

# **Occasional paper no. 27**

**Flexible governmental budgeting: Not fewer rules, just different ones**

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Published: December 2015

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**Michael Di Francesco** is Senior Lecturer in Public Sector Management and Director of the Case Program at the Australia and New Zealand School of Government, and Honorary Senior Fellow in the School of Social and Political Sciences, University of Melbourne. He holds a PhD in public policy from the Australian National University, and has held tenured academic appointments at the University of Sydney and Victoria University of Wellington.

Michael also has extensive senior practitioner experience in public financial management, including budget reform leadership at the NSW Treasury, and many expert advisory appointments at the International Monetary Fund and World Bank. Michael has published numerous articles and chapters, and has twice been awarded the Sam Richardson Award for the most influential article in the *Australian Journal of Public Administration*.

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## Flexible governmental budgeting: Not fewer rules, just different ones

A seminar presentation from Michael Di Francesco and John Alford<sup>1</sup>

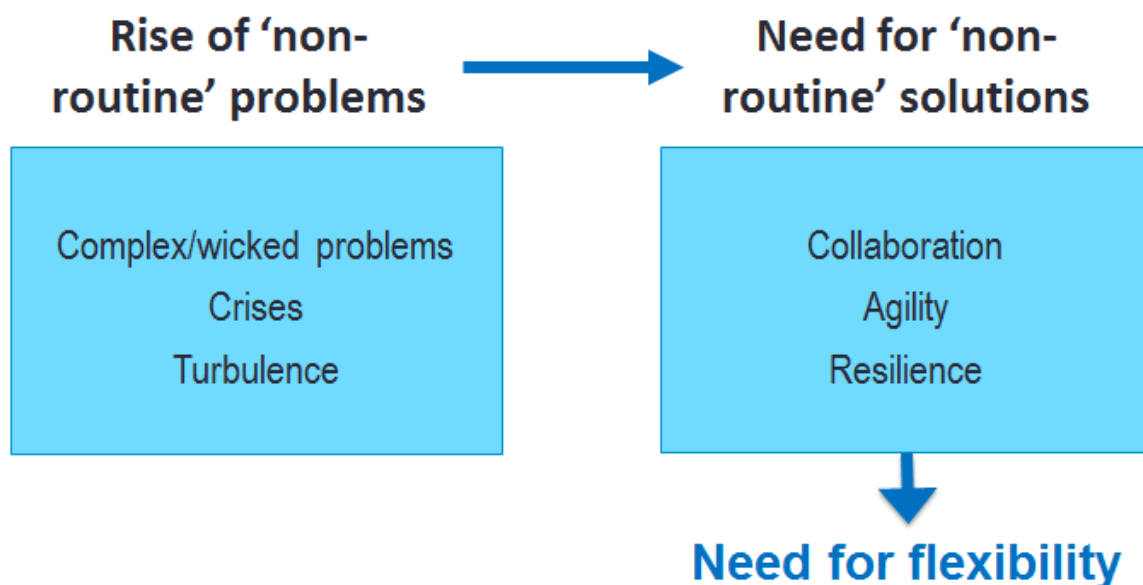
### Why flexible budgeting?

**John:** There's a question I get asked a bit when I tell people I'm doing stuff in the field of budgeting, and that is *why are you looking at budgeting*, rather than some of the sexier topics of public management like network governance or public value? The implication is that there's something inferior about budgeting, or at least hard to understand. It's actually the case that I got involved in budgeting precisely because I was doing some of those sexier topics, looking at things like collaboration and wicked problems and political influences on managers. All of that led me to thinking about, in dialogue with Michael, what budget systems do for our efforts to reshape public management so it can deal with the modern kinds of problems it's currently faced with.

### 'Non-routine' problems and public accountability

We conceptualise these as 'non-routine' problems: wicked problems that are intractable and difficult and involve multiple interests; crises where there are unprecedented events that present threats or the need for urgent change; or turbulence where an organisation is buffeted by a series of difficult events. All of these things tend to require a different approach to management than the routine. What this means is that if we've got these kinds of non-routine problems then we probably need non-routine solutions like collaboration, agility, resilience.

Figure 1. Non-routine problems and solutions



Some of the processes and structures of government are getting in the way of collaboration and decreasing the trust that's required for effective partnerships, and we argue that many of these are in the area of budgeting.

