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Applicability of Value Added Tax in Nepal

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INTRODUCTION

Value Added Tax (VAT) is a tax imposed on value added by business firms on goods and services at the successive stages of production and distribution. Value addition on a commodity or services is simply the excess of sales value over business purchases by a business entity. A VAT is the multy-stage, commodity and service based, one of the forms of sales tax (AnnuxreTable 1).

The VAT has been considered as an attractive alternative to existing indirect tax system, spreading around the world (AnnuxreTable /4) at a speed which is unmatched by any of other tax in the modern time, (Shoup, 1990) although it is the youngest form of taxation innovated in second half of the twentieth century, it has been emerging as a main element of the worldwide tax reforms. In every attempt of tax reform VAT is gaining the primary preference. The process of VAT harmonisation has been completed in EU member countries. It is compulsory to adopt VAT to be a member of EU. Among the 24 member of OECD countries all of them have adopted VAT except the USA.

THE NEPALESE SCENARIO

Nepal is facing a serious problem of resource gap and high dependency on foreign loan (Annuxre Table2). Cutting expenditures on development works, infrastructure and social services will not be just for a country crawling toward development. So, higher resource mobilisation through taxes remains to be the best option available in narrowing the fiscal gap in Nepal.

There is a predominant role of indirect taxes, especially import duty and sales tax in Nepalese tax structure. Income tax and other indirect taxes are not playing desired role because of their inefficient operation. Sales tax, however, is providing a considerable bulk of revenue, but, it has suffered from vary narrow base and cascading and pyramiding effects are creating distortions without generating potential amount of revenue. Nepal's tax

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effort ratio of 10.8 percent is perhaps the lowest in the world, next to Bangladesh (Dahal 1993). Elasticity and buoyancy elements of Nepalese tax structure are very low (Dahal 1984 and Ghimire 1994).

Meanwhile His Majesty's Government has decided to implement VAT in Nepal. But the business communities confused about this system making strong voice against it, i.e. a congenial atmosphere is not created for VAT in Nepal.

A BRIEF REVIEW OF NEPALESE TAX STRUCTURE

Tax structure of Nepal is highly dominated by indirect taxes, reflecting an average contribution of 81.7 percent in comparison to 18.3 percent by direct taxes during the period 1983/84 to 1993/94. The share of direct taxes seems declining from initial year of 1983/84 which sharply declined in 1991/92 with the contribution of only 16.2 percent (Annuxre Table 3).

The share of direct tax to the total revenue in Nepal seems to be very low in comparison to other countries of the world. It is argued that the declining share of direct taxes and increasing share of indirect taxes in a tax structure signifies the stagnant condition of the economy as well as tax structure, (Henrich 1969), and sign of regressiveness of tax structure. But personal taxes are hard to collect in predominantly rural and agricultural economics like Nepal (Dahal 1991).

In Nepal's indirect tax structure, revenue from consumption, goods and services share an average portion of 57.4 percent and taxes on international trade have share of 42.6 percent during the period 1983/84 to 1993/94. This shows the greater revenue potentiality from taxes on consumption, goods and services. The contribution of custom duties and excise duty to tax revenue seems to be declining slowly and the sales tax growing fastly.

Sales taxation, which was introduced first in 1965/66 through retail level in Nepal, is now limited to the import/manufacturing level. Now it covers only five services, has very narrow tax base, creating cascading effects, high burden on domestics, and inefficiency being principal features needs prompt rationalisation.

VALUE ADDED TAX IN THEORY

The VAT is collected from sellers on the basis of their value added at each of the stages of business process, thus, the same value is never taxed twice and never produce cumulative effects. Burden of the VAT is presumably shifted forward to the consumer. The optimum base of the VAT is gross national product.

The type of VAT can be classified on a three fold basis on the ground of treatment of producer's goods (Shoup 1969):

Gross National Product type of VAT

It does not allow to deduct the producer's goods from the tax base and there remains no provision of deducting depreciation from the base. It includes consumption expenditure plus investment in the tax base. In this sense, aggregate base of this type of VAT is gross domestic product.

The Income type of VAT

Though, Capital goods purchased from other firms are not excluded in this form of VAT, it allows to deduct depreciation from the tax base in the subsequent tax period. So. tax base in this type of VAT is the consumption expenditure plus investment . In aggregate sense, it is egual to net national income.

Consumption type of VAT

It allows a deduction or tax credit from its base for the full value of capital goods at a time of purchase. No depreciation is deducted from the tax base. In aggregate sense, the base of the consumption type of VAT is the consumption expenditure in national accounts. This type imposes tax burden on final consumption goods and exempts full value of investment goods.

The consumption variant is the most popular form among the three types of VAT. Almost all the VAT countries use the consumption type because it doesn't penalise investment and the growth. It is considered to be neutral regarding the method of production and administratively feasible.

