

CHAPTER ONE

INTRODUCTION

1.1 General Background

In the modern days, role of government has immensely increased due to the rise in the value of government expenditure but the sources of revenue to meet the required expenditure is very limited and with narrow base. So, there is a problem of resources gap of government.

Taxation is an important sources of domestic resources mobilization and financing government activities. In every country the largest part of Nepal revenue is raised through taxation. Tax is imposed on the income or wealth of an individual which is liable to pay according to his/ her level of income.

Nepal has been facing serious problem of resource gap which is fulfilled by external debt and donation. The external sources of resource mobilization are necessary and easy to obtain, but they create political instability and colonization. Moreover, the foreigners may directly impose there condition which are not in favour of Nepal. So it is better to mobilize internal resources through the process of taxation.

There are mainly two types of tax direct and indirectly. If we see from Nepal present tax structure, direct taxes has lesser contribution for resource mobilization compared to indirect taxes. Direct taxes have a very narrow base and therefore they possesses only distribute aspect on the other hand, indirect taxes are superior from the points of view administrative efficiency, resource mobilization, etc. The tax sector reform initiated after to restoration of multi party democracy has the only objectives of resource mobilization which is possible it based indirect

taxes are leaved in this contest. Vat has been introduced in Nepalese tax structure since 16th November 1997.

The evolution of vat dates back to 1919 AD when Wilhelm van siemens recommended Germany to replace the multistage sales tax. But, this development was only theoretical and the theoretic pregnancy took almost 35 years to be matured when France introduced vat in its tax system.

The concept of vat in Nepal was introduced in early 1990s. Nepal government it's intention to introduced vat in the 8th plan subsequently two tier sales tax system to make the base of implementing vat from the fiscal years 1992/93 under the financial assistance of USEIO in order to make necessary pre-paration for the introduction of vat. The vat tax force prepared the draft of vat legislation.

1.2 Statement of the Problem

To meet the growing public expenditure founds originated from both internal and external sources, the vital role has to be played internal source, which is the leader of growth external source is only the follower and facilitator.

Nepal is the developing country, where must of the people live under poverty line. Population growth rate is in careering government expenditure is also in caring but government is not growing equivalently as per the expenditure.

Tax is important source of public revenue and major fiscal policy instrument. There are necessary to accelerate the peace and development. The rate of capital formation is low due to small resource based and large revenue expenditure gap. As expenditure is increasing tendency of growth in revenue is still stagnant which widnesses the resource gap and either raises foreign dependency or decreases the development

expenditure. Nepal has been adopting deficit financing since 1964, which is another reason for use research gap.

We can not claim that increasing tendency of public expenditure is the slow determine of resource gap. It is statement revenue structure which is asepsis in this regard that is budgetary deficit is the consequence of only not only increasing expenditure but also poor performance of existing taxes. Keeping this fact in account the government in the 90s initiated to reform programme introduces value added tax. It was expected that tax GDP ratio will increase and the resource gap will diminish with the introduction of vat. four different taxes "Sales tax entertainment tax, contract tax and hotel tax."

Where substituted by vat. Almost 8 years have already gone and it is time to evaluation. This tax system. The new introduction has shown positive as well as negative aspect. The study will try to find out the prospects of vat and try to evaluate inerrant theoretical as well as practical problems.

Taxation is not sole receipt of government but it is considered as one of the most important part of government receipts. It plays a important role in domestic resources mobilization.

1.3 Objectives of the Study

The general objectives of the study is to identify problem and prospect of VAT in Nepal. The specific objectives of the stud are as follows:

-) To examine the structure of VAT in Nepal.
-) To identify existing problems of VAT in Nepal.
-) The study of the problem and prospects VAT effective and efficient.

1.4 Significance of the Study

The causes for the persisting fiscal deficit are small resource base therefore, Nepal has to depend upon external resources but self sustaining development impossible only if external resources are utilized optimally, for strengthening internal resources of revenue collection, Nepal has adopted vat administration and policy as an ingredient of fiscal sector reform. The major objective vat is:

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

But, majority of Nepalese people far unknown about various aspect of vat even though valuables eight year have already been spent.

So, this study mainly focus in those aspect which are unknown to general public like theoretical aspect of vat structure and administration of vat in Nepal, significant of vat in the contest of fiscal sector reform, existing practical problem of vat in Nepal.

Vat come into operation recently so people are unknown about various aspect of it vat being it self a complicated and modern tax system, more efforts should be more on actual circumstances.

1.5 Limitation of the Study

The main limitation of the study is:

- a) The study only covers the time period from 1998/99 to 2006/07: the rational for choosing this period is mainly for the simplicity of analysis is data itself.

CHAPTER - TWO

REVIEW OF LITERATURE

Tax reform is the main aspect of fiscal system reform in almost all the countries in the later half of 21th century. A distinguished and even essential feature of tax reform is the adoption of VAT in their tax system.

Although, extensive literature has been developed the tax policy and design aspects of VAT, very little has been written on its implementation. In Nepalese context, some studies related to vat has been carried out but they have focused on theoretical soundness of VAT.

2.1 International Context

A study on value added tax in developing countries by lent, casanegra and guard examines the applicability of VAT in seven developing countries considering the fact that many uncertainties arise in the introduction of any major new tax especially with very limited experience. According to the study the most important feature of VAT in such countries is its conceptual basics such as taxable base (value added) exemption treatment of small traders and farmers. The feasibilities and problem of implementation of VAT in developing countries depends largely on the ability of the country's administration. Economic and social atmosphere also plays vital role to make comprehensive tax basis of VAT. VAT is more revenue productive and elastic by lower rate because it is broad based and it makes substantial contribution to government, the study shows that: (Casanegra and Guard, 1973).

Developing countries has limited range of vat bases by excluding the most trouble some sectors (farmers retailer etc) because they have their own difficulties. VAT produces between 10 to 30 percent of government revenue of seven developing countries. There are fundamental difficulties in VAT operation and administration in developing countries. The problem is the

treatment of small tax payers which includes large number of retailer service enterprise and farmer, (Casanegra and Guard;1973).

Bogetic and Hassen empirically analyzed the determinants of VAT revenue on sample of 34 countries in which there is a sample of 20 single rated countries and a sample of 14 multi- rated countries. The rate, the base and the rate of dispersion are the key variables to influence revenue performance through VAT. The rate of dispersion is found to affect VAT negatively. The study conforms that vat generates, catteries paribus higher revenues in single rate countries than in multiple rate countries the difference in the estimated models for the two country groups is statistically significant indicating a structural change the structural change most consider other factors such as the base and capacity of tax administration.

The study gives clear cut idea to the policy makers that to generate higher revenues, a VAT should be lived on a single rate on as broad base as possible and it most also be accompanied by a strong tax administration to ensure enforcement and compliance, (Bogetic and Hassen,1933).

Musgrave and Musgrave, suggest that among three types of VAT i.e. GNP, income and consumption types the latest is the best for practical consideration on consumption is similar to the retail sales tax, especially for poor countries. The invoice method for calculation is more preferable and advantageous then the value added approach, (Musgrave and Musgrave, 1976).

Describing the problems of vat the state "A sales tax may be imposed in either single or multiple stage form if letter is implemented in the value added (rather than turnover) sense it is equivalent form economic point of view to a corresponding single stage tax. At each stage the value of production is increased and these price rise according which is the value added tax base".

Among the two types of alternative i.e. VAT and RST (retail sales tax) posing the same tax base which one is more preferable this strong difference in their opinions is analyzed as:

The number of tax payers are less in RST and VAT therefore the tax administration is feasible in RST than VAT. The exclusion of capital goods enforcement in voice system for calculation of tax liability than under RST. Vat constitutes problem in such countries, which have federal system. In such system all the states have power to impose tax.

Due, John f and Fried Lander so that, among the sales tax VAT is the best one. Because of broader coverage, it offers much more revenue potentiality as compared to other types of sales taxes. The base of tax being value added is defined as the difference between the sales of firm's product and the amount paid to its factor. VAT is subjected to objection common to other consumption related taxes mainly on the ground equity the authors accepted that the main visualized problem of VAT in developing countries is the administrative complexities. On the other hands, advantages of VAT are: (Due, John f and Fried Lander 1977).

- I. Major source of revenue.
- II. Supplement of income tax incase of developing countries and
- III. Facilitation of cross checking in auditing.

Even though they visualize problem of VAT, they concluded, "It is undoubtedly the ideal form of sales tax in money developing countries"

Binguang Hsiung had conducted a study in 1991 to evaluate the VAT in Taiwan, which was in effect since 1986. The study showed the good result of VAT after some years of experiences. The impact of vat showed the business tax revenue increased considerably due to cross checking procedures of VAT. Adoption of VAT did not cause price fluctuation.

The tax reform committee, India headed by professor Raja J Chelilan has expressed the desirability of full-fledged VAT for India the committee observes 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 and sumptuary excise duties the central excise, the state sales taxes the municipal octroi, the goods and passengers tax and the electricity duty. The Indian budget of various fiscal years indicates the intention of India to introduce a vat in order to rationalize the commodity tax system.

Michelle Gerad in her paper unpublished doctoral dissertation submitted to Columbia university in 1972, illustrated that it is not easy to say to implement VAT in developing countries. Open border along with least experience of border based tax implementation in developing countries likely to face initially a more difficult problem.

Early revenue collection was satisfactory in Brazil in the first year 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 is learnt that most of inputs were exempted where as output was taxable due to this reason industrial sector increased the VAT.

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 the vat did not have 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, reduce evasion, increase revenue and solved major problem associated with previous taxes. The study shows mainly summarize as:

- ❖ The Korea government and the public were fully prepared for adoption of VAT in 1997.

- ❖ The government for preparation spent a good number of years.
- ❖ The government become success to convey the message that the adoption of VAT. Benefited the businessman in Korea.
- ❖ There was no serious problem of tax evasion.
- ❖ VAT enjoys of positive reception from tax payers.

Shahni, Balbir S. has conducted a study on “Saving and Economic Development with Special Reference to India” the main task of this study was to determine the role of different variables influencing the levels of saving in India during her planned economic development. In the absence of necessary data for verification, the estimates of saving as compiled by the Reserve Bank of India have been accepted and used for further analysis. This study has covered the time span of 12 years from 1950/51 to 1962/63. The main conclusion thus arrived at assets the significant relationship between the increase in saving and growth of productivity, and the gross national product in India during the first decade of Development Planning.

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

2.2 Nepalese Context

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

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

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

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

Before introducing VAT, following things should be considered.

- ❖ Keeping in mind the increment of the number of tax payer in a VAT system, it is necessary to collect prepared records of potential value added tax payers.

