

## MUNICIPAL OWN SOURCE REVENUE MANAGEMENT AND ITS POTENTIALITY IN NEPAL

(An Analysis of Financial Management Performance of Hetauda Sub-Metropolitan City)

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### ABSTRACT

*The main portion of own source revenue of Hetauda Sub-Metropolitan City is tax revenue. The key reasons of this study are to study the potential own sources of revenue and analyze the municipal revenue compliance in Hetauda Sub-Metropolitan City. Both analytical and descriptive research designs were applied for the analysis of revenue potentiality and its compliance in Hetauda Sub-Metropolitan City. Non-probability sampling method was used to select the Sub-Metropolitan City and random sampling method was applied to choose the respondents for questionnaire survey. Questionnaire Survey, Focus Group Discussion and Personal Interview (KII) tools were used for various types of data collection. Both the taxpayers and municipal policymaking advisors were the respondents of the study. Participants for focus group discussion and key informants for personal interview were chosen purposively. Most of the taxpayers (i.e. about 86 %) have paid municipal tax revenues and out of them, more than 39 percent taxpayers have paid the municipal tax below one thousand rupees per annum.*

**KEYWORDS:** Financial Management, Municipal Revenue Compliance, Municipal Tax Revenue, Own Source Revenue & Revenue Potentiality

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### INTRODUCTION

The revenue sources of Nepalese municipalities are both tax-based and nontax-based. The major tax revenue sources are the following: integrated property tax (IPT), house rent tax, house and land tax, business/profession/enterprise tax, vehicle tax, advertisement tax, and video tax (commercial). Similarly, the major nontax revenue sources are the following: municipal property (non-movable) rental charge, service fee/charge, building permit fee, vehicle-parking charge, etc. (LSGA, 1999). In spite of the Government of Nepal having favorable thoughts regarding the growing efficiency in service delivery, it is not so primarily because of needless expenditure toward the end of the fiscal year (Ministry of Finance, 2008). Irregular monitoring of performance, lack of sound procurement plans, nonperformance of competitive tendering, and absence of performance auditing also contribute to the reduced efficiency. There are only a limited number of tax bases in Nepal; nevertheless, the local and central governments have conflicting benefits through taxes, with the central government mainly playing a regulatory role and granting financial help to the local government (Hansson, 2010). For example, when the local government needs to purchase transport services, it has to do so following the procurement regulations laid down by the central government. Although the local government benefits by the principle of taxation, the central government benefits by the capability to pay principle. Despite these deductions, ground reality in Nepal is entirely different. Municipal taxes or fees are rendered for the benefits of the services

obtained. However, only when the benefits from the services are acknowledged can taxes be obtained as a result of this benefit principle (Shrestha, 2009). The Sub-Metropolitan City is finding it challenging to administer its taxes; this is a consequence of the aforementioned situation. Subsequently, the following factors were identified as encouraging municipal revenue compliance: rewarding tax payers, positive peer attitude, proposing prizes for best taxpayers, reducing aspirations and lowering profits, etc. The possible influencing causes for noncompliance of revenue are the following: unawareness of tax laws or inadequate tax education programs, high rates of tax and nontax revenues, unfairness or misuse of revenues, complexity in tax administration procedures, etc. (Mumumba Omweri Marti, 2010). The fiscal exchange theory of public finance suggests that when government expenditures exist, there is greater tax compliance, which can be further enhanced by efficiently meeting the demands of the municipal body for its required goods or services. However, the political legitimacy theory suggests that tax compliance is based on the belief of the citizens on the municipal government. Both these theories help to conclude that there is a direct relation between tax knowledge and awareness and revenue compliance (Merima Ali, 2013). Nepal is a developing country, and several researches have focused on the taxpayers' attitude towards municipal government/local government, the influence of individual interest on tax fraud, as well as on other factors influencing tax compliance behavior (James O Alabede, 2011).

