

## Budgets? We Don't Need No Stinkin' Budgets<sup>1</sup>

### Ten Things We Think We Think We Know about Budgeting and Performance

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**Learning is the only sure way to achieve ongoing performance improvement. Budgeting and learning are fundamentally orthogonal processes. Budgeting stabilizes, which is a good thing in itself, and promotes economy, but it discourages understanding of variation. Learning requires perturbation and measurement. Given the processes through which service accomplishment and operational excellence are realized, it is unlikely that budgeting, as generally practiced in government, can promote continuous improvement in enterprise performance.**

**Keywords:** Budgets, performance measurement, performance management, targets, annuality, transparency

#### 1 Introduction

For the past twenty years we have beavered away in vain on behalf of a reform agenda outlined in Vice President Al Gore's National Performance Review, which called for mission-driven, results-oriented budgets (Thompson, 1994; Barzelay & Thompson, 2006; Smith & Schiffel, 2006). In the meantime, we have become convinced that output maximization and its necessary concomitant, risk neutrality, profoundly misconceive the fundamental purpose of governmental enterprises. It is, at best, a distinctly secondary consideration.

Arriving at this conviction came hard for us. But the inescapable fact remains that public-management scholars are, for the most part, just not interested in the disciplines most directly relevant to output management – financial economics and managerial accounting and control. This state of affairs would be unthinkable if the aspirational purpose of government enterprises were, in fact, something like output maximization. Central to this realization is that budgeting and the budget

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<sup>1</sup> Our title is intended as a playful reference to a well-known line from John Huston's 1948 film, *The Treasure of the Sierra Madre*: "Badges? We don't need no stinkin' badges." Mel Brooks quoted this line in his 1974 film *Blazing Saddles*. It should not be taken literally.

process need to be rethought to make sense of current budget practice and to align these mechanisms with government's aspirational purpose.

### **1.1 The budget process is costly and time consuming**

Fixing these mechanisms is clearly worthwhile. Budgeting is a cumbersome and complicated affair that requires the attention of armies of analysts, managers, and elected officials. Budgeting in the United States is especially costly and time consuming (Meyers, 2011). As Alice Rivlin (1984: 133) observed: "No government in the world devotes as much time, energy, and talent to budget decision making as ours does." At the same time, the process is singularly frustrating. As Joachim Wehner (2011: 350) explains, "its outcomes are increasingly erratic, the process is broken, the only real question is not whether the process needs to be fixed, but how."

### **1.2 The budget process does not do what it was supposed to do**

America's unified, annual executive budget was created by the Federal Budget and Accounting Act of 1921. At that time, reformers claimed that it would moderate spending growth, produce better estimates of revenues and expenditures, and reduce government waste and fraud. Hugh Rockoff (1985) demonstrates that an executive budget accomplished none of these things. "The growth of federal spending was not curtailed, waste and inefficiency were not eliminated, and even on a more down-to-earth level, the federal budget did not become an accurate blueprint of federal activity for the following fiscal year." According to Jeffrey Sachs (2011), if anything, things have gotten worse in the interim.

Since its creation the mechanism has been periodically expanded and made more complicated, more time consuming, and more costly in pursuit of greater fiscal balance, coherence, and efficiency (Joyce, 2011; Meyers, 2011). Yet, those ends seem ever more distant and unattainable. It is a commonplace that "stupidity is doing the same thing over and over again, hoping for a different result."

### **1.3 What we should ask budgets to do**

The powers to spend, to tax, and to borrow are the principal means through which the purposes of government are realized. To the extent that budgeting puts these powers to work, it is arguably the master decision-making process of government. But this claim begs the question. To give this claim meaning one must first say something about governmental purpose. On this point, we believe that Judt and Božić got it right, we "have to have active interventionist states protecting us against things that frighten people" (2010:11). Paul Krugman (2010) is even pithier: "government ... is ... essentially a huge insurance company with

an army.” In other words the basic purpose of government is the mitigation of systemic and idiosyncratic risk. That answer provides a satisfactory explanation for all of government’s basic functions – macroeconomic stabilization, income redistribution, compensation for various other market failures, as well as the basic night-watchman functions of the state<sup>2</sup>.

