

Siddhajyoti Interdisciplinary Journal (SIJ)

Vol. IV, January, 2023

(A Peer Reviewed Open Access Research Journal)

ISSN: 2645-8381

Published by Research Management Cell, Siddhajyoti Education Campus, Sindhuli

<https://www.nepjol.info/index.php/sij>

Analysis of the Relationship between Tax Revenue and Economic Growth in Nepal

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Article History: *Received:* 30 June 2022; *Reviewed:* 30 November 2022; *Accepted:* 10 December 2022

Abstract

This study aimed at assessing the relationship between tax revenue and economic growth in Nepal. A Causal comparative research design was employed using the time series data from the fiscal year 1974/75 to 2019/20. Accordingly, GDP at the constant price was considered the dependent variable, and income tax, excise duty, value-added tax, and customs duty as independent variables. Since all the variables at their log forms were stationary at their first difference, in order to measure the nature and strength of the relation of the dependent and independent variables, a vector error correction model (VECM) was employed. Besides, Johansen's co-integration results revealed the existence of the relationship between the variables in long run. In addition, the results of the analysis also found that, in the long run, income tax has significant and negative relationship, value added tax has a significant and positive relationship but the customs duty and the excise duty have insignificant and negative relationship with the GDP. Regarding the short-run, the value of the error correction term (ECT) indicates that, though the move is towards the equilibrium, is weak and all the independent variables have positive relation with the dependent variable.

Keywords: Economic growth, ECT, relationship, tax revenue, VECM

Introduction

Nepal has developed and is continuing to develop a simple tax system by reducing the rates of the tax and extending the base of the tax. Besides, efforts should also be made to divert the tax revenues towards growth, which seems to be a tough task since the composition of the budget shows that less than 20 percent of the expenditure comprises developmental expenditure. However, due to the severe budget deficit, it is forced to impose the high rate of tax in comparison to the South Asian Countries.

The major task of a government is to facilitate the general public with public goods. As such, to cope with this, the government imposes taxes as the sources to meet the expenses of the targeted economic growth and development. Thus, taxes of different forms have relationship with growth. Tax implies a compulsion levied on any subject or property to society by the government. (Ebiringa, 2012).

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Siddhajyoti Interdisciplinary Journal (Peer reviewed), Volume 4, January, 2023

In the least developed countries like Nepal, where the per capita income is very low the government comparatively relies on indirect tax rather than direct tax revenues. In the initial phase of economic development, indirect tax plays a vital role but, with the gradual growth in the economy, direct tax plays a significant role and is an important factor for long-run economic growth (Gupta et al., 2015).

The tax system is also intended to address different social and economic issues that exist in a society and also promote equity. Taxes also affect the household decisions to save and supply labour as well as influence the firm's decision in production, job creation, business expansion, investment, and innovation. It is not only the amount of taxation that applies to these decisions but also how various tax instruments are structured and implemented to raise revenues and taxation should be not like killing the goose laying golden eggs (Bonu & Motau, 2009).

It is very essential to understand that all government revenues do not respond to the economy in the same way, instead, there are distinct relations between different forms of taxes imposed and economic growth (Johanson, et al., 2008). However, there are ongoing disagreements regarding the efficiency of the government revenue collection system, and substantial research has been conducted on the various types of government expenditure to see whether they promote economic growth at the national as well as international levels (Abomaye-Nimenibo et al., 2018).

Tax, both the direct and indirect are considered to the prominent sources of government revenue in Nepal and important instruments in meeting the public expenditures as well. However, the imposition of direct and indirect tax in order to meet the government expenditures also influence the economic growth of an economy and this study tries to make an analysis of the relationship between the different forms of tax with the gross domestic product, a proxy of economic growth of Nepal.

Theoretical Framework

This study is based on the expediency theory of taxation to analyze the relationship between tax revenue and the economic growth of Nepal. Accordingly, expediency theory emphasizes on the subject that the collection of the tax is to attain the economic objectives that lead an economy on the path of economic growth and prosperity.

