

# Introduction

## CHAPTER

# 1

In what many characterize as the *information age*,<sup>1</sup> it is to be expected that any book dealing with large organizations operating in the world economy would focus extensively on information. This text is about complex governmental institutions that operate in a world economy and society, and its extensive focus on information is no surprise. We consider budgets, budgeting systems, and budgeting processes; the nature of the decisions that are made; and the processes by which those decisions are made. Budgeting has always been about information, and budget systems are about gathering the best information available, whether that information be primarily of a technical nature or of a political nature, and bringing that information to bear on decisions about allocating resources to purposes.

Public budgeting involves the selection of ends and the means to reach those ends. It involves the division of society's economic and financial resources between the public sector and the private sector, as well as the allocation of such resources among competing public sector needs. Public budgeting systems are systems for making choices of ends and means. These choices are guided by theory, by hunch, by partisan politics, by narrow self-interest, by altruism, and by many other sources of value judgment, including avarice and perceptions of the public interest.

Public budgeting systems work by channeling various types of information about societal conditions and about the private and public values that guide resource allocation decision making. Complex channels for information exchange exist. Through these channels, people process information on what is desired, make assessments of what is or is not being achieved, and analyze what might or might not be achieved. Integral to budgeting systems are intricate processes that link both political and economic values. In making decisions that ultimately determine how resources are allocated, the political process uses sometimes bewildering and often conflicting information about values, actual conditions, and possible condition changes. This text analyzes procedures and methods—past, present, and prospective—used in the resource allocation process.

This chapter examines some basic features of decision-making and budgeting systems. First, some major characteristics of public budgeting are explained through comparison and contrast with private forms of budgeting. Second, the development of budgeting as a means of holding government accountable for its use of society's resources is reviewed.

Next, budgets and budgeting systems are defined. Finally, the role of information in budgetary decision making is considered.

## **DISTINCTIONS REGARDING PUBLIC BUDGETING**

Budgeting is a common phenomenon. To some extent, everybody does it. People budget time, dollars, food—almost everything. The family hardware store budgets, Wal-Mart budgets, and governments budget. Moreover, important similarities exist in the budgeting done by large public and private bureaucracies.<sup>2</sup>

Budgeting is intended as a mechanism for setting goals and objectives, for allocating the resources necessary to achieve those objectives, for measuring progress toward objectives, for identifying weaknesses or inadequacies in organizations, and for controlling and integrating the diverse activities carried out by numerous subunits within large bureaucracies, both public and private. Budgeting is the manifestation of an organization's strategies, whether those strategies are the result of thoughtful strategic planning processes, the inertia of long years of doing approximately the same thing, or the competing political forces within the organization bargaining for shares of resources. Once resources are allocated through the budgetary process, the organization's strategies become apparent even if they have not been articulated as strategies. Budgeting means examining how the organization's resources have been used in the past, analyzing what has been accomplished and at what cost, and charting a course for the future by allocating resources for the coming budget period. Whether this process is done haphazardly or after exhaustive analyses, whether it is carried out by order of the chief executive officer or requires the extensive input of citizens, it is still budgeting.

Public budgeting is also about assigning responsibility for accomplishing the results intended by the executive and legislative actors that ultimately set the budget. Budgets are generally executed by individuals in large bureaucracies. Budget allocations identify not only the amounts to be spent and the intended purposes of those expenditures, but also the unit within the bureaucracy—and by implication, the individuals managing that unit—responsible for achieving the intended results. In the contemporary age in which much of the value in any process, whether producing a commercial good or producing a public service, is in the information or knowledge applied, responsibility for budget decisions and budget implementation is vastly more complicated. First, the information available to the decision makers, whether they choose to use it or not, is much more extensive. Second, decision-making processes are highly visible to citizens and other stakeholders. Thus, for practical reasons, and because strong central government controls are politically less feasible than in the past in most countries, budgetary decisions are more decentralized than ever.

### **Public and Private Sector Differences in Objectives**

#### *Resource Availability*

Important differences exist between the private and public spheres. In the first place, the amount of resources available for allocation in the budget process varies greatly. Both family and corporate budgeting are constrained by a relatively fixed set of available

resources, even if vastly different in size. Income is comparatively fixed, at least in the short run, and therefore outgo must be equal to or less than income. Of course, income can be expanded by increasing the level of production and work, such as a member of the family taking a second job, or temporarily by borrowing, but the opportunities for increasing income are limited.

Governments, in contrast, are bound by much higher limits. In the United States, at least, government does not use nearly all of the possible resources available. Only in times of major crises, such as World War II and the recession that began in 2007, has the government of the United States begun to approach the upper limits of its resources. In those two crises, the federal government borrowed an amount that eventually came close to equaling or even exceeding the total production of the economy in a year. During World War II, the government borrowed an amount about equal to the total economy's production, called *gross domestic product* (GDP), and the government spent most of it directly and indirectly on the war effort. Rationing, price controls, and other measures were imposed so as to severely limit private sector consumption and in its place allocate most of society's resources to the government. In the most recent recession, government again borrowed enough, on top of decades of annual budget deficits, that total government debt equaled and exceeded total GDP. That borrowing had a different purpose, of course—to stimulate the economy and to put money in the hands of producers and consumers.

During times not characterized by crisis, much of the total economy is left to the private sector, with government using only a fraction of society's workforce, goods, and services. In 2010, combined federal, state, and local government expenditures amounted to 36% of total GDP, with about three-fifths of that from the federal government. That percentage was several points higher, a result of government stimulus programs to combat the recession, than the 25% to 30% that has been typical since 1960, but it was still on the lower end compared to most industrialized countries (see the chapters on the public sector and economic development).<sup>3</sup> Government has the power to determine how much of society's total resources will be used for public purposes. Private parties operate within the limits of their ability to acquire resources through their market activities: selling their labor, selling goods, and so forth.

### *Profit Motive*

Another major distinction between private and public budgeting is the motivation behind budget decisions. The private sector is characterized by the profit motive, whereas government undertakes many things that are financially unprofitable. In the private sector, profit serves as a ready standard for evaluating previous decisions. Successful decisions are those that produce profits (as measured in dollars). Some companies, of course, focus on short-term profits, and others may take a longer-term view, but in the end, failure to achieve a profit or at least break even means the company goes out of business.

