply of any goods and services. The specimen of an invoice has been prescribed in schedule 5 and 6 of VAT regulation, 1997. It is necessary to mention supplier's PAN, buyer's PAN whether it is registered in VAT or not, address of sellers and buyers, date of transaction, date of invoice issue, description and price of goods and VAT amount on the tax invoice. The invoice must be issued in sequential order from the starting of every fiscal year. A minimum of the three copies of each invoice must be raised. First copy must be provided to purchaser mentioning tax invoice.

Only retailers are entitled to issue abbreviated tax invoice with prior approval of Inland Revenue Office. It is not necessary to mention details in abbreviated tax invoice as shown in tax invoice. It can't be issued for transaction exceeding Rs. 5000 including VAT. It also must be issued in sequential order. Tax is calculated by multiplying the sales value by rate of tax divided by adding 100 to rate of tax. It shall be the duty of a registered person to provide a tax invoice who asks for that. A recipient, who receives an abbreviated tax invoice, cannot claim credit for VAT.

vi) Accounting:

All the registered taxpayers are required to maintain following accounts as referred to schedule 7, 8 and 9 of VAT regulation:

- Purchase Account
- Sales Account
- Value added Tax Account

Purchase account reveals the purchase details whereas sales account shows the sales details of the taxpayer of specified period. VAT account gives the taxable summary of both accounts. The specimen of above mentioned accounts are designed in a way that even a person who knows the simple calculation idea can keep it easily. One can issue tax invoice and maintain his accounts on computer also with prior approval of tax administration.

A VAT registrant must update the accounts. All documents and accounts relating to the business must keep for the period of six years.

vii) Tax Credit:

VAT is implemented on tax credit method. All the tax paid on purchase of goods and services, including assets, stationery and other expenses, related to business are allowed to credit full amount from the output tax colleted on sales. There are some goods that are very different to ascertain where in rule 41 (1) tax may not be deducted in respect to the following goods and services:

- Beverages;
- Alcohol or alcohol mixed beverage such as liquor and beers;
- Petrol
- Entertainment expenses.

Some goods are used for the both purposes of the business and personal use. Tax paid of the following goods may be deducted on the following proportions:

40 percent of purchase value on automobiles (any motor vehicle with three or more wheels used on a road for carriage of passenger).

viii) Return Filing:

VAT is based on self-assessment system. Taxpayer himself calculates all taxes. Every registered taxpayer is obliged to submit the return to respective Inland Revenue Office within twenty-five days after the completion of tax period. Such return shall have to be submitted whether or not a taxable transaction was carried out in that tax period.

Failure to submit return in specified time is penalized as:

- Nil return or credit return Rs. 1000 flatly.
- Debit return-0.05 percent per day of due amount or Rs. 1000 whichever is higher.

ix) Management Tax Assessment:

VAT is self assessed tax. Taxpayers assess their liability themselves. They are self-allowed to get credit tax paid on purchases. Self-assessment system is developed in the assumption that the taxpayer himself has the proper knowledge of his transaction than any other person. Taxpayer may assess wrongly or may fail to pay correct tax. To correct this situation there is a provision of management tax assessment, which is done by the tax officials. Following criteria has been fixed for management tax assessment:

- If tax return is not filed,
- If tax return is filed lately,
- If tax return contains incomplete information or
- If tax official has proper reason to believe the tax is not genuine.

x) Tax Refund:

Excess of input tax over output tax of any tax period can be adjusted in the following tax period by carrying forward to next period or can claim for refund to the inland revenue office. Two major criteria have been fixed in VAT Act for the claim of refund by taxpayer. It is allowed to claim either by regular export basis or by regular six months credit basis. Exporters having more than forty percent export of total sales are treated as regular exporter.

There is also a separate provision of refund for the diplomat and foreign aided projects. They are allowed to claim refund immediately in Inland Revenue Department.

xi) Appeal

A taxpayer may file an appeal to the Inland Revenue Department for Administrative Review within 30 days against tax assessment or penalty charged by a tax office. The taxpayer may file an appeal to Revenue Tribunal against the decision of Department or an order by the Director General (DG) relating to the suspension of his place of transaction.

Before filing the appeal in the Department, the taxpayers must deposit the one third of disputed amount of the assessed tax due, and the whole amount of the rest.

2.3 Review of Literature

VAT is simply a multi-stage tax that exempts the purchase of intermediate goods and services from the tax base. Value added by a business firm is the difference between the firm's sales proceeding and its expenditures in purchasing intermediate goods and services from other firms. For all firms in the national economy, value added is the national product. This may be expressed as under.

Value added = Total Transactions- Intermediate Transactions = GNP
Wages + Interest + Profit + Rents + Depreciation

The administration of value added tax does not require firms to calculate value added. VAT is administered by the invoice method. All transaction is taxed at a fixed proportional rate irrespective of whether they are final or, intermediate purchases. Invoice method is also called the tax credit method. The use of this method can be demonstrated as follows:

Tax Liability = Tax payable on sales – Tax paid on purchases.
Or Tax Liability = Tax of value added.

VAT is a very fast growing tax in the field of taxation. It has spread widely within a short period. VAT was introduced as a part of an overall tax reform package. Although extensive literature has been developed on the tax policy and design, lots of the economists have studied the VAT in the world. Their findings are easily found in various books, research papers, seminar papers, report of international institution, issues of journals and articles. Even in the context of Nepal, some studies related to VAT have been carried out but all those were conducted almost before the implementation of VAT and have been focused on the theoretical soundness of VAT. Some of the studies reviewed in the study have been focused in the following section.

2.3.1 A study on "Value Added Taxation in Developing Countries" by IMF staffs, Lent, Cascenegra and Guerard (1973: 318-378), examined the application of VAT in seven developing countries (Brazil, Equatorial Guinea, Ivoiry Cost, The Malagasy, Republic of Morocco, Senegal and Uruguay) considering the fact that many uncertainties arises in the introduction of any major new tax especially with very limited experiences. According to the study, the most important feature of VAT in such countries is its conceptual basic such as taxable base (Value added), exemptions, treatment of small traders etc. Problem of implementation and feasibility of VAT depends on the administrative capacity in developing countries. Economic and social atmosphere also plays vital role in making comprehensive tax base of VAT. VAT applies only through the production, import or wholesale stage and advantages of non-interference with market process. VAT is more elastic and revenue productive by lower rates because it is broadly based and it makes substantial contribution to government, the study showed that:

i) Developing countries have limited range of VAT bases by excluding the most troublesome sectors (farmers, retailers etc.) because they have their own difficulties.

ii) VAT produces between 10 to 30 percent of government revenue of seven developing countries. The revenue of VAT is expected to increase in faster rate then the rate of growth of the economy.

iii) There are fundamental difficulties in VAT operation and administration in developing countries. The problem is the treatment of small taxpayers, which includes large number of retailers, service enterprise and farmers.

It is not possible to construct a model of VAT in developing countries based on law enacted in those countries.

Value added techniques have greater precision in elimination of the cascading. If there exists the remission of taxes on exports, it is less subject to tax evasion.

Recommendation of the study is also valuable lesson of UDCs:

- There is neutral effect of applying VAT on the ground of production, distribution and consumer prices.
- Sufficiency of record maintaining and book keeping by firms is indispensable.
- To adopt VAT without previous experience with a sales tax and strengthened administrative services is inadvisable.
- Proper level of tax rate that would justify introduction of VAT rather than alternative forms of sales tax.

The degree of fulfillment of above conditions determines the comparative success of implementation of VAT against other sales tax.

2.3.2 John F Due (1976) examines VAT in the paper entitled "Value added tax in developing economy" in the book "Taxation and Development" on the contribution to UN in 1976. The study has both theoretical and implementation parts in detail as well as its nature and history. The useful major recommendation derived by the author is:

A**. Theoretical Aspect**

i) VAT is regarded as a sales tax to overcome the demerits of turnover tax. VAT is entirely acceptable for the sales tax in comparison to other forms of sales taxes.

ii) The most important requirements for successful operation of a VAT is its universal ness and simplicity.

iii) VAT is imposed in more than one stage in business process. Therefore, it has distinctive feature of fractional impact without cascading effects.

The major criteria recommended for evaluation of the tax in UDC are:

- Acceleration of economic growth.
- Optimal use of available resources.
- An acceptable pattern of income distribution.
- Reasonable price stability.
- Avoidance of foreign domination of the economy.

B. Implementation Aspect

- The lawyers related to tax jurisdictions should draft the tax law.
- A computer system is basic for VAT operation.
- The same personnel administration of sales tax should be utilized for the VAT operation.
- Registration of the business firms should be done in great care.
- Tax returns may be filed at relatively frequent intervals.
- Inspections and audit should be operated, separately by the related careers. Crosschecking is the best solution.

2.3.3 Mr. Due and his collaborates Friedlander (1977), state in their empirical work "Government Finance" that VAT is most critical among other sales taxes because it has broader coverage and offers great revenue potentiality as compared to other types of sales taxes.

Value added tax is the tax base defined as the difference between the sales of firm's product and sum of the amounts paid by the firms. On the ground of revenue potentiality and equality (regressively), it is related to sales tax. As the other part of coin, advantageous or good features of VAT are a major source of revenue. In fact, indirect tax can be treated as a supplement of tax revenue but there are many difficulties in underdeveloped countries for effective operation of high income tax. It may be a key element to raise revenue. However, its administrative complexities are excess burden in developing countries.

As a reformed form of sales tax, evaluation of VAT is outlined as:

- VAT produces no economic distortion if properly designed.
- Exemption and zero-rating operation can be used easily in VAT system.
- Cross check audit is easier with the VAT.
- VAT is the optimal form of sales tax.
- Must not affect the negative effects in consumer's choice and purchase.
- Should be equitable in sacrifice.
- Cost of both administration and compliances must be minimized.
- Must be neutral in production and distribution.
- More revenue productive.

Consideration on above grounds, researcher accepted that "The administrative complexity" is the main visualized problem of VAT in developing countries. However, they concluded that it is undoubtedly the ideal form of sales tax in many countries.

2.3.4 In a seminar "Value Added Tax on Asia" Organized by IMF/UNDP, Jakarta of Indonesia, (1991); Alan A. Tait Presented a paper entitled "VAT Issue : Structure, Inflation and Export" and later arranged on the occasional paper IMF, Washington D.C edited by the same author in 1991. The study concentrates on the policy concerns on the basic illustrations of same theoretical as well as empirical proofs.

- VAT is an alternative of retailer sales tax. However, both do not fully tax the unofficial business but the underreporting of sales value will show up under VAT.
- The VAT is for the buoyant base of revenue maintaining neutrality and efficiency in taxation.
- It is preferable that VAT has the capacity of covering all the stages of production to retail level and the services.
- Over all, VAT may not contribute in promoting exports but it makes the system easier.
- Single positive rate of VAT and few exemptions prove regressive but it should be evaluated, based on proofs, relatively less regressive than others.
- It should be weighted compared to the deficits.
- VAT simply, changes related prices but not the overall price increase. Tax increase should be deflationary.
- VAT administration is affected by many components which are whether all retail sales and services are taxed, how many rates are to

be used, the treatment of capital goods, financial services, small traders; all will affect the administration of VAT.

