Financial Management of Urban Local Bodies in India: A Paradigm Shift in Development

Simran Nain
Student, M. Com. (Hons -Final Year), Department of Commerce, M. D. University, Rohtak, India

Abstract

Financial management is an integral part of the overall management, on other disciplines and fields of study like economics, accounting, production, marketing, personnel and quantitative methods. Public finance and particularly the financial management and accounting of government institutions have become fundamentally important. This matter has received global attention and substantial innovation and fiscal reform had been introduced. The Indian financial system has changed considerably since the 1990s. Public financial management is a complex field with many new initiatives. Implementing public financial management reform is a challenge in all countries of the world and especially in developing countries like India, but to successfully mount and execute public financial management projects in resource constrained countries has proven rather difficult. On one hand, hard technical requirements surrounding the full policy/budget cycle in modern public finance systems are fundamental when developing reform programs. On the other hand, soft institutional and organizational factors are of equal importance in the implementation of public finance management reform programs. Experience with reform programs indicate that it is often the “soft” factors that constitute real barriers to successful reform. The 2nd Administrative Reforms Commission of India has made an effort to reform the public financial management of India. So, this paper mainly covers the different aspects of financial management like prospects of reforms in budgetary process, centre-state fund flow, accounting process, internal control over finance and Parliamentary Control over finance.

KEYWORDS: Financial management, urbanization, Urban Local Bodies (ULBs), Finance Commission, Constitutional 74th Amendment Act, Model Municipal Law (MML), Administrative Reforms Commission

Introduction:

The rapid urbanization in the country poses the challenges before political leaders and municipal managers to find new and more effective ways of managing their cities. This entails the creation of a conducive and enabling environment for urban local bodies (ULBs) to effectively perform their functions, and for city managers to acquire the knowledge, skills and expertise which are necessary to plan, manage and govern their cities. It is widely accepted that professionalization of ULBs is an urgent need to address a wide range of critical issues like planning; organizational and financial issues. Urban local bodies have a fairly long history in India. The first municipal corporation in India came into existence at Madras in 1688. The Corporation consisted of the Mayor, Aldermen and Burgesses. The Corporation was empowered to raise taxes from the inhabitants and to use funds for development and maintenance purposes.[i]

Since British period, the states controlled the local government through administrative, fiscal, and planning policies. Local self-government is a state subject under the Constitution of India. However, the 74th Constitutional Amendment Act provides a Constitutional status to the structure and mandate of urban local bodies for enabling them to function as effective institutions of self-government. It aims to empower urban local bodies by the devolution of functions, planning responsibilities, a new system of fiscal transfers and the empowerment of women and weaker sections of society etc. It envisaged a new era of government-people participation in the field of planning and implementation. Though political devolution has taken place in most states, fiscal and administrative devolution has not been fully achieved in the true spirit of decentralization. The ULBs, which have been specifically mandated to extend basic urban services are experiencing inability to cope with the unprecedented demand due to insufficient resources, limited reach of services, deteriorating quality of existing urban infrastructure, rising service demand and shortage in investments, inadequate capacity of staff including their inability and unwillingness to adapt the changing environment. The implication of this for ULBs is to upgrade their capacities and capabilities to achieve higher level of organizational effectiveness. Today management of complex urban living is an astounding task requiring a host of qualified personnel. Effective management depends upon adequate availability of administrative, professional and technical personnel. Capacity building is a process of acquiring new ideas and knowledge to strengthen an organization's vision, structure, direction and talent and enable it to contribute to common goals. In the case of ULBs, capacity building is expected to make the administrative machinery more efficient, accountable, people-friendly, responsive and transparent with a view to improve the proper service delivery system. So, the area of finance posses a key role in capacity building of ULBs because of the fact that no decision can be finalized unless its financial implications have been worked out fully and examined thoroughly. Finance is a sine-qua-non for any economic activity. Smooth functioning of government at all levels needs a sound financial system. Financial management is the oxygen for local self governments.[ii] Financial management is ultimately interwoven into the fabric of management. Needless to say that finance is that powerful force which controls and coordinates welfare functions of ULBs. This paper attempts to provide a conceptual paradigm for financial management of urban local bodies.

