

Determinants of Budgetary Slack and Its Impact on Organizational Performance

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ABSTRACT

Budgetary slack is a common phenomenon in corporate budget management, characterized by management intentionally underestimating revenues or overestimating costs during the budgeting process to create a financial cushion. Organizations need to be mindful of the potential negative consequences of excessive budgetary slack, which can undermine financial stability and transparency. This article aims to identify and analyze the key factors influencing budgetary slack and examine its impact on organizational performance. Using a review analysis approach, we investigated the determinants of budgetary slack and its effects on organizational outcomes. The analysis reveals that budgetary slack is influenced by factors at three distinct levels: the organizational level, the environmental level, and the individual level. While moderate budgetary slack can provide flexibility in uncertain environments, excessive slack ultimately impairs organizational performance through resource wastage and reduced managerial effort. Budgetary slack is a relatively complex phenomenon that requires careful management. Organizations must balance the need for operational flexibility with maintaining accountability and transparency. Further research could explore the underlying mechanisms contributing to the detrimental effects of budgetary slack, providing valuable insights for organizations to effectively manage it.

Contribution/Originality: This study contributes to the existing literature by synthesizing research on budgetary slack through a comprehensive three-level framework (organizational, environmental, and individual). This paper's primary contribution is finding that while moderate budgetary slack provides flexibility in uncertain environments, excessive slack ultimately impairs organizational performance through resource wastage.

1. Introduction

The budget serves as a core element in management accounting (Namazi & Rezaei, 2023). It is characterized as a quantitative or financial plan that outlines all organizational activities within a limited period (Haliah, 2021). Budgeting plays a vital role in strategic planning, organizational structuring, and operational assessment, while also shaping employee behavior (Dokulil et al., 2020). When applied correctly, a budget can function as a motivational tool for managers, driving improvements in organizational performance (Ngo et al., 2017). Conversely, improper use may lead to demotivation, adversely affecting performance. Specifically, opportunistic behaviors in budgeting, such as budgetary slack, hinder the budget's effectiveness (Shu et al., 2023).

Budgetary slack, referring to the deliberate underestimation of revenues or overestimation of costs (Church et al., 2019; Dunk & Nouri, 1998), is acknowledged as a critical concern in managerial accounting. Budgeting enables companies to allocate resources in advance and establish performance targets, ensuring the seamless execution of production and business operations. However, because budget goals directly affect managers' compensation, incentives, and career progression, they often exploit their informational advantage during the budgeting process. From a self-interest standpoint, managers may set lower performance targets, generating budgetary slack to more easily achieve positive evaluations and secure rewards by surpassing expectations. Budgetary slack is often regarded as a deliberate act by budget managers who intentionally set targets below optimal levels, reflecting dysfunction in budget management (Shu et al., 2023; Kramer & Hartmann, 2014). The presence of budgetary slack not only hinders communication and information flow between departments but also reduces resource allocation efficiency, increases operational costs, and ultimately impedes profit maximization and business growth (Otalor & Oti, 2017). More critically, excessive budgetary slack can foster dishonest behavior among employees. For example, in many companies, the achievement of budget targets is traditionally linked to employee performance-based compensation. In this context, employees inclined toward budgetary slack tend to set lower, unrealistic targets that are easier to meet, allowing them to secure rewards. Conversely, honest employees who strive for more challenging targets may find it difficult to adequately reflect their true performance, even with greater effort. Jensen (2003) refers to this phenomenon as "paying people to lie", highlighting that such practices undermine trust within the organization and pose a threat to the company's long-term development.

However, some researchers argue that moderate budgetary slack can serve as a protective mechanism, helping companies mitigate unforeseen risks during development and granting management the flexibility to adapt, thereby fostering organizational growth (Ashbaugh-Skaife et al., 2008). Haliah (2021) further emphasizes that the resource buffer provided by budgetary slack alleviates employee psychological stress, enabling them to respond to potential risks with greater ease. Vanacker et al. (2017) suggest that budgetary slack can boost employee morale and reduce potential dysfunctional conflicts among managers and organizational units caused by resource scarcity.

In conclusion, although budgetary slack may play a role in managing uncertainty and achieving budget goals, its long-term effects can weaken an organization's financial stability, transparency, and innovation capacity, ultimately having a negative impact on overall performance. Therefore, organizations should conduct a comprehensive

evaluation of their budgeting processes to ensure they promote accountability, enhance transparency, and stimulate innovation, rather than encouraging budgetary slack.

