

Report No. 41204-IN

India Synthesis Study of Public Financial Management and Accountability in Urban local Bodies

March 30, 2007

Financial Management Unit
South Asia Region



Document of the World Bank

CURRENCY EQUIVALENTS

Currency Unit = Indian Rupee (Rs.)
US\$1 = approx. Rs. 40
1 Crore = 10 million
Rs. 1000 Crores = approx. US\$250 million

FISCAL YEAR

April 1 – March 31

Vice President	: Praful C. Patel, SARVP
Acting Country Director	: Isabel M. Guerrero, SACIN
Manager	: Robert J. Saum, SARFM
Task Team Leader	: Priya Goel, SARFM

CONTENT

Executive Summary	i
1. Introduction	1
1.A. Background	1
1.B. Approach and Methodology	1
1.C. Urban Governance: Mandate for PFM	2
1.D. Highlights of Urban PFM Legislation and Reform	3
2. Components of the PFMA Framework	5
2.A. Enabling Legislation Framework	6
2.B. Budget Planning	8
2.C. Budget Execution	12
2.D. Accounting and Management information systems	13
2.E. Reporting	16
2.F. Cash and Fund Flow Management	18
2.G. Procurement	19
2.H. Internal Control and Audit	21
2.I. Assets and Liabilities Management	22
2.J. External Audit	24
2.K. External Oversight	27
3. Key Issues and Way Ahead	30
3.A. Improving ULB Budget Preparation	30
3.B. Support for Accounting Rules and Manual	31
3.C. Review and Strengthening of ULB Audit	31
3.D. Improving Procurement Performance	33
3.E. Staffing and Capacity Building	34
3.F. PFMA Report Card and meeting Minimum fiduciary Standards	34
3.G. Ensuring Compliance	34
3.H. Improving Public Oversight	35
3.I. Conclusion	35
Annex A. Experts and Officials Visited for PFMA Study	36
Annex B. Accounting Initiatives in Different States	37
Annex C. PFMA Reforms and Progress under JNNURM	42
Annex D. Cost and Performance Indicators	44
Annex E. PFMA Urban Reforms in India	46
Select Bibliography	51

LIST OF BOXES

Box 2.1. Autonomy to Urban Local Bodies in Kerala	7
Box 2.2. ULB Budget Reforms of Karnataka	9
Box 2.3. Budget as a Tool for Long-Term Strategic Planning in Kapra Municipality	10
Box 2.4. PROOF Initiative in Bangalore	10
Box 2.5. Output/Outcome Budgeting	11
Box 2.6. Fiscal Responsibility and Budget Management Act	13
Box 2.7. Sources of Municipal Accounting Policies	14
Box 2.8. IPSAS and NMAM	16
Box 2.9. Human Resource Structure Supporting ULB Financial Management	16
Box 2.10. E-Procurement in Andhra Pradesh	20
Box 2.11. Eleventh Finance Commission Guidelines for Involvement of C&AG in ULB Audits	26
Box B.1. Tamil Nadu Accounting Manual	37
Box B.2 Tamil Nadu Accounting – Key to Success	37

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
APUSP	Andhra Pradesh Urban Services for the Poor
BMP	Bangalore Mahanagar Palike
BWSSB	Bangalore Water Supply and Sanitation Board
CAA	Constitutional Amendment Act
C&AG	Comptroller and Auditor General of India
CRRID	Centre for Research in Rural and Industrial Development
DFID	Department for International Development (United Kingdom)
EFC	Eleventh Finance Commission
FIRE(D)	Financial Institutions and Reforms Expansion (Debt Servicing)
GASB	Governmental Accounting Standards Board
GIS	Geographic Information System
HIPC	Heavily Indebted Poor Country (Initiative)
ICAI	Institute of Chartered Accountants of India
IMF	International Monetary Fund
IPSAS	International Public Sector Accounting Standard
JNNURM	Jawaharlal Nehru National Urban Renewal Mission
LFA	Local Fund Audit
MIS	Management Information System
MoUD	Ministry of Urban Development
NEGAP	National e-Governance Action Plan
NMAM	National Municipal Accounting Manual
PEFA	Public Expenditure and Financial Accountability
PFMA	Public Financial Management and Accountability
PROOF	Public Record of Operations and Finances
SFC	State Finance Commission
ULB	Urban Local body
URIF	Urban Reform Incentive Fund
USAID	United States Agency for International Development

Acknowledgments

This synthesis study was conducted from March through December 2006. The World Bank Task Team was led by Priya Goel and Ivor Beazley under the overall guidance of Robert Saum and PK Subramanian (SARFM).

It is important to mention the invaluable contribution of Mr. Rajamani (Joint Secretary, Ministry of Urban Development, Government of India) and Mr. Aniruddh Kumar (Director, Ministry of Urban Development, Government of India); Mr. Arun Mehta (Director, Ministry of Urban Development, Government of India); Mr. R. N. Ghosh (Principal Director, Local Bodies, Comptroller and Auditor General of India); Ms. Geeta Menon (Director Local Bodies, Comptroller and Auditor General of India) who guided the team and provided direction and comments as the study progressed. We would also like to thank Mr. Om Mathur, Mr. K.Dharmarajan, and Mr. A.Shiromany for their advice and comments.

The Study benefited from the comments of Joel Turkewitz (SARPS), Raghu Kesavan (SASEI), Chris Heymans and Anup Wadhawan (WSP), Manoj Jain (SARFM), Rama Krishnan Venkateswaran (SDNCA) and Rajiv Sondhi (ESPC) who acted as Peer Reviewers. Comments received from Vinod Sahgal and Ramola Bhuyan were also very helpful. Consulting support was provided by Ashwajit Singh, Abhijit S.Ray, Abdul Rahim, Ashish Rao and Suresh Gupta of Infrastructure Professionals Enterprise (IPE).

The study also draws on State Financial Accountability Assessments and related Public Financial Management and Accountability Assessments at the Panchayati Raj Institutions. These were conducted at Andhra Pradesh (by Ken Jones), Karnataka (by TK Balakrishnan), Uttar Pradesh (by Rajat Narula and Priya Goel), and Orissa (by Vinod Sahgal). The study is based on a request from the Ministry of Urban Development.

The report has been discussed with GOI but does not necessarily bear their approval for all its contents especially where the Bank has stated its judgment/opinion/policy recommendations. For further information on the synthesis study, please contact Priya Goel at pgoel@worldbank.org.

Executive Summary

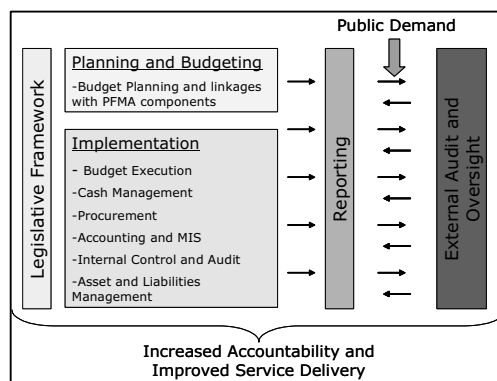
1. An improved public financial management and accountability (PFMA) environment is crucial to better urban governance and performance. All urban local bodies (ULB) in India stand to gain from better PFMA in the form of improved governance and accountability, realistic and participatory planning of expenditures, and consequently stronger revenue flows and provision of better services. This study assesses the current state of PFMA systems in Indian urban local bodies. It identifies, analyzes, and documents good practices, focusing on their existing context, success factors, and replicability. It is important to mention that urban governance in India is a state subject and there are vast differences in the levels of reform that have achieved in different states. For the purpose of comparison, this study has developed good practice benchmarks in each PFMA area and used those to compare practices across ULBs.

PFMA REFORM

2. The 74th Constitutional Amendment Act (CAA), 1992, created the overall enabling framework for PFMA in urban local bodies by envisaging for the ULBs the status of the third tier of government to be vested with appropriate funds, functions, and functionaries. The Right to Information Act, 2005, is a landmark policy to strengthen transparency and accountability in public finance management. An Urban Local Government Disclosure Bill, 2006, has been drafted and is expected to further reinforce PFMA issues of accountability and transparency. The Model Municipal Law has important provisions for ensuring better PFMA practices; but since it can only recommend and not mandate, there is no compliance. The nationally sponsored reform-driven initiatives—the Jawaharlal Nehru National Urban Renewal Mission (JNNURM) and National Municipal Accounting Manual (NMAM)—also help in laying down prescriptions for attaining better PFMA.

PFMA FRAMEWORK: STRATEGIC AREAS, OBJECTIVES, AND OUTCOMES

3. The PFMA framework in this study is based on the Public Expenditure and Financial Accountability¹ (PEFA) framework. It was modified for this study in consultation with key stakeholders, including the Ministry of Urban Development (MoUD), office of the Comptroller and Auditor General of India (C&AG), and other donor agencies. The framework, as illustrated in the adjoining figure, brings out the linkages between legislative, budgeting, implementation, reporting, and oversight process in the urban local bodies. Improved functioning in these areas would lead to increased accountability and enhanced levels of service delivery. The recent impetus for reforms brings to the forefront the acceptance, need, and requirement to focus on the vital link of public financial management and accountability to improved governance and service delivery.



PFMA COMPONENTS: BENCHMARKS, PRACTICE, POLICY, AND PROGRESS

4. The study analyzes linkages between the legislative, budgeting, implementation, reporting, and oversight process in urban local bodies. Benchmarks and indicators have been developed for each strategic area. Analysis of policy, practice, and progress in each strategic area has also been conducted.

Legislative Framework

5. *Benchmark.* The good practice benchmark for a sound legislative framework would imply a framework that covers major areas of PFMA, is backed by comprehensive rules, and provides appropriate incentives for performance and penalties for nonperformance.

¹ PFMA benchmarks for Indian urban local bodies was based on the Performance Measurement Framework for Public Financial Management developed by the PEFA Secretariat (www.pefa.org). The PEFA program is a partnership among the European Commission, the UK Department for International Development, the Swiss State Secretariat for Economic Affairs, the French Ministry of Foreign Affairs, the Royal Norwegian Ministry of Foreign Affairs, the Strategic Partnership with Africa, IMF, and the World Bank. A Steering Committee, comprising members of these agencies, manages the program. A Secretariat is located in the World Bank in Washington, DC.

6. *Practice.* In India, urban local bodies are governed by respective state municipal acts. While comprehensive in areas such as financial control, budgeting and audit, there are gaps in procurement, monitoring, and enforcement. Also, the present framework shows weakness in aspects of participative planning; public accountability; and modern accounting in line with international good practice, audit, and management practices.

7. *Policy.* Although the legislative reform environment is positive, urban local bodies lack implementation capacity. Furthermore, there are no systems of penalty for nonperformance. However, adoption of state fiscal responsibility acts, as recommended by the Twelfth Finance Commission, with Karnataka and Tamil Nadu as proactive examples, can positively impact compliance and performance issues.

Planning and Budgeting

8. *Benchmark.* The good practice benchmark for budgeting and planning entail that budget planning is realistic, comprehensive, and participatory.

9. *Practice.* In Indian urban local bodies, budgets are generally seen as a statutory requirement, and hence limited to providing sanctions for expenses and revenues. Current budgeting practices are not directly linked to a larger strategic, multi-year planning process. The rigor of planning is replaced by incremental budgeting and need for debates, and participation is limited to elected representatives. However, certain leading practices have been observed in West Bengal and Kerala (public participation); Karnataka (standard forms for budgeting); and Kapra, Andhra Pradesh (multi-year planning) that can be replicated.

10. *Policy.* Within the framework of incentive-linked JNNURM, improvements can be expected through the city development plan and financial operating plan wherein urban local bodies are required to develop a perspective planning framework based on long-term policies, programs, and strategies to match fund requirements. This should move budgeting from a stand-alone process to an integrated and strategically linked planning aid.

Budget Execution

11. *Benchmark.* The good practice benchmark for budget execution is that the budget is used as a tool for planning, procurement, and expenditure control.

12. *Practice.* Weak monitoring, lack of variance analysis and unpredictability of transfers from the Center and states impede budget implementation. Re-scheduling of budget heads during the year is common practice because expenditures are not based on resource realization. Furthermore, shortfalls in revenue generally lead to cuts in capital and recurring expenditures. Citizen interface is weak except in the case of the Public Record of Operations and Finances (PROOF) in Bangalore. Since own source revenues are limited and dependence on state funds is still high and the unpredictability of state transfers is a serious concern for effective budget execution. The recent recommendation of the Twelfth Finance Commission for state enactment of fiscal responsibility legislation is a step to improve predictability of timing and quantum of state transfers and strengthen budget execution. The Reserve Bank of India circulated a model fiscal responsibility bill to the states, and some states have enacted the Fiscal Responsibility and Budget Management Act. However, improvements in ULB budgetary systems have yet to accrue from this Act.

13. There has been limited progress in the area of budget execution by urban local bodies. Only few acts (for example, in Kerala) provide for verifying budgeted expenditure with resource realization. The recent Karnataka Municipal Accounting Rules have prescribed a monthly reporting format for budget variance.

14. *Policy.* Legislation fails to specify fiscal management responsibilities of respective officials and levels of government (states) and therefore needs to be strengthened.

Accounting and Management Information System

15. *Benchmark.* The good practice benchmark for accounting implies that accounting is complete, accurate, timely and meaningful to decision makers.

16. *Practice.* Urban local bodies in India have traditionally followed the single entry cash basis of accounting. This limits their ability to prepare meaningful performance reports and statements of financial position. Accounting work utilizes a predominantly manual system with a multiplicity of registers and limited staff capacity resulting in accounts in arrears for several years.

17. *Policy.* Adoption of a double entry accounting system in urban local bodies has been limited despite Supreme Court intervention and provision of the National Municipal Accounting Manual. Tamil Nadu is the only state to have implemented a double entry accounting system in all its urban local bodies. Currently, efforts are underway for state-level implementation in Karnataka, Uttar Pradesh, West Bengal, Gujarat, Kerala, Tripura, Maharashtra and Rajasthan. Experience shows that states need some initial handholding support and technical assistance for shifting to modern methods of accounting and computerized technologies. The challenge is to build capacity for generating and using this financial information for improved decision making in urban local bodies.

Cash and Fund Flow Management

18. *Benchmark.* The good practice benchmark of efficient cash and funds management entails a system that is able to document receipts, payments, and fund flows effectively and efficiently in the urban local bodies.

19. *Practice.* Most urban local bodies in India are characterized by weak cash management and treasury systems. This is primarily due to poor budget preparation, absence of cash flow forecasting, lack of a single treasury account, and delayed reporting of expenditure. Bank reconciliations are generally in arrears, and cash management is limited to prioritization of check issue. In addition to overcoming their weak capacity, urban local bodies need to improve interdepartmental co-ordination of treasury management. A successful initiative in treasury management is the case of Madurai, which swapped its debt through a bond issue resulting in interest savings in excess of Rs.8 crores per annum. Although many urban local bodies raised money through bonds, not all of them could optimally utilize the funds. Therefore, any movement toward treasury management must be done cautiously as most urban local bodies lack the requisite capacity and technical knowledge.

20. *Policy.* Municipal acts and accounting rules of respective states prescribe systems for maintenance of cash and bank books by the urban local bodies. While these formats are generally followed, the concept of treasury and fund management is lacking in urban local bodies.

Procurement

21. *Benchmark.* The good practice benchmark for procurement implies procurement system which promotes increased competition, value-for-money, and transparency in purchases by the urban local bodies.

22. *Practice.* Procurement practice is characterized by a lack of uniformity in rules and procedures, insufficient management and oversight, and severe capacity constraints on the side of the public and private sectors. With procurement comprising over half of ULB budgets and increased procurement envisaged under initiatives like JNNURM, inefficiencies in the manner in which urban local bodies design, contract, and implement projects; and purchase goods are a strong constraint on the effectiveness of local spending. Some urban local bodies have shown progress in this area—budget information data sheets in Madurai; preparation of bi-annual list of capital works in Bhubaneshwar and e-procurement in Andhra Pradesh. Rajasthan (under ADB funding) and Kerala (under Royal Netherlands Embassy and Department for International Development funding) are now set to expand the project-based e-procurement to statewide e-procurement

23. *Policy.* Legislation governing procurement, though rudimentary, defines procedures and limits for procurement. However, there is no focus on quality and performance nor a linkage with planning. Improving performance of ULB procurement systems is an important way to save money, improve quality of spending, and enhance delivery of services. A useful approach to improving procurement in urban local bodies would combine simplification of rules supported by the drafting and implementation of a model procurement law and enhanced monitoring through strengthening the provision of public information, auditing, and capacity building; and developing public-private partnership mechanisms.

Internal Control and Audit

24. *Benchmark.* The good practice benchmark for internal control and audit is a strong and clearly defined system of controls with and effective policies, systems, and procedures for internal transactions.

25. *Practice.* Internal controls in most ULBs are either weak or non-existent. Internal audit, where it exists is poorly defined and not independent. ULBs also need to do considerable work on strengthening their financial, operational and transactional controls. They also need to put in place effective and independent departments for internal audit. An example of an independent internal audit system is that of Kolkata Municipal Corporation, where the Municipal Accounts Committee is headed by the Opposition leader.

26. *Policy.* ULBs accounting rules are very weak in the areas of internal (operational and financial control) and most ULB-related legislation does not provide for internal audit. Internal controls are generally incorporated in financial rules and focus on delegation of financial limits. Some urban local bodies have a standing committee for audit and accounts with the objective of scrutinizing ULB accounts at each level and ensuring compliance with audit notes. However, with the shift to a double entry accounting system and the increased demand for accountability (through the Right to Information and Public Disclosure Laws) there is a need to strengthen controls and put in place internal audit.

Assets and Liabilities Management

27. *Benchmark.* The good practice benchmark for asset and liability management is that a comprehensive database of all assets and liabilities is available and there are adequate policies and procedures in place to provide for their operations, maintenance, replacement and revaluation.

28. *Practice.* Urban local bodies generally hold significant fixed assets (land, buildings, and infrastructure) but few have exploited the commercial potential of these properties to generate non-tax revenues. The maintenance of infrastructure assets is poor and expenditure for operation and maintenance is either not allocated in the budget or is not available due to deficits. Most urban local bodies do not have proper inventories of assets which are updated regularly. As a result they are neither able to utilize their assets effectively nor deal with liabilities in a planned manner. Ludhiana, Ramanagaram, Lucknow, and Ahmedabad have demonstrated good practice. Ludhiana Municipal Corporation added about 800 properties to its assets worth an estimated Rs. 1,900 million as a result of a survey of its properties with the revenue records. Asset inventory in Ramanagaram identified salable assets worth Rs.16 crore. Indore also prepared a computer database of its properties and is developing a strategy for optimal use of these assets.

29. *Policy.* Modern accrual accounting practices are expected to address the shortcomings in assets and liabilities management.

Reporting

30. *Benchmark.* The good practice benchmark for reporting would mean timely, meaningful, and user-friendly reports that provide reliable financial information and facilitate effective decision making and engagement with stakeholders.

31. *Practice.* Reporting requirements for ULBs are weak. Although the environment for reporting is becoming stronger, there is still lack of demand for such information from within government and from the public. Media campaigns (similar to those used for Right to Information Act) could help to ensure that the community recognizes the need for and starts demanding relevant information. This level of participation will add to ULB accountability.

32. *Policy.* The overriding focus of state legislation is on reporting to the state and is limited to compliance certificates, budgets, and periodic administrative statements. There are no guidelines on disseminating financial results to the public. Some efforts have been made through the Public Disclosure Law, National e-Governance Action Plan (NEGAP), and citizen facilitation centers. Karnataka has incorporated a public reporting requirement in its recent accounting rules as well. These efforts are intended to improve the accountability of urban local bodies to the citizens.

External Audit

33. *Benchmark.* The good practice benchmark for external audit would imply a strong and independent external audit function that does a certification of accounts of ULBs in accordance with national auditing standards.

34. *Practice.* The current external audit mechanism relating to audit by the Local Fund Audit (LFA) continues to be the weakest link in the PFMA cycle. There is an extensive backlog of audits due to limited capacity of Local Fund Audit (LFA) and increasing transactions of urban local bodies. While the C&AG has been auditing ULBs under Section 14 of the C&AG's Duties, Powers and Conditions of Service Act, 1971, wherever attracted, the C&AG's involvement in audit of ULBs has been strengthened in line with recommendations of the Eleventh Finance Commission. Accordingly, C&AG has now been entrusted with Technical Guidance and Supervision (TGS) of the LFA including audit of ULBs under Section 20 of the CAG's Act. With adoption of a double entry accounting system, audit capacity needs to be enhanced. Also, professional independent audits that comment on the *truth and fairness* of financial statements are required in addition to the routine compliance audits.

35. *Policy.* As per most state legislation, the statutory audit of urban local bodies is generally carried out by the Local Fund Audit and limited to transaction reviews and focused on prudence and compliance. Audit objections or *paras* are made when the follow-up process is weak.

External Oversight

36. *Benchmark.* The good practice benchmark for a well functioning external oversight system is that there should be mechanisms to ensure that key decision makers are accountable to the public.