The concept of profit, however, can lead to gross oversimplifications about corporate decision making. Not every budget decision in a private firm is determined by the criterion of making an immediate profit. Corporations sometimes forgo profits in the short run. In the case of price wars, they attempt to increase their share of a given market even if it means selling temporarily at a loss. At other times, they incur large debts and take other, apparently unprofitable, actions to combat a hostile takeover, an attempt by an outsider to purchase

enough stock to exercise control over a corporation's assets. Their major objectives are sometimes to produce a good product and to build public confidence. They have enough confidence in their pursuit of customer service that the result will be sustained, long-run profits. At other times, they undertake actions for mainly social motives, wishing to make a contribution to the society that sustains their corporate existence, a concept known as corporate social responsibility (CSR).<sup>4</sup> Still, in private sector firms, revenues must exceed costs over the long run.

Large firms also budget significant resources for research and development (R&D) activities, only a few of which will eventually lead to a product that generates large sales and profits. An R&D division can be evaluated over the long term by how many of its developments contribute to profits, but this kind of evaluation is difficult. Often, the results of R&D are subtle improvements in existing products, and measuring the amount of investment relative to the incremental profit gain is impossible. In this regard, private budgeting for R&D is no less difficult than the federal government's support of R&D. Overall, the evidence is that investing in R&D yields positive returns on that investment.<sup>5</sup>

Regardless of the role profit plays in the private sector, government decision making in general lacks even this standard for measuring activities. Exceptions to this generalization are government activities that yield revenues. State control and sale of alcoholic beverages, whether undertaken for profit or for regulation of public morals, can be evaluated, like any other business, in terms of profit and loss. Similarly, the operation of a water system, a public transit authority, or a public swimming pool can be evaluated in business profit-and-loss terms. This does not mean that each of these should turn a profit. After all, operating a public swimming pool may be the result of a decision to provide subsidized recreation to a low-income neighborhood whose residents cannot afford other private recreational alternatives. The budgeting process, however, can be used to assess the operation as a business to clarify the subsidy level and to aid decision makers in comparing costs with those for other public services provided free of direct charge (see the chapter on capital assets).

Nevertheless, the majority of private sector budget decisions pertain to at least long-term profits, and most public sector budget decisions do not. Governments undertake some functions deliberately instead of leaving them to the private sector. Public budgetary decisions, for example, frequently involve allocation of resources among competing programs that are not readily susceptible to measurement in dollar costs and dollar returns. For example, there are no easy means of measuring the costs and benefits of a life saved through cancer research, although the value of future earnings is sometimes used as a surrogate measure of the value of life. The U.S. government undertakes large programs to control or eradicate malaria and other tropical diseases in Africa, based not on economic or financial returns, but on a broad concept of the public interest in eradicating diseases that affect low-income populations in developing countries. Nor is there a ready means of clearly separating private incentives from public incentives. For example, although the National Cancer Institute spends millions of public dollars annually on cancer research, the amount is minuscule compared with the amount spent by private companies on research for cancer prevention and treatment.

Just because most public sector activities are not intended to be profitable does not mean that business-like measurement of results in relation to costs is useless. Although not

susceptible to bottom-line or profit-and-loss measurement, many government programs are able to measure their results in terms of output (efficiency) and outcome (effectiveness). The tropical disease eradication programs undertaken by the U.S. government for reasons of the public interest, for example, can and are measured by the efficiency and effectiveness with which the programs are implemented. Legislation passed in 1993 mandated the use of performance measures to improve the federal government's accountability for the results of its expenditures. That act was reaffirmed and updated in 2010 with the GPRA Modernization Act (GPRAMA).<sup>6</sup>

## Public and Private Sector Differences in Services Provided

### Public Goods

Some government services yield public or collective benefits that are of value to society as a whole, whereas corporate products are almost always consumed by individuals and specific organizations. When Ford Motor Company produces automobiles, people buying the automobiles use them to meet their own personal needs. When the Departments of Defense and Homeland Security produce a network for preventing nuclear devices from entering the nation's ports, that network benefits the public in general. Economists call these kinds of products and services *public goods*. They have two properties. The first is *nonexcludability*. Once the network is in place, no one can be excluded from its benefits, even if they are unwilling or unable to pay for them.<sup>7</sup> The second is *nonrivalness*. One person's use of the good or service does not diminish another person's use. For example, a second person can "consume" national defense without lessening the benefits that the first person gets from that public good. Of course, few public products and services qualify as pure public goods, and many goods and services produced by governments are also produced by the private sector. Police protection is a public service, but communities, companies, and individuals also purchase various forms of protection against crime from private security companies.

### Externalities

Another class of government services consists of those from which individuals can be excluded but for which the benefits, or costs, extend beyond those who are the immediate targets of the service. When Ford Motor Company sells a car, its stockholders enjoy the benefits of the profits, but those profits do not spill over to society at large. However, when a child is educated through a school system, not only does the child benefit, but society's productive capacity is also enhanced. Many private schools educate children for a profit, and the owners of the schools enjoy the benefits of the profits along with the children and society. However, it seems unlikely that these same for-profit schools would willingly provide equivalent education to all children who cannot make tuition payments. Economists label the benefits that spill over to the rest of society *externalities*. Governments provide at least some services that produce significant externalities because the private sector would provide these only to the extent that profit could be made. Education, if left entirely to the private sector, would presumably be available only to those who could pay, or would be provided in insufficient quantity and quality for the needs of society.

### *Pricing Public Services*

Defining just what is clearly public in nature and determining what the private sector presumably cannot or will not provide is controversial. During the 1980s and 1990s, the federal government cut back on transfers to state and local governments, which also faced more stringent tax and spending limitations inspired by their voters (see the chapter on transaction-based revenue sources). As a consequence, many services once thought to be exclusively public were converted to private services or to public services provided by private firms on a contract basis.<sup>8</sup> That trend continued when state and local budgets shrank dramatically in the two recessions of the first decade of the 2000s, though there is some evidence that smaller jurisdictions or smaller private contracting for public services has waned somewhat, while large contracts seem to be increasing.<sup>9</sup>

This trend advanced throughout many developing countries with public sectors even larger than in the United States. The Margaret Thatcher government, in privatizing many formerly public services such as the water utilities throughout the United Kingdom, served as a model for the early 1980s movement in the United States and around the world (see the discussion of various forms of privatization and private participation in public services).

