



REFORMING PUBLIC EXPENDITURE MANAGEMENT IN KERALA, INDIA-ISSUES AND CHALLENGES

Dr. Johnson V

Associate Professor, PG Department of Commerce, Pavanatma College, Murickassery.

Abstract

Over the past couple of decades, the financial squeeze in the state of Kerala has become a major issue in the academic narratives, policy analysis and in the everyday discourses. Corollary to the above, empirical studies also bring out evidences suggesting that there is serious stress on the finances of Kerala. This is more explicitly reflected in the recurrent revenue expenditure mismatch leading to budgetary imbalances, deficits and borrowings. Since revenue enhancement is relatively difficult, the present paper attempts to set focus on issues relating to reforming and strengthening the Public Expenditure Management practices of Kerala Government for weathering the imminent threat encircling the very foundations of the finances of the state, on the way to achieving fiscal consolidation and aggregate fiscal discipline.

Key Words: Financial, Squeeze, Expenditure, Deficits, Revenue, Fiscal Consolidation.

1. NEED FOR PUBLIC EXPENDITURE MANAGEMENT

Ample evidences can be gathered from empirical studies¹, in support of the general view that there is serious stress on the finances of Kerala. This is also visible in the unending revenue-expenditure mismatch, entailed by the ever increasing public expenditure, leaving little for productive capital investments on the one hand and huge deficits on the other. These mounting deficits necessitated increased borrowings eventually culminated into a debt-deficit spiral in the state. Though the Government has dismissed suggestions that it was passing through a financial crisis², the reassuring statements of the government as to financial soundness itself rings the alarm bells signalling that the state is heading towards an inevitable crisis; pushed further up by the falling rupee and the economic standoff at the centre. The so called string of stringent fiscal consolidation measures initiated by the Government of Kerala (GoK) for weathering the present crisis are unlikely to deliver at this critical juncture.³

Revenue enhancement and expenditure management seem to be the two possible ways through which the crisis may be addressed with, of which the former remains to be a difficult proposition at the moment as the growth rate of revenue is only 12.11 percent as against the targeted figure of 26 percent based on figures up to July 2014⁴. This forces the GoK to bank heavily on expenditure management, which lies at the heart of public financial management today. The present paper, therefore, seeks to address the central question of public expenditure management as a vital development imperative for weathering the imminent threat encircling the very foundations of the finances of Kerala, on the way to achieving fiscal consolidation and aggregate fiscal discipline.

2. PUBLIC EXPENDITURE MANAGEMENT– THE CONCEPT

Public expenditure management is a new approach to an old problem⁵. It is a basic means of government policy distributing and utilizing sources productively, effectively and sensitively⁶. Public Expenditure Management (PEM) does not stand for mere cuts or compressions of expenditure. Instead, it is a comprehensive term that signifies appropriate and transparent allocation of public resources among competing priorities with a view to producing intended results at least cost. 'It lays out plan of actions to eliminate wastages and leakages and ensures efficiency, economy and frugality in the use of budgetary resources with a view to effecting 'strategic prioritization and rationalization of expenditure'⁷ based on efficiency, quality and effectiveness.

PEM focuses on ensuring that limited resources are allocated to increasing transparency in the use of priority areas over the medium term public funds⁸, introducing a performance focus in planning and budget management and ensuring that the planning, management and reporting of public funds meet international standards⁹. It also calls for adoption of innovative practices in accounting, budgeting, auditing, Integrated Financial Management Information System (IFMIS) and other private sector style management practices akin to international standards. Thus effective management of public expenditure becomes the real challenge, as there is no *one size fit all* PEM theory.

3. REFORMING PEM OF GOVERNMENT OF KERALA

Contrary to general perception, Kerala's fiscal strain is not merely a reflection of a cash flow problem alone but fundamentally it is a structural affliction. Hence the fiscal situation of the State calls for radical and comprehensive reforms of which public expenditure management has to be conceived as a vital imperative. While the PEM system in the



state appears to be consistent with well-established budgeting, accounting, audit, and legislative control systems, recent studies¹⁰ (Johnson, V. 2004 & George, K. K. 2012) point out that there is still considerable scope to improve the efficiency of government spending and public service delivery by strengthening the institutional framework for public financial management. The following are the core areas, where radical reforms are increasingly felt useful for the Government of Kerala.