### **Municipal Financial Management Performance**

Financial management of an organization cannot be assessed independently, as its performance depends on the overall management. The issues considered while determining the overall management performance are the following: qualification (skilled and experienced) personnel and their attitude, working environment, job satisfaction, managerial capability, nature of organization, management of resources, institutional strength, etc. Qualified and motivated personnel are a prerequisite to handle complex problems such as implementation of change, performance management, financial management, and fiscal decentralization (Mughees Ahmed, 2012), as well as being a fundamental aspect for municipal finance management. This empirical study as well as literature has highlighted the fact that the key challenge for municipalities, apart from accessing money, is the efficient management of financial resources. In addition, valuable human resources are critical for successfully managing municipalities (Plessis, 2013).

### **Predicaments of Revenue Management**

Most taxpayers are negligent regarding tax issues, and may not consider tax evasion as an ethical issue. Their ethical values are fashioned by the tough situations they might have experienced rather than by unrealistic anticipation (Philip M.J. Reckers D. L., 1994). In developing countries such as Nepal, budget execution and accounting are either performed manually or by ineffective software applications. Such a futile process results in incompetent municipal expenditure management systems, which are not appreciated (Khemani, 2006, p. 2). However, local governments have performed better in public service delivery and regional development by being an integrated part of the overall government; they do so even if they are not completely self-contained and self-governing bodies (Kitayama, 2001). The tendency to engage in corruption is dependent on the type of government system. Corruption is rampantly seen in the developing world because of weak public institutions, low levels of education, and the presence of an underdeveloped civil society (Prier, 2007, p. 76). The management of municipal finance in Nepal is not transparent and, therefore, is a cause of concern, as the Nepal government and Udle/GTZ (development partner agency for local governments of Nepal) have acknowledged (MLD, udle/GTZ, 2008) that there is no clear transparency regarding the utilization of the levied taxes. .

The municipal administration fails to dispense better services for the taxes levied on the taxpayer. The following are the main causes for this ineffectiveness by the municipal administration: lack of well-defined mission and comprehensive functional role, lack of proper structure for the development process, and low quality of staff (Adams, 2012, pp. 4-13). However, inefficient revenue mobilization is mainly because of the following reasons: lack of interagency coordination, conflicting laws, lobbying to form alliances among the interested groups, low administrative efficiency, negatively motivated local staff, low tax effort, low effort to maintain transparency (dissemination and mass communication), political instability, nontax compliance, and nonfeasible local revenue sources (Nepal Government, 2010). In spite learning several matters related to finance and taxation, there is yet lack of proper understanding with respect to tax evasion, including its measurement, explanation, and control (Alm, 2012). It is challenging to study the taxpayer's attitude because of the unavailability of reliable data, as the taxpayer is generally reluctant to expose one's own noncompliance (Merima Ali, 2013, p. 5).

### **Revenue Compliance in Nepal: Policy Perspective**

In Nepal, to ensure revenue compliance by its citizens while paying their municipal tax, the government according to Section 260 of Nepalese Local Self Governance Act (1999) recovers tax, duty, charges levied or contracted, or any amount due and payable to the local bodies as government dues through the District Administration Office. In addition, the government takes action against individuals through the Sub-Metropolitan City when they do not pay the taxes, fees, charges, and tariffs contracted or imposed by it according to the subsection 2(a &b) and 4 of section 165 of Nepalese Local Self Governance Act (1999). The local bodies are granted provisions as mentioned in the section 59 of Local Bodies Resource Mobilization and Management Manual (2012) issued by the Nepal Government. However, the local bodies have to meet all specifications of the budget authority, circulars, and directions issued from the concerned ministries, as well as the provisions of minimum conditions and performance measures (MCPM) manual (MoFALD, 2012).

The Department of Revenue Investigation (DRI) of Nepal has been established to ensure the proper functioning of all regulatory boards for revenue compliance. This department ensures compliance of the acts and rules, mobilization of flying and emergency squad, adherence to code of conduct by the investigation officials, issuance of guidelines and orders, and use of information technology to uphold the process of revenue collection (Nepal Government, 2014).

