A STUDY OF DIFFERENT SECTOR'S CONTRIBUTION TO VAT

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LETTER OF RECOMMENDATION

This thesis entitled **"A Study of Different Sector's Contribution to VAT"** has been prepared by Mr. Naba Raj Khanal under my supervision. I hereby recommend this thesis for examination by the thesis committee as a partial fulfillment of the requirements for the Degree of Master of Arts in Economics.

....

Associate Prof. Kamal Bahadur Chitrakar

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Date: February, 2009

APPROVAL LETTER

We certify that this thesis entitled **"A Study of Different Sector's Contribution to VAT"** submitted by Mr. Naba Raj Khanal to the Central Department of Economics, Faculty of Humanities and Social Science, Tribhuvan University, in partial fulfillment of the requirements for the Degree of Master of Arts in Economics has been found satisfactory in scope and quality. Therefore, we accept this thesis as a part of the above mentioned degree.

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ABBREVIATIONS

CBS	–	Central Bureau of Statistics
CEDA	–	Center for Economic Development and Administration
CEDECON	–	Central Department of Economics
CPI`	_	Cost of Purchased Input
FNCCI	–	Federation of Nepalese Chambers of Commerce and Industry
FY	–	Fiscal Year
GDP	–	Gross Domestic Product
GNI	–	Gross National Income
GNP	–	Gross National Product
IMF	–	International Monetary Fund
IRD	–	Inland Revenue Department
LDCs	–	Less Developed Countries
MOF	–	Ministry of Finance
MST	–	Manufacturing Sales Tax
NCC	–	Nepal Chamber of Commerce
NEFAS	–	Nepal Foundation of Advanced Studies
NNP	–	Net National Product
NPC	–	National Planning Commission
NRB	–	Nepal Rastra Bank
PAN	–	Personal Account Number
RST	–	Retail Sales Tax
SAARC	–	South Asian Association for Regional Cooperation
SV	–	Sales Value
VAT	–	Value Added Tax
VDC	–	Village Development Committee
WB	–	World Bank
WST	–	Wholesale Sales Tax

CHAPTER I

INTRODUCTION

1.1 Background

A government has to spend a lot of money to fulfill its responsibility towards people. Due to this, government expenditure is increasing day by day. It has to accumulate money to fulfill its responsibilities. The source of income of government is called revenue. There are two types of sources of revenue collection, which are internal and external or foreign. Such foreign sources are uncertain and inconvenient. It is thus better to mobilize internal sources rather than expecting the aid from the foreign donors.

The internal sources of revenue consist of two types. They are: Tax revenue and non-tax revenue. Tax is a compulsory contribution of the citizens to the government without expectation of special benefit. There is no portion of quid pro quo in the tax transaction. Basically tax consists of two types viz. direct and indirect. Direct tax is paid by the person to whom it is legally imposed. These types of tax can't be transferred to others. On the contrary, indirect tax is imposed on one person but paid partly or wholly by others. It includes entertainment tax, hotel tax excise duty, import and export duties and others.

Because of low per capita income and agriculture being the main base of the economy, the contribution of direct tax is very low. So, indirect tax is a major source of the revenue in Nepal. It has become the main source of resource mobilization to meet the financial requirements of the government. Value added tax (VAT) is the most recent Innovation in the field of indirect taxation. It is a broad base indirect tax and its importance can't be denied in developing countries like Nepal.

VAT is considered as one form of sales tax. It is a multiple stage tax, which has grown as a hybrid of turnover tax and retail level sales tax. VAT is similar to the turnover tax in the sense that both these taxes are imposed at each stage in the production and distribution process. VAT, however, differs from turnover tax as the turnover tax is imposed on total value at each stage while VAT is imposed only on the value added at that stage. VAT is similar to the retail sales tax because the tax base of the consumption type of VAT and of the retail sales tax on consumer goods and services are identical. VAT however, varies from retail sales tax in the sense that VAT is impose at each stage of production and distribution while the retail sales tax is imposed only at the final stage.

Value added tax is a tax which is imposed on the value added in each economic activity from production to consumption. It means VAT is charged to value addition done to prepare the final product. VAT is the most recent Innovation in the field of taxation. It was first recommended by Wilhelm Von Siemens in 1919 for Germany to replace the umsatzsteur (multistage sales tax) in order to avoid the undesirable effects, particularly cascading of vertical integration of the latter tax. The concept of VAT was developed further in 1949 by a tax mission to Japan led by Prof. Carl S. Shoup. This mission recommended the Fuka-Kachi-Zai (VAT) for Japan in order to avoid the undesirable and unintended effects of the Japanese expertise and turnover taxes in place of the later tax at that time VAT was considered seriously but decided not to be introduced at that time. VAT was not introduced in any country until 1953.

First of all VAT was adopted in France in 1954. Then, it was implemented by ivory coast (1960), Senegal (1961), brazil and Denmark (1967) and so on. Nepal introduced VAT in the year 1997; however, the VAT act was passed in 1995. The VAT replaced the existing sales tax, the contract tax, entertainment tax and the hotel tax.

1.2 Statement of the Problems

The government has to spend a lot of money for development activities, social services and so on. The expenditure of the government, which is spent in its regular and development activities, is increasing day by day in his speed. But the revenue, which is collected from domestic and foreign sources, is not increasing as fast as the expenditure. So, the resource gap is increasing continuously. Domestic sources of revenue can be split into two parts namely tax revenue and non tax revenue. The tax revenue can be collected from various methods. Among them VAT is one. The increasing trend of resource gap has necessitated increasing the revenue. Since VAT is new innovation in the field of taxation, it can be fruitful to reduce the resource gap.

Nepal is facing serious problem of resource gap and dependency on foreign grants and loans. High inflation rate, corruption especially in financial sector, unmanaged and unjustified agricultural sector, political instability are the few example that have been deteriorating the growth of economy. Resource gap is one among the various causes of low economic growth.

The main task of the government of Nepal is to reduce the resource gap for sustainable development. So, the bringing issue at present is how to reduce the resource gap.

VAT can be collected form different sectors. These sectors are service, production, trade etc. Contribution of these different sectors to VAT may be different. As the different sectors contribute to VAT diffidently, which sectors contribute more to VAT and which less should be clear. So this study focuses on this issue.

1.3 Objectives of the Study

The basic objective of this study is to study the VAT collected from different sectors comparatively. However the specific objectives of this study are given below

- To analyze the structure of tax in Nepal.
- To study the contribution of services, trade and production sectors to VAT and
- To examine the major problems of VAT and recommend appropriate measures to mobilize the addition revenue from VAT.

1.4 Limitation of the Study

a) No attempts have been made to examine the reliability of the data due to time and budget constraints.

b) This study covers the period from FY 1990/91 to FY 2006/07

1.5 Significance of the Study

The implementation of VAT has crossed its 9th years. VAT was expected to occupy an important part of Nepal's revenue. In a country, that has narrow basis for revenue to assume this tax which is based on consumption and imposed at all level of production, import, wholesale and retail would widen the tax base was not wrong. The expectations from VAT were that it would include value addition in distribution1.5process including services with in its spare, get the tax payers who are used to paying tax within tax net, reduce the possibility of tax evasion due to catch-up, self-policing feature, improve valuation of goods and make the implementation income tax import duty and excise duty more effective.

The experiences of the last ninth years show that VAT has been implemented in various countries and has achieved success as expected, has been unable to generate similar results in our county. Our expectations still remain in the form of expectations. They have not been able to take tax form of a living example. In such a situation, government is required to identify the existing challenges and shortcomings in VAT implementation and solve accordingly. A successful implementation of VAT should have positive impact on our above exception and on whole economy. In this regard, this study carries a great significance to identify rectify existing challenges and short comings in effective implementation of VAT and to know the contributions of different sectors through improve and successful implementations of VAT.

1.6 Research Methodology

This study is undertaken to find out the contribution of production trade and services sectors to VAT comparatively. It is based on the published data. This study covers the data and information only after 1990, the year of restoration of democracy. For this purpose, descriptive as well as analytical research design has been applied. To carry out the research on "valued added tax in Nepal" the nature and sources of data, the methods of data collection and the methods of data analysis are as follows.

a. Nature and sources of data

This study is totally based upon the secondary data and information which is collected from following sources.

- Publication of MOF, budget speech and economic surveys,
- Various publications of Inland Revenue Department (IRD)
- Reports and publication of FNCCI and NCC.
- Publications of NRB and CBS.
- Internet (http://www.mof.gov.np)
- Various journals. Of CEDECON, TU
- Publications of CEDA.

b. Methods of data collection

Since this study is based on secondary data, the necessary data have been collected from different publications of above mentioned sources. The data published in these publications are directly tabulated and no attempts have been made to examine the reliability and authenticity of the data.

c. Methods of Data Analysis

The data have been analyzed by using various mathematical tools such a percentage, rations etc. The following multiple regression model is used to study about the different contributors of VAT comparatively.

$$V = a_{0} + a_{1} P + a_{2}T + a_{3}S + e \text{..........................(i)}$$

Where, V = revenue colleted from VAT

P= VAT revenue from production sector

T = VAT revenue from trade sector

S = VAT revenue from services sector

a_0 =constant

a_1, a_2, a_3 = coefficients of production trade and service sectors respectively.

To calculate elasticity and buoyancies of VAT, the automatic growth of revenue should be separated from total revenue growth by eliminating discretionary changes since total growth of revenue includes automatic growth and growth of revenue due to discretionary actions. For this, we should have cleared or adjusted revenue series. In order to make adjusted revenue series, proportional adjustment method of Sahota is used. The model is:

$$IT_t = \frac{ATt - DCt}{AT_{tZ1}} \mid IT_{tZ1} \qquad \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots..(ii)$$

Where, IT_t = net tax yield at time period t

IT_{t-1} = net tax yield of previous year

AT_t = actual tax yield in time period t

AT_{t-1} = actual tax yield of previous year.

DC_t = tax yield due to discretionary change.

To calculate elasticity and buoyancy coefficients the following double log linear model is used:

$$\log T_a = \log \sim + \quad \log y$$

Where, T_a = adjusted VAT revenue

Y= GDP

= elasticity coefficient

$$\log T = = \log \sim + \quad {}_1 \log y \quad \ldots\ldots\ldots\ldots\ldots\ldots\ldots.(iii)$$

Where, T = total VAT amount

Y= GDP

$_1$ = buoyancy coefficient

CHAPTER II

REVIEW OF LITERATURE

2.1 International Content

Carl S. Soup (1969) in his book entitled, "public finance" explains the value added tax as the latest and probably the final stage in the historical development of general sales taxation at the national level which is levied on the value added, the differences between the sales proceeds and the cost of the materials etc. That has been purchased form other firm. VAT has eliminated the convene impact of turnover tax of the manufactures and wholesalers sales taxes. A comprehensive consumption type of VAT is equivalent to a retail sales tax in its pure form except that the later does not offer an option between the destination principle and the origin principle. Soup has explained VAT differently in closed and open economy as follow:

Value added tax in closed economy

a) Gross product type of value added tax:

Tax base = GNP = C+I= W+P+D

Where, c= consumption, I= gross investment, W= wage, P= net profit after depreciation, D= depreciation

b) Income type of value added tax:
tax base = NNI = C+I-D = W+P

c) Capital exemption type of value added tax

Tax base = C+W+P+D-I

Value added tax in open economy

In an open economy, considering relative impotence of the gross-product type of VAT from practical point of view, more focus is given to capital – exemption type of VAT.

Wage type of VAT: the destination principle is less satiable as it would require each import to be broken down into its wages and profit elements. Similarly, each export will need to be broken down into the same two elements so that a tax rebate can be given for the value added tax paid domestically at earlier stages on the wage element. These complication are entailed under origin principle, moreover, no tax refund on account of the exemption of profits will be required.

Consumption type of VAT: Considering a two countries world, this type of VAT under destination principle would exempt the export sales of firms of a country and would impose a tax on the import purchases of another country's firms. These types would be much simple for both taxpayer and administration under destination principle.

