

ACCOUNTABILITY OF LOCAL GOVERNMENTS

CAG's Initiatives and the Challenges Ahead

By R N Ghosh¹

1. INTRODUCTION

Two diverse trends were witnessed in the world in the 1990s, globalisation of the economies and localisation of authority and governance. Although the concept of local governance is as old as the history of humanity, only recently has it received renewed attention with countries attempting to reexamine the roles of various levels of government and bringing in reforms which typically involve transfer of responsibilities to local governments with the objective of strengthening local governance. While local government refers to specific institutions or entities created to deliver a range of specified services to a relatively small geographically delineated area, local governance is a broader concept and would include formulation and implementation of collective action at the local level. Good local governance is not only about delivery of services but also about preserving the life and liberty of residents, providing an environment for democratic participation and civic dialogue, supporting environmentally sustainable local development, and facilitating outcomes that enrich the quality of life of residents.

Decentralisation calls for a sub-national government structure with several tiers with each tier delivering those services that provide benefits to those residing in their jurisdiction. The term 'decentralisation' encompasses political, economic or fiscal and administrative decentralisation. In the Indian context, it means providing a suitable legislative framework for establishment of elected bodies of self-government at local level and transfer of power from State Governments to democratically elected local bodies.

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The 73rd and 74th Constitution Amendment Acts 1992, supplemented by legislation/resolutions in the States in 1994, changed the structure of governance permanently from a two-tier to a three-tier system consisting of the Union, the States and the Panchayats/Municipal Bodies with a distinct developmental orientation. With these landmark Constitutional amendments, the units of local self-governments at various tiers/levels got a new lease of life and many far-reaching changes in the Constitution and the State laws were brought about to ensure proper functioning of democracy at the grassroots. The Government of India (GOI) Task Force on Decentralisation (2001) stated,

“Decentralisation in the context of panchayats means that when authority is transferred from the state to the local governments, the latter should have the prerogative of taking decisions on the planning and implementation of such activity.”

The functioning of the third tier of government depends on the devolution of resources, subjects and functionaries to the Panchayats and Municipalities. With increasing funds being made available to the local self-governments and the slow but gradual transfer of functions to these units, the question of accountability of these institutions has assumed great importance. The need for capacity building in accounts, budgeting, monitoring, etc. becomes all the more critical in this context.

This paper broadly addresses the issues related to improving accountability of local self-governments in India. The issue of accountability in the larger perspective involves political, administrative as well as financial accountability. This paper however discusses the issues related to improving financial accountability of Panchayati Raj Institutions (PRIs) and Urban Local Bodies (ULBs) with focus on Comptroller & Auditor General of India (CAG)’s initiatives in improving the accounting and auditing arrangements at the grass roots level. The paper is organized in four sections: –Section I deals with local self-governments, their historical & legal framework, Section II is concerned

with issues in financial accountability and CAG's initiatives in improving the accounting and auditing arrangements, in Section III the lessons learnt in the process are discussed and Section IV charts the way forward.

I

2. LOCAL SELF GOVERNMENTS – THE HISTORICAL AND LEGAL FRAMEWORK

2.1 Pre-independence scenario

It is well-known that India had a long history of self-governing village communities, characterized by 'agrarian economies'. During the pre-independence period, the village panchayats were replaced by the village administrative setup under government control, with limited powers of levying and collecting taxes. The first municipal corporation was established in Madras in 1687, with powers to levy taxes for buildings. Lord Ripon's initiative of getting a government resolution passed in 1882, providing for local bodies, consisting of a large majority of elected non-official members and a non-official chairman was a major watershed in the structural evolution of local self government in the country. Another significant step in this direction was the Government of India Act 1935, which empowered the provincial governments to enact legislation for empowering the Panchayats with administrative powers including criminal justice.

2.2 Post – independence initiatives

Notwithstanding such existing legislation, the makers of the Constitution of independent India were not satisfied with the working of these local bodies as institutions of popular government and therefore a Directive was included in the Constitution of 1949 in Article 40 as follows:

“The State shall take steps to organize village panchayats and endow them with such powers and authority as may be necessary to enable them to function as units of self-government.”

Later, in 1957, the Balwantrai Mehta Committee recommended democratic decentralization by setting up Panchayati Raj Institutions (PRIs), and devolving the necessary resources, powers and authority to them. Rajasthan became the first State to institute Panchayati Raj in 1959, followed by Andhra Pradesh. By 1959 most States had passed Panchayats Acts. However, with little devolution of funds and powers, not much attention was paid to strengthening these institutions of representative democracy in the country. The appointment of the Ashoka Mehta Committee in 1977 improved the situation with some of the States like West Bengal, Karnataka, Maharashtra and Andhra Pradesh setting up effective panchayati raj systems.

2.3 73rd and 74th Constitutional amendments

The success of the Panchayati Raj System in the aforementioned States gave further momentum for building up support for transforming the local bodies into Constitutional entities and finally led to the passage of 73rd and 74th Constitutional Amendment Acts in 1992, by inserting parts IX and IXA in the Constitution. While Part IX relates to the Panchayats, containing Articles 243 to 243O, Part IXA contains Articles 243-P to 243-ZG relating to municipalities.

'Local Government' including self-government institutions in both rural and urban areas is an exclusive State subject under Entry 5 of List II of the Seventh Schedule (Article 246), so that the Union can not enact any law to create rights and liabilities relating to these subjects. What the Union has, therefore, done is to outline the scheme, which would be implemented by States by making laws or amending their own existing laws to bring them in conformity with the provisions of the 73rd and 74th Constitution Amendment Acts.

The main features of the Articles are:

- Establishment of a three tier structure of local self-government in rural and urban areas
 - For rural areas, Panchayats at the village, intermediate and district levels.

- For urban areas, a *Nagar Panchayat* for a transitional area (an area in transition from a rural area to an urban area), a Municipal Council for a smaller urban area and a Municipal Corporation for a larger urban area.
- Regular elections every five years.
- Proportionate seat reservation for SCs / STs as well as for women not only in membership of panchayats but also for posts of chairpersons.
- Constitution of State Finance Commissions to recommend measures to improve the finances of local bodies.
- Constitution of State Election Commissions.
- Gram Sabhas at the Gram Panchayat level.

Besides being institutions of self-government and performing agency functions in respect of Central or State government-sponsored schemes of community development or direct delivery programmes, the local bodies were intended to be developed as powerful institutions of economic development. Articles 243G and 243W vest powers in the State Legislatures to endow Panchayats and Municipalities with such powers and authority to function as institutions of self-government. Panchayats and Municipalities are responsible for preparation of plans and their execution for economic development and social justice with regard to 29 subjects listed in the Eleventh Schedule and 18 subjects in the Twelfth Schedule of the Constitution respectively (***Annexure I a and I b***).

Thus, the Constitution now envisages a three-fold role for local bodies:

- as institutions of self-government
- as institutions for planning their economic development and ensuring social justice

- as agents of Central and State governments in implementation of schemes for economic development and social justice as may be entrusted to them.

The constitutional amendments consolidated many of the gains achieved earlier and introduced a political uniformity on the structure and working of the third tier. They perceived popular participation as the key in decision-making and service delivery, with democratic decentralization and empowerment of local people through the rural & urban local governments.

2.4 Current status of local bodies

Thus, local governments now function as the third tier of governance in the country. While the Constitutional amendments introduced certain uniformity in the fundamental structure of these bodies at the national level, being a State subject, State legislative Acts govern these bodies and set out their powers, responsibilities, service delivery mandates and obligations with regard to accounting, audit and oversight. In States, the local bodies work in close co-ordination with the Department of Panchayati Raj or Rural Development and the Department of Municipal Administration. At the Government of India level, Ministries of Panchayati Raj, Urban Development and Urban Employment and Poverty Alleviation and other relevant ministries formulate policies, sponsor and support programmes, co-ordinate activities of various state governments and monitor programmes implemented by local bodies across the country. Of course, the ministries can only influence and encourage these local bodies and not mandate any desirable practices or systems. In addition, the Planning Commission and the Central Finance Commission also provide policy support and make recommendations for growth, development and financing of local bodies.

Elections in local bodies have widened the base of Indian polity, with about 3.6 million directly elected representatives, with no less than 1 million women members, making it one of the biggest experiments in

deepening of democracy and empowerment at the grassroots level. While the number of local bodies in the country is over 2.4 lakh,² the total revenue and expenditure of Panchayati Raj Institutions (PRIs) for 2002-03 was Rs. 24,010.52 crore and Rs.24,286.29 crore and the all India revenue and expenditure of Urban Local Bodies (ULBs) for the same period amounted to Rs.12,596.50 crore and Rs.13,997 crore respectively. However, the extent of fiscal decentralization which depends on the expenditure responsibilities and revenue assignments devolved to the lower tiers shows a declining trend. The total expenditure of local governments (PRIs and ULBs), as a proportion to the combined expenditure of the Union, State and local governments comes to about 5.1% in 2002-03 as against 6.4% in 1998-99. The own revenue (tax + non-tax revenue) of local bodies as a proportion of the combined tax and non-tax revenue of the union, States and local governments also declined to 1.9% in 2002-03 as compared to 2.7% in 1998-99. This is when we compare with the most advanced countries where the local governments normally account for about 20-35 percent of total government expenditure.

