# Value Added Tax in Nepal


### Abstract

*Introduc on of the value added tax (vat) is one aspect of the tax reform in Nepal. It was introduced to replace the exis ng sales tax, contract tax, entertainment tax and hotel tax. With the increase in expenditure, government requires more resources. For this broad-based taxa on system is necessary. Value added tax is one form of the broad-based tax. With the imposi on of value added tax, it is necessary to study about the effec veness, contribu on of the tax, etc. This study is based on the descrip ve analysis. This study makes comparison between the contribu on of VAT in the total tax revenue and contribu on of four different taxes, in the past, which were replaced by value added tax. The contribu on of four taxes, which were replaced by value added tax, was, on average, 31.63%, whereas such contribu on of value added tax is 33.57%. The share of value added tax, in each fiscal year, on the total tax revenue is more than 30%. But, in the past, situa on was not of this type with those four taxes. Thus, with the introduc on of value added tax, the collec on of revenue has increased over the me. This shows that through the tax reform, government is able to collect the rela vely higher level of revenue. In this context, government of Nepal is successful in tax reform.*




## 1. Introduction

Revenue is one component of government budget.Another component is expenditure. Government has different economic objectives, like high rate of economic growth, reduction of economic inequality , reduction of poverty , etc. To achieve these objectives, government should spend money. For this, it requires revenue. There are two different sources of revenue, i.e. tax and non-tax sources. Taxes are divided into two types. They are: direct taxes and indirect taxes. Direct taxes are levied directly on the individuals and organizations. The major types of direct taxes are income tax,

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corporation tax, wealth tax, interest tax, etc. On the other hand, indirect taxes are levied on the goods and services. The major types of indirect taxes are value added tax, excise duty, customs duty, and so on. In the direct taxes, the burden of taxes cannot be shifted to others. But, in case of indirect taxes, the burden can be shifted to others- partly or completely.

In the least developed countries (LDCs) like Nepal, the share of direct taxes on the total tax revenue of government is very limited. The major reason behind this is low level of income and wealth of people. So, such countries are heavily depending upon indirect taxes to collect the necessary revenue to f nance the expenditure. Among different types of indirect taxes, the contribution of value added tax (VAT) is highest in the Nepalese economy.

VAT is the latest form of indirect tax. It was f rstly recommended by Wilhelm Von Siemens in Germany in 1919 to replace the multistage-turnover tax in order to avoid the undesirable effects, particularly, cascading and vertical integration of the later tax. However, the government has not implemented the VAT at that time but it decided to reduce the rate of turnover tax. Similarly, Professor Thomas S. Adams recommended VAT for USA in 1921. In 1953, Michigan State of USA introduced a limited feature of VAT. However, tax was not introduced by any country till 1953. In real practice, France launched VAT in 1954 (Subedi, 1998).

As a part of tax reform, government of Nepal has introduced theVAT in 16 November 1997. It was levied to replace contract tax, entertainment tax, hotel tax and sales tax. Due to the political instability and strong opposition from business community , initially government of Nepal could not implement it fully. Later on, in the f scal year 1998/99, it was fully implemented.

VAT, in the Nepalese economy, was designed to collect the same revenue as the four taxes that it replaced collected. Since the collection of both customs duties and income tax depends, to a great extent, upon the ef fectiveness of VAT, it is expected to help enhance revenue collection. VAT is a broad-based tax as it covers the value added to each commodity by a f rm during all stages of production and distribution. It is a modern tax system to improve the collection of taxes, to increase ef f ciency and to lessen tax evasion. It is also regarded as the backbone of income tax system in Nepal

(Inland Revenue Department).

VAT is a tax imposed on the value added on goods and services at each successive stage of production and distribution by the producers and distributors. It should be noted that value added refers to the excess of sales value over the purchase value of the producer or distributor. The producers and distributors add value on the goods and services during the process of production and distribution. For example, a producer adds value on the purchased raw materials while producing the f nal goods by using those raw materials. Such process of value addition by producer involves the cost on labour, capital goods, transportation, etc. Similarly , a distributor adds value on the goods, for example, while transporting goods from one place to another place.

How value added is computed and VAT is calculated from that can be shown with the help of table 1:

Table 1: Computation of Value Added and VAT (VAT Rate: 13%)

| Stages of Production and distribution | Purchase Price (Rs.) (A) | Sales Price (Rs.) (B) | Value Added (Rs) (B-A) | VAT (Rs.) |
|---|---|---|---|---|
| Producer | 100 | 200 | 100 | 13 |
| Wholesaler | 200 | 400 | 200 | 26 |
| Retailer | 400 | 700 | 300 | 39 |
| Total | 700 | 1300 | 600 | 78 |

Source: Arbitrary f gures estimated.

