



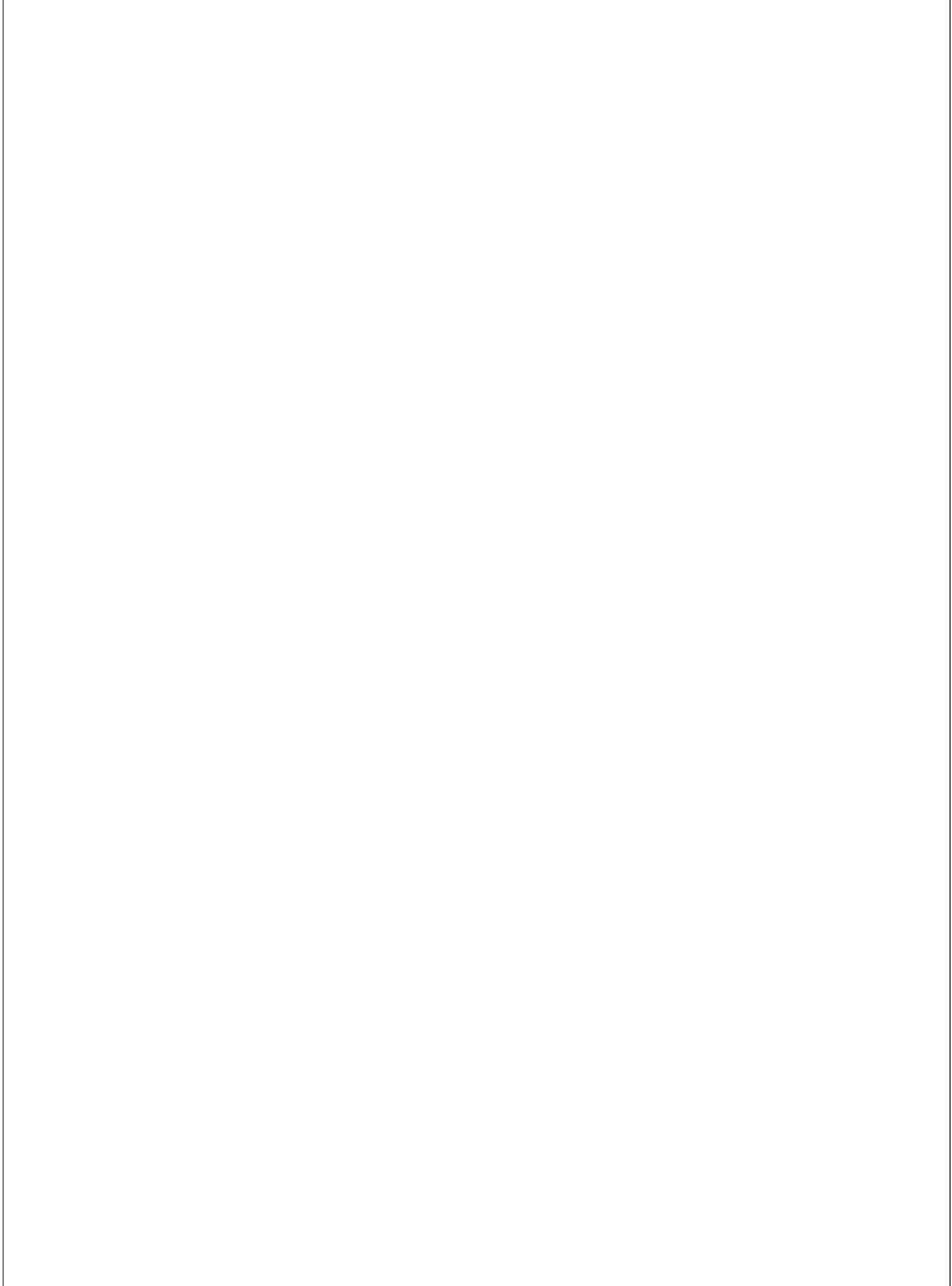
COUNTRY STUDY REPORT

NEPAL



Tax Policy and Enterprise Development in South Asia





COUNTRY STUDY REPORT
NEPAL

TAX POLICY AND ENTERPRISE
DEVELOPMENT IN SOUTH ASIA

Nanda Kaji Budhathoki | Manbar Singh Khadka



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About the Research

This research examines the impacts of property tax, value-added taxes, and tax exemptions and concessions on small enterprise development in South Asia. The goal is to provide decision-makers with data and insights to support more informed policy formulation and implementation for inclusive growth, productive employment, and enterprise development. The research also aims to examine the issues as they affect women entrepreneurs, to promote positive learning experiences among the countries, build fruitful exchanges, and foster effective policy discussions in a regional context.

The targeted outcomes include 5 Country Study Reports as well as a regional report based on meta-analysis. The reports are published and widely disseminated at the policy engagement workshops. Other project outcomes are policy workshops in all five countries and workshop reports, as well as an interactive website to support research and advocacy.

About IIDS

Founded in 1990 after the promulgation of the multi party democracy as a successor of the Integrated Development system (IDS), the Institute of Integrated Development Studies (IIDS) is a leading non-governmental, non-profit organization research institute of Nepal registered under the Societies Registration Act 1977. The mission of IIDS is to contribute to identification, analysis, understanding and response to major development policy issues facing the country. Since its establishment, the major goal of IIDS has always been to contribute to more informed public policies and programs through the provision of technical assistance and dissemination of the research findings and recommendations in different formats to target audiences, mainly the government. It has helped build informed understanding on different key priorities of national importance, such as economic reforms, water resources development, poverty alleviation and human development and so forth.

IIDS has engaged itself, in the constructive and informed analysis of the critical and strategic socio-economic issues of national concern of Nepal. While it has been able to maintain a long tradition of research excellence, a key challenge facing the Institute is to prepare itself as a think-tank of the country for the next millennium.

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The Institute for Integrated Development Studies (IIDS) conducted this three year project on Tax Policy and Enterprise Development in South Asia (TEDSA) at the request of the Governance Institute Network International (GINI), Pakistan and funded by IDRC (International Development Research Center during March 2012 to January 2015. This study is part of regional studies which were carried out by Institute for Integrated Development Studies (IIDS) from Nepal, Beacon house National University (BNU) from Pakistan, Centre for Policy Dialogue (CPD) from Bangladesh, Institute of Policy Studies (IPS) and the National Institute of Public Finance and Policy (NIPFP) from India. The main objectives of this study were to study: the Impact of Tax Exemptions and Concessions on Enterprise Development; the Impact of the Value-Added-Tax (VAT) on Enterprise Development; and the Impact of Property Tax on Enterprise Development. The study team consisted of team of IIDS young Professionals namely Mr. Nandakaji Budhathoki (Principal Resereacher and economist) and Mr. Manbar S.Khadka (economist) and Mr. Shankar Aryal (overall coordinator of the project), Mr. Ashwasthama Pokhrel, Mr. Binod Shrestha (Statistian), and Anuj Bhandari (data processing and tabulation), Mr. Devendra Shrestha (financial management),and Mr. Govinda Ghimire (lay-outing of the report). I would like to thank them for their hard works in producing this report. I also would like to thank all implementing partners of TEDSA as well as concerned stakeholders who participated in the key informant interviews, Focus Group discussion, enterprises surveys and review meetings during the project study.

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Last but not the least; I would like to thank the GINI for providing opportunity to IIDS in conducting this study and look forward for further research collaboration in the future.

Bishnu Dev Pant, Ph.D
Executive Director
IIDS

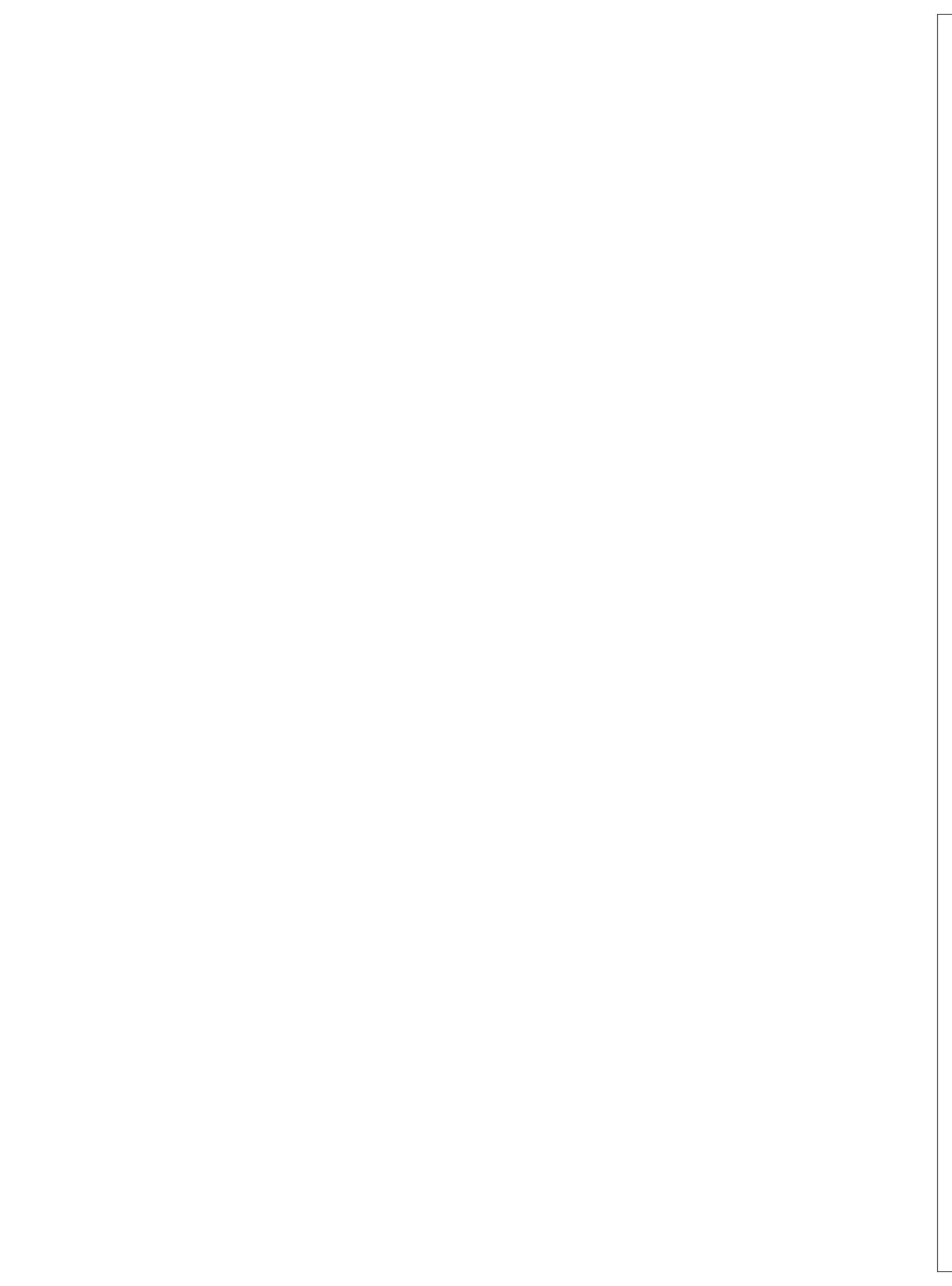


Table of Contents

List of Tables		X
List of Figures		XI
Acronyms		XII
Executive Summary		1
Section I	Literature Review	3
Section II	Conceptual and Analytical Framework	9
Section III	Sampling Design and Rationale for Primary survey	11
Section IV	Findings	15
	4.1 <i>Results of the survey</i>	15
	4.2 <i>Results of Key Informant Interviews</i>	26
	4.3 <i>Results of Focus Group Discussions</i>	31
	4.4 <i>Results of Case Studies</i>	33
Section V	Conclusion	35
Section VI	Policy Implications and Recommendations	37
References		39

List of Tables

Table 1:	Total number of SMEs in major cities of Nepal	10
Table 2:	Sampling cities and sampling population	11
Table 3:	Entrepreneurs' perception on tax and tax officials	16
Table 4:	The major causes of SMEs Non-Compliance	17
Table 5:	Opinions on tax related assistance	17
Table 6:	Major causes of VAT Non-Compliances	18
Table 7:	Administration friendly	19
Table 8:	Types of Property Tax	19
Table 9:	Criteria used for imposition of Property tax	20
Table 10:	Problems faced while dealing with Property Tax	20

List of Figure

Figure1:	Analytical Framework	9
Figure 2:	Industrial Survey Area	10
Figure 3:	Extent of Formalization	11
Figure 4:	Ownership structure	12
Figure 5:	Educational Qualification of Entrepreneur/Major Decision Maker	12
Figure 6:	Experience (In Years) of Entrepreneur/Major Decision Maker	13
Figure 7:	Lengths of operations	14
Figure 8:	Total number of staff employed	14
Figure 9:	Nature of business place	14
Figure 10:	Nature of land used by SME/MSME for business purpose	15
Figure 11:	Sources of credit	15

Acronyms

DDC	District Developments Committees
FGD	Focus Group Discussion
FNCCI	Federation of Nepalese Chambers of Commerce and Industries
FY	Fiscal Year
GDP	Gross Domestic Product
GINI	Governance Institute Network International
GTZ	Gesellschaft für Technische Zusammenarbeit
HALT	House and Land Tax
IDRC	International Development Research Center
IEA	Industrial Enterprises Act
IFC	International Finance Corporation
ILO	International Labor Organization
IPT	Integrated Property Tax
IRD	Inland Revenue department
ITD	International Tax dialogue
KII	Key Informant Interview
LSGA	Local Self Government Act
MSE	Micro and Small Enterprises
NLFS	Nepal Labor Force Survey
SEZ	Special Economic Zone
SMEs	Small and medium scale enterprises
SSI	Small Scale Industries
UDLE	Urban Development through Local Efforts Program
VAT	Value-Added-Tax
VDCs	Village Development Committee

Executive Summary

This report is a cross country research study which focuses on exploring the impacts of VAT, tax exemption and deduction and property tax on Small and Medium Scale Enterprises (SMEs) development in countries of south Asia. This study was funded by International Development Research Center (IDRC), Canada and spearheaded by GINI (Governance Institute Network International), Pakistan.

