

Mitigating Budgetary Slack in Local Governments: An Emerging Country Case

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Abstract. This study aims to examine the role of the control system, compensation, and organizational culture in mitigating the propensity to create budgetary slack in local governments moderated by moral reasoning. This study used a survey method, with a sample of 212 respondents who were directly involved in the budget preparation process, from 48 regional work units of Lampung Province, Indonesia. Data were analyzed using Wrap-PLS 7.0. The results showed that the control system, and organizational culture moderated by moral reasoning were able to mitigate the tendency to create budgetary slack in regional work units in Lampung province. The control system is too strict and has rigid procedures, causing a positive relationship between the control system and budgetary slack. However, this relationship can be weakened by the presence of moral reasoning. While compensation can trigger budgetary slack, if compensation is used as the basis for short-term performance appraisal. So an alternative compensation system is needed, for example a compensation system that contains punishment, and clawback provisions.

Keywords: Budgetary Slack, Control System, Compensation, Culture, Local Governments, Emerging Country

1 Introduction

Budget is an important factor in the management control mechanism [1]; [2], so that the management of the organization can allocate resources efficiently to achieve organizational goals. A good budget is a budget that is challenging but not impossible to achieve [3]. An organization's budget serves as a tool for performance evaluation, staff motivation, and resource allocation [4-6]. The study's findings [7] support the idea that the budgeting process, which determines how the budget is created and carried out, influences not only financial performance but also the conduct of those involved.

The propensity of budgeting managers (subordinates) to fabricate their performance capabilities (i.e., to include slack in their budgets) is one of the frequent issues related to the budget-setting process. Budgetary slack behavior can lead to some abuse of the budget as a management control instrument [8] [5]. Budgetary slack is defined as a deliberately created difference between actual and submitted budget estimates [6, 9-12], tends to underestimate

profits and overestimate costs [13] so that budget targets are easily achieved [14]. Indicates performance targets below actual capabilities [15].

In his study comparing slack in public and private sector organizations, T. Busch came to the conclusion that public organizations have more slack than private sector companies. In addition, compared to the private sector, public sector firms have a worse organizational management control system [16].

The Regional Apparatus Performance Unit (SKPD) in Indonesia creates the budget, and its implementation serves as the foundation for assessing the SKPD's performance the following year. Employees can use financial slack in these circumstances to help make the budget a reality (budget absorption). How certain an employee is that they will be in the same role the next year (i.e. at budget realization) also affects this attitude. The possibility that they will commit financial slack increases with the degree of confidence (i.e., continuity of position). Since there are no regulations governing the transfer of individuals within each state government, each person's degree of confidence will vary greatly. This mutation's lack of regulations breeds uncertainty, particularly while the budget is being prepared.

The results of the research [17] elated to budgetary slack in the public sector show that, public sector budgets in Indonesia, are prepared with an estimated increase in expenditure between 5% and 7% and a projected increase in revenue between 7% and 12%. The budget preparation of each SKPD is accompanied by positive slack to anticipate the policy of transferring funds and activities outside the budget. So, this positive slack is deliberately done to ensure that each unit has enough money. slack is determined based on annual trends and is intended for interdivisional fund transfer policies, and this is done as a form of anticipation because the approach used in budgeting is top-down [17]. In 2022, Lampung Province ranked first in the Percentage of Expenditure Realization of the Provincial APBD in Indonesia for the 2022 Budget Year, the achievement of 48 SKPDs was 97.25% (below 100%) while from the percentage of revenue realization, the average of 48 SKPDs was 100.68% (Above 100%). This already indicates the existence of budgetary slack, where the revenue budget is understated while the cost budget is overstated [13, 18, 19]. So budget realization is relatively easy to achieve [11].

Budgetary slack has negative implications for the organization, and can lead to misallocation of company resources, bias in performance evaluation, and low manager effort [10] [15]. Therefore, budgetary slack has been viewed as a behavioral problem because it is related to the moral framework of budgeting arrangements [20] and leads to dysfunctional budget behavior [21]. [15] argues that budgetary slack contains ethical problems because budgetary slack is inconsistent with role-related norms and desirable virtues of professional managers and accountants. Such behavior violates social norms and professional standards that are expected to perform [22].