2.3.5 The famous pair of modern economists Musgrave and Musgrave (1976), in their book, "Public Finance : Theory and Practice" suggest that among three types of VAT, i.e. GNP, income and consumption types, the latest type is of practical consideration for both efficiency and quality criterion; and tax based on consumption is similar to the retail sales tax especially for the poor countries. The invoice method for calculation is more preferable and advantageous to the value added approach.

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

Between the two types of alternates; i.e. VAT and retail sales tax (RST) posing the same tax base; which one is more preferable? The strong difference in their opinion are analyzed as:

- Numbers of taxpayers are less under the RST than under VAT.
- Therefore the tax administration is feasible in RST than VAT.
- The exclusion of capital goods is more effective in VAT system than under RST.
- VAT constitutes self-enforcement in invoice system for calculating tax liability than under RST.

- VAT constitutes problems in such countries like USA, which have authority of tax calculation posed by the state level.

2.3.6 D. K. Stout in the empirical study on "Value Added Taxation: Exporting and Growth for Great Britain"(1963), has derived following conclusions:

- VAT is slightly inflationary but once at a time.
- VAT system encompasses lower rate and wider base.
- VAT does not deter the investment policy.

The entire empirical findings were drawn on the following ground and overlooked the administration and collection side:

- Using 1960’s data of Great Britain.
- Applying algebraic analytical methodology.
- Assuming ten percent of flat rate instead of all tax on goods, services and income tax.
- Compares two firms of Great Britain.
- Considering VAT a multiple stage tax.

2.3.7 Michelle Gerard in her paper entitled "The Brazilian State Value Added Tax", unpublished doctoral dissertation, submitted to Columbia University in 1972, illustrated that it is not easy as saying to implement VAT in developing countries. Open border along with least experiment of broader based tax implementation in developing countries is likely to face initially a more difficult problem. Early revenue collection was satisfactory in Brazil. In the first year of its introduction, revenue increased by 54 percent. Out of 54 percent it was realized 30 percent was due to price increase. Manufacturing industries accounted for 60 percent of total collection of VAT although it generated less than one fourth of GNP. It was learnt that most of inputs were exempted where as output was taxable. Due to this reason industrial sector increased the VAT.

2.3.8 Kwang Choi in his paper entitled "Value added Tax in the Republic of Korea" outlined the experience of VAT in his country. He declared that they did not have a major impact on the price increase. It showed a good impact on the investment. Studies found that the VAT in Korea was more or less regressive with respect to income. In its overall evaluation, the VAT has broadened tax base, reduced evasion, increased revenue and solved major problems associated with pervious taxes. The study was mainly summarized as:

- The Korea government and the public were fully prepared for adoption of VAT in 1997.
- The government spent a good number of years for preparation.
- The government became success to convey the massage that the adoption of VAT would benefit the businesspersons in Korea.
- VAT enjoys a positive reception form taxpayers.
- There was no serious problem of tax evasion.

Besides, the positive effects stated above, few realistic problems also realized in Korea. VAT poses a corresponding increase in tax administrative work. Administrative and compliance cost may be substantial.

2.3.9 Carl S. Scoup in his article "The VAT and Developing Countries" points out that:

- VAT reduces vertical integration because of its nature.
- VAT offers more revenue and coverage than other forms of sales tax.
- The tax is relatively easy to administer.
- The tax is inflationary to some extent.
- Basic account problems and efficient and empirical tax administration are lacking in developing countries, which are the main obstacles to VAT.
- The effects of VAT can't be generalized for all developing countries.

The study is mainly devoted in theoretical and policy issue.

2.3.10 The tax reform committee of India, headed by professor Raja J. Chellian has expressed the desirability of full-fledged VAT for India. The committee observed that the ideal solution, from the economic point of view, would be to have a single VAT at the central level, reaching down to the retail stage in replacement of most indirect taxes other than protective duties, the central excise, the state sales taxes, the municipal control, the goods and passengers tax and the electricity duty. The Indian budget of various fiscal years indicates the intention to introduce a VAT in order to rationalize the commodity tax system. In India, MODVAT system is applied.

2.3.11 Dr. Govinda Ram Agrawal has done research on "Resource Mobilization for Development: The reform of Income Tax in Nepal", in 1998 of the period between F/Y 1951/52 to 1978/79. The trend of resources gap and domestic resource mobilization through various taxation of the same period has been nicely analyzed in his study.

Following result has been observed after calculation of elasticity and buoyancy coefficient of various taxes using Sahota Method of adjusted index for separating automatic from discretionary changes of the period between F/Y 1967/68 to 1975/76.

Table 2.3

Elasticity and Buoyancy of Tax

Tax Heads	Elasticity	Buoyancy
Excise Duties	1.28	2.24
Custom Duties	0.80	1.18
Sales Taxes	1.74	2.20
Land Tax	0.12	0.17
Income Tax	2.01	2.10

According to his own words, the major findings of this study is since both buoyancy and elasticity coefficient are greater than unity, sales tax in Nepal is previously responsive to change GDP. However, the major constraints in the effective functioning of the tax system seem to be administrative deficiencies, complicated tax paying procedures etc."

2.3.12 Mrs. Kamala Devi Bajrachrya in her Masters Degree Dissertation on "A study on resource mobilization and excise taxation in Nepal" in 1993 of the period F/Y 1980/81, the major findings of this study in her own word "above 55 percent of the development finance is governed through foreign resource mobilization during the research period. The increasing trend of resource mobilization during the period between F/Y 1980/81 to 1990/91 is 16.3 percent while the public expenditure is increasing at the rate of 19.4 percent per annum. The trend of increasing resource gap of the period between 1980/81 to 1990/91 is 3.1 percent per annum and the resource mobilization through excise duties has been increasing every year."

2.3.13 Mr. Gopal Ghimire in his Masters' Degree Dissertation on "Measuring Responsiveness and productivity of Tax yields in Nepal's Tax structure" in 1994 of the period between F/Y 1972 to 1991/92; the major finding of this study, in his own words is 'the trend of different source of taxation shows that the contribution of total tax revenue from direct taxes has continuously declined and indirect taxes has continuously raised. The trend shows that magnitude as well as percentage contribution of traditional direct taxes i.e lands tax decline continuously, oppositely income tax and registration duty are increasing. High tax revenue contributor sector i.e custom duties also are in the first position presently. However, the revenue from import duties has set at second position. It has substituted by sales tax. Excise duty is also in increasing trend. Therefore, Nepalese revenue is heavily reliant on indirect taxes."

He has computed the elasticity and buoyancy coefficient of various taxes of the same period as follows:

Table 2.4

Elasticity and Buoyancy of Different Taxes

Tax Heads	Elasticity	Buoyancy
Total Revenue	0.6310	1.2456
Non Tax Revenue	0.1470	1.4256
Total Tax Revenue	0.4995	1.2014
Direct Taxes	0.4053	1.0758
Income Taxes	0.1727	1.2224
Indirect Taxes	0.9577	1.3245
Import Duties	0.5755	1.1102
Custom Duties	0.3456	0.9838
Export Duties	1. 3891	0.4095
Excise Duties	0.3668	1.8749
Sales Taxes	0.7168	0.8415

According to his study elasticity and buoyancy coefficient of overall taxes are less then unity, means that it is inelastic in nature. The export duty has negative elasticity in fact; the inelastic nature of tax system in developing countries is an inheritance characteristic resulting from heavy reliance in indirect taxes. The shares of indirect taxes are around 11.8 percent and non-tax revenue is 26.9 percent on total revenue.

2.3.14 A high level task force headed by Prof. Dr. Madan Kumar Dahal reviewed the Nepal's tax system in 1995. The team outlined the following reason to adopt VAT in Nepal:

- To broaden the tax base to increase the tax revenue.
- To make the tax system transparent and elastic.

- To prevent tax evasion.
- To make the system efficient and
- To encourage exports.

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

- A functional organizational pattern.
- Development of effective tax refunds system.
- Measure to increase self-compliance.
- Prompt taxpayer service and intensive tax education.
- Computerization of the tax administration.

2.3.15 Nepal chamber of commerce also made a study to analyze the possible effects of VAT in Nepalese economy in 1997. Dr. Pushpa Rajkarnikar headed the team. The main findings of the study report was as follows:

- VAT affects adversely in price level.
- It increases the price of imported goods ultimately which increases the cost of production thereby reduces the export business.
- Requirement of bookkeeping is complicated.
- It would finally affect the small traders.
- It is untimely to implement.
- It would be unjustifiable on social ground.
- Present administration is incapable for handling VAT.
- Computerization system is not sufficient and it is new concept for the tax administrator.

The study report suggested for a partial VAT on some commodities. It was in favor of phase-wise implementation of VAT. The study analyses negative impact of VAT neglecting its positive impact.

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

Different aspects of VAT have also been analyzed in his book. "The Nepalese Tax system" in his own word tax compliance is very poor in Nepal and different taxes are not being fully paid as per the law. There is a lack of transparency and both the taxpayers and tax collection authority take undue advantage of the situation. There is a lack of coordinated approach and long term strategy. Several tax measures were introduced in 1997/98 without any consideration and their possible effects.

CHAPTER- THREE
RESEARCH METHODOLOGY

All data are collected from secondary source. Secondary source of data are collected in order to fulfill the objective of study. As regards with the historical background of Value Added Tax, descriptive data helps to examine the historical background of Value Added Tax. Descriptive abstracts are taken from books, booklets, articles, newspapers, and magazines by making adjustment of own view to highlight the historical background of value added tax in the global context.

For the examination of effectiveness of value added tax in Nepal, the data are collected for 11 years relating of value added tax in total revenue collection procedure. In the same way, study is made on the basis of relevant factors such as rate, structure of VAT, contribution on GDP, total revenue, tax revenue and indirect tax revenue. The collection of data is arranged subsequently where tables are made; while making tables Rs. in 000000 (Million).

3.1 **Research Design**

Most of the data and information of the study are concerned with past phenomena of the performance either they were numerical or opinions. So it can be regarded as historical research design too. After the collection of past data and experiences, this study has analyzed and described its own procedure. Thus this study has also followed an analytical as well as descriptive research design.

3.2 **Nature and Sources of Data**

This study is based on secondary data. The tax revenue and other related data are collected from various Economic survey & budget speeches of Government of Nepal, Ministry of finance as well as publications of Inland Revenue Department. Attempts are also made to formulate more accurately the relationship between tax receipts and income by adding other independent variables to the estimating equation such as lagged income or population.

Other data collection sources are as follows:

- Published documents from ministry of finance.
- Published documents of different trade institution such as Nepal chamber of commerce (NCC), Federation of Nepalese Chamber of Commerce and industries (FNCCI), Confederation of Nepalese Industries (CNI).
- Published journals from Nepal Rastra Bank.
- Publications of Inland Revenue Department.
- Publications of National Planning Commission and Central Bureau of Statistics.