Responsibilities of Urban Local Bodies:

Urban Local Bodies are statutorily responsible for provision and maintenance of basic infrastructure and services in cities and towns. These bodies are under fiscal stress to operate and maintain existing services. Due to little revenue base; they are unable to function properly. The Constitutional 74th Amendment Act, 1992 is a path-breaking initiative in the urban governance reform in India. The Act introduces certain uniformity in the structure and mandate of municipal governance system across the country. It emphasizes the participation of directly elected representatives of the people in planning, management and delivery of civic services. Regarding the functional domain of ULBs, the Act envisages that the State Governments may, by law, endow them with such powers and authority as may be necessary to enable them to function as institutions of self-government and such law may contain provision for the devolution of powers and responsibilities upon municipalities.[iii]

The twelfth schedule of the Constitution includes these areas of consideration for ULBs: urban planning including town planning; regulation of land use and construction of buildings; planning for economic and social development; roads and bridges; water supply for domestic; industrial and commercial purposes; public health, sanitation, conservancy and solid waste management; fire services; urban forestry, protection of the environment and promotion of ecological aspects; safeguarding the interests of weaker sections of society, including the handicapped and the mentally retarded persons; slum improvement; urban poverty alleviation programmes; provision of urban amenities and facilities such as parks, gardens, and playgrounds; promotion of cultural, educational and aesthetic aspects; burials and burial grounds, cremations, cremation ghats/grounds, and electric crematoria; cattle pounds, prevention of cruelty to animals; vital statistics including registration of births and deaths; public amenities including street lighting, parking lots, bus stops and public conveniences; and regulation of slaughterhouses and tanneries etc.

ULB Finances and the Role of Finance Commissions:

The finances of ULBs comprises an important element of the larger fiscal scenario of the country, as ULBs are the Constitutional entities engaged in providing a variety of civic amenities and infrastructure. To perform these tasks, local bodies have to be financially sound with commensurate amount of powers for raising resources. However, while the Constitution has specified and listed the expenditure responsibilities, it does not provide a clear regime of taxes and revenue sources of ULBs. The expenditure liability of a municipality depends on the service cost, service norms and population parameters. This applies to all categories of services. Revenues raised depend on the size of revenue base, extent of access to the base, the rates and the collection efficiency.

Several Committees and Commissions have been appointed by the Government of India from time to time to look into the matter of local finance.[iv] However, even today the municipal finance is largely left to the discretion of the respective State Governments. The major ULBs taxes include the tax on land and buildings, taxes on vehicles, entry tax on goods (octroi), use consumption and sale, theatre show tax and tax on advertisements other than in newspapers. As a result, most ULBs find it difficult to match the available resources with the responsibilities assigned to them. The taxes, duties, tolls and fees to be levied by the municipalities and assigned to them as also the grants-in-aid to be given to them have been left at the discretion of State governments. This has allowed the fiscal mismatches to continue because there is not adequate decentralization of ULB resources to correspond the decentralization of ULB expenditures.

At the time of framing the Indian Constitution, a team was visited in Australia and studied the Commonwealth Grants Commission as well as borrowed the concept of Finance Commission.[v]The Tenth Central Finance Commission (CFC) was constituted in June 1992 and the report was submitted in November 1994. Originally, the Commission did not consider the aspect of local bodies finance in the terms of reference but the 73rd and 74th Amendment Acts had become effective before finalizing the report of the Commission. Therefore, the Commission was obliged to make recommendations regarding measures needed to augment the Consolidated Fund of States for supplementing the resources of the panchayats and the municipalities. In this response, the Commission made the ad-hoc provisions of Rs.100 per capita of rural population in each state to be distributed amongst panchayats over and above their due by way of their share of the assigned taxes, duties, tolls, fees etc. A provision of Rs.1000 crore for the five year period i.e. 1995-2000 covered by its recommendations for urban local bodies. With these ad-hoc provisions the Commission made it clear that this need not necessarily be a precedent for future Commission.[vi]

The Eleventh CFC was the first Commission who had the power to recommend the measures needed to augment the Consolidated Fund of a State on the basis of the recommendations of the State Finance Commissions (SFC). The Commission recommended Rs. 10,000 Crore for local bodies during 2000-2005, to be utilized mainly for maintenance of civic services like primary health, family welfare, education as well as other public utility services etc. Out of total recommended amount, Rs. 1600 crore and Rs.400 crore per annum was reserved for rural and urban local bodies respectively according to the criteria highlighted in table-1.[vii]

