

# Financial Reforms for Municipal Governance – A Critical Assessment and Roadmap



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## BACKGROUND AND ECONOMIC IMPORTANCE OF MUNICIPALITIES

Cities contain about one third of India's population,<sup>1</sup> and provide more than half of India's GDP and thus hold tremendous potential as engines of economic growth, job creation and poverty reduction. Provision of urban services and infrastructure for such a large segment of concentrated population is a big challenge and raising the required resources for the same is an equally daunting task for the Municipalities. Both of these require substantial improvement in the governance at municipal level, which is at a very abysmally low level. By the 74th Constitutional Amendment Act of 1992, Local Bodies were conferred with the

Cities contain about one third of India's population and provide more than half of India's GDP and thus hold tremendous potential as engines of economic growth, job creation and poverty reduction. Central Government has been pushing for financial reforms in Urban Local Bodies (ULBs) to enhance transparency, accountability and efficiency. Under the ambitious Smart City and AMRUT Missions, ULBs are expected to be self-sustaining viable entities by improving their internal resource mobilisation and raising additional resources. Financial reform implementation process in ULBs so far has resulted in a mixed bag of successes, failures and sub-optimal results depending on the approach, institutional mechanism, manpower, software, and other resources deployed. Financial reforms, if implemented effectively, will save huge costs and generate additional resources. There is a need to have tough measures for improving the governance at the third tier of government.

status of the third tier of government after the Union and State Governments.

### Terms used for Local Bodies

"Local Bodies" means both Panchayat and Municipality

"Panchayat" means an institution of self-government for the rural areas.

"Municipality" (also known as Urban Local Body) means an institution of self-government for urban area and includes:

"Nagar Panchayat" for an area in transition from a rural area to an urban area;

"Municipal Council" for a smaller urban area; and

"Municipal Corporation" for a larger urban area,

Thereafter, successive Union Governments have launched a number of ambitious programmes for resource mobilisation and reforms to strengthen these local governments and improve their governance level. Some of the major flagship programmes launched for municipalities and funded by the Central Governments are:

- Jawaharlal Nehru National Urban Renewal Mission (JNNURM) and Urban Infrastructure Development Scheme for Small and Medium Towns (UIDSSMT), 2005 with outlay Rs. 1 lakh crore
- Smart Cities Mission, 2015 to create 100 smart cities. Estimated investment for 60 cities Rs. 1.34 lakh crore.
- Atal Mission for Rejuvenation and Urban Transformation (AMRUT), 2015 to cover 500 cities.

<sup>1</sup>As per Census 2011 India's urban population was 37.7 crore, i.e. 31.16% of total population

Apart from these programmes, Tenth Central Finance Commission (CFC) for the first time recommended a grant of Rs. 1,000 crore for the municipalities. Successive CFCs increased the grant amount and Fourteenth CFC recommended a grant of Rs. 87,144 crore for a five year period<sup>2</sup>.

### Grants CFCs for Municipalities

CFC	Period	Core Rs.
X	1995-2000	1,000
XI	2000-2005	2,000
XII	2005-2010	5,000
XIII	2010-2015	23,111
XIV	2015-2020	87,144

The High Powered Expert Committee (HPEC) appointed by the Ministry of Urban Development (MoUD), estimated the investment required for urban infrastructure over the next 20 years at Rs. 39.2 lakh crore.<sup>3</sup>

## EVOLUTION OF FINANCIAL REFORMS FOR MUNICIPAL GOVERNANCE

Considering the importance of financial reforms, successive CFCs recommended measures to be adopted and allocated additional resources for it. Tenth CFC recommended that the Comptroller and Auditor General of India (C&AG) should prescribe formats for the preparation of budgets and for keeping of accounts for the local bodies. Expressing serious concerns over non-availability of data on the finances of the local bodies, it also recommended for creation of a database on the finances of the panchayats and municipalities at the District, State and Central Government levels.<sup>4</sup> Eleventh CFC stipulated that the first charge on the grants should be maintenance of accounts and audit, followed by the development of a financial database. Twelfth CFC recommended that a proper accounting system be put in place at the grass root level to facilitate realistic assessment of the needs of the panchayats and municipalities for basic civic and developmental functions.<sup>5</sup>

Thirteenth CFC brought in an element of performance based grant to speed up reforms. 20% of the grants were linked to progress achieved in identified reforms which included improvement in accounting system and tax collections.