The Expediency theory of taxation is based upon the principle that tax proposals should go through the practicality test and the authorities must only consider when to choose. Moreover, the objectives of the state regarding the social and economic targets and the aftermath of the tax system should be considered irrelevant (Bhartia, 2009). Expediency theory links the activities of the state with tax liability. This theory states that the members of a society should be changed by the state for the services to be provided which shows the justification for the imposition of tax on the society members (Anyafu, 1996).

Literature Review

Kalas et al., (2021) made an exploration regarding the impact of taxes on the economic growth in the United States using the time series annual data from the year 1996 to 2016. The results of the model show the significant impact of tax revenue and social security contributions. However, personal income tax and corporate income tax do not have a significant effect on the gross domestic product. Moreover, though

the personal income tax is considered the major form of tax in the United States, does not have a significant effect on the GDP in comparison to the social security contribution which has a low share.

Etim et al. (2020) made an analysis regarding the relationship between tax revenue and economic growth in Nigeria considering the time series annual data from the year 1980 to 2018 employing both descriptive and inferential statistics. Accordingly, the study came to conclude the positive and significant relationship between gross domestic products the personal income tax, petroleum profit tax, and company income tax. However, the education tax, customs, and excise duties were not found to be significant. Moreover, the coefficient of error correction term indicated the slow adjustment between the short and long run.

Maganya (2020) in an analysis regarding the effects of tax revenue and economic growth of Tanzania considering the time series annual data from the year 1996 to 2019 employing the ARDL model bounds test came to conclude the positive and significant relationship between the tax revenue on goods and services and the economic growth. However, the income tax was found to be significant and negatively related to economic growth.

Emmanuel and Stephen (2020) made an examination of the relationship between tax revenue and the economic growth of Nigeria using data from the years 2003 to 2017. The study came up with the result that value added tax and income tax of the companies have a significant relationship with economic growth while petroleum profit tax does not have significant relation with economic growth.

Korkmaz et al. (2019) made an investigation on the effects of an indirect and direct tax the economic growth of Turkey using the quarterly data from 2006 Q1 to 2018 Q3 employing the ARDL bounds test model. Accordingly, the results of the study came to conclude that indirect tax has a significant and positive relationship with economic growth while the direct tax has the significant and negative relation with economic growth both in the short run as well as the long run.

Ahmad et al. (2018) made an assessment regarding the short run and long run relation between the indirect tax and economic growth in Pakistan using the time series annual data from 1974 to 2010 employing auto regressive distributive lag bounds testing. The results of the study came to conclude that indirect taxes have significant and negative influence on economic growth in the long run. However, the coefficient indicated insignificant regarding the relation of indirect tax with the GDP in the short run.

Gashi et al. (2018) considering the time series annual data from the year 2007 to 2015, made an analysis of the influence of the tax structure on the GDP of Kosovo employing linear regression. The results concluded that profit tax, individual business tax, value added tax, monthly statement tax, corporate tax, tax on interest, dividends, tax on property rights, rentals, lottery, and gambling winning tax have a significant and direct influence on GDP. However, personal tax and withholding tax were found to be insignificant and have an indirect influence on the GDP.

Geetanjali and PrVenugopal (2018) made a study on the relationship between direct tax and the GDP of India, employing the ordinary least square approach, considering the time series annual data from 2000 to 2016. Accordingly, the unit root

test, heteroskedasticity, autocorrelation, and normality test were performed in order to examine the strength of the data. The study found a significant and positive relation between direct tax and GDP.

Mdanat et al. (2018) made an analysis regarding the tax structure and economic growth of Jordan considering the time series annual data ranging from the year 1980 to 2015. Accordingly, the study came to conclude that income tax, corporate tax, and personal tax have a negative impact whereas, tariffs and consumption tax were found to have a positive impact on economic growth.

Ogundana et al. (2017) made an assessment regarding the relative influence of direct tax and indirect tax on the GDP of Nigeria considering the time series annual data from 1994 to 2013 employing regression analysis. The study concluded the significant and positive influence of indirect tax in comparison to the direct tax which has an insignificant but positive relationship with economic growth.

