INDIA: Evaluating Bank Assistance for Public Financial Accountability in the 1990s

A Country Assistance Evaluation

Vinod Sahgal
and
Deepa Chakrapani

Director-General, Operations Evaluation: Robert Picciotto
Director: Gregory Ingram
Manager: Ruben Lamdany
Task Manager: Gianni Zanini

The authors are respectively the Lead Evaluation Officer and Research Analyst working in the area of Public Financial Accountability in the OED Corporate Evaluation and Methods Group (OEDCM) of the World Bank. This paper is available upon request from OED.

2002
The World Bank
Washington, D. C.

OPERATIONS EVALUATION DEPARTMENT

ENHANCING DEVELOPMENT EFFECTIVENESS THROUGH EXCELLENCE AND INDEPENDENCE IN EVALUATION

The Operations Evaluation Department (OED) is an independent unit within the World Bank; it reports directly to the Bank's Board of Executive Directors. OED assesses what works, and what does not; how a borrower plans to run and maintain a project; and the lasting contribution of the Bank to a country's overall development. The goals of evaluation are to learn from experience, to provide an objective basis for assessing the results of the Bank's work, and to provide accountability in the achievement of its objectives. It also improves Bank work by identifying and disseminating the lessons learned from experience and by framing recommendations drawn from evaluation findings.

OED Working Papers are an informal series to disseminate the findings of work in progress to encourage the exchange of ideas about development effectiveness through evaluation.

Contact:
Operations Evaluation Department
Partnerships & Knowledge Programs (OEDPK)
email: ecampbellpage@worldbank.org
email: eline@worldbank.org
Telephone: 202-458-4497
Facsimile: 202-522-3125
http:/www.worldbank.org/oed

Acronyms

APSEB	Andhra Pradesh State Electricity Board
CAG	Comptroller and Auditor General
CAS	Country Assistance Strategy
CDF	Comprehensive Development Framework
CDR	Comprehensive Development Review
CFAA	Country Financial Accountability Assessment
CPFA	Country Profile on Financial Accountability
CGA	Controller General of Accounts
FMS	Financial Management Specialists
GOI	Government of India
ICAI	Institute of Chartered Accountants of India
IDF	Institutional Development Fund
IIM	Indian Institute of Management
LACI	Loan Administration Change Initiative
OED	Operations Evaluation Department
PLA	Personal Ledger Accounts
PMR	Project Management Reports

Contents

Preface

This paper is one of the background papers prepared as an input to the India Country Assistance Evaluation (Task Manager: Mr. Gianni Zanini) by the Operations Evaluation Department (OED) of the World Bank. Findings are based on a review of project appraisal and completion reports, sector reports, and a number of other documents produced by the Borrower, the Bank, OED, and research papers. Bank staff were interviewed at headquarters. Limited fieldwork was also carried out.

An earlier version of this paper was reviewed by the India Country Team, the South Asia Regional Financial Management Advisor and his team, the Bank's Internal Auditing Department, and the concerned Financial Management specialist in the Loans Department. Comments were also received from the office of the Controller General of Accounts in the Ministry of Finance of the Government of India.

The authors are grateful for all comments received, which have been taken into account in this revised version. However, the views expressed in this paper remain entirely those of the authors. They do not necessarily represent the views of OED or the World Bank.

Executive Summary

1. Public financial accountability is the system by which the legislature and citizens of a country hold the government to account for its performance and its use of public resources. It encompasses a range of stakeholders including legislature, government, external auditors, media and civil society. The Bank and many other stakeholders in India have explicitly raised concerns on public financial accountability. These concerns relate to the need to increase effectiveness of the Legislative Committee system, to improve and reform civil service culture, to modernize the accounting and auditing functions including, further strengthening the Office of the Comptroller and Auditor General, to revitalize state-level financial management and control, and to enhance public awareness on the economic and social costs of corruption and waste.

2. This Operations Evaluation Department (OED) desk review assesses the impact of the Bank's efforts on public financial accountability in India. It finds that public financial accountability is a recent area of emphasis for the Bank and that the Bank's knowledge of the issue area at the country and state levels is nascent and growing. The Bank's limited knowledge is centered on financial management and internal control procedures in the central government and very recently, has extended to a few "focus" states. There are significant gaps in knowledge—the most significant being the effectiveness of the legislative scrutiny processes at the center and at the states.

3. The Bank has not articulated a clear and consistent long-term strategy for strengthening public financial accountability in India. While elements of a strategy are slowly emerging at the state level, the Bank has yet to deal with public financial accountability issues at the country level. At the project level, the Bank has made efforts to improve accounting, auditing and budgeting systems at the project implementing agency level and in specific operating departments in state government. These interventions, however, were not designed to help resolve the significant capacity problems in the country's overall financial accountability systems.

4. The nature and extent of risk of fraud, waste and abuse of public funds is growing. With the recent emphasis on programmatic lending in India, the overall public financial accountability systems assume greater importance and the Bank is commended for some pioneering work in this area in the state of Uttar Pradesh. But this initiative alone may not be sufficient. Accountability has to be induced, it cannot be decreed by fiat. Accountability is a result of a complex set of incentives, transparency in processes and decisionmaking, and checks and balances at various levels of government. Thus, unless the Bank dialogues with the Government of India (GOI) on the need to modernize India's overall public financial accountability systems, its efforts at the state level alone may be neither effective nor sustainable. The proposed conference for speakers of state legislatures to be organized by Uttar Pradesh is an ideal forum for the Bank to articulate its recommendations on public financial accountability issues at the national level.

5. The Bank also needs to further build its own capacity to deal with country and state level issues in public financial accountability. Lessons of experience with implementing LACI (Loan Administration Change Initiative) suggest the importance of: (a) Bank and borrower commitment to enhance financial management and control, (b) training and experience of Bank staff in public sector auditing, accounting and scrutiny systems, and most importantly, (c) communication to the borrower of consequences for less than satisfactory compliance with fiduciary obligations as specified in the Loan Agreements. The Bank should supplement and build on its existing skill base in project financial management with specialists in public accountability systems. There is an urgent need to upscale capacity building to the national and sub national levels.

1. The Political Economy And Public Financial Accountability

1.1 Public financial accountability is not an option; it is intrinsic to a successful democracy. It provides the litmus test for good governance. At the governance level, it promotes performance that is within the financial limits and ethical standards set by legislature. It is the manner in which the legislature and the citizens of a country hold the Executive to account for its performance and its use of public resources. At the operational level, it ensures openness, sound internal control, transparent accounting, auditing and financial reporting. A sound public financial accountability system not only mitigates against fraud, misappropriation and waste of public funds, but more importantly, facilitates sustained and equitable economic growth.