- ❖ A separate administration unit of VAT is necessary.
- ❖ Computer use should be introduced to assist administration.
- ❖ The rate system of VAT should be single one and if more, dual rates 10% to 15% will be appropriate.
- ❖ Agricultural products, basic necessities and other similar goods and exports should be exempted. Necessary forms of ledgers should be improved; this should be simple and coverage should also be extended to services such as electricity consumption and telephone services.
- ❖ Studies should be operated on the aspects such as need of this tax, effects and targeted tax payers, according to studies policy should be prepared and after a preparation period it will be appropriate to take 3 or 4 years for introduction of VAT.
- ❖ The rate of customs and excise duty should be adjusted; most of the taxable goods under excise duty should be transferred under VAT and specific excise duty on luxuries.

Agrawal has done research on "Resource mobilization for development: the reform of income tax in Nepal" in 1978 of the period between F/Y 1951/52 to 1978 to 1979. The trend of resource gap and domestic resource mobilization through various taxation of the same period has been nicely analyzed in his study, (Agrawal, 1978).

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

Tax heads	Elasticity	Buoyancy
Excise duties	1.28	2.24
Custom duties	0.80	1.18
Sales tax	1.74	2.20
Land tax	0.12	0.17
Income tax	2.01	2.10

According to his own words the finding of this study is "Since both buoyancy and elasticity coefficient are greater than unity sales tax in Nepal is previously responsiveness to change in GDP. However the major constrain in the effective functioning of the tax system seems to be administrative deficiencies, poor tax paying procedures", (Agrawal 1978).

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

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

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

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

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

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

The sales tax was narrow based and most of the sales tax was collected from custom/manufacturing points. The huge exemption made on socio economic ground resulted on week tax administration and low yields of revenue. Moreover delegation of taxing authority to the local bodies to make them financially also caused low performance of central taxes. In such condition, the author stresses on the proper implementation of VAT in Nepal. But VAT is not

great panacea because there are many hindrances on the implementation of VAT, most of the business vendors do not want to be registered under VAT. Cross checking has not been possible and under valuation is dominating. So in conclusion the writer suggest that VAT will generate more revenue in the days to come when it becomes fully operation, (Khadka, 2000}

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

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

By comparing VAT with manufacturing level sales tax (MST) he argues that VAT would have a broad base than the existing MST because VAT would be levied on retail level also and it brings more goods and services under its tax net than the MST. There are so many challenges to implement VAT in Nepal. VAT system demands better tax administration does not seem so good. That's why, it is necessary to reorient tax administration in the light of modern administration reorient action and taxpayers education will not be adequate for the success of VAT in Nepal. It needs an over all tax reform packages, which is very helpful for the implementation of VAT.

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

- ❖ To broaden the tax base and increase tax revenue.

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

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

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

Chamber of commerce made a study, after the declaration of implementation of VAT in Nepal, to analyze the possible effects of VAT in Nepalese economy and especially to the business community and made some observation which are: Vat affects adversely in price level. Increase in the price of imported goods would hit the import business and reduce revenue from customs duties, requirement of book keeping is complicated. Present administration is incapable for handling VAT. That's why there is change of failure of VAT in Nepal. It will finding affect the small traders. So, in conclusion the study suggested that VAT should not be imposed only in some commodities for experimentation if experiment proves right the full-fledged VAT could be imposed. (Chamber of Commerce, 1997)

A high level task force headed by Prof. Madan K. Dahal reviewed the Nepal's tax system in 1995. The report outlined the following reason to adopt VAT in Nepal.

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2.3 Review of Related Literature

Several researchers have conducted various studies regarding the financial performance analysis and evaluation of commercial bank and companies. Some researchers have already conducted studies about many aspects of commercial banks and financial companies. In this study attempts have been made to review some published and unpublished reports available in the libraries of T.U Kritipur and P.N Campus, Pokhara.

2.3.1 Review of Books and Published Dissertation

Shrestha with a view to analyze commercial banks performance, investment pattern on securities and loans and to observe the relationship between the bank portfolio variables with national income and other financial variables, has conducted a research study entitled, "A Study of Portfolio Behavior of Commercial Banks of Nepal" in which the writer has mainly assessed the financial performance of commercial banks by analyzing their financial statements, resource structure, and their sources and uses of funds. This study was based on secondary data. This study has covered the time span of ten years (1980 to 1990). In this study the writer has found that the general trend of

commercial banks asset holding is growing. Deposits have been a major source of funds and leading uses of fund for the commercial bank of Nepal. The reserve levels of the banks are in excess and are still growing that allow idle money and loss of opportunity, (Shrestha, 1995).

The investment of commercial banks in shares and securities is normal and not found to have strategic decisions towards investment in shares and securities. Yield on security has been found to be satisfactory. Investment in various economic sectors, such as agriculture, industry, commerce social and general purpose social sectors, showed industrial and commercial sector taking higher share or loan till 1990. The hypothesis that investment in various sectors has a positive impact on the national income from their respective sectors has been accepted for all the sectors.

Demand for deposit or commercial banks in Nepal is positively affected by the drop from non-agriculture, and the deposit rate and lending rate of interest. Borrowing of commercial banks from the central banks has been found to be positively affected by the cash reserve requirement, bank rate and treasury bill rate

2.3.2 Review of Papers and Publications

Poudel, D.P has written an article entitled, “Finance Companies in Nepal an Overview” in which he has examined the performance of Finance Companies. According to him in 1996, the ratio of capital funds of Finance Companies to their deposit was increasing over time but latter it fell substantially below the authorized level of deposit mobilization, which is 10 times of the capital base. Nevertheless, some of the Finance Companies have been mobilized the deposits by more than 10 times of their capital base by violating the regulatory norms issued by Nepal Rastra Bank. The credit/ deposit ratio has remained quite high leaving the room for doubt about the quality of loan especially in the absence of repaying schedule. The loan diversification has been improved however, the repayment schedule is not satisfactorily improved however; the

repayment schedule is not satisfactorily improved during a short span of time. As such, the hire purchase, housing and term loans are the major sectors, which altogether received more than 95% of the total loans and advances in mid July 1996. Because of the mushrooming growth of the number of Finance Companies, the average source of funds for each company is natural to decline. Due to the very teen aging factor, it is too early to evaluate the performance of the Finance Companies in Nepal but equally important factor is that the regulatory and supervisory authority should keep close eyes on their activities (Poudel, 1996).

2.3.3 Review of Unpublished Thesis

Adhikari D.R with a view to analyze Nepal Bank limiter's performance investment pattern on securities and loans and to observe the relationship between the bank portfolio variables with national income and other financial variable has conducted a research study entitled, Evaluating the financial performance of /Nepal Bank limited, In which he has mainly assessed the financial performance of NBL by analyzing their financial statement, resource structure, asset-structure and their source and uses of funds . This study was based on secondary data. This study has covered the time span of 9 year (2038/39to2046/47). In this study the investigator has found that the investment portfolio of the bank has not been managed so efficiency to maximize return that is why, the bank was suffered from series of operation losses over the period (2038/39to2046/07). So, operational efficiency was not satisfactory. Likewise, allocation of loans and advance made by the bank was not so profitable as the productive sector had little share in the loan portfolio. Similarly low return on investment and low market value was a reflection of the bank's share as against the book value was a reflection of the weaker financial performance of the bank. Nothing was satisfactory expect liquidity position of NBL, (Adhikari, 1992).

Shahi K.B with a view to analyze a public banks and joint venture banks. Investment pattern interest rate and to observe the relationship between the bank portfolio variable with national income and other financial variables has conducted a research study entitled, "A comparative study of public banks and joint venture bank in Nepal" He has mainly assessed the financial performance of commercial banks by analyzing their financial statement, resource structure and their sources and uses of funds. This study was based on secondary data. In this study he has found that the amount of total deposits of NBL was 2.17 and 7.39 times higher in the 1994/95 and the same of NGBL was 2.12 and 6.78 times higher in the FY 1995/96 than that of NGBL and RBB respectively. But increasing rate of deposits of public banks was slightly higher than the NGBL.

Loans and advances of public banks were increasing each year and that of the NGBL was also increasing. The percentage change of loan and advance of NGBL was higher (61.46%) than that of public banks. The average deposit utilization position of public bank was higher than that of NGBL and RBB respectively than that of NGBL during the study period. The study area was Pokhara Sub-metropolitan, (Shahi, 1998).

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter consists of the methodology of the study the problem and prospects of value added tax in Nepal 1998/1999 to 2006/07 attempts have been made to collect and analyze the relevant vat data and information. Here the focus has been made on research design, source of data, method of data collection, data processing from of presentation and their interpretation. The search methodology has been designed on the secondary data by using useful economic served.

3.2 The Research Design

Research design is the plan structure and strategy of investigation conceived so as to obtain answer to research equation and to control: A research design is purely and simply the framework or plan for the study that guides the collection and analysis of the data. The main objective of this study is to analyze and evaluate the problem and prospects of vat in Nepal. This study follows the analytical and descriptive research design. To complete this study following design and format has been used. First of all the information and data are collected. The important information and date are selected. In analysis part interpretation and comments are also made wherever necessary. Result and conclusion are given after analysis of data recommendation and suggestion is also given. The design has been adopted from previous research work.

3.3 Source of Data

The study is based on secondary data. The data are collected from the published by National Planning Commission (NPC) world Bank (WB) Nepal Rasta Bank (NRB) Economy Survey 2007/08 MOF, July.

3.4 Method of Data Collection

Data in social sciences are based on our sense observation, which include all forms of perception used in recording responses as though they impinge upon our senses. In short, all the relevant. The information that can be expressed in numerals has been treated as data in this study. This study is based on the secondary data. The data collected from various Budget speech of HMG/N, ministry of finance Economic survey. The gross domestic product (GDP) to be taken from Economy survey HMG/N ministry of finance. During the study period (1998/99to2006/07) will be taken from national account publication of CBS and other related. Beside these publications of CEDA, Nepal Rastra Bank, etc has been used to collect necessary data and information.

CHAPTER FOUR

THEORETICAL ANALYSIS OF VAT

4.1 Introduction of VAT

4.1.1 Concept

Value added tax is a tax levied on value added to goods and services by the business enterprises at each stage of production and distribution process (Lent, Casangera, and Guerand, 1973:319). "The value added is the difference between the receipts from the sales of the firms' product and the sum of the amount paid by the firm for produced goods purchased during the period, and therefore, is equal to the sum of the factor payments made by the firm including profit of the owners" (Due and friend lender, 1976:416) value is added by purchased items with its own labor or machinery or building or other capital goods.

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

Let's consider an example of sugar production. A farmer produces sugar cane and sells it to miller. The miller transforms sugarcane into sugar. The miller adds value in which his profit is also included. He sells his product to the wholesaler who, in turn, adds value and sells to the retailer. Ultimately, sugar is sold to the consumer with some additional value. In this way, at each stage the value of the product is added and total sum of such increased value just equals to the final sales value of sugar.

From the above example, it is clear that VAT falls under the category of indirect tax family as burden of tax totally shifted to the ultimate

consumer of that good or service. But, base of tax is only the value added in production at every stage.

