

**Budget Rules and Flexibility in the Public Sector:**

**Towards a Taxonomy**

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**Abstract:** The practices and norms of public budgeting have often been seen as a brake on the flexibility needed of government organisations. This remains true despite historically significant financial management reforms designed around budgetary devolution. Seeing flexibility as operating along two dimensions – devolution and discretion – this paper revisits the underlying features of traditional public budgeting to develop a taxonomy of six generic ‘budget rules’. By isolating key properties of budget control, the paper uses two of the more prominent rules – annuality and purpose – to illustrate how the rules interact to generate control capacity, as well as the scope for rule variability in promoting increased flexibility.

**Keywords:** public sector budgeting, control, flexibility, collaboration, public sector reform

*Every criticism of traditional budgeting is undoubtedly correct . . . Why, then, has traditional budgeting lasted so long? Because it has the virtue of its defects . . . it is simpler, easier, more controllable, more flexible than modern alternatives . . . (Wildavsky 1978, p.508).*

## INTRODUCTION

In the field of public management today more ‘flexibility’ is usually regarded as a desirable feature in the design of public institutions, a necessary antidote to the assumed ‘inflexibility’ that in the popular consciousness is synonymous with government. This is particularly the case in policy environments characterised by highly complex problems and increasing political and economic turbulence. Enhancing flexibility is seen as a means of enabling organisations in the public sector to more effectively meet their accountability for achieving results.

However, flexibility can also be contrasted in the public sector context with another concept of enduring significance: ‘consistency’. Its guiding value is the most common form of fairness – the equitable treatment of citizens – typically manifested in a focus on procedural fairness. This has been sustained historically through a cultural orientation to ‘rule following’, but more fundamentally also rests on constitutional foundations about the accountability of governments. Because they prescribe and enforce rules as to the allocation, transfer and spending of public money, budget systems are perhaps the key means of operationalising this accountability.

Against this backdrop, budget processes in government are inevitably caught between contending institutional imperatives for responsiveness and consistency, such that the practices and norms of public budgeting are often seen as a brake on organisational flexibility. These types of claims tend to discount over thirty years of public sector budget modernisation fervently prosecuted in the name of managerial and resource ‘devolution’, the so-called ‘new public financial management’ (Olson et al., 1998; see also Schick, 2013). In this paper, therefore, we revisit the traditional model of public budgeting and financial management – which emphasises control of and accountability for financial inputs – so as to better understand why its practices and cultural orientation remain so prevalent in government. Our aim is to identify which features of public budgeting can be made more ‘flexible’ in order to better balance the central oversight need for standardisation and the local situational need for flexibility. To do this, we develop a taxonomy of ‘general rules’ of budget control that can assist in mapping how the traditional model operates and assessing the prospects for expanding flexibility through the notion of rule variability.

The paper proceeds in four steps. First, we briefly survey the centrality of budgeting to organisational control, and compare and contrast approaches to budgeting in the public and private sectors. Second, we outline how budget practices are said to inhibit flexibility in the public sector by focussing on the ways in which collaboration between organisations can be impeded. Third, we explore the concept of ‘flexibility’ in more detail and seek to define it as operating along two dimensions of devolution and discretion. Fourth, we develop a taxonomy to characterise the generic ‘budget rules’ that define operations in the public sector, and seek to explain how they operate through key properties of control. We focus our analysis on two of the most prominent rules, the ‘annuality’ and ‘purpose’ of spending. We demonstrate how these rules have been internalised by relevant institutional actors and how, in the face of

historically significant efforts to modernise budget processes, the rules continue to exert strong influence on budgetary behaviour. Our focus here is on government in Westminster-type parliamentary systems, but we believe the taxonomy has broader application and relevance.

## **AN ‘ORGANISATIONAL IMPERATIVE’: APPROACHES TO ANALYSING BUDGETING**

It is almost self-evident that in both public and private organisations budgeting is one of the primary functions that enables planning and control. As both an output and a process, ‘the budget’ is directed at reconciling expenditures with a constrained resource set. Whilst in both contexts budgeting is easily portrayed as a technical question about the methods of financial control, it has long been acknowledged to also be a political question that goes to the determination of relative priorities and the way conflict and bargaining influence those decisions (both of which, in the public sector, are structured by the way authority is controlled and accounted for).<sup>i</sup> As a consequence, theories of budgeting, especially in the public sector, tend to focus on describing and explaining budget formulation (the practices and documents of budget decision processes, or how allocative decisions are made) and budget execution (the systems and techniques of budget implementation, or how allocations are managed and controlled) (see Mitchell and Thurmaier, 2012). The public budgeting literature is of course vast, but for our purposes we can condense this into two broad approaches.

The first of these analyses the *routines* of budgeting and the way they are shaped by, and help to shape, the roles and interactions of institutional actors within government. These

theories are synonymous with the concept of ‘incrementalism’: the way bounded rationality and conflict management narrow budget decisions to small changes to an existing base. Most prominent among them are variations on Aaron Wildavsky’s ‘guardians and spenders’ explanation of how budget routines institutionalise ‘rationing’ and ‘claiming’ roles on the basis of specialisation and shared understandings (Wildavsky, 1979). Over many years this literature has been characterised by seesaw arguments over the extent to which fiscal austerity and regular ‘reform’ of budget procedures has much altered incrementalism as a type of systemic inherency (Rubin, 1990; and Kelly and Wanna, 2001).

The second *economic* approach analyses the social choice consequences of budgetary actors engaging in self-interested behaviour. It is closely associated with public choice theories that emphasise how utility maximising behaviour by politicians, but especially bureaucrats and interest groups, drives budget maximisation and the over-production of public goods; it is commonly joined with new institutional economic prescriptions that see budget maximisation as essentially a specification and monitoring problem of ‘agency’ (Lane, 1995). Whilst very influential in policy terms (Hughes, 2003, pp.10-13), and closely associated with the contract-based reforms underpinning the New Zealand model of public management in the 1980s and 1990s (Boston et al., 1996), the economic approach has just as often been criticised for overplaying the role of self-interest as a motivator, and certainly the extent to which formalised monitoring schemes can align interests and improve the rationality of budgeting remains contested (for example, Anders, 2001; and Robinson, 2000).