Other related records and data relevant to the study are taken from Economics journal, New business age, Rajaswa, Bazar, Spotlight, Nepal tax Patrika Value Added Tax Act, 2052, Vat Added Tax Regulation, 2053.

3.3 Procedure of Processing and Analysis of Data/ Statistical Tools.

The collected data are arranged systematically in sequential order then the required data are taken from appendix to put in tabular form. The statistical tools used for analysis of data are as follows:

- Simple Average
- Ratio
- Percentage
- Tabulation and trend presentation.
- Performance analysis by using standard deviation model.
- Other tools as needed.

3.4 Specification of the Model

In this study, I have tried to show the performance of sales tax from the fiscal year 1991/92 to 1996/97 for six years and VAT performance from the year from F/Y 200/2001 for six years or more where possible by using simple average, percentage etc.

Tabulation and presentation are used, especially in standard deviation (S.D) model.

For sales tax period, suppose 'x' be the independent variable of every years and 'y' be independent variable of VAT period respectively. Then 'n' is the symbol of number of years and ± indicate standard deviation (S.D).

Formula of standard deviation of individual series as on shortcut method

$$\pm \; X \sqrt{\frac{d^2}{n}} \; Z \; \frac{d}{n}^{\;2}$$

Where d = Variable's value (x/y) minus assumed mean of the series (x/y-a)

n = Number of years

CHAPTER – FOUR
NEPALESE TAX STRUCTURE WITH TREND OF VAT AND ANALYSIS OF DATA

4.1 Current Status

Not only to collect the large amount of tax but also to maintain the economic stability and social justice through improvement in the distribution of wealth, are the primary objectives of taxation. In this way, tax structure stands as a mirror of the fiscal policy instrument. The taxing capacity of the government as well as ability of people to pay tax is the major factor of constituting the tax structure. For the underdeveloped countries like Nepal, the role of taxation in the process of economic development is considerably significant. In this respect, the tax structure has vital role in development of the country.

Resource mobilization has been one of the challenging jobs for the developing nations. Mobilization of internal resources is emphasized for meeting the need of increased expenditure and investment for development works, and for gradually replacing the foreign assistance. In Nepal, itself has been faced with scarcity of internal resources.

Taxation is the major part of total government revenues. It is also the pillar of the fiscal policy as it contributes more than seventy five percent to the total revenue. In this situation, the tax structure stands as a mirror of the fiscal policy. For the purpose of the studies, tax structure of recent year from F/Y 1990/1991 to 1999/2000 has been employed in this chapter. Nepalese tax is simply divided into the following four categories:

- Tax on international trade.
- Tax on consumption and production of goods and services.

- Land revenue and registration.
- Tax on property, profit and income.

According to the incidence and the burden of the tax it can be broadly classified into two category i.e. direct and indirect tax. Various taxes have been introduced in Nepal. It's very difficult to make a clear demarcation between direct and indirect tax.

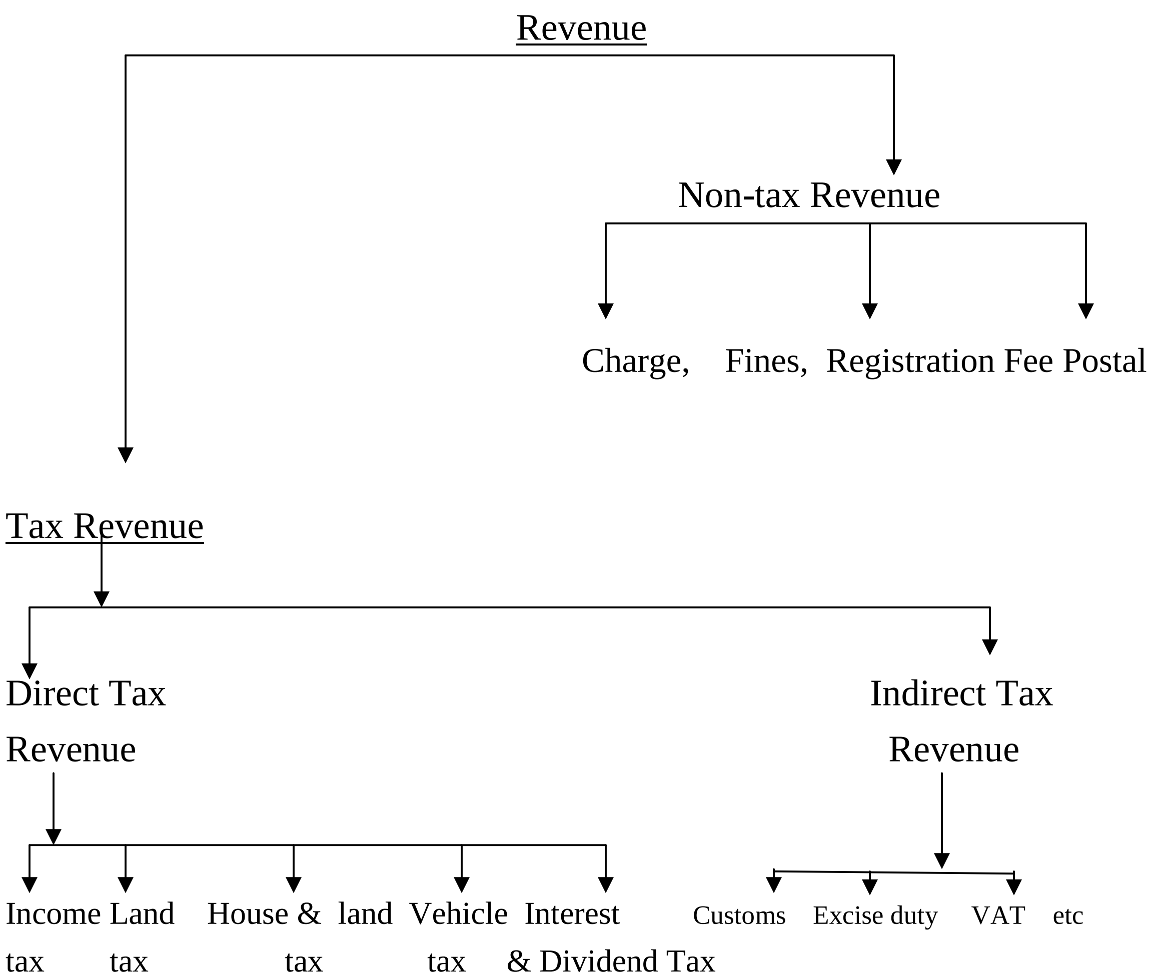
4.2 Historical Issues

The history of tax can be traced back to time when the society divided into two parts i.e. ruler and ruling. Probably the ancient Hindu religious book Manusmriti, the famous book of Emperor Manu, described about the tax system first. The other worldwide famous religious book of Hinduism such as; Mahabharat says in its description of Rajagya (the law of king) under Shanti Parba that every people of nation must pay their one sixth part of production to the king (Veda Vyas: about 31 st century BC). Coming to Nepal, in the Lichchhavies and even in Malla Regime, the development of tax became as bhaga (tax on agriculture sector), bhoga (tax on animal husbandry) and Kara (in general or periodical tax). According to the time of earlier Shah regime, tax concepts were sounded by the traditional land tax and other period. At that time, taxes were levied on agriculture, incomes from forest and mines, business etc. However, the tax system and trend of revenue collection was commenced with the budget speech of 1951 but which were limited to traditional sectors.

Income tax was introduced from fiscal year 1959/60. Sales tax, Contract tax, house and land rent tax in 1965/66. Tax reform programs and implementation of new tax system were continuous in Nepalese tax structure. In this way, the government has introduced and implemented Value Added Tax from 1997.

4.3 Revenue Structure of Nepal

The total revenue of government of Nepal is collected from tax and non-tax sectors. The tax revenue, which is compulsory sacrifice of the people, can be divided into two components; direct and indirect taxes. That revenue collected as income tax, land tax, property tax, etc. are direct tax and those revenues collected as sales tax (VAT), excise, customs etc. are indirect taxes. Other kinds of revenue e.g. postal services charge, fees, fines, dividend, interest, sale of assets etc. are non tax revenues. Non-tax revenue is not imposed specially on view of revenue collection. The structure can be seen in figure.



A. Analysis of Tax and Non Tax Revenue

Table 4.1

Revenue Trend of Nepal

In Million

S. No	Fiscal Year F/Y	Total Revenue (TR)	Tax Revenue	Tax Revenue % TR	Non-Tax Revenue	Non Tax Revenue % TR
1	1991/92	13512.06	9877.32	73.10	3634.74	26.90
2.	1992/93	15148.40	11662.50	77.00	3485.90	23.00
3.	1993/94	19580.80	15371.00	78.50	4209.40	21.50
4.	1994/95	24605.10	19660.00	79.90	4945.10	20.10
5.	1995/96	27893.10	1268.00	77.70	6225.10	22.30
6	1996/97	30373.50	24424.30	80.40	5949.20	19.60
7	1997/98	32937.90	25939.80	78.70	6998.10	21.20
8	1998/99	37133.10	28752.90	77.40	8380.90	22.60
9	1999/00	42893.80	33152.10	77.29	9741.60	22.71
10	2000/01	48893.60	38865.10	79.49	10028.80	20.57
11.	2001/02	50445.50	39330.60	77.97	11115.00	22.03
12.	2002/03	56229.80	42587.00	75.74	13642.70	24.26
13.	2003/04	62331.00	48173.00	77.28	14158.00	22.71
14.	2004/05	70122.70	54104.70	77.15	16018.00	22.84
15.	2005/06	72282.10	57430.40	79.45	14857.70	20.54
16.	2006/07	87712.20	71126.00	81.01	16585.00	18.91
17.	2007/08	107622.25	85155.5	79.12	22467.0	20.88
	Total			78.06		21.26

Note : VAT Includes sales Tax , Entertainment Tax, Hotel Tax, Contract Tax.

