URBAN LOCAL BODIES IN INDIA- PRUDENT FINANCIAL CONTROL PRACTICES

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Abstract

Indian Urban Local Bodies have the status of third tier local government. Constitutionally built-in imbalances in the functions and finances have made the urban local bodies dependent on grants from upper tiers of government. In addition there are urban local bodies that have insufficient financial resources due to their failure to adequately exploit existing sources of revenues. In such a situation, there is a need for urban local bodies to exercise prudent financial control practices in order to match mandated functions with available finances and so to ensure financial sustainability. We focus on three types of financial control. Urban local bodies should try to meet administration, operation and maintenance costs from own source receipts and also to utilise the amount of any grants received for the intended purposes. We have also suggested a format for presentation of information in the annual financial statements for better understanding of the controls. Our paper ends with a case study where we have shown that the percentage of recurrent surplus is higher in those urban local bodies which exercise financial control. Our findings should be particularly helpful in small and medium-sized urban local bodies where budgetary control system is not well developed.

Introduction

Urban local bodies have a fairly long history in India. The first municipal corporation in India came into existence for Madras in 1688 under a charter transferring financial responsibility to the newly created corporation. 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. Mayors' courts were established in Madras, Bombay and Calcutta through the Royal Charter of 1720 (Aijaz 2006, p.6). The charter provided for the constitution of a corporation in each presidency town consisting of Mayor and Aldermen. Lord Mayo's Resolution of 1870 provided for strengthening of urban local bodies. The Government of India Act, 1919 was another development towards the evolution of urban local bodies. This Act transferred the responsibility for local government from the hands of the district officers to a department controlled by a popular minister. The popular ministers of provincial governments proceeded to establish elected councils and gave executive authority to the elected chairman (Aijaz, 2006, p.7). The Constitution of India, after independence, allotted local self-government to the state list of functions but it did not make any specific provision for urban local bodies. Originally, the Constitution of India envisaged a two-tier system of federal government.

Our paper focuses on financial control of urban local bodies including financial sustainability. We identify controls over receipts and expenditure of both a recurrent and capital nature. Finally we examine the influence of such financial controls through a case study. Financial reporting should provide a good view of the status of each urban local body's funds, identify controls and any improvements which may be needed (AGA, 2007). Financial data available from the "Administrative Report of Municipal Affairs Department 2001 – 2005, Government of West Bengal" and from the website of the department is used to assess whether the urban local bodies have adequate financial control and its impact on financial performance.

Constitutional Status

Until 1992, local governments were not part of the Indian government's planning and development strategy. A dramatic change in the federal system of India came with the introduction of the Constitution Amendment Act of 1992 conferring the status of the third level of government to local bodies. This amendment took Indian democracy one step forward and added a new dimension to the federal system of government. Through this amendment the establishment of a local representative government empowered with administrative and financial abilities to deliver mandated services to its citizens came into force. It transferred responsibilities for services to urban local bodies that elect their own representatives and gave them the power to raise their own revenues and authority to make investment decisions. (Rondinelli & Cheema, 2002)

The Constitution Amendment Act aimed to introduce strong grassroots level democracy through the establishment of urban local bodies, but left the issues of their empowerment and operationalization to the discretion of the state governments. The state governments, as a part of municipal governance reforms, should amend their municipal legislation to comply with the spirit of the Constitutional Amendment. However, state municipal legislation mainly covers electoral reforms and there has been little effort towards widening the functional and financial domain of urban local bodies.

In addition, legislation primarily aims to make urban local bodies accountable to their state government rather than to the citizens (Synthesis Report, 2006).

Functions and Finance

In the urban context, functional and financial decentralization should flow from the state to the cities and thereafter from the elected council to its wards. Indian urban local bodies enjoy constitutional responsibility for the preparation of plans for economic developments and social justice and implementation of such plans and schemes as may be entrusted to them. The Constitutional Amendment Act has specified eighteen functions which may be considered as the responsibilities of the urban local bodies. In addition state governments may assign them any tasks relating to the preparation and implementation of plans for economic development and social justice.

