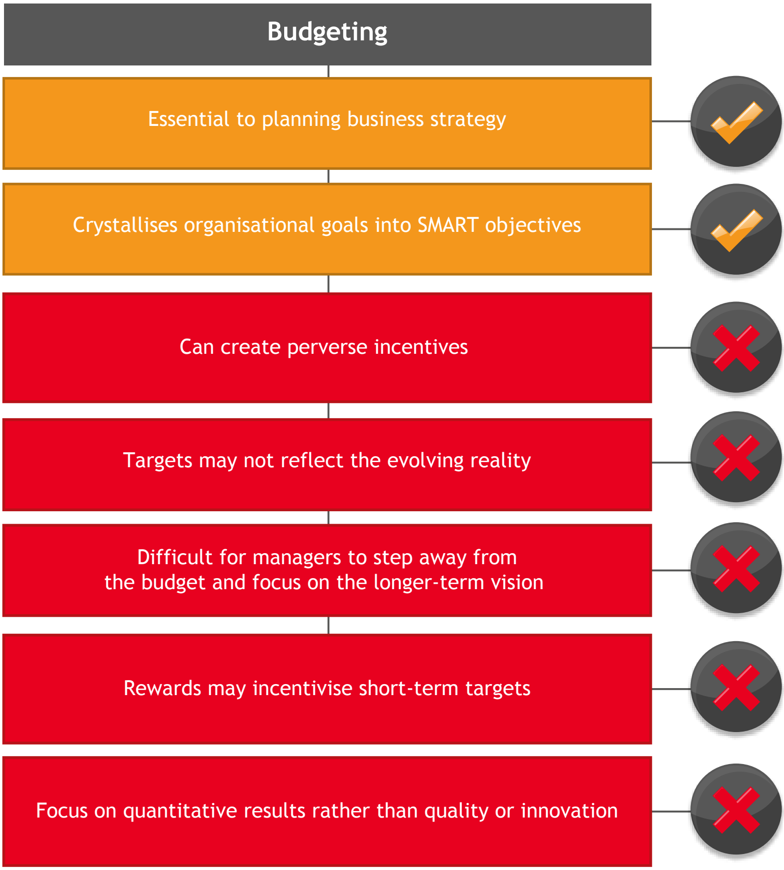
Chapter 16

Budgets - Problems and Perverse Incentives

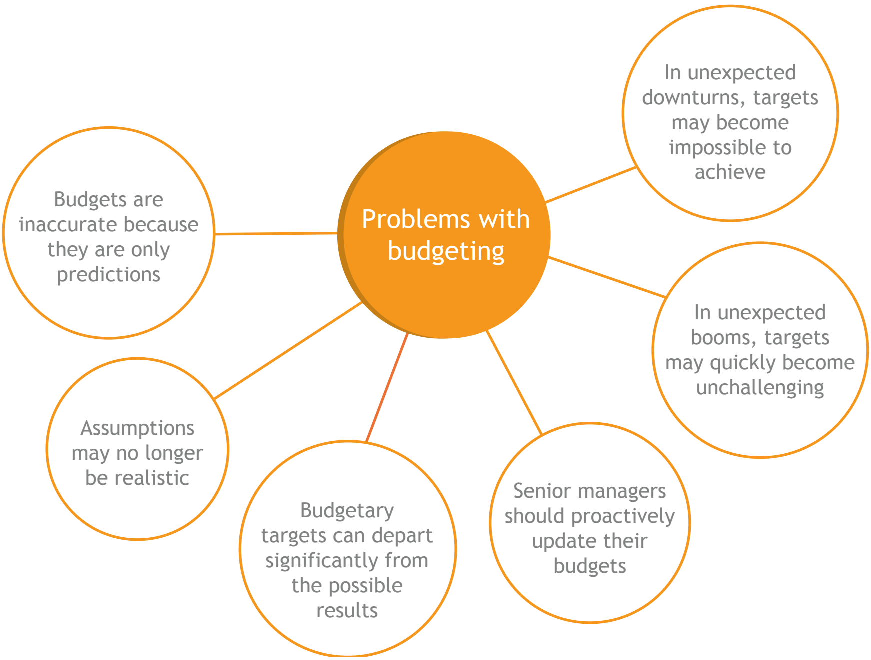
What problems does budgeting cause and how can it create perverse incentives?

Budgeting is essential to planning a well thought-out business strategy, but it can also bring significant problems and create perverse incentives for managers within the organisation.