The Institute for Integrated Development Studies (IIDS) collaborated with GINI to implement the project. IIDS has conducted primary enterprise survey in small and medium scale enterprises of manufacturing units of three main business corridors of Nepal. Findings obtained from primary enterprises surveys have been substantiated by information received from other survey tools such as key informants' interviews (KII), focus group discussions (FGD) and case studies. The preliminary findings of the survey results were disseminated and discussed with the partner organizations through virtual media.

The survey result found that majority of SMEs were registered in the association of small and medium scale enterprises and minority of SMEs were registered with Inland Revenue Department (IRD), Department of Industries and municipalities. Similarly, majority of SMEs were headed by sole proprietors and half of the sample enterprises belonged to so-called upper caste Brahmins and Chettris. The other survey also revealed that more than half of the enterprises had less than six employees when they started their businesses and most of them operated in the rented private land. The survey result also shows that three fourths of the SMEs started their businesses about half decade before.

The survey result showed that sample enterprises did not receive any sorts of rebates and discount in tax. There has been certain provisions of tax rebates and concession on industrial policy and income tax act etc, but often been invalidated by fiscal policy of each year. Likewise, survey finding shows that property tax is not properly implemented in Nepal; it has been normally paid in the form of House and Land Tax (HALT), Integrated Property Tax (IPT), and commercial property tax mainly in the urban areas. Due to improper accounting, poor record keeping and lack of trained manpower in local bodies, significant problems have been realized for effective implementation of property tax in Nepal. Discretionary valuation of property by taxmen is considered to be one of the major hurdles of property tax implementation. Compliance cost of property tax is estimated to be NRs. 1,600 annually and it takes around 9 man-hours annually to pay property tax.

With regard to VAT, SMEs are treated no differently than large scale industries. Industries, whether large, medium or small, if their annual transactions exceed Rs. 2 million must register with VAT. However the firms whose annual turnover is below Rs. 2 million can voluntarily register with VAT authority.

The study found that there is no negative tax impact on women entrepreneurship development in Nepal. However, they often face problem on expanding and strengthening their network among business communities due to other additional social and familial responsibilities. Likewise, the survey finding reflects that there are no such cases reported on brain drain issue as a result of existing tax law. Though, significant numbers of workers and owners have migrated within and outside the country closing down their businesses when security condition deteriorated during the decade long political instability.

VAT compliance ensures some competitive advantages. For instance exporting firms are likely to get some incentives, but as a result of low volume of transaction, corruption and malpractices, many of the firms tend to be non compliers of VAT. Primary survey shows that lack of book keeping and record keeping are the major obstacles in VAT compliance. Since large numbers of SMEs are operated by uneducated and less educated entrepreneurs, record keeping and maintaining VAT record is beyond their capacities. For that, they have to hire part time or full time tax professional once they register with VAT. On average, VAT compliance cost of a firm was found to be around NRs 35000 in 2012. Enterprise survey showed that lack of awareness, no benefits in returns, procedural complexity, and possible hassles from VAT administration are considered to be the prime causes of non VAT compliance in Nepal. Results show that they shift 100 percent cost of VAT compliance to the customers.

The study recommends that SMEs should be imposed lower taxes so that they will have enough funds available for other economic activities that will help to enhance growth in SMEs sector. Moreover, it will provide opportunities for the SMEs to be better equipped in the competitive environment. Increasing tax exemption, providing tax incentives and tax holiday will not only help to attract potential investors to invest in SME sectors but also encourage voluntary tax compliances.

Likewise, the study further recommends that government should make VAT rate more comprehensive and progressive so that it discourages under invoicing. Increasing VAT thresholds will help to formalize SMEs sector. Regarding the property tax, scientific valuation methods should be developed to replace discretionary valuation based on manual developed by local government, area based valuation will be optimal.

SECTION-I

Literature Review

The World Bank/IFC (2009) survey, which focus on factors, that plays vital roles to determine whether the economy is prospering or not, notes that a conducive business environment helps and encourages the economy to operate efficiently. If there is stimulating business atmosphere, every business person has incentives to innovate and increase their scale of production, which ultimately leads to generate income, revenue and employment in the economy. Both quantitative and qualitative data in the World Bank survey were collected through face to face interview with the managers and owners of the firms regarding the business environment of the firms and their productivity. From the survey, it was identified that political instability and electricity are the major obstacles in enterprise development in Nepal for all types of the firms. Limited numbers of women are managers and owners in those organizations. It takes longer time to take operations, constructions and import licenses as compared to other South Asian and low income countries. Value loss as a result of power outage is higher in Nepal as compared to other South Asian and low income countries of the world, whereas giving bribes while meeting with tax inspectors is less as compared to others south Asian neighbors. The World Bank/IFC report also found that about 80 percent of the firms were expected to give gift or bribes while obtaining government contract, which is higher in Nepal as compared to others in the study. Likewise, less percentage of firms are expected to give bribes to get construction permits, import license and operating licenses. Around 65 percent of firms think that court is impartial, uncorrupt and fair. The survey also shows that more than 90 % firms started their operation without formally registering in the government organizations. It shows that there is prevalence of informality in the private enterprises in Nepal. Approximately 80% of the funding of Nepalese firms obtained from internal sources; whereas more than 40% firms obtained credits from formal banking channels. This survey shows that less percentage of women are working on a temporary basis as compared to male workers and above 20 percent of females are working in permanent position.

The World Bank (2009) informal sector survey conducted in Nepal found that 67 percent of total informal sectors are concentrated in the central region of Nepal. More than half of the total informal firms produce and sell food and beverages, while others are in tailoring, furniture and repairing business. Firms operating in informal sectors have cost advantages as they avoid taxes and regulation. However, informal firms cannot grow beyond certain level as they do not have access to the formal banking system, suffered from managerial and management weaknesses and have absence of downstream linkages with the formal sectors. The large informal economy means less revenue generation for government. This

ultimately leads to slow economic growth. Besides that, it also distorts healthy competitions among production firms. As a result, firms do not have incentives to invest more on innovations and enhancing production capacity in the long run. The study found that giving more tax incentives and exemptions, broadening tax net and reducing tax rates to the formal economy, efficient tax administration etc might discourage informality.

Afram and Del pero (2012) Tax Compliance Cost Survey found that about 35.4 percent of taxpayers having turnover of Rs 2 million to Rs 10 million and registered with Value Added Tax (VAT) have been found not paying VAT for years. Most of these tax payers find that compliance to VAT is difficult as it increases the number of submission and payments significantly, thereby raising cost of doing businesses in Nepal. According to survey, overall average compliance cost is Rs 9382. There is significant increment in the compliance cost from below the VAT threshold to the initial VAT applicable slab. The surveys revealed that majority of businessmen do not have their own bank account. The study further found that taxpayers prefer to settle tax issue by means other than appeal; tax payers lack knowledge about VAT; Businesses often overstate the actual expenditure in their tax returns by about 40 percent and hide the actual revenue by about 20 percent in order to evade the tax.

Local Self-Governance Act (1999) deals with the organizational structure and functions, duties and powers of the Village Development Committee (VDC), Municipality and District Development Committee (DDC). It also looks after matters related to financial resources, personal management of these bodies along with relationship between these bodies and government of Nepal. The VDC is entitled to levy taxes in its area, not exceeding the rates prescribed by the village council. The council prescribes rates for house and land tax, land revenue or land tax, market shop tax, vehicle tax, entertainment tax, rent and tenancy tax, advertisement tax, business tax, commercial video tax and natural resources utilization tax. This act is however currently dormant due to absence of constitution assembly.

The Industrial Policy formulated in FY 2010/11 was designed to accelerate the pace of industrialization in response to the diversity in the service industry and tap the opportunities arising from it. The policy provides special incentive for promotion of micro enterprises, cottage and small industries and women headed enterprises. However, this policy is yet to be implemented as the parliament was dissolved before it was passed.

Property tax in Nepal is applied only in major cities. It was first introduced in 1962 which was replaced in 1990, which was again replaced by the urban house and land tax in 1995/96. Currently there are two kinds of property tax: a) House and Land Tax (HALT) and b) Unified Property Tax or Integrated Property Tax (IPT). A new law on property tax

has also been drafted. Once the law is implemented, it will compel all Nepalese to compulsorily declare and pay tax for property owned by them¹.

Dahal (2009) found that estimated tax effort or tax burden ratio is found to be 15.7% of Gross Domestic Product (GDP) in FY 2008/09. Although the Nepal's tax structure revenues are buoyant but inadequate to supplement development activities. He identified the major problems of taxation in Nepal as: (i) marginally high tax rates (ii) limited tax base (iii) low tax elasticity (iv) poor voluntary compliance (v) leakages in tax collection (vi) rigid Income Tax Act 2000, (vii) inefficient, indifferent and corrupt tax administration, and (viii) no consolidated record of property (land and building) with the Internal Revenue Department (IRD). In the article, he stated that Agriculture sector is enjoying zero tax on income earned from agriculture and others industrial sectors have also been offered blanket exemption, deduction and concessions for the years. Still, IRD does not have consolidated record on property tax; Nepal has very poor voluntary tax compliances and limited tax base and large share of revenue generated from custom duties.

The VAT was introduced in Nepal in November 1997. This tax was levied in place of the Sales Tax, Hotel Tax, Contract Tax and Entertainment Tax. However, it could not be implemented fully until the Fiscal Year (FY) 1998/99 due to political instability and strong opposition from the business community. VAT replaces the old Sales Tax, Contract Tax, Hotel Tax and Entertainment Tax. Since the collection of both customs duties and income tax depends upon the effectiveness of VAT to the greater extent, it is expected to enhance revenue collection. The current threshold for VAT registration is Rs. 2 million. Those vendors whose annual turnover is below the threshold can, however, register voluntarily.

ILO (2005) report on Micro and Small Enterprises (MSE) policy review found that MSEs play the significant roles on creating employment opportunities and alleviating poverty in Nepal. However, their contributions have been undermined due to subsistent nature, scattered existence and scale of operations. Nevertheless, their contribution is significant and considers MSEs as the vehicles for economic growth at the grass roots level. The MSEs are estimated to employ 1.6 million persons, which is more than the 70 percent of workforce engaged in the non agriculture sectors. Females' participation on micro enterprises is conspicuously high but low in the small enterprises. Micro enterprises are more common in rural areas and not being registered with any governmental authority. Whereas, small enterprises are common in the rural settings, nearly 60 percent of small enterprises have been registered with one of the governmental authorities. Registration is less common among female-owned and managed enterprises. These MSEs are highly reliant on informal finance. Access to the credit market is a major constraint for micro, small and medium scale industries. Their activities had to be financed overwhelmingly by

¹ M. M. Sharma, "New Property Tax Act in the offering", Republica, dated September 3, 2012.

the savings of the entrepreneurs themselves, or of their relatives and friends. Not much has been done to change this situation, which is the main hindrance to the expansion of these Industries. The report further mentions that current incentive schemes are biased in favor of large industrial enterprises and against MSEs. The Industrial Policy (1992) and the Industrial Enterprises Act (IEA) (1992) extend a number of incentive schemes to MSEs in the industrial sector only, while the revision of the Industrial Enterprise Act in 1996 and the new Taxation Act of 2002 has removed most taxation-based incentives. The current incentive system provides tax exemption for cottage industries and nominal custom duty for imported raw materials for export purposes. Regarding taxation, most MSEs are not able to enjoy tax exemption and tax deduction offered by the government due to the cumbersome processes.