37. *Practice.* Limited availability of reports in the public domain, weak community structures, and lack of involvement of citizens lead to poor external oversight. In absence of properly functioning ward committees, the only oversight is taken up by nongovernmental and community-based organizations, as exemplified by PROOF and Citizen Report Cards in Bangalore.

38. *Policy.* Public involvement in ULB governance is at first glance missing in the current legislative environment.

KEY ISSUES AND THE WAY AHEAD

39. This study identifies short, medium, and long-term PFMA measures that can be implemented in urban local bodies.

40. *Improving ULB budget preparation.* A framework for output/outcome budgeting, standardization of forms and formats, role of community structures, and linkages with parastatals should be developed in a model ULB budgeting manual. It should also include aspects of multi-year rolling plans, capital investment, and procurement planning for effective budgeting and execution.

41. *Support for accounting rules and manual.* The National Municipal Accounting Manual needs to be reviewed in the context of International Public Sector Accounting Standards (IPSAS) guidelines. Model accounting rules should be developed and a centralized technical assistance unit set up to assist states in adapting and implementing the National Municipal Accounting Manual. Special assistance may be required for clearing account arrears and preparation of opening balance sheet for the urban local bodies.

42. *Review and strengthen ULB audit.* A task force should review the capacity and role of various agencies in a ULB audit and suggest measures for its strengthening. It could also advise on moving toward performance and management audits; clearing old audit backlogs; and training LFA auditors with reference to the changed financial reporting scenario, double entry accrual accounting, and modern audit techniques.

43. *Improve procurement performance.* The Ministry of Urban Development can assist by drafting a model procurement regulation, establishing simple reporting requirements for procurement operations, and complement these with efforts to promote the adoption of electronic procurement. It may also mandate a transparency law, along the lines of Karnataka, for procurement and link fund release with its implementation. Urban local bodies also need support to promote public-private partnerships in urban local bodies for alternative service delivery models.

44. *Staffing and capacity building.* The capacity of existing staff should be enhanced through training needs assessment; reviewing available PFMA-focused courses; and, if necessary, developing PFMA-focused curricula. The Central Government should support compulsory recruitment of professional accountants for JNNURM cities or prescribe training requirements for ULB finance officers.

45. *PFM report card.* A scoring of urban local bodies against PFMA indicators could be initiated to enable the Government to assess the baseline, monitor progress, and facilitate inter-ULB comparisons on PFMA indicators. This would act as a powerful incentive to creating a demand side pull for accountability, transparency and better stewardship of public funds.

46. *Ensuring legislative compliance.* Various mechanisms to ensure legislative compliance could be explored. Recommended actions include (a) mandating the tabling of budgets and financial statements of urban local bodies to general public and/or state legislature ; (b) fixing timelines for Action Taken Report on audit queries; (c) ensuring dissemination of Annual Financial Report; and (d) making funds available to urban local bodies based on compliance with key legislative requirements, especially in PFMA areas.

47. *Improving public oversight.* In order to encourage public debate and discussion, an annual performance report containing financial statements and a management discussion and analysis section should be prepared. The report should be discussed in a public forum. Citizens should have access to the reports through websites and other media in the public domain.

1. Introduction

48. India's urban population has grown fivefold since 1947. Urban households in India account for 27 percent of the national population and contribute more than 50 percent of the country's gross domestic product and 90 percent of the taxes.

49. Increasing urbanization has meant that urban local bodies (ULBs) which are the third tier of government responsible for urban areas, are required to have higher capital investment and better management of available resources. In addition, recent legislation, like the Right to Information Act (RTI), has placed greater responsibility on ULBs to become more accountable for management and use of public money. The Government of India recognizes the need to make urban local bodies self-reliant and responsive. To encourage urban reform, the Government formulated the Jawaharlal Nehru National Urban Renewal Mission (JNNURM).

50. An essential part of JNNURM is the reform and strengthening of the public financial management and accountability (PFMA) systems of ULBs. These comprise — accounting; auditing (with clear, unambiguous audit opinions); internal controls; procurement; and public oversight mechanisms.

51. PFMA in ULBs has become important to augmenting the financial position of urban local bodies, since the maintenance and production of accurate and timely financial information about their assets, liabilities, stocks and flows would help them access the market to raise debt for their growing infrastructure requirements. It is in this context that India's Department of Economic Affairs expressed interest in an analytical study on status of PFMA in urban local bodies in India.

1.A. BACKGROUND

52. This study synthesizes existing literature on PFMA in urban local bodies, identifies key PFMA areas where focused attention was required, and suggests ways forward. The main objectives are:

- To describe the current PFMA environment in urban local bodies in India and identify replicable good practices.
- To use the Public Expenditure and Financial Accountability (PEFA)¹ benchmarks in developing good practice in each PFMA activity and to develop indicators for assessing PFMA in Indian urban local bodies.
- To identify challenges and suggest priorities for improving the PFMA environment in Indian urban local bodies so as to feed into JNNURM.

1.B. APPROACH AND METHODOLOGY

53. Case material for this study was selected on the basis of two parameters—demonstrable good practices that have potential to be replicated and representational samples from across the country. This study benefited from reviews of existing literature and consultations with experts and stakeholders, including from development agencies;² and from Central and state governments and local organizations.³ It covers aspects of enabling legislative framework that are relevant to financial management; budget development and execution practices; accounting and financial reporting; procurement; asset management; and external oversight, including audits.

54. This study does not focus on the financial performance or on quality of expenditure in terms of specific aspects of efficiency or effectiveness of spending by urban local bodies. It does not cover intergovernmental relations either in any level of detail except to the extent that such relations impact

² Agencies include U.S. Agency for International Development, U.K. Department for International Development, Asian Development Bank, and United Nations Development Program.

³ Annex A lists those people who were visited and consulted for this study. We are particularly grateful to the Ministry of Urban Development (MoUD) and the Office of the Comptroller and Auditor General of India (C&AG) for their help and support in this regard.

PFMA performance. These areas are in the fiscal domain while this is a financial management and accountability study.

55. It is important to mention that this study does not attempt to develop a scoring system for indicators and therefore does not rate relative performance among urban local bodies. It does however suggest as a key recommendation that states could adopt a scoring system or a “PFMA Report Card” for the urban local bodies as a means of comparison of PFMA performance to build a demand for better governed ULBs.

1.C. URBAN GOVERNANCE: MANDATE FOR PFM

56. In India, urban governance is a state-level subject. Governance includes both the administration of urban areas as well as the requirements of control and transparency on public spending. Urban local bodies are classified by type, population size and density, percentage of population deriving nonagricultural income and economic importance, and other parameters.

57. State legislative acts govern urban local bodies and set out their powers, responsibilities, service delivery mandates,⁴ and obligations with regard to accounting, audit, and oversight. However, most state legislation is nebulous with regard to PFMA obligations on urban local bodies for accounting, audit, and oversight. While existing legislation does require that accounts be maintained and audited by Local Fund Audit (LFA), there are no penalties prescribed for nonperformance, and neither are there any institutional oversight mechanisms prescribed in the acts. Although Councilors (elected ULB representatives) have the right to ask for and inspect accounts, there are no other public bodies where the audited accounts of urban local bodies must be presented.

58. As a result, due to the weak PFM legislative framework and low public demand for accountability of public money, the small to medium local bodies in most states have many decades of accounting and audit arrears. The larger local bodies can produce recently finalized and audited accounts, but this is driven by the requirement to get credit ratings and access to bond markets rather than strong legislative mandate.

59. Most states have departments of municipal administration that are responsible for overseeing urban local bodies. These departments can only provide incentives for good PFMA practices but they do not have direct dominion⁵ on ensuring that prudent financial accountability practices such as timely completion and audit of accounts are followed. Since the fiduciary role of the states is limited, they are not able to influence the PFMA environment in ULBs significantly. The state’s role and oversight over the ULB should be reexamined and a system of incentives and disincentives for PFMA performance other than small punitive measures like withholding grants from State Finance Commissions (SFC) should be thought of.

60. The ULB council and the area’s constituent public can significantly impact the PFMA environment in the urban context. Councils can be held to task by local people under the Right to Information Act, 2005, which extends to urban local bodies as well and establishes the rights of the people over public spending information. In addition to this, the incentives provided by good credit ratings to access market capital are a powerful tool to establishing good accounting, sound audit, and control practices.

61. The Government of India and its constituent ministries responsible for urban development (the Ministry of Urban Development and the Ministry of Urban Employment & Poverty Alleviation) formulate policies, sponsor and support programs, co-ordinate activities of various state governments, and monitor programs concerning urban development in the country.⁶ Through these policies and programs, the ministries can *influence* and *encourage* good PFMA practice in urban local bodies. However, they cannot *mandate* good PFMA practice. The Planning Commission (through National Five-Year Plans) and the Central Finance Commission also provide policy support and make recommendations for growth, development, and financing of urban local bodies.

⁴ The ULB service delivery mandate varies across states depending on the extent of devolution effected by the state after implementation of Constitution (74th Amendment) Act, 1994, (Annex C). In general, urban local bodies are entrusted with provision of water supply; public health, sanitation, and solid waste management; fire services; urban environment; urban amenities; and parks, gardens, and playgrounds.

⁵ State Municipal Acts do not give state governments a fiduciary role.

⁶ <http://urbanindia.nic.in/moud/theministry/ministryofurbandevlopment/main.htm>

1.D. HIGHLIGHTS OF URBAN PFM LEGISLATION AND REFORM

62. Due to the factors highlighted above, urban PFMA reform has been a complicated topic. The demand for good public financial management and accountability is weak and the current ambiguous structure of legislative requirements does not make sound public financial management mandatory.

63. The enabling legislation referenced throughout the PFMA study addresses both the supply and demand sides. In the paras that follow, the study lays out some of the key legislations that have shaped the nature of PFM and urban governance in ULBs in India. A more detailed breakdown of the history of urban PFM reform is provided in Table E.2, Annex E.

Legislation to Strengthen the Demand Side

64. **The 74th Constitution (Amendment) Act, 1992.** The 74th Constitution Amendment Act (CAA) recognizes urban local bodies as the third tier of government in India and recommends that they be made autonomous through devolution of powers.⁷ With respect to public financial management, as evolving process of implementing the CAA in spirit, the Eleventh Finance Commission recommended that Comptroller and Auditor-General of India (C&AG) be entrusted with technical guidance and supervision of ULB audit in all states having implemented the 74th CAA, as well as undertaking of audit of larger urban local bodies by C&AG. Under this support, C&AG has prepared accounting and auditing formats for urban local bodies. Presently only 18 states have given full entrustment of technical guidance and supervision to C&AG.

65. **Model Municipal Law, 2003.** The Ministry of Urban Development formulated a Model Municipal Law to serve as a template for states to revise their municipal legal frameworks. With respect to public financial management, the Model Municipal Law prescribes the development of standard municipal accounting manual and practices, creation of a Municipal Accounts Committee, and preparation of annual financial statements and preparation inventory of all municipal assets. However, this remains a supply side measure, which was recommendatory in nature and consequently not adopted by most states. Until now, only Orissa has amended its Municipal Act to incorporate provision of Model Municipal Law while Rajasthan has floated a bill to amend its act accordingly. Maharashtra and Madhya Pradesh have set up committees to consider the recommendations for adoption in their respective municipal laws.

66. **Right to Information Act, 2005.** The Right to Information Act empowers citizens of India to hold government and bureaucracy answerable to the people in all matters of public spending. The Act has far-reaching implication for public accountability systems in India. It requires government bodies to provide any information sought on its operations within a specified time frame. It also promotes pro-active disclosure of certain information by government bodies. The Act provides for elaborate disclosure requirements, appointment of responsible officers as Central and State Information Commissioners, and an independent appeal mechanism and stringent penalties for default. Since the Right to Information Act is applicable to urban local bodies as well, it is an important leverage to enhancing the demand for good public financial management.

67. **Urban Local Government Disclosure Bill, 2006.** Although not yet adopted by any state government, the Urban Local Government Disclosure Bill recommends state-level implementation along the lines of the Model Municipal Law, 2006. This proposed Bill aims to enhance transparency and accountability in local government functioning. Urban local bodies would be required to maintain adequate records and disclose key information to the public at regular intervals. The Bill envisages voluntary sharing of information by the urban local bodies and is a step forward from the Right to Information Act.

Supply-Side Incentives for PFM Reform

68. **Access to Debt Markets.** The access to debt market has been one of the key demand-side incentives to good public financial management. In order to access bond markets, urban local bodies are required to demonstrate financial discipline and accountability. These include updated accounts, credit rating, and sound reporting practices—all essential components of a good PFMA environment. Despite urban local bodies having weak finances in India, none of the 15-odd municipal bond issues have defaulted in repayment to date. The first bond issue was floated in 1998 followed by issue of guidelines for tax-free municipal bonds (2001). Given the current environment where almost Rs.1,500 crores

⁷ Specifically, the 74th CAA directs states to devolve specific (18) functions (as listed in Schedule XII of the Constitution). Table E.1, Annex E, illustrates the extent of devolution across states. The 74th CAA also requires creation of State Finance Commissions in each state to review and make recommendations regarding distribution of taxes, grant-in-aid, and revenue-sharing policy between the state and urban local bodies.

(US\$330 million) has been borrowed, new legislation needs a fresh look at defining thresholds on borrowing based on capacity and also defining the role and obligations of states with regard to municipal debt.

69. **Supreme Court Judgment on Accrual Accounting in Municipalities.** In the case *Almitra Patel vs. Union of India* (SC:2002), the Supreme Court ordered the Government of India to develop guidelines for moving all urban local bodies to a full accrual accounting system. Accordingly, the Government⁸ developed the National Municipal Accounting Manual (NMAM) that sets out processing for moving to double entry accrual accounting for urban local bodies. The Manual was issued in 2005; Karnataka, Andhra Pradesh, Gujarat and West Bengal have already adopted it and drawn up accounting manuals accordingly. However, many states have yet to draw up accrual-based manuals. In addition to the Manual, state legislation needs to provide a legal basis for accrual-based accounting because, until that happens, this incentive-led reform will remain only recommended rather than institutionalized and mandated by law.

70. **Urban Reform Incentive Fund (URIF).** The Government of India decided in 2002 to accelerate urban reform by providing reform-linked financial assistance to states by setting up the Urban Reform Incentive Fund (URIF) with an initial outlay of Rs. 500 crores per annum. The Fund was designed to provide incentives to state governments for reforms in state and local government, including repeal of the Urban Land Ceiling Act, rationalization of stamp duty, reform of rent control laws, introduction of computerized registration, reform of property tax, levy of user charges, and adoption of double entry accounting system. However, being allocation driven rather than reform driven, the Urban Reform Incentive Fund failed to energize the urban local bodies. The incentives were small to carry out the large reforms. The City Challenge Fund, another reform effort, did not receive Cabinet approval and never materialized.

71. **Jawaharlal Nehru National Urban Renewal Missions.** JNNURM was launched in 2006 as a reform-driven, fast track mission for integrated and planned development of 63 identified cities. Its focus was on asset creation and management, efficiency in urban infrastructure and services delivery, community participation, and accountability. JNNURM has a central outlay of Rs. 50,000 crore (US\$11billion) for a seven-year period. The program requires a tri-partite memorandum of agreement between the urban local body, the state government, and the central government that clearly identifies PFMA reforms, among others, and a timeline for achieving the same at all levels. This is an important program from the PFM viewpoint. The key reforms include modern and transparent budgeting system, shift to double entry accounting system, improved asset management, e-governance, updated financial management systems, enhanced property tax collection efficiency, enactment of Public Disclosure Law and Community Participation Law, quarterly monitoring by central and state level agencies, and the preparation of a financial operating plan. So far, 8 states have signed memoranda of agreement, and 30 out of the 63 cities⁹ have come up with their City Development Plans under the JNNURM.

⁸ A task force under chairmanship of the Deputy C&AG of India was appointed in 2001 to develop an accounting system and processes for better financial recording and reporting by urban local bodies.

⁹ As of February 2007

2. Components of the PFMA Framework

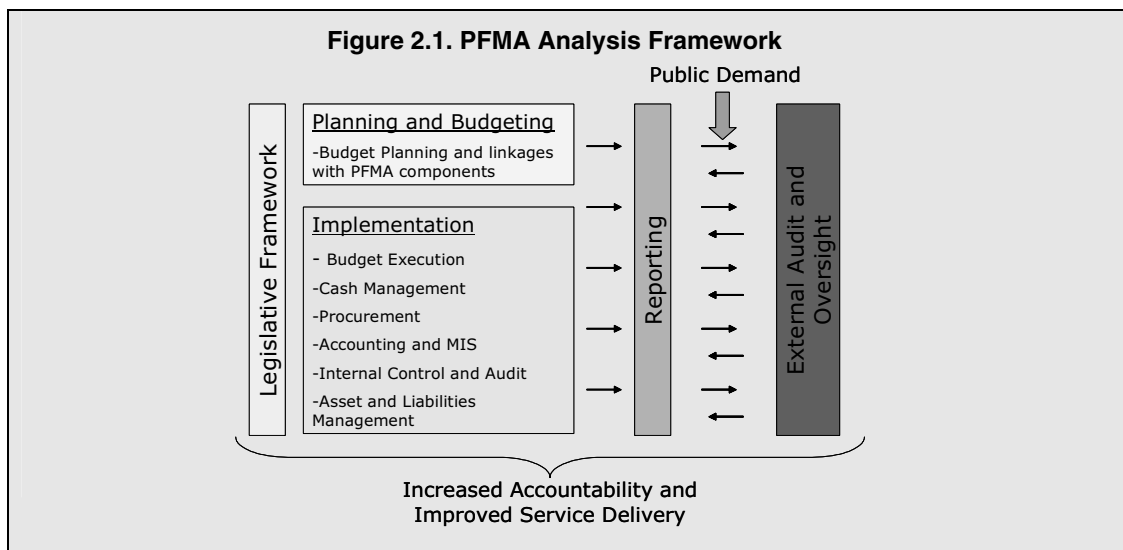
72. The PFMA framework for this study has been developed around broad areas defined in the handbook for Performance Measurement Framework issued by the PEFA secretariat.¹¹ The basic tenets of good financial management of public funds as defined by PEFA have been modified for this study in consultation with key stakeholders, including the Ministry of Urban Development, Office of the Comptroller and Auditor-General, and other donor agencies. The key components of the PFMA framework and the desired outcome in each strategic area in the context of urban local bodies are presented in Table 2.1.

Table 2.1. PFMA Components – Strategic Areas and Desired Outcomes

<i>Framework component</i>	<i>Strategic area</i>	<i>Desired outcome</i>
Legislative framework	Enabling legislative framework	A strong and comprehensive legislative framework exists which creates appropriate incentives and disincentives for institutionalization of good PFMA practices
Planning and budgeting	Budget planning	Realistic, comprehensive and participatory Budgets which reflect the ULB priorities.
	Budget execution	Budgets are appropriately executed and translated into action
Accounting and reporting	Accounting and Management Information System	Accounting and Management Information Systems provide complete, accurate, timely and reliable data for decision making
	Reporting	Timely and user-friendly reporting systems are in place allowing effective engagement with various stakeholders
Cash and fund flow management	Cash and fund flow management	Cash receipts, payments and fund flows are managed efficiently
Procurement	Procurement	An efficient system of procurement is in place promoting increased competition among vendors and providing greater value-for-money to the ULB.
Internal control and audit	Internal control and audit	An effective system of internal control and internal audit is in place
Asset and liabilities management	Asset and liabilities management	Information about assets and liabilities is available and used for their effective management
External audit and oversight	External audit	Clearly defined systems for timely, independent and effective external audit are in place
	Oversight	An independent oversight function is carried out by the state and public to increase accountability and participation

73. The study analyses the linkages that exist between the legislative, budgeting, implementation, reporting, and oversight process in urban local bodies in India (Figure 2.1). Benchmarks and indicators have been developed for each strategic area and analysis of policy, practice, and progress in each of these areas has been conducted.

¹¹ The PEFA Framework incorporates a PFM performance report and a set of high-level indicators that draw on the HIPC expenditure tracking benchmarks, IMF Fiscal Transparency Code, and other international standards. It forms part of the strengthened approach to supporting PFM reform, which emphasizes country-led reform, donor harmonization and alignment around the country strategy, and a focus on monitoring and results. This approach seeks to mainstream the better practices that are already being applied in some countries. See *Public Financial Management, Performance Measurement Framework*, PEFA secretariat, June 2005, www.pefa.org.



74. Each of the components of the PFMA framework is described in the sections 2.A through 2.K. The context of the PFMA components is described briefly. The benchmark of good practice for that PFMA component is set out; this is followed by the outcome could be achieved if the benchmark is achieved. Thereafter, each section analyzes whether there exists appropriate policy to support the achievement of the desired benchmark and what is the practice on the PFMA strategic area covered¹².

2.A. ENABLING LEGISLATION FRAMEWORK

Key Benchmark

75. The basis of a sound and comprehensive legislative framework is that the prevailing rules and regulations provide an enabling environment for key aspects of PFMA (Table 2.2). This includes consistent and realistic budgets, accurate and timely accounts, transparent procurement practices, independent external audit, and appropriate controls. Notably, provision of enabling environment includes provision of appropriate incentives for performance and disincentives or for non performance.

