

# Accounting System Reform and Public Management in Local Governments

—Is it possible to integrate the reforms for improving public accountability with those of public management ? —

Kiyoshi Yamamoto

## 1. INTRODUCTION

The public sector reforms have been implemented since the 1980 s in all industrialized countries. The new public management (NPM), which is rooted in management theory and new institutional economics, has been "in fashion" in many countries. NPM's philosophy is the belief that private sector management and commercial business practices are superior to public management and practices.

Accounting is of course not exceptional. The change from cash based accounting or budgetary accounting to accrual accounting is part of a broader public sector reform process in the Anglo-Saxon democracies. The New Zealand Government, the most advanced at national level in accrual based reporting, has prepared its annual report in accrual base since 1991. Full accrual accounting system is able to provide more information

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than is disclosed under a cash based accounting system in terms of quantity and quality ; the latter is a subset of the former. The aims of the introduction of accrual accounting are to facilitate more transparency in agency performance and to improve public sector efficiency and effectiveness. However, the introduction is not an end in itself : its value depends on the level of user's understanding and contribution to decision makings. It is therefore inappropriate for us to focus on whether accounting system reform has succeeded or not. In this perspective, a contingency model on the accounting innovations in the public sector which Lüder (1992, 1994) developed has also the three following limitations, though the model is not only comprehensive but also applicable to accounting reforms in every country.

Firstly, his model aims at explaining how the accounting system reform, not management system reform, has been determined. Accrual accounting system is, as indicated above, not a fundamental objective but a process element toward public sector reforms. Indeed, accounting information even if in accrual based reporting is a just little useful for citizens [Alijarde, 1997 ; Yamamoto, 1997].

Secondly, Lüder has considered the accounting reform at the national level. In addition to the difference in population between central government and local government, local government has a distinct feature of local autonomy. Local government in democracies is governed by the principle of local autonomy. In its governance, self-government and residents' autonomy are the major rule. The former means that local government is able to regulate its own affairs, while the latter does that citizens participate in political decisions. We have to therefore consider the element of direct democracy in reforming in local government.

Thirdly, his model assumes that full accrual accounting system is better than cash accounting and modified cash or accrual accounting systems. He also implicitly supposes the change to accrual accounting will surely contribute to improve transparency and to promote efficient use in the public sector. The New Zealand governments and the executive agencies in the UK have shown the successful results on improving accountability and management through the introduction of full accrual accounting system. In contrast to these, another approach on fiscal policy (financial management), operating in a cash based accounting environment, has been taken in Europe and the US. The member countries of EU must meet the convergence criteria set by the Maastricht Treaty for the entry into the Union in 1999. One of these criteria is that budget deficit should be not more than three percent of GDP and its debt should not exceed sixty percent of GDP. In the US, the 1990 Budget Enforcement Act provided deficit control mechanism. The act imposed a requirement that policy change for a particular year does not increase the estimated current and near term deficits relative to the levels forecast at the beginning of the current fiscal year. The policy of fiscal target or control by caps, for the present, appears to successfully reduce budget deficit in each country, despite of expenditure control in cash based accounting. Thus, the assumption may need to reconsider.

The above results from different approaches may be supported by an emerging economic theory, *Comparative Institutional Analysis (CIA)*. CIA indicates that a diversity of institutional arrangement is possible and the relative efficiency of various institutions depends on the value of exogenous parameters [Aoki, 1996 ; Nelson, 1995].

Also, empirical studies of accounting system on financial performance [Daniels and Daniels, 1991 ; Yamamoto, 1992] have shown accrual ac-

counting was little effective to improving performance in the public sector compared to cash based accounting. Besides Mussari (1995) indicated that accrual accounting did not directly lead to improve public accountability in Italian local governments.

In this respect, we will develop, in the next section, an expanded model in which accounting system is considered a subset of management system based on a multi-principal and agent model. In Section 3, the possible scenarios are indicated in the Japanese local governments by using the expanded model. In Section 4, we describes the emerging reform policy in an innovative local government. Lastly in Section 5, some conclusions are shown.