The Principal Methods of Ensuring the VAT Base

Addition Method

In this method value added is computed by adding all the factor payments, including profits, made by the business firms during a tax period (Annuxre Table 1).

Subtraction Method

Under this method the tax base is determined by deducting the business purchases from its sales. Thus, value added equals to sales minues purchases by a business entity during a taxable period. (Annuxre Table 6).

Invoice Method or Tax Credit Method

Under this method VAT paid on total purchases is deducted from VAT levied on total sales, wich is the net VAT liability (Annuxre Table 7). This approach is known as indirect substration technique or invoice method. In this method, excess of input tax over the output tax is refundable or can be claimed as a tax credit. Generally, value added tax is not to be included in the base. This method is entirely based on invoices issued by the seller.

The tax credit method is considered as a tool for cross-checking measure under a VAT system. In this sense, VAT is said to be self-policing or self-enforcing in nature.

To adjust international trade VAT uses one of the two following principles:

Destination Principle: It taxes all imports and exempts all exports.

Origin Principle: It taxes all exports and exempts all imports.

Among them destination principle is more used and popular.

Theoretically, VAT is neutral among the method of production and distribution as well as consumer choices. Thus, it does not distort the economic efficiency. A VAT has the broad coverage in its base which tends to generating more revenue and presumed to be horizontally equitable in the sense of consumption expenditure, while more tax payers of equal ability to pay are taxed equally. But VAT is considered vertically inequitable, thus, regressive one. Exemptions and zero-rating on goods and services for basic need may loosen the regressivity of the VAT. A VAT which replaces another indirect tax would only have a slight effects on prices.

PROS AND CONS FOR A CASE OF VAT IN NEPAL

In order to mobilise more tax revenue, tax system shoud be made efficient, simple and transparent. There is a need of total reform in existing tax system of Nepal. The existing Nepalese sales tax system is not efficient, generates less of the potential amount of revenue and it is far from equity norms. Cascading and pyramiding are overall problems making room for vertical integration, distortions and tax evasion. To reduce such inefficiencies, it is necessary to move towards VAT system and initiate administrative reforms.

Focusing on the ever increasing resource gap, inefficiency in existing tax collection and growing need of revenue for handling development works, VAT should be implemented in Nepal. For neutral , stable and more revenue generating, transparent fiscal system and to eliminate growing fiscal deficits as well as to lower dependency on foreign loans VAT is the best form of sales tax which simply fulfills more of the above requirements.

Because of its being not distorting and fairness in nature, the VAT eliminates capital goods from tax base. VAT is neutral among the factors of production and will be helpful to enhance investment. In this sense, VAT will not hinder the investment. Rebating the exact amount of tax, VAT simply helps to the exports.

The most serious problem for implementing VAT in Nepal is the administrative inefficiency. Qualified, intelligent, competent, knowledgeable and well trained manpower is necessary to investigate and audit the business transactions for VAT purposes. The present tax administration of Nepal is inefficient and corrupt in nature.

Non - standard accounting system is the next serious problem for it. Lack of knowledge and information of taxpayers about VAT and rampant illiteracy make VAT difficult to implement. The present sales tax administration of Nepal is not capable to handle VAT efficiently in its present condition. More qualified intelligent and skilled manpower need to be recruited and to be trained well to make it efficient. Revenue Administration Training Center is totally incapable to handle VAT training in its present condition. There is a need of experts for VAT training to encompass distinctive and comprehensive knowledge on them to handle the VAT system properly. So that the tax evasion which effects the vertical equity of a tax system resulting dicrease in efficiency and the productivity of a tax can be avoided.

VAT is considered as a broad based tax, and potential advantages of it cannot be attained fully if the tax is not extended through retail level. Nepal has an agrain economy where a large number of small retailers are spread over the Kingdom without proper accounting habits. Under such condition extending VAT through retail level may prove costly, still VAT should be extended right through the retail level after a proper preparation and with moderate threshold. Except those services which are *hard* to tax should be taxed. Agricultural products and its raw materials, foodstuffs for basic needs i.e. rice, maize, millet, flour, low quality loaf bread, *'Kora'* and *'Khadi'* clothes, medicines, household fuels, public transportation fees (except air transport and luxury coaches) etc. should be exempted from VAT coverage. Very small traders below a threshold should be excluded from registration. A monitoring system should be developed for the proper handling of threshold system.

Rate structure plays prominent role for efficiency and the success and failure of a tax. Multiple rate seems complex and less effective, since, it reduces regressivity of the VAT, and the single rate proves highly simple to handle but tend to high degree of regressivity, a dual rate may prove moderate way to solve both problems.