What we found was that there are contending pressures on public managers because of the rise of non-routine problems and the persistence of traditional budgeting systems. Sometimes this is cast as a

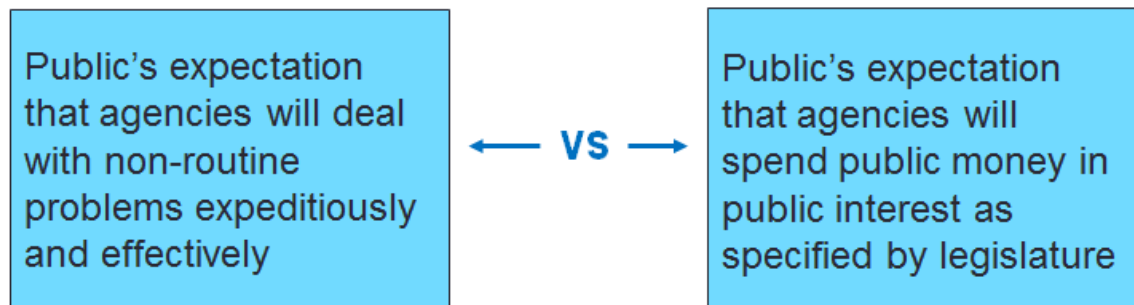
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<sup>1</sup> Based on the ANZSOG-funded research project "Flexible governmental budgeting". This seminar presentation was edited by Sophie Yates.

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principle vs a constraint; we want to have more flexibility but it's constrained by these structures. However, I think the constraint is also a principle - in a sense, there's a tension between on one hand the public's expectation that agencies will deal with non-routine problems expeditiously and effectively, and on the other hand the public's expectation that agencies will spend public money in the public interest as specified by the legislature.

**Figure 2. Contending pressures on public managers in respect of budgeting/financial management**



So this is an unresolved tension, and we were fascinated by that. This leads us to budgeting and the role that it plays.

### **Traditional budgeting inhibits flexibility**

**Michael:** So what are some examples of the way that budgeting inhibits flexibility in government? We've come up with a snapshot of three key ways, and they are important because they also point to the way that particular types of basic rules in government budgeting operate.

One of them has to do with the way that they *complicate reallocation* across the programs, which goes to the 'what' of government funding. An example of this is from Manchester, the Resettlement Consortium for Youth Offenders. Earmarked contributions were effectively operating as constraints on the way that intentions for collaborative working could be focused on the client – in this instance, case managed programs for disadvantaged youth in different local government areas around Manchester. There are probably many different examples of this across social services in most jurisdictions, but this is a particularly good one because it was subject to really rigorous research. What it told us is that trust was undermined from the beginning because of the way that budgets were approached by those individual partners. They didn't want to share, they didn't want to lose control. They had challenges in interacting with other partners because of their own internal financial management systems. And all this undermined trust, which John alluded to as being important to the solutions for non-routine problems. So this idea of reallocation, and the way it is constrained by current budget rules constrain, is a key area.

A second one is the idea of centralised control in the delegation of decision authority, so in effect *decision rights*. An example about trying to coalesce services and ensure that there's a degree of client focus is Indigenous Coordination Centres here in Australia, where a range of agencies were either brought together or organically came together in order to try and focus resources and program service delivery on the needs of clients. But those who were operating at the coalface were not being given the authority to make decisions on things like reallocating funding between programs, or altering the nature of service delivery to meet client needs. Because of existing hierarchical decision processes they were having to go back to central decision-makers in order to hold up their part of the bargain associated with a collaborative undertaking. So this type of centralised control and the need for mutual adjustment at the coalface is something we flag as a key inhibitor of flexibility.

And finally the idea of being able to *redistribute across timeframes*, despite the types of reforms that have occurred over the last 30-35 years, remains quite significant. We still budget on an annual basis, which

discourages the long-term view, and the capacity to commit over a multi-year time period. So while this is not by any means exhaustive, these are indicative of the types of issues that we’re talking about.

**What is budget flexibility?**

I want to explain how we went about framing this issue. The most obvious one was how you go about defining budget flexibility: what do we actually mean by flexibility in this context? We looked at the way that different budget rules were operating across the key stages of budget processes. This isn’t the most novel of views, but it provided a strong platform. In effect we’re talking about budget formulation and budget execution - the way that they’re determined, the way that major categories and rules associated with budget processes impact the way that allocative decisions are taken; and then the way that budgets are being executed, which is the rules associated with how you spend the money, and who’s accountable for what, and how they’re accountable.