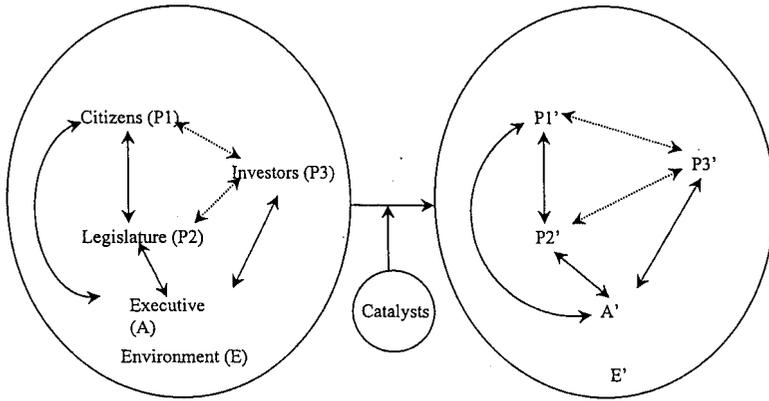
## **2. MODEL**

Lüder (1994) indicated three major players in accounting reform process, the public, politicians and bureaucrats. It is useful that the players are separated to information provider and information user in terms of local autonomy, since citizens or the public have the mandate of direct participation. We further divide the players into principal and agent from the democratic point of view. In this principal-agent relationship, principals are no doubt citizens (P 1) and legislature (P 2) including an independent auditor, though legislature is also the agent of citizens. Investors (P 3), as GASB (1985) described, are also the principal because they provide the fund to local governments. On the other hand, agent is the head and its bureaucrats (A) as executive branch.

Under the framework, the structural and obstacle variables, in Lüder model, which affect the player's behavior could be considered environ-

mental factors (E). The stimulating elements which are not fixed or unstructured are similarly regarded as thrusts for players : fiscal scandals for P 1 and P 2, deregulation in capital market for P 3, and fiscal stress or deficit for A. In addition to this, if we examine an accounting reform process, another element should be considered because the reform's outcome is not only determined by the player's behavior under the given environment but also influenced by the catalysts (C). Though this framing is a modified Lüder model, as indicated before, we have to define the intended management system at the same which reflects on the vision of governance (see Figure 1). While the visions of governance are able to be classified by dimensions in many ways, in this paper we select two dimensions from the autonomous point of view in local governments. The first is the dimension in regard to whether local government is centralized or empowered (decentralized). The second is the dimension as to whether residents have the full power in policy decisions or not. By using two dimensions, four government types are determined (see Table 1).

The empowered and direct participative type has the strong citizens and is regarded as a democratic government. The second type of empowered and indirect participative one has an accurate representative character, hence it is a representative government or an agreement (conflict resolving) government. The empowered and market-driven type corresponds to a re-inventing government whose vision is the NPM. The fourth type operates under the entrepreneurship or centralized and market-driven principle ; this type is an entrepreneur government or a constitutional government. In this case centralized nature means that central government has controlled local governments or the head (governor or mayor) of local government has a strong leadership.



$\Delta E = E' - E =$  Change of environment  
 $\Delta P_i = P_i' - P_i (i=1, 2, 3) =$  Change of principal's preference  
 $\Delta A = A' - A =$  Change of agent's preference

Figure 1-a. Multi – Principal and Agent Model

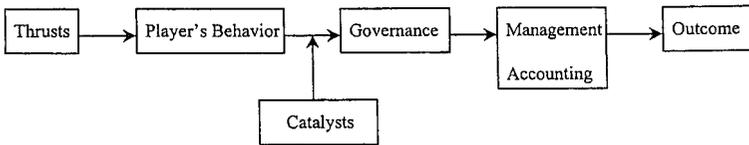


Figure 1-b. Relationship with Governance and Reform's Outcome

Each type has a dominant player ; citizens in the democratic government, legislature in the representative democratic one, investors in the reinventing, and executive in the entrepreneur or constitutional government. Responding to the government vision, the most fitting management and accounting system are also selected. In the democratic government, participative management matches the combination of budgetary (cash)

