

THE CONSEQUENCES OF CONTROL OVER BUDGETARY SLACK AND MANAGERIAL ORIENTATION IN PROMOTING BUDGETING HARMONIZATION

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Abstract: *The purpose of this study was to analyze the effect of control over budgetary slack and managerial time orientation in budgeting in order to encourage the budget harmonization on local government in the province of South Sulawesi. This research method is quantitative by using Structural Equation Model (SEM-PLS) with Partial Least Square (PLS) as an analytical tool. Samples chosen in this study is an area that has good performance (high budget absorption) and areas that are performing poorly (has a low budget absorption). Respondents in this study were middle managers in local government.*

The findings of this study indicate that local government staff in each unit felt that the tight budget controls cause them to perform budgetary slack. This is in line with the principal-agent theory on public sector organizations that agents behavior is never in line with principal's expectations for there is no compensation to make it perfect. In addition, the local government staff felt that the tight budgetary control carried out by the local government does not have a connection with short-term oriented budget activity.

Keywords: budget control, budgetary slack, dysfunctional behavior, performance

INTRODUCTION

Literature in public choice has been observing on various forms of inefficiency in public sector organizations, and one of the important observations made by Migue and Belanger (1974) and Niskanen (1975). Preliminary studies conducted by them at government organizations within the framework of principal-agent relationship, based on the study it appears that there is an attempt to maximize the difference between total of received revenue and the real service cost, so that this condition results in organizational inefficiencies (or known as budgetary slack). The inefficiency of the public sector is associated with unproductive activities from government organizations such as personal interests according to Williamson (1964), low effort (Wyckoff, 1990), excessive risk aversion (Peltzman, 1973), and corruption (review more in-depth view Wintrobe, 1997). Later on, there are several theories to analyzed the relationship between the efficiency of the bureaucracy with elements of the institutional and political environment (Falch, 2001).

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Bureaucratic efficiency heavily depends on the form of the organization control which oversees the budget. Therefore, a control system that compactible with the organization's environment is needed. That is, an error in applying a form of control will lead to bureaucratic inefficiency. Merchant (1985a) stated that the overall philosophy of the company control can be seen in some macro construction and one of these constructs is the level of stringency in the budgetary control system. In various studies, strict control does not have a consistent definition and operationalization, and this has been a problem in theory for many years (Simons, 1995: 161). This condition has become the talk of academic discourse relating to the identification of the components that make up the system of a strict controls and their impact (Chow *et al.*, 1996).

Meanwhile, from the observations of management on control system, Anthony explained that a strict control system is one of the tool to evaluate the performance of a manager, especially in its ability to achieve the budget aims in each reporting period (Anthony and Govindarajan, 1998: 436-437). In other words, strict controls in Anthony terms was depending on the nature of the budgeting process, such as emphasizing on the amount of budget that must be achieved, the amount of detail the budget review, and others. However, Merchant (1985b) found that strict controls have limitations with regard to the degree of individual freedom they controlled, but Anthony had a different view because of strict controls do not always involve detailed control over the monthly budget and performance reviews on a regular basis. Furthermore, other construction related to strict controls have been introduced in the literature, such as diagnostic control (Simons, 1995) and administrative controls (Merchant, 1981). Although this construction may have some elements in common, although few, they have been used in reference to each other.

In addition, some authors define or describe the tight control by elaborating their components (Anthony and Govindarajan, 1998), or how the budget can be achieved (Merchant, 1985b), while others conclude a tight control system from the result (Merchant, 1985a, 1990), In connection with the results of strict control, for example, Merchant consider control system (budget or other) as more stringent if it has a greater effect on decision-making (Merchant, 1985a, 1990), or if it giving a high degree of certainty that employees act in accordance with organization desires (Merchant, 1998).

The purpose of this study was to adjust and measure the components (micro attributes) on a tight budget control (macro constructs), which can then be used in management accounting research in the future. First of all in this study, the researchers identified five tight budgetary controls related to micro-attribute from Van der Stede (2001) and use the survey items for each of the attributes that have been developed in the public sector organizations by Johansson and Siverbo (2014). The five micro-those attributes are: (a) emphasis on the budget achievement; (B)

provision budget revision in one year; (C) the amount of the budgetary control in detail; (D) tolerance for interim budget deviations; and (e) the intensity of budget-related communications. Furthermore, we analyzed confirmatory factor data collected from the 90 service units of 3 observation districts, which is the level directly under the leadership / management area, then, we examine empirically how well the survey items represent those micro attributes, and in turn, the tight budget control macro-construct will be observed.

