Performance Budgeting

Performance Budgeting

Linking Funding and Results

Edited by

Marc Robinson

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Jim Brumby, an Australian national who joined the IMF in 1999, has been engaged in public management reform at state, national, and international levels for two decades. Prior to moving to the Fund's Office of Budget and Planning in late 2005, he worked in FAD on public expenditure management, providing technical assistance to China, Indonesia, the Slovak Republic, Slovenia, Bulgaria, Malawi, Ghana, and Nigeria. He has also contributed to fiscal transparency reports on Italy, Malawi, and the USA, and played a leading role in assessing public expenditure management systems in the so-called "heavily indebted poor countries." Prior to joining the IMF, he was in charge of the Organization for Economic Co-operation and Development's program on budgeting and management run by the Public Management Service (PUMA), with responsibilities that included coordinating the work of the Senior Budget Officials working party. He worked in the New Zealand Treasury for four years as head of its unit providing advice on public service reform and prior to that at the central finance ministry of the State of Victoria in Australia. He has a Masters degree in public administration from Harvard University.

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Preface

The Fiscal Affairs Department of the International Monetary Fund (IMF) has seen in recent years a marked upsurge in demand for technical assistance on the design and implementation of performance budgeting systems. This upsurge reflects a broader wave of international interest in performance budgeting. Leaders in the field such as the United Kingdom, the United States, and Australia have, over the past decade, implemented new performance budgeting systems with strikingly novel features. Nations as diverse as France, India, South Africa, Ethiopia, Brazil, Belarus, and Colombia—to name just a few—have also implemented, or are in the process of implementing, performance budgeting.

This volume is part of the IMF response to these developments. Performance budgeting is about expenditure efficiency, and the IMF views expenditure efficiency as not only important in its own right, but also as having an important connection with fiscal discipline and, therefore, macroeconomic stability.

Performance budgeting seeks to improve expenditure efficiency by systematically linking funding to results, making use of performance information to achieve that linkage. It aims to redesign the budget process so as to improve the allocation of public expenditure—so that it is directed towards services of greatest social value—and also to increase the efficiency of the production process. In the language of economists, it aims to boost both allocative and technical efficiency. There are, as this volume stresses, different forms of performance budgeting. One major strand of performance budgeting practice—of which "program budgeting" is representative—places primary emphasis upon allocative efficiency and, more specifically, upon improving expenditure prioritization in the budget preparation process. Governments have not always been good at prioritizing expenditure. They have often been much better at identifying priorities for new or increased spending than at identifying and cutting out low priority or ineffective spending. This suggests that there are great welfare gains which can be made by improving prioritization processes.

Good expenditure prioritization is particularly essential when governments face new and unexpected challenges which require substantial expenditure responses. We are all well aware, for example, of the enormity of the fiscal challenge which the AIDS pandemic has posed for many countries over recent decades. Finding the funds to meet these and other emerging challenges is never an easy matter.

It is not an option to respond to emerging new fiscal priorities by continually increasing aggregate expenditure. Rising expenditure has to be financed, and this can only be through deficits or higher taxes—both of which are costly in resource and social terms. Budgeting is therefore necessarily about expenditure choices. And these choices are often tough. The tighter the aggregate expenditure constraints facing governments, the more important it is to be able to prioritize expenditure well.

A distinguishing characteristic of some of the new performance budgeting systems which have emerged over the past decade has been the idea of using the funding process as a means of putting pressure on government agencies to perform better, either or both by improving technical efficiency and by improving the design and management of programs. In some countries, this has been done by setting demanding performance targets as part of the budget process. In other countries, the funding process has been transformed in something like a "purchaser-provider" transaction. In general, the idea is to build even tighter links between funding and results than classic forms of performance budgeting sought to build. Closely linked to this has been the idea that budgeting mechanisms—and public management systems more generally—should be stripped of unnecessary controls and restrictions which inhibit managers from performing effectively.

Whether achieved through better expenditure prioritization, or through improved efficiency and effectiveness at the agency level, the social benefits of increased expenditure efficiency are clear. There is also good reason to believe that expenditure efficiency can contribute to aggregate fiscal discipline. If performance budgeting contributes to rising public sector productivity, agencies are able to do more with less and this will help to some extent to reduce the upward pressure on public expenditure over time. Good expenditure prioritization should also have the same effect of facilitating aggregate expenditure restraint over the medium and long term by helping to finance new priorities by cuts in low-priority existing programs. In the short run, moreover, improved expenditure prioritization should contribute to aggregate fiscal discipline under circumstances where fiscal consolidation is required. This is because if expenditure reductions target the least useful areas of expenditure and preserve higher-priority social spending, fiscal adjustment is more likely to be sustainable.