Exemptions, if properly designed, on basic needs and *special consumption duty* in luxury goods would reduce the regressivity of VAT. Since the existing measure of sale tax rates of 10 percent and 20 percent are considered to be moderate the VAT rate between 10 percent to 15 percent is favoured. In specific sense, a single rate of 13 percent, supporting by a exemption system for basic needs and *special consumption duty* for luxuries would be preferable in Nepal.

VAT proves to be a complex tax system. Preparing its formalities, improving accounting habits, collecting returns, rebating them, keeping proper accounts, checking and auditing the business seem to be complex process for Nepal's tax administration and tax payers. It needs proper and effective efforts for its successful implementation. Cross-audit feature of VAT may result in vain if it is not implemented well and if the invoice chain is disturbed.

Experiences also show that VAT implemented after full preparations and taking supports from business people proved to be successful in Korea. VAT is not successfully moving in Philippines because it was implemented without adequate planning and preparations. But Indonesia's VAT is most successful, although, it took only 30 months time of infrastructure development. Experts recommend a period of 18 to 24 months for the preparation of a VAT system.

CONCLUSION

Value-Added Tax, theoretically is the best form of sales tax, especially because it is neutral regarding the methods of production, and helpful in generation of more revenue. The self-enforcing feature of VAT would make the administrative works easier. The existing import/manufacturing level sales tax as well as other seem to be inefficient and less productive that have created cascading and pyramiding effects. So, the rationalisation of such taxes in Nepal is a need of time.

Empirically, VAT is found to be the best alternative for reducing such inefficiencies. Because of its broad coverage, VAT would generate more revenue with less distortions and will unify more numbers of taxes producing very low amount of revenue. Neutrality, revenue productivity, fairness and the transparency are the desired goal to be achieved from VAT in Nepal. Achieving both, efficiency and equity objectives simultaneously is difficult under a really pragmatic tax system. It also makes the tax system complex. Yet the minimum level of equity is the basic need of a tax system in a condition of rampant poverty prevailing in Nepal. In this context if we deeply consider the problem of acute deficits and dependency on foreign loans, the VAT is an effective alternative in Nepal with following safeguards:

- Enforcement of VAT should be made on the basis of well set up legal bases. Preparation of legal bases should framed very sincerely which will minimise the operational problems. VAT should be implemented after preparing minimum required level of infrastructure.

- A consumption type of VAT, fully excluding producer's goods from tax base and taxing as many goods and services as close to the consumer, should be introduced.

- Tax-credit method for computation, and tax credit, should be applied on all producer's goods and services i.e. capital goods, raw material and intermediate goods.

- Destination principle i.e. tax in all imports and relief in all exports from VAT net should be applied.

- Exemptions should be extended on those goods and services which are for social welfare and are very hard to tax. Zero rate for exports should be adopted.
- Agriculture sector should be exempted at initial stage.
- Services sector also should be covered as much as possible.

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Table 1

A Simple Process Of Value Added Tax (in NRs.)

Stages of Production and Distribution	Net Purchase Price (A)	Sales Price (B)	Value Added (B-A)	Value Added Tax (at VAT rate of 10%)
Primary Producer	10	100	90	9
Spinner	100	230	130	13
Wholesaler	230	300	70	7
Retailer	300	400	100	10
Total	640	1030	390	39

Source: Framed by The Author with Arbitrary Figures.

Note: VAT at primary production $= 90 \times \frac{10}{100} = 90$

VAT paid by spinner in his production = 130 x 10 percent = 13

VAT paid by wholesaler = 70 x 10 percent = 7

VAT paid by Retailer = 100 x 10 percent = 10 and total VAT revenue received by the government in the economy = 390 x 10 percent = 39

Table 2
Resource Gap In Nepal

(NRs. in Milion)

	Govt. Expenditure	Total Revenue	Resource Gap A	Foreign Grant	Resource Gap B	Foreign Loan	Resource Gap C
1983/84	7437.3	3409.3	4028.0	876.6	3151.4	1670.9	1480.5
1984/85	8394.8	3916.6	4478.2	923.4	3554.8	1754.9	1799.9
1985/86	9797.1	4644.5	5152.6	1172.9	3979.7	2501.1	1478.6
1986/87	11513.2	5975.1	5538.1	1285.1	4253.0	2705.8	1547.2
1987/88	14105.0	7350.4	6754.6	2076.8	4677.8	3815.8	862
1988/89	18005.0	7776.9	10228.1	1680.6	8547.5	5666.4	2881.1
1989/90	19639.3	9287.5	10351.8	1975.4	8376.7	5959.6	2416.8
1990/91	23549.8	10729.9	12819.9	2164.8	10655.1	6256.7	4398.9
1991/92	26418.2	13512.7	12905.5	1643.8	11261.7	6816.9	444.8
1992/93	30897.7	15148.4	15749.3	3793.3	11956.0	6920.9	5035.1
1993/94	31334.9	19580.8	11754.1	2393.6	9360.5	9163.6	196.9

Source: (i) Budget Speeches 1983/84 to 1994/95 MOF/HMG/N.
(ii) Economic Surveys 1983/84 to 1994/95 MOF/HMG/N.

