

# **CHAPTER -1**

## **INTRODUCTION**

### **1.1 Background**

Tax is the largest source of public revenue of the modern governments. It is the internal source of national income. Tax is the legal duty of every citizen of a country to pay honestly. In the present day, a government has to spend a lot of money to fulfill its responsibility towards its people. The responsibility may be either for security, for health, education or other developmental activities. To meet the growing public expenditure, the government has to manage its funds from internal as well as external sources. External sources of funds are foreign grant and loans. Such external sources are uncertain, inconvenient, and not good for healthy development if there is heavy dependent on them. It would be better to mobilize internal resources rather than expecting with beggar eyes to the donors. The experiences of developing countries show that there are negative results of increasing international aid and loan to finance the public development activities. As a result, their economic condition has gone down day by day. The government imposes tax on the people to repay the external debt, as a consequence of which the capacity or people to work to save decline.

The tax reform exercise has been the most important and technically the most exciting component of reform program in the economic sector. In the present context of raising needs of development expenditure and deficiency of government revenue there is a need of entire reforms. The government of a country requires sufficient revenues to carry out development plans, to handle day-to-day administration, to maintain peace & security, to maintain law & Order and other public welfare activities. The government collects revenues from various sources such as tax, revenues from public enterprises, special assessment, fees, fines, grants and assessment etc. Among them tax is the main source of government revenue.

The term "tax" defined as a liability to pay an amount to the government. It is a compulsory contribution to the national revenue from the taxpayers according to law. It is used for common interest of the people. The taxpayer could not get direct personal benefits. The tax can be classified in two types. They are; 1)



Direct tax 2) Indirect tax. A Direct is a tax paid by a person on whom it is legally imposed. In Direct tax, the person paying & bearing tax is same. It is not shift able to others. For examples; Income tax, property tax & Gift or prize tax are direct tax. Similarly, Indirect tax means that tax which is imposed on one person but partly or wholly paid by another. In Indirect tax, the person paying & bearing tax is different. It is shift able to others person. In other words, those types of taxes are ultimately paid by consumers' not a businessman or entity they are only mediators. For examples; Excise duty, custom duty, & Value added tax (VAT) are Indirect tax. Among the Indirect tax, VAT is the most recent innovation in the field of taxation.

There is a global trend of tax reforms. So, the global trend should be encouraged Nepal to change its tax system for meeting the worldwide scenario. But, there is no compulsion to flow in the world flood. A tax system should be structured depending on the countries own economic and social condition or tax reform should be as per the industrial and trade situation of the country but minimum adjustment or reforms must be made to meet the global changes. Thus, we cannot route back to the global trend it ultimately should be followed.

Developing countries try to mobilize internal source. So the government should be trying to reform tax policy and strategy. Nepal also has changed its policy and strategy to achieve more internal resources by replacing sales tax in to Value added tax (VAT). It is the tax imposed on value added by business firms on good and services at the successive stages of production and distribution, value is added, in such production distribution in successive stage. Value addition on a Commodity or services is simple the excess of sale value over business Purchases. By a business entity, during the successive stage of production and distribution processes, business enterprises add value to their purchase by processing handling them by their own machinery, building or other capital goods. VAT is consider as one form of sales tax it is the multiple stage tax which has grown as a heterogeneous of turnover tax and retail level sale tax. Thus VAT is the multistage sales tax, which is levied on the value added of business enterprises at different stage of production and form of old sales tax. VAT is the important tax innovation on the second half-twentieth century. VAT is a scientific tax system. Which was first introduced in 1954 in France. VAT has been spreading all over the world. Since late 1960s and now this tax has become one of the main stays of the tax system in over the world



130 countries. In south Asia Pakistan adopted a VAT in 1990 and Bangladesh and Silence have since 1991 and 1995 respectively. Also in India, VAT is adopted in restricted form called; modified value added tax (MOD VAT) with effect from 1986. The MOD VAT is limited in scope it covers only a half of the revenue collected. An India has just adopted full VAT since the year 1999. Nepal is considering a VAT since 1992. The first Intension to move toward VAT could be found in Eighth plan (1992-97). A commitment to implement a VAT in Nepal was made in 1995/96 budgets and it was scheduled to come into effect from April 1997.

In Nepal, Value Added Tax (VAT) was introduced on 16 November 1997. This Tax was levied in place of the manufacturing level, Sales Tax, Hotel Tax, Contract Tax & Entertainment Tax. However, it could not be implemented fully until the Fiscal Year (F/Y) 1998/99 due to the political instability and strong opposition from the business community. VAT replaces the old sales Tax, the Contract Tax, the Hotel Tax and Entertainment Tax. It has been designed to collect the same revenue as the four Taxes it replaced. Since the Collection of both Custom duties and Income Tax depends to a great extent upon the effectiveness of VAT, it is expected to help enhance revenue collection .The VAT is broad -based Tax as it covers the value added to each commodity by a firm during all stages of production and distribution. It is a modern Tax system to improve the collection of taxes, to increase efficiency and to lessen tax evasion. It is also regarded as the backbone of income Tax system in Nepal.

The current threshold for VAT registration is RS.2 million. Those Vendors whose annual turnover is below the threshold can, however, register voluntarily.

There is persistent increase in the number of VAT registrants. It has crossed the 3100 mark. At the time of conversion from sales Tax to The VAT a total of 2045 taxpayers were converted as VAT registrant's .As the taxpayers are increasing, the amount of revenue collection and the level of tax compliance is improving too.



Value added tax is a tax 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. Ultimate resting-place of this tax is final consumption so that consumers are the sole taxpayers of the VAT. Business people only collect the VAT as a mediator so that don't bear its burden. In conclusion, VAT should be the most essential choice for the developing countries as an ingredient of their tax reforms because it is the most improved from of sales tax and revenue enhancement and economic efficiency .It is an important instrument for the mobilization of internal resources. There is tremendous scope for increase its contribution in coming days. VAT is an improved form of sales tax. It is not a genuinely new form of taxation but merely a sales tax administered in different form. Under VAT system, consumer knows the amount they are paying in form of VAT. VAT is more transparent and account based tax system. Thus, tax reform and adoption of a VAT is integral part of whole Tax system in present situation.

## **1.2 Statement of problem**

A government has to spend a lot of money to fulfill its responsibility towards its people. The responsibility may be either for security or special service economic development or other development activities. So government expenditure is rising. To meet the growing public expenditure the government has to manage its funds from internal as well as external sources. Such external sources are uncertain, inconvenient and not good for healthy economic development if there is heavy dependent on them. It is better to mobilize internal sources rather than with beggar's eye to the donors. Taxes are the important sources of public revenue and major fiscal Policy instrument have an important role in increasing rate of capital formation and they're by achieving and high rate of economic growth. Nepal is facing the serious problem of resource append high dependency on foreign loan. Cutting expenditures on development work infrastructure and social services will not be just for a country crawling towards development. So, higher resource mobilization through taxes remains to be the best option.



Nepal on the basis of Gross national capital (GNP) per capital has come down early at the last position of backward. It is the nine positions in the list of ten least developing countries. In the world, this shows that Nepal still remains as one of the members of ten poorest countries in the world. Despite more four decades of landed development, the Nepalese economy is persistently suffering from general poverty stagnation. The low-income people of Nepal suffered from economic humiliation ever before then they are suffering today and this has led to several economic and VAT registrants' political disturbances in the country. Tax reform and adoption of VAT is an important fiscal phenomenon. The adoption of VAT as a substitute of existing sales taxes is expected to improve the Nepal's tax system in various ways. The Sales Tax is expected to improve in the Nepalese tax system has too many causes. They are; the sales tax system is very narrowly based and less productive, it is also putting much pressure on economic activity by its distortion characters and it has cascading effect. By contrast, a VAT is a broad-based tax, it is based on self-assessment system and provides the facility of tax credit as well as tax refund, increases the revenue elasticity and it avoids cascading effect existed in sales tax and contains catch-up effect (perhaps it is the most charming feature of VAT). Similarly, it has also some merits. Such as; less chance of tax evasion, simple to administer, transparent & minimum burden to consumers, mass participation of taxpayer and it is based on value added not on total price. So, price does not increase as a result of VAT. It is expected that the VAT would contribute more than 40 percent of country's total revenue. It is the reality shown in developed countries.

VAT is a new experiment in Nepalese tax system. So that, so many problems and difficulties have to face in primary phase of implementation. There's no conducive environment for execution of the concept of VAT. The tendency of unnecessarily troubling taxpayers must be stopped to ensure a friendly atmosphere at various tax collecting offices. The major problem associated with VAT is lack of knowledge. In Nepal most of the taxpayers are unknown about the VAT. The billing systems also confuse for the taxpayer. The billing system is lacking. Most of the businessman is not showing VAT in bill to their customers. If they did, they are charged extra amount in the name of VAT. The general concept is that, VAT increases the prices of commodities and services.



In Nepal, resources mobilization is still poor that does not cover the growing expenditure. Because of deficit financing and external loan, the Economy has to face the resource Gap; debt trap problem. It is widening continuously with the increment of total expenditure in respect to total revenue collection. It is shown in following Table:

Table No.1  
Resource Gap in Nepal

Rs. in million				
Fiscal Year	Expenditure	Revenue	Resource Gap	% Of Resource Gap
2001/02	80072.00	50445.40	29626.60	37.00
2002/03	84006.00	56229.70	27776.30	33.06
2003/04	89443.00	62311.00	27132.00	30.33
2004/05	102560.40	70021.00	32539.40	31.73
2005/06	110889.20	72282.00	38607.20	34.82
2006/07	131851.00	86135.20	45715.80	34.67

Source: Economic Survey 2006/07(GON, Ministry of Finance)

Above Table shows that the scarcity of internal resource because of growing resource gap that existing in Nepalese economy, there's no alternative resolution to finance the additional expenditure except deficit Financing. Since 1965, Nepal has been attempting the deficit financing although its nature is inflationary. Each budget contributes enlarging its size in the Budget. So, we can conclude that its increasing trend is still continuous. Government expenditure is increasing day by day but there is no increasing in government revenues equivalently. Such unbalanced growth in revenue and expenditure has resulted in massive revenue expenditure gaps or budgetary deficit in the country. The major cause of persisting fiscal deficit in Nepalese economy is inadequate resources mobilization. It is the result of poorly designed tax structure. The design of tax in Nepal is poor and defective. The revenue instruments are always having very weak performance. Contribution of tax to the national revenue is low due to the above reasons. In other sense weak performance of tax is the root cause of low tax GDP ration.



To avoid deficit budget, properly implementation of VAT would be an important tool. In Nepalese Tax structure, Sales tax has suffered from very low tax base, cascading effect and distortion effect. But, VAT is considered as the best form of sales tax having many merits like as; self policing, catching up effect, broad base, mass participation, transparent, account based neutral etc. Least developed countries are facing numerous problems in the process of economic development. Nepal is an example to this condition. About 31 percent of total population is below the poverty lines. The majorities of people have out of reach to get basic needs. Government needs huge amount of capital to meet growing public expenditure. The government expenditure rate is exceeding over the growth rate of revenue almost every year from the beginning of the planned development in Nepal. Thus the study focused on how to overcome resource gap problem and recommendation of effective implementation of VAT in order to increase its contribution to the national revenue.

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

The main objective of this study is to analyze the contemporary Issues of VAT in Nepal.. The specific objectives of this study are:

- To analyze present provision and status of VAT,
- To compare VAT with other major taxation,
- To analyze the problems and prospects of VAT,
- To analyze contribution of VAT on revenue mobilization,
- To give suggestion for effective implementation of VAT,

### **1.4 Significance of the study**

Nepalese government has already been implemented VAT for achieving ultimate objective of economic development and acceleration growth rate of economy through expanding the tax net without any distortions, promoting exports and making the tax system more buoyant. During the last 11(Eleven) years of VAT implementation, government has made a great effort to make VAT more effective and productive. However, VAT was subject of a strict opposition from the business community in initial stage of implementation.



Letter there were some correction in VAT rules and regulation and then slowly business community accepted the system and further demanded it to extend the retail level so that all the businessman firms will be treated equally. In such situation, internal resource mobilization should be strengthened to overcome resource gap problem. The experience shows that successfully implemented of VAT will have positive impact on the economy. For strengthening internal resource mobilization of Nepal, the government has already adopted VAT administration and policy, according to the reform policy and programmed noted in the eight five-year plans.

Nepal has adopted VAT since 16 November 1997 which the following objectives:

- a) Expanding the tax net
- b) Export promotion
- c) Reduce economic inefficiency
- d) Acceleration the development by reducing cascading effect.
- e) Evolving a clean and transparent tax system in place as sales taxation.

Despite more than 10 years of VAT implementation, many Nepalese people are unknown about various aspects of it. This study basically concentrates on administrative structure of VAT, the importance of VAT to improve internal resource mobilization, existing problems of VAT in Nepal and provided effective suggestion to making VAT effectiveness.

In this regard, this study carries a great significance to mobilize additional resources through improved and successful implementation of VAT and hence make the country self -dependent to some extent instead of the rapidly persisting resource gap.

## **1.5 Research Methodology**

In This study, entitled "ISSUES AND PRACTICE OF VALUE ADDED TAX IN NEPAL" secondary sources of data's are basically used. To make study extensive, accurate and more effective, primary sources of data's are also used.



### **1.5.1 Primary data**

Primary data's are collected by administering questionnaires to sample Population in Nepalgunj and Surkhet. For this purpose, Economists, tax officers, Businessmen and consumers are respondents. Besides this, subjective opinion and information are collected from discussions and interactions with related journalists, Exports other persons. Purposive sampling Method has been used for data collection. Sample size is 50(fifty).

### **1.5.2 Secondary data**

Basic data needed in the study are collected from the secondary sources. These data's are obtained from various sources. These sources are: Inland Revenue Department, central bureau of statistics, Ministry of finance, customs Department, Economic survey & Budget speech of different years, Rastra Bank' publication, World Bank Development Reports, FNCCI's monthly journal, research booklet, manuals, research papers, newspaper, Websites and relevant books. For the analysis of all collected data of various aspects of value added tax are arranged in order and processed. The statistical tools and analytical tools have been applied in the way of analysis so that the findings could be presented and interpreted properly and clearly.

## **1.6 Chapter Scheme**

This study is divided in to following six chapters:

### **Chapter I: Introduction**

This chapter includes General background of the study, Statement of problem, Significance of study, Objectives of study, limitation of study and Chapter Scheme.

### **Chapter II: Literature Review**

This chapter is connected with review of literature. The reading material of this chapter is conceptual review of related literatures.



### **Chapter III: Research methodology**

This chapter is consists of Research design, sources of data, data collection techniques, and analysis of data.

### **Chapter IV: Theoretical and practical Analysis of VAT**

This chapter has covered Concept of VAT, provision of VAT, An overview of VAT system, Methods of calculating VAT etc.

### **Chapter v: Presentation and analysis of Data**

This chapter includes Revenue collection through VAT, Comparative contribution of VAT, Trend of VAT collection, Growth of VAT, Survey Result (in various aspects of VAT implementation).

### **Chapter VI: Summary, conclusion and Recommendation**

This chapter covers Summary of this study, Conclusion of research findings and Recommendation for effective implementation of VAT.

## **1.7 Limitations of the Study**

All research study has been lunched to solve a particular research problem. It requires various kinds' data, materials and other relevant information, which may not sufficient to the researcher. This study also cannot escape from the frame of Limitations. The limitations that occurred in the study are as below:

- Due to the lack of time and resource, the opinion survey is conducted in limited persons.
- The sample size is taken only fifty, which can not represent a whole Nepalese people. Like wise, policy maker could not include on it.
- Data's are only used up to FY 063/64. Recent data of FY 064/65. Could not available because of remote area and no budget on timely.
- The reliability of secondary data is not examined. The primary data's are collected from Nepalgunj and Surkhet.
- Capital city is also excluded on survey. It does not represent of all Nepal



## CHAPTER -2

### REVIEW OF THE LITERATURE

Tax reform is one of the most important concerns of any country's fiscal system. Although there are several experiments on value added tax as a major instrument on tax reform for last three-four decades. There are very few efforts have been undertaken on the topic concerning Nepal such available studies are found to be descriptive rather than analytical. The present chapter would review the tax reform containing VAT by analyzing recently developed sophisticated tools and techniques, as well as briefly reviewed the recently developed literature on VAT in Nepal.

At first, Wilhelm von Siemens recommended value added tax in 1919 for Germany to replace the Umsatzsteuer (multistage sales tax) in order to avoid the undesirable effects particularly cascading and vertical integration, for the latter tax. In spite of serious consideration by German government, it was decided to reduce the rate of Umsatzsteuer instead of applying VAT. A tax mission to Japan led by Prof. Carl S. Shoup developed the concept of VAT further in 1949. This mission recommended the Fuka Kachi-zei (VAT) for Japan in order to avoid the undesirable and unintended effects of Japanese enterprises and turn over taxes in plan at that time.

2.1 John F. Due (1976) analyzed the different aspects of VAT, especially, in the context of developing countries through a paper entitled "Value Added Taxation in Developing Economics." The first part of the study deals with the theoretical aspect including nature and history of VAT and the next part analyses the implementation aspect in developing countries and makes useful recommendations for its successful implementation.

2.2 Due and Friedlander (1977)<sup>1</sup> showed that among consumption taxes, VAT is the best one, as the latest form of sales tax. Its usages have been expanded rapidly. Because of broader coverage, this tax offers much greater revenue potentiality as compared to other types of sales tax.

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<sup>1</sup> Due, John F and Ann Friedlander "Government finance economic of the public sector" Richard D. Irwin, Inc., Illinois, 1977. pp. 416-433



The base of tax being value added is defined as the difference between the sales of firm's product and sum of the amount of factor payment made by the firm during the period. VAT is subjected to objections common to all consumption related sales tax mainly on the ground of equity e.g. regressively. On the other hand, advantages or good feature of VAT are the major source of revenue, it can be used as a supplement to income tax, especially in undeveloped countries where effective operation of high income tax is difficult. It may be the key element to raise revenue. But its administrative complexities are burden in some developing countries. The tax credit method is single method, which facility is cross checking in auditing.

Evaluating VAT as form of sales tax, its merits are outlined as: (i) VAT Produces no economic distortions or loss of efficiency if properly designed (ii) There is a greater case in excluding producer's goods from tax (iii) cross checking is quit easier. As a sales tax, the optimal form of VAT (a) must not create the negative effects in consumer's choice and purchase (b) Should equitable, i.e. proportional level of burden for all income group (c) cost of both administration and compliance must be minimized (d) must be neutral among various methods of organization and conduct of production and distribution (e) more revenue productive considering on the above grounds. The authors accepted that the main visualized problem of VAT in developing countries is "the administrative complexity" However they concluded that it is undoubtedly the ideal form of sales tax in many countries.

2.3 'Richard Goode (1984)<sup>2</sup> a leading economist, in a short comment on the "Government finance" in Developing countries, stresses that" among the advantages of the value added tax are its board coverage and relative neutrality." The book shortly points out that the tax usually applies to imports but not to exports there are two famous terminologies in the VAT that is, exemption and zero rates.

A significant distinction between exemption and zero rates should be noted. An exempt enterprise receives on deduction or tax credit for this

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<sup>2</sup> Goode, Richard (1984) Government finance in Developing countries. New Delhi Tata MC Graw-Hall



purchases and it treated in this respect like a consumer whereas an enterprise in a zero-rated activity receives a rebate of tax on its imports. In this connection author expresses exports appear to be effectively zero rated in all countries (through there are formal differences in legislation) while certain services, nonprofit activities, and sometimes agriculture are exempted.

In Goode view, the major disadvantage of the value added tax is that, it must be collected from all registrants business firm and huge amount of paper work should be applied in computing and verifying credits or deductions. It is more complex than a single stage manufactures and importers tax.

After reading the whole text, we find the advantage and practicability of VAT is questionable for countries where much business firm is carried on by small enterprises. Account is unreliable, and tax administration is weak. Richard Goode does not make any empirical text about VAT in this book. The book explains the VAT is general.

2.4 Silwal, Narayan (1988) <sup>3</sup> stated that most of the developing countries are now engaged in the study of VAT very seriously and most of the Economists of all countries have realized that the VAT only is the source of tax revenue which has very high tax potential yield among the existing tax systems. It will not be on exception for Nepal. VAT is said to be consumption tax by when the taxable good and services are consumed will ultimately pay the tax. If any goods become spoiled before consuming, it will not liable to tax. The feature of tax are stated: (i) Input tax credit (tax paid on earlier stages) (ii) Neutrality (VAT does not offer unnecessary burden of tax in any sector) (iii) Compulsory invoice system (for its good operation) (iv) Wide tax coverage (Covering from importing & producing to retailing stage, products, services, and others) similarly possibility of tax evasion and cheating are also minimized.

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<sup>3</sup> Silwal, Narayan "Value added tax: its problem and prospects in Nepal" Rajashwa; Nepalese journal of public finance and development (year 8, vol. 2), Lalitpur, 1998



Pointing out the problem of VAT in Nepal, the author writes "When retail level sales tax was introduced firstly in 1965, there appeared several absurdities such as: very low monitoring and supervision skill of tax administration, informal retailing system, lack of compulsory income system and lack of skilled and experienced administrator Which are exactly remained even today leaving very few improvements. So, VAT is problematic in Nepal. The author recommended that before introducing VAT, some necessary conditions should be fulfilled. They are: (a) change in the organization of the tax administration: to monitor, handle and to make supervision of VAT, a task force for necessary preparation for it is recently needed (b) development in personnel and staff, to administer VAT, personnel should be prepared selecting from tax administration staff and from general administration and providing them training (c) sufficient information system about VAT should be developed and introduced (d) choice of the tactics and policies should be developed. This study concludes, "There is no condition of waiting for along period of time to introduce VAT in Nepal.

2.5 Ahamad and Sterm (1987) <sup>4</sup>, suggest the tax reform to India through the paper "Alternative sources of Government revenue Illustrations from India 1979- 80" after analyzing the Indian tax system by employing the advanced sophisticated tools and Techniques. There was a very considerable taxation of Intermediate goods in India shows that calculation of 'effective taxes" inputs of Some goods were taxed more than 20 percents, and on the average the taxation of inputs was 6-7 percent, taxation of inputs arose mainly due to federal excises on domestic production is the major important things of tax system. Other major notable point is that the exports were also taxed at 6 percent through inputs taxation. The rebates to the exports as a remission of domestic taxation were clearly insufficient.