As a result, urban local bodies are in need of substantial funds to execute their constitutionally assigned functions. The legislature of a state may, by law, authorize an urban local body to levy and collect taxes, duties, tolls and fees. Central and state governments may also provide grants-in-aid to their urban local bodies. Thus there are two main sources of revenue for urban local bodies, internal and external. Internal source revenue is commonly known as own source and it includes income generated from various taxes and non-taxes levied on the citizen. External source revenue mainly includes funds obtained from the central and state governments in the form of grants or loans. There may be other external sources of funds, for example, loans from domestic institutions or financial intermediaries. Some urban local bodies have also chosen to raise money from capital markets by issuing bonds. (Aijaz, 2006)

Recently attempts have been made to identify new avenues to mobilise resources for urban local bodies, such as capital markets and financial intermediaries. Furthermore, there are a number of innovative practices to raise other financial resources for local governments, especially in the case of larger urban centres governed by municipal corporations. (Aijaz, 2006)

Constitutional Imbalances

The Amendment Act, 1992 specified the functions of urban local bodies, but it did not provided a corresponding list of legitimate sources for their revenue, and so this has been left to the discretion of state governments. Therefore, there is a constitutional imbalance in the division of expenditure, liabilities and revenue raising powers of urban local bodies. The mismatch between extensive functions and inadequate sources of finance is called a vertical imbalance. Constitutional imbalances between the functions and finances of urban local bodies often lead to their high dependency on their state governments and then the state governments on the central government.

The principle of fiscal federalism suggests that funds from upper tiers of government should be devolved to lower ones that is from central government to state governments and from state governments to local governments. Indian urban local bodies receive grants from the upper tiers of government which may be used for general purposes (for example, motor vehicle tax grant or stamp duty grant); for carrying out specific projects or schemes; or in the form of reimbursements of specific expenditures.

Grants received by urban local bodies may be of a recurrent or capital nature. A recurrent grant, usually in the nature of a subsidy, is generally utilised for meeting recurrent expenditure during the ordinary course of activity (for example, pay and allowance grant, repair and maintenance grant), the benefits of which usually expire within the accounting year in which it is incurred. Revenue grants may also be given for operating specific schemes or programmes (for example, census grant, pulse polio grant and other social welfare grants), the benefits of such expenditures may spread over several financial years. Capital Grants, usually given for a specific project or scheme (for example, integrated urban area development grant, construction grant), are utilised for capital expenditure, that is the creation of fixed assets (like land, buildings and equipment). The benefits of capital expenditure are of an enduring nature, spreading over an extended period of time. Certain specific purpose grants may include both capital and recurrent components (for example, grants for the construction of new roads and subsequent repairs and maintenance). Sometimes grants may have a deduction of certain charges or dues (for example, interest on loans, electricity dues) by the upper tier of government. Urban local bodies may also receive agency grants for specific beneficiaries who are required to submit utilisation statements. In other cases, scheme expenditure may be met by the urban local body itself.

Due to resource constraints, upper tiers of government may not be in a position to provide adequate resources for urban local bodies. The funding shortfall may also be further deepened, by the failure of the urban local bodies to adequately exploit existing sources of revenues and other factors like population growth, liberalization, and globalization.

Initiative by Government of India

The lack of adequate finances for urban local bodies led to the introduction of two significant constitutional provisions. State Finance Commissions are to be formed by state governments to recommend the devolution of state resources to local bodies. Similarly, the Central Finance Commission recommends grants-in-aid for local bodies through augmenting state consolidated funds. These provisions are designed to establish a proper balance between the finances of the local, state and central governments.

The central Government of India continually tries to strengthen the governance and finances of urban local bodies. The National Action Plan, launched in September 2001 by the Ministry of Urban Development and Poverty Alleviation in association with UN-HABITAT, recommends action plans in the area of decentralization, finance, financial management etc. The Jawaharlal Nehru National Urban Renewal Mission aims to ensure the fiscal empowerment of municipalities. A working group of state finance secretaries and other experts has been constituted by the Reserve Bank of India to consider additional reforms. Finally, the strategic plan of the Ministry of Urban Development for 2011-2016 has a clear mission and vision for urban local bodies.