We then took a look at two dimensions of flexibility. The first is something we’re very familiar with, and that’s levels of budget decision-making, which is to do with delegated authority and decentralising decision-making. You will be familiar with the notion of devolved managerial authority; the rhetoric at least is something that’s been in place now for some time. But one that’s perhaps not as familiar, and we suspect harder to pursue, is the notion of budget rule variability: within devolved authority, how is it that you can vary the way that rules are applied in different situational contexts? We’ve defined this in terms of latitude within budget rules for varying decisions about parameters, purposes, allocations, the nature of control. And we refer to this as the horizontal aspect. So what we posit is that budget flexibility is actually a combination of these two things. The idea that you are a) pushing decisions to those that are best placed, a staple of best management practice, and accompanying this is b) a wider variety across the stages of budgeting in the way that different types of rules can be applied to promote increased latitude for movement.

The type of taxonomy below, as far as we know, has not been done before. It was an attempt to try and unpack the way that existing conventional approaches to rules and budgeting operate at their most basic level. The purpose of that was to try and understand how control properties operate in public budgeting. Many of these properties interact, and we’ve gone through a process of trying to separate those out for the purposes of understanding what they look like and how they might operate.

**Table 1. Budget rules: a basic taxonomy**

Rule		Example
<b>1. Accountability</b>	Who can spend	Appropriations to Minister or department
<b>2. Amount</b>	How much can be spent	Appropriations specify expenditure limits
<b>3. Purpose</b>	What it can be spent on	Appropriations specify purpose
<b>4. Time</b>	When it must be spent	Appropriations authorise spending for a discrete period (annuality)
<b>5. Transfers</b>	How spending can be changed	Appropriations prohibit reallocations between spending categories (virement)
<b>6. Information</b>	How spending is accounted for	Financial control through inputs and compliance (regularity and legality)

We then took a look at how some of these rules could be pursued to characterise low flexibility - what we'd see corresponding to a traditional approach to budgeting. We looked at how we'd characterise high flexibility. The purpose was to set out two extremes to indicate how the rules were operating, and how they interact to achieve stronger accountability, often at the expense of flexibility.

Two that we focus on in some detail in our forthcoming book are *time*, in this case combined with amount, and purpose. Time is equated with annual budgeting, and the extent to which changes over the last 30 years have actually mitigated the constraining impacts of annuality. We argue that despite some of the most recent changes to multi-year budgeting and the use of accruals in accounting, constraints have not been overcome to any great extent.

Second is *purpose*, which corresponds with program definition. This is one of the building blocks of budget practice but also budget reform: moving from highly specified line items to one-line budgets defined as one or a small number of highly aggregated outcomes. How those things are operationalised is part of what we're trying to explore here, and we do so through the prism of regulatory relationships. We want to take a look at the way that rules can be reconfigured in such a way that rather than doing as previous reforms have done, which is to focus on fewer rules, you focus on the way the rules are actually being understood and applied.

**Table 2. Low vs high budget flexibility**

	Low flexibility	High flexibility
<b>1. Accountability</b>	<ul style="list-style-type: none"> <li>Apex accountability</li> <li>One-to-one relationship with organization</li> </ul>	<ul style="list-style-type: none"> <li>Budget authority attached to outcome</li> <li>Multiple accountabilities</li> <li>One-to-many relationship</li> </ul>
<b>2. Delegation</b>	<ul style="list-style-type: none"> <li>Principle of 'hierarchy'</li> <li>Centrally determined limits</li> </ul>	<ul style="list-style-type: none"> <li>Principle of 'subsidiarity'</li> <li>Situationally determined limits</li> </ul>
<b>3. Time and Amount</b>	<ul style="list-style-type: none"> <li>Annuity</li> <li>Underspend returned and overspend sanctioned</li> </ul>	<ul style="list-style-type: none"> <li>Non-lapsing multi-year authority</li> <li>Allocations continuously adjusted</li> </ul>
<b>4. Purpose</b>	<ul style="list-style-type: none"> <li>Specified in detailed line items (inputs or functions)</li> <li>Attached to organization</li> </ul>	<ul style="list-style-type: none"> <li>Specified in highly aggregated line items (outcomes or programs)</li> <li>Attached to purpose</li> </ul>
<b>5. Transfer</b>	<ul style="list-style-type: none"> <li>Reallocation prohibited or requires ex ante approval</li> </ul>	<ul style="list-style-type: none"> <li>Reallocation is a process of continuous adjustment</li> </ul>
<b>6. Information</b>	<ul style="list-style-type: none"> <li>Performance is strict compliance</li> <li>Reporting is general, frequent, detailed and sanction-oriented</li> </ul>	<ul style="list-style-type: none"> <li>Performance is outcomes-based</li> <li>Reporting is situational, frequency and content variable, and dialogue-oriented</li> </ul>