There is the supposing of income inequality the social marginal cost (SMC) of raising revenue was highest for federal excises followed by state sales tax and import taxes respectively. Similarly the SMC of raising

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<sup>4</sup> Ahmad. Ehtishma and Nicholas stern (1987) "Alternative sources of government Revenue: Illustration from India 1970-80". The theory of taxation for developing countries Newbery and stern, oxford university press for the World Bank, New York



revenue from cereals, food items fuel and light was the highest and SMC of raising revenue from milk and dairy, clothing and light was the highest and SMC of raising revenue from milk and dairy, clothing and other non food item the lowest income tax was more preferable to raise an extra amount of revenue rather than to use commodity taxes. For strong income inequality the argument for income tax is very strong, cereals become very unattractive as a source of Revenue and import duties represent the most desirable general source of extra indirect tax revenue.

The paper also suggests that a move to a VAT at uniform rate would have adversely affected the poorer section of the Indian society. Given the non-distorting effects of VAT on production however, here might have been well advantages in considering a non-uniform VAT supplemented by selective excises and tariffs.

2.6 Shoup (1988)<sup>5</sup> stated that VAT is a tax on the value that a business firm adds to the things it buys from others firms in producing its own products. A VAT is comprehensive if it covers all economic activities from the earlier stage of farming or mining right through to the retail. The speed with which the VAT has spread around the world is unmatched by that of any other tax in the modern times. VAT reduces vertical integration because of its nature that is taxes of the value added but not turnover.

VAT offers more revenue and coverage more than other forms of sales taxes. It exempts exports well considering the problem of deducting the capital goods. A consumption type of VAT is superior then other form. In calculation, tax credit methods are the universal one. VAT is more revenue productive, self-enforcing and if foods and basic necessities are to be zero-related regression may be reduced. The author pointed out some disadvantages of VAT. They are: (i) difficulty both in the case of and administration or collection (ii) Inflationary in nature (iii) more problematic in developing countries and (iv) Regression. It is superior then other form of tax. But it needs caution in implementation. His main findings in this study are (i) VAT is not ideal for the developing countries (ii) Basic accounting problem and efficient and empirical tax

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<sup>5</sup> Shoup Carl S. "Value added tax and developing countries" Research observer (vol. no.2.). The world bank . Washington D.C. July 1988. pp. 139-156.



administration are lacking in developing countries, which are the main obstacles to implement it. iii) The choice between turnover taxes and the VAT becomes a matter of weighing the pros and cons (iv) no generation seems Justified on the suitability of the VAT for developing countries as a group that (Means circumstances are) also important.

But the scenario is absolutely changed as compared to past. In the past two-decade applicability VAT is dramatically increased. Share of VAT in total revenue is gradually increased. At present, it seems that the VAT is a major source of national revenue for many developing countries. This study is mainly concentrated on policy issues only.

2.7 Rup Bahadur Khadka (1989)<sup>6</sup> has reported, "VAT in Asia pacific Region". He has examined the structure and operation of VAT in the Asian pacific countries. It focuses on the nature of VAT and the various types and methods of production and analyses the reasons for its growing popularity. Further, it also explore the possibility of introducing VAT in Nepal and examines various issues concerning to it. He writes that VAT is levied on the value added to each commodity by a firm during the process of production and distribution and it is shifted forward completely to the consumers. Among the Asian pacific countries, china, Indonesia, Korea, Newzeriland, Philippines and Taiwan has introduced VAT as a part of large-scale tax reform programs. Popularity of VAT is growing rapidly because of its several positive aspects such as neutrality, more equitable than other form of sales tax except retail level sales tax. Self-policing nature in administration, difficult for the evasion, advantages to exempt and Zero-rates for promotion exports, broad based etc.

However, VAT is complex and difficult for implementation, especially from administrative point of view and it is vertically inequitable since it puts a relatively higher burden on the lower income group vis-à-vis to their higher income counterparts. In spite of positive and negative aspects of VAT, he concluded that the need of VAT introduction in Nepal.

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<sup>6</sup> Khadka. Rup Bhadur (1989), VAT in Asia and pasfic Region, International Buearu of fiscal Documentation. Amsterdam



Furthermore he suggests that especial consumption tax could be levied on luxuries and socially undesirable goods, inter-alias, to mitigate the regressively of commodity taxes. Lately, he concludes that VAT should be seen as a long term and a major step for the rationalization of Nepalese tax system and should be introduced only after adequate and proper preparation.

2.8 Tiwary, Narayan Raj (1990),<sup>7</sup> stated that VAT is considered as the mostly growing trend in the field of taxation: Discussing the merits of VAT, the reason for its growing attraction in the world are: (i) VAT is based on the most modern theories (ii) It is more informative and sustain (iv) increment of taxpayers are also advanced . (v) It is less tedious (vi) it is free from cascading effect due to the input tax credit (vii) it is effective to control price raise and reduce tax evasion discussing the development of tax in Nepal the author focuses the problems of Nepalese sales taxes such as administrative in efficiencies, very large number of small taxpayers with no record keeping and issuing the invoices and sales tax concentrated only on import manufacturing level. Considering modern context and fulfilling the resource scarcity, it the time of introducing VAT in Nepal.

To answer this question how shows the need to identify such backwards which are pre-conditions for VAT system. These pre-conditions are (i) keeping in mind that the increment the number of taxpayer in a VAT system. It is necessary to collect prepared records of potential value added taxpayers. Firstly that makes feasible to register them while introducing VAT. (ii) A separate administrative unit for VAT is necessary (iii) Because of not being separate, "Revenue service" in Nepalese, tax administration creates several problems. So it should be maintained according to the classification of revenue source "group", should be established and operation of training programs, development and extension is a must. (iv) Use of Computer should be introduced to assist administration (v) the rate system of VAT should be a single one. If

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<sup>7</sup> Tiwari. Narayan Raj "Value Added Tax: its problems, prospects and suggestion in Nepal " Rajashwa year (10 vol. no.1) 1990



needed more rates; the appropriate dual rates would be 10% and 15%. (vi) A threshold for very small retailers should be maintained. (vii) Agriculture products, basic necessities and other similar goods and exports should be exempted (viii) necessary forms ledgers should be improved. They should be simple and coverage should also be extended to services such as electricity consumption and telephone services (ix) experiences of abroad about VAT should be studied by giving chance to the tax officials through study visit and advice provided by tax experts and economists (x) studies should be operate on the aspects such as ended of this tax, effect and targeted taxpayers. According to studies, policy should be prepared and after a preparation period it will be appropriate to take 3 or 4 years for introduction of VAT (xi) the rates of custom and excise duty should be revalued. Most of the taxable goods under excise duty should be transferred under VAT and specific excise duty on luxuries.

2.9 An IMF Occasional paper (1991) <sup>8</sup> Washington DC Entitle-"Value added tax administrative and policy issue" edited by Alan A. Jait brings out the beauty of the VAT and briefly reviews the reasons why the VAT is chosen as the main sales tax.

The study concentrates on the policy concerns on the basic illustration of some theoretical as well as empirical proofs. The study clearly depicts three main group of reason to adopt a VAT: revenue, neutrality and efficiency.

Revenue: VAT would generate more revenue with less cost than that taxes it replaces." Traditional income and sales taxes have been meeting public resistance and the VAT provides a new concept. Buoyant revenue base, typically yielding more then initial estimates as the case of Indonesia, Korea, New Zealand, Portugal and Tunisia show "Because of broad coverage this tax offers much greater revenue potentiality as compared to

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<sup>8</sup> Tait. Alan A. (1991) "VAT policy issues structure, regretaroty inflation and exports " Value Added Tax: Administrative and policy issues.pp. 1-16(ed). IMF personal papers Washington D.C.



according to of revenue in most countries. According to this study the VAT contributes from 12 percent to 30 percent.

Neutrality: The VAT is non-distortion provided. There are few exemptions and little zero-rating. VAT on investment should be fully credited and this frequently is an improvement over the taxes replaced that often taxed capital goods:

VAT is natural with respect to the choice methods of production and distribution. Since the tax is levied. Only on the value added at each stage in the system, tax liability remains the same regardless of the system of Producing and distributing. Total tax paid on a given commodity depends on the rate of the tax and on the total value added. (i.e. the final price ) of that commodity but not on the number of stages through which it has passed. So the tax is considered vertically neutral except for negligible element of discrimination. It also doesn't discriminate the production whether it is capital-intensive or labor

Efficiency: A significant characteristic of an ideal tax system is efficiency. An efficient tax system is one that does not cause any distortion introduction and consumption. In other word such a tax system does not bring any unintended and undesirable effect in the methods of production and distribution or in consumption. Rather it avoids probable distortions of the optimum allocation of resources. In this connection Editor Nan a Tait writes-the VAT was often replaced Inefficient, distortion and badly administered taxes. The introduction of the VAT provides an opportunity to sweep away the cobwebs and revamp a substantial part of the tax administration

2.10 Sing S.K (1991) <sup>9</sup> stated, "administration of VAT doesn't require firms to calculate value added. It is administrated by invoice method". He found following merits; if VAT as neutral and efficient resources allocation neutral between different good and service, neutral between businesses,

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<sup>9</sup> Sing S.K. " Public finance in developed and developing countries" S.Chand and company Ltd. New Delhi 1991.pp. 789-827



neutral between different types of Production and distribution, neutrality in imported and home produced good is possible in a VAT systems because it does not distort any one of the above: (i) registration of demand by means of price mechanism.(ii) Income distribution: VAT at single rate with exemptions of food staffs farmers housing, finance, health, education, Charities newspapers books and periodical may be levied in such a way as to make the entire system of taxes and benefit the goods more progressively (iv) effective enforcement. The cross audit feature of VAT provides this facility to reduce tax evasion. And demerits: (i) VAT may rise price at the time of replacement (ii) VAT being a complex tax individual and small firms do not maintain proper record. (iii) Accumulation of inventory is likely to hider smooth tax payment.

Regarding the VAT in developing countries the main requirements to introduce VAT are described as: (a) ability to administer VAT, determines its feasibility (b) small business and compliance are also others problem which should be treated very carefully in developing countries while introducing VAT (c) successful introduction of VAT depends largely on previously experience of multiple stages sales taxes or general sales tax.

2.11 Due and Greany ((1991) <sup>10</sup> wrote a successful story of VAT in Trinidad and Tobago. A value added tax of general type went in to effect in Trinidad and Tobago in 1990. Development of VAT was carefully planed and it went through the several Phased from 1986 to 1986. A tax performance committee was established to review the current tax system and develop a preliminary recommendation for directions of reform. The studies showed that the existing tax system was in urgent need of revision for several respects. The value added tax was put forward as an alternative. Further, the issues such as choice of rate structure, exemption, tax administration etc. were resolved for the final adoption of VAT. The structure VAT was drafted in the final report after a careful examination of several issues including revenue and equity with the development of analytical models. Finally it was drafted and passed by the legislation in

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<sup>10</sup> Due John F and franis Freany (1991) "Trinidad and Tobago: The development of value added tax" Mulletion for the international Bureau of fiscal documentation vol. 55 no 6, Amsterdam: IBFD.



1989 after several detailed works. A reasonably satisfactory operation of VAT was seen even in the first year of the VAT implementation. As the VAT was well received and also welcomed by the business community, it yielded the previously expected and force acted results. Although proper choice of tax structure, efficient administration, closes co-relation between the government and the business sector, extensive program for public awareness is stilled required. The coordinated reforms in other taxes such as purchase tax income tax and selection of competent person, and experts in key positions were the several reasons for getting expected revenue yields with successful implementation. Many suggestions and lessons can be taken for the introduction and successful operations of VAT to other developed countries from the experience of Trinidad and Tobago.

2.12 Professor Sijbren Cnossen (1992) <sup>11</sup>, after very seriously observing the value added tax both in EC and OECD countries provides a model of VAT for central and Eastern European countries after the transition from a planed economy to market oriented economy publishing an article on "key question in considering value added tax for central and eastern European countries" state that " It requires nearly complete overall of the tax system, and most of countries the introduction of VAT is considered a corner-stone of the necessary tax reform." He further added, "This forms of taxation is a world part form of transaction based, accounts system. In absence of a workable income tax financing requirements in this situation can be best met by a product natural factor natural and revenue productive such as a VAT.

In this study social economic and technical issue pertinent to introduction and operation of the VAT are examined, including the burden distribution of the VAT, its efforts on price level, economic growth as well as coverage definition of best and choice of rate structure. Similarly various legal and administrative aspects and problem are overviewed in the subsequent sections, which are grouped in to four main chapters. The study proceeds on the analytical methodology considering both

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<sup>11</sup> Sijbern. Key question in considering a value added tax for central and eastern European Countries IMF staff paper (vol.29, No. 2) IMF. Washington DC. 1992 pp. 211-255.



theoretical as well as empirical works. The merits of VAT as compared to the other types of sales tax are outlined, as the VAT being able to precise identification and distribution. It is an exceptionally stable and flexible. Source of government revenue neutral regarding the production, broadly based and easiness in checking or auditing and in integrated market similarly objections made against VAT are on the ground of its regressively, being inflationary any administrative complexity and costly also. But from above simulation regressively may be lowered by taxing luxuries in higher rates and by zero-rating the necessities.

A VAT is superior then income tax because of the ground in promoting economic growth. No effect on retail prices or in a shift of consumer price index trend line there of conclusion. Prof, Cnossen states "an appropriate VAT for central and eastern European countries has proceeded from the widely agreed premise that the tax should be used almost exclusively to generate revenue for government budget in as neutral and administratively feasible manner as possible". While the income tax can be employed to achieve distribution objectives and excises and imports duties to attain allocation goal

"The focus of VAT should be the revenue."

Properly designed and operated VAT required:

- (a) The VAT should be productive of revenue and responsive to changes in revenue needs.
- (b) Unintended distortions of producer's choices and consumer's choices should be minimized.
- (c) VAT should be simple and easy to understand
- (d) Destination principle should be applied
- (e) Cost of collecting and enforcing the VAT should be minimized.
- (f) VAT should be to comply with and should interfere as little as possible with the free function of business and trade.



2.13 Bogetic and Hassan (1993) <sup>12</sup> empirically analyzed "Determinants of VAT revenue" on a sample of 20 single rated countries, a full sample of 34 countries and a small sample of multiple rate countries. The results of the regression conform to the conventional views on the key variable influencing the VAT revenue performance: the rate, the base, and the rate dispersion. The dispersion of rate is found to affect VAT revenue negatively. Empirical results confirm another conventional view that VAT generates, the other things being constant, higher revenue in single VAT rate countries than in multiple rates countries. The difference in the estimated models for the two country groups is statistically significant indicating a structural change. However, this change in the pattern of VAT revenues cannot be exclusively in terms of different in rate structures. Satisfactory explanation, therefore, must include other factors such as the base and tax administration capacity. The implication for policy makers are clear to generate superior revenue, a VAT should be levied in a single rate on as broad base as possible, it also must be accompanied by a strong tax administration.

2. 14Dr. Thapa, Govinda Bahadur (1994) <sup>13</sup> made an efforts in "Value-Added tax in Nepalese context". He applied the theoretical methodology and deal with theoretical issues. The conclusion of the study was "considering the present condition of Nepal facing government expenditure, low revenue efforts high dependency on foreign loan, need of more economic growth of the economy, and because of low revenue potentiality from the direct taxes there is a prompt need to improve the sales tax of Nepal. But there is less chance to mobilize more revenue through existing form of sales tax. In this context there is no any other alternate except introducing VAT in Nepal." However, the study is directed to Nepal but is fully dependent on theoretical issues.

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<sup>12</sup> Bogetic zeizko and Hassan Fareed "Determinants of value added tax revenue". A cross section an analysis. Europe and central Asia country department 1, The world Bank Octobre.

<sup>13</sup> Thapa. Govinda Bahadur "Value Added Tax in Nepalese context Mirate . Bankers Club. Nepal Rastra Bank. Kathmandu, 1994 pp.38-44



2.15 Kadka, Rup Bahadur (1996) <sup>14</sup>, in his paper "A VAT for Nepal" focuses on the purposed structure, operation and administrative set up of a VAT for Nepal and necessary steps to be taken for its early introduction. In its purposed Structure the coverage of VAT should be made as broad as possible covering all business transaction. Exemption should not be granted unless there is a Specific reason to do so, such as administration and equity. Zero rating should be single in order to avoid complication and inefficiencies in collection.

The purposed operation as VAT requires that the taxpayers above a Threshold limit should be registered. The vendor should issue an invoice for Each sale, keep a clean account as his purchases and sales (separate accounts for Zero rated, exempted and positive rate goods) and VAT liability should be Calculated of its taxable sales, tax credit methods should be used as a methods of computation of the tax, and tax payment and refund Period should be of one Month. The present sales tax department and excise department should be restructured drastically to administer a VAT. Officer level posts should be increased Considerable and extensive training should be provided including the causation of computer system. A VAT implementation team including experts and Person from every field should be set up. A detailed preparation should be considered as a pre-requisite for the introduction of VAT. Comprehensive VAT Education program must be launched to be educating the taxpayers.

2.16 A study made by Nepal chamber of commerce (1997a) <sup>15</sup> to analysis the Possible effect of VAT on Nepalese economy make some observation. The observations are:  
Adverse effect on price level,  
Increase in the prices of imported goods would hit the import tax,  
The account keeping requirements of VAT would increase the tax compliance cost and cost of doing business, it would adversely affect the small traders,

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<sup>14</sup> Khadka, Rup Bhadur (1996) "A VAT for Nepal" "VAT Monotony and Analyze Administration International Bureau of Fiscal Documentation 1995 pp.39-42.

<sup>15</sup> Nepal Chamber of Commerce. (1997 a) study report on possible effect of value added tax on different areas. Nepali Kathmandu: Nepal Chamber of Commerce.



Adverse effects on domestic production due to the abolition of protection policy under VAT,

VAT would be unjustifiable on social ground; it would aggravate the income distribution,

Negative effects on revenue collection and

Chances of failure of a VAT in Nepal are great because the present Administration is incapable for handling a VAT.

The study concludes that a VAT in Nepal should not be implemented in haste. A partial VAT on some commodities should be implemented on experimental basis to know its pros and after that a full VAT might be considered.

2.17 Nepal chamber of commerce (1997 b) <sup>16</sup> organized a nation wide discussion program on VAT. According to a report of the discussion program (Nepal chamber of commerce, 1997) the various views expressed about VAT in Nepal may be summarized as follows:

Government machinery is not capable for implementing a VAT.

The business community has no confidence in the administration because it has failed to implement many other taxes effectively and fulfill its own commitment even previously.

VAT will hamper genuine trade and as a consequence, illegal trade will prosper. Rise in the prices of domestic products will make them less competitive. Import and re-export of imported goods will get a negative impact leading to decline in government revenue.

VAT will inhibit the growth of newly developing trade and industrial activities in the country.

The modern account keeping system required by the VAT is difficult to keep. This will raise the costs of doing business.

There will be a sharp price rise if a VAT is introduced; consumers will be badly affected due to price rise. Nepalese markets in border area will dry up due to VAT.

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<sup>16</sup> Nepal Chamber of Commerce. (1997 a) study report on possible effect of value added tax on different areas. Nepal Kathmandu: Nepal Chamber of Commerce.



It is concluded that it is not possible to implement a VAT in Nepal and if implemented, it will have adverse effect on the economy.

2.18 Subedi Babu Ram (1997)<sup>17</sup>, in his dissertation entitle existing tax system is not efficient in raising adequate revenue, and it is also distortion, inequitable and gives incentives for tax evasion, the finding of the study emphasize the need for the reform of entire tax system. To reform the tax system, it is desirable and necessary to move towards VAT and improves the administration. A VAT in Nepal expands the coverage of tax, removes distortion effects of the existing taxes and will have a minor effect on prices. Empirically VAT is also found to be the best alternative for reducing the inefficiencies and introducing neutrality, fairness, productivity and transparency in the tax system. A VAT however, would rise the regressively of tax system.

According to this study, the most important problem of implementing a VAT is administrative inefficiency. The present sales tax administration is not capable of handling a VAT. Others problem associated with the application of VAT are on account keeping system, lack of knowledge about VAT, lack of co-operation between the government and private sector, illiteracy and low public awareness. The existing tax evading practices also pose a serious problem. The full advantage of VAT cannot be achieved with out extending it to the retail level but the extension of VAT to the retail level is impossible and impracticable in Nepalese context.

The study suggests that moderate single rated VAT is desirable. If the VAT is implemented well, it will generate 1.5 to 2.5 more revenue then existing sales tax. But, however a VAT in Nepal may not be "A hen with golden eggs" and it is not a "Panacea" for curing all ills, it requires actives efforts and commitment of all sides-the study concludes.

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<sup>17</sup> Subedi. Ram (1997) "Applicability of value added tax in Nepal" M.A. Dissertation: Central Department of Economics. Tribhuvan University, Kathmandu



2.19 Glenn Jenkins and Dr. Rup B. Khadka (1998)<sup>18</sup> In this research under the title of "Tax reform in Singapore." This working paper carries the successful story of VAT's introduction and implementation in Singapore to be a good lesson for the non-VAT countries and VAT countries. According to authors Singapore put forwards the VAT in order to make Singapore's economy internationally competitive. In this discretion the government of Singapore formed a task force committee for the tax reformation. The committee recommended that the government must shift direct to indirect taxes as its main sources of revenue.

The research paper concluded that Singapore would be facing the problem of an aging population. In such a situation Income taxes will put a greater burden on smaller group of younger, working Singaporeans, might inhibit growth and enterprise. It is therefore, necessary to introduce a broad-based tax like GST/VAT to distribute the burden of taxation among a larger section of the population, GST in tax on consumption and has several futures. It relieves investment and saving from the tax burden and 'rewards enterprises and strengthens economic resilience. GST relives exports commodity taxes through the zero- rating mechanism. Since VAT is a fairer tax and is levied on a large section of the population including the self-employed, it is less affected by Economic Cycles GST provides a more stable source of revenue than many other taxes.

The main objective of Singapore to introduce VAT is to makes its economy internally competitive, to promote exports and to develop a board based and stable source of tax revenue.