According to agency theory, people are self-centered when they maximize their own well-being [23], which also demonstrates that everyone in the organization would act in their own best interests [24]. To accomplish effective, efficient, transparent, and responsible state financial management, an internal control system is therefore necessary; governors, ministers, and regents/mayors must oversee the execution of government operations based on SPIP. According to some experts, financial slack is created when there is a lack of control [10, 25]. People will be able to create financial slack without being caught if there is a weak internal

control mechanism. Even people with strong moral convictions could feel under pressure to conform the budget to organizational standards in this case.

Performance-based compensation systems can encourage individuals or managers to create budgetary slack [4, 20], where they submit budgets that are too low or too high, to easily achieve targets [14]. When performance-based compensation is implemented without considering ethical aspects and moral reasoning, it can create an environment that supports the creation of budgetary slack. However, if individuals or managers have high moral reasoning, they are likely to resist the practice despite incentives from the compensation system. Therefore, moral reasoning serves as a control that reduces the negative impact of the compensation system on the creation of budgetary slack.

Ethical organizational culture will support and strengthen individual moral reasoning by providing an environment that encourages correct, fair behavior and tends to mitigate budgetary slack [26]. When a strong and positive organizational culture meets individuals who have high moral reasoning, it will mitigate budgetary slack.[15]

This research can contribute to how to mitigate budgetary slack in local government. This is important, because by minimizing budgetary slack in local governments, misallocation of resources can be avoided, performance evaluation presents the real situation, so that the performance of regional heads can be maximized which will ultimately improve the welfare of the society.

2 Literatur Review

2.1 Budgetary Slack

The discrepancy between the actual performance capabilities of subordinates and their anticipated performance targets is known as budgetary slack [9, 14, 15, 27, 28]. Budgets for expenses are typically exaggerated, whereas those for revenues are typically understated [13, 18, 19]. As a result, the budget gap occurs when managers purposefully set goals that are comparatively simple to meet [11]. Managers take this action to safeguard themselves against unforeseen circumstances and to raise the likelihood of hitting budgetary goals so that they can be rewarded [28]. According to this perspective, managers are 'forced' to create financial slack, either directly or indirectly, particularly if the organization views the budget as the primary instrument for assessing manager performance [29]. Creating budgetary slack is mostly done by managers to make sure that the budget can be easily met [30]. The amount by which a subordinate underestimates his productive ability when allowed to choose the work standards that will be used to evaluate his performance" is how [14] characterizes budgetary slack.



Fig. 1. Budgetary Slack

2.2. Control System

Internal control is a system that connects company performance, plans, attitudes, politics, system integration, human resource management to help achieve organizational goals [31]. In the context of government, Government Regulation No. 60 of 2008 governing the Government Internal Control System (SPIP) serves as the foundation for the internal control system “to achieve effective, efficient, transparent and accountable state financial management; ministers/heads of institutions, governors, and regents /mayors are required to control the implementation of government activities carried out based on SPIP. SPIP aims to provide adequate assurance for the achievement of effectiveness and efficiency in achieving the objectives of state governance, reliability of financial reporting, safeguarding state assets, and compliance with laws and regulations. SPIP consists of elements of the control environment, risk assessment, control activities, information and communication, and internal control monitoring, so that SPIP can be said to be an integral part of the activities of government agencies.”

2.3. Compensation

Compensation is something that employees receive in place of contributing their services to the organization, in achieving company goals [32]. Compensation suitability is the appropriateness or suitability of what the organization gives to employees in the form of periodic salaries or hourly wages in return for the work that has been done for the organization [33]. Compensation can trigger employees to do their work optimally. However, not a few individuals become obsessed with compensation, especially if compensation is performance-based. [20, 34]

2.4. Organizational Culture

Organizational culture refers to the values, norms, and practices that prevail in an organization and shape the behavior of individuals within it [35]. Culture includes elements such as work ethics, honesty, collaboration, and transparency. One element of organizational culture is the code of ethics, the code of ethics and moral reasoning of employees together influence ethical behavior within the organization. In organizations with a culture that emphasizes transparency, accountability, and ethics, there is greater pressure for individuals to act with integrity.