Divergent as they are, these two approaches to explaining public budgeting are linked in important ways. They share a focal point that seeks to dispel budgeting in government as a purely technical exercise, and to expose the inherently political nature of resource allocation

and its management. And in doing so, both perspectives are in fact commentaries on the way that budget routines and corresponding roles are situated within a broader – and, some might say, monolithic – institutional framework of government accountability. In the political systems we use as the focal point for our analysis – Westminster-type parliamentary systems such as the United Kingdom and Australia – constitutional arrangements ensure that the principle of annual appropriation is not only the foundation for the accountability of executive government but is also, through ‘confidence and supply’, the very basis for government formation (Rhodes et al., 2009). Since the late seventeenth century, these systems evolved to give parliament supreme constitutional power to authorise the funds available to government and the purposes for which they can be spent. The key mechanism of parliamentary control was a cash-based system of government accounting that operated alongside consolidated ‘fund’ accounts (Funnell et al., 2012). The central place of the annual Budget has meant that government accountability has traditionally operated through the *control locus* of ministerial departments and a *performance focus* on legal compliance and financial inputs.

The role of politics is not, however, confined to budgeting in the public sector. An instructive exercise is to briefly compare these norms and practices with conventional budget practice in the private sector. Much is made of the differences in context – most obviously the discipline of market competition and the relative clarity of profit as a yardstick – and the wellspring of innovation that this is said to represent for both organisational structure and managerial practice (Dittenhofer, 2001). But, by and large, budgeting in the private sector continues to be influenced by two defining models: traditional management control systems and responsibility budgeting (Otley, 1999; and Jones and Thompson, 2000). The former rests on a ‘command and control’ orientation that attaches annually determined targets to

functional responsibilities; the latter is a common form of 'remote control' budgeting by a strategic apex in still prevalent multi-divisional organisational structures.

Rather like their public budgeting equivalents, both forms of corporate budgeting are essentially hierarchical, and neither of them is immune from accusations of being a drag on organisational performance. Indeed, recent approaches to budget reform in the private sector have converged on some version of the 'performance trap', or the way annual fixed budget targets distort managers' abilities to respond flexibly to changing circumstances (see, for example, Hope and Fraser, 2000; Otley, 2006; and Frow et al., 2010). The different strands of this literature also point to the most important modes of solution, some of which are quite conventional and correspond with the modernisation agenda pursued in government – like transferring budget decision-making authority to operating managers – and others which are decidedly more radical – such as replacing predetermined budget targets with continuously updated performance standards (the notion of 'relative performance contracts'). This suggests that even though in the private sector budget targets remain an 'organisational imperative' for cost control and financial performance, they are also readily acknowledged to blunt the incentives for and scope of managerial agility (Otley 1999).

### **BUDGETING AS AN INHIBITOR OF FLEXIBILITY**

Budget rules are usually seen as 'hard' factors in the management of organisations: they derive their force from the simple fact that they govern the administration of the key resource for implementing government priorities: money. To the extent that budgeting does entail the application of rules – which we take to be authoritative statements of what may or may not be done – it can be seen as inhibiting flexibility. These inhibiting effects may be intended or

unintended, and can operate either directly or on and through intermediate factors, and can be illustrated through the example of collaborative working.

‘Collaboration’ – or what is also known as ‘networked governance’ – is where one or more government agencies deliberate and work together with other government agencies, private firms or non-profits on a particular set of tasks. Typically it involves the participating parties sharing the decision-making, or the actual work, or both (Alford and O’Flynn, 2012, pp.5-26). At their most elaborate, collaborations can involve multi-party networks with complex governance arrangements.

Collaboration often requires the devotion of funds to a purpose transcending the organisational units involved. It is quite common for this to entail the contribution by two or more organisations to a common fund, or it may be that organisations retain their own funds but agree to reallocate them to the agreed common purpose (Raine and Watt, 2013; and McDaid, 2012). However, budget rules usually mandate that one entity is the ‘budget holder’ for a particular allocation, which means there needs to be either a high level of trust between the participating entities, or an institutional mechanism to safeguard the over-riding purpose – especially when circumstances change. Either way, these arrangements are likely to entail the reallocation of funds from one organisation to another, or from one program to another within the same organisation. To the extent that budget rules limit the degree to which funds can be thus reallocated, they constrain the basic wherewithal for implementing the purposes of the collaboration. They also complicate the ability of funding parties to contribute their fair share or to honour undertakings, which in turn undermines the trust that is so necessary for the partnership.

Collaboration can also be enhanced by the parties involved being able to reallocate monies from one time period to another. For example, this might be the case where it turns out that only modest spending is required in the start-up year of a project, as the initial groundwork turns out to be less expensive than expected, requiring the bulk of dedicated funding to be allocated over the subsequent operational years; or perhaps in circumstances of urgency or opportunity that might require funding additional to that originally planned being brought forward from later budget years. To the extent that budget rules limit the capacity to move funds across time periods, they hamper multi-year projects. In doing so they can also encourage behaviour that is dysfunctional not only for the organisation but also for the collaboration, such as the rush to spend unspent funds near the end of the financial year.

Third, and to some degree acting in tandem with the previous two points, collaboration can be impeded where the parties to the venture – at the ‘coal-face’ of the partnership – lack autonomy in respect of financial decision-making, and are thereby constrained in the extent to which they can allocate or reallocate monies between organisations, programs or time periods (O’Flynn et al., 2011; and Campbell, 2012). Centralised budget decision-making, as well as rigidly defined budget accountabilities, means that organisational representatives at the front line have to keep going back to their superiors for permission to make a change, which both slows proceedings down and further undermines trust.