2.20 Sharma Krishna Prasad (1998)<sup>19</sup>, in his dissertation entitled "value added tax in Nepal: issue and options." Submitted to the central department of economics Analyses of the different aspects of VAT; issues concerning applicability effects, revenue potential, the narrow tax base, inefficiency,

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<sup>18</sup> Glenn Jenkins and Khadka. Rub.Bahadur (1997) value added tax policy and implementation in Singapore. ITP/Harvard Law school. Harvard University, Cambridge

<sup>19</sup> Sharma. Krishna Prasad (1998). Issue and Option in the Applicability of Value Added Tax in Nepal, Unpublished M.A.Dissertation Central Department of Economics.Tribhuvan University, Kathmandu.



distortion character, weak administration are the major defects of the existing sales tax. Adoption of full fledged VAT would make tax system more productive and elastic by widening the tax base and it would not be more regressive than the present tax system. Tax base in VAT would increase about three fold of the present sales tax base in case of imported goods.

Study considers "applicability of VAT as the biggest problems on the support of the following issues (i) lack of administrative capacity (ii) underdeveloped business structure practice and distribution system, (iii) business community constitutes a large number of small trades most of who are illiterate and lacks proper accounting records (iv) existence of open border and a large amount of unauthorized trade (v) under valuation, (vi) existing tax evading practice and corrupting nature of the tax administration and (vii) lack of the co-operation between the government and the business community.

Clearly VAT will raise price, but in general, it would be lower than that of the taxed commodities if it were properly managed. Although VAT is regressive on the ground of income distribution, it would not be more than existing sales tax. Further, VAT will have favorable effect on the country's balance of payment's collection of income tax and import duties, on the one hand and on the other it will broaden the base for corruption, illegal trade

And tax evasion. VAT will also make incentive to the trades to split their business to go below the threshold limit, which makes business sector fragmented, and less efficient. Thus study concludes that VAT is not 'fully' applicable to Nepal.

2.21 Ghimire Lalmani (1998)<sup>20</sup> in his dissertation, entitled "Value added tax: key issues in Nepal " According to this study, administrative capacity, organization structure, audit and inspection style, reward and punishment, political intervention, selection of skilled and experienced manpower are

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<sup>20</sup> Ghimire Lalmani (1998) "Value Added Tax, Key issue in Nepal" Dissertation for management (MBA). Tribhuvan University, Kirtipur. Kathmandu



needed to improve for effective implementation of VAT among which the first time is not challenging. As Nepal is an agrarian economy, there are a large number of traders. So more, revenue can be generated only if VAT is extended through retail level, which needs proper and adequate preparation to make the retail stage. VAT more effective and efficient, the major suggestion of this research is to improve the following aspects: (i) Administrative power and creditability. (ii) Taxpayer identification system (iii) registration and educational programs. (iv) some incentive for small traders. Single rated VAT is appropriate in Nepalese context because of administrative simplicity although it is more regressive than the multiple rated. The exiting major problem of VAT implementation in Nepal is existence of small trades in large proportion, lack of large amount of unauthorized trade from accounting records, illiteracy and high compliance cost, the existence of broader and India to Nepal poses a great threat to the success of VAT in Nepal. Strong administration, educational program, existence training program, technical data base system, Combination of various revenue offices high level VAT implementation terms, co-ordination of VAT department close co-operation between government and private sector etc. are essential pre-requisites for the successful implementation of VAT in Nepal. Focusing on the ever increasing resource gap, inefficiency in sales tax and need of revenue for handling developmental works, VAT should be implemented in Nepal "VAT is applicable in Nepal " and is more useful then sales tax system. This is necessary for making the system broad based, neutral stable, and more revenue creating, transparent and eliminate growing fiscal deficits as well as to lower dependency on foreign loan Nepal.

2.22 Sharma, Chintamani (1998) <sup>21</sup>, examined several aspects of VAT administration such as its problem constructions, possibility, operation and other aspects. In his dissertation he has found the following findings. (i) Most of the traders and businessmen are lacked with the minimum concept of VAT. They are facing pricing billing and accounting problem

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<sup>21</sup> Sharma. Chintamani "Value Added Tax in Nepal: An administrative and policy issues". A dissection submitted to central department of management, T.U. 1998.



etc. (ii) An adequate VAT education programs are not conducted (iii) VAT administration has been facing the lack of administration has been facing the lack of administrative personnel (iv) the relation between government and business community is broken, which has been barrier to implement VAT successfully. His suggestion to the government for successfully implementation of VAT in Nepal are as follows: (i) the government should try to produce gazette manpower and to train them well (iii) comprehensive education programs should be launched by government (iv) other matters relating to operational issues and taxpayer education should also be discussed with them and with other such as employee's association. At last, he concluded that VAT requires the strengthened administration for its effective and efficient implantation.

2.23 Bista, Raghu Bir (1999) <sup>22</sup>, in his research entitle, "Applicability and feasibility of VAT in Nepal'. He has found the followings;

- J The sales tax system is failure to several cases: narrow tax base, in-elasticity of tax rate, incapable and week administration, tax leakage, corruption and political intervention. So, the entire tax reform is needed.
- J A VAT is account based, invoice based and record based; it checks the tax loopholes such as under evaluation, non-recording and unauthorized trade. It discourages such issues and problems existed in the sales tax system.
- J VAT mobilized the additional resources and the rest of internal resources by broadening tax base and by discouraging the existing tax loopholes.
- J In VAT system, tax refund and threshold, two provisions are necessary for the effective implementation of VAT. But, they are two gates of possible mal-practice and tax evasion for the effective implementation of VAT in Nepal; these gates should be closed by conducting strict monitoring system and by operating the punishment section of VAT enactment.

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<sup>22</sup> Bista. Raghu Bir "Applicability and feasibility of VAT in Nepal", a dissertation submitted to the central depart mention of economics. T.U. 1999.



- ) For implementation VAT, the public awareness level relating VAT and VAT administration should be good and it's a prerequisite in the preparation of VAT.
- ) VAT administration should be strong and efficient in order to implement properly. But, in Nepal, VAT administration has been facing the problem like corruption, incapability, inefficiency, delaying ineffectiveness inadequate physical environment, inexperienced and untrained employee and weak organizational setup - The purpose of each fiscal policy is to reduce the economic inequality between the rich and poor by giving the tax incentives to the poor for the social welfare and by redistributing the national income. VAT has the Therefore; its effects are found positive on social welfare and negative on the economic in the economic inequality.

2.24 Khadka and Shukla (1999)<sup>23</sup> made a study present status and the future prospects in domestic indirect taxes in India. India will have to depend more on indirect taxes in the foreseeable future. Because of the continuing trend to lower the rates of customs duties in view of the liberal economic policies, there is no likelihood of increase in revenue from customs duties. This means more revenue will have to be generated mainly through the domestic indirect taxes. i.e. the excise duties at the central level and at the state level. For this reason and also for the overall reforms of the indirect taxation, the conversion of these taxes in to some form of VAT has become an attractive alternative. Various tax reform committees of India have recommended moving towards VAT instead of other tax system. According to the Chelliah committee, the ideal solution would be to have a single VAT at the central level reaching down to the retail stage in replacement of most indirect taxes other than protective duties and sumptuary excise duties the central excise, the state excise, the municipal octroi, the goods and passengers tax and the electricity duty while sharing the proceeds of VAT among the three levels of government.

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<sup>23</sup>Khadka. Rup "Preparation and implementation of VAT of Nepal" in International VAT monitor.(Vol.10.No.2.) 1999



This study suggest that in pure economic terms, it would be desirable to levy a full fledged VAT extending right through the retail level in place of the central excise, state sales taxes and local level octroi.

2.25 Khadka, Rup Bahadur (2000) <sup>24</sup>, In his book " The Nepalese tax system" reviews the overall Nepalese tax system and tax administration. He also examines the different steps that are taken in the process of developing tax system in Nepal. Further, he recommends so measures to design the tax system that is broad-based, low rated, neutral, simple and transparent, and also some essential measures for the reforms of tax administration are suggested.

The current issues of the Nepalese tax system identified are: (i) lack of co-ordinate long-term strategy (ii) narrow coverage (iii) artificial tax base (iv) defective organizational structure (v) weak and traditional tax administration (vi) traditional and complex procedures (vii) un-enforced local taxes. The study concludes that tax officials are mostly responsible for the existing problem of tax system and the hesitation of the policy makers to take hard decision is also being boundary to clean tax system. The following steps are suggested to take in order to rationalize tax system;

- (i) Adopt a long term co-ordinate approach (ii) Broaden the tax base (iii) Enhance the tax compliance (vi) implement local taxes. Along with these existing issue and suggestions, the study considering the introduction of VAT in Nepal in states that there was no choice other then to introduce VAT in Nepal to generate revenue required for improving it's deteriorating macro economic performance. As VAT is based on transition value, need not to fix arbitrary or artificial values for tax purpose, which avoids the existing problems of under valuation, corruption, non-transparent etc. Achievement of this good feature of VAT depends up on its implementation, which is the major issue for its success in Nepalese context.

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<sup>24</sup> Khadka.Rup B. (2000). The Nepalese tax system. Sajha, Prakashan, Kathmandu,



2.26 Laudari, Raju (2001) <sup>25</sup> In his dissertation analysis the problem and prospects of VAT in Nepal, basically on the theoretical aspect. He stated that in the current status of decreasing revenue from custom duties due to the liberal economic policies, importance of VAT is growing for resource mobilization. The contribution of VAT in tax revenue and gross domestic product is growing. While the contribution of other tax; replaced by VAT is gradually declining. From the field survey, the study concludes that the VAT having positive effect on the national economic growth. Major problems associated with the VAT system to business houses are account keeping and billing.

From the field survey, the study concludes that VAT will have effect on economic growth. Major problems associated with the VAT system to business houses are account keeping and billing. Weaknesses of VAT administration are lack of motivation, service minded attitude and dishonesty in VAT officers. VAT system, the best and advanced fiscal tool in theoretical sense, could not yield the expected returns in Nepal because of the lack of strong and honest tax administration, lack of motivation and service minded attitude among tax officials, lack of the cooperation of business community, lack of co-ordination between tax collectors and taxpayers, lack of strong political commitment and weak public consciousness.

2.27 Khadka, Rup (2060BS) <sup>26</sup>, explain the evolution of sales tax /VAT in Nepal. The writer depicted the issues and challenges of VAT implementation are:

- (i) Lack of billing system. It includes: No billing, Low billing, Low level of consumer awareness about billing,- If bill is issued, vendor says that consumer should pay extra VAT and low billing in custom evaluation,
- (ii) Huge amount of tax refund,(iii) Large scale of total tax credit,(iv) Increase in tax due and tendency of no-submission of tax return,(v) Failure of taxation for all taxable turnovers,(vi) Some potential Taxpayers

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<sup>25</sup> Laudari, Raju, (2001) Value Added Tax in Nepal: An analysis of its Problem and prospects, M.A. Dissertation Central Department of Economic. T.U. Kirtipur

<sup>26</sup> Khadka, Rup B. (2060BS). Nepalko bitta baybasta ; chunauti tatha ranganati : Pairabi , Prakashan, Kathmandu



are outside the tax net,(vii) Lack of accurate book and account and,(viii) Low level of tax compliance,

To face the above challenges the writer suggests the various strategies. They are: (i) reduce and finally remove the provision of tax-exempt (ii) Regular survey of potential taxpayer, (iii) Effective monitoring and evaluation, (iv) Enhanced the tax boundaries, (v) Strengthening tax administration, (vii) Easy provision to submit tax return, (viii) Promoting billing exchange, (ix) Increase in tax rates.



## **CHAPTER -3**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

The main objective of this research is to analyze and interpret the issues present status of VAT in Nepal. VAT is being applied instead of import/manufacturing level of sales tax, entertainment tax, hotel tax and contract tax. So, it should be sound and effective value added tax system results the increasing rate of indirect tax on tax structure as well as national revenue at satisfactory and reasonable level. Therefore the main concentration of this study is on the role of value added tax, VAT structure, VAT coverage and planning, organizing and administrative requirement. However, the major focus on different issues, present practice and future prospects of VAT to implement effectively in Nepal.

The problem of delaying tax assessment, tax evasion and avoidance etc may be solved through efficient management system. After performing analytical system on this subject matter, it tries to recommend for tax administration to execute policy of VAT effectively. To achieve these objectives a research methodology has been designed in this chapter.

#### **3.2 Research Design**

Most of the data and information of this study were concerned with past phenomena of the performance either numerical or theoretical. This study is based on both the description as well as analytical method. After collection of opinion and views and some data, this study has tried to analyze and describe the system by its own procedure.

#### **3.3 Natures and Source of Data**

In order to achieve the accurate results of this research, primary as well as secondary data were collected from different sources.



### **3.3.1 Sources of Primary Data**

The primary data were collected from the person representing from various sector conducting VAT. For the research study, the interview and discussion, field visit, interaction with taxpayers, Economists, tax Students, businessman and visit on Inland Revenue office etc.

### **3.3.2 Sources of Secondary Data**

The secondary data were collected through books, articles, magazines, newspaper and reports. The main sources of secondary data are:

- a) Published report, articles and research
- b) Published documents of National planning commission and Nepal Rastra Bank.
- c) Published report and seminar paper of industry and trade association.
- d) Publication of Inland Revenue department
- e) Publication of VAT project
- f) Budget speech as and economic survey of various fiscal years.
- g) Different Publications of central bureau of Statistics.
- h) World Bank reports
- i) Newspaper, magazines and journals.
- j) Various Websites
- k) Related other different books. etc.

### **3.4 Methods of Analysis**

This study was based in descriptive and analytical methods for the presentation and analysis of data. At the time of presentation and analysis of primary and secondary sources data, were edited and processed. Table, Graph, Diagram, simple percentages and time series analysis are used for the purpose of presentation and analysis of data.



## **CHAPTER -4**

### **THEORETICAL AND PRACTICAL ANALYSIS OF VAT**

#### **4.1 Concept**

Value added tax is a tax levied on value-added on goods and services by the business enterprises at the successive stage of production and distribution. Value added for a firm is the gross receipt from sales after subtracting all expenditure in good and services purchased from other firms. Looking from one angle value added by a firm is the sum total of incomes paid out by firm to factors employed and value is added by processing or handling these purchased items which its own labor force and its own machinery, building or other capital goods.

Clear concept can be attained through an example. Let's consider the case of sugar production. A farmer produces sugarcane and sells it to the miller. Miller adds value in the process of changing sugarcane into sugar. All the expenditure including profit made by the miller constitutes the value added of that miller. Miller sells his products that are sugar to the wholesaler who, in turn, sells to the retailer with an increasing value. Ultimately sugar is sold to the consumer with the some additional value. Thus, at each stage of production and distribution value is added and sum total of all sum value added exactly equals to the final sales value of the sugar.

VAT, like other sales taxes in classified as an indirect tax because it is paid by business firm to the government and shifted to the purchasers of the product rather than being collected directly by the government fro the purchases. Goods and services constitutes base of VAT and it is shifted forward to consumer. A basic characteristic of VAT is that deduction is permitted of tax paid on purchases of goods purchased for direct resale and material and parts physically incorporated in to good to be sold.

##### **4.1.1 Origin and Development**

Value added tax a recent innovation in the field of taxation, is being a major step in the process of tax reform in many countries in the world. Such



widespread popularity of the VAT in the last some years has become one of the most astonishing phenomena of public finance. The evolution of VAT is the most significant event in the history of commodity taxes and the speed with which the value added tax has spread around the world is unmatched by that of any other tax in modern time (shoup, 1988:139).

While going to the origin point of the VAT, it was proposed for the first time by Dr. Wilhelm von Siemens, for Germany in 1919 as an improved turnover tax. The improvement consisted in the subtraction of previous outlay from taxable save with the results that the tax base of each firm would be reduced to the value. This is added to the product. (Sullivan 19656:12). Thereafter in 1921, profit Thomas S. Adams suggested the tax for the United States of America to replace the existing corporate income tax. Further, some tax was recommended in 1949 by the Shoup Mission for the purpose of reconstructing the Japanese economy by avoiding the existing defects of the turnover taxes. Although, these proposal and recommendation were not came into practice.

Real practice of VAT started since 1954 in France; however it covered only the industrial sector and was designed only up to the wholesale level. After a gap of six years, Ivory Coast became first follower of France when it adopted VAT in 1960. Next African country, Senegal also implemented VAT since 1961. VAT in these both African countries, was limited to import and manufacturing stage only. Since the 1960s VAT become a popular subject matter of taxation in many countries in the year of 1968. France redesigned the existing VAT system and extended it to the retail level. Vietnam as the first country in Asia to introduce VAT, which adopted it in 1973, Pakistan introduction VAT in 1990 as a first among the SAARC countries. Nepal has adopted VAT since 1997.

As the experiences shows, VAT still has not become a perfect substitute for other taxes like excise duties, special consumption tax etc. So VAT has gaining a growing attraction in both the developed and developing countries. The countries adopting VAT are listed as following:



Year of the introduction	Name of the countries
1954	France
1960	Ivory Coast
1961	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, Nicaragua
1976	Honduras, Israel, Peru
1977	Korea, Panama
1980	Mexico
1982	Haiti
1983	Dominican Republic Guatemala
1984	China
1985	Indonesia, Turkey
1986	Morocco, New Zealand, Niger, Portugal, Spain, Taiwan
1987	Grenada, Greece
1988	Hungary, Philippines, Tunisia
1989	Japan, Malawi
1990	Iceland Kenya, Pakistan, Trinidad and Tobago
1991	Bangladesh, Benin, Canada, Jamaica, South Africa, Egypt.
1992	Algeria, Armenia Azerbaijan, Belarus, El Salvador, Estonia Fiji, Kazakhstan, Kirgiza Republic, Moldova, Russia, Tazilistan, Thailand, Turkmenisthan, Ukraine, Uzbekistan
1993	Burkina faso, Chez Republic, Mongolia, Paraguay, Prland, Rominia, Slovakai, Venezuela
1994	Bulgeria Finland, Lithuania, Singapore, Tanzania, Western Samoa, Madagas Car, Nigeria
1995	Gabon, Ghana, Shrilanka, Switzerland, Zambia Malta, Maurrania, Togo, Latvia



1996	Albania, Guyinea, Uganda
1997	Congo Republic, Nepal
1998	Croatia, Mongolia, Tanzania Bhanu Atu.
1999	Cambodia, Cameroon, Mozambique, Netherlands, Antilles, Papua New Guinea, Slovenia.
2000	Australia, Chad, Macedonia, Namibia, Sudan.
2001	Rwanda
2002	Lebanon.

Source: VAT project, 2002

#### **4.1.2 Preparation of VAT in Nepal**

In Nepal VAT preparation began in September 1993 when a VAT task force was created in order to make necessary preparation for the introduction of VAT. A VAT steering committee was also set up to evaluate and monitor VAT preparatory activities. The United States agency for international development (USAID) provided financial assistance in order to support the VAT preparation and implementation process in Nepal. Under this project, the technical assistance of the Hardware institute for International Development (HIID) began in the fall of 1993. Members of the VAT task force and the HIID consultants worked together. USAID/HIID assistance was supposed to last August 1996.

However, a change of government took place in late 1994 when a minority government was formed. The new government did not show the same commitment in the beginning to implement VAT. Consequently, the USAID activity was suspended at the beginning of 1995. The new government, however, kept the idea of VAT alive. This government appointed a tax system review task force in order to review the overall tax system and tax administration. The task force strongly recommended VAT for the rationalization of the Nepalese tax system. There was again a change in the government in late 1995 when a new coalition government was formed. This government decided introducing VAT at the earliest date, As a result, the USAID/HIID technical assistance resumed in February 1996 for a period of about 8 months. The USAID/HIID assistance was letter extended and



continued until the end of September 1997. Assistance for the implementation of the VAT was continued beyond September 1997 through financing provided by the Danish Government. The assistance of DANIDA's, was originally meant for 2 years, but still coming up with high enthusiasm.

#### **4.1.2 Design of VAT Law and VAT System**

The VAT law was drafted in 1994. It was discussed in depth at several stages with in the VAT task force with the efforts of the low reform commission and the various business groups. It was review by the VAT steering committee. The draft was sent various business groups including the Federation of commerce and industry (FNCCI) and Nepal chamber of commerce for their comments. While this was a good beginning to seek the opinion of the private sector on the proposed VAT law before its approval by the parliament in written comments were received from the private sector on the draft VAT act.

The VAT regulations were drafted in July 1996. Like the VAT Act, the regulations were discussed at different stages. They were sent to the FNCCI for comments. As in the case of VAT act, no comments were received from the private sector on the VAT regulations. Cabinet approved the regulations on 27 January 1997.

The operational manual was initially drafted in 1996 and was finalized in the fall of 1997. HMG approved the operational manual on 21 September 1997. The manual has been prepared in volumes, covering all aspects of VAT from the law through investigation of offenses. They are: (i) organization and management (ii) charging and accounting for value added tax (iii) VAT registration (iv) collection and enforcement (v) payment of claims for refunds (vi) verification and audit (vii) fraud investigation (viii) the VAT computer system and (ix) VAT act and rules.

#### **4.2 Types of VAT**

There are several bases to classify the different types of VAT. However, the classification of VAT on the basis of the treatment of capital goods is much



important. Considering the treatment of capital goods, the following classification has been made in broad sense.

#### **4.2.1 Consumption Types**

Under this type of VAT discrimination is done with respect to capital or consumable goods. Whatever is purchase for the use of business is treated at per. This implies that full credit of inputs is provided. It is indeed the most superior from the VAT and is universally practice. Since no discrimination between capital and other consumption is made this system is natural and does not lead to alternation or substitution between methods of production.

#### **4.2.2 Income type**

When capital goods used for methods of production are not deductible but only a portion relevant to particular period is allowed to deduct and the remaining portion is carried over for the next period, then it is termed as income types of VAT. Under this method the capital equipment are divided over a period on the basis of their useful life. Such methods are called depreciation. Since the tax base equals to Private personal income under this method, it is called as income type of VAT. This type of VAT is fraught with some difficulties as well face in calculating income for a particular period. AS a result many countries do not practice these types of VAT.

#### **4.2.3 Gross Product Type**

Under this variant, Capital goods purchased by a firm from other firms are not deductible from the tax base in the purchases year. This variant does not allow the deduction of deprecation from the tax base in subsequent years either. Hence the tax is levied both on consumption and gross investment and the conceptual tax base of this variant is gross domestic products. Here the principle of neutrality of tax is defected that is why; of all the types this is the uncommon and rarely practiced in any country.