2.5 Moral Reasoning

Moral reasoning is the way individuals address the issue of ethical dilemmas to then provide an assessment of whether something is right or wrong and then provide justification for this because when individuals experience ethics-related dilemmas, they will consider cognitively in their minds” [36]. Moral reasoning refers to the process of assessing the behavior of individuals, institutions or policies by applicable moral standards”, furthermore “The stage of individual moral reasoning is used to maintain a position when faced with a moral dilemma” [37].

2.6 Internal Control System, Moral Reasoning, and Budgetary Slack

Organizations that implement an internal control system effectively can protect their organization from the possibility of negligence or actions that should not occur. The relationship between the control system and budgetary slack can be influenced by managerial choices, the

economic environment, task uncertainty, and individual characteristics. So the design and implementation of the system must consider the broader organizational context and individual behavior to balance efficiency and effectiveness. Some researchers emphasize that lack of control leads to the creation of budgetary slack [10, 25]. The internal control system hurts budgetary slack [38].

According to Kohlberg's cognitive development theory [37], when situational factors, such as an internal control system, are implemented effectively, people with low moral reasoning will be afraid of punishment and will follow existing rules, policies, and procedures to avoid punishment. In contrast, people with high moral reasoning will not commit budgetary slack whether or not an organization has an internal control system in place because they believe the act is unethical and could harm many people [39]. As a result, people with strong moral convictions are honest and can resist the urge to spend money carelessly for their own benefit.

H1: Budgetary slack is negatively impacted by the system of internal control.

H2: The association between the system of internal controls and budgetary slack is moderated by moral reasoning.

2.7 Compensation, Moral Reasoning, and Budgetary Slack

Performance-based compensation systems can encourage individuals or managers to create budgetary slack. [20, 34]. To achieve performance, individuals will submit budgets that are too low or too high so that targets are easily achieved [14] to ensure compensation. Thus, when the compensation system is not well designed, it can encourage opportunistic behavior that contributes to the creation of budgetary slack.[20, 40]

According to cognitive moral development theory, “individuals with a high level of moral reasoning (post-conventional) will focus more on the interests of many or universal rather than self-interest”[41], this is because “individuals who have high moral reasoning (post-conventional) have more attitudes and standards from the internalization of good values (norms) that they have held so far” [42]. Thus, individuals who have good norm preferences will try to reduce the occurrence of budgetary slack that can harm the company even though they are under pressure, and vice versa [43].

H3: Budgetary slack is positive impacted by compensation.

H4: The association between compensation and budgetary slack is moderated by moral reasoning.

2.8 Organizational Culture, Moral Reasoning, and Budgetary Slack

High ethical standards are likely to be formed among members of an organization if that culture is robust and encourages high ethical standards; this will lead to positive employee behavior [26]. Budgetary slack in the public sector is negatively impacted by organizational culture [44]. Because organizational culture is a collection of shared assumptions, values, and beliefs, it can have a significant impact on members' moral development. In other words, it can influence members' thoughts, feelings, and behavior, or it can be said that organizational culture will improve each person's cognitive moral development. A strong corporate culture that upholds high ethical standards, as well as an individual's knowledge of morality while making

moral decisions, will all be influenced by these factors that supports high ethical standards will influence individual decisions to act ethically” [26].

H5: Budgetary slack is negatively impacted by organizational culture.

H6: The association between organizational culture and budgetary slack is moderated by moral reasoning