### **Potential of Municipal Governments to Generate Own Source Revenue**

Municipalities generate revenue by internal sources as well as external sources. Internal sources of revenue are stable and consistent, whereas external sources of revenue are less reliable, as there is wide fluctuation in revenue generated. Therefore, external revenue is only a supplementary source of financing for the municipalities. Consequently, the internal revenue base is of high priority for the municipalities. They must have authorization to expand their internal revenue base and modify the tax rate according to local situation to enable them to generate adequate revenue to meet their financial needs (Thapa, 2004, p. 4). Until recently, revenue collection trend of integrated property tax has been static and the tax potential has not been met. In the FY 2005/06, integrated property tax generated 8% of the total revenue of municipalities. Governments must improve their collection rates for all revenues, and at the same time keep the payment-making process simple and easy for its citizens (Larson, 2007, p. 34). The Government of Sri Lanka has set a good example with regard to this; using revenue manuals and revenue surveys, it has identified current and potential revenue sources that enable local officials to regulate taxes, fees, and charges according to the suggestions of policymakers (Ministry of Local Government and Provincial Councils, 2008, p. 36). Revenue compliance can be achieved only by the

collaboration of the municipal people and the prospective taxpayer. Deciding on the best system of compliance for implementing revenue policy has always been the primary focus in revenue administration.

Local or municipal policies are formulated and implemented by the respective municipalities. In addition, the municipality conducts programs in partnership with other local governance bodies. As a result of these prominent roles that the municipality plays, it helps to coordinate the various local actors to create a common vision on taking action for the issues raised during governance (MLD, 2012). Nepalese municipalities have the potential to increase their revenue by 60%. However, this has not been achieved because of the opposition of taxpayers and because integrated property tax in many municipalities is not implemented properly. Opposition by the taxpayer is a consequence of mistrust against the local administration (MLD, udle/GTZ, 2008, p. 9). Furthermore, revenue through the municipal bodies has not reached its full potential in Nepal because there are no revaluations in tax rates and integrated property tax has not been put into effective practice. Although tax compliance is critical for effective municipal revenue generation, there is limited empirical evidence; however, evidence provided by the available analyses suggests that compliance can be improved or deteriorated under decentralization. The outcome is influenced by economic conditions, citizen's attitudes toward municipalities, and differences in municipal or local bodies' political dynamics, including the willingness and ability of municipalities to administer the tax code (Smoke, 2013). Therefore, further research is required for moderating the effect of risk preference on relationship between taxpayer's attitude towards tax evasion and his/her compliance behavior to examine the consistency of the results produced by this study on this moderator (James O. Alabedi, 2013).

Municipalities/Sub-Metropolitan cities mainly generate their own revenue in the following manner: property taxes, business licenses, market fees, and various user charges. These revenue sources are substantial and reliable if well administered; however, in practice, all the sources have serious drawbacks (ICTD, 2013).

## **METHODOLOGIES**

### **Research Area**

Hetauda is a Sub-Metropolitan City and the district administrative headquarter of Makawanpur. It has been an industrial district for the past forty years. It is situated in the central southern part of Nepal. The east–west highway from Mechi to Mahakali and north–south road linked with capital city Kathmandu to Raksaul (India) cross Hetauda.

### **Research Design**

The criteria for forming Metropolitan and Sub-Metropolitan cities differ from those of municipalities. Nepal has 12 Sub-Metropolitan cities. The selection of Sub-Metropolitan cities in this study was by nonprobability sampling technique. Hetauda Sub-Metropolitan city was chosen as a sample from the Central Region (Hill Ecological Belt) of Nepal. To analyze the financial management performance, determine compliance of municipal body's own source revenues, and to find the potential in Hetauda Sub-Metropolitan city, analytical and descriptive research design was applied. The respondents in the study were selected randomly from among municipal taxpayers and policy-making advisors.

