

Do Informal Economic Activities Matter for Loss of Customs Revenue in Nepal?

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Abstract

Informal economy and informal trade are present in almost every countries of the world. Irrespective of their stages of development, OECD, transition and developing countries are facing the positive or negative impact coming from informal economy. Nepal is a landlocked country with open border to India and dependent on India for transit to the sea coast. The major objective of this article is to estimate the size of the informal economy and thereby customs revenue loss due to the presence of informal economic activities and informal trade. The size of the informal economy in Nepal is found to be about 40 percent of the official economy in an average during the period of 2001/02-2009/10. Further, it is observed that the informal trade and activities have significant impact on total revenue loss for Nepalese customs.

1. What are Informal Economic Activities?

Informal economic activities are those activities which are either illegal or legal but do not come under GDP count. An unreported as well as an illegal activity both consists of informal sector. In broad sense, informal household activities such as: household works done by housewife, teaching of own children, watering own garden etc. also include in informal economic activities but in narrow sense, the economic activities performed to evade tax are called informal economic activities. Here, by referring the word informal activities we have to understand it in the narrow sense. Therefore, informal economic activities, here constitute activities such as: smuggling, corruption, black marketing, narcotics, illegal trade and the informal legal jobs hiding from tax net.

2. Types of Informal Activities

Most of the informal economic activities are performed in cash basis. Some of the examples of such activities are: cash payments to the shopkeepers who do not provide valid cash invoice, payments to the contractual workers, transactions involved in smuggling, transactions involved in drug trafficking, transactions in illegal sales. Self-employed persons are also involved in tax evasion and informal economic activities because these activities are not recorded. According to Lippert and Walker (1997, p. 5), the informal economic activities can be categorized as follows:

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Table 1: Taxonomy of Types of Informal Activities

Type of Activity	Monetary Transactions		Non Monetary Transactions	
Illegal Activities	Trade with stolen goods; drug dealing and manufacturing; prostitution; gambling; fraud; etc.		Barter of drugs, stolen goods, smuggling etc. Produce or growing drugs for own use. Theft for own use.	
	Tax Evasion	Tax Avoidance	Tax Evasion	Tax Avoidance
Legal Activities	Unreported income from self-employment; wages, salaries and assets from unreported work related to legal services and goods.	Employee discounts, fringe benefits.	Barter of legal services and goods.	All do-it-yourself work and neighbor help.

3. Formation of Informal Economy

The informal economic activities constitute informal economy which is always parallel to the formal one and the rise in the size of the informal economy is the concern of the policy-makers. Tax and social security contribution burdens, low quality of public goods and services, tedious administrative procedures, complexity in laws and regulations etc. are the factors those help to form informal economy. Informal economic activities exist in each and every countries either they are developed or transition or developing. In this context, Friedrich Schneider (2007) studied about informal economy and estimated the size of informal economy for 145 countries. According to him, the average size of informal economy (as percent of official GDP) in 2004/05 in 96 developing countries is 36.7%, in 25 transition countries is 38.8% and in 21 OECD countries is 14.8%. His estimations suggest that in 2004/05, the size of informal economy in Nepal is 39.3% of official GDP.

In most of the cases, activities in informal economy have significant negative impact on social welfare of the country. According to M. Ali Kemal (2007), contrary to the above, sometimes, increase in the informal economy affects positively to the formal economy. Empirical findings of Schneider (2007) show that tax losses may be moderate, as at least two-third of the income earned in the informal economy is immediately spent in the official economy and increases the standard of living of at least one third of the working population.

4. Estimation of Size of Informal Economy in Nepal

There are only few literatures about the estimation of size of informal economy in Nepal. Among them, the most authentic one is the study of Friedrich Schneider who is a Prof. of Johannes Kepler University of Linz, Australia. He has studied about the shadow economy of most of the countries of the world in 2004, 2005 and 2007. According to the Dynamic Multiple-Indicators Multiple Causes (DYMIMIC) and Currency Demand Model, the informal economy is the product of illegal money in circulation and the velocity of money. The velocity of money is the ratio of GNP to legal money and legal money is the narrow money (M_1) less illegal money. Using DYMIMIC and Currency Demand Model, Prof. Schneider has estimated the size of informal economy in Nepal for 2001/02-2004/05. The rest estimation for 2005/06-2009/10 is done on the basis of same model. The detailed data, equations and econometric specification methods are not presented here, in stead, only the results of estimation are given in the following table.

Table 2: Size of Informal Economy in Nepal

Title	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Official GDP² (Rs. in Billions)	459.44	492.23	536.75	589.94	654.08	728.18	818.4	960.01	1126.10 ³
Informal Economy (% of official GDP)	39.7	40.8	40.2	39.3	40.0	40.1	39.9	39.8	39.6
Informal Economy (Rs. in Billions)	182.40	200.83	215.77	231.64	261.63	292.00	326.54	382.08	445.93

The above table suggests that the shadow economy seems to be in a pick point in 2002/03 as 40.8% of the official GDP and gradually decreasing in succeeding years till 2004/05. Again reached to another pick in 2006/07 as 40.1% and again decreased.