1.1. Research Objectives

This study aims to identify and analyze the factors influencing budgetary slack from organizational, environmental, and individual perspectives. It explores the relationship between budgetary slack and organizational performance, synthesizing existing literature to provide a comprehensive understanding of the mechanisms through which budgetary slack impacts organizational outcomes. Furthermore, this research seeks to offer practical recommendations for managing budgetary slack more effectively, ensuring a balance between operational flexibility and efficiency.

2. Literature Review

2.1. Discovery and Definition of Budgetary Slack

In an early study, [Cyert and March \(1963\)](#) discovered through survey research that budgetary slack arises from negotiations over budgetary goals among different management levels within a firm. [Williamson \(1963\)](#) highlights that subordinate managers attempt to sway the budget-setting process to secure slack in budgets. Similarly, [Lowe and Shaw \(1968\)](#) provide evidence suggesting that sales forecasts can be manipulated to generate budgetary slack. [Schiff and Lewin \(1970\)](#) observed that when the compensation of individuals responsible for budgets increases as budget difficulty decreases, those individuals may distort information during communication with supervisors through budget participation, setting more achievable targets and resulting in budgetary slack.

The definition of budgetary slack has been a topic of ongoing debate among scholars. [Cyert and March \(1963\)](#) were the first to introduce the concept of "slack." The budget is understood as a negotiation process among organizational members aimed at achieving goal alignment, while slack is defined as the gap between the resources available to the organization and the resources required to sustain it. [Merchant \(1985\)](#) defined budgetary slack as the difference between the total and necessary budgets within a certain range. He argues that when managers can choose their performance evaluation criteria, they intentionally create several resources that exceed actual needs or intentionally underestimate productive capacity. This tendency is particularly evident when supervisors evaluate the performance of their subordinates by the extent to which they meet their budgeted tasks. According to [Lukka \(1988\)](#), the slack budget is a budgetary phenomenon relative to the "honest budget estimate," in which the budget maker intentionally sets the budget value (cost, expenditure, or resource consumption) higher than the "honest budget estimate," thus making it more likely that the budget will be achieved. [Simons \(1988\)](#) defined budgetary slack from the perspective of performance outcomes. He described it as the practice of setting easily attainable budget targets, where employees who might underperform when facing tight budget targets are instead perceived as performing well and rewarded by the organization under conditions of budgetary slack. [Kilfoyle \(2011\)](#) suggested that the root cause of budgetary slack often lies in budget participants' pursuit of personal interest maximization. This is primarily reflected in two areas: revenue slack and cost slack. Specifically, revenue slack refers to the discrepancy between budgeted revenue and actual achievable revenue, while cost slack manifests as the mismatch between the budgeted resources required to achieve

targets and the actual resource needs. Combining the above definitions, budgetary slack is the intentional underestimation of revenue or capacity and overestimation of costs or resources in accomplishing budgetary tasks (Shu et al., 2023; Church et al., 2019; Dunk & Nouri, 1998).

2.2. Theoretical Basis

2.2.1. Agency theory

The agency theory was first proposed by Berle and Means in their 1932 seminal work "The Modern Corporation and Private Property." With the development of the economic and social environment, the increasing size and complexity of enterprises gave rise to the role of professional managers. Enterprise owners (principals) establish agency contracts, delegating actual operational control to enterprise managers (agents). These managers leverage their expertise and full commitment to manage the enterprise. Throughout this process, ownership and control gradually become separated. However, while this separation of ownership and control fosters enterprise growth, it also gives rise to agency problems (Eisenhardt, 1989; Jensen & Meckling, 1976).

Agency theory posits that the interests of principals and agents are not always aligned. In corporate governance, principals strive to maximize their wealth, while agents seek to achieve the highest utility with the least effort. Agents, who hold partial decision-making power, may engage in behaviors that conflict with the objectives of the principals (Mitchell & Meacham, 2011). Moreover, there exists information asymmetry between principals and agents. Agents typically possess more resources and information, and the majority of the resources and information required by principals are provided by agents. This asymmetry can make it difficult for principals to detect actions by agents that may harm their interests (Shapiro, 2005). Enterprise managers can easily exploit this informational advantage to manipulate budgets and interfere with the owners' assessments of the company's future operations, ultimately resulting in budget mismanagement.