Furthermore, Merchant (1985b, 1998) defines a strict quality control system widely as one of the tools that provide a high degree of certainty, that the employee act in accordance with the organization desire. According to Merchant (1985b, 1998), tightening of the control system can be done by: (1) defining the purpose. Tightening of control means defines the goal of becoming a more complete, more specific, and / or at the same direction with the organization's goals; (2) communication the purpose. Tightening of control means changing the communication models so the employees will have a better understanding and acceptance of the organization's objectives. Including a more effective, timely, frequent, and convincing communication; (3) monitoring. Tightening of control involves controlling the actions and / or results that more often, in more detail, and / or more timely. Furthermore, the last tightening control system is (4) Award. Tightening control means increasing the value of rewards to employees who are evaluated, and the definition becomes a tight relationship between remuneration and performance.

THEORETICAL BACKGROUND

In general, the control procedure of organization's activities can be traced through the management leadership style, although this leadership model gradually underwent a change to a more enlightened and democratic form, which is a different leadership style according to nineteenth-century predecessors. But it is still questionable whether, in general, the control procedure also changes in accordance with the leadership style of more participatory management?

Based on this area Rensis Likert distinguish four models of management leadership. The first system, the authoritative of exploits type using fear and threats, downward communications, there was a great distance between superiors and subordinates psychologically and almost all decisions are taken at the top of the pyramid organization. The second system, which is more subtle authoritative style in which management uses rewards to encourage performance, flow upward communication is limited to information that wants to be heard by the supervisor. This model is subject to superiors and most of the decisions taken by the leadership, while the delegation on the policy making only a small fraction.

Furthermore, the third system is consultative type, where management used rewards, the communication is two-way although the upward communication

was more cautious and limited. Communication takes place in accordance with the information that the leader want to hear, the involvement of several employees and subordinates in a moderate level of policy, but in general the policy decisions are on the top leaders of the organization. The fourth system is a participative style that provides economic rewards to fully maximize the group participation. The group participation performed in order to achieve high performance and improve working methods. Communication flows downward and upward accurately among co-workers and managers; subordinates and superiors psychologically close and organization-wide decision making is done through a process of group interaction.

Based on that style of leadership, we analyze the model of leadership in government organizations in Indonesia more specifically, which further illustrate the control model applied. In general, the definition of control is to compare actual performance against standards of performance and take corrective action if necessary. The main elements of the budgetary control is a system that is a benchmark for comparison. Performance planning is defined as a target to be achieved by management and used as a basis for motivating managers on its accomplishment.

The ground theory in this study is the theory of principal - agent. This theory was developed in the beginning, simultaneously but separately, both in economics and political science. The development of agency theory in political science is not as fast as in economics. In economics, the initial originator of this theory is Stephen Ross in 1973, known as the economic theory of agency, and in political science put forward by Barry M. Mitnick 1973, where the basic concept is similar to both of these approaches is the principal problem and agent. Indeed, both approaches can be seen as complementary to each other but the use of the concept are under different assumptions.

In short, Ross introduced the study of the agency within the frame of the compensation contract issues, in which the agency are regarded from the light of incentive problems. While Mitnick see it from the side of institutions that form their agents, was involved with the affairs of their agent, and respond imperfections agency relationship in terms of behavior. This is due to the behavior of agents who were never in line with expectations of their principal for the is no compensation to make it perfect (Mitnick, 1973). In connection with the principal-agent relationship problems, Williamson (1975) introduced a working relationship with transaction costs model. The viewpoint in this model is based on the exchange and not in the control model. While on the other hand, Mitnick (1973) conclude that the existence of cost of control are more primary. He suggested that the theory of control is the center of an agency relationship - not just the exchange theory alone - that's where the concept can provide new insights for public institutions in general. Therefore, this study uses both approaches so that an overview and

understanding of agent behavior in public sector organizations (ie. government) can be obtained in a holistic manner.

