Module 5

PERFORMANCE BUDGETING

GOVERNMENT OF ALBERTA

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Overview For Workshop Participants

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Faced with fiscal constraints and demands for more and better public services, governments at every level are discussing, experimenting with, and implementing new ways of budgeting. The budget is increasingly being seen as a tool to promote government accountability and effectiveness, rather than simply as a vehicle for allocating resources and controlling expenditures.

Performance based budgeting has been defined as a system wherein managers are provided with the flexibility to utilize agency resources as required, in return for their commitment to achieve certain performance results. This was also the fundamental underlying philosophy of the business planning process adopted by the government of Alberta in 1993. Ministries were provided with fixed resource allocations and expected to fulfill program obligations within those parameters. In exchange, financial controls were relaxed and the authority to reallocate funds among programs was delegated to ministries.

While no Canadian jurisdictions seem to have fully implemented performance based budgeting, many are putting in place the necessary prerequisites, such as activity based costing and performance measurement. In the US, a number of cities and states use this approach to budgeting; leading the field are the states of Texas and North Carolina.

What the various approaches have in common is an emphasis on results. Budgets are based on agreed upon outcomes rather than "historical efforts and good intentions."[1] Initiatives such as these are often referred to as *performance budgeting* and are designed to help answer the questions: can issues and problems be solved with more money or might other measures be more effective.[2]

What is Performance Budgeting?

Performance budgeting is a system of planning, budgeting, and evaluation that emphasizes the relationship between money budgeted and results expected.

Performance budgeting:

- *Focuses on results*. Departments are held accountable to certain performance standards. There is a greater awareness of what services taxpayers are receiving for their tax dollars.
- *Is flexible*. Money is often allocated in lump sums rather than line-item budgets, giving managers the flexibility to determine how best to achieve results.
- *Is inclusive*. It involves policymakers, managers, and often citizens in the budget "discussion" through the development of strategic plans, identification of spending priorities, and evaluation of performance. [3]
- *Has a long-term perspective*. By recognizing the relationship between strategic planning and resource allocation, performance budgeting focuses more attention on longer time horizons. [4]

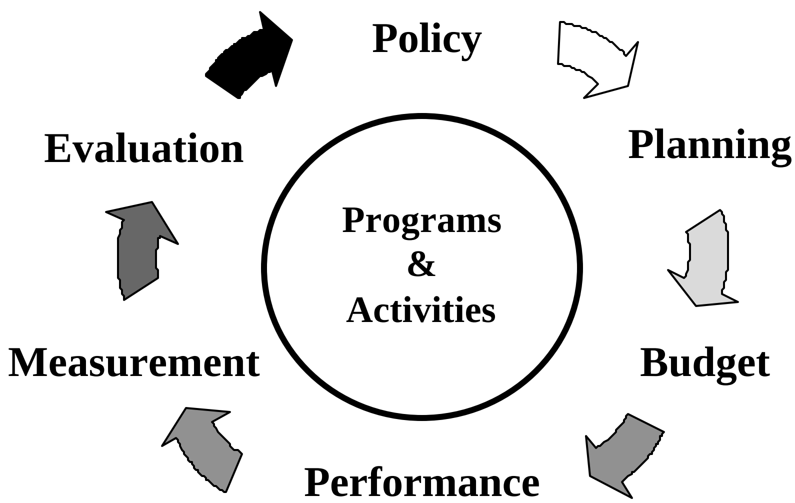
Common characteristics of performance budgets include:

- Agency identification of mission, goals, and objectives;
- Linkage of strategic planning information with the budget;
- Development and integration of performance measures into the budget; and
- Disaggregation of expenditures into very broad areas (such as personnel, operating expenses, and capital outlays) rather than more specific line-items.

As shown in *Figure 1*, performance budgeting is an integral part of an *ongoing process* that focuses on government accountability and performance improvement.

Figure 1

Budgeting is Part of the Performance Measurement Cycle



How Can Performance Information be Incorporated into the Budget Process?

Performance information can be incorporated into the budget process in three primary ways. Governments can: [5]

- Allocate resources based on results;
- Improve internal management of a given level of resources; and/or
- Use performance measures in financial reporting.

Although this training curriculum focuses on the use of performance information to allocate resources, there are clearly ways that individual managers can use and benefit from performance information even if their jurisdiction is not undertaking a broader effort. Individual managers are encouraged to turn to Module 4, *Using Performance Results*, for further information on how they can use performance information in managing internal resources and reporting to the public.

Contrast to Traditional Budgeting Methods

Performance budgeting represents a significant departure from traditional line-item budgeting.