World Bank (2012a) study on Nepal investment climate shows that industrial contribution to the national economy has been declining in the recent years. Over the last two decades, other South Asian neighbors like India, Bangladesh and Sri Lanka have transformed their economics by expanding their trade base and competitiveness. In contrast, Nepal only achieved meager value added growth in all sectors, but particularly performed worse in the manufacturing sectors. There are several factors contributed to the low growth of manufacturing sectors, specifically worsening security conditions, lack of infrastructures, limited access to the credit markets, labor market issues, rigid tax law. Until and unless those issues are addressed, business confidence cannot build up. For creating investment climate, reducing cost of production, to increase declining competitiveness in the domestic and international markets and curbing mass unemployment and enhancing manufacturing growth contribution to the GDP, such obstacles need to be dealt immediately. The study further reveals that the average size of formal manufacturing firms in the private sector is very small. The private sector is characterized by informality- it is estimated that 70 percent of workers are employed in the informal sector- and by the prevalence of micro firms. Outside the agriculture sector, firms with less than five employees account for 65 percent of informal firms and 70 percent of the registered firms.

Rajbamsi (2005) in his paper stated that Industrial development in Nepal is in initial stage and all types of manufacturing industries contribute around 10 percent of the Gross Domestic Product (GDP) and providing employment to not more than 2 percent of the labor force. However, SMEs overwhelmingly dominate the industrial sector of Nepal. It plays a major role as sources of employment in the manufacturing sector and significantly contributes to value addition and export trade of the country. The export of manufactured and processed goods accounted for more than 80% of total export. SMEs account for 96% of total industrial establishments and 83% of total employment generation by industrial sector. Only SMEs have contributed almost 9% in overall GDP.

Informal and unregistered businesses are wide spread in Nepalese economy. The informal sector of Nepal is estimated to account for significant proportions of growth, consumption and employment of Nepalese economy. Nepal Labor Force Survey (NLFS) 2008 found that still 70 percent of employment in non agriculture sector is from informal sector. According to the International Tax Dialogue (2007), the informal businesses do not go for registration, because they do not see any benefit from it. Moreover, they would also like to avoid possible labor union clashes and registration charges. There are other factors as well which lead to operate the small enterprise in the informal economy. Taxation is leading motivating factor, but it is not only cause of informal/undocumented economy. There are numerous other reasons which differ from country to country.

- Direct tax burden
- Complexity of tax system
- Average direct tax rate
- Marginal tax rates
- Average total tax
- Unemployment
- Higher compliances cost
- Higher tax rates
- Lengthy and complex administrative procedure

The same study revealed that a small enterprise not required to register for the VAT may still be highly affected by the tax – and may even benefit from it. Even in the absence of VAT withholding such a firm will bear unrecovered VAT on inputs that it purchases from VAT-registered firms or imports. If it cannot pass this unrecovered tax along to the buyer, the real burden of the tax must be borne by the owners or employees of the enterprise.

Atawadi and Ojeka (2012) studied the factors that affect tax compliance among the small and medium scale enterprises in North Central Nigeria found that tax compliance among SMEs are very poor. High tax rates and complex filing procedures are the major factors responsible for non compliance of SMEs. Besides these, multiple taxes and lack of knowledge of taxes that also affect tax compliances to the some extent. They recommended that lower amount of taxes should be levied; it will create extra funds for other activities and lead to economic growth. Lower amount of taxes implies that they will have more opportunities to sustain in the competitive environment due to less cost of production. Along with this, they also suggested to provide more tax incentives and tax exemptions, which will help to attract not only potential investors but also encourage voluntary tax compliances. However, some of the authors are against of providing tax

incentives/exemptions to the small scale industries (SSI). According to Bagchi et al (2005), providing reservation and incentives to the SSI at the cost of large industries in India are the major responsible factor of poor economic growth during 60s and 70s. Such policy may have helped to generate or sustain employment in the informal sector; such employment was provided at low levels of income and thus contributed to the persistence of poverty across the country. The design of protection provided through preferential treatment in taxation has also been a subject of criticism as a factor inhibiting the growth of SSI units as they serve as a disincentive to grow beyond the level upto which the concessions are available.

Bunjongjit and Oudin (1992) in their study in Thailand reveal that access to the credit market is a major constraint for micro, small and medium scale industries. Their activities had to be financed overwhelmingly by the savings of the entrepreneurs themselves, or of their relatives and friends. Not much has been done to change this situation, which is the main hindrance to the expansion of these Industries. While institutionalized savings -- through banks -- and tax receipts were re-oriented towards investment by big companies, small-scale enterprises had to rely on the remaining savings from households in order to finance their investment. On a nation-wide scale, then, the saving capacity of the population is not fairly distributed. Small scale industries are very fragile due to the following reasons: lack of incentives from government; difficult access to credit; subordination to large-scale industries and traders; competition in the labor market.

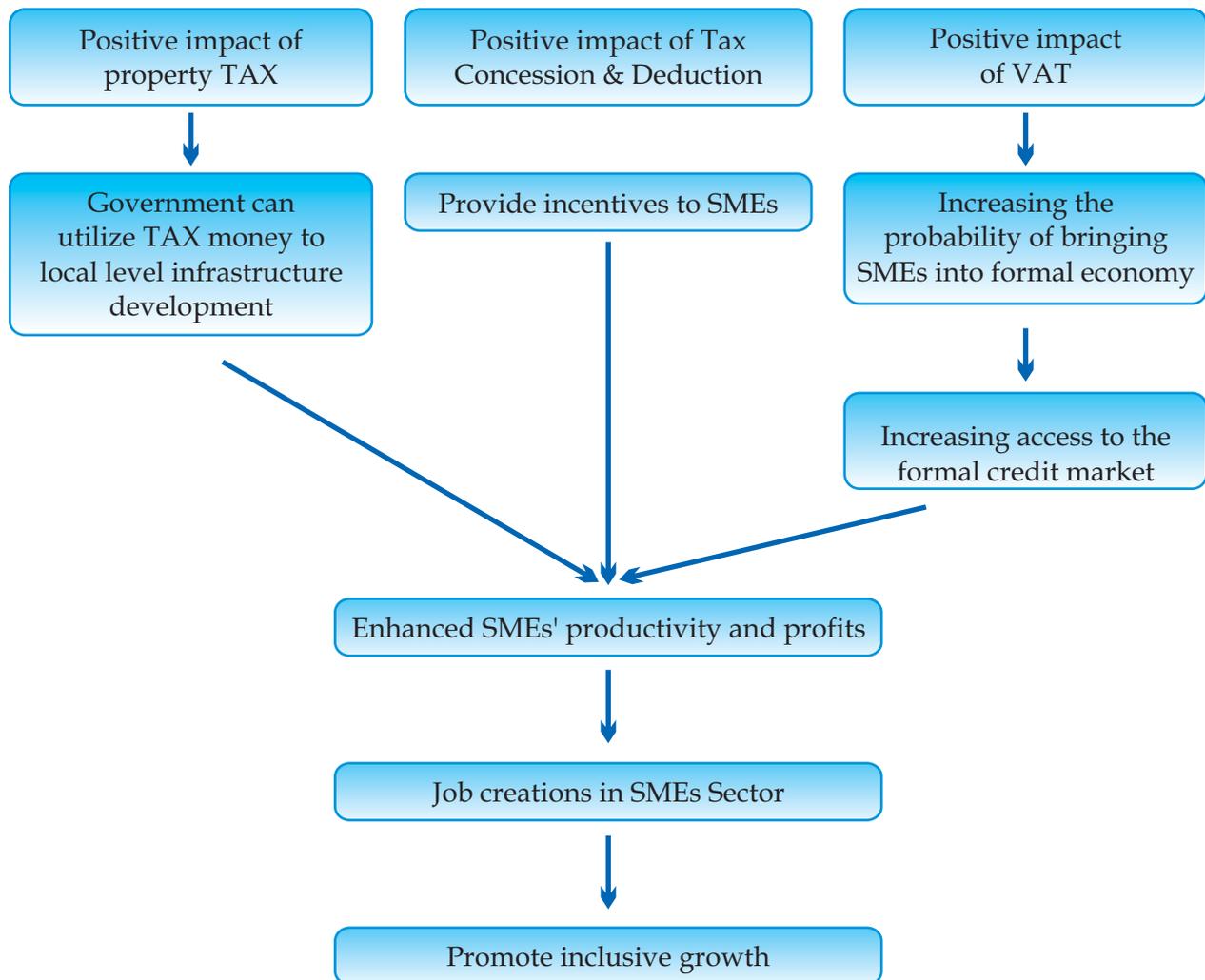
Koirala (2012) in his study in Nepal tried to assess the performance of VAT since it was implemented in 1998. The study basically focused on exploring the current scenario of VAT administration, major issue related with VAT and possible immediate corrective measures to deal VAT related problems. Both primary and secondary data were collected. Based on the survey, it is found that there is huge non-tax compliance due to weak tax enforcement of tax authorities. Counterfeit billings, no refund from government treasure to the tax payers in time, avoiding tax, lingering the taxpaying data etc are common practices in the recent years, despite that government is successful to reduce tax dues last years. The study suggested that there are various ways to deal with those irregularities existed in the economy; it consists of trimming down the exemption and deduction lists, providing high quality tax services to the consumer to attract them into the formal tax system, taking strong legal action to the tax dodger, increasing tax threshold etc.

SECTION-II

Conceptual and Analytical Framework

The following analytical framework depicts (figure 1) that how efficient provision of tax concession and tax exemption, VAT and property tax in the Small and Medium Enterprises (SMEs) will ultimately promote inclusive growth in Nepal. There is wide spread poverty and unemployment in the Nepalese economy. To cope with these problems, enterprises development is essential. Large numbers of small and medium scale enterprises, which are the major sources of employment and contribute significantly to the economy, are still unorganized and undocumented. Government needs to create trustworthy and conducive environment for bringing these informal businesses into formal one by offering amicable and administrative friendly efficient tax policy (ITD, 2007). For instance by providing more tax exemption and deduction to the SMEs might encourage them to invest more on enhancing their existing capacities and operating new businesses. This will generate ample employment opportunities into the economy. Likewise, by providing efficient VAT and property tax system, will help to bring all the informal businesses into tax nets. This will be mutually beneficial for government and entrepreneurs. Government will collect huge amount of revenue through taxes on the one hand, at the same time, entrepreneurs as well receive the incentives and support from the government once they formalize their businesses. This will enhance the productivity and profit of SMEs. Increasing profit and productivity will create job opportunities in the economy. Ultimately, it helps to augment growth by reducing unemployment and mass poverty.

Figure1: Analytical Framework



SECTION-III

Sampling Design and Rationale for Primary Survey

A number of survey tools were used in collecting primary data and information. The survey used both the quantitative and qualitative approaches. The quantitative approach includes the enterprises survey of around 200 formally registered SMEs from five main business corridors of Nepal. While qualitative survey consisted of key informant interviews, focus group discussion and case studies. Based on the semi structured questionnaire, we conducted 10 key informants' interviews. We have interviewed academicians, tax officials, and former members of Planning Commissions, Bankers, and Director of Agro Enterprises Services at FNCCI, former Deputy Governor and former Director of Central Bank of Nepal, Chartered Accountant, NGOs head especially working on small and micro enterprises in Nepal. Likewise, three Focus group discussions (one for each theme) were conducted to gather required information. At the same time, four case studies were also reported to further supporting the findings received from quantitative and qualitative survey.

The survey was conducted among formal businesses registered under the Inland Revenue Department (IRD), association of small scale and cottage industries, municipalities, the Department of Industries etc. This survey is focused on small and medium scale enterprises, and therefore large scale industries have been eliminated from the sampling procedure.

For conducting survey, the country is divided into three geographical regions namely eastern, central and western based on the industrial and economic activities of major cities. The western region includes districts like Kaski, Banke, Kailali and Rupendehi whose major industrial and economic cities are Pokhara, Nepalgunj, Dhangadi and Butwal respectively. The central region includes districts like Kathmandu, Lalitpur, Bhaktapur and Chitwan. Similarly, the eastern region includes districts like Jhapa, Morang and Sunsari, whose major cities are Bhadrapur, Biratnagar and Itahari, respectively.

The table 1 given below shows the total number of small and medium scale industries in the major cities of Nepal.