Thus, VAT is collected at each stage of production and distribution.V AT has the following features:

Broad-based tax

Zero-rating mechanism

Self-policing mechanism

Catch-up effect

No cascading/pyramiding effect

Discourages the vertical integration of f rms

## 2. Objectives of the Study

The main objectives of the study are to examine the legal provision of VAT in Nepal and to f nd out the contribution of VAT on the total tax revenue of government of Nepal. The specif c objective is to examine the comparative contribution of VAT with the contribution of those four taxes, in the past, which were replaced by VAT.

## 3. Methodology of the Study

### A. Nature and Source of Data

This study is based on the secondary data. These data were taken from the economic survey published by ministry of f nance (MOF), government of Nepal (GON).

### B. Time Frame Considered

This study is based on the time span of 26 f scal years. To study the contribution of four taxes which were replaced by VAT, the period of 1984/85-1996/97 is considered whereas to study the contribution ofVAT the period of 1998/99-2010/11 is considered.

### C. Tools of analysis

The study is based upon the descriptive analysis. For the purpose of analysis, simple tools, like ratio, percentage, etc. are used.

## 4. Types of VAT

Shoup (1961) has classif ed the VAT in three types. They are: consumption type VAT, income type VAT and product type VAT.

a) Consumption type VAT

This is the most commonly used type ofVAT. Almost all countries that are introducing VAT apply this approach. In this type, the base of VAT is f rm's gross receipts minus the value of all its purchases of intermediate goods and capital goods. Thus, here tax base becomes the consumption expenditure.

This type of VAT is equivalent to a general retail sales tax on consumer goods, the two differing in administrative procedure only (Musgrave & Musgrave, 1989).

As this type of VAT exempts all producer goods from taxation, it encourages the investment. Similarly, it is easier to calculate because under this approach there is no need to make distinction between different types of capital goods- all of them are exempted.

b) Income type VAT

In this type, the base ofVAT is f rm's gross receipts minus the value of all its purchases of intermediate goods and depreciation on capital goods. Thus, in other words, tax base is equal to net national product (NNP) of economy.

The difference between consumption type VAT and income type VAT is that the former allows the deduction of gross investment whereas the latter allows the deduction of depreciation.

c) Product type VAT

In this type, the base ofVAT is f rm's gross receipts minus the value of all its purchases of intermediate goods. Thus, in this approach, the tax base is gross national product (GNP) of the economy . Here, tax is imposed on both consumer as well as capital goods. It is the most comprehensive type of VAT.

In short, the types of VAT and their base is shown in the table 2:

Table 2: Types of VAT and their base.

| Type of VAT | Tax function | Tax base |
|---|---|---|
| Consumption type | $t(GNP-I_G) = t[GNP-(I_N + D)]$ | Value of consumer goods |
| Income type | $t(GNP-D) = t(NNP)$ | Net national product = value of consumer goods + value of capital goods - depreciation |
| Product type | $t(GNP)$ | Gross national product = value of consumer goods + value of capital goods |

Sources: Column 2: Musgrave & Musgrave (1989), column 3: author's analysis.

In table 1, GNP = gross national product, NNP = net national product, $I_G$ = gross investment, $I_N$ = net investment, D = depreciation, and t represents for function.

## 5. Methods of Computing VAT

There are three methods of computing VAT. They are: addition method, subtraction method and tax credit method.

In the addition method, the value added is calculated by adding the factor payments made by the f rms, i.e. wage, rent, interest, and prof t. "Virtually, no country uses the addition method, although, Argentina and Israel have applied it to selected economic activities, such as banking and f nance, where value of inputs and outputs is dif f cult to measure" (Cnossen, 1992). This method is complex to compute VAT.

In the subtraction method, the value added is calculated by deducting the purchase value from sales value. Thus, in this method, the net turnover of the business is taken as value added.

In the tax credit method, the value added is calculated by deducting the tax on inputs from the tax on outputs. This method is also known as indirect subtraction method or invoice method. It is universally preferred method of computing VAT. It can be easily used in the multiple rate structure. It is suitable for tax credit on the export. "In addition, the tax credit method is much easier for most f rms to comply with. This is much easier to cumulate taxes and deduct this sum from the f gure of tax times total sales than to add together a number of separate items that constitute value added or deduct various types of expenses from total sales (Due, 1957). "Furthermore another meritorious feature of tax credit method realized is the cross audit, or audit trail" (Subedi, 1998). "The tax credit method also stresses the consumption nature of the tax and lessens the danger of pyramiding" (Due, 1957).