Primary data for the study was collected by a cross-sectional method of survey; secondary information was collected with the help of the records at Hetauda Sub-Metropolitan city, MoFALD (Ministry of Federal Affairs and Local Development), District Development Committee (DDC) Makawanpur, Urban Development through Local Efforts (udle/GTZ), and Local Bodies' Fiscal Commission of Nepal. For macro analysis, appropriate articles, journals, books, as well as published and unpublished resources and performance of the associated organizations working with municipalities

were accepted. For analysis of secondary data, various analytical tables were set up, whereas for analysis of primary data, different analytical tools of statistics including SPSS-20 software were used. This research study is limited to Hetauda Sub-Metropolitan city because of time and cost constraints.

## RESULTS

A total of 176 respondents (140 municipal taxpayers and 36 municipal policy advisors) were identified for the study to collect their views regarding municipal tax compliance and the potential of Hetauda Sub-Metropolitan city to generate its own revenue. The study included 73.4 percent male and 26.6 percent female respondents. Among the 40 municipal policy advisors, thirty-seven (more than 90%) belonged to the male sex, with 23 respondents (57.50%) being local political party members, 8 respondents (20%) CCI Members and 5 respondents (12.50%) civil society members. The majority of the taxpayer respondents were engaged in business activities (61 percent), followed by involvement in government and nongovernment services (31 percent), with the remainder involved in agriculture (8 percent). Data regarding the scenario of municipal tax compliance, potentiality of revenue, and expressed reasons for noncompliance municipal revenues were collected with the help of a questionnaire survey conducted between April and June 2015. The data are presented and discussed as follows:

**Table 1: Comparative Analysis of Five Major Own Source Revenues**

Income Headings	Fiscal Years (Rs. '000)										Average Growth Rate (%)	
	2003/004	2004/005	2005/006	2006/007	2007/008	2008/009	2009/010	2010/011	2011/012	2012/013		Total Rs.
House and Land Tax/IPT	5,644	5,566	8,266	7,727	7,790	9,462	6,873	9906	11433	11912	84577	11.03
Business/Professional Tax	722	1,109	935	921	961	1,226	1,615	2239	2687	3196	15609	19.75
House Rent Tax	142	126	177	260	343	491	230	417	879	1032	4097	34.19
Building Permit fee	1,272	1,888	2,161	2,494	2,509	3,304	4,857	6065	5253	6353	36156	21.11
Service Fee	458	464	771	828	1,033	1,435	1,267	2056	3746	2717	14774	27.08

Source: Annual Reports of Ten Fiscal Years of Hetauda Sub-Metropolitan City Office

The above table (Table: 1) showed the own source revenue collection performance of Hetauda Sub-Metropolitan City of past 10 fiscal years. Among them, house rent tax has the highest growth rate (i.e. 34.19%) during the study period. In the same way, integrated property tax (IPT)/house land tax had lowest (11.03 %) growth rate in the same period. In comparison to the collection amount, the performance of integrated property tax (IPT) was far better than other tax and nontax revenues. Likewise, building permit fee was the second largest own revenue source of Hetauda Sub-Metropolitan City during the study period.

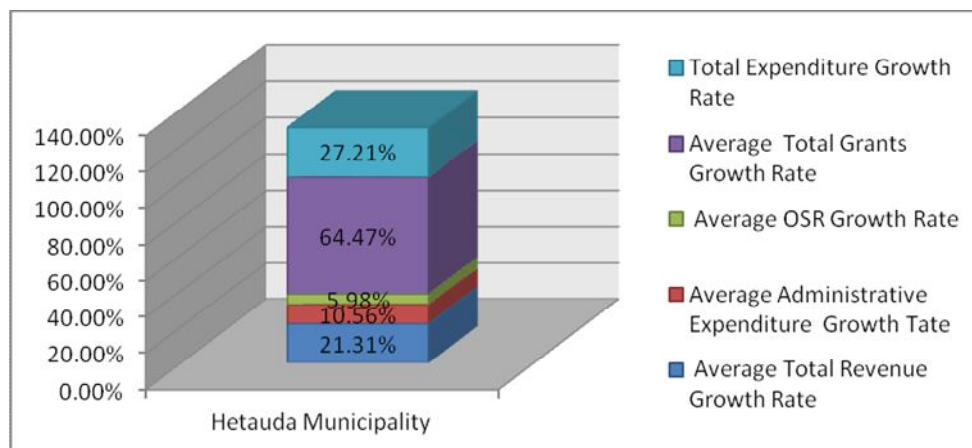
**Table 2: Administrative Expenditure Performance Analysis**