3.1. Introduction of Accrual accounting system

Accrual accounting is an accounting methodology under which transactions are recognized as the underlying economic events occur, regardless of the timing of the related cash receipts and payments¹¹. According to the prevailing practices, the Government of Kerala is obliged to prepare annual balance sheets, statement of uses and sources of funds, and income and expenditure statements on cash basis, which is deficient in not being able to provide the complete picture of the financial position of the Government. It lacks complete information on assets and liabilities, and therefore makes it difficult to ascertain the total cost of services provided by Government departments¹².

Further, owing to traditional maintenance of accounts on a cash basis government activities are in many cases managed with poor quality financial information. It is often unreliable, unaudited and untimely with inconsistencies in reporting practices from one year to the next¹³. While the Government balance sheet prepared on the accrual basis of accounting would indicate the net worth erosion in net worth as compared to earlier periods provides a measure of the fiscal deficits and the long run solvency of the government¹⁴. The accrual accounting system enables better internal control, better quality information for decision making, a more complete and transparent view of the financial position of the Government.

In the context of accrual accounting system, concerns range from technical issues like valuation of assets to broader questions regarding differences in the requirements of the public sector versus the private sector and administrative accountability¹⁵. The susceptibility of cash accounting to manipulations of financial statements by managing the timing of transactions is considered as key criticism. However, the scope for manipulation in accrual accounting is also there in the formation of estimates of revenues and expenses due to considerable scope for judgment¹⁶. There is still limited unanimity at the political and administrative level, even after taking a principled stand to introduce accrual accounting, due to apprehensions regarding risks involved, likely costs involved, and requirement of administrative capacity.

A number of countries switched over to double entry book keeping and adopted the accrual based system of accounting during the 1980's. Chile was the first state that introduced accrual accounting for the public sector in early 70s, followed by New Zealand in 1990. However, unlike New Zealand where the change was comprehensive, other Countries have made gradual changes. For example, in the USA the Generally Accepted Accounting Principles (accrual accounting) have been adopted only by some states. In USA and Australia the passing to accrual accounting occurred in 1997 but only in central governmental administration, in local administration the change being implemented just now. Canada took over the system in 2001-2002.

In India the decision to switch over to accrual accounting is Constitution bound. Article 150 of the Constitution of India stipulates that "The accounts of the Union and of the States shall be kept in such form as the President may, on the advice of the Comptroller and Auditor General of India, prescribe." Accordingly, with the support of the Government of India, the Government Accounting Standards Advisory Board (GASAB) was constituted by the Comptroller & Auditor General of India on August 12, 2002 for the Union and State. The GASAB roadmap to introduce accrual accounting system envisages a transition period of 10 to 12 years divided into several stages. Progress seems to have made in the case of Urban Local Bodies where introducing the accrual accounting system has gained momentum.

The Comptroller and Auditor General of India (CAG) prepared National Municipal Accounting Manual incorporating the principles of accrual accounting in a stage-wise approach. Many State Governments have also shown interest in this direction. Still, systematic efforts need to be made over a number of years to implement accrual accounting. Helpful steps to achieve this would include imparting necessary training, recruiting suitable professionals, preparation of accrual accounting manuals, getting together comprehensive data regarding assets and liabilities, establishing suitable accounting standards and norms, and using information and communication technology. Thus in line with the innovations taking place elsewhere, the GoK may attempt a stage-by-stage approach to introduce accrual accounting in the state to reflect a realistic picture of state finances to better tackle the problem of PEM.