Research Framework

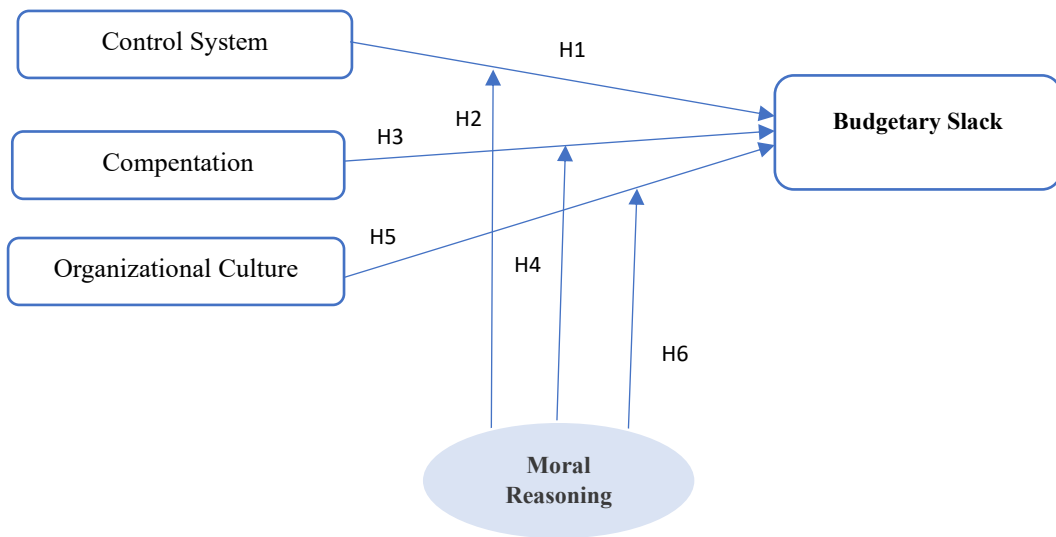


Fig. 2. Research Framework

3 Research Method

This research used a survey method, with a sample of 212 respondents who were directly involved in the budget preparation process, from 48 regional work units of Lampung Province, Indonesia. Wrap-PLS 7.0 is used as an analytical tool to support this research.

Table 1. Measurements

Construct	Measurements	Developed by
Budgetary Slack	1. My area of responsibility is highly productive due to the budgetary standards. 2. I can safely reach the budgets set for my area of responsibility. 3. Due to financial limitations, I must closely control expenses in my area of responsibility. 4. The budgets in my area of responsibility are not very strict. 5. I have not been overly concerned with increasing efficiency in my area of responsibility because of budgetary targets. 6. The budget's goals are challenging to accomplish	Dunk (1993) [18]

Construct	Measurements	Developed by
Control System	<ol style="list-style-type: none"> 1. The control environment. 2. Management of risk assessment. 3. Information and communication systems for accounting 4. Manage operations 5. Monitoring of internal controls 	COSO and Government Regulation [31]
Compensation	<ol style="list-style-type: none"> 1. Monetary compensation. 2. Acknowledgment inside the organization for successful work performance 3. Advertising 4. Completing tasks 5. Reaching the objective. 	Fanning [33]
Organizational Culture	<ol style="list-style-type: none"> 1. An obvious role model for leadership 2. Putting the code of ethics into practice 3. Providing ethical training 4. Penalties for unethical behavior 5. Mechanism for ethical protection 	Sun 2008, [35]
Moral Reasoning	<ol style="list-style-type: none"> 1. An emphasis on self-interest 2. An emphasis on obedience and punishment; 3. An emphasis on interpersonal harmony and compliance 4. Direction is maintained by authority and social order. 5. An emphasis on social contracts 6. Universal moral standards 	Kohlberg (1996) [37]

Respondent Characteristics

Table 2. Respondent Characteristics

Category	Description	Number of Respondents	%
		212	100%
Gender	Man	149	70%
	Woman	63	30%
Age	20 - 30 years	29	13,6%
	31 - 40 years	94	44,4%
	41 - 50 years	58	27,4%
	51 years and above	31	14,6%
Last education	High School Equivalent	19	8,9%
	Diploma	38	17,9%
	Bachelor	118	55,7%
	S2/S3	37	17,5%
Work experience	Less than 5 years	39	18,39%
	6 - 10 years	70	33,01%
	11 - 15 years	48	22,65%
	16 - 20 years	30	14,15%
	More than 20 years	25	11,80%

Given that men make up 70% of the sample, the sex distribution is more prevalent in this table of respondent characteristics. The majority of responders (44.4%) are between the ages of 31 and 40, indicating a very balanced distribution of age features. The majority of respondents (55.7%) had a bachelor's degree or higher. The majority of responders (33,01%) have 6–10 years of job experience, while 22,65% have 11–15 years. It demonstrates that a sizable portion of responders have been with the company for an extended period.