Sources: (i) Annual Report (Various years), IRD

(ii) Economic Survey (Various years), MOF

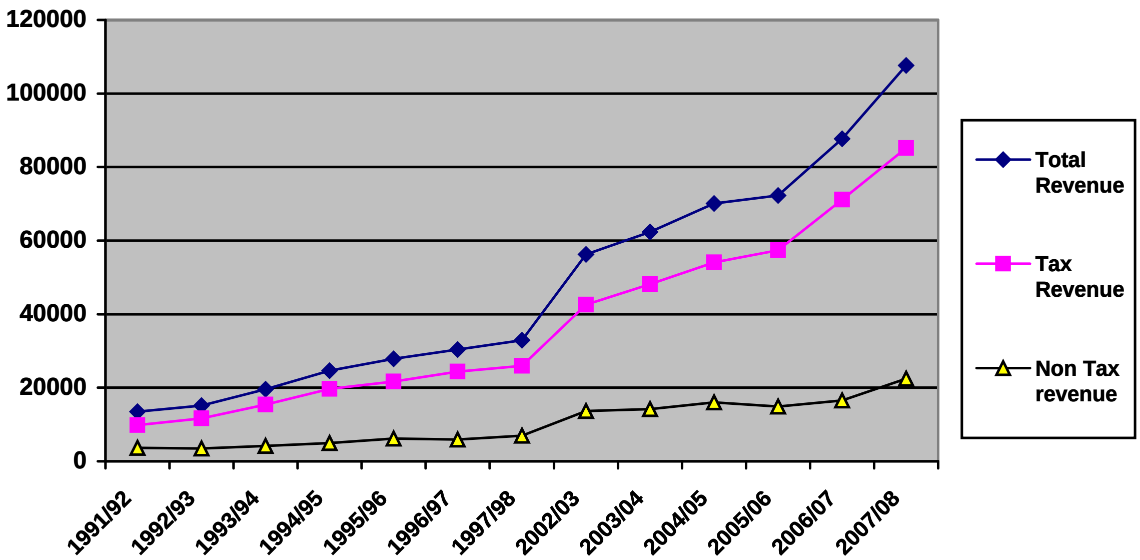
The composition and magnitude of total revenue as well as tax and non-tax revenue of Nepal is visualized in table 4.1. In F/Y 1991/92 the total revenue was Rs. 13512.60 millions, in which the share of tax and non-tax revenue was 73.10 and 26.90 respectively. It became 79.12 and 20.88 respectively in 2007/08. This shows that contribution of tax revenue is slightly increased on total revenue. If we analyze the above figure of different years, we find that dependency of revenue is uneven. It indicates that there is no specific growth in tax and non-tax revenues. The non-tax revenue is the crude source of revenue in underdeveloped countries but Nepal could not come out from this situation.

The total revenue collection was increased almost 4 times from the F/Y 1991/92 to 2007/08. But the rate of increment is uneven.

Revenue Trend of Nepal

(Tax and Non tax Revenue)

Figure No 4.1



Year 1991/92 to 2007/08

B. Tax Revenue and its Magnitude

From the beginning years, indirect tax has occupied a major share in tax revenue as well as in total revenue. This trend has not changed till now and possibility of changes seems rare in coming years also. Indirect tax was 61.27 percent share in total revenue and 83.85 percent share in tax revenue in F/Y 1991/92 whereas direct TAX contributions had a remaining share of 11.80 percent in total revenue and 16.15 percent of tax revenue.

Table 4.2

Magnitude of Tax Revenue

(Rs. in Million)

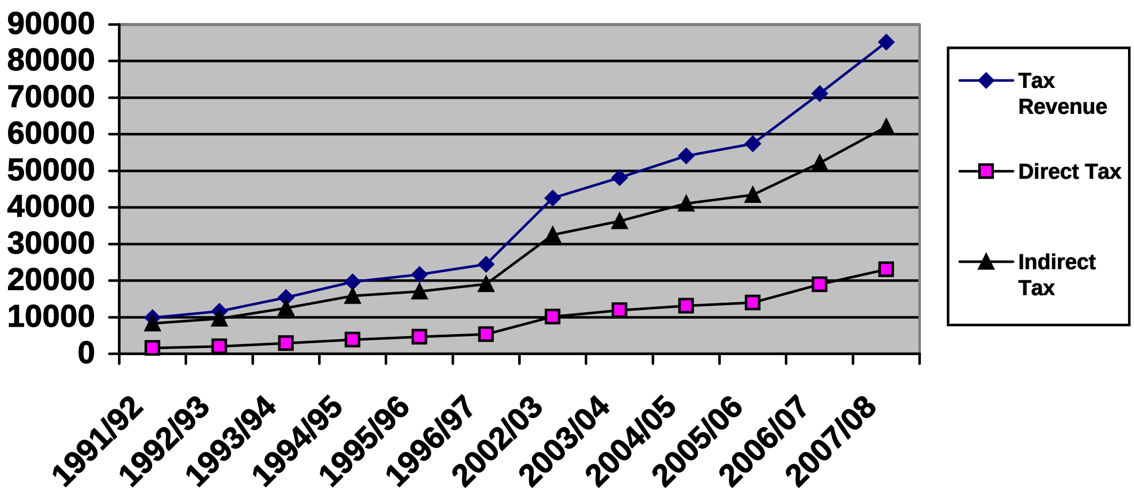
Fiscal Year	Total Revenue	Tax Revenue	Direct Tax			Indirect Tax		
			Amount	% of Total Revenue	% of Tax Revenue	Amount	% of Total Revenue	% of Tax Revenue
1991/92	13512.6	9877.32	1595.20	11.80	16.15	8280.40	61.27	83.85
1992/93	15148.4	11662.5	2036.20	13.44	17.46	9626.30	63.54	82.54
1993/94	19580.8	15371.0	2855.30	14.58	18.58	12516.2	63.91	81.42
1994/95	24605.1	19660.0	3849.30	15.66	19.58	15810.7	64.33	80.42
1995/96	27893.1	21668.0	4655.90	16.69	21.49	17012.1	60.99	78.51
1996/97	30373.5	24424.3	5340.00	17.58	21.86	19084.3	62.83	78.14
1997/98	32937.8	25939.8	6187.90	18.78	23.85	19751.9	59.96	76.15
1998/99	37133.8	28752.9	7516.10.	20.17	26.14	21236.8	57.00	73.86
1999/00	42893.8	33152.1	8951.50	20.87	27.00	24200.6	56.42	73.00
2000/01	48893.6	38865.1	10159.4	20.78	26.14	28705.7	58.71	73.86
2001/02	50445.5	39330.6	10597.5	21.00	26.94	28733.1	56.96	73.06
2002/03	56229.8	42587.0	10105.8	17.97	23.73	32481.2	57.76	76.27
2003/04	62331.0	48137.0	11912.6	19.11	24.72	36260.4	58.17	75.27
2004/05	70122.7	54104.7	13071.8	18.64	24.16	41032.9	58.51	75.83
2005/06	72282.1	57430.4	13968.1	19.32	24.32	43462.3	60.12	75.67
2006/07	87712.2	71126.7	18980.3	21.63	26.68	52146.4	59.42	73.31
2007/08	107622.2	85155.5	23087.7	21.45	27.11	62067.8	57.67	72.89
Average				18.00	23.28		59.85	76.92

Sources: Economic Survey F/Y 2007/2008, MoF

It is clear from the above table that the share of direct tax to total revenue and tax revenue marginally increased by 9.65 percent and 10.96 percent respectively on the comparison of the F/Y 1991/92 to 2007/08. Due to increase in the share of direct tax to total revenue and tax revenue the share of the indirect tax to total revenue and tax revenue reduced by 3.60 and 10.96 percent respectively. Though the share of indirect tax to total revenue has decreased in reviewing period, the role of indirect tax is more than that of direct tax because its share is still 76 percent of tax revenue.

Figure No 4.2

Tax Revenue Trend of Nepal



Year 1991/92 to 2007/08

C. Magnitude of Indirect Taxes

Indirect tax has a dominant role in the tax revenue. Similarly, Sales and value added tax has dominant position in indirect tax. For the comparison purpose, those taxes received from contract, hotel and entertainment tax has been included in value added tax because after the adoption of VAT all those taxes were replaced by VAT. In F/Y 1991/92 the share of customs duties, sales tax /VAT and excise duty was 40.6 percent, 39.70 percent and 17.10 percent respectively. Likewise, in F/Y 2007/08 the shares of customs duty, sales tax/VAT and excise duty are 33.93 percent, 48.04 percent and 14.03 percent respectively. which shows that the share of custom duty and VAT has increased in review period 2007/08 than that of F/Y 1991/92, but the share of excise duty and others are decreased.

Now, Nepal just has been the member of WTO. Its universal (main) norms are that, all goods and services can be imported in and exported from any country freely without any hindrance with equal and lowered custom rate base. So, we can say that custom duties will be decreased in future. In this situation, we have to strongly impose VAT and expand its areas, which will be main source of revenue collection. Certainly, the share of VAT will take good place than other component in indirect tax structure. In replacement of Custom duty, the Excise duty also has a significant share in increasing trend in tax revenue.

Table No. 4.3

Magnitude of Indirect Taxes

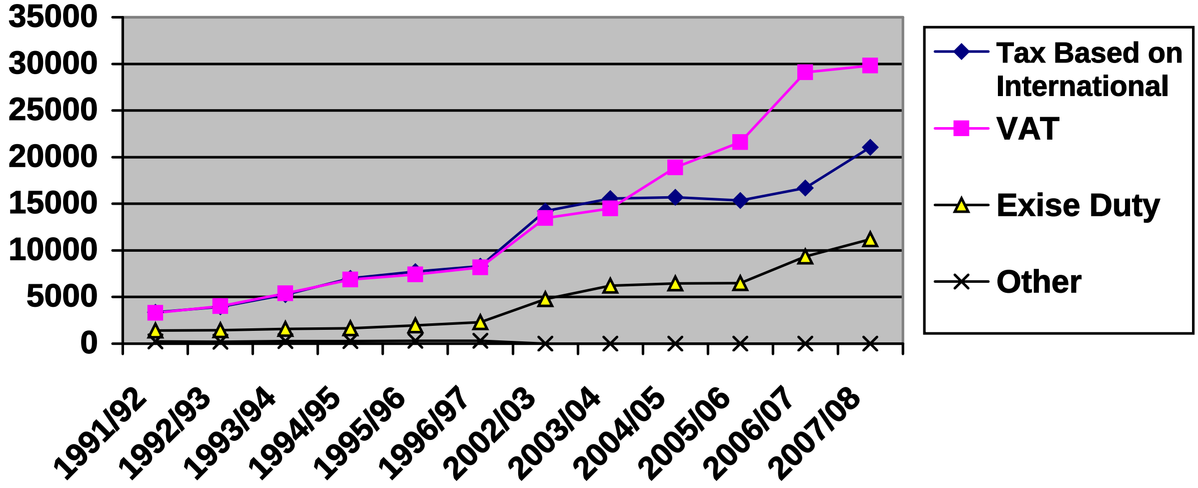
Fiscal Year	Tax based on international trade	VAT	Excise duty	Other	Total	% of Tax based on international trade	% of VAT	% of Excise Duty	% of Other
1991/92	3358.90	3283.60	1414.30	223.6	8280.40	40.60	39.70	17.10	2.60
1992/93	3945.00	4007.70	1452.80	220.8	9626.30	41.00	41.60	15.10	2.30
1993/94	5255.00	5380.90	1592.50	287.8	12516.2	42.00	43.00	12.70	2.30
1994/95	7018.10	6857.10	1657.30	278.2	15810.7	44.40	43.40	10.50	1.70
1995/96	7727.70	7429.30	1944.30	311.1	17012.1	43.10	43.70	11.40	1.80
1996/97	8309.10	8162.90	2298.10	314.2	19084.3	43.50	40.60	14.60	1.30
1997/98	8502.20	8020.60	2885.80	343.3	19751.9	43.00	40.60	14.60	1.20
1998/99	9517.70	8525.20	2935.20	240.7	21236.8	44.80	40.10	13.90	1.20
1999/00	10813.3	10259.7	3127.60	00.00	24200.6	44.70	42.40	12.90	0.0
2000/01	12552.1	12382.3	3771.20	00.10	28705.7	43.73	43.13	13.14	0.0
2001/02	12658.8	12267.3	3807.00	00.00	28733.1	44.06	42.69	13.25	0.0
2002/03	14236.4	13459.7	4785.10	00.00	32481.2	43.83	41.44	14.73	0.0
2003/04	15554.8	14478.9	6226.70	00.10	36260.4	42.89	39.93	17.17	0.0
2004/05	15701.6	18885.4	6445.90	00.00	41032.9	38.26	46.02	15.70	0.0
2005/06	15344.0	21610.7	6507.60	00.00	43462.3	35.30	49.72	14.97	0.0
2006/07	16707.6	26095.6	9343.20	00.00	52146.4	32.04	50.04	17.92	0.0
2007/08	21062.5	29815.7	11189.6	00.00	62067.8	33.93	48.04	18.03	0.0