Management and Finance Practice

The comparative advantage of local government undoubtedly resides in its superior knowledge of local conditions and the needs of local communities. Local Government can make an important contribution to public well being through the execution of government policies and the delivery of local public services. Local government also has the potential to be the most transparent and accountable level of government. Full realization of that promise, however, requires strong fiscal administration to ensure that citizen interests are reflected in local programs; policies are conducted in a fiscally sustainable way; and resources are not lost through inefficient, ineffective, wasteful, or corrupt operations (Mikesell, 2007).

State and local governments have made great strides in measuring and improving performance over the last two decades. This is partly a response to economic crises, decreasing revenue streams, and cuts in state and federal funding (Foltin, 2005). It is in this context that improved public financial management and accountability is crucial not only for better governance, but also for improved service delivery (Synthesis Report, 2006).

Inefficiency in Financial Practices

There may be inefficiency among urban local governments in the management of their finances, which could adversely affect the efficient delivery of basic civic services. This may include: deficiencies in the procedure for determining the cost of services; low levels of revenue collection; high areas from previous years and high dependence on external sources of finance (Aijaz, 2006).

Many urban local bodies are unable to meet the basic service requirements of their populations. Elected representatives and officials of urban local bodies regularly stress the need for the timely provision of funds from upper tiers of government, but they may not be able to maintain basic civic services nor initiate appropriate action for raising local revenues. Prudent financial control practices should match available resources to the function of urban local bodies.

Prudent Financial Control Practices

All resources need proper planning and control in their utilisation to satisfy the public interest (Achua 2009). Financial management initiatives include effective controls over receipts, expenditures, funds, property and other government assets (Audit Federal Financial Controls: Sooner Rather than Later? 2005).

Legislatures should not only appropriate money, but they should also ensure that funds are spent according to their intent, in an economic and efficient manner and produce the intended results (Ahsan, 1996). Proper public expenditure management at any level of government should:

(a) adequately control the total level of revenue and expenditure,
(b) appropriately allocate public resources between sectors and programs, and
(c) ensure that governmental institutions operate as efficiently as possible (Rao & Bird 2010).

Prudent financial control practice should also aim to ensure financial sustainability of urban local bodies. The generation of recurrent surplus is thus one of the key indicators of financial sustainability.

Elected representatives are power seekers and their major decisions are oriented at gaining votes. Therefore they may not take adequate measures to collect sufficient own sources. They may also make unnecessary or irregular expenditure. Public officials should constrain such action by the elected representatives, but they may prefer to keep quiet in order to avoid conflicts with the elected representatives especially if they are popular. Political power supersedes administrative power.

As a result, prudent financial practices are not necessarily adopted by urban local bodies. There are some large urban local bodies which are better governed, but the financial condition of small and medium-sized towns are often poor.

