Chapter 2
American Political and Economic Environment and Government Accounting Theory Development

INTRODUCTION

Government accounting is a government's financial measurement and reporting system. Under different political and economic systems, governments are structured differently and perform different functions. Accounting standard-setting bodies believe that the environment of accounting affects the incentive of government to produce financial information and potential users' demand for such information. Researchers have therefore tried to identify the characteristics of the environment and investigate the effects on government accounting. These studies have succeeded in identifying the people who have the right and need to know a government's finances. Scholars have also appealed to the theory of democracy to derive government's financial accountability. Based on these studies, American government accounting standard-setting boards have formulated a series of objectives of government accounting as the cornerstone of the official conceptual frameworks. To a lesser extent, these environmental characteristics also have implications for the content of financial reports. However, research to date has not advanced to the point of enabling the standard-setting boards to systematically and consistently make choices among alternative measurement methods.

This chapter will describe efforts to give government accounting a solid theoretical foundation. Such a foundation rests on a study of the nature of government, in this case the American government. There are many ways to describe the nature of government. Since government is primarily a political institution and accounting is concerned with financial measurement and reporting, it is logical to study the political and economic characteristics of American government, and to discern their effects, if any, on American government accounting.

This chapter is structured as follows. The first section will use a series of statistical tables to describe the size of the American public sector to give readers an appreciation of the important but limited economic role of government in the United States. The second section will then examine the structure of American government and its underlying political philosophy and constitutional principles. The third section will present and analyze research studies that attempt to deduce the effects of the American political and economic environment on American government accounting. A theory capable of explaining the demand for and supply of government financial information is offered. This theory will hopefully help accountants specify the form and content of government financial reports.

CHARACTERISTICS OF THE AMERICAN ECONOMIC ENVIRONMENT

The United States has a mixed economy in which the market determines the supply of and demand for most goods and services, but is subject to government regulations. The government plays a compensatory role in the American economy by performing those functions that the market economy does not perform efficiently or lacks the incentive to undertake those functions. Economists have classified these functions as: (1) allocation—the provision of public goods and services, (2) distribution—the adjustment of the distribution of wealth or income in society to conform to a principle of fairness; and (3) stabilization—the use of fiscal and monetary polices to achieve high employment, price stability, and economic growth.

The United States is organized as a federal system. In a federal system, the national, state, and local levels of government perform the above functions in varying degrees. The national government is more heavily engaged in economic stabilization and redistribution functions. State and local governments provide many essential services, but their ability to stimulate economic growth and job creation is limited. The mismatch between service responsibilities and resources can give rise to financial problems, since higher levels of government can preempt more productive tax sources.

A Statistical Profile of the American Public Sector

The public sector in the United States consists of the Federal Government, fifty state governments, and approximately 87,000 local governmental units, half of which are school districts providing elementary and secondary education. Economists often use revenue, expenditure and debt statistics to measure the size of government. The following tables are compiled by the Bureau of Census, an office in the Federal Government.

Exhibit 2.1
Government Consumption Expenditures and Gross Investment in Relation to GDP
(Billions of Dollars)

Year	Federal	State and Local	Government	GDP
Dollar Amounts				
1960	$64	$48	$112	$530
1970	114	120	234	1,045
1980	244	322	566	2,824
1990	508	672	1,180	5,838
2000	579	1,143	1,722	9,856
2004	828	1,388	2,215	11,788
Percentages				
1960	12	9	21	100
1970	11	11	22	100
1980	9	11	20	100
1990	9	12	20	100
2000	6	12	17	100
2004	7	12	19	100

Source: Extracted and derived from Table B-1 Gross Domestic Products, 1959-2005, *Economic Report of* the *President,* 2006, p. 281.

Exhibit 2.1 shows that in recent decades government expenditures have increased substantially. Government expenditures have accounted for approximately one-fifth of gross domestic product (GDP) of the United States. Within the public sector, state and local governments have grown more than the Federal Government, almost reversing their proportions.

Exhibit 2.2 shows the Federal Government's projected revenues and expenditures in the Fiscal Year 2007 Federal budget. Taxes, consisting mostly of income and payroll taxes, account for approximately 90 percent of Federal revenues. Military and security expenditures and public pensions and health care for the elderly combine to account for three-quarters of the Federal Government's total expenditures. The Federal Government is projected to continue to run large annual deficits, continuing the trend that began in the 1960s (see Exhibit 2.3). The main reasons for the large deficits in the 1980s were a combination of the Republican political ideology of low taxes and large defense build-up during the Cold War, along with legally mandated domestic social spending. The same Republican fiscal policy and the global war on terror have contributed to the large deficits since 2001. In addition, these reasons, there are two even more fundamental reasons for the large Federal budget numbers. The first is that under the continuing influence of Keynesian economics, the Federal Government's budget is a tool for stimulating and cooling the economy, as well as for managing the Federal Government itself. The second is that the Federal Government's budget has become a means of helping the poor and the elderly population.

Exhibit 2.2

Table S–8. Receipts By Source—Summary

(In billions of dollars)

Source	2005 Actual	Estimate					
		2006	2007	2008	2009	2010	2011
Individual income taxes	927.2	997.6	1,096.4	1,208.5	1,268.4	1,370.1	1,466.9
Corporation income taxes	278.3	277.1	260.6	268.5	277.1	282.0	292.0
Social insurance and retirement receipts	794.1	841.1	884.1	932.1	980.7	1,037.4	1,096.7
(On-budget)	(216.6)	(231.1)	(241.8)	(253.0)	(264.5)	(278.9)	(295.1)
(Off-budget)	(577.5)	(610.0)	(642.3)	(679.1)	(716.2)	(758.5)	(801.6)
Excise taxes	73.1	73.5	74.6	75.9	77.5	78.9	83.1
Estate and gift taxes	24.8	27.5	23.7	24.4	26.0	20.1	1.6
Customs duties	23.4	25.9	28.1	31.4	31.7	34.0	36.2
Miscellaneous receipts	33.0	42.8	48.4	49.4	52.7	55.7	58.4
Total receipts	2,153.9	2,285.5	2,415.9	2,590.3	2,714.2	2,878.2	3,034.9
(On-budget)	(1,576.4)	(1,675.5)	(1,773.5)	(1,911.1)	(1,998.0)	(2,119.7)	(2,233.3)
(Off-budget)	(577.5)	(610.0)	(642.3)	(679.1)	(716.2)	(758.5)	(801.6)