BUDGET CONTROL MODEL AND ITS CONSEQUENCES

A strict budgetary control operationalized and measured based on the reflection of the second order constructs developed by Van der Stede (2001). Van der Stede develop this construct with synthesizing previous literature in order to conceptualize the tight budgetary controls in a more perfect and complete way. Concepts and constructs related to control of tight budgets earlier, such as the evaluation of leadership style (Hopwood, 1972), feedback (Hirst and Lowy, 1990), emphasis budget (Dunk, 1993), and the linkage with the remuneration (Merchant, 1985), criticized as a discussion that had a narrow scope because they only explain the sections of the tight budgetary control constructs (Van der Stede, 2001). Initially Van der Stede (2001: 124) proposed a second order construct consisting of five elements based on the literature. Van der Stede identify the elements of control following a strict budget or for short, a tight budget control exists when the management does: (1) put a lot of emphasis on budget performance; (2) do not easily accept the revised budget in one year; (3) have an interest in the details of the budget item; (4) does not easily tolerate interim deviations of budget target; and, (5) intensively involved in budget-related communications. After the operationalization of these elements as a measurement instrument (questionnaire) the first and second constructs were analyzed in order to establish the reliability and validity, Van der Stede found that only four of the above elements reflects uniformly tight budgetary control. According to Van der Stede (2001), an element of a revised budget for the current year do not reflect a tight budget control. Accordingly, this element is excluded / ignored from the concept of strict budgetary controls. In some studies, they replicate elements of the construct that has been built by Van der Stede for strict budgetary control and adopt the proposed 20 item questionnaire (although Van der Stede noted that only 13 items that are valid psychometricly according to the situation).

There are two kinds of budgetary control model, namely strict budgetary control and flexible budgetary control (Van der Stede, 2001). This study will discuss more of the tight budgetary control model, because the model provides the consequences of dysfunctional behavior of individuals to control, and the impact on the organization as a whole.

The creation of slack as a means of protection from the potential failure to achieve the budget in the future is very often carried out by managers. This situation, especially when taken in organizations using the budget as a commitment for the managers of the institutions, and using the budget as a tool to evaluate their performance. Indeed, strict budgetary control implies that resources and career prospects are increasingly dependent on the ability to meet the budget. Therefore,

there is a positive relationship between the fulfillment of the budget (tight budgetary control model) with the tendency of managers to build slack. Slack increase the chances of “playing the numbers” when budgeting, avoiding further top level management intervention, and reduces the risk of loss of resources in the future (Taylor, 2009). As we all know that there is a possibility if the budget is not absorbed, then in the future the amount of the budget will be minimized. But on the other hand, there is no authority that selects all the budget proposals that could lead to budget cuts, so it’s likely not all of the budget proposal is approved. This has become one cause of budgetary slack.

Several studies in the management literature of private organizations documented on how the control based accounting focus can encourage bad management practice, where they will maximize short-term gains at the expense of long-term effectiveness (Lavery, 1996; and Merchant, 1990). The pressure on management to show a good performance today (short term) will make the manager have no innovation and development of the long term programs (Jaeger and Baliga, 1985), stifling creativity (Miller, 1986), and weakens the commitment to innovate (Hitt *et al.*, 1996). In short, if the budget control at the manager unit is too rigid, and the organization has too little wisdom, then it will impact management orientation. In this case, management tends to pay less attention to the long term things that may not be achieved, as reported by Merchant (1990).

The above discussion shows that the tight budgetary controls can reduce budgetary slack, as empirical evidence in Dunk (1993) study and Merchant (1985b). In addition, strict budgetary control could also encourage managers to be short-term result oriented (Lavery, 1996; and Merchant, 1990). This raises the following hypotheses:

H1: Tight budget control affect budgetary slack

H2: Tight budget control affect the short-term orientation of managerial

Based on the H1 above, the expected results of the budgetary slack relationship with managerial short-term orientation is negative. This allegation is in line with research conducted by Merchant (1985b), who said that the slack gives managers the opportunity to face the uncertainties through flexible resources of short-term commitments. Thus, making the budgetary slack on resources allows managers to experiment more safely, for example, the introduction of a new program and other innovative projects that unformed (Nohria and Gulati, 1996).

More direct evidence for a negative relationship between budgetary slack and managerial short-term orientation is given by Merchant and Manzoni (1989). They found that the manager did slack in the budget to reduce the urge for the work unit managers to be involved on other dysfunctional behavior. Based on the explanation above, the hypothesis is;

H3: budgetary slack have an influence on managerial short-term orientation.