In 2001 Supreme Court issued directions for accounting reforms in local bodies.<sup>6</sup> Thereafter, the Task Force constituted by the C&AG of India recommended for introduction of accrual basis of accounting system for the Urban Local Bodies (ULBs) and suggested model budgeting and accounting formats for that purpose. In January 2005 MoUD circulated to all States/UTs a National Municipal Accounting Manual (NMAM).

In 2005 with the launch of JNNURM and UIDSSMT following major financial reforms were made mandatory for ULBs:

- Budgeting - Earmarking Funds for Urban Poor, revised formats and uniform chart of accounts
- Accounting - Migration to Accrual Based Double Entry Accounting System (DEAS)
- Property Tax - Enhancing coverage and Collection using GIS base
- User charges - Rationalisation and phased recovery of

operations & maintenance cost (O&M) and full cost In 2015 as part of Smart City and AMRUT Mission, these reforms were further fine-tuned with well-defined activities and results to be achieved in the given timeframe. Credit Rating was added to reform agenda. Under Smart City and AMRUT Missions, ULBs are expected to be self-sustaining viable entities by improving their internal resource mobilisation and raising additional resources through issue of municipal bonds.<sup>7</sup> Financial Reforms are thus at the core of improving governance in Municipalities.

Financial reforms primarily aim at four fundamental issues:

- Tax revenue by improving coverage and collection;
- Non-tax revenue by levy of user charges and recovery of cost of services
- Expenditure management for economy and efficiency
- Asset-liability management to leverage additional resources for urban services.

These targets can be achieved through the process of improving budgeting and accounting, financial management, and integration of all municipal functions with costing and financial accounting modules in an e-governance framework.<sup>8</sup>

### Core Financial Reforms for Municipalities under AMRUT Mission

Sl.	Reform	Milestone	Timeline
3	Augmenting double entry accounting	Complete migration to double entry accounting system and obtaining an audit certificate to the effect from FY2012-13 onwards.	12 months
		Appointment of internal auditor	24 months
		Publication of annual financial statement on website	Every year
8a	Municipal tax and fees improvement	1. At least 90% coverage, 2. At least 90% collection, 3. Make a policy to, periodically revise property tax, levy charges and other fees, 4. Post Demand Collection Book (DCB) of tax details on the website, 5. Achieve full potential of advertisement revenue by making a policy for destination specific potential having dynamic pricing module.	12 months
8b	Improvement in levy and collection of user charges	1 Adopt a policy on user charges for individual and institutional assessments in which a differential rate is charged for water use and adequate safeguards are included to take care of the interests of the vulnerable, 2. Make action plan to reduce water losses to less than 20% and publish on the website, 3. Separate accounts for user charges, 4. At least 90% billing 5. At least 90% collection.	12 months
9	Credit Rating	Complete the credit ratings of the ULBs	18 months

## CRITICAL ASSESSMENT OF REFORM IMPLEMENTATION - KEY ISSUES AND LESSONS

Reform implementation process through several decades has

<sup>2</sup> Report of the Fourteenth CFC.

<sup>3</sup> In its report of 2011, prices at 2009-2010.

<sup>4</sup> Report of the Tenth CFC, Para 8.19 and 8.21.

<sup>5</sup> Report of the Twelfth CFC, Para 8.43.

<sup>6</sup> Almitra H. Patel and Ors. v. Union of India and Ors.

<sup>7</sup> AMRUT Mission Statement & Guidelines, June 2015, MOUD, Govt. of India.

<sup>8</sup> Abraham, CT (2013) Municipal Accounting Reforms in India An Implementation Guide, ADB South Asia Working Paper Series No. 20, October 2013.

resulted in a mixed bag of successes, failures and sub-optimal results in various cities and states depending on the approach, institutional mechanism, manpower, software, and other resources deployed. Desired outcome in the form of reliable financial data for planning and resource allocation is still deficient. Lack of financial data and its poor quality, are the key concerns expressed by the successive Central and State Finance Commissions.

#### Observations of 14th CFC on Implementation of Reforms

Successive Finance Commissions have expressed concern on the near absence of financial data and its poor quality, wherever it is available.

While most States had self-certified the adoption of the accounting framework, the C&AG informed that the actual maintenance of accounts still needed improvement. Financial recommendations get acted upon while those dealing with systemic improvements are seldom addressed.