Expenditure Headings	Fiscal Years (Rs. '000)										Growth Rate (%)
	2003/004	2004/005	2005/006	2006/007	2007/008	2008/009	2009/010	2010/011	2011/012	2012/013	
Salaries	15,422	14,276	14,170	11,449	18,327	18,192	22,629	18223	30312	29070	11.01
Total Admin Expenditure	19993	20529	18758	18798	25843	24211	31550	32646	44792	44176	10.56
Total Expenditure	40196	42752	49389	105956	77371	108700	168614	211481	100784	168026	27.21

Source: Annual Reports of Ten Fiscal Years of Hetauda Sub-Metropolitan City Office

The above table (Table: 2) depicted the administrative expenditure performance of Hetauda Sub-Metropolitan City. In an average, the salary expense had increased 11.01 percent in the study period. Likewise, both the administrative

expenditure and total expenditure have increased 10.56 percent and 27.21 percent respectively. The growth rate of salary expenditure indicated that the growth of other administrative expenditure was lower than salary expenditure which indicates that either Hetauda Sub-Metropolitan City had been suffering from overstaffing or exercising to reduce overheads.



Source: Annual Reports of Ten Fiscal Years of Hetauda Sub-Metropolitan City Office

**Figure 1: Financial Management Performance Analysis Fiscal Year 2003/004 to 2012/013**

Above figure: 1 revealed the financial management performance of Hetauda Sub-Metropolitan City in the fiscal year 2003/004 to 2012/013. The average grant receipt performance was more than 64.47 percent, whereas average own source revenue receipt performance was only 5.98 percent. The average total revenue receipt performance and the average administrative performance were 21.31 percent and 10.56 percent respectively. The performance of administrative expenditure was nearly double than own source revenue collection performance. It signified that Hetauda Sub-Metropolitan City should to increase revenue administration power to cope with administrative expenditures.

**Table: 3 (Annual Tax Contribution Scenario)**

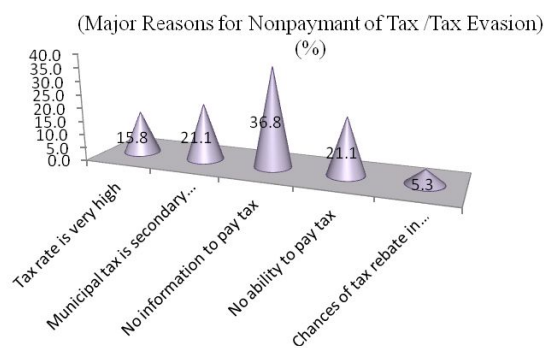
Tax Descriptions	No. of Taxpayers	Percent
Tax Not Contributed Taxpayer	19	14.2
Tax Contributed Taxpayers:		
Less than Rs.1000	45	33.6
Rs. 1000 to Rs. 2000	40	29.9
Rs. 2000 to Rs. 5000	17	12.7
Rs. 5000 to Rs. 10000	6	4.5
Above Rs. 10000	7	5.2
<b>Total</b>	<b>134</b>	<b>100</b>

Sources: Field Survey Report, 2015

Table: 3 depicted that 33.6 percent of the taxpayers of Hetauda Sub-Metropolitan City had paid municipal taxes below Rs.1000/- per year. Out of 134 taxpayers, 19 taxpayers did not comply with payment of municipal tax by presenting various causes. Apart from the mentioned or latent causes, the municipal policy-making advisors and tax payers have voiced several more possible reasons for evasion of tax and nontax revenues.

