

Implementing Reforms in Public Sector Accounting

Susana Jorge
Editor



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CREATION OF INTERNAL MARKETS AND TRANSPARENCY AND CONTROLLABILITY OF THE MUNICIPAL SERVICES' COSTS STRUCTURES: COMPREHENSIVE EDUCATION IN THE CITY OF TEMPERE

Introduction

During the last fifteen to twenty years, a trend of adopting different market – in practice often quasi-market – models has taken place in the production of municipal services. Market models have been adopted not only in municipalities' relationships with external stakeholders but also within the municipalities, in the municipalities' internal relations. The public utilities particularly, such as energy, water and wastewater treatment, but also different internal support services, such as real estate management, machine and vehicle services, accounting and human resource services, have been organized to function as profit centres or investment centre type of units and as independent accounting entities.

From the perspective of those municipal units producing welfare services, such as education, health care, etc., for the residents, the use of internal profit and investment centre structures in producing municipal support services is in many respects problematic. First of all, the profit and investment centre models always include an idea of profit making. This means that the profits attained in support services centres are made at the expense of the welfare services. Another set of problems is related to municipal decision-making and transparency of budgeting and accounting information. The separation of the provision and production of services in the form of the purchaser-provider split (see, for e.g., Siverbo, 2004) or contracting out obscures the accounting numbers, e.g. the cost structures of producing the welfare services. Instead of presenting the cost elements (such as salaries, materials, heating, electricity etc.) in the accounting reports, there are aggregate cost items such as 'purchase of services' or 'purchase of internal services'.

The aim of this paper is to *examine and demonstrate how the internal markets, based on the use of profit and investment centre structures and the purchaser-provider split within municipalities, affect the municipal budgeting and accounting information regarding the transparency and controllability of the costs of the welfare services.* The empirical case is taken from the budgets and accounts of the authors' home city. The selected welfare

service is comprehensive education. Based on both the publicly available and internal budgeting and accounting information, we will examine the transparency of the cost information, the change of cost structures and controllability of costs of the “provider unit of comprehensive education” in the case city. The research method used is based on the analysis of accounting data. The results of the analysis are then linked to relevant theoretical accounting frames and concepts.

The paper starts introducing the theoretical background, following with the case study presentation and finalising with a discussion and conclusions.

1. Theoretical background

This paper will be connected to several theoretical perspectives, for instance markets and hierarchies (see, for e.g., Williamson, 1975; Williamson and Ouchi, 1981; Ezzamel and Wilmott, 1993; and Lapsley and Llewellyn, 1995) and fabrication (see Latour, 1987) of budgets and accounts (see, for e.g., Preston *et al.*, 1992). This paper is more empirically and technically than theoretically oriented and, therefore, we have limited our theoretical background to some key ideas and concepts often used in the accounting context.

Our theoretical framework is related to the New Public (Financial) Management (NPM/NPFM) and the development trends pertaining to that ideology (see, for e.g., Hood, 1995; Nashold, 1998; Olson *et al.*, 1998; Bowerman, 1998; Guthrie *et al.*, 1999; Pollit and Bouckaert, 2000; Nolan, 2001; and Lähdesmäki, 2003). Hood (1995) has listed seven elements or dimensions of change associated with NPM. The first of these is a *shift towards greater disaggregation of public organisations into separately managed ‘corporatized’ units for each public sector ‘product’* (each identified as a separate cost centre, with its own organisational identity in fact if not in law, and greater delegation of resource decisions, in a movement towards ‘one-line’ budgets, mission statements, business plans and managerial autonomy). Olson *et al.* (1998) have listed five NPFM components, the *development of commercially-based market-oriented management systems and structures to deal with the pricing and provision of public services, such as cash management, contracting out and charging mechanisms* being some one component of those five. Also on Gruening’s (2001) list of NPM characteristics *competition and contract-based competitive provision of services, contracting out, customers and user charges* have a central status. To apply ‘business models’ in the public sector means that the accounting and management control systems should also be developed accordingly. *Improved accounting, improved financial management, promotion of accrual accounting and reliance on professionally set accounting standards* belong to the lists of NPFM characteristics.

Municipalities in Finland have adopted different market – or quasi-market-models. They have established more independent economic entities to produce various support and welfare services. They may be net budgeted units, municipal enterprises or limited companies. In some cases, municipalities have also privatized their enterprises and assets. In many cases, municipalities use outsourcing and purchase services from the private sector. In addition, various public-private partnerships are increasingly used. Inside their own organisations municipalities have developed internal markets and internal (or transfer) pricing.