Table 1. Governing Types and Management / Accounting

Player	Thrust	Catalyst	Principle	Governance	Management	Accounting
P1	Fiscal Scandal	External Monitoring, Disclosure	Citizen's Participation	Decentralized (Empowered) and Direct Participation	Participative Management	Cash Accounting and Social Reporting
P2	Fiscal Scandal	External Monitoring, Disclosure	Representativeness	Decentralized and Indirect Participation	Accountable Management	Accrual Accounting
			Mutual Agreement (Consensus)	Coordination	Cooperative Management	Cash Accounting and Segment Reporting
P3	Market Force	Big Bang in Capital Market	Market Mechanism	Decentralized and Market	NPM	Accrual Accounting
A	Fiscal Stress	Bandwagon	Consumerism	Entrepreneurship	NPM	Accrual Accounting
		Enforcement (Law)	Rationalization	Constitution (Centralized and Market)	Balanced Budget	Cash Accounting and Supplementary Accrual Accounting

based accounting and social reporting as a satellite account since the average citizen has little knowledge about business accounting. The representative government needs to control the executive branch and to coordinate the conflicting matters. Accrual accounting is a useful tool for the oversight bodies to control the financial management. It assists them to take the less biased and less creative financial information about the executive's activities, if the level of understanding among them is significantly high as users. In order to reach a mutual consent, cooperatism is adaptable and matching to cash accounting with segment reporting by district, class, and generation such as generation accounting. In the mar-

ket-driven and entrepreneur governments, the corresponding NPM matches accrual accounting which is used in the private sector. As the constitutional government requires the balanced budget in the longer terms, cash accounting system has to be supplemented by accrual accounting in the limited areas such as pension fund.

Table 1 shows the interrelationships between accounting system and other elements. We can understand from this table why the introduction of accrual accounting system has produced good results in New Zealand while the same introduction has little contributed to improving transparency in Italian local government. The table also explains the reason why local governments in the UK adopted the modified accrual accounting in the Thatcher's three successive administrations. The successful results in New Zealand was caused by the matching among interrelated elements in governance. NPM operates in market mechanism. Accrual accounting in the private sector should be transferred to the public sector. Simultaneously citizens seem to act as customers to government rather than participants. In the UK the conservative new right policy was implemented to accomplish local autonomy as financial independent organization by central interventions such as restricting the spending [Elcock, 1994]. In this environment, focused information is spending in cash based accounting, not cost in accrual accounting.

### **3. PUBLIC SECTOR REFORMS IN JAPANESE LOCAL GOVERNMENT**

#### *Political System*

The Japanese local governments are organized into two tiers, prefec-

tures and municipalities. Prefectures include forty–seven administrative divisions. Municipalities are basic local public entities and are classified into cities, towns and villages by the criteria of population and urban activities.

Each of the forty–seven prefectures has a governor and a unicameral assembly, both elected by direct popular vote every four years. Like the prefectures, municipalities are self–governing units administered independently and each municipality has its own elected mayor and assembly. Thus local governments have two principal organizations : the assembly as the legislature and the chief executive officer as their executive. It is known as the "president system" or the "chief system".

Though local assemblies are the right to decide, only the matters of special importance such as local regulations and budget are determined by the assembly and other decisions are within the power of the chief executive. Japan has a centralized rather than federal system of government, even though the Constitution provides the basic principle of local autonomy. Local governments largely depend on central government both administratively and financially. The national ministries have the authority to intervene significantly in local government. Especially in financial autonomy, central government has a great central power through the financial distribution system (Figure 2). While the ratio of national taxes to local taxes is approximately 2 to 1, the ratio of national expenditures to local expenditures is conversely about 1 to 2. This reverse figure is caused by two reasons. The first is that a fixed percentage of national taxes are provided as local allocation taxes to local governments for unrestricted use. The second is that the central government grants subsidies to local governments for specific purposes.