As in other democracies, decentralization in India has passed through teething troubles and resistance to reach a level of some maturity. The struggle between conflicting perspectives on governance and development strategy has characterized the growth of local governments in the country, with the process of decentralization making progress in a gradual manner. Today, after two constitutional amendments and affirmative legislation by States, which underpin decentralization, effective empowerment of the local governments has not taken place in the manner expected in the Constitutional amendments, which would endow them with the means to deliver results. However, despite the delays and bottlenecks, panchayati raj reforms have made progress in States with a history of grassroots level decentralization or where the reforms have received a degree of popular support. It is a matter of

²PRIs: 243676 (Gram Panchayats 236350, Panchayat Samities 6795 and Zilla Panchayats 531) and ULBs: 3723 (Municipal Corporations 109, Municipalities 1432 and Nagar Panchayats 2182)

some concern though that the gains made over the past decade are in the danger of being undermined by the trend of whittling down the power of panchayats and gram sabhas in some States through amendments to existing State Acts by strengthening the hands of political representatives and bureaucracy at the state level.

2.5 Devolution of funds, functions and functionaries to the PRIs

In keeping with the spirit of the Constitutional amendments and the philosophy of decentralization which recognizes that grassroots level participation and implementation is the very essence of good governance, local bodies are being increasingly invested with responsibility of implementation of many schemes and programmes. Substantial funds are already being transferred through Jawaharlal Nehru National Urban Renewal Mission, National Rural Employment Guarantee Scheme, Drinking Water Mission, and Total Sanitation Campaign, among others.

Accountability concerns mount in the context of increasing responsibilities. This calls for a re-look at the existing system for ensuring accountability, strengthening of procedures and practices. Most importantly, this demands that the local bodies are suitably empowered administratively and financially to discharge their enhanced responsibility. Devolution as a process assumes critical importance in this context and the extent of devolution of the three Fs, namely, funds, functions and functionaries determines the success of the decentralization process.

2.6 Functions, funds and functionaries

Rural scenario

For PRIs to perform the functions assigned to them effectively, they must be fiscally capable and autonomous. Funds must follow functions. The possible sources of Panchayat revenue include taxes, duties, fees and tolls, as well as grants-in-aid from the State. From the

table at **Annexure II**, which gives a summary of the position of devolution of funds and functions in the States, it can be seen that while some States have transferred all or a majority of the 29 functions, others have been relatively conservative in their interpretation of the role of PRIs in rural development

Functions: In some States, Panchayat Acts have devolved broad functions to PRIs, leading to overlap of functions and ambiguities in the specific role to be played by the different tiers. Union and the State governments have embarked on detailed 'Activity Mapping', which is the foundation of sound panchayati raj. It involves systematic unbundling of the broad subjects listed in Eleventh Schedule and devolving activities across government tiers using mainly the principle of subsidiarity which holds that any activity which can be performed at a lower level should be undertaken only at that level and at no higher level.

Funds: If local bodies are to perform their assigned functions effectively, they must be fiscally capable and autonomous. However, taxation powers at the GP level are entirely dependent on the discretion of the state. As the table at Annexure-II reveals, there is a significant mismatch between functional and financial capabilities of PRIs in many States. The innovative idea of setting up state finance commissions to further augment financial resources of local bodies has also had problems in implementation.

Functionaries: Along with the transfer of functions and funds comes the issue of administering them. There is a disjoint between the transfer of functions and functionaries. In many States, functionaries remain state officials on deputation to the local bodies, with Panchayats exercising little administrative control over them. This undermines accountability - one of the outcomes expected from decentralisation.

Urban scenario

Post the seventy-fourth amendment, the urban local bodies have undoubtedly acquired Constitutional status, legitimacy and protection. However, the municipal system in India has not undergone any structural

change and there are few signs of any redistribution or realignment of powers between municipalities and state governments. Apart from a set of exclusive functions for municipalities, the concept of a distinct and separate tax domain for these bodies needs to be recognised. There is some diversity in ways in which States have gone about the implementation of decentralisation as seen from the table at **Annexure III** on extent of devolution of functions to municipalities in States.

It is generally accepted that decentralization and the extension of genuine autonomy to urban government institutions have so far not received adequate attention. The identified institutional models for increased citizen participation have also not been effectively established. While the PRIs of local government in rural areas have increased in strength, and have one elected representative per 380 people, in urban areas ULBs remain underdeveloped, and the ratio of elected representatives to citizens is one elected representative to 3400 citizens. The absence of Ward committees or their ineffectiveness in comparison with Gram Sabhas is an indicator of the extent of the gap in the decentralization process between the rural and urban areas. The profusion of parastatals within the jurisdiction of ULBs is also often cited as further dilution of the accountability and decentralization process in the urban context.

Financial transfers to ULBs are entirely discretionary in nature and depend on the willingness of the State Governments to devolve functions and powers to these bodies. Often the transfer of funds to these bodies is sought to be linked to performance of the bodies measured in an “objective manner”, though there are serious conceptual and operational problems in building up performance indicators using the budgetary figures of urban local bodies. The recommendation of State Finance Commissions, which are to determine transfers to the ULBs, distribution of revenues between State Governments and ULBs as also the inter-se allocation are not uniformly adhered to by the State Governments in regard to approach, methodology or the principles governing the devolution package.

With the growth of population in cities and towns and the urban sector being considered as the engine of economic growth, genuinely responsive, decentralized and sustainable institutions of urban governance have assumed great importance.



3. ISSUES IN FINANCIAL ACCOUNTABILITY

3.1 Need for financial accountability

After the 73rd and 74th amendments, local bodies are expected to assume not only administrative and financial powers, but also to function effectively as institutions for participatory self-government. With increasing funds being made available to the local self-governments and slow but gradual transfer of functions to these units, the question of accountability of these institutions has assumed great importance.

Financial accountability involves accountability for whether the money and other resources have been utilised according to the legal requirements and the efficiency in utilisation of resources. The most important factor in securing financial accountability is the preparation and publication of accounts statements. The financial statements should be prepared in time and audited professionally to provide assurance to the stakeholders that the public funds have been spent judiciously as per law. It is generally agreed that as wide publicity as practicable should be given to the accounts of local bodies and that these should be published in such a form as to be intelligible to ratepayers without special knowledge of accountancy. There should be an obligation on local bodies to devise a means of providing the electorate with financial information about services in reasonably simple and straightforward terms.

A local body's statement of accounts should be required to 'present fairly' the financial position of the authority at the accounting date and its receipts and payments for the year. Since local bodies

provide services to ratepayers, the latter must be heard by auditors in the process of certification of accounts.

Articles 243 J and 243 Z provide for maintenance of accounts and audit of Local bodies, which state that *“The Legislature of a State may, by law, make provisions with respect to the maintenance of accounts by the Panchayats/Municipalities and the auditing of such accounts”*.

3.2 Adequacy of systems of financial accountability in local bodies

Even before the 73rd and 74th amendments, States had passed legislation for maintenance of accounts and audit of local bodies. In most States, the Director Local Fund Audit (DLFA) or a similar statutory authority³ had been empowered under the local Act/Rules to audit the local bodies. Similarly, rules for maintenance of accounts of local bodies had also been made by the States.

However, in some States the local bodies were plagued by shortages of accounting staff, with insufficient skills in maintaining accounts, especially in gram panchayats, where there were instances of a single gram panchayat secretary working for 2 to 3 panchayats, and being unable to cope with the work. This had led to a situation where local government accounts were either in arrears for several years or were not being maintained properly. There was also no credible database on the finances of the local self-governments, which could give aggregated data about the financial position of all the local bodies in a state. In addition, the accounting formats of PRIs were also large in number and difficult to maintain.

The audit of local funds conducted by the DLFA Examiner of local account or auditors of the concerned departments was limited to reporting compliance audit findings to the State Governments to enable

³ Auditor of the local bodies is variously designated as Director, Local Fund Audit, Examiner, Local Accounts, Chief Auditor, Local Fund Accounts, Controller of State Accounts, Director of State Audit, etc.

them to oversee proper functioning of local bodies. The system was supposed to work with provisions for disallowance and punitive surcharges, but this was not effective due to abysmally poor recoveries. Further, there was no provision for publishing the annual performance reports along with certified financial statements of the local governments. There was also a need for substantial augmentation of technical skills among the local fund auditors and their independence needed to be protected and strengthened as stipulated in the local acts.

