

Some Aspects of Indirect Taxes in Nepal

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Abstract

Developing countries raise part of the vast financial resources required for their development needs from tax. Considering the limited scope of direct tax, revenue largely depends on indirect taxes like custom duty, sales tax and excise duty. Contribution of indirect taxes to total revenue has an erratic trend. Custom duty constitutes major source hence the revenue policy amounts virtually to import based. The distribution of incidence of indirect taxes has been found regressive. Buoyancy of components indirect taxes such as customs and sales tax is found greater than unity while that of excise duty is less than unity. In terms of GDP sales tax is found more buoyant.

1. Background

Being a developing country, the role of government in Nepal is still vital to build up infrastructure, to provide social services and to alleviate the abject poverty. Such a challenging role of the government demands the growing necessity of government expenditure generally and development expenditure particularly. Unfortunately, resources mobilization is very low compelling the government to depend on foreign assistance heavily. Development expenditure depends almost entirely on foreign aid. Revenue surplus covers only one-fifth of the development expenditure. Revenue effort reached to 11.2 percent of the GDP in FY 1997/98 from 6.1 percent in FY.1974/75. This is lower than the LDC average of 17-22 percent of the GDP and South Asian neighbours viz. Sri Lanka has a revenue effort of 18.6 percent of GDP, Pakistan 16.3 percent and India 13.2 percent in 1998 (IFS, 1999).

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Indirect tax is a major source of tax revenue in Nepal. It covers more than 77.2 percent of tax revenue in 1997/98 in which custom duty provides 33.4 percent of total tax revenue followed by sales tax (27.9 percent) and excise duty (10.9 percent). This kind of tax structure generally affects many economic activities such as savings, investment, consumption, production and distribution of national income.

In the developing country like Nepal, there is a necessity for raising a larger volume of resources for financing a sustained growth of public investment. The prospect of mobilizing resources through sources other than the taxation has not been encouraged. It is not possible in these countries to mobilize resources by curtailing existing consumption level because it is very low. Public borrowing and inflationary saving also have some limitations. Deficit financing is inflationary and foreign borrowing is not a reliable source. Taxation is commonly believed to be non-inflationary financing, to redistribute income and to create egalitarian society. Mobilization of resources through taxation is sine qua non for discouraging the consumption of conspicuous goods and services. In this context, taxation is no longer looked upon as a means of 'finding the money' for the expenditure of the government, but as one of the weapon in the government's armoury for ensuring general economic and monetary stability (Kaldor 1966, 273).

Taxation is a powerful tool held by the government. In Ursula Hicks words, "Tax bankruptcy was an important contributing factor to the fall of the Roman Empire. Unjust and inefficient taxes set the French revolution aflame. An important part of the explanation of Germany's failure in the war of 1914-18 was her antiquated tax structure..... inefficient taxes helped to lose Britian the American colonies"(Hicks, 1948, 10)

Moreover, there is an economic and administrative limit to the mobilization of resources through direct taxation in the developing countries. Thus as a matter of logical necessity, more resources can be raised only through the exploitation of indirect tax. In this context, it seems plausible to analyse the actual situation of indirect tax in Nepal in relation to its theoretical consideration. This paper has attempted to present some aspects of indirect taxes in Nepal. This paper proceeds with a brief review of theoretical literature in section second after discussing a background for it. The third section examines the role and structure of indirect taxes in the Nepalese tax system. Distributional impact of indirect taxes in Nepal is presented in section four. Section five gives a bird's eye view on elasticity and buoyancy of major indirect taxes. The last section concludes the overall discussion with some recommendations.