3.1 Measurement Model Analysis (Outer Model)

Validity Test Result

Convergent and discriminant validity tests were the two phases of validity testing used in this investigation. According to [45] all constructs must have an Average Variance Extract (AVE) value greater than 0.50 and the indicator loading factor value must be greater than 0.7 for the convergent validity test criteria to be considered valid. Two indicators (BS3 and MR5) in this study have to be removed since their loading factors are less than 0.4. After these two indicators are removed, the AVE values for each variable are greater than 0.50, as shown in Table 4, which shows that the findings of the convergent validity test are legitimate.

Table 3. Combine Loading & Cross Loading Test

	BSG	CGE	GCS	GOC	MRE	P-value
BS1	0.747					<0.001
BS2	0.564					<0.001
BS4	0.826					<0.001
BS5	0.781					<0.001
BS6	0.656					<0.001
CG1		0.749				<0.001
CG2		0.808				<0.001
CG3		0.817				<0.001
CG4		0.782				<0.001
CG5		0.754				<0.001
CS1			0.740			<0.001
CS2			0.822			<0.001
CS3			0.843			<0.001
CS4			0.914			<0.001
CS5			0.923			<0.001
OC1				0.931		<0.001
OC2				0.910		<0.001
OC3				0.923		<0.001
OC4				0.919		<0.001
OC5				0.807		<0.001
MR1					0.819	<0.001
MR2					0.858	<0.001
MR3					0.853	<0.001
MR4					0.786	<0.001
MR6					0.815	<0.001

Source: Warp-PLS 7.0 (2021) Data Processing Output

Notes: BSG: Budgetary Slack Government, CGE: Compensation of Government Employees, GCS: Government Control System, GOC: Government Organizational Culture, MRE: *Moral Reasoning Employees*. n=212.

Table 4. Average Variance Extracted (AVE) Value for Each Construct

BSG	CGE	GCS	GOC	MRE
0.839	0.806	0.791	0.893	0.665

Source: Warp-PLS 7.0 (2021) Data Processing Output

Additionally, checking for discriminant validity is the second step in the validity test; a variable is considered discriminant if its indicator has the largest loading value among its variable group [45]. Table 5 presents the results of the discriminant validity test, which demonstrate their validity.

Table 5. Loading Value for Discriminant Validity

	BSG	CGE	GCS	GOC	MRE
BSG	0.768				
CGE	-0.089	0.735			
GCS	-0.008	0.631	0.829		
GOC	-0.128	0.410	0.553	0.893	
MRE	-0.268	0.103	0.631	0.510	0.871

Source: Warp-PLS 7.0 (2021) data processing output

Reliability Test Result

Cronbach's Alpha and composite reliability scores for all variables in the reliability test were ≥ 0.70 , indicating that the instruments employed to assess each variable in this study are deemed reliable. Table 6 below displays the reliability test results.

Table 6. Reliability Parameter Value

Indicator	<i>Cronbach's Alpha</i>	<i>Composite Reliability</i>
BGS	0.819	0.824
CGE	0.862	0.878
GCS	0.828	0.891
GOC	0.801	0.883
MRE	0.911	0.933

Source: Warp-PLS 7.0 (2021) data processing output

Notes: BSG: Budgetary Slack Government, CGE: Compensation of Government Employees, GCS: Government Control System, GOC: Government Organizational Culture, MRE: Moral Reasoning Employees. n=212.

3.2 Structural Model Analysis (Inner Model) as a Hypothesis Test

The Average Path Coefficient (APC), Average R-squared (ARS), and Average Adjusted R-squared (AARS) values are examined in the initial assessment. If the p-value for APC, ARS, and AARS is less than 0.05, the Goodness of Fit model is considered valid [46]. Table 7 shows that the p-values for APC, ARS, and AARS are less than 0.001, indicating that the model is accepted. As a measure of multicollinearity, the average block VIF (AVIF) and average full collinearity VIF (AFVIF) values should equal 5; nevertheless, 3.3 is still acceptable [46]. The AVIF and AFVIF values in Table 7 are 3.414 and 3.238, respectively, indicating that multicollinearity is not an issue in this research model. Testing the model fit based on the Tenenhaus GoF value is the last assessment. According to Kock & Hadaya [44] a model is

considered to have a modest fit if its value is ≥ 0.10 , a medium level if its value is ≥ 0.25 , and a strong fit if its value is ≥ 0.36 . Table 7's GoF value of 0.440 indicates that the model employed in the study has a strong model fit [44].