A line-item budget is primarily a tool for controlling expenditures. As shown in *Figure 2*, a line-item budget typically spells out the level of spending allowed for specific purposes. As the fiscal year progresses, departmental spending must be within these amounts unless formal budget amendments are approved. Underspending in one category cannot automatically be used to supplement another category.

Figure 2

Sample Line-Item Budget

Department of Economic Development

	FY1993	FY1994
Personnel Costs	$1,813,015	$1,870,417
Employee Benefits	337,527	398,196
Travel In-State	60,533	86,000
Travel Out-of-State	112,105	198,000
Repairs and Maintenance	20,220	48,201
Rentals and Leases	454,123	377,000
Utilities and Communication	170,232	197,500
Professional Services	1,355,752	1,397,000
Supplies & Operating Expenses	188,380	428,102
Transportation Equipment Maintenance	2,611	43,000
Transportation Equipment—Purchases	-0-	80,000
Other Equipment—Purchases	13,278	20,000
Total Expenditures	$4,527,776	$5,143,416

While line-items can be useful in helping managers with internal control, they are not as useful as a policy or decision making tool. They assure elected and administrative officials that money is being spent only for approved purposes, but they do not show what is being accomplished with the money.

Other major drawbacks of line-item budgets include:

- They promote "inertia," with the focus being on making marginal changes from year to year.
- They can result in inefficient and uneconomical activities because management is not permitted enough flexibility to address changing situations and often must "use it or lose it" at the end of the year.
- They invite micromanagement, encouraging questions such as "why are we spending so much on supplies?" rather than "how have our efforts increased manufacturing exports this year?"

In contrast, performance budgeting has more of a policymaking orientation. It:

- Connects plans, measures, and budgets;
- Forces departments and policymakers to think about the big picture;
- Provides better information about the impact of budget decisions on people;
- Gives departments increased budgetary flexibility and incentives for generating budget savings;
- Allows for ongoing monitoring to see if agencies are moving in the right direction;
- Strengthens legislative decision making and oversight;

- Enhances financial accountability to citizens, decision makers, and governmental monitoring agencies; and
- Supports better management and evaluation.

As shown in *Figure 3*, a performance budget tells the reader much more about what the department does and what it is expected to accomplish with the funds budgeted.

Figure 3

Sample Performance Budget

Health Department, City of Milwaukee

Objective 1: To control the spread of communicable disease in Milwaukee by increasing the immunization level of two-year olds from 35 percent in 1993 to 90 percent by the year 2000.

		1993 Actual	1993 Expenditure	1994 Estimate	1994 Budget
Outcome Indicator:	Percent of two-year-olds immunized	35.0%	$4,172,585	37.2%	$5,813,303

Source: Excerpted from Anne Spray Kinney, "Mission, Management, And Service Delivery: Integrating Strategic Planning and Budgeting in Milwaukee," *Government Finance Review*, October 1995, p. 9.

Does moving to a performance budget mean that elected officials must give up all control over expenditures? No. Elected officials continue to have the authority to review expenditures at any time, although typically they do so only as a spot check or to resolve particular problems.[6] And, most importantly, elected officials have the authority to hold department heads accountable for achieving the performance targets specified in the budget–and within the funds appropriated.

Nevertheless, some governments make the transition to performance budgeting slowly in order to increase decision makers' comfort with the new system. Some, for example, continue to appropriate by line-item, while giving managers more flexibility to move funds; others maintain general types of line-item control, such as ceilings on the number of job positions in each department.[7]

The Evolution of Performance Budgeting

The current interest in performance budgeting builds on previous budget research and experience. For example:

- The New York Bureau of Municipal Research of 1907, the Hoover Commission of the 1940s, and systems analysis of the 1950s introduced elements that have found application in later budgeting systems, including attention to developing measures of workload and cost effectiveness;

- The Planning-Programming-Budgeting system (PPBS), which was applied initially at the federal level and became more widely popular in the 1960s, strengthened and institutionalized program analysis, multi-year planning, and rolling multi-year budgets;[8]

- Management by objectives (MBO), a technique that requires regular reports on departmental progress toward achieving agreed-upon objectives, became popular in the 1970s–though primarily as a management, rather than budgeting, tool; and

- Zero-based budgeting (ZBB), introduced at the U.S federal level in the 1970s, emphasized evaluating all programs each year rather than "concentrating on budgetary changes at the margin." ZBB attempted to analyze the incremental change in a program's output at different levels of funding.

