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OVERVIEW OF BUDGETARY SLACK GOVERNANCE -- BASED ON THE INFORMAL GOVERNANCE PERSPECTIVE

Jia Bin^{1,2*}, Noorul Azwin Md Nasir¹, Zaminor Zamzamir@Zamzamin¹, Amira Jamil¹

¹ Faculty of Entrepreneurship and Business, Universiti Malaysia Kelantan, Malaysia

Email: a22e011f@siswa.umk.edu.my, azwin@umk.edu.my, zaminor@umk.edu.my, amira@umk.edu.my

² Department of Economics and Management, Bozhou University, Bozhou, China

* Corresponding Author

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Abstract:

The existence of budgetary slack makes it difficult for budget management to play the expected function, and managers put their interests above the interests of the company through the implementation of budgetary slack behaviors, which allocates the company's budget resources unbalanced, increases the agency costs, and ultimately leads to a decline in the quality of the sustainable governance of the company. Scholars have conducted quite a lot of research on how to govern budgetary slack, aiming to find ways to effectively govern budgetary slack. Previous scholars have studied the governance of budgetary slack mainly from the perspective of formal governance, and the results are quite fruitful, but the problem of budgetary slack still exists and is getting worse. Few scholars have studied the governance of budgetary slack from the perspective of informal governance. This article argues that informal governance is a kind of implicit contract based on social relations and emotions, which is more capable of obtaining the unanimous recognition and common compliance of the whole company and may play an unexpected role in the governance of budgetary slack. Therefore, this article will use the literature review method to sort out the studies on informal governance and summarise the informal governance measures for governing budgetary slack, which is expected to provide valuable reference suggestions for company managers and business leaders.

Keywords:

Budgetary Slack, Trust; Culture, Reputation, Joint Sanctions

Introduction

Budget management, as a core element of management control system, is widely used in modern firm management, which is an important management tool for optimising resource allocation, controlling costs, carrying out plans, and enhancing the efficiency of decision-

making (An, Zhao, & Shen, 2018). However, from the results of practical feedback, budget management does not seem to play the expected effect. The reason for this is mainly that the budget opportunistic behavior represented by budgetary slack weakens the control and management functions of budget management (An & Liu, 2022; Dewi, Putrayasa, & Suarjana, 2020).

Scholars at home and abroad have conducted quite a lot of research on budgetary slack and proposed many important measures to govern budgetary slack, such as strengthening information communication (Liu, 2018; Kristianto & Apriliya, 2023), optimising the remuneration incentive system (Li, 2021; Bai & An, 2021; Huang, 2020), strengthening internal oversight and promoting accountability mechanisms (Qiu, 2018; Yu, 2020; Tang, 2020; María Dolores, 2022). However, these governance measures are mainly formal and codified, lacking the recognition and sense of belonging of company members, and are often illusory, making it difficult to play a substantial role. If budgetary slack can be governed by invisible contracts such as trust, company culture, values, reputation and joint sanctions, unexpected results may be achieved. Therefore, this article will sort out the studies on informal governance through the method of literature review, summarise the informal governance measures to govern budgetary slack, and provide valuable reference suggestions for company managers and business leaders.

The Essence Of Budgetary Slack

Definition Of Budgetary Slack

The so-called budgetary slack refers to the phenomenon that the responsible person intentionally overestimates the costs or underestimates the benefits in order to easily achieve the budget goals and get the salary incentives or the promotion of the position, so that there is a discrepancy between the budgeted quantity and the actual quantity (Dunk & Nouri, 1998). Budgetary slack encompasses both revenue slack and cost slack (Bai & An, 2021). From the perspective of organisational and individual behavior, budgetary slack is the result of a game between the manager and the organization, where the organisation aims at profit maximisation and the manager, while pursuing the maximisation goal, must leave enough financial buffer for himself to cope with the loss of personal interest due to uncertainty, even though this may harm the organisational bandwagon (Gao & Guo, 2023).