Table 2.2. Constituents of Enabling Legislative Framework

<i>Indicator</i>	<i>Source</i>
Legislation for PFMA areas are clearly defined with requirements, timelines, responsibilities for following key areas: <ul style="list-style-type: none"> • Budgeting and financing • Transparency in procurement • Financial systems • Internal control and internal audit • Public participation and oversight • Accountability and reporting 	Municipal Act, Rules, Regulations and Government Orders
Legislation provides for implementation, monitoring and enforcement of non-compliance / delays in key areas of PFMA	Municipal Act, Rules, Regulations and Government Orders

Policy and Practice

76. Every state has one or more municipal act governing urban local bodies. Most states have separate acts for each type of urban local body, but some (Tamil Nadu, for example) have one act for all categories.

¹² It may be noted that the “Practice” sections in this study are also a synopsis of the existing situation.

77. In some exceptional cases (as in West Bengal), separate acts exist for each corporation and a common act for all other municipalities. These acts usually provide for the broad aspects of PFMA, such as procedure for passing the budget, maintenance of accounts, and use of municipal fund. Most states have subordinate legislation for detailing the processes for accounting, administrative systems and other aspects, including maintenance of tax records and write offs. Larger urban local bodies (municipal corporations) are generally empowered to make their own rules or by-laws.

78. All municipal acts require the presentation of the budget to the elected functionaries;¹³ however, there are generally no provisions for citizens' involvement and/or bottom-up budgeting. In addition, most existing legislation is based on older laws and therefore generally provide for archaic practices, such as single entry accounting, use of colored pencil, carbon, etc. Modern concepts—double entry accounting system, computerization, output budgeting—are conspicuous by their absence.

79. The focus of the state legislative acts seems to be on compliance rather than encouraging autonomy and self-sustainability of the urban local bodies, but penalties for nonperformance are not provided. Thus, enforcement mechanisms are weak. Although time schedules are prescribed for preparation of budgets, finalization of accounts, and submission of administrative reports, there is no penalty or deterrence in case of delays. It is perhaps for this reason that accounts of several urban local bodies were outstanding for up to 10 years (including, until recently, India's second largest urban local body, Kolkata Municipal Corporation).

Progress

80. There have been significant changes in the legislative framework after the 74th CAA with several states amending their acts accordingly. A detailed status of devolvement of functions is given in Table E.1, Annex E. Only four states (Delhi, Kerala, Madhya Pradesh, and Tamil Nadu) have devolved the responsibility for economic and social planning to urban local bodies. While most states have devolved provision of basic services to urban local bodies, in many of these states functions such as water supply, sanitation, and conservancy, are still being handled by parastatal agencies. For example, the Kerala Water Authority is handling water supply provision due to lack of capacity at the local level. Similar instances are observed in Karnataka (Karnataka Urban Water Supply and Drainage Board) and Tamil Nadu (Tamil Nadu Water Supply and Drainage Board). Apart from these model states, not all states have constituted a State Finance Commission, or have not acted on the SFC recommendations as seen from Action Taken Reports. Only 18 states have come forward in accepting the recommendations for improved ULB-level audit functions through C&AG technical support and involvement. Similarly, implementing the double entry accounting system has not been accepted in all states. The desired effect of decentralization leading to effective PFMA has been, on the whole, limited, slow, and uneven across states. There are however a few exceptional states (Kerala, Karnataka, Tamil Nadu, and West Bengal), which have made efforts to ensure greater autonomy to urban local bodies (Box 2.1).

Box 2.1. Autonomy to Urban Local Bodies in Kerala

The Kerala Municipalities Act, 1994, transfers 165 functions (29 groups of items) to urban local bodies. This is among the most elaborate list of functions assigned to municipalities in any state. The functions have been classified as mandatory, sectorwise, and general functions. A major function entrusted to the municipalities in Kerala is planning and implementation of various developmental projects in the productive, infrastructure, and social service sectors.

81. In some states, specific and additional legislation has been adopted for key PFMA areas. The Transparency in Public Procurement Act of Karnataka and Tamil Nadu and the Karnataka Local Fund Authorities Fiscal Responsibility Act, 2003, are two such acts that apply to all levels of government, including local bodies. The Model Municipal Law recommended by the Government of India tries to integrate good practices into a replicable template for adoption by states. According to the Twelfth Report of the Standing Committee on Urban Development, Lok Sabha (2006), a majority of states, except Assam, Bihar, Haryana, Jharkhand, Manipur, Meghalaya, and Uttar Pradesh, have initiated necessary action to incorporate various provisions of the Model Municipal Law in their municipal acts.¹⁴

¹³ Kerala Act also refers to preparation of budget estimate by the Standing Committee.

¹⁴ To date, only Orissa has made amendments to its municipal acts based on the Model Municipal Law; the Rajasthan legislature has passed a bill. Maharashtra and Madhya Pradesh have formulated committees to review the same; other states are in initial stages.

82. An associated aspect of the legislative framework is the volume and multiplicity of amendments. Tamil Nadu has integrated several different acts into the single Tamil Nadu Urban Local Bodies Act, 1998, thereby reducing redundancies and consequently halving the size of the legislation. Perhaps this model can be replicated in other states.

Key Findings and Way Ahead

83. Tamil Nadu emerges as a good case for replication of legislative reforms in others states. It has brought related laws under one umbrella act to eliminate ambiguities, overlap, and duplication. Although adoption of the Model Municipal Law is pending approval from state government, Tamil Nadu has made great stride in legislative reform. The unified Tamil Nadu Urban Local Bodies Act, 1998, covers all aspects of urban governance and replaces all other acts.

Some of the major areas where ULB legislation needs strengthening include the following:

- (a) Monitoring and enforcement for noncompliance;
- (b) Public participation and involvement in budgeting;
- (c) Transparency, accountability, and disclosure requirements toward citizens; and
- (d) Efficiency enhancement measures, such as performance audits and cost management.

84. The Model Municipal Law is an illustrative example where the legal framework can be developed in a manner that relates to broad policy areas. It also gives independence to states to adapt and adopt legislation based on their own choices from several policy options. Model Municipal Law takes into account the new compulsions from the provisions of the 74th CAA and the new concerns for urban management reforms by breaking way from age-old legislative structures and suggesting innovations wherever possible.

Desired Outcome

85. The outcome of a strong and comprehensive legislative framework would be the creation of an enabling environment for the adoption of good PFM practices in ULBs.

2.B. BUDGET PLANNING

Key Benchmark

86. Budget planning should be used as an exercise for efficient resource allocation, supported by appropriate policy direction, participation by people, and realistic estimates. Focus of budgets should be on results achieved and not merely money spent by the urban local body. The components suggested for this are in summarized in Table 2.3.

Table 2.3. Budget Planning

<i>Indicator</i>
Budget preparation is participatory and based on needs and multi-year time horizon. <ul style="list-style-type: none"> • A number of public discussions need to be held before budget finalization. • Includes percent of last years incomplete works and works in progress. • Budget linked to service delivery gaps based on a longer-term document like city development plan, vision plan, etc.
Budgets are realistic and achievable. <ul style="list-style-type: none"> • Analysis of budget vs. actual reflect not more than a percent of variation. • A percent of proposed programs completed. • Level of spending outside the budget is less than X%.
State maintains a database of budget information from all urban local bodies <ul style="list-style-type: none"> • Budgets are received by departments of municipal administration latest within the dates prescribed under the act. • Budget made public/advertised with specific programs and benefits. • Budget is used as a tool for monitoring by all stakeholders.

Policy and Practice

87. Budget documents in most Indian urban local bodies are primarily considered as an annual regulatory requirement and not a management tool. Most urban local bodies prepare budgets on cash

basis failing to capture the full cost by excluding several items of non-cash revenues and expenses (including depreciation). Budget formats are generally prescribed in municipal acts or rules; however, most state legislation does not outline any scientific basis for budgeting. Lack of adequate guidelines and formats have resulted in urban local bodies preparing budgets based on incremental estimates of revenue and expenditures. This has resulted in significant variations between budgeted and actual figures, thus resulting in lack of accountability.

88. Most ULB budgets are revenue based with almost exclusive focus on input (i.e., expenditure), and performance being judged in terms of spending. This has usually resulted in poor expenditure controls, inadequate reporting, and an incentive to spend the budget allocation as soon as possible, thus lacking focus on actual service delivery. The concept of linking budgets to strategic vision or multi-year budgeting is almost nonexistent.

89. The need for public participation and oversight in budget preparation is not mandated in Indian urban local bodies. As a result, barring a few urban local bodies, budgets are prepared without any debate with citizens or citizens groups. This has also resulted in urban local bodies preparing budgets not focused on needs of the poor and the pro-poor.

Progress

90. Some attempts at standardizing and developing better participative budgets have been made in India, but these are largely stand-alone efforts. JNNURM and other reform initiatives have emphasized the importance of long-term strategic planning, which would link to annual planning and budgeting exercise.

91. Some states have taken the initiative of preparing standard and scientific reporting formats for budgets. Karnataka (Box 2.2), Andhra Pradesh (Box 2.3) and Kerala are the torchbearers in this effort. With advent of JNNURM, more states are expected to improve their budget systems. While Karnataka has set up standard and scientific guidelines and formats for preparation of budget documents, Kapra (Andhra Pradesh) demonstrates use of multi-year budget planning in urban local bodies, taking into account the regular income and expenditure account, as well as additional expenditure for operation and maintenance.

Box 2.2. ULB Budget Reforms of Karnataka

Karnataka has taken up budgeting reforms along with its implementation of a double entry accounting system. The Karnataka Municipal (Accounting) Rules, 1965, have been replaced by Karnataka Municipal (Accounting & Budgeting) Rules, 2006. According to the 2006 Rules, the existing budgeting forms are proposed to be replaced with a summary sheet and a set of 8 schedules—estimate of revenue receipts, revenue payments, capital receipts, capital payments, loans repayment, loans & advances, deposits & recoveries and investments made.^a This breakup of budget forms is expected to facilitate better planning and a more accurate estimation by the urban local bodies. The process of budgeting has been streamlined providing for a number of Budget Information Data Sheets to be used by urban local bodies for working out detailed calculations for budgeting purpose. A system of budgetary control has been prescribed and a monthly budget variance report has been mandated.

^a Suggested by Infrastructure Professionals Enterprise (P) Ltd as the Nodal Firm for implementation of a fund-based accounting system in 43 municipalities of Karnataka.

92. In the post-74th CAA era also, instances of public debate over ULB budgets and planning process are limited in India; Bangalore being a notable exception. Ward committees, envisaged as institutions enabling public participation, have either not been formed or are not active in most states. West Bengal and Kerala are notable exceptions in this case wherein a bottom-up budgeting process has been adopted.

Box 2.3. Budget as a Tool for Long-Term Strategic Planning in Kapra Municipality

Post 2003-04, Kapra Municipality adopted a multi-year perspective for the preparation of budgets.^a In 2004-05, a multi-year financial operating plan was prepared with assistance from Andhra Pradesh Urban Infrastructure Development Fund Corporation. The DFID-funded Andhra Pradesh Urban Services for Poor (APUSP) program under the Comprehensive Municipal Action Plan for Poverty Reduction stresses the need for comprehensive and long-term (financial) planning to enable revenue inflow and expenditure over a longer term. The model financial operating plan has been designed to assess the impact of proposed investment over the planning horizon (20 years). This model takes into account the regular income and expenditure account of the local body as well as additional expenditure for operation and maintenance due to increased service levels and proposed creation of infrastructure. A financial operating plan also acts as an important factor in the preparation of the annual budget.

^a The municipality at the time was not under the APUSP program but as the municipal commissioner had worked previously with the APUSP and realized the importance of preparing a financial operating plan, he initiated the process in Kapra. This is a good example of benefit of building capacity of the municipal officials.

93. Kerala has introduced the concept of the People's Planning Campaign for participatory planning and budgeting, which follows a bottom-up approach. Budgets are first prepared by respective wards committees and submitted to the urban local body. The local body bases its budget on this input and sends for approval. This allows a more efficient demarcation and utilization of the approved budget, and improves accountability through enhanced public participation along with other key stakeholders. Inputs from budget prepared by all urban local bodies were taken for preparation of the Ninth Five-Year Plan budget for Kerala, setting a precedent in this area.¹⁵

94. Innovative practices like the Public Record of Operations and Finances (PROOF) forum in Bangalore have also been useful in involving citizens in the budget exercise (Box 2.4). However, sustainability and replicability of such initiatives need to be tested. For instance, in Bangalore itself, lack of participation of councilors who pass the budget in the PROOF platform has had a negative impact on accountability to some extent.¹⁶

Key Findings and Way Ahead

95. Efforts undertaken by Karnataka, Kerala, and Andhra Pradesh emerge as practices that could be replicated across other states. With the advent of JNNURM, reforms in area of budget planning are expected. There is, however, a need to shift from an input focus to output/outcome focus budgeting wherein urban local bodies can be held accountable for delivery of services rather than merely the expenditure made for it (Box 2.5).

Box 2.4. PROOF Initiative in Bangalore

The PROOF campaign was a collaborative effort of four non-profit, independent, nongovernmental organizations for carrying out budget analysis and fiscal performance audit of Bangalore Mahanagar Palike (BMP). This initiative was started in 2002 with a focus on "disclosure, debate, dialogue, and discussion" on the use of public funds. Efforts were made to involve citizens in performance audit.

¹⁵ K. N. Harilal, Reforming Local Governance Structures in India, Lessons from the Kerala Experiment. Paper presented in the International Symposium Citizen's Participation in Local Public Policy Making: European Experiences in Global Perspectives, 8-9 November, 2004, VNG International, The Hague, Holland.

¹⁶ While most councilors prefer to remain absent from PROOF meetings, some politically conscious and seasoned councilors have used PROOF as an opportunity for forwarding their political ambitions. Since the number of such councilors is limited, there has been no conflicts of interest. However, PROOF is wary of this trend. (From discussions with Swati Ramanathan, June 2006).

Box 2.4. PROOF Initiative in Bangalore

The PROOF campaign draws from practices in corporate governance on disclosure of financial performance.^a Despite distinct methods in performance and administrative structures, the common principle between corporate governance and local governance is the efficacy in utilization of public funds. The model adopted by PROOF was that of the Governmental Accounting Standards Board.^b The PROOF campaign focused on three aspects: (a) obtaining quarterly financial statements from the Government (now half-yearly), (b) developing performance indicators for assessing work done by BMP largely incorporating the report card concept, and (c) involving the public in BMP functioning.

PROOF has also been involved in questioning rationale behind budget allocations; this has had positive implications for budget allocations and improved accountability of BMP, but the efforts have been limited (schools and public toilets). An analysis of BMP-incurred expenditure on BMP-supported schools revealed that per student expenditure was more than even in the best of private schools. PROOF used its BMP-citizens interface to bring this issue forward. Since then, suitable changes/actions have been taken to ensure better budget utilization.

^a For a detailed note on the history of Corporate Disclosure & Financial Statements, see Ramesh Ramanathan, Public Record of Operations and Finance: PROOF: Campaign Note, Janaagraha, Bangalore, 2002.

^b Governmental Accounting Standards Board was organized in 1984 by the Financial Accounting Foundation to establish standards of financial accounting and reporting for state and local governments in United States of America.

Box 2.5. Output/Outcome Budgeting

Output-based budgeting requires policy makers to define 'outputs'. These outputs are tangible products (such as the number of tubewells and the number kilometers of road) and, based on a system of elimination and prioritization, resource allocation is made for the accepted output. These outputs are further linked to outcomes—larger social benefit flows from the provision of outputs.

The major utility of output/outcome budgets is to facilitate performance monitoring using physical indicators. However, it is this conversion of outputs to outcomes that is critical to the process of outcome budgets. The steps involved are (a) defining intermediate and final outcomes specifically in measurable and monitorable terms, (b) standardizing unit cost of delivery, (c) benchmarking the standards/quality of outcomes or services, (d) setting up effective monitoring and evaluation systems, and (e) facilitating these through ensuring flow of funds and capacity building.

The Government of India has already developed an Outcome Budgeting Model that from 2006-07 is used to plan and report budgets for all national ministries and departments.

96. Outcome budgeting will require a revision of budgeting practices, such as defining programs, outputs and regrouping of budget heads. It will improve budget monitoring and enable measurement against outcomes. As more is learned from national outcome-based budget under JNNURM, it could become the norm for increasing accountability and external oversight in urban local bodies.

97. Going forward, the central government can consider preparation of a Model Budgeting Manual (on NMAM lines) with assistance from the C&AG and the Institute of Chartered Accountants of India (ICAI), and involvement of states and urban local bodies. This Model Budgeting Manual could look at outlining policies, procedures, and formats for budget estimation in urban local bodies; establishing role of community/other key stakeholders; and establishing linkages with budgets of parastatal/metropolitan plans. Other areas where the Model Budgeting Manual should focus include:

- (a) *Public participation*: creating linkages with citizen/ward/community structures for identifying local problems, solutions, and priorities. Models like PROOF adopted in Bangalore could be streamlined and institutionalized in this context;
- (b) *Pro-poor budgeting*: prioritizing concerns of the poor and focusing on services in under-served areas;
- (c) *Budget forecasting*: identifying procedures for seeking evidence-based estimates to allow better estimation, prioritization, and allocation. Models like Budget Information Data Sheets propagated in Karnataka can be reviewed for its adoption as a mandatory output;

- (d) *Multi-year rolling plans*: annual budgets need to be developed within ambit of multi-year rolling plans for capital investment. The concept of Medium-Term Expenditure Framework (MTEF), financial operating plan, etc., could be explored; and
- (e) *Capital investment and procurement planning*: systems for allowing investment planning, estimation of requirement, timing and sequence of purchases, procurement planning and control, etc., need to be brought in.
- (f) The provision of appropriate software for budgeting should also be considered.

Desired Outcome

98. The outcome of realistic, comprehensive, and participatory budget preparation would be efficient ULB resource spending leading to improved accountability.

2.C. BUDGET EXECUTION

Key Benchmark

99. The basis for a well-executed budget is when policy is appropriately translated into action, wherein the budget document is actively used for detailed planning, procurement, and expenditure control. The key indicators in this regard are shown in Table 2.4.

Table 2.4. Budget Execution

<i>Indicator</i>
Budget is effectively used as the central tool for planning, control, and management linked to various activities across the urban local bodies. <ul style="list-style-type: none"> • Not more than (%) variation in budget and actual expenditure and receipts.
Budget is linked an integrated financial management information system. <ul style="list-style-type: none"> • Periodic (quarterly) reviews of budget with the actual are done.
Budget analysis reports are prepared on at least quarterly basis – within one month of the end of the quarter. <ul style="list-style-type: none"> • Sent to state government for external oversight. • Made available to public for discussion and accountability.

Policy and Practice

100. Budget execution in urban local bodies is largely guided by respective acts and rules. Lack of standardized procedures in this regard results in large budget variances. This results in some budget heads not being fully utilized, and some budget heads facing critical shortages with no mechanisms to balance the two.

101. Presently, expenditure is not conditional on resource realization. The operating departments use their allocations irrespective of revenue realized or availability of money. This further leads to the need for rescheduling of the budget heads. Since salary expenses are already fixed, any shortfall in revenues invariably leads to cut in capital expenditure and operation and maintenance.

102. Budget monitoring practices differ across states. In general, the Department of Municipal Administration is required to monitor ULB budgets externally while internally the Standing Committee/Council is responsible for ensuring that budgets are adhered to. Since municipal acts and rules do not mandate regular budget monitoring, there is little data on whether this is done.

Progress

103. There has been limited progress in the area of budget execution by urban local bodies. Only few acts (as in Kerala, for example) provide for verifying budgeted expenditure with actuals. The recent Karnataka Municipal Accounting Rules have prescribed a monthly reporting format for budget variance. Citizen participation also remains weak except for the few partial successes like the PROOF initiative. With limited own source revenues, the dependence on state funds is still high, and their unpredictability remains a serious concern for effective budget execution.

104. The recent recommendation of the Twelfth Finance Commission for state enactment of fiscal responsibility legislation is a step in this direction (Box 2.6).

Box 2.6. Fiscal Responsibility and Budget Management Act

In 2003, the Conference of State Finance Secretaries decided that the Reserve Bank of India would provide technical assistance to help states prepare fiscal responsibility legislation. The Reserve Bank of India circulated a model fiscal responsibility bill to the states. Recently, states of Karnataka, Punjab, Kerala, Tamil Nadu, Uttar Pradesh, Maharashtra, Orissa, Rajasthan, Assam, Gujarat, Himachal Pradesh, Haryana, Chattisgarh, Madhya Pradesh Tripura, and Andhra Pradesh have all enacted the Fiscal Responsibility and Budget Management Act. However, improvements in ULB budgetary systems are yet to accrue from this Act.

Source: Fitch Ratings, India Special Report, March 20, 2006.

Key Findings and Way Ahead

105. Budget planning must be seen as a development process and not merely a statutory exercise, only then can it be used as a management aid. For starters, standard budget formats need to be developed by urban local bodies; this could be done similar to the C&AG-prescribed budget format for PRIs. Policy-based budgeting needs to be supported, and urban local bodies need to focus on outcome-based budgeting. In this context, efforts of JNNURM to promote preparation of city development plans and financial operating plan would be useful.¹⁷ Process for monitoring of state-level ULB budgets also need to be strengthened. Tamil Nadu and Andhra Pradesh have already taken positive steps in this direction.