This type of conversion is not a new idea, but public sector budget pressures have changed the landscape to require those who benefit directly from a government service to pay for its cost. For example, in the 1990s the U.S. Coast Guard stopped providing towing services to disabled boats unless a genuine emergency exists; it instead notifies private operators, who charge the cost to the disabled boat captain. That practice has cut back significantly on calls for towing in general, with prices providing a rationing mechanism. What is private and what is public varies over time, and public budgeting is affected by those variations.<sup>10</sup>

### *Other Public and Private Sector Differences*

Whatever objectives, other than profit, that private corporations may have, to stay in business they must seek economic efficiency and obtain the greatest possible dollar return on investments. In contrast, governments may be intentionally inefficient in resource allocations, undertaking services that the private sector would be reluctant to provide at all. For example, government-financed medical care for the elderly may be inefficient in the sense that other government programs provide greater economic returns to society, but it has been agreed that at least some support should be provided to the elderly. Governments are also charged with other unique responsibilities such as intervention in the economy (see the chapter on government and the economy).

Another difference between private and public organizations lies in the clientele and the owners of the means of production. In theory, at least, both corporations and governments are answerable to their stockholders and clients. In the private sector, these individuals can disassociate themselves from firms. Their counterparts in the public sector are denied this choice except through the extreme act of emigration. Private stockholders expect dollar returns on their investments, and if they are not satisfied, they sell their shares. Because government costs and returns are not so easily evaluated, the electorate has no simple measure for assessing the returns on the taxes they pay, and they have no means to sell their shares, other than to move to another country. Even so, many state and local governments

provide annual reports to citizens that are similar in purpose to stockholder reports. These reports emphasize the investments government is making and the benefits citizens are receiving in lieu of profits. Of course from time to time the stockholders of corporations and of governments force management to change, the latter through regular elections.

Corporate budgetary decision making is usually more centralized than government decision making. Corporations can stop production of economically unprofitable goods such as Hummer vehicles. Given the nature of the public decision-making process, however, governments encounter more difficulty in making decisions both to inaugurate programs and to eliminate them. For example, though there was an apparent large majority consensus for more than two decades that the Medicare program that assists the elderly in financing health care should include some form of prescription drug coverage, it was not until 2006 that a program was finally implemented.

## RESPONSIBLE GOVERNMENT AND BUDGETING

The emergence and reform of formal government budgeting can be traced to a concern for holding public officials accountable for their actions.<sup>11</sup> The government performance monitoring movement represents the most recent manifestation of a rather ancient concern that public officials be held accountable for their actions.<sup>12</sup> No matter the particular reform terminology in vogue, in a democracy, budgeting is a device for limiting the powers of government. Two issues recur in the evolution of modern public budgeting as an instrument of accountability: responsibility to whom and for what purposes.

### Responsible to Whom?

#### *Responsibility to Constituency*

Basically, responsibility in a democratic society entails constituents holding their officials answerable, usually through elections. Elected executives and legislative representatives at all levels of government are, at least in theory, held accountable through the electoral process for their decisions on programs and budgets. In actuality, budget documents are not the main source of information for decisions by the electorate. Obviously, most voters do not diligently study the U.S. budget before casting their votes in presidential and congressional elections. However, when the government's share of the total economy grows, it is increasingly clear that voters do hold elected representatives responsible for the overall budget, the budget deficit, and the general performance of the economy. That the electorate holds presidents responsible for the economy was evidenced in 1992 by President George H. W. Bush's defeat in his bid for reelection. Eight years later, the 2000 election showed that even in the midst of a booming economy, many voters were more concerned about apparent ethical and moral lapses in the White House than their happiness with the economy.

The 2010 midterm elections changed the majority party control of the U.S. House of Representatives from Democratic to Republican hands and reduced the Democratic majority in the Senate. The 2010 election issues spoke to the voters' concerns about the economy and the national debt.

State and local governments have specific creditors: the purchasers of bonds issued to finance long-term capital improvements. The interest rates that state and local governments have to pay on their bonds are affected by their ability to provide creditors with convincing evidence of their creditworthiness (see the chapter on capital finance and debt management). Hence, financial institutions that purchase bonds and ratings institutions that rate state and local bonds are important constituents to whom these governments are accountable.

Because the public in a large society cannot be fully informed about the operations of government, the United States has used the concepts of *separation of powers* and *checks and balances* as means of providing for responsible government. Power is divided among the executive, legislative, and judicial branches, and each provides some checks on the others. Although the president is held responsible to Congress for preparation and submission of an executive budget, only Congress can pass the budget. Specifically, the U.S. Constitution, in Article I, Section 9, states that “no money shall be drawn from the Treasury, but in consequence of appropriations made by law....” In most states and many localities, the chief executive has a similar responsibility to recommend a plan for taxes and expenditures. The legislative body passes judgment on these recommendations and subsequently holds the executive branch responsible for carrying out the decisions. Local government practice varies more since some local governments do not have an elected chief executive.

### *Development of the Executive Budget System*

The development of an executive budget system for holding government accountable was a long process that can be traced as far back as the Magna Carta in 1215. The main issue that resulted in this landmark document was the Crown’s taxing powers. The Magna Carta did not produce a complete budget but concentrated only on holding the Crown accountable to the nobility for its revenue actions.<sup>13</sup> At the time, the magnitude of public expenditures and the use of these funds for public services were of less concern than the power to levy and collect taxes. It was not until the English Consolidated Fund Act of 1787 that the rudiments of a complete system were established. A complete account of revenues and expenditures was presented to Parliament for the first time in 1822.<sup>14</sup>

The same concern in eighteenth-century England for executive accountability was exhibited in other countries. It was carried over to the American experience even prior to the ratification of the Constitution in 1789. Fear of a strong executive branch was evidenced by the failure to provide for such a branch in the Articles of Confederation in 1781. Fear of “taxation without representation” probably explains why the Constitution is more explicit about taxing powers than the procedures to be followed in government spending.

The first decade under the Constitution saw important developments that could have resulted in an executive budget system, but the trend was reversed in subsequent years. The Treasury Act of 1789, establishing the Treasury Department, granted to the secretary the power “to digest and prepare plans for the improvement of the revenue ... [and] to prepare and report estimates of the public revenue and expenditures.”<sup>15</sup> Alexander Hamilton, secretary of the treasury, in interpreting his mandate broadly, asserted strong leadership in financial affairs. Although the act did not grant the secretary power to prepare a budget by recommending which programs should and should not be funded, such a development might have subsequently occurred.