## **DEFINING FLEXIBILITY**

According to the *Shorter Oxford Dictionary* (1993), ‘flexibility’ refers to ‘pliancy’ or ‘ability to be bent’; ‘susceptibility of modification or alteration; capacity for ready adaptation’. In the context of public sector budgeting, this is basically a matter of how readily budget

allocations, expenditures and reporting processes can be varied to enable useful responses to non-routine problems. And this in turn is largely a function of how much decision-making authority is *devolved* to those dealing with those problems, in particular, those public servants who are ‘close to the coal-face’ or involved in collaboration with other organisations.

Thus budgeting and financial management systems, with their underlying rationale of control, by their very nature complicate efforts to engage in collaboration. Public sector workers on the spot in non-routine situations – the delegates and boundary spanners (Williams, 2002) – typically have limited capacity to make authoritative decisions about budget allocations and reallocations, which are the preserve of officials at higher levels in government. Thus, flexibility in budget processes should be seen as largely a matter of *devolution* of decision-making authority. It is true that at every stage of those processes, someone in effect has the flexibility to assign and reassign monies to non-routine purposes. The problem is that in most of those stages, that ‘someone’ is far removed from the situation in question, with attenuated information and several layers of management separating them from the issue. A further complicating matter is that the degree of flexibility or devolution may vary across the stages of budgeting.

All of this points to the need for a multi-dimensional definition of flexibility. In Table 1 we posit two dimensions – levels of budget decision-making and budget rule variability – operating across the main stages of budgeting. By the *stages* of budgeting we mean the sequence of steps that characterise the formulation and execution of budgets within government. In a typical Westminster-based parliamentary system this comprises a calendar of legal and administrative processes relating to Budget preparation by the executive and its approval by the parliament, and the three principal implementation elements of budget

execution: management (translating budgets into operational plans), control (spending approval and monitoring) and assessment (reviewing budget compliance and budget program performance). For analytical purposes these processes are somewhat stylised, conceived here as discrete and sequential, when in reality they can overlap or entail feedback loops.

The first dimension is the *level* of budget decision-maker, whose authority is endowed by the law and/or is attached to the office or position they occupy within an organisational hierarchy. In Table 1 we distinguish a number of conventional levels, from high to low in terms of the authority or positional power potentially wielded within the formal processes of budgeting, and we provide no more than an indication of where each level might be routinely expected to exercise influence. It is of course quite conceivable for anyone from program managers to department heads, Ministers and Finance Ministers to have more or less decision-making authority. The greater the number of levels that have budget decision-making authority (which in practice usually means the lower the level of actors to whom power to make decisions is devolved) the more the budget system can be said to be flexible.

The second dimension – which we will call budget *rule variability* – is the range of alternative possibilities for each type of budget rule. We propose to examine the nature and consequences of budget control rules in much more detail (see the next section below), and in Table 1 we set out a range of practices merely to illustrate each budgeting stage. The wider the range of possibilities available to a decision-maker for any given rule, the more flexible we can say that rule is. For example, under ‘budget management’ if managers in all departments are able to reallocate funds only within organisational units or within programs, that would be less flexible than if they could allocate between units or programs.

Table 1

## Levels and Dimensions of Flexibility in Budgeting

Stages of budgeting		Budget Formulation		Budget Execution		
		Budget Preparation	Budget Approval	Budget Management	Budget Control	Performance Assessment
		<ul style="list-style-type: none"> <li>Budget parameters</li> <li>Budget decision process</li> <li>Executive negotiation and decision on allocations</li> </ul>	<ul style="list-style-type: none"> <li>Budget format</li> <li>Legislative review and decision</li> <li>Appropriations</li> </ul>	<ul style="list-style-type: none"> <li>Internal resource allocation</li> <li>Implement service plans</li> <li>Manage finances</li> <li>Adjust activities and allocations</li> </ul>	<ul style="list-style-type: none"> <li>Spending authority and budget compliance</li> <li>Financial reporting</li> <li>Executive or legislative process for adjustments</li> </ul>	<ul style="list-style-type: none"> <li>Performance reporting</li> <li>Periodic evaluations</li> <li>Ad hoc reviews</li> <li>Audit</li> </ul>
Dimensions of variability		<ul style="list-style-type: none"> <li>Multi-year fiscal rules, e.g., borrowing constraints, budget planning, tax measures</li> <li>Annual budget objectives, e.g., surplus or deficit</li> <li>Budget process design, e.g., individual minister / entity basis, integration of program information</li> </ul>	<ul style="list-style-type: none"> <li>Budget presentation and review, e.g., allocating to inputs, programs or outcomes, recurrent vs capital expenditure</li> <li>Money bills &amp; legislative veto</li> <li>Relationship between appropriations and Budget presentation</li> </ul>	<ul style="list-style-type: none"> <li>Budget implementation, e.g., allocating within and between inputs, processes, outputs, programs or outcomes</li> <li>Relationship between appropriations and internal resource allocation</li> </ul>	<ul style="list-style-type: none"> <li>Budget controls as either approval to spend (e.g., drawing rights) or monitoring, (e.g., reporting and variance analysis)</li> <li>Focus on budget compliance vs. program performance</li> <li>Executive or legislative processes for spending or timing adjustments</li> </ul>	<ul style="list-style-type: none"> <li>Focus on budget compliance (time, amount, purpose) vs. program performance</li> <li>Range of regular and ad hoc evaluation and review</li> <li>Integration of non-financial performance information with budget and management processes</li> </ul>
Level of decision-maker	Parliament	■	■		■	
	Prime Minister and / or Finance Minister	■	■		■	■
	Portfolio Minister	■	■		■	■
	Finance Department	■	■	■	■	
	Department Head	■		■	■	■
	Program Manager			■	■	■
	Frontline public servant					

In summary, therefore, flexibility has both ‘vertical’ and ‘horizontal’ dimensions. The vertical dimension concerns how far down the hierarchy decision-making authority is devolved (or how far it is decentralised from central to line agencies): the further down (or further out) this authority is extended, the more flexible the system can be seen as. The horizontal dimension concerns the degree of latitude within the budget rules for varying decisions about purposes, allocations, reallocations, control and performance assessment: the more alternative options there are in each rule for managers to choose from, the more flexible the system. In this way, flexibility can be seen as the *product* of the degree of vertical devolution and horizontal variability. A highly flexible system is one with substantial devolution of decision-making authority to public managers further down the hierarchy, and considerable latitude for them to vary their responses to the rules.