Table 1: Total number of SMEs in major cities of Nepal

Regions	Major cities (Districts with number of industries)
Eastern	Bhadrapur (Jhapa-71), Biratnagar (Morang-171), Itahari (Sunsari-89) - 331
Central	Kathmandu(2183), Lalitpur (412), Bharatpur (Chitwan-118) and Bhaktapur (125)-2838
Western	Pokhara (Kaski-179), Nepalgunj(Banke-49), Dhangadi(Kailali-23) and Butwal (Rupendehi-115)- 366

Sources: *Department of Industries of Nepal*

Figure 2: Industrial Survey Area



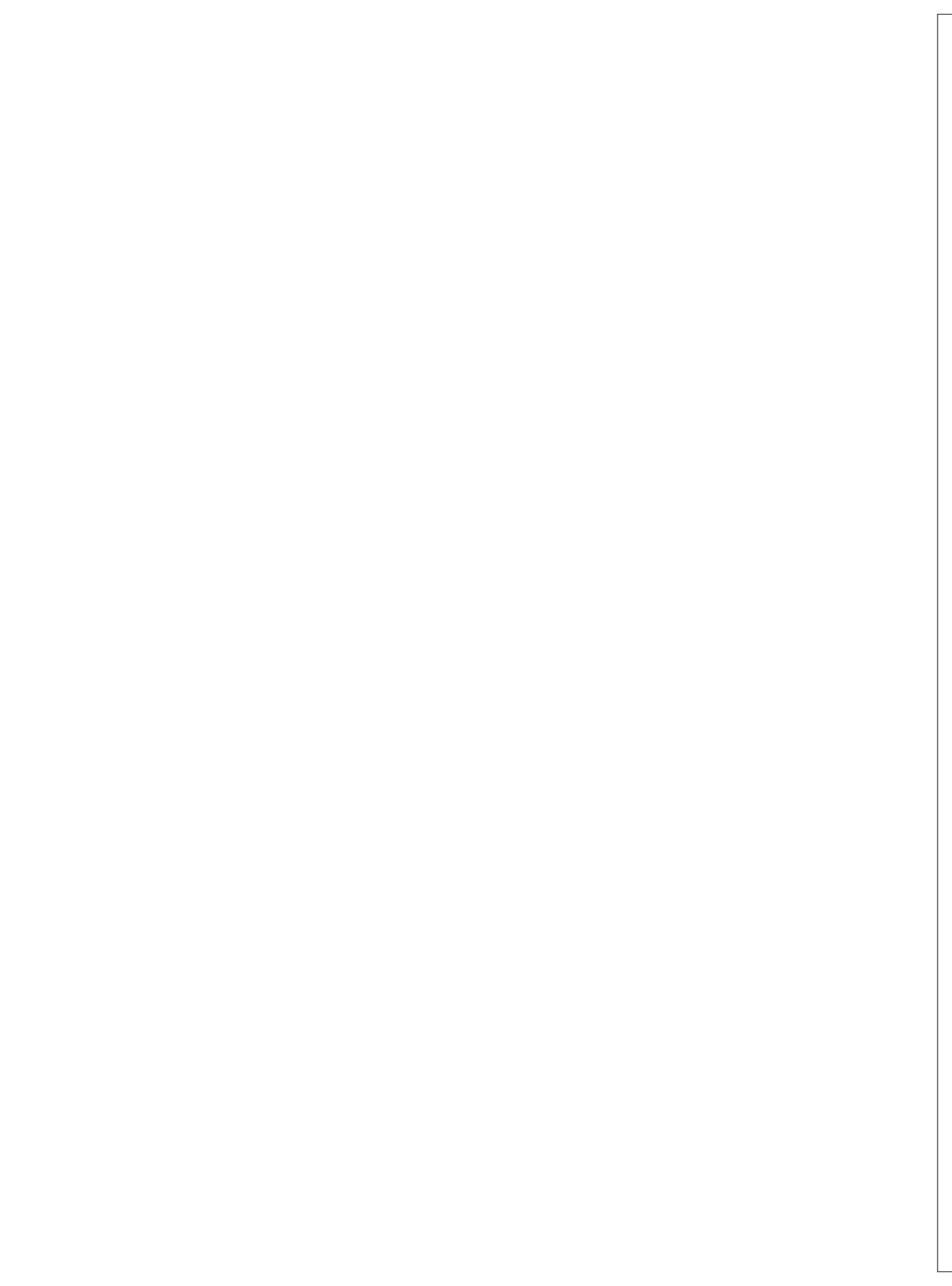
According to the Industrial Statistics 2010/11 of Nepal, the 11 districts contain more than 75% of the total industries. The central region alone consists of 55% and Kathmandu has around 50% of the total businesses registered in Nepal.

A total of 202 small and medium scale industries out of 3535 are selected for the study. It uses purposive sampling technique and focuses on five major cities. Since the central region consists of 55% of the total industries; approximately 50% of the total sample is drawn from it. Twenty five of the samples were drawn from each of the eastern and the

western regions as shown in table 2 below. The samples were selected from the list provided by the Federation of Nepalese Chambers of Commerce and Industries (FNCCI). Out of the total samples drawn women-headed enterprises comprise only 7%.

Table 2: Sampling cities and samplings population

Region	Cities	Sample size
Central Region	Kathmandu, Patan and Bhaktapur	102
Western Region	Butwal and Bhairahawa	50
Eastern Region	Biratnagar	50
Total		202



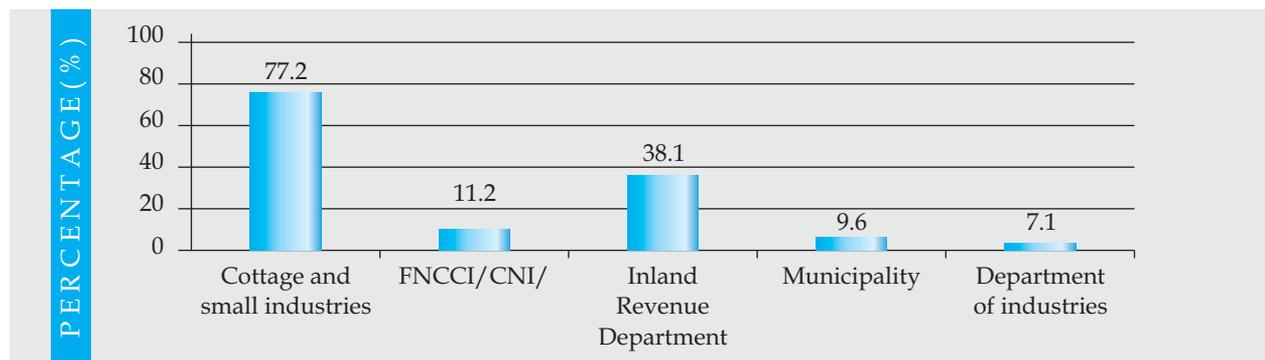
SECTION-IV

Findings

4.1 Results of the survey

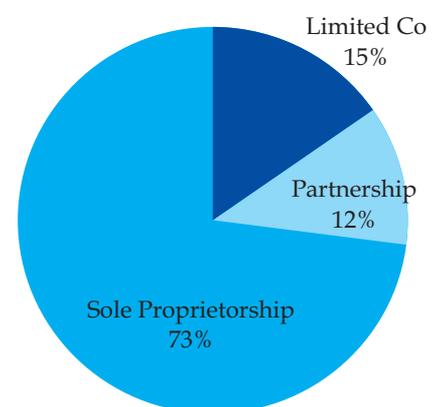
From the formally registered enterprises survey conducted in different parts of the Nepal, It was found that around the three fourth of the sample enterprises were registered under the small and cottage industry. Likewise one fourth of the enterprises were registered under the Inland Revenue Department (IRD) followed by FNCCI/CNI, municipality and department of industries subsequently as shown by bar diagram in figure 3.

Figure 3: Extent of Formalization



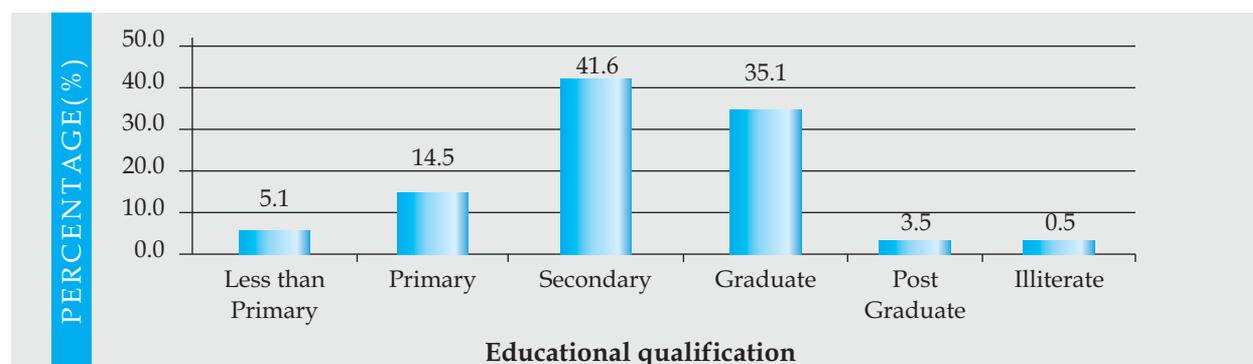
The survey illustrated that the most common legal form adopted by private SME sectors in Nepal is sole proprietorship. The Majority of the manufacturing units were found to be operated under sole proprietorship businesses mostly headed by male members of the family as shown by pie chart in figure 4. More specifically, 73% of the small and medium scale enterprises were headed by sole proprietors, 12% were established as joint ventures and the remaining 15% were owned by private companies as found in previous study conducted by Afram & Del Pero (2012). Since SME sectors do not require huge amount of investment, so most of the SMEs operated with small amount of investment under sole proprietorship.

Figure 4: Ownership of structure



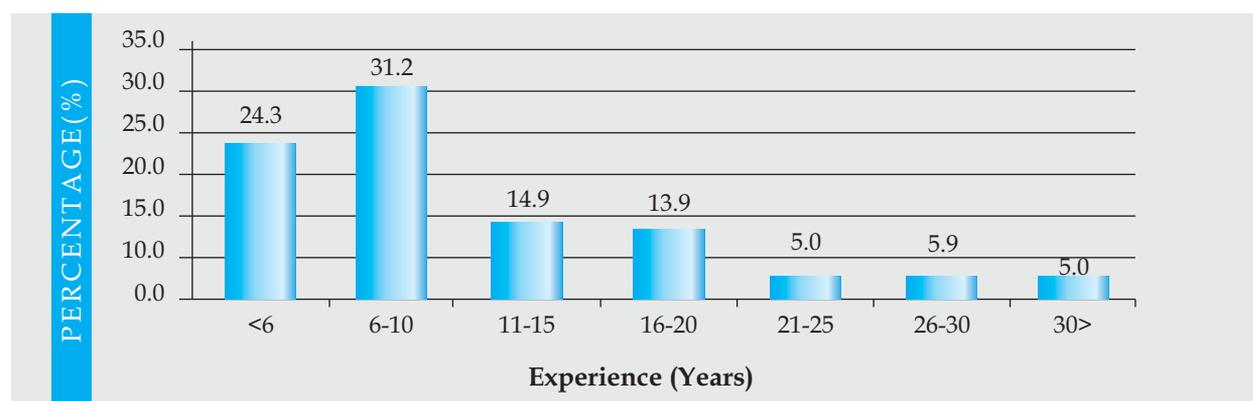
Likewise, it is observed that majority of the entrepreneurs had less than secondary level education. Only 0.5 % of them were illiterate. Three and half percent of the entrepreneurs had a postgraduate degree that is the highest education obtained by owners of SMEs, 35.1% were graduates and nearly three fifth of the entrepreneurs had less than secondary level of education, as mentioned in figure 5. From that we can infer that poor performance of SME sectors in Nepal might be due to run by less experienced and not qualified entrepreneurs.

Figure 5: Educational Qualification of Entrepreneur/Major Decision Maker



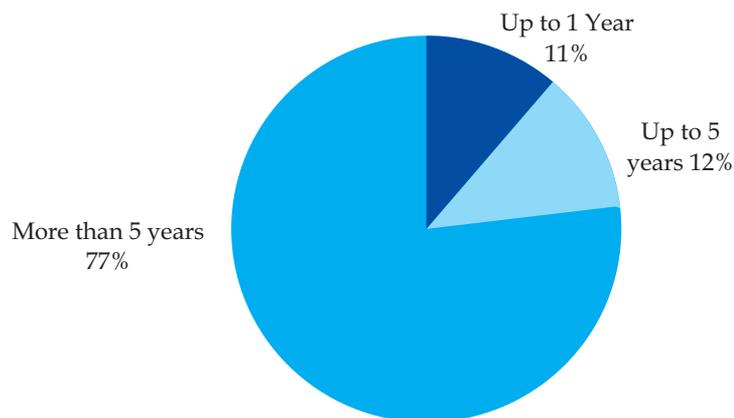
The result shows that more than half of the manager or decision makers had less than ten years of experience in their field. Entrepreneurs with 21-25 and more than 30 years of experience were the least, i.e. only 5% each whereas the ones with 6-10 years of experience were the highest, i.e. 31.2%, followed by entrepreneurs with less than 6 years, 11-15 years, 16-20 years and 26-30 years respectively (figure 6).