THE IMPACT OF COMPETITIVE STRATEGY IN ORGANIZATION

Management accounting literature generally argued that private organizations competition in the market – namely competitive strategy – influence the design of management control system (Langfield-Smith, 1997). Similarly happens in public organizations (particularly the government), competitive strategy is done to achieved good performance (Kettl, 2000 in Shah 2007). Furthermore, organizational theory states that some slack should be made to encourage the success of the strategy, requires a high degree of flexibility in responding to changes in the sustainability of organizational environment (Bourgeois, 1981). Therefore, competitive strategy is expected to be the antecedent of budgetary control model, and the creation or need for budgetary slack.

This type of strategy to deal with competition that is often used in research management control is the idea of Porter (1980) which is a low cost vs. differentiation and idea of Miles and Snow (1978), namely defender vs prospector (Van der Stede, 2000). While the idea of public organization proposed by Kettl (2000) in terms of “make the managers manage vs let the managers manage”. Strategy model “make the managers manage” was used by the local government of New Zealand, while “let the managers manage” model was applied to Australia and Sweden government. Furthermore, competitive strategy variables that will be used in this study is the incorporation of the three concept ideas mentioned above.

According to Porter (1980), the key to successful implementation of the strategy is the ability to identify that different competitive strategies require different organizational settings. Management control is one of the important organizational arrangements. The focus of this study is on accounting-based budget control, which is an integral part of management control system (Merchant, 1998).

Additionally, the creation of a very limited slack on cost leader/defender strategy because of strategy suppression lies precisely in costs cutting, standardization of services and service coverage. As generally known, contradictory phenomenon occurs in strategy differentiation/prospector who face a very high level of uncertainty in the future, thus creating a high slack. Under these circumstances, the hypothesis can be derived as follows:

H4: Competitive strategies affect tight budget control

H5: Competitive strategies affect budgetary slack

BUDGET CONTROL RELATION WITH PERFORMANCE

Relation between budget control and performance has been a debate in the literature of management control (Merchant and Simons, 1986). Moreover, it is unclear as to what extent dysfunctionality occurs on the budgetary control or how it compromise the performance (Nohria and Gulati, 1996).

This study uses performance as an independent variable to see its relation with budget control, due to the application of certain control systems are a response to the high or low of past performance (Otley, 1978 and Merchant, 1985a). For example, an organization that has a good past performance will have less influence toward tight budgetary control. This means that these organizations can better enjoy the flexibility of their expenditure (Merchant, 1985a).

The same thing was also expressed by organization theorists, that budgetary slack is the dependent variable (Bourgeois, 1981) and past performance is one of the antecedents of budgetary slack (Onsi, 1973). Their empirical evidence shows that good performance improves budgetary slack and poor performance will lower it.

In addition, Merchant and Manzoni (1989) found that managers who have shown good performance in a given time period can enjoy most of the budgetary slack. They found that a good performance is something urgent, because if the performance is not achieved, it can be used as an excuse for the higher ups to reduce budgetary slack, or in other words to tighten budget control. Good performance is urgently needed, even though such actions came from short-term management orientation that may have adverse long-term strategy (eg, cutting development expenditure). Overall, their study can prove that there is an inverse relationship between budgetary slack and pressure on managers to short-term oriented. Another finding of the study is the tolerance on budgetary slack in good condition and damping of budgetary slack when the conditions are bad.

Furthermore, they also concluded that to achieve an expected good conditions, the management can perform any action, they are even allowed to encourage short-term oriented action where such decision may be detrimental. Therefore, in this case, there is a trade-off between budgetary slack and past performance, as stated by Simons (1987), if budgetary slack managed to be reduced then this condition can improve performance, or at least the "short-term performance". This raises the following hypothesis:

H6: past work unit performance affect tight budget control.