3.2. Strengthening the Internal Audit System

The Internal Audit Function has been viewed as an integral part of government financial management and is increasingly an instrument for improving the performance of the Government. Internal Audit in India is an inchoate area which in today's



economic scenario requires greater attention. The focus of Internal Audit, till now, has been mainly on compliance audit, i.e. to ensure proper maintenance of records, proper application of rules, regulations and Instructions issued by the Government of India from time to time and also to ensure accuracy in accounts and efficiency in operations. The following definition gives a better view, “Internal auditing is an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization. The objective of internal auditing is to assist members of the organization in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analysis, appraisals, recommendations, counsel and information concerning the activities reviewed¹⁷. According to this definition, an internal auditor has to go beyond the books of account and records and appraise the various functions of the organization. One of the main weaknesses of the internal audit system in India is that it has not kept pace with emerging international standards and practices¹⁸. Unless urgent steps are taken to rectify the situation, the financial management of the government will remain inundated from established international standards. The internal audit is emphasized as a management tool and an integral part of both management controls and communication processes¹⁹.

Unfortunate to say, in India, it is still conducted based on departmental codes and manuals, which are a legacy of the past. Internal audit, for example in Defence Accounts Department—where it is fairly well organized—is done with reference to rules laid down in Defence Audit Code, Financial and other Regulations for Defence Services and other orders issued by Government and other competent financial authorities²⁰. In fact, internal audit needs a convergence of financial propriety, accounting techniques, administrative mandate and refinement of personal skills to make it an effective tool in the hands of the executive that will encompass the entire domain of governance to achieve the stated outcomes²¹.

The recommendations of the Task Force 2006 appointed by Government of India (GoI) subscribed to the modern view that internal auditing should not be restricted to financial issues alone, but should also extend to issues like cost benefit analysis, utilization and deployment of resources, matters of propriety, effectiveness of management etc. and the focus should be on risk, control and governance issues. It also provided other multiple recommendations including: segregating duties relating to internal audit from those relating to financial advice and accounting functions, setting up an Apex Board to prescribe internal audit standards like the auditing standards issued by the International Organization of Supreme Audit Institutions (INTOSAI) and Institute of Internal Auditors (IIA) and processes across jurisdictions, legislating internal audit standards and policies, establishing a Board of Internal Audit (BIA), and ultimately, appointing a Chief Internal Auditor (CIA) trained in auditing. The CIA would function in accordance with standards and procedures prescribed by BIA. Thus internal audit shall not only supplement the external audit but also create and strengthen the overall audit consciousness of the various organs of the state akin to international standards and practice. Accordingly, the ultimate aim of audit should be to improve reliability, transparency and public accountability instead of the mere compliance to statutes.

3.3. External Audit

The external audit by the Comptroller and Auditor General of India (CAG) has played crucial role in India and assisted the Parliament in exercising financial control over the executive. The CAG of India is an authority, established by the Constitution of India under article 148, who audits all receipts and expenditure of the Government of India and the state governments²². The recent performance audit reports by the CAG have raised nationwide debate on corruption in Government and the necessity of adopting strong measures to improve the accountability of the executive and the elected representatives. The timely unraveling of the three recent scams including the 2G spectrum; the Commonwealth Games scam 2010 and the coal scam are manifestations, testimonial to the great services of the CAG in this context. The external audit by the CAG has contributed to transparent financial management by raising audit observations repeatedly relating to budgetary controls, deficiencies in revenue collection, wastage of public resources, inappropriate accounting, poor returns on investments, diversion of funds, and system deficiencies.

Effectiveness of external audit largely depends on the interest it evokes and support it obtains from the Public Accounts Committee (PAC), a parliamentary committee, scrutinizes the audit reports. The functioning of PAC over the year has shown that the percentage of audit observations being discussed in PAC has been reducing. The Ministries and Departments take only those audit paragraphs seriously which were scrutinised by the PAC. While external audit has been a strong element of Indian PFM system, the follow-up process needs improvement to enable the external audit system to play its desired role. To be more specific, the audit by the Comptroller and Auditor General (CAG) should undergo external quality control reviews.