In conclusion, consumption type of VAT is regarded superior, however; wage type of VAT is simpler that that of consumption type under the origin principle. While analyzing the computing methods of VAT, author favors the tax-credit method; however, the origin principle and the tax-credit method are somewhat incompatible, through perhaps not so much. So a country moving to the origin principle need give up the use of the tax-credit method. Lastly, VAT a more productive and neutral tax is also complex and regressive in nature.

Musgrave and Musgrove (1976), stated that a sales tax may be imposed in single or multiple stages. A properly implemented value added tax is equivalent to a single stage sales tax, from the economist's point of view. They suggested that among three types of VAT (GNP type, income type and consumption type), the consumption type of VAT is most important from the practical point of view, which includes both efficiency and equity criterion. Tax based on consumption is similar to the retail sales tax especially for the poor countries. Among the three types of tax calculation methods (additive, subtractive, and tax invoice), the later is more preferable and advantageous.

Richard Goode (1986), in his book entitled, "government finance in developing countries", described that VAT is most important innovation in public finance. This tax is applied to the value added at successive stages of production and distribution. Value added in equivalent to the sum of wages, salaries, interest, rent and profit. A value added tax may extend through the retail stage. In that case, it is similar to a retail sales tax on goods and services covered with the important difference that the value added tax is collected at each stage rather than being concentrated at the final stage of distribution.

Goode mentioned that the advantages of value added tax are as follows:

a) it is broad-based and relatively natural

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

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

d) It generates the possibility of using information as a cross-check on compliances with other taxes, particularly income taxes.

Although VAT appears to have been successful in a number of developing countries, its advantages and practicability is questionable fro countries where much business is carried by small enterprises accounting is unreliable and the administration is week.

A.R. Prist (1995) stated the disadvantages of turnover taxes levied at each stages of production in terms of artificial inducements to vertical integration and artificial deterrents to exports. The advantages of VAT relative to retail sales tax are: it can collect a substantial amount of revenue at earlier stages; there is more opportunity for cross checking compared to any form the single stage tax.

It should be thought that many formidable problems do not remain to be solved when UDCs decide to adopt VAT. Abut the exact treatment of exports and imports, the extend of coverage of domestic output, the treatment of investment goods, the rate structure,. The difficult cases such as construction and financial services, all have their analogous in UDCs. But there are some particular problems, which arise in a more acute form in such countries. The most obvious is the treatment of small enterprises, whether in agriculture, retail trading or other services. There is certainly no simple solution here but the best approach is to bring all business enterprises within the scope of tax in principle yet to have a high initial exemption limit. It may be that particular product exemptions would, in any case, leave due quite a lot small enterprises, but it seems much better to legislate on the basis of the size of business rather than solely on product exemptions. Another possible alternative is to have a lower exemption limit but to apply some kind of forfeit principle for small enterprises but this is a less attractive device.

Other features of VAT, which is likely to be of particular importance in LDCs, are:

a) The way used goods are treated.

b) Prompt repayment as well as payment of tax.

c) Linkage between national VAT and any existing sales taxes levied at state and local level.

d) Imposition of VAT as argued is found to exacerbate inflationary decency in economy.

e) Requirement of great deal of advance planning at official level and of communication with both traders and consumers before it can be introduced.

f) Requirement of a compels system of administration, both at private and public level.

g) Involvement of cost on administrative exercise.

2.2 National Context

Babu Ram Subedi (1997), in his dissertation "Applicability of value added tax in Nepal" concluded that there was need for reformation of entire tax system because the existing tax system was not efficient to raise adequate revenue, and it was also discretionary, inequitable and gives insensitive for tax evasion. To reform the entire system, it was desirable and necessary to adopt VAT and improve the administration. VAT would be the best alternative for reducing the inefficiencies and introducing neutrality, fairness, productivity and transparency in the tax system.

According to this study, the problems of implementation of VAT were as:

a. The existing sales tax administration is not capable of handling a VAT.

b. There is no account keeping system.

c. There is lack of knowledge about VAT, lack of co-operation between the government and private sector, illiteracy and low public awareness.

d. There are tax-evading practices also.

This study suggested that a moderate single rated VAT is desirable for Nepal. If the VAT is implemented well, it will generate 1.5 to 2.5 fold more revenue than existing sales tax. But VAT in Nepal may not be "a hen with golden eggs".

Baburam Karki (2003), in his dissertation entitled "Revenue mobilization through value added tax in Nepal" analyzed the structure of VAT with respect to total tax structure. He also examined the existing challenges for VAT implementation. This study also examined the productivity and responsiveness of VAT. This study concluded:

a) The scope of VAT in Nepalese economy is immense that can give right direction to the tax revenue and can be a perennial source of domestic revenue.

b) Inefficient tax authorities, low level of public and tax payers awareness, insufficient and inefficient manpower, lack of research about the weakness of existing VAT system, low level of implementation of findings of scholars, lack of political commitment, absence of proper mechanisms for monitor and audit are creating hurdles and obstacles on the path of VAT implementation. Because of these the economy is unable to experience positive impact of VAT.

c) Since the elasticity coefficient is low in absolute term as well as in comparison to buoyancy coefficient, the government should give priority to its discretionary power to meet the short term revenue requirements.

The recommendations of the study were as follows:

a) In order to improve the performance of VAT, the government can change the environment by providing education; information and knowledge of tax payers that may help increase voluntary compliance.

b) The best way to cope with administration problems, however, is to make a change in tax law. The tax law and regulations should be simple and concise.

c) Focus should give on transparency, fairness and timely and quality production in administration instead of simple collection. Efforts should give to establish functionally will- organized tasks where the tasks are carried out in a modern, effective, efficient and service-minded manner.

Rup Bahadur Kahadka (1995), in his paper, VAT for Nepal" focused on the purposed structure, operation and administrative set up of a VAT for Nepal and necessary steps to be taken for its early introduction. The purposed structure of his paper was that the coverage of VAT should be as broad as possible covering all business transactions. Exemptions should not be granted unless there is a specific reason to do so. Zero-rating should be limited to exports and tax rate should be single in order to avoid complications and inefficiencies in collection.

The purposed operation of VAT requires that the tax payers above a threshold limit should be registered, the vender should issue an invoice for each sale, keep a clear account of his purchases and sales (separate accounts for zero-rated, exempted, and positive rated goods) and VAT liability should be calculated of its taxable sales. Tax credit method should be used as the method of computation of the tax and the tax payment and refund should be of one month. The present sales tax and excise department should be restructured drastically to administer a VAT. Officer's level posts should be increased considerably and implementation, team (including experts and persons from every field) should be set up. A detailed preparation should be considered as a prerequisite for the introduction of VAT. A comprehensive VAT education program should be launched to educate the tax payers.

Rup Bahadur Khadka (1997) published a book entitled "VAT and its relevancy in Nepal". In this book, he discussed about the various prospects of VAT and its relevancy in Nepal. According to this book, VAT is considered as one form of sales taxation. It is multistage tax which has grown as hybrid of turnover tax and retail sales tax. It is similar to and different from the turnover tax in some sense. Similarly, it is similar to and different from retail sales tax in some sense.

He discussed about types of VAT in this book. There are three types of VAT, which are consumption type, income type and gross national product type. Under the consumption type of VAT, all capital goods purchased from other firms in the year of purchase are excluded from the tax base while depreciation is not deducted from the tax base in subsequent years. Since investment is relieved for taxation under this variant, the base of tax is the consumption. The income type of 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 years. Under the GNP types of vat, capital good purchased by a firm from other firms are not deductible from the tax base in the year of purchases. This variant does not allow the deduction from depreciation from the tax base in subsequent year either.

He has also discussed about the methods computation of VAT. VAT can be computed by three methods, which are additive, subtractive and tax credit method. He has compared VAT with MST, WST and RST. VAT would have a broader base than MST. Further, VAT would bring more goods and services under tax net than the MST and VAT would be more neutral than the MST also.

When we are comparing VAT and RST, they are identical in the sense that base of both taxes is consumption. However, they differ in the sense that VAT is collected at each stage of production and distribution while RST is imposed only at the final stage.

According to him/his book, VAT would not be inflationary. The general consensus in taxation literature is that VAT as a new tax brings only one rise in price and does not cause any inflation.

This book also discussed about VAT in Nepal. It stated that VAT became a popular topic of tax reform in recent years. This book examined the structure of the Nepalese VAT, pointed out the need to introduce of this tax and indicated the challenges and strategy to be adopted for a detailed preparation and successful implementation of VAT in Nepal.

Khadka stated that it is necessary to make full preparations before the introduction of VAT. It is also necessary to revamp the tax administration, with emphasis on fulfilling the staffing requirements and training the staff before the introduction of VAT. To give an idea about the various aspects of the VAT to the potential taxpayers and others, a comprehensive taxpayer education program should be launched.

Rup Bahadur Khadka (2001) , in his book, "VAT in Nepal: theory and practice" gave emphasis on the reasons of introducing VAT and measures for successful implementations. He considered that introduction of VAT was the part of an overall tax reform. The VAT should be introduced for broadening the tax base, for reducing the tax base and for making the tax system more transparent, fairer and less distortion.

He stated that the purpose of tax reform package should be:

a) To enhance the competitiveness of the Nepalese economy in the post VAT regime.

b) To develop a stable source of revenue by boarding the tax base.

c) To promote the interchange of information between the other tax systems particularly trade taxes, as custom information is required to determine the validity of input tax credit claimed.

d) To streamline tax police in general.

e) To abolish discrimination against the domestic product vis-a-vis import. To establish an account based modern tax system.

Amrit Prasad Shrestha (2006), published an article entitled, "Assessment to of VAT in Nepal" in Kathmandu post. He stated that the primary objective of VAT implementation was to avoid the problems inherent to manufacturer's sales tax. The VAT was universally accepted because of its growing popularity, catch up effect, free from cascading and being a broad based tax. He also stated that widespread leakages were normal practices due to lack of professionalism, integrity, technically competent and international orientation. According to him, refund process mechanism had to attract investment and promote exports. Since compliance rat is very low in Nepal, the revenue is not being collected significantly.

He recommended that the government has to pay serious heed for increasing the tax base rather than increasing rate. A bold vision, evolutionary leadership, efficient bureaucrats, honest tax payers and collectors and grant free society are invisible infrastructure required. So, all these must think from a long run perspective rather than weighing up immediate pros and cons. He also recommended that IRD should come up with a forward moving process, concrete action plan and policies to cope with a global challenges in order to accelerator the reform process.

CHAPTER- III

THEORETICAL ANALYSIS OF VAT

3.1 Introduction

VAT is the most recent innovation in the field of taxation. It is considered as one of the most powerful tools of the fiscal policy. From the long experience of VAT is several countries, many economists and policy markers have agreed that VAT is probably the best indirect tax.

VAT is also an indirect tax, which replaced the existing retail sales tax, contract tax, hotel tax and entertainment tax. It is based on consumption. Since this tax is based on consumption, the burden of tax has to be borne by the consumers. VAT is levied on the value addition at each stage of production and distribution. Value addition implies the difference between the purchase and sales price that has been incurred in labor, capital, land etc. in relation to the production or distribution of goods and services. Since VAT is levied only on the value addition made at each stage in the process of production and distribution, this tax system seems to be more neutral, efficient, elastic and fair. It is also said that VAT is an improved version of the sales tax. VAT is levied on sales of all goods and services including those that have been exempted by the law. VAT exemption is generally granted to those goods and services which are administratively difficult to tax or those goods and services that are day to day basic necessities of a large number of people. The vendors whose annual turnover is below the specified threshold do not have to register under VAT and they do not have to collect VAT on their sales. The current threshold for VAT registration in Nepal is Rs. 2 million.

3.2 Types of VAT

Several bases are used to classify the different types of VAT. The classification of VAT on the basis of the treatment of capital goods, however, is much important. From this angle, types of VAT are as follow.