Source: Budget of the United States Government, FY 2007, Summary Tables, pg. 329

Table S–11. Budget Summary by Category
(In billions of dollars)

	2005	2006	2007	2008	2009	2010	2011
Outlays:							
Discretionary:							
DOD military	473	510	503	471	471	484	499
Homeland security	30	32	34	35	36	38	40
Other	465	490	492	473	468	461	455
Total,Discretionary	968	1,032	1,029	980	975	983	994
Mandatory:							
Social Security:							
Current program	519	550	581	612	645	683	722
Personal accounts	—	—	—	—	—	24	57
Medicare	294	338	387	399	421	447	489
Medicaid and SCHIP	187	198	205	218	233	250	270
Other	320	370	320	332	355	367	386
Total, Mandatory	1,320	1,457	1,494	1,562	1,655	1,771	1,924
Net Interest	184	220	247	272	291	307	322
Total Outlays	2,472	2,709	2,770	2,814	2,922	3,061	3,240
Revenues	2,154	2,285	2,416	2,590	2,714	2,878	3,035
Deficit	−318	−423	−354	−223	−208	−183	−205

Source: Budget of the United States Government, FY 2007, Summary Tables, pg. 332

Exhibit 2.3
Federal Budget – Receipts, Outlays, and Debt: 1960 to 2005
In billions of dollars

Year	Receipts	Outlays	Surplus or deficit(-)	Outlays as % of GDP	Federal Debt Held by Public	Federal Debt as % of GDP
1960	92	92	0	18	237	56
1965	117	118	-1	17	261	47
1970	193	196	-3	19	283	38
1975	279	332	-53	21	395	35
1980	517	591	-74	22	712	33
1981	599	678	-79	22	789	33
1982	618	746	-128	23	925	35
1983	601	808	-208	24	1137	40
1984	666	852	-185	22	1307	41
1985	734	946	-212	23	1507	44
1986	769	990	-221	22	1741	48
1987	854	1004	-150	22	1890	51
1988	909	1064	-155	21	2052	52
1989	991	1144	-152	21	2191	53
1990	1032	1253	-221	22	2412	56
1991	1055	1324	-269	22	2689	61
1992	1091	1382	-290	22	3000	64
1993	1154	1409	-255	21	3248	66
1994	1259	1462	-203	21	3433	67

1995	1352	1516	-164	21	3604	67
1996	1453	1561	-107	20	3734	67
1997	1579	1601	-22	20	3772	66
1998	1722	1653	69	19	3721	64
1999	1827	1702	126	19	3632	61
2000	2025	1789	236	18	3410	58
2001	1991	1864	127	19	3320	57
2002	1853	2011	-158	19	3540	60
2003	1782	2160	-378	20	3913	62
2004	1880	2292	-412	20	4296	64
2005, estimate	2053	2479	-427	20	4721	66

Source: *Statistical Abstract of the United States*, Table 459

The next three tables concern state and local governments. Even though they receive substantial Federal financial assistance, state and local governments have their own fiscal systems. Most of them operate under balanced budget laws and are prohibited from running large deficits over long periods of time. They also have more diversified revenue sources. State governments are financed mostly by sales and income taxes, and local governments by property taxes. American state and local governments perform many services, with large expenditures for education (see Exhibit 2.4).

American state and local governments generally issue bonds to finance major capital expenditures. General obligation bonds are supported by the issuers' full faith and credit, which requires a pledge to tax whatever amounts necessary to repay the debt and pay interest. Revenue bonds are backed by specific revenue streams of business enterprises of government (see Exhibits 2.5 and 2.6). Access to the capital market subjects American state and local governments to the monitoring by credit rating agencies. These organizations require borrower governments to provide their budgets and annual financial reports, in addition to other documents associated with specific bond issues. Since the 1970s, the rating agencies have considered lack of conformance with generally accepted accounting principles (GAAP), and the absence of independent audits, as negative factors in bond ratings. Since lower bond ratings would likely lead to higher interest rates, American state and local governments have a powerful economic incentive to follow GAAP and submit to independent audits by private-sector certified public accountants (CPAs).

Exhibit 2.4
State and Local Governments'Summary of Finances: 1990 to 2003
In billions of dollars

	1990	**2000**	**2001**	**2002**	**2003**
Revenue	**1032**	**1942**	**1891**	**1808**	**2047**
From Federal Government	**137**	**292**	**324**	**361**	**389**
From State and local sources	**895**	**1650**	**1567**	**1447**	**1658**
General, net intergovernmental	713	1249	1323	1324	1374
Taxes	502	872	914	905	939
Property	156	249	264	279	297
Sales and gross receipts	178	309	320	324	338
Individual income	106	212	226	203	199
Corporation income	24	36	35	28	31
Other	39	66	69	71	74
Charges and miscellaneous	211	377	409	419	435
Utility and liquor stores	59	90	100	107	108
Insurance trust revenue	124	311	143	15	176
Direct expenditure	**973**	**1743**	**1895**	**2044**	**2160**
By function:					
Direct general expenditure	832	1503	1622	1731	1818
Education	288	522	564	595	621
Highways	61	101	107	115	118
Public welfare	107	233	257	280	306
Health	24	51	53	59	62
Hospitals	50	76	81	87	93
Police protection	31	57	60	64	67
Fire protection	13	23	25	26	28
Corrections	25	49	52	55	55
Natural resources	12	20	22	22	23
Sanitation and sewerage	28	45	47	50	52
Housing and community development	15	27	27	32	35
Parks and recreation	14	25	28	30	32
Financial administration	16	29	30	33	35
Interest on general debt	50	70	74	75	77
Utility and liquor stores expenditures	78	115	134	144	149
Insurance trust expenditures	63	125	140	170	193
By character and object:					
Current operation	700	1289	1405	1497	1579
Capital outlay	123	217	233	257	263
Assistance and subsidies	27	31	33	33	35
Interest on debt (general and utility)	59	80	84	87	89
Insurance benefits and repayments	63	125	140	170	193

Source: *Statistical Abstracts of the United States*, Table 426, abridged.

