

VAT in Nepal

Dr. Rup Khadka*

VAT has become a popular topic of reform in recent years. This tax has already been adopted by about 100 countries and many others, including Nepal, are seriously considering introducing this tax. This paper examines the structure of the Nepalese VAT, points out the need to introduce VAT in Nepal, reviews the preparation made so far for the introduction of this tax, and indicates the challenges and strategy to be adopted for a detailed preparation and successful implementation of VAT in Nepal.

1. The Structure of the Nepalese VAT

1.1 Coverage

Nepal has adopted a broad-based consumption-type VAT using the tax-credit method. Under this system the tax is levied on all types of goods and services, both imported and domestically produced, except those specifically exempted by the Law. Tax exempt goods and services may broadly be classified as goods and services of basic needs, basic agricultural products, agricultural inputs, social welfare services, goods made for the use of disabled persons, most passenger transport services, educational and cultural goods and services, personal

* Dr. Khadka, a member of the High Level Decentralization Co-ordination Committee, was a Research Fellow at the Seijo University from May 1990 to April 1991.

VAT in Nepal

services, the purchase and rent of land and buildings, financial and insurance services, postage and revenue stamps.

VAT is extended right through to the retail level. It is levied on the value added by each firm at each stage in the production and distribution process. However, small vendors whose annual turnover is below the registration threshold—irrespective of their place in the production and distribution chain — are not required to register for VAT and thus the tax will not be applied to goods and services that they sell.

1. 2 Operation

The base of VAT is the value added by each firm through its production and distribution activities. The value added, however, 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 wood cutter sells to a furniture maker one cubic foot of wood at Rs. 1,000. The furniture manufacturer uses the wood to make furniture and sells it to the furniture dealer at Rs. 1,300. Finally the dealer sells the furniture to the final consumer at Rs. 1,500. On the basis of these figures VAT will be levied in the following manner :

PRODUCTION AND DISTRIBUTION STAGES	SELLING PRICE	VALUE ADDED	OUTRUT TAX (tax collected on Sales)	INPUT TAX (tax paid on purchases/ imports)	VAT TO BE PAID TO THE GOVERNMENT
Wood Cutter	1,000	1,000	100	0	100
Mannfacturer	1,300	300	130	100	30
Dealer	1,500	200	150	130	20
TOTAL VAT					150

VAT in Nepal

Using a VAT rate of 10 percent the wood cutter collects Rs. 100 as VAT on his sales and pays it to the treasury. The furniture manufacturer collects a VAT of Rs. 130 on his sales but has an input tax credit of Rs. 100 and thus remits Rs. 30 to the government. Finally, the dealer collects VAT of Rs. 150 but deducts his input tax of Rs. 130 and remits the balance of Rs. 20 to the government account. Thus the government gets a total revenue of Rs. 150.

1. 3 Input tax credit

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

1. 4 Tax rate

The Nepalese VAT will be levied at a single positive rate. The rate will be fixed by the Finance Act. Exports are subject to a rate of zero percent.

1. 5 Exemption versus zero-rating

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 vendor supplying zero-rated goods and services is entitled to recover the input tax paid on his

VAT in Nepal

purchase used to make a zero-rated supply.

On the other hand, in the case of the dealer dealing with exempt goods and services, VAT is not levied on his sales and he is not entitled to a credit for VAT paid on his purchases/imports. An exemption is generally granted if it is desirable to exclude a particular product or transaction on administrative grounds, i.e. when it is extremely difficult to collect tax on such products or transactions. For example, petty vendors having an annual turnover below the threshold are exempt. Such vendors are not required to register for VAT purposes and do not collect tax on their sales. As tax exempt vendors, they are not entitled to the input tax credit.

1. 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 input tax (the tax on purchases and inputs into the business) over output tax (the tax on sales). Such a provision is made to encourage exports and generate foreign exchange. The possibility of a 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 months.

2. Need to introduce VAT in Nepal

It is necessary to introduce VAT in Nepal for many reasons. Broadening the tax base, reducing the tax rates, and making the tax system transparent, fairer and less distortionary have been the important features of recent tax reforms in the international arena.