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

4.1.2 Origin and Development

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

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

Before the introduction of VAT, sales tax was the main source of revenue mobilization. In the developed countries revenue mobilized through sales tax followed custom duties. While imposing tax on sales, there was a debate that in what stage of sales tax is imposed and to which

communities up to modern days as well, value added tax is considered a major breakthrough because it is a revised version of sales tax.

After the world war II, Japanese government wanted to reform the existing traditional tax system and formulated a committee under the chairmanship of Kan. A Shoup in 1949, the committee recommended value added tax in the place of turnover tax. But Japanese government also hesitated to introduce VAT because it was a new concept and no person was known about the new tax regime.

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

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

4.2 Types of VAT

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

A. The consumption Type:

This classification is considered as neutral type because under this type no discrimination is done with respect to capital or consumable goods. It is really a superior for the VAT because full credit of inputs, irrespective of what type of purchase is done provided. Since investment is relieved

from taxation under this variant, the basis of tax is consumption. That is why this variant of VAT is known as the consumption type VAT. All capital purchased from other firms in year of purchase, are included from the base with depreciation is not deducted from the tax base in the subsequent year. Investment is freed from taxation and consumption is considered as the base of tax. Under consumption type:

Gross National product- gross investment = total consumption expenditure.

B. The income type:

The income type VAT does not exclude capital goods purchased from other firms from the tax base in the year of purchase. This variant, however, does exclude depreciation from the tax base in subsequent year. The tax falls both on consumption and net investment and the conceptual tax base of this variant is the net national income. Thus income type = gross national product

Depreciation = Net investment + consumption = Net national product.

C. Gross National Product type:

Under this method the purchase of capital goods are neither deducted from the tax base in the year of purchase nor the depreciation is allowed to deduct from the tax base in the subsequent years. As no input tax on the purchase of capital goods is allowed in this variant, it discriminates among the techniques of production and finally 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 discriminative for saving, investment and capital-intensive production.

The base of VAT under various categories may be shown as consumption type = Gross National product - Gross investment = Total consumption expenditure.

Income type = Gross National product – Depreciation = Net investment + Consumption = Net National Product.

Gross National Product = Gross investment + Consumption both the income and GNP variant do not include the purchase of capital goods from the tax base in the year of purchase. But the income type includes the depreciation from the tax base in the subsequent years while GNP type does not treat as so. The GNP type of VAT is less practicable because it is biased to labor incentive technique. The income types also rare in practice because it includes the depreciation from the tax base in the subsequent years. Both types of VAT are theoretically defective and practically difficult to implement. It has just academic value. The consumption type of VAT is must popular and widely recognized by almost all the countries. It does not affect decision regarding investment and growth since it includes investment from any tax burden. Furthermore the consumption variant is more uncreative from the point of view of tax administration as well ad from the consideration of foreign trade. As several advantages have incorporated in consumption theory in comparison to others, it has widely accepted and successfully implemented in VAT system.

4.3 Principal of VAT

There is no doubt that VAT is levied on consumption and consequently Final burden of the tax is shifted to the consumer. In the age of globalization and liberalization the world has been narrowed as s small village. Goods and service can be provided broadly either by domestically or by importing from other countries. When two countries are involved in trade there might be a question of borders. Whenever

international trade between two countries is considered cross boarder adjustment is necessary for the purpose of imposing VAT, principle of VAT can be divided into following two categories.

4.3.1 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 principal, preference is given to imported goods or service over domestic production because all imports are treated as taxable whereas all import are treated as non-taxable. These sorts of principle may be beneficial where common trade is enlisted like European Union, otherwise rest of the countries do not prepare this principle.

4.3.2 Destination Principle

Contrary to the earlier, destination principle is imposed at the place where it is consumed irrespective of where it is produced for referred. Neither it prefers imported goods or service 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. For the purpose or boosting exports, many countries prefer to apply this principle of taxation.

4.4 Methods of computation of VAT

Value added tax may be collected by adopting various method. But the choice of appropriate method depends upon the type of VAT employed and the principle under which VAT is adopted. The value added tax can be collected by using following method

4.4.1 Addition Method

In this method, the tax base is calculated by adding the payments made by the firm to the factors of production employed in turning out the

production such as wages, interest, rent royalties and profit. So VAT under addition Method is given by $VAT = f(w + R + I + P)$

Where w = wages, R = rent, I = interest, P = profit

The additional method is applicable to income type but clumsy for consumption type of value added tax (Musgrave and Musgrave 1976: 401). More over it is applicable if the firm produces the commodity rather than purchasing it. "virtually on country uses addition method although Argentina and Israel have applied this method to selected economic activities such as banking and finance where the value of inputs and outputs are difficult to measure "(Conssen 1992, 217, 218) It would be award to use the additional method to compute the consumption type VAT, since to the net profit figure there would have Since to the net profit figure there would have to be added depreciation and the encess of opening inventories over closing inventory with subtraction of capital goods purchased or prduced within the firm and subtraction of an encross ofclosing inventory over opening inventory (shoup 1969; 258) for practical purposes, the method is very complex to compute.

4.4.2 Subtractions Method

Under this method value added is determined as net turnover, which is obtained by subtracting the cost of materials from sales proceeds (Khadka 1997; 5). The subtraction procedure was uses in the Michigan VAT (Due 1976; 71) Value added is obtained by subtracting purchase of produced goods from the sales during the period that is given In functional form by $VAT = (SV - PV)$ where, $S.V.$ = sales value and PV = Purchase Value.

This method of the computation is suitable for consumption type of VAT. It needs no adjustment to operate correctly for import under origin prunciple but if destination principles is applied, it can't supply the information needed to compute precisly enport rebate the import

compensating tax, more over, It multiple rate VAT is levied, this method poses serial problem.

4.4.3 Tax credit Method

Tax credit method is known as indirect subtraction method invoice method under this method tax payers are allowed to subtract the tax already paid by their suppliers but they have to collect gross tax liability which is levied on the total value of their sales. Their purchase is not ultimate consumers will also deduct the deduct the amount what they have already paid as tax, so that $VAT = f(\text{output} - \text{input}) = \text{tax paid on sales tax less tax paid on purchase}$.

Among the three method of computing VAT, the tax credit method is didely used in EEC and else where. This invoice method is used generally in European countries and constitutes an advantage of the value added approach, especially in countries where tax compliance is poor. (Musgrave and Musgrave 1976: 402) The invoice method is superior to other methods it terms ok compliance, enforcement and adaptability of various rate modifications. The methods can be especially usefull if it is desired to reduce the rate of value added tax at same in production and distribution process say raw materials or forms products stage for administration reasons without reducing the total tax paid on total value added. (Shoup 1969: 259)

However, the invoice system is also subject to objection because it falls to give credit for tax prior to the empt given to pre-import stage concept the first stage as the chain is broken. In spite of or positive and negative aspects of invoice method, it has a power to make the over all rate depends on the rate imposed at the last stage of production or distribution which is irrespective to the rate at earlier stages.

A simple example of the calculation of value added tax liability under three different method is given table 4.1 below.

Table 4.1**Calculation or VAT liabilities under different method (10% VAT)**

Addition Method		Stage of production and distribution			
		Manufacture (Rs)	Wholesaler (Rs)	Retailer (Rs)	Total (Rs)
A	wage	1400	800	400	2600
B	Rent	300	200	200	700
C	Interest	200	200	200	600
D	Profit	100	300	200	600
E	value added (a+b+c+d)	2000	1500	1000	4500
F	VAT Liability	300	150	100	550

Subtractions Method		Stage of production and distribution			
		Manufacture (Rs)	Wholesaler (Rs)	Retailer (Rs)	Total (Rs)
A	sales	12000	13500	14500	40000
B	Purchase	6000	8000	9500	23,500
C	Valued added (a-b)	6000	5500	5000	16500
D	VAT Liability (10% of co)	300	150	100	550

Tax credit methods		Stage of production and distribution			
		Manufacture (Rs)	Wholesale (Rs)	Retailer (Rs)	Total (Rs)
a	Sales	10000	11500	12500	34000
b	Tax on sales	1100	1150	1250	3500
c	Purchase	8000	10000	11500	29500
d	Tax on purchase	800	1000	1150	2950
e	VAT liability 9 (b-d)	300	150	100	550

Source: Economy Survey, 2007/08: MOF July, 2008.

Note: All sales and purchases are Exclusive of tax and figure are arbitrarily estimated.

Table 4.1- shows that VAT liability calculated by using any of the three methods is the same Rs 550. However same VAT liability is possible only when same rate is applied on all stage of sales.

Tax credit method is superior to other method because this method possesses several advantages over the other method.

- a) The tax liability in this method is attached with the transaction that makes it technically and legally superior to further method.
- b) Cross checking is possible.
- c) Due to this, catch up effect, under valuation and evasion of tax is impossible.
- d) Tax collection is easy and transparent because of these attraction most of the countries adopt this method of computation of tax.

4.5 Structure of VAT

4.5.1 Tax Base

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

It is desirable to include all kinds of goods and services or business activities in to the scope or VAT so that all consumption expenditure comes under taxable base of VAT. But all the consumption items for practical purpose are not included in the tax base. A VAT levied on selected goods and services and economic activities are narrow based while of VAT is levied on wide range of goods, services and economic activities are broad based. A broad based VAT extends to the retail level

to the manufacturing level. A Pre-retail level to the manufacture level (or wholesale level) makes the VAT base smaller.

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

4.5.2 Freeing from VAT

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

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

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

4.5.2.1 Zero Rating

Zero rating implies that VAT is levied at a zero percent rate on some selected goods and services this means that actually no VAT is payable on zero rated supplies, but they are otherwise regarded as taxable zero rating is VAT is guided by two basic purposes.

- a. To serve social welfare.
- b. To encourage the export industry.

On the zero rated items, tax credit can be claimed and full rebate is obtained. If government adopts a policy to stimulate export zero rating is attractive as the exporters can claim tax credit to the tax paid earlier. So they have a liability to be registered on VAT moreover, zero rated items are also exempted from tax. But zero rating is superior to exemptions because under zero rating, there is no possibility of tax evasion. If zero rates are applied only at the first stage, the tax credit method works satisfactory there is no over taxation (Shoup 1969: 260). Moreover, business enterprises concerned with the zero rated goods and service are the formal members like all other registered member and hence they have to fulfill all formalities associated with the VAT operation.

4.5.2.2 Exemption

If goods or services or economic activity is not deliberately included in the tax net, then it is known that the goods or services or economic activity is exempted goods, doesn't pay VAT, but still he/she pays VAT on liability and purchases. It is desirable on the administrative ground to keep certain goods or services or transition outside the tax net, and then they should be exempted from VAT. (Khadka 2000, 76) similarly, basic necessities increase their demand and relative price and full benefits is questionable, similarly there are some goods and services such as goods for children, educational and medical service, cultural activities etc are exempted from the tax. Exemption of VAT has strong disadvantages are:

- a) Exemption reduces the tax base and hence reduces the revenue potential VAT.