### **BUDGET RULES: ANALYSING BUDGET FLEXIBILITY**

Thus far, our discussion of budgeting has focussed on the underlying rationale of control and the way that defining characteristics of traditional accountability in government can frame budgetary behaviour in certain ways. If Wildavsky (1978, epigraph above) was broadly right about *why* the traditional budget endures – and the premise for this paper is that it *does* – then it ought to be possible to characterise the simplicity of its design as a set of interlocking control mechanisms. In this section we approach this task in two ways. First, we will propose a set of ‘general rules of budget control’ that characterise traditional budgeting in government and, second, we will describe how these rules tend to operate by focussing on the two dimensions of flexibility, introduced above. Such an enterprise is inevitably reductionist, but

we are firmly of the view that a taxonomy of basic budget rules is essential both to describing how flexibility is constrained as well as assessing the prospects for its expansion.<sup>ii</sup>

As we noted earlier, the ‘traditional’ accountability of government in Westminster-type parliamentary systems is effectively equated with *financial control*. At its most basic this comprises the formation of government and its answerability to parliament through the twin conventions of ‘confidence and supply’ and individual ministerial responsibility. And these conventions operate through three standard features of financial control:

1. The chain of accountability (that is, the delegation of authority to spend and the upward answerability of delegates within organisational hierarchies);
2. The concept of fiduciary accountability (that is, the administration of public monies is accounted for primarily, if not exclusively, through regularity and legality); and
3. The financial objective of economy (that is, the control of expenditure is exercised through fixed financial inputs).

More broadly, these traditional controls can also be differentiated by type and purpose (Jones and Thompson, 1986; see generally, Tommasi, 2013). Ex ante controls are applied before spending occurs; they take the form of legal requirements or regulations enforced by budget controllers about what may or may not take place in a budget (for example, approval of payments prior to commitment). Ex post controls, on the other hand, are applied during or after spending occurs; they take the form principally of post-implementation inspection (for instance, through financial reporting and external audit). In government, financial accountability and control has been weighted heavily towards ex ante controls, and a defining trend of budget modernisation under new public financial management has been the shift towards ex post controls, such as performance-based budgeting (Ruffner and Sevilla, 2004).

We argue that budget control within traditional budgeting and financial administration can be synthesised into a small number of ‘general rules’. In Table 2 we identify six discrete rules with the aim of specifying basic properties of budget control. These rules (and their corresponding control properties) are about:

1. Who can spend (accountability);
2. How much can be spent (amount);
3. What it can be spent on (purpose);
4. When it must be spent (time);
5. How spending can be changed (transfers); and
6. How spending is accounted for (information).

The operation of the rules can be explained by the way they limit discretion – or delegated authority – and how they do so in combination with other rules. We argue that the rules are pervasive, in fact so deeply engrained in political and administrative institutions that irrespective of efforts at rule change they are quite simply taken for granted as ways of seeing and doing.

We concede this exercise is artificial – arguably some of the ‘rules’ are indistinguishable – but separating out properties permits us to examine the way they are *designed* to interact, which we contend is equally important in explaining their staying power. The rules have diverse provenance and can therefore take different forms: some are enshrined in constitutional instruments, others in statute law and administrative regulations, and others still operate largely through institutional norms and shared understandings. In addition, whilst their specific application varies between administrative systems, the rules represent common practices that, irrespective of the type of rule change that has marked efforts at modernisation,

appear to have *enduring influence* on financial management and broader administrative behaviour. This is the simplicity of form and function that Wildavsky admires.

**Table 2**  
**General rules of Budget Control**

<b>Rule</b>	<b>Description</b>	<b>Examples</b>	<b>Impact on Discretion</b>
<b>1. Accountability</b>	Who can spend	<ul style="list-style-type: none"> <li>Parliamentary appropriations to departments or Ministers</li> <li>Legislation sets out financial accountability of departmental head</li> <li>Departmental delegations specify staff positions authorised to spend</li> </ul>	<ul style="list-style-type: none"> <li>Political accountability rests with Minister</li> <li>Departmental head has legal responsibility for departmental appropriation</li> <li>Spending authority matched to seniority rather than proximity to program</li> </ul>
<b>2. Amount</b>	How much can be spent	<ul style="list-style-type: none"> <li>Parliamentary appropriations specify total amounts for expenditure</li> <li>Program structures specify budget allocation amounts</li> <li>Departmental delegations nominate upper limits on authority to spend</li> </ul>	<ul style="list-style-type: none"> <li>Program structure is explanatory and amounts can be changed (but see 6)</li> <li>Program structures may not correspond with management structures</li> <li>Spending authority may not correspond with program allocations</li> </ul>
<b>3. Purpose</b>	What it can be spent on	<ul style="list-style-type: none"> <li>Parliamentary appropriation specifies a purpose</li> <li>Program structures categorise budget allocations on the basis of objectives, inputs, activities, or outputs</li> <li>Departmental delegations nominate operational areas of responsibility in which spending can be incurred</li> </ul>	<ul style="list-style-type: none"> <li>Program structure is defined by departments and can be changed</li> <li>Program structures may not correspond with management structures</li> <li>Spending authority may not correspond with program management</li> </ul>
<b>4. Time</b>	When it must be spent	<ul style="list-style-type: none"> <li>Parliamentary appropriations authorise spending for a discrete time period, usually one financial year (annuality)</li> </ul>	<ul style="list-style-type: none"> <li>Prevailing emphasis on managing spend to annual limit</li> <li>Restricts ability to bring planned expenditure forward or to carryover unused expenditure to subsequent years</li> </ul>
<b>5. Transfers</b>	How spending can be changed	<ul style="list-style-type: none"> <li>Most amounts cannot be reallocated between categories of appropriations, e.g., between purposes or between departments (virement)</li> <li>Some amounts do not lapse at year end and are available to be spent in subsequent years, e.g., departmental operating costs</li> </ul>	<ul style="list-style-type: none"> <li>Restricts ability to reallocate amounts between purposes and between departments without central agency or parliamentary approval</li> <li>Ability to carryover unused operating costs but restricted by central approval processes</li> </ul>
<b>6. Information</b>	How spending is accounted for	<ul style="list-style-type: none"> <li>Monthly financial reporting to monitor the use of cash and to track the budget against</li> </ul>	<ul style="list-style-type: none"> <li>Prevailing emphasis on managing spend to annual limit</li> </ul>