Causes Of Budgetary Slack

Budgetary slack is a subjective and opportunistic behavior that aims to ensure that private interests are not compromised, and more and more scholars have studied the causes of budgetary slack. Zeng (2019) argues that managers, as rational economic agents, intentionally create budgetary slack in order to obtain excess compensation and increase the level of on-the-job consumption. Budget participation provides conditions for managers to create budgetary slack (Fitriani & Fisher, 2019), and Zhao (2020) argues that principal-agent relationship exacerbates information asymmetry and is the main cause of budgetary slack. In addition, when budget superiors are too harsh and subordinates bear increased pressure, the probability of budgetary slack occurring at this time also increases (Shafer & Wang, 2018).

Consequences Of Budgetary Slack

Proper budgetary slack can cope with unforeseen risks, reduce managerial stress and anxiety (Vanacker, Collewaert, & Zahra, 2017), and mobilise managers (Yi, Sun, & Fu, 2023). However, budgetary slack brings more harm than good. Dewi, Putrayasa, and Suarjana (2020)

argued that the existence of budgetary slack reduces the efficiency of decision-making and the quality of governance in companies and distorts the effectiveness of budget management. Budgetary slack leads to waste of company resources and inefficiency in management (Tong & Prompanyo, 2021). From an accounting point of view, budgetary slack makes profits shift from the organisation to the manager, which harms the company's interests and increases internal costs (Zhao, 2020). Budgetary slack creates the illusion of overshooting targets and hides the true development of the company (Zeng, 2019). Li (2021) argues that budgetary slack can lead to the paradoxical phenomenon of 'whipping the fastest cow' and 'rewarding lying' in companies, and in the long run, the quality of sustainable governance of companies will decline.

The Governance Of Budgetary Slack

The governance of companies has always been at the centre and difficulty of management activities, and it is the number one priority in maintaining and promoting the sustainable development of the company. Governance usually includes formal and informal governance, formal governance is also known as contractual governance, which refers to laws, regulations, systems, contracts and covenants that are consciously established and formalized in the form of documents or in writing (Zhu, Dai, & Zeng, 2013). Informal governance is based on social relationships and trust, it refers to unwritten but unanimously recognized governance mechanisms by the members of an organization, it is an implicit contract, which plays a controlling role for all members and can motivate all members to work together towards the same goal (Gao & Guo, 2023). Although previous studies have focused mainly on formal governance, more and more scholars are noticing the importance of informal governance for internal control and management of companies, emphasizing that informal governance is as important as formal governance, and that the two complement each other and play their respective roles. Informal governance has a "bottom-up" effect that encourages managers to take initiative (Zhao & Ni, 2022), thus reducing managers' opportunistic tendencies and the firm's agency costs (Dong & Chen, 2022) and achieving long-term governance of budgetary slack (An, Zhao, & Shen, 2018; Church, Kuang, & Liu, 2019).

Informal governance accomplishes governance in ways that formal governance cannot by means of bilateral or multilateral interactions, and the effects of its governance are complementary to formal governance (Shi, Zhang, & Gao, 2016). This suggests that, compared with formal governance models, informal governance is better able to promote the continuous participation of actors in governance issues, which in turn leads to consensus and programme iteration through repeated exchanges and continuous learning (Huang, 2024). Peng (2010) argues that informal governance can not only guard against opportunistic behaviors, but also overcome the knowledge sharing dilemma. In addition, Wang (2021) argues that informal governance is conducive to restraining the behavioral motives of organizational members, avoiding the occurrence of moral hazard incidents, and thus promoting the effective operation of the whole organization.

Trust can be used as an informal governance mechanism that can mitigate agency conflicts and has an important role in controlling agency problems such as information asymmetry (Liu, 2021). Lv, Wu, & Zhou (2018) argued that trust and punishment governance mechanisms have an important influence at different stages of knowledge networks. Park and Rogan (2019) found that reputation can significantly moderate the relationship between companies and partners. Informal governance is based on social relations, mainly in the form of trust, reputation, incentives, access restriction, joint sanctions, etc., and it is believed that trust and

communication, among others, play an important role in it (Yu & Xiong, 2021). Table 1 summarizes the results of previous research on informal governance.