- b) It is an incentive for the producers and consumers to divert their resources towards exempted goods and services.
- c) Administration becomes more complicated

4.5.2.3 Threshold

Small vendors having an annual turnover up to certain amount are not required to register under VAT. The amount fixed for this purpose is known as threshold. (Khadka, 200, 78) The level of threshold is fixed taking into account such factors as revenue requirements, administrative capability and status of the book keeping system in the industry and trade and so on. The provision of threshold is attractive because provision of threshold is attractive because the trader's with a low revenue yield relative to compliance cost are not necessary to be registered if all traders are included under tax net the administration will be more complicated.

4.5.3 Tax Rate

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

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

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

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

4.6 Operation of VAT

4.6.1 Registration

The first and necessary step towards VAT operation is registration of vender who is legal tax payer. All the firms and traders selling taxable goods and services and having an annual or periodic turnover above a specific limit should register in tax office before collection of VAT is started. The firms which have a turnover below the threshold have no compulsion to register to start the business.

The firms which want to start business have to fill up the registration form. Then the form is returned back to the VAT office and coding is made. Although all the vendors having a transaction of taxable capacity may not be registered, it is essential to make door to door visit especially in underdeveloped countries. The educational visits also help the

registrants to understand the procedure and solve the problem. In order to check such practice and to attract the vendors to register under VAT, some provisions like providing knowledge, careful checking and penalty system need to be made in tax law. A VAT register gets a VAT registration certificate.

4.6.2 Tax Invoice

The Tax invoice is a crucial document for VAT as it establishes the seller's liability for tax and the purchaser's entitlement to credit. Each registered firm must issue an invoice namely tax invoice and final consumer invoice are used. Tax invoice are the basic for claiming the credit of the tax on purchase. So tax invoice are needed to issue the transaction between the register firms and taxpayers. Generally, three copies of each invoice are prepared among which one is given to purchaser. The remaining two needs to be kept by the sellers himself so that he could provide one copy to the tax office to claim tax credit while other copy have to be provided for the purpose of inspection and cross checking. On the other hand, final consumer invoices are issued only to consumers or to unregistered purchasers. These are not so important and can be deleted and final price may be shown including tax rather than showing VAT and price change separately. Only a copy of such invoice is enough if each sale is entered into the sale book. But in underdeveloped countries as public awareness level is very low and the practice of tax evasion is very high, final consumer invoice also plays significant role and hence it must be made compulsory.

In some case, issue of invoice is not necessary such as the case of self supply. In some case such as newspaper sell, street stalls, passenger transportation etc. issues of invoice are practically impossible. That is why such transaction is not required to issue a tax invoice. The value added tax system believes on self policing mechanism which needs

accurate invoice system. So buyers are needed to make responsible for demanding invoice in their purchase exceeding a certain amount and sample check of the place of business is needed to control tax evasion.

4.6.3 Books of Account

Every VAT register firm is required to maintain a clear record of his transactions. The records of all invoice including other information's like serial number, date of issue, transaction subject to different rates, the amount changed self consumed goods etc, should keep fairly for 4 to 6 years so that cross checking to keep fairness and accuracy is possible. But it is problem creating because the record for too much time makes burden to the business firm. However, the tax administration is not responsible if any vendor cannot get tax refund due to the lack of records.

4.6.4 Tax Return and Payment

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

1. Total sales including transfers form inventory to personal use of the owners.
2. Exemption Sales
3. Zero Rated Sales
4. Taxable Sales
5. The Gross Tax (Taxable Sales and Tax Rate)
6. Tax on Purchase (Exclusive of the purchase for credit allowed exempt related sales)
7. Net Tax liabilities

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

4.6.5 Penalties

Penalties are useful measure to discourage tax evasion and to smooth the effectiveness of VAT rules. It prevents from the revenue losses due to the functions of the tax payers. Penalties create an incentive to tax payers to deter evasion and noncompliance; however, penalties should be fair and reasonable. Otherwise they become inequitable if they are imposed heavily on some defaulters, but not to others.

The penalties have been broadly divided into four forms;

- a. Automatic Financial
- b. Non-Automatic Financial
- c. Criminal Financial
- d. Criminal Non Financial

The severity of penalty depends upon the type of offence made. Financial charges are often made for a less serious offence, some other typical devices for penalties are attached with bank account, revocation of business certificate, seizure of property, shut down of premises, temporary suspension of trading license, threat of imprisonment, imprisonment criminal prosecution etc. (Tait-1988.318/19)

4.6.6 Audit of VAT

VAT audit is a selective review of the tax payers book and records including year-end the statements, balance sheets and profit and loss accounts to ensure that the major areas of purchases, sales and stocks are substantially correct. The purpose of the Vat audit is to find out, according to the law and regulations, the actual Vat liability of the taxpayers. A VAT audit may be integrated with that of income tax or may be conducted separately. However, the integrated audit is more desirable and popular.

The types of Vat audit maybe divided into field audit and office audit where the former includes advisory visits, verification of records and fraud investigation and the latter includes desk audits checking the return of arithmetical accuracy and completeness.

4.7 VAT and Other Forms of Sales Tax

Manufacturing Level Sales tax (MST) Retail Level Sales tax (RST) Wholesale Level Sales tax (WST) are some well known forms of sales tax. It would be desirable to compare these forms of sales tax with VAT. The comparison of VAT with MST, WST and RST has been given below:

4.7.1 VAT and RST

Both VAT and RST are acceptable taxes on theoretical grounds. They are identical in the sense that the base of both taxes is consumption. They however, differ in the sense that VAT is collected at each stage of production and distribution while RST is imposed only at the final stage. Since the base of these taxes is the same, a given tax rate should generate the same amount of revenue under the either system. Both taxes are based on the destination principle i.e. exports and relieved from tax imports are taxed under both system.

Both VAT and RST are neutral with respect to methods of production and distribution. As VAT is levied only on the value added at each stage in the system, tax liability remains the same regardless of the system of production and distribution. Total tax paid on a given commodity depends on the rate of the tax and on the total value added of that commodity but not on the number of the stages through which it has passed. Similarly, as the RST is levied on the actual selling price to the consumer, the amount of tax depends on the rate of tax and final price of a given commodity but not on the number of stages through which it has passed. Thus, both VAT and RST considered vertically neutral.

VAT and RST avoid the problem of cascading effect (levying a tax on a tax) because inputs are relieved from taxation through the suspension techniques under the RST while the same objective is achieved through the tax credit method under the VAT. Another similarity between VAT and RST is that both are attractive from the point of view of foreign trade consideration. This is because it is possible to refund the exact amount of tax levied on the export under VAT. Under the RST most exports take place before the tax levied. Exports by retailers are exempted from the tax, so there is no need to refund tax on exports under RST.

There is similarity between the VAT and RST regarding the tax based and neutrality. There are so many differences between the two taxes regarding administrative and tax compliance. While in a VAT much of the tax is collected before the retail level, RST places the entire impact of the tax upon the retailers. The tax payer's responsibility is spread much more widely under the VAT in smaller amounts and a large portion of VAT is collected from manufactured or other organized sellers which are more effective and reliable in the developing countries.

Even though VAT is administratively more demanding than RST the control of latter is much susceptible as it is vulnerable to evasion and it

does not have controlling mechanisms as VAT has. VAT is easier from the point of view of the seller. VAT also provides a more complete audit trail than RST.

4.7.2 Value Added Tax and Manufactures Sales Tax (MST)

Manufacture sales tax basically covers domestic manufacturing as well as imports. This is a single stage levy. In practice manufactures and importers are required to register for sales tax purpose. Generally, this type of tax is applied on the sales value in the case of domestic manufacturing and on the import value in the case of imported goods. A single stage tax at manufacturing level is designed to limit the tax to sales by manufacturers to wholesalers or to retailers. This type of tax is favored in many developing countries in the sense that it more or less avoids the cascade evil and covers more organized entrepreneurs so as to make administration easy.

MST does not completely avoid the cascading evil although cascading in MST is less than in a turnover tax. Similarly, pyramiding effects (if a tax included rise in price is higher than the revenue generated from the tax) are coherent with this tax, if goods and services are purchased from registered firms by non registered firms and supply to registered firms cascading becomes inevitable. In practice, it is possible in many countries, where importers directly sell their imports to non registered firms to persons, which may be raw materials for manufacturing industries. Similarly tax is levied on capital goods and other goods as in furniture for office, use of transportation and telephone bills etc. which are inserted into taxable price leading a chronic cascading. Likewise, small production firms cannot claim tax credit because of administrative complexity. Even the purchase of raw materials from registered firms or primary producer is also taxed. Cascading will also be further extended, which will strike a growing economic sector. In contrast value added tax

does not offer cascading and pyramiding effects. It does not impose a negative impact on economic growth. The burden also falls stepwise under a VAT system, rather than at once in an import manufacturing levels sales tax. The stepwise burden will not distort economic sectors. So they will not encourage evading tax. But if burden is laid down at once, a very high load will depress entrepreneurs so as in creating the tax evasion.

Under MST tax burden on domestic product is more than imported goods because importers profits remains out of tax net and producer's profit margin. It includes under tax net.

From the above analysis we can conclude that MST is not neutral, limited in base and encouraging various difficulties with the culmination of tax evasion. VAT proves advantageous over MST, that it has broad coverage equipped with catch up effects eliminating cascading and pyramiding and desirable in developing countries because it is distributed thoroughly according to the consumers expenditure. The main disadvantage, coherent to VAT, in comparison to MST is the large number of tax payers with poor record keeping. But can be converted by means of improvement in administration.

4.7.3 Value Added Tax and Wholesale Level Sales Tax (WST)

Wholesaler's sales tax, one step closer to retail stage and on stage far from manufacturer's sales tax, generally means the taxation on sale to retailers. Basically wholesalers are required to register for sales tax purpose under a wholesale level sales tax system in practice; WST is levied in its two faces as;

- a. Originally on Wholesale Enterprises
- b. Accompanied with Manufacturing or Retail Systems (two tier system)

Principally, it should be taken into account, its original form. Hence it is required to register wholesaler as a tax payer and collect tax on their sales to retailers if not to final consumers.

More contradictory and evil effects of the WST also cannot be ignored in practice. This is worse and serious for example, if the manufacturer directly sells to retailers or consumers, the result revenue will be nil. Because of generating more revenue, maintaining neutrality, avoiding tax evasion and discriminating effects VAT proves to be a superior in comparison to WST.