		revised current year estimates <ul style="list-style-type: none"> <li>Annual reporting of previous years' financial results and comparison of actual versus planned non-financial performance set out in Budget statements</li> </ul>	<ul style="list-style-type: none"> <li>Budget performance is reported and assessed on a year-to-year basis</li> <li>In-year reporting focus is on financial rather than non-financial performance</li> </ul>
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Take for instance the accountability rule governing 'who can spend'. It clearly corresponds with the basic need to identify 'budget holders' for accountability purposes, in this case either a political budget holder (such as through an appropriation to a Minister) or a managerial budget holder (usually the statutory financial administration obligations of a departmental head or equivalent). It is, of course, axiomatic in bureaucracy, public or private, that authority to spend must in turn be delegated to prescribed staffing positions – usually matched to seniority rather than proximity to where and what the funds are budgeted for – and that the 'who can spend' rule operates in close combination with other rules relating to amount, purpose and transfers (for a classic treatment, see Foldes, 1955). In the context of the accountability rule, therefore, there are two defining issues with which budget modernisation has been preoccupied: first, the way an apex 'budget holder' must ultimately be accountable for expenditure control and, second, the deadening effects of highly prescriptive budget delegation and how best to match budget responsibility with spending authority. Similar analysis can be conducted for each of the remaining rules set out in Table 2. However, in the interests of brevity, we will confine our consideration to two rules that have highly prominent status in defining financial control in the public sector: when funds must be spent (the timeframe of spending) and what funds can be spent on (the purpose of spending).

The first of these aligns with the *principle of annuality* which, as periodic authorisation to tax and spend, is the central concept of parliamentary control of the executive. Virtually all

governments in the world have annual budget cycles, which has quite profound and well-known impacts on financial management. In essence, annuality requires budget allocations to be spent during a discrete time period, usually a financial year. There is a tallying of spending against the budget – application of the ‘how much can be spent’ (amount) rule – and both underspending and overspending have consequences. The former means any remaining funds are lost to the budget holder, which can lead to expenditure surge (the annual phenomenon of departments desperately trying to spend money in the last month or two of the financial year) (Forster, 1990). The latter is usually seen as a more serious matter, and can attract penalties for the individual budget holder or the organisational unit. In fact, the ‘time’ rule has been characterised as perhaps *the* source of inflexibility in public budgeting because it embodies a type of ‘double-bind’: annuality creates demands on a budget holder *simultaneously* to avoid overspending (at the risk of illegality) and underspending (at the risk of losing unused funding from a budget). The more strictly annuality is enforced, the more likely management behaviour is aligned to compliance with fixed budgets.

It comes as no surprise then that the annuality factor of the ‘time’ rule has been the chief target of budget modernisation strategies. At its height in the 1980s and 1990s, the new public financial management not only encouraged a relaxation of budget control rules but in particular placed a premium on expanding the time horizon for financial management to enable greater funding certainty and managerial freedom (Olson et al., 1998). This is perhaps best illustrated by the coupling of multiyear planning frameworks for the annual budget cycle with a loosening of the annuality restrictions on some budget authorisations, normally operating expenses.<sup>iii</sup> The key discretionary changes, illustrated by the pioneering ‘running costs’ system implemented by the Australian Department of Finance in the 1980s and early 1990s (Keating and Holmes, 1990), included the ability to carry forward unspent balances

from one year to the next, more latitude in determining the timing or allotment of funds, and greater optionality to retain within the organisational unit some or all of any savings made. The expectation, of course, was that this type of rule change would not only increase flexibility and rationality – something that proponents argued could ultimately be measured by declines in year-end expenditure surge – but also relieve some of the ‘double-bind’ attitudinal pressure that annuality imposes on budget managers.

Curiously, for a rule change of such magnitude, the relaxation of annuality in budget control has seldom been investigated.<sup>iv</sup> However, the evidence that is available suggests that year-end flexibility has had marginal impact on the influence of the ‘time’ rule. An illustrative example is the introduction of carry forward rules for unspent balances as part of the implementation of resource (accrual) accounting reforms in the United Kingdom central government (Hyndman et al., 2007). In this case, whilst Treasury and line departments came to an understanding on the operation of carryovers at the sectoral level, the new arrangements were *not* replicated for lower level budget holders *within* departments. Not only did officials working within departments tend to accept the need for annuality, they were generally highly supportive of it, with departmental financial controllers in particular acknowledging that annuality helped to manage ‘risks’ relating to over- and under-spending. Those risks were more often than not political: departmental officials felt pressure to *avoid* carryovers rather than have their minister explain a ‘surplus’. In other words, the ‘time’ rule remained timeless: ‘annuality still dominates front-line managers’ thinking and actions . . . good intention has run up against cultural, institutional and political barriers that appear to accept (and, in some cases, value) the structures of tight annual controls’ (Hyndman et al., 2007, pp.234-5).

A second rule of budget control that has defining status is *purpose*, or what it is that funds can be spent on. Like periodicity, highly prescriptive purposes for spending has been an indispensable component of parliamentary control of the executive. This has operated principally through two mechanisms. The first, and most heavily criticised, is the traditional form of line-item expenditure budgeting in which legislative purpose corresponds with the inputs to administration – salaries, material and equipment – usually on an organisational basis. Purpose, in other words, was simply input to activity. The second, related device was that line-item budget authorisations often operated at the highest legal level – appropriations – requiring laborious parliamentary approval to amend items or to transfer funding between lines. Taken together, these control mechanisms are almost indistinguishable from the transfer rule (how spending can be changed) or what in the financial literature is more commonly referred to as ‘virement’.

