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# Politics and accounting in the public sector

**Noralv Veggeland**

Department of Economics and Organization Science, Lillehammer University College, Box 952. 2604 Lillehammer, Norway

**Email address:**

[noralv.veggeland@hil.no](mailto:noralv.veggeland@hil.no)

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**Abstract:** The transition from the accounting management of the use of resources, i.e. net budgeting, to business-oriented performance management is an important element in the introduction of management by objectives and results in the public sector. This took place in Western European countries in the 1990s and encompassed what is referred to as business-oriented accounting. Business-oriented accounting in the public sector is currently a hot topic in the public debate. The system is complex and lacks clear lines of political accountability

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## 1. Business-Oriented Accounting in Capitalistic States

Management by objectives and results in the public sector is currently a hot topic in the European public debate. The criticism is based on three arguments. 1) The first approach creates an unnecessary, expensive bureaucracy, because the results must be measured, registered, coded, reported, evaluated and controlled on the basis of quantifiable indicators, and the results that are generated must be compared between institutions and feedback must be given. 2) Quality cannot be measured through quantifiable indicators alone. 3) The system is complex and lacks clear lines of political accountability. The transition from the accounting management of the use of resources, i.e. net budgeting, to business-oriented performance management is an important element in the introduction of management by objectives and results in the public sector. This took place in Western European countries in the 1990s and encompassed what is referred to as business-oriented accounting.

Accounting is based on revenues and expenditures. Revenues represent claims on cash receipt, either immediately or at some future date. Expenditures represent obligations for cash payments, either immediately or at some future date. With net budgeting in the public sector, the budget should be balanced at the end of the budget period. The focus is on the money effect in the sense that budgeted activity is maintained and developed during this

period. Since public sector budgets show expenditures (payroll, schools, public assistance, health care, roads) and how they are to be financed in the form of revenues (tax revenues, duties, etc.), traditional budgets represent an expenditure and revenue budget, or a money budget in other words.

Business accounts focus on the profitability effect of revenues and expenditures. The profitability effect refers to profitability in the form of revenues (accrued revenues) and profitability in the form of expenditures (investments). This entails two-dimensional accrual accounting. A profitability accrual principle is introduced, in addition to the money accrual principle. The first-mentioned principle – often referred to imprecisely as the accrual principle – is used to report the profitability effect of both revenues and expenditures (Monsen 2009).

The selection of an accounting model for use in the public sector has traditionally been based on a political desire linked to the right and opportunity to govern. The introduction of business-oriented accounting in the public sector has weakened the opportunity to govern. Why this reform, then? Norvald Monsen (2009) suggests the following answers in an article on accounting in the public sector:

- (1) “There is a political perception that the public sector should be governed to the greatest possible extent like the private sector, and thus there is a need to prepare the same accounts that are prepared in the private sector (business accounts in other words).

- (2) Insufficient knowledge of what business accounts represent.
- (3) Insufficient knowledge of the alternatives that exist for business accounts.”

Let us take a closer look at business-oriented accounting in the public sector, its origins and implementation, and its consequences.

Accounting can be perceived as a neutral tool for budgetary control. But it is not. What may look like technical functions, such as bookkeeping and liquidity management, provide, in addition to the purely technical aspects, guidelines for political assessments and how the administration of public services takes place, and they trigger growth in the so-called measurement bureaucracy (Veggeland 2009).

Additionally, business operations are closely tied to the realisation of profits. But this, in itself, is irrelevant in the public sector, which bases its activities and budgets on the taxpayers' money. It is important to understand that the model for business-oriented accounting nationally has been based on an international standard – the International Public Sector Accounting Standards (IPSAS) – which originated in the early 1990s ([www.ipsas.org/](http://www.ipsas.org/)). This standard was created in the Anglo-Saxon tradition of public administration (the UK, the US, New Zealand, Australia, etc.), and this tradition was business-oriented at its core. The standards spread to a number of other western countries, included those in southern Europe, with the consequences that had for their economies in the late 2000s in the form of a deep-seated economic and social crisis. In accordance with the IPSAS, revenues are recorded in the budget period in which they are earned, regardless of when they are received. The same holds true for expenses; they are also recorded in the period they are incurred, whether or not they have been paid (Deaconu, Nistor, Filip 2011). It is the profitability accrual principle that applies.

## 2. The Difficult Financial Control

This creates ambiguity in the budgets of public institutions, and makes financial control difficult – for example, when using unit price financing of patients in the health services and students at universities and university colleges. The timing of revenues and total expenses often does not correspond. For instance, when students are admitted to a study programme, they are recorded as an expense, whereas the revenues in accordance with unit price financing are accrued two years after the students have passed their final examinations. In this way, an apparent “deficit” is created. On the other hand, if the number of students declines in the period (due to failed examinations or other reasons), a genuine deficit occurs. In the hospital sector, patients may be released too early because, from an economic perspective, if those same patients were to be readmitted they would be recorded as new revenue in the hospital accounts in keeping with the unit price system. The Coordination Reform, i.e. the agreement between the municipalities and health trusts on

the transfer of patients whose treatment is completed to the municipalities, may reinforce the tendency to release patients from hospitals too early. The price set for each student and each patient is often arbitrary. In the public sector one cannot rely on demand in the market for price information.