Exhibit 2.5
State and Local Governments' Indebtedness: 1980 to 2003
In billions of dollars

		Outstanding Debt		Debt Activities	
Year and Level	Total	Short term	Long term	Debt issued	Debt retired
1980: Total	**336**	**13**	**263**	**42**	**17**
State	122	2	80	16	6
Local	214	11	183	26	12
1990: Total	**858**	**19**	**474**	**108**	**65**
State	318	3	126	44	23
Local	540	17	349	65	42
1995: Total	**1115**	**27**	**697**	**129**	**95**
State	427	6	205	53	37
Local	688	21	492	77	58
1998: Total	**1284**	**17**	**843**	**204**	**145**
State	483	2	237	83	58
Local	800	15	605	121	86
1999: Total	**1369**	**18**	**907**	**229**	**153**
State	510	3	249	83	56
Local	859	15	658	146	97
2000: Total	**1452**	**24**	**960**	**185**	**122**
State	548	6	267	75	44
Local	904	18	693	110	78
2001: Total	**1554**	**22**	**1039**	**200**	**131**
State	576	4	287	81	51
Local	978	18	751	118	80
2002: Total	**1686**	**43**	**1127**	**262**	**162**
State	642	19	318	104	65
Local	1044	25	809	159	97
2003: Total	**1813**	**40**	**1243**	**346**	**215**
State	698	16	366	149	86
Local	1115	24	876	197	129

Source: *Statistical Abstract of the United States*, Table 433.

Exhibit 2.6
Long-Term Municipal New Bond Issues for State and Local Government: 1980 to 2002
In billions of dollars

Year	Total	General Obligation Bonds	Revenue Bonds
1980	46	14	32
1985	202	40	163
1990	126	40	86
1995	156	60	96
1997	214	72	142
1998	280	93	187
1999	219	70	149
2000	194	65	129
2001	284	101	182
2002	356	126	230

Source: *Statistical Abstracts of the United States*, Table 434.

Government Service and Finance

The government specializes in producing public goods and finances these goods with taxes. Public goods benefit a large group of people and are collectively used by anyone, including free-riders, who are people who do not pay for what they enjoy. In contrast, private goods can be owned exclusively and enjoyed individually, and can be bought and sold in market transactions; the ability to pay determines their allocation. Business firms have the incentive to produce private goods but not good public goods. Since only the government can impose taxes and has the responsibility of promoting general welfare, it is best equipped and has the mandate to produce public goods.

In addition to providing public goods, American government distribute plenty of personal benefits to individuals, as well as quasi-public goods, which have attributes of public goods *and* private goods. Exhibit 2.7 gives some examples of the types of goods and services produced by each level of American government. They are spread along the "public to private" continuum, with the quasi-public goods in the middle column.

Exhibit 2.7
Examples of Who Produces What Public Service

Producers	**Public Goods**	**Quasi-public goods**	**Private Goods**
Federal Government	national defense legal system disease control environmental clean-up air traffic control interstate high system	capital market regulation bank deposit insurance pension benefit guarantee	elderly health care aid to families with dependent children flood insurance old-age pensions subsidies to farmers postal service
State Governments	criminal justice system	health care for the poor higher education	toll roads state lotteries
Local Governments	police & fire protection traffic lights street lighting	elementary & secondary education	water sewer parking garages airports

The nature of public goods and tax financing poses serious theoretical and practical problems for government accounting. Since public goods are not bought or sold in the market place, it is difficult to apply "service efforts and accomplishment" as a criterion for the seller (the government) to recognize its revenue. Government accounting is also inextricably tied to the government budget, because the budget is the mechanism for allocating public goods and the basis of taxation.

In summary, the economic role of governments in the United States is important but limited. It is important because the Federal Government uses its fiscal and monetary policies to influence the performance of the economy, and government at all levels provides many services to the American people. But its economic role is also limited because governments in the United States regulate, supplement, and complement the private sector, rather than dominating it. Consequently, public enterprises tend to be fewer and less significant in the United States than in some European countries. Despite the relatively small size of the public sector, government as a political institution plays a dominant role in the society and the political aspects of government that have a decisive influence on government accounting. Therefore the next section will examine the nature of the American political environment.

CHARACTERISTICS OF THE AMERICAN POLITICAL ENVIRONMENT

The American political environment has several characteristics that significantly influence government accounting: federalism; representative democracy; separation of powers, and checks and balances; and the rule of law.

Federalism

The federal structure of the United States owes its origin to the thirteen British colonies that declared their independence from Britain in 1776. These colonies united for the common purpose of winning the War of Independence, but were reluctant to give up their autonomy. During the decade after independence, the states conferred only limited power on the Federal Government, which relied on the states for its revenues and was at their mercy to the point of fiscal starvation. Thus a convention was called to solve the financial problems in 1787, but the delegates instead drafted the Constitution of the United States, in part to grant greater fiscal power to the national government.

Under the Federal constitution, the states retain all the powers that are not expressly given to the Federal Government. Each state has its own constitution and has the power to manage its fiscal affairs and supervise the local governments in its jurisdiction. Separately, the Federal Government has its own budgeting and financial management system. The Federal Government has its administrative structure with regional offices throughout the country to manage its own programs, and does not rely on state governments to collect its taxes or manage its spending.