1.2 A prerequisite for a sound public financial accountability system is active participation of key stakeholders—legislature, executive (government), external auditor, civil society and media (chart 1). Public financial accountability is not complete until it encompasses the wide-ranging activities, attitudes and reporting relationships between the key stakeholders (chart 2). The following are indicative of a sound public financial accountability system:

- Legislature: effective legislative oversight mechanism for public finances;
- Government: budgeting, accounting, auditing and internal control systems that promote performance reporting and that identify and deter undesirable behavior;
- External auditor: audits and evaluations that promote performance and learning;
- Civil Society: active participation by media and civil society in decision making processes.

1.3 India is the world's largest democracy, with regular and free elections. Its constitution is based largely on the Westminster model of governance that is characterized by the supremacy of Parliament. The legislature (two houses of parliament), as elected representatives of the people hold the executive government to account for performance. Parliament has the authority to raise revenues, fund the public mandate and is the people's "watchdog" on the performance of the Executive. Parliamentary scrutiny is undertaken through specially constituted committees.

1.4 The executive arm of government is expected to exercise control over all financial transactions. It is expected to provide the public and Parliament a full and fair presentation of the accounts of the State—including the use of donor funds—at least annually. The legislative auditor reviews government's financial performance and reports to Parliament on matters that in his opinion require further attention. A similar framework is used to hold state governments to account (see annex B for political economy).

1.5 The Bank, the development community and stakeholders in India have explicitly raised concerns on public financial accountability. A 1998 conference on governance and accountability, Bank documents and external literature all highlight of the deterioration and key gaps in public financial accountability (annex B reviews issues raised). The gaps are reportedly widening and relate to all constituencies in the public financial accountability arena—legislature, government and legislative auditor. Further, as India is not a homogenous country, there are many accountability issues in the relationship between the Central, state and local governments. There are also significant differences between states in terms of capacity, the gaps therein, constraints and openness to reform.

1.6 Given the deteriorating financial accountability environment, the Bank's sizeable investment and its emphasis on clean government and good governance (as part of the Comprehensive Development Framework), a review of the Bank's efforts in this area is both timely and relevant.

2. The Extent Of Bank Knowledge

2.1 ***Country level.*** Public financial accountability has received explicit attention only recently and the Bank's knowledge of issues and capacity gaps is still evolving. Discussions with Bank staff suggests that this knowledge has been growing since the early 1990s, but in the absence of adequate institutional memory, OED could not find any formal evidence of Bank knowledge on public financial accountability prior to 1996.

2.2 The 1997 country economic memorandum argues for centrality of fiscal adjustment and highlights problems in financial management at the state level. The Bank has prepared a paper on government accounting and auditing systems (referred to as the 10-pager) on the basis of a specific request from the Finance Secretary. The Bank has also undertaken a Country Profile on Financial Accountability (CPFA) in FY99. Issues of governance and financial accountability are also addressed in the Bank's draft Comprehensive Development Review (FY00).[1]

2.3 The CPFA is the Bank's most recent formal document on financial accountability and management in India. It recommends:

- Separating accounting and audit at the state level
- Setting up an internal audit department within state governments
- Establishing a national commission to review government financial management systems
- Setting up a cadre of financial management specialists in line ministries
- Moving to accrual based accounting system from a cash-based one
- Removing the use of specialized Personal Ledger Accounts (PLA)
- Establishing a separate Government Accounting Standards Board

[1] India - Comprehensive Development Review of Policies to Reduce Poverty and Accelerate Development, by PREM, South Asia Region, June 30, 1999.

2.4 In his comments to an earlier draft of the OED paper, the Controller General of Accounts (CGA) in the Ministry of Finance expressed strong support for all the above recommendations but with one exception—moving to an accrual system of accounting. The CGA urges caution and gradualism in any move towards accrual-based accounting systems, as it believes them to be too ambitious and costly for developing countries.[2]

2.5 The Bank's Comprehensive Development Review (CDR) views improved public financial accountability as an important tool for the Bank's anti-corruption agenda. It draws attention to several issues and gaps in financial accountability and management related to the devolution of power to the states, and the budgetary and accounting processes in government (annex C).

2.6 ***State level.*** With increased decentralization, the role of state governments has increased significantly. The CDR suggests that better economic and fiscal management at the state level is necessary for growth and poverty reduction. The Bank's knowledge on financial accountability gaps at the State level is very recent and is focused on few states—Rajasthan, Andhra Pradesh and Uttar Pradesh.

2.7 A 1997 Bank report on Andhra Pradesh also raised the need for the state to increase the developmental impact of public expenditure, better manage its public finances, and improve revenue mobilization—in terms of efficiency and volume.[3] It suggests that the state should consider restructuring public sector enterprises and recommends staffing reform, privatization, increased autonomy and commercial orientation. On expenditure management, the Bank recommends computerization of accounts, a realistic and rational determination of estimates and expenditure ceilings for departments in the budget process, and medium-term rolling expenditure planning. However, this report does not go beyond government to address related public accountability issues such as legislative scrutiny and public rights and access to information.

2.8 Recently, the Bank has addressed financial accountability (comprehensively) as one priority area in its preparatory work for a proposed program loan to Uttar Pradesh (UP).[4] The Bank, in close collaboration with the State government, was requested to prepare an economic and fiscal assessment that helped stimulate dialogue on key public sector reforms, including financial accountability. The Bank report suggests that revamping the State finances requires a long-term, sustained effort. It recommends appointing a controller to modernize the financial management system, setting up of a modern internal audit function in the State government and constituting a task force of

[2] Regarding the proposal for a specialized cadre of financial management staff at the state level to undertake accounting and payments, budgets, financial advice and internal audit functions, the CGA suggests using a special cadre (ICAS) for this purpose. This cadre was set up in 1976, when accounting and audit were separated in the Central government, but the role of this cadre has so far been restricted to accounting, payments and internal audit.

[3] Andhra Pradesh: Agenda for Economic Reforms, World Bank. Washington DC.

[4] Uttar Pradesh is the most populous state and one of the poorest in India (41% of its 42 million population are poor). Initiating Memorandum–Uttar Pradesh Fiscal Reform and Public Sector Restructuring Loan, World Bank.

key stakeholders to design an appropriate internal control system, including the form and content of government accounts.