Among these three types of VAT, the consumption variant has been widely used in several countries in Europe and else where in recent years. The reasons



for the popularity of this type are that this variant does not affect decisions regarding investments and growth since it relieves investment from any tax burden.

### **4.3 Methods of Calculating VAT**

There are three basic methods by which VAT can be -calculated:

#### **4.3.1 Additional Method**

Under this method value added is the total sum of the factor payments made by the business firms, which is equivalent to the gross income received by the factors of production. The tax base is computed by adding the payments made by the firms to factors of productions employed in turning out the product, such as wages, interest, rent, royalties and profits. Thus, VAT under additional method is the function of the total factor payment as given by:

$$\text{VAT} = f(W+R+I+P)$$

Where,

W = wage,

R = rent

I = interest,

p = profit

#### **4.3.2 Subtraction Method**

Under this method value added is determined as net turnover which is obtained by subtracting the cost of materials from sales proceeds and the procedure was used in the Michigan VAT. Value added is obtained by subtracting purchase of produced goods from the figure of sales during the period, as given in the functional form by,

$$\text{VAT} = f(S_v - P_v)$$

Where,

$S_v$  = Sales value

$P_v$  = purchase value



This method of calculating VAT is suitable for the consumption variant of VAT. It is not well suited for discrimination among types of consumer goods but it needs not any adjustment to operate correctly for imports under the origin principle. Some thing also happens to the addition methods. However, under the destination principle, these principles, these both methods of direct calculation can not supply the information needed to compute precisely the export rebate or the import compensating tax when there is not uniform rate to all stages of value added of all goods and services.

#### **4.3.3 Tax Credit Methods**

Tax credit method is also known as the invoice method and uses an indirect subtraction technique to compute the tax liability. Value added as such never calculated at all. In this method, but the effect is exactly the same as if the figure was calculated and the tax rate applied. Since, the firm deducts the amount of the tax paid on its purchases during the period from the figure calculated by applying the tax rate to its figure of taxable sales for the period. Under this method taxpayers are allowed to subtract the taxes already paid by the supplier and passed on to them from the gross tax liability, which is levied on the total value of their sales. Thus, in contrast to the subtraction method, which deducts purchases from sales and levies taxes on the difference, tax on purchases is subtracted form the tax on sales under the tax credit method.

Hence net tax liability is given by:

$$\text{VAT} = f (\text{Outputs} - \text{Inputs})$$

Where,

Outputs= tax collection from sales

Inputs = tax paid on purchases

Among the above three method of computing VAT, the tax credit method is widely favored in the countries. The invoice method is used generally in European countries. The tax credit method is so superior to the other method in terms of application and enforcement as well as adaptability to various rates modification that is now universally employed. The methods of calculating VAT liability under the different methods are shown in the table below:



**Table No. 4.1**  
**Calculation of VAT liability by different methods (13% VAT)**

Figures in Rs.

	Stage of production and distribution			Total
<b>A. Addition method</b>				
(a) Wages	15000	25000	10000	50000
(b) Rent	5000	3000	2000	10000
(c) Interest	3000	2500	1500	7000
(d) Profit	1000	1500	500	3000
(e) Value added (a+b+c+d)				
(f) VAT liability (13% of e)	24000	32000	14000	70000
	3120	4160	1820	9100
<b>B. Subtract Method</b>				
(a) Sales	40000	30000	30000	100000
(b) Purchases	30000	25000	25000	80000
(c) Value added (a-b)	10000	5000	5000	20000
(d) VAT liability (13% of c)				
	1300	650	650	2600
<b>C. Tax credit method</b>				
(a) Sales	60000	40000	25000	125000
(b) Tax on sales (@13%)	7800	5200	3250	16250
(c) Purchases	50000	35000	20000	105000
(d) Tax on purchases (@13%)	6500	4550	2600	13650
(e) Net VAT liability (b-d)	1300	650	650	2600

Note: All sales and purchases are exclusive of tax and the figures are assumed.

Among three methods, the tax credit method is much better than other. It has following major benefits over the other two types of VAT computation. (i) In the tax credit method, tax liability is attached to transaction that makes it legally and technically superior. (ii) Tax Collection is easy (iii) cross checking is possible, (iv) It provides the benefits catch up effect that makes under



evaluation and tax evasion impossible (v) there will be no loss of revenue due to the exemptions granted to the small traders (vi) It never demands for the calculation of value-added total tax (vii) Liability entirely depends on the rate on the last stage, so rate differentiation is possible for the same revenue yields. Calculation of VAT liability under tax credit method is described in detail below:

**Table No. 4.2**  
**Calculation of VAT liabilities by tax credit method**  
**(VAT rate 13%)** In Rs. thousand

	Stages of production and distribution			
Particular	Farmer	Manufacturer	Wholesaler	Retailer
Type of production	Sugarcane	Sugar	Sugar	Sugar
(a) Purchase	0	200	400	400
(b) VAT paid on purchase	0	26	52	58.5
(c) Sales value	200	400	450	510
(d) Gross VAT liability on sales (@ 13% on (d))	26	52	58.5	66.3
(e) Net VAT liability (d-b) or VAT paid in each stage	(26-0)=26	(52-26)=26	(58.5-52)=6.5	(66.3-58.5) = 7.8
Actual sales price	226	452	508.5	576.3

Note: Figure is estimated arbitrarily and both the sales and purchase value exclude tax liability.

Here, for the sake of simplicity, the purchase value of the farmer is assumed zero as shown in the table 4.2 Each seller calculates the gross tax liability by applying the given tax rate to his sales value and then gets net VAT liability by subtracting the amount of VAT liability paid by the seller at different stages equals to the gross VAT liability on sales with the same VAT rate, so far as tax credit chain is not broken. Unlike the remaining two methods, there will be no change in total VAT liability two methods in the tax credit method, there will be no change in total VAT liability by the rate differentiation in earlier stages.



## **4.4 Principles of VAT**

There are two principles in the case of international trade under the VAT system. One is taxing all domestically produced goods and services including exported and exempting imported and second is taxing all imported good and exempting all exported goods and other principles are as follows :

### **4.4.1 Origin Principle**

Under this principle, goods and services produced in a country are taxed at the place where they are produced or rendered, irrespective of whether they are consumed there or not. It implies that all exports are taxable and all imports are non-taxable. Where there is border and Cross-country trade this principle gives preference to imported goods services over domestic production. Countries with international boundaries prefer not to have this principle while taxing.

### **4.4.2 Destination Principle**

Under this principle, goods and services are not taxed at the place where they are produced or rendered. The tax is imposed at the place where they are actually consumed. Alternatively all imports are taxed while all kinds of exports are tax-exempt. The main benefit of this principle is that, it non-discriminate between import and internal production. This is the most popular form of principle adopted by a large of countries. This lends support for exportation, many countries are eager to boast export therefore they follow this principle. The equal treatment provided for imports and domestic production fulfills the criterion of tax criterion of tax being neutral.

## **4.5 Tax Inclusive Versus Tax-Exclusive Prices**

There are two alternative ways of applying the tax rates on prices. The tax may be applied to the figure of sales exclusive of tax or inclusive of tax. If the tax rate is applied to the figure, after fixing the price of the product at first, the method is called the tax-exclusive price. However, separate requirement of tax statement and the price of the product are not essential. But the tax-inclusive price requires the application of the tax rate to the whole figure and further is



demanding the amount of tax itself into the tax base again. For example, with 20 percent tax rate. The tax on an item selling for Rs.100 net of tax will be Rs. 20 (before deducting tax paid on purchases) with the tax inclusive method.

The tax exclusive method has a great advantage of simplicity and greater ease in forward shifting of the exact amount of tax. The effective tax rate is clearly revealed. The inclusive method is confusing and has no possible merit, except to yield more revenue at a given normal tax rate. However, it neglects basically on the ground of administrative difficulty.

#### **4.6 Value Added Tax and Other Sales Taxes:**

VAT is a modern and scientific tax, then other form of sales tax. VAT is compared with other form tax as follows:

##### **4.6.1 Value Added Tax and Turnover Tax:**

Turnover tax is a form of sales tax, which applies to the selling price of each point of sale. In this sense a turnover tax is the multiple stage cascade tax. This means the effective tax rate applies to all stage of production and distribution. This tax offers mainly two advantages: (a) A low tax necessity for given sum of revenue (ii) there is no complication of concession for various types of firms. Under this system tax evasion may arise because there is possibility of vertical integration. Such integration distorts the economy. This effect of tax is reducing economic efficiency which is the worst level of the tax.

A turnover tax further discriminates against the domestic product and imported goods. Imported goods need to pass less stages of transaction if the goods are finished products. On the contrary domestic products need to pass many stages of production and transaction. Turnover tax applies to the total volume of transaction of the product at each stage of production and distribution; it creates a strong incentive for reducing the economic activities at earlier stages like performing many activities of producing and distribution under a single roof. There will not be any incentives for integration in a VAT system, since the total amount of tax on the product will be the same in the production and distribution system and the taxable price is always equal to the final price of the product. Thus from the view point of neutrality VAT is so far superior to the turnover tax.



The turnover tax is comparatively easy to administer as it applies only on gross so that there is no need of tax credit. The double-checking and several provisions associate with the VAT create complicity however makes the tax system transparent, efficient and equitable.

Comparative easiness and simplicity also can be found in turnover tax in the viewpoint of tax compliance. But due to the self-enforcing feature of VAT, it is more attractive to check the tax evasion. An uneven burden is also created on various commodities by turnover tax and further the burden varies with the typical number of transaction through which a commodity passes on its way to the final consumer.

#### **4.6.2 VAT and Manufacture's Sales Tax (MST)**

Manufactures sales tax (MST) basically covers domestic manufacturing as well as imports. This is a single stage levy. In practice manufactures and importers are required to register for sales tax purpose. Generally this type of tax is applied on sales in case of domestic product and on the import value in the case of imported goods. These types of tax is favored in many developing countries in the sense that it more or less avoids the cascade evil and covers more organized entrepreneurs so as to make administration easy.

In contrast, VAT avoids cascading and pyramiding effects. It does not have a negative impose on negative impact on economic growth. The tax burden also falls stepwise under a VAT system, rather than at once in an import level of sales tax. The stepwise burden would not disport economic sectors. So, they will not encourage evading tax. But if, burden is laid down at once, a very high load will depress the entrepreneurs so as in creating the tax evasion. From the above discussion we can conclude that MST is non-neutral, limited in base and encouraging various difficulties with the culmination of tax evasion. VAT proves advantageous over MST, that it has broad coverage equipped with catch up effects, eliminating cascading and pyramiding and desirable in developing countries because it is distrusted roughly according to consumer expenditure. The main disadvantage, coherent to VAT, in comparison to MST, is the large number of taxpayer with poor record keeping. But it can be covered by means of improvement in administration.



#### **4.6.3 VAT and Wholesale Level Sales Tax (WST)**

Simply speaking, the wholesale level sales tax (WST) means the taxation on sales to retailers by wholesaler. In underdeveloped country, wholesalers are more organized than the producers and retailers. Thus it is easy to implementing in practice and more meritorious than MST in the sense that it covers value added by wholesalers. Wholesaling goods are carried directly from producers or importers. But in many countries, there is no provision of separately registers. Making the provision of separate registered as domestic enterprises and imports can enlarge the volume of taxable base. Which makes WST more suitable too? As a theme WST can be levied in two ways i.e. WST impose on wholesale enterprise and accompanies with manufacturing or retail system. On the ground of revenue potentiality, Value added tax provides more revenue than WST but as compared with MST, wholesaling enterprises lie some how greater than MST compared to VAT. For the administrative formalities like calculating tax base cross checking and auditing, refund procedures etc are less under the WST system. Further more, WST is easy to handle since it needs only to watch on sales point of wholesalers. On the basis of this reasoning WST is argued to be superior. The inclusion of new items i.e basic necessities would make VAT more vertically inequitable than MST and WST as it will be levied at uniform rate however, the imposition of VAT on services. Which the higher income group largely consumes would have opposite effect. Despite these few merits of WST, we cannot ignore the contradictory and bad effect of WST in practice, which puts the demerits of VAT, is shadow. If manufactures or importers encourage direct sell to retailers or consumers then the revenue will be nil. The problems should be more serious when for the two kinds of goods having same qualities and price whereas distribution process is different. Suppose one commodity (say A) supplied from producer to wholesaler and wholesaler to retailer successively but the other commodity (say B) is supplied directly from producer to retailer or to consumer, then definitely the price of 'B' becomes for below than 'A' due to the WST. In this case, the commodity 'B' cannot complete with 'A' in the market. Such a vast alternation compels the producer of commodity 'A' to close down his production. Thus WST is on neutral among the production and distribution process as well as consumer choices. But in contrast, it is notable



that VAT does not create such discrimination because VAT is levied in every stage of business process.

Thus, WST encourages manufactures or importer to sell directly to the retailers so that product remains beyond the tax net. This results a loss in the revenue on the other hand, it discriminates against those products by means of competitive advantage, which bear the tax burden favoring those firms, and product, which do not bear the tax burden. In contrast, VAT does not create such discriminations since it is levied at every stage of production and distribution and tax evasion is also more difficult. Thus VAT is neutral among the process of production and distribution.

#### **4.6.4 VAT and Retailer's Sales Tax (RST)**

VAT and RST are acceptable on theoretical grounds because both are identical in the sense of tax base. Both differ in tax collecting techniques in which VAT is collected at each stage of business process while RST is imposed only at the final stage. Each system provides the same amount of revenue because total value added of final goods and services are same and both are principally the destination based consumption type.

From the administrative point of view RST seems to be simple as compared with VAT because their records and audit are sufficient on keeping the single stage. And the number of taxpayer remains more under VAT than RST. RST based on the suspension principal in which tax retailers are required to register for the sales tax purchase. Thus it is meant that the RST is levied only on the sales, which is registered to sale the consumer.

VAT and RST are vertically neutral with respect to production and distribution as total tax on a given commodity depends on the final price under both systems. On the other hand VAT and RST both are able to avoid the problem of cascading effects since there is no possibility to impose on tax. Both taxes avoid the problem of pyramiding since there seems no need to apply the mark-up on the tax amount levied at earlier stages. So, consumer price increase only by the amount of tax.



RST is more vulnerable to tax evasion than VAT. RST places a heavy burden only at the retail stage. Under this tax system, the whole tax is imposed at single stage (i.e. retail level). If a retailer does not file his return under the VAT, tax collection is dispersed over the whole production and distribution process. Thus the tax burden is distributed among a large number of taxpayer who feels it less burden

some as compared to RST. VAT provides a self-policy mechanism, which is not available under RST VAT also provides a more complete audit trail than RST. As a conclusion, we can say that VAT is more preferred in developing countries but it required efficient tax administration.

## **4.7 Operation of VAT**

For effective implementation of VAT, the following provisions are needed:

### **4.7.1 Registration**

This is the first step for the smoothly operation of VAT. The registration of firms subject to the tax is a master roll of taxpayers. In this process, all the venders having a taxable business turnover are compulsory registered on VAT. Any business enterprises that have not compulsion for registration, if they desire to register can register voluntarily. However, there is no compulsion to register for the small vendors who have an annual turnover below the threshold.

The registration procedure starts with a notice to the potential taxpayers through extensive publicity campaign. Then the registration forms and distributed so that the vender will fill up to be a formal member of the taxpayer under the VAT system. Then the registration form is returned back to the Inland Revenue Department and their coding is made. Thus registered taxpayers may be unknown about VAT in detail. So, an informative visits needs to be made and check detail whether the provided information by the taxpayers are correct or not.

Although all the venders having the transaction of taxable capacity may not be registered so it is almost essential to make a door-to-door check, especially in developing countries. The newly hired staff of inspectors and enforcement



officers can be used for this purpose and strongly monitoring and supervision is also required. In the Nepalese VAT system small vendors having annual turnover below the threshold apply for voluntary registration and the Inland Revenue office.

If tax officer is satisfied about applicants may register them for VAT purpose. Like other registered vendors, who are registered voluntarily will be able to claim back input tax paid on their purchases, to collect VAT on their sales, to hold the collected tax until the date of its payment to the concerned tax offices. The tax-registered vendors should get a VAT registration certificate, which must be prominently displayed in the public area of his business.

It is being very difficult to know which of trader is legal taxpayers and liable to register under the VAT. There is no strong evidence to show that one should register and tax administration can't compel that one should register without any record. Trend of VAT registration in Nepal, is shown in table below:

**Table No. 4.3**  
**Trend of VAT registration**

Year	No. Of Taxpayers	Increasing rate in (%)
2055 Ashad	4959	-
2056 Ashad	9082	82.64
2057 Ashad	17947	86.13
2058 Ashad	21093	17.53
2059 Ashad	25147	19.23
2060 Ashad	29872	18.78
2061 Ashad	34174	14.40
2062 Ashad	39776	16.39
2063 Ashad	46831	17.13
2064 Ashad	52965	13.10
Average growth rate in 9 years		42.81

Source: Inland Revenue Department (annual Report 2063/064)

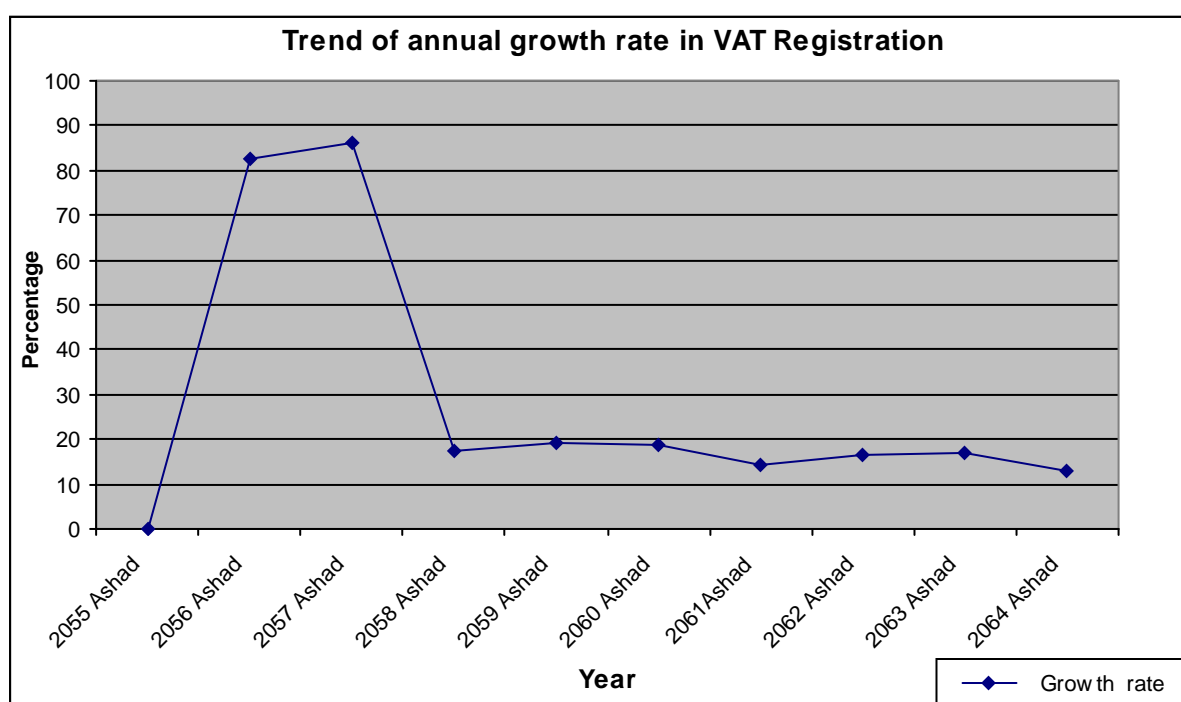
Above table depicts that in initial stage of VAT introducing, the growth rate of VAT registration is high but for the time being the rate is reduced.



In the past nine years average growth rate is 42.81percent. In late years the growth rate can't move up 20 percent above. Until Potential taxpayers could not tie up with tax net.

Effective monitoring and supervision is still required to expand the tax base. Trend of annual growth in VAT registration can be clearly shown in graph below:

**Figure No.4.1**  
**Trend of VAT Registration**



#### 4.7.2 Tax invoice

The tax invoice is a crucial document for VAT as it established the seller liability for tax and purchaser's entitlement to credit. A VAT registrant is required to issue a tax invoice whenever a transaction takes place. Invoices are the important documents for VAT control. There are two types of invoices; (i) tax invoices and (ii) abbreviated invoice.

Tax invoices established both the liability of the supplier and the amount of the deduction allowed to the registered purchaser. A VAT registrant is required to issue a tax invoice in the prescribed form whenever a transaction takes place. Only VAT registrants' taxpayers should issue a tax invoice. A minimum of



three copies of each invoice must be prepared. The first copy must be given to the buyer and the vender must retain the remaining two copies. A tax officer must make these available at all reasonable times for inspection. The invoice must be used in sequential numerical order. However, they can prepare invoices with different serial numbers for branches or different sections with prior approval of the VAT office.

The abbreviated invoice is simple type of invoice for registered sales to unregistered persons, who should be considered final consumer under the VAT. VAT registrants may make an application to use abbreviated invoice and the tax officers may allow it use. In the case of sales under abbreviated invoice, VAT is calculated by multiplying the sales by the VAT quotient. The VAT quotient is found by dividing the rate of VAT. The abbreviated invoice can issue up to 5 thousand transactions. There is restriction to cross the limit.

#### **4.7.3 Accounting**

Every VAT registered vender should be kept clear account of his activities (purchases and sales), which come into VAT base. The record of all invoices including other information such as the serial number and date of issue, of invoices the amount charges, and the VAT charged. The account should be kept in such a way that the VAT authorities are able to check the accuracy of VAT returns. Such records are kept for 4 to 6 years. So that it can be provided the tax administration if asked to check its accuracy and fairness. The period relating to the preservation of the account depends on internal audit. VAT liability should be calculated accordingly VAT account. This is, because if it is levied only on the cash basis, Taxpayers might delay payment. Small venders, public or local bodies and not profit making organization, however, may be allowed to account for their output tax input tax only upon receipt or payment.