Federalism has several consequences for government finance and accounting. The Federal Government cannot instruct the states or their local governments how to manage their financial affairs. The Federal Government can and does provide substantial financial assistance in the form of contracts and contracts to state and local governments. But this assistance is intended to give the recipient resources and incentives to cooperate with the Federal Government to achieve Federal goals. The Federal Government is not responsible for the fiscal disparity among the states, and does not provide fiscal transfers solely to equalize the states' fiscal capacity. State and local governments borrow on their own credit and are responsible for their own debt; they cannot rely the Federal Government to bail them out of fiscal crises.

The Federal Government can and does attach budgeting, accounting, and financial reporting and auditing requirements to its grants and contracts to state and local governments. However it cannot and does not regulate state and local governments accounting in general. In the aftermath of a series of municipal financial crises in the mid-1970s, the Federal Government created a Financial Capacity Sharing program to help state and local government improve their financial management. This program gave a $1 million grant to the Government Finance Officers Association (GFOA) to improve state and local government accounting standards, but its influence did not extend beyond the short grant period.

The most direct consequence of federalism is that the United States has two government accounting standard-setting bodies: the Federal Accounting Standards Advisory Board (FASAB) and the Governmental Accounting Standards Board (GASB) for all state and local governments. These two boards enjoy amicable relationships with each other in part because they have separate jurisdictions and do not interfere with each other's operations. While they exchange information, they have no obligation to consult with each other or seek each other's approval. A Federal official, the Comptroller General of the United States, is a member of the advisory council of the GASB, and for some time a member of the GASB was on the FASAB as a public member. But these representatives did not appear to have more than their share of influence. There was no need, no incentive and no mechanism for the two boards for harmonize their standards to arrive at a single set of American government accounting standards.

Representative Democracy

The United States is a representative democracy. That means that the people usually are not directly involved in making public policies, but instead elect representatives to do so. In a democracy, elections are the ultimate means for holding government and public officials accountable. Regular elections are held to choose the highest national government officials for fixed terms: the President and Vice President of the United States for four years, U.S. Senators for six years, and members of the U.S. House of Representatives for two years. The governors of the states and the mayors of most cities are elected, so are members of the state legislature and city councils. In some jurisdictions, fiscal officers, such as treasurers, comptrollers and auditors, are elected as an expression of the people's control of the public purse.

Government accountability is ensured by political competition. American politics is dominated by two major national political parties: the Republican Party and the Democratic Party. Every American voter can simply declare their political party affiliation, but does not have to belong to any party. The parties nominate candidates to compete in elections, thus offering voters alternatives. Election campaigns provide information and critical insights about the candidates' policy preferences and the incumbent's performance record in office. During the period between elections, voters rely on the opposition political party to challenge the policy proposals of the majority party, thereby preventing the abuse of the party in power.

Candidates' speeches and advertisements are not the only source of information for voters. The freedom of speech and freedom of the press guaranteed by the American Constitution provide multiple and possibly diverse points of view. Furthermore, journalists' investigative reporting about official misconduct provides an unofficial check on public officials and government.

As in other public policy areas, fiscal policy decisions are made mostly by government officials. However, in some states, local government's bond issues are subject to voter approval. In some jurisdictions, voters can vote on public school budgets, but such direct actions are rare. In general, voters' need for government financial information is primarily for holding government officials accountable, and not for direct personal decision making—except of course in electing those public officials to make decisions for them. Nevertheless, as a matter of upholding the democratic principle, before a fiscal year starts, government budgets are made available to the public in public libraries or on the government's website. Government financial reports are issued after a fiscal year is over. Government officials usually address the financial reports to citizens since these reports are regarded as documents for demonstrating and discharging fiscal accountability.

Elections and political competition have the salutary effect of making government officials responsive to voter preferences. American democracy, however, has a number of flaws. Without public financing of campaign expenditures, candidates for public offices rely on private donations. This practice creates at least the appearance of political corruption: money for political favors, such as favorable laws and earmarking of appropriations. Furthermore, freedom of association has resulted in the proliferation of interest groups to influence public policy on behalf of particular segments of the society, such as the elderly for health care and farmers for subsidies. Finally, individuals naturally prefer less taxes and more government services, thus contributing to large government deficits and borrowing in a democracy.

Separation of Powers, and Checks and Balances

A major feature of the American government system is the separation of powers and the checks and balances among the legislative, executive, and judicial branches of government. The legislature makes laws, the executive carries out laws, and when these two branches of government have disputes, the courts step in to adjudicate them. The independence of the judiciary, which has the authority to rule on the constitutionality of laws and administrative actions, is an important element of the American constitutional system. This doctrine of separation of powers, and checks and balances is most commonly illustrated with the Federal Government, but it is also practiced at the state level.

The intricate relationships among the three branches of government are most evident in a typical American government budgeting system. Typically the chief executive presents a budget proposal to the legislature, which approves or disapproves the budget, often with change. The budget enacted by the legislature is subject to executive veto, which can be overridden by the legislature. Of course, all these actions have to meet the test of constitutionality, which is decided by the courts.

Another example can further illustrate the balance of power in American government. The Constitution of the United States makes no mention of the role of the President in the Federal budget process. In 1921, Congress reluctantly authorized the President to prepare annual budgets for the whole government. It even created a Bureau of the Budget to assist him carry out this task. In the same legislation, however, Congress created the General Accounting Office (recently renamed Government Accountability Office) to serve as its own “watchdog” agency. Congress routinely requests the GAO to investigate executive departments. In recent years, the GAO have also audited the Federal Government’s financial statements. Until 1990, Congress and the executive branch were embroiled in a dispute over who has the power to set Federal Government accounting standards.

Rule of Law

Americans take pride in the rule of law in the United States. According to legal scholar Brian Tamanaha, rule of law has three meanings: government limited by law; formal legality; and rule of law, not man.