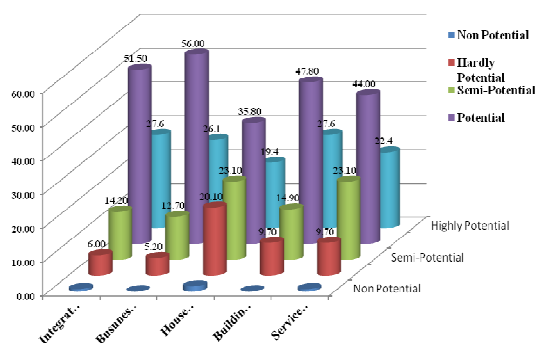
Figure: 2 presents the reasons for municipal tax evasion by the potential taxpayers. In Hetauda Sub-Metropolitan City, 7 non-taxpayers (36.8%) out of 19 had not paid tax citing lack of information. Furthermore, 4 municipal people

(21.1%) avoided tax payment by considering municipal tax as secondary tax. In Hetauda Sub-Metropolitan City, 8 citizens cited high tax rate, chances of tax rebate in future, and inability to pay as the reasons for tax evasion.



Sources: Field Survey Report, 2015)

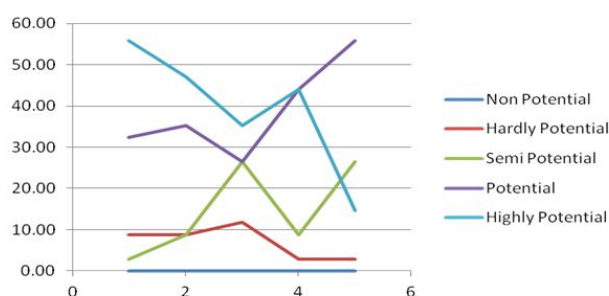
Figure 2



Sources: Field Survey Report, 2015

Figure 3: Views of Taxpayers on Major OSR Potentiality of Hetauda Sub-Metropolitan City

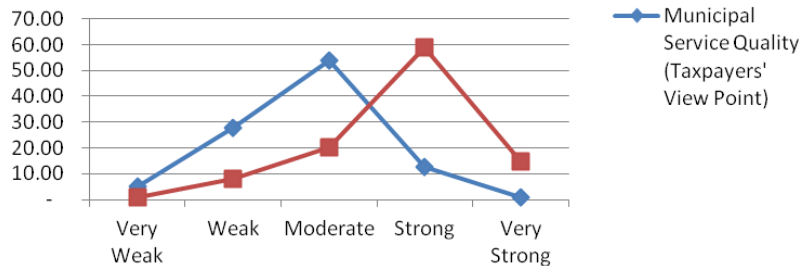
The above figure (Figure: 3) showed the major own source revenue potentiality in Hetauda Sub-Metropolitan City. All the tax and nontax revenues were potential sources in Hetauda Sub-Metropolitan City from the view point of taxpayers. Comparatively, business/ profession tax was more potential.



Sources: Field Survey Report, 2015

Figure 4: Policymakers Views on Potentiality of Major OSR

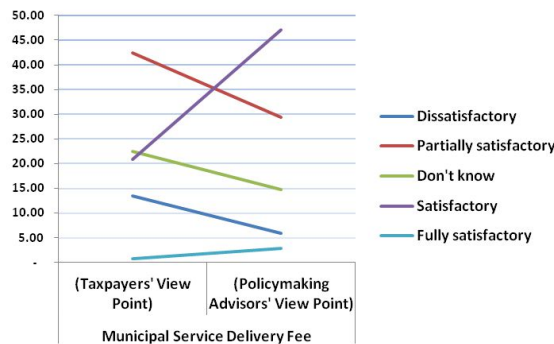
The above figure (Figure: 4) depicted the degree of potentiality of major own sources of revenue from the view point of municipal policy making advisors. Integrated property tax was highly potential revenue source of Hetauda Sub-Metropolitan City from the policy perspective. Similarly, service fee and building permit fee were potential sources of revenue.