4.8 Public Expenditure and Revenue

4.8.1 Public Expenditure

Public expenditure is an important part of government which plays a crucial role expand large scale of economic activities and for peace building security ad social welfare. Prior to FY 2007/08, government expenditure used to include two types of expenditure: regular expenditure and development expenditure. However, FY 2007/08 on wards the Nepalese government started following international practices of expenditure classification and reclassified the government expenditure into recurrent expenditure, capital expenditure and principal repayment. Before the introduction a new classification principal repayment used to be a part of regular expenditure, "Prior to the early 1990s regular expenditure accounted for about one third of expenditure while development expenditure was about two thirds of total public expenditure. The regular expenditure increased rapidly and exceeded the de4velopment expenditure during 1998/99. Not only in terms of volume but also in the share in total expenditure" (Khadka, 2005:147)

Regular expenditure has been increasing at a faster rate than revenue due to the following reasons. Increment in the number of office and

employees, increment in the pension and other social security, benefit provided by the government, repayment of principal and interest of internal and foreign loans, increase on the pace and security expenses due to growing conflict situation devaluation of Nepalese currency vis-à-vis other currencies. These expenditure are likely to increase even more rapidly in the future on the other hand, development expenditures have been increasing at a slow rate. This is not a desirable situation in developing country like Nepal where there is a need to enhance development expenditure in order to create the infrastructures required for economic development and the execution of many projects to improve the social conditions such as health and education. (Khadka, 2005, 148).

Necessities to increase development expenditures:

- To control unproductive and unnecessary expenses.
- To reduce the number of government offices and downsize the officials
- Present pension system should be restructured.

The development budget should be increased to meet the growing expenses in social sectors and fulfillment of basic needs like education and health (Dahal, C.N. 2006:189)

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

Table 4.2
Ratios of Government Expenditure and Revenue of GDP (In Current
Producer's price)

In percent

Fiscal	Government Expenditure (A)				Revenue (B)	Difference between A and B
	Recurrent	Capital	Principal repayment	Total		
1998/99	9.30	6.7	1.40	17.40	10.90	6.50
1999/00	9.40	6.70	1.40	17.50	11.30	6.20
2000/01	10.4	6.4	1.3	18.1	11.1	7.0
2001/02	10.6	5.4	1.4	17.4	10.9	6.5
2002/03	10.6	4.5	1.9	17.0	11.4	5.6
2003/04	10.3	4.3	2.0	17.6	11.6	6.0
2004/05	10.5	4.6	2.5	17.4	11.9	5.5
2005/06	10.2	4.5	2.2	17.0	11.2	6.0
2006/07	10.6	5.5	2.3	17.4	12.1	6.3

Source: Economy Survey, 2007/08: MOF July, 2008.

From the table it is clear that the governments liabilities to repay debt has been increasing in term of GOP. It actual value is increasing very rapidly. The different between the government expenditure and revenue is decreasing due to the incapacity of government expenditure and revenue is decreasing due to the incapacity of government to make capital expenditure for development activities. If there is increase in government expenditure it is due to increase in the debt repayment and the need for recurrent expenditure to finance security and social welfare.

4.8.2 Public Revenue

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

Tax revenue contribute about three quarters of total revenue while non tax revenue represent about one quarter of the total revenue.

4.8.2.1 Tax Revenue

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

Table 4.3
Contribution of Direct Tax and Indirect Tax Revenue

Fiscal Year	Total tax Revenue	Direct tax Revenue	Direct tax % of total tax revenue	indirect tax revenue	Indirect tax as % of total tax revenue
1998/99	28752.9	7516.1	26.14	21236.8	73.86
1999/00	33152.1	8951.5	27.00	24200.6	73.00
2000/01	38865.1	10069.4	26.14	28795.5	73.06
2001/02	39330.6	10597.5	26.94	28733.1	76.27
2002/03	42507.0	10105.8	23.73	32481.2	75.27
2003/04	48173.0	11912.6	24.72	36260.4	75.28
2004/05	54104.7	13071.8	24.16	41032.9	75.84
2005/06	57430.4	13968.1	24.32	43462.3	75.69
2006/07	71127	18980.5	26.68	52146.5	73.31

Source: Economy Survey, 2007/08: MOF July, 2008.

Being an underdeveloped country most of the Nepalese people live in the level of subsistence and all their income is spent out on consumption their could be a reason that direct tax is not producing more revenue than indirect tax.

4.8.3 Non Tax Revenue

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

Table 4.4
Relative Share of Non Tax Revenue and Tax Revenue on Total Revenue

Rs. in Million

Fiscal Year	Total Revenue	tax Revenue	% of tax revenue	non tax revenue	% of total revenue
1998/99	37251.00	28752.90	77.20	8498.10	28.80
1999/00	42893.80	33152.20	77.30	9741.60	22.70
2000/01	48893.60	38865.00	79.50	10028.60	20.50
2001/02	50445.50	39330.60	77.90	11114.90	22.10
2002/03	56229.8	42586.90	75.50	13642.90	24.30
2003/04	62331.10	48173.00	77.30	14158.10	22.70
2004/05	70122.70	54104.70	77.20	16018.10	22.80
2005/06	72282.1	57430.4	79.45	14851.7	20.55
2006/07	87717	71127.0	81.08	16590.00	18.91

Source: Economy Survey, 2007/08: MOF July, 2008.

4.9. Nepalese Taxes

The history of systematic tax system in Nepal has not been so long. The sensitivity of revenue mobilization was realized only after the people's movement of 1950 AD. prior to that, the than Rana rules used the national properties and the revenue of the government as there own personal property. During that time, excise duty, custom duty and land tax was the main sources of national income. To collect revenue from these sources, there was the absence of systematic mechanism. After the success of people movement of 1950, the first budget was submitted to the nation and thus was started making the tax system much more transparent and systematic (Mainali, 2005/198)

"In recent year, the government has taken several measures to reduce tax induced distortions, strengthening tax administration, simplifying tax laws and procedures to make than more transparent with an aim to broaden the tax base the government enacted new income tax Act in 2002. The custom Act was amended to make the Nepalese system compatible with the WTO valuation system, broaden the tax base and mobilize additional revenue by curtailing wide range ok exemptions. In 1997, the government introduced VAT aiming to develop it as the backbone of Nepalese revenue. (MRB 2006, 20)

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

Table 4.5
Composition of Tax Revenue

Rs. Million

Description	1998/99	99/00	00/01	01/02	02/03	03/04	04/05	05/06	06/07
Customs duties	9517.7	10813.3	12552.1	12658.7	14236.4	15554.8	15701.6	15344.0	16708.0
Tax on domestic production of goods and services	11719.1	13387.3	16153.6	10743.0	18244.8	20705.6	25331.3	28118.3	35439.0
Taxes on income property and profits	6513.0	7935.6	9546.5	9465.7	8691.5	10215.1	11272.6	11787	16727.0
Tax and land revenue and registration	1003.1	1015.9	612.9	1131.8	1414.3	1697.5	1799.2	2181.1	2253.5

Source: Economy Survey, 2007/08: MOF July, 2008.

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

Is somehow regressive

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

4.9.1 Customs Duty

The custom duties of the study are decomposed of,

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

Import duties are levied on goods imported into Nepal while export duties are levied on goods exported from Nepal. Under India Nepal trade treaty 1995, as amended from time to time; those India products which are subject to excise will be refunded by Indian government if those products are directly imported into Nepal. Custom duties are the traditional sources of tax revenue in Nepal, which contribute about one third of total tax revenue. In the past, while internal sources of revenue were not developed and the government has adopted the closed economic system, custom duty was the single largest source of tax revenue. But recently, due to the WTO and SAFTA provisions along with liberalization and external sector, the relative share of

custom duty to the total tax revenue has been decreasing and it is now the second largest sources of internal revenue.

Table 4.6
Custom Duty as Percentage of Total Tax Revenue

Rs. Million

Fiscal Year	Custom Revenue	Custom duty as a % of total tax revenue.
1998/99	9517.70	33.10
1999/00	10813.30	32.61
2000/01	12552.10	32.29
2001/02	12658.70	32.18
2002/03	14236.40	33.42
2003/04	15558.40	32.28
2004/05	15701.6	29
2005/06	15344.0	26.72
2006/07	16708.0	23.49

Source: Economy Survey, 2007/08: MOF July, 2008.

The relative share of custom duties on total tax revenue had decreased from FY. 1998/1999 to FY 2001/02. In 1998/99 the share of custom duty on total tax revenue was 33.10 percent which had 32.18 percent in 2001/02. But its share to total tax revenue remained at 33.42 percent in FY 2002/03 and it had decreased to 23.49 percent in FY 2006/07. Previously it was single largest source of revenue but from the FY 2006/07, it has been the first largest source of revenue.

Table 4.7
Composition of Custom Duties in FY 2006/07

Rs. Million

Items	Revenue	% of total custom duties
Export	708.7	4.24
Import	13626.1	81.56
Indian Excise refund	1896.5	11.35
Other	476.3	2.85
Total	16707.6	100

Source: Economy Survey, 2007/08: MOF July, 2008.

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

4.9.2 Excise Duties.

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

Excise duties are fourth largest source of tax revenue in Nepal. The relative share of excise duties is decreasing in the recent years because only socially harmful products are subject to tax and government has adopted a policy to cut down the number of goods to level excise. In the fiscal year 2007/08 only about 26 goods are under the excise duty which was 61 in the fiscal year 1992/93 but the rate of excise is increasing year by year with Nepal's entry into WTO and

SAFT, the revenue from customs duties is decreasing in this context, there is possibility of increasing excise duty.

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

Table 4.8
Contribution of Excise Duties in Total Tax Revenue
(Rs. In Millions)

Fiscal Year	Excise Revenue	Excise Revenue as of total tax revenue:
1998/99	2953.0	10.27
1999/00	3127.6	9.43
2000/01	3771.2	9.70
2001/02	3807.0	9.67
2002/03	4785.1	11.23
2003/04	4226.7	12.93
2004/05	6445.9	11.93
2005/06	6507.6	11.33
2006/07	9343.2	13.13

Source: Economy Survey, 2007/08: MOF July, 2008.

4.9.3 Income Tax

In Nepal income tax on business profit and remuneration was introduced by the finance act 1959. In the very next year than parliament introduced business, profit and remuneration tax act 1960. In fact income tax act as such was for the first time to time. The income tax act of 2002 was introduced in place of the income tax act

of 1974. The new act is compressive and follows modern concept. The source of income according to there act are employment, business investment. It has adopted a full-fledged self assessment system and reduced the discretionary power of tax officials.

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

Table 4.9
Contribution of Income Tax in Total Tax

Rs. in Million

Fiscal year	Total tax Revenue	Income tax	Income tax as a of total tax revenue.
2000/01	38865.1	9153.9	23
2001/02	39330.6	8903.6	22.63
2002/03	42587.0	8132.2	19..09
2003/04	48175.0	9504.0	19.72
2004/05	54104.7	10456.0	19.32

Source: NRB Quarterly Bulletin -2006 mid October.

Income tax which is a major sources of direct tax in Nepal, contributes about 20 percent of total tax revenue. Total number of income tax payers in Nepal is still less than 1 percent of the total

population. Revenue from income tax collection is still less than 2 percent of GDP (Nepal, 2003) this shows the high three should for income tax and widespread poverty.