3.2.1 The Income Type

Under the income type, VAT does not exclude capital goods purchased from other firms from the tax base in the year of purchase. But depreciation is excluded from the tax base in the subsequent years. In this variant, capital equipments are classified over a period on the basis of their durability. The tax falls both on consumption and net investment and the conceptual tax base of this variant is the net national income. For this reason a comprehensive at of the income variety is equivalent to flat rate integrated tax on corporate and personal income with no exemption or deductions other than these needed to measure income. Therefore the tax base under this type is:

Base of VAT = GNP-deprecation

= net investment consumption

= NNP

3.2.2 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. So, the tax is levied both on consumption and gross investment and the conceptual tax base of this variant is gross notional product. Hence the base of taxes as follows:

Base of VAT = GNP

= Gross Investment + Consumption

3.2.3 Consumption Type

Under this type of VAT, all capital goods purchased from other firms in the year of purchase are excluded from the tax base while depreciation is not deducted from the tax base in the subsequent year. Since the investment is relieved from taxation under this variant, the base of tax is consumption. So, this variant of VAT is known as the consumption type VAT. As exports are relieved from tax base while imports are taxed, the base of this tax is identical to the base of retail sales tax on consumer goods and services. Thus, the base of tax under consumption type is given as:

Base of tax = Gross national product- Gross investment

= Total Consumption Expenditure

Thus, this variant of VAT differs regarding the treatment of capital goods. The consumption variant excludes all capital good purchased from other firms in the year of purchase from the tax base but makes no allowance for depreciation from the tax base in the subsequent year. Both the income and the gross national product variant do not exclude the purchase of capital goods from the tax base in the year of purchase. These two variants differ in that the income variant excludes the depreciation from the tax base in the subsequent years while the gross national product variant does not.

Among these types of VAT, the consumption variant has been widely used because this variant does not affect decisions regarding investment and growth since it relieves investment from any tax burden. The consumption variant is attractive from the point of view of tax administration as there is no need to distinguish between the purchase of intermediate goods and capital goods under this variant as is necessary under the other two variants. Further more, the consumption variant is more attractive than the income variant from the consideration of foreign trade, because the consumption variant is compatible with the destination principle of taxation. Under the destination principle, the tax base is consumption. Hence, exports are relived completely from the VAT. On the contrary, the income variant is consistent with the original principle of taxation, where the goods are taxed in the country of production and hence exports are taxed while imports are relieved from the tax.

The consumption variant, thus, possesses several advantages over the income and the gross national product variants. That is why the consumption variant is accepted and successfully implemented.

3.3 Methods of Computation of VAT

value added tax can be collected by using different methods of computation, however the choice of the appropriate method depends basically upon the type of VAT employed and principle under which VAT is adopted. The VAT can be computed by employing any of the following three methods.

3.3.2 Additional Method

Under this method, the tax base is computed by adding the payments made by the firm to the factor of production employed in turning out the product such as wages, interest, rent, royalties, profits etc. This method is appropriate for the income type of VAT that includes the rewards to all factors in its base. Hence, the tax base under this method is as follows:

Base of VAT = t (Wage+ Rent + Interest + Profit)

Where, t = the rate of VAT.

3.3.2 Subtraction Method

Under this method, value added is determined as net turnover, which is obtained by subtracting the cost of materials from sales proceeds. Thus, the VAT is levied on the amount which is derived by subtracting purchases from sales. This method is appropriate for the consumption variant of VAT. Thus, the base of tax under this method is as follows:

Base of tax = t (SV-CPI)

Where,

T = the rate of VAT, SV= sales value

CPI = Cost of Purchased Input

3.3.3 Tax Credit Method

Under this method, tax is levied on the total value of sales, and the taxpayers are permitted to deduct from their gross tax liability the taxes already paid by their suppliers and passed on to them. This method is also known as invoice method or indirect subtraction method. Thus, in contrast to the subtraction method, which deducts purchases from sales and levies taxes on the difference, tax on purchase is subtracted from the tax on sales under the tax credit method. Thus, the base of tax under tax credit method is as follows:

Bade of tax = t. SV – t. CPI

Where, t = tax rate SV= Sales Value

CPI = Cost of Purchase Input

Whatever be the method of calculation of VAT, the basis of VAT is the value addition in the process of production and distribution of goods and services. Value addition is the difference between the purchases and sales price of goods. For example, if a retailer purchases shirt from a wholesaler at Rs. 500 and sells to a consumer at Rs. 750, the value addition will be Rs. 250 (750-500) and this amount is taxed.

If the tax rate is same throughout the production and distribution process, all there method will yield the same amount of revenue. Among the three methods of computation of VAT, the invoice method is widely used because:

a) the tax liability is attached to transaction that makes it legally and technically superior.

b) It is easy to collet the tax under this method.

c) This method creates a good audit trial that makes the cross checking possible.

d) Due to "catch-up effect", "under-valuation" and evasion are not possible.

e) It provides an effective way to free any product completely form tax such as exports and makes tax adjustment easier and possible.

f) Even though there is exemption granted to small firms or products, no revenue will be loosed.

g) Since the liability depends entirely on the rate on the last stage, rate differentiation is possible for the same amount of revenue.

h) It never demands for the calculation of value added total tax.

Thus, the tax credit method is desirable and has been adopted by many countries of the world. Nepal has also adopted this method to calculate VAT net.

The calculation of VAT liability can be viewed by different method by the help of following example, which shows that the amount of revenue under these three methods is same if the same tax rate is applied.

Table 3.1

Calculation of VAT liability by different methods (10% VAT)

Figures in

	Stages of Production and Distribution			
	Manufactures	**Whole seller**	**Retailer**	**Total**
A. Addition Method				
a Wage	1200	200	100	1500
b. Rent	400	300	150	850
c. Profit	300	100	50	450
d. Interest	100	50	50	200
e. Value added (a+b+c+d)	2000	650	350	3000
VAT liability	200	65	35	300
B. Substation Method				
a. Sales	5000	5650	6000	16650
b. Purchases	3000	5000	5650	13650
c. Value added (a-b)	2000	650	350	3000
d. VAT liability	200	65	35	300
c. Tax Credit Method				
a. Sales	5000	5660	6000	16650
b. VAT on slaes	500	565	600	1665
c. Purchases	3000	5000	5650	13650
d. VAT on purchase	300	500	565	1365
e. Net VAT liability (b-d)	200	65	35	300

Note : Figures in this example are arbitrarily assumed.

The change in the VAT liability will be the same under both the additional and subtraction methods as there is same amount of value added at each stage of production and distribution. Assuming that the transaction presented in the table are for the economy as a whole in a specified period of time, a VAT of 10% rate gives Rs 300 as tax under the first two method where the amount of value added is Rs. 3000. It tax credit method, value added is never calculated; however VAT liability is exactly same as that of other two methods. Calculation of VAT liability under tax credit method is shown below.

Table 3.2

Calculation of VAT liability by tax-credit method (VAT rate 10%)

	Stages of Production and Distribution			
	Farmer	**Manufacturer**	**Whole seller**	**Retailer**
Types of Product	Cotton	Cloth	Cloth	Cloth
Purchase value (a)	0	100	200	210
VAT paid on purchase (b)	0	10	20	21
sales value (c)	100	200	210	230
gross VAT liability on purchase (d)	10	20	21	23
net VAT liability (d-b)	(10-0) = 10	(20-10)-10	(21-20)=1	(23-21)=2
actual sales price (c+d)	110	220	231	253

Note: Figures in the table are arbitrarily estimated and both the sales and purchases value exclude tax liability.

3.4 Structure of VAT

3.4.1 Tax Base

The tax base may be defined as the set of income and transactions on which direct and indirect taxes are levied. Taxable base of includes all types of expenditure on final consumer goods where the consumption types of VAT are adopted. tax base explains whether a VAT is levied on all goods and services or on some subject of such comprehensive base.

3.4.2 Tax Exemption and zero-rating

Tax exemption and zero- rating are two popular methods of escaping from value added tax. But there is difference between tax exemption and zero-rating under the VAT system. The transaction of tax exempted goods and services remain outside the puriew of VAT. Such transactions do not have to fulfill any formalities, even registration under VAT. Such taxpayers neither have to collect tax on these sales nor can they claim for a refund of the tax paid on purchases or imports. This means that the tax mount incurred on the inputs of tax exempted goods and services go to the consumer inclusive of the cost price.

On the other hand, if the transaction of certain goods and services are under zero-rated tax, such goods and services or transactions will be kept within the purview of VAT system. The transactions of such goods and services have to be registered under VAT and the registrants should collect VAT at the rate of zero percent on their sales and they can deduct the tax incurred on their purchases. This means the zero-rated goods and services do not bear the burden of VAT but should follow all the formalities of VAT.

Neither the output tax can be collected nor the input tax can be claimed on the tax exempted goods and services. But a zero-rated tax, which actually equals to none, is levied and the input tax can be claimed on the zero-rated goods and services. Hence, there is no burden of VAT on the zero-rated goods and services whereas the burden of VAT paid on input remains even through VAT is not levied on the sales in the tax-exempted goods and services. If some goods and services should be kept free from VAT, zero rated VAT should be applied. But, if it is difficult to apply tax on certain goods and services administratively, such goods and services should be kept under tax exemption.

3.4.3 Threshold

VAT is levied on each level of sale from the production and import to distribution of all goods and services except exempted ones. But for small business persons engaged in the sales of goods and services bellow the specified level, it is not mandatory to register under VAT. To keep small business persons outside the tax purview, a threshold has been specified under VAT system. The whole seller, retailers, dealers or producers who sell taxable goods and services below the threshold level do not have to be registered under VAT and neither have they to collect VAT on their sales.

3.4.4 Tax Rates

VAT may be levied on single rate or multiple rates. The choice may depend upon economic nature and social will such as consideration, administrative capacity, nature of product, direction and composition of foreign trade etc. A single rated VAT is desirable in UCDs because it makes VAT less costly, easy to comply with and administer.

Multiple rates make the tax system inefficient from the economic point of view. They give an incentive to producers to divert their resources from higher-rated to lower-rated industries to save on tax payment even when other economic considerations do not justify such reallocations of resources. Similarly, they stimulate the consumer to divert some of his purchase from higher-rated to lower-rated commodities. Thus, multiple rates create scope for tax evasion that may result in considerable revenue loss.

3.5 Operation of VAT

3.5.1 Registration

All vendors carrying on taxable business are required to register for VAT. However, registration must not be made mandatory for small vendors having an annual turnover below the threshold level which can be determined on both the retrospective basic and prospective basis. Under the retrospective basis, the turnover may be calculated on the basis of the last 12 months' figure while under the prospective basis, the taxpayer has to prove that turnover will be below the threshold for next 12 months.

Small vendors having annual turnover below the threshold may apply for voluntary registration and the VAT officer, if satisfied, may register them for VAT purposes. Like other registered vendors, small vendors, who are registered voluntarily, will be able to claim back input tax paid on their purchases, to hold the collected tax until the data of its payment to the concerned tax offices. The registered vendor must remain registered for a minimum period of two year.

3.5.2 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. It should be able to provide necessary information required by the VAT Act and regulation. It is, however, not necessary to specify the format and content of the tax invoice; taxpayers may be allowed to prepare the format of the tax invoice according to their requirements.

3.5.3 VAT Account

It should be made mandatory for a VAT registered vendor to keep clear accounts of his purchase and sales, which are subject to positive rate, zero rate and exemption. Accounts along with all supporting documents should be preserved for four years. In general, accounts must be maintained on the accrual basis because taxpayers might delay payment. Small vendors, public or local bodies and non-profit organization may be allowed to account for their output tax and input tax only upon receipt or payment. This is intended to ease the cash flow problems of small vendors.

3.5.4 Taxable Value

VAT should be levied on the gross sales price (excluding VAT) for the supply of goods and the rendering of services. The gross sales price should be considered as the amount of money that the buyer has to pay to the seller under normal conditions. In the case of imported goods, the taxable value should include prices of goods plus all cost unto the point of importation such as commissions, parking, transport, insurance and other costs and all taxes, duties and charges levied except VAT.

3.5.5 Tax Credit

Tax credit is one of the important features of VAT. Taxpayers are allowed to deduct tax under it. This is known as the tax credit or tax invoice method, which is better than other methods of tax computation viz. the addition method and subtraction method.

Net tax liability of a vendor under the tax credit method is obtained by deducting his input tax from his output tax. This calculation is made for a transaction basis. Input tax of the reporting period is deducted from the output tax of the same period.