106. States also need to take initiatives to ensure regular and timely transfer of budgetary allocations prescribed by their respective State Finance Commissions, as done in Tamil Nadu. This effort has presented urban local bodies in Tamil Nadu a means to effectively plan their expenses in advance and reduce misutilization of funds.

107. Disclosure of financial information in urban local bodies also needs to be strengthened. Participation of citizens in review of budgetary performance (allocations and spending) needs to be encouraged. Adoption of international good practices, such as disclosure requirements set by the International Public Sector Accounting Standards (IPSAS) would also encourage reporting of budget variances by urban local bodies.

108. The Model Municipal Law supports a range of reforms, including processes and established timelines for preparation and approval of budget, clear demarcation of outstanding loans and recoveries from own source revenue heads, and clear demarcation of item-wise receipt and expenditure. Pressure needs to be mounted from the central government to ensure implementation of these critical areas of reforms by states.

Desired Outcome

109. The desired outcome of good budget execution would be the appropriate and timely translation of policies into action by the urban local bodies.

2.D. ACCOUNTING AND MANAGEMENT INFORMATION SYSTEMS

Key Benchmark

110. The benchmark of a good accounting system is the production of timely accurate accounts. Good accounting should appropriately reflect the transactions and balances of the entity, should adequately disclose all items that have a material impact on the financial status of the entity. Good accounting comprises provision of appropriate information with three broad purposes:

- (a) Effectively record all transactions and balances of the urban local body;
- (b) Facilitate budgeting and planning of revenues, expenditures, and debt management; and
- (c) Help the government be accountable to the public.

111. The three purposes reflect the progressive stages in the accounting spectrum, moving from routine recording of transactions to management decision making to accountability. To ensure progress in the three purposes, it is required that financial information should be complete, accurate, timely, and

¹⁷ Annex C discusses PFMA reforms and progress under JNNURM.

meaningful. The systems should generate information that is useful to decision makers, provides information in a user-friendly way, and is integrated with the budgeting process. It should be prepared in accordance with accepted policies of accrual accounting and follow good practices on municipal accounting and disclosure (Table 2.5).

Table 2.5. Accounting and Management Information System

<i>Indicator</i>	<i>Source</i>
Financial information system is comprehensive, accurate, and provides timely information for decision making. <ul style="list-style-type: none"> • Monthly accounts are prepared and circulated. • Year-end annual accounts are prepared within prescribed time. • Accounts committee is in place and functional with regular meeting. 	Accounts Department and Management Information System
Financial statements are prepared using double entry accrual-based accounting. <ul style="list-style-type: none"> • Opening balance sheet in place. 	Accounting Rules, Reports
Accounts department has sufficient and appropriate staff to carry out necessary functions and utilizes computerized accounting systems.	Accounts Department / Head
Reports/information are made available to public. <ul style="list-style-type: none"> • Quarterly accounts reports are made available to public through website, newspaper, or other publicly accessible media. 	Accounts department, citizens, nongovernmental organizations

Policy and Practice

112. The current system of municipal accounting is characterized by two features: single entry system of bookkeeping¹⁸ and cash basis of accounting.¹⁹ This leads to certain weaknesses: (a) no segregation between revenue and capital expenses, (b) inability to prepare a complete balance sheet, (c) poor information about assets and liabilities, (d) non recognition of depreciation and other non-cash expenses, and (e) omission of receivables and payables distorting the true and fair performance reporting of the urban local bodies. Recognizing these drawbacks, the Indian Government's National Municipal Accounting Manual prescribes standard policies, documentation, and reporting requirements under an accrual-based double entry accounting system. However, the Manual only recommends, and is not mandatory. Although many states have adopted NMAM with some modification, there are others which have not. Some of the key accounting pronouncements that are used for ULB accounting are given in Box 2.6:

Box 2.6. Sources of Municipal Accounting Policies

The Institute of Chartered Accountants of India

The Institute of Chartered Accountants of India brought out a Technical Guide on Urban Local Bodies in September 2000 that recommends the adoption of accrual accounting in urban local bodies and advises on the applicability of various accounting standards to urban local bodies. To date, the ICAI has released 29 accounting standards that apply at varying levels of importance and relevance to urban local bodies.

Ministry of Urban Development, Government of India

The National Municipal Accounting Manual was developed by the Government of India with participation of the C&AG and state governments. The Manual is based on the accrual-based double entry accounting system and also permits fund accounting, if desired. It is a template that can be used by states to adapt to their requirements. It also prescribes a structure for Chart of Accounts and recommended formats for financial books and reports. However, the National Municipal Accounting Manual only catered to accounting requirements and did not extend to budgeting.

¹⁸ Records are maintained through a number of registers rather than the double entry system of debits and credits.

¹⁹ Transactions are recorded only when cash (or checks) are received or paid and not when benefits are received or provided. Thus, receivables, payables, non-cash items of expenditure, provisions, etc. are not considered in the accounts therefore the real ULB financial picture remains obscure.

International Public Sector Accounting Standards Board

International Public Sector Accounting Standards are international standards for state and local governments released by the Public Sector Accounting Committee of the International Federation of Accountants (IFAC). The IFAC has issued several accrual-based IPSAS since May 2000. It has also released a standard on cash basis of accounting and has conducted research studies on moving from cash to accrual basis in government accounting.

Governmental Accounting Standards Board, USA

The Governmental Accounting Standards Board (GASB) is the supreme authority to promulgate accounting standards and requirement for state and local governments in the United States. Its pronouncements form the U.S. generally accepted accounting policies. These requirements are put together into a Codification of Governmental Accounting and Financial Reporting Standards. This code sets the standards for governmental financial reporting and accounting in the United States, including for local bodies.

113. In states where single entry system of accounting is prescribed, the only reporting mechanism is the actuals figure mentioned in the budget format (usually in the budget of the second year following the end of the financial period). Apart from this, the other reporting documents are the Annual Administrative Report and the Audit Report.

114. The Annual Administrative Reports in almost all states comprise function-wise information about the various activities undertaken, results achieved and other happenings. These reports include annual financial statements. While preparation of the annual administrative report is mandatory under prevalent ULB legislation, in most cases these reports are not prepared and published on time. This reduces much of their value.

Progress

115. Apart from individual city efforts, Tamil Nadu is the only state to have implemented double entry accrual-based accounting in all its urban local bodies. In fact this was achieved in 1999 before the National Municipal Accounting Manual was developed. Efforts are ongoing for state-level implementation in Karnataka, Uttar Pradesh, and Rajasthan.

116. The National Municipal Accounting Manual today can only recommend a good starting point for conversion to a double entry accounting system. It needs considerable state effort to adapt and use in their urban local bodies. The current status of accounting reforms and adoption of a NMAM-based double entry accounting system is shown in Table 2.6. Some of the state-level accounting initiatives have been discussed and compared in Annex B.

Table 2.6. Situation of Conversion to a NMAM-based Double Entry Accounting System

<i>JNNURM commitment for double entry accounting system (by year) – signed memorandum of agreement</i>	<i>Initiated process of conversion to double entry accounting system on their own</i>	<i>States still to make major progress in double entry accounting system</i>
Andhra Pradesh (3), Chattisgarh (3), Gujarat (3), Madhya Pradesh (3-4), Maharashtra (2) (Pre-NMAM), Rajasthan (0), Tamil Nadu (0) (Pre-NMAM), West Bengal (2-4)	Orissa, Kerala, Uttar Pradesh, Karnataka, Delhi	Punjab, Bihar, Himachal Pradesh, Jharkhand, Uttaranchal, Manipur, J&K, Arunachal Pradesh, Assam, Tripura, Mizoram, Nagaland, Sikkim

Key Findings and Way Ahead

117. Some key benefits likely to accrue through adoption of the National Municipal Accounting Manual include adoption of uniform accrual-based accounting policies and preparation of true and fair' financial statements; standardization of financial recording and reporting formats, and ability to consolidate ULB accounts at state and national levels using the standard Chart of Accounts under the Manual. However, two aspects need to be highlighted: (a) states will need support for implementation of the manual and (b) once the process of switch over to accrual accounts stabilizes, the Ministry of Urban Development and the Apex Level technical Committee, could at a later stage consider reviewing the provisions of the

Manual against the internationally accepted standards and principles (Box 2.8).

Box 2.8. IPSAS and NMAM

The International Public Sector Accounting Standards are drawn from good practices worldwide in government and public sector accounting. IPSAS not only reflect the unique aspect of government (such as emphasizing the service nature of functions, include definition of service assets) but also the nature of government accounting (such as providing a separate treatment for non-exchange transactions like taxes). Similarly, the IPSAS on budgeting mandates presentation of comparative information between budget and actual figures.

The National Municipal Accounting Manual, while incorporating good practices from the Indian accounting context, could benefit from a review against the IPSAS requirements. Revision of the National Municipal Accounting Manual to incorporate these measures would improve the financial recording and reporting environment in urban local bodies in India.

118. The state-level implementation of the National Municipal Accounting Manual requires (a) modifying the Manual to suit state/ULB requirements; (b) amending accounting rules; (c) strengthening capacity of staff to implement the new system and implementation of training; (d) preparing opening balance sheet, including data collection and reconciliations; (e) integrating budgeting system in order to synergize the planning, execution, and evaluation ULB functions; and (F) improving management information system for enabling the financial information to be used for decision making. Of these, the capacity of staff needs to be addressed upfront as implementation success will definitely hinge on this issue. Some guidance on finance personnel is provided in Box 2.9.

119. Key initiatives that could be taken up to strengthen the accounting and MIS aspects would include (a) design and development of model municipal accounting rules based on accrual accounting for states to adopt; (b) dissemination of good practices in municipal accounting through workshops, site visits, and documentation; (c) specialized technical assistance to states for preparation of opening balance sheet, customization of accounting manual, and implementation support; and (d) demonstration of good decision making using financial statements and systems. It is generally found that even if financial information is available, its usage is limited.

Box 2.9. Human Resource Structure Supporting ULB Financial Management

There is no doubt that the capacity of financial management staff is very weak in medium- and small-size urban local bodies in India. Most urban local bodies do not have qualified accountants and have little possibility of having chartered accountants or finance professionals. According to the Companies Act, 1956, any company with a share capital in excess of Rs.2 crores (US\$0.4 million) is required to engage a full-time company secretary. Most private firms with a turnover of Rs. 5 crores (US\$1.1 million) hire full-time chartered accountants. However, in urban local bodies where the annual budget is much in excess of the above-mentioned figures, there is no provision for qualified finance and accounting professionals. Kolkata Municipal Corporation has a budget of over Rs.600 crores (US\$135 million) but does not have a single chartered accountant among its employees²⁰. A typical profile required for the financial controller of a large urban local body should be a qualified chartered accountant with experience in double entry accrual accounting, planning, and management. The chartered accountant should be assisted by qualified professionals with expertise or experience in finance, accounting, audit, budgeting, and management. Based on this, detailed guidelines need to be developed for appropriate human resource structure in urban local bodies of different sizes and needs.

Desired Outcome

120. The desired outcome would be to have an integrated financial management information system that provides complete, accurate, timely, and reliable data for decision making.

2.E. REPORTING

Key Benchmark

121. Timely, meaningful, and user-friendly dissemination of ULB financial reports is a prerequisite for effective and transparent management. Preparation of various financial and analysis reports enables

²⁰ Except those who have come on deputation from the State Government Finance and Accounts service.

comparison and helps identify deviations. This in turn facilitates better budgeting and stakeholder participation. Indicators of a sound reporting system are listed in Table 2.7.

Table 2.7. Reporting

<i>Indicator</i>
Budget, certified accounts, audit reports, and other statements are available within 6 months of year end <ul style="list-style-type: none"> • Current budget analysis and audit report is widely circulated.
Reports are widely available and disseminated (including through media, website, etc.).
Facilitate comparison and analysis for variations. <ul style="list-style-type: none"> • Comparison with last two years is presented in all reports. • Provides ward-wise, service-wise details.

Policy and Practice

122. Internal and external reporting in urban local bodies remains weak. Legislation is weak in enforcing compilation and dissemination of ULB reports. At most, urban local bodies publish their budgets and accounts in annual reports, of which only a limited number are printed and circulated.

123. Internal ad hoc reporting mechanisms generally do not have proper guidelines. Employees of Bhubaneswar Municipal Corporation note that the internal reporting mechanisms changed with every municipal commissioner, each demanding different sets of information in different formats. They also note that the information passed onto the council and the standing committees also varied over the years because of the same reason.

Progress

124. There has been marginal progress in public financial reporting by urban local bodies. Along the lines of the Management Discussion & Analysis section recommended for financial reports under the Governmental Accounting Standards Board (USA) requirements, some urban local bodies have started including such reporting in their financial statements. The Karnataka Municipalities (Accounting & Budgeting) Rules, 2006, provide for an Annual Performance Report that includes a City Management Report, Auditor's Report, and Financial Statements; it also provides for Cost and Performance Indicators (of which a sample data form is presented in Annex D). Specific timelines are provided for preparation of financial statements, conducting financial statements audit, preparation of Annual Performance Report, and publicizing such report to the public.

125. The *Right to Information Act, 2005* is important legislation enabling citizens to access information. Other efforts toward public reporting—Public Disclosure Law, National e-Governance Action Plan (NEGAP), and citizen facilitation centers—have been initiated in select urban local bodies.

126. *Citizen facilitation centers.* National Mission Mode Project on e-governance in municipalities under the NEGAP has opted for citizen facilitation centers as their service delivery provider. Citizen facilitation centers act as a direct interface between the local government and the citizenry thereby bridging the information gap. Services generally covered by citizen facilitation centers include registration of and issuing birth/death certificates, collection of property tax and utility bills, responding to grievances and suggestions, issuing building approvals, administering health programs, and handling municipal accounts and financial reports. With the Right to Information Act in place, the role of citizen facilitation centers has assumed greater significance, but the absence of ready information by urban local bodies makes the impact limited in the PFMA context.

127. *The Urban Local Government Disclosure Bill, 2006* proposes pro-active disclosure of information by the urban local bodies. The broad PFMA-related areas covered include annual budget allocations to each ward indicating particulars of the plans; proposed expenditure and major services provided; particulars of major works; the manner of execution and amounts allocated; particulars of officers who grant concession, permits, or authorization; and details of municipal funds, including taxes, duties, and grants.

Key Findings and Way Ahead

128. While the environment for reporting is improving, there is still lack of demand for such information internally from municipal staff and externally from citizens. Municipal staff need orientation in collecting, reporting, and using such information. As for citizen groups, there is need for media campaigns (similar to

those in Right to Information) to ensure that the community starts demanding information and uses it to make the ULB machinery accountable. The Public Disclosure Bill needs to be enacted in each state under JNNURM and should be able to address a number of concerns in reporting.

129. In the meanwhile, urban local bodies should commit to preparing their financial reports within 6 months of year-end and should include necessary explanations and details in a GASB-recommended section, Management Discussion & Analysis. The financial statements should also include some costs and performance indicators on the lines of Karnataka Municipalities (Accounting & Budgeting) Rules, 2006. These reports should be accessible by citizens through various means including a common portal hosted by the government.

Desired Outcome

130. A timely and user-friendly reporting system is in place allowing effective engagement with various stakeholders.

2.F. CASH AND FUND FLOW MANAGEMENT

Key Benchmark

131. The basis of efficient cash and fund flow management is that systems of reporting, planning, procurement, and implementation allow optimal management and utilization of ULB resources. This includes efficient management of receipts and receivables, judicious management of payments and payables, and optimal utilization of available funds. Key components are mentioned in Table 2.8.

Table 2.8. Cash and Fund Flow Management

<i>Indicator</i>
Regular reconciliation of cash receipts and cash deposits. <ul style="list-style-type: none"> • Bank reconciliation statements prepared on a monthly basis. • List of debtors and creditors prepared quarterly.
Regular reporting of cash balances made to the council.

Policy and Practice

132. Municipal acts and accounting rules of respective states prescribe systems for maintenance of cash and bank books by ULBs. While the formats are generally followed, the concept of treasury and fund management is lacking in urban local bodies. This results in pending reconciliations, poor scheduling of funds, and suboptimal utilization of available balances.

133. The commonly followed single entry cash-based accounting system does not allow ULBs to generate reliable information on debtors and creditors and therefore inhibits their ability to utilize funds fully.

134. Arrears in bank reconciliation result in inefficient cash management and the ability of ULBs to know and plan their exact fund position and prioritize payments. In some smaller urban local bodies for instance, the bank balance appearing in the bank statement is treated as the amount available for issue of checks; consequently checks are issued even beyond the balance available in the bank account.

Progress

135. In the post-NMAM era, many urban local bodies have managed to improve their cash and fund flow management as a result of availability of information under double entry accounting system. Some urban local bodies have started appreciating the benefits of treasury operation and fund management. A changing economic environment has also benefited urban local bodies. Madurai Municipal Corporation, for example, was effectively able to save around Rs.8 crores of interest repayment through a debt swap.

Key Issues and Way Ahead

136. The double entry accounting system has helped in making cash management information readily available; however, use of such information is still limited. Although largely a capacity issue, successful management of treasury functions requires a strong interdepartmental relationship (including among revenue, engineering, and finance) for it to be successful. In the short run, urban local bodies should be encouraged to access external support for managing treasury functions; especially those related to receivables management, payments scheduling and structuring of projects, and financing mechanisms.

137. A related issue is the restriction on urban local bodies for investment of funds, except in fixed deposits and, in some cases, government bonds. Although urban local bodies should not be encouraged to undertake speculative investments, there is a need to find a balance between risk and returns that urban local bodies should expect from their funds.

Desired Outcome

138. Cash receipts, payments, and fund flows are managed efficiently leading to better utilization of funds.

2.G. PROCUREMENT

Key Benchmark

139. ULB procurement needs to ensure that public purchasing is done in an efficient and effective manner that supports the achievement of the objectives of public spending. The procurement system should be characterized by practices that ensure that the best value for money is obtained through the application of simple rules by competent officials in a transparent fashion that is subject to rigorous oversight by government officials and the community. Key components for procurement are listed in Table 2.9.

Table 2.9. Procurement

<i>Indicator</i>
Procurement regulation is simple, comprehensive, and reflects good practice. <ul style="list-style-type: none">• Regulations for the procurement of goods, works, and services are contained in a single piece of legislation that applies to all institutions wherever public money is used.• Open competition is defined as the default method of procurement.• The rules require effective public disclosure of contact opportunities and awards and contain provisions for an independent appeals mechanism.
Procurement is carried out in a competitive, efficient, and transparent manner. <ul style="list-style-type: none">• % of the value of procurement that takes place through competitive bidding.• % of contracts that are signed without undue delay – within the time periods defined in the regulations.• % of contracts tendered through e-procurement.• % of contact awards posted in an accessible manner in accordance with regulations.• % of contracts subject to delay in payment of suppliers and average period of delay.• % of projects completed on time.
Procurement is subject to rigorous oversight. <ul style="list-style-type: none">• Number of audit findings related to procurement transactions.• Number of complaints regarding procurement, and % of unresolved cases.• Issuing of annual procurement performance report.• Number of public meetings organized to review procurement performance.

Policy and Practice

140. Legislation governing procurement of goods, works, and services are often found in different laws that do not always cover all aspects of contracting. The existing rules frequently do not reflect good practice in areas relating to transparency and efficiency. In most cases it is defined although very rudimentary and mostly based on lowest cost basis (L1 basis). Most state acts prescribe urban local bodies to follow state (procurement work directive) rules for the purpose of procurement. In some cases where donor agencies are funding certain projects, they can insist on conducting procurement based on their guidelines. The concept of value for money is generally missing in procurement guidelines. Procurement rules and guidelines also lack core concepts, such as annual procurement planning and independent complaint-correction mechanisms.²¹

141. The guidelines for procurement prescribe the limits for which one needs to go for limited tendering and above which open tendering is required. Guidelines also prescribe financial limits for which advertisement inviting tenders are to be published in local newspapers and above which invitations have to be released in national newspapers. Most urban local bodies also maintain a roster of contractors based on their ability to execute projects of particular size, and limited tender invitations are sent to the entire list. The roster is developed and updated annually following a process of expression of interest. Most urban local bodies use state (procurement work directive) schedule of rates and quality standards

²¹ Spending done through procurement accounts for between one-third and one-half of all ULB spending. This value is likely to increase in the short term due to planned increases in spending for infrastructure and other capital investments. Most ULBs execute all procurement transactions in-house through user departments.

for execution of projects.

142. It is fair to say that most urban local bodies do not actively manage their procurement systems. There is usually no person who is assigned responsibility for establishing procurement policies, or monitoring and overseeing procurement outcomes. For that reason, there is usually no reporting on procurement outcomes or systematic efforts to improve procurement practices.

Progress

143. In most urban local bodies there is inadequate linkage of procurement with planning. Departments need to be encouraged during the budget preparation to review and plan their tentative procurement schedules and timeframes so that budgets can be appropriately allocated. Some of the urban local bodies have shown progress in this area. In Madurai, each department prepares Budget Information Data Sheets at the beginning of the year detailing the different procurements to be conducted. Similarly, in Bhubaneshwar, a bi-annual list of capital works is drawn and advertised inviting proposals.