Table 1: Summary of Informal Governance

Article Source	Key Views
Gao and Guo (2023); Zhao and Ni (2022); Huang (2024)	Based on social relationships and emotions, it is unanimously recognized by the members of the organization.
Huang (2024); Shi, Zhang, and Gao (2016); Park and Rogan (2019)	It can promote sustained engagement in individual behavior and enhance interactive communication.
Dong and Chen (2022); Wang (2021); Peng (2010); Liu (2021)	Prevent and punish opportunistic behavior and reduce agency costs.

Source: Author's collation

Based on previous research, this article selects trust, reputation, culture, and joint sanctions as the four mechanisms of informal governance to study the relationship between informal governance and budgetary slack. The conceptual framework of this article is shown in Figure 1.

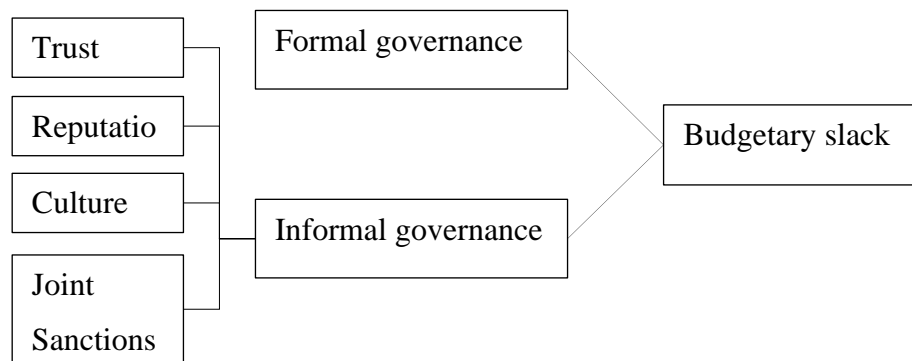


Figure 1: Conceptual Framework

Source: Author's illustration

Informal Governance Mechanisms

Trust Mechanisms

In the company, trust is a demonstration of the willingness of superiors and subordinates to share information, where one party does not take advantage of the other's shortcomings or vulnerabilities to exercise opportunistic behavior for the sake of gain (Middleton, 2015). Trust governance, on the other hand, is a trust process in which both parties cooperate and interact through information sharing to promote goal achievement and efficiency. Many scholars have researched trust governance with fruitful results. Agency theory considers that there is both a cooperative and reciprocal relationship and an antagonistic and preventive relationship between individuals and organizations, and if a trust communication mechanism can be established, it can slow down this agency conflict and antagonistic relationship and balance the interests between individuals and organizations (Wang, 2024). Mou et al. (2020) showed that trust governance is effective at any stage of the company, which can slow down conflict and opportunism and make the goals clearer. Chen, Chen, & Chen (2020) sorted out the three dimensions of trust governance and showed that bilateral relationships are influenced by trust

governance, and when the level of trust declines and there is a ‘crisis of trust’, the bilateral relationship is bound to be implicated. This is because trust is not just a balanced and reciprocal relationship, but it can also lead to willingness to take risks, compromise and even sacrifice. Trust does not come straight away, it takes time to develop and is a learning process that emphasizes the need for participants to be ethical, disciplined and honest. Once a trusting relationship is established, there is less concealment and fraud between individuals and organizations, and transaction and opportunistic costs are significantly reduced (Vahlne & Johanson, 2021). In budgeting, increased trust can enhance the transparency and truthfulness of budgeting, resulting in budgetary goals that are close to the true goals, further improvement in the quality of budget management, and a reduction of budget fraud (Bisogno & Cuadrado-Ballesteros, 2022), in other words, increasing trust can reduce the probability of budgetary slack occurring, therefore, this article argues that the trust mechanism is an important informal governance mechanism, which can alleviate the budgetary slack problem subconsciously and contribute to the sustainable development of the company.

The specific governance process of trust mechanism on budgetary slack is shown in Figure 2. The trust mechanism facilitates information transfer, strengthens information exchange, and reduces fraud and concealment by managers from the firm, thereby alleviating budgetary slack and improving the quality of budget management. The alleviation of budgetary slack in companies indicates that the adoption of trust mechanisms is feasible, a result that in turn reinforces the continued adoption of trust governance mechanisms.