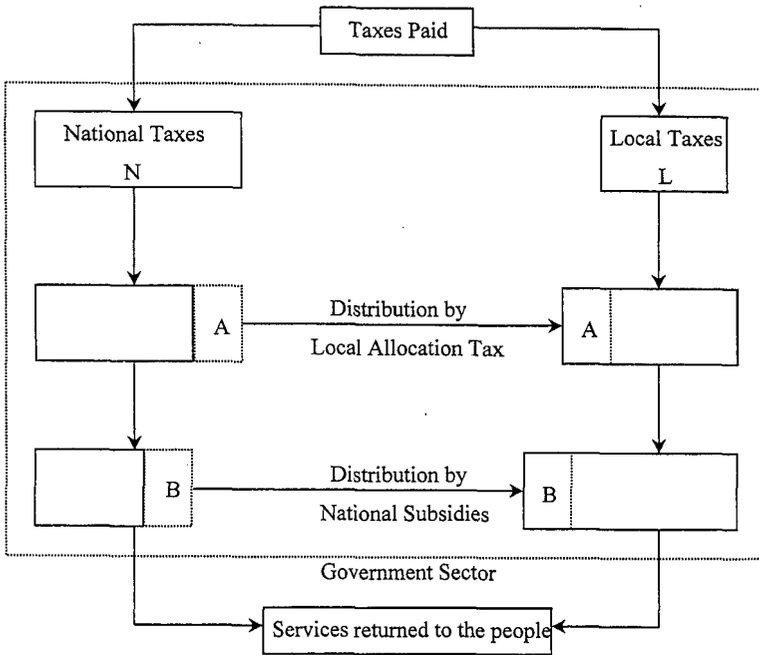


Figure 2. Exchange of Funds Between the Central and Local Governments

Note

- 1:  $N : L = 2 : 1$
- 2:  $N - A : L + A = 1 : 1$
- 3:  $N - (A + B) : L + A + B = 1 : 2$
4. The right sector indicates Local Finances while the left sector does National Finances

*Backgrounds*

The centralized unitary system resulted in standardization and catching up the developed countries in people's lives among the different local governments. On the other hand, the unitary system by central government gradually does not cope with the varied needs of citizens. Rather the innovative local governments have anticipated national policies, for

example, making free of charge in medical care for the elderly (now a small part of the care cost is burden on them) and regulations on pollution.

The accumulated broad will, which would like to replace the present centralized system with the decentralized system, passed the Decentralization Promotion Law in 1995. Decentralization moved from the debating stage to the implementation stage by this legislation. Since the decentralization delegates central functions to local functions, local governments need to operate their functions in more independently. In other words, more self-determination is theoretically required for them more self-responsibility. As for the former, the skills for policy makings and financial management are demanded and the latter requires an independent control or oversight body in place of the tight control by central government. These are the first thrust for public sector reforms. The next thrust is the financial stress in local governments. The share of local bonds of total revenues in local finance has expanded every year since 1990, it accounts for 16.7 percent in 1995. The outstanding local debts at the end of 1995 are approximately \$ 1,000 billion. The stress in local public finance demands efficient using of public money or cost savings to local governments. The third thrust is the fiscal scandals. They are spending which local bureaucrats used the travelling and meeting expenses to other unfair objectives such as private entertainments and meeting with central bureaucrats at the highest restaurants. The Hokkaido prefecture is the worst in spending the unfair objectives which came to the surface in 1995. Its expenses amounted to \$20 million. The local regulations concerning disclosure of information that preceded the law by central government, also assists citizens to check and detect the unfair matters. These

scandals have not only made citizens more interesting in activities of the local government, but required more transparency in implementing process. In Hokkaido prefecture the number which people demanded for audit to inspection commissioners increased at fifteen times in a few years (1 in 1993 to 15 in 1996).

### *Catalysts*

This year may be the first one in the Japanese local finance reforms. Two major catalytic policies have been proposed by the Hashimoto Administration. The first is the introduction of external auditing to local governments which are every prefecture and the large cities. At present the inspection commission system is established by the Local Autonomy Law. The commission consists of four persons appointed by the chief executive in case of prefecture, two from the assembly members, two from the informed persons. The office is independent of the chief executive though it belongs to the executive. However most of the informed have the backgrounds of its own government. Table 2 shows the backgrounds of commissioners in all prefectures. The new external auditing will be done in

Table 2. Backgrounds of Inspection Commissioners  
( number and percent )

Background	1995. 11 (A)	1996. 7 (B)	(B) / (A)
Assembly member	94 (50.0)	94 (50.0)	1.00
Retired Official	74 (39.3)	64 (34.0)	0.86
The Informed	20 (10.6)	30 (16.0)	1.50
Total	188 (100.0)	188 (100.0)	1.00

the annual contract with the chief executive by the person fulfilled one of the following conditions :

- having the qualification of certified public accountant
- having the qualification of lawyer
- having the experience of auditing in central or local government

Since the new system strengthens independency and professionalism in overseeing the executive, it would not only contribute to improve transparency but also to check the unfair behavior in local finance.