Corporate budget management can be viewed as a series of transactional activities between owners and management based on the principal-agent relationship. Through negotiation and consultation, both parties reach a consensus on the budget, establish contracts, and use budget performance as a basis for evaluating managerial performance and determining managerial compensation (Shu et al., 2023). During the budget formulation and execution process, owners, aiming to maximize enterprise value, tend to set challenging budget targets. In contrast, managers, driven by personal interests, are more likely to propose targets that are easier to achieve. Furthermore, managers may use their informational advantage to influence owners' assessments of the company's future operations, which can lead to the creation of budgetary slack.

2.2.2. Contingency Theory

In addition to agency theory, contingency theory is another significant framework scholars use to study budgetary slack. Contingency theory posits that organizations establish slack budgets to reserve sufficient resources to address future uncertainties, providing a critical cushion against internal and external environmental uncertainties (An & Ai, 2022). External factors such as the level of market competition and economic uncertainty influence how organizations design their management control systems,

thereby affecting the degree of budgetary slack. Thus, retaining a certain level of budgetary slack aligned with an organization's strategic objectives can better help it adapt to changes in internal and external environments. For example, organizations pursuing a defensive or cost-leadership strategy typically have a narrower product sales scope and focus on low-cost, standardized, and undifferentiated products in competitive markets. In contrast, organizations adopting an aggressive or differentiation strategy emphasize product uniqueness in the market. Since the latter faces greater uncertainties than the former, they are more likely to establish slack budgets to cope with these uncertainties (Frihatni & Abbas, 2020).

Contingency theory emphasizes that management controls within an organization cannot rely on a fixed model; instead, they must adapt to the internal and external environments in which the organization operates. Specifically, regarding budget management control decisions, contingency theory posits that the effectiveness of budget management control systems depends on their alignment with governance structures, levels of external market competition, and other factors. Therefore, budgetary slack is a product of continuous adjustments in budget management to accommodate an organization's internal and external environments, enabling it to better respond to external uncertainties (An & Ai, 2022).

3. Research Methods

This study employed a review analysis approach to examine the determinants of budgetary slack. To ensure comprehensive coverage and analytical rigor, we employed a structured research process that included multiple stages of analysis and synthesis. The research began with an extensive literature search using major academic databases, including Web of Science, Scopus, Google Scholar, and China National Knowledge Infrastructure. We used various combinations of key terms such as "budgetary slack," "budget slack," "determinants," "factors," and "influences" to identify relevant studies. The search covered all years to capture the evolution of research in this area. To ensure the quality and relevance of the included literature, we applied strict selection criteria. We focused on studies published in peer-reviewed academic journals, particularly those that investigate the determinants of budgetary slack. Additionally, selected studies were required to provide clear empirical evidence or a theoretical framework and include a detailed research methodology and findings.

Our analysis followed multiple interconnected stages. First, we conducted a preliminary screening of titles and abstracts to identify potentially relevant studies. Next, we performed an in-depth review of the selected articles, extracting key findings and identifying emerging patterns in the literature. Through this process, we observed that the factors influencing budgetary slack could be categorized into three distinct levels: organizational (Sanjiwani & Suryanawa, 2020; Dunk & Nouri, 1998), environmental (Frihatni & Abbas, 2020; Dunk & Nouri, 1998), and individual (Agustina et al., 2024; Dunk & Nouri, 1998). To ensure the reliability of our analysis, we evaluated each selected study based on its research methodology, clarity of findings, theoretical foundation, research context, and academic impact. This evaluation process allowed us to identify the most robust and relevant contributions in the literature while strengthening the validity of our conclusions.

4. Influencing Factors of Budgetary Slack

To effectively address the issue of budgetary slack, it is essential to examine the factors that contribute to its occurrence. A clearer understanding of the intrinsic relationship between budgetary slack and its determinants can facilitate the development of more effective strategies for managing and mitigating slack (Haliah, 2021). Existing research generally identifies three primary causes: organizational factors (Sanjiwani & Suryanawa, 2020; Dunk & Nouri, 1998), environmental factors (Frihatni & Abbas, 2020), and individual factors (Agustina et al., 2024; Dunk & Nouri, 1998).