Moreover, the basic mechanisms of the budget process are well designed to support these functions. Budgets exhibit stability, inertial forces, lines of continuity stretching through time, because precedent drives the process. Budget formulation typically takes current service or operating levels, activity requirements, activity consumption rates<sup>3</sup>, resource requirements, and factor prices as starting points. This base is then modified to generate budgets for future periods on the presumption that service/operations levels drive activity requirements and that resource requirements are linked to activity levels via stable activity consumption rates. Since spending plans are based on precedent, they are known to be operationally feasible: they already work (Covaleski et al., 2003).

Consequently, it makes sense to think of budgets as accumulations of incremental bargains governing entitlements, employee salaries and wages, service levels, and performance indicators. Nevertheless, it should be stressed that these matters that are only indirectly related to the budget process per se (see, for example, Patashnik, 1996, for a compelling statement of this perspective). The U.S. could eliminate the annual budget process altogether, reverting to the situation that obtained prior to 1921, where Congress provided continuous budget authority on an ongoing basis, modifying appropriations if and when circumstances demanded such changes.

Much of the cost and effort devoted to budgeting is due to the norms of annularity and authoritativeness (Sundelson, 1935). Rivlin (1984) notes that we could make the budget process much less costly and time consuming if only we were willing to revisit decisions less often or render them in less exquisite detail. So why not put spending on automatic pilot, passing continuing resolutions for the existing appropriations acts annually, and focus on changes, incremental adjustments and bargains only when they are ripe for legislative ratification? As Larkey and Devereux (1999: 171) explain, “A good budgetary decision process minimizes conflict specifically and transactions costs generally where the conflict and the costs contribute nothing to the substantive quality of the decisions.” Ours does

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<sup>2</sup> Under contemporary economic theory, the basic market failure is the absence of a full set of Arrow-Debreu contingent-claims contracts, often due to missing or asymmetric information, which typically takes the form of adverse selection or moral hazard problems. In this sense, all these functions are addressed to market failure and, as increasing functions of risk aversion and wealth, welfare enhancing.

<sup>3</sup> The activity consumption rate is the quantity of each activity that is required to produce one unit of service; the resource consumption rate is the quantity of each resource that is required to perform one instance of each activity.

not. Therefore, one might reasonably conclude that it is a bad decision making process<sup>4</sup>.

Nevertheless, even if our basic purpose is stability, there are a couple of changes to the process that might make sense. First, transfer payments should be moved from the expenditure side of the budget to the revenue side and treated as negative taxes (Buiter, 1990, Mirrlees et al., 2012). Second, a stable expansion path for expenditures should be identified and adhered to (see Dothan and Thompson, 2009; Frankel, 2011).

#### 1.4 Don't throw the baby out with the bathwater

To say that performance isn't the only thing is not to say that it is nothing. That budgeting as practiced in government has little to do with performance management does not mean that better government performance wouldn't be a good thing. Government budgets are basically spending plans. Regardless of format, they focus the attention of organizational actors on spending. Spending targets are easy to hit and, once in place, give rise to relatively few capacity-reducing behaviors. Indeed, where precedent drives the budget process, they guarantee stability in service delivery.

At the same time, their power to induce dysfunctional outcomes is well established (Hofstede, 1967; Onsi, 1973; Merchant, 1984; Lukka, 1988). They give spending units every conceivable reason to seek the maximum spending authority that they can get and to use it before it expires. Moreover, quarterly or monthly fiscal review tends to focus not on performance, service efforts and accomplishments, but on burn rates – that spending is going according to schedule<sup>5</sup>. They also lock things into place, not only activity consumption rates, but existing organizational architectures as well. Under existing norms, once budgets have been adopted, they must be executed as enacted, spending is supposed to follow the numbers in the budget. This has the effect of constraining responsiveness and retarding experimentation and learning.