The second catalyst is the freeing policy of capital market in Japan. The policy intends to make the capital market global, fair and free by the 21 st century. It is a comprehensive and drastic change in a short period, therefore, called as " Japanese Big Bang". The Big Bang will inevitably affect on public financial market which is now controlled under the Fiscal Investment and Loan Program (FILP). The FILP is greatly funded from the Postal Savings Fund and the Social Welfare Fund (see Figure 3). As a result, the Postal Savings and Postal Life Insurance Services, and the Welfare Insurance Service as the main sources of FILP are the candidates for privatization. If these services are privatized by the freeing policy, the local bonds will lose the safety and reliable creditor. Under the present system, local governments are guaranteed for meeting their financial needs by issuing local bonds as a substitute for the approvals of the Minister of Home Affairs. The privatized Postal Saving and Welfare Insurance services will invest their funds in market mechanism. If the regulation on issuing local bonds are also removed, the same superior conditions in local bonds, which any local government regardless of financial state can finance at the same lower rate than private finance, will disappear. Local governments will be required to disclose their financial statements in the

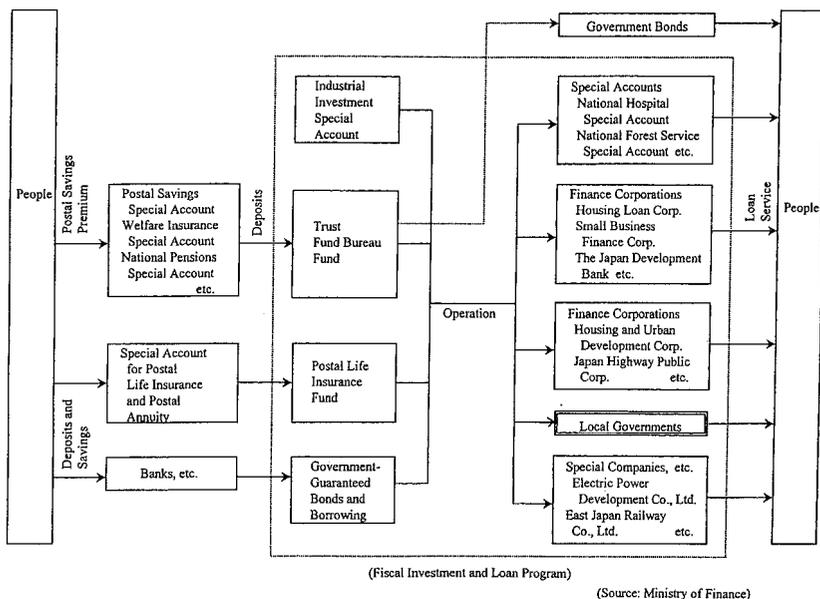


Figure 3. Fiscal Investment and Loan – Flow Chart of Fund

same business style as private companies, that is, accrual accounting.

### *Possible Scenarios*

We now come back to the multi-principal and agent model. According to the model, major players in public sector reforms are citizens, legislature, investors and executive including bureaucrats. The Japanese citizens gradually have the power to check the local government because the local regulations on disclosure of information gives a tool to open the government. A voluntary non-profit oversight body, Citizen's Ombudsman, has achieved successful results on detecting many unfair matters by using the regulation. Though the new proposed external auditing would assist the body to check local government, the body still focuses on checking the

unfair or illegal behavior rather than participating in decision making or evaluating the policy. Also many people are little interested in participation or policy making.

On the other hand, assembly members, the agents as citizens, have a limited mandate because of president system in local government, which is different from parliamentary system in central government. At the same time, the member organization is biased in representativeness ; minor groups in population are in the majority of assembly members<sup>1</sup>. Citizens little trust assembly members. We are therefore unable to consider citizens and legislature dominant players.