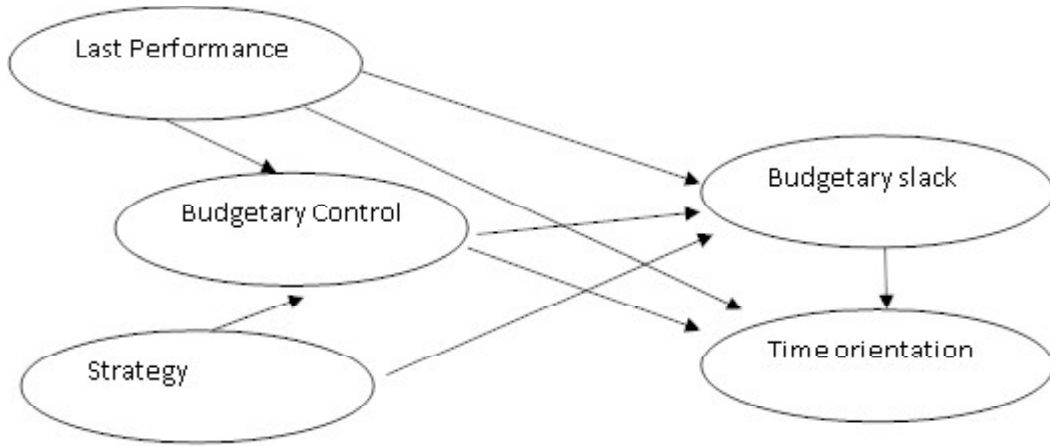
H7: past work unit performance affect budgetary slack.

H8: past work unit performance affect managerial short-term orientation

Based on the hypothesis that has been built, the research model can be described as follows,

The equation model for testing the hypothesis:

- (a) Analysis of the determinants of the budgetary control to test the hypothesis (H4 and H6) by the following equation,



Picture 1: Research Model

$$Y_1 = \gamma_1 X_1 + \gamma_2 X_2 + e_1$$

- b. Analysis of the determinants of budgetary slack to test the hypothesis (H1, H5, and H7) by the following equation,

$$Y_2 = \beta_1 Y_1 + \gamma_3 X_1 + \gamma_4 X_2 + e_2$$

- c. Analysis of the determinants of management orientation to test the hypothesis (H2, H3 and H8) by the following equation,

$$Y_3 = \beta_2 Y_1 + \beta_3 Y_2 + \gamma_5 X_1 + e_3$$

Notes: X_1 = last performance; X_2 = strategy; Y_1 = budgetary control; Y_2 = budgetary slack; Y_3 = time orientation; $\beta_1.. \beta_n$ = coefficient of endogenous variables influence the endogenous variable; $\gamma_1.. \gamma_n$ = coefficient of influence of exogenous variables on endogenous variables; $e_1..e_n$ = model error

DISCUSSION

Hypothesis testing

This study has 8 hypotheses were tested using path analysis. This path analysis is an extension of regression analysis for causal relationships between variables predetermined by the theory. Hypothesis 1 in this study aimed to examine the effect of the budgetary control toward budgetary slack and hypothesis 2 is to test the effect of the budgetary control toward managerial orientation. Hypothesis 3 in this research examines the budgetary slack on managerial time orientation.

Meanwhile, hypothesis 4 test the competitive strategies toward budget control and hypothesis 5 in this study test the competitive strategy toward budgetary slack. Furthermore, hypothesis 6 aims to test performance toward budget control,

while hypothesis 7 aims to test performance toward budgetary slack, and finally, hypothesis 8 aims to test performance toward managerial orientation.

According to Hair *et al.* in Jogiyanto and Abdillah (2009: 63), path coefficient or inner models indicate a level of significance in hypothesis testing. Path coefficients or inner models scores are indicated by the T-statistics should be above 1.96 for a two-tailed hypothesis and above 1.64 for the one-tailed hypothesis for hypothesis testing at alpha 5 percent and 50 percent power. Structural model in PLS evaluated using R-square for the dependent variable and the value of path coefficients ($\hat{\alpha}$) for the independent variables, which the significance are then assessed based on the T-statistic of each path.

The test results for H1 (see Table 1), which states that budget control affect budgetary slack is supported. These findings indicate that the tight budget controls on local government organizations causes deviant behavior in terms of budget. This is in accordance with Hartmann (2000) as well as Marginson and Ogden (2005) which states that in certain cases, a tight budget control can generate findings that are ineffective and do not motivate. This is in line with principal-agent theory on public sector organizations stated by Mitnick (1973) that the agents' behavior is never in line with principal's expectations because there are no compensations to make it perfect.

Results of testing H2 (see Table 1), which states the budget control affect managerial time orientation is not supported. Meaning, regardless of the presence or absence of tight budget control, this managerial behavior still occurs. This is consistent with the principal-agent theory (Mitnick, 1973) which states that managers tend to do risk aversion, such as to avoid risks that are difficult to achieve. This is in line with Nutt (2005) and Kihn (2011) which states that to avoid the risk of not achieving targeted budget, managers tend to be more short-term oriented and ignore the effectiveness of long-term strategic objectives.