2. Indirect Tax: Theoretical Consideration

Of the two types of taxation, direct and indirect, the latter is incidental to a transaction involving the expenditure rather than the receipt of money by the tax payer while direct tax falls on income. As a part of taxation, indirect tax is an instrument of fiscal policy to achieve broader objectives of stabilisation, optimal allocation of resources and overall economic growth. The indirect taxes are considered to be shifted forward and backward but direct taxes are considered to be non shifting in nature. Direct taxes are taken superior on distributive and allocative aspects but indirect tax is superior on administrative and economic growth aspects. The switch from direct to indirect taxes normally would be expected to produce an increase in the propensity of saving in private sector. Indirect taxes are generally imposed to allocate resources on proper direction by curtailing consumption and production. It has the objectives of sumptuary with raising revenue. The role of indirect tax is high in the developing countries because of poor tax administration to collect direct taxes, low per capita income and evasion possibilities. In case of developing countries, average propensity to consume is high which logically suggested to mobilize resources from current consumption. It is possible only through indirect taxes. Through development procedure, the tax structure changes from preliminary direct taxes — land tax to indirect taxes such as custom, excise and sales. Then at highly developed stages, direct taxes such as income and wealth tax occupy the large portion in the revenue.

The traditional analysis of indirect tax concludes that it is regressive in reference to ability-to-pay benchmark. Its regressivity results from the fact that consumption tends to be a declining proportion of increasing income. However, the exemption of essential goods tries to reduce the degree of regressivity.

Major headings of indirect taxes are custom duty, sales tax and excise duty. In fact custom duty and excise duty are a kind of narrowed based sales taxes. Sales taxes are imposed on a market transaction base. The imposition of it may be placed at various stages of economic activity such as resources extraction, manufacturing, wholesale and retail levels. If it is placed at only one of these transaction points, the tax is referred to as a single-stage sales tax. A tax imposed at two or more stages of economic activity is known as a multistage or multiple sales tax. Sales tax of this kind is best represented by turnover or value added tax which will be discussed in section six.

Beside revenue considerations, custom duty is imposed for the protection of domestic industries and restriction of luxurious consumption in the economy. The state of being large

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volume of import due to low level of development in the developing countries, make the custom duty to occupy significant position in the government revenue.

Excise tax is imposed for the purpose of reduction of the consumption of certain goods. To be successful for this purpose, excise tax should be imposed on those goods; which are elastic in nature. Interestingly, major sumptuary excise taxes applied in Nepal are on products (alcohol beverages and tobacco products) that are essentially price inelastic in demand. Hence, the continued use of excise duty on these products apparently represents a pragmatic revenue objective. In this theoretical backdrop, the role and structure of indirect taxes in Nepal is presented below.

3. Role and Structure of Indirect Taxes

The Indirect taxes has been playing significant role in the Nepali tax system. This is depicted in the following table. Its contribution to total tax revenue peaked up to 84.9 percent in 1979/80 from 79.3 percent in 1974/75, and declined to 76.8 percent in 1997/98. It is the outcome of the growing contribution of income tax. Likewise contribution of indirect taxes to the total revenue increased to 69.8 percent in 1979/80 from 66.3 percent in 1974/75 and declined to 60.5 percent in 1997/98 as a result of significant contribution of income tax and non-tax revenue. In terms of GDP, the contribution of indirect taxes increased from 4.0 percent in 1974/75 to 7.2 percent in 1994/95 and slightly declined to 6.8 percent in 1997/98, due to the slackness in revenue collection in this year.

Table 1: Role of Indirect Taxes

As Percentage of	1974/75	1979/80	1984/85	1989/90	1994/95	1997/98
1. Tax Revenue	79.3	84.9	83.5	81.2	80.7	76.8
2. Total Revenue	66.3	69.8	67.2	63.7	64.5	60.5
3. Gross Domestic Product	4.0	5.6	5.6	5.7	7.2	6.8
4. Regular Expenditure	122.2	111.6	90.5	88.6	82.3	71.9
5. Total Expenditure	44.1	37.4	31.3	30.1	40.6	34.5

Source: Economic Survey, 1999, HMG/N

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There was a time when the indirect tax alone covered the regular expenditure and generated some surplus for development financing. Such a situation prevailed up to 1982/83. After 1983/84, the indirect tax has not been able to cover the regular expenditure. Its contribution to regular expenditure continuously slow down from 90.5 percent in 1984/85 to 71.9 percent in 1997/98. It is, in fact, the result of fast moving regular expenditure than the revenue collection. Similar tendency existed in case of contribution of indirect tax to total government expenditure. In 1974/75, indirect tax alone contributed 44.1 percent of total government expenditure. It is continuously declined to 34.5 percent in 1997/98.