It is indeed a marvel that a government that makes and enforces laws is itself bound by the law. The United States Government may be the largest and most powerful in the world, but its power is limited by the Constitution of the United States, the oldest written constitution in the world. The concept of constitutionalism is an antidote to the arbitrary power of government and is very much related to republicanism—the idea that the sovereign power of the state rests with the people.

Formal legality means that laws should be open and predictable so that people know the legal consequences of their actions. This requires that laws be sufficiently general to cover many situations and applied equally to all concerned. This concept of rule of law has led to abundance of laws, rules and regulations, as well as opinions of judges, in the litigious American society. Among the different branches of law, public law—constitutional law and administrative laws—are particularly relevant for government accounting, as well as budgeting and public financial management in general.

The third meaning of rule of law is to contrast the rule of law with the rule of man. In this interpretation, the impersonal law is thought to be fair and objective, even though its human agents may be biased and subjective. Unfortunately laws are man-made, and it takes human beings to interpret and enforce laws. Judges are therefore assigned the role of guardians of justice. That is why the U.S. Constitution created an independent judiciary.

American government operates under all these three meanings of the rule of law, which are reflected in its accounting. It is now a common practice for governments to issue year-end financial reports prepared using accounting standards set by bodies that are not directly controlled by government. Government accounting is increasingly becoming similar to law in that many formal rules have been adopted through due process, which is a legal concept. Finally, auditors, who may be likened to financial judges, issue opinions about the accuracy of financial statements.

In conclusion, the American economic and political environment creates the necessity and incentive for American government to be accountable and transparent about their financial affairs. Politically, the government is accountable to the electorate and has the duty to inform them. Economically, the government is accountable to taxpayers and creditors to whom the government owes services and debt service, respectively.

IN SEARCH OF A THEORY OF GOVERNMENT USEFUL FOR GOVERNMENT ACCOUNTING

Other than the conceptual frameworks of the GASB and the FASAB, the development of government accounting theory has received little attention. Formulating a conceptual framework is a preliminary step in theory building, but a conceptual framework as a way of organizing ideas is itself not a theory. Building a theory of government accounting requires an appropriate theory of government. This section suggests a way to think about government theoretically that may be useful for developing government accounting concepts and standards.

Government as a System

The emphasis on formal institutions and their roles in the previous section is typical of the structural functional approach to the study of government before the 1960s. The 1960s saw the emergence of the behavioral revolution in political science. David Easton pioneered the use of the systems approach to studying politics, and Karl Deutsch used cybernetics to investigate the problems of political communication and control (see the list of references at the back of the chapter). They both concepts in systems analysis to conceptualize government.

A government is an open system, in the sense that it constantly engages in political, economic, and social transactions with elements of its environment, as shown in Exhibit 2.8. The arrows in the exhibit indicate the direction of the flow of resources. In this context, resources include all things of value -- economic as well as political resources, such as the power to vote or appoint public officials. The numerous and complex transactions between a system and its environment can be conceptualized as flows of inputs and outputs. The government, similar to a business firm, converts inputs into outputs. Its survival and growth require the reconversion of outputs into inputs, for example, financial resources to acquire other inputs, such as labor. These similarities are superficial, especially on the output side, due to the unique nature of government outputs and decision-making processes and criteria for resource allocation.

The government uses both political and market processes to acquire inputs and distribute outputs. Exhibit 2.9 provides a framework for understanding a variety of situations discussed below.

Public Goods and Other Outputs. The output-to-input reconversion process in the public sector often is complex and sometimes breaks down for two reasons. First, the government, particularly the Federal Government, performs the income and wealth redistributive function in society. A taxpayer does not receive public services in proportion to the amount of taxes he pays. The extent to which non-reciprocity applies to a person is suggested by the non-overlapping area between the taxpayer and service recipient circles in Exhibit 2.10. The greater the non-overlapping area, the more redistribution exists. In public sector activities, there is often extensive cross-subsidization among members of the society in different socioeconomic classes.

Second, government specializes in producing public goods. It acts when the market fails: when firms lack the incentives to produce and consumers lack the incentive to pay for certain goods due to their non-appropriability (quadrant I in Exhibit 2.9). The appropriability of a good refers to the ability of the person who paid for the good to enjoy the full measure of its benefits. A private good is appropriable in that (1) the consumer can exclude another person from enjoying it, and (2) what is consumed by A is not available to B. Under certain conditions, such as symmetric information and competition, the market allocates private goods optimally. But some goods are non-appropriable, in that it is infeasible to exclude non-payers, and so the goods are consumed jointly. Goods with the attributes of non-excludability and non-rivalry of consumption are called public goods. National defense, police and fire protection, and public parks are typical examples of public goods.

Free-ridership gives rise to problems in financing the production and distribution of public goods. Since self-interested individuals may not be willing to pay for public goods, coercive means of financing, such as general taxation, become necessary (quadrant II in Exhibit 2.9). However even self-interested individuals realize that if everyone behaved as they did, public goods of value to them would not be provided. Enlightened self-interest therefore leads to the production of public goods.

The market process cannot be used to finance public goods, nor can it be relied upon to allocate them. Instead, a political process is used. This process involves the participation of the public as well as of public officials. The electoral process in the democracy ensures that in the long run elected officials will be responsive to citizen preferences. In addition, through measures such as propositions and referenda, voters exert a direct role in limiting taxes, expenditures, and government borrowing. Perhaps the single most important instrument in allocating public goods is the budget. A budget determines who gets what from government, and who pays for the services.

While the provision of pure public goods is the exclusive province of government, government also sells goods and services when it is possible to identify their consumers and exclude others who do not pay (quadrant IV in Exhibit 2.9). For example, a government in the Chicago area erected a fence around a public beach to collect admission fees from nonresidents. Similarly, a government can set up barriers to collect tolls on some roads. Under financial pressure and the declining willingness of the taxpaying public to subsidize others, governments have increasingly resorted to these methods to reduce the financial burden of taxpayers. In this way, government resembles a business in that the ability to pay determines access to goods and services desired.