144. However, most states do not have any standard documents directing procurement procedures and outlining the forms to be used at various stages of procurements. Lack of standardized procedures also results in delays in tendering processes and award. Such delays largely happen at the evaluation and approval stage since proposals are received in different formats making it difficult to evaluate. Delays in evaluation are also often a result of poorly drafted technical specifications, badly developed project estimates, and unclear criteria for evaluating bids. This can lead to substantial cost overruns for the bidder and procurer. Many urban local bodies maintain a roster of contractors based on their ability to execute projects of particular size, and limited tender invitations are sent to the entire list. The roster is developed and updated annually following a process of expression of interest. Most urban local bodies use state (procurement work directive) schedule of rates and quality standards for execution of projects.

145. Some progress is being made in this area through e-procurement, which is a relatively new concept for urban local bodies in India. Andhra Pradesh has launched e-procurement for all its urban local bodies in the state. It is one of the few states to have taken this initiative (Box 2.10). In other states, e-procurement initiatives are largely limited to donor-funded projects. However, Rajasthan (under ADB funding) and Kerala (under RNE and DFID funding) are now set to expand the project-based e-procurement to statewide e-procurement.

Box 2.10. E-Procurement in Andhra Pradesh

Through a July 2004 order, the Andhra Pradesh state government stated that all the existing rules applicable to the processing of conventional tenders would be applicable to bids secured through e-procurement. The government also stated that e-procurement should be followed by all departments, public service units, and local bodies for procurement of works costing above Rs.10 lakhs and goods and services costing above Rs.5 lakhs.

Even before this order, the state government had clearly defined the procedure of procurement starting from allocating funds for developmental works through budgeting. Only works up to 5 percent of the allocated amount for any sector/scheme were allowed to be let out on nomination basis on emergency/immediate need basis. The state developed an e-procurement website—eprocmnt.gov.in—which is a comprehensive e-infrastructure that helps the government and the citizens realize the vision of fuelling growth via services like catalog purchase, e-tendering, and e-auctions. The platform provides its members with access to several trading suppliers. The tender management software helps both the buyers and the suppliers to reduce cycle time, unnecessary paper work, and long queue waits; and simultaneously maintain the transparency in the entire process.

146. There is a marked absence of transparency when informing citizens about various bids awarded and works done. An exception is the case of Hubli-Dharwar Municipal Corporation (Karnataka), which has an on-line grievance system. The system allows the public to see the list of short-listed firms for a tender, the firm to whom tender has been awarded, the time duration within which the tender has to be implemented, and the concerned ULB nodal official in charge. After completion of works, the Corporation displays the contractor's invoices online for seven days inviting objections/complaints from citizens on work performance. Payments to contractors are made only if no complaints are registered or after all complaints have been addressed by the contractor.

147. Following conventional practices, most original bids and records are generally preserved by urban local bodies; these are however not put to use during the implementation process wherein the urban local body can ask the contractor/consultant to take alternate approaches proposed in other bids that are better suited to local requirements.

148. Given the fiduciary risks involved in procurement, transactions are subject to oversight by internal and external audit. However, oversight function is not undertaken effectively given the weakness of the audit systems.

Key Findings and Way Ahead

149. Improving the performance of ULB procurement systems is an important direct way to improve spending quality and enhance service delivery. Effective procurement systems feature executing agencies that devote sufficient attention to ensuring that they get value for money in their purchases; clear and consistent rules applied efficiently by skilled procurement specialists; a competitive private sector that actively seeks government contracts; and constructive processes for monitoring outcomes that involve external audit bodies, legislatures, business associations, and groups that directly use procured goods, services, and works. Most urban local bodies have weak procurement systems.

150. Detailed guidelines would increase the accountability and transparency in the ULB procurement process. A useful approach to improving procurement in urban local bodies would combine the following:

- simplification of rules supported by the drafting of a model procurement law, including standard formats and procedures;
- standardization of procurement practices and exploration of e-government procurement; and
- enhanced monitoring achieved through strengthened auditing, enhanced provision of information on procurement, the publishing of an annual procurement report, and the holding of public meetings to discuss planned and on-going procurement and elicit public comments.

151. These steps would need to be complemented by capacity-building efforts of concerned officials for proper application of rules and establishing procedures to improve the quality of technical specifications and the work of evaluation committees. Certain other innovations such as just in time procurement and value for money procurement also need to be looked into for adoption of appropriate policies at the ULB level.

152. Urban local bodies need to begin to develop skills to manage new relations with the private sector. The ULB infrastructure needs far outstrip traditional funding sources. Public-private partnerships hold out promise for greatly expanding the resources available to government for infrastructure development and, when used effectively, mutually benefiting both sides of the partnership.

153. While the 74th CCA envisages reducing ULB dependence on traditional systems of municipal funding based on planned and budgetary allocations, urban local bodies are not prepared to take on this task. Limited finances, greater public demand for efficiency, and recent successes in private sector involvement have led to public-private partnership emerging as a potent instrument for improved service delivery. Most urban local bodies lack clear-cut guidelines to deal with the private sector. It is vital for urban local bodies to establish clear rules defining the process. These rules ensure that all partnerships are formed in appropriate circumstances in a transparent and competitive manner, and that contracts are then managed in a professional and competent fashion.

154. Some states, including Gujarat and Andhra Pradesh, have passed legislations to regulate private sector involvement in service delivery and other municipal functions. The Andhra Pradesh Infrastructure Development Enabling Act, 2001, looks at improving service delivery and attracting private sector participation in all aspects of project management of bankable projects in the state. The 2001 Act provides comprehensive legislation for reducing administrative and procedural delays, identifying generic project risks, detailing various incentives, and detailing project delivery process. Similarly Karnataka and Tamil Nadu have also passed the Transparency in Public Procurement Act.

155. In general, there is a need for preparation of standard documents and for dissemination of good practice in public-private partnerships in urban local bodies.

Desired Outcome

156. An efficient system of procurement is in place promoting increased competition among vendors and providing greater value for money to the urban local body.

2.H. INTERNAL CONTROL AND AUDIT

Key Benchmark

157. A good internal control framework comprises clear policies, systems, and procedures incorporating internal checks and controls, and a monitoring mechanism to identify deviations and promptly address risk areas. Key components for internal control and audit are listed in Table 2.10.

Table 2.10. Internal Control and Audit

<i>Indicator</i>
Clearly defined internal control framework and processes in place to ensure compliance with the controls. <ul style="list-style-type: none">• Internal controls and operations manual in use.• Audit committee is in place and functional with regular meeting.
Internal audit function is effective and produces timely reports aimed at corrective actions. <ul style="list-style-type: none">• Monthly reports are prepared and responded to.• Mechanism for pre-audit is in place.• Performance/efficiency issues are looked at.
Internal audit department/agency has necessary capacity to undertake functions.

Policy and Practice

158. Most legislation governing urban local bodies does not provide for internal audit. However, some larger corporations are required to have internal audit carried out. The Chennai City Municipal Corporation Act provides for carrying out an internal audit but the function is more aligned to transactional control rather than risk based control and lacks adequate independence required for it to be effective. The Kolkata Municipal Corporation Act, 1980, provides for a position of Chief Municipal Auditor responsible for undertaking internal audits periodically. Other large urban local bodies (Bangalore, for example) have also set up a separate audit department with responsibility for undertaking concurrent audits. These departments are staffed by the State Accounts Department. But the structure of the function needs to be critically reviewed to provide it with the independence and risk based focus that it requires for it to be effective. In light of the shift to modern systems of accounting, and the building constituency of demand for good governance and better disclosure, the need for a strong internal audit function has become pronounced.

Progress

159. There has been limited progress on internal audit. While some states, like West Bengal, have moved ahead in terms of transparency and financial accountability, other states are yet to embrace the internal audit function. In Kolkata Municipal Corporation, the Municipal Accounts Committee acts as a check on the financial activities of the council. This has become an effective means of exercising legislative oversight on financial functions of the urban local body and its staff. Even in urban local bodies where internal audit is prescribed, there is generally an absence of detailed policy guidelines, procedures, and formats for such audits, making it a sort of ritual without much impact on the PFMA environment.

Key Findings and Way Ahead

160. Urban local bodies need to have a separate department for internal audit and hire or train necessary staff to conduct internal audit efficiently. The role of the Audit Committee should be structured along the lines of the private sector with independent representatives of the public in addition to the Councilors. States could empanel professional firms to act as auditors of urban local bodies and the C&AG could take the lead in prescribing guidelines, roles, and responsibilities of ULB internal auditors. The implementation of a phased internal audit could cover larger urban local bodies first.

Desired Outcome

161. An effective framework for internal control and audit is in place for ULB transactions.

2.1. ASSETS AND LIABILITIES MANAGEMENT

Key Benchmark

162. Effective asset and liability management is important for efficient operational performance by urban local bodies. The benchmark would be an asset management system providing information to the ULB about its assets and liabilities in order to facilitate prudent financial management. Key components for assets and liabilities management are listed in Table 2.11.

Table 2.11. Asset and Liabilities Management

<i>Indicator</i>
List of all movable and immovable assets is available and up to date with details like location, purchase details, name of official responsible, etc., with unique identification number. <ul style="list-style-type: none">• Updated annual asset register easily accessible• Clear rules for valuation and depreciation are in place.
Information available from asset base and liabilities is effectively used for decision making and maintenance. <ul style="list-style-type: none">• Used as a tool to monitor recoveries (current assets) and maintenance (of fixed assets).• List of assets with encroachments and legal proceedings is available.• List of overdue current assets is used to initiate recoveries and legal proceedings.• Capital assets/properties are used for revenue mobilization/replacement.• List of liabilities is prepared on a monthly basis.• Records for actual and contingent liabilities are maintained.
Clear-cut guidelines are available for acquisition of new assets and management of old assets. <ul style="list-style-type: none">• All use of municipal assets is duly approved by council.

Policy and Practice

163. ULBs generally hold a significant amount of fixed assets in land, buildings, and infrastructure. Some local bodies (New Delhi Municipal Corporation, for example) have exploited the commercial potential of municipal properties (especially land) to generate significant revenues. For infrastructure assets, maintenance is poor; and expenditure for operation and maintenance is either not allocated in the budget or is not available due to deficits.

164. Most urban local bodies do not have a proper inventory of assets nor do they update them regularly. Often villages on the periphery are brought into municipal limits as the city expands. Panchayat land then comes under municipal ownership, which is often unrecorded in the ULB records. Similarly, there is an incomplete list of equipment and infrastructure in most urban local bodies.

165. On the liabilities side, urban local bodies again do not have complete listings of creditors. In a cash-based system, the expenditure gets booked only when the payment is made. Details for other liabilities, such as gratuity and pensions, are not available leading to the inability of the urban local bodies to plan for these expenses in advance. Although a gratuity and pension register is maintained in Bhubaneswar Municipal Corporation, it is not used at budget preparation. At the time of budgeting a notional amount based on experience is allocated under this heading, which often has to be revised during the year.

Progress

166. Proper records for assets and liabilities are not maintained in urban local bodies. With the adoption of double entry accounting system, computerization, and mapping technology, it will become easier to assess and record assets.

167. By surveying properties through revenue records, Ludhiana Municipal Corporation added assets of about 800 properties worth an estimated Rs. 190 crores. Asset inventory in Ramanagaram identified saleable assets worth Rs. 16 crores. Indore also prepared a computer database of its properties with USAID assistance through the FIRE(D) project,²² and is developing a strategy for optimal use of these assets.

Key Findings and Way Ahead

168. Although asset management is an area with a high potential for resource mobilization, it has not been given priority. Several options can be evolved to optimally make use of assets to generate sustainable sources of revenue for the ULB. The first task is to conduct a detailed study of assets (including record reviews and field verification) to prepare a complete list of properties with valuation. On completion of this exercise the urban local body can make informed decisions regarding sale, lease, or

²² Financial Institutions and Reforms Expansion (Debt Servicing).

alternative usage of these properties. Each property will need to be handled on a case-by-case basis, and optimal revenue generating options sought. The state will need to encourage urban local bodies to ensure reform action in this area, including higher devolution of funds and improved access to donor support. Proper assets and liabilities records are among key requirements for preparation of opening balance sheets and a prerequisite for double entry accounting system. This could be considered as a reform measure supported under JNNURM or any other central incentive scheme.

Desired Outcome

169. Information about assets and liabilities is available and used for their effective management.

2.J. EXTERNAL AUDIT

Key Benchmark

170. Benchmarks of sound external audit comprise clearly defined standardized systems for timely, independent, and effective external audit leading to improved transparency in usage of public funds. Key components for external audit are listed in Table 2.12.

Table 2.12. External Audit

<i>Indicator</i>
<p>External audit is independent and meaningful (i.e., timely action is taken based on recommendations).</p> <ul style="list-style-type: none"> • Audit is completed within specified time as prescribed under the Act. • Action Taken Report is available as prescribed under the Act.
<p>Performance/management audit is being undertaken (instead of simply a transaction audit).</p> <ul style="list-style-type: none"> • Action Taken Report clearly defines improvement in performance post correction.
<p>Audit findings are reported to stakeholders.</p> <ul style="list-style-type: none"> • Audit findings are tabled in council and council remarks are duly incorporated in Action Taken Report, which is also presented to the council. • Audit Report accompanies Annual Financial Statements and is addressed in the ULB Management’s Report.

Policy and Practice

171. Most municipal acts provide for the appointment of statutory auditors by state governments and this appointment normally goes to the Local Fund Auditor or equivalent authority. The scope of a statutory audit is broadly provided in the municipal act and limited to transaction audits with the objective of identifying cases of fraud; misuse of funds and authority; and noncompliance with rules, regulations, and government orders.

172. The current system generally requires a 100 percent audit of all transactions making it a lengthy and time-consuming job. The general perspective of audit (in case of expenditure) includes the following:

- (a) *Audit against provision of funds*—analyses the financial position of the government, and the trends and quality of receipts and expenditures.
- (b) *Regularity audit*—audit observations on aspects, such as irregularities and nonobservance of rules and regulations, wasteful or unnecessary expenditures, and inefficiency and delays, and non achievement of objectives in project implementation.
- (c) *Propriety audit*—assessing the need, justification, and effectiveness of any expense.
- (d) *Efficiency-cum-performance audit*—evaluate performance of local government on various financial management and accounting issues. While there is a provision for efficiency-cum-performance audit, the comments on this area are very limited. This is primarily due to limited capacity of a Local Fund Audit division to conduct such a review.

173. The general output in such a case is audit comments or paras which include:

- (a) Local audit notes that are expected to be addressed at the individual section/departments audited;

- (b) Inspection reports that contain more important findings to be brought to the attention of department heads; and
- (c) Financial audit reports issued annually and submitted to the state government and tabled at the legislature.

174. Although useful, these audit paras lose their efficacy due to the delay in audits that are caused due to limited capacity of the Local Fund Audit division as well as the increasing number and complexity in ULB transactions. In Bhubaneswar Municipal Corporation, for example, the audit for 2001-02 is currently in progress, and financial audit reports up to 1999-2000 have been tabled.

175. The follow-up process on audit paras is very weak. It takes the urban local bodies a long time to reply to Local Fund Audit remarks and takes more time for issues to get resolved. In case of Bhubaneswar Municipal Corporation, replies for 1998-99 are being currently prepared. At most, if embezzlement is detected, the Local Fund Audit division has the power to allow the errant employee to deposit the amount to correct the loss. Detected minor omissions and commissions, after due notice, result in a fine or surcharge on errant employees. Serious irregularities are reported to the appropriate authorities for necessary action.

176. Despite being a well-structured and comprehensive mechanism, the Local Fund Audit system has been unable to play a proactive role in increasing accountability in urban local bodies. These are generally due to the following:

- *Limited staff.* With the increasing role and transactions of urban local bodies, the responsibility of Local Fund Audit is increasing. Considering the limited number of staff in Local Fund Audit division and requirement for complete audits in the urban local bodies, there is lack of personnel that invariably causes delays in the audit process.
- *Audit methodology.* Audit techniques and methodology are generally based on complete checks and usually without computer-aided audit techniques. They are geared toward verifying compliance rather than reviewing performance and hence have become a routine and isolated activity, without much management involvement and utility.
- *Lack of training in double entry audit systems.* With the introduction of double entry accrual accounting system in many urban local bodies, the LFA auditors need to be conversant with modern accounting, reporting, and budgeting techniques. This area is weak although the C&AG office is supporting their technical development.

177. In summary, the current audit practices, have limited benefit due to capacity constraints, delays in implementation, and old audit processes.

Progress

178. There has been progress in external audit by enhancing the role of the C&AG to address the issues of arrears, procedural and performance audit, and to provide technical guidance and supervision.

179. *Role of C&AG Office.* Traditionally, the C&AG has audited receipts and expenditure of local bodies that are substantially financed from central or state revenues. Based on Eleventh Finance Commission (EFC) recommendations and Ministry of Finance guidelines on utilization of 2001 EFC grants, the C&AG has been entrusted with technical guidance and supervision for the maintenance of accounts and the audit of local bodies, including providing technical guidance to the director of Local Fund Audit (Box 2.11).²³ These audits also highlight performance issues and the quality of decentralization.

180. As on March 31, 2005, 18 out of 24 states, where the 74th CAA is applicable, have fully entrusted C&AG with technical guidance and supervision of PRIs and urban local bodies. Efforts continue to seek full entrustment in remaining states. Of these, ULB audit reports have been tabled to legislature in three

²³ Technical guidance and supervision to the LFA director includes assistance in preparation of audit standards, audit planning, improved audit methodologies, and professional training from the C&AG office, as well as a test audit. To fulfill the technical guidance and supervision mandate, the C&AG has prescribed a ULB accrual accounting system in the National Municipal Accounts Manual, auditing standards in keeping with international good practice, and a training module on ULB audit. Thus, C&AG audit is now supplemented by the technical guidance and supervision arrangement worked out by the states. In order to oversee and monitor a smooth transition to the accrual system of accounting, many states have set up state-level steering committees whose mandate may include (a) strengthening role of Local Fund Audit in accrual accounting; (b) collaborating with C&AG to reinforce training efforts for double entry accrual system, risk-based audit, use of computer-assisted audit techniques and sampling; (c) examining the scope of cost audits in select functional areas; and (d) examining role of Municipal Audit and Accounts Committees.

states—Tamil Nadu (FY2004-5), Kerala (FY2003-4) and West Bengal (FY2003-4). ULB audit reports have been issued to state government in four states—West Bengal (FY2004-5), Rajasthan (FY2003-4), Uttar Pradesh and Maharashtra (FY2004-5). Work in other states continues.

Box 2.11. Eleventh Finance Commission Guidelines for Involvement of C&AG in ULB Audits

The Eleventh Finance Commission in addressing accounts and audits of urban local bodies has clearly prescribed guidelines for increased involvement of C&AG in ULB audits.

- States should review existing accounting heads under which the funds are being transferred to the local bodies for each such major head/subhead; six minor heads should be created in consultation with the C& AG and the Controller General of Accounts, to ensure uniformity among the states.
- The C&AG should be entrusted with responsibility of excising control and supervision over the proper maintenance of accounts and their audit for all tiers/levels of *panchayats* and urban local bodies.
- The director, Local fund Audit or any other agency made responsible for the audit of accounts of the local bodies, should work under the technical and administrative supervision of C&AG in the same manner as the chief state electoral officers work under the supervision of Central Election Commission.
- The C&AG should prescribe the format for the preparation of budgets and for keeping of accounts for local bodies.
- Local bodies, particularly village-level panchayats and in some cases intermediate-level panchayats that do not have trained staff, may contract upkeep of accounts to an outside party.
- Audit of accounts of local bodies be entrusted to the C&AG, who may use own staff or outside agencies, on payment of remuneration fixed by him/her. An amount of one-half percent of the total expenditure incurred by the local bodies should be placed with the C&AG for this purpose.
- The C&AG report relating to audit of accounts of panchayats and municipalities should be placed before a committee of the state legislature constituted on the same lines as the Public Accounts Committee.

181. *Professional external audit.* In some cases, as in Kolkata for example, separate external audit is carried out by an independent firm of chartered accountants to certify the *true and fair* view of financial statements. This is usually insisted upon by financial institutions and development agencies that have lent money to the urban local bodies and would like to have an independent professional opinion of the financial position and performance.

182. Along these lines, the Karnataka Municipal (Accounting & Budgeting) Rules, 2006, provide for two distinct audits—a statutory audit by the Local Fund Audit and financial statements audit by a firm of Chartered Accountants or retired state accounts official. The objective of the latter audit is to comment on accounting and reporting aspect rather than compliance aspect of transactions. It is proposed that the financial statements auditor be appointed from an empanelled list of firms by the director of Municipal Administration. This auditor will present a review of the financial statements and accounts in a prescribed report form.