A common feature for all the aforementioned action models is that traditional municipal service production and hierarchical control of activities have been replaced by market-oriented models. By law, a municipality is responsible for providing services for its residents, but the producer of the services can be either the municipality itself or some other public or private organizations, often also in the third sector. In any case, there are two different parties: a purchaser and a producer; in English, the expression ‘purchaser-provider split’ is often used. In purchaser-provider split models, hierarchical control is replaced by contract management and control. The purchasers and providers of services negotiate and make contracts concerning the quantity, quality and prices of services.

In this disaggregated action model even the budgeting and accounting information are different than before in the hierarchical control model. Our keen interest in this paper is to examine what has happened to the ‘controllability’ of costs and ‘transparency’ of cost information as a consequence of the disaggregation and marketization of municipal activities. As a consequence of the build-up of profit and investment centres to produce different support services for the welfare service producers, transfer pricing and contracting have come to be used extensively in the Finnish municipalities. The municipal units are said to be financially more autonomous today and to have more self-determination in decisions on how to use their one-line or lump sum budget appropriations. But the situation is not necessarily that clear and simple. Increasing use of contracting out, internal profit centre structures and full cost plus – pricing means that the support service prices are at least partially ‘non-controllable’ from the welfare service provider’s decision-making.

‘Transparency’ is a commonplace term which means different things to different groups¹. One cannot find the term ‘transparency’ in accounting dictionaries (e.g., in the Macmillan Dictionary of Accounting). But in the literature related to corporate governance, public sector accounting and financial reporting, fiscal transparency and democratic accountability, for example, transparency is one of the key terms and issues (see, for e.g., Gray, 2000; Christiaens, 2001; Robinson, 2002; Ezzamel *et al.*, 2004; and Blomgren, 2007). The following definition of transparency (found in Wikipedia) serves us well in this paper: “Transparency implies openness, communication, and accountability. It is a metaphorical extension of the meaning used in the physical sciences: a ‘transparent’ object is one that can be seen through.” Again, it can be said that “In governments, politics, ethics, business, management, law, economics, sociology, etc., transparency is the opposite of privacy; an activity is transparent if all information about it is open and freely available.”

Especially in the public sector, accounting information should be transparent enough to make the use of information possible in decision-making. We argue that the development has been rather the opposite. As a consequence of NPM-related reforms, such as the use of lump-sum budgeting and competitive market models in

¹ Transparency refers to an environment in which the objectives of policy, its legal, institutional and economic framework, policy decisions and their rationale, data and information related to monetary and financial policies, and the terms of agencies’ accountability, are provided to the public in a comprehensible, accessible and timely manner (OECD, Glossary of Statistical Terms).

service production, less information is openly given and freely available today than earlier, for example, in the municipal budgets and accounts. In the new competitive environment there are less line items in the budgets and accounts and more space for business secrets and freedom for decentralised and delegated private-sector style of management and decision-making.

In the following case we are going to demonstrate some of the consequences of the above-mentioned characteristics of the NPFM in the municipal sector in Finland. We believe that the same developments are more than possible in other countries also and in all levels of public administration, not only in the municipalities and in Finland.

2. Empirical Case²

A Finnish municipality today can be described as a ‘concern’ or ‘group’ that consists of numerous internal ‘accounting entities’, doing ‘business’ with each other. Municipalities themselves are financiers and purchasers of different welfare services. The contract-based providers or producers of services might be either municipal, private or third sector units, or a combination of them all. The municipalities perceive themselves not only as financiers and purchasers but also as owners of municipal production facilities and other assets – an idea that has led to the profit and investment centre structures and strong ‘return on investment’ thinking in municipalities. This latter fact concerns especially all the public utilities and municipal support services.

In order to illustrate our research topic, we have examined our case city’s (City of Tampere, Finland) budgets and accounts. The case city is one of the first cities in Finland to apply a purchaser-provider split model throughout its organisation. This means that the Comprehensive School for instance, is one of the service providers (providing education for junior and senior grades; children 7-15 years old) as the city (City Council) is the purchaser of these services for its residents. The Comprehensive School system, which in the case city consists of some 50 schools and 17,000 pupils, is understood and referred to in the budgets and other documents as the “Comprehensive School Provider Unit” (hereafter CSPU).

In 2001 (that is, before the time of the extensive use of internal market and purchaser-provider split models in the case city), the City of Tampere’s annual budget approved by the City Council (Table 1) displayed the classification of total revenue and cost (in Million Euros) of the school system.

² Data were collected from budgets, annual reports and internal accounts of the City of Tampere, Finland.