Clearly, performance budgeting is not an entirely new budgeting system. Elements of earlier systems that are reflected in performance budgeting include:

- The planning emphasis of PPBS is incorporated through strategic planning and the use of a program structure;
- Common to both MBO and performance budgeting are the setting of objectives and performance targets; and
- ZBB's determination of expected levels of performance for each level of expenditure and setting priorities on spending "packages" are concepts which a number of governments have incorporated into performance budgeting initiatives.

What lessons can be learned from these earlier efforts? Analysis by the Congressional Budget Office suggests that:[9]

- Commitment to the measurement system at all levels is necessary if it is to be successful. Earlier efforts suffered from lack of clear agreement over goals and objectives.
- The data that are collected must be used. Each of the earlier systems produced "mounds of paper" which, for the most part, were not read nor used for decision making—breeding cynicism among participants.
- The design of the budget systems must take into account the difficulties in linking the measurement of outcomes to budgeting

Implementation Steps

As you move towards implementation, be sure to give attention to the shortcomings that derailed earlier efforts–in particular, take steps to help ensure that performance information will be *used*. Also, be aware that implementation is a continuous process; it evolves as improvements are made in performance measures and the reporting of performance.

Step One: Gain consensus and commitment from key players.

As discussed in further detail in Module 7, *Creating and Sustaining a Supportive Environment*, there are two basic approaches toward creating both a structure and attitudes that will support performance budgeting over the long-term. The "top-down" approach mandates these activities through resolution or legislation. The state of Arizona and the city of Austin, Texas, for example, both used legislation to "kick-start" budget reform.

The "bottom-up" approach seeks to build consensus more slowly. Catawba County, North Carolina, took such an approach, asking departments to volunteer for a pilot program rather than mandating participation by all departments. The result has been a dual budgeting system in which some departments continue to develop a line-item budget, while other departments develop performance measures, have more budget flexibility, and focus on outcomes.

Performance based budgeting is not envisioned as a reward and punishment system based on level of performance, but rather as an approach to evidence based decision making. The key intended benefit is to shift the focus and debate away from the level of program inputs, and focus on results. If the current level of results is unacceptable, the reasons for poor performance should be examined and if current strategies are ineffective, program changes may be necessary.[10]

The relationship between all stakeholders is crucial for understanding and success. A lack of consensus between the branches is likely to result in either:

- Management viewing performance measurement as merely a "paper exercise" and failing to use the information for program improvement; and/or
- The legislature failing to see the value of performance information and continuing to rely on line-item budgeting.

Early involvement of stakeholders in the development of strategic plans and performance measures can go a long way towards building consensus and commitment. As discussed in further detail in Module 4, *Using Performance Results*, decision makers and other stakeholders are generally most supportive of performance measurement systems that they have helped to develop themselves. Not only are such systems most likely to address their needs, but they are also less "threatening" by nature. Indeed, many individuals feel very threatened when a performance measurement system is introduced, fearing that "negative" performance information will lead to budgetary or staffing reductions–or even program elimination.

If managed well, in fact, performance budgeting may over time strengthen relationships between the branches of government. In Arizona, for example, the legislative fiscal office and the executive budget office have been brought into closer contact in conducting the in-depth program reviews required as part of the state's budget reform legislation.[11]

Step Two: Develop an implementation plan and timetable.

Development of an implementation plan can help smooth your transition to performance budgeting by addressing potential roadblocks, establishing clear expectations and responsibilities, and laying out a timetable to keep efforts on track. In developing such a plan, a number of jurisdictions have found it helpful to consult with both the "developers" and "users" of budget information. In Iowa, for example, the Department of Management conducted detailed interviews with all 26 department heads, surveyed 200 top officials, and conducted focus groups with legislative leaders and budget staff.[12]

The budget calendar should be an important element in your implementation plans. At a minimum, your calendar should indicate when:[13]

- Budget instructions will be provided to departments;
- Citizen input will be obtained;
- Department submissions must be completed;
- Meetings will be held with department representatives to clarify submissions;
- The draft budget will be presented to the governing body;
- The proposed budget will be advertised;
- The budget will be formally adopted; and
- The budget will go into effect.

Be realistic in establishing your plans and timetables. It is important to recognize that it takes considerable time and effort to implement successfully a performance budgeting system. Most governments devote a significant amount of time at the front end to building support and expertise. Florida, for example, has established a seven-year calendar for phasing all agencies into a new performance budgeting system. Each agency is expected to take approximately one year to define its programs and develop appropriate performance measures. "While this appears to be a long time," observes the National Association of State Budget Officers, "most states undergoing this process realize that developing relevant measures and integrating them into the management of an agency is a change that requires both time and capacity."[14]

Smaller jurisdictions can expect to need considerably less time, although change can still not be expected to happen overnight. In Milwaukee, for example, lead time was needed in order to establish links between strategic planning and budgeting. First, a citywide strategic plan was developed in 1991. Agencies then developed strategic plans in 1993 prior to preparing 1994 budget requests under a new performance budgeting system. With some experience under their belts, the annual budget calendar–as shown in *Figure 4*–has been streamlined from what was initially required.