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<sup>4</sup> Putting operating budgets on automatic pilot and amending them piecemeal is consistent with two more of Larkey and Deveraux's prescriptions for spending decisions: improve the signal to noise ratio and use different budgets for different purposes..

<sup>5</sup> Of course, even under *ex ante* budgets, better performance can sometimes be realized through savvy, skillful bargaining carried out *in media res* and over several operating cycles (Thompson, 1993). But, all too frequently, the participants in this process aren't particularly skillful and forgetting runs faster than learning. Given the evident drawbacks inherent to *ex ante* budgeting, regardless of the format, one has to wonder why governments are so wedded to it, although there is no question that they are (Moynihan, 2006). Perhaps, the answer is to be found in the benefits *ex ante* budgets do offer. Stability is one benefit. They are also useful for "task control" and technical/legal compliance. Consequently, they can be an extremely effective means of steering public funds to the right places and recipients, i.e., those of greatest political importance.

Abandoning the annual budget cycle would mitigate these pathologies. But dumping annularity would not guarantee better performance.

### 1.5 Delivering in the present versus creating the future

One of the hardest challenges for any enterprise is figuring out what performance means. In some cases it means maximizing throughput; in others it means making sense of things, learning how to do things not just better and more effectively, but also things one doesn't know how to do. Unfortunately, the kind of institutional arrangements that promote the former are typically inimical to the latter (Roberts, 2004). One can reconcile increased throughput with stability and stability-inducing mechanisms such as baseline budgets and machine bureaucracy. Consequently, it is not surprising that better performance realized over several operating cycles is typically a matter of throughput – delivering in the present rather than creating the future. That is not also the case where rapid learning and thereby, qualitative improvement, is sought. One cannot easily reconcile stability with rapid learning.

Because much of what government does involves information processing (government mitigates risk – risk and uncertainty are terms for ignorance, which is what learning and sense making are supposed to defeat), this is a serious matter. Brynjolfsson and Hitt (2000) argue that learning organizations must employ a specific relational architecture, set of processes or routines, and culture, which allows them to maintain focus and communicate goals, foster information access and communication throughout the organization, link incentives to performance, hire the best people, and invest in human capital. Learning requires exploration and experimentation – variation as well as measurement. Consequently it implies redundancy, duplication, overlap, waste, and risk taking. Learning is inherently destabilizing and is, at best, orthogonal to budgeting<sup>6</sup>.

Our pessimism here may be due to the idiosyncratic nature of the American constitutional order with its checks and balances and its commitment to norm of authoritativeness. This norm, which says that budgets ought to be executed precisely as enacted, is arguably a by-product of the pre-eminent fiscal role assigned to Congress by the U.S. Constitution (Meyers & Rubin, 2011; Wehner, 2011). Elsewhere it is conceivable that the kind of loose-tight, steering mechanisms – capital budgets, programming, responsibility budgets, etc. (see Thompson, 1994; Simons, 1995; Johnson & Bröms, 2000; Hope & Fraser, 2003) – called for by a diversity of enterprise purposes, especially those requiring learning, are entirely feasible and workable.

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<sup>6</sup> In systems design, orthogonality means that a component does not affect the other components of the system or, at the very least, the other components do not depend on its effects.

### **1.6 High throughput competes with stability**

Under the aegis of the New Public Management (NPM) and its mantra of 'make the managers manage, let the managers manage,' New Zealand, Australia, the UK, Switzerland, Sweden, Iceland, Chile and others have experimented with annual contracts, under which public managers are compensated and retained based upon the measured financial performance of their organizational units. And, while spending levels at the administrative unit levels are much less certain under these kinds of contracts than under rigid spending plans that must be strictly executed, costs are on average also lower.

All too often, however, performance contracts also lead to the kinds of short-term performance gains/cost savings that come at the expense of long-term capacity building and sustainable operations: cutting costs by encouraging employee turnover and skimping on research, training, maintenance, service quality, supplier development, relationship building, and learning by doing, all of which lead to deviation-amplifying effects upon operations and, therefore, instability.