Sources : Economic Survey (Various years), MoF

Note: Sales Tax/ VAT = Sales Tax +Entertainment Tax + Hotel Tax + Contract Tax

Figure 4.3

Indirect Tax Revenue trends



Years 1991/92 to 2007/08

4.4 Sales Tax and Value added Tax Effort Ratio

The relationship between Sales tax/VAT and GDP is known as GDP Sales tax/ VAT effort ratio and relationship between total revenue and Sales Tax / VAT is known as revenue Sales Tax/VAT effort ratio or revenue VAT effort ratio of the economy. All ratios have given different messages which are sales tax/VAT to GDP ratio is the indicator of the utilization of taxable capacity, which depends on the ability of people to pay and ability of taxable capacity, which depends on the ability of people to pay and ability of the government to collect the tax.

Table No 5.4 and 5.5 tries to show the relationships of sales tax/VAT to GDP, Total Revenue, Tax revenue and Indirect tax revenue.

Table 4. 4

Sales Tax and Value added Tax Effort Ratio

Before Implementation of VAT

Rs. In Million

Fiscal Year	GDP at Factor Cost	Tax Heads				Efforts Ratio of Sales Tax as % of			
		Total Revenue	Tax Revenue	Indirect Tax	VAT	GDP	Total Revenue	Tax Revenue	Indirect Tax
1991/92	144933	13512.70	9875.60	8280.40	3283.60	2.27	24.30	33.25	39.66
1992/93	165350	15148.40	11662.50	9626.30	4007.70	2.42	26.46	34.36	41.63
1993/94	191596	19580.90	15371.50	12516.20	5380.90	2.81	27.48	35.01	42.99
1994/95	209974	24605.10	19660.00	15810.70	6857.10	3.27	27.87	34.88	43.87
1995/96	239388	27893.10	21668.00	17012.10	7429.30	3.10	26.63	34.29	34.27
1996/97	269570	30373.50	24424.30	19084.30	8162.90	3.03	26.88	33.42	42.77
Total Average						2.82	26.60	34.20	42.35

Sources: Economic Survey F/Y 2003/04 / MOF

Table 4.5

Sales Tax and Value added Tax Effort Ratio

After Implementation of VAT

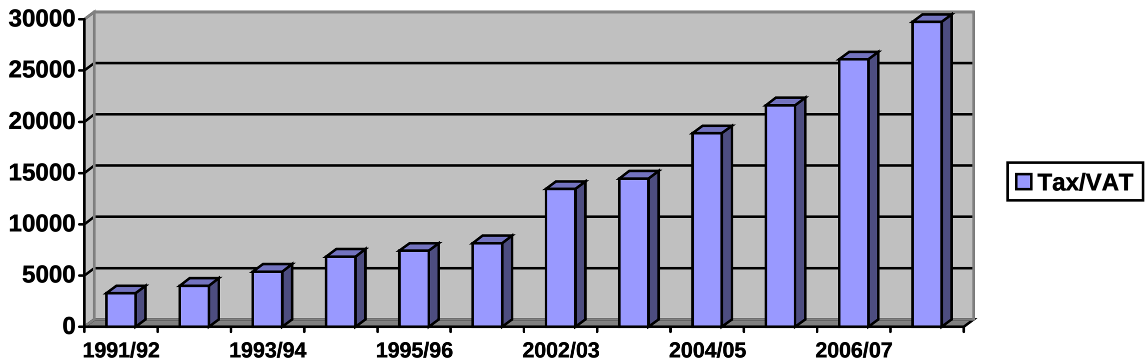
Rs. In Million

Fiscal Year	GDP at Factor Cost	Tax Heads				Efforts Ratio of Sales Tax as % of			
		Total Revenue	Tax Revenue	Indirect Tax	VAT	GDP	Total Revenue	Tax Revenue	Indirect Tax
1997/98	289798	32937.9	25939.8	19751.9	8020.60	2.77	24.35	30.92	40.61
1998/99	330018	37251.0	28752.9	21236.8	8525.20	2.58	22.89	29.65	40.15
1999/00	366251	42893.8	33152.1	24200.6	10259.7	2.61	23.92	30.95	42.39
2000/01	441519	48893.6	38865.1	28705.7	12382.5	2.80	25.33	31.86	43.14
2001/02	459443	50445.5	39330.6	28733.1	12267.3	2.67	24.32	31.19	42.69
2002/03	492231	56229.8	42587.0	32481.2	13459.7	2.73	23.93	31.60	41.44
2003/04	536749	62331.0	48173.0	36260.4	14478.9	2.69	23.22	30.05	39.93
2004/05	589412	70122.7	54104.7	41032.9	18885.4	3.20	26.93	34.90	46.02
2005/06	654055	72282.1	57430.4	43462.3	21610.7	3.30	29.89	37.62	49.72
2006/07	727089	87712.2	71126.7	52146.4	26095.6	3.58	29.75	36.68	50.04
2007/08	818401	107622.5	85155.5	62067.8	29815.7	3.64	27.70	35.01	48.04

Sources: Economic Survey (Various years), MoF, Nepal Government

In comparison of the above tables 4.4 and 4.5, the sales tax to GDP ratios in six years before implementation of VAT and after implementation of VAT, we found that the average VAT to GDP ratio is greater than average sales tax to GDP ratio. It indicates that after implementation of VAT has seemed good performance than before implementation of VAT. Another comparison like sales/VAT to total revenue ratio, sales /VAT to indirect tax ratios are slightly less immediate after implementation of VAT than before implementation of VAT. The reason, we can take various causes like in 1st period nobody had a good knowledge about VAT, even tax administrator, taxpayers and lack of political commitments. After two, three years period of implementation of VAT, our country faced very serious problems of internal conflict, which directly affected the business sector. Even though, despite various obstacles, in aggregate comparison of VAT seems good performance than sales tax.

Figure 4.4
Sales Tax/ VAT Collection



Fiscal year 1991/92 to 2007/08

Before implementation of VAT After Implementation of VAT

4.5 Comparison of Performance between Sales tax and VAT by using Standard Deviation Model

A. Concepts

The tax literature provides some analytical tools to evaluate the tax structure model and comparative study between different types of taxes. Tax ratio, marginal tax rate, index of tax efforts etc. are such components. But to measure responsive effect of taxes, we can use mean deviation or standard deviation or correlation or regression analysis tools.

Among them, standard deviation tools are usually used in the absolute measurement of dispersion in which the drawbacks present in other measures of dispersion are removed. It is said to be the best measure of dispersions as it satisfies most of the requisites of a good measure of dispersion.

B. The Data

This study has been based on the secondary data. The tax revenue and other related data are collected from Economic survey (various years) of government and Annual Report of Inland Revenue Department as well as various publication of NRB and CBS. Besides these, publication of CEDA, NRB etc. have been used to collect necessary data and information.

C. Comparison of Data

For comparision, the data for sales tax are taken from F/Y 1991/92 to 1996/97, for 6 years and for VAT from 2002/03 to 2007/08, 6 years. The secondary data are not examined.

D. Analysis of Data Using Tools of Standard Deviation

Standard deviation (S.D) is defined as the positive square root of the mean of the square of the deviations taken from the arithmetic mean. It is denoted by ± (sigma).

For comparison of performance, the data of whole period is not considered for convenience of calculation because the data of sales tax period is available of just six years. So the data of Value Added Tax is also considered for six years only. This research tries to solve the problem by individual series by using short cut methods.

Standard Deviation is computed by this formula

$$\pm \ = \sqrt{\frac{d^2}{n}} \ Z \ \frac{d}{n}^{\ 2}$$

Where, d = x-a,

x = Observations

a = assumed mean

n = No. of observation years

E. Coefficient of Variation

Standard Deviation is the absolute measure of dispersion. The relative measure of dispersion based on the Standard Deviation is known as the coefficient of Standard Deviation.

Coefficient of S.D. = $\frac{\pm}{\overset{z}{x}}$

The coefficient of dispersion based on Standard Deviation multiplied by 100 is known as the coefficient of variation.

C.V = $\frac{\pm}{\overset{z}{x}} \mid 100$

Where, $\overset{z}{x}$ = mean of the series

It is independent of unit so two distribution can be compared with help of C.V for the variability, consistency, performance etc.

F. Decision Model

More the C.V, less will be uniformity, consistency and high variation etc. Less the C.V more will be uniformity, consistency and performance etc.

Table 4.6

Computation of Standard Deviation

Before Implementation of VAT

Rs. in Million

F/Y	Sales Tax (X)	d= x- a	d^2
1991/92	3283.60	-2097.30	4398667.29
1992/93	4007.70	-1373.20	1885678.24
1993/94	5380.90	00.00	00.00
1994/95	6857.10	1476.20	2179166.44
1995/96	7429.30	2048.40	4195942.50
1996/97	8162.90	2782.00	7739524.00
	x =35121.50	d = 2836.10	d^2 =2039878.53

Calculation of S.D before implement of VAT

Assumed mean, a = 5380.90

Difference, d = x - a

Mean of the series $\left(\bar{x}\right) = \frac{x}{n} = \frac{35121.5}{6} = 5853.58$

we have,

$$\pm = \sqrt{\frac{d^2}{n} \text{ Z } \left(\frac{d}{n}\right)^2} = \sqrt{\frac{20398978.53}{6} \text{ Z } \left(\frac{2836.10}{6}\right)^2}$$

$$= \sqrt{3399829.75 \text{ Z } \frac{8043463.21}{36}} \text{ X} \sqrt{3399829.75 \text{ Z } 223429.53} \text{ X} \sqrt{3176400.22}$$

$\pm$ = 1782.25

Finding the Coefficient of Variation:

If $\left(\bar{x}\right)$ be the arithmetic mean and ± be the standard deviation of the services, then the C.V. is defined by:

$$C.V = \frac{\pm}{\bar{x}} | 100 \ X \frac{1782.25}{5853.58} | 100 \ X 33.45\%$$

Table 4.7

Computation of Standard Deviation

After Implementation of VAT

Rs. in Million

F/Y	VAT (Y)	d = y- a	d^2
20002/03	13459.70	-8151.00	66438801.00
2003/04	14478.90	-7131.80	50862571.24
2004/05	18885.40	-2725.30	7427260.09
2005/06	21610.70	0.00	0.00
2006/07	26095.60	4484.90	20114328.01
2007/08	29815.70	8205.00	67322025.00
	y =124346	d = -5318.20	d^2 = 212164985.34

Calculation of Standard deviation after implementation of VAT

Assumed mean , a = 21610.70

No. of years, n = 6

Difference, d = y-a

Mean of the series $\left(\bar{y}\right) = \frac{y}{n} = \frac{124346}{6} = 20724.33$

Then we have,

$$\pm \;=\; \sqrt{\frac{d^2}{n} \; Z \; \left(\frac{d}{n}\right)^2} \; X \sqrt{\frac{212164985.34}{6} \; Z \; \left(\frac{Z5318.20}{6}\right)^2}$$

$$= \sqrt{34575179.11} \quad = 5880.06$$

$$\pm \;=\; 5880.06$$

Finding Coefficient of Variation:

If $\overline{y}$ be the arithmetic mean and ± be the standard deviation of the series, then the C.V is defined by

$$\text{C.V} \;\; \frac{\pm}{\overline{y}} \mid 100 \; X \frac{5880.06}{20724.33} \mid 100 \, X \frac{588006}{20724.33} \; X \, 28.37\%$$

Decision:

Above calculation of the series before and after implementation of VAT are 30.45 and 28.37 percent respectively. According to the phenomena of S.D., the C.V. of VAT is less than C.V. of sales tax. From the above observation we can conclude that the performance of VAT is better than the performance of Sales Tax. Since the S.D. of VAT is higher due to higher rate of increase in VAT collection.