All these called for reforms, in recognition of which, the Eleventh Finance Commission recommended a series of measures to improve the accounting and auditing arrangements at the local government level, including an enhanced role for the CAG.

4. INITIATIVES OF CAG IN LOCAL BODIES ACCOUNTING & AUDITING

4.1 Technical Guidance & Supervision/Support (TGS)

4.1.1 TGS - salient features

The Eleventh Finance Commission (EFC) had expressed concern over the maintenance of accounts of local bodies and their audit. The Commission recommended that in view of an unsatisfactory system of accounts and audit with accounting formats not reflecting the changing realities and the lack of trained staff, the system of accounting and auditing needed improvement under the close supervision of the CAG. In the words of the Commission

“The C&AG should be entrusted with the responsibility of exercising control and supervision over the proper maintenance of accounts and their audit for all the tiers/levels of Panchayats and urban local bodies.”

This was considered necessary in view of the far-reaching Constitutional amendments that empowered local governments both administratively and fiscally requiring the question of accountability of these institutions to be addressed on priority.

Based on the EFC recommendations and after issue of Ministry of Finance⁴ guidelines on utilization of EFC grants in 2001, CAG was entrusted with Technical Guidance & Supervision/Support (TGS) over the maintenance of accounts of local bodies and their audit, including providing technical guidance to the Director of Local Fund Audit (DLFA) in a majority of the States where 73rd and 74th amendments are applicable⁵. The parameters of TGS to the DLFA include assistance by CAG in adopting the auditing standards, audit planning, improved audit methodologies and professional training; besides supplementing the audit done by the Local Fund Audit Department to ensure proper certification of accounts and, thereby enhance its quality. To fulfil the TGS mandate, the CAG has prescribed accounts and budget formats for PRIs, accrual accounting system for ULBs, auditing standards, guidelines for certification audit, a list of codes for programmes, functions and activities to facilitate classification of accounts and has drawn up a training module on PRI accounts and budget, PRI & ULB audit training modules, a Manual of Audit for PRIs., etc.

While providing Technical Guidance and Support to the DLFA, CAG's audit was expected to reflect qualitatively higher concerns for cost, efficiency and performance in respect of the schemes that the Panchayats manage, in contrast to the DLFA's concerns, which are generally legalistic and focus more on observance of financial rules or government orders. CAG's audit, besides touching on these issues by way of a supplementary check of the work of DLFA, would essentially focus on performance issues. However, taking cognisance of the large scale devolution of finances and functions to institutions of local self governance without an adequate institutional mechanism and the concomitant risks flowing there from, CAG's audit has also retained audit checks necessary to focus on the more traditional audit concerns relating to fraud and corruption. Subversion of internal controls in the

⁴ Ministry of Finance Guidelines for Utilisation of Local Bodies Grants recommended by the EFC-June 2001

⁵ In 19 out of 24 States where 73rd & 74th amendments are applicable all the parameters of TGS have been accepted; in 3 states of Haryana, Chhattisgarh & Tamil Nadu entrustment of TGS is partial, with Punjab & Arunachal Pradesh yet to agree to the TGS arrangement. (The 73rd amendment is not applicable to Nagaland, Meghalaya & Mizoram and not extended J&K)

local bodies leading to fraud, corruption, misappropriation and mismanagement of funds has been reported in CAG's audit. Strengthening internal controls aimed at institutionalising financial management and accounting best practises and systems as also capacity building within these institutions has been recommended.

The CAG's audit provides the necessary audit assurance on the accounting of public funds, absence of fraud, as also efficiency in usage of funds and fulfilment of the larger objectives of decentralisation. The system of TGS strengthens the quality of accounts of local bodies besides improving the credibility of the accounts and audit of local bodies, leading ultimately to greater accountability of these institutions. The training programmes and supervision by CAG as part of TGS help in capacity building and improving the expertise of the staff of DLFA.

4.1.2 TGS - audit arrangement

In most States, the Director Local Fund Audit or a similar authority under the respective State Acts is the primary auditor. In the States of West Bengal, Bihar and Jharkhand, the CAG's institution is the primary auditor of local bodies under the respective State Acts and works as the Examiner of Local Accounts. In all other States, CAG's audit of local bodies is based on various provisions of the CAG's Duties, Powers and Conditions of Service (DPC) Act, 1971.

- Under Section 14, the CAG has been conducting the audit of receipts and expenditure of those local bodies both rural and urban, which are substantially financed from Union or State revenues apart from audit of specific grants under Section 15.
- The first two tiers of Panchayat institutions in Karnataka - Zilla Parishads and Taluk Panchayats - have been entrusted to the CAG in terms of Section 19 (3) *ibid* which States that the Governor of a State or the Administrator of a Union territory having a legislative assembly may, where he is of the opinion

that it is necessary in public interest so to do, entrust the audit of a corporation or a body established by law, to the CAG after consultation with him

- Entrustment of TGS over the local bodies audit and accounts, including technical support to the DLFA, in most States is under the provisions of Section 20 (1) of the DPC Act which states that the CAG may be requested by the President or the Governor of a State or the Administrator of a Union territory having a legislative assembly, to undertake the audit of the accounts of a body or authority on such terms and conditions as may be agreed upon between him and the concerned government.

4.1.3 TGS - administrative mechanism

To translate the mandate given to CAG into action, a formal Local Bodies Wing under a Deputy Comptroller and Auditor General was set up in CAG's office in December 2001. The main activities of the LB Wing include:

- Setting Policy, Strategy and Direction
- Processing of Audit Reports & Consolidated Inspection Reports
- Human resource planning
- Research & Training
- Budget & Accounts Formats implementation
- Collaborative networking with stakeholders
- Knowledge management & dissemination

In order to replicate these activities at the State level and in recognition of the Constitutional position of the local bodies as the third-tier of government, 17 new offices were created in the Indian Audit & Accounts Department under the CAG beginning August 2004. This has

placed the administrative structure of LB audit on a firm footing to strengthen local bodies audit to meet the expectations and discharge the responsibilities entrusted to CAG.

4.1.4 TGS - documentation

As part of the mandate for strengthening the accountability mechanism in local bodies, substantial documentation laying down the theoretical framework has been developed and prescribed by CAG. These serve to lay a strong foundation and set standards for the task of preparation and maintenance of accounts and their audit.

The CAG has prescribed *Auditing Standards* for PRIs & ULBs, to be followed by public auditors, which would help the auditors in proper conduct of audit, promote public accountability and provide valuable assurance to the concerned Union/State agencies and other stakeholders. With a view to ensuring that accounts of the PRIs properly present the financial position of the authorities, the CAG has prescribed '*Guidelines for Certification Audit of PRIs*', which would improve the quality of audit being undertaken by the primary auditors and bring in greater accountability.

As a major initiative, with respect to accounting, the CAG has prescribed *receipts and payments formats for PRIs on a modified cash basis*, with a few statements on demand, collections and assets that address critical aspects on accruals appended to the accounts. The formats depict all activities listed in the Eleventh schedule to the Constitution and show funds transferred to local bodies under various programmes and schemes.

While the formats have been adopted with suitable modifications in some States, feedback from many States suggested that a simplified structure with a minimum functional classification would meet the requirements, especially at the Gram Panchayat level. Since it has been the CAG's endeavour to facilitate the development of a culture of accounting in PRIs, despite the constraints of human resources and

skills, an attempt has been made to reduce the elaborate six-tier classification structure similar to the government accounting system to a more manageable three tier system and also standardise certain commonly used items of expenditure to simplify the system further. The simplified formats are now available with the State Governments, which they may like to consider and which would not require much change from the system suggested earlier.

For the Urban Local Bodies, the CAG had set up a **Task Force** in February 2002 to recommend appropriate accounting and budget formats for Urban Local Bodies, which suggested moving to the accrual basis of accounting. The accounts would be accompanied by significant accounting policies, cost of important utilities and services and MIS Reports. Based on the Task Force Report finalised in December 2002, which recommended accrual accounting system for Municipalities, the **National Municipal Accounts Manual (NMAM)** was formally launched in December 2004. This comprehensively details the accounting principles, policies, procedures and guidelines designed to ensure correct, complete and timely recording of municipal transactions and produce accurate and relevant financial reports. The National Municipal Accounts Manual provides for a codification structure that facilitates capture of all types of financial information within an urban local body which are essential in a government set-up – including the budget which is based on various functions and the accounting of individual transactions under the same. Thus accounting by both functional and head of account level as suggested in the NMAM enables placing each transaction within the context of the function/ budget centre that it comes under, while at the same time providing a clear indication as to the nature of the accounting entries involved (i.e. revenue or expenditure, asset or liability) and the overall impact of the transaction on income and expenditure statements as also the balance sheet. This pattern of accounting has been agreed to by almost all the States and they are in the process of customising and adapting the NMAM suitably to meet State specific requirements.