The problem is one of insuring that sufficient attention is given to capacity development and sustainability. The balanced scorecard is one mechanism for achieving this focus (Chai, 2009). Both the Common Assessment Framework and the Excellence Model of the European Foundation for Quality Management, the most widely used performance assessment models in Europe, have integrated sustainability in their recent versions. One can presumably have a reasonable amount of stability and build capacity (learn) at the same time as long as it is clearly understood that these are different aims and require different measures and mechanisms to accomplish them. Simultaneously maximizing throughput, stability, and learning is impossible.

### **1.7 Building capacity is orthogonal to stability**

Annularity is another source of short sighted, destabilizing behavior. There is no question that this behavior degrades capacity and amplifies operational instability (Andersen & Mortensen, 2010; Whitford, 2003).

That spending should be matched to revenues on an annual basis is an arbitrary relic of an agrarian past. Revenues fluctuate daily, monthly, and quarterly. We regularly use savings and borrowing to smooth out spending over these periods. Why not from one year to the next? The answer given is that governments face a "hard budget constraint" (Rodden, Eskeland & Litvack, 2003), although as an immediate practical matter that is rarely the case.

What needs fixing is unstable spending. The solution lies in using savings and/or debt to smooth out spending, thereby avoiding deep cuts when the economy goes bust and unsustainable spending growth during booms. This can be accomplished by basing spending on long-term revenue growth rather than annual

forecasts (Dothan & Thompson, 2009). This approach can also easily be adjusted to deal with emergencies. Maintaining resilience – the capacity to deliver what's needed when it's needed, which means maintaining a residual or surge capacity, the ability to respond rapidly in an emergency – is inherent to the governmental enterprise.

The effectiveness of this general approach, both for controlling expenditure growth and for stabilizing programmatic support, is suggested by various case studies, most persuasively by the Chilean experience (Frankel, 2011). Chile has the world's most volatile revenue structure and a commitment to balanced budgets. It avoids boom and bust by balancing spending against the long-term rate of revenue growth. Each year, economists in the Chilean Ministry of Finance calculate a sustainable rate of revenue growth and Chile's executive and legislative branches use that figure to make their spending plans. If revenues come in above the long-term trend, they are kicked into a sinking fund, which can be used only to make up revenue shortfalls, to pay down the national debt, or to respond to emergencies.

### **1.8 Learning is the only sure way to achieve ongoing performance improvement**

Performance improvement over time comes from capacity building and is sustained by collective learning<sup>7</sup>. Learning requires measurement and perturbation, exploration and experimentation, as well as dialogue and conflict. Measurement should focus on an enterprise's purposes: service delivery, reliability, maintaining and building capacity.

How do people learn from experience and extrapolate the lessons learned at a source site to a target site? Collective learning from similarities and differences (perturbation) requires benchmarks, structured by a common set of expectations about what constitutes a good result. Absent such benchmarks, we cannot distinguish experimental success from failure, let alone link improvements to specific practices, processes, or relationships. And, if what counts is building and maintaining capacity, then capacity building (learning) ought to be the object of measurement and evaluation.

Learning requires differences as well as similarities. Unless participants are free to tinker with alternative mechanisms and processes, an enterprise cannot hope to learn from successful perturbation<sup>8</sup>. Furthermore, participants must coll-

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<sup>7</sup> In the management literature this view is associated with the work of Senge, 1990; Simons, 1995; Johnson and Bröms, 2000; and Greve, 2003; in our field, Moynihan, 2008; and Behn, 2007.

<sup>8</sup> This kind of learning has a cost. Standardization promotes stability and is one way of achieving high levels of performance at a given level of capacity. It is axiomatic that an enterprise can be good at innovating or at getting superior operational results in the here and now, but not both.

actively examine the processes that produced success and the social relationships through which effective practices were enacted, paying careful attention to the context in which workable solutions to practical problems were improvised and executed, otherwise core technologies will remain the province of the successful deviants: no one at the collective, institutional level will really understand how they work or why. In other words, learning how to effect practice improvements depends upon engaging practitioners in dialogue and debate, analyzing why some practices work and others do not and, then, feeding the product of this process back into the larger pool of knowledge.