Account system can be made simple and clear by using a separate purchase book to record all the details of purchases and a separate sales book, which records all the details of sales. However in case of the details of sales. However in case of the small venders the cash flow problems can be made simple by allowing accounting for their output tax and input tax only upon receipt or payment. Government can also provide a form for the accounting purpose to



the vendors. It is undesirable to prescribe exact form because record systems differ significantly among the various types of businesses.

#### **4.7.4 Submission of Return**

Nepalese VAT system, taxpayers must complete a VAT return and submit their returns to the concerned Inland revenue office within 25 days of the month following the end of the accounting period, this is for the use of compulsory registrants, and four months for voluntary registrants. The head office is required to submit tax returns for the transaction carried out by it and its branches and sub-branches if any. There are no special rules, for example for seasonal business. Even if there is no transaction, it is necessary to submit a zero return. On receipt of a VAT return, the tax officer is required to examine the return and check for arithmetical accuracy of this confirms that the amount shown, as payable and other particulars on the return are correct, the return is to be accepted. There is no need to attach purchase and sales invoices or any other document relating to the tax with the return. Returns can be classified in 3 categories. They are;

**(i) Debit Return:**

Debit return are those return where taxpayer have to pay tax to the government.

**(ii) Credit Return:**

In credit return, collected VAT on sales is greater than payment of VAT on purchase. In this case, VAT is refunded to taxpayer.

**(iii) Zero Return:**

Similarly, collected VAT on sales is equal with payment of VAT on purchase or there is no any transaction.

If a taxpayer doesn't submit a return within the stipulated time, he will be subject to penalty of 0.05% of payable tax per day or Rs.500 whichever is higher. In below table, trend of tax submission is clearly shown.



Table No. 4.4  
Submission of tax Return

Year	No. of taxpayer	<i>Submission of Return</i>					Not Submission	
		Total (No.)	Dr. (%)	Cr. (%)	Zero (%)	Total (%)	Number (No)	p.c. (%)
2057 Ashad	17947	17271	34.90	44.97	20.12	96.21	676	3.79
2058 Ashad	21093	19710	35.95	41.86	22.68	93.28	1383	6.72
2059 Ashad	25147	21473	32.30	41.19	24.25	84.82	3676	15.18
2060 Ashad	29872	23099	31.06	41.36	25.85	82.41	5255	17.59
2061 Ashad	34174	25049	33.87	38.42	27.08	78.57	7322	21.43
2062 Ashad	39776	28525	33.20	36.00	29.00	77.04	8492	22.96
2063 Ashad	46831	33633	31.06	38.17	30.14	78.73	13198	21.63
2064 Ashad	52965	36457	31.43	37.29	30.29	85.42	7098	14.58

Source: Annual Reports (2063/064), Inland Revenue Department

In above table implies that initial stage of introducing VAT, percentage of submission is high but in recent year the trend is gradually reduced. It is a signal of indiscipline and ignorance of law. There is a need of regular monitoring and supervision. Reward and Punishment is also required.

#### **4.7.5 Payment of tax**

In the Nepalese VAT system, if a registrant output tax liability is greater than his input tax credit, he is required to remit the difference to the government with in 25 days form the close of the month in which the tax liability occurs. Compulsory registrants have to pay tax monthly while the voluntary registrant



will have to pay trimester basic. On the other hand, if input credit is greater than the output tax liability, the balance of credit is to be forward up to a six-month period. The excess credit for a continuous period of six month should be refunded to the vender concerned with in refunded to the vender concerned with a month for date of submission of the return. If the VAT registrant has more than 60% of his sales as exports, he can apply for a refund instead of carrying forward of excess credit. In the above both cases the VAT office should pay 15% interests, if the Tax officer doesn't refund with in two month form the date of submission of appeal of the return.

The VAT act makes provision for the additional charge as the late payment penalties. The rate of penalties is 10% of the VAT payable first month, and additional 10% in the second month and then no further action is taken. There is also a provision for interest on non-payment. The current rate of interest is 15% interest on overdue VAT is charge on calendar month basic.

#### **4.7.6 Tax Assessment**

VAT is self-assessment tax. The taxpayers determined their liability and pay tax. This system a taxpayer determines his tax liability and files his return to the Inland Revenue office. However, not all taxpayers may file their return and pay tax with in the specified time. Similarly not all taxpayers may file the correct return and pay the correct return and pay the correct amount of tax. In such cases, Tax officials may have to make a tax assessment. Such assessment could be computer or management assessment.

#### **4.7.7 VAT Enforcement**

Enforcement of VAT is one of the major requirements for successful operation of VAT. VAT system can be found more equitable along with the restriction for tax evasion when the enforcement of VAT is effective. For the purpose of VAT enforcement various techniques have been developed and used. The most important is the requirement of adequate account keeping and preserving it for a long time and administrative power to review to inquiry, size and check the records in the cases of suspected fraud. Tax officials can enter and search the business premises. In addition those, the tax liability of a VAT payer when they



tax liability or when return are not presented at all. Further, a system is developing for ascertaining failure to file and pay. The system is easier through master file management and use of computer programmers. The delinquents are persuaded to pay through notices and visit, If they sill delay with them. Such measures include automatic penalties, different changes and action including legal action.

#### **4.7.8 Penalties**

Penalties play the important role for effective operation of VAT. Actually penalties are designed to punish the taxpayers who are not following the legal rule. Penalties are considered essential as they create an incentive to tax payers to deter evasion and non-compliance for smooth functioning and producing a full revenue potential of a VAT system. However penalty taxes became inequitable if they are imposed heavily on some defaulters but not on others, so all defaulters should treat equally.

The penalties have divided into four forms: automatic financial, automatic non-financial, criminal financial and non-financial. Some other typical devices for penalties are attachment of bank account, revocation of business certificate, seizure of property shut down of premises, temporary suspension of trading license, threat of imprisonment, criminal prosecution etc." (Alan a Tait 1998:3 19)

#### **4.7.9 Auditing**

The purpose of the audit is to find out, according to the law and regulation, the actual VAT liability of the taxpayers. Auditing in VAT system is a selective review of the taxpayer's books of accounts and other records including balance sheet profit and loss accounts. Main cause of auditing is to be ensured that the major areas of purchases, sales, stock and profit or loss accounts are substantially correct or not. The purpose of VAT audit is to find out actual VAT liability of the taxpayer's. A VAT audit, which is based on the principle of self-assessment by taxpayers, may be integrated with that of income tax. However the intergraded audit is more desirable and popular. The types of a VAT audit can divide into field audit and office audit, where the former include advisory visit, verification of records and fraud investigation and the latter



includes desk audit checking the return for arithmetical accuracy and completeness. The office audit is desirable to check each return for probable accuracy, as a basis for selecting account for audit.

Several activities and steps; which appear in performing the audit, are included in the audit management. Generally the audit management activities includes (Sharma, 1997:40) :

- a) Searching of the taxpayers who fail to register and file the return.
- b) Reviewing the tax returns, checking the conformity of calculation and verifying the data inputs, outputs, zero-rated goods and exemptions.
- c) Selecting the business unit for audit through the establishment of appropriate selection criteria and accounting to the audit capacity of the administration.
- d) Preparation for audit and audit result for further decision-making and auditors, allocation of tasks among inspectors and auditors, audit manuals etc.

#### **4.7.10 Computerization**

This is an age information technology. Computer is an integral part of information technology. Computerization is an essential element of VAT operation for efficient monitoring administering and controlling departmental policies. Modern tax system is highly demanded efficient administration efforts. The need is fulfilled by computer technology. So, computerization may be considered as an essential and accompanying component in VAT operation. Thus, regardless of their exact form computer performs several functions. Computerization makes it possible to select suspect cases for audit, which would be very different to so manually. Similarly, default, non-filers and non-payers considering this a comprehensive computerization system have been developed in Nepal.

#### **4.8 Structure of VAT**

The structure of Nepalese VAT is designed in VAT Act 1996. The main characteristic of Nepalese VAT is as follows:



### **4.8.1 Coverage**

It is not possible to cover all the goods and services under tax but it is desirable to make the commodity coverage of VAT as broad as possible. The coverage of VAT is defined with respect to both taxable transaction and persons. Each person transaction should be liable to VAT. The term "person" is defined broadly to include besides a natural person, all form of business including partnership, Corporation, co-operatives, government and local bodies, and other organization regardless of whether there is a profit motive or not. Nepal has adopted a broad based consumption type of VAT, using tax credit methods. Under this system, the tax is levied all types of goods and services, both imported and domestically produced; except those specifically exempted by law.

Tax exempt goods and services are broadly be classified as; basic needs, basic agriculture products, agriculture inputs, social welfare services, goods and services of educational and culture goods and services, personal services purchase and rent of land and building, financial and insurance services, postage and revenue stamps.

VAT is extended right through the retail level. It is levied on the value added by each by each firm at each stage in the production and distribution process. However the small traders whose annual turnover is below the registration threshold are not required to register for VAT.

### **4.8.2 Operation**

The base of VAT is the value added by each firm through its production and distribution activities. The value added is not calculated directly but the exact result obtained by levying tax on total sales and deducting tax on purchases from tax on sales. For example, let us suppose that a wheat producer sells to miller a quintal at Rs 700. The miller sells wheat floor to the dealer at Rs.2400. Finally, the dealer sells it to consumer at Rs.3000. On the basis of these figure, VAT will be levied in the following manner.



Table No. 4.5  
Operation of VAT

Production and Distribution stages	Purchase price	Selling prices	Value added	Output tax collected on sales	Input tax (tax paid on purchased imported)	VAT payable to gov.
Farmer to Miller	-	2000	2000	260	0	$260-0=260$
Miller to Dealer	2000	2400	400	312	260	$312-260=52$
Dealer to consumer	2400	3000	600	390	312	$390-312=78$
Total VAT paid to Government						390

For the above calculation, Applicable VAT rate is 13%, the farmer collects Rs 260 as VAT on his sales and pays it to the treasury. The miller collects VAT of Rs 312 on his sales but has on input tax credit of Rs 260 and thus remits Rs 52 to the government. Finally, the dealer collects VAT of Rs. 390 but deducts his input tax of Rs 312 and remits the balance of Rs.78 to the government account. Thus the government gets Total revenue of  $(260+52+78)$  Rs. 390.

#### 4.8.3 Input Tax Credit

Tax credit is one of the important features of VAT. Taxpayers are allowed to deduct their input tax from their output tax. In other words a taxpayer is allowed to deduct tax paid on purchases from the tax collected on sales for his business. This deduction is known as input tax credit. Input tax credit includes the tax paid on the purchases or import of raw materials, semi -processed goods and overhead that they are used to make taxable good or services.

#### 4.8.4 Tax Rate

The Nepalese VAT will be levied at single positive rate, in order to make the VAT system easier and simple. This is because, the multiple rates makes tax administration more complicated and there is need to classify records of commodities and have to supply more information which preparing their tax



returns resulting in higher burden on the businessman and tax administration. Moreover in a developing country like Nepal, many small traders who are not sufficiently literate sell a number of commodities. They are not able to apply properly the different rate to various goods they sell. So in Nepal, VAT has levied at a single positive rate. The rate will be fixed by the finance etc. In past the rate was 10%. This rate is remained unchanged until 10 years (from 1996 to 2006). Since January 2006, the rate of VAT is charged by 13 % at a single positive rate. Exports are subjects to a rate of zero percent.

#### **4.8.5 Exemption versus Zero Rating**

Exemption means an exclusion of a certain kinds of goods and services from the tax net. In Nepal, basic needs goods, and services, basic agriculture products, agriculture inputs, social welfare services, educational and culture goods and services, personal services purchase and rent of land and building, financial and insurance services, postage and revenue stamps are tax- exempt. These are tax-free goods and services. Neither tax is collected from sales nor payment of tax on purchase. There is no facility of tax credit on the transaction of mentioned goods and services.

Zero rating means a zero percent tax on goods and serves. Under the current VAT act exported goods and services are zero-rated. The trader supplying zero rated good and services is entitled to recover the net tax paid on his purchases used to make a zero rated supply. Main objective of Zero-rating is to promote specific goods and Services (e.g. exports), to give facilities for some person (e.g. tourist). But these goods and services are taxed for another purpose or person at prescribed rate.

On other hand, in the case of the dealer dealing with exempt good and services, VAT is not levied on his sales and there is not entitled to a credit for VAT paid on his purchase or imports. An exemption is generally granted, if it is desirable to exclude a particular product to transaction on administration ground; i.e. traders having an annual turnover below the threshold are exempt. Such traders are not collect VAT on their sales. As tax-exempt traders they are not entitled to the input tax credit but in Zero -rating provision person has enjoyed this facility.



#### **4.8.6 Tax Refund**

Under the Nepalese VAT system, there is a provision for the refund of VAT. Such a situation will generally arise in the case of zero rated goods. I.e. exports where there will be an excess of inputs tax over output tax such a provision is made to encourage exports and generate foreign exchange. The possibility of tax refund will also arise in the case of domestic sales if the excess of input tax over output tax is reported in each of six consecutive methods.

#### **4.8.7 Threshold**

Relating to simplification of the VAT administration, many countries provide a threshold level even for taxable supply. A threshold would keep of trades from VAT who sells below the prescribed level. The only major difference between exemption and threshold is that, a threshold applies to taxable supply and more often that not there is an option to register voluntarily in the VAT where as, under exemption, registration is out of question. So, any one sells below a level of threshold, if gets in to the VAT voluntarily he/she would be getting an equal treatment to other registered taxpayer. Many countries even provide extra privilege for voluntary registration.

In case of Nepal, small traders whose annual turnover is below a certain level are not required to register on VAT. The level of the threshold varies from country to country depending up in the revenue requirement, administrative capability, level of record and accounting proficiency in the industry and business etc. Section I of the VAT Act 1995 has made a provision for setting a threshold limit and initially the level was fixed by VAT regulation. Later, this threshold level was raised to Rs 2 million by Economic Act 2054.

### **4.9 An overview of Value Added Tax in Nepal**

#### **4.9.1 Introduction**

In Nepal, **Value Added Tax (VAT)** was introduced on 16 Nov. 1997. This tax was levied in place of the Sales Tax, Hotel Tax, Contract Tax and



Entertainment Tax. However, it could not be implemented fully until the FY 1998/99 due to political instability and strong opposition from the business community.

VAT replaces the old Sales Tax, Contract Tax, Hotel Tax and Entertainment Tax. It has been designed to collect the same revenue as the four taxes it replaced. Since the collection of both customs duties and income tax depends, to a great extent, upon the effectiveness of VAT, it is expected to help enhance revenue collection (VAT) is a broad-based tax as it also covers the value added to each commodity by a firm during all stages of production and distribution.

It is a modern tax system to improve the collection of taxes, to increase efficiency and to lessen tax evasion. It is also regarded as the backbone of income tax system in Nepal. The current threshold for VAT registration is Rs.2 million. Those vendors whose annual turnover is below the threshold can however register voluntarily.

There is a persistent increase in the number of VAT registrants. IT has crossed the 40,000 mark. At the time of conversion from the then existing sales tax to VAT, a total of 2045 taxpayers were converted as VAT registrants. As the taxpayers are increasing, the amount of revenue collection and the level of tax compliance are improving today.

#### **4.9.2 Methods of Tax imposed**

VAT is a tax imposed on the value added to goods and services consumed in Nepal or exported outside. The tax is based on the principle that each producer or distributor adds value, in some way, to the materials they have purchased and it is this added value that is taxed at each stage of the production and distribution chain. There is the presumption that VAT is shifted forward completely to the Consumer.

In the VAT system, producers, distributors and people providing services raise VAT on the products value, in some way, to the materials they have purchased and it is this added value that is taxed at each stage of the



production and distribution chain. There is the presumption that VAT is shifted forward completely to the Consumer.

In the VAT system, producers, distributors and people providing services raise VAT on the products or services sold or provided. The difference between the VAT collected on sales and the VAT charged on purchases determines the amount a registrant must remit or the amount that may be claimed as a refunding other words, if the tax on sales is more than the tax on purchases, the dealer / businessman remits the difference. If the tax on sales is less than the tax on purchases, the dealer may carry forward this credit to the next month.

#### **4.9.3 An in put tax credit**

Registered businessmen are obliged to collect and remit VAT on their taxable transactions. These registrants are entitled to recover the tax paid on their purchases. This recovery or refund is known as input tax credit. The Input Tax Credit (ITC) is the total of the tax paid or payable on taxable goods and services purchased in Nepal, and the tax paid on taxable goods imported into Nepal. Where VAT is paid or payable by a registrant on a purchase or on imports, the registrant is allowed to claim input tax credit for those purchases made by the registrant in his commercial activities.

However, even though the purchase of goods or services may relate in part to a commercial activity, in certain circumstances the purchase may not generate input tax credit entitlement when he sells goods or services, which are tax-exempt.

Most registrants are entitled to claim input tax credits for the tax paid on acquisitions capital goods for use primarily in commercial activities. Unlike the income tax deduction rules, the input tax credit for any VAT paid on capital goods is not amortized over the life of the asset. It can be claimed in full in the period in which it is acquired. If the capital goods are later put to a non-commercial use, special change-of-use rules will apply. Taxpayers whose export is more than 50% of total sales or those who are



continuously on 6 months credit may claim for refund. Refund shall be made within 30 days from the receipt of refund claim.

#### **4.9.4 Categories of goods and services for VAT purpose**

VAT divides all goods and services into two basic categories, taxable and tax-exempt. Goods and services are either taxed at the standard rate of 13 percent or they are taxed at 0%. Those taxed at the standard rate include all goods and services except those, which are specified as taxed at 0% or tax-exempt.

#### **4.9. 5 Tax-Exempt**

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

- a) Goods and services of basic needs which include rice, pulses, flour, fresh fish, meat, eggs, fruits, flowers, edible oil, piped water, wood fuel.
- b) Basic agricultural products are also tax-exempt, for example, paddy, wheat, maize, millet, cereals and vegetables.
- c) The expense of buying goods and services required to grow basic agricultural products are tax-exempt. This includes live animals, agricultural inputs including machinery, manure, fertilizer, seeds, and pesticides.
- d) Social welfare services including medicine, medical services, veterinary services and educational services.
- e) Goods made for the use of disabled persons.
- f) Air Transport.
- g) Educational and cultural goods and services such as books and other printed materials, radio and television transmissions, artistic goods, cultural programs, non-professional sporting events and admissions to educational and cultural facilities.
- h) Personal services are also tax-exempt. These are services provided, for example, by actors and other entertainers, sportsmen, writers, translators and manpower supplies agents.



- i) Exemption from VAT is also extended to the purchase and renting of land and buildings
- j) Financial and insurance services.
- k) Postage and revenue stamps, bank notes, cheque books.

#### **4.9.6 VAT on Imported Goods**

The VAT Act, Schedule I lists imports which are tax-exempt. Some of these include prescription drugs, basic groceries, medical devices and agricultural products.

Most imports, however, are fully taxable at customs point. There after these are treated on the same basis as domestically produced goods. The VAT on imported goods is collected by Customs. It is calculated on the dutiable value of the goods, in other words, on the value of the goods including transportation, insurance, freight and commissions plus any duty or other taxes (other than VAT) payable on the goods.

The value for the duty of the goods is determined in accordance with the valuation provisions contained in the Customs Act. Registrants may claim input tax credit for the VAT paid on imported goods used in their commercial activities.

#### **4.9.7 VAT on Exports goods**

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

#### **4.9.8 Registration on VAT**

Registration is required for any business:

- (a) With an annual taxable turnover of more than 2 million rupees.



- (b) Belonging to a conglomerate that has an aggregate annual taxable turnover exceeding 2 million rupees.
- (c) The importer who imported goods more than 10 thousand at ones time.

#### **4.9.9 Affected by VAT**

In addition to consumers, VAT affects persons involved in commercial activities. A person means an individual, firm, company, association, cooperative, institution, joint business, partnership, trust, government body or religious organization.

There are categories of persons and organizations which are not required to collect VAT nor allowed to claim a refund of the VAT they have paid in producing their goods and services for sale. These would include unregistered small suppliers, that is, persons with annual sales of taxable goods and services of Rs. 2 million or less. But even such people can voluntarily register for VAT purposes.

#### **4.9.10 Determining annual sales of taxable goods and services**

In assessing the value of taxable supplies a vendor must include the value of the supplies taxed at the standard VAT rate and his sales of supplies sold at 0% (the zero- rated supplies). Sales of exempt supplies will not be included. If he has had or expects an abnormally large sale he should contact his IRO to determine if this sale should be taken into account when calculating his need to register.

#### **4.9.11 Registration of small business**

Businesses with taxable annual sales fewer than 2 million rupees may apply to register.

If a business chooses to register, it must remain registered for a full fiscal year.



#### **4.9.12 Cancellation of Registration**

A VAT registration may be cancelled by any one whose total taxable sales for four consecutive calendar quarters is not more than 2 million rupees and who has been registered for a full fiscal year or by persons who no longer has a commercial activity because of bankruptcy, receivership, or cessation of the business.

#### **4.9.13 Obligations of VAT registrants**

VAT registrants are required to:

- a) Submit VAT returns and pay tax within the 25th day of the following month.
- b) Provide their customers with a tax invoice
- c) Maintain Purchase Book, Sales Book, and VAT Account.
- d) Keep their VAT records for a period of 6 years.
- e) Inform the IRO of changes to the business including new address, telephone number or a reorganization of a partnership within 15 days.
- f) Put their Certificate of Registration in the premises where customers may easily see and read it.
- g) Allow tax officers to enter the business to examine the business records and the stock on hand.

#### **4.9.14 Requirement of tax invoice**

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



#### **4.9.15 An abbreviated invoice**

Tax Officers may grant permission for a VAT registrant to issue an abbreviated invoice for retail sales below the value of Rs.5000. The chief difference between the two tax invoices is that an abbreviated invoice does not require the name and address of the purchaser.

The registrants have the right to request a detailed tax invoice, as they will not be able to claim input tax credits with abbreviated invoices. IRD may order taxpayer to issue invoices by using cash machine or computer. The procedure in such case shall be as prescribed by the DG of IRD. IRD will have anytime access to the database of the taxpayer.

#### **4.9.16 Maintaining special accounting system**

Most businesses will require only minor modifications to their record keeping. In order to complete his VAT return a taxpayer will need to ensure that his books and records provide:

- a. The amount of VAT paid on purchases
- b. The amount of VAT collected on sales
- c. A method of distinguishing between taxable and exempt sales
- d. The time the goods and services were supplied, and
- e. Evidences that goods were exported, if any.