3.4. Extended use of Performance Budgeting

The failure of the traditional input based line item budgeting to justify budget allocations paved way for the emergence of Performance Based Budgeting (PBB) since the dawn of the 20th century. Traditional or line-item budgeting relates to allocation of funds based on line item costs regardless of the ability to meet the goals. The line-item budgeting involves focus



on inputs i.e. staff, equipment, supplies, etc. The budget justification is based on increase in line item costs, an incremental approach leading to arbitrary estimate of expenditure. There is lack of attention to results or impacts of programmes or performance. Managers are encouraged to spend, not to economise or innovate. PBB, on the other hand aims to improve the efficiency and effectiveness of public expenditure by linking the funding of public sector organizations to the results they deliver, making systematic use of performance information.²³

A Performance Based Budget comprises an annual, integrated performance plan, indicating the relationship between the levels of program funding and the anticipated outcomes. It refers to a single or a set of performance targets which must be achieved at a given expenditure level. Performance budgeting, thus, focuses on results funding outcomes, rather than inputs. Assessing results by measurable indicators, holding managers responsible for performance, giving flexibility to managers to 'manage' and 'innovate', and having a medium-term and long-term view of use of resources are some of the significant features of the performance budgeting system which enhance the performance of the departments. Its central tool is the annual budget which provides a direct link between expected results and resource requirements²⁴.

Since the regular budget presented in the Parliament is a separate process from the ministry wise outcome budgets tabled later in the budget session, this relationship between the departmental outcome budget and the general budget decisions needs to be strengthened to improve the performance orientation of the budgeting system. However, PBB is not a weapon to trim down the organisation and to cut spending. Philip Joyce, while acknowledging that "no standard definition" of PBB exists, states that "it involves a sophisticated web of relations, from inputs to outputs, to outcomes..... the connecting of resources to results for budgeting purposes"²⁵.

The performance budget in India was introduced in 1968 following the recommendations of the first Administrative Reform Commission. The objective of introducing the performance budget as a supplement to the traditional incremental budget was to provide a link between the financial budget of the departments to tangible targets in order to enhance the effectiveness and efficiency of public spending. Thus, taking deviation from structural rigidities, the Indian approach in this context has been to supplement traditional incremental budget with a ministry-wise performance budget for the same budget session. The general budget presented in the Parliament can best be described as traditional budget²⁶ and displays characteristic problems. For, PBB establishes a top-down, logical framework, using a number of strictly defined concepts, such as expected results, performance indicators and outputs.

The incremental system of budgeting, based on an arbitrary increase over previous year figure, followed by the centre and state governments in India results in discretionary margin and unrealistic estimates of expenditure for the coming year. This systemic weakness may be overcome by adopting Performance Budgeting or integrating parts of which with the current budgeting system. The government can also look into the possibility of making extensive use of FMIS by building physical and financial database on an online basis for the purpose of controlling aggregate spending, strategic prioritisation of expenditures across policies and better use of budget resources. The legislative control in the state over public expenditure needs to be tightened by a greater use of the legislature's own powers and strengthening its committee system. The legislators should uphold the sanctity of legislative sanction while voting for expenditures.

3.5. Fiscal Transparency

Fiscal transparency is a vital instrument of PEM. It is increasingly seen as an important precondition for effective governance, improved economic performance, and prudent fiscal policy, resulting in lower deficits and debt accumulation. In addition to generating economic benefits, fiscal transparency also functions as a political expression of democratic governance, giving citizens and tax-payers information that they are entitled to and that they can use to hold their governments accountable²⁷. Though India is able to conform to three out of four principles of Fiscal Transparency Code laid by IMF²⁸ to a certain extent, the one key area, which is the most important part of Government shut up to the people is budget preparations, which deprives them of an opportunity to know about the rationale behind estimation of revenue and expenditure of government.

This is against the will of the people as they are forced to contain themselves with whatever little provisions in the budget which they come to know when everything is over. Even in a democratic country like India, this is true as the finance minister and other officials, under the pretext of official secrecy, are in a position to inject their political will into the budget right from budget preparations are on from the month of November. So everything is under the veil of official secrecy and the aspirations of people are steamrolled in the process.

Though Section 6 (1) and (2) of the Fiscal Responsibility and Budget Management Act 2003 prescribes that the Central Government shall take suitable measures to ensure greater transparency in its fiscal operations in public interest and



minimize as far as practicable, secrecy in the preparations of annual financial statement and demands for grants, laying emphasis on Open budget process, Public availability of information, Clarity of roles and responsibilities and Assurance of integrity, no major steps seems to have taken to give effect to the above.