4.1.5 TGS - database on finances of local bodies

An important way of securing accountability and transparency is to make available data related to finances of the local bodies, to all stakeholders viz. the local body itself, public and the district/state/central level governments. Recognizing the need for such a database, on the recommendations of the Eleventh Finance Commission, the Ministry of Finance in its guidelines had stated that,

“The database on finances of panchayats and municipalities shall be developed at the district, State and Central Government levels and shall be made easily accessible by computerisation. The data shall be collected and compiled in standard formats as prescribed by CAG.”

A portion of the local bodies grants amounting to Rs. 200 crore was set-aside for this purpose. The database formats suggested by CAG seek to present a comprehensive financial profile of local bodies and provide valuable information on financial progress of use of funds received from the Central Finance Commission (CFC), the State Finance Commission (SFC) and programmes/schemes, profile of expenditure and income from own sources besides physical progress of funds allotted by CFC/SFC and programmes/schemes. The formats have received wide acceptance and efforts are continuing to bring all States on board. Some of the States have initiated action to set up the infrastructure for collection, transmission and maintenance of the database.

4.1.6 TGS - capacity building: training initiatives by CAG

Recognising the need for capacity-building of the staff of LADs and local bodies as an important adjunct to accountability, the CAG has taken the initiative of organising comprehensive training in areas of accounts preparation, certification and audit.

As part of the TGS model, over the last three years, training programmes have been organised in PRI and ULB accounts and audit. The training in PRI accounts has essentially been a ‘Training for Trainers’ and has been very well received in view of its practical content and

emphasis on hands on training. The focus is now increasingly on improving the audit skills of the DLFA's staff in different States. Accordingly, training in PRI and ULB audit is planned in large number of States. Refresher courses in accounts are also organised based on specific requests from State Governments. Though trained staff from local bodies is expected to organise subsequent courses in PRI accounts, the office of the CAG has continued to assist these efforts in terms of expertise and training material etc.

To facilitate the training efforts, **Audit Training Modules** have been developed by Regional Training Institute (RTI) Kolkata, a field training unit of the CAG. These training modules which are open to further customisation by individual offices have enabled conducting of audit training in a structured manner covering various aspects of PRI and ULB finances, accounts, their historical background and statutory basis, audit of various LB schemes including critical components like works and contracts as well as relatively newer areas like 'Social Audit', gender perspective, etc. A National Training Manual to accompany the NMAM and fill in the skill gaps vis a vis accrual accounting in ULBs is being developed by the National Institute of Urban Affairs in close collaboration with the MOUD and the CAG. In addition, recommendations are also being made for selection of appropriate accounting software to be in sync with the larger scheme of National e-Governance Action Plan (NeGAP).

4.1.7 TGS - in partnership with DLFA

As part of the TGS arrangement, a significant development has been the close collaboration with the DLFAs in various States. In fact, building a sound working relationship and rapport with DLFA is the cornerstone of the TGS arrangement with the States. While the training sessions have helped to improve overall skill levels of the DLFA and his/her staff, conferences of DLFAs of various States have also been organised to discuss the TGS arrangement and how best to increase

cooperation. These initiatives have brought to the fore a slew of good practices, policy expectations and some immediate requirements, which could lead to improved functioning of the DLFAs. Thus, a credible framework has been built to improve accountability further by involving DLFAs as partners in the process. Continued collaboration and technical cooperation would be an ongoing process and, in the interest of accountability and good governance, need to be further strengthened.

A noteworthy effort in this regard was the joint training-cum-audit exercise in PRI audit conducted by Accountant General (Accounts & Entitlements) office at Rajkot along with staff from DLFA and Panchayat functionaries in Gujarat in May 2005. Undertaken in a selected tribal block of District Dahod, this exercise essentially sought to demonstrate the efficacy of TGS by means of a 'learning by doing' method, which not only sought to train audit staff but also educate villagers about their own participation in Gram Sabha meetings when accounts are placed before them as per the legal provisions.

This effort was appreciated by the State Govt, the DLFA's staff and the Panchayat functionaries since it enabled a demystification of the process of writing of accounts and their audit. For the AG's staff, it was an opportunity to appreciate the difficult conditions at the village level that made account keeping a tremendous challenge as also the constraints within which the DLFA's organisation functions. This exercise is being replicated in other States.

In order to monitor the progress of implementation of the Scheme of TGS in various States, state level Steering Committees comprising representatives of the AG, the State Government and the DLFA have been constituted. Meetings of these committees have been an exercise in cooperation and have enabled a constant exchange of views and facilitated the prompt resolution of outstanding accounting and auditing issues.

4.1.8 TGS - reporting mechanism

With the theoretical foundation and the administrative structure for carrying out TGS in place, the emphasis in the initial stages was to report audit findings in those States where reforms in local bodies had met with some degree of success and where substantial funds and functions have been devolved to the local bodies. Accordingly, audit findings have been prepared in the form of separate reports for the state legislatures in Karnataka, Kerala, Tamil Nadu and Rajasthan. A separate committee of the legislature to examine the reports of CAG on the local bodies on the lines of the PAC has been set up in Kerala. Separate Committees of legislature to examine the reports of DLFA already exists in Gujarat and Maharashtra. Consolidated Annual Technical Inspection Reports on local bodies audit have also been presented to the State Governments in UP, Maharashtra, Uttaranchal and West Bengal.

The reports finalised till now provide valuable insights into the functioning of the PRIs and ULBs, besides the quality of account keeping and the working of DLFAs, with a view to improving the functioning and effectiveness of the local fund audit organisations in the States. In addition, the actual implementation of schemes focussed on grassroots level relevance has been reviewed. The emphasis has been to evaluate the effectiveness of social sector programmes like rural roads, drinking water, empowerment of women, welfare of socially and economically weaker sections, etc. Reviews of Implementation of schemes affecting the quality of life of ordinary citizens like municipal solid waste management have revealed the actual progress made in this regard by ULBs. The attempt has been to focus less on establishment matters and other issues of regularity in the reviews, unless cases of fraud and misappropriation are noticed. The audit focus is on two broad themes and its overall impact on the accountability framework:

- i) **perceived benefits** to be derived from increasing decentralization like improved service delivery, greater popular involvement in governance, increased revenue mobilization, and

- ii) **the risks/costs** on account of ineffective or inadequate decentralization like efficiency losses due to poor local level capacity, lack of physical and financial resources, potential for increased corruption

The performance has been particularly commendable in States where CAG is the sole auditor like West Bengal and Karnataka (first two tiers). In West Bengal, the Examiner of Local Accounts who is an officer of the Indian Audit & Accounts Department and reports to the State Accountant General, over 3350 gram panchayats have been audited every year. In Karnataka, Audit Reports on the functioning of ZPs for the state legislature have been placed for the last four years.

Some of the key audit concerns brought out in CAG's Reports are summarised below:

Accounting & budgeting procedures

➤ **Budgeting**

- Weak budgeting and budgetary control.
- Budget proposals not approved by the PRIs/gram Sabha.
- Due to non-formulation of annual plan in time:
 - ❖ majority of local bodies could not incorporate estimates of receipts and payments relating to Plan schemes in their budgets and
 - ❖ local bodies incurred plan expenditure without budget approval

➤ **Postings in Cash Book**

- Differences in opening and closing balances.
- Non-accountal of receipts.
- Incorrect and incomplete postings.
- Non- reconciliation of cash book with bank pass book.

➤ **Accounts**

- Delay in preparation of monthly and annual accounts
- Lack of up to date accounts by the local bodies leading to incomplete picture of their financial position.
- Non maintenance of accounts in the Accounts Formats prescribed by CAG rendering comprehensive analysis of the finances and expenditure difficult.
- Local bodies are yet to create the database on finances prescribed by CAG. In some States this work has been entrusted to consultants
- Lack of a centralized agency for consolidation of accounts and creation of a comprehensive database on finances of local bodies.

➤ **Utilization of funds**

- Incomplete works.
- Fraudulent/irregular/excess payment noticed during test check of muster rolls.
- Release of excess grants leading to increased unutilized balances.
- Non – adjustment of Abstract contingent Bills.
- Non- maintenance of property records – risk of encroachments/ mis-utilization.
- Sums due to Gram Panchayats not transferred by ZPs
- Diversion of expenditure for schemes to other purposes/ schemes.
- Weak material management – absence of periodical stock-taking; reconciling shortages; purchases without tenders/ quotations.

➤ **Internal controls**

- Lack of internal controls in the areas of budgeting, procurement of stores and execution of works leading to fraud, misappropriation and embezzlement of funds
- Absence of periodic reconciliation of receipts and expenditure.
- Non-operational internal controls against errors and inaccuracies through monthly accounts.
- Lack of receipts and expenditure controls resulting in huge savings and excess expenditure.
- Weak asset management – missing asset registers, inadequate physical verification, lack of effective control & no institutional mechanism to track assets.
- Absence/arrears in internal audit in the local bodies.