2.9 ***Project level.*** The Bank-wide Loan Administration Change Initiative (LACI) has stimulated assessments of financial management capacity at the project implementing agencies. These assessments are expected to certify the adequacy of financial management systems in these agencies. While this assessment could also help to identify country-wide risks, they are expected to serve the specific needs of the project and as such, do not aim to build borrower capacity beyond the implementing agency. Consequently, expectations for capacity building are modest.

2.10 ***OED assessment.*** The knowledge built so far by the Bank at the state and country levels has focussed on government accounting, auditing and internal control systems. Its analysis, however, raises questions of ownership, as it is looking "outside-in," and does not provide clear guidance on operational priorities. The Bank may need to undertake collaborative assessments with specific institutions to identify capacity gaps and actionable areas.

2.11 The CPFA's recommendation of setting up an accounting standards board for the government is supported by the CGA. However, India already has a well-established standard setting board at the national level for the private sector. The feasibility of using this organization to set standards for the public sector has not been explored. Admittedly, there is little interest and participation by qualified accountants in government accounting and auditing. But there is no shortage of qualified human resources in the private sector. Existing capacity in the private sector and institutes like that of Chartered Accountants of India (ICAI), IIMs and Cost Accountants should be tapped to contribute to improvements in government financial management.[5]

2.12 The recommendations in the CPFA call for significant and substantial changes in the form of government systems, implying significant change in existing civil service norms. In spite of the CGA's support for them, the political support for their adoption is not clear.

2.13 The Bank does not have adequate knowledge of the workings of other critical aspects of public financial accountability namely, the capacity and effectiveness of the legislative auditor and the legislative scrutiny process, the Bank does not have adequate knowledge of the. The role of the media and civil society in promoting public financial accountability is yet to be fully explored. The Bank has also not availed itself of the public information that is reportedly available on the nature and effectiveness of relationships between key stakeholders in public financial accountability. [6]

2.14 The country team expects to examine some of the issue raised above in greater depth through the Country Financial Accountability Assessment (CFAA), proposed for

[5] The CGA suggested that membership in the proposed government accounting standards board be extended by representatives of the institutes of chartered accountants and cost accountants.
[6] The local FMS believes that such information is already available in India.

FY-01. The CFAA is expected to take a holistic view of financial accountability issues at the state level. The team is now trying to build ownership for the CFAA from within the country. The recent emphasis on state level programmatic lending provides the opportunity for the Bank to build adequate knowledge in specific states to address public financial accountability issues in its dialogue with willing and interested clients.

2.15 OED reviewed sample assessments of financial management capacity undertaken for LACI in two projects. The review suggests that the Bank has sufficient knowledge on the systems in place for capturing and reporting financial information, but it does not assure itself of the effectiveness of the system. For instance, a review of the LACI assessment of the Andhra Pradesh State Electricity Board (APSEB) highlights the inadequacies in the financial management system such as lack of trained human resources, poor internal audit, poorly coordinated management information systems, etc. It suggests that there is a well-defined system for recording financial expenditures and accounts but does not test the system for effectiveness.

3. Application Of Knowledge By The Bank

3.1 ***Country level***. The 1997 Country Assistance Strategy (CAS) is based on the Bank's comparative advantage and focuses selectively on few reform-minded states.[7] It identifies the need to "strengthen public finances, further liberalize its economy, invest massively in infrastructure and accelerate human development."[8]

3.2 However, there is no significant emphasis in the 1997 CAS on public financial accountability, despite increased awareness about this significant constraint to development effectiveness. Nevertheless, the 1997 CAS identifies participatory decisionmaking, strengthened local responsibility and public accountability at local levels as key success indicators for agriculture and rural development programs. Improved financial accountability through increased Central Bank supervision and off-site surveillance were also identified as key needs.

3.3 The 1997 CAS also reports that corruption is viewed as an impediment to investment. It identifies contributory causes as excessive discretionary power for public officials, lack of transparency in the rules of governance and cumbersome procedures. It suggests that the Bank's anti-corruption strategy include promoting transparency in public infrastructure investment and enhancing financial management capacity at the Bank-financed project level through LACI.

3.4 ***State level.*** The Bank has developed an assistance strategy for Uttar Pradesh which recognizes the need for strengthening public financial accountability. A proposed

---

[7] Financial sector, private sector development, rural development (rain-fed agriculture, urban poverty alleviation, health and sanitation) are identified areas of priority.
[8] 1997 Country Assistance Strategy, World Bank, page 1.

one-tranche Fiscal and Governance Reform loan (supported by subsequent program loans) would support a long-term effort to improve governance, restore fiscal sustainability and accelerate growth. For this purpose, the Government of Uttar Pradesh has committed to take concrete steps for reforms in financial accountability in the areas of legislative scrutiny, external audit, as well as government financial management systems for accounting and internal control. These reforms are aimed at:

- Improving financial management architecture, including among others:
    - Appointing a Comptroller of Accounts in fiscal 2000
    - Enhancing the state's treasury function[9]
    - Determining the form and content for published financial statements
    - Increased training in financial management
    - Abolishing year end transfers of unspent amounts to the personnel ledger accounts[10]
    - Establishing an Internal Audit Department and a State Internal Auditor to consolidate and strengthen the internal audit function.
- Developing a strategy to improve financial accountability (task force to be appointed)
- Initiating dialogue with the central government and Comptroller and Auditor General (CAG).

3.5 The Bank's strategy in Uttar Pradesh puts adequate emphasis on the need for a "homegrown" reform process. It requires the state government to initiate dialogue with stakeholders and develop a well-articulated long-term strategy for implementing sound financial accountability. The Uttar Pradesh Government has also indicated its commitment to build consensus on ways to strengthen scrutiny by state legislatures. It is expected to organize a national level conference on "Parliamentary Control over the Public Purse" by June 30, 2000. Parliamentarians, speakers of state legislatures, the CAG, media and civil society representatives are expected to participate. The Uttar Pradesh state legislature has endorsed the reforms proposed by the state Government. This is a first important step in the right direction. GOI and Bank support for the reforms are expected to have a strong demonstration effects in other states.

3.6 The Bank must therefore now focus on implementation of the reforms. It must work with the State Government to build consensus and ensure adequate incentives among politicians and the civil service. It must also build broad-based support for reforms with other stakeholders in the state such as academicians, civil society groups, policy think tanks, media and the public at large.