Key Findings and Way Ahead

183. The key issues in improving external audit are as follows:

- (a) *Determining audit requirements of various stakeholders.* The urban local bodies now have a large group of stakeholders, including financial institutions, investors and development agencies. These stakeholders have varying requirements of audit and assurance from the ULB financial statements. These should be examined, and the audit function suitably amended to provide them the comfort of audit as required.
- (b) *Reviewing the role and mandate of Local Fund Audit.* The role of Local Fund Audit needs to be reviewed for its growing responsibilities, statutory audit requirements, and the increased transactions in urban local bodies. This may result in augmentation of strength and capacity or revision to ensure that the scope of work and available resources can be matched.
- (c) *Capacity building of LFA staff.* In order to be more efficient in its performance, the LFA needs to enhance its capacity for taking up and reviewing ULB accounts. This requires a concerted

attempt at capacity building on modern risk-based audit techniques, international auditing standards, certification audit and computer-aided audit techniques.

- (d) *Using audit as an internal management tool.* Audits need to move away from more procedural and conventional checking to innovative cost, management, efficiency, and performance audits, which would prove more useful to ULB management.
- (e) *Strengthening social oversight of audit.* Audits need to focus on strengthening social oversight. Kerala is one state where social oversight is a practiced norm; other states need to follow suit.
- (f) *Appointment of audit committees.* In some states, there is a requirement to have audit committees chaired by the Opposition (on the lines of public accounts committees) to review all audit observations and reports. This practice ensures that audit reports are followed up, and action taken on them in time. This committee should be independent of the preparation of accounts.
- (g) *Action Taken Report on audit comments.* There should be a requirement to table an Action Taken Report on the audit comments and reports submitted by the auditors. Dissemination of audit reports along with financial statements should be encouraged.
- (h) *Use of independent professional auditors.* Based on Karnataka's Rules (2006), external audit firms (chartered accountants) may be appointed overcoming the capacity constraints of Local Fund Audit. This will also be useful as an independent financial attestation of performance for raising funds.

184. The Ministry of Urban Development may consider addressing these issues through a C&AG-appointed task force. The role of the state steering committees is also critical, especially where accounting is moving on to the accrual accounting system. Close engagement between the steering committee and the C&AG will help in improving the audit context of urban local bodies in the states.

Desired Outcome

185. External audits act as a transparency and accountability mechanism bringing out weaknesses and drawbacks in a constructive and timely manner.

2.K. EXTERNAL OVERSIGHT

Key Benchmark

186. An effective oversight function leads to increased awareness and engagement of beneficiary stakeholders and elected representatives ensuring greater accountability in planning, budgeting, and public spending. Key components for external oversight are listed in Table 2.13.

Table 2.13. External Oversight

<i>Indicator</i>
Major financial reports and budget are made available to public/other key stakeholders at large.
Effective engagement of citizens on major financial (formal and informal) reports is underway. <ul style="list-style-type: none"> • Effective reviews taken up by citizen groups/community-based organizations. • Query-response ratio for queries received from councilors/public on published audit.
Feedback from citizens' discussions used for effective decision making. <ul style="list-style-type: none"> • Extent of feedback/responses used for next budget, corrective action, program design, etc.

Policy and Practice

187. The concept of public involvement in decision making is missing in the Indian urban local governance environment. Limited availability for reports in the public domain, weak community structures, and lack of involvement of citizens in decision making have led to weak external oversight in urban local bodies.

188. *Ward committees.* The 74th CAA provides the legislative mandate for creation of ward committee in urban local bodies with population above 3 lakhs. The major objective of setting up these committees is to enable closer interaction between the people and their elected representatives. However, to date, only a few states (Kerala and West Bengal, for example) have adopted the same.²⁴ In other states (Andhra Pradesh, Uttar Pradesh, Madhya Pradesh, Karnataka, Himachal Pradesh, for example), although constitution of ward committees is provided in the 74th CAA, they are yet to be operationalized. West Bengal has pioneered the concept by issuing distinct Ward Committee Rules, 2001, and providing for ward committees to be involved in tax collections, local planning, and social development activities.

189. *Social auditing.* In absence of properly functioning ward committees, the role of external oversight has often been taken up by nongovernmental and community-based organizations. Most nongovernmental organizations have taken to social auditing, a process of understanding whether the expenditures are being made for stated social aims. It works to support accountability and being responsive to the needs of the people. There are other bigger players who are encouraging interventionist measures of designing budgets by the locals on topical issues (PROOF discussed in Box 2.4).

190. *Citizens' Report Card.* Another good practice that has been used to promote external oversight is the Citizen's Report Card, a transparent mechanism of user satisfaction surveys to establish how various public services are faring. This presents the voice of the citizens who otherwise would not have the opportunity to share their experiences. Feedback is usually gathered on aspects of services like access or availability, usage, responsiveness, effectiveness, and overall satisfaction. On one hand it helps the urban local body to improve the level of services; on the other hand it also generates interest among the citizens on the functioning of their local body. A good example of Citizens' Report Cards is in Bangalore, Karnataka.²⁵

Progress

191. External oversight is one of the weakest links in PFMA reforms primarily due to lack of availability of information in public domain and limited initiative by the citizenry to learn about the working of local government. Creation of mass political awareness about ULB accounts and their audit is lacking. JNNURM aims to take a step further toward effective governance through people's participation, but its success needs to be tested on a mass scale.

Key Findings and Way Ahead

192. For legislative and civil society oversight, the coverage and scope of ward committees need clarity. Election guidelines should be established in ward and zonal committees, and provisions should be made to draw on local knowledge. Ward committees should be given some independence for resource management and active participation in bottom-up budgeting. Ward committee meetings should be publicized to ensure maximum citizen participation.

The effort at improving oversight must address the following concerns and issues for successful implementation:

- (a) *Awareness and involvement of citizens.* This constructive and regular engagement of citizens is itself a challenge for urban local bodies. The relative ignorance toward reforms needs to be removed by involving nongovernmental and community-based organizations in the process.
- (b) *Representative bodies.* The ward committees, if established as a model for citizen participation, need to have a representative character and regularly involved in various ULB activities. Some degree of encouragement (through fiscal authority and tax responsibility) should also be given to encourage the performance of ward committees.
- (c) *Availability of information.* The availability and access to information is a prerequisite for making any oversight function useful. Urban local bodies should establish adequate systems for managing information and disseminating it in public for effective monitoring; and develop user-friendly reporting formats (Management Discussion & Analysis Report, for example). Citizens should be provided access to reports that could be posted on ULB notice boards and ULB and state websites, and published as abridged accounts in local newspaper (for corporations and large cities).

²⁴ In West Bengal, committees have been set up for each municipal ward. In the case of the Kolkata Municipal Corporation, in addition to the ward committees, the borough or zonal committees have existed for a long time.

²⁵ Samuel Paul, et.al., *Benchmarking India's Public Services: A Comparison across the State*, Public Affairs Centre, 2005; and Sita Shekhar and Manisha Shah, *Benchmarking Bangalore's Public Services: What the Third Citizens Report Card Reveals*, Public Affairs Centre, 2006.

(d) *ULB responsiveness.* Oversight is dependent not only on people's participation but on the continued interest and responsiveness of urban local bodies. A good start to develop responsiveness and thereby PFMA would be to have active audit committees and a robust public grievance mechanism.

Desired Outcome

193. An independent oversight function is carried out by the state and public to increase accountability and participation in ULB activities.

3. Key Issues and Way Ahead

194. The main constraints to strong PFMA in urban local bodies are the weak legal framework, low demand for accountability, lack of incentive for compliance or penalty for noncompliance with existing rules, and limited use of available guidelines. This chapter summarizes key interventions for improving PFMA in urban local bodies and outlines a roadmap for their implementation at national, state, and local levels of government. These interventions could be aligned with the ongoing JNNURM program or introduced separately.

3.A. IMPROVING ULB BUDGET PREPARATION

195. A strengthened ULB budgeting process needs to include realistic and participatory frameworks for budget estimation and establishment of appropriate linkages with parastatal organizations and metropolitan plans. To guide urban local bodies through the basic tenets of realistic and participatory budget preparation, a model budgeting manual should be developed by the Central Government. This NMAM-style manual could provide guidelines for the process as well as formats for the following:

- (a) *Participation.* Budgets could be prepared in consultation with representative citizens' groups. The citizens' groups play a key role in identifying local problems, suggesting solutions, and monitoring progress. Models like PROOF could be institutionalized in this context.
- (b) *Pro-poor budgeting.* The participation of the poor in the budgeting process and prioritization of their concerns should be mandatory. In this context, budget priorities should be aligned with the needs of under-served and under-privileged areas.
- (c) *Budget forecasting.* Procedures should be established for seeking evidence-based estimates for accurate calculation and prioritization of expenditure on ongoing and proposed schemes. Models like Budget Information Data Sheets in Bangalore could be studied.
- (d) *Multi-year rolling plans.* A multi-year rolling plan should be adopted for capital investment. Annual budgets based on this plan would help to maintain policy direction.
- (e) *Capital investment and procurement planning.* This should include investment planning, estimation of requirement, timing and sequencing of purchases, and procurement planning and control.
- (f) *Outcome/output budgeting.* Rather than money to be spent, budgeting should be planned in terms of outcomes, which include services to be provided (such as drinking water to a calculated number of persons) or outputs to be created (such as a calculated number of pumping stations). Output/outcome budgets would facilitate performance monitoring using physical indicators. However, it is important to note that urban local bodies would need guidance for conversion of outlays to outcomes. This will require:
 - (i) Defining intermediate and final outcomes specifically in measurable and monitorable terms;
 - (ii) Standardization of unit cost of delivery;
 - (iii) Benchmarking of standards/quality of outcomes or services;
 - (iv) Setting up of effective monitoring and evaluation systems; and
 - (v) Ensuring flow of funds and capacity building.

The outcome budgeting model could be based on the Government of India's Outcome Budget.

196. The model budgeting manual could be prepared at the national level with inputs from states, urban local bodies, citizens, and experts. The manual would provide the policy and detailed implementation guideline to be customized and adopted by the states and urban local bodies.

3.B. SUPPORT FOR ACCOUNTING RULES AND MANUAL

197. While the National Municipal Accounting Manual is moving in the right direction towards an improved accounting system in urban local bodies, it needs to be reviewed for international good practice, specifically IPSAS guidelines. In addition, urban local bodies require support for adopting and implementing the National Municipal Accounting Manual. Some urban local bodies may require particular help in clearing their accounting backlog before NMAM adoption and implementation.

NMAM implementation would require addressing some critical issues:

- (a) Adapting the manual to suit state and ULB requirements (urban local bodies would have different accounting requirements depending on size and scope of operations);
- (b) Amending state-level accounting rules to support the maintenance of accrual accounts;
- (c) Strengthening staff capacity with more qualified personnel and specialized training programs for municipal accounts (with requirement for certification to ensure a minimum quality standard);
- (d) Preparation of opening balance sheets including data collection and reconciliation with records maintained by other departments;
- (e) Integrating accounting with the budgeting system in order to synergize the planning, execution, and evaluation ULB functions; and
- (f) Improving the Management Information System so that accounting information becomes integral in decision making.

198. Apart from these issues, audit functions need to be re-assessed with regard to implementation of a double entry accounting system and computerization, thus allowing for concurrent audit in a computerized environment and improving accountability.

199. Developing model accounting rules would add to the momentum of accounting reforms. These rules could provide a framework for the double entry accrual accounting system and be a mandatory requirement for state adoption under JNNURM. States could require extra help from the Central Government when customizing the National Municipal Accounting Manual. The Ministry of Urban Development could set up a centralized technical assistance unit to assist states in this task. Most urban local bodies might also require special assistance with preparation of opening balance sheet since they lack reliable data for assets and liabilities.

200. Similarly, demonstrating good practice and replicable models would be useful learning for states. Indicative timelines of activities for accounting and budgeting activities at national and state levels are suggested in Tables 3.1 and 3.2:

3.C. REVIEW AND STRENGTHENING OF ULB AUDIT

201. The C&AG supports strengthening the audit function in urban local bodies through technical guidance and supervision. To help strengthen them, the C&AG works with the state LFA teams, which are the statutory ULB auditors. However, since C&AG technical guidance and supervision has not been accepted in all states, there is a need to extend this to all Local Fund Auditors across all states. In addition, State governments need to review current audit practices and methodologies to ensure sound and independent certification of ULB accounts. To do so, LFA auditors should also be familiar with accrual accounting and rudiments of financial certification audit.

202. In this context, it is important to mention that many states have set up steering committees to support the transition to accrual accounting. These steering committees are well placed to take on some of the actions to strengthen audit such as:

- (a) Strengthening the role of the Local Fund Auditor by reviewing the existing audit process and methodology, roles, mandate, capacity constraints, and backlog of audits.
- (b) Collaborating with C&AG office to reinforce training efforts for double entry accrual system, risk-based audit, use of computer-aided audit techniques, and sampling.
- (c) Examining the scope of cost audits in selected areas.

Table 3.1 National-Level Timeline for Accounting and Budget Reform

Action	Months	Responsibility
<i>National Municipal Accounting Manual and Budgeting Manual</i>		
1. Review of NMAM in line with IPSAS and amendments, if any	1.5	C&AG & MoUD
2. Development of budgeting policy including multi-year approach, outcome/output budgeting and participation	2	C&AG & MoUD
3. Design of budget form, structure, programs, and budget heads in line with policy requirements; links to accounting and MIS reports	3.5	C&AG & MoUD
4. Development of detail sheets, processes including for capital budgets and procurement scheduling	4	C&AG & MoUD
5. Development of model ULB budgeting manual	6	C&AG & MoUD
<i>Preparation of Opening Balance Sheet</i>		
6. Development of NMAM-based opening balance sheet guidelines for urban local bodies (to include determination, valuation, and presentation of assets and liabilities)	2	C&AG & MoUD
<i>Accounting & Budgeting Rules</i>		
7. Development of model accounting and budgeting rules, including requirements of disclosure, participation, and PFMA features	7	C&AG & MoUD
<i>Implementation Support</i>		
8. Setting up of technical assistance unit for advising states on customizing and implementing National Municipal Accounting Manual	4	MoUD
9. Design prototype of software for double entry accounting system	6	MoUD
10. Standardized software for double entry accounting system	12	MoUD & Technical assistance unit
11. Develop model terms of reference for field-level support	3	MoUD
12. Develop model training material of accounting and budgeting	8	MoUD & Technical assistance unit

Table 3.2 State- and Local-Level Timeline for Accounting and Budget Reform

Action	Months	Responsibility
<i>NMAM and Budgeting Manual</i>		
1. Review of budgeting format, including linkages with NMAM and account codes, including compliance with IPSAS	4	State governments
2. Develop state specific accounting and budgeting manual adapting NMAM and model budgeting manual	8	State governments
<i>Preparation of Opening Balance Sheet</i>		
3. Adoption of opening balance sheet guidelines	4	State government
4. Inventory of assets, liabilities, and their valuation	7	ULB
5. Preparation of opening balance sheet	12	ULB
<i>Accounting & Budgeting Rules</i>		
6. Modification and adoption of accounting and budgeting rules	10	State governments
<i>Implementation Support</i>		
7. Implementation of training	10	State & ULB
8. Appoint field-level support for implementing double entry accounting reforms	10	State & ULB
9. Start of double entry accounting system	12	State & ULB
10. Preparation of monthly financial statement under double entry accounting system	12	ULB

- (d) Assuming the role of Municipal Audit and Accounts Committees to ensure that audit reports are examined and there is accountability of the councillors for public funds.
- (e) Examining the efficacy of independent attestation through empanelled professional auditors. The recommendations should be implemented in a time-bound manner to strengthen the role and function of audit in urban local bodies. There should be a simultaneous effort to encourage public disclosure and improve public oversight.

3.D. IMPROVING PROCUREMENT PERFORMANCE

203. Procurement is one of the largest, and weakest, components of ULB spending. Improving performance of ULB procurement systems will lead to cost savings, improving quality of spending, and enhancing the delivery of services. To date, procurement of goods and services in urban local bodies ranged between 30 to 50 percent of the budget, a substantial part being spent on recurring expenses. However, with the advent of capital intensive schemes like JNNURM, this is expected to increase to 6 to 8 times existing levels over the next few years.

Improving procurement in urban local bodies requires the following key actions:

- (a) Simplification of procurement rules supported by the drafting of a model procurement law, which includes standard formats and procedures;
- (b) Standardization of procurement practices and introduction of electronic procurement;
- (c) Enhancing monitoring and oversight through effective audit mechanisms and public dissemination of information;

- (d) Establishing procedures to improve the quality of technical specifications and work of evaluation committees;
- (e) Enhancing procurement capacity of ULB staff

204. The Ministry of Urban Development could promote improved procurement practices by drafting model procurement regulations, establishing simple reporting requirements for procurement operations, and defining policies for disclosure of relevant information and the manner of its disclosure. The Ministry could complement these steps with efforts to promote the adoption of e-procurement and the standardization of procurement practices. In addition, the Ministry could consider developing a manual and toolkit for assisting urban local bodies in standardizing and improving procurement systems. It could also consider mandating implementation of a transparency law for procurement, similar to the one in Karnataka; funds would be linked with its implementation.

205. Developing public-private partnership regulations would be useful for most ULB procurement. Urban local bodies should develop skills to manage relations with the private sector. To promote public-private partnership, urban local bodies should establish processes for efficient and transparent operations. This could also serve as a model guideline at the national and state levels. Some states (Gujarat and Andhra Pradesh, for example) have passed legislation to regulate private sector involvement in service delivery and other municipal services.

3.E. STAFFING AND CAPACITY BUILDING

206. States and urban local bodies, with help from Central Government, should revise outdated staffing practices and build capacity of municipal staff through:

- (a) Introduction of a certification requirement for ULB accountants, and
- (b) Provision of ongoing training.

207. Some national and state training institutes (like the Administrative Staff College of India) have courses on financial management, procurement, and budgeting that should be tailored to ULB requirements. ULB staff should be encouraged to take these courses and certification requirements should be mandated for certain key positions in accounting and finance.

208. In addition, the Central Government should require compulsory appointment of qualified chartered accountants to head the finance function in larger JNNURM cities and prescribe education and (training) certification requirements for finance officers in other cities. The Ministry of Urban Development could also link the training of staff with incentives through the JNNURM.

3.F. PFMA REPORT CARD AND MEETING MINIMUM FIDUCIARY STANDARDS

209. Keeping in mind long-term investment and effectiveness, the Government should institute the scoring of urban local bodies on PFMA indicators. These PFMA indicators could be based on those developed in this study (sections 2.A through 2.K). These would enable the Government to assess the baseline, monitor progress, and facilitate inter-ULB comparisons on PFMA indicators. Accordingly the Central Government should define a Minimum Fiduciary Standard that all ULB participants in JNNURM should meet. This Minimum Fiduciary Standard should be predicated on public disclosure of audited accounts drawn on accrual basis within a reasonable time at the end of the financial year. The Central Government could also work with the Rating Agencies to devise a way to incentivize PFMA reform by giving more credence to urban local bodies with better PFMA scores, as is happening in United States.

3.G. ENSURING COMPLIANCE

210. The implementation of existing PFMA provisions in municipal acts remains weak due to absence of enforcement and follow-up mechanisms. While there must be action taken and penalties assessed for noncompliance and delays, there should also be incentives for compliance with mandated legislative requirements, such as regularly updating the status of ULB budgets and financial statements, replying to audit queries in a timely way (a reasonable, Government-defined timeline), and disseminating annual financial statements.

3.H. IMPROVING PUBLIC OVERSIGHT

211. The financial performance of all urban local bodies should be available to the public for debate and discussion. An annual performance report containing financial statements and a Management Discussion & Analysis section should be prepared by all urban local bodies within 6 months of year-end. The report would include a review of the previous year's performance, comparison with budget, response to audit qualifications, and plan for the current year.

212. The annual report should be discussed and openly debated in a forum much like an annual general meeting held by many corporations and organizations with stakeholders. Citizens should have access to the reports by mandatory posting on the ULB notice boards and ULB websites and advertising of abridged accounts in local newspaper (for corporations and large cities). The Government may also consider a state and national website to host all ULB reports and comparator PFMA ratings mentioned above. The disclosure and timely preparation of accounts would be an important indicator of compliance with PFMA requirements and hence can be linked to the PFMA report card and devolution criteria.

213. Disaggregated data should be discussed at ward committee and area *sabha* meetings, which would identify local planning needs.

3.I CONCLUSION

214. The Government of India has taken an important step with the introduction of the JNNURM. Significant details on the implementation of the accounting reforms are still to be worked out and implemented. In addition to this, the PFMA areas other than accounting (like audit, accountability, disclosure, staffing and capacity development, appropriate linkages with IT and procurement) that are equally important to robust institutions that efficiently deliver urban services must also be strengthened.

Annex A. Experts and Officials Visited for PFMA Study

The team met the following experts and officials on different occasions for discussions with reference to the PFMA study.