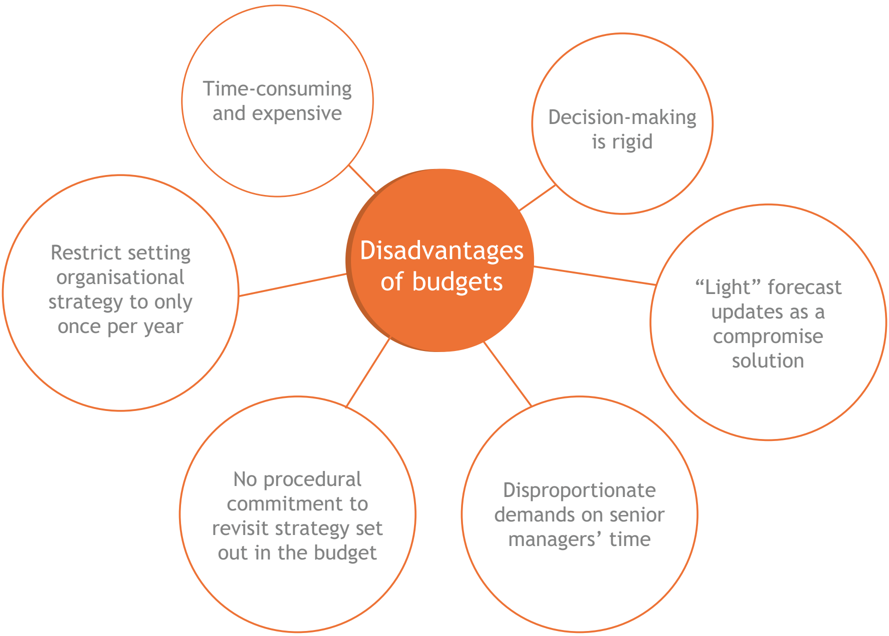


Whilst it crystallises general organisational goals into SMART objectives that filter down through all levels of the business, budgeting also anchors managers into focusing on targets which may not reflect the evolving nature of the business. It becomes difficult for managers to step away from the budget, and refocus back on the organisation's core mission and longer-term vision, particularly where personal financial incentives align to specific short-term targets. In short, the financial outcomes that meet the targets in the budget, can replace the broader goals that the business really wants to achieve. Budgets focus attention on short-term quantitative results, and this risks damaging long-term commitments to qualitative outcomes, such as quality or innovation.

Budgets can be inaccurate because they are inherently forward-looking, and even the best budgets are only predictions about future performance. They are based on a set of conditions and assumptions which may have been realistic when the budget was drawn up, but may no longer be reflective of business' current environment.



As unforeseen events occur and circumstances change, the targets for revenues and costs estimated in the budget can depart significantly from the actual results it is possible to achieve. Unless senior managers proactively update their budgets, for example in an unexpected economic boom, sales targets may quickly become unchallenging, and fail to motivate departmental managers to maximise their performance. Conversely, in an unexpectedly challenging market environment, profit targets may be impossible to achieve, and therefore demotivating to staff whose rewards are heavily aligned with meeting them.



The budget for the next financial year is usually drawn up towards the end of the previous year, and this can be seen to restrict the setting of organisational strategy to only once per annum

This makes decision-making rigid, because for the rest of the year there is often no procedural commitment to revisit the strategy set out in the budget, even when significant changes in the business environment or market conditions occur. A key reason for this is that budgets are time-consuming and expensive to create and modify, with demands falling disproportionately on senior managers. More sophisticated organisations may do "light" forecast updates quarterly, or even monthly, as a compromise solution.

Budgets introduce perverse incentives for managers not to cut costs, and indeed, even to engage in excessive expenditure. Effectively reducing costs and spending under budget may be incorrectly assumed by senior managers to be evidence of permanent efficiency gains. The danger is that they then cut the department's budget for the next period, without considering whether there were any special circumstances which made this simply a one-time saving. To protect their budget, and their perceived status and power within the organisation, the department manager may adopt a use-it-or-lose-it approach in which they authorise significant expenditure, irrespective of their actual need for the funds.

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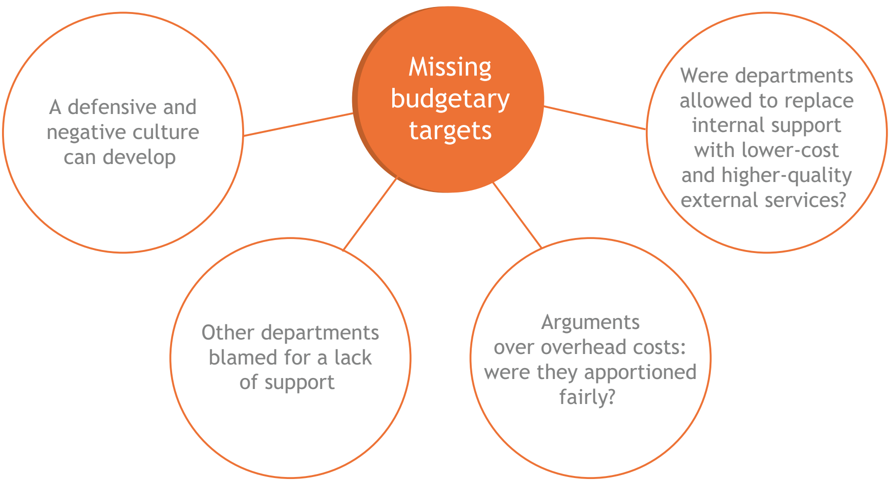
Furthermore, cynical managers may deliberately introduce budgetary slack when negotiating budgets with their line managers. Here, they argue for reduced revenue targets and increased cost estimates to virtually guarantee they achieve favourable variances that evidence good performance in their appraisals. The truth is, that if it is allowed to persist, budgetary slack will quickly undermine performance and erode the business' competitive position.

Perverse Incentives	
1	Spending under budget may be incorrectly assumed to be evidence of permanent efficiency gains
2	The department's budget is then cut
3	To protect their status, managers may adopt a use-it-or-lose-it approach
4	Managers may deliberately introduce budgetary slack
5	Easy targets guarantee favourable variances for appraisals
6	Budgetary slack quickly erodes the business' competitive position

When budgetary targets are missed, a defensive and negative culture can quickly develop

Accepting that objectives have not been met, managers may look to blame other departments for a lack of support, or for not providing key services effectively. They may therefore argue that the overhead costs apportioned to their departments were unjustified, because they did not receive the services they required. This may be a particular problem in organisations where departments are not allowed to replace services provided internally, with those from other businesses that may be lower-cost and higher-quality.

To avoid the problems of an excessive short-term focus, organisations sometimes use a balanced scorecard. Under this approach, they incentivise managers with a wide range of objectives, not only budgetary targets, but also longer-term goals such as customer satisfaction and staff retention.



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