In a study conducted by International Budget Partner Ship among 125 nations on budgeted related legislations, India was grouped under 'Countries with more extensive mentions of transparency in budget legislation' only. Only seven out of 125 countries investigated include provisions for citizen participation and engagement in their budget related legislation: they are Brazil, Croatia, Ecuador, Finland, Honduras, Nigeria, and the United Kingdom. Brazil is the country with by far the most detailed legal provisions for participation in the budget process. Thus India heavily lags behind in this process.

The rationale for including transparency clauses in budget legislation is straightforward: establishing specific budget principles and practices in law, rather than in less formal arrangements and increasing the likelihood that implementation will be consistent, sustainable, and equitable. Thus legislation that requires the disclosure of budgetary information constrains the abuse of power by political authorities and gives citizens a means to demand such information from government institutions. New Zealand is an example of transparency legislation. New Zealand's Public Finance Act was approved by Parliament in 1989 and amended in 2004, which legalized vital elements of Fiscal Transparency closely align to the Fiscal Transparency Codes of IMF. India too, needs such a piece of legislation to make the government more accountable for the implementation of fiscal policy and thereby strengthen credibility and public understanding of economic policies and choices and significantly enhance the quality of budget data both at the centre and states.

3.6. Extended Application of Market Principles

The recognition of the inadequacies of the conventional approaches in budgeting, accounting and management, as discussed earlier, has contributed to the emergence of a new approach to PEM. The New Management Philosophy also known as New Public Management (NPM). The main ingredients of NPM, as identified by Hood²⁹, are hands-on-professional management, explicit standards and measures of performance, emphasis on output controls, shift to disaggregation of units in the public sector, greater competition in the public sector, stress on private sector styles of management practice, and stress on greater discipline and parsimony in resource use. The basic idea of NPM, pioneered most notably in New Zealand, is that government shall seek to improve quality by giving managers broad discretion in running their programmes and holding them accountable for results.

The application of the market principles involves the liberation of the spending agencies from the government monopolies and the freedom to seek their inputs from the best source available on the basis of competitive bids. Government agencies are expected to be commercial in their approach based on market testing, contracting out and cost efficient.

In the Indian context, however, these innovative ideas find no place in PFM in its fuller extent, as the topic of government finance is shrouded under the veil of official secrecy. Though innovations initiated in this direction have been fruitful to certain extent, a more extended application of these principles would definitely pave way for frugality in resource use on the way to successful PEM in Kerala. Concerted efforts on the part of government are required to break the shackles of officialdom by suitable reforms so as to liberate the spending agencies and enable them go market oriented and embrace professionalism, thereby heralding a new era in the PEM domain in the Union and States in India.

3.7 Public- Private Partnership (PPP)

The concept of PPP model has emerged as an instrument of far-reaching significance for rapidly advancing the socio-economic development of countries, especially an emerging economy like India. Government and the public sector alone is unable to deliver the service with its existing resources capabilities, there is an obvious need of private party participation to fill these gaps.

PPP attracts private capital as well as makes use of private sector skills and management expertise to deliver and operate public projects more efficiently over their lifetime. With various forms of PPPs, the ultimate goal is to achieve the better value for money through the exploitation of private sector competencies and the allocation of risk to the party best able to manage it.

Creative public-private partnership could be a better way out in this issue to overcome the insufficiency that the government system is undergoing at present. This partnership never means to relieve the government off its duties, however, transforms it from its traditional role of an all-rounder as a policy-maker, regulator, financier and service provider to a guardian who formulates the policy and regulatory framework through a greater reliance on the private sector.



The structuring of PPP contracts requires due diligence of a high order because of the complex nature of the partnerships and the need to protect the interests of the users as well as the exchequer. For, PPP projects are based on long-term contracts and may involve delegation of governmental authority such as for toll collection, besides enabling private control over monopolistic services etc.