	<i>Name</i>	<i>Organization</i>
1	Mr. J P Gupta	Centre for Research in Rural and Industrial Development
2	Mr. N Bhattacharjee	U.S. Agency for International Development
3	Ms. Debashree Mukherjee	U.K. Department for International Development
4	Mr. Alok Shiromany	USAID FIRE Project
5	Mr. Aniruddha Kumar	Ministry of Urban Development, Government of India
6	Mr. Jayant Gokhale	Institute of Chartered Accountants of India
7	Ms. Aparna Das	United Nations Development Program
8	Mr. Manoj	Rajasthan Urban Infrastructure Finance Development Corporation, Rajasthan
18	Dr. J V Nandana Kumar	Karnataka Urban Infrastructure Development Finance Corporation
19	Ms. Jyothi Krishnamoorthy	Asian Development Bank
20	Mr. Alex Jorgensen	Asian Development Bank
21	Mr. C T Abraham	Asian Development Bank
22	Mr. Srinivasan	Asian Development Bank
24	Ms. Meenakshi Gupta	New Delhi Municipal Corporation
25	Mr. Andrew Kenningham	U.K. Department for International Development
26	Mr. Chris Heymans	Water and Sanitation Programme, World Bank
27	Mr. B B Pandit	New Delhi Municipal Corporation
28	Mrs. S Khullar	New Delhi Municipal Corporation
29	Mr. K Dharmarajan	Senior Policy Advisor, USAID FIRE Project
30	Mr. Harish Chandra	Director (HUD)
31	Prof O P Mathur	National Institute of Public Finance and Policy
32	Ms. Geeta Menon	Comptroller and Auditor General of India
33	Mr. R N Ghosh	Comptroller and Auditor General of India
34	Mr. Mahesh Singh	Joint Secretary, Urban Development, Government of Gujarat
35	Mr. Janardan Reddy	Project Director, Andhra Pradesh Urban Services for the Poor, SGoAP
36	Mr. P. V. Ramesh	Director, Andhra Pradesh Urban Infrastructure Development Fund Corporation, SGoAP
37	Mr. Sudhakar	Additional Director, Department of Municipal Administration
38	Mr. Prasad	Chairman, special committee for formulating the model municipal law for the state, SGoAP
39	Mr. K. Jairaj	Commissioner, Bangalore Mahanagara Palike,
40	Mrs. Lakshmi Venkatachalam,	Principal Secretary, Urban Development, Karnataka.
41	Dr. Samuel Paul	Founder and Chairperson, Public Accounts Committee
42	Mr. N.V.Muniratnampa	Local Fund Auditor/Controller, State Audit Department, Karnataka.
43	Mr. Jawaid Akhtar,	Managing Director, Karnataka Urban Infrastructure Development Finance Corporation
44	Mr. Krishna Rupanagunta	E-Governance Foundation, Bangalore
45	Dr. Niranjan Maradi	Commissioner, MAD, Tamil Nadu
46	Mr. Vikram Kapur	Managing Director, Tamil Nadu Urban Infrastructure Financial Services Limited
47	Mr. Sellamuthu,	Secretary, Urban Development, Tamil Nadu
48	Sh. D.J. Dhinakkaren,	Commissioner, Madurai City Corporation

Annex B. Accounting Initiatives in Different States

215. **Tamil Nadu Municipal Accounting Initiative.** The chief reason for the state government desiring for the conversion of ULB accounting system to double entry accrual was to enable it to be able to present acceptable information to funding agencies for their support to the investments of municipal bodies in the state. The accounting reforms process formally started in January 1998 with the appointment of a three-member committee. The committee prepared an accounting manual for introducing the double entry accrual accounting system in the municipal bodies within six months and submitted its first draft to the state in June 1998 (Box B.1).¹

Box B.1. Tamil Nadu Accounting Manual

The Tamil Nadu accounting manual is divided into three parts. The first part of the accounting manual deals with accounting procedures, the second provides the chart of accounts, and the third presents the forms and formats to be used in the new accounting system. Every procedure, account, and form was specifically designed for the state's municipal bodies. The committee developed separate procedures for key municipal functions, including taxes and fees, accounting, water supply and drainage fund accounting, suppliers/material accounting, contractors accounting, loans and grants accounting, etc.

216. Government clearance was received in January 1999 and the Tamil Nadu Urban Development Fund was entrusted responsibility for smooth implementation of this reform action. The Tamil Nadu Urban Development Fund then undertook training of officials in the accounting and auditing departments to build capacity at the local level. All records were also computerized to facilitate implementation of the new system by developing tailor-made software.² This reform action was taken over by World Bank-funded Tamil Nadu Urban Development Project II in November 1999, and the first phase of reforms was finished by successfully converting 12 urban local bodies to the new system of accounting. By April 2001, all urban local bodies were converted to the new system. The implementation process was undertaken by hiring 25 local chartered accountant firms that provided handholding support to urban local bodies during the shift from single entry based to double entry accrual-based system (Box B.2).

Box B.2 Tamil Nadu Accounting – Key to Success

Continuous updating and improvement of the accounting manual and the system in the light of the experiences gained from the implementation process was integral to the implementation program. For speedy and efficient implementation of the accounting reforms, Tamil Nadu Urban Development Project II also announced an award scheme in association with USAID FIRE (D) Project. Other key reasons for its success included (a) strong support from the state government; (b) statewide unified accounting system approach; (c) series of training and opinion building workshops for technical officials and elected representatives; (d) involvement of experienced government officials (retired) who ensured contextualization to local requirements; (e) appropriate implementation methodology; and (f) ULB-level commitment, motivation, and ownership.

217. Tamil Nadu has adopted the modified accrual-based, double entry accounting system but with the consolidated fund format. In light of NMAM requirements, they need to upgrade it. One key issue is that the accounting system provides for co-relation between budget code and account code at a very broad level. Another issue is that the detailed accounting code is co-related with broad budget heads and not with an individual budget item; this requires change as detailing and 'wed locking' (one to one matching) of the budget or object code with accounting code items will facilitate cost analysis and control at the micro level and will also avoid maintenance of separate accounting and budgeting database. Finally, the accounting software also needs various improvements in light of the above and NMAM requirements.

¹ R. Joshi, Succeeding in Municipal Accounting Reforms, paper written for IIR, 2003.

² The Electronic Corporation of India, Hyderabad, developed the software.

218. In spite of these issues, the Tamil Nadu experience clearly demonstrates how municipal accounting reforms, until now considered difficult, can move forward and be completed within a relatively short period of time (in Gujarat it took 8 years). Successful introduction on a statewide scale is possible if there is effective political and administrative will; and if various other factors in addition to the right design, like pragmatic leadership, recognition, respect, and involvement of in-house talent, are present.

219. **The Gujarat Accounting Initiative.** While Tamil Nadu is the best known and most cited example of accounting reforms initiative, there are a few other city-level initiatives as well. In 1990 as part of its financial assistance to Gujarat Urban Development Project in 1985, the World Bank had insisted on the introduction of accrual-based accounting in the (6) recipient municipal corporations and also in Anand, which had a municipality status. The process began in 1990 with World Bank-funded consultants who designed a financial accounting system for the municipal bodies. After 1994, the work on the accounting system continued, however the municipalities paid. From 1998 onwards, the new system was operationalized. However, this effort could not be sustained due to several reasons—lack of involvement by consultants at the implementation stage, lack of interest by the state government to carry forward the work after World Bank assistance ended, lack of insistence on part of the Bank, inadequate scope of reforms that completely overlooked audit reforms, and lack of contextualization of the system to local requirements.

220. **Karnataka Municipal Accounting Initiative.** Karnataka is presently in the process of implementing a fund-based accounting system in all urban local bodies, the first state to do so in accordance to requirements of the National Municipal Accounting Manual. The basis for shifting to fund-based accounting was set by the Bangalore Agenda Task Force, which initially implemented this system in Tumkur (with a budget of around Rs.20 crores) and Bangalore (with a budget of around Rs.1,000 crores). Both these urban local bodies shifted to a fund-based accounting system in 2002. In 2003, based on learning from this exercise, Bangalore Agenda Task Force advised shifting of all urban local bodies to a fund-based accounting system; this was undertaken by Karnataka Urban Infrastructure Development Finance Corporation through ADB support.

221. In the first phase, Karnataka prepared uniform NMAM-based accounting and a budget manual for implementation across 43 urban local bodies in the state. Uniform software and training manuals have also been developed. In most urban local bodies, recent commerce graduates have been recruited and trained to work on the initiative. Local firms of chartered accountants are being appointed as field-level consultants to prepare the opening balance sheet and implement the system. The entire initiative is being run under the Additional Secretary (Reforms), a specially created senior-level position for implementing this initiative, with assistance by a nodal firm (IPE) responsible for drafting the manual and budget rules, training, and providing handholding support for implementation. Under the proviso of the initiative, the reports and Management Information System would also be integrated and analyzed at the state level allowing for benchmarks and detailed analysis to be programmed through the special software (developed by e-Governments foundation). Implementation begins 2005-06.

222. **Other Accounting Initiatives at City Level – Importance of State Role.** Individual cities have wanted to shift to double entry accounting. Ludhiana undertook all necessary groundwork to shift to double entry accrual system of accounting under dynamic leadership. However, once the leadership changed, this initiative was given a cold treatment. State laws did not require urban local bodies to move to the more complex form of accounting. Agra is another example of a city that undertook the groundwork to shift to double entry accrual system of accounting but was thwarted by lack of support from the state government. Chennai and Mumbai also shifted to double entry accounting system of accounting, but these reforms were not reflected at the state level until much later.

Table B.1. Comparison of Double Entry Accounting System across States

Accounting aspect	Maharashtra	Tamil Nadu	Hyderabad	Delhi	Kolkata	Karnataka
Accounting Method						
Method of accounting adopted	Double entry accrual-based accounting system	Double entry accrual-based accounting system	Double entry, modified accrual-based accounting. .	Double entry accrual-based accounting system	Double entry cash-based accounting. The accrual accounting adjustments are separately added to the cash-based account at the year end. This is done while compilation of financial statements and is not part of the accounting system / software.	Double entry accrual-based fund accounting system.
Governing legislation for accounting	Mumbai Corporation Act. City of Nagpur Corporation Act Mumbai Provincial Municipal Corporations Act, 1949 & Maharashtra Municipal Councils, Nagar Panchayats and Industrial Townships Act, 1965	Tamil Nadu Urban Local Bodies Act, 1998 & Tamil Nadu Urban Local Bodies Rules, 2000	Hyderabad Municipal Corporation Act, 1955	Delhi Municipal Corporation Act, 1957 (Amended 1993).	Conventional format. According to the statute, the State Government is to notify the format of accounts, which it has not yet done.	Karnataka Municipalities Act, 1964 and Karnataka Municipal (Accounting & Budgeting) Rules, 2006. Separate Regulations based on Rules for Corporations.
Computerization level	Currently manual. Supported by an accounting manual containing all the details. To be computerized.	Computerized accounting. Supported by an accounting manual, and also a User Manual.	Computerized accounting. Supported by an accounting manual.	Computerized accounting (Tally)	Computerized accounting No accounting manual in place yet.	Web-enabled customized software under implementation. Will run in parallel.

Accounting aspect	Maharashtra	Tamil Nadu	Hyderabad	Delhi	Kolkata	Karnataka
Books of Accounts / Financial Statements						
Accounts maintenance	There is provision for getting overall picture and utilization of funds from each special fund and reserve. Can generate separate groupings of funds.	Separate accounts are maintained for : a) Revenue Fund b) Capital Fund c) Water Supply and Drainage Fund d) Elementary Education Fund.	No separate fund-wise accounts are maintained	Fund accounting is done for various funds such as General Fund, Capital Projects Fund, Debt Management Fund, Special Revenue Funds, Trust & Agency Funds, and Proprietary Fund.	The Municipal fund is supposed to be maintained in 6 different accounts viz. i) Solid Waste Management Account ii) Sewerage & Drainage Account, etc. The accounts are maintained separately for each of the accounts and presented in a consolidated as well as separate accounts in the financial statements	Separate accounts maintained for 3 funds: (i) General Fund (ii) Water Supply & Sewerage Fund & (iii) Enterprise Fund
Frequency of financial statements	Annual & Quarterly	Annual.	Financial Statements – Annual. Comparison with budget, and review - Annual.	Annual	Financial statements - Annual Comparison and annual review with budget / previous period is carried out monthly.	Required to prepare half yearly accounts.
Annual financial statements	Overall Income & Expenditure Account, and Balance Sheet prepared	Separate Income & Expenditure Account and Balance Sheet are prepared for Revenue Fund, Capital Fund, Water Supply and Drainage Fund, and Elementary Education Fund. Consolidated financial	Income & Expenditure Account, and Balance Sheet are prepared. Apart from these, fund-wise financial statements are prepared in columnar form, for General Fund, City Development Fund, Community	Statements of Revenue, Expenditures, and Fund Balances', and Balance Sheet are prepared for the different funds. In addition, combined financial statements for all the funds, grouped under Governmental	Income & Expenditure Account, Receipts & Payment Account and Balance Sheet are prepared. Apart from these, separate accounts of the municipal fund are prepared such as Solid waste, sewerage, etc., as well as details of revenue and expenditure for each market, etc.	Consolidated and Fund-wise Income & Expenditure Statement, Receipts and Payment Account, Balance Sheet, Notes to accounts and performance indicators.

Accounting aspect	Maharashtra	Tamil Nadu	Hyderabad	Delhi	Kolkata	Karnataka
		statements are not prepared.	Development Fund, Debt-Service Fund (grouped under Municipal Fund), and Salary & Pension Fund (grouped under Fiduciary Fund).	Fund and Fiduciary Fund are also prepared.		
Bank reconciliation statement	Done, but tends to be in arrears.	On monthly basis	Done manually, on monthly basis.	Done periodically.	Done periodically. Even at present, some accounts have not been reconciled for several years.	Required to be done monthly.
Fixed assets register	The assets are treated individually and the track of each asset item is kept in the Fixed Asset Register. In the accounts, assets are treated as a block.	As per the Accounting Manual, Fixed Assets Register has to be maintained category-wise, and all assets created on and from 1-4-99 have to be entered in the Register.	Separate Fixed Assets Register has to be maintained for grant/scheme funded assets and other fixed assets.	Fixed Assets Register has been collated and updated. However, this process is continuing, and is likely to continue for the next one or two years.	Fixed Assets Register is maintained.	Prescribed in formats. Separate register for Land, immovable Properties and Movable Properties.

Annex C. PFMA Reforms and Progress under JNNURM

223. JNNURM is a mission for reforms driven, fast track, planned development of identified cities with focus on efficiency in urban infrastructure/services delivery mechanism, community participation and accountability of urban local bodies/parastatals toward citizens. The mission objective is integrated development of infrastructural services in the cities covered under the mission; secure effective linkages between asset creation and asset management; ensure adequate investment of funds to fulfill deficiencies in the urban infrastructural services; planned development of identified cities including peri-urban areas, out growths, urban corridors, so that urbanization takes place in a dispersed manner; scale up delivery of civic amenities and provision of utilities with emphasis on universal access to urban poor; and take up urban renewal program, i.e., re-development of inner (old) cities area to reduce congestion. Some of the mandatory and optional reforms that relate to PFMA areas are discussed below.

224. **Legislative framework for PFMA:** JNNURM has made efforts in bringing about various progressive changes in the legislative framework. Its core aim is to strengthen the implementation of 74th CAA by giving the rein of public funds to local governments and making them responsible and accountable for its efficient utilization. Further, it makes it mandatory for state governments to ensure community participation and public disclosure at ULB level. These legislative changes will have a ripple effect on the other PFMA areas, hence having far reaching impact on the overall functioning of ULB's.

- The enactment of Urban Local Government Disclosure Bill, 2006, will ensure preparation of medium-term fiscal plan and release of quarterly performance information to all stakeholders.
- Similarly enactment of Community Participation Law will institutionalize citizen participation and introduce the concept of Area Sabhas with "city planning function" in order to enable need-based allocation of funds external oversight over them

225. **Planning and budgeting:** The mission, through its reform agenda, tries to make the planning and budgeting exercise more comprehensive, realistic and participatory. It incorporates a multi year perspective in budget preparation with timelines for implementation. Own source component in financing mix has been limited to 10 percent considering the current fiscal constraints of urban local bodies. Issues related to unavailability of accurate information, timeliness, and uniformity of formats will be addressed by adoption of double entry accounting system and introduction of computerized systems (Management Information Systems, Geographic Information Systems, etc.) As mentioned above, public disclosure and community participation will help in bottom-up planning which is demand driven. Structural and administrative reforms will further streamline the planning process and help in preparing effective and achievable budgets.

226. **Implementation:** JNNURM takes a leap forward in ensuring better implementation of planned projects with financial control and outcome achievement. Strategic PFMA areas like accounting and Management Information System, cash and fund flow management, procurement, internal control and audit, assets and liabilities management, have been addressed with specific reform agendas:

- Introduction of double entry accounting system;
- Introduction of e-governance using information technology applications like GIS and MIS;
- Internal earmarking within local bodies, budgets for basic services to the urban poor;
- Levy of user charges with the objective that full cost of operation and maintenance is collected within next 7 years;
- Reform of Property Tax with GIS for revenue enhancement with arrangements for its effective implementation to achieve at least 85 percent collection efficiency within next 7 years;
- Revolving fund for meeting operations and maintenance costs of assets;
- Linkage between asset creation and asset management to make them self-sustaining over time;
- Introduction of computerized process of registration of land and property (optional);

- Public-Private Partnership will ensure maximum asset utilization and minimum liabilities (optional).¹

227. There is a proposal to require credit rating for all cities for accessing funds under JNNURM. This should motivate cities to improve creditworthiness and financial discipline. This would have a positive impact on PFMA systems in urban local bodies

228. **Reporting:** Reporting structures under JNNURM have been clearly delineated at all levels with proper institutional set ups. It also ensures that ULB's internal and external reporting systems are improved by the end of seven years. Release of funds has been linked to its utilization and achievement of milestones agreed for implementation of mandatory and optional reforms at the state and ULB level. Public reporting will be ensured through the Urban Local Government Disclosure Bill.

229. **External Audit and Oversight:** State level nodal agency will maintain audited accounts of funds released to ULB's, conduct techno economic appraisal of projects and monitor implementation of reforms. Public oversight will be an integral with the passing of Community Participation and Public Disclosure laws.

PROGRESS TO DATE

230. Twelve states have signed the memorandum of agreement with Government of India (Table C.1), and City Development Plans for 43 out of 63 cities have been submitted; with approvals to date for 26 cities (Table C.2).

Table C.1. Implementation of Reforms under JNNURM

S.No	State	Cities having signed memorandum of agreement (as of 22 September 2006)
1	Gujarat	Ahmedabad
2	West Bengal	Asansol
3	Madhya Pradesh	Bhopal, Indore , Jabalpur
4	Tamil Nadu	Coimbatore
5	Andhra Pradesh	Hyderabad
6	Rajasthan	Jaipur
7	West Bengal	Kolkata
8	Tamil Nadu	Madurai
9	Maharashtra	Nagpur, Nanded, Pune
10	Chattisgarh	Raipur
11	Gujarat	Rajkot, Surat, Vadodra
12	Andhra Pradesh	Vijayawada, Vishakhapatnam

Table C.2. Status of City Development Plans under JNNURM

<i>(as on September 22, 2006)</i>		
<i>Plans approved</i>	<i>Plans under appraisal</i>	<i>Plans not submitted</i>
Agartala, Ahmedabad, Amritsar, Asansol, Bhopal, Bhubaneshwar, Chandigarh, Coimbatore, Greater Mumbai, Guwahati, Hyderabad, Indore, Jabalpur, Jaipur, Kohima, Kolkata, Madurai, Nagpur, Nanded, Pune, Raipur, Rajkot, Surat, Vadodara, Vijayawada, Vishakhapatnam	Agra, Ajmer-Pushkar, Allahabad, Bodhgaya, Chennai, Faridabad, Kanpur, Lucknow, Ludhiana, Mathura, Meerut, Mysore, Nashik, Patna, Srinagar, Ujjain, Varanasi	Itanagar, Delhi, Panaji, Shimla, Jammu, Dhanbad, Jamshedpur, Ranchi, Bangalore, Cochin, Thiruvananthapuram, Imphal, Shillong, Aizwal, Puri, Pondicherry, Gangtok, Dehradun, Haridwar, Nainital

¹ However, it has been clearly stated in JNNURM documents that projects with public private partnership will be given preference over self-financed projects for greater efficiency and lesser financial dependence.

