

# DOMESTIC RESOURCE MOBILIZATION

## Case Study of Nepal, 1997-2016<sup>1</sup>

### Summary

Over the last two decades, the government of Nepal (GON) achieved remarkable revenue growth despite recurring political and economic challenges. During this period, domestic revenues have soared, nearly doubling as a percentage of gross domestic product (GDP).

Nepal's success in improving domestic resource mobilization (DRM) has been the result of a long-term program of tax policy and tax administration reforms, starting with the introduction of value-added tax (VAT) in 1997 and new income tax act in 2002, which was followed by administrative modernization efforts that included the rapid adoption of information and communications technologies (ICT); organizational restructuring; and improvements in taxpayer services.

The case of Nepal illustrates several basic lessons for achieving DRM success. First, and foremost, Nepal's performance demonstrates that impressive revenue gains are achievable even in post-conflict conditions with prolonged periods of political turmoil. Second, sound policy measures, supported by sensible administrative reforms, are important cornerstones of sustained DRM improvements. Third, tax reform is a long-term process: major reforms implemented in the 1990s in Nepal only began to pay off in the mid-2000s as reforms were consolidated and institutionalized.

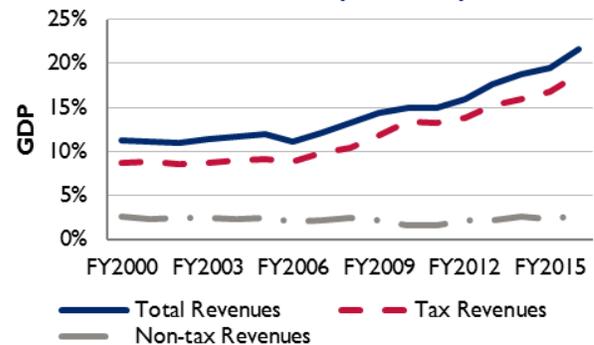
Fourth, host-country ownership is vital to success. Finally, international cooperation plays an essential but evolving role in the most prominent DRM successes. International support, including from USAID, was instrumental in triggering transformational changes in the early stages of Nepal's reform process; but the focus of development partners gradually shifted to supporting technical improvements, as GON capacity to drive the reform agenda improved.

### Success in Mobilizing Domestic Revenue

Despite prolonged domestic conflict and political turmoil and devastating earthquakes in 2015, Nepal sustained moderate GDP growth averaging 4 percent per year over the decade to 2016. This growth was driven mainly by the service sector, which expanded

by 5.3 percent per year over this period, while growth in agriculture and manufacturing grew more modestly.

**Figure 1. Domestic Revenue Trends FY 2000-2016 (% of GDP)**

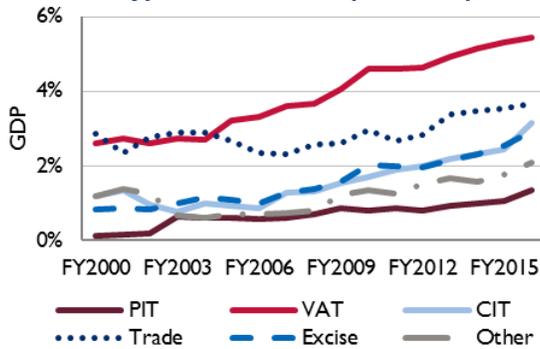


A large share of economic activity is still concentrated in smallholder agriculture and micro-, small and medium-sized enterprises, but a notable feature of Nepal's changing economy has been the growth of remittances, reaching 29.7 percent of GDP in 2016.

Notwithstanding difficult political conditions, the GON has achieved a remarkable improvement in tax performance. Between FY1999/00 and 2015/16, total domestic revenue (excluding grants) climbed from 11.3 percent of GDP to 21.6 percent driven by an increase in tax receipts, which rose from 8.7 percent of GDP to 18.7 percent. In comparison, the average tax-to-GDP ratio for South Asia increased less than three percentage points between 1999 and 2014, from 10.9 percent of GDP to 13.8 percent.

Revenue performance in Nepal improved for all major taxes between FY1999/00 and 2015/16. VAT revenue more than doubled from 2.6 percent of GDP to 5.4 percent (Figure 2), with the VAT efficiency ratio improving steadily, in 2015/16 generating 0.42 percent of GDP in revenue for every percentage point of the VAT rate compared to 0.26 percent in 1999/00. Over the same period, personal income tax (PIT) and corporate income tax (CIT) revenue combined grew from 1.3 to 4.5 percent of GDP, while excise revenue climbed from 0.8 to 2.9 percent of GDP.

**Figure 2. Domestic Revenue by Tax Type, FY2000-2016 (% of GDP)**



## How Nepal Achieved These Results

### Tax policy

In the 1990s, the end of the absolute monarchy and beginning of a constitutional monarchy precipitated a series of reforms, following recommendations from a special Task Force on Economic Policy Reform 1991.