In conclusion, government produces a variety of goods and services, but only public goods are unique to government. The political process of taxation and budgeting is the primary means by which public goods are financed and allocated. On the input side, however, the government is subject to the same kind of market forces as other buyers in input markets.

Competitive Factor Markets. Economists use the term factors of production to refer to the inputs for producing goods and services. Like any other organization, government requires various inputs to produce the outputs. Unlike nonprofit organizations, which receive donated goods and services, government has to purchase these inputs from factor markets (quadrant III in Exhibit 2.9). The problem on the output side is aggravated by the fact that government has to pay competitive prices in the labor, capital, and other factor markets. In some cases, the tax-exempt status of government bonds and notes gives governments more favorable interest rates. By and large, however, these markets are governed by direct reciprocity. Consequently, the government also has to pay competitive prices in order to procure the goods and service its needs.

Exhibit 2.8
Government as a System

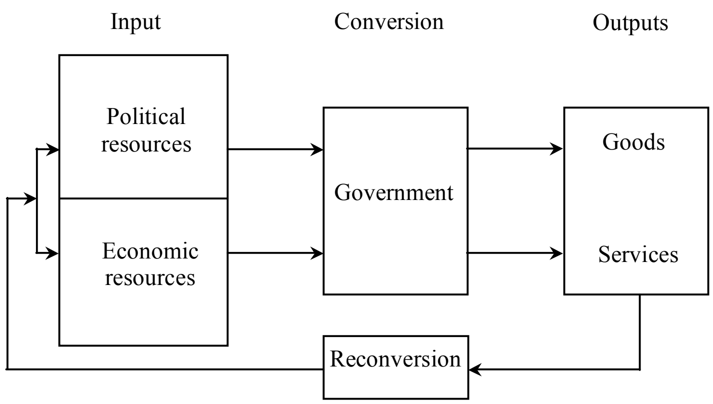
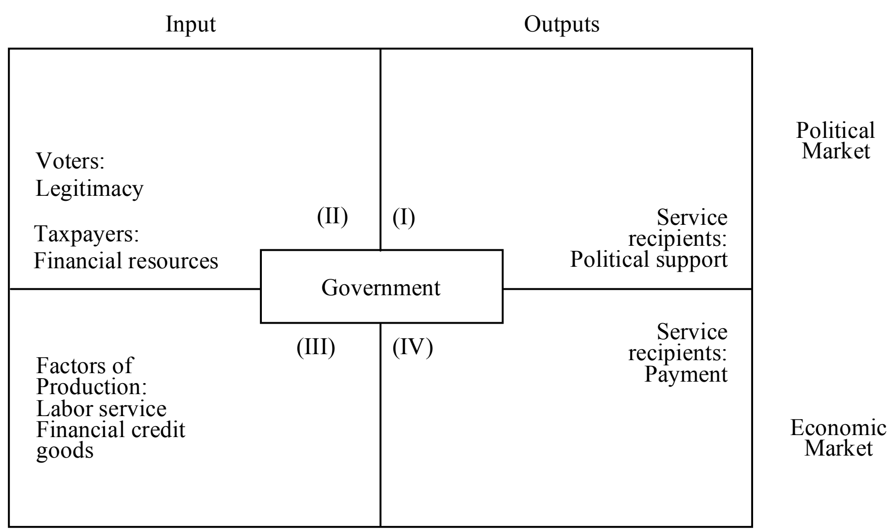


Exhibit 2.9
Government in Political and Economic Markets



While the systems perspective provides a useful way to think about what a government does and how government works, government accounting needs a theory that answer the question: to whom is the government accountable?

STAKEHOLDER THEORY OF GOVERNMENT

The behavioral revolution in political science started twenty years after a similar revolution in public administration. In his 1945 book *Administrative Behavior,* Herbert Simon examined what government officials actually did and found that they struggled to hold their organizations together by offering inducements to attract the contribution of those who hold resources needed for their organizations to survive. These actual and potential resource providers are stakeholders of an organization, whether it is a business or a government.

As mentioned earlier, governments and business firms alike convert outputs into inputs to survive. In contrast to business firms, governments do not have owners and do not seek profits as a primary objective. Nevertheless, business financial accounting, which is focused on the determination of income for potential distribution to owners, has served as a frame of reference for government accounting. In the last three decades, there are numerous attempts to adopt and adapt business accounting practices in the public sector. These attempts have been controversial and not entirely successful. In order to provide the basis of comparing the accounting for these three types of organizations, this section presents a general theoretical framework.

This theoretical framework is based on Herbert Simon's insight that an organization in essence consists of a set of contracts among people who share a common interest in the organization's survival. These people make different kinds of resources available to a common pool and in turn are rewarded for their inputs (Exhibit 2.10). They are called stakeholders because, by virtue of their investment of resources or efforts, their well-being depends on success, or at least survival, of the organizational coalition. In Simon's terminology, the coalition survives or remains at equilibrium if its managers succeed in arranging sufficient inducements to attract continued contributions of the stakeholders.