Custom duty has been occupying the lion's share in the indirect tax revenue although its contribution is declining (Table 2). Its contribution to indirect tax revenue declined from 49.2 percent in 1974/75 to 42.7 percent in 1997/98. Reduction of import duties following the economic liberalisation policy, leakage in the custom points and low valuation are some of the reasons, accountable for declining contribution of custom duties. Future of the custom duty is not seemed sustainable because Nepal is gearing up to be the member of the World Trade Organisation and planning to implement SAFTA (South Asia Free Trade Agreement), which demands lowering of the import duties.

Custom duty is followed by Sales tax (now it is called VAT) in case of contributing in indirect tax revenue. Sales tax contributed a share of 28.5 percent in total indirect tax revenue in 1974/75, which rose to 38.1 percent in 1994/95. Then, due to the bewildering state of value added tax in place of sales tax, its contribution declined down to 35.7 percent in 1997/98. Lowering down and consolidating various sales tax rates into single tax rate of 10 percent of VAT is also a reason for declining trend of it. Role of this tax depends on the effective implementation of VAT. Full implementation of VAT will obviously increase its contribution in coming days.

Due to narrow tax base of excise duty, a third major item of indirect tax, its contribution significantly declined from 17.9 percent in 1974/75 to 10.4 percent in 1994/95 and slightly increased to 14.5 percent in 1997/98. Very few industrial productions like alcohol, beer, cigarette, molasses etc are subject to excise duty. It is generally imposed to redirect resources from alcoholic and tobacco production.

Remaining portion of indirect tax is fulfilled by other indirect taxes, the share of which are always less than 10 percent. Contract tax, air flight tax, entertainment tax, hotel tax, vehicle Tax fall under the other tax headings. Now, VAT has replaced the contract tax, hotel tax and entertainment tax. However, air flight tax is collected by Civil Aviation Authority since January, 1999 directly.

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Table 2: Structure of Indirect Taxes (in percentage)

Structure of Indirect Taxes	1994/75	1979/80	1984/85	1989/90	1994/95	1997/98
Custom duty	49.2	46.9	40.5	45.4	44.2	42.7
Sales Tax	28.5	30.8	32.1	27.0	38.1	35.7
Excise Duty	17.9	16.6	18.4	18.1	10.4	14.5
Other Indirect Taxes	4.4	5.7	9.0	9.5	7.2	7.1
Structure of Custom Duty						
Export	8.8	10.3	5.3	1.2	4.7	2.5
Import	54.2	83.0	85.2	98.6	83.2	84.4
Indian Excise Refund	32.9	6.5	9.4	0.0	11.9	13.0
Miscellaneous	4.1	0.2	0.1	0.2	0.1	0.1
Structure of Sales Tax						
Production	-	-	-	-	23.6	16.4
Import	-	-	-	-	69.2	70.5
Sales, Dist. & Services	-	-	-	-	7.2	13.2
Structure of Excise Duty						
Cigarettes and Bidi	-	-	-	-	45.3	49.5
Liquor & Beer	-	-	-	-	47.4	47.3
Other Industrial Product	-	-	-	-	7.3	3.3

Source: Economic Survey, 1999, HMG/N

Import duty is a single major source of custom revenue. Its contribution to custom revenue increased from 54.2 percent in 1974/75 to 83.0 percent in 1997/98. Since 1978/79, it has been covering always more than eighty percent of custom revenue. In 1989/90, the contribution of import duty on custom revenue even increased to 98.6 percent. It was due to nil contribution from Indian excise refund as a result of discontinuation of Nepal and India trade treaty. In this way, it has been seen that our revenue structure is import based. Second major item of custom duty is Indian Excise Refund, a refund of excise duty paid in India on the import of goods from there. In 1974/75, Indian Excise Refund covered almost one-third of custom duty. However, its contribution dramatically declined to 6.5 percent in 1979/80 due to trade diversification towards third countries. In 1997/98, it covered the 13.0 percent of custom duty indicating increasing Indian share in the import of Nepal. Other items of custom duty, such as exports and miscellaneous cover very small segment of the custom duty.