Instead, Hamilton's apparent lack of deference to Congress strengthened that body's resolve for greater legislative control over financial matters. To curtail the discretion of the executive branch, Congress resorted to the use of increasing numbers of line items, specifying in narrow detail for what purposes money could be spent.<sup>16</sup> The pattern emerged that each executive department would deal directly with Congress, thereby curtailing the responsibilities of the secretary of the treasury. The budgetary function of the Treasury Department became primarily ministerial. The Book of Estimates, prepared by the secretary and delivered to Congress, could have become the instrument for a coordinated set of budgetary recommendations. Instead, it was simply a compilation of departmental requests for funds. A. E. Buck wrote, "Thus budget making became an exclusively legislative function in the national government, and as such it continued for more than a century."<sup>17</sup>

### *Modern Executive Budgeting*

By the beginning of the twentieth century, changing economic conditions stimulated the demand for more centralized and controlled forms of budgeting. E. E. Naylor wrote that before this time there was little "enthusiasm for action ... since federal taxes were usually indirect and not severely felt by any particular individual or group."<sup>18</sup> By 1900, however, existing revenue sources no longer consistently produced sufficient sums to cover the costs of government. At the federal level, the tariff could not be expected to produce a surplus of funds, as had been the case. Causes of this growing deficit were the expanded scope of government programs and, to a lesser extent, waste and corruption in government finance. The latter is often credited as a major political factor stimulating reform.

Local government led the way in the establishment of formal budget procedures. Municipal budget reform was closely associated with general reform of local government, especially the creation of the city manager form of government. In 1899, a model municipal corporation act, released by the National Municipal League, featured a model charter that provided for a budget system whose preparation phase was under the control of the mayor. In 1907, the New York Bureau of Municipal Research issued a study, "Making a Municipal Budget," that became the basis for establishing a budgetary system for New York City.<sup>19</sup> By the mid-1920s, most major U.S. cities had some form of budget system.

Substantial reform of state budgeting occurred between 1910 and 1920. This reform was closely associated with the overall drive to hold executives accountable by first giving them authority over the executive branch. The movement for the short ballot, aimed at eliminating many independently elected administrative officers, resulted in governors being granted greater control over their bureaucracies. Ohio, in 1910, was the first state to enact a law empowering the governor to prepare and submit a budget. A. E. Buck, in assessing the effort at the state level, suggested that 1913 marked "the beginning of practical action in the states."<sup>20</sup> By 1920, some budget reform had occurred in 44 states, and all states had a central budget office by 1929.<sup>21</sup>

Simultaneous action occurred at the federal level, and much of what took place there contributed to the reforms at the local and state levels. Frederick A. Cleveland, who was director of the New York Bureau of Municipal Research and who played a key role in national reform, asserted that "it was the uncontrolled and uncontrollable increase in the cost of government that finally jostled the public into an attitude of hostility."<sup>22</sup> In response

to this public concern, President William H. Taft requested and received from Congress in 1909 an appropriation of \$100,000 for a special Commission on Economy and Efficiency. Known as the Taft Commission, the group was headed by Cleveland and submitted its final report in 1912, recommending the establishment of a budgetary process under the direction of the president. This report was to spur activity at the state and local levels.

The Budget and Accounting Act, which established the new federal system, was not passed until 1921.<sup>23</sup> In the interim, deficits were recorded every year between 1912 and 1919, except for 1916. The largest deficit occurred in 1919, when (largely because of the need to finance World War I) expenditures were three times greater than revenues (\$18.5 billion in expenditures as compared with \$5.1 billion in revenues). During this period, vigorous debate centered on the issue of whether budget reform would in effect establish a superordinate executive over the legislative branch. In 1920, President Wilson vetoed legislation that would have created a Bureau of the Budget and a General Accounting Office on the grounds that the latter, as an arm of Congress, would violate the president's authority over the executive branch. The following year, President Warren G. Harding signed virtually identical legislation into law.

Thus, an executive budget system was established, despite a historical fear of a powerful chief executive. In 1939, as a result of recommendations made by President Franklin D. Roosevelt's Committee on Administrative Management (the Brownlow Committee), the Bureau of the Budget was removed from the Treasury Department and placed in the newly formed Executive Office of the President. This shift reflected the growing importance of the bureau in assisting the president in managing the government. Ten years later, the budgetary task force of the First Hoover Commission on the Organization of the Executive Branch recommended that the Bureau of the Budget be reinstated in the Treasury Department, but the commission as a whole opposed the recommendation.<sup>24</sup> The Budget and Accounting Procedures Act of 1950 reinforced the trend of presidential control by explicitly granting the president control over the "form and detail" of the budget document.<sup>25</sup> The Second Hoover Commission in 1955 endorsed strengthening the president's power in budgeting as a means of restoring the "full control of the national purse to the Congress."<sup>26</sup> A president, who had full control of the bureaucracy, could be held accountable by Congress for action taken by the bureaucracy.

One of the stated goals of the reform movement was to bring the sound financial practices of business to the presumably disorganized public sector—a goal often expressed by current reformers. Available evidence, however, indicates that business practices were not particularly exemplary at the turn of the century, suggesting that the reforms were largely invented in the public sector rather than being transferred into government from the outside.<sup>27</sup> It remains popular to advocate bringing good business practices to government, but the corporate accounting scandals that revealed false revenue claims in such giants as Enron and the subprime mortgage investment practices of the major financial market institutions suggest that private practices are not always exemplary.

## Responsible for What?

### *Revenue Responsibility*

The earliest concern for financial responsibility centered on taxes. As indicated above, the Magna Carta imposed limitations not on the nature of the Crown's expenditures but

on the procedures for raising revenue. The same concern for the revenue side of budgeting was characteristic of the early history of budgeting in this country. The Constitution is more explicit about the tax power of the government than about the nature or purposes of government expenditures.

### *Expenditure Control, Management, and Planning*

The larger the budget has become, the more the concern has shifted to expenditures. Increasing emphasis has been placed on the accountability of government for what it spends and for how well it manages its overall finances. Expenditure accountability may take several different forms. Budgeting scholar Allen Schick described the focus on accountability in U.S. budgeting as having gone through three stages by the 1960s.<sup>28</sup>

The first stage he characterized as concern for tight control over government expenditures. The most prevalent means of exerting this type of expenditure control is to appropriate by line item and object of expenditure. Financial audits are then used to ensure that money is, in fact, spent for the items authorized for purchase. This information focuses budgetary decision making on the things government pays for, such as personnel, travel, and supplies—the objects of expenditure—rather than on the accomplishments of government activities. In other words, responsibility is achieved by controlling the resources or input side.