4.6 Trend of VAT in Nepal

Registration

All vendors dealing with taxable goods and services are required to register for VAT if their total turnover is above the threshold. The current

Threshold is Rs. 2 millions. Those vendors whose annual turnover is below the threshold can register voluntarily. The status of registration is as follows:

Table No. 4.8

Statistics of VAT Registration

Time (F/Y)	Number of VAT Registration	Percentage Increment	Cumulative Total
Mid –July 1999	NA	-	9692
Mid- July 2000	8512	87.82	18204
Mid- July 2001	3577	19.65	21781
Mid- July 2002	3368	15.46	25149
Mid-July 2003	4723	18.78	29872
Mid-July 2004	4302	14.40	34174
Mid-July 2005	5602	16.39	39776
Mid-July 2006	7052	17.73	46831
Mid-July 2007	6134	13.10	52965
Mid-July 2008	6742	12.73	59707

Source : Annual report 2064/65, Inland Revenue Department

As stated earlier, the number of sales tax registration was 2045 at the time of introduction of VAT. The number of VAT registrations reached 9692 by the end of the fiscal year 1998/99. Eventually 8512, 3577,3368,3205,4750, 1526, 6994, 6155, 6605 new registrants in VAT on 1999/2000 to 2007/08 respectively which is taken as good trend of VAT registrants. About one third are voluntary and two third are compulsory. The composition may be seen by table No 4.9

Table No. 4.9

Voluntary and Compulsory Registrants

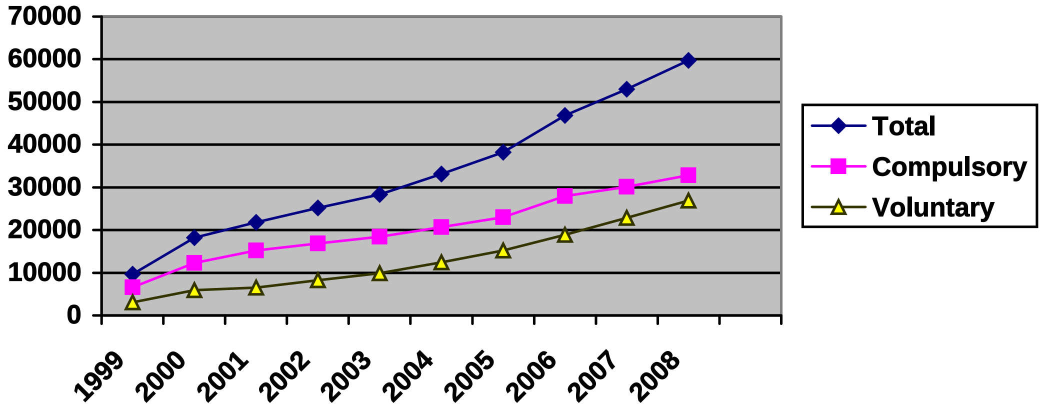
Time	Registrants				Total
	Compulsory	Percent	Voluntary	Percent	
Until Mid-July 1999	6613	68.23	3079	31.77	9692
Until Mid-July 2000	12284	67.48	5920	32.52	18204
Until Mid-July 2001	15248	70.01	6533	29.99	21781
Until Mid-July 2002	16877	67.11	8272	32.89	25149
Until Mid-July 2003	19429	65.04	10443	34.96	29872
Until Mid-July 2004	21331	62.42	12843	37.58	34174
Until Mid-July 2005	23961	60.23	15815	39.76	39776
Until Mid-July 2006	27972	57.51	18859	40.27	46831
Until Mid-July 2007	30095	56.81	22870	43.18	52965
Until Mid-July 2008	32797	54.92	26910	45.07	59707

Source : Annual report (Various Years), Inland Revenue Department

From the above table, it is clear that the VAT registrants are in increasing trend, which shows good performances of VAT implementation in Nepal.

Figure No 4.5

VAT registrants Trend



Mid-July 1998 to 2007

Value added Tax Returns

There is a legal provision of VAT Act that all the registrants are required to submit their VAT returns to the concerned Inland Revenue office within the specified tax period, which is generally monthly, or others. Similarly, all the registrants need to maintain and update their transactions in purchase and sales register. The returns are filed according to their maintained register. The returns are as follows:

Debit Return

All the purchasers pay value added tax to the supplier for taxable transactions. The importers also pay such tax at the custom point at the time of import. The registrants claim that amount of tax which they paid which is called credit tax. And in sales transaction, the registrants collect tax, which is called debit tax. If debit tax is greater than credit tax, the vendors have to deposit the debit tax to the office that types of return are called debit return.

Credit Return

Credit return is just opposite to debit return. In these returns, the credit tax exceeds the debit tax. If the purchase amount is greater than sales amount than there exists this situation. At the time of export also the credit amount exceeds the debit amount because of zero rate in export where the venders can get the different amount from tax office.

Zero Return

In some tax period, the vendors may not have any transaction. At that condition, they neither get credit nor collect any tax. But the vendors have to submit their blank return filling zero. That kind of return is called Zero Return.

Table 4.10

Trend of VAT Returns

Description / Fiscal Year	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Total Vat Registrants	17947	21097	25149	29872	34174	39776	46831	52965	59707
No. of Submitted Returns	17271	19710	21437	23099	25049	28525	33633	36457	40149
Debit Returns	6027	6975	6936	7178	8483	9478	10449	11457	12052
Percentage	34.90	35.39	32.30	31.06	33.87	32.20	31.06	31.43	30.02
Credit Returns	7766	8250	8844	9553	9625	10260	12882	13594	15050
Percentage	44.97	41.86	41.19	41.36	38.42	36.00	38.17	37.29	37.49
Zero Return	3475	4471	5207	5972	6783	8271	10139	11.44	12779
Percentage	20.12	22.68	24.25	25.85	27.08	29.00	30.14	30.29	31.83
Non decided Return	3.00	14.00	486.00	396.0	158.00	516.00	163.00	362.00	258
Percentage	0.02	0.07	2.26	1.72	0.63	1.80	1.40	0.99	0.64
Non Filer	676	1383	3676	5255	7322	8492	13198	7098	9050
Percentage	3.79	6.72	15.18	17.59	21.43	22.96	21.63	14.58	16.66
Deregistration	123	172	80	18	30	30	36	31	150
Close of Business	-	172.00	360.00	531	570.00	445.00	647.00	793.00	863

Source : Annual Report (Various Years), Inland Revenue department (IRD)

From the above table, we can compare the various types of returns in various fiscal years. In fiscal year 2000, the percentage of debit return, credit return, zero return and non decided return was 34.90, 44.97, 20.12 and 0.02 respectively. But in the fiscal year 2008, the ratio became 30.02, 37.49, 31.83 and 0.64 respectively. The figure shows that debit and credit returns are in decreasing and zero and non decisive returns are in increasing trend. The decreasing trend of debit return indicates that the actual number of taxpayers for internal tax collection is not satisfactory.

The large ratio of credit return indicates that either the numbers of exporters is increasing or the taxpayers are holding a lot of stock. The zero return percent is increasing. It also proves that the average Nepalese business is falling that's why the business organization are running without transactions. The percentage of non-filers has increased from 3.79 in 2000 to 16.66 in 2008 which indicates the negligence of taxpayers and poor performance of tax administration too.