#### **4.9.17 Necessity of books and records must be kept**

A taxpayer must keep the following books and records:

- (a) A purchase book, (b) A sales book and (c) A VAT accounts.

#### **4.9.18. Matter included in the purchase and sales book**

Purchase and sales books include: (a) The invoice number, (b) The invoice date, (c) The supplier's name and PAN number in the purchase book, (d) The customer's name and PAN number in the sales book, (e) The taxable value and (f) The amount of VAT.



Businesses, which sell both taxable and exempt goods, will need to complete additional columns of information to separate exempt sales and the purchases related to them. IROs will be pleased to provide taxpayers with a sample Purchase Book (Schedule 8) and a sample Sales Book (Schedule 9) format. PAN number refers to the Taxpayer Identification Number, which will be allocated to each registrant after completion of the registration process.

#### **4.9.19 VAT account**

The VAT account is a monthly summary showing the source of the figures used in the VAT return. This account contains purchases and sales and the VAT spent and collected. A sample VAT Account (Schedule 7) may be obtained from the concerned IRO.

#### **4.9.20 Offences**

Fines will be imposed if the taxpayer fails to file his return within the specified time. A registrant will make his VAT payment at a bank where he will receive a bank voucher as proof of payment. This number is to be entered on his VAT return to be submitted within 25 days after the end of the month of business transaction. The VAT Act imposes fines for failing to register. Similarly, if a registrant fails to use his registration number or clearly display his registration certificate in the business premises, he is liable to fine.

Other penalties may be imposed if, for example, a registrant fails to file a return, issue invoices, keep an up-to-date account of transactions, obstructs visits by a tax officer in investigation, prepares false accounts and invoices or attempts to evade tax. Similarly, IRO/IRD may purchase or cause to purchase under invoiced goods.

#### **4.9.21 Administrative Review**

A taxpayer who is not satisfied with the Tax Assessment of a Tax Officer may submit an application to the DG of IRD for administrative review within 30 days from the time of receiving such decision.



#### **4.9.22 Tax Plate**

In order to make public the status of the registered taxpayer, automatically, each registered taxpayer is required to display the tax plate, which is visible from outside in the premises of the taxpayer. The size and the color of the tax plate should be as follows:

**A. Size:** The size of the tax plate should be 30 cm long and 10 cm width.

**B. Information:** Information to be shown on the tax plate:

(i) Permanent Account Number (PAN)

(ii) Taxpayer's Name.

**C. Color:** The tax status of the taxpayer will be identified on the basis of the following background and the color of the tax plate:

- a) Bush green background and letters in white color: VAT registered tax payers.
- b) Lemon yellow background and letters in black color: Tax payers dealing in VAT able goods and services but whose transaction is the below threshold i.e. Rs.2 million per year.
- c) Signal red background and letters in red color: Tax payers dealing in non - VAT able goods and services.

#### **4.9.23 Conscious Consumer Lottery Program.**

In order to encourage billing system and thereby improve the tax system and motivate the consumers to take bills on the purchase of goods and services and motivate the sellers to issue bills on the sale of goods and services, a conscious consumer lottery program has been introduced since Magh, 2060.

Types of bills to be included in lottery programs are:

- i. Purchase bill issued by VAT registered taxpayers to consumers who are not registered in VAT.
- ii. Tax invoice or abbreviated tax invoice in the name of natural person, among individual purchasers who are unregistered.
- iii. All types of bills except the purchase of vehicle (excluding bicycle) and star hotel will be allowed to participate in the program.



However, bills issued in the name of government authority, public enterprises, local level authorities and diplomatic missions and the bills issued by the public enterprises will not be entertained in the program.

<b><u>Provision of Cash Prizes to Consumers</u></b>	<b><u>Total Prize amount</u></b>
(i) First winner - 1 Person.	Rs.1, 00,000
(ii) Second winner- 5 Persons (Rs.20, 000 each)	Rs. 1, 00,000
(iii) Third winner- 10 Persons (Rs.10, 000 each)	Rs. 1, 00,000
(iv) Consolation Prize - 20 Persons (Rs.5,000 each)	Rs. 1,00,000
<b>Total</b>	<b>Rs. 4, 00,000</b>

The prize will be declared once a month on the basis of coupons distributed in that month.

#### **Procedures of conducting lottery program:**

- a) IRD will print lottery coupons with serial numbers of two copies.
- b) A separate number will be marked in each coupon.
- c) One coupon will be issued to the purchaser after receiving the purchase bill of Rs. 1,000 and the contractor conducting the program will retain a copy. For instance, if a consumer submits 3 bills containing the purchase of Rs. 400 each, he will receive one coupon and will be eligible to get another coupon in each additional amount of Rs. 1,000. However, surplus amount will not be entertained for the purpose of competition once coupons are issued after submission of the bills. The bills worth less than Rs. 250 will not be entertained in the program.

#### **Provision of Cash Prizes to sellers:**

In order to motivate the sellers to give bills to the buyers, those sellers whose invoices have enabled the cash prizes to the consumers will also get the following cash prizes:



<b><u>Provision of Cash Prizes to Sellers</u></b>	<b><u>Total prize amount</u></b>
(i) First winner - 1 Seller	Rs. 25,000
(ii) Second winner- 5 Sellers (Rs.5,000 each)	Rs. 25,000
(iii) Third winner- 10 Sellers (Rs.3,000 each)	Rs. 30,000
(iv) Consolation Prize - 20 Sellers (Rs.2,000 each)	<u>Rs. 40,000</u>
Total	Rs. 1,20,000

#### **4.9.24 Proxy Criteria**

Taxpayers whose annual turnover is more than Rs.2 million are required to register in VAT compulsorily. Taxpayers who fall below this limit will be required to register in VAT within 30 days of their annual transaction reaching or crossing Rs.2 million. However, if the tax payer falls under any one of the following proxy criteria, he is required to register in VAT compulsorily:

- a) If the stock of the tax payer exceeds the specified amount when the tax officer inspects the stock or if the monthly sale exceeds Rs. 2 lakh or More during a month;
- b) If the annual expenses of the tax payer on the telephone and the rent Exceeds Rs. 1 lakh; or
- c) If the premises of the taxpayer lies within the specified area of the market or the street as specified by the Department (IRD).



## **CHAPTER- 5**

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

#### **5.1 Revenue Collection**

Generally, internal source of revenue are tax and non-tax income. Tax is the major sources of the government revenue. It covers nearly 80 percent of total revenue besides this, non- tax revenue is only limits with in 20 percent. Tax revenue can be classified in to two groups; one is direct tax and another is indirect tax. Average trend of these two taxes is that indirect tax covers 75 percent and direct tax covers only 25 percent of total tax revenue. VAT, custom duty, excise duty are the main source of indirect tax. In this chapter, basically VAT is analyzed in various angles. The data of income tax, custom duty, excise duty and total revenue are also used for clarifying the study and shown comparative position of VAT among them. Before implementation of VAT in Nepal, the role of sales tax, contract tax, hotel tax and entertainment tax are very important. This tax had signification contribution to the total revenue collection. In 1997 these tax (sales tax, hotel tax, contract tax and entertainment tax) had been replaced by VAT. So the VAT of source has more accountability in Nepalese tax system and revenue mobilization.

##### **5.1.1Composition of major revenue heads**

VAT, Income Tax, Custom Duty, Excise Duty are the major revenue source in Nepal. This four revenue heads contribute approx 77 percent of total revenue. Among them VAT, Income Tax, Excise Duty are administered by Inland Revenue department like wise, Custom Duty is administered by Custom department. Although VAT and Excise duty on imported goods are charged on custom points by custom administration. Comparative Status of major revenue heads is shown in table below:



Table No. 5.1  
Comparative Status of major revenue heads

Rs in million

Fiscal Year	Excise Duty	Income Tax	Custom Duty	VAT	Total Revenue
2001/02	3807.0	8436.0	12658.7	12267.3	50445.4
2002/03	4785.1	7102.1	14236.4	13459.7	56229.7
2003/04	6226.7	8512.5	15554.8	14478.9	62311.0
2004/05	6445.9	9402.4	15701.6	18885.4	70021.0
2005/06	6506.9	10933.5	15343.7	21610.7	72282.0
2006/07	8686.2	14607.4	16911.2	26055.0	86135.2
Average growth in 10th plan	17.94pc	11.61pc	5.96pc	16.26pc	11.29pc

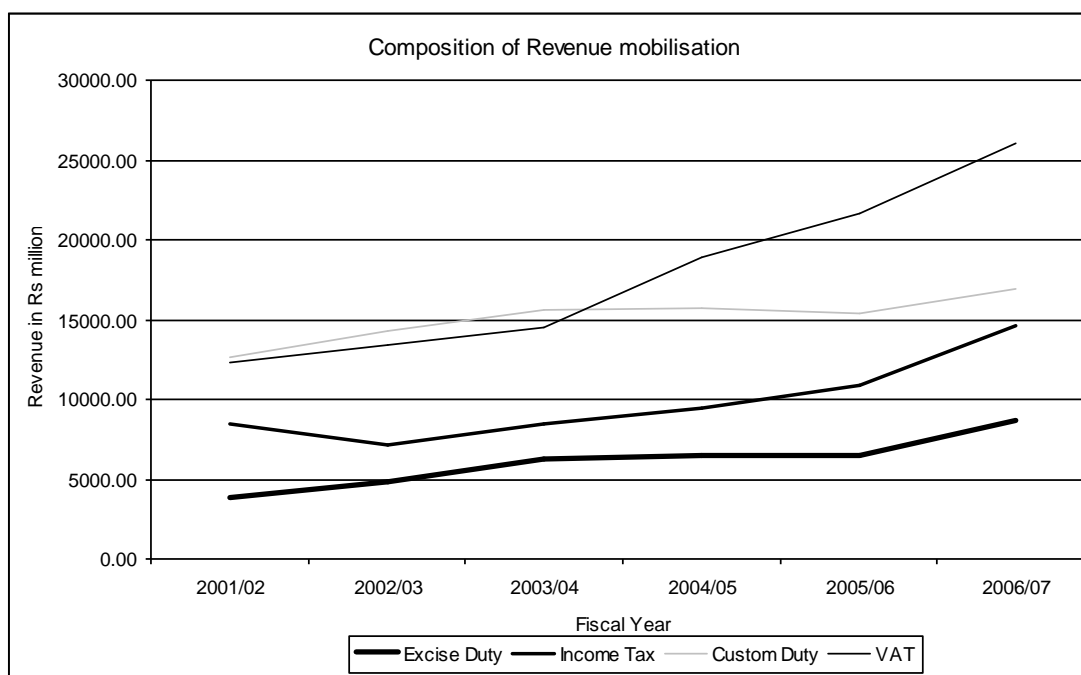
Source: Economic Survey (2006/07), Ministry of Finance.

In above table, composition of VAT, Income Tax, Custom duty, Excise duty and total revenue is shown from Fiscal Year 2001/02 to 2006/07. The table also shows Average growth of above taxes in 10th plan. Among these four taxes VAT has great contribution to the total revenue as compared to other taxes. Average growth rate of VAT is more than other taxes except excise duty. It has higher rate than total revenue growth rate. It clears that there is no doubt that, VAT has great potentialities at present and future for revenue mobilization.

Besides above table, Composition of revenue mobilization can be shown by using figure. It shows the trend line of major revenue heads. It helps to analyze the prospect of VAT. Given figure shows the comparative trend line of VAT, Income Tax, and Custom Duty and Excise duty. It gives the mirror of tax revenue collection in Nepal. The graph is presented as below:



Figure 5.1  
Composition trend of revenue mobilization



In above graph, composition trend of Excise duty, custom duty, Income tax and Value added tax are shown. An initial year, custom duty is the main source of revenue. But later, this position is changed after fiscal Year 2003/04. Since 2003/04, VAT became a major source and it is leading total revenue. Slope of trend line of VAT collection is increasing. In fiscal Year 2001/02 revenue collection from Excise duty, Income tax custom duty and Value added taxes are Rs. 3807.0, 8436.0, 12658.7 and 12267.3 millions respectively. But the composition is dramatically changed up to fiscal Year 2006/07. In this year revenue collection from Excise duty, Income tax, custom duty and Value added taxes are Rs. 8686.2, 14607.4, 16911.2 and 26055.0 millions respectively.

### 5.1.2 Revenue structure

Nepalese revenue structure is composed of VAT, income tax, excise duty and custom duty. Percentage contribution of each tax on total revenue is shown in table below:



Table No. 5.2  
Proportion of VAT on total revenue

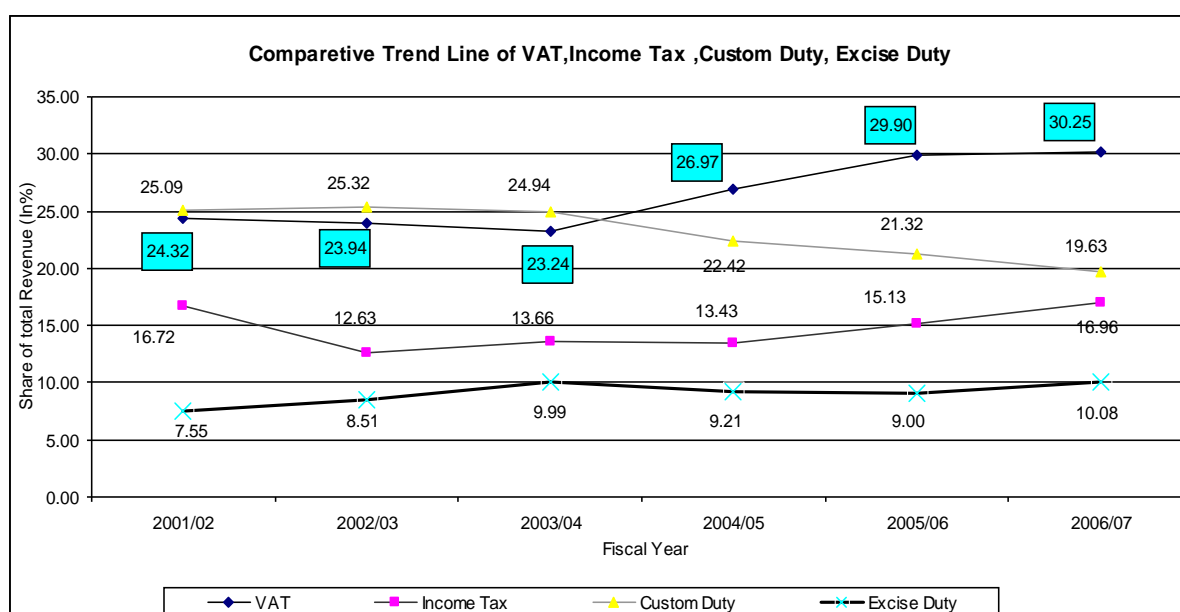
FY	VAT	Income Tax	Custom Duty	Excise Duty
2001/02	24.32	16.72	25.09	7.55
2002/03	23.94	12.63	25.32	8.51
2003/04	23.24	13.66	24.94	9.99
2004/05	26.97	13.43	22.42	9.21
2005/06	29.90	15.13	21.32	9.00
2006/07	30.25	16.96	19.63	10.08

Source: Economic Survey (2006/07), Ministry of Finance.

In above table, depicts percentage contribution of every tax on total revenue from fiscal year 2001/02 to fiscal year 2006/07. In fiscal year 2001/02 contribution of VAT, income tax, custom duty and excise duty were 24.32, 16.72, 25.09 and 7.55 respectively. Like wise in fiscal year 2006/07 the contribution of VAT, income tax, custom duty and excise duty would became 30.25, 16.96, 19.63 and 10.08 respectively. The table clears that contribution of VAT is increasing but contribution of custom duty is declining. It proofs that VAT is the back bone of revenue mobilization.

Besides above table, following figure more clears the above facts.

Figure 5.2  
Contribution trend of major revenue heads





### 5.1.3 Trend of VAT collection

Trend of VAT collection is analyzed as follows:

Table No.5.3  
Contribution of VAT on Total revenue

Rs. in thousand		
Fiscal year	VAT collection	Growth rate (in %)
2054/055	7120000	10.00
2055/056	7880000	11.00
2056/057	9850000	25.00
2057/058	12047760	22.34
2058/059	11947955	-0.83
2059/060	13449123	12.56
2060/061	14478896	7.66
2061/062	18094627	20.50
2062/063	21946014	16.14
2063/064	26704180	21.00

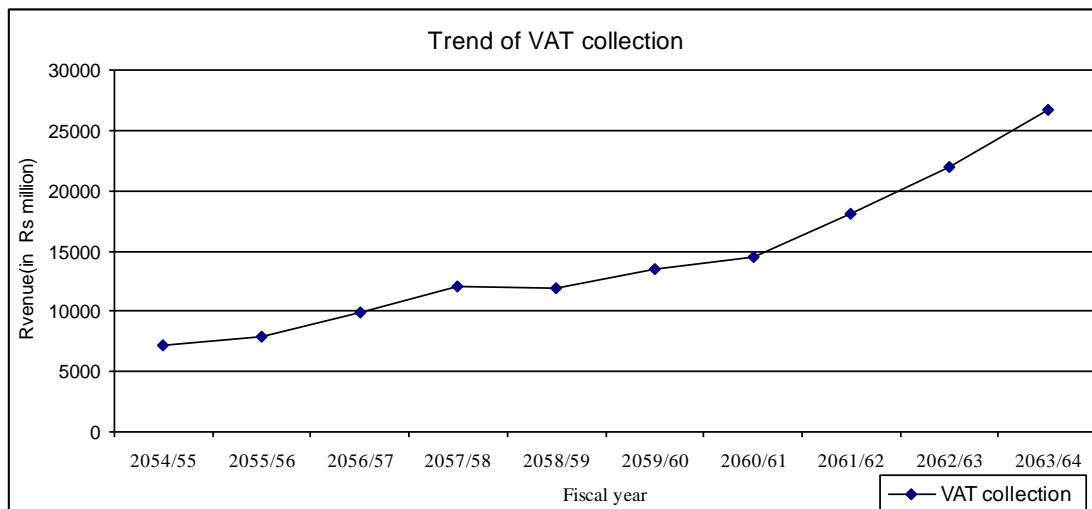
Source: (a) Economic Survey (2006/07), Ministry of Finance.

(b) Annual Report (2063/064), Inland Revenue department.

The table No. 5.3 shows that the trend of VAT revenue collection. The VAT revenue collection growth rate was in increasing order till fiscal year 2056/57. After that the growth rate percentage started decreasing. Similarly fiscal year 2058/59 the growth rate was negative i.e. -0.83 %. In short, the trend of VAT collection is not so bad except fiscal year 2058/59. In fiscal Year 2059/060 rate was increased by 12.56 % but year 2060/061 growth rate was decreased as compared. After that this rate also up – down frequently. Trend of VAT collection from fiscal year 2054/055 to 2063/064 (10 years) is shown in following figure No. 5.3.



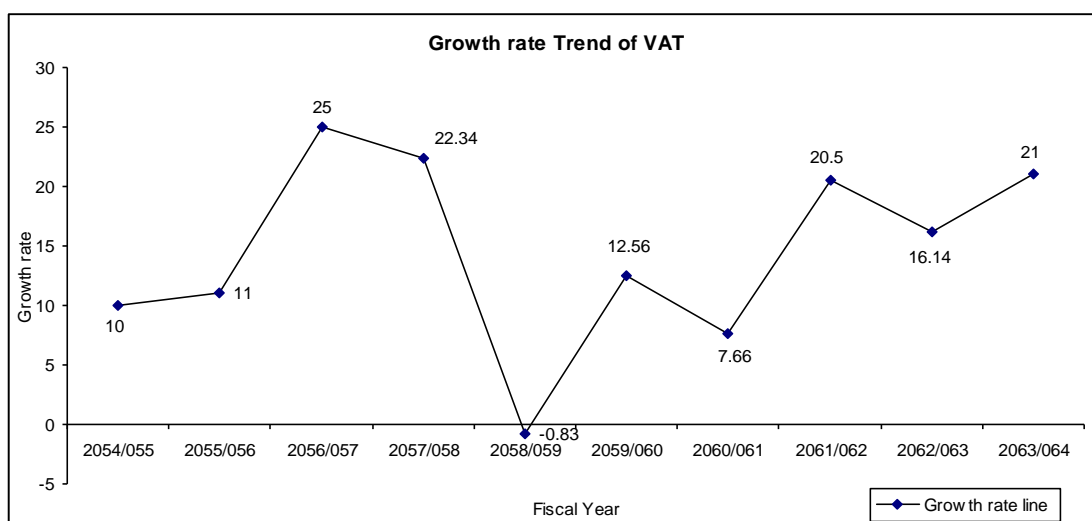
Figure No. 5.3  
Trend of VAT collection



In above figure VAT collection is increasing in every fiscal year. Thus, it has prospect.

Another important issue of VAT is its growth rate. Trend of growth rate forecast its potentialities. The figure given below clears its growth status during past ten years.