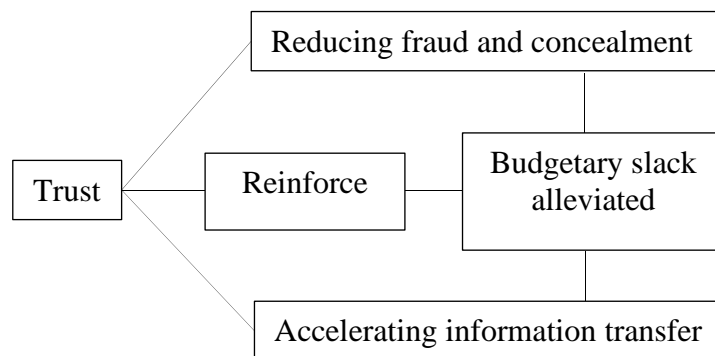


Figure 2: Process of Governance of Budgetary Slack by Trust Mechanisms

Source: Author's illustration

Cultural Mechanisms

Company culture is a firm-specific philosophy of values and shared beliefs that are actively promoted by the company's managers and adhered to by both managers and members of the company. Therefore, corporate culture plays a role in constraining and controlling members' behavior, which ultimately influences the overall behavior of the firm, which is cultural governance (Dong & Zhang, 2022). Cultural governance refers to the use of culture as a soft tool, introducing cultural concepts into company governance, influencing managers' emotions, fostering cohesion, and ultimately transforming them into action, which reflects the catalyst role of the cultural mechanism (Huang, 2023). Bao et al. (2024) confirmed from the perspective of the stakeholder theory that cultural governance enhances the efficiency and performance of companies because the level of culture can improve the managers' professionalism and reduce moral hazard. In addition, cultural governance can effectively reduce the transaction costs of internal and external stakeholders. Setyowati and Prabowo (2024) studied the relationship

between organizational culture and budget through interview methods and observation methods, and the results showed that a good culture creates an efficient working atmosphere, which provides the conditions for managers to allocate budgetary resources and prepare accurate budgets. Cultural mechanisms are an important informal governance tool that acts as a lubricant to reconcile contradictions and reduce friction and conflict, and participants prepare budgets that are more in line with practice cultural values (Jayasinghe et al., 2020). Cultural norms and values may influence fiscal transparency, at the local government level, political culture drives citizens' desire for transparency (Piotrowski & Van Ryzin, 2007)), and higher budget transparency reduces the probability of budget irregularities and thus budgetary slack. Namazi and Rezaei (2024) similarly argue that budgetary slack can significantly influence company performance, but this relationship is influenced by cultural differences. Indudewi et al. (2021), through the use of questionnaires, confirmed that the level of culture inhibits budget distortions of the participants and makes the budget decision-making process more truthful and transparent, and therefore, the Shaping a healthy organizational culture is effective in curbing budgetary slack.

Figure 3 reports on the specific process of governance of budgetary slack by cultural mechanisms. On the one hand, cultural mechanisms act as a lubricant by reducing friction and conflict. On the other hand, they act as a catalyst for staff cohesion, efficiency and budget transparency, which mitigates budgetary slack, and in turn, the mitigation of budgetary slack facilitates the establishment of cultural mechanisms.