## 6. Legal Framework Regarding VAT in Nepal

The Government of Nepal has specif c legal framework for the collection of resources through the VAT. Value Added Tax Act, 2052 (1996) provides the foundation for mobilizing the resources through the VAT. According to Value Added Tax Act, 2052 (1996) (Law commission):

"... it is expedient to increase the mobilization of revenue needed for the economic development of the country, by making the process of revenue recovery effective and to levy the revenue in ef fective manner by systematizing the process of recovering the Value Added Tax on all kinds of transaction including sale, distribution, transfer , import and export of goods and services and to realize the tax …….. Parliament has enacted this Act……"

This Act guarantees the single rate of VAT as prescribed in the f nancial act made for the concerned f scal year. There is the provision of zero rate for the goods exported from Nepal and services to be supplied to persons outside Nepal. Similarly, there is the provision of VAT exemption on a number of goods and services, like basic agricultural products; goods of basic needs; live animals and animal products; agricultural inputs; medicine, medical and similar health services; etc.

The seller should issue the three copies of tax invoice: the original copy should be given to the purchaser , the second copy is to be retained for the audit purpose and the third copy is for the seller to use in preparing a record of transaction. There is the provision of abbreviated invoice for the retail sales below the value of Rs. 5000.

For the purpose of imposing VAT, all the goods and services are divided into two categories, viz. taxable and tax-exempt. The taxable goods and services are either taxed at the standard rate of 13% or they are taxed at 0%. All the businesses whose annual taxable turnover is more than Rs 2 million must be registered for the purpose of payment of VAT. Similarly, belonging to a conglomerate that has an aggregate annual taxable turnover exceeding Rs. 2 million must be registered. On the other hand, the businesses with annual turnover of taxable goods and services of Rs. 2 million or less need not to collect VAT. However, these businesses can voluntarily register. Similarly, the purchaser needs not to pay VAT on tax-exempt goods and services.

One should not be confused with the concepts of zero-rating and exemptions. Zero-rating means certain goods and services are taxed at the rate of zero percent. Under the current VAT act, only exported goods and services are zero-rated. The businesses that supply zero-rated goods and services are entitled to recover the input tax paid on their purchases. On the other hand, in the case of exempt goods and services, VAT is not levied on the sales of goods and services but the businesses are not entitled to a credit for VAT on their purchases (Khadka, 2001). It should be noted that the exemption of certain goods and services from VAT is granted, particularly , on administrative grounds. It is not possible, for example, to makeVAT applicable to very small vendors, who are unorganized, seasonal and who do not keep the record of their transactions. Such small vendors are very lar ge in number and they are scattered throughout the country. In case of exemption, the exempt businesses are not completely free from the burden of VAT- they are partially free. On the other hand, zero-rating is applied to make the businesses completely free from the burden of VAT. Sometimes zero-rating is granted on the social welfare grounds. For example, it is not desirable to impose VAT on basic necessities. Similarly, in case of exported goods, the reason behind the zero-rating is to make them competitive in the international market.

## 7. Contribution of VAT in Total Tax Revenue

The article analyzes the contribution of VAT in the total tax revenue of government of Nepal. Similarly, the contribution of sales tax, entertainment tax, contract tax and hotel tax; which were replaced by VAT, in the period of f scal year 1984/85-1996/97 is also analyzed. The objective of such analysis is to make the comparison between the VAT and the taxes replaced by VAT within the period of equal number of f scal years.

Table 3: Share of sales tax, entertainment tax, contract tax and hotel tax on the total tax revenue.

| Fiscal year | Sum of sales tax, entertainment tax, contract tax and hotel tax (Rs. in ten million) | Share on the total tax revenue (%) |
|---|---|---|
| 1984/85 | 101.26 | 32.13 |
| 1985/86 | 117.30 | 32.06 |
| 1986/87 | 136.30 | 31.18 |
| 1987/88 | 161.25 | 28.03 |
| 1988/89 | 169.89 | 27.02 |
| 1989/90 | 195.38 | 26.82 |
| 1990/91 | 235.44 | 28.80 |

| | | |
|---|---|---|
| 1991/92 | 328.36 | 33.25 |
| 1992/93 | 400.77 | 34.36 |
| 1993/94 | 538.09 | 35.01 |
| 1994/95 | 685.71 | 34.88 |
| 1995/96 | 742.93 | 34.29 |
| 1996/97 | 816.29 | 33.42 |
| Average | | 31.63 |

Source: Author's calculations based on The Economic Survey, 2011/12, Ministry of Finance, Government of Nepal.