3.5.6 Tax Refund

Excess of input tax over output tax in any tax period can be adjusted in the following tax period by carrying forward to the next period or can be claimed for refund to the tax office. In the case of exporters, refund should be made within one month from the date of submission of the return. In other cases, if the input tax is more than output tax, the balance should be carried forwarded up to six months period. The excess credits for a continuous period of six months should be refunded to the concerned vendor within a moth from the date of submission of the return. It must be remembered that an efficient system of refunds is an integral part of VAT. Many tax administration, however are not well known for providing quick refunds. Refund should be made promptly. Interest should be paid on refunds that are not made within a month of the receipt of a return, provided that the return is completed satisfactorily.

3.6 Overview of International VAT System

3.6.1 The Evolution of VAT

VAT is the youngest member of the sales tax family, which was first recommended by Wilhelm Von Siemens in 1991 for Germany to replace the Umsatzsteuer (multi-stage sales tax). This recommendation was made in order to avoid the undesirable effects, particularly cascading and vertical integration of multi-stage sales tax. The VAT proposal was seriously considered by the German Government, but as the tax was new and thought to be complicated, the government decided to reduce the rate of existing sales tax instead of adopting the VAT.

The concept of VAT was developed further in 1949 by a tax mission to Japan led by Prof. Carl S. Shoup. This mission recommended the Fuka-Kachi-Zei (VAT) for Japan in order to avoid the undesirable and unintended effects of the Japanese enterprise and turnover taxes in place at that time. Serious discussions were held to implement VAT and, even though the law was passed by the parliament, it was not implemented by Japan because of the lack of knowledge regarding its implementation and owing to the newness of this tax. Thus, although the concept of this tax was introduced in Germany, and a detailed form was prescribed for Japan, VAT was not implemented in any countries until 1953. Upto that time, VAT remained a topic of academic discussion.

3.6.2 The Implementation of VAT

After three and half decades of the evolution of the concept of VAT, France took the courage to put VAT into practice. France introduced VAT in 1954 at the wholesale level in the industrial sector.

Up to 1959, this tax was confined to the boundary of France. After then, VAT was adopted by Ivory Coast in 1960, Senegal in 1961, Brazil and Denmark in 1967. Thereafter, many countries started adopting the VAT. VAT. Among the SAARC countries, Pakistan was the first country adopting VAT. VAT was adopted by Pakistan in 1990 and then, Bangladesh introduced in it 1991, Nepal in 1997, Srilanka in 1998 and India in 2003. The year of starting VAT by various countries has been shown in appendix I.

3.7 An Overview of Nepalese VAT

3.7.1 Adoption of VAT

In the eighties, various countries adopted various types of reform programs to maintain a sound macroeconomic policy. As the adoption of reform program was at the heart of worldwide policies, Nepal could be no exception. Nepal had adopted the market-oriented economy from eighth five-year plan (1992/93-1996/97). In the process of tax reform policy, it had mentioned that VAT would be introduced at the mid plan period. After the restoration of democracy in 1990, the new government took a number of measures to liberalize the trade, investment and financial system. Subsequently, the then state minister of finance announced in his FY 1992/93 budget speech that VAT on domestic production will be applied on an experimental basis from the FY 1992/93. A two-tier sales tax system was in practice at that period. Under this system, dealers and distributors of nine selected items were required to register for sales tax purpose and collect tax on their sale. It was extended further to five more items in FY 1993/94.

After about five year's paper work, VAT was adopted for FY 1997/98, when a high level task force headed by Prof. Dr. Madan Kumar Dahal recommended adopting VAT for the reformation of taxation system. Thus, VAT came into operation in Nepal since 16 November 1997. The existing sales Tax Act, Hotel Tax Act, Contract Tax Act and Entertainment Tax Act were replaced along with the implementation of VAT. Nepal has used consumption type of VAT, which is based on destination principle, and tax credit method has been used to calculate VAT base.

3.7.2 Structure of the Nepalese VAT

3.7.2.1 Rate and Coverage

VAT may be levied on single or multiple stages. This choice may depend upon economic nature and social will such as revenue requirement, equity consideration, administrative capacity, nature of product, direction and composition of foreign trade etc. Nepal used a single rate VAT at 10 percent up to FY 2004/05. From FY 2005/06, VAT rate has been 13 percent. However, exports are subject to a rate of zero percent.

Nepal has adopted a broad-based consumption type VAT using the tax credit method. Under this system, tax is levied on al types of goods and services, both imported and domestically produced, except those especially exempted by law. The list of tax exempted goods and services are shown in appendix II.

VAT is levied on the value added by each firm at each stage in the production and distribution. However, small vendors having annual turnover below the specified threshold are not required to register for VAT and , thus, the tax will not be applied to goods and services that they sell.

3.7.2.2 Input Tax Credit

A taxpayer is allowed to deduct the tax paid on purchases from the tax collected on sales for his business. This deduction, known as an input tax credit, includes the tax paid on his purchases or importation of raw materials, semi-produced goods and overheads, provided that they are used to make taxable goods or services.

3.7.2.3 Exemption and Zero Rating

Zero- rating means certain goods and services are taxed at the rate of zero percent. In Nepal, only exported goods and services are zero rated. The list of zero-rate goods and services are shown in appendix III. In case of exempted goods and services, VAT is not levied on the sale and the dealer dealing with these goods and services can not claim credit for VAT paid on his purchases/imports. An exemption is generally granted when it is extremely difficult to collect VAT on such products of transactions.

3.7.2.4 Tax Refund

The excess of input tax is refunded in case of zero-rated goods and services. Such a provision is made to encourage exports and generate foreign exchange.

3.7.3 Operation of VAT

3.7.3.1 Registration

All venders carrying on taxable business in Nepal are required to register for VAT. However, the venders having the transactions of only exempted goods and services or falling below the specified threshold is not required to register for VAT. Therefore, VAT is not applicable for all transaction. Small vendors having annual turnover below the threshold may apply for voluntary registration. Like other registered vendors, small vendors who are registered voluntarily, will be able to claim back input tax paid on their purchase. They must remain registered for a minimum period of two years.

A vendor who operates a head office and branches in different places should register all branches separately in the district offices if these branches keep their own accounts separately. In such cases, the turnover limit for registration is not applied to the supplies of each branch separately, but to the aggregate of the braches.

3.7.3.2 De-Registration

If the owner dies in case of personal ownership, if it is dissolved in case of partnership firm, if registration is done in error and if a registered person cease to be engaged in the taxable transaction, a VAT registered firm can apply for deregistration. If the incorporated firm is closed down, sold or transferred, de-registration will be done.

3.7.3.3 Tax Invoice

The tax invoice will require the name and address of the seller and the purchaser, the seller's PAN and invoice number, the date of the transaction and a description of the sale including the number of items purchase, the unit cost of each item and a mention of any discount given. The tax invoice must be prepared in three copies. The first copy should be clearly identified as a tax invoice. The original copy is to be given to the purchaser, the second copy is to be retained for audit purposes and the last copy is used by seller to prepare a record of the transactions.

3.7.3.4 VAT Account

The account is a monthly summary showing the source of their figure used in the VAT return. This account contains purchases and sales, and VAT spent and collected. All the registered taxpayers are required to maintain a purchases book, sales book and a VAT accounts. The purchase book includes the invoice number, the invoice date, the supplier's name and PAN, the taxable value and the amount of VAT. Likewise, the sales book includes all of purchase book, except the name and PAN of supplier, but it includes the name and PAN of consumer.

To complete the VAT return, a tax payer's books should ensure that and records provide the amount of VAT paid on purchases, the VAT amount collected on sales, the distinguishing method between taxable and exempt sales, the supply time of good and services, and evidences that those goods were exported, if any. The vendor, who sells both taxable and exempt goods, needs to prepare additional columns of information to separate exempt sales and the purchases related to them.

3.7.3.4 Tax Offences

Fines will be imposed if the taxpayer fails to file the return within the specified period. The VAT Act imposes fines for failing to register. Similarly, if a registrant fails to use the registration number or clearly display registration certificate in the business premises, it is liable to fine. Likewise, if a registrant fails to file a return, issue invoice, keep an up-to-data account of transactions and if he obstructs visits by a tax officer in investigation, prepares false accounts and invoices or attempts to evade tax, other penalties may be imposed to him/her. Failure to submit return in specified time is penalized as follows:

A. For nil return or credit return: Rs 1,000 flatly.

B. For debit return: 0.05% per day of the due amount or Rs. 1,000 (whichever is higher).

CHAPTER IV

ANALYSIS OF THE NEPALESE VAT STRUCTURE

4.1 Structure of Total Revenue

As Nepal is a developing country, it has to conduct many regular as well as development activities, which are also done by developed and underdeveloped countries. The democratic government of 21st century has to perform many social activities as well. It is necessary to have sufficient amount of income to the government to perform such type of activities. The government collects revenue from various sources to conduct such types of activities. There are two popular methods of collecting revenue such as tax revenue and non-tax revenue, which are subject to non-repayment. Besides these, the government collects revenue from internal and external loan and grant. The internal and external loans are subject to repayment with interest after a specified time period.

Nepalese economy is characterized by a low level of equilibrium trap. Even though the magnitude of total revenue is in increasing trend, its growth rate is less than the growth rate of public expenditure. The contribution of total revenue to GDP is almost constant from last 17 years. In this time period, the contribution of total revenue has increased from 9.24% to 13.79%. This can be seen in table 4.1. Tax revenue and non-tax revenue are the major sources of government, which are analyzed below.

4.1.1 Tax Revenue

Taxation is the main source of government revenue. It is also the pillar of fiscal policy. Taxes are compulsory contribution made by the individuals and business irrespective to direct benefit. In Nepal, the contribution of tax revenue to GDP ranges from 6.81% to 10.64%. Likewise, the contribution of tax revenue to total revenue ranges from 73.08% to 81.32%. In FY 2005/06, Rs 57 billion is collected from tax revenue. The contribution of tax revenue is significant and high as compared to non-tax revenue. Though the contribution of tax revenue fluctuates up to FY 2001/02, its total is in increasing trend. It is also illustrated in table 4.1.

Table 4.1

Structure of Total Revenue, Tax Revenue and Non-Tax Revenue in Nepal

Rs, in Million

FY	GDP (At current price)	Total Revenue		Tax Revenue			Non Tax Revenue		
		Amount	As % of GDP	Amount	As % of GDP	As % of TR	Amount	As % of GDP	As % of TR
1990/91	116127	107229.8	9.24	8176.3	7.04	76.20	2553.5	2.20	23.80
1991/92	144933	13512.7	9.32	9875.6	6.81	73.08	3637.1	2.51	26.92
1992/93	165350	15108.4	9.14	11622.5	7.03	76.93	3485.9	2.11	23.07
1993/94	191596	19580.9	10.22	15371.5	8.02	78.50	4209.4	2.20	21.50
1994/95	209974	24605.6	11.72	19660.5	9.36	79.90	4945.1	2.36	20.10
1995/96	239388	27893.1	11.65	21668.0	9.05	77.68	6225.1	2.60	22.32
1996/97	269570	30373.4	11.27	24424.3	9.06	80.41	5949.1	2.21	19.59
1997/98	289746	32937.9	11.37	25939.8	8.95	78.75	6998.1	2.42	21.25
1998/99	330018	38242.0	111.59	29752.9	9.02	77.80	8489.1	2.57	22.20
1999/2000	366251	42893.7	11.71	33152.1	9.05	77.29	9741.6	2.66	22.71
2000/01	394052	48893.9	12.41	38865.1	9.86	79.49	10029.0	2.55	20.51
2001/02	106138	50445.6	12.42	39330.6	9.68	77.97	11115.0	2.74	22.03
2002/03	437546	56229.7	12.855	42587.0	9.73	75.74	13643.0	3.12	24.26
2003/04	474919	62331.0	12.12	48173.0	10.14	77.29	14158.0	2.98	22.71
2004/05	508651	70122.7	13.79	54104.7	10.64	77.16	16018.0	3.15	22.84
2005/06	63672	72282.1	11.97	57427.0	9.51	79.45	14855.0	2.46	20.55
2006/07	670589	86135.5	12.84	70046.2	10.45	81.32	16089.0	2.40	18.68

Sources: Budget Speech of Various Fiscal Years and Economic Survey of FY 2001/02, FY 2005/06 and FY 2006/07

Tax revenue can be divided into two parts viz. direct and indirect tax, which are analyzed below:

4.1.1.1 Direct Tax Revenue

Direct tax is paid by the person on whom it is legally imposed. So the impact and incidence of tax lie upon the same person. Direct tax includes the taxes on income, profit, property, land revenue and registration. Direct tax is one of the two sources of tax revenue in the tax revenue structure the magnitude of direct tax depends upon the economic development of the country. If the growth rate of the economy increases, the annual pre capita income of the people of that country rises and the magnitude of direct tax goes up. Thus, the contribution of direct tax to total tax revenue in developing countries like Nepal is less than that of the developed countries. The contribution of direct tax to total tax revenue is lesser than the contribution of indirect tax in developing countries. Table 4.2 shows the contribution of direct tax to the GDP, total revenue and tax revenue. The trend of direct tax is in increasing trend from last 17 years, which contributes around 2% to GDP. The contribution of direct tax to total revenue ranges from 11.46% to 21.36% , which is very low in comparison to developed countries. Similarly, the contribution of the direct tax to total tax revenue is also insignificant, which ranges from 15.69% to 26.26% . These can be seen in table 4.2 .