4.9.4. Value Added Tax

- VAT is levied on all goods and services unless specifically exempted by the law, and collected at the different stage on the process of production and distribution. VAT is a member of sales tax family. The introduction of VAT replaced existing sales tax, hotel tax, entertainment tax and contract tax in 1997.
- In the context of Nepal, to see the effect on vat in price, many think should be considered firstly, VAT is not additional tax on the existing tax, it is tax imposed instead of existing sales tax, hotel tax, entertainment tax and contract tax. During implementation of VAT, the existing sales tax was reduced from 15 to 10 percent and adjustment made in customs duty and income tax. VAT has been exempted on basic necessary goods and services. If VAT is imposed on goods which were exempted from sales and other taxes, the increment in price of goods is likely.
- Business with annual turnover of less than 2 million are not required to register for VAT, goods exempted for VAT include primary agriculture products. Goods of primary needs, livestock's and their products, agricultural, materials, medicine and health services, education paper and cultural services. VAT is not levied on goods for export.
- From the revenue productivity point of view, VAT has a great significance as revenue has been increasing in both absolute and relative terms since VAT was introduced in 1997. As it is a

broad based tax the importance as a source of revenue is bound to grow in the futures well, ”for the first time since VAT was introduce in November 1997, VAT become a single largest sources of total tax revenue. Largest sources of total tax revenue while until 2003/04, the customs revenue used to be the higher contributor of tax revenue. In 2004/05 the share of VAT revenue in tax revenue by around 6 percent. In 2004/05 the share of VAT and customs duties stood at 34.9 percent and 29 percent respectively in the tax revenue. (NRB 2005;23)

Table 4.10
VAT Revenue as the percent of GDP

Rs. in Million

Fiscal year	GDP	VAT Revenue	Percent of GDP
1999/00	330018	8765.9	2.65
2000/01	366251	10259.7	2.80
2001/02	394052	12382.4	3.14
2002/03	406138	12267.3	3.02
2003/04	437546	13459.7	3.07
2004/05	474129	14478.9	3.05
2005/06	508651	18885.4	3.71

Source: Economy Survey, 2007/08: MOF July, 2008.

As shown in table 4.10 the share of VAT revenue as percent of GDP was 2.65 percent in FY 1999/00. This figure was below 3 percent in 2000/2001 and increased to 3.71 percent in 2005/06. In the earlier years of the implementation of VAT, Share of it on GDP is low due to the lower rate of new tax regime and opposition from the business communities.

4.9.5 Comparison of VAT and custom Duty

On the tax composition by individual taxes customs and VAT are two major sources of tax revenue in Nepal of the total revenue in Nepal. Of the total revenue mobilization of the last nine years; on an average customs duty contribution 32 percent while VAT provided 31 percent of total tax revenue.

Table 4.11
Comparison of VAT and Customs Duty

Rs. in Million

Fiscal Year	Total Tax revenue	Customs duty	Custom duty % of total tax revenue	VAT	% of total tax revenue VAT
1998/99	28752.9	9517.70	33.10	8765.9	30.48
1999/00	33152.1	10813.30	33.61	10259.7	30.99
2000/01	38865.1	12552.10	32.28	12382.4	31.85
2001/02	39330.6	12658.70	32.18	12267.3	31.19
2002/03	42587.0	14236.46	33.42	13459.7	31.60
2003/04	48173.0	15558.40	32.26	14478.9	30.05
2004/05	54104.7	15701.60	29.0	18885.4	34.92
2005/06	57430.4	15344.0	26.71	21610.7	37.63
2006/07	71127.0	16708.0	23.49	26095.6	36.69

Source: Economy Survey, 2007/08: MOF July, 2008.

In above table 4.12 maximum tax revenue is Rs. 71127.0 in fiscal year 2006/07. In the beginning year minimum of total tax revenue than increasing trend of the study period. In the FY 1998/99, 1999/00, 2000/01, 2001/02, 2002/03, 2003/04, 2004/05, 2005/06 is Rs.28752.9, Rs.33152.1, Rs.38865.1, Rs.39330.6, Rs.42587.0, Rs.48173.0, Rs.54104.7 and Rs.57430.4 million respectively total tax revenue. The custom duty is also increasing trend of the study in the F/y 1998/99 is Rs.9517.7 million and of custom duty which is minimum in the study period. In the fiscal year 2006/07 is Rs.16708.0

million of custom year. Some of year custom duty increase high different rate and some of year was increase low different ratio. Percentage of custom duty on total tax revenue is fluctuating trend. In the beggins year decreasing trend and F/y 2002/03 is increasing i.e. 33.42% than the decreasing rate of the study period. The fiscal year 2006/07 is 23.44% which is minimum % of custom duty on total tax revenue.

Vat of study year 1998/99 is Rs.8765.9 million, which is minimum of the study period. Vat is increasing trend in last year 06/07 is Rs.6095.6 million. Which is maximum vat in this study period. Percentage of vat on total tax revenue in increasing trend. In the FY 1998/99 to 2006/07 is 30.48%, 30.99%, 31.85%, 31.19%, 31.60%, 30.05%, 34.92%, 37.63% and 36.69% respectively % of vat of total tax in FY 2005/06 is maximum % of vat of total revenue minimum is 30.05% of FY 2003/04.

CHAPTER FIVE

STRUCTURE OF VAT IN NEPAL

5. VAT in Nepal

5.1 Evolution

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

Retail Level Sales Tax (RST)

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

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

The tax was introduced without any preparation. Neither the tax officials nor the taxpayers were familiar with this kind of tax. As the number of

retailers was very high but illiterate, it invited many problems such as not issuing bills, under valuation of the product etc.

Wholesale Level Sales Tax (WST)

Retail level sales tax created many problems, so it was replaced by wholesale level sales tax in 1968. Under wholesale level sales tax system only the manufacturers and wholesalers were required to register. The tax was levied on the sales of wholesalers to retailers and retailers consumers. This tax net is more convenient because wholesalers are more organized and the number is manageably small so that tax administration is easier.

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

Import/ Manufacture Level Sales Tax (MST)

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

The MST tax gained some features of VAT in 1985 when an advance sales tax system was introduced. Under this system, sales tax registered firms were required to pay the advance sales tax on inputs which were credited against the tax on output. The new system helped to check leakage to some extent but it complicated the tax system and led to harassment to taxpayers by the tax officials as well. Value added element was further extended in the sales tax system in 1992/93 when two -tiers system was

introduced in the case of some selected domestic products. Under this system besides manufactures, dealers and distributors of some selected items such as beer, biscuit , and noodles were required to register for sales tax purpose and to collect tax on their sales. The two-tier system was expected not only to broaden the tax base but also to discourage the malpractice of selling taxable goods at artificially lower prices.

5.2 Reasons for the Adoption of VAT in Nepal

Nepal introduced VAT for several reasons, which are

(A) Revenue Enhancement

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

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

B) Broaden the tax base

VAT will be broaden the base of the Nepalese tax both legally and administratively. Legally, VAT brings the value added at the wholesale and retail levels under the tax net and makes it easier to levy tax on the service sector. VAT broadens the base administratively as well as it minimizes the problems if understatement of import value/ ex- factory price due to the "catch up effect". Under the VAT any understatement of taxable value at the import/ manufacturing point would be corrected on subsequent sales since the credit for taxes paid on purchases would be correspondingly lower. Further, there may not be an incentive for VAT registered vendors to buy goods from those importers/ manufactures who have undervalued their goods since they will not be able to obtain input tax credits. As VAT provides an invoice and audit trail, it makes tax evasion more difficult. Furthermore, as VAT would be levied right through the retail stage, taxpayers will think that they might be caught at a later if they evade tax at an earlier stage.

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

C) Tax Reform

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

In order to achieve these objectives, the tax reform programmes after the 1970s were directed toward the introduction of VAT, reduction of the tax

rate and broadening the tax base and enhancing administrative efficiency. Such overall reform is done only through a package program in which adoption of VAT is a major component.

D) Removing the Problems of Sales Tax

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

E) Administrative Efficiency:

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

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

F) Promote Economic Growth

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

5.3 An Outline of Nepalese VAT System

5.3.1 Characteristics of Nepalese VAT

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

- The adoption of consumption type of VAT.
- The computation of VAT through tax credit method.
- The principle of destination is adopted.

- The provision of exemption and zero rated goods and services.
- The application of VAT to all business turnovers through the retail stages i.e., broad base.
- The allowance of tax credit for taxable suppliers including the zero rated supply.
- The facility of tax refund.
- The use of positive rate of 13 percent.
- The level of threshold of Rs. 2 million.
- Extensive and excellent information about the new tax provided to the public and business firms.

5.3.2 Structure of Nepalese VAT

A) Coverage of VAT

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

VAT could be implemented up to the retail level. But small vendors who have an annual turnover of less than Rs. 2 million are out of tax net because it is believed that they cannot keep their contribution on revenue generation is only nominal. So, from administrative point of view, there is a provision of threshold.

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

B) Exemptions

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

Exemption of goods and services are granted on different grounds. Goods and services of basic needs are exempted on the ground of social welfare to maintain equity. Moreover, some goods and services are exempted with the view of administrative simplicity. It is better not to bring the unorganized small vendors and scattered business firms into VAT. Again, the exemption technique is applied for selected goods and services to encourage their investment and production as well.

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

- Goods and services of basic needs which includes rice, pulses, flour, fresh fish, meat, eggs, fruits, flowers, edible oil, piped water, wood fuel, and kerosene.
- Basic agriculture products are also tax-exempted, for example, paddy, wheat, maize, millet, cereals, and vegetables.
- The expenses of buying goods and services required to grow basic agriculture products are tax-exempted. These include live animals, agriculture inputs including machinery, manure, fertilizers, seeds, and pesticides.
- Social welfare services including medicine, medical services, veterinary services and educational services.

- Goods made for use of disabled persons.
- Transport Services.
- Educational and cultural services such as books and other printed materials, radio and television transmissions, artistic goods, cultural programme, non professional sporting events and admissions to education \al and cultural facilities.
- Personal services are also tax aimed. These are the services provided, for example, by professionals, by actors and other entertainers, people charging for academic and technical research and computer services.
- Exemption from tax is also extended to the purchase and rent of land and buildings.
- Financial and insurance services.
- Postage and revenue stamps, banknotes, cheque book.

C) Threshold

Most of the countries impose certain threshold on compulsory registration of value added taxes depending on the specific context of their own. Nepal has three types of threshold which are: a) Domestic transaction: total annual transaction of 2 million of taxable goods and services b)import and export: Rs 10,000 in one time or annual Rs 100,000 and c) government suppliers more than Rs 35,000

The threshold even in government suppliers in Nepalese tax system is directed towards bringing more reluctant taxpayer into the tax net. (Mainali. 2005; 204)

D) Zero Rating

Under the VAT some goods and services are taxed at a zero rate. The objectives behind the introduction of zero rating is to relieve some goods and services completely from taxation. Zero rated items technically remain

within the tax net so a purchaser is allowed to credit him input tax. It is generally levied in the case of exports, which need to be free completely from internal commodity taxation. But zero rating increases the burden considerably on the part of both taxpayers and the tax administration due to the requirement of maintaining books of account, submitting returns and refunding the tax levied on the inputs of zero items.