3.7 ***Project level.*** The Bank's strategy as stated in the 1997 CAS was to improve project financial management systems through LACI. All projects approved by the Board after July 1998 are required to have adequate financial management systems to generate periodic Performance Management Reports (PMR). Where existing systems are not adequate, the borrowing agency is expected to draft an action plan to develop an

[9] Treasury offices will be converted into Integrated Pay and Accounts Offices with payroll responsibilities.
[10] Personnel ledger accounts have largely been abolished. Amounts budgeted but not spent in a fiscal year were transferred to the PLA.

acceptable financial management system prior to project effectiveness. The South Asia Region has recruited necessary staff to work on financial management at the project level and implementing LACI in all its recent projects in India.

3.8 The Loans Department in its Bank-wide one-year LACI review formed a sub-committee that evaluated five LACI projects in India. The findings of the sub-committee were not made available to OED. A draft summary of Bank-wide first-year LACI review highlights some difficulties in LACI implementation, applicable to projects in India such as:

- Inconsistencies in documentation, procedures and maintenance of records
- Resource constraints–human and physical.
- Uncertainty in using Performance Management Reports as basis for disbursement
- Uncertainty on the adequate and timely implementation of financial management action plans
- Overlap in the roles of Financial Management Specialists (FMS) in the Region and the Loans Department

3.9 The nature of funds flow in India's federal system is very complex and the funds take different routes depending on the project-implementing agency. The Bank, at the request of the government has recently prepared a paper that identifies some of the problems with the funds flow process in India. This paper, currently under discussion with Government, highlights some problems in the process and makes suggestions for improvement. None of project implementing agencies (except Central Public Enterprises since 1993, Central Autonomous Institutions and some Financial Institutions) can directly access the special accounts. For State government entities, the money is channeled through the national and subsequently, the state budgets.[11] The Bank believes that this process is cumbersome and circuitous, that it delays the transfer of funds to implementing agencies, causes inconsistency between the books of the center and the state, and fragments accountability for transfer of funds between many departments and agencies.

3.10 ***OED assessment.*** The Bank is yet to articulate a clear and consistent countrywide strategy in the area of financial accountability. Discussions with the Regional Financial Management team as well as internal notes suggest the country team has focussed primarily on the "ring fencing" projects with adequate financial management systems. There has been little emphasis on the country's overall public financial accountability systems**.**

3.11 There has been no direct attempt to effectively deal with the accountability issues at the national level.[12] OED was informed that the problems with funds flow have been raised with the Government in the past as part of the portfolio review process and that the Government has not shown much interest. This raises questions on the commitment of the government to modernize its financial management and accountability systems.

[11] Internal Note dated 1/28/2000 entitled India: Funds Flow Statement – Problems and Solutions.
[12] OED was informed of an internal strategy paper on financial management issues developed by the Loans Department for the South Asia region. This paper is yet to be shared with OED and the country team.

3.12 The Bank's strategy for financial accountability at the state level is evolving. In dealing with states with a poor reputation for good governance and financial accountability, the Bank has rightly, for the first time, tried to explicitly address financial accountability issues. The Bank should consider raising public financial accountability for possible priority Bank support in its future dialogue with the Government of India.

3.13 At the project level, none of the projects subject to LACI have reached the stage of disbursements based on Project Management Reports (PMR). There is an also an issue on using LACI-based disbursement rules for rural and social development projects in India. This is currently under negotiation with the Government. LACI was not designed to build capacity beyond the level of the project implementing agency. Further, it is not clear if the financial management systems developed under LACI will be sustainable beyond the life of the project. LACI could probably add greater value it were to be integrated as part of a more comprehensive strategy for public financial accountability at the national level. Ideally, the ownership of such strategy would lie with the national government.

3.14 Thus, strategy formulation for capacity building is in its infancy at the Bank. The Bank is now attempting to upscale from project to state level issues in public financial accountability. The Indian Constitution provides the central government considerable clout on matters associated with public financial accountability. OED believes that unless the Bank addresses these issues concurrently and more effectively at the national level, the full impact of its state level initiatives are unlikely to be realized.

3.15 The in-depth knowledge building exercise through the planned CFAA to address country and state level issues as well as the Bank's regional project-level initiatives should provide a good foundation to develop a Bank strategy for public financial accountability in India.

4. Results Of Investments To Build Capacity For Financial Management And Accountability

4.1 The Bank has made very little direct investment to improve financial accountability and management in India. The one exception is an IDF for the Auditor General's Office. The grant aimed to help modernization of Government audit in India. It provided for exposure and training of a core team of skilled auditors in public debt, privatization, and computerized accounting systems. These auditors would disseminate the knowledge through countrywide training programs. Implementation of the grant is deemed satisfactory. The Bank is considering a second phase of the grant: (a) to train auditors and expose them to best practice, (b) to enable the auditors to understand Bank operations and thereby improve the quality of the audits of Bank projects.

4.2 Most Bank efforts have been directed towards financial management issues at the project and sector levels. The Bank has largely undertaken only investment projects in India; there are only two recent adjustment loans—one in Andhra Pradesh and another is under preparation for Uttar Pradesh. The latter is the first time that the Bank has addressed financial accountability issues at the State level.

4.3 Even at the project level, financial management has been a recent area of emphasis in the Bank. An OED analysis of a few sample closed loans indicates that few projects have a component that addresses financial management (annex D). A review of the eight projects approved in the 1980s and exiting in FY90 and FY91 reveal that there was only one project that had a component for financial management.[13] On the other hand, a review of the projects exiting in FY98 and FY99 indicate that four out of thirteen projects (about 31%) contained a financial management or accountability component.[14] In the case of on-going projects, OED reviewed a random sample of 14 projects (out of 70). There was only one project in this sample that had a component dealing with financial management.[15]

4.4 ***OED assessment.*** The efforts in the 1990s were not designed to build effective capacity for financial management and accountability and have not made a lasting impact on the systems of public financial accountability in the country. The Bank's efforts to-date in this area have focussed on building accounting and budgeting systems, and improving procurement procedures at the project level. Thus, while the Bank's emphasis building capacity at the project level for improved financial management is creditable, these efforts were neither designed nor linking to a country level strategy for building sustainable borrower capacity. They did not form part of an over all strategy for improved public financial accountability.