Annex D. Cost and Performance Indicators

S. No.	Particulars	Current Year	Previous Year
BASIC CITY STATISTICS			
1.	Area of City (sq. km)		
2.	Population (year) Estimated No. of Households		
3.	SC / ST Population (year) BPL Population Slum Population		
4.	Literacy rate % (Men, Women)		
5.	No. of properties in the city (as per property tax records)		
COUNCIL DETAILS			
6.	Year of establishment of Municipality		
7.	No. of Wards		
8.	Council Members Men Women TOTAL SC / ST Council Members		
9.	No. of employees of the Municipality		
SERVICES STATUS			
10.	Water Supply (LPCD) Normal Season Summer Season	<u>TARGET</u>	<u>ACTUAL</u>
11.	Water Connections (as per municipal records)		
12.	No. of days of water supply per week (Normal season)		
13.	No. of hours of water supply in a day (Normal season)		
14.	Service coverage in slums		
15.	% of surface water treated		
16.	Treated water quality		
17.	% of waste water treated		
18.	Length of Roads (km) Metalled Asphalt Others		
19.	% of road side drains to road length		
20.	% of pucca drains to road side drains		
21.	Streetlights (No.) Sodium Vapour Tube lights Others		
22.	Solid Waste Management (MT per day) Generated Collected Treated / Disposed in Landfills		
23.	% Households under door to door collection		
24.	Road length cleaned per day		
25.	Sewerage / Drainage (km) Surface drains Underground Sewerage / Drainage Others		
26.	Sewerage Connections (as per CMC records)		
27.	No. of vector borne disease cases per 1000 population		

S. No.	Particulars	Current Year	Previous Year
28.	No. of water borne disease cases per 1000 population		
29.	% of areas of parks maintained		
30.	% amount spent on SC/ST Development Fund vs. amount to be spent on 18%		
COST OF SERVICES			
31.	Supply of Water (Rs. per million litres)		
32.	Maintenance of Roads (Rs. Per km)		
33.	Maintenance of streetlight (Rs. per unit)		
34.	Solid Waste Management (Rs. per MT)		
RECOVERY OF COSTS			
35.	Recovery of water cost (Rs.per million litres)		
FINANCIAL INDICATORS			
Performance Ratios			
36.	Surplus / (Deficit) <after depreciation> to Total Income Ratio... (%)		
37.	Income per Citizen... (Rs.)		
38.	Expense per Citizen... (Rs.)		
39.	Per capita tax receipts		
40.	Per capita non tax receipts		
Efficiency Ratios			
41.	Current Year Property Tax Collection Ratio ... (%)		
42.	Arrears Property Tax Collection Ratio ... (%)		
43.	Maintenance costs to Net Fixed Assets ratio ... (%)		
44.	Current year water tax collection Ratio ... (%)		
45.	Arrears water tax collection Ratio ... (%)		
Leverage Ratios			
46.	Loans to Reserves Ratio ... (times)		
47.	Debt Service Coverage Ratio... (times)		
Asset Ratio			
48.	Fixed Assets to Total Assets Ratio... (%)		

Source: Schedule VIII to the Draft Karnataka Municipalities (Accounting & Budgeting) Rules, 2006.

Annex E. PFMA Urban Reforms in India

Urban Context

231. India has a parliamentary system of government which is federal in structure,¹ with a three-tier structure: national government, state governments (for every federal state), and local government (comprising of urban and rural local bodies). Urban development is a state subject with further delegation to urban local bodies.

232. Urban local bodies comprise municipal corporations for larger settlements, municipalities for small and medium settlements, and *Nagar Panchayats* for transition settlements.² Urban local bodies are created and governed by state acts with classification based on pre-determined criteria.³ The state usually has a Department of Municipal Administration that is responsible for overseeing and regulating urban local bodies in the state. Service delivery mandate of urban local bodies vary across states depending on the extent of devolution effected by the state after implementation of Constitution (74th Amendment) Act, 1994 (Table E.1). On the whole, urban local bodies are entrusted with provision of water supply; public health; sanitation conservancy and solid waste management; fire services; urban environment; and urban amenities and facilities, such as parks, gardens, and playgrounds.

233. At the national level, the Ministry of Urban Development and the Ministry of Urban Employment & Poverty Alleviation formulate policies, sponsor and support programs, co-ordinate activities of various state governments and monitor programs concerning urban development in the country.⁴ The Planning Commission (through National Five-Year Plans) provides policy support, and the Central Finance Commission augments resources for putting policies into action.

Mapping Urban Reforms

234. In the complex Indian socio-politic setting, there has been a dynamic policy environment for issues of local governance and development. The National Commission on Urbanization Report (1988) was perhaps the first document recognizing urbanization challenges and its linkage to economic growth in the country. Since then, there have been a series of reform for the overall development and improvement of urban governance environment in the country. Some key milestones (with focus on key PFMA areas) are summarized in Table E.2.

The key features of these policy initiatives are summarized below.

Policy framework

235. **The Constitution (74th Amendment) Act, 1992.** The Constitution (74th Amendment) Act was passed in 1992 to accord formal recognition to urban local bodies in the Constitution and make them more autonomous and participatory. It provided powers to urban local bodies to function as “independent institutions of self-government” and directed states to devolve 18 specific functions as listed in Schedule XII of the Constitution. The 74th CAA also required creation of State Finance Commissions (SFC) in each state to review and make recommendations regarding distribution of taxes, grant-in-aid, and revenue-sharing policy between the state and urban local bodies. It also recommended that audit of large urban local bodies should be carried out by the Comptroller and Auditor-General of India (C&AG) and the reports presented before the ULB board and the state’s legislative assembly. The detailed prescription of audit for urban local bodies was left to the states. The 74th CAA was a landmark in state recognition of urban local bodies and for creating a broad framework of transparent financial management through oversight and accountability mechanisms.

¹ Governed by the Constitution of India, which was effective January 26, 1950.

² These settlements have different names in different states; Uttar Pradesh Municipal Corporations use *Nagar Nigam*, and Municipal Councils use *Nagar Palika*.

³ The gradation of an area into transitional, small, or large is determined by the state governor on the basis of population, area, density, local-generated revenue, employment in nonagricultural activities, and other factors that point to the economic importance of the area [Article 243(Q)(2), Constitution of India].

⁴ Ministry of Urban Development, see website access in Select Bibliography.

Table E.1. List of Functions mentioned under 12th Schedule devolved in States

Functions	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
Andhra Pradesh	x	x	x	√	x	√	x	√	√	x	x	√	x	√	x	√	x	√
Delhi	x	x	√	x	x	√	x	x	x	x	x	√	x	√	√	√	√	√
Gujarat	x	x	x	√	√	√	√	√	√	x	x	√	√	√	√	√	√	√
Haryana	x	x	x	√	√	√	√	x	x	√	x	√	x	√	√	√	√	√
Himachal Pr.	x	x	x	√	√	√	√	x	x	x	x	√	x	√	√	x	√	x
Karnataka	√	√	x	√	√	√	x	√	√	√	√	√	√	√	√	√	√	√
Kerala	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√
Madhya Pr.	√	√	√	√	√	√	√	√	√	x	√	√	x	√	√	√	√	√
Maharashtra	x	x	x	√	√	√	√	x	x	x	√	x	√	√	√	√	√	√
Rajasthan	x	x	x	√	√	√	√	x	x	x	x	x	√	√	√	√	√	√
Tamil Nadu	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√
Uttar Pradesh	√	x	x	x	√	√	x	√	√	√	√	√	√	√	√	√	√	√
West Bengal	√	√	x	√	√	√	√	√	√	√	√	√	√	√	√	√	√	√

Note: "x" refers to functions not devolved by the state to urban local bodies; "√" refers to functions which have been devolved.

Function codes: 1. Urban planning including town planning; 2. Regulation of land-use and construction of buildings; 3. Planning for economic and social development; 4. Roads and bridges; 5. Water supply for domestic, industrial and commercial purposes; 6. Public health, sanitation conservancy and solid waste management; 7. Fire services; 8. Urban forestry, protection of the environment and promotion of ecological aspects; 9. Safeguarding interests of weaker sections of society, including the handicapped and mentally retarded; 10. Slum improvement and upgrading; 11. Urban poverty alleviation; 12. Provision of urban amenities and facilities such as parks, gardens, and playgrounds; 13. Promotion of cultural educational and aesthetic aspects; 14. Burials and burial grounds: cremations, cremation grounds and electric crematoriums; 15. Cattle pounds; prevention of cruelty to animals; 16. Vital statistics including registration of births and deaths; 17. Public amenities including street lighting parking lots, bus stops and public conveniences; 18. Regulation of slaughterhouses and tanneries.

Source: National Commission to Review the Working of the Constitution: Decentralization and Municipalities

Table E.2. Urban Reforms in India (PFMA context)

Year	Policy intervention	Link with PFMA context
1985	7 th Five-Year Plan	Policy recommendations for revitalization of civic bodies; reform of municipal administration; constitution of State Finance Commission's; and constitutional status for local government.
1988	National Commission on Urbanization	Link between urbanization and economic growth explicitly acknowledged. Reiteration of the need for decentralized urban growth and emphasis on the role of local governments
1991-92	New Economic Policy	Autonomy of local governments seen necessary for deregulation and privatization of provision and maintenance of urban infrastructure and basic services.
1992	74 th Constitutional Amendment Act	Devolution of powers (political, administrative and fiscal) to urban local bodies for functioning as 'independent institutions of self government'
1992-97	Formation of State Finance Commissions	To correct fiscal disabilities imbalances of local bodies and improve their financial situation and review financial position of urban local bodies and make recommendations regarding distribution of taxes, revenue-sharing arrangements, grant-in-aid system, etc.
1998	First Municipal Bond (Ahmedabad Municipal Corporation)	Landmark initiative followed by issue of guidelines for issuing tax - free municipal bonds in Feb 2001 and increase in the limit from Rs. 2,000 million in 2001-02 to Rs. 5,000 million in 2002-03.
2000	11 th Central Finance Commission	Recommend measures for augmentation of resources of states so that they can supplement resources of local bodies. Also recommended C&AG involvement in providing technical guidance and supervision to local bodies.
2000	The Transparency in Public Procurement Act	Karnataka was the first state to pass this legislation followed by Tamil Nadu
2002	Urban Reforms Incentive Fund	Policy initiative aimed to encourage reforms in urban local bodies (covered some PFMA areas like accounting, budgets, etc.)
	Supreme Court Judgment on Solid Waste Management	Highlight the issue of accountability of executives in urban local bodies for service delivery. Instituted reforms in accounts for greater transparency and better management of service costs.
	C&AG Task Force	Took the initiative to formulate policy guidelines on municipal accounting reforms through Double Entry Accrual-based accounting.
	Pooled Finance	Precedence set by Tamil Nadu for smaller urban local bodies to raise funds from capital markets.
2003	Model Municipal Law	Template for states to revise their municipal legal framework. Key focus on improving state oversight of municipal finances through SFC recommendations
2005	Right To Information Act	Government of India initiative towards transparency and accountability. Adopted by most of the states.
	National Municipal Accounting Manual	Guidelines to the states/urban local bodies for accounting reforms on Double Entry Accrual System
	Launch of JNNURM and UIDSSMT	Reforms-driven, fast track mission for planned development of identified cities with focus on efficiency in urban infrastructure and services delivery, community participation, and accountability of local governments towards citizens.
2005-2010	12 th Central Finance Commission	Recommends enactment of fiscal responsibility legislation at state level, which is likely to improve budget preparation, execution and monitoring situation in urban local bodies.
2006	ULG Disclosure Act	Provide for transparency and accountability in the functioning of urban local bodies

236. **Expanded scope of Central and State Finance Commissions.** The 74th CAA also expanded the scope of the Central Finance Commission to include review and recommendations for local government financing. The Eleventh and Twelfth Finance Commission have, in particular, addressed key issues of local finances including:

- Separate tax domain for local bodies;
- Establishment of a separate framework for allocations of central grants to local bodies; and
- Requirement for Action Taken Report by state government on SFC recommendations within six months.

237. Further, the role of State Finance Commissions was also expanded to include review of finances and recommendations on revenue sharing, financial autonomy, and financial management practices in urban local bodies of the state. Although many states did establish State Finance Commissions, Action Taken Reports show that compliance and acceptance of the recommendations is generally weak.

238. **Model Municipal Law.** In order to help facilitate the implementation of 74th CAA, the Government of India developed a Model Municipal Law in 2003 to serve as a template for states to revise their municipal legal framework. Key provisions of the Municipal Law include:

- Acknowledgement of role and recommendations of State Finance Commission in municipal finances;
- A form of administrative receivership for cities that default in performance of their duties;
- Mandatory framing of ULB debt limitation policy;
- Development of standard municipal accounting manual and practices;
- Creation of municipal accounts committee and preparation of annual financial statements;
- Mandatory requirement for urban local bodies to prepare inventory of all municipal assets;
- Encouragement for urban local bodies to prepare their own development plans; and
- Enabling private sector participation in the construction, financing, and delivery of urban services.

The Model Municipal Law is a guidance document and is expected to be useful for states that are revising or replacing their earlier municipal laws.

239. **The Right to Information Act, 2005.** This Act has far-reaching implication for public accountability systems in India. It requires government bodies to provide any information sought on its operations within a specified timeframe. It also promotes proactive disclosure of certain information by government bodies. The Act provides for elaborate disclosure requirements, appointment of responsible officers as central and state information commissioners, an independent appeal mechanism, and stringent penalties for default. However, its effective implementation at the local level remains a challenge due to poor recordkeeping, weak political will, and bureaucratic procedures.

240. **Urban Local Government Disclosure Bill, 2006.** This proposed legislation aims to enhance transparency and accountability in local government functioning. Every urban local body shall be required to maintain adequate records and make disclosure of key information at regular intervals to the public. Disclosures have been prescribed to be made through newspapers, internet, notice boards, and ward offices, among others. The Bill envisages voluntary sharing of information by the urban local bodies and is a step forward from the Right to Information Act.

Resource Mobilization and Financial Management

241. **Municipal Bonds and Pooled Financing.** The access to debt market has been one of the key developments in urban finance during the last decade. The Ahmedabad Municipal Corporation pioneered this through a municipal bond issue 1998. Thereafter, several large corporations have issued municipal bonds. The Government of India has also supported these initiatives by exempting the interest earned on such bonds from income tax (Finance Act, 2000) and prescribing guidelines for tax-free municipal bonds (February 2001).

242. Smaller local bodies unable to access the capital market on their own reverted to alternative financing models, such as pooled funds, pioneered by Tamil Nadu (2002) and followed by Karnataka (2004). In 2006, the Government of India proposed development of a Pooled Finance Development Fund to institutionalize and support smaller urban local bodies in this process.

243. Perhaps the most important outcome of this process was not the amount raised by the urban local body, but the familiarity with market expected financial discipline and accountability systems. These included updated accounts, improved financial planning, and sound reporting practices—all essential components of a good PFMA environment. Interestingly, in spite of urban local bodies having weak finances in India, none of the 15 odd municipal bond issues have defaulted in repayment to date.

244. **Accrual Accounting in Municipalities.** *Almitra Patel vs. Union of India* (SC:2002) was one of the landmark judgments by the Supreme Court in the area of municipal management. Concerned with the weak financial reporting system in urban local bodies, the Supreme Court ordered the Central Government to develop guidelines for moving to a full accrual accounting system for urban local bodies. Accordingly, a task force was appointed in 2001 under chairmanship of the Deputy C&AG to develop an accounting system and process to be followed by urban local bodies for better financial recording and reporting.

245. Based on the recommendations of this task force, the Government of India initiated development of a National Municipal Accounting Manual (NMAM) for conversion of ULB accounting to double entry accrual basis of accounting. The NMAM was issued in 2005. Some states, including Karnataka, Andhra Pradesh, Gujarat and West Bengal, have already adopted the NMAM recommendations in their accounting manuals.

Incentive-led reforms

246. **Urban Reform Incentive Fund.** In order to accelerate process of urban reforms, the Government of India decided to provide reform-linked financial assistance to states. In 2002, the Government set up an Urban Reform Incentive Fund (URIF) with an initial outlay of Rs. 500 crores per annum. The URIF was designed to provide incentives for reforms in state and local government, including repeal of the Urban Land Ceiling Act, rationalization of stamp duty, reform of rent control laws, introduction of computerized registration, reform of property tax, levy of user charges, and adoption of double entry accounting system.

247. The URIF in practice became more allocation driven than reform driven. Progress toward the envisaged reforms was extremely slow due to low level of incentives available to states expected to tackle large-scale reforms, such as the rationalization of stamp duty. Other efforts (City Challenge Fund, for example) did not materialize failing to receive Cabinet approval.

248. **Jawaharlal Nehru National Urban Renewal Mission (JNNURM).** JNNURM (2006) is designed to be a reforms-driven, fast-track mission for integrated and planned development of 63 identified cities with focus on asset creation and management, efficiency in urban infrastructure and services delivery, community participation, and accountability. JNNURM has a central outlay of Rs. 50,000 crore (US\$11 billion) for a seven-year period. The program requires a tri-partite Memorandum of Agreement between the ULB, the state government and the Central Government that clearly identifies PFMA reforms, among others, and a timeline for achieving the same at all levels.

249. Some of the key reforms envisaged under JNNURM with PFMA impact include modern and transparent budgeting system, shift to double entry accounting system, improved asset management, e-governance, updated financial management systems, enhanced property tax collection efficiency, enactment of Public Disclosure Law and Community Participation Law, levy of reasonable user charges, process re-engineering using quarterly (information technology) monitoring by central- and state-level agencies, financial operating plan under city development plans, and credit rating. It is encouraging to note that 8 states have already signed memoranda of agreement and 30 out of the 63 cities have already come up with their city development plans as part of the requirements to access JNNURM.

250. To summarize, there exists a broad policy framework (74th CAA, Right to Information, etc.), appreciation of urban reforms areas, and incentives for their implementation (JNNURM). These need to be channeled toward result-based interventions and institutionalization in order to improve key PFMA areas and enhance the urban governance environment in the country.

Select Bibliography

- Andhra Pradesh Infrastructure Development Enabling Act, 2001 (Act No.36 of 2001).
- Asian Development Bank. 2002. Diagnostic Study of Accounting and Auditing Practices, India, Asian Development Bank, Manila.
- Athukorala, S. L., and B. Reid. 2003. Accrual Budgeting and Accounting in Government and its Relevance for Developing Country Members. Asian Development Bank. Manila.
- Bird, Richard. 1976. Charging for Public Services: A New Look at the New Idea. Canadian Tax Foundation. Toronto.
- Burki, S. J., and G. Perry (eds.). 2000. Decentralisation and Accountability of the Public Sector. World Bank. Washington, D.C.
- Comptroller and Auditor General (Duties, Powers and Conditions of Service) Act, 1991
- Karnataka Municipal Corporation Rules, 1977
- Karnataka Municipal Corporations Act, 1976
- Lalwri, A. and S. Fardaust. 2000. Indian States: The Road to Reforms. www.statesforum.org .
- Manual of Tamil Nadu Acts and Rules, Volume 3, 1995.
- Mathur, O. P., and Sandeep Thakur. 2004. India's Municipal Sector: A Study for the Twelfth Finance Commission (TFC). National Institute of Public Finance and Policy. New Delhi.
- Matthew, George, and Anand Matthew. 2003. India: Decentralisation and Local Governance: How Clientilism and Accountability Works. New Delhi.
- Morris, Sebastian (ed.). 2003. India Infrastructure Report 2003: Public Expenditure Allocation and Accountability. 3iNetwork. New Delhi and New York: Oxford University Press,.
- Nagarpalika Network. 2002. Issues in Governance of Urban Local Bodies. All India Institute of Local Self Governance. New Delhi.
- National Commission to Review the Working of the Constitution. 2001. A Consultation Paper on Efficacy of Public Audit System in India: C&AG Office-Reforming the Institution. New Delhi.
- NCRCL. 2002. Public Financial Accountability in Urban Local Bodies in Karnataka.
- Norton, A. and D. Elson, 2000, What's Behind the Budget? Politics, Rights and Accountability in the Budget Process, Overseas Development Institute.
- Paul, Samuel, Suresh Balakrishnan, Gopakumar K. Thampi, Sita Sekhar, and M. Vivekananda. 2006. Who Benefits from India's Public Service? A People's Audit of Five Basic Services. Academic Foundation. New Delhi.
- Paul, Samuel, et.al. 2005. Benchmarking India's Public Services: A Comparison across the State. Public Affairs Centre, Bangalore.
- PEFA Secretariat. 2005. Public Financial Management Performance Measurement Framework. World Bank, Washington D.C.
- Reserve Bank of India. 2002. State Finances: A Study of Budgets of 2002-03. Mumbai.
- Sekhar, Sita, and Manisha Shah. 2006. Benchmarking Bangalore's Public Services: What the Third Citizen Report Card Reveals. Public Affairs Centre. Bangalore.
- Sen, Tapas, K. 2003. Fiscal and Procurement Processes in India Infrastructure Report. New Delhi: Oxford University Press.
- Stabilisation and Fiscal Empowerment: The Twin Challenge Facing India's States.
- Tamil Nadu Transparency in Tender Rules, 2000.
- Tamil Nadu Transparency in Tenders Act, 1998.

Vaidya, C. 2000. Property Tax Reforms in India: Some Issues. Paper presented at Local Governance for Millennium with Special Reference to Financial Reforms. RCUES, AILSG, Mumbai. September 21 and 22, 2000.

World Bank. 2004a. India: Orissa State Financial Accountability Assessment. Financial Management Unit, South Asia Region, World Bank, New Delhi.

World Bank. 2004b. India: Uttar Pradesh State Financial Accountability Assessment. Financial Management Unit. South Asia Region, World Bank, New Delhi.

World Bank. 2004c. India: Urban Finance and Governance Review, Volume I (Executive Summary and Main Report). Energy and Infrastructure Unit. South Asia Region, World Bank, New Delhi.

Relevant Websites

Department of Economics, Bonn Graduate School of Economics
<http://www.bgse.uni-bonn.de/>

Public Expenditure and Financial Accountability
www.pefa.org

Ministry of Urban Development, Government of India
<http://urbanindia.nic.in/moud/theministry/ministryofurbandevlopment/main.htm>

wb170883

M:\FINANCIAL MANAGEMENT+AUDIT\PFM in ULBs\ULB Study April 20, 07 Final Version Corrected on Nov 27.doc

11/28/2007 10:04:00 AM