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Decomposition of sales tax according to sources such as production, import and sales, distribution and services began from 1994/95. Almost 70 percent of sales tax is collected from imports. Sales tax (VAT) is also import based. It is followed by the sales tax on production and, on sales, distribution and services. Sales tax collection from production is in declining trend due to weak performance of industrial sector. Production sector provided the 23.6 percent of sales tax in 1994/95 declined to 16.4 percent in 1997/98. Contrary to it, the sales tax collection from the sales, distribution and services is in increasing trend. This provided 7.2 percent of sales tax in 1994/95 surged up to 13.2 percent in 1997/98. It is the result of expansion of sales tax base to cover services, and replacement of entertainment tax, contract tax, hotel tax by value added tax.

Decomposition of excise duty according to source such as cigarette and bidi, liquor and beer, and other industrial products also began from 1994/95. Cigarette, bidi, liquor and beer cover more than ninety percent of excise duty and a very small segment of excise duty is covered from the other industrial production. It is so because, there is heavy excise duty on tobacco and alcoholic products and low growth of other industrial product, with limited range of excise duty. Due to industrial stagnation, contribution from other industrial sector even declined from 7.3 percent in 1994/95 to 3.3 percent in 1997/98.

4. Distribution of Incidence of Indirect Taxes

The study of incidence of taxation is very essential for analysing tax system on equity and distributive justice because economic effects of taxation are manifold: micro effects on the distribution of income and the efficiency of resources use as well as macro effects on the level of capacity output, employment, prices and growth (Musgrave et.al,1973:235). The incidence of tax implies the final resting place of imposed tax rates. The introduction of taxes brings many changes in the economy just like the round circle emerged in a pond when a stone thrown on it. Incidence is the money burden of the tax which is the result of shifting. The process of shifting is common in commodity taxation where price is the medium of it. The incidence is the settlement of the tax burden on the ultimate tax payer who can not shift it further.

Incidence measurement has many facets and the complete analysis of it needs the general equilibrium frame, which is complex and require extensive information. The incidence can be measured by analysing changes in the position of any household in terms of change in its income (Singh, 1991, 239). The calculation of Gini-coefficient, before and after tax, can also be one of the measures of incidence which indicates the impact of taxes on income distribution. For overall measurement of incidence, we can calculate per capita

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incidence by dividing revenue collected from taxes by population, and per rupee burden by dividing with GDP.

Per capita incidence of tax in Nepali tax system in current rupees term increased by more than 18 folds from Rs. 65.57 in 1974/75 to Rs.1213.94 in 1997/98 (Table 3). Likewise, incidence of indirect taxes increased by the same fold but the direct taxes increased by more than twenty folds. However, in real term at 1984/85 price, the incidence of taxes increased just from Rs.193.16 in 1984/85 to Rs.345.33 in 1997/98. In this term, per capita incidence of indirect taxes even declined from Rs.269.73 in 1994/95 to Rs.265.21 in 1997/98.

Table 3: Per Capita and Per Rupee Incidence of Taxes

Fiscal Year	Per Capita Incidence of Tax (in Rs.)			Per Capita Incidence of Tax (in 1984/85 price) in Rs.			Per Rupee Income Incidence (%)		
	Total	Indirect	Direct	Total	Indirect	Direct	Total	Indirect	Direct
1974/75	65.57	52.03	13.54				5.07	4.02	1.05
1979/80	104.37	88.61	15.76				6.54	5.55	0.99
1984/85	193.16	161.27	31.89	193.16	161.27	31.89	6.76	5.65	1.12
1989/90	402.86	327.10	75.76	226.89	184.22	42.67	7.04	5.72	1.32
1994/95	979.17	790.06	189.11	334.29	269.73	64.56	8.97	7.24	1.73
1997/98	1213.94	932.29	281.65	345.33	265.21	80.12	8.83	6.78	2.05

Source: Economic Survey, 1998

Incidence per rupee income also increased from 5.07 percent in 1974/75 to Rs. 8.83 percent in 1997/98. This implies that tax payers on an average paid about Rs. 5 out of their income of hundred rupees in 1974/75. This liability increased to about Rs. 9 in 1997/98. During this period incidence per rupee income almost doubled in case of direct tax but increased by 68.6 percent in case of indirect tax. In contrast to it, incidence of indirect tax per rupee income declined from 7.24 percent in 1994/95 to 6.78 percent in 1997/98. It is the outcome of growing contribution of direct taxes.