Figure 5.4  
Trend line of growth rate



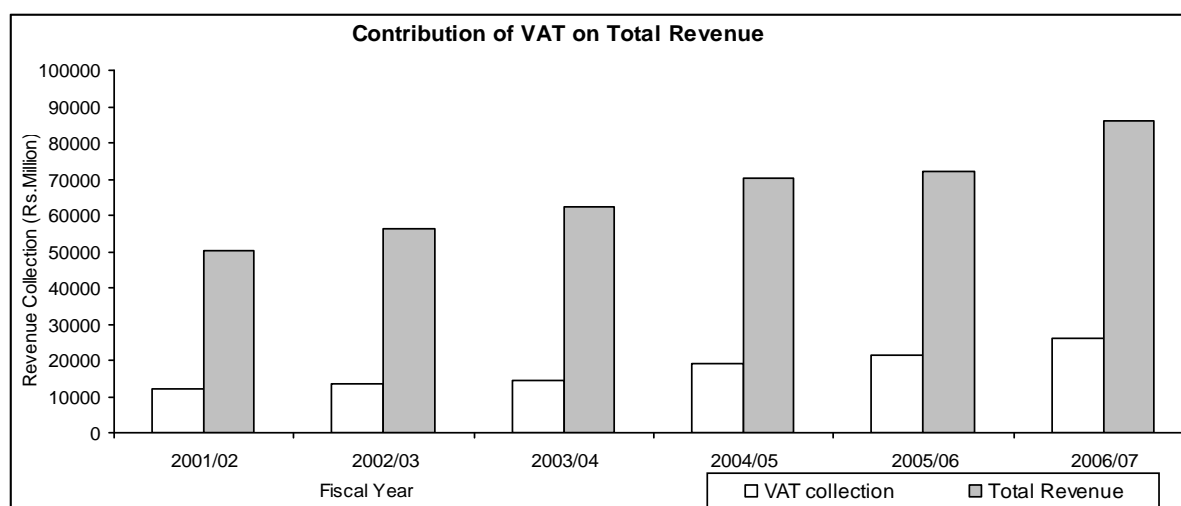


In above figure, trend of VAT growth rate is shown. In fiscal year 2054/055 the growth rate was only 10 percent. The rate increased 11 percent and 25 percent in fiscal year 2055/056 and 2056/057 respectively. After this year, the rate started to decline up to year 2058/059. The fiscal year 2058/059 was very bad for VAT collection because of negative growth rate i.e. -0.83 percent. Again the rate tries to move up. Rate of VAT collection is above double digit except fiscal Year 2058/059 and 2060/061. We can easily predict that growth rate is not stable because of political stagnation economic distortion, administrative inefficiency and tax evasion. In spite of fluctuation, there is double digit growth rate in given eight years. Thus we can conclude that VAT has large prospect in Nepalese tax system.

#### 5.1.4 Contribution of VAT on total Revenue

VAT is the major source of total revenue. It contributes more than 30%. Contribution of VAT is shown as follows.

Figure no.5.5  
Contribution of VAT on Total Revenue



Source: Economic Survey (2006/07), Ministry of Finance.

Above Diagram (figure 5.5) clearly shows the share of VAT on Total Revenue. In initial years both VAT and total Revenue is low. Gap between VAT and total Revenue is large. But recent years both incomes are gradually increasing



and their gaps also reducing. This trend indicates that, VAT has great revenue potentialities in future.

### 5.1.5 Composition of VAT Revenue

Total VAT collection is divided in to two parts. They are Domestic VAT and Imports VAT. Domestic VAT is collected from national goods and services which are produced or operated in Nepal. It is collected by Inland Revenue offices. Like wise Imported VAT is collected from imported goods at custom points by custom offices. Volume of it's revenue depends up on foreign trade. In Nepal, most of the VAT is collected from imported goods. Ratio between Domestic VAT and Import VAT has large different. It is cleared by table below.

Table No. 5.4  
Composition of VAT Revenue

Rsin thousand

Fiscal year	Total VAT collection	Domestic VAT	Import VAT	Domestic/Imports ration
2055/56	78800.00	2810000	5070000	36:64
2056/57	9850000	3720000	6130000	38:62
2057/58	12047760	4744720	7303040	39:61
2058/59	11947955	4608373	7339582	39:61
2059/60	13449123	4819610	8629513	36:64
2060/061	14478896	5604123	8874773	39:61
2061/062	18894627	6624333	12270294	35:65
2062/063	21946014	8057438	13888576	37:63
2063/064	26704180	9689979	17014201	37:63

Source: Inland revenue Department, Annual Report 2063/064.

In above table, total VAT collection, Domestic VAT collection and Import VAT collection and its ratio are presented. Trend of domestic and import VAT collection is given in table No 5.4. Domestic / Import ratio in fiscal year 2055 /



056 was 36: 64. It means that Domestic VAT collection was 36% and import VAT collection is 64% in total VAT revenue. Similarly, domestic / imports ratio are 38:62, 39:61, 39:61, 36:64, 39:61, 35:65, 37:63 and 37:63 in fiscal year 2056/057, 2057/058, 2058/059, 2059/060, 2060/061, 2061/062, 2062/063 and 2063/064 respectively. It denotes that Nepalese VAT Revenue is mostly depends on imported goods. Proportion of domestic VAT could not increased above 39 percent. Approximately, 2/3 portion of total VAT is collected from imported goods. This tendency is not favorable for self-dependent economy. Proportion of domestic VAT should be increased for developing VAT as a back bone of total revenue.

### 5.1.6 Target and Achievement of VAT revenue

For effective mobilization of national revenue, fixation of target revenue collection is needed. All efforts should be made to achieve targeted goal. It helps to measure the capabilities of tax administration and to disclose it's problems and prospects. In given table No.5.5, Targeted VAT, collected VAT and percentage of target achieved, is shown from fiscal year 2054/056 to 2063/064:

Table No. 5.5  
Target and Achievement of VAT revenue

Rs. In thousand

Fiscal year	Targeted VAT	collected VAT	Target achieved (in %)
2054/055	8006600	7120000	88.93
2055/056	9420000	7880000	83.65
2056/057	10460000	9850000	94.17
2057/058	13500000	12047760	89.24
2058/059	14750000	11947955	81.00
2059/060	13730050	13449123	97.95
2060/061	15503500	14478896	93.39
2061/062	16950000	18894627	111.47
2062/063	23650000	21946014	92.79
2063/064	26463000	26704180	100.91

Source: Annual Reports (2063/064), Inland Revenue Department.



In above table, targeted VAT could not be collected except fiscal year 2061/062 and 2063/064. These two fiscal years, collected VAT is more than targeted VAT. In fiscal year 2054/055, 2055/056, 2057/058 and 2058/059 target is achieved 80 percent to 90 percent. Like wise, In fiscal year 2056/057, 2059/060, 2060/061, and 206/063 target is achieved 90 percent to 99 percent. It shows that, In 10 years periods only 2 year target is achieved and remaining 8 years fail to meet target. For this failed situation tax administration is more responsible. This situation is occurred because of administrative inefficiencies, huge amount of tax evasion, economic stagnation, and low projection capacity or more ambitious than they could do.

In Nepal, the full implementation of VAT has reached ten years but still the revenue collection has not been able to increase as expected. The above data shows that the difference between targeted VAT and Actual collected VAT. Even though, growth of total VAT collection increasing slowly but not as estimated. The gapes between targeted VAT collection and Actual VAT collection are fluctuation in percentage.

There are so many problems, by which the gap between target and achievement of VAT is remaining for long time. Low public awareness, lack of billing system, Lack of coordination between government and private sector, lack of skilled manpower, corruption and bribe are main obstacles among them.

## **5.2 Survey Result**

In initial phase of VAT introducing, the business community and consumers were strong opposition of VAT or against VAT implementation. They had developed a kind of miss-concept regarding VAT. The government has lunched several publicity and provider information through media. There have been done several studies before and after VAT implementation, provision of rules and regulation is changed and make it tax payer friendly, administrative procedure is simplified. In recent years, Business community and consumer are slowly changing their miss-concept and accept the VAT, but not totally. They realized the relative worth of VAT among other taxes that replaced by VAT.



So, it is claimed that this system of VAT has not been implemented effectively but situation is not so bad. Reform programs are launched to solve arise problems.

In this study, the analysis has been done about VAT on the basis of information collection from tax officer, Economists, Businessmen (wholesaler, retailer, and producers) and Consumers (general consumers, students). Basically, questionnaires are used as study tool. The sample size is taken only fifty from the different field as given in the table below:

Sample size of field survey

Respondents	Simple size	percentage
Economist	5	10
Tax Officer	10	20
Businessman	15	30
Consumer	20	40
total	50	100

According to the above table, out of total respondents 5(10%) are Economist, 10 (20%) are Tax officers, 15 (30%) are Businessman and remaining 20 (40%) are consumers.

### 5.2.1 Billing System on VAT

VAT is based on billing system. So that issuance of proper bill is necessary for the successful implementation of VAT. In other words, the success of VAT depends on bill issuance by traders and compulsory receipt of bills by consumer. In Nepal, however the widespread practice of not issuing VAT registered bill while selling goods is still an impediment in the effective implementation of VAT, paralyzing the government commitment to develop VAT as the backbone of revenue collection. Even after eleven years of enforcement of VAT, consumers are unaware of the significance of billing system. The culture of asking for bills while purchasing goods has not developed in spite of government's commitment and administrative efforts. Due to the lack of public awareness about billing system, very few people ask bills



for their purchases. Thus, the billing system could not play crucial role in the field of VAT system. With out proper billing system principle of VAT could not effectively implement. Therefore, it should be compulsion to issue VAT bill for all level of purchase and selling for effective implementation of VAT. In Nepal the billing system has been one of the main burning problems. The respondent related to different field have given their views on billing system are given below.

According to the field survey, 80% economist, 70 percent Tax officer, 60 percent businessman and 65 percent consumer or in total 66 percent respondents advocate for the possibility of billing system in VAT. Similarly, 10 percent tax officer, 7 percent businessman and 10 percent consumer or in total 8 percent respondents claim that billing system is not possible. While at the same time 20% tax officer and 13 percent or in total 8 percent businessman says that billing system is costly. Like wise, 20 percent Economist, 20 percent and 25 percent Consumer or in total 18 percent respondent's views that total billing system in VAT is impracticable. Out of total samples (respondents) 66% say possible, 8% say not possible, 8% say Costly, and 18% say impracticable. The survey result is summarized in the table below.

Table No- 5.6  
Views on Billing System

Respondents	Possible		not possible		Costly		impracticable		Total
	No.	%	No.	%	No.	%	No.	%	
Economist	4	80	-	-	-	-	1	20	5
Tax officer	7	70	1	10	2	20	-	-	10
Businessman	9	60	1	7	2	13	3	20	15
Consumer	13	65	2	10	-	-	5	25	20
Total	33	66	4	8	4	8	9	18	50

Source: Field survey

On the basis of result of above field survey we come to the conclusion that most of the respondents view that billing system is possible. We should be never forget that it is possible gradually not at once time because our tendency



is difficult to change over a night. Tax administration, consumers and business entity should be committed for effective implementation of billing system in VAT.

### 5.2.2 Relation between Rising Price and VAT System

During the earlier period of VAT implementation, there was strong opposition from the business community and basic argument behind it was that VAT would raise the price. In recent year, the consumers complain that the businessman charge more price without following the act of VAT. Here an endeavor has been made to get the information from the respondents to find out price due to VAT system.

There is 40% of Tax officer, 50% of Economist, 67% of Businessman and 60% of consumer or in total 58% of total respondents are considered VAT has increased price. Remaining percentage of the respondents, 60% of Tax officer, 50% of Economist, 33% of business man, 20% of consumer says that there is not rise in price due to VAT. According to the study 8% consumer have no idea about VAT that increase or decrease of price of commodities.

Table No. 5.7  
Views on Rising Price due to VAT System

Respondents	Increase		Not increase		I don't know		Total
	No.	%	No.	%	No.	%	
Tax Officer	2	40	3	60	-	-	5
Economist	5	50	5	50	-	-	10
Businessman	10	67	5	33	-	-	15
Consumer	12	60	4	20	4	20	20
Total	29	58	17	34	4	8	50

Source : Field Survey

In the outcome, majority of respondent, 58% has no doubt that the VAT increases price of product. There view is certainly effected by misconception about VAT, Businessman are charged extra profit in the name of VAT, lack of billing system, weak of market monitoring, low awareness of consumers. It is



fact that, all of the above mention factors are the major causes of raised in price.

### **5.2.3 Most Challenging Problem on VAT**

The taxpayers as well as the tax collectors must be more conscious for the successful implementation of VAT because it is new and advanced tax system. Since eleven years experience, it is found that the future success of VAT basically depends on its implementation aspects. In our country there are many problems of VAT. Respondents are asked to identify the most challenging problem. There may be so many problems in implementation of VAT system. For simplicity of research study, smuggling and under valuation, lack of proper billings, lack of proper account and weak tax administration are identified as major problems.

According to the field survey, it is found that 20% of Tax officer, Economist, businessman and 15% consumers or in total 18% of total respondents say that smuggling and under valuation is the most challenging problem of VAT implementation. Similarly, Lack of proper account is also the problem of VAT effectiveness. 60% of Tax officer, 50% of Economist, 67% Businessman and 60% consumer or in total 60 % of total respondent believes that Lack of proper billing system is the main problem of VAT implementation. Like wise, 20% of Tax officer and 5% of consumer or in total 4 respondent's views is Lack of proper account system is main problem of VAT implementation. Besides this, 30% of Economist, 13% of businessman and 5% of consumer or in total 12% of total respondent says that weak administration is challenging problem in effective VAT implementation.

Most of the Businessman claims that corrupted nature of the Tax officer is the basic problem. On the other hand consumer says that week and irresponsible administration is encouraged for under invoicing and smuggling. In brief, out of total respondent 18% identified smuggling and under valuation, 60% identified lack of proper billing, 4% identified lack of proper account, 12% identified weak administration, and 6% of respondent has no any idea about problem of VAT implementation.



Survey result is summarized in the table below:

Table No. 5.8  
Views on most challenging problem

Respondents	Smuggling and under valuation		Lack of proper Billing		Lack of proper Account		Weak tax administration		I don't know		Total
	No	%	No	%	No	%	No	%	No	%	
Tax officer	1	20	3	60	1	20	-	-	-	-	5
Economist	2	20	5	50	-	-	3	30	-	-	10
Businessman	3	20	10	67	-	-	2	13	-	-	15
Consumer	3	15	12	60	1	5	1	5	3	15	20
Total	9	18	30	60	2	4	6	12	3	6	50

Source: Field Survey

On the above table we come to the conclusion that most of the respondents view that all of them are the main problems of VAT in Nepal. But numerically, most of the respondents (i.e.60%) believe that lack of proper billing system is most challenging problem among them. For effective implementation of VAT, all problems should be resolved.

#### 5.2.4 Major problems of VAT Administration

An effective and efficient administration is crucial for the proper implementation of VAT. The tax administration should be strengthened significantly. The VAT is modern and complex tax. We cannot implement it without an efficient and modernized administrative setup. It is reported that there have been various weaknesses in the administration for the implementation of this VAT system. The field survey shows that there are several problems in VAT administration.

For 20% of Tax officer and 20% of Economist or 6% in total respondent claims that lack of expertise is the main problem. While, 20% of Tax officer, 53% of businessman, 20% of Economist, and 10% of consumer or 26% in total



respondent report that process oriented administration is the major problem of VAT administration.

Similarly, lack of physical infrastructure is the problem for 40% of Tax officer, and 10% of Economist or 6% in total respondent. Likewise, all of them are the problems for 20% of Tax officer, 30% of Economist, 34% of businessman and 40% of consumer or 34% in total respondent. Beside this, 28% respondents have reported a number of miscellaneous problems. They are; lack of motivated manpower, control of retailer, lack of loyal tax administration, dishonesty of tax personnel, lack of co-operative environment, wide network of corruption etc. The finding of the survey has been summarized as below:

Table No. 5.9  
Views on Major problems of VAT Administration

Respondents	Lack of expertise		process oriented		Lack of physical infrastructure		Miscellaneous		All of them		Total
	No.	%	No.	%	No.	%	No.	%	No.	%	
Tax officer	1	20	1	20	2	40	-	-	1	20	5
Economist	2	20	2	20	1	10	2	20	3	30	10
Businessman	-	-	8	53	-	-	2	13	5	34	15
Consumer	-	-	2	10	-	-	10	50	8	40	20
Total	3	6	13	26	3	6	14	28	17	34	50

Source: Field Survey

In conclusion, we can say that several problems are stand still in Nepalese VAT administration. Government of Nepal should be concerned and aware to overcome these problems. Otherwise, the VAT system may be failed in our country.

### 5.2.5 Rate Structure of VAT

Nepalese VAT rate is levied at a single positive rate from its initiation phase. The rate will be fixed the finance Act for the respective year. According to the finance Act 1996, the tax rate was 10%.This rate was remained constraint with in ten years. To increase tax mobilization and fulfillment of budget deficit, the rate of VAT was increased to 13% from 10%.The new rate is in act from



January 2006 (2062 magh first). It is introduced by finance ordinance 2006. The field survey is also conducted about the rate structure of VAT.

The survey result shows that 60% tax officer, 50% of businessmen, 60% of consumer and 80% Economist or in total 66% respondents are suggested that establishing two or three rates such as 5% (for basic goods), 10% ( for moderate goods) and 15% ( for luxurious goods). It clears that most of the respondents suggest establishing two or three VAT rates. The logic of behind multiple rate of VAT are ; expanding it's coverage, gradually avoiding tax exemption facilities, maintaining equity ( charged tax on luxurious goods by high rate and basic goods by low rate) and make a VAT as a back bone of total tax system. However, 13% of businessmen and 15% of consumer or in total 10% respondent suggest that present VAT rate should be decreased. Similarly, there is no one in favor of increasing the rate of VAT. At the same time 15% of consumers have no idea about rate structure of VAT. Besides these, 40% tax officer, 20% Economist, 20% Businessman and 10% consumer or in total 18% respondents are believed at present VAT rate is appropriate. There would be necessary to establish two or three tax rates. The result of field survey is presented as below.

Table No. 5.10  
View on Rate structure of VAT

Respondents	Existing rate ( i.e.13%) is OK.		Increase the rate		decrease the rate		Establish two or three rates		I don't know		Total
	No.	%	No.	%	No.	%	No.	%	No.	%	
Tax officer	2	40	-	-	-	-	3	60	-	-	5
Economist	2	20	-	-	-	-	8	80	-	-	10
Businessman	3	20	-	-	2	13	10	50	-	-	15
Consumer	2	10	-	-	3	15	12	60	3	15	20
Total	9	18	-	-	5	10	33	66	3	6	50

Source: Field survey

In conclusion, it could be say that, to enhance tax base, to increase VAT revenue, to establish a VAT as major source of national revenue and to make effective VAT system multiple rate of VAT is compulsory.



## 5.2.6 Effect of VAT in Investment Sector

Taxation and investment are closely to each other. Every tax system will have an impact on the investment sector of the economy. However the extent of the impact depends on tax rate, structure, coverage, given facilities, Administrative procedure, etc. The effect may be positive or negative or normal. Among various taxes VAT is a major determinant tax in modern economy in every country. It has also effect on investment sector. Generally it has positive impact because of its unique attributes. Such attributes are; input tax credit, tax exemption, zero rates, self- policing catch up effect, transparent and account base, no cascading effects and so on. Because of these characters investors are encouraged to invest their capital as compared to other tax.

In survey shows that most of the respondents view is that the effect is positive. While others view is negative and some of them think that the effect is normal. For 80% of Tax officer, 60 % of Economist, 40 % of businessmen and 40 % of consumers or 48 % in total respondents think that the effect is positive. While, 20 % of businessman and 25% of consumers or 16 % of total respondents think that the effect is negative. Similarly, 20 % Tax officer, 40 % of Economist, 40 % of businessman and 20% of consumer or 30 % of total respondents think that the effect of VAT is normal in investment sector. But, 6 % of total respondents have no idea about any effect of VAT on investment.

The outcome of field survey is presented in table below:

Table No. 5.11  
Views on Effect of VAT on investment sector

Respondents	Positive impact		Negative impact		Normal impact		I don't know		Total
	No.	%	No.	%	No.	%	No.	%	
Tax officer	4	80	-	-	1	20	-	-	5
Economist	6	60	-	-	4	40	-	-	10
Businessman	6	40	3	20	6	40	-	-	15
Consumer	8	40	5	25	4	20	3	15	20
Total	24	48	8	16	15	30	3	6	50

Source: field survey



Thus, we can say that VAT has positive impact on investment as compared to other tax that replaced by VAT.

### 5.2.7 Effect of VAT on Economic Growth

In some extent, economic growth depends upon tax policy adopted by country. The ultimate aim of the government is to achieve the economic growth, economic development and accelerate the rate of economic growth. Economic growth of a country depends on the various aspects. The effective tax system is the major tool of country's development. It is expected that the present VAT system helps the government to collect more revenue than previous sales tax. Generally, possible impact of VAT on economic growth may be positive, negative or normal.

In field survey result shows that, 80 % of Tax officer and economist, 53 % businessman, 60% consumer or 64% in total respondents claim that the effect is positive. While, 20% businessman and 10% customer or in total 10 % respondents understand that the effect is negative. For 20% Economist and Tax officer, 27 % businessman and 20% consumer or 22% in total respondents views that the effect is normal. 10% consumers have no idea about the effect of VAT on economic growth.

Survey result is present in the table below:

Table No. 5.12  
View on Effect of VAT on Economic Growth

Respondents	Positive		Negative		Normal		I don't know		Total
	No.	%	No.	%	No.	%	No.	%	
Tax officer	4	80	-	-	1	20	-	-	5
Economist	8	80	-	-	2	20	-	-	10
Businessman	8	53	3	20	4	27	-	-	15
Consumer	12	60	2	10	4	20	2	10	20
Total	32	64	5	10	11	22	2	4	50

Source: field survey



In above table, most of the respondents believe that VAT has positive impact on economic growth. Thus, we can declare that VAT system support the economic growth as compared to other forms of taxation.

### 5.2.8 Responsible for Tax Evasion

Tax evasion is the great problem of our country. Tax Evasion not only tosses the revenue but also creates distortions, market imperfection, encourage illegal business, decline business ethics etc. There are many groups such as consumers and administration who always support business enterprise for tax evasion for their benefits. The field survey is conducted to provide the views on most responsible group for tax evasion among respondents.

Survey shows that 60 % Tax officer, 30 % Economist and 50 % consumer or 32 % in total respondents said that business enterprises are most responsible for tax evasion under VAT system. Similarly, 20% Tax officer and Economist, 7 % businessman and 5% consumer or in total 10 % of respondents claim that consumers are responsible for tax evasion. Like wise, 20 % Economist, 67 % Businessman and 20 % consumer or 32 % in total respondents said that the tax administration is the most responsible for tax evasion. At the same time, 20 % Tax officer, 30 % Economist, 26 % businessman and 15% consumer or 20% in total respondents claim that all of them ( Business Enterprise, Consumer, and Tax Administration ) are responsible for tax evasion. Where as, 10 % consumers cannot say any things that who is responsible for tax evasion. It shows the lack of awareness in consumer group.