VAT in Nepal

VAT is the best option to broaden the base and reduce the rates of our taxes and to make the tax system more transparent in line with liberal economic policies introduced in recent years.

2. 1 Broaden the tax base

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

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

2. 2 Promote economic growth

VAT in Nepal

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

2. 3. Establish a fairer tax system

It is necessary to introduce VAT to make the Nepalese tax system fairer. The existing commodity tax system encourages smuggling and under-valuation, resulting in a discrimination against those goods which are not smuggled and/or under-valued. Further, the existing import/manufacturing level sales tax discriminates against those goods that generate a higher value added at an earlier stage or stages. This is also true, as stated earlier, in the case of domestic products. The tax system has also become discriminatory due to the lack of its effective implementation.

As VAT makes smuggling and/or under-valuation more difficult and less attractive, the tax is likely to be levied more uniformly on all taxable commodities. Further, VAT will place an equal burden on all

goods and services irrespective of their proportion of value added at different stages. The tax will also be fairer due to its wider coverage, uniform rate and effective enforcement. As VAT will help strengthen the over-all tax system, it will make the Nepalese tax system fairer.

3. VAT Preparation

The VAT preparatory work has been progressing since September 1993. A VAT Task Force has been established under the Sales Tax and Excise Department in order to make necessary preparation for the introduction of VAT. Technical assistance has been provided by the Harvard Institute for International Development under USAID financial assistance. The VAT Act has been passed, the draft regulations are completed, and operating manuals are in progress. Brochures have been prepared and VAT information and discussion programs are being organized in various places in order to familiarize the industrialists, businessmen, administrators, politicians, journalists and others with the VAT. The private sector is also being consulted in an effort to minimize conflicts between the private and public sector's interests.

A study to determine the estimated revenue and the proper tax rate is being undertaken. Computerization is also in progress. A functional organizational structure for the administration of VAT has already been approved, and implementation began on July 16, 1996. Sections and subsections have been created on the basis of the function of VAT administration, such as tax refund, taxpayer services, tax audit, investigation, return processing, and registration. New officer level positions have been created. Some tax officials have already been trained, while others are scheduled for training later in the year.

4. Challenges Ahead and Strategy

4.1 Administration

While the Government has already announced the date for VAT registration (April 16, 1997) and collection (July 16, 1997) of this tax, the business community does not seem to be in a mood to accept this tax readily. While industrialists and businessmen have not challenged the theory of VAT, they have been expressing their concern, time and again, regarding the implementation of this tax. The business community suspect that this tax also, like other theoretically sound measures introduced in the past, will not be applied in practice in an effective manner due, *inter alia*, to the traditional, less motivated and weak tax administration. This is also the concern of the government and others who are interested in taxation issues.

VAT demands a strong tax administration as it is a broad based tax that covers a large number of goods and services at all stages of production and distribution. VAT is going to replace sales tax, hotel tax, entertainment tax and contract tax, meaning that VAT is expected to generate about 40 percent of the total tax revenue. The tax administration has to be strong and attentive at all times to implement this tax in an effective manner and to prevent a fall in government revenue, particularly through the abuse of the tax credit mechanism and fraudulent refund claims. Greater vigilance is important in a county like ours where the channels of distribution are limited and less traceable and the record and account keeping system is poor.

The existing administration does not seem to be adequate to administer VAT in several ways. Sales tax has been neglected from the

VAT in Nepal

administrative point of view from its inception in 1965. While the Tax Department was made responsible for the administration of sales tax, neither a sales tax unit was created nor was the number of personnel increased for the administration of this tax. As this department already administered about a dozen taxes, it could not concentrate on the administration of the sales tax which generated about a quarter of total tax revenue. Tax officials preferred to concentrate on the income tax, which generated only about five or six percent of total tax revenue. Such a situation existed until almost the mid-1980s.

Attempts have been made to strengthen the sales tax administration since 1984/85, when a sales tax unit was created in the Tax Department. Sales tax branch offices were opened in big industrial districts in subsequent years. A separate Sales Tax Department was established in 1992. This department and the Excise Department were unified as the Sales Tax and Excise Department in 1993. The new department, in turn, was converted into the VAT Department on July 16, 1996. This means that this department will be made responsible for the administration of VAT.