5. Conclusions

5.1 The Bank should addresses national issues in public financial accountability on a proactive basis. The incidence of fraud, waste and abuse of public funds is reportedly widespread. The lack of effective parliamentary scrutiny of the public purse, for instance, is therefore a matter of concern. The systems of financial management and accountability in the states are essentially a replica of those at the Center and are often influenced by the Center. OED believes that unless the Bank deals concurrently with important national issues such as modernizing the financial management and control

---

[13] The Madhya Pradesh Urban Development Project financed a study of the financial management (accounting & budgetary) systems of the implementing agency. The Completion Report rated performance on the component as satisfactory.
[14] Performance on the financial management component is rated unsatisfactory in 2 of 4 projects (annex D).
[15] Rubber Project (C2409): The performance on the financial management component is not evident from the Project Status Report (PSR) of February 2000. The computerization program for accounting systems is reported to be proceeding satisfactorily.

systems, its efforts to improve financial accountability at the state level may not be sustainable.

5.2 The timing for proactive involvement is now. An event of consequence is the proposed all-India conference for speakers being organized by Uttar Pradesh. This may be an ideal forum for the Bank to clearly state its position on minimum standards for public financial accountability and clarify the consequences of not addressing financial accountability issues on a timely basis. The Bank should closely monitor and learn from the experience in Uttar Pradesh as it proceeds with negotiating similar arrangements in other states.

5.3 The Bank must also continue to build its own capacity—human as well as physical—to deal with country and state level issues for public financial accountability. Further, if task leaders are to take primary responsibility for capacity building, there is also a need to train and sensitize task managers to deal with such issues on a consistent basis across the country.

Annex A

List of Documents Reviewed

This note is based on a review of the following documents:

1. India - Comprehensive Development Review of Policies to Reduce Poverty and Accelerate Development, by PREM, South Asia Region, June 30, 1999.
2. Background Paper on *Governance and Accountability* for an International Seminar on Governance and Accountability held at India Habitat Center, New Delhi, May 1998. This paper was published jointly by the International Development Research Center, Ottawa, Canada and Consortium for Financial Management of Public Systems, New Delhi India.
3. A report on the International Seminar on Governance and Accountability held at India Habitat Center, New Delhi, May 1998.
4. A Report on the ASOSAI/IDI Seminar on Auditing Foreign Aid Effectiveness and Accountability held in Lahore, Pakistan in March 1994.
5. Internal Note on India Funds Flow Process – Problems and Solutions, dated Jan 28, 2000.
6. Economic Intelligence Unit's Country Report on India for 1999-2000.
7. Accounts and Accountability, Theoretical Implications of the Right-to-Information Movement in India, Third World Quarterly, autumn, 1999.
8. India Country Assistance Strategy, World Bank Document, May 1995
9. India Country Assistance Strategy, World Bank Document, December 1997
10. Transparency International (TI) 1998 Corruption Perceptions Index, web-site.
11. India Country Profile of Financial Accountability, 1999.
12. India 1997 Economic Update: Sustaining Rapid Growth, World Bank Document, 1997.
13. India Country Economic Memorandum, Recent Economic Developments: Achievements and Challenges, World Bank Document, May 1995
14. India Andhra Pradesh: Agenda for Economic Reforms, World Bank Document, 1997.
15. Government of Uttar Pradesh, Strategy Strengthening the Systems of Financial Management and Accountability, 1999
16. Government Accounting and Auditing in India: Proposed Agenda for Change, 1998.
17. India: Proposed Fiscal and Governance Reform Loan for State of Uttar Pradesh, Operations Committee Meeting on the Initiating Memorandum, October 1999.
18. Uttar Pradesh Government Financial Management and Accountability Assessment, Internal World Bank Document.
19. Internal Note: India IDF Grant, Audit Skills Up-gradation and Development Program for Comptroller and Auditor General, January 1998.
20. Project Appraisal Document, Andhra Pradesh Power Sector Restructuring Project, 1998.
21. Review of Loan Administration Change Initiative, Internal World Bank Note (draft).
22. The Loan Administration Change Initiative: Implementation Handbook.

Annex B

Context to the Review of Public Financial Accountability in India

The Political Economy and Public Financial Accountability

1. India is the world's largest democracy, with regular and free elections. Its constitutional democracy is based on the Westminster model of governance that is characterized by the supremacy of Parliament. The legislature (two houses of parliament), as elected representatives of the people hold the government to account for performance. The Lower House—Lok Sabha is elected every five years by universal adult suffrage while members of the upper house (Rajya Sabha) are elected by their respective state legislatures, according to state quotas. The Lok Sabha elects the Prime Minister and both houses of Parliament and the state legislatures indirectly elect the president—once every five years. The President is confined to acting on the advice of the Council of Ministers, who are chosen by the Prime Minister.

2. Parliament has the authority to raise revenues, fund the public mandate and is the people's watchdog on the performance of the Executive. Parliamentary scrutiny is undertaken through specially constituted committees. In the financial accountability area, the committees involved are the Public Accounts Committee (PAC), Public Undertakings Committee (PUC) and the Estimates Committee (EC). Parliamentary reports are made public though committee proceedings are not open. The government exercises control over all financial transactions and is expected to provide Parliament and the public a full and fair presentation of the accounts of the state—including the use of donor funds—at least annually. The legislative auditor reviews the government's financial performance and reports to Parliament on matters that in his opinion require further attention. The Indian constitution provides for an independent judiciary, with courts in every state and a Supreme Court at the center.

3. The country is made up of 26 states and 6 union territories. Governance at the state level is similar to that in the center and is headed by a governor, appointed by the President. The Constitution divides most powers between center and states, while the responsibility for the remaining powers—the concurrent list—is shared. But in practice, till recently, power was largely centralized. States had limited powers of taxation and relied heavily on transfers from the center[16]. Large state current-account deficits have led to recent efforts by the central government to clarify the states' responsibility for balancing expenditure. The 73rd and 74th amendments to the Constitution have decentralized power below the state level to several tiers of local government structures called Panchayati Raj Institutions (PRI).

4. State governments now play a decisive part in promoting regional economic development. The 1998-99 budget transferred 29% of the divisible pool of central taxes to state governments, substantially increasing the resources available to the states. But the financial position in many States is weak. It is reported that the overall state expenditure on non-developmental outlays, administration and interest payments amount to 70% of revenue receipts. The central government is encouraging states to improve management of their finances by controlling current expenditure and promoting private investment in infrastructure projects.