Table 1 – Financial budget information (The Income Statement Plan) of the Comprehensive School Provider Unit (CSPU including higher secondary school) in the Case City’s annual budget for 2001 (1,000 Euros)

Operating revenue (million Euros):		
Sales revenue	0.0	
Other sales revenue	0.2	
Financial support and grants	0.2	
Other operating income	0.3	
Internal revenue	0.4	
Internal rent	0.0	
Total Revenue	1.2	
Operating costs (million Euros):		
Personnel costs	-62.0	65.89 %
Purchase of services	-17.4	18.49 %
Material	-3.5	3.72 %
Internal purchases	-1.5	1.59 %
Other operating costs	-0.3	0.32 %
Internal rent costs	-9.3	9.88 %
Total Cost	-94.1	100 %
Operating contribution	-92.9	
Depreciation (pre-set plan)	-0.9	
Deficit for the financial year	-93.8	

Note: Percentages displaying the cost structures were added by the authors.

The annual budget information in 2001 was detailed and transparent enough to tell the decision makers, school administrators and other interested stakeholders the total amount of the budget money and how it was to be allocated among different cost components, such as wages and salaries, purchase of services, material, rents, etc. Today (2007), as a consequence of the lump-sum budgeting reform and use of the purchaser-provider split model, the financial information concerning, for example, the comprehensive school system (CSPU) in the annual budget is extremely aggregated and non-transparent as to use of the money or the cost structure of the schools. Today, the city councillors make their decision of the total school funding only and the budget information contains a mere three lines as in Table 2.

Table 2 – Financial budget information of the Comprehensive School Provider Unit (CSPU now including after-school activities³) in the Case City’s annual budget for 2007 (1,000 Euros)

The CSPU	Budget 2006	Budget 2007	Estimate 2008	Estimate 2009
Operating income	850	815	843	868
Operating cost	- 112,775	- 118,124	- 121,668	- 125,318
Operating contribution	- 111,925	- 117,306	- 120,825	- 124,450

³ One of the common characteristics of the municipal budgets and accounts are annual structural changes that make periodic comparisons impossible. In our case, the CSPU budget in 2001 included higher secondary schools, but in 2007 after-school activities.

Compared to the annual budget information in 2001 (Table 1), the 2007 information is modest, as Table 2 above demonstrates. This information only reveals that the total costs and the net budgets of the comprehensive school system will increase slightly in the four-year period 2006-09. The verbal budget information additionally has it that the number of pupils in the comprehensive education (20.09.2006) is 17,281 and that it will decrease by about 1,000 in the 3-year planning period, and by about 2,000 in the 6-year period 2005-2010. The decision-makers can be proud and happy: the City is going to ‘invest more in school children’ each year during the four years’ period. But this is not the whole truth!

After the budget has been approved by the City Council, the Municipal Board of Education prepares a more detailed plan of how to use the budget money. The Income Statement Plan for the CSPU (now also including after-school activities), approved by the Municipal Board of Education for 2007 (in Million Euros) is displayed in Table 3.

Table 3 – Income Statement Plan for the CSPU in 2007

Operating revenue:		
Sales revenue (from the purchaser i.e. the City Council)	117.5	
Other sales revenue	0.3	
Financial support and grants	0.4	
Other operating income	0.2	
Total Revenue	118.4	
Operating cost:		
Personnel costs	-75.8	64.02 %
Purchase of services	-17.2	14.53 %
Material	-3.9	3.29 %
Rent costs	-21.2	17.91 %
Other operating cost	-0.3	0.25 %
Total Cost	-118.4	100 %
Operating contribution	0.0	
Depreciation (pre-set plan)	-0.9	
Deficit for the financial year	-0.9	

Notes: a) Percentages displaying the cost structures were added by the authors; b) In addition to the budget of operating activities listed above, the comprehensive schools are allowed to invest 1 Million Euros in new ADP software and projects and furnish new school buildings to the extent of 0.7 million Euros in 2007.

If we compare the 2001 and 2007 CSPU budgets, we can see that almost 2% less of the total budget could be used for personnel costs in 2007 than in 2001. In 2001, the share of the personnel costs was 65.89%, and in 2007 64.02%, respectively. Why? The budget does not provide any information on this issue – information is not open, available and transparent. Only a more thorough investigation and a tailor-made report prepared by the researchers using the case city’s internal budgeting and accounting information for 2007 makes the finances of the comprehensive school unit more transparent.