Source: Field Survey Report, 2015

**Figure 5: Service Quality: Comparative Views**

The above figure (Figure: 5) illustrated that the comparative views of taxpayers and municipal policymaking advisors on municipal service quality. From view point taxpayers and municipal policymaking advisors, municipal service quality was moderate and strong respectively in Hetauda Sub-Metropolitan City. It indicated that they had not similar observations on municipal service quality.



Source: Field Survey Report, 2015

**Figure 6: Views on Municipal Service Delivery Fee**

The above figure (Figure: 6) revealed the integrated views of taxpayers and municipal policymaking advisors on service delivery fees levied by Hetauda Sub-Metropolitan City. From the view point of taxpayers and municipal policymaking advisors, municipal service delivery fee was partially satisfactory and satisfactory respectively in Hetauda Sub-Metropolitan City. It signified that they have different feelings on service delivery fees imposed by the Sub-Metropolitan City. From the policymaking advisors' perspective, there was significant correlation (0.67) between service delivery fee and service quality at the one percent level (2-tailed).

At Hetauda Sub-Metropolitan City during the fiscal year 2012/013 to 2003/004, the mean growth rate of house and land tax/integrated property tax (IPT) was 11.03%. Considering the collected amount, integrated property tax was a



more significant revenue source compared to tax and nontax revenues. The second largest revenue was generated by the building permit fee. Because integrated property tax and building permit fee were identified as potential revenue sources, Hetauda Sub-Metropolitan City must concentrate its efforts in collecting them efficiently. With regard to expenditures, growth rate for total administrative expenditures was the lower in comparison with the growth rate for salary expenditure (i.e. 10.56 % < 11.01%). Similarly, the growth rate of development expenditure (social program and capital expenditure) was higher than the growth rate of administrative expenditures. The different types of central grants delivered a better performance at 64 percent than the own source revenue performance at 6 percent. The average total revenue performance and the average administrative expenditure performance were 21.31 percent and 10.56 percent, respectively. As per the reports of udle/GTZ, in the fiscal year 2006/07, the performance of own source revenue to total revenue was only 28.54 percent. This was much lower than the set standard at 60 percent (udle/GTZ, 2008). These findings indicated that Hetauda Sub-Metropolitan City had to put in additional effort to reduce the performance gap. According to the taxpayers municipal service quality was moderate and municipal service delivery fee was partially satisfactory, whereas the municipal policymaking advisors considered municipal service quality as strong and municipal service delivery fee as satisfactory. These contrary assessments suggest that municipal service quality and its service delivery fee were judged by different perspectives by different parties (Upadhyay, 2015).

## **CONCLUSIONS**

Hetauda Sub-Metropolitan City has generated most of its revenue through taxes. This study reiterates the fact that the potential for a municipal government to generate its own source revenue is entirely unrelated to tax compliance. Although only forty percent taxpayers of Hetauda Sub-Metropolitan City have paid the minimum amount of tax (i.e., less than Rs.1000/- per annum), revenue compliance is satisfactory despite nominal tax amounts. Nominal tax payment indicates that either the capability to administer taxes is low or there is insufficient tax education and revenue mobilization plan. Most non-taxpayers anticipate tax rebates by the Sub-Metropolitan City in the future, as similar policies have been implemented in the past.

Hetauda Sub-Metropolitan City generates most of its own revenue through integrated property tax (IPT), business/enterprise tax, house rent tax, building permit fee and service charge. This study did not show consistency in the tax revenue generated, which is included to the own source revenue, and the total revenue within the study period. However, this municipality imparts moderate quality service and its service delivery fee partially satisfactory as per the taxpayers.

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