Tax policy reforms focused on indirect taxes, notably moving from a sales tax to a VAT. The VAT was introduced on 16 November 1997, with a tax rate of 10 percent, and quickly became the backbone of the tax system. By FY2000/01, VAT accounted for 2.7 percent of GDP (out of a total tax-to-GDP ratio of 8.8 percent). At the outset, the tax base for VAT was very narrow, but expanded as more businesses entered the formal sector. The VAT rate remained at 10 percent until 2005, when it was raised to 13 percent.

In 2002, Nepal implemented a new Income Tax Act. The Act retained the prior marginal tax rates, at 0, 15, and 25 percent, while modernizing provisions for taxpayer self-assessment, introducing a Permanent Account Number (PAN) for taxpayers, and clarifying the treatment of different types of income, among others. Also in 2002, a new Excise Act extended the coverage of excise duties to imports and services, in line with international norms. And in 2007, a new Customs Act and accompanying regulations addressed requirements of Nepal's accession to the WTO (which took effect in 2004), including simplification of customs documentation requirements.

Overall, *tax policy* reforms since 2000 do not appear to have been a major driver for boosting revenues, although the addition of a new 35-percent tax band to the personal income tax (PIT) structure for high-income individuals in 2010 may have had some revenue impact. The importance of tax policy reforms for domestic resource mobilization (DRM) stems mainly from the impact they had on the buoyancy of the VAT and income taxes—in others words, the

responsiveness of revenues from these taxes to economic growth and the surge in remittance flows.

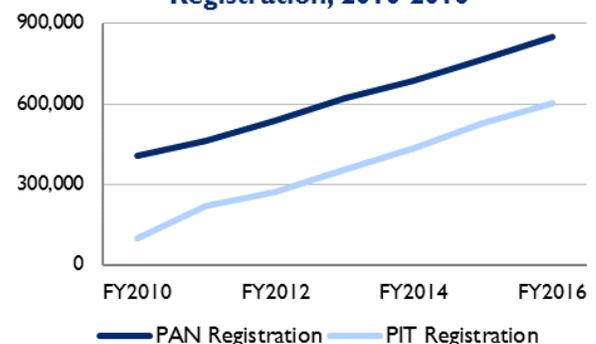
In fact, Nepal has achieved strong tax performance *despite* policies that contributed to the proliferation of costly tax incentives. The GON has regularly granted ad hoc exemptions, rebates, and tax holidays to promote industrial development goals. There have also been partial tax amnesties in several years. The Inland Revenue Department (IRD), the GON's national tax administration, estimates that the revenue loss from tax incentives may be as large as 5 percent of GDP. These incentives distort investment decisions, complicate tax administration, and have not generally resulted in strong growth for favored sectors.

### Tax administration

Steady progress in modernizing tax administration was an important driver of Nepal's DRM success as well. Three components of the reform program for tax administration figured most prominently: (1) the introduction of ICT, (2) institutional restructuring, and (3) improvement in taxpayer services.

**Introduction of ICT.** IRD has been steadily improving and expanding the revenue administration ICT systems since 1997. With funding from Danida and GIZ/GTZ, the central VAT office was computerized first with modules for registration, refunds, declarations, payments, audits, and other basic functions. Computerization then rolled-out to VAT field offices. By FY2014/15, 98 percent of tax filings and nearly 100 percent of registrations were conducted online.

**Figure 3. Expansion of Taxpayer Registration, 2010-2016**



Success with ICT has made IRD a leader in e-governance in Nepal, has improved administrative efficiency, and has simplified taxpayer registration, filing, and payments. Computerization has also helped curb opportunities for corruption and negotiation between tax officers and taxpayers, and improved public perception of IRD as a more professional, transparent organization.

The Department of Customs (DOC) also embarked on computerization in 1997, with a seven-year program to introduce the Automated System for Customs Data (ASYCUDA). The program began at Tribhuvan International Airport, with funding from the Asian Development Bank (ADB), and was later rolled out across the country.

***Institutional Restructuring.*** IRD was created in 2001 by combining the VAT and Tax Departments. This helped to consolidate the taxpayer registration database, facilitate the use of a common PAN, and reduce administrative costs. It also helped pave the way to modernize IRD's organizational structure by function, rather than by tax type.

The single most important organizational reform was the creation of the Large Taxpayer Office (LTO) in 2004, supported by the IMF. This began a process of reorienting IRD operations by taxpayer segment (defined by size), including the more recent establishment of taxpayer service offices (TSOs) focused on small and medium-size taxpayers. This segmentation allows the IRD to more efficiently direct resources and staff training to the special circumstances of each taxpayer segment.

***Taxpayer services improvements.*** A third major focus of the reform program has been to broaden the taxpayer base and promote voluntary compliance through improved taxpayer services. IRD set up the first TSOs in 2010, initially in high-density areas, to handle front-line operations such as registration and filing. This network was then expanded to other geographic areas offering full services, such as audit, debt management, and enforcement.

Both IRD and DOC have expanded taxpayer education and outreach -- providing extensive taxpayer information in Nepali on their websites, establishing dialogue on tax issues, and providing joint tax training for businesses. In addition, the Ministry of Commerce established the Nepal Trade Information Portal through the Trade and Export Promotion Centre, a one-stop portal with transit and tax-related information for importers and exporters.