Table 4.2

Structure of Direct and Indirect Tax

Rs in million

FY	GDP (at current price)	Total Revenue	Tax Revenue	Direct Tax				Indirect Tax			
				Amount	As % of GDP	As % TR	As % of TXR	Amount	As % GDP	As % TR	As % of TXR
1990/91	116127	107229.8	8176.3	1368.7	1.18	12.76	16.74	6807.6	5.86	63.45	83.26
1991/92	144933	13512.7	9875.6	1549.8	1.07	11.47	15.69	8325.8	5.74	61.61	84.31
1992/93	165350	15108.4	11622.5	1932.9	1.17	12.79	16.63	9689.6	5.86	64.13	83.37
1993/94	191596	19580.9	15371.5	2813.9	1.47	14.37	18.31	12558.0	6.55	64.13	81.69
1994/95	209974	24605.6	19660.5	3795.8	1.81	15.43	19.31	15865.0	7.56	64.48	80.69
1995/96	239388	27893.1	21668.0	4843.9	2.02	17.37	22.36	16824.0	7.03	60.32	77.64
1996/97	269570	30373.4	24424.3	5224.9	1.94	17.20	21.39	19199.0	7.12	63.21	78.61
1997/98	289746	32937.9	25939.8	6012.9	2.08	18.26	23.18	19927.0	6.88	60.50	76.82
1998/99	330018	38242.0	29752.9	7412.1	2.25	19.38	27.92	22340.0	6.77	58.42	75.08
1999/2000	366251	42893.7	33152.1	8150.2	2.23	19.00	24.58	25002.0	6.83	58.29	75.42
2000/01	394052	48893.9	38865.1	9395.2	2.38	19.22	24.17	27470.0	7.48	60.27	75.83
2001/02	106138	50445.6	39330.6	9734.5	2.40	19.30	24.75	29596.0	7.29	58.67	75.25
2002/03	437546	56229.7	42587.0	9546.3	2.18	16.98	22.42	33041.0	7.55	58.76	77.58
2003/04	474919	62331.0	48173.0	11212.0	2.36	17.99	23.27	36961.0	7.798	59.30	76.73
2004/05	508651	70122.7	54104.7	12265.0	2.41	17.49	22.67	41839.0	8.23	59.67	75.33
2005/06	63672	72282.1	57427.0	13962.0	2.31	19.32	24.31	43466.0	7.20	60.13	75.69
2006/07	670589	86135.5	70046.2	18394.0	2.74	21.35	26.26	51652.0	7.70	59.97	73.74

Sources: Budget speech of various fiscal years and economic survey of FY 2001/02, FY 2005/06 and FY 2006/07

4.1.2.2 Indirect Tax Revenue

Indirect tax is imposed on one person but paid partly or wholly by another person. So, the impact and incidence of tax lie upon a different person. In Nepal, indirect tax is broadly divided into custom duties, excise duties, sales tax/ VAT and other taxes. Before the implementation of VAT, contact tax, hotel tax and entertainment tax were also included in indirect tax. Then after, all these have been included in VAT. In the context of Nepalese revenue structure, the contribution of the indirect tax to GDP, total revenue and tax revenue has always been very high and significant. The table 4.2 shows the contribution of the indirect tax to GDP, total revenue and total tax revenue.

The above table clearly shows that the contribution of indirect tax to GDP, total revenue and total tax revenue is significant and considerable. It contributes around 7% to GDP, 61% to the total revenue and 80% to tax revenue. In FY 205/06, the contribution of indirect tax was 7.2% to GDP, 60.13% to total tax revenue and 75.69% to tax revenue. The contribution of indirect tax revenue was much than direct tax, which was 2.13% to GDP, 19.31% to total revenue and 24.31% to tax revenue in FY 2005/06.

4.1.2 **Non-Tax Revenue**

Non-tax revenue is not compulsorily imposed to the public by the government. Non-tax revenue includes the revenue from fees, fines, dividends, interest, sales of government property, donation, gifts, and son on. The contribution of non-tax revenue to GDP and total revenue is insignificant and stagnant. It contributes to GDP also almost about 2% and about 23% to total revenue. Table 4.1 also illustrates the contribution of non-tax revenue to GDP and total revenue from FY 1990/91 to FY 2006/07.

4.2 Structure of Indirect Tax in Nepal

Tax is compulsory contribution made by tax payers to the government irrespective to the direct benefit. A tax is said to be indirect if the impact and incidence of tax lies upon different persons. In Nepalese revenue structure, the contribution of indirect tax is significant, which can be easily seen in table 4.2. In Nepal, indirect tax is broadly divided into custom duties, excise duties, sales tax/VAT and other taxes. The contribution of these types of tax to the indirect tax may be different, which is shown in table 4.3.

Table 4.3

Structure of Indirect Taxes in Nepal

FY	Total Indirect Tax	Custom Duties		Excise Duties		Sales Tax/VAT		Others taxes	
		Amount	As % of Indirect Tax	Amount	As % of Indirect Tax	Amount	As % of Indirect Tax	Amount	As % of Indirect Tax
1990/91	6807.6	3044.3	44.72	1199.6	17.62	2026.7	29.77	537.0	7.89
1991/92	8325.8	3358.9	40.34	1414.1	16.98	2740.9	34.12	711.9	8.55
1992/93	9689.6	3945.0	40.71	1452.4	14.99	3438.6	35.37	853.6	8.81
1993/94	12558.0	5255.0	41.85	1592.2	12.68	4693.4	37.37	1017.0	8.10
1994/95	15865.0	7018.1	44.24	1657.3	10.45	6031.7	38.02	1157.6	7.30
1995/96	16824.0	7324.4	43.54	1944.3	11.56	6431.3	38.23	1124.1	6.68
1996/97	19199.0	8309.1	43.28	22.98.1	11.97	7126.5	37.12	1465.7	7.63
1997/98	19927.0	8502.2	42.67	2885.8	14.48	7122.6	35.74	1416.3	7.11
1998/99	22340.0	9517.7	42.60	2953.2	13.22	8765.9	39.24	1103.0	4.94
1999/2000	25002.0	10813.3	43.25	3127.6	12.51	10259.7	41.04	801.3	3.20
2000/01	27470.0	12552.1	42.59	3771.2	12.80	12382.4	42.02	764.2	2.59
2001/02	29596.0	12658.8	42.77	3807.0	12.86	12267.3	41.45	863.0	2.92
2002/03	33041.0	14236.4	43.09	1785.1	14.48	13459.7	40.74	559.5	1.69
2003/04	36961.0	1554.8	42.08	6226.7	16.85	14478.9	39.14	700.6	1.90
2004/05	41839.0	15701.6	37.53	6445.9	51.41	18885.4	45.14	806.5	1.93
2005/06	43466.0	15343.7	35.30	6506.9	14.97	21613.0	49.72	1.9	0.00
2006/07	51652.4	16911.2	32.74	8686.2	16.82	26055.0	50.44	0.0	0.00

Sources: Budget speech of various fiscal years and economic survey of FY 2001/02, FY 2005/06 and FY 2006/07

The above table shows the contribution of excise duties, custom duties, sales tax/VAT and other taxes to indirect tax. It can be easily seen that the contribution of custom duties to indirect tax was significant before FY 2002/03. After then, its contribution to indirect tax (in percentage) has been decreasing even though the amount is in increasing trend. On the other, the share of sales tax/ VAT has been increasing both in absolute as well as relative terms during the study period. Its contribution to indirect tax was 29.77% in FY 1990/91 but its contribution to indirect tax increased to 50.44% in FY 2006/07.t his shows that the contribution of sales tax/VAT has been increasing and more than 50% of indirect tax can be collected from VAT in recent fiscal year.

Before the adoption of VAT in Nepal, the contribution of sales tax was not significant as compare to custom duties and VAT revenue of recent years. Revenue form VAT remained low for the first three fiscal years VAT implementation because of poor registration, implementation, lack of adequate preparation of administration, lack of adequate knowledge to tax payers. But its share to indirect tax has been gradually increasing after then.

Revenue from excise duties also has been increasing in absolute term, but in relative term, it fluctuates between 10.45% and 17.62%. Because of political conflict, low growth of industrial product and lack of security in industrial sector, relative share of excise duties has been fluctuating. Its highest share (17.62%) was in FY 1990/91 and lowest share (10.45%) was in FY 1994/95.

The following table is presented to show the share of VAT to GDP, total revenue and indirect tax revenue.

Table 4.4

Sales Tax/VAT as % GDP, total revenue and indirect tax Revenue

Rs. in million

FY	GDP (at Current Price)	Total Revenue	Indirect tax Revenue	Sales Tax/VAT Revenue			
				Amount	as % of GDP	as % of Total Revenue	as % of Indirect Tax
1990/91	16127	10729.8	6807.6	2026.7	1.75	18.89	29.77
1991/92	144933	12512.7	8325.8	284.9	7.96	21.02	34.12
1992/93	165350	15018.4	9689.6	3438.6	2.08	22.76	35.49
1993/94	191596	19580.9	12558.	4693.4	2.45	23.97	37.37
1994/95	209974	24605.6	15865.0	6031.7	2.87	24.51	38.02
1995/96	239388	27893.1	16824.0	6431.3	2.69	23.06	38.23
1996/97	269570	30373.4	19199.0	7126.5	2.64	23.46	37.12
1997/98	289746	32937.9	19927.0	7122.6	2.46	21.62	35.74
1998/99	330018	38242.0	2234.0	8765.9	2.66	22.92	39.24
1999/2000	366251	42893.7	25002.0	10259.7	2.80	23.92	41.04
2000/01	394052	78893.9	29470.0	12382.4	3.14	25.33	42.02
2001/02	406138	50445.6	29596.0	12267.3	3.02	24.32	14.45
2002/03	437546	56229.7	33041.0	12459.7	3.08	23.94	40.74
2003/04	474919	62331.0	36961.0	14478.9	3.05	23.23	39.17
2004/05	508651	70122.7	41839.0	18885.4	3.71	26.93	45.14
2005/06	603672	72282.1	43466.0	21613.0	3.58	29.90	49.72
2006/07	670589	86135.5	51352.0	26055.0	3.89	30.25	50.44

Sources: Budget speech of various fiscal years and economic survey of FY 2001/02, FY 2005/06 and FY 2006/07

It can be seen from the table that the contribution of sales tax/VAT to GDP, total revenue and indirect tax is in increasing trend. It contributed to GDP by 3.89% in FY 2006/07 but in FY 1990/91, its share was only 1.75%. Similarly, the share of VAT to total revenue and indirect tax revenue has also been increasing year by year. The share of VAT to total revenue and indirect tax revenue was 18.89% and 29.77%

respectively in FY 1990/91. But in FY 2006/07, its share increased and reached to 30.25% and 50.44% respectively.