Another principal of executive, investors, have a possibility to play a significant role if the complete freeing of capital market would be implemented. The privatization of Postal Services including Postal Savings and Postal Insurance Services is now a hot political issue in the public sector reform. The Commission for Public Sector Reforms has suggested that the Postal Services should be transferred to a public company which is independent of the Ministry of Posts and Telecommunications. The restructuring in public finance, as indicated above, produce a competitive environment in bonds market. In this case, the local government would prepare and disclose its financial statements in accrual based accounting whether it prefers or not, because investors will require the same disclosure as private companies. The possibility of this scenario surely depends on the result of financial market reforms.

Lastly, the chief executive and bureaucrats as agents are the strong power, because the chief executive has leadership under the direct election system. In contrast to the central government<sup>2</sup>, in which bureaucrats are most influential in policy making, the chief executive as an elected

politician has more power than bureaucrats especially in strategic policy making. It is never accidental that the innovative policies such as information disclosure and preserving traditional scenes are implemented in advance of the central government. In this respect the chief executive holds an important player, and can lead the reform. However its goal is not uniquely determined.

Whether the intended governance is empowered and market type or centralized and market one produces the different financial management model. The former type is NPM accompanied with accrual accounting, while the latter is the balanced budget system based on cash based accounting. The traditional political culture, which is centralized and governed by the bureaucrats majored in law, evidently conflicts with NPM. The lower influence by accountants to policy making would accelate the difficulty to introduction of NPM. Such restriction may reduce the successful probability of the reform based on NPM. While the only hopeful catalyst is a bandwagon effect which management system could be transferred through mutual interactions with organizations adapting NPM, its reforming process will become a long journey.

On the other hand, balanced system is more acceptable to Japanese political system, because it focuses on spending not quality of services or customers and had been repeatedly used as the administrative reform. Its objective is not only definite in quantity but also becoming visible in short period, it therefore appeals to citizens and politicians. Restructuring of government organizations which includes separation of some executive functions to independent bodies has surely a symbolic influence in providing the image of efficient government to citizens. As a process of restructuring, the newly established independent bodies may operate under the

management principle of private sector. In this case, even though partly, accrual accounting would be introduced to the local governments. Consequently, the scenario which local governments will have cash based accounting with partly accrual accounting most likely occurs.

#### **4. NEW TRENDS FOR REFORMS**

The new approach is implemented in some advanced local governments, though it does not completely adopt NPM. Mie Prefecture Government at the middle Japan began the administrative reform in 1995 under the political leadership of Governor Kitagawa. The basic philosophy consists of the following ideas :

- residents oriented
- objective oriented
- value focused
- result oriented
- total system approach

These ideas are similar to NPM because the reform has been supported by a private consulting company which intends to transfer NPM to the public sector. The company recommends Reinventing Government [Osborne and Gaebler, 1992] as the reform model. However the philosophy lacks two elements of NPM, that is, market mechanism and empowerment. As Governor indicates, the center of reform is the project evaluation system (see Figure 4). The system consists of five processes :