4.1. Organizational level

Organizational-level factors encompass budget-related elements such as information asymmetry, budgetary participation, budgetary emphasis, and organizational commitment. Within the framework of budget management, agency relationships and information imbalances are prevalent. Information asymmetry arises when subordinates (agents) possess critical insights that influence decision-making, creating a knowledge gap between them and their superiors (principals) (Namazi & Rezaei, 2023). Mohanna and Sponem (2020) highlight that in many organizations, subordinates often have access to private information that allows for a more accurate assessment of performance than their superiors. When subordinates conceal or distort this information, budgetary slack inevitably emerges. Moreover, this asymmetry enables those with privileged information to manipulate circumstances, thereby enhancing their perceived performance during evaluations. The issue of information asymmetry becomes even more pronounced when subordinates actively participate in budgeting processes and their compensation is linked to budget outcomes. As a result, slack arising from information imbalances can significantly affect organizational efficiency (Pramudiati et al., 2022).

Budget participation refers to the involvement of subordinates in the budgeting process, reflecting ongoing interactions between superiors and subordinates, with both parties contributing to the final budget. Existing research underscores the crucial role of budget participation in the creation of budgetary slack, identifying it as a key determinant of slack formation (Pramudiati et al., 2022). Schiff and Lewin (1970) argue that allowing subordinates to participate in budgeting may introduce slack, ultimately reducing organizational productivity. Similarly, Nasution (2020) found a significant positive relationship between budget participation and budgetary slack. Furthermore, Kepramareni et al. (2019) observed that information asymmetry amplifies the impact of participatory budgeting on slack creation.

Budget emphasis refers to the practice of evaluating subordinates based on their ability to meet budget targets, where performance assessments directly influence compensation (Ngo et al., 2017). When combined with participatory budgeting, budget emphasis often exacerbates slack formation (Pramudiati et al., 2022). In a study of firms of varying sizes, Onsi (1973) found that when budgets serve as the basis for performance evaluations, managers at all levels tend to introduce slack to secure personal financial benefits. Brownell and McInnes (1986) further suggest that when performance assessments are budget-based, subordinates are more likely to engage in negotiations with higher management, resulting in slack within the final budget. Moreover, Nasution (2020) highlights that budget emphasis moderates the relationship between budget participation and budgetary slack.

Organizational commitment is defined as "*an individual's relative strength of mind to become part of an organization/company*" (Islami & Nahartyo, 2019, p. 154). Employees with strong organizational commitment demonstrate a greater dedication to supporting and contributing to the organization's success, striving to meet its goals. Consequently, organizational commitment plays a significant role in mitigating budgetary slack (Sanjiwani & Suryanawa, 2020). Employees who exhibit higher levels of commitment tend to prioritize organizational interests over personal gain, thereby reducing the likelihood of slack creation. Accordingly, a higher level of organizational commitment among employees correlates with a lower incidence of budgetary slack (Pramudiati et al., 2022).

4.2. Environmental level

Environmental factors primarily refer to environmental uncertainty, which arises when individuals are unable to accurately assess the likelihood of success or failure in decision-making due to the difficulty of predicting future outcomes (Sanjiwani & Suryanawa, 2020). This uncertainty often compels organizations to adjust their strategies and operations in response to external conditions. Key sources of uncertainty include competition, consumer behavior, supplier dynamics, regulatory changes, and government policies (Nasution, 2020). Kren and Liao (1988) argue that organizations often struggle to distinguish between unintentional forecast bias and intentional budgetary slack, making slack nearly inevitable. They suggest that under conditions of environmental uncertainty, organizations should assess the extent of uncertainty to more accurately measure budgetary slack. Kren (2003) further asserts that environmental changes act as external forces contributing to slack creation, with greater external volatility increasing the likelihood of slack formation. Similarly, Yilmaz and Özer (2011) highlight that heightened environmental uncertainty not only weakens the effectiveness of budgetary controls but also increases the tendency of budget participants to introduce slack.

4.3. Individual level

Research at the individual level examines the behavior of budget participants and explores how human actions contribute to the creation of budgetary slack. Onsi (1973), expanding on the concept of budgetary slack, investigated the issue from a behavioral perspective to identify factors influencing its occurrence. He proposed 13 distinct behavioral factors. Collins (1978) analyzed the impact of individual personality traits on budgetary slack, finding that individuals with flexible personalities tend to be open-minded, emphasize relationship-building with colleagues, actively participate in budget management, and strive to achieve budget goals. In contrast, those with rigid personalities are more conservative, prioritize hierarchical relationships, and are more inclined to create budgetary slack.