**Finance ministries as regulators**

**John:** What we began to look at next is what are the kinds of ways you can set up the financial management system of government agencies? And we hit upon this idea of regarding the finance ministry or treasury as a 'regulator' of line departments. If you think about it, what regulators do is get people to comply with their obligations. We sometimes hear people talk about regulation as though it's the application of the coercive legal force of the state. That's one of the ways that people can be persuaded to comply with their obligations, but we know there are various other ways: monitoring, incentives, appealing to values, making it easier for them, and so on. Sophisticated regulators these days recognise that there are all these options for encouraging compliance. So if we regard treasury or finance as the regulator and the line agencies as regulatees, we establish that kind of relationship, which may or may not involve coercion. It's worth noting of course that the relationship until not that long ago was one where there was a fair amount of the command and control kind of mentality in it.

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We looked at a number of options. First of all there was the traditional approach: command and control, before New Public Management, meant detailed 'ex-ante' or before the fact input and control. There's been a move to ex-post kinds of controls, and the former seems to be much more constricting.

Then there's what we've decided to call a kind of contemporary orthodoxy, where we've seen performance control systems like New Public Management. There's a greater focus on outputs, measurement standards are set up, and the idea is to control line departments through focusing on the outputs they come up with. There is a related idea that if you're only talking about what the results should be rather than how they should do it, that leaves them some flexibility to deploy their expertise to do it the best way.

Just as performance control contains within it a critique of the traditional approach, where we've now got to is a series of new approaches that tend to be more collaborative than performance control, more contingent, more based on a variety of motivations. We identify three alternative approaches within that space about what comes after New Public Management. This is a question well worth asking given that New Public Management has been 'new' now for what, 30 years?

We saw three possibilities there, and I'll take you through them. The first one is *leadership and cultural change*, a matter of the finance department engaging in persuasion, exhortation and so on. It seeks to increase their capacity with training and development, and providing frameworks that make it a bit easier. Now if that happens, it means that behaviours tend to be more embedded. People have really taken it on board in an agency's ways of working, and this approach can also foster longer term inter-agency trust. But it comes up against a fundamental problem, which is that we're talking about money here. It's likely to apply insufficient pressure on agencies to comply. It's likely to be vulnerable to gaming behaviour by agencies, and it also has a tendency to be one-size-fits-all. Whereas if you look at the compliance postures of different entities you're regulating, you'll find that some of them will always do the right thing, some will always do the wrong thing, others will do contingent things in between. And what you need is a set of motivations and levers and instruments that will cover that whole spectrum.

Second is one where the finance ministry is an overseer or negotiator of *appropriate rule breaches*, for example the classic case of the police officer who stops a speeding car only to find that it contains a woman in labour, at which point he or she escorts the car to the nearest hospital. Police will tell you that most of their job is exercising discretion: "How should we apply the law to this particular situation?" One of the things this leads to is workarounds, where people find a way to achieve a purpose even if the resources and structures are not well set up to enable them to do that. The advantage of course is that it's a basis for trust building, and it's also a good diagnostic tool to give a sense of the organisation's health. But it leads to pretty uncertain ground - we all know that sticking your neck out can be a dangerous thing in the public sector. It means they need to have good judgement about this. There's again a vulnerability to gaming, and questions about how far you can scale it up beyond a certain point.