The Twelfth CFC recommended that an amount of Rs. 20,000 crore and Rs. 5000 crore for rural and urban local bodies respectively may be given to the states for the period of 2005-2010. The PRIs should be encouraged to take over the assets of water supply and sanitation and 50% of recurring costs should be recovered from the user changes in this regard. The 50% of the grant given to the states for urban local bodies should be dedicated to the solid waste management scheme through public-private partnership. The local bodies should keep the expenditure on creation of data base and maintenance of accounts on high priority. The modern technologies like Geographic Information System (GIS) and computerization should be used for mapping of properties and financial management respectively. Grants should be recommended separately for normal as well as the fifth and sixth Schedule areas of the Constitution. The Central government should not impose any condition for release or utilization of the grants. The State governments should not take more than 15 days in transferring the grants to these bodies after their released by the Central government. If it happens so, then Central government should take serious view in this undue delay. The State should adopt the best practices to improve the sources of the panchayats.[viii]

The thirteenth CFC recommendations have started a new era of fiscal decentralization based on a proportionate sharing of the divisible pool of central revenue which will strengthen the municipal finance considerably. Timely transfer of funds, normative assessment of services, reduction in governance deficit and updating land and property records will inject more effective self governance at ULB level.[ix] Article 280(3) was amended by adding sub-clauses (bb) and (c) through 73rd and 74th Amendment Acts. According to these sub-clauses it is obligatory upon the CFC to make recommendations as “the measures needed to augment the Consolidated Fund of State to supplement the resources of the panchayats/municipalities in the State on the basis of the recommendations of SFC. So, the thirteenth CFC recommends amending the sub-clauses of the above said Article by replacing the words ‘on the basis of the recommendations’ through ‘after taking into consideration the recommendations’. Article 243-I provides for the establishment of Finance Commission every fifth year for each State. The 13th CFC recommends substituting the words ‘or earlier’ after the words ‘every fifth year’. The other recommendations of the 13th CFC[x] as follows:

- State governments should increase the number as well as the capacities of local fund audit personnel.

- Reform the accounting system by including a separate head-wise statement of actual expenditure under the same heads of finance accounts as used in the budget for local bodies and these changes should be brought into effect from March 31, 2012.
- The Central and State governments should issue executive instructions for all their respective departments regarding payment of service charges to local bodies.
- The State governments should share the income with those local bodies from which the government collect the royalties for increasing their income.
- State governments should ensure that the recommendations of SFCs are implemented without delay and the action taken report is promptly placed before the Legislature. Urban local bodies should use some portion of their grants for revamping the fire services falling in their jurisdiction.
- Local bodies should be associated with city planning functions wherever the development authorities are mandated this function. These authorities should also share their revenues with local bodies.
- The District Planning Committees (DPCs) should manage the development plans of civilian areas of Cantonment Board/areas.
- State governments should lay down the guidelines for the constitution of nagar panchayats.

Table-1

A Comparative View of Fund Distribution Criteria of Central Finance Commissions

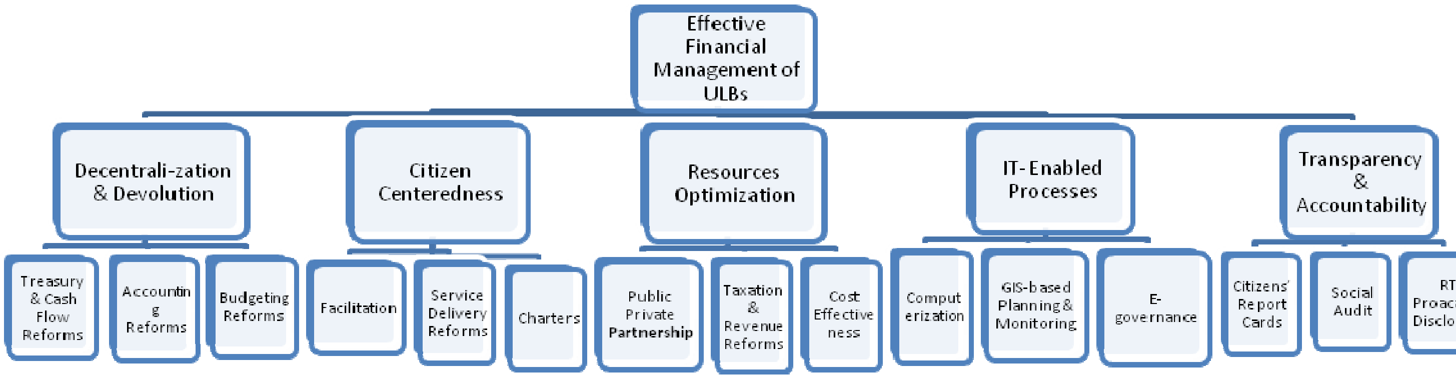
Sr. No.	Criteria Indicators	XI CFC	XII CFC	XIII CFC
1	Population	40%	40%	25%
2	Index of Decentralization	20%	-	-
3	Distance from Highest per Capita Income	20%	20%	-
4	Revenue Efforts	10%	20%	-
5	Geographical Area	10%	10%	10%
6	Index of Deprivation	-	10%	-
7	Fiscal Capacity Distance	-	-	47.5%
8	Fiscal Discipline	-	-	17.5%