In most States where property tax is being levied, the rates have not been revised periodically. The list of taxable properties is not being updated and a large number of properties remain outside the tax net.

## INSTITUTIONAL FRAMEWORK AND MONITORING

Implementation of financial reforms in ULBs was initiated mainly through projects funded and supported by a number of multi-lateral and bi-lateral agencies like World Bank (WB), Asian Development Bank (ADB), Japan International Co-operation Agency, Department for International Development, UK (DFID), USAID etc. The reform agenda was part of their overall funding mechanism which had to be implemented as a mandatory covenant. NMAM was prepared with the support of USAID–FIRE (D) project. External agencies also supported States in preparing State Municipal Accounting Manuals (SMAM). Since the funds and technical assistance teams for reforms were also provided by these agencies, MoUD, States or ULBs did not develop the required institutional framework to sustain the reforms.

NMAM envisaged setting up of a Committee in MoUD with the authority to make additions in prescribed mandatory codes.<sup>9</sup> But such a committee has not been constituted so far. There is no review by MoUD of the State Manuals to check if they are in line with the principles prescribed in NMAM. However, separate Project Management Units (PMUs) are functional in MoUD for various missions – Smart City, AMRUT, Swaccha Bharat etc.

## POLICY ISSUES WITH REFORM AGENDA

Migration to accrual based DEAS, was considered as one of the important tools to reinforce transparency and accountability in utilisation of public funds by ULBs. Accordingly, it was made a mandatory reform under JNNURM and UIDSSMT in 2005. SEBI Regulations also require the municipalities to prepare accounts in accordance with NMAM or similar SMAM of respective State (i.e. accrual based accounting), to become eligible for issue of Bonds.<sup>10</sup> But in the reform agenda of Smart City and AMRUT Missions launched in 2015, the words 'accrual based' have been dropped. But each ULB is required to get the credit rating done for bond issue, which is governed by SEBI guidelines that require accounts to be prepared on accrual basis. Smart City and AMRUT guidelines also require ULBs to have an appropriate cost recovery mechanism

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in order to make them self-reliant and cost-effective. This again is not feasible without accrual based accounting. This intended or unintended dropping of words 'accrual based' from the reform agenda has sent confusing signals to ULBs.

Accrual based DEAS is the back bone of all financial reforms. It is a tool to ascertain the actual financial health of ULBs and to provide accurate accounting information for financial management, cost management, recovery of user charges, and efficient planning of municipal services. After decades of efforts to migrate to accrual based accounting, suddenly the key reform is dropped from the reform agenda. Migration to accrual based accounting is a difficult task for the ULBs given the quality of manpower and resource constraints they have. But instead of dropping the required reform on that ground, challenges in its implementation should have been addressed.

Another policy issue is that budget is to be prepared on cash basis but accounting is to be done on accrual basis. Budget reporting, therefore, is based on receipts and payments and does not match with accounts prepared on accrual basis. To overcome this, ULBs have resorted to change in prescribed budget formats defeating the intended uniformity across all ULBs.

## REFORM OWNERSHIP

Financial reforms aiming at enhanced transparency and accountability are generally viewed with suspicion and hindered by the elected representatives and municipal staff, whose vested interests are at stake. They are more interested in infrastructure development projects where contracts can be awarded and physical



<sup>9</sup> National Municipal Accounts Manual, MoUD, November 2004.

<sup>10</sup> SEBI Regulations for Issue and Listing of Debt Securities by Municipalities, 15th July 2015.



progress can be demonstrated to the electorate. They also avoid taking decisions to increase property and other taxes and user charges fearing impact on their vote banks. Reform implementation has been successful where ULBs took ownership for the reforms.

## PROPERTY TAX COLLECTION IMPROVEMENTS

Most of the States have adopted self-assessment system for property tax. But very few States/ULBs could actually complete the full cycle of improvement plan involving GIS mapping, door-to-door property survey, validation, reconciliation, demand register updation and collection drive. Key challenges in the process are coordination between GIS mapping and survey teams and municipal officials. Municipal officials resist, drag and delay the process of validation and updating demand registers. Efforts for tax revenue improvement have proved to be cyclical in absence of a robust monitoring mechanism. Recovery drives by active Commissioners are abandoned once they are transferred or due to political interference. 14<sup>th</sup> CFC observed that "In most States where property tax is being levied, the rates have not been revised periodically. The list of taxable properties is not being updated and a large number of properties remain outside the tax net". Even in the capital city of Delhi Municipal Corporations have not raised property tax since 2004 although huge investment has been made in urban infrastructure for metro network, elevated corridors, flyovers etc.