5. Estimation of Revenue Loss for Nepalese Customs

To estimate the revenue loss for Nepalese customs we have to find the types of taxes that Nepalese customs collect in customs points. Customs points collect customs duty (import duty, export duty, agricultural reform fee etc. in customs points and Indian excise refund by custom department), import VAT and import excise duty. Then we have to find the share of customs duty in official GDP. We have already estimated the size of informal economy in table 2. Assuming that due to the reason of informal trade out of customs point, Nepalese customs are losing the same proportion of customs duty in informal economy too, we can estimate the customs duty loss in customs. The estimated figures are presented in table 3.

Table 3: Customs Duty Loss due to Informal Trade in Nepal

Year	Official GDP (Rs. in Billions)	Informal Economy (Rs. in Billions)	Customs Duty ⁴ (Rs. in Billions)	Custom Duty (% of official GDP)	Customs Duty Loss due to Informal Trade (Rs. in Billions)
2001/02	459.44	182.40	12.66	2.76	5.03
2002/03	492.23	200.83	14.24	2.89	5.81
2003/04	536.75	215.77	15.55	2.90	6.25
2004/05	589.41	231.64	15.7	2.66	6.17
2005/06	654.08	261.63	15.34	2.35	6.14
2006/07	728.18	292.00	16.71	2.29	6.70
2007/08	818.4	326.54	21.06	2.57	8.40
2008/09	960.01	382.08	26.64	2.77	10.60
2009/10	1126.1	445.93	33.13 ⁵	2.94	13.12

The above table shows that the share of customs duty in official GDP in an average is 2.68% in these nine years. The customs duty loss due to informal trade in 2001/02 is estimated as Rs. 5.03 billions. In succeeding years it is increasing as the amount of informal economy is also

² Official GDP is taken from Central Bureau of Statistics

³ Estimated by the author

⁴ Customs duty, import VAT and import excise data are taken from Budget Speeches of different years

⁵ 2009/10 figures are targets for revenue collection

increasing. For 2008/09, it is estimated that the figure of customs duty loss reaches more than double than it in 2001/02 and in 2009/10 we will be losing Rs. 13.12 billions in customs duty.

In the similar way like customs duty we can estimate the import VAT loss. The figures of loss are presented in table 4.

Table 4: Import VAT Loss due to Informal Trade in Nepal

Year	Official GDP (Rs. in Billions)	Informal Economy (Rs. in Billions)	Import VAT (Rs. in Billions)	Import VAT (% of official GDP)	Import VAT Loss due to Informal Trade (Rs. in Billions)
2001/02	459.44	182.40	7.35	1.60	2.92
2002/03	492.23	200.83	8.63	1.75	3.52
2003/04	536.75	215.77	8.87	1.65	3.57
2004/05	589.41	231.64	12.27	2.08	4.82
2005/06	654.08	261.63	13.46	2.06	5.38
2006/07	728.18	292.00	16.46	2.26	6.60
2007/08	818.4	326.54	19.07	2.33	7.61
2008/09	960.01	382.08	25.92	2.70	10.32
2009/10	1126.1	445.93	34.25	3.04	13.56

The share of import VAT in official GDP in an average is 2.16% in these nine years but in the recent years the share seems in increasing trend. The import VAT loss due to informal economic activities in 2001/02 is estimated as Rs. 2.92 billions. In succeeding years, it is increasing as the amount of informal economy is also increasing. For 2008/09, it is estimated that the figure of import VAT loss reaches more than three fold than it in 2001/02 and in 2009/10 it is estimated that we will be losing Rs. 13.56 billions in import VAT.

Let's see what happens in case of import excise loss in table 5.