The VAT administration, however, is still considered to the least attractive part of the revenue administration. In general, revenue officials working in the VAT administration seem to be less motivated and prefer to work in other branches of the revenue administration. Similarly, officials who are working in the other branches of the revenue administration do not want to get transferred to the VAT administration. It is, therefore, necessary to find ways to make the VAT administration more attractive. In this context, one alternative could be to create a VAT sub-group within the revenue group and recruit

VAT in Nepal

officials exclusively for this administration. It is necessary to create opportunities, including overseas training, for VAT officials to make working in the VAT department desirable.

Another option, that could make the overall tax system more efficient, is to combine various revenue offices into one office. Now there are several revenue offices, such as tax office, VAT office, customs office and land revenue office in one district. The physical condition and facilities of these offices are much less than satisfactory. In many cases the roofs leak, there is a lack of furniture, and inadequate space. Often these offices are run in rented houses. Many of these offices administer a limited number of taxpayers and collect nominal revenue. It would be much better to have a single revenue office dealing with all taxes in one district with adequate space, required furniture, and computers in the context of modernizing the tax administration. By doing this the government can better serve its taxpayers at lower costs. Taxpayers also will not have to go to different offices several times in connection with different taxes. In this way, both the administrative cost of tax collection by the government and compliance cost of the taxpayers may be reduced. Such a system will also avoid the existing situation where the revenue officials try not to be transferred to the VAT administration.

Another point to be mentioned in this respect is that most tax officials working now in the VAT administration are not familiar with the VAT. Therefore, both new entrants and existing VAT staff will require extensive training on various aspects of VAT before they are assigned particular jobs. Although VAT is based on the principle of self-assessment by the taxpayers, it demands a large number of

qualified and trained officials. VAT officials have to conduct a survey of potential taxpayers from time to time so that qualified taxpayers may not remain outside the tax net. They will have to process the monthly tax returns submitted by the taxpayers and notify taxpayers if they have made any mistakes. If a taxpayer fails to file a monthly return, a tax official must follow-up and notify the taxpayer. Books of account must be audited on a sample basis. For this, VAT officials will be required to have advanced accounting and auditing skills. It is equally necessary to modernize the tax administration. It must be noted that under the existing sales tax system, manufacturers are required to get taxable values of their products approved by the concerned tax office. Taxpayers complain that tax officials generally do not agree to reduce the taxable value even if the prices of their products have come down due to the reduction in the prices of their inputs or other market conditions. VAT cannot run with such a mentality. It is, therefore, important to reorient the tax officials in line with the concept of the VAT. Tax officials should be prepared to accept the prices declared by the taxpayers at their face values. Taxpayers should not be asked to get their price lists approved by a tax official. Instead, tax investigation and audit should be made effective in order to make taxpayers more careful in fulfilling their duties. This fact must be made clear to other organizations such as the Revenue Investigation Department, the Special Police Department, the Auditor General Office and the Authority Abuse Research Commission.

4. 2 Taxpayer education

There is a general impression that VAT is a complicated tax. Some

VAT in Nepal

industrialists and businessmen fear that this tax will be too complicated to comply with and would require them to hire a separate accountant for the purpose of this tax. This is not true. As indicated in the following table, tax formalities will be much easier under the VAT than under the existing sales tax :

Formalities	Sales tax	VAT
Registration	Yes	Yes
Renewal of registration	Yes	No
Approval of the price by tax office	Yes	No
Certification of invoices by the VAT office	Yes	No
Issuance of invoice	Yes	Yes
Maintenance of books of account	Yes	Yes
Tax credit	Yes (Partial only)	Yes (Full)
Submission of returns	Yes (four forms)	Yes (one form)
Signature of the tax officer on voucher	Yes	No
Payment of tax	Yes	Yes
Submission of annual return	Yes	No
Annual assessment	Yes	No

As indicated in the above table, the existing sales tax is more complicated than the VAT. Under the existing system, some of the payers of sales tax may be required to pay hotel tax, entertainment tax or contract tax. In that case, tax formalities increase considerably as the taxpayers have to study four tax laws, four regulations, and complete several formalities for the purpose of these taxes. As all these taxes will be replaced by the VAT, taxpayers will have to know only about the VAT Act and Regulations and perform formalities relating to VAT only.