Business-oriented accounting has a number of other consequences that affect the political and social order. One of these is that it pressures society to move towards a greater degree of privatisation and the competitive tendering of public services. A major reason for this is the problem of pricing public assets, such as public property: buildings, land, furnishings and technical equipment – and infrastructure. Should these be priced according to their market value or their value to society and the community? Value-based pricing tends to be based on the present value of the capital assets and cash flow and does not incorporate changes over time. The price is usually too high and arbitrary (Newberry 2012).

Most assets are usually priced too high. The result is that, from an accounting perspective, the services produced in public enterprises are found not to be competitive with services produced in the private companies. This becomes a driving force towards more privatisation and competitive tendering in the public sector due to the political guidelines in the accounting system.

Another consequence is that politicians must almost be experts in analysing financial statements to understand the information in the accounts. Even experienced economists and top-level managers can find it difficult to follow changes in assets and budget accruals in which expenses can be recorded in one year, while the revenues may not be recorded until several years into the future. What happens in the interim when pricing does not occur in a fluid market, but rather in the public sector?

Sue Newberry (2012), a researcher in this field, gives an example of similar problems in New Zealand. In 2005, it was discovered that the authorities had sold a public electrical power plant that had been recorded according to business-oriented accounting principles. However, the accounts also showed that the very same power plant was leased back from an owner in a tax haven. There was no debate about this since it was difficult to see it in the accounts. When it was discovered, it was too late to reverse the sale. In general, Newberry cautions against using business-oriented accounting and urges Western European countries to learn from New Zealand's mistake, a country that has reversed the trend towards management by objectives and results, which has a monopolising effect, and business-oriented accounting.

## 3. The Norwegian Case

Politicians and employees in the public sector do not necessarily have a background in private business, which is why they often find it difficult to understand business-oriented accounting. This creates a democratic problem because politicians, institutional leaders and inspectorates

are often placed in a position of powerlessness (Newberry and Pallot, 2006).

Business management is known from the organisationally independent public enterprises and companies in Norway. It was implemented in such diverse areas as hospitals, postal services, railways, roads, telecommunications, electrical power, etc., and in ordinary public institutions (such as universities and university colleges).

The Norwegian Government Agency for Financial Management was established on 1 January 2004 under the Ministry of Finance, and was charged with responsibility for the administration of regulations for business-oriented accounting. In 2011, the Norwegian name of the agency was changed from *Senter for statlig økonomi (SSØ)* to *Direktoratet for økonomistyring (DFØ)*. The DFØ is the government's expert body on financial management within public sector activities. The overall objective of the directorate is to facilitate suitable common solutions within the state and effective management in the individual public enterprises. The directorate seeks to promote the efficient use of resources in the state through business-oriented accounting systems. This is to be accomplished through training measures, advisory services and the development of methods and tools. Accounting services are delivered to about 60 per cent of public enterprises. The DFØ is responsible for the state's accounts and the state's cash pool.

As a regulatory body, the DFØ seeks to counteract the negative effects of an increasingly fragmented state that uses many different forms of accounting. However, the Ministry of Finance cautions: "The SSØ must balance consideration for direct profits through standardised common solutions with the need for customised solutions in the individual public enterprises" (Ministry of Finance 2009: 2). This is where risk assessment and risk management come into play. Integrated into general risk theory is the concept of vulnerability. In this context, vulnerability may be understood as the combination of business management and uncertainty with regard to a balanced budget, and it is taken for granted that the system is vulnerable. This means in practice that accrual-based business-oriented accounting should not be viewed only on the basis of the current situation, but also on the basis of complex conditions in the past and future. It is the task of the DFØ to assist institutions with this.

Thus, part of the risk assessment performed by the DFØ entails formulating an opinion on whether an institution managed according to business principles is organised so that it can respond to reasonable expectations of the services it provides. Expectations of a public service institution, such as a hospital, will encompass conditions related to internal processes and problems, as well as to external conditions such as waiting lists and patients' rights.

Public institutions cost money. Internal expenses are related to operations and bureaucracy, expensive measurement and reporting activities, quality assurance in connection with effective financial management and

maintaining an overview of earnings. There is a risk that an imbalance will develop. A paradox arises (Veggeland 2012). Increasing internal transaction costs impact the primary activity, whereas the DFØ, coming from a completely different perspective, registers good budgeting and accounting practices and effective use of public assistance schemes. In the view of the state, everything is working as it is supposed to. This conflict in perspectives is familiar from the health, care and education sector as well as from other sectors. Is the state independent or just confused (Difi report 2012)?