Personality traits influence individuals' attitudes toward risk, which in turn affects their likelihood of engaging in budgetary slack. Research suggests that risk preference is a critical factor in this process. Young (1985) found that risk-averse individuals are more likely to introduce budgetary slack than risk-seeking individuals. Webb (2002) argued that budget holders take into account the potential impact of slack on their reputation, which in turn influences their decision-making. Similarly, Stevens (2002) suggested that reputation, shaped by moral values, serves as a more stable and significant factor in reducing budgetary slack. Furthermore, a literature review by Agustina et al. (2024)

emphasized that trustworthiness—encompassing integrity, benevolence, and ability—can help mitigate budgetary slack behavior.

5. The Effect of Budgetary Slack on Organizational Performance

Budgetary slack, a commonly occurring but unexpected phenomenon in enterprise budget management, has a significant impact on economic activities. It is frequently regarded as dysfunctional (Shu et al., 2023; Lukka, 1988) and unethical (Pramudiati et al., 2022; Douglas & Wier, 2000) and is therefore considered a factor that should be minimized. The existence of budgetary slack can lead to resource wastage and managerial inefficiencies (Otalor & Oti, 2017). When budget targets are set below actual performance levels, employees may still meet organizational goals and produce satisfactory results without fully utilizing available resources—a practice that organizations should not encourage (Yee, 2014). Excessive budgetary slack may prevent budget executives from realizing their full potential while enabling them to conceal errors, ultimately resulting in inefficient management (Islami & Nahartyo, 2019). Moreover, slack in budgeting distorts resource allocation, leading to inefficiencies and unnecessary costs that negatively impact organizational performance. Otalor and Oti (2017) identified a significant negative correlation between budgetary slack and managerial performance, further reinforcing its detrimental effects on organizational effectiveness.

Conversely, some scholars argue that budgetary slack can provide functional benefits under specific circumstances, contributing to organizational efficiency. An et al. (2020) found that in companies adopting aggressive strategies, moderate budgetary slack serves as a cushion, enabling firms to navigate environmental uncertainty, capitalize on investment opportunities, and accommodate unforeseen future demands. This flexibility not only reduces the pressure imposed by rigid budget targets but may also positively influence company performance. Haliah (2021) further suggests that in uncertain environments, budgetary slack grants management the flexibility to mitigate risk pressures and allocate resources to address organizational challenges, thereby supporting long-term sustainability. Additionally, Ashbaugh-Skaife et al. (2008) emphasize that appropriate budgetary slack can alleviate principal-agent conflicts, enhance managerial motivation, and ultimately improve overall company performance.

6. Conclusion

Budgetary slack can lead to inefficiency in environments characterized by asymmetric information, reducing managerial effort and increasing resource consumption, which ultimately impairs organizational performance (Mohanna & Sponem, 2020). However, some scholars argue that a reasonable level of budgetary slack can help shield companies from unexpected risks during their development, providing managers with the flexibility to respond effectively and facilitating better organizational growth (Ashbaugh-Skaife et al., 2008). From a long-term perspective, budgetary slack inevitably increases costs, wastes key resources, and fosters complacency among managers and employees, all of which are detrimental to a company's sustainable development. Many studies, including those by Otalor and Oti (2017) and Mat et al. (2022), suggest that budgetary slack ultimately undermines organizational transparency, employee morale, managerial efficiency, and overall performance.

Therefore, organizations must carefully evaluate their budgeting processes to ensure they promote accountability, transparency, and innovation rather than incentivizing budgetary slack. Additionally, organizations need to recognize the potential adverse effects of excessive budgetary slack and strive to balance risk management with maintaining organizational performance. Budgetary slack is a complex behavioral phenomenon, and understanding its driving factors is essential for effective control. Future research could explore the underlying mechanisms contributing to the harmful effects of budgetary slack and provide practical recommendations for organizations to manage it more effectively. Moreover, existing studies have primarily focused on budgeting system design and behavioral factors, often neglecting the institutional context's fundamental impact on budget implementation. A promising direction for future research would be examining how organizations can mitigate or eliminate the risk of budgetary slack by considering their institutional frameworks, strategic orientations, and operational practices.

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Not applicable

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Conflict of Interest

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