## CREDIT RATING, MUNICIPAL BONDS AND POOLED FINANCE

Ever since Ahmedabad Municipal Corporation become the first ULB to receive credit rating in 1996 and then issued municipal bonds worth Rs. 100 crore in 1998, credit rating, municipal bonds and pooled finance are being pushed as part of financial reform agenda. But the actual performance of bond issue has been very dismal. Till 2010 only 25 municipal bonds worth Rs. 1549.14 crore were issued. In 2012-13 bonds worth Rs. 845 crore were issued.<sup>11</sup> This is a very tiny sum as compared to the total investment being made and planned for urban infrastructure. Only two pooled finance schemes have been successfully implemented so far-Tamil Nadu Urban Development Fund (TNUDF), 2003 and Karnataka Water and Sanitation Pooled Fund (KWSPF), 2005. TNUDF is the only pooled fund which issues bonds regularly. Despite such a dismal performance, AMRUT Mission requires all the ULBs to get a credit rating. Unless financial health of ULBs is improved by reforms, resource mobilisation through municipal bonds will not work.

## UNIFORM SOFTWARE FOR ULBs

Reforms like migration to accrual accounting, improving tax coverage and collection, cost recovery of services should ideally start with a centrally controlled integrated software covering various operational areas like basic accounting, costing, budgeting, property tax, licence fee, user charges, inventory and fixed assets. MoUD had plans to develop uniform software for ULBs when NMAM was being prepared, but it did not take off. Migration to accrual accounting would have been much easier and faster with a uniform accounting software and it would have also facilitated comparison across ULBs, consolidated reporting and monitoring at state and national level. GIS supported module for property tax would have helped improving coverage and collection efficiency. ULBs also need integrated modules to facilitate realistic budget projections, budget monitoring and control, procurement management, tracking contract commitments and unpaid bills. Lack of uniform software to support financial reforms had been a



major constraint to sustainability of financial reforms. Most of the ULBs tried to manage with standard applications like Tally and software from local vendors. Local vendors with political patronage have often dictated and exploited ULBs leading to loss of data and manipulations due to poor security features. In Andhra Pradesh, Telangana, Karnataka, and Kerala uniform state level accounting software is operational for all ULBs of the state, but integration with other modules is yet to be achieved. Attempt to implement uniform accounting software in Chhattisgarh did not succeed. Madhya Pradesh had a very ambitious plan for introducing SAP based integrated ERP software. Pilot project for Bhopal Municipal Corporation with the assistance of DFID initiated in 2009 took more than six years to become functional. In the meantime another project to implement SAP based ERP in all the 350 ULBs was initiated in 2015, it is yet to be operational even in a few large municipal corporations.

## ACCRUAL BASED DEAS

Migration from single entry accounting system to accrual based DEAS, is generally slow in the initial stage as it requires setting up a system for flow of information by re-engineering the business processes. Since migration to DEAS was a mandatory reform and external funds were available, the process started with the appointment of external consultants. ULBs being under staffed, and with high resistance to learn and adopt new methods, incomplete records, and poor accountability the responsibility was conveniently assigned to consultants. For quick compliance, focus was on preparation of opening balance sheet and annual financial statements (AFS) without improving on the required processes. ULBs thus worked on single entry cash basis system and consultants converted the data to prepare AFS on accrual basis. This process continued till the support of funding agencies, after their exit most of the ULBs found it very difficult to continue and sustain the reforms. Which were either abandoned or scaled down and revived with next phase of external support. Generally the task of migration to DEAS is considered as the job of Accounts department alone. But the key details like financial year wise segregation of demand and outstanding amounts for various items of tax and non-tax revenue, outstanding work orders and bills for constructions works and supplies, inventory and fixed assets etc. are either not available or inaccurate data is provided to Accounts department. The resultant AFS are incomplete and inaccurate to that extent and this defeats the purpose of migration to DEAS for

<sup>11</sup> Financing Urban Infrastructure through Municipal Bond, JNNURM, 2012

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accurate aggregation of period costs and revenue. Since the use of cost centre and services codes is not mandatory as per NMAM, most of the ULBs are not using these codes. As a result, reliable cost details for municipal services are generally not available. Thus moving towards full cost recovery as envisaged under financial reforms, may be delayed in absence of reliable cost data.