Table 7. Inner Model

Indicator	Value	Condition	Conclusion
Average path coefficient (APC)	0.360, P<0.001	P sig	Accepted
Average R-squared (ARS)	0.302, P<0.001	P sig	Accepted
Average adjusted R-squared (AARS)	0.286, P<0.001	P sig	Accepted
Average block VIF (AVIF)	3.414	Accepted if ≤ 5 , Ideal if ≤ 3.3	Accepted
Average full collinearity VIF (AFVIF)	3.238	Accepted if ≤ 5 , Ideal if ≤ 3.3	Accepted
Tenenhaus GoF (GoF)	0.440	Weak ≥ 0.1 , Medium ≥ 0.25 , Strong ≥ 0.36	Strong Model

Source: Warp-PLS 7.0 (2021) data processing output

Result

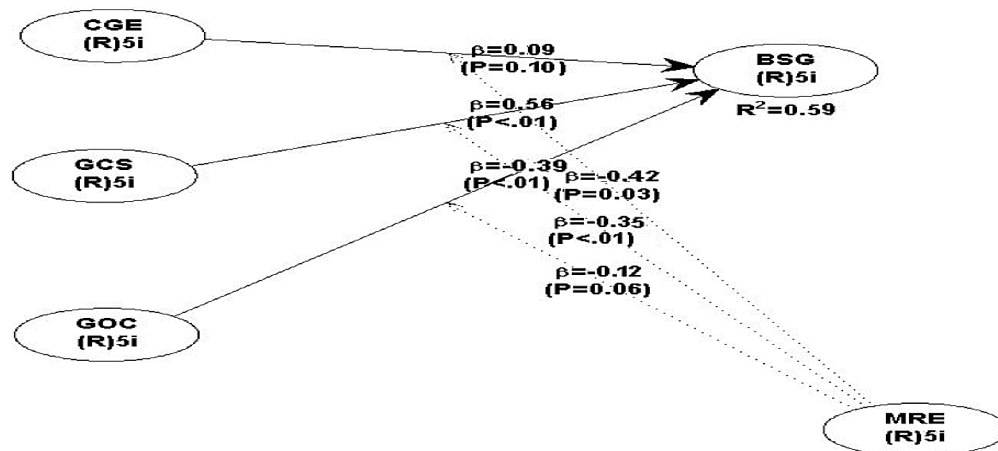


Fig. 2. Measurement Model Estimates

Notes: BSG: Budgetary Slack Government, CGE: Compensation of Government Employees, GCS: Government Control System, GOC: Government Organizational Culture, MRE: Moral Reasoning Employees. n=212.

Table 8. Result of Measurement Model (Hypothesis Testing)

Construc	P-value	Koefisien (β)	Adj. R ²
H1: GCS \rightarrow BSG	<0.01***	0.56	
H2: MRG*GCG \rightarrow BSG	<0.01***	-0.35	
H3: CGE \rightarrow BSG	0.10	0.09	

H4: MRG*CGE →BSG	0.03**	-0.42	0,59
H5: GOC →BSG	<0.01***	-0.39	
H6: MRG*GOC →BSG	0.06*	-0.12	

*p<0.10; **p<0.05; ***p<0.01

H1: The control system's positive substantial impact on budgetary slack, as indicated by the path coefficient (0.56) and p-value (<0.01), led to the rejection of the hypothesis. within the range of 99% confidence. These results indicate that the control mechanism or policy in 48 SKPDs in Lampung Province increases budgetry slack. This can be caused by strict controls or rigid procedures, thus encouraging unethical behavior. A control system that is too tight can create high pressure on managers to achieve certain targets. This pressure can encourage managers to create budgetary slack, as a way to ensure they can achieve targets without having to face negative consequences [47, 48].