Figure 4.6

Trend of Filing of Tax Returns

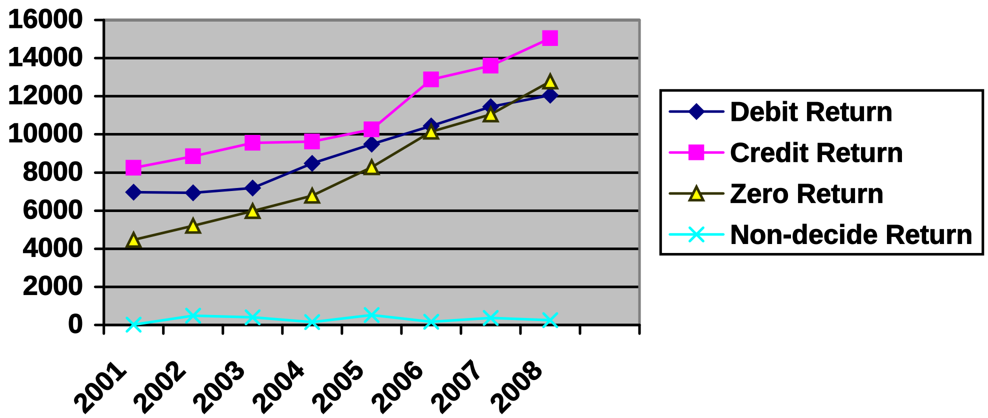


Figure 4.7

Trend of De-Registrations

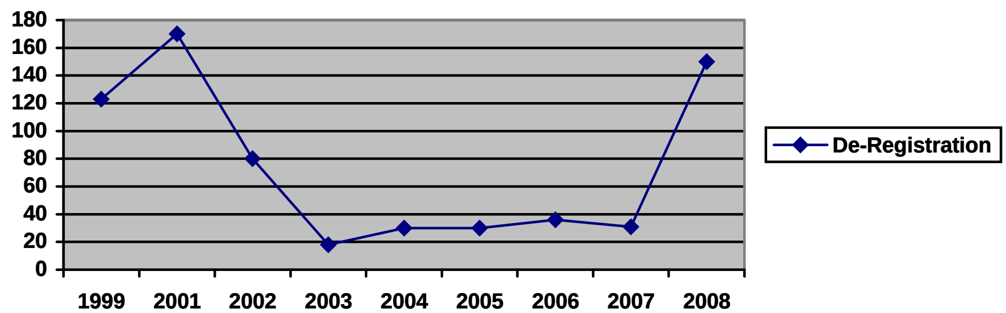
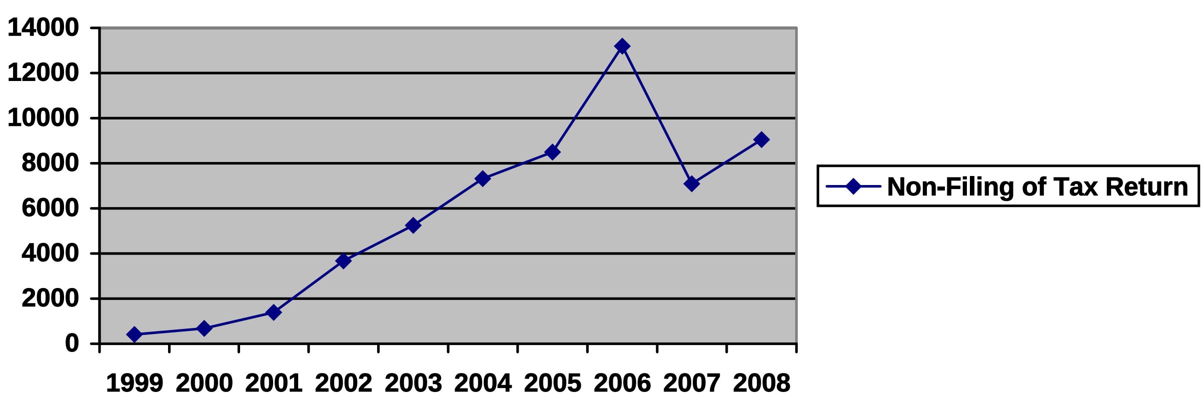


Figure 4.8

Trend of Non-Filing of Tax Return



4.7 KEY ISSUES OF VAT IN NEPAL

VAT was in effect from November 16, 1997. Nepal has just twelve years of experience in VAT. Though it is considered as a developed form of sales tax, its concept and system was completely new to Nepalese people. General situation were not congenial at he time of its introduction. Various issues were raised before and after its implementation. Most of them were gradually settled down. Few of them are still prevailing. They can be explained as follows:

4.7.1 Invoicing Issue

Tax invoices are crucial for effective implementation of VAT. They establish both the tax liability of the supplier and the amount of dedication allowed to the registered purchaser. The real invoicing is becoming a challenging job for the VAT administration in Nepal. From the very beginning of its introduction, it has been a hot issue of discussion. All the salient features of VAT are based on the assumption of real invoicing. Self-policing feature and catch-up effect of VAT would not be applicable in the absence of real invoicing.

Even after the four and half years of its implementation, the market price has not been established. Under invoicing and non-invoicing has been the greatest problem of VAT implementation. Wholesalers and retailers blame producer/importers and wholesalers for the same. Wholesalers and retailers say that they can't issue the proper invoice because they themselves do not get proper purchase invoice.

Collection of VAT will not be affected by the suppression of invoice at any one stage of distribution. VAT assumes that whatever tax is suppressed in the earlier stage that will be recovered from the next stage. This assumption applies only when the bill of actual transaction is realized at any one of the stages of distribution. Nepal has a bitter experience in this front. From importer to realer, no one shows the real transaction.

Despite the various liberal steps taken in Nepal after the advent of liberalization and deregulations regime, the mentality of businessmen, tax officials as well as political leaders have not changed. Businessmen do not want to lose the earnings that come from the evasion of tax. Some tax officials also support them directly or indirectly for their personal gain. Politicians also ask money from the businessmen in different names like donation, welfare etc. then there will be evasion on the same scale. There are still many honest and sincere persons in the business, bureaucracy and political party. Due to minority in number they are compelled to hear all the blames for which they have not done any fault. These people who tried to be pioneer for the correction of the evil have become victim of the majority of people who are in favor of illegal gain.

4.7.2 Valuation Issue

Under-valuation is the important point as well as it has also problem of real invoicing. When self-valuation method was in effect at custom point, as requested by the businessmen, the self-valuation system was discarded and transaction value was applied. The transaction value, as shown by the importers, is not par with reality.

It was experienced that goods were undervalued even in a self-valuation system. The situation further deteriorated after the introduction of transaction value for valuation. It was assumed that transaction value would be higher than self-value and ultimately increase the revenue. For this reason duty of customs were reduced. But the situation went adverse in contrast to the assumption. Sometimes there is the controversy that Customs Department accuses IRD for not taking the situation whereas IRD accuse customs department for the same. Contradiction between the revenue collecting government agencies only supports the importer for under-invoicing. The proper cooperation and coordination between two agencies should be maintained for the effectiveness of VAT otherwise it leads to deteriorate the situation.

Businessmen are of the view that structure of income tax and not accepting the bill value by customs official are the main cause for the under-valuation. According to them the rate of income tax is still high in Nepal. They fear not for VAT but of burden of income tax. They also blame government for not accepting the value of bill produced by them even after the announcement of adopting transaction value.

As small vendors are mostly illiterate and unorganized they move from one place to another for sale and it is very difficult for them to comply all the formalities of VAT, neither can they contribute a substantial amount of tax from their sale. A high number of taxpayers without contribution of VAT will only create complexity to administration. For the simplification of administration every nation keeps a threshold. Nepal is no exception of this phenomenon.

Fixation of threshold has also been a major debatable issue from the very beginning. Businessmen ask for higher threshold giving the reason that lack of accounting knowledge and proper information of tax existed in the business circle of Nepal and they can't comply with all the formalities of VAT properly. Government tries to fix low threshold with a view to broaden tax base. Government accuses the businessmen of denial to show actual transaction. They do not like to show their actual transaction fearing the burden of income tax.

5.7.3 Threshold Issue

A provision of threshold is necessary for the implementation of VAT. A high threshold limit does create some problems. Small business whose value added is untaxed are given an advantage. Traders are, therefore, tempted to misrepresent sales to remain below the threshold.

Threshold has been changed four times within seven years of its introduction. VAT regulation, 1997 had fixed a threshold of Rs. 1 million by the Finance Act, 1998 after eight months of its introduction. It did not existed for long time. It was further extended to Rs. 4.5 million by VAT rule (first amendment) 1999, Finance Act, 2000 again reduced it to Rs. 2 million, which is existing till now.

4.7.4 Exemption Issue

Though the provision of exemption from tax is also essential for the implementation of VAT, the area and the selection of goods and services to be exempted are becoming a controversial issue between the government and the businessmen from the initial stage of VAT implementation. It is granted on administrative and social grounds. Many goods and services for the exemption of tax are not based on only single reason. It is affected by several reasons. Out of them the following are considered as crucial reasons:

- Problem of administration
- Social ground
- Potentiality of tax collection
- Cost of collection
- Political pressure
- Consumer attitude

- Tax base
- Accounting base
- Use and necessity of goods and services
- Overall economic condition of the country

Selection of goods and services for the exemption of VAT should be in line with the principle of VAT. A fundamental characteristic of exemptions in the VAT system is that they generally do not provide complete relief from the tax. From the both theoretical and practical viewpoints, exemptions should be kept to a minimum. Granting heavy exemptions would create difficulties than simplification. For this reason, government tries to keep the list of exemption as few as possible. In reality, other forces, in addition to government, also play a crucial role in determining the goods and services for tax exemption. Businessmen of Nepal are in favor of high magnitude of exemptions. They feel comfortable in VAT administration by granting exemption of tax in various goods and services.

Due to various reasons government has provided a lot of concession in VAT. A list of exempted goods and services provided in VAT has not reduced in comparison to goods and services provided in sales tax.

It is not a good signal for the proper implementation of VAT. It has been a burning issue to select the goods and services for tax exemption in accordance with the principle of VAT. Undue pressure for exemption of VAT is neither beneficial to economy nor to the businessmen. It is a challenging job for the VAT administration to convince the taxpayers and businessmen in favor of curtailing exempted goods and services that are not necessary to continue.

4.7.5 Administrative Issue

TAX administration of Nepal has been blamed for poor service delivery and performance, weak administration, traditional attitude, restricted mentality and negative to taxpayer. It has not been successful to get the confidence of taxpayers. VAT is based on modern concept. For the effective implementation of VAT, the cordial relationship between taxpayers and tax officials is necessary as both are involved in tax collection. A broad based value added tax was introduced in an adverse situation. Taxpayers as well as policy makers were not confident that the existing tax administration could administer the VAT. Most the tax officials were not motivated in VAT administration and still wanted to transfer to other uncreative department. There was a problem of retaining well-trained staffs. Most of tax administrators worked in controlling system of taxation. The attitude of being a master in tax administration has not changed. All the posts, vacant in the organization, have not been fulfilled in time. Administration is still not strong as is desired by system of VAT, which assumes automated tax administration. Though in-service training programme has been organized to make staffs trained but it is not sufficient. The most challenging job for tax administration is to control the tax evasion and to establish the market price. Question mark is continually hanging at the capability and efficiency of tax administration, which has been a major issue of debating. The audit and investigation of the taxpayers is a strong tool of the tax administration to curb tax evasion. If effectively performed it encourage voluntary tax compliance. But investigation process is not based on proper information and scrutiny, so it has not given expected result.

CHAPTER- FIVE
SUMMARY, FINDINGS, CONCLUSIOIN AND RECOMMENDATIONS

5.1 Summary

Value added tax, the youngest member of the sales tax family, has already been implemented popularly in more than 125 countries in the world. VAT is multi-stage commodity and service based tax, which is levied on the value added of business enterprise at different stages of production and distribution. During he last four decades of tax reform all over world, VAT became superior to all types of sales tax. It was seriously considered in Nepal during the first half of 1990s and came into practice since 1997. Some studies were conducted in that period and concluded that, VAT was applicable to Nepal. But for the purpose of its effective implementation, the administration faced serious challenges. Adequate preparation was suggested for its success in future. However, despite the resistance from some faction of the business community and general people in the early stages, VAT is now accepted increasingly and is well implemented as an integral part of the Nepalese tax system. Among the three types of VAT, viz. gross national product type, income type and consumption type, the latter type is widely used in the world, which excludes capital goods from its base and hence does not penalize investment and growth in the economy. This consumption type is considered to be neutral to any investment decision for adaptation of either capital intensive or labor-intensive technique of production. It is also desirable from the viewpoint of foreign trade because it is compatible with destination principle and it is much easier to handle administratively as compared to other variants. The methods of calculating VAT are addition methods, subtraction method and tax credit or invoice method, among which the last one is the most popular, under which net VAT liability is calculated by subtracting VAT paid on purchases from the VAT collected on sales hence value added, as such, is calculated automatically.