## RECOMMENDED ROAD MAP FOR SUSTAINING FINANCIAL REFORMS

Though there has been progress in financial reform implementation, some of the Cities and State have achieved excellent results. But in the overall assessment results achieved fall short of the targets despite a longer time span and higher costs incurred than envisaged. It requires a change in approach to plan and implement reforms with a commitment and stringent monitoring mechanism. Financial reforms, specially cost and financial accounting system, if implemented effectively, will save huge costs and generate additional resources in the same manner as Aadhar linking has done for subsidy. After the bold and tough reform initiatives of demonetisation and GST, there is a need to have tough measures for the third tier of government to improve governance. The suggested roadmap for effective and time bound implementation of reforms:-

### Monitoring Cell at MoUD and State Level

ULBs' working environment requires regular review, monitoring and follow up to push for achieving reform targets. Centralised monitoring Cell at MoUD, will make the States more vigilant and speed up the pace of implementation of reforms. The Cell may also provide technical guidance to the States. Similar State level Cells to coordinate with and guide State ULBs need to be established.

### Dedicated implementing agency at State Level with a Core Team to support ULBs

A dedicated State level agency with pool of technical and support manpower is necessary to sustain reforms. Such an agency can provide technical guidance, capacity building and hand holding support to the ULBs. In Andhra Pradesh, Centre for Good Governance was entrusted with this task and has managed it very well.

### Accountability of Elected Representatives

Elected representatives and ULB's top management should be made accountable for delay in implementation of reforms.

### Development of Uniform web-based Software

Development of a uniform municipal software, centrally monitored at the national/state level, like the one for Birth and Death registration and Panchayat Accounting Software, with secure data and real-time availability, will ensure greater transparency, accountability and efficiency at ULBs.

### Review, Revision and Consolidation of Manuals

NMAM was prepared 12 years ago in 2004, thereafter Training

Manual and Asset Valuation Manual were prepared in 2007 and 2009 respectively. Consistency review of NMAM, Training and Asset Manuals prepared at different points of time, is required. The accounting code structure based on manual system needs to be fine-tuned to facilitate seamless inter-linkages among various modules of municipal system being developed on ERP platform in some States.

A framework for analysis of cost of various municipal services needs to be developed for planning cost recovery through user charges. This will help in revenue enhancement through a two pronged approach of cost management and timely revision of user charges. Therefore, review, revision and consolidation of NMAM to incorporate contemporary requirements for financial and cost accounting and to facilitate computerisation are required.

### Budget Reforms

Budget is the basis for accounting and financial controls, budget reforms should precede accounting reforms. Structure and content of budget should be in line with the proposed accounting reforms. ULBs should be supported to improve the Budget preparation process, develop and establish budget monitoring and control system.

### Transition planning for phased implementation

Complete migration to DEAS in one go is very difficult to achieve in ULB's operating environment. This requires a careful phased migration planning, achievable target setting, regular monitoring and timely corrective action. One solution for all ULBs does not work due to variation in staff, operating procedures and quality of manual records. Detailed As-Is assessment should be done before transition planning. Piloting in a few ULBs is necessary before roll out for full scale implementation in a large number of ULBs at a time. In the first phase, accrual accounting should be done at period ends-annual, half yearly or quarterly. Real time accrual accounting may be initiated after realigning processes, establishment of regular flow of information, building capacity of ULB staff.

### Capacity Building of ULBs and exit plan for Consultants

Hand holding support should, to the extent possible, be provided by the consultants who have been adequately guided by the Central Monitoring team to ensure uniformity across all ULBs in the State. Except for study visits, training of ULB staff should be carried out at their workplace on-the-job, on-the-software. Active involvement of ULB staff at all levels is necessary for sustaining reforms. Continuity of staff trained for reform activities should be ensured.

### Municipal Cadre for Finance and Accounts

A cadre for Revenue, Finance and Accounts personnel should be established at State level to ensure availability and continuity of trained personnel for carrying out reform activities. Some States including Madhya Pradesh have taken lead in creating specialised cadre of engineers, revenue and finance officials. 