Schick's description of the second stage was that of a management orientation, with emphasis on the efficiency of ongoing activities. Historically, this orientation is associated with the New Deal through the First Hoover Commission (1949). The emphasis was on holding administrators accountable for the efficiency of their activities through methods such as work performance measurement. Budgeting by activity achieves accountability by measuring the activities carried out for the money expended.

The third stage of budget reform Schick identified was based on the post-Hoover Commission concern regarding the planning function served by budgets. The traditional goal of controlling resource inputs may be accommodated in the short time frame of the coming budget year. Managerial control over efficiency, although aided by a longer time perspective, also may be accommodated in a traditional budget-year presentation. The planning emphasis focuses on a longer time frame. Many objectives of government programs cannot be accomplished in one budget year. A multiyear presentation of the budget is thus necessary to indicate the long-range implications, both financial and program results, of current budget decisions.

The advent of program budgeting in the 1960s with its focus on multiyear planning and the ultimate results of government programs was the culmination of the planning focus on outcomes that must be measured outside the government itself. Control-oriented information such as objects of expenditure and managerial-oriented information such as the outputs produced by government activities (and the costs to achieve those outputs) do not really require measurement outside the orbit of governmental agencies. A focus on outcomes requires much more extensive information that is not generated by the accounting system. Understanding outcomes requires information about what happens as a result of government expenditures. Typically, these outcomes are achieved only by commitment of resources over many budget years.

Some services provided by government lend themselves well to measures of accomplishment, and some do not. Federal responsibilities for defense and foreign policy certainly have visible consequences, but narrowing down to particular budget decisions on expenditures and particular defense or foreign policy outcomes is both conceptually and practically difficult at best. Local government services such as water, streets, solid waste collection and disposal, and so forth are much more susceptible to results measurement. The planning approach epitomized by program budgeting reforms stressed outcome measurement over a multiyear horizon. Are society's ends being achieved as a result of program expenditures?

### *Financial Management, Financial Condition, and Program Performance*

Since those three stages were first characterized in the 1960s, additional improvements in using information to ensure responsible government budgeting have become standard practice. Some have suggested that these efforts since the 1960s constitute additional or new stages of budget reform. One author has offered up prioritization, characterized by budget cutbacks in both federal and state government budgeting in the 1980s, as a fourth stage, and accountability, emphasizing performance measurement, as a fifth stage.<sup>29</sup> Another has suggested a similar fourth stage, labeling it limitation, emphasizing the attempts in the 1980s to shrink the federal budget and state taxing and expenditure limitations (see the chapter on budgeting for revenues and taxes).<sup>30</sup>

While it is clear that budgeting at the federal, state, and local levels continues to change in terms of emphasis and focus, the labeling of additional stages is somewhat in the eye of the beholder. It is difficult to discern a major difference between *limitation* and *control*, for example. It is also clear that some additional budgetary analysis and planning tools have become important in public budgeting systems since the three-stages description was first put forward. One of these is performance measurement and performance management, which enhances the ability to budget for the achievement of results. Another is financial management, which entails greater attention to the financial soundness of public sector institutions and new and enhanced tools to measure and report on financial soundness. Measuring financial health and increased use of business-like financial management tools enhances the ability of elected leaders to exert control over resources.

### *Performance Management*

Performance measures associated with work activities and with long-term results are not new, as already noted. However, performance measurement has evolved and expanded since the 1980s. Program budgeting was much more an approach for the executive to gain greater understanding and control over spending by focusing on plans and results. Today, performance measurement and management have a strong emphasis on public reporting on progress and redefining programs based on citizen response to the measured progress. This emphasis on public reporting is a logical extension of the broader concept of *accountability for results* that characterizes budgeting systems and reforms in budgeting. Newer information tools are focused on external communications. Local government budgeting increasingly focuses on performance budgeting as the major tool for communicating with the public and garnering public support for the budget.<sup>31</sup>

With or without a complete budgetary system overhaul such as program budgeting entails, all levels of government in the United States, and especially state and local government, typically have extensive performance management systems.<sup>32</sup> The “reinventing government” movement and the National Performance Review of the Clinton administration were two examples of the trend toward more measurement and management of results, but with a much greater emphasis on public reporting.<sup>33</sup> The George W. Bush administration built on that progress even while ending the National Performance Review, but moved toward the use of performance ratings with its Program Assessment Rating Tool and the President’s Management Agenda. The GPRA Modernization Act in 2010 included provisions intended to enhance both congressional and executive emphases on performance measurement and management.

Performance management emphasizes setting objectives and then motivating managers to be entrepreneurial in their pursuit of those objectives. Of course, since managing growth in government and achieving efficiencies is such a strong focus in performance management, the tools may also be used to shrink programs for other than managerial reasons. Other countries also have given the same emphases to results-oriented or value-driven budgeting as a primary tool in increasing the efficiency and reducing the size of the public sector.<sup>34</sup>

### *Financial Management*

Another feature that has seen heightened focus is the financial health of the governmental entity or the entire government. There are two facets to this: (1) improved public reporting on the financial condition of government, and (2) a significant focus on the value and condition of long-lived assets such as infrastructure systems. Publicly traded corporations have always had to answer to their stockholders for the financial condition of the corporation, and privately held companies at a minimum have to demonstrate sound financial condition to secure debt financing from lenders. But the application of financial management concepts to focus on the financial condition of government agencies was new in the late 1980s. The emphasis has been on creating tools for measuring the financial condition of government, adapted from private financial and managerial accounting practices, and new mechanisms for ensuring that the government remains in a sound financial position.