4.3 Analysis of Elasticity and Buoyancy Coefficients

In measuring the responsiveness of taxes in a tax system, elasticity and buoyancy are two popular concepts in which elasticity measures the automatic response of tax to the change in national income but buoyancy includes discretionary changes and revenue through administrative efforts. Elasticity provides the basis for natural growth of revenue to GDP without any change in structure or base of tax. But buoyancy provides what actually happens in the economy in which normal growth of revenue, discretionary changes and the revenue through administrative efforts are included.

An elasticity of unity implies the one percent change in tax revenue will be accomplished by the one percent change in GDP. Elasticity garter than unity implies the one percentage change in tax revenue will exceed the percentage change in GDP. If the elasticity coefficient is greater than unity then a tax system is said to be elastic and it is said to be inelastic if the elasticity coefficient is less than unity.

The buoyancy coefficient measures the total response of tax revenue to change in GDP, which includes the effect of discretionary change in tax system. If buoyancy coefficient is greater than the elasticity coefficient, the discretionary changes can raise additional revenue and vice versa.

In this study, the dependent and independent variables for the estimation of elasticity and buoyancy are as follows:

Dependent variables	Independent variables
Total revenue	Total GDP
Tax revenue	Total GDP
Indirect tax revenue	Total GDP
Sales Tax/ VAT	Total GDP

The dependent variables mentioned above are regressed with GDP to estimate the elasticity and buoyancy coefficient. Fro this, double log linear model is used.

In the total growth of revenue, since both automatic growth of revenue and the growth of revenue due to the discretionary actions are included, automatic growth of revenue should be separated from the total growth of revenue by eliminating discretionary changes. For this proportional adjustment method of Sahota is used. It adjusts the actual figure of current years on the basis of adjusted figure of the previous year. Since the budget documents do not provide actual revenue derived from discretionary changes separately, budgetary estimate has been used to compute such series. The revenue series derived on this basis by using Sahota method is shown in the following table.

Table 4,5
Estimated, actual and adjusted sales tax/ VAT revenue series

Rs in million

FY	Estimated, Sales Tax/ VAT Revenue			Actual Sales Tax/VAT Revenue			Adjusted Revenue
	NG	DC	Total	NG	DC	Total	
1990/91	1720 (95.53)	80.2 (4.47)	1800.5 (100)	1936.1 (95.53)	9.6 6 (4.47)	2026.7	2026.7
1991/92	2350 (95.92)	100 (4.08)	2450 (100)	2725 (95.92)	115.9 (4.08)	2840.9	2725
1992/93	3650 (94.81)	200 (5.19)	3850 (100)	3260.1 (94.81)	178.5 5.19)	3438.6	1 327.10
1993/94	3950 (90.43)	418.2 (9.57)	4368.2 (100)	4244.2 (90.43)	449.2 (9.57)	4693.4	2859.72
1994/95	5705 (97.27)	160 (2.73)	5865 (100)	5867 (97.27)	164.7 (2.73)	6031.7	4824.85
1995/96	8000 (96.39)	300 (3.61)	8300 (100)	6199.1 (96.39)	232.2 (3.61)	6431.3	4958.76
1996/97	7109.2 (83.72)	1383 (16.28)	8492.2 (100)	5966.3 (83.72)	1160.2 (16.28)	7126.5	4600.23
1997/98	8660 (91.74)	780 (8.26)	9440 (100)	6534.3 (91.74)	588.3 (8.26)	7122.6	4217.96
1998/99	7435.8 (78.94)	1984.2 (21.06)	9420 (100)	6919.8 (78.94)	1864.1 (21.06)	8765.9	4097.86
1999/2000	8930 (85.38)	1530.2 (14.62)	10460.2 (100)	8759.7 (85.38)	1500 (14.62)	10259.7	4094.96
2000/01	11740 (84.96)	2030 (15.04)	13500 (100)	10520.1 (84.96)	1862.3 (15.04)	12382.4	4198.90
2001/02	14053.1 (95.28)	696.9 (4.72)	14750 (100)	11688.3 (95.28)	579 (4.72)	12267.3	3963.53
2002/03	13030 (94.90)	700 (5.1)	13730 (100)	12773.3 (94.90)	686.4 (5.1)	13459.7	4127.01
2003/04	15203.5 (98.06)	300 (1.94)	15503.5 (100)	14198 (98.06)	28.9 (1.94)	14478.9	4353.39
2004/05	15805.5 (93.25)	1148.5 (6.75)	16950 (100)	17610.6 (93.25)	1274.8 (6.75)	18885.4	5295.00
2005/06	22450 (94.93)	1200 (5.07)	23650 (100)	20517.2 (94.93)	1095.8 (5.07)	21613	5752.52
2006/07	25389 (96.09)	1025 (3.91)	26423 (100)	25036.2 (96.09)	21018.8 (3.91)	26055	6663.64

Sources: Budget speech of various fiscal years and economic survey of FY 2001/02, FY 2005/06 and FY 2006/07

Table 4.6

GDP, Actual and Adjusted Revenue Series of Different Tax Head

FY	GDP	Actual Revenue				Adjusted Revenue			
		TR	Tax Revenue	Indirect Tax Revenue	VAT	TR	Tax revenue	Indirect Tax Revenue	VAT
1990/91	16127	10729	8176	6808	2027	10729	8176	6808	2027
1991/92	144933	12512	9876	8326	2841	12973	9545	8013	2725
1992/93	165350	150108	11622	9690	3439	13907	10713	8877	3127
1993/94	191596	19580	15372	12558	4693	16370	12784	10514	3860
1994/95	209974	24605	19660	15865	6032	20065	16160	12975	4825
1995/96	239388	27893	21668	16824	6431	21958	17474	13381	4959
1996/97	269570	30373	24424	19199	7127	21731	17855	13725	4600
1997/98	289746	32937	25940	19927	7123	22166	17843	13418	4218
1998/99	330018	38242	29753	2234	8766	22241	17251	13048	4098
1999/2000	366251	42893	33152	25002	10260	23305	17930	13464	4095
2000/01	394052	78893	38865	29470	12382	24031	18863	14201	4199
2001/02	406138	50445	39331	29596	12267	23269	18289	13431	3964
2002/03	437546	56229	42587	33041	13460	24834	18888	14305	4127
2003/04	474919	62331	48173	36961	14479	25319	19975	14928	4353
2004/05	508651	70122	54105	41839	18885	26840	21075	16139	5295
2005/06	603672	72282	57427	43466	216113	26295	21584	15980	5753
2006/07	670589	86135	70046	51352	26055	30793	24958	17893	6656 4

Sources: Budget speech of various fiscal years and economic survey of FY 2001/02, FY 2005/06 and FY 2006/07

Table 4.7

Elasticity coefficient of different tax head and their hypothesis test

Tax Head	Elasticity Coefficient (β)	R^2	Adjust-ed R^2	F- Statistics		D-W	
				calculated	tabulated	calculated	tabulated
Total Revenue	0.526	.894	.887	127.13	4.54	0.546	d_L= 1.536 d_u =1.015
Tax Revenue	0.553	.874	.866	104.37	4.54	0.417	d_L=1.536 d_u=1.015
Indirect Tax	0.467	.851	.841	85.83	4.54	0 .486	d_L =1.536 d_u =1.015
sales Tax/VAT	0.463	.649	.625	27.68	4.54	0.424	d_L= 1.536 d_u =1.015

The overall elasticity coefficients of various taxes of 17 years (from FY 1990/91-2006/07 are depicted in table 4.7. It can be seen from the table that the elasticity coefficient of total revenue, tax revenue, indirect tax revenue and sales tax/ VAT are 0.526, 0.553, 0.467 and 0.463 respectively. These indicates that one percent increase in GDP increases total revenue by 0.526 percent, tax revenue by 0.553 percent, indirect tax revenue by 0.467 and sales tax/ VAT revenue by 0.463 percent respectively . Since the elasticity coefficients of all types of taxes are less then unity, the Nepalese tax system is not self corrective. When we compare the elasticity coefficients of above mentioned tax heads, the value of sales tax/VAT is smaller than the value of other taxes. It indicates that automatic growth of revenue from sales tax/VAT is less than other taxes.

The above table also depicts the value of R^2, adjusted R^2, F-statistics, D-W statistics. Since the values of R^2 and adjusted R^2 are near to unity, there is good and strong relationship between dependent and independent variables. Since the calculated value of F-statistics is greater than the tabulated value of regression line is highly significant. Since the calculated value of D-W test is less than the tabulated value, there is positive auto correlation.

Table 4.8

Buoyancy Coefficient of Different Tax Head and Their Hypothesis test

Tax Head	Buoyancy Coefficient (β_I)	R^2	Adjust-ed R^2	F- Statistics		D-W	
				Calculated	Tabulated	Calculated	Tabulated
Total Revenue	1.218	.992	.991	1843.49	4.54	1.32	d_L= 1.536 d_u =1.015
Tax Revenue	1.241	.991	.990	1599.50	4.54	1.27	d_L=1.536 d_u=1.015
Indirect Tax	1.168	.990	.990	1516.69	4.54	1.39	d_L =1.536 d_u =1.015
sales Tax/VAT	1.402	.989	.988	1375.23	4.54	1.23	d_L= 1.536 d_u =1.015

The table 4.8 shows the overall buoyancy coefficients of various taxes of study period. It can be seen from the table that the buoyancy coefficient of total revenue, tax revenue, indirect tax revenue and sales tax/VAT are 1.218, 1.241, 1.168 and 1.402 respectively. These indicates that one percent change in GDP changes total revenue by 1.218 percent, tax revenue by 1.241 percent, indirect tax revenue by 1.168 percent and sales tax/VAT by 1.402 percent respectively. The buoyancy coefficients of all these taxes greater than the elasticity coefficients indicate that the discretionary changes can raise the additional revenue. Among the buoyancy coefficient of these taxes, the coefficient of sales tax/VAT is high, which indicates that the discretionary actions can mobilize additional revenue from VAT than others. And the government gives more emphasis on discretionary actions (especially on VAT) rather than broadening the VAT base and solving the problems of VAT.

The above table also depicts the value of R^2, adjusted R^2 , F-statistics, D-W statistics. Since the value of R^2 and adjusted R^2 are near to unity, there is good and strong relationship between dependent and independent variables. Since the calculated value of F- statistics is greater than the tabulated value of regression line is highly significant. But, since $d_L<d<d_U$, D-W test is unable to analyze whether there is autocorrelation or not where d is calculated value and d_L and D_U are tabulated value.

CHAPTER V

ANALYSIS OF CONTRIBUTION OF PRODUCTION TRADE AND SERVICES SECTORS TO VAT

5.1 Structure of VAT in Nepal

After the introduction of VAT in Nepal, which replaced the existing sales tax, hotel tax, entertainment tax and contract tax, it was levied on production, imports, sales and distribution and services. After FY 2002/03, VAT on service sector was divided into contract and consultancy, tourism business and other services. Now in Nepal VAT is levied on production, imports sales and distribution, contract and consultancy, tourism business and other services. In this study VAT is broadly divided into production trade and services. The trade sector includes VAT on imports and sales and distribution. The service sector includes VAT on contract and consultancy, tourism business and other services. The contribution of these sectors of GDP, total revenue and VAT is different in different fiscal years, which are shown in Table 5.1.