Phiri (2016) employed the smooth transition regression (STR) model to make an analysis of the impact of the taxes both direct and indirect on the GDP of South Africa using the quarterly data from the year 1990Q1 to 2015Q2. Accordingly, the results concluded the existence of a negative relationship between direct tax and economic growth but positive relation between indirect tax and economic growth under the threshold of 10.27 percent.

Romer and Romer (2010) concluded that taxation helps to sustain the economic growth and enhance global competencies, finance social and infrastructure necessities, lessen the dependency on aid, and ensure good governance.

Engin and Skinner (1996) came to conclude the inverse relationship between taxes and economic growth. Accordingly, taxation discourages investment, reduces labour supply, diminishes growth productivity, reduces capital's marginal productivity, and lowers the effective utilization of human capital.

Kaldor (1963) came to conclude that if a country wishes to be developed, needs to collect taxes amount of about 25 to 30 percent of its gross domestic product (GDP), more than the taxes about 10 to 15 percent practiced in the developing countries.

Methods and Procedures

Sources of Data

Time series annual data from the fiscal year 1974/75 to 2019/20 of the gross domestic product at a constant price, income tax, excise duty, value added tax along with the customs duty at their log forms is considered. Moreover, the data was collected from secondary sources, from the official websites of the ministry of finance and Nepal Rastra Bank.

Specification of the Model

This study makes analysis of the relationship between the tax revenue and the economic growth of Nepal. Accordingly, the GDP at the constant price was considered as the dependent and the income tax, excise duty, VAT, and customs duty as the independent variables. The linear specification model of the study is:

$$\text{GDP} = f(\text{INT}, \text{EXD}, \text{VAT}, \text{CUS}) \dots\dots\dots (3.1)$$

The linear statistical model derived from the specification model is

$$\text{GDPC} = b_0 + b_1\text{INT} + b_2\text{EXD} + b_3\text{VAT} + b_4\text{CUS} + e_t \dots\dots\dots (3.2)$$

The log- linear form of the above equation, for the interpretation in the percentage form is presented as

$$\text{LNGDPC} = b_0 + b_1\text{LNINT} + b_2\text{LNEXD} + b_3\text{LNVAT} + b_4\text{LNCUS} + \text{et....} \quad (3.3)$$

Where,

GDPC= Gross Domestic Product, INT= Income Tax, EXD= Excise Duty, VAT= Value Added Tax, CUS= Custom Duty, b_0 = Constant, b_1, b_2, b_3, b_4 = Slope Coefficients

In order to examine the relationship between the dependent and the independent variables, non-stationarity property of the variables was examined using the Augmented Dickey Fuller (ADF) test. Moreover, all the variables under the consideration were stationary at their first order difference in their log form. Thus, in order to assess the short run as well as long run relation between the dependent variable GDP at constant price and the independent variables income tax, excise duty, value added tax, and customs duty, the vector error correction model was employed as the variables were co-integrated as well.

Method of Analysis

All the variables under analysis were stationary at first order difference in their log forms. In order to assess the long run relation between the variables, Johansen co-integration was conducted. Moreover, for the computation of the short and long run dynamics of variables, a vector error correction model was employed.

Data Presentation and Analysis

In order to make the assessment of the relationship between the gross domestic product at the constant price and different forms of taxes at their log forms, a vector error correction model was employed. Moreover, the augmented dickey fuller (ADF) test was conducted to examine the stationarity of the variables which showed that all the variables were stationary at their first difference.

Unit Root Test

In order to examine whether the variables under consideration were stationary or not, an augmented dickey fuller test was conducted. The results show that none of the variables at their log forms were stationary at level. Rather, all the variables were stationary at first order difference.