H2: The hypothesis is approved. With a value of (β): -0.3) and a p-value (<0.01), the hypothesis test results demonstrate that moral reasoning can attenuate the relationship between the internal control system and budgetary slack. somewhere inside the 99% confidence range. This implies that the relationship between budgetary slack and the internal control system can be moderated by moral reasoning.

H3: H3: With a path coefficient of 0.09 and a p-value of 0.10, the hypothesis that compensation has a positive impact on budgetary slack is accepted. inside the 90% confidence interval. This indicates that the compensation provided can motivate individuals to carry out budgetary slack. This is very likely to happen, if compensation focuses on achieving short-term targets [18] [5]. So that individuals tend to avoid the risk of not achieving targets, by creating budgetary slack [11].

H4: With a path coefficient (-0.42) and p-value of 0.03, it is recognized that their moral reasoning can limit the relationship between pay and budgetary slack. within the range of 95% confidenc. This indicates that moral reasoning can moderate the relationship between compensation and budgetary slack. If an individual has high moral reasoning, has high integrity, will continue to uphold ethics, and will not take unethical actions, budgetary slack.

H5: The hypothesis that organizational culture significantly reduces budgetary slack with a path coefficient of -0.39 and a p-value of less than 0.01 is accepted. In the 99% confidence interval. This indicates that a good and strong organizational culture can reduce the tendency of individuals to create budgetary slack. Individuals who work in an environment where honesty and transparency are valued tend to be more committed to achieving realistic and honest targets in budgeting.

H6: With a p-value of 0.06 and a path coefficient of -0.12, the hypothesis that their moral reasoning can limit the relationship between the organization's culture and budgetary slack was accepted. Within the 90% confidence interval. This indicates that high moral reasoning can reduce the negative impact of a weak or unethical organizational culture on the tendency to budgetary slack. In other words, even though organizational culture does not strongly encourage ethical behavior or promote transparency, individuals with high moral reasoning will tend to reject or avoid unethical practices such as budgetary slack.

4 Discussion

Budgetary slack has negative implications for the organization, and can lead to misallocation of resources, bias in performance evaluation, and low manager effort [10] [15]. Therefore, budgetary slack has been viewed as a behavioral problem because it is related to the moral framework of budgeting arrangements [20] and leads to dysfunctional budget behavior [21]. System control has an important role in budgetary slack. The control system in 48 SKPDs in Lampung province shows that the presence of a control system tends to increase the creation of budgetary slack. This may be due to the existence of strict control or rigid procedures, thus creating high pressure for individuals to achieve certain targets. This pressure encourages individuals to create budgetary slack, as a way to ensure target achievement without having to face negative consequences [47, 48]. Compensation that focuses on achieving short-term targets [18] [5] can increase the occurrence of budgetary slack. This is done to avoid the risk of not achieving targets, by creating budgetary slack [11]. A good and strong organizational culture can reduce the tendency of individuals to create budgetary slack. Individuals who work in an environment where honesty and transparency are valued tend to be more committed to achieving realistic and honest targets in budgeting. Moral reasoning can moderate the relationship between the control system, compensation, and organizational culture with budgetary slack

5 Conclusion

The conclusions of this study are Control system and compensation have a positive effect on budgetary slack in 48 regional work units of Lampung province. Strict controls and rigid procedures create high pressure for individuals to achieve budget targets, thus encouraging individuals to create budgetary slack. Meanwhile, organizational culture has a significant negative effect on budgetary slack. Individuals who work in an environment where honesty and transparency are valued tend to be more committed to achieving realistic and honest targets in budgeting.

Some suggestions for future research related to budgetary slack mitigation, especially in local government, first, future research can expand the research area to other provinces, so that it reflects a portrait of Indonesia as a whole. Second, to deepen the cause and effect of budgetary slack in the public sector, experimental methods can be used. Third, use alternative compensation schemes that can reduce budgetary slack, for example compensation that contains penalties, clawback provisions.

The limitations in this study are the limited research time and the limited number of samples used, so a larger number of samples are needed with more varied research objects, namely SKPD representatives from all Indonesian provinces, to enable more robust research results and reflect budgetary slack in Indonesian local government.

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