A study was carried out to measure the distribution of incidence of indirect taxes in 1996 (Shrestha, 1996). The study decomposed the surveyed people into decile groups according to their per capita income and calculated the percentage of income to be paid for indirect taxes. The result shows that the first decile group has to pay 8.18 percent of their income for indirect taxes which is lower the highest decile group who pay just 6.70 percent

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of their income (Table 4). The incidence of indirect taxes increased from first decile group to second decile group. In contrast to it, incidence declined in third decile group. The incidence of indirect taxes from fourth decile to eighth decile is lowered than the second decile. Moreover, the ninth and tenth decile has to pay even lower than the first decile group.

Table 4: Distribution of Incidence of Indirect taxes (in percent)

Decile	Incidence	Quintile	Incidence
1 st	8.18	1 st	8.71
2 nd	9.25	2 nd	7.05
3 rd	6.39	3 rd	7.18
4 th	7.72	4 th	7.47
5 th	5.97	5 th	6.10
6 th	8.39		
7 th	5.70		
8 th	9.25		
9 th	5.51		
10 th	6.70		

Source: Shrestha, P. K., 1996.

It implies that there is, to some extent, the regressive distribution of incidence of indirect taxes. It can generally be supported by theory because lower income groups spend more amount of their income on consumption on which indirect taxes are imposed.

Cyclical distribution of incidence from third decile to tenth decile is found due to non-uniform consumption behaviour of households within each decile group. It implies that consumption behaviour is not sensitive to indirect taxes imposed. The consumption pattern is found to be influenced by habit, culture, obligation and personal interest than price level. For example, consumption of cigarette and alcohol are feature of habitual addiction. The consumption of clothes, purchase of construction material etc. may be due to obligation and personal interest.

The analysis of impact distribution according to quintile group gives the clear picture of incidence distribution. The first quintile that means lowest twenty percent has to pay 8.71 percent of their income for indirect tax (Table 4). Then the tax burden declines to 7.05 percent and rises slightly from 7.05 to 7.47 in the fourth quintile. The highest twenty percent pays only 6.10 percent of their income for indirect taxes which is 2.61 percentage point lower than the amount paid by the first twenty percent. In this way,

there is some progressiveness of distribution of incidence from the second quintile to fourth quintile, However, the overall distribution can be said regressive because the lowest quintile has to pay more portion of their income as indirect tax as compared to the highest quintile.

The marginal propensity to tax, which implies the relationship between the tax revenue and income level, was found out as 0.069 in this study. It also denotes that indirect tax paid increased by 0.069 amount for one unit increment of income level.

5. Buoyancy and Elasticity of Some Major Indirect Taxes

Responsiveness of the tax system can be measured from buoyancy and elasticity calculation. The former indicates responsiveness with various discretionary measures while latter denotes the automatic responsiveness of the tax system. The estimating equation for elasticity and buoyancy of some major indirect taxes – custom, sales, excise is given below:

$$I_n (TH)_t = a + b I_n (GDP)_t + U_t$$

where,

- TH = respective taxes at time 't'
- I_n = natural log
- a = intercept
- b = elasticity or buoyancy coefficient
- GDP_t = Gross Domestic Product at time 't'
- U_t = disturbance term

Elasticity is calculated on the basis of above equation by adjusting actual series of respective taxes by using Sahota's Method as:

$$NR_t = \frac{AR_t - DR_t}{AR_{t-1}} \times NR_{t-1}$$

where,

- NR_t = net or adjusted revenue series in year 't'
- AR_t = actual revenue collection in year 't'
- DR_t = proportional revenue collection through discretionary changes in year 't'

For calculating base buoyancy and elasticity, following estimating equation has been used.