➤ **Implementation of schemes**

- Loss of assistance due to failure to adhere to stipulated conditions and underutilization of available funds.
- Blocking of funds.
- Instances of unfruitful/doubtful expenditure noticed.
- Diversion of scheme funds.
- Irregular adjustment without vouchers & utilization certificates.
- Defective identification of beneficiaries and selection of beneficiaries.

➤ **Grassroots planning**

- District Plans did not reflect the felt needs of local bodies.
- Release of funds before approval of action plans.

➤ **Loss of revenue**

- Non-realisation of taxes, rent, license fee and auction proceeds.
- Short collection of sales tax; non-remittance of statutory taxes & cess to govt. account.

4.2 Model Municipal Law

Ministry of Urban Development and Poverty Alleviation developed a Model Municipal Law (MML) in October 2003 as part of its initiatives towards good urban governance and making urban local bodies self-sustaining viable entities of local self-government. It sought to assist urban local bodies in the areas of accounting reforms, resource mobilisation and entry of private sector partnership. The MML prescribed the development of standard municipal accounting manual and practices, creation of a Municipal Accounts Committee and preparation of annual financial statements and preparation of inventory of all municipal assets. The MML was to facilitate and assist State Governments in amending/enacting state level municipal statutes accordingly.

Based on the advice of the CAG, the draft law was amplified in order to incorporate the responsibility and role of the CAG in exercising control and supervision over proper maintenance of accounts and audit of all ULBs thereby giving a legal footing to the TGS entrustment received from State Governments besides strengthening the overall accountability of public funds in the context of increased devolution to urban local bodies. Almost all the States have reacted favourably to the MML and have initiated action for examining the MML and the amendments thereto in order to suitably modify the State Level Municipal Acts.

4.3 Co-ordination with Government of India

Continuing with its stewardship of accounting reforms in Local Bodies, the CAG is now associated with the Apex Level Committees formed in the Ministry of PRI, and MOUD, GOI with Deputy Comptroller and Auditor General (LB) and the Secretary PRI and Secretary MOUD as co-chairpersons. These committees would help to provide direction to all these efforts and to strengthen the overall framework within which PRIs and ULBs function. The Committees would deliberate on accounting policies, initiate steps towards setting up accounting standards and help in bringing a broad uniform structure of accounts and budgets reflecting the added responsibilities and multifarious functions being performed by the local bodies after the 73rd and 74th constitutional amendments.

The inaugural meeting of the Committee on ULBs was held in October 2006. It provided an opportunity for sharing experiences in implementation of accounting reforms, besides deliberating on draft accounting standards and other outstanding issues like capacity building through training and upgradation of skills.

4.4 Twelfth Finance Commission recommendations

The Twelfth Finance Commission (TFC) recommended grants amounting to Rs. 25,000 crores for the period 2005-10 (Rs. 20,000 crores for PRIs and Rs. 5,000 crores for ULBs) mainly to improve the service delivery by PRIs in respect of water supply and sanitation in PRIs and enhance the service delivery of solid waste management services in ULBs, apart from maintenance of accounts and creation of databases.

In terms of the Ministry of Finance's guidelines,⁶ the CAG has been requested to audit the release and use of these grants. In specific terms, the audit is to examine whether the grants have been released by the State Governments within 15 days of their receipt from the Central Government and that these funds have been utilised by local bodies for the purposes for which they have been sanctioned

This mandate essentially recognises the effectiveness of CAG's role in ensuring accountability in usage of public funds. Thus, the CAG has to provide a reasonable assurance on utilisation of funds in real time and be a part of the effort to improve and streamline the system further. Based on the certificates of release of funds received from the State Government, Audit has been able to assess the progress of release and also point out delays and irregularities, if any.

4.5 Establishing synergies with Social Audit

Audit is recognized as a fundamental tool for ensuring accountability and in India, the CAG's audit has been able to provide the necessary degree of assurance to the public at large about the economy, efficiency and effectiveness of funds spent by various

⁶ Ministry of Finance Guidelines for Release and Utilisation of Grants recommended by TFC (June 2005).

governments. However, in view of the size, scale and extent of implementation of Governmental activities in a country like India, in spite of the availability of a large human resource pool, it is not possible for the coverage by Government audit to be as extensive and detailed as required in the beginning to ensure complete grassroots level accountability.

It is recognition of this reality and a gradual creation of consciousness among people of their own rights and powers that has strengthened the movement for 'social audit' accompanied by the 'Right to Information'. Social audit seeks to be a participative, popular and persistent evaluation of Governmental activities.

In the rural areas, jan sunwais (public hearings) have been used by peoples' organisations like the Mazdoor Kisan Shakti Sangathan as a means of empowerment to enable villagers to speak out and be heard. Such hearings demand access to muster rolls, vouchers and records of bill payments of development projects at the panchayat level. There have been similar initiatives on the urban side, under the aegis of NGOs like Parivartan that have sought to evaluate expenditure on road, sanitation and drainage works in the slums of Delhi besides the PROOF campaign in Bangalore, a collaborative effort of four non-profit, independent, non governmental organisations for carrying out budget analysis and fiscal performance audit of Bangalore Mahanagar Palike (BMP). With focus on disclosure, debate, dialogue and discussion, the initiatives focussed on the use of public funds and involve citizens in performance audit.

Instructions have been issued by the Ministry of Rural Development (MORD) which stipulate that the Gram Sabha should be specifically empowered to conduct social audit or collective audit by the Gram Sabha, into all public works and beneficiary oriented programmes implemented at the village level under various schemes of the MORD. These instructions also require that the completion certificate for all village level public works should be awarded by the Gram Sabha, and such a certificate of completion can be awarded by the Gram Sabha only after conducting social audit of the work in question. Recent schemes like

NREGP have also built in social audit as an essential component of the Scheme at different stages.

With a view to establishing synergies between Social and Government Audit, the Manual of Instructions for Audit of PRIs issued by CAG specifically advises audit teams to take into account the findings of social audits and action pending to be taken thereon. Wherever mandatory, audit teams are advised to see whether meetings are held as prescribed as also the doubts on the quality of works raised at such meetings apart from ensuring that bills, vouchers, details of labour *and* material components are given sufficient publicity as required. They are also required to see if appropriate action has been taken on any mismatch reported in social audit between expenditure on village work and the actual valuation of the work.

While social audit has its place in ensuring grassroots level accountability, a recent ⁷ study has revealed that for public goods like rural infrastructure projects, strong external audit has a greater deterrence and is therefore more effective in reducing missing expenditure and curbing corruption related to the material components. In contrast, the social audit mechanism has a relatively greater impact in reducing labour expenditure. The study suggests that grassroots monitoring may be more effective for government programmes that provide private goods (subsidized food, education, healthcare, etc.) where individual citizens have a personal stake that goods are delivered and leakage is minimised. In view of substantial flow of funds to local governments and lack of effective control mechanism, a strong top down monitoring through government audit is essential to reducing corruption and missing expenditure in government programmes.

Taking cognizance of the growing importance of social audit, seminars and workshops conducted by the CAG have deliberated on the subject and attempted to work out the contours of any collaboration between Government and social audit in the future.

⁷Monitoring corruption: evidence from a field experiment in Indonesia by Benjamin A Olken – Harvard University 2005

5. LESSONS LEARNT

Some of the lessons learnt relating to the accountability issues in general are summarized below:

Arrears in accounts: Recognising the importance of accurate and up to date account keeping, the EFC had suggested an indicative amount of Rs.4000 per panchayat per annum for the purpose of upkeep of accounts, if need be, even on contract basis. As mentioned earlier, in the paper, CAG had prescribed revised accounts formats and codes and these were further simplified to pave the way for their easy adoption. Extensive training has also been provided to build up skills in the revised accounts and budget formats. However accounts in PRIs continue to be in arrears with serious implications on the extent to which accountability can be ensured in these circumstances. Recognising the not so encouraging performance in this regard, the Twelfth Finance Commission also urged the States to earmark funds from the total allocation to extend funding support for maintenance of accounts and building database. States need to adopt the simplified accounts formats and codification structure prescribed by CAG, explore the possibility of use of information technology (IT) for preparation of accounts and overcoming arrears in collaboration with National Informatics Centre (NIC) and its field units and also seek assistance of an informal cadre of experts or para-accountants for drawing up accounts in PRIs.

Lack of database: Despite attempts to introduce database formats and establish, efforts have been handicapped by the lack of information about finances & Accounts or any institutionalized mechanisms for collating and managing such data in respect of LBs at the state level. The absence of minimum documentation is a challenge in itself for conducting meaningful audit. Echoing the concerns of the successive Central Finance Commissions, the need for consolidated financial information about the local bodies has been also emphasized through the audit reports.