Table 1
Conclusions of Research Hypothesis Testing Results

No	Hypothesis	Original Sample	T-statistic	Information
1	Budget control influence budgetary slack	0,582	11,934	Accepted
2	Budget control effect managerial time orientation	-0,006	0,071	Rejected
3	Budgetary slack influence managerial time orientation	0,147	1,575	Rejected
4	Competitive strategies influence the budget control	0,224	4,521	Accepted
5	Competitive strategies influence budgetary slack	0,032	0,582	Rejected
6	Past performance influence budget control	0,572	8,670	Accepted
7	Past performance influence budgetary slack	0,241	4,613	Accepted
8	Past performance influence managerial time orientation	0,249	3,002	Accepted

Source: Data processed, 2016

H3 test result referring to budgetary slack influence toward managerial time orientation is not supported. These findings suggest that dysfunctional budgetary slack behavior does not control the other dysfunctional behaviors such as managers' budget time orientation. This is consistent with the principal-agent theory which says that the agency is self-interest in which to avoid the risks they create budgetary slack simultaneously with the orientation of the short-term budget (Lukka, 1988).

H4 test results that stated competitive strategies affect budget control is accepted. These findings suggest that in order to achieve high competitive strategies, it requires tight budget control. Mitnick (1973) argued that in public institutions, control is the center of an agency relationship and not just a mere exchange theory.

H5 test results regarding competitive strategies affect on budgetary slack is not supported. These findings indicate that the strategy innovation at government organizations do not require budgetary slack as a room to respond toward uncertainty. This is due to the uncertainty faced by government organizations is relatively smaller than private organizations which faces more intense market competition (Langfield-Smith, 1977).

H6 test results regarding past performance affect on budgetary control is supported. These findings suggest that a good past performance is interpreted as successful budget control. Therefore, a good past performance supports tight budget control. This finding is not consistent with Merchant (1985a) who argues that good past performance will encourage principals to loosen control over the budget. As known, the need for the level of confidence and control is equally important to minimize the influence of dysfunctional behavior on budgetary control (Hartmann, 2000; Van der Stede, 2000). In this regard, local governments organization faces political and institutions pressure in complying with the budget, in a way that even though past performance is good, control over the budget remains high (Wildavsky, 2001; Johansson and Siverbo, 2004).

H7 test results in regards of past performance affect on budgetary slack is supported. These findings support the view that a good past performance provides broader flexibility for managers to perform budgetary slack. This is due to them trying to maintain the accomplishments they already achieved. Empirical evidence of this study are consistent with Bourgeois (1981) and Onsi (1973) researches which stated that good performance improves budgetary slack and poor performance lowers it.

H8 test results toward past performance affect on managerial time orientation is accepted. This finding is consistent with Marsoni and Merchant (1989) who argued that in order to achieve the expected performance conditions, managers can perform any action, including dysfunctional behaviors such short-term budget orientation that can harm the organization.

CONCLUSIONS AND RECOMMENDATIONS

This study examined primary data in the form of 326 questionnaires that were distributed to the local government staff at the head of finance and financial staff. The results of SEM (Structural Equation Model) testing using SmartPLS 3.2.3 can be summarized as follows.

Local government staff in each unit felt that the tight budget controls tend to cause them to perform budgetary slack. In addition, good past performance also tend to increase the budgetary slack. On the other hand, budget control has no effect on managerial short-term budget orientation. Similarly, budgetary slack do not influence short-term budget orientation of managers. This is consistent with the principal-agent theory which states that local government staff (agents) is self-interest in a way that they tend to avoid the risks, and that they undertake short-term budgetary orientations. This condition is in accordance with empirical research evidence which shows that in the regional government's past performance is closely associated with short-term budget orientation of manager. Meaning, local government staff acquire good past performance due to during the planning they tend to be more oriented to short-term budget that is easily accessible and scalable with regard to performance.

Other conclusions stated that the competitive strategies and past performance affect the budget control. The higher the competitive strategies is and the better the past performance was, it will also increasing the tight control over budgets by local governments.

Based on the study's limitations, the suggestions can be given for the development of this topic is that a new construct that is more in line with the characteristics of government organizations is necessary. Moreover, further testing in a different context, time and place in government organizations is needed. Additionally, for the development of local government policy, it is needed to develop a control system over the budget that is more effective to prevent the occurrence of budgetary dysfunctional behaviors.

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