Table 4.1 Results of the Examination of Unit Root Test

Panel	Variable	Result of ADF Test	Probability Value	Remarks
Panel I Level	Lngdpc	0.3717	0.9705	p-value>0.05 Non-Stationary
	lnint	0.2507	0.9729	
	lnexd	0.5373	0.9862	
	lnvat	-0.3609	0.9070	
	lncus	-0.4730	0.8869	
Panel II First Difference	Lngdpc	-6.6057	0.0000	p-value<0.05 Stationary
	lnint	-4.9511	0.0002	
	lnexd	-6.5866	0.0000	
	lnvat	-6.4270	0.0000	
	lncus	-5.8632	0.0000	

Source: Calculation using eviews 10

In table 4.1 the probability value of all variables at the level in their log forms, are above the 5 percent level of significance which indicates that none of the variables were stationary at level. Moreover, after considering the first order difference of the variables, all the variables were stationary as the probability values of all the variables at first order difference were below a 5 percent level of significance.

Selection of Lag Length

For the vector error correction model, the selection of the optimum lag is the most. Accordingly, the modern approach of the time series annual data states that in order not to lose the degree of freedom, the number of lags is normally small, with a maximum of two lags (Wooldridge, 2002). Thus, considering this, an optimum lag length of 2 was selected for the analysis.

Johansen Co-integration Test

Johansen co-integration test is applied in the case of the multivariate framework. Moreover, it is used to determine the number of co-integrating relationships between the dependent and independent variables in cases when all the variables are stationary at the first order difference I (1). After confirming that all the variables are stationary at the first order difference, to examine the long run relation between the dependent and independent variables, Johansen co-integration test was conducted.

Table 4.2 *Results of Co-integration Rank Test (Trace)*

Hypothesized (No. of CE(s))	Eigen Value	Trace Statistics	0.05 Critical Value	Probability
None	0.5552	77.5229	69.8189	0.0107
At most 1	0.3970	41.8806	47.8561	0.1621
At most 2	0.2862	19.6250	29.7971	0.4486
At most 3	0.1028	4.7885	15.4947	0.8309
At most 4	0.0004	0.0168	3.8415	0.8966

Source: Calculation using eviews 10

The results of table 4.2 shows the trace statistics which states that only the none is significant which implies that there is only one co-integrating equation.

Table 4.3 *Results of Co-integration Rank Test (Maximum-Eigenvalue)*

Hypothesized (No. of CE(s))	Eigen Value	Max-Eigen Statistics	0.05 Critical Value	Probability
None	0.5552	35.6423	33.8769	0.0305
At most 1	0.3970	22.2556	27.5843	0.2076
At most 2	0.2862	14.8365	21.1316	0.3005
At most 3	0.1028	4.7716	14.2646	0.7703
At most 4	0.0004	0.0168	3.8415	0.8966

Source: Calculation using eviews 10

In table 4.3 the probability value of none is less than the 5 percent level of significance, thus we reject the null hypothesis indicating that there is no co-integration in the model. In this case, also, only the none is significant which indicates only one co-integrating equation. Thus, the results of the trace as well as eigenvalue statistics, show that there is only one co-integrating equation

Vector Error Correction Model

After the confirmation that all the variables were stationary at the first order difference that is integrated at same order I (1) and co-integrated as well, vector error correction model (VECM) was employed.

Table 4.4 Results of Long-run Relation of Vector Error Correction Model

Variable	Coefficients	Standard-error	t-Statistics
LNGDPC(-1)	1.0000		
LNINT(-1)	112.8156	22.1461	5.0942
LNEXD(-1)	5.3798	18.8720	0.2851
LNVAT(-1)	-152.3293	33.3126	-4.5727
LNCUS(-1)	14.4174	38.6075	0.3734
C	252.2077		

Source: Calculation using *evIEWS 10*

For the relationship to be significant, the value of t-statistics should be greater than 1.96. Accordingly, the value of the coefficients in the long run outcome is interpreted inversely. Table 4.4 shows the results of long-run coefficients which indicate that income tax has a significant and negative, value added tax has a significant and positive relation with the GDP in the long run. However, customs duty and excise duty have negative but insignificant long run relationship with the GDP.