One of the motivations behind the concern to hold government accountable for its long-run financial position was the New York City budget crisis of the mid-1970s. Following on the heels of that near-bankruptcy, both financial institutions that purchased municipal bonds and citizens who wondered about their own cities sought to improve the reporting of the long-term financial position of governments.<sup>35</sup> At the time, the general operating budget and related accounting reports often did not reveal the overall financial position of the government entity. Now, virtually every large local and state government in the United States, as well as the federal government, routinely produces reports, often with much public fanfare on their financial condition.<sup>36</sup>

### *Fixed Asset Management*

Concern at the federal level has led to a much greater emphasis on fixed asset management and increased attention in the annual budget to investments in long-lasting assets. The Governmental Accounting Standards Board Statement No. 34 (GASB 34) requires state and local

governments and other public entities to report on their fixed assets (see the chapters on financial management and capital assets). Some government expenditures are really investments in future economic productivity. Others primarily consume resources with little hope of any future payoff. Investment means creating additional productive capacity, such as improving transportation networks that reduce the cost of private sector economic activity through more efficient means of transportation and upgrading education systems that enhance the long-term intellectual ability of students to develop new products and new processes.

All governments budget for these activities, but not all government budgeting systems make explicit the consumption-versus-investment tradeoffs in budget decisions. The argument can be made that some funds should be diverted away from social welfare programs that fail to produce new capability and toward investment opportunities that stimulate regional and national economic development. While most state and local governments employ formal capital budgeting techniques, federal agencies typically do not, although in specific types of investments, such as information technology, formalized capital investment planning and analysis now are required (see the chapter on capital assets).<sup>37</sup>

The notion of stages in budgeting can be overemphasized. Whether one decides ultimately to label trends as new stages, it is clear that there is a stronger emphasis on program and performance measurement and on financial management and reporting with significant efforts and new information tools at all levels of government. Most of the emphasis in this text is on the budget as an instrument for financial and program decision making at all levels of government—federal, state, and local. The one responsibility that most sharply differentiates federal budget decisions from state and local decisions is the federal government's responsibility for the overall state of the economy. Not only does the federal budget allocate resources among competing programs, but it is also an instrument for achieving economic stability and growth (see the chapter on government and the economy). The responsibility to use it as an instrument of economic policy has been a part of the federal budgetary process since the Employment Act of 1946.<sup>38</sup>

Budgeting is an important process by which accountability or responsibility can be provided in a political system. As has been discussed, responsibility varies both in terms of the people to whom the system is accountable and in terms of its purposes. Given the various forms of accountability and the types of choices that decision makers have available to them, different meanings can be attached to the terms *budget* and *budgeting system*. Depending on the purposes of a budget, decision makers will need different kinds and amounts of information to aid them in making choices. The following sections focus on the kinds of information required for different budgetary choices and the kinds of procedures for generating the necessary information.

## BUDGETS AND BUDGETING SYSTEMS

### What Is a Budget?

#### *Budget Documents*

In its simplest form, a budget is a document or a collection of documents that refers to the financial condition and future plans of an organization (family, corporation, government), including information on revenues, expenditures, activities, and purposes or goals.

In contrast to an accounting operating statement, which is retrospective in nature, referring to past conditions, a budget is prospective, referring to anticipated revenues, expenditures, and accomplishments. Of course, budgets always contain some information about past revenues and expenditures that is consistent with accounting records. Historically, the word *budget* referred to a leather pouch, wallet, bag, or purse. More particularly, “In Britain the term was used to describe the leather bag in which the Chancellor of the Exchequer carried to Parliament the statement of the Government’s needs and resources.”<sup>39</sup>

The status of budget documents is not consistent across political jurisdictions. In the federal government, the budget has limited legal status. It is the official recommendation of the president to Congress, but it is not the official document under which the government operates. As will be seen later, the official operating budget of the United States consists of several documents—namely, appropriation acts. In contrast, local budgets proposed by mayors may become official working budgets adopted in their entirety by the city councils.<sup>40</sup>

In still other instances, there may be a series of budget documents instead of one budget for any given government. These may include (1) an operating budget, which handles the bulk of ongoing operations; (2) a capital budget, which covers major new construction projects; and (3) a series of special fund budgets that cover programs funded by specific revenue sources (see the chapter on financial management). Special fund budgets commonly include those for highway programs financed through gasoline and tire sales taxes. In such cases, revenue from these sources is earmarked for highway construction, improvement, and maintenance. As another example, fishing and hunting license fees may constitute the revenue for a special fund devoted to the stocking of streams and the provision of ample hunting opportunities.

The format of budget documents also varies. On the whole, budget documents tend to provide greater information on expenditures than on revenues, which are usually treated in a brief section. On the expenditure side, budgets are multipurpose, in that no single document and no single definition can exhaust the functions budgets serve or the ways they are used. At the most general level, budgets can be conceived of as (1) descriptions, (2) explanations or causal assertions, and (3) statements of preferences or values.

### *Budgets as Descriptions*

Budgets are first descriptions of the status of an organization, whether it is an agency, a ministry, or an entire government. The budget document may describe what the organization purchases, what it does, and what it accomplishes. Descriptions of organizational activity are also common in budget documents. Expenditures may be classified according to the activities they support. For example, a revenue department may be concerned with initial tax collection, taxpayer assistance, and audit/enforcement. Another type of description, organizational accomplishments, states the consequences of resource consumption and work activities for those outside the organization. For example, successful job placements for individuals finishing a vocational rehabilitation program constitute one type of outcome or consequence of a public expenditure. These statements require external verification of the effects of the organization on its environment.

As descriptions, budgets provide a discrete picture of an organization at a point or points in time, in terms of resources consumed, work performed, and external effects. The

dollar (or euro or pound sterling) revenues and expenditures, according to these types of descriptions, may be the only quantitative information supplied. Alternatively, information may be supplied about the number and types of personnel; the quantity and kinds of equipment purchased; measures of performance, such as the number of buildings inspected or the number of acres treated; and measures of impact, such as the number of accidents prevented, the amount of crop yield increases, and so forth. Generally, the more descriptive material supplied, the more the organization can be held accountable for the funds spent, the activities supported by those expenditures, and the external accomplishments produced by those activities. Much of the history of budget reform reflects attempts to increase the quantity and quality of descriptive material available both to decision makers and to the public.

### *Budgets as Explanations*

When they describe organizations in terms of purchases, activities, and accomplishments, budgets also at least implicitly serve a second major function—explanation of causal relationships. The expenditure of a specific amount for the purchase of labor and materials that will be combined in particular work activities implies the presumed existence of a causal sequence that will produce certain results. Regardless of how explicit or how vague the budget document or the statements of organization officials may be, budgetary decisions always imply a causal process in which work activities consume resources to achieve goals. Some organizations may have little accurate information about accomplishments, especially public organizations whose accomplishments are not measured in terms of profit and loss. Governments may choose not to be explicit about particular results because they are difficult to measure, politically sensitive, or both. Regardless of the availability of information or the willingness of an organization to collect and use it, the budget is an expression of a set of causal relationships.