In addition to the “Personnel Costs”, there are two other big lump-sum cost items in the CSPUs Income Statement Plan: “Rent Costs” and “Purchase of Services”. The comprehensive school unit buys internal support services from several other units (profit or investment centres) owned by the city. In the Case City, these units are called ‘partners’ and they are, for e.g., the Premises Centre (*Tilakeskus*), the ‘owner’ of the school buildings and other premises, the Caterer (*Tampereen Ateria*) that produces and sells the daily school meals, the IT Centre (*Tampereen Tietotekniikkakeskus*) that takes care of the IT equipment and services, and the Occupational Health Care Centre (*Työterveyshuolto*).

In 2007, the CSPU is to pay (according the budget plans and based on contracts made with the partners) almost 24.4 million Euros for the Premises Centre in rent and cleaning services costs: rent 20.6 million Euros (compare the internal rent cost 9.3 million Euros in the 2001 Income Statement Plan) and cleaning services to the amount of 3.8 million Euros. In this sum, the Premises Centre, as the ‘landlord’ or ‘owner’ (in reality as the administrator) of the school buildings and other premises, collects pure profit, to the tune of some 9 million Euros. The Premises Centre is a municipal enterprise, a corporatized investment centre and accounting and reporting entity that has its profit objective approved by the City Council.

What was stated about the Premises Centre is also valid for the Caterer, the IT Centre and the Occupational Health Care Centre. They are all municipal enterprises, City Partners that provide support services for the CSPU – and often in a monopoly position. The total amount of the profit contributions of all these partners charged from the CSPU is about 9.6 million Euros in 2007, which are about 8% of the total costs and budget appropriations of the school unit (Table 4).

Table 4 – Profits of the City Partners in their internal transfer prices of support services for the CSPU in 2007

The Case City: Comprehensive School Provider Unit (CSPU) Budget funding 2007	Million Euros	Million Euros
Total Cost (incl. depreciation) (118.4 + 0.9)		119.3
Includes:		
Internal transfer prices: that includes Internal Profit	Transfer Price	Internal Profit
To the IT-Centre	1.3	0.2
To the Premises Centre	24.4	9.1
To the Caterer	7.1	0.3
To the Health Care Centre	0.3	0.03
SUM of Internal Profits		9.6
Internal Profits as percentage of the Total Cost:		8%
Number of pupils in 2007		17,200
Annual cost/pupil (Euros)		6,937
Annual cost/pupil (Internal Profits eliminated Euros)		6,379
Difference in the unit cost (Euros)		558

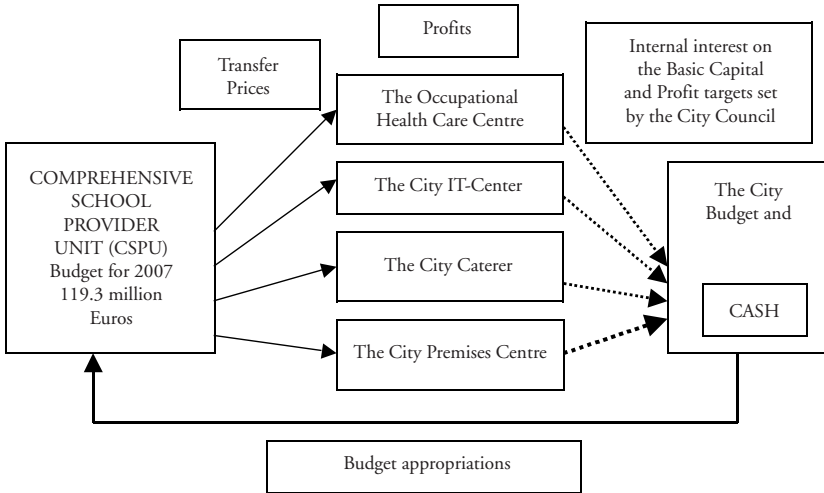
The turnover of the Case City’s Premises Centre, for example, has been estimated to be 108.8 million Euros, and profits 40.1 million Euros in 2007. More than 50%

of the profits are to be paid to the City in compensation (as interest) for the so-called basic capital ‘invested’ by the City in its Premises Centre. The ownership policy of the City is demanding: the City charges 6% interest on the capital invested that more or less tallies with the fair value of the school buildings and other premises. In this way, the city as the ‘owner’ of assets collects a lot of budget money back into its own cash as an ‘internal interest’ or ‘return on investments’. In practice, this system automatically decreases the amount money that can be used, for example, for the everyday school education activities.

Comparisons and benchmarking are done at national level and internationally between, for example, comprehensive education in different municipalities and countries. One criterion of comparison is the unit cost of education, i.e. the input or resources used by the governments in different countries for education. The cost per pupil in our case city is almost 7,000 Euros in 2007, but if the internal support service partners’ operating profits are eliminated, the cost per student is less than 6,400 Euros (see Table 4 above). The internal partners’ profits do not bring any ‘value added’ for the comprehensive school system and cannot be seen as the city’s input for comprehensive education. This fact alone means that international comparisons do not provide reliable results, if such background facts and differences have not been taken into account in calculations and eliminated from the information.