1. Making tree consisting of mission, policy, program and project (Figure 5)
2. Define objectives

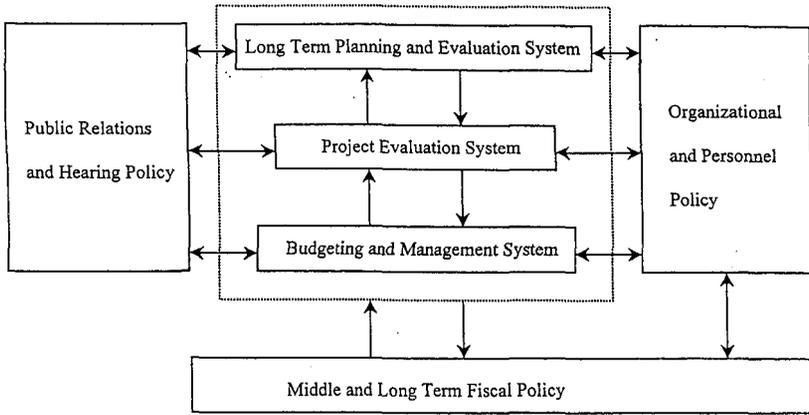


Figure 4. Framework of Reforming

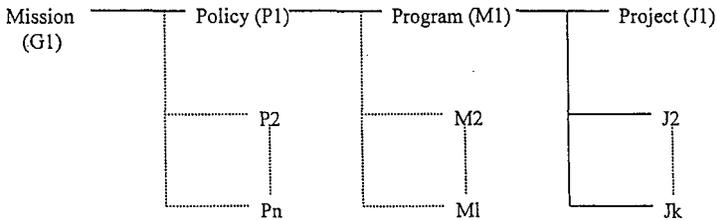


Figure 5. Tree Diagram

3. Establish outcome measures
4. Identify the project in two dimensions of cost and outcome
5. Compare with other projects of different policies.

The remarkable points are the third, fourth and fifth processes. The result by a project is evaluated in terms of outcome, not output or activity. The evaluation manual describes an example in case of street cleaning project ; outcome is the degree of street cleanness while output is the distance of street cleaned up. Each project of the program that outcome measures are established is placed in two dimensions (see Figure 6). The

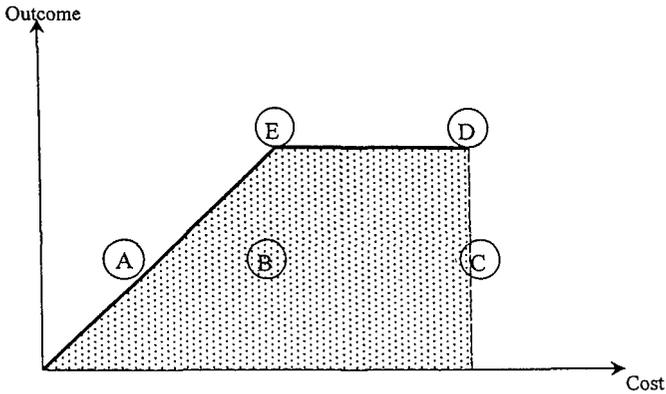


Figure 6. Positioning of Projects

relation between outcome and cost is illustrated according to the decreasing principle of marginal utility. The point E is the ideal position, while projects located at other points in the dotted should be improved. The project pointed at A should be more expanded or progressed, in case of point B outcome should be more increased. On the other hand, at the point C cost reduction has to be done while at the point D both of outcome and cost should be improved.

The most innovative process is in the last process. All projects from different programs are placed in two dimensions of cost and degree of expected outcome (see Figure 7). Here cost is measured by adding budget for the project to personnel cost which is calculated as required time multiplied by standardized wage rate. The degree of expected outcome is defined as the allowance for outcome improvement  $[(\text{intended outcome} - \text{present outcome}) / \text{present outcome}]$  multiplied by the weighting coefficient that means the degree of contribution to the related program. As shown in Figure 7, every project is classified into four blocks, A, B, C and D. Block A is

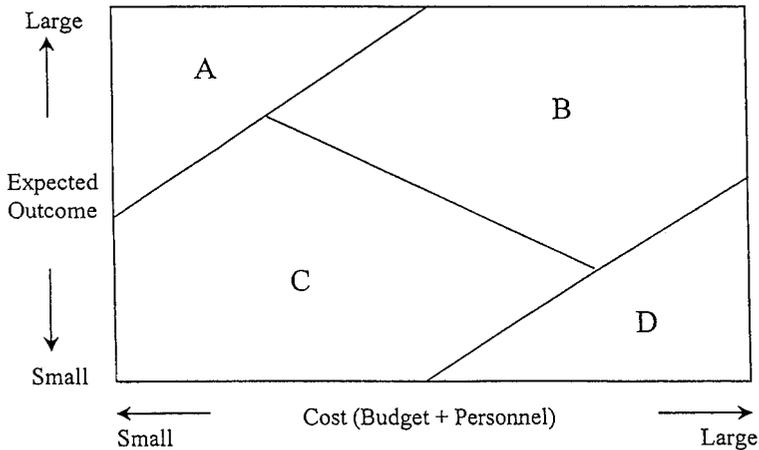


Figure 7. Comparison Among Projects

the area which more resources should be allocated while block D should be restructured. On the other hand, block B should be improved intensively and block C should be reviewed in terms of cost reduction.