### *Budgets as Preferences*

Budgets are statements of preferences. Whether intended or not, the allocation of resources among different agencies, among different activities, or among different accomplishments reveals the preferences of those making the allocations. These may be the actual preferences of a few decision makers, but more often they are best thought of as the collective preferences of many decision makers arrived at through complex bargaining. A preference schedule reflects, if not any one individual's values, an aggregate of choices that become the collective value judgment for the local government, state, or nation.

## **What Is a Budgeting System?**

### *Systems*

Budgeting can best be understood as a kind of system, a “set of units with relationships among them.”<sup>41</sup> Budgetary decision making consists of the actions of executive officials (both in a central organization such as the governor's office or the mayor's staff and in executive line agencies), legislative officials, organized interest groups, and perhaps unorganized interests that may be manifested in a generally felt public concern about public

needs and taxes. All these actions are related, and understanding budgeting means understanding the interrelationships. Such understanding is best achieved by thinking in terms of complex systems.

A complex social system is composed of organizations, individuals, the values held by these individuals, the norms they act upon, and the relationships among these elements. A system may be thought of as a network typically consisting of many different parts with messages flowing among the parts. The elements of systems interact with each other to produce system results, or consequences, and the network of interactions may produce the same set of results through several different paths, or the same path may from time to time produce different outcomes.<sup>42</sup> Budgeting systems involve political actors, economic and social theories, numerous institutional structures, and competing norms and values, all of which produce outputs in patterns not immediately evident from studying only budget documents.

### *Budget System Outputs*

In a budgetary system, the outputs flowing from the network of interactions are budget decisions, and these vary greatly in their overall significance. Not every unit of the system will have equal decisional authority or power. A manager of a field office for a state health department is likely to have less power to make major budgetary decisions than the administrative head of the department, the governor, or the members of the legislative appropriations committees. Yet each participant does contribute some input to the system. The field manager may alert others in the system to the emergence of a new health problem and, in doing so, may contribute greatly to the eventual establishment of a new health program to combat that problem. Modern information technology and the greater emphasis on responsibility at all levels of the organization for achieving results means the lower-level staff in an agency are much more influential than they have been in the past. Even actors not in the formal budgeting system may influence the decisions. For example, doctors and hospitals, who are part of surveillance for early detection of the latest flu, in effect are providing inputs to the budgeting system.

Like the outputs of any other system or network, budget decisions are seldom final and more commonly are sequential. Decisions are tentative, in that each decision made is forwarded for action to another participant in the process. This does not mean that all decisions are reversible. Major breakthroughs, such as passage of the Elementary and Secondary Education Act of 1965, which provided substantial federal aid to education, are abandoned only in response to powerful political pressure.<sup>43</sup> The No Child Left Behind Act, which reauthorized major elements of federal assistance to elementary and secondary education, continued most of the key elements of the original 1965 legislation, although giving great emphasis to testing student achievement as a means of ensuring accountability at the classroom level (see the discussion in the chapter on intergovernmental relations).<sup>44</sup> Likewise, the introduction of prescription drug care into Medicare in 2006 was only after years of debate and proposals. Despite dissatisfaction, eliminating such hard-won programs once in place is nearly impossible. Subsequent budget decisions, therefore, are in large part bounded by previous decisions. The subsequent decisions tend to center on the question of changing the level of commitment—allocating more resources, fewer resources, or different kinds of resources—to achieve desired levels of impact or different types of impact.

### *System Interconnectedness*

Another feature of a system is that a change in any part of it will alter other parts. Because all units are related, any change in the role or functioning of one unit necessarily affects other units. In some instances, changes may be of such a modest nature that their ramifications for other parts of the system are difficult to discern. However, when major budgetary reforms are instituted, they assuredly affect most participants. For example, if one unit in the system is granted greater authority, individuals and organizations having access to that unit have their decisional involvement enhanced, whereas those groups associated with other units have diminished roles.<sup>45</sup> Thus, each individual and institution evaluates budget reforms in terms of how political strengths will be realigned under the reforms.

## INFORMATION AND DECISION MAKING

### Types of Information

To serve the multiple functions described in the preceding section, budgeting systems must produce and process a variety of information. Most of the major reforms, whether attempted or proposed, in public budget systems have been intended to reorganize existing information and to provide participants with new and greater quantities of information. Basically, two types of information exist: program information and resource information. The latter is more traditional. People are accustomed to thinking of budgets in terms of resources, such as monetary units and personnel. A budget would not be a budget if it did not contain dollar, ruble, or other monetary figures. Similarly, budgets commonly contain data on employees or personnel.

Conventional accounting systems provide much of the information that public organizations use for budgetary decisions. This type of information is limited to the internal aspects of organizations—for example, the location of organizational responsibility for expenditures and the resources purchased by those expenditures. When the decision-making system incorporates information about the results or implications of programs, one must leave the boundaries of the organization to examine consequences for those outside it. This step requires more extensive and more explicit clarification of governmental goals and objectives (see the chapter on the expenditure side of budget preparation) and increases the importance of analysis. This feature of budget reforms, such as program budgeting, zero-base budgeting, managing for results, and performance budgeting, with their emphasis on program information and priority setting, has generated the most heat among critics of budget reform.<sup>46</sup>

### Decision Making

Much of the criticism of reform has involved the argument that reform of decision-making systems must take into account the limitations on human capabilities to use all the information that might be collected and analyzed.<sup>47</sup> Although sometimes subtle differences distinguish theories of decision making, the various theories are often classified into three basic approaches: pure rationality, muddling through or incrementalism, and limited

rationality.<sup>48</sup> An early application of these notions to public sector decision making was Graham Allison's study of the 1962 Cuban Missile Crisis, *The Essence of Decision*, in which he characterized three models as rational, organizational, and governmental/political.<sup>49</sup> These are descriptive theories as well as prescriptions for how decisions ought to be made.