Finally, institutional learning efforts must be sustained over time if they are to affect materially what an enterprise does and how.

### **1.9 More iterations of any process produce faster learning**

Arguably, the faster an enterprise can check results against actions, the more opportunities it will have to learn from experience, from comparisons of differences and similarities, and the faster it will learn. Behn (2007) attributes much of the success of CitiStat at improving operating performance in Baltimore, Maryland to shortening its evaluation cycle to 2 weeks. One of us made a similar observation with respect to the effectiveness of performance management in the United States Air Force Materiel Command, where much of the payoff in terms of operational improvement came from shortening the operating/performance/evaluation cycle from an annual one to a quarterly one (Barzelay & Thompson, 2006).

The conclusion is straightforward. The annual budget cycle is as bad for learning as it is for stability. This is definitely not an argument against performance evaluation<sup>9</sup>. Efforts and accomplishments should be measured frequently and assessed in the light of actual events – the more frequently the better. In contrast with performance contracts, rather than trying to manage the behavior of organizational units strictly by the numbers and at arms length, the emphasis should be on dialogue and administrative argument about actions taken, why they were taken, and what happened, what was learned as a result, and what will be done next. Unit managers should be required to make sense of their plans, efforts, and accomplishments and to engage in frequent debate with their superiors about the relative merits of alternative plans and actions in terms of the enterprise's purposes and measured outcomes, but ultimately they must be trusted to do what they think is necessary to sustain capacity and deliver satisfactory results (Simons, 1995; Neely & Najjar, 2006).

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<sup>9</sup> Simons (1995) refers to this mechanism as "diagnostic control."

### 1.10 Transparency

The traditional budget norms are annularity, authority, comprehensiveness, balance, accuracy, and transparency (Sundelson, 1935). We argue that the emphasis given to annularity and authority are misplaced. We wholeheartedly support comprehensiveness; the problem is that budgets are rarely comprehensive. Reasonable accuracy and balance are also worthwhile goals. Transparency is especially important. As John Dewey explained, if the consequences of conjoint activity are to be understood, they must not only be freely communicated to all the members of the community, they must also be interpreted by all those who experience them. Thus, Dewey argued, “No government by experts in which the masses do not have the chance to inform the experts as to their needs can be anything but an oligarchy managed in the interests of a few” (Dewey, [1927] 1984: 364).

From the standpoint of transparency, the problem with annularity and authority is that they reinforce a propensity to define accountability in terms of compliance with the spending plan: did government buy the things it planned to buy on schedule? Did it burn through cash at the planned rates? Accountability means giving account of what actually happened: did we spend more than last year? Did we increase reliability? Throughput? Capacity? How? Why? Answering those questions is the essence of accountability. Businesses tend to emphasize results for a very good reason. They matter. Businesses rarely emphasize spending plans for an equally good reason. They don't matter. Indeed, they rarely formulate overall spending plans. Their operating budgets typically focus on performance targets, often stated in financial terms to be sure, not spending. Overall, greater transparency means a lot more information about government's efforts and accomplishments (Greve, 2003) and a lot less emphasis on spending plans, especially annual spending plans.

Again we would note that the U.S. is an extreme case. The fiscal rigidity we ascribe to annularity and authority are largely a by-product of the formal separation of powers that characterizes the American system of governance. However, the American system of governance also predisposes it to a very high degree of transparency and accountability, although not necessarily with regard to results.