Modernisation of the purpose rule has an even longer lineage than the new public financial management driven changes to annuality, in substance dating back to the ‘programming planning budgeting’ (PBB) systems pioneered by the US Department of Defense in the early 1960s (see Schick, 1966). We now take for granted that government budgets are organised as some variation of a program structure where appropriations are categorised either as activities supporting a common objective, as discrete outputs, or even with regard to the outcomes that an organisation plans to achieve. Put another way, purpose is reconfigured in relation to *objectives* and what is produced. The advantages of such a program budget are well-rehearsed: programs clarify the objectives of government activity, provide clearer specification of the outputs produced, and aggregate line item expenditure on the basis of total program cost. Such characteristics are intended to permit decision-makers to compare qualitatively different activities and, importantly for our discussion, give program managers

greater latitude in the choice of inputs to deliver program outputs. In sum, the wider the program scope, and the more aggregated the budget line authorisation, the more flexibility program managers have in modifying purposes and transferring funds between them.

This transformation of the purpose rule is emblematic of the shift from *ex ante* to *ex post* budget control under new public financial management. The budget ‘program’ is widely regarded as the central organising concept that links budgeting and operational management within a contemporary performance management control system, such that the program is the level at which a manager is given *both* increased budget authority and flexibility (Robinson 2007). A good example is the complex ‘output’ architecture used in the New Zealand state sector reforms of the 1980s: through detailed specification of the goods and services to be purchased by government, these reforms aimed to decentralise budgetary control through contract-based performance accountabilities (Boston et al., 1996). However, this particular property of budget control is also afflicted by a number of internal contradictions, which are themselves a product of the interaction between the purpose rule and the ‘transfer’ rule that restricts movement of funds between appropriations. Three such contradictions come readily to hand.

The first of these is that any program structure creates standardised budget categories (‘boxes’ for money) that are potentially as artificial and restrictive as any expenditure classification based on line items, functions or organisations. The inclination for both departments and program managers is therefore to define programs in highly aggregated terms. A second, related problem is that the institutional settings of accountability mean parliament and executive have very different strategic interests in the way the transfer rule operates, so that the appropriate level of *disaggregation* for program structures emerges as

the key mechanism for regulating managerial flexibility (Bourdeaux, 2008).<sup>v</sup> Since program definition is far from an exact science – a program can be specified along any number of product or organisational lines – this is, as we have seen, as much a political question as a technical issue. Third, the malleability of program specification tends to undermine its claim to increase executive control through standardisation. The program ‘concept’, which is dependent on increasingly detailed activity description at sub-program levels, can also be understood as a bureaucratic technology that enables program managers to institutionalise and defend sectional interests through ‘rational’ means (Olson, 1990). On this interpretation, the ‘certainty’ of budget program structures is little more than a veneer for legitimising contending organisational ideologies.

### **BUDGET RULE VARIABILITY: WHAT HIGH FLEXIBILITY MIGHT LOOK LIKE**

Both the ‘time’ and ‘purpose’ rules emphasise how traditional public financial accountability works through distinct control properties. Whilst they are certainly only representative of the ‘general rules’ we have proposed, their analysis helps to explain how such rules have been designed to limit different aspects of budgetary discretion and to operate in combination with other rules to be mutually reinforcing. In particular, the time and purpose rules point to the prevalence and continuing influence of the general rules in contemporary budget and administrative practice.

However, we have also proposed that within government organisations, flexibility can be conceived as operating along two dimensions: a vertical aspect corresponding to the devolution, and a horizontal aspect gauged by the discretion that decision-makers have to

vary rules. Acknowledging that the general budget rules appear to be firmly embedded in administrative attitudes and practice, we now ask what *scope* there may be for rule variability as a source of flexibility. In other words, what would high flexibility look like for each rule, how does this compare with the low flexibility of traditional budgeting, and what are some of the implications for rule modification? It is important to note that in this exercise the concepts of ‘low’ or ‘high’ flexibility should not necessarily be seen in normative terms but rather as constructs in support of analysis.

**Table 3**  
**Rule Variability and Flexibility**

<b>Rule</b>	<b>Description</b>	<b>Low Flexibility</b>	<b>High Flexibility</b>
<b>1. Accountability (Individual)</b>	Accountability for budget authority resides with an individual (the ‘accountable officer’)	<ul style="list-style-type: none"> <li>• A single individual is ultimately accountable for the use of budget authority, i.e., Minister or Departmental Head</li> <li>• Often one-to-one relationship with an organisation (interaction with Rule 4)</li> </ul>	<ul style="list-style-type: none"> <li>• Budget authority relates to a broadly defined purpose (or outcome) so that accountable officers may have multiple accountabilities for different purposes and across different organisations</li> <li>• One-to-many relationship with organisations</li> </ul>
<b>2. Delegated Authority</b>	Delegation of budget authority within an organisation is defined by strict limits	<ul style="list-style-type: none"> <li>• Budget authority is delegated according to the principle of hierarchy (seniority level and functional authority within an organisation) and defined by strict spending limits (interaction with Rules 3 and 5)</li> </ul>	<ul style="list-style-type: none"> <li>• Budget authority is delegated according to the principle of subsidiarity (lowest level of organisation best able to make decision) and defined by situationally determined spending limits</li> </ul>
<b>3. Time and Amount Limits (Annuality)</b>	Budget authority is granted for a discrete time period (financial year) and places strict limits on the amount and purpose of spending	<ul style="list-style-type: none"> <li>• Budget authority is limited to one year (or less)</li> <li>• Unused allocations must be returned to the centre and overspending is sanctioned (interaction with Rules 4 and 5)</li> <li>• Spending must correspond with closely defined legislative purposes</li> </ul>	<ul style="list-style-type: none"> <li>• Budget authority does not lapse, i.e., corresponds with a multi-year period</li> <li>• Budget allocations are retained and continuously adjusted over the multi-year period</li> <li>• Legislated purposes defined in highly aggregated terms</li> </ul>
<b>4. Purpose (Budget Categories)</b>	Budget authority is classified and controlled in terms of defined categories of expenditure, including	<ul style="list-style-type: none"> <li>• Budget authority is attached to a single organisation (and corresponding accountable officer) (interaction with Rule 1)</li> </ul>	<ul style="list-style-type: none"> <li>• Budget authority is attached to a broadly defined purpose (or outcome) and not a single organisation</li> <li>• Legislative purpose and budget planning</li> </ul>