Table 5.1

Structure of VAT in Nepal

Rs. in million

FY	Total TR	VAT	VAT From								
			Production			Trade			Service		
	Amount	Amount	Amount	as % of TR	As % of VAT	Amount	as % of TR	As % of VAT	Amount	as % of TR	As % of VAT
1997/98	32937.9	7122.6	1165.1	3.54	16.36	5147.2	15.63	72.27	810.4	2.46	11.38
1998/99	38242	8765.9	1305.2	3.41	14.89	5511.2	14.41	62.87	1065.8	2.79	12.16
1999/2000	42893.7	10259.7	1341.2	3.13	13.07	6951.3	1621	67.75	1562.5	3.64	15.23
2000/01	78893.9	12382.4	1755.4	3.59	14.18	8223.6	16.82	66.41	2068.7	4.23	16.71
2001/02	50445.6	12267.3	1711.1	3.39	13.95	8178.3	16.21	66.67	2074.6	4.11	16.91
2002/03	56229.7	13459.7	1896.7	3.37	14.09	9304.9	16.55	69.13	2258.2	4.02	16.78
2003/04	62331	14478.9	1957.1	3.14	13.52	9714.3	15.59	67.09	2807.5	4.50	19.39
2004/05	70122.7	18885.4	2455.9	3.50	13.00	13430.6	19.15	71.12	2998.9	4.28	15.88
2005/06	72282.1	21613	2899.9	4.1	13.42	14819.9	20..50	68.57	3893.3	5.39	18.014
2006/07	86135.5	26055	3257.8	3.78	12.50	17956	20.85	68.92	4841.2	5.62	15.58

Sources: Budget speech of various fiscal years and economic survey of FY 2001/02, FY 2005/06 and FY 2006/07

Nepal has adopted VAT from 16 November 1997. Before FY 1997/98 sales tax was in operation. In this study, the different sectors of VAT such as production, trade and services are comparatively studied after FY 1997/98, implementation FY of VAT in Nepal. The first four months' sales tax was included into VAT of FY 1997/98. When we analyze the contribution of the production sector to total revenue and VAT revenue, it is almost constant in percentage even through its total magnitude is increasing. Production sector contributes to total revenue around 3.5 percent. But the contribution of production sector to VAT is decreasing. It was 16.36 percent in FY 1997/98 but only 12.5 percent in FY 2006/07.

On the other hand, the contribution of trade sector to total revenue and VAT revenue is increasing. It contribution to total revenue has been almost constant up to FY 2003/04 which was around 16 percent. But after then, its contribution to total revenue increased and reaches 20.85 percent in FY, 2006/07. But contribution of trade sector to VAT has fluctuated between 62.87% and 72.27%. It was lowest in FY 1998/99 and highest in FY 1997/98. In other FYs its contribution to VAT was around 68%.

The contribution of service sector to total revenue and VAT has been increasing form FY 1997/98 to FY 2006/07 apart from FY 2004/05 where its magnitude has also been increasing considerably year by year. Its contribution to total revenue and VAT has been 2.46% and 11.38% respectively in FY 1997/998 which has been increasing and reaches to 5.62% and 18.58% respectively in FY 2006/07. Among these three sectors, the contribution of trade sector to total revenue and VAT is decreasing even though its magnitude is increasing and it contributes more than 65% to VAT. It is also clear form above table that the main source of VAT is trade sector. The contribution of production sector is not considerable because of the low productivity in industrial sector and so many goods and services are exempted form VAT.

5.2 Comparative Study of VAT from Different Sectors

To study about the contribution of production, trade, and services to VAT comparatively, VAT is regressed with VAT from production, trade and services where VAT is dependent variable and VAT from production, VAT from trade and VAT from services are independent variable. After analyzing the multiple regression models, the following values are found.

Coefficient of VAT from production	1.46
Coefficient of VAT from trade	0.889
Coefficient of VAT from services	0.952
Value of R^2	0.998
Value of adjusted R^2	0.998

5.3 Interpretation

The above regression model presents the relationship of total amount of VAT revenue with VAT from production, trade, and services sectors. In this model, the coefficient of production, trade, and services are 1.46, 0.889, and 0.952 respectively. These indicates that one percent change in production sector changes VAT revenue by 1.46% one percent change in trade sector changes VAT revenue only by 0.899% and one percent change in services sector changes VAT revenue by 0.952%. It can be clearly seen that the coefficient of trade is small than the coefficients of other sectors. It indicates that there are many loopholes in trade sector. To overcome from such problems, the government should give interest to trade sector and control these loopholes. Since the value of R^2 and adjusted R^2 are near to unity, there is good and strong relationship between dependent and independent variables.

CHAPTER-VI

PROBLEMS AND PROSPECTS FOR ADDITIONAL REVENUE MOBILIZATION FROM VAT

6.2 The existing problems with VAT

After the implementation of VAT in Nepal, it becomes the main source of government revenue. Before the implementation of VAT, sales tax had contributed only around 35% to indirect tax. But, now, more than 50% of indirect tax is collected from VAT. So VAT is able to collect additional revenue. Now the rate of VAT is 13%, which was 10% in the beginning years. The rate was increased by 3% in order to collect additional revenue, but it is not able to collect desired revenue. Nepalese VAT system has entered into its eleventh year of implementation, but it is still facing various problems. The main problems of VAT are analyzed below.

6.2.1 Consumer's Unwillingness of VAT

The consumers are confused and agitated as the government has not been able to give confidence to the public that the paid amount will be properly utilized. Since there is leakage in financial system having lots of loopholes with corruption, people are not sure that VAT, would really go to the taxation department. The consumers also do not know which shop would give VAT invoices and which shop would not. It is also known that the administration will not initiate any action when VAT invoices are not issued where they should be.

6.2.2 Defective Organization Structure

The organization structure of tax administration is defective. The VAT department creates various sub-departments. There are 17 offices under VAT department and 29 main custom offices, and 143 sub-custom offices under the custom department. Most of these offices deal with the limed number of taxpayers and a nominal amount of revenue.

Taxpayers are compelled to visit different offices in connection with various taxes. They also have to know about the different procedures related to the different taxes. This increases the compliance cost. On the other hand, the tax officials have to deal with the same taxpayers in connection with different taxes. This not only increases the administrative cost but also opens the scope for corruption and harassment.

6.2.3 Issuance and receiving of invoices

Billing system plays a role in VAT implementation. How much taxpayers paid on the purchase, how much was taken from the sales, how much has to be paid to the government and how much has to be refunded are determined on the basis of invoice. But, issuance and receiving the invoices are also low in the market up to now. All registrants do not issue invoices of their sales and those who issue invoices do not issues proper invoices. While some vendors have been issuing improper invoices others have been stating that an additional 13% has to be paid if invoices are required. There is also a problem of under-voicing at the customs.

6.2.4 Large Number of VAT-Exempted Goods and Services

In Nepal, the number of VAT-exempted goods and services are still large which is shown in appendix II. Nepal is an agricultural country, where around 36% of GDP is contributed by agricultural sector and around 80% people are engaged in it. But, almost all the agricultural products are exempted from VAT net. Gold, gold coins, gold ornaments, betting, casinos lotteries etc. are also include in VAT-exempted goods, since so may goods and services are exempted from VAT net, it is obvious that the base of VAT will be low and VAT revenue will not be as desired.

6.1.5 Open Boarder and Unauthorized Trade

There is open boarder in east, west and south direction of Nepal. There is not any measurement of authorized trade between Nepal and India. Unauthorized trade is very much organized in the boarder area. There are many organized groups active on both sides of boarder and these groups are responsible for supplying goods illegally form India to Nepal. Since so many goods are imported illegally, the revenue is automatically loosed.

6.1.6 Large Number of Non-Registered Potential Taxpayers Promoting Unhealthy Competition

Many potential taxpayers have not been registered yet even in Kathmandu as well. In one hand, there is large number of non-registered taxpayers. On the other, illegal import and under invoicing is great. As a result, the honest taxpayers who are within the VAT net have to do unfair competition with other sellers. If such trend extends, the honest and registered taxpayers will have the problem to continue the transaction and they will attempt to exceed the tax net or be compelled to hide the transaction.

6.1.7 Delay in File Procession

Tax file entry and procession do not seem to happen in time and the discipline to precede the right file has not been maintained. As a result, the number of suspended file has unnecessarily increased. Likewise, taxpayers who do not submit their file in due time are not informed in time. Due to the increasing number of taxpayers, the problem is likely to increase

6.1.8 Frequent Disputes Concerning the Threshold

In an original VAT act, threshold limit was determined to Rs. 1 million. Finance Act 1997 increased it to Rs. 2 millions and again, the changed finance Act 1998 increased it to Rs 3 millions just after eight months of its implementation. First amendment in VAT rules 1997 was done only to increase the threshold limit further to Rs. 4.5 millions. This amendment was again replaced by the Finance Act 1999/00. The threshold limit again lowered to Rs. 2 millions. It can be seen that the threshold limit has been much debated issue in Nepalese context. Some consider that the existing threshold is too low and should be increased while others consider that the threshold should be reduced. It the threshold is too high, a majority of the businessmen may not come under the VAT net and under such circumstances, it will simply not to implement VAT effectively. Therefore, it is common to keep the threshold as low as possible. If the threshold is not established, the thousand and thousands of small venders will have to be registered for

VAT and it is hard to control the large number of taxpayers in a country. Bringing very small venders under the VAT cannot be justified from revenue, administrative, or equity points of view.

6.1.9 Practical inconveniency of Tax Refunding System

Tax refunding system is not convenient in practice. If the taxpayer has paid more tax in purchases than that has been collected in sales, the exceeded amount should be refunded in VAT system. Incase of the export, it is refunded immediately. In case of local sales, it can be adjusted in tax to be paid in the following month. If the credit cannot be adjusted for six consecutive months, there is provision to get a refund of the exceeded amount. Export permit card, bill of entry, and certificate of payment clearance are required to verify the exporting. Likewise, purchase invoice and import permit card are required to verify the tax paid in purchase. At present, except in the case of Tibet, production certificate is asked to export the goods to other countries. Now, it has been found that the bill of entry is not asked in the case of export to Tibet. According to which, there is a provision of refunding tax after verifying the certificate of tax paid on export and import or sales. But in practice, it is not so because in some case, it is found that VAT personnel refund without inspecting the tax refunds made up to the period of the claim and they refund without checking the value added and recovery ratio.

6.2 Prospects for Additional Revenue Mobilization from VAT

It can be seen from above that the Nepalese VAT system is facing various problems up to its eleventh year of implementation. If such problems are solved or controlled, the revenue from VAT will automatically increase. On the other hand, when we see the value of elasticity and buoyancy coefficients from above, the elasticity coefficient. It indicates that the government has concentrated more on introducing various discretionary measures rather than broadening the VAT base. To broaden the VAT base, the tax-exempted goods and services should be reduced.

Even gold, gold coins, gold ornaments, silver and silver coins, betting casinos and lotteries etc. are included in the list of VAT-exempted goods. Since so many goods and services are exempted from VAT net, the revenue from VAT will not be as desired. Similarly, the VAT rate is 13 percent for both necessary and luxurious goods. It is not desirable to levy the same rate for all types of goods. So, the special consumption duty should be levied for luxurious goods.

Since there is debate about exemption limit, it should be ended. The exemption should not keep so high because it leaves many vendors from VAT net. The exemption limit should not also keep so little as it covers thousand and thousands small vendors and it may be hard to control the large number of taxpayer. It is also found that under invoicing is prevail in the market which has lowered the VAT amount. The vendors who issue fake bill/ not VAT bill should be punished in order to increase the VAT revenue.

Similarly, since the coefficient of trade sector is low in comparison to other sectors, there are so many loopholes in this sector such as tax evasion, illegal trade etc. if these problems are controlled the revenue from VAT can be increased and additional revenue can be collected.

CHAPTER VII

SUMMARY, CONCLUSION AND RECOMMENDATIONS

7.1 Summary

This study outlines the contribution of production, trade and services sectors to VAT, examines the problems of VAT, recommends the measures to mobilize the additional revenue from VAT and analyzes the structure of VAT in Nepal. Secondary data have been used to study about these.

The tax comprises direct and indirect tax. Direct tax also plays a vital role to generate the government revenue. But for countries like Nepal, where per capita income is very low and rural agricultural is the main base of the economy, the drastic increase in revenue through direct tax is not possible. The situation is not also favorable to raise the rate of direct taxes. Therefore, the only way to generate additional revenue is indirect tax. The indirect tax can be composed of custom duties, excise duties, sales tax/VAT and other taxes.

The custom duties played a vital role before the implementation of VAT in Nepal. At that time, it contributed around 42% to indirect tax. But now, because of the entrance to WTO and SAFTA, the government of Nepal has reduced its tariff rate and contribution of custom duties has been decreasing. Similarly, the contribution of excise duties is not also so high.

VAT is a recent and an important innovation in the field of tax reform, which was introduced in Germany at first in 1919. Upto now, more than hundred countries have adopted VAT, which is considered as the most scientific taxation tool invented until the data. Most of the European, south and north American, and Asian countries have already adopted this system and the African and Oceanic countries are interested in adopting this system gradually.