Table 5: Import Excise Loss due to Informal Trade in Nepal

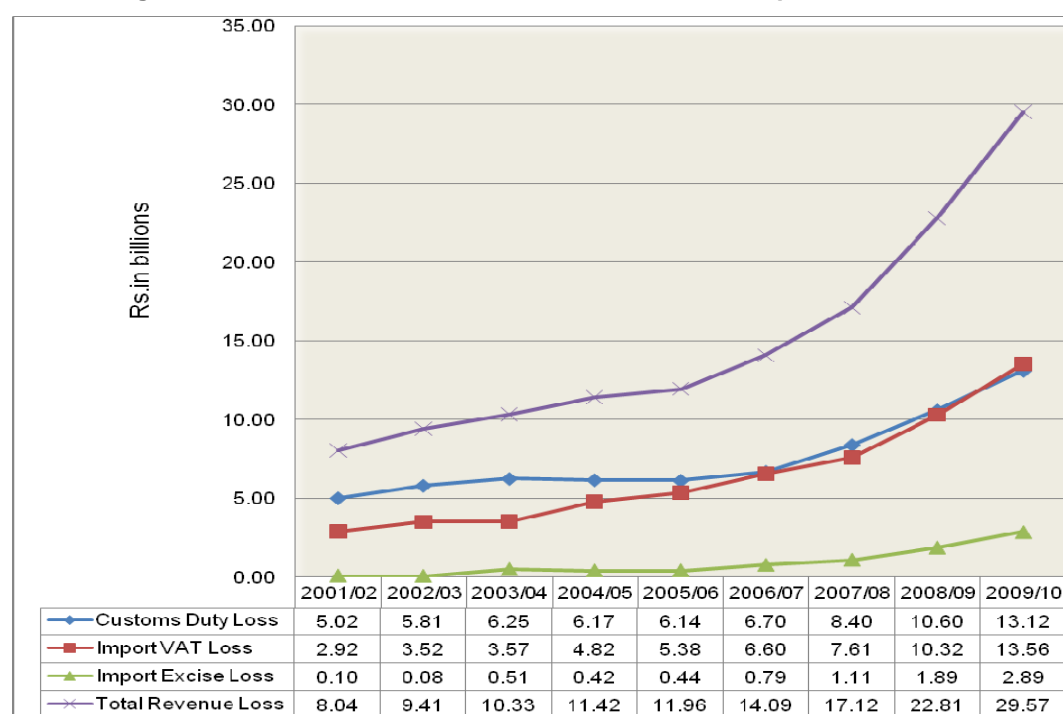
Year	Official GDP (Rs. in Billions)	Informal Economy (Rs. in Billions)	Import Excise (Rs. in Billions)	Import Excise (% of official GDP)	Import Excise Loss due to Informal Trade (Rs. in Billions)
2001/02	459.44	182.40	0.25	0.05	0.10
2002/03	492.23	200.83	0.19	0.04	0.08
2003/04	536.75	215.77	1.28	0.24	0.51
2004/05	589.41	231.64	1.08	0.18	0.42
2005/06	654.08	261.63	1.09	0.17	0.44
2006/07	728.18	292.00	1.97	0.27	0.79
2007/08	818.40	326.54	2.78	0.34	1.11
2008/09	960.01	382.08	4.76	0.50	1.89
2009/10	1126.10	445.93	7.29	0.65	2.89

The share of import excise in official GDP in an average is 0.27% in these nine years but in the recent years the share seems in increasing trend. The import excise loss due to informal economic activities in 2001/02 is estimated as Rs. 0.10 billions. In succeeding years, it is increasing as the amount of informal economy is also increasing. For 2008/09, it is estimated that the figure of import excise loss reaches about 19 fold than it in 2001/02 and in 2009/10 it is estimated that we will be losing Rs. 2.89 billions in import excise.

Total revenue loss for Nepalese customs is the sum total of the customs duty loss, import VAT loss and import excise loss. The figure 1 represents the estimated trend of total revenue loss for Nepalese customs.

Here we are trying to estimate how much revenue is going to be missing every year from FY 2001/02 to FY 2009/10 in Nepal due to the presence of huge informal economic activities that was supposed to be collected in customs points if there was the absence of informal trading. In 2001/02, it is estimated as Rs. 8.04 billions and gradually increasing to Rs. 29.57 billions in 2009/10 which is more than 3 fold.

Figure 1: Estimated Trend of Total Revenue Loss for Nepalese Customs



The total revenue loss line is sharply going in upward direction indicating that every year Nepalese customs are losing a significantly huge amount of revenue because of the cause of presence of strong informal trade in Nepalese Economy.

6. How to Reduce Revenue Loss for Nepalese Customs?

There is always debate among Nepalese policy makers about the size of informal trade in Nepal. Due to the open border to India, the informal trading is always a crucial issue of concern for Nepalese politicians and bureaucrats. They talk much about the measures to adopt for reducing informal trade and there by reduce revenue loss for customs. Once a month there is always a high level meeting fixed to be held in the office of the revenue secretary of Ministry of Finance including the high level representation of Ministry of Home Affairs, Nepal Police, Armed Police Force, Customs Department, Department of Revenue Investigation, and Inland Revenue Department. The Central Monitoring Committee and District Level Monitoring Committee to control the revenue leakage are also in actions but the issue of informal trade is still in the same place.

To reduce the volume of informal trade, we need to adopt some measures such as: (1) proper co-ordination among different agencies of Nepal government like Nepalese Customs, Nepal Police, Armed Police, Local Administration, (2) effective information channels, (3) some type of regulating mechanism for people entering to and from India (4) review of the location of customs points, (5) simplification of customs procedures, (6) effective co-ordination between Nepalese and Indian customs offices, (7) effective post clearance audit.

7. Conclusion

Estimation shows that informal economic activities have significant impact on loss of customs revenue. Therefore, informal economic activities definitely matter for loss of customs revenue in Nepal. Absolutely controlling informal trade in case of Nepal-India trade is almost impossible but we can reduce it in relative term. Simplification of custom procedures, co-ordination and enforcement by all the concerned government agencies help to reduce the volume of informal trade and there by customs revenue loss in Nepal.

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