E) Tax Rate and Base

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

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

To begin with, VAT rate was fixed at 10 percent, but from mid January 2005, an upward adjustment was made in VAT rate by 3.0 percentage points. Therefore, at present, VAT rate is 13 percent.

5.3.3 Implementation of VAT.

A) Registration

The business firms whose transaction is above threshold have to be compulsorily registered for VAT purpose but the traders with transaction below threshold can register voluntarily. Determination of threshold is a difficult task as many transactions level were suggested and it was finalized in Rs 2 million for general business.

A VAT registered vendor should get a VAT registration certificate, which must be permanently displayed, in the public sight in his business place.

When sales tax was converted into VAT the automatic registrants were 2048 in number but at the end of fiscal year 2003/04, it reached 34, 174. So, the number of registrations is increasing gradually. The objective of the tenth plan is to register 40000 in VAT which will be fulfilled if the current ratio continues.

B) Tax Credit

Tax credit is an important element of Nepal's VAT. Under this system, VAT registrants making only taxable supplies including the zero rated supply are entitled to claim input tax credit. A taxpayer must hold and be able to produce a valid tax invoice for the goods or services for which credit is claimed.

Since only VAT registration are allowed to claim input tax, small traders falling below the registration threshold and not registered are not allowed to claim to take an input tax credit.

A person involved in mixed transaction i.e., making both taxable and tax exempt transactions, is entitled to claim input tax credit on the purchases related to the making of taxable sales. He is, however, not entitled to claim input tax credit on purchases related to his exempt sales.

Some goods are used for both the purposes of the business and personal use. These include such items as computers, and automobiles. Only partial tax credit can be provided on such goods. Similarly, with certain goods and services, it is very difficult to ascertain whether they have been used for the purpose of the business or for personal use. These include items such as liquor beer petroleum fuel for vehicles and entertainment expenses. In these cases, there is no provision of tax credit i.e., no input tax credit is

allowed. There are other tax credit methods such as full credit, proportional credit etc.

C) Tax Refund

Under the Nepalese VAT system, there is a provision for the refund of VAT. Such a provision is made to encourage exports and generate foreign exchange. Tax refund is an important feature of VAT system. It generally happens in the case of export which are zero rated. This is because experts of taxable goods do not have to collect tax on their exports but are entitled to claim tax paid on the inputs of exports. VAT law provides immediate refund to the exporters. Any exporter may take an application for refund of VAT to the concerned VAT office. The office will proceed the refund claim and forward it to the Refund Section of VAT Department for final approval and refund to the taxpayer.

There is also a situation where it is necessary to refund in the case of a taxpayer that is not an exporter. A taxpayer may have excess credits even if he is not an exporter. In this case, he can carry forward his excess credit. He can also claim for a refund if he has excess credits for a continuous period of 6 months or more.

Refund is also provided to the accredited diplomats on reciprocal basic. Some of their imports are zero rated; they do not have to pay tax on imports. But they are required to pay VAT on domestic purchases first and than claim for refund. Furthermore, other officials of international organizations that are accredited by the ministry of Finance also are entitled to claim for refund. Also the project run under bilateral and multilateral agreements get this facility.

There are also situations where VAT may be collected by mistake, for example, on a product that is either zero rated or exempt. There is a provision for the refund of this tax to the person who paid it.

Since the tax refund is an important aspect of VAT, it must function properly. Credibility of VAT system will be questioned if refund is not processed timely and properly. Thus, tax officials should facilitate, not discourage tax refunds otherwise this brings contraction in the tax base, leading to lower amount of tax collection. VAT administration must make an effort to run the refund system properly.

D) Invoicing / Accounting

VAT registrant is required to issue a tax invoice whenever a transaction takes place. It is necessary to mention seller's and buyer's TPIN if both are registered vendors, addresses of sellers and buyers, description and price of goods and VAT amount on the invoices. A minimum of three copies of each invoice must be prepared. First copy must be given to the buyer and the vendor must retain the two copies. The invoice must be issued in sequential numerical order. However, they can prepare invoices with different serial number for branches or different sections of a business with prior approval of VAT administration.

Similarly, VAT registrants are also required to maintain VAT account. It is monthly summary of taxable purchases and sales and tax paid on purchases and charged on sales.

E) Return and Payment

VAT registrant is required to complete VAT return and submit it to the concerned VAT office within 25 days of the months following the end of the accounting period. Accounting period is one month for the compulsory registrant and four months for the voluntary registrants.

On receipt of VAT return the tax officer is required to examine the return and check for arithmetical accuracy. If this confirms that the amount shown, as payable and other particulars on the return are correct, the return is to be accepted.

Payment of VAT is to be made to the concerned VAT office if the tax amount is less than Rs 5000. Payment vouchers may be collected at the designated bank and submitted to the concerned tax office.

F) VAT Audit

Since VAT system highly believes in self assessment system, very few taxpayers are selected for audit in each year. In Nepal, annual audit list is prepared by tax administration from the weightage average parameter of potential revenue rise and is sent to the audit. Audit team mainly carries out three types of audits depending on requirement namely refund, verification and full audit, which is relatively important in the examination of tax declaration, applies various cross linkages to ensure the accuracy. Remaining these types of audit are just verification of tax invoice, purchase and sales books and tax return.

5.3.4 Contribution of VAT in Revenue Generation

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

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

When VAT was introduction in 1997, VAT was thought to be the single largest source of revenue but until 2004/05 the custom duties has remained

the single largest source. From 2005/06 the share of VAT in revenue is the highest.

Table 5.1
Contribution of VAT Revenue in Total Revenue and Total Tax Revenue

Rs. in Million

Fiscal Year	Total Revenue	Total Tax Revenue	VAT Revenue	VAT revenue as % of total tax revenue	VAT Revenue as the % of total Revenue
1998/1999	37251.0	28752.9	8765.9	30.48	23.53
1999/2000	42893.8	33152.1	10259.7	30.99	23.91
2000/2001	48893.6	38865.1	12382.4	31.85	25.32
2001/2002	50445.5	39330.6	12267.3	31.19	24.31
2002/2003	56229.8	42587.0	13459.7	31.60	23.93
2003/2004	62331.0	48173.0	14478.9	30.05	23.22
2004/2005	70122.7	54104.7	18885.4	34.92	26.93
2005/2006	72282.1	57430.4	21610.7	37.63	29.89
2006/2007	87717	71127.0	26095.6	36.69	29.74

Source: Economy Survey, 2007/08: MOF July, 2008.

In the study period, the share of VAT revenue is increasing in both relative and absolute terms. It has stood only 23.22 percent of total revenue in the year 2003/004 and increased to 29.89 percent in 2005/006. Moreover, the contribution of VAT revenue to total tax revenue has also increased from 30.05 in the FY 2003/004 to 37.63 percent in 2005/006.

5.3.5 Existing Problems

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

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

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

17. There is a controversy in Nepal with regard to the multiple or single rate of VAT. Some people are of the view that the VAT rate should be multiple having a minimum of three rates including zero. But the tax administration opposes this on the ground of administrative difficulties. The logic of advocating multiple rates is that high and is causing tax evasion. It is making difficult to bring lots of exempted items within tax net.
18. The exemption facility is working as a problem for creating distortion in the economy. There are more than 50 items under the exemption list under which VAT uses to be hidden. By using the umbrella of exempted items, taxpayers are evading the tax also on nonexempt items.

5.3.6 Current Efforts to make VAT Effective

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

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

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

CHAPTER-SIX

PROBLEMS AND PROSPECTS OF VAT WITH RESPECT TO REVENUE MOBILIZATION

6.1 Problems for Revenue Mobilization

a. Structural Problems

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

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

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

- i. The goods and services of basic needs such as medical and health services, milk, not processed food stuffs, vegetable, etc are exempted with the equity consideration but this provision increases their demand and the relative prices and the fool impact of such exemption will not be felt by the poor.

- ii. Some goods and services are exempted because of the administrative complexity, under this provision the small trades farmers and special service firms are excluded from VAT, farmers are exempted for its difficulties of proper records and financial fragility as well as to avoid the negatively effects on primary products.
- iii. The exemption technique might be used for selected goods and services to encourage their production and consumption such as educational and medical services, cultural activities, public transport, sports, etc.

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

b. Administrative Problems

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

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

c. Problems Related with Tax Laws and Regulation.

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

d. Problems Relating to Open Boarder and Unauthorized Trade.

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

6.2 Prospects for Revenue Mobilization

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

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

On the other hand, there is less possibility of collecting huge amount of income tax because of low per capital income of the Nepalese people; therefore VAT is only one alternate. Because of all these castors Nepal has already adopted broad based consumption type VAT, using tax credit method. Despite the preliminary resistance,

VAT is currently well received by customers as well as the business and industrial communities. There has been made a progress in revenue mobilization. The prospects of VAT for the revenue mobilization can be outlined as;

a. Prospects of VAT Revenue Mobilization at Various Rates

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

b. Prospects of Revenue Mobilization by Broadening VAT Base

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

c. Reducing the Threshold Level

VAT is not applicable to all transactions. An annual threshold of Rs. 2 million in transaction has been specified for this purpose. But still there is strong Argument that the present threshold is so high. Because of high level of threshold only limited business vendors are registered, which is providing scope for the sales of smuggled or

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

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

6.3 Strategies and polices in Tenth and Three Interim

Development Plan

A. Strategies

- ❖ To bring effectiveness in revenue mobilization, in tax base will be broadened through structural reforms. To develop value added tax as a primary source of domestic revenue, its scope and coverage will be expanded. Custom tariffs will be further simplified by bringing every income-generating sector within income tax net.

- ❖ Administrative and legal reform will be prepared to make tax administration simple, transparent and perfect. The mechanisms designed for controlling revenue leakage use effectively.

B. Polices

- ❖ The Direct and indirect tax will be adjusted in consonance will foreign trade structure, protection of Domestic industries, accession to the WTO and SAFTA.
- ❖ The areas of income generations that have not been incorporated within tax base will be brought under the tax net thereby adopting the policy to gradually reduce the income tax burden.
- ❖ Areas where VAT is levied will be reviewed. Arrangement will be made to adopt the task of issuance of tax invoice up to consumer level and to implement it strictly.
- ❖ “Public-Private sector partnership” will be promoted to increase participation of the private sector on revenue policy formulation.
- ❖ Various awareness and promotional programs will be initiated to bring potential taxpayers into the tax net.
- ❖ An integrated information system will be developed for the regular monitoring of revenue policy reforms and implementation.
- ❖ A permanent revenue board will be established and activated for making institutional arrangement that assists in providing prompt understanding on current situation of the economy and assist in financial decision-makings.
- ❖ The monitoring capacity of the agencies involved in controlling revenue leakages will be extended and the effectiveness of the

monitoring units that are working at the central level will be increased.