Budgetary processes in local bodies: State Acts and rules contain elaborate provisions for preparation and approval of budgets in PRIs and ULBs. Budgets are prepared primarily to comply with statutory requirements, are incremental and are not generally used as tool for financial control, long term planning and effective management decision making. A top down approach in budget making reduces public participation, transparency and accountability and can lead to insufficient attention being paid to the felt needs of the local populace. Recent initiatives in some states like Karnataka, Kerala, West Bengal, to name a few, have tried to make the budgetary process more effective and outcome oriented.

Fund flows: The local bodies receive funds from different sources and are largely dependent on central and State funds, more so in the case of PRIs and the smaller ULBs. The system of funding the local bodies is largely by way of tied grants, which makes them dependent on the Centre or the State governments. If local bodies remain financially dependent on the grants from Centre or State governments, then they would be principally accountable to these governments and not to the people. Accountability to the people rather than to a centralized bureaucratic system should be the objective to achieve the goal of self-governance. The adherence to the recommendations of the State Finance Commission governing the distribution of net proceeds of taxes, duties, tolls and fees leviable by the government is important in this regard.

Role of State Finance Commissions (SFCs): Apart from suggesting principles for distribution of financial resources of State Governments among local bodies, SFCs also suggest important measures to improve the financial position of the panchayats and the municipalities. Their recommendations can impart greater stability and predictability to the transfer mechanism. The Twelfth Finance Commission had cited the delays in constitution of SFCs, their constitution in phases, frequent reconstitution, qualification of the persons chosen, delayed submission of reports and delayed tabling of the action

taken report in the legislature as having defeated the very purpose of this institution. CAG's audit has also observed that unlike the Central Finance Commission, even principal recommendations of the SFC are by and large not adhered to. Numerous instances of deviations from the recommendations of SFCs and guiding principles for utilisation of SFC grants have been noticed and highlighted in audit.

Internal control: A good internal control framework comprises clear policies, systems and procedures incorporating internal checks and controls, and a monitoring mechanism – generally internal audit - to identify deviations and promptly address risk areas. Weaknesses in the internal control mechanism in PRIs and ULBs have been documented in CAG's Audit Reports. The numerous cases of fraud and corruption noticed in audit and reported in the media further strengthen the case of a strong internal audit and internal control mechanism in the local bodies. PRIs and ULBs routinely structure their systems and procedures in a way that establishes accountability and oversight and to minimise fraud and embezzlement.

Though the Panchayati Raj Acts and related rules of most States provide for a tight set of internal controls for the use of resources, particularly those dealing with PRI funds, at the PRI level, internal auditing is either non-existent or inadequate. Apart from internal auditing, the controls within PRIs' administrative processes also need to be tightened as seen from numerous instances of lack of reconciliation of accounts, variances in balances, non-implementation of treasury checks etc.

In most urban local bodies, legislation does not provide for internal audit. Even where internal audit is prescribed, there are generally no detailed policy guidelines, procedures and formats for such audits. In the light of the shift to modern systems of accounting, the need for an internal auditor becomes more pronounced as necessary corrective action can be taken at the time of the transaction itself. ULBs need to have a separate department for internal audit and train necessary staff to conduct the audit functions efficiently.

Functioning of DRDAs: In many states, District Rural Development Agencies (DRDAs) continue to exist as separate and distinct bodies. In these States, funds pertaining to rural development programmes are channelised through the DRDAs. DRDAs are expected to be a facilitating and supporting organisation to the Zilla Panchayats providing necessary executive and technical support in respect of poverty reduction efforts. However, in some of the states DRDAs handle bulk of the rural development funds of the Government of India with out establishing any linkage with the PRIs.

District Planning Committees: In terms of Article 243ZD of the Constitution, District Planning Committees (DPCs) are to be constituted by the State governments so as to consolidate the development plans formulated by the PRIs and the municipalities based on the planning from below. While DPCs have been constituted, there is a need to improve their functioning and effectiveness for them to be genuine vehicles for grassroots level planning.

Weak asset management bedevils rural development. Since in a grassroots level audit, one of the objectives for the Government auditors should be to verify a sample of assets created in the villages before certifying the accounts, no meaningful physical verification would be possible in the absence of assets register, which seeks to prepare inventories and account for all assets in the jurisdiction of a panchayat. CAG's accounting formats for PRIs which includes formats for maintenance of records of land, roads, buildings and other physical infrastructure seek to effect an improvement in the situation. If properly implemented, these records would serve to establish a database of assets at the PRI level.

The issue of asset management assumes critical importance in the context of ULBs that are increasingly switching over to accrual accounting. Although asset management is an area with a high potential for resource mobilisation, it has not received the required attention in most ULBs. Most ULBs do not yet possess an up to date inventory of assets and the valuation of assets and preparation of an opening balance

sheet continue to pose serious problems in these organisations. The NMAM prepared for accounting by ULBs comprehensively covers all aspects of asset accounting beginning from the definition of assets, to their acquisition, depreciation, period end treatment, reclassification and even preparation of an opening balance sheet and may provide the necessary inputs in this regard.

Following are some of the lessons learnt relating to audit of local bodies:

Skill upgradation: The lack of adequate staff & skills in local bodies only goes to reinforce the need for further training and upgradation of the DLFA's organisation, which is the primary auditor, and improving training efforts by the CAG in coordination with the State Governments. Empowering and strengthening the independence, skills and capacities of the staff of the local fund audit should be a major focus of the CAG's institution

Rationalisation of audit resources: The scale and number of institutions to be audited with the practice of 100 percent check of accounts and other records is far more than the audit resources with the DLFA and often results in inadequate coverage and mounting arrears of audit. Hence there is a need to take a re-look at audit priorities and plans and rationalize available resources to yield the optimum results. This becomes even more essential given the large number of schemes handled and funds flowing from different sources to local bodies at various levels. Use of more intensive statistical sampling could bring a greater level of assurance in audit of local bodies.

Audit risks: It has been an important learning over the past few years that in the context of poor documentation and the lack of an accountability culture there are increased audit risks, which Audit must factor in and guard against.

Preponderance of **non-measurable parameters** like people's participation, grassroots planning and empowerment of marginalized group, requires appreciation of the role and importance of non-quantifiable factors.

Post reporting issues: Since a local government institution is not accountable to the State government alone and its primary accountability is to the local community, possibility of discussion of audit reports by the local populace requires greater deliberation.

Accountability requires that Audit Reports be discussed by stakeholders and corrective action be taken promptly so as to increase the effectiveness of working of Local Governments. The lack of effective implementation and in some cases, lack of an institutionalised mechanism backed by statutes and laws is a serious shortcoming in the present arrangement. This requires immediate attention to ensue that the DLFA's and AG's audit findings are discussed and acted upon at appropriate forums and the accountability cycle completed.

With the audit focus, concerns and issues moving beyond the purview of the conventional to more qualitative aspects and the absence of well established accounting procedures etc, there is a **need for innovative techniques** of evidence gathering – physical verification, photographs, interviews etc. in order to improve the overall effectiveness of audit.

Close collaboration and establishment of synergies with the **social audit mechanism** assume greater significance for evaluating the effectiveness of social sector programmes.

These areas of concern and focus have been also vindicated by the Resolution of the sixth round table of Ministers in-charge of Panchayati Raj at Guwahati, November 2004 (**Annexure IV**).

6. ISSUES FOR THE FUTURE

Decentralisation involves taking governance to the people by empowering local governments through devolution of funds, functions and functionaries. Activity mapping of functions by applying the principle of subsidiarity is a pre-requisite for comprehensive devolution. This should be accompanied by transfer of corresponding funds and functionaries to make the process of decentralization effective. Experience suggests that exercises in decentralization in many parts of

the country have faced innumerable delays and bottlenecks despite more than a decade having elapsed since the 73rd and 74th amendments.

Therefore, it is time for Government audit to mainstream the critique of the nature of decentralisation into the audit process itself while reviewing the schemes and programmes implemented by local governments. Audit findings should be seen through the prism of the devolution of funds, functions and functionaries to the local governments for better delivery of public services and genuine participative governance.

Decentralisation is often expected to foster local democracy. However, in situations of sharp social inequities, there is a need to guard against these institutions becoming instruments in the hands of the privileged few which may actually discourage larger participation and even accentuate the existing inequalities. This would ultimately dilute the accountability process itself. While the constitutional amendments have tried to create a framework whereby such inequities are addressed through empowerment of women and other marginalized sections of society, the existing accountability structures would also have to address these challenges towards a more vibrant and participative local democracy.

Another significant limiting factor in ensuring accountability and good governance is the prevalence of widespread corruption, particularly related to development programmes and even in the electoral processes. The persisting misuse of public funds has been a part of public discourse and calls for heightened vigilance by formal and non-formal accountability mechanisms.