ICT innovations have improved taxpayer services and increased administrative efficiency within IRD. As a notable example, with support from USAID, the Office of the Company Registrar was linked electronically to the IRD, enabling new companies to register for tax and receive their PANs immediately upon company registration, and allowing IRD to search for non-compliant companies. Similarly, and again with initial support from USAID, IRD implemented the Any Branch Banking System (ABBS) for large taxpayers,

allowing them to pay their taxes monthly through any nationwide commercial bank.

Outreach to taxpayers and simplification of tax compliance through e-registration and e-filing has helped to broaden the tax net. Between FY2009/10 and 2015/16, PIT registrations increased from less than 100,000 to 603,581, while PAN registrations more than doubled to 849,236 (Figure 3).

### **Donor Support**

Donor support has been catalytic in some areas of tax reform in Nepal, and highly supportive in others. In the 1990s, USAID's support for the design and introduction of VAT laid the foundations for rapid revenue growth in subsequent decades. Long-term support from Danida, GIZ, and ADB to computerize tax and customs operations was then instrumental in modernizing tax administration as a cornerstone for broader e-governance reforms.

The IMF provided major support to IRD to establish the LTO, which in 2015/16 accounted for 54 percent of total IRD collections. The IMF—along with the ADB, the World Bank, and other development partners—also worked extensively with DOC to formalize its early reform strategies and operating plans, through which DOC improved operational efficiency and trade facilitation.

Increasingly, the GON has bolstered its capacity to take the lead in planning and implementing tax reforms. For instance, the recommendations of the High-Level Tax System Review Commission in 2015, though informed by international best practices, were fully home-grown. And, both IRD and DOC developed their most recent strategic plans largely on their own.

### **Unfinished Business**

***Enhancing administrative autonomy.*** Efforts to strengthen the revenue service were hampered by the rotation of revenue officers every 18-24 months, low civil-service pay, and lack of control over personnel decisions. The creation of a semi-autonomous Central Revenue Board has been on the reform agenda for nearly a decade; greater operational autonomy could alleviate some of these human resource constraints.

***Harmonizing the tax code.*** The GON has drafted a Single Tax Code to consolidate the legal framework for major taxes (CIT, PIT, VAT, Excise). The Code, when passed, will help harmonize tax laws and reduce compliance costs.

***Reducing tax expenditures.*** It is critical to rationalize tax incentives and bring transparency and coherence to the granting of new tax expenditures.

**Strengthening filing compliance.** IRD still faces a very high incidence of non-filers and late filers. In FY2015/16, the non-filer rate was nearly 40 percent for PIT and 30 percent for the VAT.

**Improving payment compliance.** Tax arrears increased sharply from Rs. 2.7 billion in FY2010/11 to Rs. 8.3 billion in FY2014/15 and reportedly remain very high, indicating a need for greater emphasis on payment compliance and enforcement. Expansion of e-payment to the majority of taxpayers, still under development, could also reap rewards in this area.

**Improving VAT refund settlement.** Nepal's VAT refunds of 3 percent of total VAT collection is much lower than international norms, suggesting a need for improved refund settlement. The export sector, with zero output tax, may be one of the largest claimants for VAT refunds. Improving refund settlement would incentivize exports, narrow the trade deficit, and stimulate growth, thus expanding the tax base.

**Streamlining customs.** Important trade facilitation reforms remain underway, including efforts to implement a National Single Window to consolidate border clearance procedures and a Trusted Trader program to expedite clearance for low-risk traders.

**Consolidating tax reform gains under federalism.** The new 2015 constitution transforms Nepal from a unitary system of government to a federal system. Moving service delivery closer to the population may improve tax morale and reinforce voluntary compliance. On the other hand, compromises made to pass the constitution and related laws and regulations may make future fiscal reforms more difficult.

For example, authority given to more than one level of government to tax the same base and to carry out the same function might create conflict between levels of government and create challenges to advance reforms.

## Lessons Learned

**DRM success is possible even in post-conflict contexts.** Nepal's DRM achievements since 2000 demonstrate that impressive gains in revenue performance are achievable, even in post-conflict conditions with prolonged periods of political turmoil.

**Host-country ownership is vital to success.** Despite political volatility, successive GON administrations have embraced international support and undertaken a wide range of reforms to tax policy and administration.

**Transformative DRM requires a combination of policy and administrative reforms.** The cornerstones of revenue performance included the introduction of VAT on the policy side, and three critical factors on the administrative side: (1) functional reorganization and operational segmentation by taxpayer size, especially for large taxpayers; (2) computerization throughout the tax system; and (3) a focus on taxpayer services to facilitate voluntary compliance.

**International cooperation plays a critical but evolving role in DRM reform.** In the early stages, donor support played an essential role in promoting reforms. As the government developed its own capacity to drive the reform program, development partners shifted their focus to targeted technical improvements. This approach has provided the continuity needed to maintain reform momentum while GON partners increasingly shaped the reform agenda on their own.

**Figure 4. Timeline of Major Tax and Customs Reforms in Nepal (1993–2015)**