Table 4.5 Results of Short Run Relation of Vector Error Correction Model

Variable	D(LNGDPC)	Standard-error	t-Statistics
cointEq1	-0.0002	0.0008	-0.2248
D(LNGDPC(-1))	0.0063	0.1523	0.0415
D(LNINT(-1))	0.1268	0.1376	0.9216
D(LNEXD(-1))	0.3833	0.2127	1.8024
D(LNVAT(-1))	0.2958	0.2792	1.0595
D(LNCUS(-1))	0.0123	0.2367	0.0522
C	-0.0697	0.0583	-1.1946

Source: Calculation using *evIEWS 10*

Table 4.5 shows the short run relationship results of the VECM. The value of cointEq1 also regarded as the error correction term indicates the speed of movement towards the equilibrium which is negative 0.0002, tending towards 0, which indicates weak adjustment. Furthermore, the findings show that all independent variables have a direct effect on the dependent variable GDP in the short run. Accordingly, a one percent increase in the previous year's income tax would lead to an increase in the current year's GDP by 0.1268 percent. Similarly, a one percent increase in the previous year's excise duty would lead to an increase in the current year's GDP by 0.3833 percent. Moreover, a one percent increase in the previous year VAT leads to an increase in the current year's GDP by 0.2958 percent. Finally, a one percent increase in the previous year's custom duty would lead to an increase in the current year's GDP by 0.0123 percent.

Stability Test

Stability of a model is examined by employing the cumulative sum of the square test introduced by Brown et al., in the year 1975. Accordingly, a model is said to be stable when the plot of the CUSUM statistics remains within the critical bounds of the 5 percent level of significance indicated by the two straight lines drawn at the 5 percent level of significance.

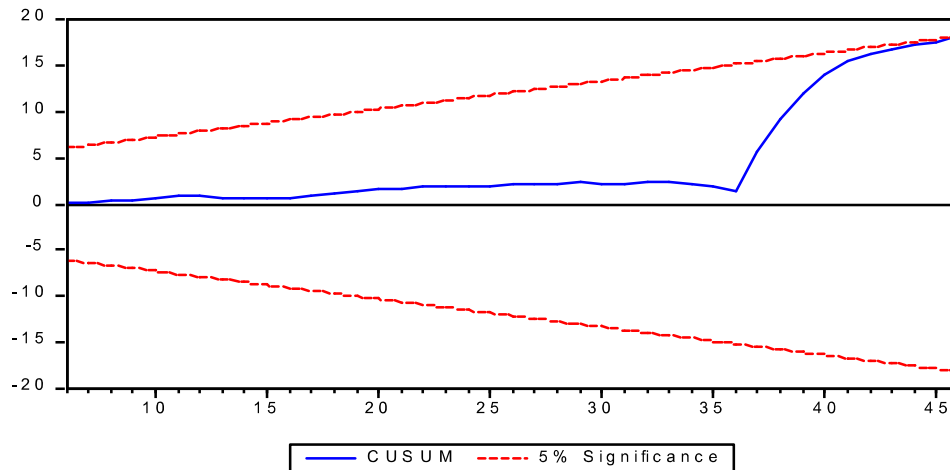


Figure 4.1 Results of the Cumulative Sum of Square

Source: Calculation using eviews 10

In figure 4.1, the plot of the CUSUM statistics lies within the critical bounds of a 5 percent level of significance. This indicates the stability of the model.

Conclusion

This study made an assessment regarding the relationship between the independent variables represented by different forms of taxes such as income tax, customs, excise duty and VAT with the dependent variable GDP at the constant price considering the time series data from the fiscal year 1974/75 to 2019/20, employing causal comparative research design. Johansen's co-integration result indicates the existence of at least one co-integration equation which implies the long run relationship between the variables under consideration. Accordingly, the long run coefficients of the vector error correction model (VECM) show the existence of a significant and negative relationship between income tax and GDP, and a significant and positive relationship between value added tax and GDP in the long run. On the other hand, the customs duty and excise duty have an insignificant but negative relation with the GDP. Regarding the short run coefficient of VECM, the value of the error correction term was negative and tending towards zero rather than one indicating that though the move is towards the equilibrium has weak adjustment. Moreover, all the variables under the consideration were positively related to GDP in the short run. Besides, the result of the CUSUM test indicates the stability of the model under analysis.