What will affect your timetable? The size of your jurisdiction and complexity of your budgeting process will have a significant impact on the amount of time needed. Other factors include:

- Need for legislation;
- Status of strategic planning efforts;
- Agency familiarity and experience with performance measurement; and
- Sophistication of existing data systems.

Your decision regarding whether to implement on a "pilot" or "full-scale" basis will also affect the time needed for implementation.

As shown in *Figure 5*, there are advantages as well as disadvantages to each approach; local circumstances should be weighed heavily in your decision.

Figure 4

Planning and Budget Calendar

City of Milwaukee

Date	**Activity**
January-March	Departments prepare plans and performance measures
March 23	Departments receive budget materials and allocations
April	Department plans and performance measures reviewed by mayor
By second Tuesday in May*	Plans and budget requests due
June 1-2, 9-10	Mayor's public hearings on plans and budgets
July-September	Mayor's executive plan and budget review
By September 28*	Plan and budget submitted to common council
October 7-28	Legislative hearings
By November 14*	Common council action on budget

** Denotes legal deadline*

Source: Anne Spray Kinney, "Mission, Management, And Service Delivery: Integrating Strategic Planning and Budgeting in Milwaukee," *Government Finance Review*, October 1995, p. 8.

If you choose the pilot approach, your next decision will be which agencies to select. Jurisdictions have used a variety of decision criteria, including:

- *Receptivity to change:* Many jurisdictions have asked for volunteers, choosing to begin with those agencies most receptive to change.
- *Ease of measurement:* Some jurisdictions have selected departments whose outcomes are most easily quantified (e.g., fire department; police department; transportation department), hoping to gain experience before tackling departments with more difficult measurement issues. Others have taken the opposite approach, reasoning that if they can succeed with the most "difficult" agencies (social services, for example), full-scale implementation should be a breeze.
- *Size of budget:* Budget size has been used as another selection criterion. Clearly, improving the performance of your largest agencies will result in the greatest overall impact.

Figure 5

Advantages and Disadvantages of Differing Implementation Approaches

Pilot Projects	Full-Scale Implementation
+ Provides opportunity to test and refine system	+ Requires less overall time for implementation
+ Can anticipate problems prior to full-scale implementation	+ Training and assistance can be provided uniformly for all departments
+ Provides opportunity to build support among non-pilot departments	+ Creates momentum for change
+ Allows for more individual assistance and attention	
– Results in longer overall time for implementation	– Difficult to devote significant amount of time to individual departments
– Initiative could lose momentum	– May result in costly mistakes
– Difficult to run two budget systems simultaneously	

Source: Drawn primarily from Price Waterhouse, *Best Practices in Performance Based Budgeting*, for the Santa Clara County Office of Budget and Analysis, April 12, 1994, pp. IV-8-IV-11.

You may also consider selecting a representative sample of agencies. In designing its performance measurement pilot project, the state of Virginia chose agencies that represented all eight secretarial areas and also sought a balance of new initiatives and base budget programs.

Step Three: Provide training.

Training in performance budgeting will involve not only introducing new *concepts* to legislators, managers, and employees, but also introducing *new budget forms* that must be completed and *new procedures* that must be followed. You will need to consider the following levels of training:

1. *Briefing sessions or workshops* to introduce the concepts of performance measurement and strategic planning. At a minimum, both managers and policymakers should receive training on:

- The benefits of strategic planning and performance measurement;
- The strategic planning process and the mechanics of developing performance measures; and
- Information on ways to use performance information, including allocating resources, formulating and justifying budgets, performance contracting, and personnel management.[15]

In these sessions it is critical to allay any fears and misconceptions about the process. Legislative fiscal staff and agency budget analysts can be important allies.

The states of Louisiana and Arizona are among those who have supplemented training workshops with written reference materials. Louisiana's *MANAGEWARE* and Arizona's *Managing for Results* handbooks provide agencies with a solid grounding in strategic planning and performance measurement concepts.