	combinations of organisation, inputs, functions or programs	<ul style="list-style-type: none"> <li>Legislative purpose corresponds with highly detailed line items (inputs and/or functions)</li> </ul>	corresponds with highly aggregated line items (programs or outcomes)
<b>5. Transfer Limits (Virement)</b>	Budget authority places strict limits on transferring funds between budget categories and/or organisations during budget execution	<ul style="list-style-type: none"> <li>The reallocation of funds between organisations, or between detailed line items (inputs, functions or programs), is either prohibited or requires ex ante central executive and/or legislative approval (interaction with Rules 3 and 4)</li> </ul>	<ul style="list-style-type: none"> <li>The reallocation of funds between organisations, or between highly aggregated line items (programs or outcomes), is a process of continuous adjustment determined at the most appropriate organisational level</li> </ul>
<b>6. Information Requirements</b>	Budget authority specifies performance standards and reporting requirements to enable central oversight during budget execution	<ul style="list-style-type: none"> <li>Performance standards are defined in narrow financial terms, i.e., strict compliance with detailed expenditure line items</li> <li>Reporting requirements are general, frequent, detailed and subject to sanction</li> </ul>	<ul style="list-style-type: none"> <li>Performance standards are defined in broad terms that integrate financial and non-financial, i.e., use of funds to achieve outcomes</li> <li>Reporting requirements are situational (frequency and content variable) and designed to inform dialogue</li> </ul>

In Table 3 we set out a spectrum analysis of budget rule variability by describing situations that might characterise low and high flexibility. To do this we have modified the general rules in two ways: first, to more clearly take account of the vertical dimension of flexibility, we have created an analytically separate rule category of ‘delegated authority’ that distinguishes delegation from individual apex accountability; second, to provide a more comprehensive consideration of time period flexibility we have combined the time and amount rule categories. So as not to duplicate too much of the previous analysis of the general rules, we will focus on the conditions characterising ‘high flexibility’.

As we have noted, *individual accountability* for the execution of budget authority has traditionally resided with an office holder, such as a minister or department head, and is sometimes referred to in relevant legislation as the ‘accountable authority’ or the more specific ‘accounting officer’. In low flexibility terms, hierarchic accountability dictates that a single – apex – individual is ultimately accountable for the use of budget authority that is usually attached to a single organisation. In contrast, high flexibility for this rule category

might see budget authority attach to the achievement of a broadly defined purpose – or outcome – rather than an organisational authorisation. In this case, accountable officers would have *multiple budget accountabilities* for different purposes that could conceivably range across more than one organisation. There is, in other words, a one-to-many budget accountability relationship with organisations.

We also know that such budget authority is almost everywhere delegated according to the principle of hierarchy, or the level of seniority and functional authority within an organisational setting. This *delegated authority* is often prescribed by strict spending limits that are defined with regard to time, amount and allowable fund movement (rules 3 and 5 in Table 3). In a high flexibility scenario, budget authority is not removed altogether from hierarchy but is delegated according to the principle of *subsidiarity*, or the lowest level of an organisation that is best able to make a decision. This is not an organisational design revelation, after all, program structures were in principle designed to more closely match budget authority with program responsibility. But since programs – broadly defined – can themselves be a source of rigidity, subsidiarity in this context calls for something different. In this set-up there could be a role for more *situationally determined* spending limits. These could conceivably decentralise decision rights to take account of different ‘domains’ of discretion, and the way objectives, managerial seniority, functional responsibility and service delivery proximity intersect (see Caza, 2012).

*Annuality* of course needs little reintroduction. The high flexibility situation is one where budget authority corresponds with a multi-year period. Again, this is not particularly novel: multi-year planning horizons for budgeting are a staple of modernisation strategies, although in the main, experience with these has been weighted towards indicative rather than binding

expenditure limits which mean ultimately that there is little certainty in funding allocations at either the aggregate or program levels (Harris et al., 2013, pp.143-5). But in a high flexibility budgeting world, funding certainty would permit allocations to be retained and continuously adjusted over the multi-year period; the trade-off, which legislatures tend to weigh up very carefully, would be the corresponding need for legislated purposes to be defined in highly aggregated terms.<sup>vi</sup>

The purpose of spending, what we have also called *budget categories*, refers to the way budget authority is classified and controlled by defined categories of expenditure including various combinations of organisational, input-based, functional or programmatic criteria. Often budget authority is attached to a single organisation – and hence an accountable officer – and in a low flexibility context legislative purpose corresponds with highly detailed line items between which the movement of funds is proscribed during budget execution (what we have referred to as *transfer limits*). As we have seen, the level of disaggregation associated with budget categories is the focal point for both legislative oversight and executive flexibility: the more highly aggregated budget classifications are, the less control a parliament has and the more flexibility public managers hold to reallocate funds between budget categories and/or organisations. For budget categories in a high flexibility setting, therefore, authority is attached to a broadly defined purpose or outcome, highly aggregated line items (ideally a single line) and a virement regime that is effectively a process of continuous adjustment determined at the most appropriate level in relevant organisations. As now, ‘program’ allocations might be either intra-organisational or multi-organisational; moreover, such allocations could be *in any one of a range of available budget categories that are apposite to the type of service*. For instance, whereas spending on employment programs might be most usefully oriented to outcomes (such as numbers of clients in jobs for more than

three months) this would be more difficult to apply to services for psychiatric patients, where outcomes (for example, numbers of clients with improved psychiatric health) are harder to define, operationalise and observe, and where it might be more manageable to pay for inputs such as person-days of specialist experts.