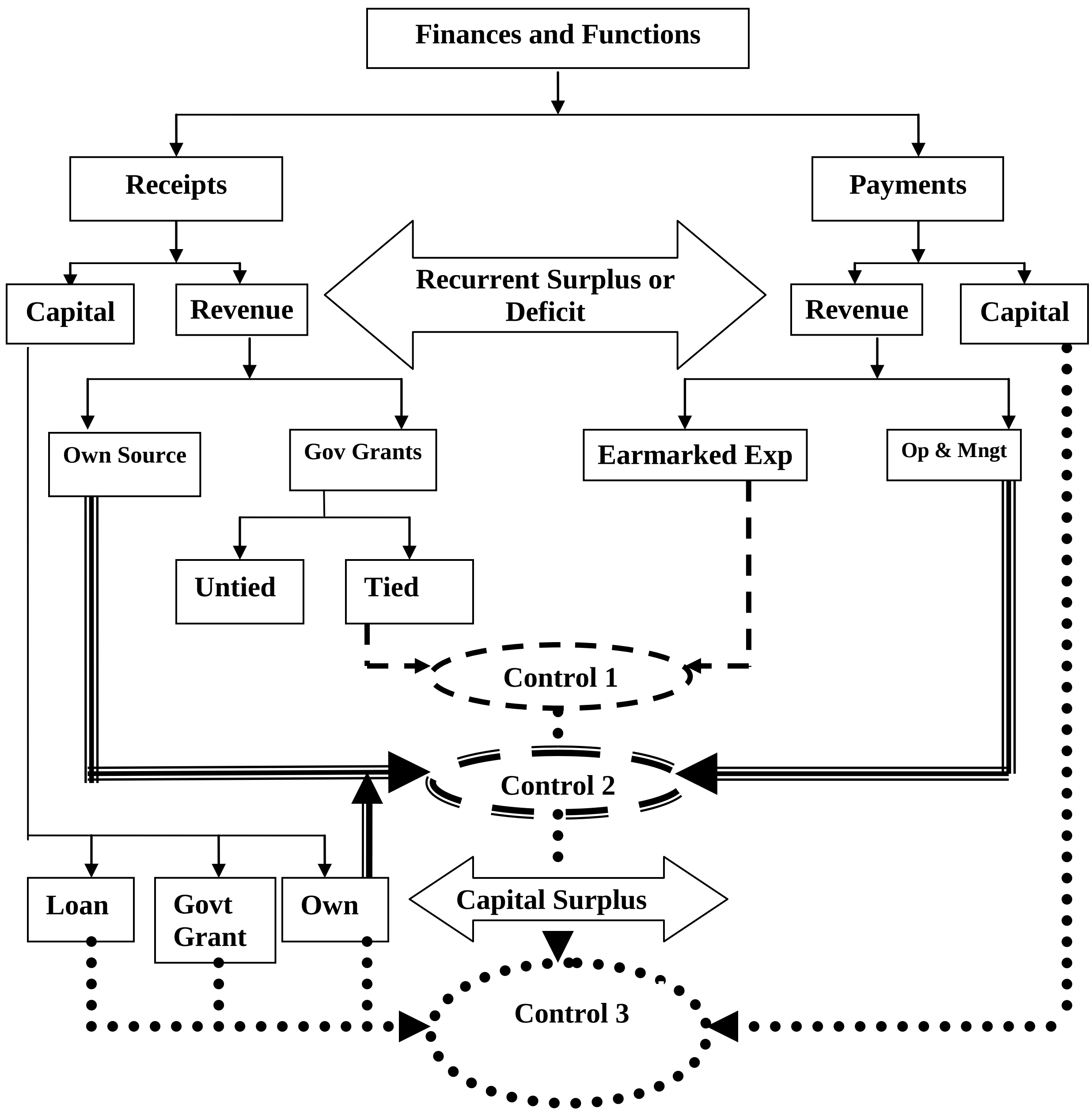

Diagram 1: Prudent Financial Controls

Control 1: This control covers tied grants received from upper tiers of governments. The grant should only be expended in accordance with authorizations of management and the direction of the issuer. However, an urban local body should also exercise financial control (1) to ensure that the amount of any tied grant is either equal to or more than the relevant earmarked expenditures.
Control 2: Appropriate resources are needed at the urban local body level to ensure the provision of basic services. An urban local body should try to meet the administrative, operation and maintenance costs (all expenses other than those covered by tied grants) out of its own source revenue collection. This is the aim of control 2.
Control 3: The result of the above two controls is either a recurrent surplus or a deficit. Any surplus is available for capital expenditure and so will complement capital receipts. Capital receipts, in the form of

a grant or loan, should be expended in line with the requirements of the issuer. Therefore control 3 is directed towards ensuring the balance between capital expenditure and capital receipts (augmented where possible by recurrent surpluses).

Accounting and Disclosure in Financial Statements:

The National Municipal Accounting Manual (2004) published by the Ministry of Urban Development describes the accounting policies, procedures and guidelines designed to ensure correct, complete and timely recording of municipal transactions and to produce accurate and relevant financial reports. An urban local body should prepare its financial statements to indicate the source and use of funds both from its own sources and those of higher tiers of government. In addition, readers of financial statements need to understand the financial control practices that have been exercised.

To achieve this we recommend that the following financial statements are produced by urban local bodies:

- Statement of Cash Receipts and Payments
- Statement of Financial Performance
- Combined Statement of Control.

An illustration of these statements is shown below.