Nepal has adopted VAT as a tax reform from 16 November 1997, which replaced the existing sales tax, entertainment tax, hotel tax, and contract tax. Nepal has adopted a broad-based consumption type VAT using tax-credit method for computation of VAT liability. Among the two principle of VAT, viz. origin principle and destination principle, Nepal has used destination principle, which is preferred in many countries.

Before the implementation of VAT, sales tax contributed around 37% to indirect tax, but now, VAT has contributed to indirect tax by more than 50%. Because of its broad coverage, the contribution of VAT has been increasing year by year in absolute as well as relative terms. In this study, the coefficients of elasticity and buoyancy are 0.463 and 1.402 respectively. It indicates that the Nepalese VAT system is inelastic and buoyant in nature. Among three sectors of VAT (production, trade and services), the trade sector plays vital role to contribute to VAT. It contributes to VAT by about 70%. But the contribution of production sector to VAT is very low in comparison to other sectors and its trend is also decreasing. Similarly, the coefficient of trade sector is less than unity and is very low in comparison to the coefficient of production sector.

Nepalese VAT system is about to enter into its eleventh year of implementation even though it has faced many problems such as unwillingness of consumer of paying VAT, defective organizational structure of tax administration, issuance and receiving of invoices, large number of VAT-exempted goods and services, large number of non-registered potential taxpayers, open boarder and unauthorized trade etc.

7.2 Conclusion

VAT has developed as an advanced form of sales tax. It is spread all over the world within a short period. Nepal has also adopted a consumption type of VAT using tax-credit method for computation of tax liability with a single positive rate. The rate was 10% in the beginning and, now it is 13%. Nepalese VAT system is based on the destination principle.

Because of low economic growth rate and low per capita income, contribution of direct tax is very low in comparison to indirect tax in Nepal. For a sustainable growth of government revenue, both taxes should be increased and this is possible when the economic growth rate and per capita income will increase. So, government should launch different programs to increase per capita income and economic growth rate.

Since the elasticity coefficient of VAT is very low ($\beta = 0.463$), Nepalese VAT system is inelastic. It also indicates that Nepalese VAT system is not self-corrective. In order to make self-corrective VAT system, the base of VAT must be increased. But, the coefficient of buoyancy of VAT being more than unity ($\beta = 1.402$) implies the buoyant nature of VAT system. It indicates that discretionary changes can increase the revenue and the government gives emphasis to discretionary changes to meet the short-term revenue requirement rather than broadening the base. This does not favor the investment friendly environment. On the other hand, since the coefficient of trade sector is very low in comparison to that of production sector, there are loopholes in trade sector such as under invoicing, fake bill issuing, illegal trade because of open boarder and so on. If such problems are controlled the revenue from VAT can be increased. Similarly, the contribution of production secretor to VAT is in decreasing trend. This is because of low economic growth rate and because most of the agricultural products are exempted from VAT net.

Nepalese VAT system has suffered from several problems, these problems have limited the VAT base. If such problems are controlled, the VAT base will automatically increase and the VAT system will be elastic. Thus, this study concludes that there is immense scope of VAT, which can give right direction to the tax revenue and can be a perennial source of domestic revenue in Nepalese economy.

7.3 Recommendations

Government of Nepal has decided to adopt VAT in Nepal as an improved and a scientific tax system to mobilize additional revenue, and to overcome from the prevailing problems of sales tax. The adoption of VAT in Nepal has crossed its tenth years with facing many problems. After the analysis of theoretical and practical aspects with the evaluation of several data and mathematical tools, the major recommendations for the consumers, the businesspersons, the tax administrations and the government are as follows:

The consumer should ask for the invoices. If the vendors do not issue proper invoices or ask for extra money to be paid on the purchased items, the consumers should make written or oral complaints about it to the taxation authority. They can take part in awareness programs about VAT run by the IRD which helps them to understand their rights and they can not be cheated. They should protest and come to the legal authority if they find out the corruption and leakage in the taxation system.

The business persons should issue the invoices to the consumer. To ask extra money to be paid on purchased items for VAT is illegal. False information to the consumer such as the goods would be cheaper without receiving invoices etc, should not be given. Under invoicing fake bill issuing, under valuation in different points of taxation and so on should be stopped. The vendors should register to the VAT authority if his annual turnover exceeds the threshold limit. The transparency in the business transition should be made compulsorily. If the business person found the corruption from the tax administration, it should be reported to the tax administration.

If some trade person does not issue proper invoice or gives under valued invoices, the administrations must punish him by using all rights vested by the law. The existing other laws of tax are interrelated with VAT. So, these laws should be revised for the proper implementation of VAT. There should be "the special consumption duty" for luxurious goods even though it is desirable to levy the VAT at a single positive rate. The personnel of sales tax are not appropriate and adequate for the successful implementation of VAT. Therefore, it is necessary to give training to these persons to make well-trained and skilled manpower.

Since so many goods and services are exempted from VAT net. The government should reduce list of VAT-exempted goods. The contribution of agricultural sector to GDP is about 36% but this sector is completely exempted from VAT net. So, some of the agricultural products should be brought under VAT net. It has been found from the analysis that the government gives more emphasis on discretionary changes rather than broadening the tax base. To given flexibility to VAT system, the government should broaden the VAT base rather than depending upon the discretionary changes. The coefficients of trade, production and services are 0.889, 1.46 and 0.952 respectively since the coefficient of trade is small than the coefficients of other sectors, it indicates that there are many loopholes in trade sectors as under invoicing, take bill issuing, illegal trade etc. these must be controlled. The government should make rules and regulation to control under-invoicing, fake bill issuing from the business persons and corruption from the tax administrators. For this, punishment and reward system should be established.

Appendix I

Name and Year of Implementation of VAT by Different Countries

Year of Implementation	Name of the Countries
1954	France
1960	Ivory Coast
9161	Senegal
1967	Brazil, Denmark
1968	Germany, Uruguay
1969	Netherlands, Sweden
1970	Ecuador, Luxemburg
1971	Belgium
1972	Ireland
1973	Austria, Bolivia, Italy, United Kingdom, Vietnam
1975	Argentina, Chile, Columbia, Costa Rica
1976	Honduras, Israel, Peru
1977	South Korea, panama
1980	Mexico
1981	Haiti
1983	Dominican Republic, Guatemala
1984	China
1985	Indonesia, Turkey
1986	Morocco, New Zealand, Niger, Portugal, Spain, Taiwan
1987	Grenada, Greece
1988	Hungary, The Philippines, Tunisia
1989	Japan, Malawi
1990	Ice land, Kenya, Pakistan, Trinidad and Tobago
1991	Bangladesh, Benin, Canada, Jamaica, South Africa, Egypt

1992	Algeria, Armenia, Azerbaijan, Belarus, Salvador, Estonia, Fiji, Kazakhstan, Kyrzistan, Moldavia, Russia, Tajikistan, Thailand, Turkmenistan, Ukraine, Uzbekistan
1993	Burkina Faso, Czech republic, magnolia, Paraguay, Poland, Romania, Slovakia, Venezuela
1994	Bulgaria, Finland, Lithuania, Singapore, Tanzania, Western Samoa, Madagascar, Togo, Latvia
1996	Albania, Guinea, Uganda
197	Congo Republic, Nepal
1998	Croatia, Mongolia, Vanuatu
1999	Cambodia, Cameroon, Mozambique, Papua New-guinea, Slovenia
2000	Australia, Chad, Macedonia, Namibia, Sudan
2001	Rwanda
2002	Lebanon
2003	India

Source: Inland Revenue Department, Kathmandu

APPENDIX II

List of VAT exempted goods and services

1. Basic agricultural products

- Paddy, rice, wheat, maize, barley, millet, pulses, flour and similar raw food materials.
- Unprocessed cereals such as sugarcane, tea leaf, tobacco cotton cardamom, and jute.
- Green and fresh vegetable, fresh fruits, fresh eggs and similar products.
- Herbs

2. Goods of Basic Needs

- Piped water, water supplied by tankers.
- Fuel wood and coal
- Kerosene (excluding air flight fuel)
- Salt

3. Live animals and animal products

- Goats, sheep, yak, buffalo, boar, pigs, rabbit and their uncooked and unprocessed varieties.
- Fresh milk
- Duck, chickens, turkey and similar other birds, their fresh meats eggs and uncooked and unprocessed verities.
- Fresh or dried fish (other than packed)

4. Agriculture Input

- Seeds of any plant listed in basic agricultural product group
- Manure, fertilizer and soil conditioner
- Agricultural hand implements
- Pesticide made mainly for use of crops
- Agriculture equipments including tractor
- Birds and animal feed.

5. Medicine, medical and similar health services

- Medical or surgical services provided by government institutions
- Human blood and products derived from human blood.
- Human or animal organs or tissues for medical research
- Animal and human treatment drugs and contraceptives.
- The supply of goods made for and suitable for only to the disabled persons.
- X- ray film and oxygen gas used for the treatment
- Raw materials purchased or imported by the drug industries to the extent approved by the department of the drug management.

6. Education

- The provision of research in a school or university
- The provision, otherwise than for profit, of professional, or vocational trainings or refresher trainings.

- The provisions of education in a school or university and supply of goods made in connection with such services.

7. Books, Newspapers

- Books, newspapers, newsletters, periodicals
- Newsprints

8. Artistic and cultural goods and services, caring services

- Paintings, handicrafts, cravings and related services
- Cultural programs
- Entrance fee of library, archeology, museum, zoos and botanical gardens.

9. Passengers and goods transportation services

- Air transports, non-tourist passenger transportation (except cable cars) and goods carriers (except transportation related to supply)

10. Personal or professional service

- Personal services rendered by artists, sports man, authors, writers, designers, translators, interpreters institutionally or individually.

11. Land and buildings

Purchase and rent of land and buildings (except the rental service provided by hotels, guest houses or similar organizations)

12. Betting, casinos, lotteries

The provision of any facilities for betting legally and any kind of registered lottery program.

Other Goods and Services Provided by Government Only:

13. Postal Services

- The services of conveyance of letters, money and postal packets by the post office.
- the supply by the post office of any service in connection with the conveyance of the letters, money and postal packets
- postage stamps.

14. Financial and insurance services

- Bank notes and cheque books
- the printing and issue of bank notes
- the supply of bank notes from outside Nepal to Nepal

15. Gold and Silver

- gold, gold coins and gold ornaments
- silver and silver coins (excluding ornaments and goods)

16. Others

- Electricity, battery operated tempo and their chassis and batteries, biogas, solar power and wind operated power generation plants and their parts by the recommendation of alternative energy center, airplane, helicopter, fire brigade and ambulance.
- raw wool, jute goods, woolen carpet, woolen carpet's weaving, dyeing, washing and knitting, cotton yarn, cotton sari, cotton lungi, dhoti and towel.
- Bags and baggage, which are imputed using custom free privileges.

- Donated goods received for calamites or philanthropic purposes approved by MoF.
- industrial machinery included in section 84 of custom tariffs and subject to five percent tariffs.
- those industries, which produce clothes, matches (wooden stick only) and 100% scarp using industry, which produces iron rod, will get VAT back as defined by the government . but the industries, which produce goods using 100% domestic scarp iron, will get back 50% of their collected VAT.

Source: Inland Revenue department, Kathmandu

Appendix III

Goods and Services Payable at Zero Percent VAT

1. Export of goods

- Goods exported outside of Nepal
- Good shipped for use stores on a flight to an eventual destination out of Nepal.
- goods loaded for use as stores on aircrafts to a destination outside of Nepal or as merchandise for sale by retails or supplied to persons in the course of such flight.

2. Export of services

- A supply of services by a Nepalese resident to the persons outside of Nepal and having no business establishments, agents or legal representatives acting on his/her behalf in Nepal.
- Where goods are supplied on a hire or loan basis by a registered Nepalese resident to the person outside of Nepal.

3. Others

- Imports of goods and services by accredited by diplomats.
- If needed zero-rated services can be grated to medical industries.
- any goods locally purchased from those registered tax payers, who have got free sales tax by virtue of treaty or contact in case of recommendation of related project

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