5. Several states have introduced measures to attract investment—privatization, labor market reform, restructuring utilities (particularly state electricity boards) and streamlining project clearance. Gujarat, Maharashtra, Karnataka and Andhra Pradesh have raised additional

[16] A pre-determined portion of the Center's revenues is transferred to the states. This is currently at 29%.

finance by issuing bonds and encouraging private investment in irrigation, infrastructure, software development, agriculture and horticulture. Most other states have made little progress. During 1997-98, 16 states resorted to overdrafts with the RBI, of which 3 had payments on their behalf halted when they failed to clear their accounts.[17]

Issues in Public Financial Accountability in India

6. The Bank, the development community and stakeholders in India has explicitly raised financial accountability as an issue of concern. A conference on Governance and Accountability in 1998, Bank documents and external literature all highlight key gaps in public financial accountability. The gaps relate to all constituencies in the public financial accountability arena—legislature, government and legislative auditor. Further, as India is not a homogenous country, there are different types accountability issues at the center, state and local levels. There are also significant differences between the 26 states in terms of capacity, the gaps therein, constraints and openness to reform. Fraud, waste and abuse of public funds are now increasing to serious proportions.

7. There is an urgent need to increase the effectiveness of the PAC, especially at the state level. In a symposium for speakers of the Lok Sabha and State Legislative Assemblies, it was observed that "the chain of accountability of the civil service to the political executive, of the political executive to the legislature; and the legislature to the people has snapped[18]." Conference participants believed that lack of transparency and delay in the discussion of the reports of the PAC and PUC in various States, among other reasons, renders them irrelevant and ineffective.

8. There is also no effective system to follow-up on the corrective actions taken by the Executive on recommendations of the Committee. Currently, the executive provides "action taken notes" on audit observations that are reportedly late or not received at all. Even at the Center, the PAC has tenure of one year only and is reported to scrutinize few audit observations and CAG reports.

9. The relationship between the Comptroller and Auditor General (CAG) and parliamentary oversight committees was raised in a recent 1998 conference on financial accountability. In Britain, Canada and other countries with similar financial accountability models, the work of the Auditor General too is examined by the PAC. In India, the relationship is one of an advisor and friend. The reporting relationship of the CAG to Parliament needs to be reexamined.

10. Independent audits by CAG are the institutional mechanism that holds the executive to account for financial irregularities. The CAG reports are tabled in Parliament and are scrutinized by the PAC. The audits focus mainly on financial irregularities and are not always management audits that suggest ways to address systemic issues. The need to improve the techniques of public audit to make them less process oriented and more results oriented has been raised. While the CAG remains highly respected, recently there has been some criticism on process issues such as delays in detection of fraud or misuse of public funds in Bihar.

11. Although, the ability of the Indian civil service is one of the highest in the world, this reputation is no longer associated with willingness to promote clean government. There are serious institutional deficiencies—lack of transparency and accountability, inadequate performance appraisal, political interference causing weak administration, bureaucratic delays, and corruption.

---

[17] Refer EIU Country Report, 1999-2000.

[18] A Report on the International Seminar on Governance and Accountability held May5-8, 1998; page 2.

12. There is little incentive for efficient service delivery. The civil service needs to be modernized to allow for greater transparency—especially the stringent rules of the Official Secrets Act and civil service conduct rules.

13. The 9th Pay Commission constituted by GOI reports that the attitude of the bureaucracy dates from the colonial era that emphasized procedures and processes not results.[19] There is little accountability. Eliminating the scope of discretionary powers (award of tenders, levy of taxes, assessments), improving procedures to formalize accountabilities and linking pay to performance are some identified issues. The challenge of reforming the civil service culture fostered by security of tenure and central planning to be more accountable, performance oriented and citizen-friendly is enormous.

14. Understatement of budget expenditures vis-à-vis the actual at the State level is reported to have increased in recent years.[20] A recent press report suggests that State governments have systematically spent more than budgeted amounts over the last twenty years, amounting to over 850 million rupees (US$2 billion), without any explanation to tax-payers and legislators on the use of the money.[21]

15. Weak expenditure controls and revenue collection procedures have facilitated leakage and misuse of budget resources. 23 out of 26 states are reported not to have regularized excess spending in the last 5 years and 14 states have unexplained overruns for 10 years. By law, the government is required to report and justify amounts over-spent to the PAC. The variation between states is large—Meghalaya has unexplained overruns for 28 years. Jammu and Kashmir, Uttar Pradesh, Bihar and Assam are the worst offenders in terms of amounts overspent. Sikkim and Pondicherry are exceptions with trivial overruns.

16. The process of devolution of financial and administrative autonomy to the States is not complete. Some states have been more successful (Andhra Pradesh) than others (Bihar) in pursuing reform and attracting foreign investments. The status on a 1992 amendment that provides administrative power to the PRI and local level governments is unclear. The 73rd and 74th amendments provide for the establishment of a State level finance commissions to make recommendations on expenditure responsibilities, tax powers, system of fiscal transfers etc. State governments are slow to accept and implement recommendations of the finance commission. Karnataka, Madhya Pradesh, Gujrat, West Bengal and Kerala are ahead of other states.

17. Recently, there has been a spate of public scandals involving senior politicians. The 1998 Transparency International report ranks India worse than China and other Asian countries, and marginally better than Pakistan.[22] Corruption is perceived as a "malaise afflicting not only the government bureaucracy but the body politic as a whole." [23] Corruption at the political level is seen to feed corruption at the bureaucratic level. Election of legislators with criminal charges pending in courts has reportedly led to criminalization of politics.

18. Corruption is still traditionally viewed as an issue of public morality; the economic costs of corruption are not as clearly articulated. It is also viewed as a by-product of state intervention in the economy. Bank documents reveal that almost 83% of local businessmen surveyed reported

---

[19] Government of India set up the 9th Pay Commission to study modernizing and reforming civil service.
[20] Documents related to the Seminar on Governance and Accountability – see annex A.
[21] Dated September 27, 1999.
[22] TI Corruption Perception Index for 1998 and 1999.
[23] Documents related to the Seminar on Governance and Accountability – see annex A.

paying bribes especially for customs, excise, taxes, licenses and government contracts.[24] Deregulation, privatization and better public financial accountability systems are believed to reduce the scope for waste and corruption.

[24] Country Disclosure Report.

Annex C

Issues Raised by 1999 Comprehensive Development Review on Public Financial Accountability in India

1. The CDR comments on the following issues and gaps in the system of public financial accountability in India:

Corruption. The CDR suggests a three-pronged approach: deregulation and privatization to reduce the role of government, improving disincentives for corrupt practices and increasing accountability, transparency and the role of citizens' voice in administrative procedures.[25] Thus, the Bank views improved financial accountability as a systemic and preventative cure for the malaise of corruption.