Statement of Cash Receipts and Payments	Amt	Statement of Financial Performance (accrual)	Amt	Statement of Financial Position (accrual)	Amt
Receipts		Income		Capital Employed	
A.Own Source:		A. Own Source:		Funds and Reserves	
Tax Revenue	400	Tax Revenue (i)	440	Retained Earnings	125
Non-Tax Revenue	500	Non-Tax Revenue (ii)	530	Reserve: Capital Contribution (i)	**320**
Other Income	10	Other Income	10	Grant, Contribution	**210**
Total Own Source	910	Total Own Source	980		
B. Transfer from Upper tiers		B. Transfer from Upper tiers		Borrowings	150
General purpose Grant	100	General purpose Grant	100	Total	805
Revenue Grant Specific Purpose	550	Revenue Grant Specific Purpose (iii)	500	(i)Capital contribution is fixed assets purchased out of capital grant.	
Capital Grant	400	Total	600		
Grant as Nodal Agency	200	Total (A+B)	1580		
Total	1250	(i) 440= 400+ Receivable(40), (ii) 530= 500+		Employment of Capital	
C. Borrowings	250			Fixed Assets:	

D. Other		Receivable(30), (iii) Income recognised to the extent expenditure made. Pay and allowance= 300, Social Welfare = 200.		Municipal Fund	30
Interest on Grant Fund	30			Capital Grant Fund	320
Total Receipts (A to D)	2440			Loan Fund	200
Payments		Expenditure		Total	550
Operation					
Salary and Wages	350	Salary and Wages	350	Net Current Assets	
Administrative, Operation & Maintenance expenses	800	Administrative, Operation & Maintenance expenses (i)	885	Current Assets	
Interest and Finance Charges	20	Interest and Finance Charges	20	Debtors	70
Revenue Grant-Specific purpose	200	Revenue Grant-Specific purpose(ii)	200	Cash and Bank Balances	270
Total	1370	Total	1455		
Capital Payments		(i)885= 800+ Payable (85). (ii)Exp. against pay and allowance grant is booked under salary and wages. Amount expended out of social welfare grant is 200		Total	340
Fixed Assets	550			Current Liabilities	
Repayment of Loan	100			Creditors	85
Other: Payment as Nodal Agency	150			Net	255
Total	800			Total	805
Total Payments	2170				
Increase/ Decease in Cash	270	Surplus	125		
Cash at the beginning of the year	0				
Cash at the end of the year	270				

Combined Statement of Control:

Particulars	Own Fund	Specific Purpose				
		Pay & Allow	Social Welfare	Cap.	As Nodal Agency	Total
		Revenue Grant		Capital Grant		
Receipt						
Tax	400					
Non-Tax	500					
Other: Interest earned	10			30		30
Total	910			30		30
Received from Upper-tiers						
Specific purpose		300	250	400	200	1150
Total	910	300	250	430	200	1180
Less: Operating Payments						
Salary & Wages	0	350				350
Adm, Op & Mt.	800					
Interest & Fin Ch	20					
Total Op Payments	820	350				350
Balance (Control Checking 1st Point)	90	-50	250	430	200	830
General Purpose Grant		100				100
Balance (Control Checking 2nd Point)	90	50	250	430	200	930
Transfer of Balance	50	-50				-50
Balance	140	0	250	430	200	880
Other Payments:						
Fixed Assets	30			320		320
Social Welfare Grant			200			200
As Nodal Agency					150	150
Loan Repayment	100					
Total Payment	130		200	320	150	670
Balance (Control Checking 3rd Point)	10		50	110	50	210

Notes:

1. Balance of specific purpose grant tallies with the balance in Statement of Financial Position.
2. Balance of available Loan Fund is 50 (250-200).
3. Balance of all funds is 270 (10+210+50) which tallies with amount in Statement of Financial Position.

The balance of specific purpose grant appearing in the "Statement of Financial Position" should reconcile with the amount in the "Combined Statement of Control". The fact of financial control and its existence can be given in the notes on accounts.

We can interpret the above information that the urban local body has used the amount of general purpose grant for making payment of salary and wages along with specific purpose grant (pay and allowances) which is received as subsidy for this purpose. The negative balance under control 1 indicates this situation. The negative balance also ensures that the amount of pay and allowance grant has been expended in full.