2. Development of budget instructions and guidelines. While the introduction of performance budgeting has typically resulted in an *overall reduction* in the number of budget forms that agencies must fill out, there are usually a number of new forms required to show linkages between budgets and expected performance results. In Texas, budget instructions have been pared from 125 legal-sized pages to 35 letter-sized pages. In addition, agencies are now required to complete only five rather than 23 budget forms.[16] The city of Milwaukee has also eliminated many forms, although two new ones have been created to show links between funding, objectives, and activities.

Department managers and employees will need specific instructions on how to complete any new forms. You may also want to take advantage of new technologies to enhance your instructional efforts. Agencies in both North Carolina and Maryland, for example, can access instructional material via the Internet.

3. Ongoing technical assistance and training. Performance budgeting will be a big change for most departments–expect to provide some “hand-holding” along the way. This task most often falls to the budget office. In Texas, for example, agency budget analysts have primary responsibility for follow-through and ongoing assistance. Keep in mind that networking can also be a valuable training tool. Virginia found peer networking to be a successful component of its performance measurement pilot program.[17]

In the USA, state and local governments have taken a variety of approaches to providing training and technical assistance.

- Oregon’s approach was to provide training to all agency heads as well as to volunteer co-ordinators in each agency. These co-ordinators–who also received ongoing guidance and assistance–served as mentors and trainers for others in their agencies. Two videos were developed to supplement the training efforts. The videos featured testimony from the governor, agency heads, a union leader, and line staff on the benefits of performance measurement.

- Other state and local governments have relied on outside consultants or organizations to provide much of the training required. A member of the University of North Carolina’s Institute of Government, for example, launched training efforts in Chatham County, North Carolina by making a presentation to the county commissioners and department heads. This was followed by separate retreats for each group, a joint retreat, and a question-and-answer session with a jurisdiction already using performance budgeting.

Step Four: Review/develop strategic plans.

Strategic planning is a powerful tool for setting priorities and making informed decisions about the future. As such, it can provide a long-term context for annual budget decisions. The observation has been made that “although strategic planning has become popular in government in recent years, it is frequently difficult to see the connection between what a strategic plan says and what next year’s budget does.”[18] Performance budgeting initiatives can provide that important connection.

In Texas, for example, agency strategic plans serve as the foundation for the state’s strategic budgeting system. In simple terms, an agency’s appropriation request represents the cost of implementing its strategic plan over the following two years. Agencies identify costs associated with carrying out particular strategies which will help them achieve their goals, then list strategy options in order of priority. In appropriating funds to an agency, the legislature provides a lump sum for the implementation of a particular strategy, accompanied by a set of performance expectations.

In Alberta, the view is that unless the costs of achieving varying levels of results can be identified, the effect of resource changes on outcomes cannot be assessed. With managers increasingly being held accountable for results, they will need information on the resources required to maintain or improve service quality and results. Similarly, information on the cost of achieving certain levels of results will help decision makers to decide if the desired outcome is appropriate given the costs involved. Costing outputs will link inputs with outcomes and provide decision makers and taxpayers with information on the relative cost of certain outcomes.[19]

As discussed in further detail in Module 1, *Strategic Planning*, there is no one best way to approach strategic planning. The strategic planning process can be undertaken at virtually any level–a department, organization, program, and/or the entire community (a city, county, region, or province).

Processes are often as simple as an annual retreat in which departmental staff or a city council goes away for two or three days to assess where they are, envision where they want to be, set goals, and decide among alternative strategies. On the other end of the spectrum are examples like "Oregon Benchmarks" and "Minnesota Milestones"–processes that were statewide in scope and involved complex, long-term organizational structures, staffing, and support. In between you can find numerous examples of city or countywide strategic planning processes.

Regardless of the approach, successful, *results-driven* strategic planning addresses four major questions:

1. Where are we now?
2. Where do we want to be in the future?
3. How will we get there?
4. How will we measure our progress?

Organizations that have already undertaken a strategic planning process and developed related performance measures will be ready to review and build upon these efforts. Those that have not yet engaged in planning efforts will find it helpful to do so prior to moving into performance budgeting. The treasury/finance department typically plays a major role in overseeing planning and performance measurement efforts, helping to ensure that measures are meaningful and accurately reflect the jurisdiction's priorities. Further details on strategic planning and performance measurement are provided in Modules 1 and 3 of this curriculum, *Strategic Planning* and *Performance Measurement.*

Step Five: Develop the budget and allocate resources.

Governments have taken a variety of approaches to developing performance budgets. Three of the most common approaches are described below.

1. Activity-Based Costing/Unit Cost Budgeting. A number of performance budgets are built around the concept of activity-based costing. This approach typically involves:

- Linking activities or strategies to performance outcomes;
- Prioritizing strategies;
- Identifying the costs of carrying out specific activities or strategies; and
- Budgeting based on desired levels of performance.