Budget process. The Bank has knowledge of key constraints in the budget process. One identified issue is the reduced comprehensiveness of the budget due to expenses being presented on a net basis for some departments, separation of the Railways budget from the main budget, and not considering future revenue and expenses even for capital projects in the budget. Further, revenue and expenditure budgets are not prepared concurrently. Post-budget expenses are incorporated without penalty in one of three supplementary budgets, and published government accounts do not aggregate actual expenditures. These policies undermine financial accountability through the budget process.

2. There is little role for stakeholders as they are consulted with only after the budget circular is given to Ministries. There is ex-ante rather than ex-post control of expenditures. Moreover, financial reporting and budgeting processes are not linked with performance budgeting system for reporting outcomes. There is little transparency and accountability and no incentive for efficient service delivery. The CAG believes this has facilitated leakage and misuse of budget resources and fueled corruption.[26]

Decentralization. The CDR presents a picture of incomplete institutional development and inadequate capacity. The decentralization facilitated by 73rd and 74th amendments to the Constitution call for greater autonomy and power to 220,000 local level governments. The CDR suggests that there is weak capacity for service delivery and accountability institutions are just being formulated. It highlights that local governments depend on the State for resources—and have little revenue mobilization authority. Further, the degree of devolution of authority has differed across states. For instance, the CAG is reported to be compiling the public accounts for some states. There are inadequate audit and accountability mechanisms for local governments in many states. The CDR suggest that strengthening state level institutions will require privatization, civil service reform, and more transparent expenditure control and financial management.

Others. The CDR also calls for implementing the 9th Pay Commission Report recommendation of a long term, multi-pronged approach to reduce size of civil service, decentralization and privatizing departments like Railways, removing arbitrary transfer of civil servants, restructuring performance appraisal systems for the civil service, passing a right to information act and revising the Official Secrets Act.

---

[25] Comprehensive Development Report – see annex A.
[26] Comprehensive Development Report – see annex A.

ANNEX D. LIST OF SAMPLED PROJECTS - INDIA

Project ID	Project Name	Status	Board Date	Closing Date
10484	UTTAR PRADESH RURAL WATER	Active	6/25/1996	5/31/2002
10449	ANDHRA PRADESH FORESTRY	Active	2/24/1994	9/30/2000
10408	BIHAR PLATEAU	Active	11/19/1992	6/30/2000
35821	DISTRICT PRIM EDUC 2	Active	6/6/1996	6/30/2003
10448	FORESTRY RESEARCH ED	Active	2/24/1994	12/31/1999
10463	INDUS POLLUTION PREV	Active	7/26/1994	3/31/2002
10390	MAHARASHTRA FORESTRY	Active	1/14/1992	3/31/2000
10561	NATL AGR TECHNOLOGY	Active	3/17/1998	12/31/2003
10416	PGC POWER SYSTEM	Active	3/23/1993	6/30/2000
9959	RUBBER	Active	7/2/1992	9/30/1999
9988	TECH EDUC II	Active	3/28/1991	10/31/1999
35824	UP DIV AGRC SUPPORT	Active	6/30/1998	3/31/2004
35827	WOMEN & CHILD DEVLPM	Active	6/29/1998	9/30/2003
43728	ENV CAPACITY BLDG TA	Active	12/23/1996	6/30/2003

Project ID	Project Name	Status	ARPP Exit Year
9807	Second railway modernization and maintenance proj	Closed	1990
9786	Madhya Pradesh Major Irrigation	Closed	1991
9788	West Bengal social forestry project	Closed	1991
9799	Uttar Pradesh Tubewells 2	Closed	1991
9802	Jammu and Kashmir and Haryana social forestry pro	Closed	1991
9809	Madhya Pradesh Urban Dev	Closed	1991
9828	Nabard credit project	Closed	1991
9976	Housing development finance corporation project	Closed	1991
9793	Second Ramagundam thermal power project	Closed	1992
9794	Second Korba thermal power project	Closed	1992
9872	Tamil Nadu Urban Development	Closed	1998
9885	Petrochemicals Develop 2	Closed	1998
9888	Power Utilities Efficiency	Closed	1998
9890	Hyderabad Water Supply & Sanitation	Closed	1998
9895	Industrial Technology Dev.	Closed	1998
9932	Tamil Nadu Integated Nutrition 2	Closed	1998
9940	Population 7	Closed	1998
9973	States Road	Closed	1998
9941	Maharashtra Power	Closed	1999

* Projects that have a component related to financial management / accountability.

ANNEX E. SAMPLE FINANCIAL MANAGEMENT AND ACCOUNTABILITY COMPONENTS IN PROJECTS IN INDIA

Loan No.	Project Name	Status	Project Objective / Description
2329	Madhya Pradesh Urban Dev	Closed	TA for 2 development authorities, 2 governing boards and 3 municipal corporations helped to finance a study to review financial management and resource mobilization systems and make reccomendations. The project financed implementation of recommendations, including training.
4478	Tamil Nadu Urban Development	Closed	At the state-level, Tamil Nadu has taken the lead in preparing a revised accounting manual for all local bodies, to support the introduction of a computerized accrual-based accounting system. Computers have been provided to the ULBs and a software company has been engaged to develop accounting soft ware based on the revised manual. The GOTN has introduced incentives to improve ULBs' financial management by budgeting for a grant which will be allocated based on their financial performance. This effort will be further supported under the project.
3436	Power Utilities Efficiency	Closed	Provide training in financial management as part of Institutional strengthening program.
3181	Hyderabad Water Supply & Sanitation	Closed	TA for the management, finance and accounting area included the development of, and related implementation of personnel training for: (a) accounting and management information systems; (b) project planning and control systems; (j) improved revenue billing and collection systems; and (k) materials management and stores inventory systems.
3096	Maharashtra Power	Closed	The project's Indstitutional strengthening program included among others plans to strengthen MSEB's finances, management and operations through setting up of corporate planning, operational performance monitoring, and management accounting systems; streamlining internal procedures; and accelerating development of data processing and internal audit systems.
2409	Rubber	Active	Institutional Support for the Rubber Board Organization includes computerization of accounts at regional offices as well as the head quarters.