Figure 6: Experience (In Years) of Entrepreneur/Major Decision Maker

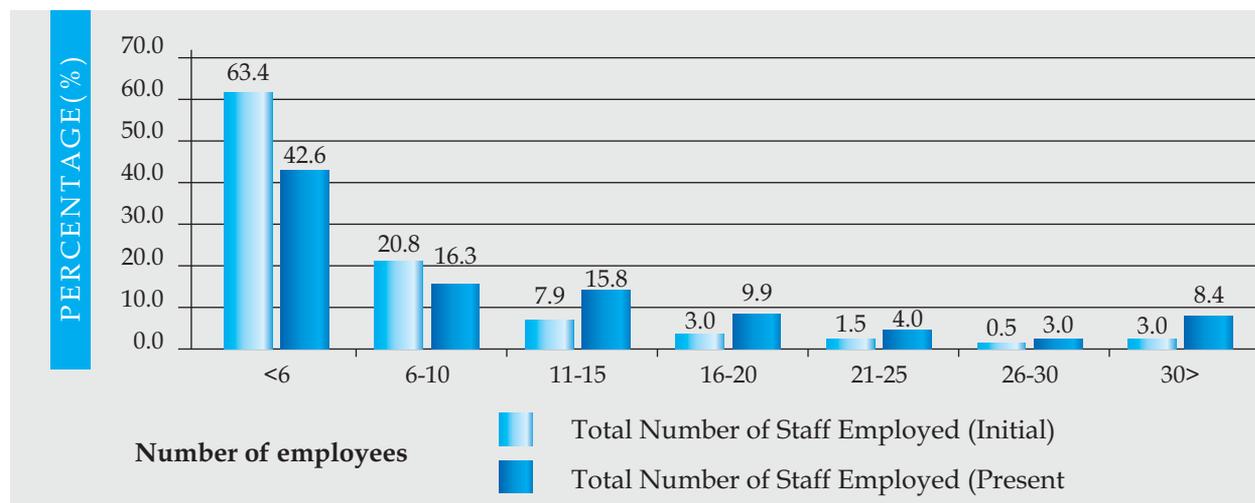


The distribution of registered firms by age shows that more than three fourth of the enterprises had been in operation for above 5 years, about 11% of the newly established businesses have been in operation for less than a year and about 12% have been in operation from 1 to 5 years (figure 7). This implies that either fewer firms have entered the market over the last five years or there is very less survival rate of the established SME sector compared to the preceding five years period. In either case, the environment for the entry of new businesses and survival of the newly established businesses has worsened for last five years.

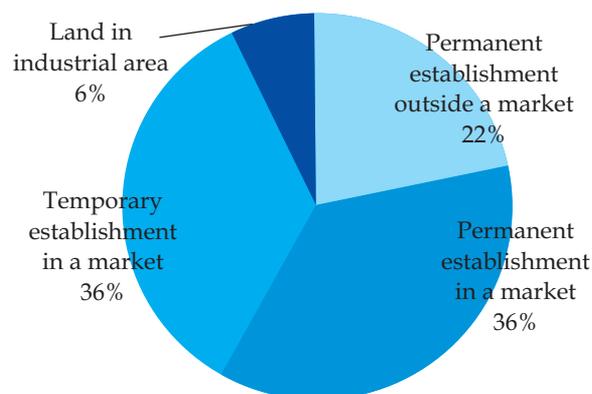
Figure 7: Lengths of operations



In term of human resources, the trends of hiring more workers have significantly increased over the years. It implies that capacities of SMEs have enhanced. It was found that about two-third of the SMEs started out with 6 members including the owner. Likewise, 20.8%, 7.9%, 3% and 1.5% enterprises employed 6-10, 11-15, 16-20 and 21-25 employees respectively during the initial phases of their business operation as shown by multiple bar diagram (figure 8). Around 3% of the SMEs hired more than 30 employees during their initial stages. The study discovered that the number of industries hiring 6 or less workers during the initial phases of operation has declined significantly. However, SMEs employing less than 15 employees still remain more than three quarters. Only about 25% employ over 15 employees. This trend of employing more staff has been increasing over the years. For instance, the 16% of SMEs that hired more than 11 workers have increased to 40%. This shows that the capacity of SMEs have been growing over the recent years.

Figure 8: Total number of staff employed

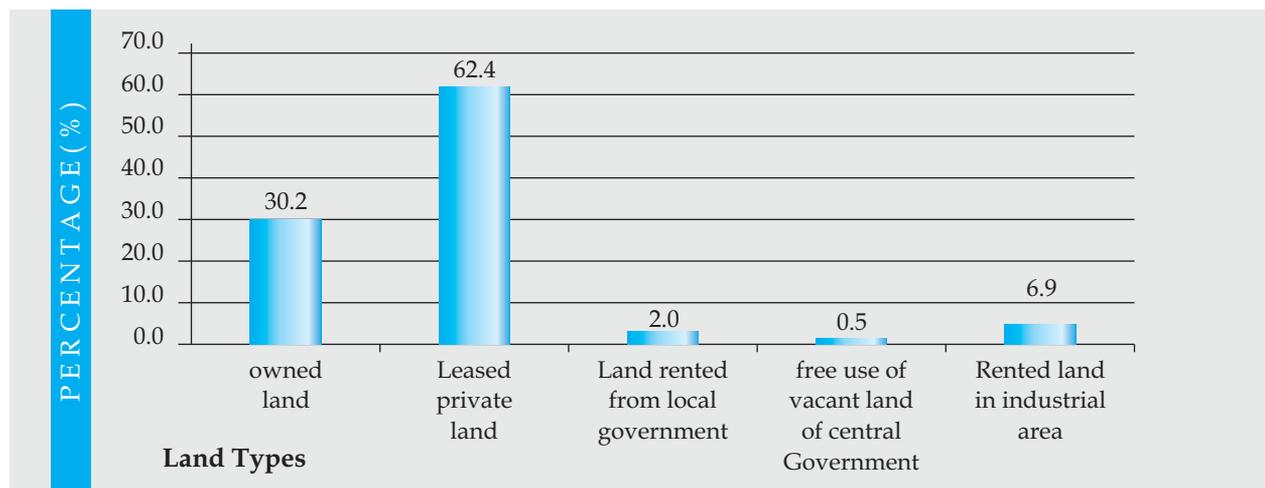
The survey also found that above one third of SMEs are operated temporarily in the market and often found hesitated to invest more on infrastructure or other developments activities due to temporary nature of business. Twenty two percent of the SMEs were set up in a permanent establishment outside market and only 6% were set up on lands in the industrial areas as shown by pie chart (figure 9).

Figure 9: Nature of business place

At the same time, three fifth of the enterprises were operated in leased private land often facing the problem of frequent land rent increment. While only about 30 % of the total SMEs were operated on their own lands. 2% of the SMEs were set up on lands rented from their local governments and they have to pay rent to the local government, 0.5% used vacant land belonging to the central government for free and the remaining 6.9% of the

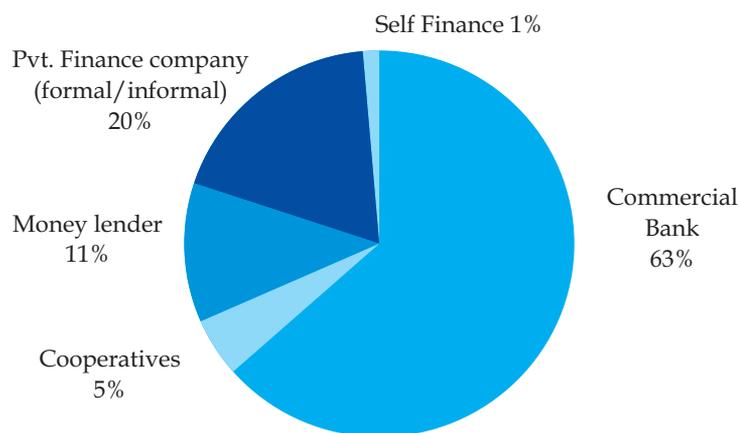
SMEs were built on rented land in the industrial areas (figure 10). Since large numbers of enterprises were operated in temporary establishment and leased private land, they could not expand their businesses as they want. Tenure Rights of enterprises' premises have significant impact on the expansion and development in the long as well as in the short run. Those enterprises which are running their operations on contracted and rented land may not wish to invest heavily on plants, buildings and machineries because they will have to shift their plants once the contractual agreements are over as stated in key informant interviews. It might be one of the causes of lagging behind of this SME sector in Nepal.

Figure 10: Nature of land used by SME/MSME for business purpose



Regarding the financing of business during last five years, most of the SMEs depended on credits especially from commercial banks (table 11); whereas some enterprises depended on informal credits markets to finance their businesses due to easy access even though there was high rate of interest. Particularly, nearly two-thirds of the SMEs borrowed from commercial banks. A fifth of the SMEs borrowed from private finance companies and about one in ten of them are financed by money lenders. The remaining few are financed by cooperatives.

The survey further revealed that SMEs owners often face difficulty to apply for loan in formal credit institutions due to collateral issue and lengthy processing times. Eligibility requirement, processing times, loan sizes affect the supply of financial services, and play a crucial role in determining the extent to which firm can and will access financial services. Nepal has the highest number of documents required to access financial services as compared to other 60 countries (Afram & Del Pero, 2012). If government can provide concessionary loan with less hassles and requirements, SMEs sector can thrive as suggested by KII and FGD.

Figure 11: Sources of credit

Enterprises surveys showed that there are some enterprises hesitated to comply with taxes as they do not get any benefits in return. Along with this, tax payers' money is not normally used for the betterments of its people. Around two thirds of enterprises perceived that there are many types of taxes which are hindering the development of SMEs or smooth running of enterprises in Nepal. Similarly, majority of entrepreneurs accepted that tax laws and regulations are too complex to follow while half of the respondents thought that they are often being harassed by tax official by asking for irrelevant and unnecessary documents and often behave them as tax evaders as shown in table 3. The Key informants interview and focus group discussion also pointed out that very cumbersome procedures, non-facilitative attitudes and ambiguous acts have created problems in their growth. A majority of them (73.8%) thought there are too many taxes to be paid in Nepal that intrude the smooth running of their businesses. 61.4% of them thought that the tax laws and procedures are too complex, others either disagreed or remained indifferent to those questions. When the issue of competency of tax officials was raised, over 60% had no complaints regarding their competency and thought they were both fair and respectful towards the SMEs, whereas, less than a quarter of them either disagreed or stayed neutral on their remarks. There were around 50% of those who complained about frequent harassment by tax officials especially asking for unnecessary documents, entrepreneurs often behave like tax evaders etc whereas 37.7% firmly denied the existence of frequent harassment by tax officials as given in table 3.

Table 3: Entrepreneurs' perception on tax and tax officials

	Strongly agree (%)	Agree (%)	Disagree (%)	Strongly Disagree (%)	Neither agree nor disagree (%)
Views on too many types of Taxes	10.4	63.4	15.8	2.5	7.9
Opinions on too complex tax law and procedures	8.9	52.5	25.7	2.0	10.9
Opinions on competency of tax officials	5.4	62.9	16.8	5.0	9.9
Tax officials' fair and respectful attitude towards SMEs	7.4	53.0	24.8	3.5	11.4
Frequent harassment by tax officials	5.9	44.6	34.2	3.5	11.9

To find out how tax concession and tax exemption have impacted on small and medium scale enterprises development is one of the research objectives of the study. The survey found that almost all the enterprises heads did not have any tax exemption and deduction in terms of tax incentives despite some provisions in industrial acts and laws. Some of the enterprises such as agro based enterprise heads told that they do not have to register with VAT authorities while others told that they have not registered with VAT since their annual transaction is below NRs 2 million. Women have some sort of concession in land registration process if it is registered in their name, otherwise they is no special concession to them. While asking about possible causes of non compliances, most entrepreneurs perceived that high tax rates, complicated tax procedures, no benefits in returns were considered to be the major causes of tax non-compliances in small and medium scale enterprises (table 4). Out of 202 respondents, 124 (61.4%) agreed that very high tax rate is one of the major causes of non compliance.

40.6% of them expressed dissatisfaction towards the complicated procedures of tax filing, while 16.3% said they had never been requested to pay taxes by the government. 13.4% said entrepreneurs are tax noncompliant because they do not receive any benefits in return. And others mentioned that information asymmetry and harassment were other causes of SMEs non-compliance (table 4) as it was found in ITD (2007).