Reforming the institutions of local governance would require adherence to the three basic principles of *responsive governance* (doing the right thing – delivering services that are consistent with citizens' preferences or are citizens focused); *responsible governance* (doing the right thing the right way –working better but costing less and benchmarking with the best performing local government); and *accountable governance* (to citizens, through a rights-based approach).

Audit should increasingly focus on governance issues to make the citizen-centered governance a reality.

6.1 Issues in urban local governance

In the next few years there is going to be a paradigm shift in municipal governance with the introduction of accrual based accounting involving issues like assets valuation and accounting, cost of services, life of assets, etc. The corresponding building of capacity in audit is bound to pose significant challenges.

The urban reforms agenda with its ingredients of 'Public Private Partnerships', issue of Municipal Bonds, rationalisation of property tax, increasing levy of user charges and e-governance calls for a renewed attempt at understanding these issues and the significant audit concerns emerging there from. Audit of Jawaharlal Nehru National Urban Renewal Mission involving substantial funds would pose a significant audit challenge. Of course, audit of local bodies in the urban sector would continue to address issues of urban poverty, unemployment, public health, slum development, sanitation and primary education.

Audit of various sources of revenue, including property tax, which is the most important and perhaps a sustainable and equitable revenue source, would also continue to receive enhanced attention.

6.2 Issues in rural local governance

In the case of rural local governments, the primary concern of Audit would be issues of governance at the grassroots level - rural unemployment with emphasis on National Rural Employment Guarantee Scheme, public health & sanitation, drinking water, roads, education, women empowerment, creation of community asset and housing. The efficacy of people's planning, lack of representation of women & other marginalised groups in panchayat affairs would require in depth examination to enable a comment on the quality of democratic decentralisation and attempt a critique of the actual devolution of funds, functions & functionaries. Auditors will have to try to act as facilitators in fostering a culture of accountability in PRIs. The efforts at building

synergies with DLFA and social audit groups will continue. Through capacity building, sharing of knowledge, ideas & experiences there will be an attempt to empower the DLFAs and thereby strengthen the overall accountability framework.

Auditors also need to take into consideration the possibility of expeditious transfer of funds to panchayat bank accounts by the Central Government or the State Governments through the current banking system by electronic credit or any rapid process and should suggest that general information technology (IT) and application controls are built in the system design, security issues are properly addressed and adequate features are in place to capture the audit trail like logs of authorisations and modifications.

6.3 Right to Information Act 2005

This Act empowers citizens to hold governments including local governments answerable to the people in all matters of public spending. The Act is an important tool for public accountability and transparency. Being the tier of governance responsible for delivery of services within the immediate reach of ordinary citizens, the pressure to not only provide the relevant information on demand, but more importantly, to also be in possession of the required data, calls upon the local bodies to make substantial efforts to improve their systems and procedures and ensure transparency.

The need for up to date financial and accounting information, a running theme in CAG's Audit Reports, assumes greater urgency in this context. Thus local governments need to be alive to the challenge of providing increasing levels of information both informally through social audit as also formal mechanisms like the Right to Information Act and schemes like NREGP and JNNURM that make disclosure of information mandatory and integral to the implementation of the schemes itself.

Similarly, as a part of JNNURM, the *Urban Local Government Disclosure Bill*, which aims to enhance transparency and

accountability in local government functioning, requires that ULBs maintain adequate records and disclose key information to the public at regular intervals. If adopted by State Governments, this Bill will require voluntary sharing of information by the ULBS and is hence a step forward from the RTI Act. Thus the stage is set for local bodies across the country to necessarily focus on updation of relevant information and be in readiness to periodically and promptly share it with the public they serve.

IV

7. THE WAY FORWARD

A new era has begun in the local bodies accounting and auditing with CAG playing a more pro-active role and being increasingly perceived as an aid to management. The increased role of CAG is also in keeping with decentralized governance at the grass roots level and is expected to result in greater accountability in respect of public funds and more effective and efficient use of resources.

In keeping with the spirit of the 73rd and 74th amendments and the EFC as well as TFC recommendations, with more and more financial resources and responsibilities being transferred to the various levels of local governments, CAG's support to the strengthening of the entire accountability framework has become even more critical. Hence CAG's efforts should be directed towards **capacity building of the primary auditors of the structure of local governance in States**. Continued focus on **training and extending of technical support** and expertise would go a long way in ensuring this.

The specific **areas for upgradation** of skills in the Local Fund Audit Department would be as follows:

- Accrual accounting
- Use of Information Technology and statistical sampling in audit

- Performance audit – evaluation of the economy, efficiency and effectiveness of programmes and schemes
- Certification audit – expressing an opinion on the fairness of the financial statements

As part of the above effort, the case for **increased infrastructural and logistical support** as also strengthening of an institutional mechanism for **enhanced autonomy and effectiveness of the DLFA** would need to be vigorously championed by the CAG's organisation.

- Specific Acts for Local Fund Audit must be enacted where these are non-existent.
- Wherever required, existing Acts should be modified to strengthen the authority and independence of the DLFA and his/her organisation.
- State Acts should acknowledge the arrangement of TGS between the DLFA and the CAG, thereby strengthening the stature of the DLFA's organisation.
- The mechanism for discussion of Reports of the DLFA and the CAG should be institutionalised in the Acts with an appropriate method for follow up on the action taken on these Reports.

EFC had recommended various measures for **improvement in the maintenance of accounts and database on finances of local bodies**. This has brought in a number of systemic changes to help in maintaining a simplified and modern system of accounts and their audit in a timely and professional manner. The Karnataka Local Fund Authorities Fiscal Responsibility Act, 2003 is a significant step forward in this regard in ensuring improved financial management of local bodies. The Act provides for withholding grants if final accounts are not prepared on time and appropriate action against the local body concerned for any slackness in ensuring strict follow up action on the audit reports. **A centralized agency for consolidation of database,**

accounts and financial information in respect of local bodies is essential for their improved financial management and to assess their working and analyse possible trends. The local bodies should take recourse to **use of IT for preparation of accounts and clearance of arrears. Internal audit departments need to be established where not in existence and their functioning strengthened in a systematic manner so that this can provide the necessary assurance on existence and effective functioning of internal controls.**

In terms of the audit function, there has to be a thrust **on introduction of certification of accounts by the Local Fund Audit** including verification of assets and publication of audited accounts. Independent scrutiny and attestation can serve as an important means of assurance. The local fund auditors need to hear the ratepayers before certifying the accounts. With the accounts of the municipalities on accrual basis, a major skill upgradation for auditors would be required to audit the financial statements and express their opinion on the financial state of affairs in urban local bodies.

Local Fund Audit would essentially concentrate on procedures and compliance, which would be validated by CAG. The audit by CAG would offer insights into the actual delivery of services by local governments, the quality of implementation and the impact this makes on the lives of ordinary citizens, besides audit checks to prevent fraud, misappropriation and corruption. The extent to which institutions of local self government are able to act as vehicles of democracy and participation and reflect the aspirations of people will be assessed through an ongoing evaluation of planning, design and implementation of schemes. It would be a good idea to arrive at efficiency (output – input ratio) and effectiveness (the relationship between output and outcome) indicators by the local governments in order to evaluate development programmes and measure performance of schemes executed by them.

Traditionally, PRIs in India have been subjected to control by

higher-level Governments. Since PRIs depend to a great extent on grants, this kind of upward accountability is inevitable and with the rise in the funding from the State and Central Governments, the accountability system needs to be further strengthened. CAG's initiatives have been largely in improving the accountability mechanism. However, a local government institution is not accountable to the State Government alone. Indeed, its primary accountability is to the local community. **The oversight functions of the gram sabha needs therefore to be substantially strengthened.** Similarly, **ward committees in urban areas** which are hampered by a limited citizen representation and an ambiguous mandate **need to be reinvigorated.**

Apart from the **formal accountability mechanism** of audit, innovative tools and methods of accountability have been introduced in some of the States to make local governments more responsive to the electorate. These are **social audit** through the empowerment of gram sabha, neighbourhood committee and monitoring committee, beneficiary committees to execute public works schemes, providing for citizen's charter, creating a watchdog institution like the **ombudsman** to ensure fair play in the functioning of the local bodies and of course the **Right to Information Act** through which citizens could demand transparency and accountability. Better accountability would be achieved only when these instruments are institutionalised. **The formal mechanisms for discussion of audit findings and reports need to be set up through legal backing in some States and in most others need to be suitably strengthened and invigorated.** It has to be remembered that the formal audit mechanism needs to be backed by other instruments of accountability and transparency as described above in order to give full effect to the principle that the primary accountability of the local government institutions is towards the local community.