ANNEX F. RATINGS OF SAMPLE FINANCIAL MANAGEMENT AND ACCOUNTABILITY COMPONENT PROJECTS

Loan		*Objective Type*			*Type of*	*Reviewed*	*ICR (PPAR/ICR Review) Ratings*					*Rating on FMA Component*	
No.	*Project Title*	*Main*	*Component*	*Hidden*	*Loan*	*Document*	*Outcome*	*Sust*	*ID*	*Bank Perf.*	*Borr. Perf.*	*Outcome*	*Remarks*
2329	Madhya Pradesh Urban Development		YES		Investment	PCR	Satisfactory			Satisfactory	Satisfactory	Satisfactory	The studies were effectively completed. The PCR reports that while project accounting and financial management has improved, there was little improvement at the sectoral level. The ID components incl. Fm were utlized effectively at the state level agencies but the improvemetns targetted at the central level agency were not achieved.
4478	Tamil Nadu Urban Development		YES		Investment	ICR	Satisfactory			Satisfactory	Satisfactory	Unsatisfactory	The ICR reports that the objective of improving financial mgmt. at the municipal levels was not fully achieved. The ICR reports that TNUDF needs to improve its own financial management & accounting administration. It has not yet established adequate financial management information system. The current system does not provide the management with timely enough financial information required for efficient management.
3436	Power Utilities Efficiency			YES	Investment	ICR	Satisfactory	Unlikely	Partial	Satisfactory	Satisfactory	Unclear	While the ICR suggests that the trasining objectives were met, it highlights weak project accounting systems as factor that effected implementation at the project level, and ineffective audit systems at the sectoral level.
						EVM	Marg. Sat.	Unlikely	Modest	Satisfactory	Satisfactory	Unsatisfactory	The project failed in its goal to encourage SEBs to undertake deep reforms needed to strengthen their operational and financial performance.
3181	Hyderabad Water Supply & Sanitation		YES		Investment	ICR	Satisfactory	Likely	Substantial	Satisfactory	Satisfactory	Highly Sat.	Institutional strengthening was successful. A new procurement system was introduced. Financial management for the sector greatly improved following the establishment of HMWSSB due to the appointment of a professionally qualified Finance Director and senior staff, and the introduction of modern computerized procedures. Accounts have been prepared on an accrual basis and, with one non-material exception, have been without audit comment ever since.
						EVM	Satisfactory	Uncertain	Substantial	Satisfactory	Satisfactory	Highly Sat.	
3096	Maharashtra Power		YES		Investment	ICR	Unsatisfactory	Uncertain	Negligible	Satisfactory	Satisfactory	Unsatisfactory	In essence, the underlying developmental objectives, including introducing institutional improvements, have not been achieved.
						EVM	Unsatisfactory	Uncertain	Negligible	Satisfactory	Unsatisfactory	Unsatisfactory	
2409	Rubber Project			YES	Investment	PSR	Satisfactory					Satisfactory	The first phase of the computerization has been satisfactorily completee and the second phase is in progress.

Chart 1: System of Public Financial Accountability

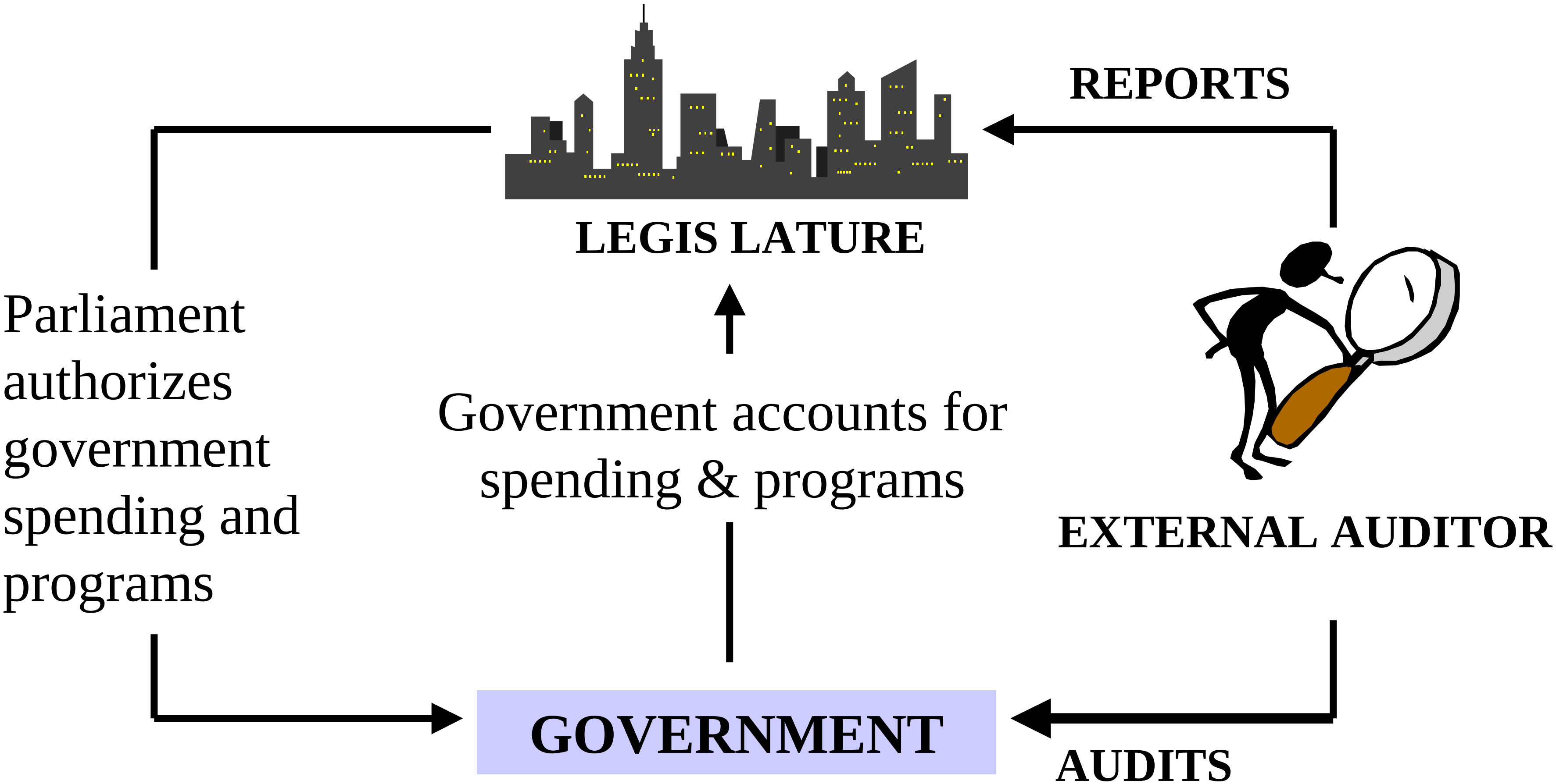

Chart 2: Key Stakeholders in Public Financial Accountability