### Rational Decision Making

Decision making according to the pure rationality approach consists of a series of ordered, logical steps. First, all of an organization's or a society's goals are ranked according to priority. Second, all possible alternatives are identified. The costs of each alternative are compared with anticipated benefits. Judgments are made as to which alternative comes closest to satisfying the relevant needs or desires. The alternative with the highest payoff and/or least cost is chosen. Pure rationality theories assume that complete and perfect information about all alternatives is both available and manageable. Decision making, therefore, is choosing among alternatives to maximize some objective function. The rational choice model is built on microeconomics and the notion of the individual actor making an optimal choice to maximize the decision maker's utility.

The applicability of the rationality model is limited, and few argue that it is a description of how ordinary human beings make most decisions. It is most consistent with notions of technical or economic rationality, where objectives can be stated with some precision and the range of feasible alternatives is finite.<sup>50</sup> Also, the model can be of use where accurate predictions of behavior are possible, such as in the private market, where assumptions regarding rational behavior can be used to predict future economic trends.<sup>51</sup>

As a description of how government budgeting works, the pure rationality model is obviously misleading. Meeting the complete requirements of even a few of the steps is impossible. It has been argued that the costs of information are so high as to make it rational to be ignorant—that is, to make decisions on the basis of a limited search and limited information. Some attempts at budget reform have been criticized as attempts to impose an unworkable model, pure rationality, on government financial decision making. The use of program information has been a particular target for criticism.<sup>52</sup> However, this criticism is somewhat misdirected in that it is not so much the information search cost that is limiting, but rather the individual decision maker's perspective. Public budgeting decisions are made in a larger political context with numerous actors involved, a more complicated situation than the clear-sighted approach toward an agreed-upon objective that is the essence of the rational choice model.

### Incrementalism

The second approach to decision making, muddling through or incrementalism, is more akin to the organizational and political processes of actual decision making identified by Allison. It has been advocated as more realistic by critics of pure rationality, such as Charles E. Lindblom, Aaron Wildavsky, and others.<sup>53</sup> According to this view, decision making involves a conflict of organizational and individual interests and a corresponding clash of information that results in the accommodation of diverse partisan interests through bargaining.

“Real” decision making is presumed to begin as issues are raised by significant interest groups that request or demand changes from the existing state. Decision making is not some conscious form of pure rationality, but is a process of incrementally adjusting existing practices to establish or reestablish consensus among participants. Alternatives to the status quo are normally not considered unless partisan interests bring them to the attention of the participants in the decision-making process. There is only a marginal amount of planned search for alternatives to achieve desired ends. The decision process is structured so that partisan interests have the opportunity to press their desires at some point in the deliberations. Decisions represent a consensus on policy reached through a political, power-oriented bargaining process.

The most important characteristic of the muddling through, or incrementalist, approach is its emphasis on the proposition that budgetary decisions are necessarily political. Its descriptive appeal is that it more accurately depicts a process in which numerous actors, each with a different point of view, negotiate and bargain for a consensus. The larger the issue, the more difficult it is to achieve consensus for radical change, which results most often in incremental adjustments to the status quo. Whereas a purely rational approach might suggest that budgetary decisions are attempts to allocate resources according to economic or other “objective” criteria, the incrementalist view stresses the extent to which political considerations outweigh calculations of optimality. The strongest critics of many budget reforms have tended to equate those reforms with seeking to establish the pure rationality model or a solely economic model, a description rarely accepted by those proposing budget reforms. As will be seen throughout this text, any “real” budget reform is forced to accommodate the political nature of decision making. In reality, elements of rationalism and incrementalism pervade the budgetary process.<sup>54</sup>

### *Limited Rationality*

The third approach to decision making, a compromise between the other two approaches, is called limited rationality. This model recognizes the inadequacies in the assumptions behind the pure rationality description of decision making as applied to complex problems. While acknowledging the inherent constraints of human cognitive processes, limited rationality does not suggest that a deliberate search for alternative approaches to goal achievement is of no avail. Searching for alternatives is used to find solutions that are satisfactory but not necessarily optimal.

Substantial evidence, cited by some of the giants in budgeting (Wildavsky) and decision making (Lindblom), indicates that many decisions are indeed incremental, and clearly each budget decision does not require a thorough review of all options and careful calculations of the possible outcomes of each option. Yet major decisions that depart dramatically from the past are made from time to time in the budgetary process. Non-incremental change, especially at the macro level, addressing major deficits and surpluses, does occur.<sup>55</sup> And, of course, major events such as terrorist threats and creating a new agency such as the Department of Homeland Security cause non-incremental change, although the core of federal budgeting did not change significantly after September 11, 2001.<sup>56</sup> Furthermore, decision makers often do attempt to achieve public values and are motivated more by the

social and economic problems their agencies must address than by bureaucratic budget maximizing and interest-group pressures.<sup>57</sup>

Limited rationality suggests that large forces are marshalled at times for major change, and incremental adjustments are made at other times for issues that do not generate demand for substantial departure from the status quo. Decision theories do differ in how they view the values that decision making serves and the capacities of decision makers to serve those values. One model assumes virtually no limits on human capacities for processing information, another suggests that decision making should be sensitive only to partisan political interests, and still another attempts to strike a balance between the other models. The history of budgeting and budget reform, we argue, reflects the tensions among these approaches to decision making.

## SUMMARY

Public budgeting involves choices among ends and means. Public budgeting shares many characteristics with budgeting in the private sector, but it often requires the application of criteria different from those used by private organizations. Chief among these differences is that few public sector decisions can be assessed in terms of profit and loss. Private sector decisions, in contrast, ultimately must consider the long-run profit or loss condition of the firm.

Budgeting systems involve the organization of information for making choices and the structure of decision-making processes. Public budgeting systems have evolved as one means of holding government accountable for its actions. Budgetary procedures are developed to hold the government in general accountable to the public, the executive branch accountable to the legislature, and subordinates accountable to their managers. Budgetary procedures also are developed to specify what the executive is accountable for. Concern for the financial solvency of some city governments and the size of the federal budget deficit and total debt have led to reform proposals to use budgeting as a device for holding governments accountable for their long-term financial position. Renewed interest is evident in citizens demanding that governments report regularly on their performance.

Budgetary systems work through information flows. However, each participant in the budgetary process pays selective attention to information. The various theories of decision making differ in terms of how much information decision makers are willing and able to consider. The decision-making approach that seems best to characterize budgetary systems is the limited rationality approach. This approach underlies the discussions throughout this text.

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