Control checking 1st point denotes whether control 2 exists or not. From this point it is evident that control 2 has been exercised.

Control checking 2nd point indicates whether control 1 has been exercised or not after considering the use of general purpose grant. Transfer balance indicates that surplus of control 2, as out of general purpose grant, should be transferred to own fund. After use of general purpose grant there is a surplus, therefore control 1 has been exercised by the urban local body.

Control checking 3rd point is for checking whether control 3 has been exercised or not.

This statement ensures financial control in terms of the amounts, but there are some other points like the condition and restriction on funds and the extent to which such conditions and restrictions have been met. These should be disclosed in the Notes to the Accounts.

Our recommended disclosure in the Notes to the Accounts is as follows:

This urban local body has adopted prudent financial control practices which have as their main focus financial sustainability. These practices are designed to match the finances with the relevant function and to strictly apply financial discipline especially of over the utilisation of grant received from upper-tiers of government. The management hereby declares that the statement of fund control is true and correct and there is no diversion.

There are three types of control which are normally used by this urban local body:

> *Control 1: Prudent financial control practices includes the policy of expending the amount of specific purpose grant for the intended purposes along with general purpose grant if it is required. Full cost of employees is not given through pay and allowance grant and therefore the urban local body uses general purpose grant for payment of salary and wages. This financial control exists in a situation where the total amount of general purpose grant and pay and allowance grant is equal to or more than the amount of salary and wages. Control checking 2nd point* ***of combined statement of control*** *indicates that this control exists. All other specific purpose grants have been given for payment of specified expenditure and the expenses, so far made are in accordance with the terms of sanction. The unexpended balances are given in Balance (control checking point 3) and control 1 exists.*

Control 2: It is a control practice of this urban local body to make payment of administrative, operation and maintenance cost out of its own source receipt to match the function with finance. This financial control exists where own source receipt is sufficient enough to meet such cost and to generate surplus for financial sustainability. Control checking point 1 establishes the existence of this control.

Control 3: Prudent financial practice also includes strict vigilance over use of capital grant and borrowings. Such funds are used for the purpose for which these have been received. It is the normal practice of this urban local body to use capital receipt for capital expenditure. So far as the capital grants are concerned this control exists as evident from control checking point 3.

Case Study and Result

The impact of financial control practices can be measured with respect to overall financial performance of an urban local body. Performance measurement is the process of determining how effectively and efficiently taxpayer resources are being used for the delivery of services and the administration of programs. Prudent budgeting, collection and analysis of data, and comparisons to benchmarks are all necessary elements in performance measurement. An important element in evaluating performance of a governmental entity is the measurement of overall financial condition. Financial condition is the ability of a government to meet its financial and service obligations, currently and in the future (Simonsen & Armitage, 2006, p. 85).

The actual data we received are reproduced below in respect of two urban local bodies:

Table 1: Sample Data

Name	Year	(1) Property Tax Revenue	(2) Other Tax Revenue	(3) Total Tax Revenue (1+2)	(4) Non-Tax Revenue
Asansol MC	2001-02	229	43	272	60
Bardhaman	2002-03	259	38	297	192

(5) Total Revenue from Own Sources (3+4)	(6) Revenue from other Govt. Funds	(7) Total Recurrent Income (5+6)	(8) Salary & Wages	(9) Other Recurrent Expenditure	(10) Total Recurrent Expenditure (8+9)	(11) Gap (7-10)
332	602	934	479	457	936	(2)
489	805	1294	1046	193	1239	55

Other tax revenues may include advertisement tax, water tax etc. non-tax receipts consist mainly of fees and user charges. Revenue from other government funds consists of transfers from the state government and is comprised of general purpose grant and specific purpose grants.