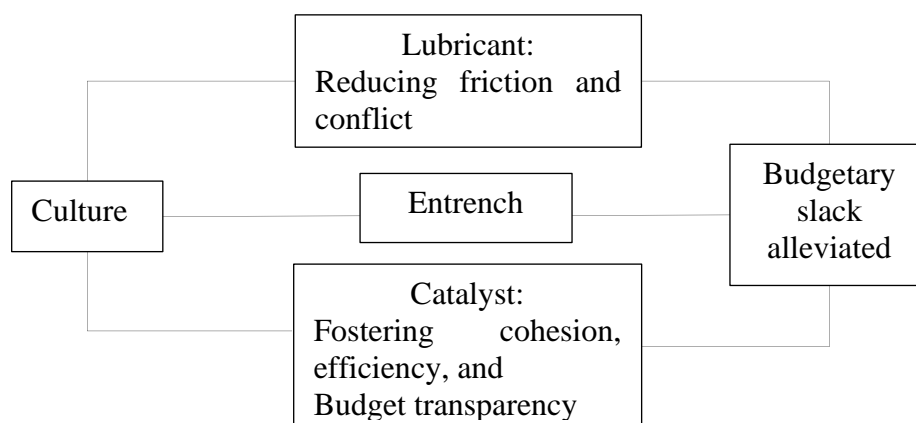


Figure 3: Process of Governance of Budgetary Slack by Culture Mechanisms

Source: Author's illustration

Reputation Mechanism

Reputation includes individual reputation and company reputation, and this article focuses on the influence of individual reputation on budgetary slack. Signaling theory suggests that reputation reflects, to some extent, a manager's competence, performance, and work attitude. Reputation is not derived from self-evaluation; it is an ensemble of comprehensive assessments made by the market over some time based on a manager's work behaviors, attitudes, quality and achievements (Wang, 2017). Reputation, as an informal governance mechanism, and the effective dissemination of its information flow can not only reduce the degree of information asymmetry and lower transaction costs but also provide a guarantee mechanism for the orderly conduct of market economic activities (Xing et al., 2024). Therefore, executive reputation can restrain the short-sightedness and opportunism of executives, in addition to that, executive reputation can reduce adverse selection and moral hazard (Xu, Bai, & Li, 2024). Compared

with incentives such as cash remuneration and equity, executive reputation has the characteristics of long-term, binding, and implicit, which can produce significant corporate governance utility (Xu, Wu, & Wang, 2017). CEO reputation can positively influence the quality of companies' internal control, suggesting that CEOs tend to make decisions in favor of the long-term value of the firm (Zhang & Chi, 2023). However, the rent-seeking effect hypothesis suggests that executives may instead ignore the long-term interests of shareholders or firms to safeguard their own reputations. For example, the higher the level of a CEO's reputation, the more likely they are to engage in short-sighted behavior in their investments (Cao, Yang, & Lin., 2017). Some studies have also found that CEO reputation has a dual effect in the Chinese context, i.e., there is a threshold for CEO reputation, and CEO reputation can only exert a positive governance effect on firm surplus quality after reaching this threshold (Xu, Zhang, & Xu, 2020). Therefore, executive reputation may influence budgetary slack, but the influence is not linear and needs to be combined with other mechanisms to govern budgetary slack.

The specific governance process of the reputational mechanism on budgetary slack is specifically shown in Figure 4. The reputation mechanism is a two-sided knife that can restrain managers' opportunism and reduce their adverse selection and moral hazard. However, the rent-seeking effect hypothesis suggests that some managers will instead ignore the long-term interests of shareholders or the firm and continue to engage in opportunistic behavior in order to safeguard their reputation. These two outcomes promote and inhibit managerial reputation, respectively.