## 4. Universal Public Services

The DFØ may be seen as occupying a role that is primarily related to neutral technocratic consulting and further development of business-oriented accounting as an instrument of management. This view is too simplistic, however, precisely because the agency's task is carried out within the neo-liberal framework of the regulatory state (Majone 1994, Veggeland 2010). The DFØ's activities with the new forms of management and business-oriented accounting in the public sector must be seen as a key component of New Public Management (NPM). Yet NPM reforms have been implemented on the basis of clear international ideological and political principles (Lane 2000, Kjær 2004).

We are familiar with NPM reforms as the basis of organisational autonomy and the establishment of public enterprises and companies in Norway. The reforms were implemented in areas such as hospitals, postal services, railways, roads, telecommunications, power plants, etc. The enterprises and companies became separate legal entities and their accounts became business driven. As we have seen, experience shows that this form of management is not unproblematic. Nor is it possible to determine which public services are beneficial to society as a whole and which are "commercially viable". Which perspective should be used? It is extremely difficult to define commercial viability, since public services are universal in nature, i.e. they are supposed to be available to everyone and independent of the market. For example, how can the commercial value of the health care sector be determined? Or social welfare schemes? Or education? In this connection, there has been an attempt to do precisely this by converting social welfare and education into capital and economic value. We are familiar with terms such as social capital, human resource capital, knowledge-based economy, etc. (Putnam 1993, Navarro 2002). In translation, such capital quantities for social welfare and education can be accounted for as commercial contributions on the revenue side based on a complex and approximate calculation.

## 5. Historical Roots

The business model has historical roots. As we have seen, the model washed over the OECD's Member States as a

result of the international financial crisis that arose in the mid-1970s. In the 1980s, globalisation, liberalisation and the creation of new markets generated a need for greater national competitiveness and innovation in order to come out of the crisis. The Anglo-Saxon countries were leaders in this regard.

The idea of also bringing public enterprises in as commercial actors in the market arose in order to increase Norway's competitiveness in a situation of tight national budgets. According to this ideology, only through the use of business management principles and competitive tendering would public enterprises become innovative and thus productive in a national economic sense (Veggeland 2012). In Norway, the model required extensive reforms. These were implemented in the 1990s and into the 2000s, followed by the introduction of business-oriented accounting. As a continuation of the strategies chosen and implemented in the 1990s, the SSØ/DFØ was established in 2004.

The establishment of the SSØ/DFØ and the agency's focus on financial management must be seen in light of the extensive market orientation in the public sector in general. The Norwegian Government, headed by the rightwing Prime Minister Kjell-Magne Bondevik in the early 2000s, was so fixated on a market-oriented approach that it stated in its introduction to the new competition legislation at the time that competition and financial management should not only be a tool for enhancing efficiency, but "a goal in itself". The recommendation for the Act, which entered into force on 1 May 2004, states: "This means that competition must be given special consideration within all political areas and that competition must be an independent goal on par with other considerations in society (Ministry of Labour and Government Administration 2003: 6). In this context, the same Government established the SSØ/DFØ – from this perspective, a regulatory body with the task of creating a rational, business-oriented approach through competition in a fragmented state created by the establishment of state enterprises. DFØ's mandate indicates such a goal. The political belief in business management that is linked to competition, unit price financing and accounting and applied to welfare services such as health, care, child protection, public communication and education can be difficult to understand. And the DFØ has also noted on several occasions that this can be difficult, but its response is usually: although not everything can be measured, why not measure what can be measured with a view to business management, based on rational economic principles? This is one of the key pillars of the new forms of public sector management that the DFØ, a regulatory and advisory agency, represents.

## 6. Social Implications

Studies show that the narrow business-oriented focus in the public sector ruins the motivation of many people who work as service providers in the public sector. They experience

stress from planning activities, indicator measurements for efficiency, reporting requirements, reams of forms, internal invoicing, calls for tenders, and continual organisational changes aimed at enhancing cost efficiency. In the end, this also affects the users of the services. Paradoxically, an enterprise can, despite these negative consequences, appear to excel in financial management, such as in statistical tables and comparisons. A key question can be asked, and has been asked by organisational theorists: Is it not perhaps time to resurrect traditional organisational forms and accounting procedures? This is what has occurred in places like New Zealand (Newberry 2012). For the DFØ, this could mean that the agency would change its name to the "Government Agency for Social Management", meaning that it would be charged with a new, broader mandate with an emphasis on "other considerations", i.e. not measurable values in the welfare state that are not identified in a purely business-oriented perspective.

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