Source: Reports of the Central Finance Commissions of India.

In acknowledgement of the need of periodically review the balance of functions and finances between the States and ULBs a provision has been made in the Constitution for the establishment of State Finance Commissions (SFCs) every five years.[xi] The State Finance Commissions are expected to review the financial position of ULBs and to make recommendations regarding the *principles* of devolution of resources from the State government to ULBs and the *measures* needed to improve their finances and functioning.

Reforming the ULB Financial Management:

It does not need much emphasis or explanation that the *measures* needed to improve the finances and functioning of ULBs imply much more than the fiscal devolution alone. It points to the improved practices of ULB management as a whole. It is a widely acknowledged fact that the different aspects of ULB management such as revenue optimization, cost-effectiveness, process reform & reengineering, transparency & accountability, people-centeredness, etc., are all interlinked and therefore it needs simultaneous and synchronous reforms. In a country of great diversity and multiplicity it is difficult to device standard formulae of ULB reforms. Hence, perhaps the best strategy of consolidating the wisdom on ULB reforms is to map the best practices in this sector and to attempt a generic analysis of these practices with a view to promote their replication and scale-up.



Effective Financial Management of ULBs

It is evident from the above discussion that the financial aspect of ULB management cannot be clearly dissociated from the other aspects and from the ULB management as a whole. All aspects of ULB management are interrelated and hence affect each other. A narrow focus on the financial management alone can, therefore, result in an inadequate and lopsided view of the issues at hand.

Model Municipal Law and ULBs Financial Management:

The diversity of contexts in which ULBs across the country exist and operate is such that the issues of ULB management can often pose a perplexing picture. In order to bring certain uniformity in this scenario and to establish certain minimum conditions of ULB management, the Ministry of Urban Development, Government of India has finalized a Model Municipal Law (MML) of India in October 2003. The basic objectives of the MML are to implement in totality about the provisions of the 74th Constitutional Amendment for empowerment of ULBs, and to provide the legislative framework for implementation of the Ministry's urban sector reform agenda. This initiative is expected not only to enhance the capacities of ULBs to leverage public funds for development of urban sector but also to help in creating an environment in which ULBs can play their role more effectively and ensure better service delivery. The salient Features of MML regarding financial management of ULBs are as follows:

• State government should prepare the municipal accounting manual and municipalities need to prepare annual balance sheets for this purpose as well as there should be a provision for appointment of a Municipal Accounts Committee. It is provided for appointment of chartered accountants as auditors.

• Capital and revenue heads should be separated out in municipal accounts and separate accounting heads should be maintained for water supply, roads, etc.

• Annual subsidy reports should be prepared.

•There should be a provision of preparing the annual inventory of municipal properties.

• A comprehensive debt limitation policy should be framed by state government.

• Provision for enabling access to capital markets and financial institutions for capital investments.

• Property tax (PT) assessment system should be based on area or capital value bases. This tax should have the self-assessment system.

• Unique property numbering system should be included into the financial management of ULBs.

• Implementation of SFC's recommendations should be maintained properly.

Good Financial Management:

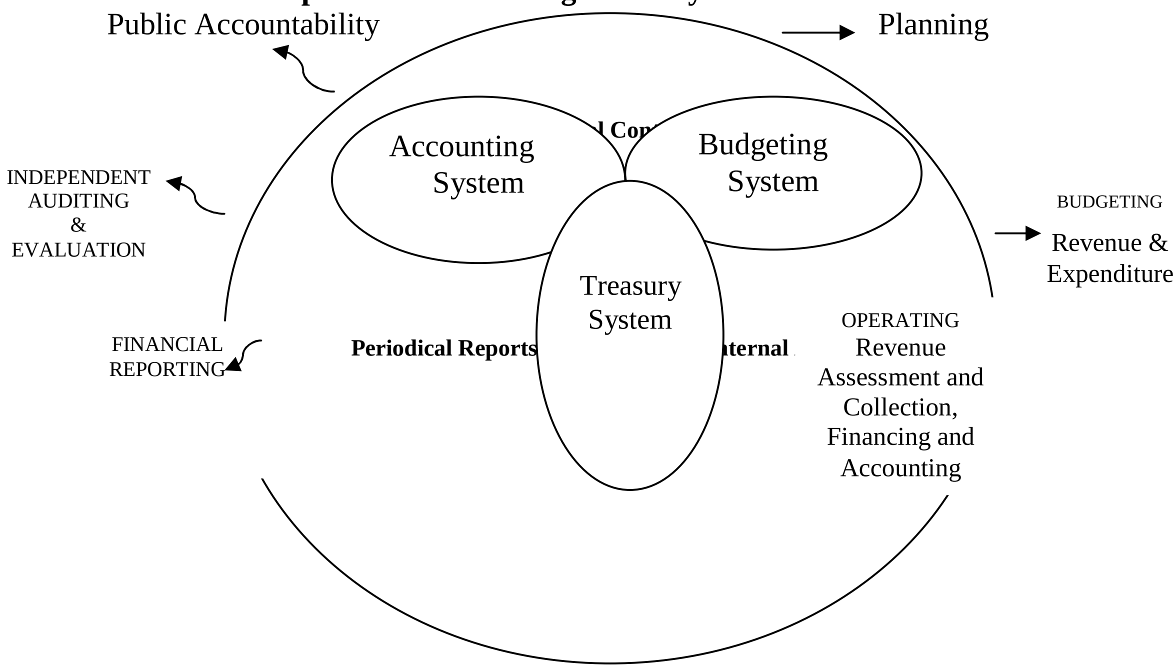
Good financial management is expressed through good budgeting, accounting and auditing. Good Budgeting means when budgets are prepared with inputs from implementers, supported by strong, effective and feasible action plans. Good Accounting deals with detailed identification and categorization of financial transactions; proper recording of the transactions and timely production and analysis of reliable financial statements by following generally accepted accounting principles. Good Auditing includes strict and regular follow-up on the sourcing, allocation, and application of financial and other resources in line with the target and budget. The ultimate aim of auditing is to prevent public properties from embezzlement, abuse, misappropriation, etc. Moreover, good auditing practice calls for independent, impartial, timely and ethical evaluation of activities and financial transactions.

Municipal Financial Management Cycle:

The overall municipal financial management system can be viewed as a collection of several integrated and closely coupled components comprising accounting, budgeting, treasury management, internal controls and audit. Accounting is an essential element of the overall system. Without proper accounting system, an ULB would not have any clear idea of how well it is performing financially, whether it is becoming more solvent or more indebted, whether it will likely have sufficient funds, whether financial activities are being executed according to the plans. Furthermore, without proper accounting, it becomes impossible to state whether funds entrusted to an ULB have been used for the intended purposes. Budgeting involves planning how resources are to be collected and distributed within/across activities. Budgeting should be realistic and relevant and it must

Periodically receive feedback from the accounting function. The entire budget exercise starts with setting up budgets and targets and ends with the taking of an action. Budgets are usually set up in the light of past experience after taking into account the changes that are expected to occur in the future. It must be the constant endeavor of the management to see that actual performance does correspond with the budget concerned. Since budgets assume the optimum efficiency attainable, the system of budgetary control helps to increase efficiency and enable the ULB to achieve targets, which are considered attainable.

Municipal Financial Management Cycle



- *Treasury Management* deals with the custody and management of assets and liabilities, such as checking accounts, petty cash, accounts payable and loans payable. The treasury component also provides important information to the accounting component that supports its recording, reconciliation and reporting tasks.
- *Internal Controls* consist of all resources, systems and tools that help in ensuring that the ULBs and its financial management functions operate as intended. They also help prevent errors, mis-statements, misappropriations, and other forms of losses to the ULB. Sound internal controls imply that the ULBs are operating efficiently.
- *Internal Auditing* is a monitoring component. It consists of internal audit conducted by auditors reporting to the Commissioners/ Councils of ULB, and external audit, which is more independent but typically involves a more narrow scope of work focused on certification of financial statements. All of the financial management components above are subject to review by the audit functions.