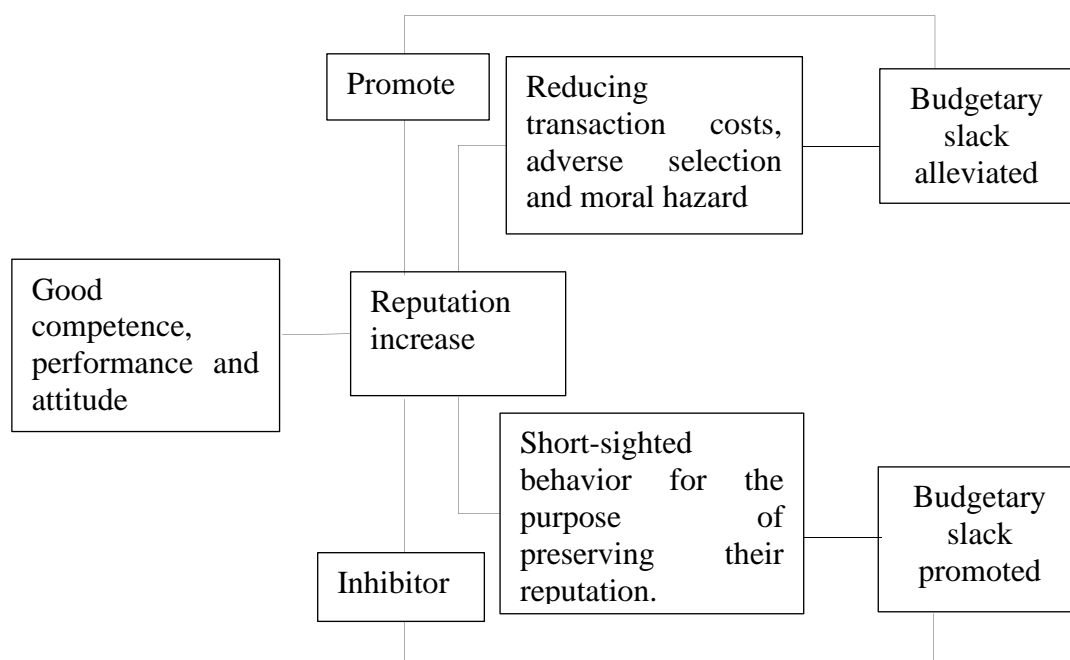


Figure 4: Process of Governance of Budgetary Slack by Reputation Mechanisms

Source: Author's illustration

Joint Sanctions Mechanism

Joint sanctions are an informal governance mechanism that punishes members at the collective level for violating common rules, ranging from discourse to expulsion (short or indefinite) and active sabotage. Joint sanctions are both a punitive measure and a monitoring mechanism that

protects transactions and safeguards exchanges because they have a sanctioning effect not only on those opportunistic members who violate common norms, but also bind all members, thus ensuring good co-operation among members (Li, 2021). Yu, Gu, & Wang (2016) argue that joint sanctioning is very effective in limiting opportunistic behaviors by maintaining good cooperation among members of the innovation network through endogenous selection. Wang, Fang, & Wang (2019) investigated how owners can govern the lazy behavior of contractors on the basis of principal-agent theory. They constructed a constraint model to study the relationship between five factors: the degree of contractors' opportunistic tendency, the level of their behavior, the cost, the level of effort they put in, and the contract price, and showed that owners can join forces to reduce the opportunistic behavior of contractor firms through this constraint model. Cheng (2021) used an evolutionary game to study the path of influence of relational governance on opportunistic behavior, and the results showed that companies in the same industry should join together to govern opportunistic behavior by establishing joint sanctions, for example, constructing a long-term credit system and contract forecasts to curb opportunistic behavior. Joint sanctions form a deterrent and supervisory effect on members, overcoming adverse selection, and members dare not rashly put their personal interests above the long-term interests of the company (Xu & Wang, 2018). The essence of budgetary slack is the opportunistic behavior and adverse selection behavior of the actors, therefore, this article extends the argument that joint sanctions can govern budgetary slack.

The specific governance process of the joint sanctions mechanism for budgetary slack is shown in Figure 5. The ability of the joint sanctions mechanism to punish opportunistic behavior that has occurred and deter opportunistic behavior that has not developed ensures good cooperation between members and reduces budget fraud, such as budgetary slack. The reduction in budgetary slack indicates that the joint sanctions mechanism is effective, which in turn reinforces the joint sanctions mechanism.