Table 3
Contribution Of Direct And Indirect Tax To Tax Revenue In Nepal

(NRs. in Million)

Fiscal year	Total Revenue	Tax. Revenue	Direct Tax		Indirect Tax	
			As % of Total Revenue	As % of Tax Revenue	As % of Total Revenue	As % of Tax Revenue
1983/84	3409.3	2737.0	15.9	19.8	64.41	80.2
1984/85	3916.8	3151.2	14.3	17.8	66.2	82.2
1985/86	4644.5	3659.3	14.2	18.1	64.5	81.9
1986/87	5975.1	4372.4	12.9	17.6	60.3	82.4
1987/88	7350.4	5752.8	13.7	17.6	64.5	82.4
1988/89	7776.8	6287.2	17.1	21.2	63.7	78.8
1989/90	9287.5	7283.9	15.4	19.7	63.0	80.3
1990/91	10729.8	8176.3	12.7	16.7	63.4	83.8
1991/92	13512.7	9875.6	11.8	16.2	61.3	83.8
1992/93	15148.4	11662.5	13.4	17.6	63.5	81.7
1993/94	19580.8	15371.4	14.6	18.6	63.9	81.4
Average %			14.2	18.3	63.5	81.7

Source: As of the Table 2

Table 4
VAT : Continentwise 1995

S.No.	Continent	Numbers of Countries Adopting VAT
1.	Europe	34
2.	Asia	22
3.	Latin America	22
4.	Africa	15
5.	North America	2
6.	Australia and Pacific	2
	Total	97

Source: Rup Bahadur Khadka, "Probability of VAT in Nepal", *Rastra Bank Samachar*, NRB 1995.

Table 5
Value Added Tax In The World 1995

Year of Adoption	Countries	Year of Adoption	Countries
1954	France	1983	Dominican Republic, Guatemala
1960	Ivory Coast	1984	People's Republic of China
1961	Senegal	1985	Indonesia, Turkey
1967	Brazil, Denmark	1986	Morocco, New Zealand, Niger, Portugal, Spain, Taiwan,
1968	Germany, Uruguay		
1969	Netherlands and Sweden	1987	Grenada, Greece
1970	Equator, Luxembourg, Norway	1988	Hungry, the Philippines, Tunisia
1971	Belgium	1989	Japan, Malawi
1972	Ireland	1990	Iceland, Kenya, Pakistan, Trinidad and Tobago
1973	Austria, Bolivia, Italy, UK, Vietnam	1991	Bangladesh, Benin, Canada, Jamaica, Mali, South Africa.
1975	Argentina, Chile, Costa Rice, Nicaragua, Colombia	1992	Algeria, Armenia, Azerbajan, Belarus, Cyprus, EL Salvador, Estonia, Fiji, Kazakhstan, Kyrgyz Rep., Latvia, Moldova, Russia, Tajikistan, Thailand, Turkmenistan, Unkraine, Uzbekistan
1976	Hounduras, Israel, Peru	1993	Burkina Faso, Czech Repulblic, Mongolia, Paraguay, Poland, Romania, Slovakia, Venezuela.
1977	S. Korea and Panama	1994	Bulgaria, Finland, Georgia, Lithumania, Singapore, Tanzania, West Samoa.
1980	Mexico	1995	Gobon, Ghana, Sri Lanka, Switzerland, Zambia
1982	Haiti		

Source: Rup Bahadur Khadka, "Probability of VAT in Nepal", *Rastra Bank Samachar,* NRB 1995.

Table 6
Working Of Subtraction Method

(In NRs)

Phases of Production and Distribution	Net Purchase Price (A)	Net Sales Price (B)	Value Added (B-A)	VAT
Primary	-	2000	2000	200
Producer	2000	4000	2000	200
Wholesalers	4000	5000	1000	100
Retailer	5000	6500	1500	150
Total	11000	17500	6500	650

Source: Framed by the Author with Arbitrary Figures.

Table 7
Working Of Tax Credit Method

Assuming: (i) 10 percent VAT rate
(ii) VAT do not enter into purchase price

(In NRs)

Phases of Production and Distribution	Net Purchase Price (A)	Net Sales Value (B)	Value Added (B-A)	Gross VAT on Purchase (D)	Gross VAT on Purchase (E)	Net VAT Liability (E-D)	
Cotton producer		300	300		30	30-0	30
Spinner	300	350	50	30	35	35-30	5
Textile Producer	350	500	150	35	50	50-35	15
Wholesaler	500	700	200	50	70	70-50	20
Retailer	700	750	50	70	75	75-70	5
Total	1850	2600	750	185	260	260-185	75

Source: As of the Table 6

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