In the Alberta government, a two year pilot project in Activity Based Costing was undertaken by the Land and Forest Service, Environmental Protection in the Northeast Boreal Region. The project's goals were to:

- Develop a "one key in" input system;
- Develop a methodology to cost out strategies and activities;
- Develop regional performance measures;
- Determine the true cost of outputs;
- Produce activity cost analysis;
- Validate the business plan.

Several issues were identified in the implementation and expansion of Activity-Based Costing, such as the regional varability of priorities and degree of detail required at different project scales. Because of these and other issues, the pilot project has concluded and no further follow up is planned at this time.

What is activity-based costing? As shown in *Figure 6*, it is a technique for identifying the "full" costs of service delivery, including not only direct labor and material costs, but also administrative and other overhead costs.

Figure 6

Activity-Based Costing

Cost Factors	Amount
Salaries of dept. personnel (including taxes, unemployment insurance, pension costs, and other fringe benefits)	________
Other direct costs (travel, utilities, materials and supplies, printing)	________
Equipment (rental, capital outlay, interest costs, maintenance)	________
Operation and maintenance of buildings	________
Insurance premiums (or claims paid if self-insured)	________
Allocated administrative costs	________
Allocated overhead cost of other executive and staff agencies	________
Management/supervision/oversight	________
Other cost factors	________
TOTAL COST OF ACTIVITY=	**________**

Source: Adapted from *Privatization Assessment Workbook* (Denver, CO: Office of State Auditor, 1989), p. 25.

Sunnyvale, California's budget system is based on full-cost accounting. The city begins by determining the cost of providing certain levels of service in 300 different areas–such as road sweeping and library services. The budget then describes what level of service is going to be provided and how much money it will cost. The budget may say, for example, that the city will sweep 1,000 miles of roads and identify the cost of doing so. [20]

Similarly, Florida's Department of Health and Rehabilitative Service, the largest state agency in the USA, was an early pioneer in experimenting with "unit cost" budgeting in that state. Plans called for defining services, clearly identifying their costs, and basing budgets on achieving a desired level of service. An Office of Evaluation was established to examine what mix of services and associated costs would be necessary to achieve a specific outcome, such as reducing the incidence of child abuse. While implementation has proven to be more difficult than anticipated, the state continues to experiment with this concept.

In a variation on the activity-based costing approach, some communities simply add up the budgeted expenditures for a service to arrive at a performance budget. This is certainly much simpler than full-cost accounting, though arguably not as accurate. While few governments currently have the cost accounting system that Sunnyvale, California has, more are moving in that direction.

2. Base Budget with Performance Incentives. Another approach that governments have taken to developing a performance budget is to add performance incentives (and expectations) to a base budget allocation.

Alberta Advanced Education and Career Development has six targeted programs for post-secondary institutions in addition to the base operations grants provided. One of these programs is the Performance Envelope which rewards institutions based on progress towards accessibility, responsiveness, affordability, and for research excellence at universities. Nine measures of performance are the basis for funding which has a system-wide and institution specific component. All institutions are assessed on employment, graduate satisfaction, enrollment levels, administrative costs, and revenue partnerships. The three campus universities are also assessed on research performance which includes the level of research funding they receive from granting councils, the references to research in other publications, the development of community partnerships, and the involvement of research sponsors. Each institution is awarded points based on its performance against specific benchmarks. Total points are then used to determine funding level.

Catawba County, North Carolina's performance budgeting process began with pilot departments receiving a budget allocation based on historical expenditure patterns, as adjusted for cost of living and general revenue increases. The budget office then negotiated performance expectations with each of the participating departments. In return for meeting at least 90 percent of their performance targets, the departments are given greater spending flexibility throughout the year and can retain half of any unspent funds or new revenues generated.

The city of Milwaukee has used a similar approach. Beginning in 1994, each department received an overall budget allocation at the beginning of budget preparation based on policy priorities set by the mayor. Rather than focusing on budget cutting, budget review now focuses on assessing whether departmental plans and objectives are consistent with the city's strategic plan and whether the links between departmental planning objectives, activities, and spending are clear.

3. Program-Based Performance Budgeting. In the USA, a number of state and local governments have found that a "program" structure is well-suited to performance budgeting. In other words, expected performance is defined across broad "program" or "functional" lines (such as economic development or education) rather than departmental lines. "Program" areas represent the kinds of services that government provides.