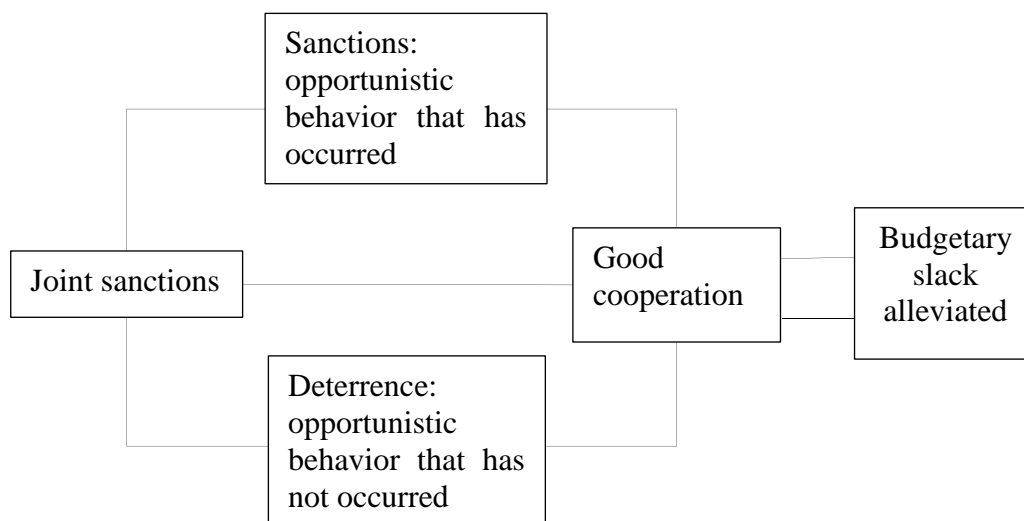


Figure 5: Process of Governance of Budgetary Slack by Joint Sanctions Mechanisms

Source: Author's illustration

Conclusion

Budgetary slack is a kind of ex ante financial fraud that increases agency costs (Huang, 2020), which refers to the behavior of managers in the budgeting stage, in order to enhance their personal interests, to set budget targets more loosely, in order to enhance the probability of budget target completion. However, this opportunistic behavior can harm the company's

interests, reduce the efficiency of the company's budgetary resource allocation and the quality of corporate governance, and in the long run, it will form a bad culture of 'whipping the fastest cow' and 'rewarding lying' (Li, 2021; Dewi, Putrayasa, & Suarjana, 2020). Informal governance mechanisms can mitigate such budgetary slack, specifically, this article argues that budgetary slack can be governed from the perspectives of trust mechanisms, cultural mechanisms, reputational mechanisms, and joint sanctioning mechanisms to mitigate the harm caused by budgetary slack.

Cultivating a relationship of trust between managers and the company, on the one hand, enhances the managers' sense of belonging to the company and stimulates their efforts; on the other hand, managers and the company can share information and establish a deep emotional relationship, and managers will take the initiative to reduce fraudulent and opportunistic behaviors towards the company. The establishment of a sound cultural mechanism and the formation of a good corporate cultural atmosphere can cultivate the self-discipline and ethical behavior of managers. Consistency of cultural values, beliefs and identity across the company ensures consistency of budgetary goals. This cultural mechanism guides the thoughts and actions of managers, regulating and limiting their opportunistic and fraudulent behavior. The establishment of an operational and enforceable reputation evaluation mechanism by the same industry can punish members who violate the rules and deter unformed opportunistic behavior. Members may voluntarily reduce fraud against the company and opportunistic behavior in order to maintain or enhance their personal reputation, but the rent-seeking effect suggests that members, perhaps in a desperate attempt to maintain or enhance their personal reputation, may instead ignore the long-term interests of shareholders or the firm and continue to practise almost-almost-alienistic behavior. Reputation mechanisms are therefore a double-edged sword and there is a tipping point where they should be combined with other informal governance mechanisms to jointly manage budgetary slack. Companies in the same industry should also work together to create a set of joint sanctioning mechanisms. Such mechanisms can penalise members at a collective level for violating common rules, ranging from discourse to expulsion (short or indefinite) and active sabotage. Joint sanctions are both a punitive measure and a monitoring mechanism, protecting transactions and safeguarding exchanges, as they have a sanctioning effect not only on opportunistic members who violate common norms, but also bind all members, thus guaranteeing good cooperation among them.

Contribution and Future study

The research in this article suggests that implicit contracts based on social relations and emotions are more likely to be recognized and adhered to by the whole firm and can play a positive role in managing budgetary slack, which fills the research gap between informal governance and budgetary slack. In addition, this article provides valuable reference suggestions for managers and business leaders who aim to improve the quality of corporate governance.

In this article, the informal governance mechanisms that influence budgetary slack are mainly sorted out from the aspect of literature review, and future research can obtain data through the questionnaire method or simulation experiment method to study how these informal governance mechanisms specifically influence budgetary slack from the perspective of empirical analysis. In addition, it is possible to combine formal and informal governance mechanisms and study the synergistic effects of these mechanisms on budgetary slack governance.

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