Survey result is presented in the table below:

Table No. 5. 13  
Views on Responsible group of tax evasion

Respondents	Business Enterprise		Consumer		Tax Administration		All of them		I don't know		Total
	No.	%	No.	%	No.	%	No.	%	No.	%	
Tax officer	3	60	1	20	-	-	1	10	-	-	5
Economist	3	30	2	20	2	20	3	30	-	-	10
Businessman	-	-	1	7	10	67	4	26	-	-	15
Consumer	10	50	1	5	4	20	3	15	2	10	20
Total	16	32	5	10	16	32	11	22	2	4	50

Source: field survey



Above field survey we can easily say that tax administration and business enterprises are major accountable for tax evasion. They are top ranked by most respondents for tax evasion according to survey result. They are blamed to each other for tax evasion. In fact, both of them are responsible and can't escape by giving blame to another group. In practical field all of them are responsible for tax evasion.

### **5.2.9 Legal Provision for proper implementation of VAT**

Legal provision is the most important part of VAT system. It regulates all of taxation procedure, tax coverage, zero rates, tax exempt, right and duty of tax administration and taxpayer and so many other provisions related to VAT system. Without legitimate law, no any state could impose tax to their citizens in modern rule of law system. Policy of government, providing facilities to taxpayer, nature of tax administration and so on aspects are depicted in tax law. So, legal provision of VAT plays crucial role for effective implementation of VAT.

The government of Nepal has prepared VAT Act 2052 B.S. and VAT regulation 2053 B.S. Generally, they are amending by every year's finance act when government realized to change or to add any provision in VAT law. The field survey has been conducted to find out whether the act and regulation are sufficient or not with reference to present VAT system.

The study shows 60 % Tax officer, 40 % Economist, 13 % Businessman, and 20% consumers or 26 % in total respondents said that present legal provision is sufficient and appropriate. While, 20% Tax officer, 50 % Economist, 53 % businessman and 40 % consumer or 44 % in total respondents claim that the present act and regulation are in- sufficient and need to improve . Similarly, 20% Tax officer, 10 % Economist, 20 % businessman and 20 % consumer or 18 % in total respondents suggest that present legal provision is complex and require simplifying. Where as, 14 % businessmen and 20 % consumer or 12% in total respondents have no idea about the act and regulation. It shows that the publicity of legal provision of VAT is lacking.



Summarized outcome of field survey is given below:

Table No. 5.14

View on Present legal provision

Respondents	sufficient and appropriate		Insufficient and need to improve		complex and require simplifying		I don't know		Total
	No.	%	No.	%	No.	%	No.	%	
Tax officer	3	60	1	20	1	20	-	-	5
Economist	4	40	5	50	1	10	-	-	10
Businessman	2	13	8	53	3	20	2	14	15
Consumer	4	20	8	40	4	20	4	20	20
Total	13	26	22	44	9	18	6	12	50

Source: field survey

From the above table shows that most of the respondents identified present VAT law is insufficient and need to improve. Thus, we can say that the VAT act and regulation should be reviewed for implementation of VAT properly.

### 5.2.10 Suggestion for effective VAT implementation

There is no doubt that VAT is major revenue source of national revenue. It has greatest contribution to national income of Nepal. Due to its unique character, it became more popular than other forms of taxation. It has no any economic distortion in economy.

In Nepal, contribution of income tax is very low because income level of Nepalese people is very poor and inequity. Like wise, revenue from custom duty is not satisfactory because of lowering. It is the cause of the liberalization and globalization effect on economy. Nepalese industrial development scenario is miserable. For this cause revenue from excise duty is also poor. In this context, broad- based VAT has great potential to mobilize required fund for nation development. Thus, there is no doubt that effective implementation of VAT should be our first motto. There may be so many suggestions for effective implementation of VAT. For this study simplification, major five alternative possible suggestions are given to all respondents alternative.



The field survey is conducted to find out the tools for effective implementation of VAT. The survey shows that 40 % Tax officer, 10 % Economist, 20 % Businessman, and 10 % Consumer or 16 % in total respondents suggest skill and trained man power is essential. Like wise, 20 % Tax officer, 20 % Economist, 7 % Businessman, and 15 % Consumer or 14 % in total respondents suggest that Proper billing and account system is required. Similarly, 10 % Economist, 40 % Businessman, and 20 % Consumer or 24 % in total respondents' views are taxpayer friendly tax administration is needed for effective VAT implementation. While, 20 % Economist and 25 % Consumer or 14 % in total respondents are recommended strictly market monitoring. Where as 40 % Tax officer, 30 % Economist, 33 % Businessman, and 30 % Consumer or 32 % in total respondents suggest that all of them (skilled and trained manpower, Proper billing and account system, Taxpayer friendly Administration, strictly market monitoring) are suggested for effective implementation of VAT.

Summarized result of field survey is presented as below:

Table No. 5. 15  
View on suggestion for VAT effectiveness

Respondents	skilled and trained manpower		Proper billing and account system		Taxpayer friendly Administration		strictly market monitoring		All of them		Total
	No.	%	No.	%	No.	%	No.	%	No.	%	
Tax officer	2	40	1	20	-	-	-	-	2	40	5
Economist	1	10	2	20	2	10	2	20	3	30	10
Businessman	3	20	1	7	6	40	-	-	5	33	15
Consumer	2	10	3	15	4	20	5	25	6	30	20
Total	8	16	7	14	12	24	7	14	16	32	50

Source: field survey

Above table shows that most of the respondents i.e. 32 % suggested that skilled and trained manpower, Proper billing and account system, Taxpayer friendly Administration, strictly market monitoring are main instruments for successful implementation of VAT in Nepal. Thus we can conclude that these suggestions are guidelines in our VAT reform journey.



## CHAPTER- 6

### SUMMARY, CONCLUSION AND RECOMMENDATION

#### 6.1 Summary

Undoubtedly, taxation and economic development are two closely interrelated concepts. Taxation has an important role in country's economic development. In recent decades, many developing countries around the world have begun to focus their poorly designed tax structures as an integral part of their development efforts. Such reform has established some new trends. One of such trends is the increasing acceptance of VAT as an important part of their tax reform program.

Nepal has been under going through several fiscal crises due to limited sources of revenue and increasing government expenditure. The trend of gap between revenue expenditure shows that, it is even conducive to increase in future leading the country to a debt trap situation. In the wake of such a crisis Nepal has adopted a VAT.

VAT is the latest innovation in the field of taxation for 21<sup>st</sup> century. It was first implemented in 1954 by the French government. Then after more then 135 countries of the world are being attracted towards this system. In Nepal, VAT was seriously considered during the first half of 1990 and came into practice since 1997. Some studies held in that period concluded that VAT was applicable to Nepal but its effective implementation through efficient administration was identified as a serious challenge. Adequate preparation suggested for its success in future.

The VAT is collected from sellers on the basic of their "**value added**" at each of the stage of business process. Thus the same value is never taxed twice and never produces cumulative efforts. The types of VAT are three. They are; gross national product type, income type and consumption type.

The later variant excludes capital goods from its base, and does not panelize investments and growth. It is considered to be natural with respect to the method of production and administratively feasible. There principle methods



ensuring the VAT bases are: addition method, subtraction method and invoice method or tax credit method. The invoice method is more popular in the world. Nepal also applies this method. VAT paid on total sales minus VAT paid on purchases by a firm is the net VAT liability under this method. While addition method adds factor products and sales value minus purchase value under the subtraction method. The tax credit method is considered as a tool for cross checking measure under a VAT system. In this stage, VAT is said to be a self-policing in nature. To adjust international trade VAT uses one of two principles i.e. origin and destination principle. Destination principle is more popular than origin principle.

Registration of the business vendors having taxable transaction and capacity is the first step of VAT operation in any economy. Each and every registered vendor should receive and give the bill while purchasing and selling the goods respectively. Every VAT registered person should keep book of record. Then tax return should be prepared and submitted to concerned tax office and pay the tax. Other important aspects that are required for the successful operation of VAT are enforcement, auditing computerization, penalties etc.

VAT is superior to other types of sales tax because it has many attributes. These attributes are : Economic efficiency, Revenue productivity, Supporting economic growth, No excess burden, Equity norms, Simplicity of administration, Price stability, Accounting base, Self -policing, Catch up effect if VAT can be implemented effectively along with its different provision like exemptions, threshold, zero rating, it will be more equitable. Avoidance of pyramiding and cascading effects and providing cross auditing self policing and catch up effects are the most favorable feature of VAT which makes it superior then RST.

Rate structure plays major role in efficiency and the success and failure of a tax. There is remaining discussion about single or multiple rate of VAT. In single rate, administration is simple and easy to all business entity. In contrast, it reduced tax base or can't expand the tax base. In equity concern, Single rate doesn't support the social equity because of equal rate for all goods and services that consumed rich or poor people. Multiple rate system seems quite



complex but it has so many positive attributes. Such as; It broadens the tax base, It increases revenue, It accepts the social equity.

If VAT is developed as a major source of revenue, there is a necessity for introducing multiple rates of VAT. The survey also shows favoring multiple rate system in Nepal. Business community is also in favor of multiple rates. Revenue consultation committee is also recommended to the Government multiple rates should be implemented. The possible multiple rates may be 5% (basic goods and services), 10% (moderate goods and services), and 15% (Luxurious goods and services). The structure of VAT in Nepal is well designed however the existing convergence of exemptions is significantly broad and the threshold limit is also high which are being helpful means for tax evasion for the business community. However, a well designed structure of VAT will be nothing if the implementation is not going according and successfully.

Implementing VAT in Nepal is not only an easy task but also a highly challenging job. The main obstacles for successful implementing of VAT are: type of business structure and their malpractice, unclear distributional channel, credit sales system, seasonal market. This aspect should be improved as the time of demand. Special problems came up due to the existence of small trades in large portion. As many of small traders cannot fully comply with the requirement of a VAT due to their low scale of operation, lack of accounting records, illiteracy and high compliance cost. A problem arises on small trades with out no substitution revenue loss and extra burden on small traders. Fixing threshold limit to exempt the truly smaller traders is only the appropriate option of this problem.

The existence of open border and large number of unauthorized trade from India to Nepal poses a great threat to the success of VAT in Nepal. The illegal import from India and China would help to form a channel of unrecorded trade or black market channel resulting in a large-scale tax evasion. Because the tax administration is not strong enough to check or control the situation, the scope for illegal trade and tax evasion would not decrease even after the adoption of a VAT. The implication of unrecorded trade is that the genuine traders would be adversely affected and illegal trade would ultimately repeal the legal trade.



Due to the lack of experts a skilled manpower in the VAT administration, the auditing system, which is one of the most importance part of VAT operation, is not effective. Refund system is not easy task, process oriented and delaying .So that, the businessman are getting trouble to get the refundable amount. A public consciousness level is very low. Businessmen are cheating consumers by charging high price to them in the name of VAT. They are also cheating government by not issuing proper bills in their sales and hence do not pay real VAT amount.

The geographical condition of the country and difficulties would create several problems for the effectiveness of VAT in Nepal. In the remote areas like Humla, Mugu, Dolpa etc. where the people most bear the burden of higher prices of commodities due to the following elements: A wage of porter and animal, Expensive flight rate of air cargo, time factor, food and other miscellaneous factor. In this condition, the applicability of VAT may be regressive. It adds additional burden to the remote area's people because miserable in equitable and unjustifiable. So the higher price level of commodities discourages completely the VAT.

Strong administration, educational, registration program, extensive training program, technical data base system, Co-ordination of various departments (i.e. IRD, CD, RID), High level VAT implementation team, co-operation between government and private Sector, etc are essential pre-requisites for success of VAT.

We cannot easily forecast the effects of VAT on various areas. In general considerations of various effects have been made extant by using some of the existing evidences. VAT would have a favorable impact on saving, investment and production activities of the country. VAT would also increase the competitiveness of Nepalese products. The business activities of country would get certain impact from the VAT business activities would get certain re-adjustment and business structure and practices would also change. The VAT would be helpful in promoting countries exports. But import would decline due to the raise in the prices of imported goods. VAT would have positive impact on the collection of income tax and import duties. Because VAT would disclose the trading records of businessmen making them more transparent,



collection of income tax would certainly increase with VAT. The VAT would put the revenue at risk. Tax liability would be distributed among more unsophisticated taxpayers like trader; there is more danger of revenue leakage.

One of the best features of VAT is its catch up effect, which makes tax evasion impossible. But this effect is difficult to achieve in practical ground because of existing channel of illegal trade and under valued transaction and lack of administrative capability to catch and destroy the illegal channel and regulate system fairly.

## **6.2 Conclusion**

It is clear that, the tax is most essential source of the government revenue. Tax can be classified as two categories; direct tax and Indirect tax. 3/4 portion of total is occupied by Indirect tax. VAT is a major source of national revenue. It covers almost 1/3 share of total revenue. Thus the conclusion is that the prospects of VAT entirely depend on its implementation aspect. VAT has bright prospect in Nepal only when it can be implemented in a successful way further, the successful featuring depends up on the strong, fair, capable, honesty, taxpayer friendly and efficient administration.

Trend of VAT collection is increasing from the past. Government also adopted VAT as a foundation of revenue. This fact is shown in 10th plan, budget speech and strategies of Inland Revenue department. Nepal adopted open and liberal economy. In liberal economy the rate of custom duty should be reduced. Contribution of custom duty in total revenue is gradually declining in recent years. Income level of Nepalese people is low, lack of industrialization. So, at present income tax can't contribute to national revenue because of above reason. High income rate discourage saving and investment. Contribution of excise duty is not sufficient because lack of industrialization. Besides this, VAT is broad -based tax system. It has many attributes that increase the potentiality of VAT in Nepal. Strong political commitment, co-operation between customs offices and revenue offices, Co-operation between private sector and the government bodies, systemization of the open brooder, high public consciousness level, transparency and improvement of rules and



regulation accordingly overtime. Thus VAT can be entrenched as an integral part of the Nepalese tax structure in the long run if the issues mentioned above are taken seriously.

There is no doubt about suitability of VAT for nation building. At present, Consumer awareness is gradually increasing, no one in opposition of VAT, All business communities accepted, Administrative capacity is strengthened, computerization system is applied are promote the implementation of VAT. Effective implementation of VAT helps other tax, Such as income tax, import duties. So many beauty aspect of VAT makes it popular. Thus, VAT has great potentialities for fulfillment of revenue scarcity.

### **6.3 Recommendations**

The following are the recommendations made in this study:

1. A value added tax should be adopted in Nepal as an important measure of reforming tax system. For its proper implementation, the various issue pertaining to VAT should be considered seriously and be resolved. Such as, low level of administrative capability, unfavorable economic and business environment, large amount of exempted goods.
2. No billing, Lack of invoicing, incorrect value in billing is the main problems observed in invoicing system, which leads to weak VAT implementation. So importers should be asked to declare their sales and distribution channels and the estimated sales prices at all stage sales.
3. Consumer should be made aware of taking invoices, which is their fundamental right and responsibility to the state. Even buying of appropriate goods with specified quality and quantity is possible after taking the invoice. Consumer awareness program should be launched through media, seminar, discussion etc effectively. It helps to the people to take invoices after buying goods and services.
4. At present in Nepal, there is unpleasant business and political environment. VAT should be designed and implemented such a way that it may not fully work with the available administration under the present business and political environment. This thing we should not



have to forget that VAT has not been successfully implemented in some countries use to the unhealthy business and unstable political situation. So, government should try to strong commitment of above business environment and political stability.

5. Most of the people are unknown about VAT. VAT process and its effects on various aspects. They have developed kings of miss-concept regarding to VAT. Proper publicity for all related persons is the fundamental tool to success of VAT. Tax related information should be published regularly through journals, magazines, newspapers, pamphlets, program with professors, researchers, tax experts and economist should be conducted and published through advertisings Medias.
6. There should be a close co-operation between the private sector and government. The various issues pertinent to VAT should be resolved through broad discussion and consultations with the private sectors. The private sector should always be persuaded to actively participate in the VAT implementation process. Any contradictory situation and direct confrontation should always be taken into confidence. There should be a well communication and exchange of ideas between the two sides.
7. The VAT administration should be kept free from any sort of intervention from the outside like political sector. Honest and capable personnel should be selected for the key (Top) positions. Training for the tax personnel should be kept at the top most priority. A good working environment should create inside the administration. Reward and punishment system should strictly be followed as major guideline of conducting administration. Tax officials should closely be monitored for any kind of misdeeds. There should be a close co-ordination collective functioning by VAT and other tax related departments with regards the enforcement of VAT as well as other taxes. VAT auditing should be carefully planned and performed. A system of paying tax through bank should be developed and promoted.
8. Taxpayer should be provided better services with due regard and honor to them. Tax officials should behave with the taxpayers on equal footing. Many discretionary powers of the tax official should be limited making them rational.



9. The administration should be very watchful to prevent any kinds of mal practice, fraud and tax evasion. Almost care should be taken to prevent any kind of bribing and corruption. Tax officials should effectively be monitored to control it.
10. To avoid the no billing, incorrect billing, low billing problems, which are realized now, consumers should be well informed to take the bill after buying goods or consumed services. Issuing of real amount bill and maintaining proper book of account should be encouraged. Strict warning should be given to businessmen for not issuing accurate bills. If they neglect the rules and regulation they should be punished.
11. There is no fixed pricing system in the market to market, shop to shop and from day to day prices of some products are determined by bargaining. There is also a frequent price fluctuation. For proper implementation of VAT, there should be uniform price of the product in the market. Otherwise, the profit margins and value added of different sellers would upper different, which is very suspicious for tax persons.
12. Many businessmen having taxable capacity are still beyond the tax net. So, the enforcement should be made more effective and voluntary compliance could be raised through a set of promontory and regulatory measure including positive and services minded attitude of the tax structure, implication of tax procedures and forms, strengthening tax administration conduction audit and investigation in effective manner and penalizing those who are break the rules. The procedures regarding registration collection, interest, penalty, audit and appeal should be simplified and improved.
13. Not only the co-operation of government sector and private sector is sufficient there must be smooth co-operation and joint effort of both customs administration and the VAT administration also the customers.
14. From the equity consideration, it would be better to differentiate the VAT rate with the higher rate on luxurious goods and lower rate on essential goods. However rate differentiation should considered only when business community is performing VAT well and VAT administration is capable to handle the situation with out much difficulty and any distortions in the economy. At present, the time has become suitable to differentiate the VAT rate because business communities are in favor of multiple rate of VAT.



15. To increase registration, the registration program should be launched as a campaign. Strong notices for the registration should be widely disseminated with strong warning of penalty for non-registration is found this should be severely treated with greater publicity among other traders so that it may act as a deterrent to others.
16. Simple accounting system should be applied as far as possible. Small traders may be supplied account books and purchases book free of cost if they demand. Tax rebate of certain percent of their tax liability may be allowed as compensation to the compliance cost of the taxpayers. Administrative procedure should be simplified. Computerization in administration system should be wide spread to all IROs.
17. To increase the capability of administration, training of tax personnel should be kept on the top most priority. Training should be designed for various level and purpose. General training for all and specialized training for particular persons and foreign training should be designed and provided.
18. Tax collection and payment activities should be made transparent. Rule and regulation should also be made simple and unambiguous. The limitation of discretionary power and transparency in tax rules and tax collection activities would reduce the change of malpractice.
19. Many traders sell both VAT able and non-VAT able goods from a single shop. They may sell both goods at a time. This creates a problem for separating the taxed and non-taxed goods. So the government should try to separate them.
20. To foster internal revenue policy, professional and corruption less administration should be developed. Reliable and predictable revenue policy is also required. Result oriented administration, healthy co-ordination; regular market monitoring mechanism should be developed.
21. Strengthening the organizational capability, reform in revenue administration, with the co-operation of private sector, enlarging tax base, reform in tax system by applying e-Governance, developing fair and integrity tax administration are components to make VAT effectiveness.
22. Taxpayer friendly tax administration is essential to increase tax compliance. There is high level of corruption and tax evasion by the means of illegal alliance between Taxpayer and tax administration. It is



say that 50 % tax is leakage due to above reason. Our effort should be concentrate to minimize tax leakage and evasion. For this purpose illegal alliance between Taxpayer and tax officials should be destroy.

23. To enhance broad based tax and increase in tax compliance, taxpayer education program is needed. Habit of exchange of billing is promoted. To achieve this goal market monitoring, publicity about billing system, increase in consumer awareness, prize coupon programs should be lunched.
24. Protection of taxpayer's right and quick services and responsive behavior is required. Procedure of tax refund is simplified and reducing in time needed. Tax compliance expanses should be reduced. To make effective the role of taxpayer services center is essential for facilitating the taxpayer.
25. Simplification of forms and proper educate them to taxpayer. Probability of tax audit is established for all taxpayer. Message should be disseminate to all taxpayer about the possibilities of cross check for all transaction. Ethical code of conduct for tax officials should be develop and strong implemented it. Business community should be involved in policy making process.



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# QUESTIONNAIRES

(A case study of issues and practice of VAT in Nepal)

*Please you are requested to provide your opinion (tick any one) about VAT for the following questions:*

1. Do you know about VAT?

- a) Yes                                      b) partially                                      c) No

2. Could it possible to implement VAT effectively in Nepal?

- a) Difficulty                                      b) Possible                                      c) not possible

3. What is your view about implement ability of billing system in all level?

- a) Possible                                      b) Not Possible  
c) Costly                                      d) Impracticable

4. Do you believe that, VAT increases the price of commodities?

- a) Increase                                      b) Not increase                                      c) I don't know

5. Which is the most challenging problem of VAT implementation in Nepal?

- a) Smuggling and under valuation                      b) Lack of proper billing system  
c) Lack of proper account system                      d) Weak tax administration  
e) I don't know

6. What is the major Weakness of Nepalese VAT administration?

- a) Lack of expertise      b) Lack of physical infrastructure  
c) Process oriented      d) Miscellaneous      e) All of them

7. What is your suggestion about rate of VAT in Nepal?

- a) Existing rate (13%) is OK.                      b) It should be reduced  
c) It should be increased                      d) Established tow or three rates



8. What effect has been shown in investment sector?
- a) Negative
  - b) Positive
  - c) Normal
  - d) I don't know
9. Who are the most responsible for tax evasion?
- a) Business enterprises
  - b) Tax administration
  - c) Consumer
  - d) I don't know
10. What do you think about legal provision of VAT in Nepal?
- a) Sufficient & appropriate
  - b) Insufficient & need to improve
  - c) Complex and require simplifying
  - d) I don't know
11. Do you have any suggestion for effective implementation of VAT?
- a) Skilled & trained manpower
  - b) Proper billing & account system
  - c) Taxpayer friendly tax administration
  - d) Strictly market monitoring
  - e) All of them