Examples at the local level include:

- The city of Indianapolis, Indiana, which has worked within the constraints of line-items (which are statutorily required) to develop a performance-orientation to its budget. Line-items serve as the building blocks for an activity-based budget, which builds to a program budget.

- Austin, Texas, whose budget is based on 10 priority areas that cross departmental lines. The program budget is developed by examining departmental budgets and allocating relevant portions to each of the 10 priority areas.

The state of North Carolina is taking similar steps to develop its Performance/Program Budget. Prior to establishing objectives and measures, North Carolina classified all its spending into “program” areas. A “program” was defined by common intended outcomes rather than by departmental organization. For example, as shown in *Figure 7*, a program entitled “Groundwater” became the classification for six budget entities in the Department of Environment, Health, and Natural Resources (EHNR) and one in the Department of Agriculture.

The advantage of beginning with a classification of funds is that the common goals of otherwise separate units of government are revealed and addressed in the planning process. In addition, true programmatic costs and redundancies become clearer.

The next steps in North Carolina's budget process will be to:

- Identify objectives and measures related to identified program areas;
- Identify the activities/strategies that will be used to achieve the objectives;
- Identify the budget funds that support the activities/strategies so that reviewers can see the "quantity" of work purchased by the budget; and
- Display the linkages between spending, activities, and objectives.

4. Investment Budgeting. While not as common as the three methods described above, there is increasing interest in a concept known as "investment budgeting." Like performance budgeting, investment budgeting focuses on outcomes. But, while performance budgets are based on the *costs* of desired performance outcomes, investment budgets are based on expected "rates of return," assessing both long-term costs and benefits. In Texas, investment budgeting is seen as "the next logical step for Texas to take in the evolutionary development of its strategic planning and performance budgeting system." In fact, May 1995 legislation directed the Governor's Office of Planning and Budget and the Legislative Budget Board to develop a means of incorporating the concept of investment budgeting into the appropriations process for the 1998-99 biennium.[21]

Step Six: Develop supporting data and accounting systems.

More often than not, governments embarking on performance budgeting initiatives find that there is a mismatch between their budgeting and accounting systems. While your accounting system can probably tell you how much you spent on salaries or travel last month, it is less likely to be able to tell you how much you spent on a particular planning objective or strategy.

The result of this mismatch? As one observer notes, "the departments' time in determining how much to ask for in each category and the [elected officials'] debate over the appropriation amounts [are] both meaningless."[22]

How can you address this problem? The most common approach is to establish "cost centers," which essentially are separate accounts for each major strategy or activity in the budget. The accounting system can then be used to track expenses in each of these accounts.

Accounting by cost centers can help provide a *reasonably* accurate monthly accounting for *direct* spending. However, it is difficult to account "to the nickel" for a couple of reasons. First, most governments do not allocate administrative and support costs to all their objectives. Second, a given expenditure may contribute to more than one strategy or objective. And third, some expenditures may contribute to "minor" objectives which are "not worth the effort" to formally define and measure.

It is certainly possible to track expenditures for more than one budget format–coding each expenditure so that it is assigned to both a line-item category and to a separate program or performance budget category. However, the cost of maintaining dual systems (in both time and money) is only justified if the time is taken to study, understand, and act upon the linkages between spending, program activity, and outcomes.

Step Seven: Monitor performance and report results.

Once appropriations are made, periodic analysis of performance information is needed to determine whether or not program activities are on track. In designing your monitoring system you should focus on answering the following types of questions:

- Are expected results being achieved?
- Does trend data show improved performance or is performance deteriorating?
- How does departmental or program performance compare with standards, targets, or the performance of others?
- What outside factors may be affecting performance?
- What is being done to bring performance back on track?

It is particularly important to look closely at the reasons for performance differences–especially if you are comparing your organization's performance to that of others. Are you really comparing apples to apples? Differences in performance and costs can result from a variety of factors—differing levels of service, differing demographics or clientele, differences in technology, and so on.

Keep in mind that monitoring performance information will be less of a chore for everyone involved if performance reporting is integrated with any existing management information systems (MIS). As discussed in Module 4, *Using Performance Results*, one model that other governments can turn to in updating their MIS systems is the state of Minnesota's "Performance and Outcomes Reporting and Monitoring System." The system–known as PERFORMs– manages performance data from agencies on a statewide basis. It offers the ability to produce both internal and external performance reports in a consistent format. The information database is capable of maintaining at least 40 years of information, enabling a comparison of actual performance against long-term goals, objectives, and measures.[23]

In Alberta, the G*overnment Accountability Framework* sets out the performance reporting mechanisms and relationships.