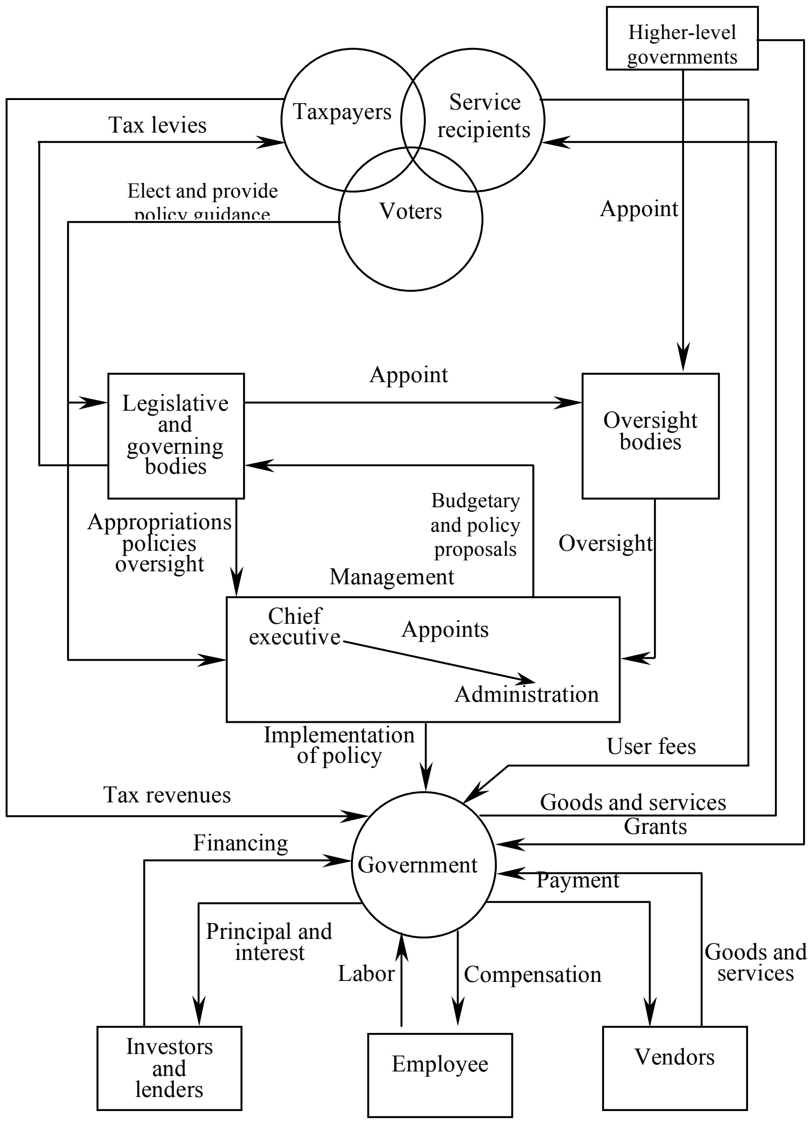
While many types of stakeholders are common to all organizations, some stakeholders are unique to each type of organization. Specifically, only business firms have owners. Only the government depends on voters to give it legitimacy, and only government can levy taxes and have taxpayers. Consequently, business firms and governments are similar in some ways, but are different in other fundamental ways.

In 1981, the author introduced Simon's ideas into the National Council on Government Accounting (NCGA) study on the objectives of government accounting and financial reporting. The stakeholders identified in Exhibit 2.10 are portrayed in Exhibit 2.11 as interacting with each other.

Exhibit 2.10 Stakeholders' Contributions and Inducements

Stakeholders	**Contributions**	**Inducements**
taxpayers	financial resources	government services
voters	political legitimacy	government services
service recipients	political support	government services
grantors	financial resources	gratitude, services
customers	financial resources	goods and services
employees	labor services	compensation
vendors or suppliers	goods and services	payments
creditors	financial resources	interest, repayment of principal
members of governing board and oversight body	implicit voter support, policy ideas, leadership	Power, compensation
managers	ideas and leadership	compensation, power

Exhibit 2.11
Interactions Among Stakeholders of Government



Shyam Sunder of Yale University has advanced the application of Simon's theory to accounting by proposing the concept of "common knowledge." Sunder believes that the function of financial accounting is to create a common knowledge base to reduce the information asymmetry among stakeholders. Sunder derives the following accounting functions from what he calls "the contract theory of the firm." Sunder uses the term "agent", as in economic agent, to stand for what we have called stakeholders.

1. Accounting measures the input of each agent to the firm's pool of resources.

2. Accounting determines and disburses the contractual entitlement of each agent.
3. Accounting informs appropriate agents about the extent to which other agents have fulfilled their contractual obligations and received their entitlements.
4. Accounting helps maintain a liquid market for contractual slots [role] and for the factors of production supplied by their occupants so that the resignation or termination of one agent does not threaten the existence of the firm.
5. Accounting provides a pool of common knowledge of verified information to all participants to facilitate negotiation and contract formation.

Sunder's contract theory of the firm corresponds to the the stakeholder theory of government. When it possible to negotiate their terms of possible participation in a government, rational stakeholders compare the contributions expected of them with the inducements offered to them. Whenever these inducements are uncertain, stakeholders have the incentives to acquire information to reduce the uncertainty. After they have joined the organizational coalition, they have the incentive to acquire information to assess the ability of management to keep contractual promises. The stakeholder theory therefore provides the theoretical rationale for the accounting system as the source of common knowledge about the government.

Implications for Government Accounting

In Simon's organization theory, all stakeholders are important to the extent they hold resources that are valuable to the survival of the organization. This feature of the theory makes it particularly useful to developing a theory of government accounting that does not single out any particular stakeholder group for emphasis. Whenever a stakeholder has the incentive to obtain information about an organization in order to compare inducements and contributions, he or she becomes a potential users of the organization's accounting information.

Stakeholders as Potential Users of Government Financial Information. The identification of users of financial information is the first step in all the conceptual framework projects of American accounting standards boards. Simon's theory was explicitly used by the National Council on Governmental Accounting in 1981 to identify most of the stakeholders in Exhibit 2.10 as the potential users of financial information of government. The qualification "potential" is significant because a stakeholder will become an actual user only if the benefits of acquiring and analyzing information are greater than the cost of such activities. In 1987, the Governmental Accounting Standards Board (GASB) designated three primary user groups of external financial reports of state and local governments: voter and taxpayers, legislative bodies and oversight boards, and investors and creditors. In 1993, the Federal Accounting Standards Advisory Board (FASAB) included executives (senior officials), program managers, along with citizens and Congress, as users of federal financial reports.