Table 4: The major causes of SMEs Non-Compliance

The major causes of SMEs Non-Compliance(N=202)	Frequency	%
Tax rates are too high	124	61.4
The procedures for tax filling are too complicated	82	40.6
Never been requested to pay taxes by the government	33	16.3
No benefit	27	13.4
Lack of information	7	3.5
Harassment	2	1.0
No utility	3	1.5

Some entrepreneurs pointed out that possible future harassment is also one of the causes of being non tax compliant. The survey showed that by reducing tax rates, offering tax exemption and providing tax holidays can enhance the productivity of the SMEs sectors as Mwangi & Nganga (2011) have found in their study conducted in Kenya. The Focus group discussion and key informant interview also further validated the findings obtained from enterprise survey. Based on these interviews and discussion, hassles related to tax and such other issues, such as harassment by tax officials are some of the key reasons as to why SMEs remain unregistered and their information remain undocumented. Table 5 mentioned that a majority of 70% said tax reduction would help their businesses grow, while 52.5% said they should be granted tax exemptions. 36.1% revealed that they wanted the tax authorities to strengthen their services, whereas the remaining 12.4% wanted the authorities to grant them tax holidays.

Table 5: Opinions on tax related assistance

Opinions on tax related assistance(N=202)	Frequency	%
Reducing tax rates	142	70.3
Granting tax holidays	25	12.4
Granting tax exemptions	106	52.5
Strengthen the services of tax authorities towards SMEs	73	36.1

In most of the cases, managers or owners maintain the tax records, where as some enterprises hire part time and full time accountant to maintain or settle the tax related issue. The survey results showed that median tax compliances cost was found to be around Rs 15000 in 2011 and 2012. It is further noticed that cost of compliance is directly related with number of employees. The survey also revealed that most of the enterprises were willing to formalize their businesses, if they get benefits in return despite harassments.

Second objective of the study was to observe the impact of VAT on small and medium scale enterprises in Nepal, the survey results showed that on average each VAT compliant firm paid VAT NRs 360000 in 2012 and most of them were registered only after 2008. The survey result showed that majority of these VAT compliant firms had to bear compliance cost in terms of hiring part time or full time staffs to maintain VAT account, cost of keeping records and cost bearing associated with VAT payment. The survey further revealed that on average, VAT compliance cost of each firm found to be NRs 35000 in 2012. In response to a question, how people perceive VAT policy, half of those who responded indicated that it is beneficial because they believe that VAT payment can be utilized properly and it can ultimately lead to economic development of the country. While others thought that accounting system will be transparent, systematic, and up to date and entrepreneurs do not need to worry or frighten with the possible hassles from the revenue departments.

However, those who thought VAT compliance is burdensome assumed that it will raise cost of production of the manufacturing items. The cost of compliances will be aggregated cumulatively from the costs associated with record keeping and the preparation of filling return, regardless of whether it is undertaken in house or by external auditor. Those small firms who are VAT compliant firms have to compete with other VAT non compliant firms, who can produce same product in cheaper price. It creates financial burden to the firms which are already in VAT as found in ITD (2007). They also observed that the procedures of VAT compliance is tedious, no return for compliance, possible harassment and unnecessary inspection of VAT authorities will have negative impact on the growth of SMEs as mentioned in FGD and KII.

Enterprise survey showed that lack of awareness, no benefits in returns, procedural complexity, and possible hassles from VAT administration are main causes of non VAT compliance in the economy as shown in table 6.

Table 6: Major causes of VAT non-compliances

Major causes of VAT non-compliances(Multiple responses)	Frequency	%
Lack of Awareness	94	62.7
No Benefits in returns	78	52.0
Procedural Complexity	91	60.7
Problematic behavior of VAT Administration	24	16.0
Possibility of Future Harassment	52	34.7
Financial burden	1	0.7
Total numbers of observations(N)	202	

The survey found that most entrepreneurs did not have any training on raising VAT awareness as they were not highly educated people. Hence providing trainings on VAT mechanisms, procedures are essential. The survey found that most of entrepreneurs shifted their 100 percent cost of VAT compliance to the customers. Likewise based on the entrepreneurs' perceptions, the survey result shows that VAT officials are not administrative friendly (table 7). Similar result was found in the previous study conducted in Nepal by IFC (2012).

Table 7: Administration friendly

	Very low	low	Indifferent	High
Perception towards performance of VAT officials	8.2	52.6	29.9	9.3
Perceiving the friendliness of VAT regulations towards SME/MSME development	5.2	51.5	35.1	8.2
Total number (N)=97				

With regard to finding the impact of property tax on small and medium scale enterprises, it is found that property tax is weakly implemented in Nepal. In response to a question of types of property tax, around three-fourths of the respondents said that they pay commercial property tax to the municipalities. Likewise just above a quarter of the respondents in some municipalities answered that they normally pay residential property tax in the form of HALT/IPT; otherwise they pay land revenue tax. Similar proportions of respondents said that they pay industrial property tax as well (table 8).

Table 8: Types of Property Tax

Types of property tax(multiple questions)	Frequency	%
Commercial Property Tax	101	74.3
Residential Property Tax	37	27.2
Industrial Property Tax	38	27.9
Total numbers of observation(N)	136	

The survey revealed that average annual compliance cost of property tax is around NRs. 1,600 and on average SMEs owners take around 9 man-hours per annum to pay property tax in Nepal. There are no strict rules and regulations of paying property tax. While selling lands and property, and purchasing property by taking credits from banking institutions, property owners have to clear all property tax. Otherwise it would not be possible to do any financial transaction with banking institutions. For paying property tax, property owners themselves pay property tax without hiring any tax professionals in most of the cases. The survey result further found that property tax is assessed based on the certain criteria fixed by the local authorities and it varies from place to place. On a question whether they maintain any separate book keeping for paying property tax, almost all respondents reported that they do not maintain any separate book on property tax. Likewise most entrepreneurs told that since property tax is minimal, it does not create any burden to their businesses. Based on the survey, it is observed that majority of enterprises pay property tax taking into account the value of land, building and machine only, where as some pay property tax based on the value of land and building and while others pay property tax based on value of land only as shown in table 9.

Table 9: Criteria used for imposition of property tax

Criteria used for imposition of property tax	Frequency	%
Value of land only	26	21.3
Value of land & building only	40	32.8
Value of land, building & machinery only	75	61.5
Number of employees	1	0.8
Annual sales/turnover	0	0.0
Annual fixed amount	3	2.5
Total numbers of observation(N)	136	

When asked about major problems or issues that their organizations faced while complying with property tax, nearly a half of the respondents pointed out that the discretionary valuation of property by taxmen and the requirement of submitting numerous documents were major problems faced by them. Nearly, one-third of the respondents said that they had no problem with the little amount that they pay as property tax. Approximately, a quarter of the respondents pointed out that the absence of self-assessment scheme is another problem in property tax compliance in Nepal (table 10). One of the important finding of the survey is that property tax enforcement is found to be poor in Nepal. Local Self Governance Act 1999 has provided full authority to the local bodies to impose property tax. The KII and FGD also pointed that poor record keeping of property by local bodies, low level of awareness of people, inefficient and not trained manpower in the local bodies are the major reasons behind weak implementation of property tax.

Table 10: Problems faced while dealing with property tax

Problems faced while dealing with property tax(N=136)	Frequency	%
No problem for non-payment or payment at a little amount	42	34.1
Absence of self-assessment scheme	23	18.7
Discretionary valuation of property by taxmen	57	46.3
Frequent asking for increased volume of tax	38	30.9
Frequent asking for submission of various documents	47	38.2
Frequent visits of taxmen causing business disturbance	20	16.3
Absence of dedicated revenue officer for collection of property tax	11	8.9

4.2 Results of Key Informant Interviews

Theme 1: Impact of Tax Exemptions and Concessions on Enterprise Development

When asked about the perceptions on the existing tax structure and bias towards SMEs/MSMEs with key informants, they told that there are various hurdles that have stalled the growth and productivity of SMEs in Nepal. The regulatory constraints have complicated the easy entry and exit provisions of the SMEs. Likewise, cumbersome procedures, non-facilitative attitudes and ambiguous acts have created problems in their growth. For instance, the Forest Act 1993 restricted the cultivation and procession of commercial crops, ginger, coffee, bamboo and tea in forest areas. Also, frequently changing and unpredictable fiscal policies and incentives, absence of guaranteed tax incentives and unavailability of declared facilities such as tax reliefs, etc. are other major fiscal barriers in the growth of SMEs in Nepal. They emphasized that VAT in packaging materials, raw materials and chemicals should be reviewed. Similarly, power shortage, inadequate transport facilities, lack of policy for industrial infrastructure, failure to materialize the concept of Special Economic Zone (SEZ) are considered to be major infrastructural constraints in the growth of SMEs in Nepal.

The key informants pointed out that lack of easy access to formal banking institutions and high interest rates are the major constraints to the growth of SMEs in Nepal. The shortage of semi-skilled and high-skilled laborers have been observed in recent years due to huge out-migration of the labor force, which stemmed from job insecurities and minimal or lack of incentives to work within the country. Inadequate and inefficient logistic services have obstructed the smooth flow of goods from the production centers to markets; lack of market information particularly that of international markets and the inability of the SMEs' products to compete with the cheap foreign products have created significant problems in the domestic market. Besides that lack of comprehensive policies for industrial promotion, the fixed exchange rate of Nepali rupee vis-a-vis Indian rupee, at a time when the competitive strength of the Indian Rupee is depreciating in the international market have severely affected SMEs.

Nepalese industrial enterprises are deprived of proper infrastructural development and support services. In addition, cheap manufactured products are predominantly imported from neighboring countries, thereby confining them to seek tax support from the government. Normally, tax supports in Nepal are provided to enterprises to enhance their competency that in turn increases productivity and their competitiveness; however, insufficient tax incentives have diminished the visibility of the desired positive outcomes. The key informants listed out certain criteria for selecting eligible enterprises. They are: (i)

Technical competitiveness (ii) Market assurance (iii) Raw material management (iii) Managerial capability and (iv) Financial soundness. The agricultural sector constituting mainly of food processing, livestock, hydropower and tourism sectors in the East and Central regions are the principal gainers of these exemptions and deductions.

Industrial Enterprises Act 1992 has distinguished the various districts of the country in terms of remote area, undeveloped and under developed areas. The incentive structure is based on industrial location as well as the number of people employed in those industries. Tax support measures are generally offered in the form of VAT refund (fully or partially), customs rebate, and tax holidays. Existing information on distribution of tax incentives is unorganized and not updated; however, it can be obtained on request. Some of the informants reported of biases whereby, tourism, agriculture and a few exporters received tax benefits in the form of cash subsidies while other manufacturers did not. It is found that the large scale industries are better organized and have more influence on tax exemptions and concessions compared to SMEs. Some of the informants therefore, accepted that the tax policy is biased towards large scale industries to some extent. This biased tax system is a bit complex for SMEs, hence emphasizing the importance for a more transparent system. There have been cases where registered and honest tax payers have been penalized for no appropriate reasons, which in turn have created an environment for deception. At the same time, the rampant closures and strikes carried out in the country have discouraged SMEs from maintaining regular accounts and official documents. The lack of transparency in transactions, which has been a result of the same, has reduced the government's revenue significantly. The key informants also stated that there are various impediments to the formalisation of the economy, such as, widespread corruption, lack of sound professional education, lack of proper governmental monitoring and implementation policies, resource shortages, geographical difficulties, and imperfect market environment as a whole. Furthermore, cumbersome law, impunity for non-compliances and non-enforcement, regressive nature of tax system, rigid labour laws, lack of awareness and political instability are the other impediments to the formalisation of the economy.

In case of women headed enterprises, there are both positive and negative biases. Less registration fee for women entrepreneurs as per the new Industrial Policy 2010, women targeted credit programs, less registration fee for land registration on their names are positive biases under financial and legal headings, whereas, the reluctance shown by financial institutions owing to their lack of faith and trust on women headed enterprises and limited access to other kinds of credit are some of the negative biases. The Industrial Policy 2010 yet to be enacted has proposed several tax incentives, such as, concessions to women run SMEs as well as industries in the fields of agriculture, cooperative, hydro, information technology. Tax incentives are also provided to small industries during their grace periods.

Regarding impact of supportive measures/ incentives, the key informants told that there are various objectives of providing tax incentives to small and medium scale enterprises in Nepal. Providing tax incentives to newly established SMEs will help them to produce qualitative products in low cost of production as compared to others. In order to compete with the big firms in the initial stage, some sort of exemptions and incentives will be needed. Otherwise, surviving and sustaining those small and medium scale industries in the long runs will be the problem.

At the same time, it will strengthen and enhance competitiveness of their products both at national and international markets. Similarly tax incentives effectively stimulate investment in small and medium scale enterprises which will ultimately foster economic growth.