As you move towards adopting reporting procedures, you will need to decide who needs to receive performance information, how often to report this information, and what specific information to report. As emphasized in Module 4, *Using Performance Results*, it is important to recognize that not all performance information will be useful to all users and decision makers. For example, what a line-manager finds useful will be significantly different from what an elected official will find relevant. And, while a line-manager may need to review performance on a monthly or quarterly basis in order to make mid-year program improvements, elected officials' needs are often met by annual reporting. Because different audiences have different information needs, reporting procedures will need to be tailored accordingly.

Step Eight: Act on results.

It is not enough simply to undertake performance measurement activities–performance information must be used in order to be of value. Incentives (or "rewards") are often provided to encourage agencies to use performance information to improve service delivery. As shown in *Figure 8*, potential rewards range from increased agency funding to expanded agency responsibilities.

Unfortunately, linkages between the budget and performance are often not straightforward. In other words, an agency that fails to meet its performance goals may be dealing with a particularly intractable problem and not merely suffering from poor management. Reducing funding as a sanction for "poor performance" may move the agency even further from its goals.

In order to address this situation, management should be given the opportunity to provide explanatory information as part of the performance reporting process. Reasons for "poor" performance should be examined by budget officers and decision makers prior to taking action.

Figure 8

Potential Rewards and Sanctions

Rewards

- Increase agency funding overall
- Increase budgetary flexibility
- Exempt agency from certain reporting requirements
- Allow agency to retain any cost savings
- Publicly recognize agency for its achievements
- Provide employee bonuses
- Expand agency responsibilities

Sanctions

- Order a management audit/develop a remedial plan
- Reduce or restrict agency funding
- Withhold or eliminate agency funding
- Cut director's salary
- Transfer agency responsibilities
- Place an agency in receivership by replacing managers or creating an oversight body

Source: Adapted from Karen Carter, The Performance Budget Revisited: A Report on State Budget Reform, *Legislative Finance Papers #91* (Denver, CO: National Conference of State Legislatures, February 1994), p. 6.

Implementation Challenges

Implementation is not an easy task. Many state and local governments have taken steps to include performance measures in their budgets. In fact, the National Association of Budget Officers reported in 1995 that 30 states and the Commonwealth of Puerto Rico were already including some type of performance measures in their budget documents. However, studies have found that performance measures have been used more frequently to improve management than to allocate resources. In most cases, resource decisions continue to be driven by traditional budgeting practices.

What challenges lie ahead?

First, don't be surprised by resistance. A budgeting system that has been in place for a long time will generally be favored by policymakers as well as department heads–it is both understood and predictable. Some of the following concerns may surface:

- Elected officials may resist relinquishing control over line-item expenditures. Performance data is particularly likely to be ignored where it is used as an "overlay" rather than replacement for line-item data.[24]
- Managers may feel overburdened already and dread the additional chore of data collection. This is particularly likely where past data collection efforts have been "paper generators" rather than useful management tools. In these cases, there may be skepticism about whether elected officials and other key decision makers will actually use the data.
- Other managers may fear that the data *will* be used (or "misused")–to reduce budgets, to eliminate staff, or in other negative ways.
- Elected officials may fear that data will be misinterpreted by the public and used against them at the polls.

Implementation Tips

What can you do to help realize the full potential of performance budgeting?

- Help elected officials and managers understand the importance and benefits of performance budgeting, but don't oversell the process–recognize that difficult budget decisions will still have to be made;[25]
- Involve elected officials as well as managers in the design of the budgeting system and the development of plans and measures, maintaining effective communication throughout the process;
- Provide incentives, not just punishments, in return for accountability. Address the fear that performance measurement is merely a tool for budget cuts and staff reductions;
- Establish a realistic implementation timetable, recognizing that it may take several years to refine performance data to the point that they are "reliable enough for budget and management control purposes."

Suggested Readings for More Information about Performance Budgeting

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[6] Budget Preparation and Enactment, *County Government in North Carolina*, p. 173.

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[14] National Association of State Budget Officers, p. 27.

[15] Harry Hatry, Craig Gerhart, and Martha Marshall. "Eleven Ways to Make Performance Measurement More Useful to Public Managers," *Public Management*, September 1994, pp. S15-S18.

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[17] Interview with Barbara Newlin, Deputy Director, Evaluation and Management, Virginia Dept. of Planning and Budget, 1994.

[18] Kinney, p. 7.

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[23] Charlie Bieleck, Minnesota Dept. of Finance, Presentation at the *Managing for Results* conference, Austin, Texas, November 1, 1995.

[24] US General Accounting Office, p. 5.

[25] NASBO, p. 27.