### **Ten Things We Think We Think We Know about the Budget Process**

1. The existing process is costly and time consuming (especially in America).
  2. It doesn't (cannot?) do what it was/is supposed to do (promote efficiency and fiscal responsibility).
  3. What it does do (promote stability) isn't sufficiently appreciated. Government's core purpose always includes capacity maintenance.
  4. Annularity exacerbates myopia and instability, degrades performance and is fundamentally inimical to capacity maintenance.
  5. Delivering in the present (maximizing throughput) requires different arrangements than does creating the future (building capacity).
  6. High throughput competes with stability, but is not necessarily inimical to it so long as sufficient attention is given to capacity maintenance.
  7. Building capacity is orthogonal to stability. If you want both, you must put up with a lot of redundancy, overlap, and duplication.
  8. Capacity building leads to qualitative performance improvements; it can be sustained only via learning. Learning requires perturbation and measurement, as well as dialogue and conflict. Measurement should focus on an enterprise's purposes: service delivery and maintaining building capacity.
  9. More iterations of any process produce more opportunities for learning.
  10. Transparency is good. It promotes both political and operational capacity building and maintenance. So is comprehensiveness, as are reasonable balance and accuracy.
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#### *Exhibit 1: Ten Things We Think We Think We Know about the Budget Process*

## **2 What do we propose?**

First, understand that budgeting and performance management are largely orthogonal processes. The former is concerned primarily with stability; the latter with learning, which requires perturbation and measurement.

Second, simplify and streamline the budget process, wherever possible, while at the same time assuring a high degree of inter-temporal stability. In the U.S., one could take the continuing-resolution process as a model. Under continuing-resolutions, agencies are authorized to spend at the same rate as under the last appropriations bills. This has the effect of stabilizing spending and at the same time greatly reducing the demands made on the participants in the budget process.

Third, grant agencies the discretion to deviate from the amounts prescribed for each object-of-expenditure and account class, so long as they do not exceed the programmatic top-lines included in the continuing resolution. This is necessary if agencies are to explore, experiment, and learn. They should subsequently be required to show they have, thereby, increased stability, capacity, or throughput. At a minimum this means measuring those results (it may also mean systematically rewarding the leaders who realize the best results, although we are not en-

tirely convinced that that is the case – in the short-run, effort and understanding are probably more important than results).

Fourth, require only major new initiatives to be authorized by legislation. Rather than incorporated into a comprehensive annual process, these should be treated like supplemental appropriations, each debated when the issue is ripe for consideration and individually authorized. The main difference between what we propose here and the typical supplemental authorization is that commitments should be expressed in present-value terms over the initiative's prospective life, not merely in terms of its initial annual cash outflow.

Fifth, there should be increased emphasis on capacity building and learning. That implies far greater accountability in terms of efforts and accomplishments. It also implies a much faster evaluation cycle. At a minimum, that means reporting results on a more frequent basis: monthly or, perhaps, quarterly at the outset.

Sixth, learning further requires continuous dialogue and debate among the participants in the service delivery process. Mechanisms must be put in place to assure open discussion and debate, including applied training, a commitment to eliminating fear/mistrust – fear and mistrust are inimical to learning, and a commitment to helping participants see the aspirational purposes of the governmental enterprise and better appreciate their role in achieving those purposes overall.

### Zusammenfassung

Lernen ist der einzig sichere Weg, um stetige Verbesserung zu erreichen. Lernen und Budgetierung sind grundlegend orthogonale Prozesse. Budgetierung stabilisiert und fördert die Effizienz, was an sich eine gute Sache ist, sie behindert aber die Leistungsmessung. Lernen erfordert Störungen und Messung. Angesichts der Prozesse, durch die Dienstleistungen und operative Exzellenz realisiert werden, ist es unwahrscheinlich, dass die Budgetierung, wie sie allgemein in der Regierung ausgeübt wird, eine bessere Leistung fördern kann.

**Schlagworte:** Haushaltspläne, Budgetierung, Performance-Messung, Performance Management, Ziele, Jährlichkeitsprinzip, Transparenz

### Résumé

L'apprentissage est le seul moyen sûr de parvenir à une amélioration continue de la performance. Le processus de budgétisation et de l'apprentissage sont essentiellement orthogonale. Budgétisation stabilise, ce qui est une bonne chose, et favorise efficacité, mais il décourage la mesure des résultats. L'apprentissage demande des perturbations et de la mesure. Il est peu probable que la budgétisation, comme elle est habituellement pratiquée au sein du gouvernement, peut favoriser l'amélioration continue de la performance des entreprises publiques.

**Mots-Clé:** Budget, la mesure de la performance, la gestion du rendement, les cibles, annualité, transparence

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