As per above discussions, All resources need proper planning and control in their utilization to satisfy the public interest. Financial management initiatives include effective controls over receipts, expenditures, funds, property and other government assets. Legislatures should not only provide money, but it is necessary to ensure that funds should be spent economically and efficient manner and produce the intended results. Proper public expenditure management should adequately control the total level of revenue and expenditure and appropriately allocate public resources between sectors and programs.[xii]

ULBs Financial Management and 2nd Administrative Reforms Commission

The Commission was constituted on August 31, 2005 with Veerappa Moily as its Chairman and five other members. The 6th report namely 'Local Governance: An

Inspiring Journey into the Future' was submitted in October, 2007 and recommended[xiii] the following aspects for strengthening the financial management of Urban Local Bodies:

- State Governments should ensure about the adoption of unit area method or capital value method for assessment of property tax in a time-bound manner. The Unit Area System has worked very well in other cities like Ahmadabad, Patna, Bangalore, Chennai, and Hyderabad apart from many other cities. Hence there is a lot of experience in its efficient working. This new system can be more transparent, reliable, hassle-free and efficient. The Unit Area Method of Property Tax has been implemented in Delhi since April 1, 2004. This is a historic reform in the administration of property tax laws and is designed to be citizen friendly, transparent, easy to calculate and promote honesty in the citizen-civic body interface. Property owners can self-assess their tax and submit. The area-based method is simple, arithmetical and transparent. It is based on fixing a unit area value per square meter of covered space for calculation of property tax. The tax for a particular property is based on the annual value of the property arrived at by multiplying unit area value assigned to the localities by the covered area of the property and the multiplicative factors for occupancy, age, structure and use.[xiv] The capital value system is based on the capital value of property. The capital value of a property is fixed by the revenue department.

- The property tax should be imposed on the every property whether authorized or unauthorized. The same tax should be paid by the occupant of the municipal lease property. There should be a provision of service charge on Union and State Government properties in lieu of services like solid waste management, sanitation, maintenance of roads, street lighting and general civil amenities. The details of the tax levied on properties should be transparent. A separate wing headed by Chief Executive should be created for physical verification of taxable properties in the municipal limit.
- A GIS mapping based computerized data base should be prepared for every municipal areas.
- On the pattern of C&AG auditing process, the government auditors should audit the randomly selected cases of assessment.
- These principles should be followed for tax management:
  - Principle of transparency and objectiveness.
  - Principle of self declaration of tax payer.
  - Principle of stringent penalties in case of fraud or suppression of facts by the tax payer.
  - Principle of establishing the separate tax collection monitoring wing headed by Chief Executive.
  - Principle of creating an independent quasi-judicial authority for managing appeals against orders of assessing officers.
- Octroi should be abolished, but the States should evolve mechanisms to compensate the local governments for the loss of revenue caused by such abolition.

- Article 276(2) should be amended for periodic review about ceiling of Profession Tax.

- An impact study should be carried out for all major developments in the city. A congestion charge and betterment levy in relation to such projects may be levied wherever warranted.
- The power to impose fines for violation of civic laws should be given to municipal authorities. These fines need to be enhanced and revised periodically without the necessity of an amendment to the law.
- The recommendations of the State Finance Commission (SFC) should be considered for fixing the borrowing limits.
- Municipal bodies should be encouraged to borrow without government guarantees. However, for small municipalities, pooled financing mechanisms will have to be put in place by the State government.
- The capacity of the municipalities to handle legal and financial requirements of responsible borrowing must be enhanced.

Conclusion:

The ever increasing needs of society coupled with changing global scenarios and growing population size, poses a challenge to Urban Local Bodies (ULBs). This is especially so with respect to issues such as poverty, inadequate infrastructure etc. These challenges call for more efficient, effective, transparent and accountable public service and reforms. In order to cope with these challenges, municipal officials need to be equipped with all the necessary tools. Revenues and expenditures should be properly identified and planned accordingly. Otherwise, all of the strategic plans and other derivative plans will be futile. This implies that, municipal financial management is the most important part of the strategic management process that requires careful planning. The fiscal gap can be redressed in the following broad ways like reducing municipal responsibilities, scaling down municipal service norms, cutting costs and unnecessary expenditures, enhancing municipal power to raise revenues, increasing transfers from higher levels of government, and stepping up local effort to raise revenues. Reforms to correct the municipal fiscal gap will need to address all of these factors in a comprehensive manner. Till date, a separate list of taxes exclusively for municipal bodies does not exist, which is most important for progressive financial management.

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