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$$I_n (TH)_t = a + bI_n (\text{tax base})_t + U_t$$

For custom duty, import is considered as a base while private consumption is taken as – base for sales tax and excise duty.

Results of both buoyancy and elasticity with respect to GDP and respective basis for the period 1975–98 are presented in the following table 5 and 6.

The results of buoyancy of some major indirect taxes — custom, sales and excise is found to be significant at 1 percent level with satisfactory high level of R^2 . The presence of autocorrelation observed in all estimated equation have been corrected by using the Cochrane-Orcutt method and the convergence have been achieved after 1 to 5 iterations in most of the cases. Buoyancy figures of both custom and sales tax are higher than unity but buoyancy figure of excise duty is less than unity (Table 5). Comparatively sales tax is found more buoyant to GDP than other indirect taxes. However, elasticities of them are found less than unity indicating low built-in-flexibility. Among them, elasticity of custom duty is very low. Difference between buoyancy and elasticity coefficient of these indirect taxes reflected that custom duty heavily depends on the discretionary measure as shown by the discretionary impact coefficient of 0.57. Comparatively, sales tax is found more elastic with respect to GDP than other indirect taxes.

Table 5: Buoyancy and Elasticity of Major Indirect Taxes with respect to GDP (19975–98)

Tax Heads	Intercept (a)	Buoyancy (b)	DW	Adj. R2	Discretionary Impact
1. Custom	-4.25 (-8.27)	1.05 (23.16)*	1.64	0.99	0.57
2. Sales					
Tax (VAT)	-4.52 (-4.47)*	1.06 (12.25)*	1.52	0.99	0.36
3. Excise	-3.40 (-2.99)	0.89 (9.34)*	1.64	0.99	0.35
		Elasticity (e)			
1. Custom	1.19 (1.29)	0.48 (5.86)*	1.41	0.94	
2. Sales					
Tax (VAT)	-1.42 (-1.77)	0.70 (9.92)*	1.93	0.99	
3. Excise	-0.63 (-3.23)*	0.54 (31.09)*	1.86	0.99	

Figures in parenthesis are t-statistics

* significant at one percent level

Table 6: Base Buoyancy and Elasticity of Major Indirect Taxes (1975 – 98)

Tax Heads	Intercept (a)	Buoyancy (b)	DW	Adj. R2	Discretionary Impact
1. Custom (on Import)	-0.19 (0.70)	0.81 (28.37)*	2.03	0.99	0.44
2. Sales Tax (on Pvt. Con- sumption)	-4.88 (3.52)**	1.11 (9.22)*	1.69	0.99	0.40
3. Excise (on Pvt. Con- sumption)	-3.72 (5.44)*	0.94 (15.70)*	2.09	0.94	0.39
Elasticity (e)					
1. Custom (on Import)	3.01 (6.14)*	0.37 (7.32)*	1.59	0.94	
2. Sales Tax (on Pvt. Con- sumption)	-1.41 (-1.89)	0.71 (10.63)*	2.11	0.91	
3. Excise (on (Pvt. con- sumption)	-0.57 (-3.09)	0.55 (32.73)*	1.74	0.99	

(figures in parenthesis are t-statistics)

* Significant at one percent level

** Significant at 5 percent level.

Base buoyancy and elasticity give more clear picture of the sensitivity and built-in flexibility of respective tax heads. Except sales tax, custom and excise duty are less sensitive to its proxy base import and private consumption respectively. Custom duty is found lower sensitive to its base (import) as compared to other indirect tax heads (Table 6). Sales Tax is found highest sensitiveness with respect to its proxy base private consumption. However, elasticity coefficients of custom duty, sales tax and excise duty are also found less than unity showing lax in built-in-flexibility of these taxes even to their bases. Base elasticity of custom duty is even lower than the elasticity with respect to GDP. Both the elasticity and buoyancy of custom duties with respect to its proxy base, value of imports, are less than unity. It is attributed to the inclusion of a sizeable amount of aid imports as well as other imports (e.g. raw materials, capital goods) which do not attract import duties or attract only nominal duties. However, built-in-flexibility of sales

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tax is 0.71, which is higher than the custom and excise. This implies that sales tax is significantly explained by and responsive to the private consumption. In case of proxy base also, custom duty is found more prone to discretionary measures.