As a consequence of internal markets (quasi-marketization) and the use of disaggregated profit and investment centre model, the budget appropriations are being ‘recycled’ in the city organisation. The support service prices are set on a full cost plus principle. Profits are used partly by the support service producers themselves partly the profits are returned to the city cash as an internal interest on the unit’s so-called basic capital or as a profit target set for the unit by the City Council. Figure 1 describes the recycling of the budget money back to the municipal cash and again via budgets to different activities.

Figure 1 – Recycling of the budget appropriation money back to the city cash as the Profit and Investment Centres’ Internal Interest and Profits



The system described above is, from the transparency of the budgeting and accounting information point of view, even more problematic. Without expert knowledge and special access to the city accounting systems, decision-makers or other stakeholders cannot trace the real cost structures and developments of the finances of welfare services. The budgets and accounts have become more non-transparent than they were before the adoption of the purchaser-provider split model. There are large non-transparent lump-sums, such as “Internal Rents” or “Purchase of Services”, for example in the comprehensive school unit’s budgets and accounts. The municipal support service providers are often in a monopoly position (e.g., the Premises Centre as to the school buildings). Their transfer prices/rents are fixed and non-controllable for the service users. The users often have no other choice than to ‘use and pay’. This is particularly true with regard to the use of school buildings and paying rents.

Discussion and Conclusions

The New Public (Financial) Management ideology, with its numerous business-originated elements, has changed drastically the municipal sector – and especially the biggest cities – in Finland. Cities, such as our Case City, Tampere, are organized very much like a business firm: the City applies the purchaser-provider split model. The City (City Council) is the most important welfare service purchaser and financier. Service providers, especially public utilities and support services centres, act as profit and investment centre type of units and accounting entities. These units have their profit targets set by the City Council. Therefore, these units price their services based on the ‘full cost plus’ or some other proxy for market price – not only to cover their costs but also to make some profits. This means that the budget appropriations reserved for municipal welfare service production actually are partly used to generate the support service units’ profits.

The terms ‘ownership strategy’ and ‘ownership steering’ have gained a strong foothold in the Finnish municipalities during the past ten to fifteen years. The City is not only the purchaser and financier of the welfare services, but it also sees itself as the owner and investor of the city assets. As a consequence of strong ownership thinking and the use of internal market models, much budget funding is spent on internal interest and other profit targets. Profits increase the service prices and the support service cost elements become fixed in (for e.g., the comprehensive schools’) budgets and accounts. More money is spent on support services and less money is available for those activities that are needed to produce the welfare service itself (such as teaching in schools). Internal service fees, in addition to personnel costs, tie the use of the budget funding very effectively. Another problem is related to the fact that the internal support services units often act in a monopoly situation in the local markets. Even though the municipal units producing, for example, the comprehensive education receive an annual lump-sum appropriation in the municipal budget, they have very little discretion and scope in deciding how to use the money, where to buy the services and at what price. As to the management (the School Office and the schools’ rectors), most cost elements are non-controllable.

An additional problem is the non-transparency of the aggregated budget and accounts information. Decision-makers at all levels and other stakeholders do not have access to transparent information about the real development of the budget funding (for e.g., of the comprehensive school system). Profit-oriented transfer pricing of reciprocal intra-municipal support services makes it challenging – if not impossible – to trace the real costs of municipal services and provide transparent and relevant cost information for different decision makers and purposes.

To sum up the main results of our case study we can state that the use of internal market models in purchasing and providing municipal services often means quasi-marketization. Municipal support service units are often practically the only producers of services and can, therefore, ‘market price’ their services in a monopoly situation. The lump-sum budgets of the welfare services units do not necessarily add to discretion in the use of appropriations compared to the former line-item budgeting system, as more and more cost elements have become fixed as a consequence of obligatory partnership contracts between municipal units. Accounting information has also become more aggregated and non-transparent due to intra-municipal reciprocal service transfers and internal profit contributions charged in profit centres’ service prices.

From the New Public (Financial) Management ideology point of view, we can conclude that several undisputed characteristics of NP(F)M (see Gruening, 2001), such as freedom to manage (flexibility), strategic planning and management, improved accounting, separation of politics and management and improved financial management, seem to find more space in the business-like support service centres than in those units providing welfare services free of charge. For the former, the use of market models has become true, whereas in the latter, the welfare service providers have to operate in competitive markets – but only as buyers and not as sellers.

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