The key informants reported that only well connected enterprises have benefited from the incentives and supportive measures. The objectives for providing incentives to enterprises have been partially obtained. There are mechanisms to monitor if the enterprises are selected for such incentives. Government departments and their branches have been established in districts for monitoring purposes but are non-existent at the central level. Other parallel effective mechanism seems to exist although assessments and reports are carried out by private sector associations. There are certain mechanisms designed for impact assessment of the supportive measures but are only in words.

According to key informants' interview, numerous documents are required to comply with the provisions of tax waiver and concession, which consist of finance bills, tax laws and Gazette notification, fiscal act, registration certificates, transaction records etc. Document requirements vary in cases of large scale firms and SMEs that are based on the size of fixed assets. Hassles are normally encountered in the form of bureaucracy, red-tapism, corruption, and certification of tax records from the entrepreneurs during the collection of documents. To make small entrepreneurs compliant to tax regulations, authority should be decentralized and handed over to local bodies, which will help shorten the procedure and establish a one door policy. Besides that, there is a need to develop a practical and illustrative tax guide, hold organize workshops and seminars on tax systems, operate fully automated e-return system; and appoint certified tax facilitators.

The key informants claimed that entry is fairly easy but exit is exceedingly difficult due to lengthy procedures involved in the clearance requirements from VAT and PAN. On the other hand, out- migration of semi- skilled and skilled laborers has been the major challenge for Nepal in the recent years, as it has caused the labor shortage in most of the SME sector. Tax regime has directly and indirectly affected emigration of entrepreneurs. Some SMEs are still operating in Nepal without being formally registered; various reasons

have been pointed out by the key informants including Inland Revenue official. They are: (i) lack of knowledge on registration of SMEs, (ii) bureaucratic hassles, (iii) lack of incentives on registration, (iv) possibility of future harassment. Hassles related to tax and such other issues, such as harassment by tax officials are some of the key reasons why SMEs remain unregistered and their information remain undocumented. Most of the key informants agreed that providing institutional support and tax incentives and simplifying the legal provisions could be effective means for ensuring better compliance.

Theme 2: Impact of the Value-Added-Tax (VAT) on Enterprise Development

With regard to VAT, SMEs are treated no differently than large scale industries. Those industries whose annual transactions exceed Rs. 2 million Nepalese rupees, irrespective of whether they are large or medium or small, must be registered with VAT. Those firms whose annual turnover is below Rs. 2 million can voluntarily register with VAT authority. Taxpayers who fall below this limit will be required to register in VAT within 30 days of their annual transaction reaching or crossing Rs.2 million.

VAT compliance may ensure some competitive advantages. For instance exporting firms are entitled to get some incentives. Unfortunately, as a result of low volume of transaction, corruption and malpractices, many firms tend to be non compliers of VAT. At the same time, VAT registered firms also try to avoid tax liability. Similarly, the key informants claimed that lack of book keeping and record keeping are the major obstacles in VAT compliance. Since large numbers of SMEs are operated by uneducated and less educated entrepreneurs, record keeping and maintaining VAT record is beyond their capacities. For that, they have to hire part time or full time tax professional once they are registered with VAT. Other obstacles are encountered during monitoring, dissemination of information and while taking strict actions against defaulters. With regard to VAT regulations in SMEs, improper maintenance of records and non-transparent assessment criteria are taken as major hurdles. There exits numerous VAT assessment criterion. This includes filing return within specified period of time, clearly displaying his VAT registration certificate in his/her business premises, issuing invoices, keeping up to date account of transaction, facilitating tax official investigation, under invoicing, penalizing those who make false invoices with the intension of evasion. Under invoiced goods can be purchased by IRD if it is done with the purpose of evading tax. It can be addressed by making assessment criteria more robust and VAT refunds system more effective. There are two provisions of VAT refunds, one for diplomats and other for entrepreneurs. Enterprises which export more than 40% of their products each month, can apply for VAT refunds. If their application is valid, they will get refund within two months.

Theme 3: Impact of Property Tax on Enterprise Development

The key informants stated that Property Tax is specified as per the annual revision of the fiscal policy in Nepal and its administration is done at the local governmental level, such as, in the Village Development Committees (VDC), municipalities including metropolitan cities and at the central level. The Local Self-Governance Act 1999 and the Local Self-Governance Regulations (1999) govern the existing structure and operation of the VDC and municipality level taxes. These laws allow the VDCs and municipalities to levy property taxes at local levels. Both VDC and municipality can levy House and Land Tax (HALT), land revenue and land tax as prescribed, on each house and land within its jurisdiction on the basis of the size, type, design, construction and structure of the house and area of compound covered by the house, as approved by the Village council and Municipal Council respectively.

Among the major weaknesses of property tax, low levels of awareness among people and improper maintenance of the property record are two major weaknesses in the property tax system. In addition to that, lack of committed political leaders at the local level and inefficient and untrained administrative manpower in local bodies are also major causes of weak implementation of property tax in Nepal. Both central and local governments should take equal responsibilities to raise awareness on property tax. Local government such as municipalities should be supported for tax campaigning, they should aware local people why tax need to be paid, and how will they use taxpayers' money for the development of their locality. Property tax is imposed on the basis of actual property data maintained by district land registration office and payment record is maintained by VDCs and municipalities. But, as a result of poor record keeping, information on property transaction is misreported allowing for evasion of tax, and this has been a common practice in Nepal. In other words, while selling and buying of the properties, both parties involve in transaction purposively devalue their properties to pay less registration fees, which is far below the actual registration charges.

Property tax has a significant impact on land market operation especially when property is used for commercial purpose. Most of the key informants stated that other taxes do not have any significant and noticeable impact on land market operations. At the same time, they also agreed that property tax laws have an impact on development and expansion of SMEs because the fixed investment costs of SMEs depend on land value. As the price of land escalate, fixed investment cost of SMEs will also increase due to the land price hike. Generally base of property tax is relatively unchanged. Property values respond more slowly than to any annual changes in economic activities and income. In contrast to that, urban areas property values of Nepal increase faster than individual income due to out-surge of migration in urban areas; it causes escalation in land values unexpectedly in the

recent years. Taking into consideration this rapidly increasing market prices of land in urban areas, a few municipalities and VDCs have also initiated to update property values of their jurisdictions to adjust property tax accordingly in regular time period.

Tenure Rights of the enterprises' premises have impact on the expansion and development of the enterprises. Those enterprises which are running their businesses on contracted and rented land may not wish to invest heavily on plants, buildings and machineries because they will have to shift their plants once the contractual agreements over.

4.3 Results of Focus Group Discussions

Theme 1: Impact of VAT on SME Development

During the FGD session, the following questions were asked. What are the hurdles in VAT reform in Nepal? Is there any resistance from business community while implementing VAT? How about the administrative capacity of Inland Revenue Department? It was reported that the Value added Tax (VAT) was introduced in November 1997. However, it was implemented only in August 1998 due to the constant resistance from the business community. The major reasons behinds resistance in the beginning were non- registration of large wholesalers, high thresholds and valuation system in customs points. The budget introduced in 1999/2000 made numbers of changes in VAT to address these issues by reducing VAT threshold to Rs 2 million from 4.5 million. Additionally, VAT registration is essential to be eligible for export related funds as well as participating in government contracts. These changes made significant rises in the VAT registrations but provisions of blankets exemptions and concession to newly registered businesses also reduced volume of VAT revenue.

Based on FGD, it is observed that weak administrative capacity is the one of the major hurdles for effectively implementing VAT in Nepal since its inception. Without enhancing administrative capacities, smoothly operating VAT in Nepal is very difficult. Non- tax compliance behaviors of the tax payers, lack of proper enforcement policy of government etc are hindering the process of VAT reform. Huge amount of tax revenues have been evaded and avoided due to weak enforcement of law both by Custom and Inland Revenue Administration. Under declaration at custom point, under billings, under invoicing in the customer markets make the VAT procedure complicated. Bogus or counterfeit billing systems to get the tax refund have been witnessed in the recent years. To crack down such malignant practices, tax payers' education is quite essential to raise awareness among

general taxpayers otherwise buckle down those practices from government side will be futile. Government have also launched tax enforcement campaign year to intensify tax enforcement, which is not that much successful. Given the poor enforcement capacity and porous and open border with India have been grey area to breed illegal and fraudulent economic activities. Malignant tax payers are raising benefits by manipulating transactions from ignorant customers.

Theme 2: Impact of Tax Concession and Deduction on SMEs Growth

Following questions were asked during the FGD session: What are the provision of concession and exemptions to the small and medium scale enterprises in Nepal? Are these instruments sufficient enough to promote SMEs in Nepal? On those issues, most of the participants told that some provisions have been made in Industrial enterprises act, income tax act. However, these provisions of exemptions and deduction often contradict with the finance bill or fiscal policy of the government publish each year, or these provisions are superseded by the government policies. Whatever facilities that enterprise act offers are often denied by the finance bill. Thus there should be some synchronization in the government acts and policies. Similarly, another question was asked on any biasness of providing concession and exemption to different small and large industries. Some participants told that some sorts of preference have been provided to agricultural sectors as they do not have to register with VAT. Likewise, export oriented businesses do not need to pay VAT. Based on that, it is assumed that there exists some degree of biasness of providing concession and exemption.

In response to another question, to which sector should receive exemption and deduction? Most participants agreed that Nepal has perennial power outage for about 12 hours a day, it causes significant drop in industrial production irrespective of whether they are small and medium or large scale industries. So, more tax holiday should be provided to mini or micro hydro project.

Theme 3: Impact of Property Tax on Enterprise Development

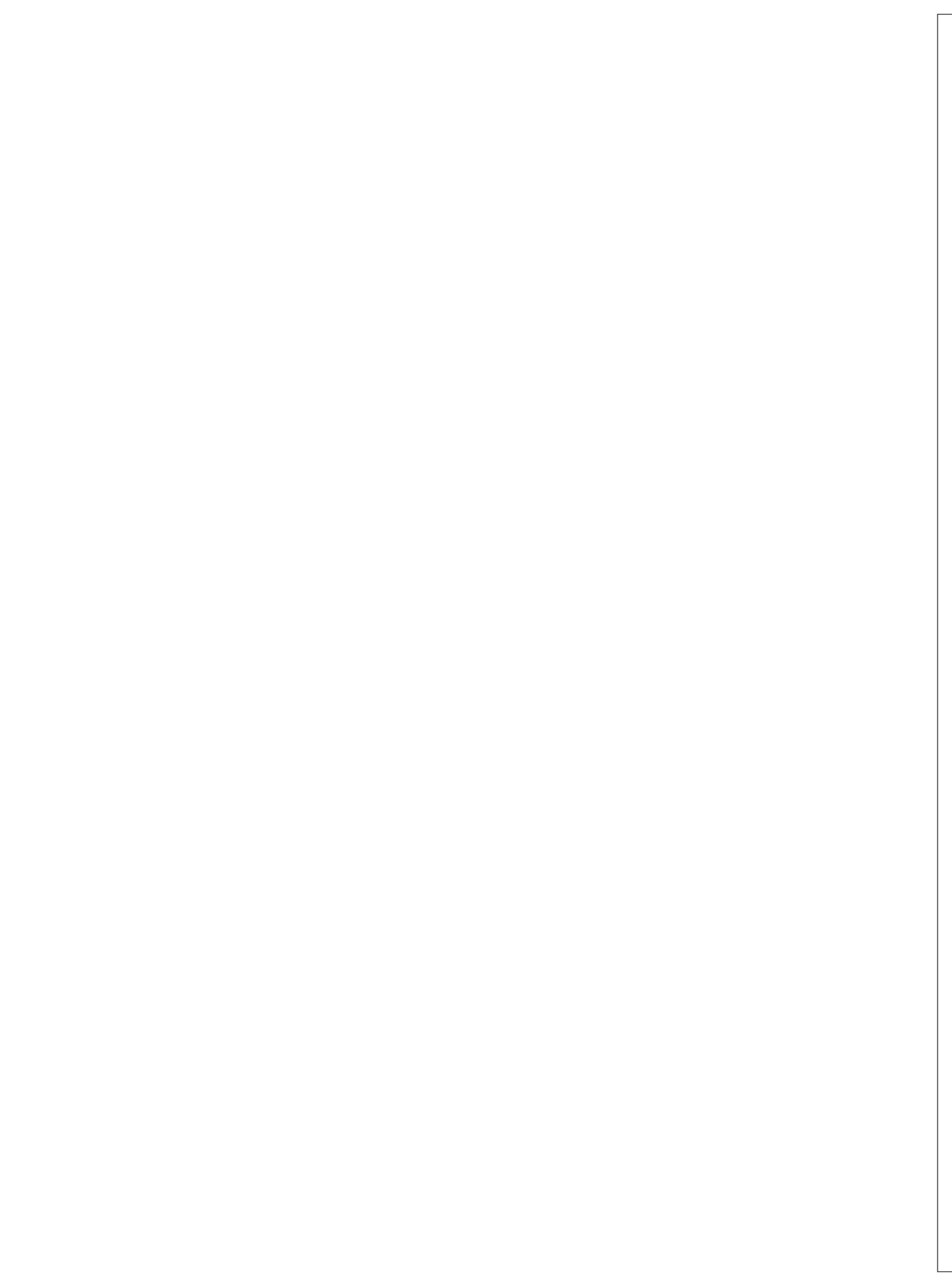
During the FGD session, following questions were asked. What are the weaknesses of the property tax? How those shortfalls can be addressed? It was reported that property tax is poorly implemented in Nepal. Since the LSGA 1999 came into existence, local government has had full authority to collect property tax; it is the main source of revenue of local government. There are HALT and IPT. According to FGD, some of the municipalities have been implementing IPT in the recent years, while others municipalities are still levying property tax based on the HALT. FGD participants pointed out some problems which are required to be addressed for efficiently implementing property tax in Nepal. Lack of

trained manpower in local government is one of the major hurdles; similarly, valuations of property have not done in full-fledged and scientific. Property records have not been updated for long and the property tax rate is very low and followed no systematic norms.