Common Knowledge. Simon's theory of multiple stakeholders has provided a foundation for normative theories of accounting. Its most important implication is that the management of the organizational coalition has the duty to provide a common knowledge base to all stakeholders. The importance of common knowledge lies in the reduction of information asymmetry among the stakeholders. Since managers control an organization's information system, it is necessary to balance this monopoly with uniform accounting rules, transparency requirements, and independent auditing.

The decisions about who receives what information is an issue in governance. Governance refers to the system of distributing the authority to make decisions, exercise control, and evaluate performance in an organization. The government tends to have varied and complex governance structures. In American government, the voters in a jurisdiction typically elect legislators and the chief executive. Even though the chief executive is head of the administration, the legislature oversees the executive branch and holds administrators or managers accountable. In the administrative hierarchy, senior managers hold their subordinate accountable, and managers hold employees ("civil servants") accountable. There are therefore three levels of accountability in the American government and political system.

The stakeholders identified in Exhibit 2.10 may be classified as internal and external stakeholders. Managers or government officials in the executive branch may be regarded as internal stakeholders, and the others as external stakeholders. Relative to the external stakeholders, managers occupy a unique position in three respects: (1) they are authorized to negotiate with other stakeholders; (2) they are entrusted with all the economic resources provided by the stakeholders; and (3) consequently, they possess the most information about the organizational coalition, and more information than other stakeholders. All three attributes make managers extraordinarily powerful, and the third attribute that has broad implications for accountants and auditors.

An organization's accounting system is usually under the control of managers, who hire the organization's accountants. Given this employment relationship, how can accountants reconcile their managerial service function with the accounting system's obligation to be fair to other stakeholders? One way to resolve this conflict is compartmentalize the accounting function. The management accounting sub-function, designed to facilitate management planning and control, is exclusively under management control. The financial accounting sub-function, on the other hand, deals with common knowledge of interest to all stakeholders. Since financial accounting also measures the performance of managers, potential conflict of interests makes it inappropriate to allow managers to set the rules and determine the contents of financial reports. Furthermore, these reports would have greater credibility to other stakeholders if they follow rules set by an independent body and are verified by external auditors. This is basically the current arrangement in the United States.

Generally Accepted Accounting Principles. The accounting rules set by independent bodies and enforced by external auditors are called "generally accepted accounting principles" or GAAP in the United States.. The term "generally accepted accounting principles" conveys the original intent that these rules ought to meet the market test of widespread approval in practice. Now however GAAP effectively means standards promulgated by bodies recognized by the American Institute of Certified Public Accountants (AICPA) on behalf of the auditing profession. The AICPA wields this power because many organizations in both the public and private sectors engage CPAs to to perform year-end financial audits in order to enhance the credibility of their financial statements.

SUMMARY

The public sector in the United States is large and still growing in terms of revenues, expenditures, and debt. It provides a multitude of services, redistributes income and wealth, and stabilizes the economy through fiscal and monetary policies. At the organizational level, a government is an open system engaging in continuous exchanges with its environment in acquiring inputs and distributing outputs. Some of the exchanges are conducted through markets, others through the political process, as in financing and allocating public goods.

The objectives of governmental financial reporting are to demonstrate and discharge accountability. The stakeholder theory of government, based on Herbert Simon's organization theory, answers the questions: To whom are the government and its managers accountable? Why does a stakeholder invest time and energy in obtaining and analyzing information about government? Why is it important to produce common knowledge based on impartial rules, such as generally accepted accounting principles? By answering these questions, the stakeholder theory of government becomes useful for developing government accounting concepts and standards.

REFERENCES AND FURTHER READINGS

Chan, J.L., "The Government Environment: Characteristics and Influences on Government Accounting and Financial Reporting," *Handbook of Government Accounting and Finance*, edited by N.G. Apostolou and D.L. Crumbley, 2nd ed. (New York: John Wiley & Sons, 1992), pp. 1-1 to 1-24.

Chan, J.L. "Government Accounting: An Assessment of Theory, Purposes and Standards," *Public Money and Management* (2003), pp. 13-20.

Chan, J.L. and M.A. Rubin. "The Role of Information in a Democracy and Government Operations: Public Choice Methodology," in *Research in Governmental and Nonprofit Accounting,* Vol.3. (Greenwich, CT: JAI Press, 1987), pp. 3-27.

Deutsch, K.W. *The Nerves of Government: Models of Political Communication and Control* (New York: The Free Press, 1966).

Drebin, A.R., J.L. Chan, and L.C. Ferguson. *Objectives of Accounting and Financial Reporting by Governmental Units*, 2 vols. (Chicago: NCGA, 1981).

Easton, D., *A Framework for Political Analysis* (Englewood Cliffs, NJ: Prentice-Hall, 1966).

Easton, D., *A Systems Analysis of Political Life* (Chicago: University of Chicago Press, 1965 and 1979).

Federal Accounting Standards Advisory Board, *Statement of Federal Financial Accounting Concepts No. 1* "Objectives of Federal Financial Reporting" (September, 1993).

Governmental Accounting Standards Board, *Concepts Statement No.1* "Objectives of Financial Reporting" (May 1987).

Katz, D. and R.L. Kahn, *The Social Psychology of Organizations*, " Organiations and the System Concept," (New York: John Wiley, 1966), pp. 14-29.

Musgrave, R.A. and P.B. Musgrave, *Public Finance in Theory and Practice,* 2nd ed.. (New York: McGraw-Hill, 1976).

Simon, H.A. *Administrative Behavior* (New York: The Free Press, 1945).

Sunder, S. *Theory of Accounting and Control* (Cincinnati, Ohio: South-West College Publishing, 1997).

Tamanaha, B.Z., *On the Rule of Law: History, Politics, and Theory* (U.K.: Cambridge University Press, 2004).

U.S. President's Council of Economic Advisors, *Economic Report of the President*. (Washington, DC: Government Printing Office, 2006).

U.S. Bureau of the Census, *Statistical Abstracts of the United States* (2005).