The evaluation system in Mie Prefecture has made progress in planning and budgeting, however, differs, if we compare to the experiment in Kagawa Prefecture at southwest Japan in 1970, in the following points :

1. Mie Prefecture is led by strong political leadership, while Kagawa's case was implemented as an experiment.
2. Mie Government is supported by a private management consultant in contrast to the central involvement of the Economic Planning Agency (EPA) in Kagawa Government.
3. Evaluation is planning to be implemented at budgeting and accomplishing stages in Mie, while Kagawa focused on budgeting stage.

Despite of many improvement, the innovation in Mie Prefecture has some critical limitations that Planning, Programming and Budgeting Sys-

tem (PPBS) had in essence. It focuses on management within government, hence citizen's participation in management and accountability to citizens is little regarded in spite of customer oriented principle. From this point, the innovation may be called as a closed reform system. Another limitation is the definition of cost which is measured in cash based accounting. Let's consider the case of comparing two projects that have the same objective but are classified to different project groups : the project X is accompanied with large investment, while the project Y only needs operating fund. Even though both projects would be ranked as the same degree of expected outcome, in terms of measured cost project X is located at right side of project Y. In the extreme case, project X may be ranked at D while project Y at A. It is apparently misleading in efficiency for resource allocation as far as finance by debt is allowed, though the present system has a merit to restrain capital spendings.

## 5. CONCLUSIONS

We have developed Lüder's contingency model in terms of governance. Multi-principal and agent model was useful for explaining plural reforms in the public sector. Accrual accounting adapts to NPM which is decentralized and market oriented management for governance. However its merits are limited unless interrelated management policies will be simultaneously introduced because of institutional complementarity. New Zealand government has been using accrual accounting as a subset of NPM. As the Comparative Institutional Analysis indicates, in case of public sector reforms accrual based accounting is not always uniquely determined system for public management. Actually the member countries of

EU now have controlled public spending in cash based accounting.

Japanese local governments are also implementing public sector reforms under the same fiscal conditions. The most probable scenario for accounting reform is cash based accounting with supplementary accrual accounting, since budget balanced financial management has the least impediment to adapt at once for the executive who is the most powerful player in the model. An innovative approach which is a hybrid model of NPM and PPBS is a ambitious one because its focus is not output in NPM but outcome. Whether the approach will produce successful result or repeat the same failure of measuring outcome in PPBS is uncertain. The former may be caused when the evaluation system will be improved by not only adapting accrual accounting but also incorporate citizen's participation. The latter has a significant probability, however, the reforming process may continue so far as political support by the chief executive has been kept and efficiency has been improved whether realistically or symbolically.

Anyway it is evident that performance evaluation will be advanced in the Japanese local governments under the pressure of efficiency and the needs of transparency from citizens. Accrual accounting will be surely introduced comprehensively to the Japanese central and local governments in a long range, even though it will not bring about in the near future. The recent reforming plan, which central government will be separated into policy unit and implementing unit as in the UK, may trigger the introduction of accrual accounting to the implementing units.

#### NOTES

1. The share of members from primary sector in towns and villages is about fifty percent despite of only five percent in population.
2. According to a public opinion poll, people placed the strongest power in policy making as follows : bureaucrats (37.0%), politicians (24.3%), industry (15.5%), public opinion (7.2%).

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### Abstract

The new public management (NPM) has now been in fashion in many developed countries. The change from cash accounting to accrual accounting is considered an important tool in NPM. The New Zealand Government and the executive agencies in the UK transferred to accrual based budgeting and accounting, while the member countries of EU and the US Government control the expenditures in cash based. This paper aims to explain why the different approaches are adopted in public sector reforms in terms of comparative institutional analysis. Firstly, a multi-principal and agent model, which expands the contingency model in accounting reforms into the arena of management reforms, is presented. By using the model, the reforms in the Japanese local governments are examined and their possible reforming scenarios are indicated; the reforms have the possibility of improving accountability and efficiency when NPM would be integrated with Planning, Programming and Budgeting System.