- ❖ Professionalism of staff in revenue administration will be enhanced through regular trainings.
- ❖ Revenue laws will be made more transparent and practicable may removing impediments in the areas of VAT, custom tariffs, excise and income tax.
- ❖ The monitoring process will be made more effective by setting up permanent revenue police.
- ❖ Revenue tribunal will be made active for early settlement of tax litigations thereby reducing the tax arrears. A separate institutional arrangement will also be made for the management of the tax arrears that exist after the decisions made by tribunal.

C. Working polices

- a. Tax base will be gradually broadened, by controlling tax leakages through modernizing the value added tax collection process
- b. Tax payers ' education and information technology will be more focused on promoting self assessment of tax.
- c. Revenue collection will be enhanced by increasing the competitive capacity of domestic industries and by improving the services and facilities.
- d. Tax rates including those of non-tax revenue will be reviewed to streamline them.
- e. Tax administration will be made efficient, cost-effective, transparent and tax payer friendly.
- f. The revenue advisory Board will be strengthened and developed to function more effectively on a permanent basis.

- g. The tax system will be adjusted according to the commitments made by Nepal to international and regional like the WTO, SAFTA.
- h. Double tax exemption treaties will be negotiated with capital exporting countries with a view to enhance mobilization of foreign investment.
- i. Institutional strengthening process necessary to improve the revenue system will be pursued.

CHAPTER SEVEN

SUMMARY CONCLUSION AND RECOMMENDATIONS

7.1 Summary of Findings

Value added tax; the youngest member of sales tax family has been implemented in more than 125 countries in the world. It is multistage commodity and service based tax which is levied on the value added of business enterprises on the process of production and distribution. Since the last four decades, VAT has gained popularity as a tax reform measure all over the world. Nepal could not remain unaffected from the world wide wave and serious considerations were started during the first half of 1990s. It has been practically implemented since 1997.

Among the three types of VAT, - GNP type, income type and consumption type, the last variant is attractive, which excludes capital goods from its base and, hence, does not hamper investment and growth. This type is neutral to any investment decision and to adopt either capital intensive or labor intensive technique of production. Moreover, it is desirable from foreign trade point of view as it is based on destination principle and easy to administrate. There are three methods of calculating VAT which are addition method, subtraction method and tax credit or invoice method among which the last one is mostly used under which net tax liability is calculated by subtracting VAT paid on purchases from VAT collected on sales like the VAT in most of the countries in the world, VAT in Nepal is of consumption type and the method used for calculation is tax credit method. Currently, threshold limit is Rs 2 million and it is subject to flat rate of 13 percent with zero percent rate on exports. Some selected goods and services are totally exempted from VAT base due to administrative complexity and equity considerations.

A multiple rated VAT is less regressive than a single rated but single rated VAT is highly desirable on different grounds. Multiple rated VAT is administratively more complex, provides loopholes for tax evasion to the traders and may create economic distortions. The structure of VAT in Nepal is well designed but the existing coverage of exemptions is significantly broad and threshold limit is also high which are being helpful means for tax evasion for the business community.

Tax revenue is a major source of public revenue for government. Tax revenue in Nepal is contributing about 80 percent of total revenue and non tax revenue which comes in the form of fines, fees, sales of commodities and services, dividends, interests etc. contributes about 20 percent. While observing the structure of total tax revenue, it is dominated by indirect tax, which is regressive in nature; however, its role is more significant in the underdeveloped countries like Nepal. Indirect tax provides higher investment ratio than direct tax providing equivalent revenue. Indirect tax is helpful to cut the consumption of luxurious and socially harmful commodities. However, the replacement of indirect tax by direct tax is the passing phase towards development. In Nepal, the share of indirect tax provided by custom duties, excise duties and VAT to total revenue is significantly high however the contribution is decreasing marginally in the subsequent fiscal years. The relative share of custom duties, major indirect tax, on total tax is decreasing as it was 33.10% in the year 1998/99 and 29% in 2004/05. Excise duties are also contributing less in the subsequent fiscal years.

The contribution of VAT as percentage of total tax revenue is increasing. The share of VAT revenue to total tax revenue is 37.63% in the FY 2005/06 showing better performance.

Whatever may be from theoretical point of view, the implementation side of VAT is not so effective in Nepal due to many problems associated with

practice. The lack of proper billings is the most challenging problem to implement VAT effectively and successfully. The other problems are smuggling in the border areas, under valuation, poor performance in tax administration, low level of public awareness, lack of co- ordination between custom and VAT offices; lack of transparency with both sides viz payers and collectors of VAT; lack of political will power to implement it effectively, corrupted nature and carelessness of tax officials, and frequent change in the tax rate.

Due to the lack of experts and skilled manpower in the VAT administration, the auditing system, one of the most important aspects of VAT operation, is not effective. Refund system is not operating effectively so that businessmen are getting trouble to get the refund. As the level of public consciousness level is very low, businessmen are cheating general consumers in the name of VAT by charging a high price but they are also cheating government as they do not issue proper bills in their sales and hence paying less VAT amount.

The existing large amount of unauthorized trade with India has been posing a great threat for proper implementation of VAT. The illegal import is helping to black market channel resulting in a large-scale tax evasion; the scope for illegal trade and tax evasion has not been decreased even after the implementation of VAT because tax administration is not strong and efficient enough to check this situation. This kind of smuggling is not only losing of potential revenue but also affecting genuine traders adversely and hence increasing the illegal trade.

7.2 Conclusion

The ultimate objective of the underdeveloped countries is to achieve the economic development and follow a rapid rate of economic growth. It demands huge amount of investment in economic overheads and other development activities for which taxation is the primary source of revenue

for the government. While analyzing the revenue and expenditure structure of Nepal, there is a trend of persisting resource gap along with the huge amount of saving- investment and import - export gap.

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

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

Theoretically, VAT is expected to have a revenue performance at least as much as the growth rate of GDP. The contribution of VAT revenue with respect to GDP remained 2.65, 2.80, 3.14, 3.02, 3.07, 3.05, and 3.53 respectively in the subsequent years of implementation. The revenue performances of replaced taxes were even higher than 3 percent, which implies less productive revenue generation through VAT. However, the

trend of VAT is improving not only from revenue perspective but also from number of registration, composition of VAT returns, general thinking of people including business community.

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

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

VAT is the modern and the best form of the sales tax however an implementation aspect is more important. More efficient and effective administration is the most important requirement for effective operation of VAT. Sound administration is lacking due to low morale of officials, lack of strong efficient and fair monitoring system, close co- operation between the custom offices and Inland Revenue offices and other general aspects.

VAT being a self- assessed, invoice based and account based tax, the role of business community along-with political leaders and general consumers is more important for successful operation of VAT system. Lack of co-

operation between private and government bodies and irresponsible political leaders are the matter of creating question for the prospects of VAT in Nepal.

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

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

In Nepal, there are some lacunae in VAT structure and administration in which should be removed to make it a success. After Nepal's entry into WTO and SAFTA, the revenue from customs will go down. This loss should be covered from VAT. If the political conflict is settled, the burden of reconstruction of the country should also be taken by this source of revenue. It means there is dire need of improvement in the VAT system. The problems, which have hindered in making VAT as the main stream of

revenue should be solved at any cost if the government wants to generate adequate revenue from this source.

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

7.3 Recommendations

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

-) Nepalese policies are directed by the politicians. The bureaucrats do whatever their political bosses call for. Most of the politicians are motivated by their own benefits and hence defective policies are likely to be made. Due to political interference, policies are not so effective to generate VAT revenue as it was expected during the initial implementations. Thus, political interest highly influences economic policies.
-) Political commitment is one of the most essential phenomena for the success of government policies. This is true for VAT

implementation as well. The leaders show their commitment but intentionally nobody has strong will power to make VAT system successful and more effective. There is a lack of proper co-operation and coordination between government and opposition parties. Hence, government should create favorable political environment for effective and successful implementation of VAT.

- J Many businessmen having taxable capacity are beyond tax net so the enforcement should be made more effective and voluntary compliance should be encouraged. The level of voluntary compliance could be raised through a set of promotion and regulatory measures including positive and service minded attitude of tax officials, rationalization of tax administration, simplification of tax procedures and forms, strengthening tax administration, conducting audit and investigation in an effective manner and penalizing those who break the rules. The procedures regarding registration, collection, interest, penalty, audit and appeal should be simplified and improved.
- J There should be close cooperation between the private sector and government sector for the successful implementation of VAT. Both sectors should always be taken into confidence by each other. Business sector participation in policy making is necessary to increase the VAT revenue for government.
- J The threshold of Nepalese VAT is relatively high because most of the retailers are beyond the tax net but their contribution on total trade is- significant. As threshold and tax refunds are two possible gates of tax evasion, auditing investigation and monitoring systems should be made simple and effective, and the period of refund should be minimized. It is recommended to minimize the threshold limit to Rs 1 million.

- J There should be the initiative from VAT administrators to win the trust of industrial and trade organizations as well as professional community. The success of VAT depends upon the honesty and transparency of members of tax administration.
- J The market monitoring system should be more effective, immediate legal steps must be taken against those who try to escape from VAT net by using any means or methods.
- J The exemption list is very long. The exemptions are mainly due to administrative complexity and equity consideration. Agriculture sector is entirely exempted on administrative grounds while many other exemptions are due to vested interest of the politicians. Some basic needs are out of tax net in order to introduce progressiveness in the tax system. But the long list of exemptions is not desirable under a broad based tax regime. Moreover, they are the main loopholes to evade tax. Further, they reduce economic efficiency. So, the exemption list should be shortened gradually so that in the long run, all transactions fall under VAT net.
- J The existing long open border is the main cause of smuggling and under valuation in the border area. Under valuation in custom points not only reduces revenue from both custom duties and VAT, but also creates distortions in the domestic market. Hence, it helps to develop smuggling economy in the long run. So, open border should be regulated to a greater extent. Moreover, customs department and Inland Revenue department should act in coordinative manner. Actions of revenue investigation department should be strengthened.
- J The VAT refund system must be made more effective in order to refund the tax without delay. The practice of credit refund must be controlled by employing a proper mechanism.

- J Lack of proper billing that is supported, encouraged and forced by the smuggling and under valuation in the border side and lack of public consciousness, is the most challenging problem. Therefore, customs administration should be made more effective and efficient and there should be close co- operation with VAT administration. Moreover, education programmes should be initiated to educate consumers about billing system.
- J Computer linkage system is necessary. The existing computer system should be revised and an integrated computer network with Customs Department, Department of tax and Ministry of Finance should be established for information and operation of this system. More improvement is needed in the present communication system.
- J Inefficient staff lacking practical and specialized training is a serious problem. So, providing training to such staff is highly essential.
- J The conscious consumer programme and the conscious seller programme have proved very effective in Kathmandu valley. These programmes should be launched and extended all over the country.
- J So, at last, the government needs full cooperation from the tax administration, the taxpayers and businessmen as well as consumers in its efforts to generate more revenue. VAT must be made successful and this largely depends upon honesty, faith and morality of tax officials and business people. Therefore, it is time for action and improvements for effective and successful operation of VAT in Nepal for future perspectives as well as present needs of-economic development.

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