In order to stimulate economic growth in the long-run, Nepal should try to reduce the rate of income tax which was found to have a negative relation. However, the decrease in the volume of the tax due to the reduction in the income tax could be

compensated with the increment in the rate of value added tax which was found to have a positive relationship with economic growth.

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Appendix A

Annual time series data of the gross domestic product (GDP) at constant price, income tax, excise duty, value added tax and custom duty

Source: Ministry of Finance, Government of Nepal

Fiscal Year	GDP at Constant Price	Income Tax	Excise Duty	Sales Tax VAT	Custom Duty
1974/75	13106.18	47.00	119.70	206.70	328.50
1975/76	13609.42	87.20	132.10	181.90	358.50
1976/77	13838.93	133.30	166.10	247.30	386.20
1977/78	14288.61	136.80	164.40	306.20	458.80
1978/79	14524.04	103.00	192.60	397.30	626.70
1979/80	14573.40	111.20	215.20	443.20	608.00
1980/81	15874.70	144.00	242.20	604.00	815.80
1981/82	16644.10	189.70	305.70	678.70	825.10
1982/83	16820.40	240.10	365.80	825.10	760.90
1983/84	18299.20	290.90	432.20	907.50	825.90
1984/85	19552.90	307.30	483.90	1012.60	1064.50
1985/86	20483.80	364.40	558.70	1173.00	1231.00
1986/87	20915.20	437.50	678.60	1363.00	1505.10
1987/88	22390.30	579.00	825.30	1612.50	2214.60
1988/89	23597.90	861.10	877.70	1698.90	2289.90
1989/90	24749.10	919.00	1097.00	1953.80	2684.90
1990/91	26395.50	746.00	1200.20	2354.40	3044.30
1991/92	27687.50	855.50	1414.30	3283.60	3358.90
1992/93	28644.90	1124.80	1452.80	4007.70	3945.00
1993/94	30911.50	1824.50	1592.50	5380.90	5255.00
1994/95	31840.70	2711.80	1657.30	6857.10	7018.10
1995/96	33668.10	3311.60	1944.30	7429.30	7327.40
1996/97	35358.60	3969.00	2298.10	8162.90	8309.10
1997/98	36559.20	4685.90	2885.80	8020.60	8502.20
1998/99	38234.80	5850.70	2953.20	8765.90	9517.70
1999/00	40574.60	7006.20	3127.60	10259.70	10813.30
2000/01	41342.85	8650.10	3771.20	12382.40	12552.10
2001/02	41409.20	8436.00	3807.00	12267.30	12650.00
2002/03	42969.93	8811.80	3771.20	13459.70	12783.20
2003/04	44865.43	8512.50	6226.70	14478.90	15554.80
2004/05	46316.50	9402.40	6445.90	18885.40	15701.60
2005/06	48043.46	9598.80	6507.60	21610.70	15344.00
2006/07	49365.06	13979.10	9343.20	26095.60	16707.60
2007/08	52225.99	16223.30	11189.60	29815.70	21062.40
2008/09	54265.24	23457.30	16220.90	39700.90	26792.90

Fiscal Year	GDP at Constant Price	Income Tax	Excise Duty	Sales Tax VAT	Custom Duty
2009/10	56575.91	33821.30	24147.60	54920.90	35218.90
2010/11	155922.30	41350.30	26338.50	61663.60	35713.50
2011/12	163204.10	51303.00	30016.10	70930.40	43390.60
2012/13	168957.20	64186.70	36234.70	83418.40	56931.80
2013/14	179114.10	75613.60	45412.60	101104.60	67980.50
2014/15	186235.80	86165.60	53538.20	112521.80	74841.30
2015/16	187042.40	114138.00	65776.40	122411.90	82159.10
2016/17	203833.70	144846.10	84805.50	161068.30	103058.80
2017/18	219370.60	154790.00	102579.20	206809.80	126865.40
2018/19	233974.30	188413.60	121853.50	240121.30	143319.00
2019/20	229088.00	213237.40	103927.70	224016.50	123790.30

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