VAT, however, will require more work from those taxpayers who are currently not registered for any of the existing taxes which will be

VAT in Nepal

replaced by the VAT. A comprehensive training on such areas as registration, invoicing, maintenance of accounts, submission of returns and payment of tax must be given to potential taxpayers in order to minimize their compliance costs. Similarly, information relating to activities such as the date of the introduction of VAT, the period within which taxpayers must register, the date of submission of returns and payment of tax, and penal provisions must be advertised widely through the media. Similarly, attempts must be made to reduce compliance costs through reform measures in the income tax, customs duties and tax administration. This message must be well communicated to potential taxpayers who think that VAT will increase their burden considerably.

The VAT education program must be launched on a wider scale for the public as well. This program should focus on the rationale and potential effects of VAT. Information should be disseminated on a large scale through the media. Seminars and public speeches should be organized at various places throughout the country.

4. 3 Tax reform package

The above mentioned measures relating to the tax administration and taxpayer education will not be adequate for the success of VAT in Nepal as these measures are not going to answer several concerns of the industrialists, businessmen, consumers and others. Perhaps, most, if not all, businessmen may fear that the introduction of VAT will lead to a substantial increase in their income tax liability. Some may be worried about the abolition of exemptions and rebates that they are taking advantage of under the existing sales tax. Most consumers may be

thinking that VAT will lead to an increase in the price level. Some may think that VAT would encourage smuggling. These all are natural concerns at this stage and need to be considered carefully by the Government.

In this context, it is extremely necessary to examine the potential effects of VAT together with other taxes, including income tax, customs duties and tax administration, on the Nepalese economy. The total burden of tax on different sectors in the pre-VAT regime must be calculated and a tax package must be developed in such a way that the total tax burden does not increase in the post-VAT regime. For example, if the base of income tax increases due to the information generated by the VAT, the government should reduce the rate of income tax in such a way that the total burden of income tax does not increase in the post-VAT regime. Similarly, any increase in the compliance cost for the payers of VAT — who are not currently registered for the purpose of any commodity based taxes — must be compensated with a reduction in the rate of some other tax(es) or some other measures. Similarly, any exemptions, rebates or facilities granted under the existing taxes which are going to be replaced by VAT but will be desirable not to be considered under the VAT, must be compensated for through other fiscal measures. For example, any increase in the burden on some items due to the imposition of a uniform rate of VAT may be offset by the corresponding reduction in the rates of customs duties or income tax or both. Such measures will not only avoid an increase in the tax burden but also will help contain the price level.

Thus, the introduction of VAT should be considered as a part of an

overall tax reform, not as an isolated step. The purpose of the tax reform package should be to enhance the competitiveness of the Nepalese economy in the post-VAT regime. The announcement of such a package would minimize uncertainty among the private sector, which is very important in order to attract investment and allow investors to make long-term plans.

A high level team, comprised of representatives from both the public and private sectors, must be constituted to provide guidance for the over all tax reform. Similarly, a working committee whose members have expertise in tax systems, tax laws, industry and commerce (probably representing the Ministry of Finance and various departments under this ministry, Ministry of Industry, Ministry of Trade, Federation of Nepal Chambers of Commerce and Industry etc.) should be created to carry out the VAT (tax reform) preparatory work on a large scale.

5. Concluding Remarks

Nepal has adopted a broad-based consumption-type VAT using the tax-credit method. It is necessary to introduce such a tax to broaden the tax base, to promote economic growth and to make the Nepalese tax system fairer.

It is necessary to make full preparations before the introduction of VAT. The international experience also indicates that a detailed process of preparation should be a prerequisite for the introduction of a VAT. In this context, it is necessary to revamp the tax administration, with emphasis on fulfilling the staffing requirements and training the staff before the introduction of VAT. It is also necessary to launch a comprehensive taxpayer education program in order to give an idea

VAT in Nepal

about various aspects of this tax to the potential taxpayers and others.

The introduction of VAT should be considered in the light of a reform of the over-all tax system and tax administration, not in isolation. The tax reform package should be designed in such a way that the competitiveness of the Nepalese economy will increase, not decrease, in the post-VAT regime.