The above results reflected that major headings of indirect tax system in Nepal as a whole is not adequately responsive to change in income. With respect to the proxy base also, the results show that tax system is not flexible enough having less than unitary elasticity.

6. Relevancy of VAT in Nepal

Value Added Tax (VAT) is a scientific and transparent tax system which was first introduced in 1954 in France. Now, almost more than hundred countries have implemented the VAT in their tax system and it has become a major source of revenue. It is, in fact, the modification of sales tax so that it is a kind of indirect tax. Following the economic liberalisation policy, Nepal has also prepared for the implementation of VAT. Since 1998, Nepal legally and administratively began to introduce VAT. However, it is in bewildering condition practically. The government has to face strong resistance from the business community.

Value Added Tax is a tax imposed on the value added in each economic activities from production to consumption. Ultimate resting place of this tax is final consumption so that consumers are the sole tax payers of the VAT. Business people only collect the VAT as a mediator so that they do not bear its burden.

VAT has a feature of correcting cascading and pyramiding effect of sales tax. Cascading effect implies tax upon tax and pyramiding effect indicates the profit upon tax. Due to these effects in case of sales tax, the revenue collected by the government from the sales tax is lower than the tax paid by the consumers. This difference goes to the pocket of business community. It may be the one of the reasons of offending the VAT for implementation. The next feature of this tax system is the transparency in transaction so that there will be the possibility of expansion of income tax base. In this way this tax system can expand the base of Nepali tax system.

However, there are some complications for implementation. One is the open border with India and Tibet (of China). Due to this situation, goods are imported without registration in custom points. VAT can not tap the leakage from the custom points. So that, there is price difference on imported goods through custom points and others. Next complication is that VAT demands strong accounting and information system. Due to large

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number of illiteracy and small-scale business units, such accounting is somehow difficult to execute. Moreover, the tax administration is also not so effective on gathering and analysing information regarding tax. Possibility of expanding e-commerce in future will also be a threat for effective implementation of VAT on that kinds of business activities.

Although there are some complications on the execution of VAT, growing necessary of resources to finance development expenditure and situation of high dependency on indirect tax resulted from structure of the economy has revealed the relevancy of VAT to be implemented outrightly even by correcting the shortcomings.

7. Conclusions

Although indirect taxes are theoretically, and practically also found, regressive in nature, the tax system of Nepal has reflected the overall dependency on indirect taxes. Shifting toward direct taxes, a policy of Nepalese tax system, is considered best for equity and distributive objectives of economic policy. But, it is still far from reality due to tardy pace of administrative and economic development of Nepal. Realising the importance of indirect taxes for the time being, the government has been trying to implement VAT by consolidating many indirect taxes together into a single rate to fill the growing necessary of resources gap. Open border, weak administration, lack of accounting based transactions due to large number small business units, anti-tax attitude of tax payers are some of the complexities of VAT which should be corrected timely. Due consideration is also to be given on the development of ways for taping e-commerce which will be the expanding activities in future.

Regressive nature of indirect taxes should be corrected by providing exemption over the items consumed by the poor class. Beside, the government should launch rigorously pro-poor social development programmes along with income generating activities so that they will be able in future to pay tax.

No one can deny the importance of indirect taxes in the developing country like Nepal. But it can be inferred from above analysis that built-in-flexibility of the indirect taxes is very poor. Such a tax system demands strenuous efforts through discretionary measures from the government level to introduce tax system properly and to avoid leakage and corruption. For this, the tax administration should be efficient, honest and alert for revenue mobilisation. In addition, tax education is also seemed essential to make people aware about the importance of revenue mobilisation. Collected revenue should also be utilised transparently and properly so that tax payers can realise the importance of their

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contribution in national development. Misuse of public resources makes the tax payers hesitate to pay tax.

Since consumption has been found to be determined by habit, locality, personal interest and obligation than price, indirect tax can not be taken for purpose of allocation and distribution of resources fully. So, government ultimately need to gradually shift to direct taxes in coming days.

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