4.4 Results of Case Studies

Case studies are used to observe the phenomenon especially tax issue on gender based dimension of enterprise development and brain-drain issue caused by taxation policy. These case studies showed that social and familial responsibilities of women entrepreneurs causing significant problems for smoothly running their enterprises. Some of the entrepreneurs pointed out that they have problem with marketing their products and have to depend upon middleman to sell their commodities, which causes significant reduction in profit margins. If government manages to buy those products from them directly at reasonable prices, it might help them to further extend their business in the long run. On the other hand, ignorance of entrepreneurs on tax related rule and regulation, poor marketing strategies also creates problem to them.

Almost all of the women entrepreneurs unanimously agreed that they have not got any sorts of rebates and incentives from the government. But at the same time, most of them agreed that they could not retain skilled manpower in their enterprises for a long time due to low wage rate. Primary survey and case studies did not find even a single case of outward or inward migration of entrepreneurs due to tax related issue. But there were several cases found on brain-drain basically due to political instability.



SECTION-V

Conclusion

The study has identified following conclusions based on the case studies, key informant interview (KII), FGD and enterprise survey:

- All the sample enterprises did not have any tax exemption and deduction in terms of tax incentives.
- The trends of hiring more workers have been significantly increased over the years. It indicates that capacities of SMEs have been enhanced.
- Around two thirds of enterprises perceived that there are many types of taxes are hindering the SMEs development as well as smoothly running enterprises in Nepal.
- Majority of the entrepreneurs accepted that tax laws and regulations are too complex to follow while half of the respondents thought that they are often being harassed by tax official by asking irrelevant and unnecessary documents.
- The prime reasons attributing to non compliances among the SMEs owners --- most of the entrepreneurs perceived that high tax rates, complicated tax procedures, no benefits in returns were considered to be the major causes of tax non-compliances in small and medium scale enterprises. These findings have been further substantiated by the studies conducted by IFC (2012) and ITD (2007).
- The survey results show that reducing tax rates, offering tax exemption and providing tax holidays can enhance the productivity of the SMEs sectors. Ojeka(2011) and Atawodi and Ojeka(2012) have similar type of finding in their studies conducted in Nigeria.
- From the enterprises survey it was revealed that most of the enterprises were willing to formalize their businesses if they get benefits in return despite possible future harassment.
- On average, VAT compliance cost of each firm found to be around NRs 35,000 in 2012.
- Enterprise survey showed that lack of awareness, no benefits in returns, procedural complexity, and possible hassles from VAT administration considered to be the prime causes of non VAT compliance in the economy. ITD (2007) also had same sort of findings in their study.
- 100 percent VAT compliance cost is shifted to consumers from producers so that they do not have to bear any cost of VAT compliances.
- The sample respondents categorically pointed out increasing need for VAT education for effectively implementing VAT policy.

- Property tax is weakly implemented in Nepal.
- Compliance cost of property tax costs them around NRs. 1,600 annually and it takes around 9 man-hours annually to pay property tax in Nepal. While comparing the cost of compliances of Property tax and VAT, compliance cost of property tax is significantly less than compliance cost of VAT.
- No separate book keeping on property tax is maintained.
- Discretionary valuation of property by taxmen as it was mentioned in Mahat (2007) and the requirement of submission of numerous documents were major problems faced by SMEs sectors in Nepal.
- The recommendations laid down by the key informants are as follows: (i) Threshold of VAT registration should be increased, (ii) Flexibility in the VAT return period, process of VAT refunds can be made simpler, and (iii) VAT rates should be modified, VAT procedure should be simplified and tax payers should be educated.
- The key informants stated that to make current tax regime non discriminatory towards particular industries, there is a need to make provisions for self assessment of tax, allow them to pay taxes from any banking channel. There is a need for transparent and scientific tax system and cascading tariff system should be improved. At the same time, the general system of tax holidays should be brought into the existing tax system for all the SMEs in Nepal. These mechanisms need to be implemented by one agency upon receiving the required documents of evidence. In order to enhance SME's growth, separate desks for SME tax payers should be created since they are the backbone of Nepalese economy with great potential. To keep records of distributed tax incentives to different categories of firms, a wide area network for all types of tax payers and a tracking system have to be institutionalized with regular reporting facilities. At the same time, the tax office in the central and district levels should have a separate department to maintain the record of tax payers, tax revenue collection, distribution and updating of the records periodically.
- Temporary tax expenditure can be adopted for attracting investment in the industrial sector specifically in the SME sector. However, it may not work in the context of remote areas of Nepal. Separate institutional structures should be set up by the government for industrial and trade welfare to effectively implement tax expenditure related activities.

SECTION-VI

Policy Implications and Recommendations

The study makes following policy recommendations based on the findings of enterprises survey, key informant interview, focus group discussion and case studies:

- The SMEs should be imposed lower amount of taxes so that they will have enough funds available for other economic activities that will help to enhance growth in business sector. Moreover, it will provide opportunities for the SMEs to be better equipped in the competitive environment.
- The Government should think of increasing tax exemption and tax incentives so that it will not only help to attract potential investors to invest in SMEs sectors but also encourage voluntary compliances. Particularly, it will generate enough revenue for the government and promote formalization of the SMEs sectors by increasing tax incentive, rebates and exemptions.
- All the stakeholder should work together to develop harmonious tax policies that should benefit both the government and SMEs sectors. The government of Nepal should provide tax holiday to the newly established businesses especially SMEs sectors to be more self sufficient and independent in the long run. Thus these sectors will be survived from the tax burden in the initial phase of their operation. This will not only create a positive attitude for tax payment also help to thrive SMEs sectors at the end.
- The study recommended that establishments of Taxpayers Service Offices at the doorsteps of the taxpayers will enhance services quality. At the same time, stringent legal actions to the tax dodger will also discourage tax evasion. Besides, experts recommended for simplification of tax procedure through application of e-based system, scaling up investment for ICT sophistication, reorganizing and restructuring of the organization etc as it was mentioned in Koirala(2012). Some FGD participants suggested that cutting down of exemptions list might reduce distortion in tax system. While other participants advocated that applying multiple VAT rates will make VAT more comprehensive and progressive as it was suggested in Dahal(2009). They also recommended for discouraging under invoicing, IRD should enforce the law to buy those goods which are undervalued to evade taxes, increasing tax thresholds will help to reform VAT.
- The study further recommended following policies: scientific valuation methods to be developed to replace discretionary valuation based on manual developed by local government, area based valuation will be optimal as it was suggested in MOLD/udle &

GTZ (2008); sometimes this could create the problem to the low income brackets people who are residing in these areas. Thus, market oriented area based valuation is preferred. Likewise, staffs should be fully trained with well equipped software packages to keep records of the property and minimum and maximum rates of the property tax should be defined to avoid tax distortions as it was recommended by Mahat(2007) in his study conducted in Nepal. The FGD participants told that some norms should be followed to demarcate municipal land parcels on the basis of those property tax payments. For instance rating the improved and non improved land, rating of business, agriculture and commercial land, rating of vacant land etc.

- Tax payers' education is quite essential to raise awareness among general taxpayers.
- There should be synchronizations in numerous government policies and acts so that ambiguity in policies and act can be corrected and modified in time.

Limitations and Areas for Further Research

Since this study is primarily conducted among the small and medium scale manufacturing units of main business corridors of Nepal in single point of time, obtaining consolidated impact at a time is impossible. It will help to provide robust impact evaluation results, if the survey is conducted in two points of time among the same manufacturing unit. There are large numbers of small and medium scale manufacturing units operated in rural areas of Nepal. If we manage to take representative samples from these areas, it will further substantiate the findings received from the primary survey.

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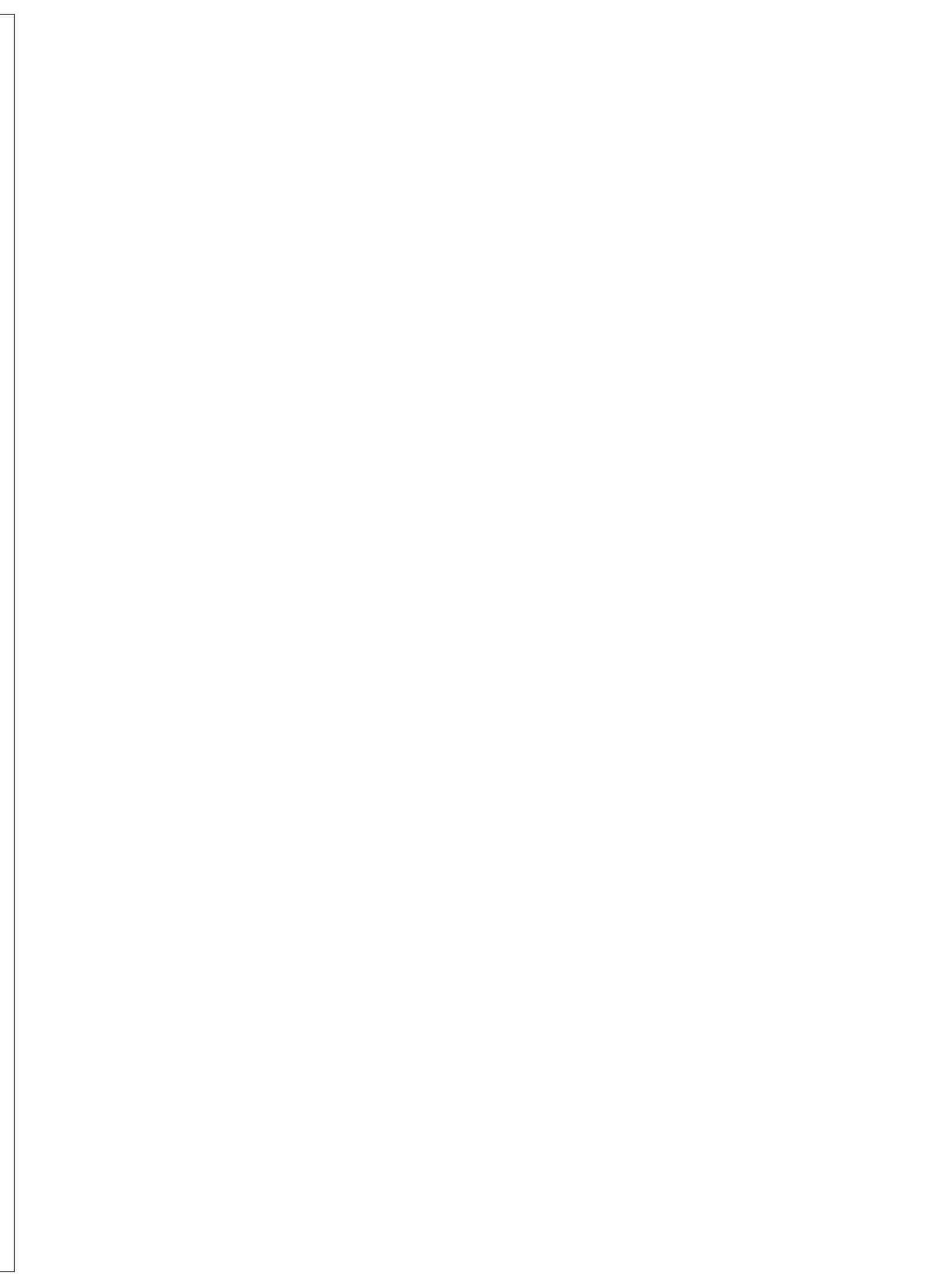
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