Finally, budget execution in both low and high flexibility environments requires *information* to permit governments to ascertain whether its purposes are being met and with what degree of efficiency, effectiveness, equity or whatever other value it sees as important. To this end budget authority specifies performance standards and reporting requirements. In a low flexibility world, performance standards are defined with regard to financial regularity, essentially strict compliance with expenditure line items. In this context, reporting requirements are universal, frequent, highly detailed, and non-compliance is subject to sanction. In a situation of high flexibility, performance standards are defined in comprehensive terms that integrate financial and non-financial criteria, that is, how well funds have been used to achieve measurable outcomes. Under these arrangements, reporting requirements are contingency-based, meaning the frequency and content of reporting is customised to organisational and programmatic circumstances, and designed less with sanction in mind than rewarding functional behaviour and encouraging program improvement. It should come as no surprise that this orientation is usually accompanied by an evaluation culture that places value on periodic review processes.

All of this points to a characterisation of high flexibility budgeting as fewer rules, expanded discretion and lower level decision-making, which of course critics would also characterise as a world of profligacy, unaccountability and, potentially, corruption. This may suggest that fewer rules is not necessarily the answer to the question of how budgeting and

financial management practices ‘embed’ rigidity in administrative practice. Instead, an alternative perspective on budget flexibility may be to reshape the type of rules and the way they are applied, rather than move almost instinctively towards fewer rules. Such an approach would give more attention to the ‘organisational effectiveness’ of budget rules, with the aim of better balancing technical feasibility with their acceptance by regulators and regulatees (as proposed, for instance, in the notion of ‘green tape’: see DeHart-Davi, 2009).

## **CONCLUSION: BUDGET RULES AND FLEXIBILITY**

This paper has explored the role budgeting plays in operationalising the balance between central oversight for consistency and the situational need for flexibility in government. The context was the growing need for government to develop greater capacity for collaboration, and claims that the practices of public budgeting are a key constraint on the ability of individuals and organisations to exercise ‘flexibility’. We considered flexibility as operating along the two dimensions of devolution (the delegation of decision making authority within a hierarchy) and discretion (the latitude within the rules that decision makers have to vary decisions).

To address claims of budget ‘inflexibility’, the paper contends that there are underlying features of public budgeting that have, over many years, remained remarkably resistant to reform efforts. As a consequence, we sought to re-examine the traditional model of public budgeting which emphasised control of and accountability for financial inputs. The objective was to characterise its key practices and cultural orientation, and to better understand why these practices and norms remain so prevalent in government. To do this we developed a taxonomy of six generic ‘budget rules’. The rules are stylistic, and are intended as a heuristic

device to help isolate key properties of control and to analyse the ways in which the rules interact to generate control capacity. Using two of the most prominent rules – annuality and purpose – we demonstrated how these rules continue to exert strong influence on budgetary behaviour.

Finally, we used the taxonomy to apply our two dimensional definition of flexibility and explore the scope for rule variability as a source of budget flexibility. High flexibility was characterised by budget authority:

- Attached to a broadly defined purpose rather than an organisational authorisation;
- Delegated according to the principle of subsidiarity;
- Oriented towards a process of continuous budget adjustment across multi-year periods;
- Able to be defined across a range of organisational and programmatic budget categories as appropriate to different types of services and delivery modes; and
- Accompanied by contingency-based information requirements where the frequency and content of reporting is customised to organisational and programmatic circumstances.

Whilst this characterisation seemed to point to fewer rules – a conventional decentralisation response – we suggested that the balance between control and flexibility may lie more in the type of rules and the way they are applied. A basic taxonomy of budget rules might be one way of starting that dialogue.

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## NOTES

<sup>i</sup> The classic formulation of the key budgeting question in government is that coined by its namesake, V.O. Key, 'On what basis shall it be decided to allocate x dollars to activity A instead of B?' (Key, 1940, p.1138).

<sup>ii</sup> We are not aware of this type of basic rule taxonomy having been developed specifically in the context of public budgeting. Having said this, similar intentions inform some analyses of budget behaviour, including efforts to classify the incentive effects of budget controls for 'strategic misrepresentation' (Jones and Euske, 1991). As we will see, some of these controls – such as budget constraints, program information asymmetry, detailed and rigid legislative oversight, temporal constraints, and excessive external audit of inputs – have broad equivalents in the taxonomy we propose.

<sup>iii</sup> Having said this, it is important to recognise that even large components of operating expenses within the public sector are in effect *non-discretionary*. These variously include, for instance, eligibility-based statutory entitlements and staffing costs (it is not uncommon for labour costs to account for three-quarters of operating expenses and the related human capital is often not 'fungible').

<sup>iv</sup> This may be due to the increasing adoption of accrual accounting for budget management in the public sector, which de-emphasises the timing of cash transactions and, in theory at least, obviates the need for carryovers (Lienert and Ljungman, 2009).

<sup>v</sup> Whilst Bourdeaux surveys these issues in the context of the United States separation-of-powers system, the broader observations on the interaction between transfer rules and program definition have no less prescience in Westminster-type parliamentary systems. For a more targeted critique of volatility in the way executive government defines and structures programs and outputs in a Westminster system, see Carlin (2006).

<sup>vi</sup> Budgeting as continuous adjustment – where approved spending limits are a starting point for 'rebudgeting' during the reporting period – is certainly not unknown in government but is strongly associated with incrementalism and informality. For these reasons rebudgeting is often equated with 'repetitive budgeting' (Wildavsky, 1986, pp.17-20), which is seen as a governance indicator of high levels of uncertainty and low levels of budget control.

## RUNNING HEADS;

DI FRANCESCO AND ALFORD

## BUDGET RULES AND FLEXIBILITY IN THE PUBLIC SECTOR