## **Responsive regulation in budget control**

So we come to a third one - *responsive regulation*. It's an idea from our very own Braithwaites here in Australia, and I think it's a very interesting and important notion in social science that has wider application. This is where the finance ministry is a responsive regulator, regulating internal to government. This entails a hierarchy of rewards and sanctions, and what you're trying to do is appeal to the best in your regulatees, but be ready for the worst. A pyramid of treatments will start at the bottom with treating people nicely, persuading, helping, educating etc. If the agency does the wrong thing, you give them a slap over the wrist. If they keep doing the wrong thing, you progressively increase the sanctions. If at any stage they start doing the right thing, you go back down the pyramid in your treatment. What it means is that agencies select themselves by their past behaviour. The ATO, where this idea started (and it's now spread right across Australia and many places overseas), actually do profiling of different categories of taxpayers as to who is showing a greater propensity to try and evade their obligations. The advantage of this is that it mobilises voluntary compliance, but also safeguards against opportunism. And it also mitigates the

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problems of having a one size fits all approach. Here we've got different treatments for different groups, and also a way for them to transition from one to another if they get more or less compliant along the way. The disadvantage in the finance setting is that it might be prone to once-off opportunism, for example the department might say "we're going to be put under the yoke if we do this, but this is a nice big sum of money so let's go with it and see what happens".

## Australian Department of Finance: First mover?

**Michael:** The Commonwealth Department of Finance has been starting to work on this idea of earned autonomy. This is one of those terms we have some familiarity with; it's often applied to the way that a regulator interacts with external regulatees, and one of the things we're trying to emphasise here is that this is an application of this framework *within* government. We're not aware of it being applied in this way, although it may well have been in other contexts. But certainly there is a great deal of its application in the way that network or quasi-market type arrangements have been constructed to create a whole range of different incentives for improved performance. The most common one is the NHS Hospital Trust, and similar types of hospital funding systems, but to some extent also the way that the Centrelink Job Network was operating.

What we're doing here is trying to conceive of spending ministries and line departments as earners of autonomy, and the idea is that finance would be setting core budget rules, and associating them with corresponding scales of control. Some of the types of rules we discussed earlier – transfers, carry-overs, reporting requirements and so forth – would allow for a scale of autonomy, and different entities would be themselves selecting how they go about undertaking their financial management obligations. The idea here is working internally to a system which is trying to calibrate the level of central monitoring with self-selected behaviour on the part of line ministries. This is also to some extent mirroring the way that some traditional notions of central agency control have operated. So some of you might be familiar with Hecló and Wildavsky's (1974) *Private Government of Public Money*. These are exactly the sorts of village culture type practices that have been operating in the past, which are basically reputation and trust based.

One of the things we're focusing on here is the extent to which earned autonomy is a way of operationalising this notion of sanctioned rule breaking. Because what it's starting to do is work through what the tolerance limits are. If Agency A has demonstrated good behaviour and can be trusted, it is given more capacity to act flexibly within existing rule sets than Agency B that has not shown those capacities.

One of the constraining influences here is going to be external perceptions of the way risk is being defined. This is exactly what the Department of Finance is working through at the moment. The Commonwealth Government has gone through a process of reviewing and then legislating for a new financial management framework that is integrated with both performance and governance requirements. It is conceiving of an earned autonomy type model operating at the Commonwealth level. The issue is that it's under construction and they are still working through how to operationalise key aspects of the model. The key idea is to look at how a minimal rule set would apply across the whole of government, and then varying its application in relation to oversight and intervention based on a central assessment of risk profile and something called 'performance'.

We've identified a couple of potential weaknesses with this approach. Firstly, the definition and the metrics for risk (Pat Barrett, the former Australian Auditor-General, has also noted this in some commentary on this type of approach). It's very hard to define risk, particularly when you're trying to calibrate political and budget risk. Budget materiality does not necessarily equate with political risk. The other potential weakness is something academic accountant Susan Newberry has noted, which is that 'reducing' disclosures misses the point of accountability. That's not the intent here, which is to ensure that there is a basic set of disclosures that are applied in more detail to those who haven't demonstrated the requisite behaviours.

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To conclude, I'll reiterate that traditional budgeting operates through a number of particular conduits. Reform over the last 25-30 years has been about trying to increase both central control and flexibility. Those rules, we note, actually endure despite the reform. What we're proposing here is one way of thinking about how you can get a better balance between a degree of central control, which is necessary for accountability, and the flexibility that is of value in improving the response to complex problems.

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