Registration of business vendors having taxable transaction is the first step of VAT operation in any economy. Then each VAT registrant is required to issue actual invoices compulsorily on his sales and prepare accounts accordingly. Then tax return should be prepared and filed to the concerned office and pay the tax amount. Other important aspects that are required for the successful operation of VAT are enforcement, auditing, computerization, penalty etc.

While comparing VAT with other types of sales tax, it is so far super on many grounds such as economy efficiency, revenue productivity, and administrative simplicity. However, retail level sales tax is only the nearest competitor of VAT. Through the retail level both will generate equal revenue with similar coverage and rates. If VAT be implemented effectively along with its different provisions like exemptions, threshold, zero-rating, it will be more equitable. Avoidance of pyramiding and cascading effects and providing cross-audit, self-policing and catch up effects are the most favorable features of VAT, which makes it superior even than RST.

Nepal has entered into a major global tax system with the introduction of VAT in 1997 and it is taken as the major step in its process of tax reform. However, for the first two years of implementation, there was confrontations and negotiations between private sector and the government bodies under the different provision of VAT so that VAT could not be implemented in its full fledged form. Like the VAT in the most of the countries in the world, Nepalese VAT is of consumption type and the method used for the calculation is tax credit method. The threshold limit is Rs. 2 million and it is subject to flat rate of 13% with zero percent rates on exports. Some selected goods and services are totally exempted from VAT base basically due to the administrative complexity and equality consideration.

A multiple rated VAT is less regressive than a single rated but a single rated VAT is slightly desirable on several grounds. Multiple rate VAT is administratively more complex. Provides a gate for tax evasion for traders and may create economic distortions. The structure of VAT in Nepal is well designed, however, the existing coverage of exemptions is significantly broad and the threshold limit is also high. However, a well-designed structure of VAT will be nothing if the implementation is not going accordingly and successfully. Exactly, same thing is happening with VAT in Nepal.

Tax revenue is the major source of public revenue for the government of any country. While observing the structure of total tax revenue, it is dominated by indirect tax, which is the general phenomenon of the underdeveloped countries. Indirect tax is regressive by nature, however, its role is more significant in the underdeveloped countries like Nepal. Indirect tax will provide higher saving- investment ratio than the direct tax yielding equivalent revenue. Indirect tax is also helpful to cut the consumption of luxurious and socially harmful commodities. However, the replacement of indirect tax by the direct tax is passing phase towards development and it is the fact which developing countries really want.

In Nepal, the share of indirect tax to the total revenue is significantly high, about 77 percent. which has played a dominant role than direct ax. In Nepalese revenue history, the average share of tax and non-tax revenue is about 77 and 23 percent respectively. In tax revenue, the indirect tax contributes about again 77 percent of the total tax revenue. The indirect tax revenue is taken by customs duties. Its average share in the indirect tax revenue is about 43 percent of total indirect tax while the rest is covered by the tax on consumption and the production of goods and services. The tax / GDP ratio of Nepal is around 9.78 percent in 2002/03 which is very low than the required level. According to A Lewis, the Tax GDP ratio should be at last 17 percent for underdeveloped countries for achieving the path of development but Nepal's condition is very much below than that.

VAT, one of the indirect tax, came into existence from 1997 in Nepal and is contributing about 3 percent of the GDP. The average share of VAT in total revenue is around 24 percent and about 31 percent of the total tax revenue. Its share is in the line of around 42 percent of the total indirect tax.

The effectiveness of VAT implementation is not quite satisfactory. Rs. 8 billion revenue was collected through VAT in the first year of its implementation. This figure has gone up almost 13 billion in the sixth year. The sales tax revenue was collected from four headings, which has been replaced by VAT. The average ratio of total revenue, Tax revenue and indirect tax revenue was 26.60, 34.20 and 42.35 percent before implementation of VAT but after implementation of VAT in equal year, the average effort ratios 24.12, 31.03 and 41.74 percent respectively which is decreasing. This fact proved that VAT has been collecting less revenue than what the other four heading of sales taxes used to collect. But it does not mean that VAT is ineffective and should be dropped off from the tax system; rather its bleak position is due to the confrontation of the business community and the unfamiliarity about the VAT to the people. It takes time to adjust in new soil, there is not alternative of the VAT. In fact, the implementation of VAT was not being an easy task in the initial days. It was a matter of great debate. Even after the imposition of the VAT, there were a lot of barriers and difficulties in introducing and implementing phase. A large number of traders and business communities were against the VAT. The first two years of VAT were very troubling. The FNCCI, NCC and their affiliated agencies were standing in opposition. Despite all this, VAT was introduced and stood up to this level. Other sides, the political stability and commitment are not taking in right direction. The whole country is facing political uncertainty. Now VAT is currently well understood by the consumers as well as business and industrial communities of Nepal. It is account-based tax that leads to transparency and accountability both on the part of taxpayers and tax collectors. Despite the strong opposition to VAT from the business community, the number of registrants has been increasing gradually and reached 59707 by July 15, 2008.

Although, VAT has been in operation for the last twelve years it is still facing a number of challenges owing to poor administration, lack of good faith and honesty, rampant corruption, political instability, the problems of non issuance of bill, narrow coverage etc. For improvement in effective VAT implementation, various areas including proper billing system, efficient tax administration, intensive billing enforcement, wide coverage, computerization etc. are needed.

5.2 Findings and Conclusions

Value added TAX puts greater significance in revenue mobilization in Nepal. The implementation of VAT, the centerpiece of government's revenue enhancement effort, started in F/Y in 1997/98. Like in any other country, the government of Nepal needs revenue to fulfill the functions and liabilities of an independent state. Generation of revenue means collection of taxes. There are various forms of tax systems. In Nepal, it was decided to introduce VAT, as this from of taxation seems to be creating the best result to other countries. VAT is a most scientific, innovative and powerful tax with built-in quality of tax system for both developed and developing economies. The biggest virtue of VAT is the revenue buoyant and highly instrumental for resource mobilization, especially, in an economy with actual shortage of resources. VAT would make possible to broaden the tax base, eliminate tax cascading, and create an investment friendly environment. It is a simple and modern tax system that exempts the basic goods and services from tax liability. This is a matter of great pride that Nepal has entered into a major global tax system with introduction of VAT.

Adoption of VAT for Nepal is both innovation and a necessity. It cannot curtail its development projects for which more revenue is required. The narrow tax base of the previously applied sales tax failed to generate the minimum required amount of revenue because it included only the import and manufacturing units. Similarly, most of the goods and services were exempted from tax. Income tax, however, has some potential for revenue generation in Nepal. The rates of income tax are slowly decreasing because government cannot put burdens on people to pay income tax. The globalization and recent trend of tax system has affected the Nepalese economy also. As we have already been a member of WTO, we need to decrease our customs duties drastically.

Custom duties are being curtailed in worldwide span in order to accept liberalization policy. Excise duty in Nepal is severely limited due to the contraction of industrial activities throughout the nation in recent years. Under such conditions, we cannot collect more revenue from income tax, customs duty and excise duty. Consumption based tax in only an alternative to collect more revenue, which directly helps to increase domestic resources. VAT is the best, one of the Nepalese tax system. It is based on consumption. However, the consumption related indirect taxes do not maintain equality norms but they can be considered as one of he reliable sources of revenue generation. There is no doubt on the fact that the VAT, will help to make Nepalese economy strong in long run. In this sense, the successful implementation of VAT system has a great significance 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 curtailed its merits and effectiveness. Its progress has been slow, initially due to opposition from the business community and subsequently to administrative problems. Even after the full-fledged implementation in 1999, the system has not been largely accepted by the taxpayers as well as business communities of Nepal and realized upon by the government, as important tool for mobilizing the revenue, which needs for public expenditure.

We cannot do anything only getting imposition but the subject is that how to implement the VAT more effectively and efficiently. It is not the matter that VAT should be removed but the implementation aspect of VAT must be managed and enhanced. VAT regime is extremely challenging in a buffer economy. The attitude of businessmen and the tax administration also appears hostile to the effective implementation like maintenance of proper books of accounts. The problem is further intensified due to lack of culture of issuing and receiving bills at the point of sale and purchase. Negative behavior of business community, and lack of sense of accountability of government and political parties, it is a big challenge to resolve these problems. Apparently, VAT cannot deliver the intended results unless these problems are addressed seriously.

Theoretically, the Nepalese VAT system has no weak provisions. It is one of the best model in the world. In practice, however, the system is not effective even today. Most of the problems concerning the implementation of VAT in Nepal have been identified. The government needs to take necessary steps to sort out emerging problems in implementation of VAT. The government needs to full cooperative to the tax administration, the taxpayers and businessmen as well as consumers in its efforts to generate more revenue. VAT can be made successful but it depends upon honesty, faith and morality of tax officials and business people. Responsibility and accountability should be maintained in every section of the economy as basic requirement, as well as honesty and confidence between the businessman and tax administration is a must. There is a need for will power and action. The government must be curative. Unnecessary hindrance to economic activities must be avoided. In the absence of growth of economic activities, revenue generation cannot be increased. Thus, it is time for action and improvements for effective and successful implementation of VAT in Nepal for future perspectives as well as present needs of economic development.

5. 3 Recommendations

Following are some major recommendations, which could be considered by authorities while reforming Nepal's VAT system :

- For the efficient implementation of VAT, timely registration of all the taxable transactions is essential.
- Adequate educational program for taxpayers as well as awareness program for consumers increases VAT collection.
- There should be a close co-operation between the business community and government for the successful implementation of VAT.
- Taxpayer whose annual transaction does not exceed the threshold should be encouraged for registration on voluntary basis.
- Proper coordination and interaction among departments of ministry of finance should be established to increase collection of VAT and minimize leakage.

- Unpractical provisions of Act and Regulation needs to be reviewed on the basis of experience gained so far.
- Inefficient staff lacking practical and specialized training is a serious problem. So, providing training to such staff is highly essential.
- Taxpayer should use registration number for all transactions related to VAT, excise, customs and income tax.
- Further computerization of VAT administration along with adequate administrative procedures enhances speed, efficiency and productivity to the operations of tax administration and hence boosts credibility of tax administration and encourages voluntary tax compliance.
- Cost of compliance as well as tax administration depends upon complexity of the tax structure and administrative procedure. The monetary as well as non-monetary cost of compliance and administration should be kept to minimum possible by avoiding unnecessary complexity in the tax structure and complex and lengthy administrative procedures.
- Luxurious goods and necessary goods should not be treated equally. So multiple rates should be applied.
- The threshold for registration should be reviewed timely.
- Strong political commitment is one of the most essential phenomena for the successful implementation of any government policy, plan which is lacking in the case of VAT implementation.
- Regular checking of manual and computer billing should be done to ensure that the vendors are revealing their actual business transactions.
- Discourage smuggling and under valuation.
- To avoid the billing problem which is realized now, consumers should be well informed to take the real bill of that amount which they have paid and strict warning should be given to businessmen also for not to issue loose bill.

- Enhancement of modern techniques of tax administration and electronic filing of returns.
- Qualitative Audit and Investigation results in voluntary tax compliance.
- Broaden the tax base lowering the tax rate is the motto of modern tax policymakers.

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