As no separate figures for general and specific purpose grants are available we assumed that the urban local bodies used the general purpose grant along with specific purpose grant to meet the cost of employees (although this may not always be the case). Therefore, the methodology adopted for examining control was as follows:

1. Existence of Control 1: An urban local body has this control if it has been able meet the cost of employees out of the amount of grant. If the amount of grant is more than the amount of salary and wages, the urban local body has such control. Example: Asansol MC has this control (602> 479). However, Bardhaman does not have this control (805 < 1046).
2. Whether Control 2 has been exercised: An urban local body has this control if the amount of own source receipts is sufficient to meet other costs (operation and maintenance). If the amount of own source revenue is equal to or greater than the amount of other costs it is considered that the urban local body has this control. Example: This control is not in Asansol MC (332< 457). However, Bardhaman does have this control (489>193)
3. We categorized the urban local bodies on the basis of having these control in each of the five years for which we had data. If any urban local body failed to satisfy both of the controls it was categorized as "No Control". If any urban local body for a particular year has both controls 1 and 2 then it was categorised as "Both Control".
4. We then considered whether each urban local body had a recurrent surplus in each of the years (rather than its total surplus or deficit).
5. The percentage of recurrent surplus or deficit was computed as follows:

   Percentage Recurrent Surplus / Deficit = **[**(Recurrent Surplus/ Deficit)/ Total Recurrent Receipts**]*100.**

We received financial data for a number of urban local bodies for the financial years from 2001-02 to 2005-06 as shown by the following table:

Table 2: Year and Number of urban local bodies

Year	**Number of urban local bodies with data**
2001-02	115
2002-03	117
2003-04	122
2004-05	107
2005-06	124
Total	**585**

We received data for a total 124 urban local bodies over five years. In total we received data for 585 urban local body-years.

We then considered the percentage of average recurrent surplus for the urban local bodies having control 1, those with control 2 and having both controls.

The recurrent surplus of urban local bodies having both controls is also included in the columns for control 1 and control 2.

Table 3: Percentage of Recurrent Surplus

Year	Total		Control 1		Control 2		Both Controls		Neither Control	
	No	Average Recurrent Surplus %	No	Average Recurrent Surplus %	No	Average Recurrent Surplus %	No	Average Recurrent Surplus %	No	Average Recurrent Deficit %
2001-02	115	7	73	14	70	8	33	21	5	-20
2002-03	117	9	59	15	76	11	26	28	8	-25
2003-04	122	12	69	18	76	14	27	33	4	-13
2004-05	107	17	78	21	66	20	40	26	3	-17
2005-06	124	13	88	17	54	21	27	29	9	-15
Total	585	12	367	17	342	15	153	27	29	-18

The results for financial year 2001-02 indicate that the average recurrent surplus of all urban local bodies was 7%. Of these 115 urban local bodies, there are 73 and 70 urban local bodies which have the Control 1 and Control 2; and these urban local bodies have average recurrent surpluses of 14% and 8% respectively. In the same year, there were 33 urban local bodies which had both controls and their recurrent surplus was 21%. The recurrent deficit in case of the urban local bodies which failed to exercise either of the controls was 20%.

It is observed from the overall analysis that the financial performance (recurrent surplus) of urban local body having both controls was higher than to the average for urban local bodies having a single control. The urban local bodies having single control has led to generating recurrent surplus in most of the years. There were a few exceptions, but these were not significant. Overall the average surplus for urban local bodies exercising at least one control was 16%; for those exercising both controls was 27%; whilst those without either control had an average deficit of 18%.

Conclusions

Generally we conclude that financial performance (as defined as a recurrent surplus in each financial year) improves if urban local bodies exercise the defined control measures.
Prudent financial control practices are helpful to small and medium-sized urban local bodies and especially to urban local bodies of developing countries. This includes the following aspects:

1. Grant guidelines are more likely to be complied with.

2. Diversion of grant is a common phenomena and one of the reasons for diversion is the absence of financial control mechanisms. The control practices, as describe in this paper, will considerably reduce the possibility of diversion of grants.

3. Prudent financial control practices help urban local bodies to deliver services within available resources. Therefore the number of urban local bodies in observing fiscal discipline will be improved.

4. Urban local bodies will be in a better position to know when to put extra effort into revenue generation.

5. Control is becoming compulsory due to the increased consciousness of people about the use of public money and increasing demands on the scarce resources of the government. (Ahsan, 1996).

6. Prudent financial control is also part of internal control procedures and so good governance.

7. Urban Local Bodies, as providers of urban services, face the challenge of increasing demands (due to rapid urban growth). Control practices will help to fulfil this objective.

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