Thus, the data suggest that the contribution of sales tax, entertainment tax, contract tax and hotel tax was signif cantly high on the total tax revenue of government of Nepal within the given period of time. Such contribution was from 26.82% to 35.01% of total tax revenue.

To analyze the contribution of VAT in the total revenue, the period of f scal year 1998/99-2010/11 is considered. It should be noted that, VAT in Nepal was fully implemented from the f scal year 1998/99.

Table 4: Contribution of VAT in total tax revenue

| Fiscal year | VAT (Rs. in ten million) | Average growth rate of VAT | Total tax revenue (Rs. in ten million) | Share of VAT on total tax revenue (%) |
|---|---|---|---|---|
| 1998/99 | 876.59 | - | 2875.29 | 30.49 |
| 1999/00 | 1025.97 | 17.04 | 3315.21 | 30.95 |
| 2000/01 | 1238.24 | 20.69 | 3886.50 | 31.86 |
| 2001/02 | 1226.73 | -0.93 | 3933.06 | 31.19 |
| 2002/03 | 1345.97 | 9.72 | 4089.60 | 32.91 |
| 2003/04 | 1447.89 | 7.57 | 4817.30 | 30.06 |

| | | | | |
|---|---|---|---|---|
| 2004/05 | 1888.54 | 30.43 | 5410.47 | 34.91 |
| 2005/06 | 2161.07 | 14.43 | 5743.04 | 37.63 |
| 2006/07 | 2609.56 | 20.75 | 7112.67 | 36.69 |
| 2007/08 | 2981.57 | 14.26 | 8515.55 | 35.01 |
| 2008/09 | 3970.09 | 33.15 | 11705.19 | 33.92 |
| 2009/10 | 5492.09 | 38.34 | 15629.49 | 35.14 |
| 2010/11 | 6166.36 | 12.28 | 17277.76 | 35.69 |
| Average | | 18.14 | | 33.57 |

*Source: Author's calculations based on The Economic Survey, 2011/12, Ministry of Finance, Government of Nepal.*

The data suggest that except in the f scal year 2001/02, in every year the level of VAT is increasing. The growth rate of VAT seems to be highest in the f scal year 2009/10, i.e. 38.34% whereas smallest in the f scal year 2003/04, i.e. 7.57%. The growth rate of VAT is signif cantly f uctuating over the time. The average growth rate seems to be 18.14%, which is also relatively high. Thus, the growth rate of VAT, on an average, seems to be satisfactory.

VAT has highest share in the total tax revenue of government of Nepal. In everyf scal year, the share of VAT is greater than 30%. On average, such share on the total tax revenue is 33.57%.

Thus, the analysis of data suggest that the contribution of those four taxes which were replaced by VAT was in some f scal years less than 30% of total tax revenue. But, in every f scal year the contribution of VAT is more than 30% of total tax revenue. Not only this, the average share of VAT on total tax revenue is greater than the average share of those four taxes in the past.

## 8. Problems of VAT in Nepal

In spite of increasing the role of VAT in revenue mobilization, there are dif ferent problems related to VAT. Some of them are as follows:

No issuing tax invoice for every transaction
Problem of fraud billing in transaction
Political interference in administrative actions against the businesses which have involved in the illegal activities
Delay of VAT return to the businesses
Illegal VAT returning from government treasury by the businesses
Weaker administrative capacity of inland revenue department

## 9. Conclusion

The reform in the tax system of Nepalese economy is very important. With the increase in the size of the government expenditure, more resources are necessary for the country. Not only is to meet the expenditure requirement of the country , but also to meet the development goals, Nepal requires more resources. Introduction of VAT is one dimension of the tax reform in Nepal. Nepal is adopting consumption type VAT using the tax-credit method. However, while comparing the contribution of VAT on the total tax revenue with those four taxes that it replaced, there is no signi f cant difference- contribution of VAT is slightly greater than the contribution of previous four taxes. So, it is necessary to make implementation of VAT more effective. As the VAT has high level of contribution on total tax revenue, certainly the reform in taxation is going in the right direction.