A strong framework and foundation has been laid for increased collaboration between the CAG and the Local Fund Departments in various States. In the coming years this should ensure the strengthening of the accountability framework besides enabling greater efficiency by

the PRIs and ULBs in discharging their enhanced responsibilities subsequent to the 73rd and 74th Constitutional amendments.

This paper has addressed some of the significant concerns that could pose a threat to genuine participative democracy at the grassroots level due to tardy progress of the Constitutional amendments and increasing trend of going back on provisions empowering local governments and gram sabhas in participative decision making. To conclude, in the words of Jean Dreze and Amartya Sen “.....the first wave of social change associated with panchayati raj amendments warrants cautious optimism about the potential for local democracy in India. There are, of course, also matters of concern. These include frequent derailing of local democracy by social inequality, the limited participation of the public in local governance on a day to day basis, the dormant condition of gram sabhas in many States, the lack of significant devolution of powers in many fields, and – last but not least – widespread embezzlement of public resources associated with local development programmes under panchayat auspices. Nevertheless, there are clear signs of a sustained expansion of democratic space at the local level, and also of local politics being an important arena of positive social change. The limitations are best addressed through democratic practice itself, and as far as the potential for the latter is concerned, there is much ground for hope.”⁸

⁸ India Development and Participation by Jean Dreze and Amartya Sen Oxford 2002

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ANNEXURE-I a

Classification of Functions in the Eleventh Schedule

Core Functions

1. Drinking Water
2. Roads, culverts, bridges, ferries, waterways, and other means of communication
3. Rural electrification, including distribution of electricity
4. Health and sanitation, including hospitals, primary health centres and dispensaries
5. Maintenance of community assets

Welfare functions

6. Rural Housing
7. Non-conventional energy sources
8. Poverty alleviation programme
9. Education, including primary and secondary schools
10. Technical training and vocational education
11. Adult and informal education
12. Libraries
13. Cultural activities
14. Family welfare
15. Women and child development
16. Social welfare, including welfare of the handicapped and mentally retarded
17. Welfare of the weaker sections, and in particular, of the SCs and STs
18. Public distribution system

Agriculture and allied functions

19. Agriculture, including agricultural extension
20. Land improvement, implementation of land reforms, land consolidation, and soil conservation
21. Minor irrigation, water management, and watershed development
22. Animal husbandry, dairying, and poultry
23. Fisheries
24. Social forestry and farm forestry
25. Minor forest produce
26. Fuel and fodder
27. Markets and fairs

Industries

28. Small-scale industries including food processing industries
29. Khadi, village and cottage industries

Note: The 11th Finance Commission gave these functions enumerated in the 11th Schedule of the Constitution and as extracted from 'Local Governments in Developing countries' –(P-209), Local Government Organisation & Finance-Rural India-an article by Dr. V.N.Alok of the Indian Institute of Public Administration, New Delhi.

ANNEXURE – I b

Twelfth Schedule

(Article 243-W)

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 the interests of weaker sections of society, including the handicapped and mentally retarded.
10. Slum improvement and up gradation
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 burials grounds; cremations, cremation grounds and electric crematoriums
15. Cattle ponds; 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 slaughter houses and tanneries

ANNEXURE – II

Summary of Devolution of Funds & Functions to PRIs by States

Sl. No.	States/UTs	Functions devolved	Functions for which funds are devolved
1.	Andhra Pradesh	17	5
2.	Arunachal Pradesh	0	0
3.	Assam	29	0
4.	Bihar	25	8
5.	Jharkhand	0	0
6.	Goa	6	6
7.	Gujarat	15	15
8.	Haryana	16	0
9.	Himachal Pradesh.	26	2
10.	Karnataka	29	29
11.	Kerala	26	26
12.	Madhya Pradesh	23	10
13.	Chhattisgarh	29	10
14.	Maharashtra	18	18
15.	Manipur	22	0
16.	Orissa	25	9
17.	Punjab	7	0
18.	Rajasthan	29	18
19.	Sikkim	24	24
20.	Tamil Nadu	29	0
21.	Tripura	12	0
22.	Uttar Pradesh	12	4
23.	Uttaranchal	11	0
24.	West Bengal	29	12
25.	Andaman Nicobar	6	6
26.	Chandigarh	0	0
27.	Dadra & Nagar Haveli	3	0
28.	Daman & Diu	9	5
29.	NCT Delhi		
30.	Pondicherry	0	0
31.	Lakshadweep	6	0

India – Rural Governments & Service Delivery – World Bank Study 2006

ANNEXURE – III

List of Functions mentioned under the Twelfth 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	ö	x	ö	x	ö	ö	x	x	ö	x	ö	x	ö	x	ö
Delhi	x	x	ö	x	x	ö	x	x	x	x	x	ö	x	ö	ö	ö	ö	ö
Gujarat	x	x	x	ö	ö	ö	ö	ö	ö	x	x	ö	ö	ö	ö	ö	ö	ö
Haryana	x	x	x	ö	ö	ö	ö	x	x	ö	x	ö	x	ö	ö	ö	ö	ö
Himachal Pradesh	x	x	x	ö	ö	ö	ö	x	x	x	x	ö	x	ö	ö	x	ö	x
Karnataka	ö	ö	x	ö	ö	ö	x	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö
Kerala	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö
Madhya Pradesh	ö	ö	ö	ö	ö	ö	ö	ö	ö	x	ö	ö	x	ö	ö	ö	ö	ö
Maha-rashtra	x	x	x	ö	ö	ö	ö	x	x	x	ö	x	ö	ö	ö	ö	ö	ö
Rajasthan	x	x	x	ö	ö	ö	ö	x	x	x	x	x	ö	ö	ö	ö	ö	ö
Tamil Nadu	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö
Uttar Pradesh	ö	x	x	x	ö	ö	x	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö
West Bengal	ö	ö	x	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö	ö

Note: “x” refers to functions not devolved by the state to urban local bodies; “ö” 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

ANNEXURE – IV

Important Resolutions of the 6th Round Table Conference of PRI Ministers at Guwahati – November 2004 on Accounts and Audit issues in PRIs

- Director of Local Fund Audit in States to work in close concert with CAG.
- States which have not entrusted Technical Guidance and Support are invited to do so & follow all literature on Accounts & Audit created by CAG – auditing standards, certification guidelines etc.
- Accounting standards to be prescribed – National Accounting Standards Board to be mooted.
- Establishment of separate Panchayati Raj Committee for examining audit reports.
- Regional Training Institutes (RTIs) under CAG, especially RTI, Kolkata, to be made full use of for training in PRI accounts for officials & elected representatives.
- Social audit is an important complement to formal audit and for the sound and healthy development of Panchayati Raj, it is essential to establish a symbiotic relationship between social and formal audit.

Accountability of Local Governments



**A Research Paper
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Office of the Comptroller and Auditor General of India

FOREWORD

The last two decades have witnessed a movement towards greater decentralization of authority-political, fiscal and administrative – to local governments. Panchayati Raj Institutions and Urban Local Bodies have now emerged as the significant third tier in governance with enormous responsibilities in improving the quality of life at the grassroots level through delivery of public services, implementation of socio economic development schemes and providing essential infrastructure in a participative and responsive manner.

An improved accountability framework is crucial to the entire decentralization process. Since 2002, this fundamental principle has guided my organisation's initiatives in the areas of accounts and audit of local bodies. In the context of the seventy third and seventy fourth Constitutional Amendments, the recommendations of the Eleventh Finance Commission and the enhanced expectations from local bodies, our efforts have been to strengthen the system of accounts, audit and accountability in the local bodies. In the face of diverse state specific legislations and administrative and financial arrangements relating to local bodies, we have tried to introduce and institutionalize certain minimum prerequisites in the interests of financial accountability, transparency and good governance while duly providing flexibility to accommodate local needs and specifications.

The positive response to the arrangement of Technical Guidance and Support to the Directors of Local Fund Audit in different states bears testimony to the success of this unique collaborative arrangement to improve public accountability. The CAG's association with Local Fund Audit and the State Governments has essentially involved development of accounting resources for local bodies, sharing of best practices and audit methodologies, besides efforts to improve accounting and auditing skills of local bodies and the Local Fund Audit. Other than commenting on the quality of accounts keeping and the working of local fund audit in

the states, audit of local bodies by the CAG's institution has provided the necessary framework for giving audit assurance on the greater accountability of public funds, more effective and efficient use of resources, and fulfillment of the larger objectives of decentralisation.

This Research Paper encapsulates our efforts in strengthening the accountability framework in local bodies, acknowledges the challenges ahead and charts out the way forward in a realistic manner. The paper is timely as audit has increasingly started focusing on people-centric and governance issues. It should prompt State and Local Governments to take a re-look at their performance in this very important area of fiscal reforms, while generating a greater awareness and debate on the issue by the public at large. I am sure this paper would be of some use to the policy planners in Government, civil society organizations, members of the public and all other stakeholders interested in decentralized governance.



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