In an emerging economy like India the importance of PPP has gained greater momentum for increasing and sustaining the current pace of socio-economic development. The Government of India (GOI) is also encouraging PPP as a mechanism for faster economic growth, especially in the infrastructural sectors. India had a few notable PPPs as early as the 19th century. The Great Indian Peninsular Railway Company operating between Bombay and Thana 1853 is the best example. However, PPP model as we see today is an offshoot of the disinvestment policy and practices in India initiated as a part of the new Industrial Policy Statement announced in July 1991.

However, the existing PPP model is hobbled by a lack of flexibility in contractual arrangements, aggressive bidding and manipulation in project costs by private players. As if these weren't enough, the PPP model has been further choked by the dying appetite of infrastructure powerhouses such as L & T, Reliance ADAG, Lanco, Gammon etc. These companies built airports, metros, roads, ports etc. under the PPP model, but nearly all are swamped by rising debts. Further, inadequate project preparation and lack of land acquisition on the part of NHAI had also resulted in discouraging prospective bidders to participate in new project bids.

To address these issues, the government is taking conscious steps including emphasis on better project preparation and land acquisition, simplified procedures for appraisal, exit policy for concessionaires, amicable settlement of disputes, amendments to the model concessionaires agreement and one-time infusion for languishing projects,. Besides, innovative project innovation models like hybrid annuity model were introduced and multi-lateral funding agencies like World Bank, ADB were roped in. In 2011 the Government of India advanced a major step forward by drafting the Public Private Partnership (Preparation, Procurement and Management) Rules 2011 to formulate the Rules for PPP projects, including rules for regulating expenditure, appropriation of revenues, contingent liabilities, etc. in PPP projects and proposed delegation of powers in this regard³⁰. Moreover in 2015 the Government of India constituted a 10-member panel under former finance secretary Vijay Kelkar to revisit and revitalise PPP mode of infrastructure development³¹. As a result, participation of the Private Sector in PPP highway projects has started showing signs of recovery. In 2015-16, one BOT project has been awarded and bids received and are under process for five. The length of these 6 projects is around 665 km and estimated cost is Rs 9,200 crores.

In spite of repeated declarations by the Government of Kerala, the number of successful PPP projects has not increased substantially in the state. In state-wise PPP project allotments among south Indian states, Kerala has only 15 PPPs under way as against 69 of Andhra Pradesh and 37 of Tamil Nadu³².

One possible reason for this is the non-availability of sufficient skilled staff in the state, which could actually look at how PPP projects should be structured. To promote the PPP programme, the State Government may set up a PPP Cell with a senior level officer deputed as PPP nodal officer and make suitable legislations in this regard. The Kerala Infrastructure Development bill, which was earlier introduced in the state legislative assembly but could not be passed to be enacted soon. The bill shall mitigate all existing issues and shall provide a statutory backing to the government's initiatives.

However, recent initiatives taken by the government reflects its determination. The government has proclaimed that it would adopt the Public-Private-Partnership mode for all the proposed mega projects³³. Accordingly it undertook many projects under way as PPP initiatives of which the Vizhinjam International Container Transshipment project of Rs. 4,360 crores, Smart City in the IT/ITES sector which envisages setting up of a techno polis and township ---Rs 1600 Cr. Kochi, and the Kochi Metro Rail Project Rs. 1966 Cr., are to be regarded as projects for the future which would pave way for savings in public money and bring down public expenditure en route to sustained fiscal discipline³⁴. Nevertheless the state has to tap local and foreign investors in PPP mode as a business destination to create world class infrastructure. The possibilities of PPPs extending to Tourism and power generation apart from infrastructure and IT may also be looked into, through extensive application of PPPs in the state.

4. CONCLUSION

For the Government of Kerala, it is high time to act upon the fiscal strain by initiating radical reforms aiming at revamping the existing system of PEM in the state. Drawing from the success stories of PEM reforms initiated in countries like New Zealand, the state Government shall look into the possibility of adopting accrual based accounting, private sector style



management practices and professionalism while strengthening the budgeting and auditing process. The legal and administrative impediments hampering the speedy implementation of the reform process also have to be addressed with due importance, before any blatant disasters occur.

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