The inherent importance of expenditure efficiency and its close link with fiscal discipline are key reasons for the current wave of interest in performance budgeting. It is not accidental that countries facing particularly significant structural fiscal pressures tend to be those most interested in implementing performance budgeting systems.

This volume aims to help governments and their advisors assess the most appropriate way of reforming their budget and funding processes to boost expenditure efficiency. Because there are today a number of forms of performance budgeting, the starting point for this has to be the development of a clear taxonomy of performance budgeting systems. What are the key forms of performance budgeting? In what specific and different ways do they seek to link results and funding? How do they differ in their approach to the use of performance information? To what extent are they alternatives, and to what extent are they complementary?

Against this background, this volume aims to significantly improve our understanding of what forms of performance budgeting work, and under what circumstances. This is not an area where we are able to easily reach conclusions with scientific rigor. The complex causality of public budgeting and management systems makes that exceedingly difficult. Nevertheless, international experience and theoretical analysis can and do provide substantial guidance on the efficacy of alternative approaches to linking funding and results. It can, moreover, be of as much value to identify what has not worked well—and to understand why—as to identify the apparent success stories. To paraphrase the famous adage, those who do not understand the lessons of failed budgeting experiments are fated to repeat them. This underlines the importance of frankness in the review of national experiences with performance budgeting.

There are many important questions which arise in any systematic assessment of performance budgeting. To give some flavor of the issues addressed in this volume, let me identify just a couple:

1. *What type of performance information is most useful for performance budgeting?* This is a question on which opinion and practice diverge to some degree. For example, some countries place primary emphasis on performance measures, while others place considerable stress on program evaluation. Some believe that accrual budgeting is essential if proper allocative decisions are to be made. Others disagree. The answer to this question is, clearly, closely linked to the choice of the type of performance budgeting. For example, the newer forms of performance budgeting have more demanding information requirements because they seek to build tighter links between results and funding. But performance information is not costless. The more sophisticated the performance information system, the more costly it will be. This makes it essential that choices about information systems be made carefully, as part of a broader decision on what model of performance budgeting is most suitable for the circumstances of each country, based on a judgment of whether the expected benefits are likely to justify the cost.
2. *How do we make sure that performance information is actually used in the budget process as performance budgeting intends that it be used?* It is not uncommon to hear that great efforts have been made in particular countries to develop performance information but that this information is not actually being used in the budget process. There are, for example, a number of countries where the budget classification has been subject to a detailed overhaul to put it on a program basis, but no use has been made of this new budget classification as a tool to improve expenditure prioritization. In other countries, performance indicators have been developed and then used for no other purpose than filling in reports. What is the problem here? Does it indicate a need to pay more attention to the mechanisms and processes for the systematic use of that information? Or are there, in the case of at least some countries, more fundamental problems which raise questions about the appropriateness of introducing performance budgeting prior to other reforms?
3. *To what extent, and under what circumstances, is it possible to give agencies and managers greater budgetary freedom without compromising aggregate fiscal discipline?* In a budgeting context, greater managerial freedom means, in particular, the reduction or elimination of appropriation controls based on input types. The idea is that managers should be held responsible for the results they deliver—and not controlled in the manner in which they produce those results. This sounds

very appealing. Are there not, however, risks that this freedom will be abused to enter commitments (such as increased employment) which will reduce longer-term fiscal flexibility? What are the preconditions which should be met for such deregulatory moves?

These questions point to a key theme of this volume: in performance budgeting, one size definitely does not fit all.

For example, more complex forms of performance budgeting may not suit countries with greater financial and human capacity constraints. The cost of the necessary information requirements may be simply unjustifiable. Or budgetary institutions may not be robust enough to make use of that information. It is always a mistake to simply copy the management systems of advanced nation without explicitly considering local circumstances and capacity.

For some countries, performance budgeting may actually be inappropriate in any form. There are, for example, a minimum set of basic elements of good public financial management which any country should have in place before it contemplates moving to performance budgeting.

Performance budgeting systems need also to take into account national characteristics in other ways. For example, the type of political system can have major consequences for the appropriate form of performance budgeting, and its probability of success. In a parliamentary system, the executive branch may be in a strong position to impose a single set of expenditure priorities. By contrast, in some presidential systems, both the executive branch and the legislature possess strong independent budgetary power. Priorities have to be negotiated.

All of these, and many other, questions are explored in this volume. They are examined partly from the perspective of national experience, in case studies which cover countries ranging from Ethiopia to the United States. And they are examined also through the prism of thematic chapters focused on, for example, the information requirements of performance budgeting and specific models such as formula funding and the purchaser-provider mechanism.

It is important that performance budgeting be seen in a broader context. It is a tool to address the basic performance problems which often characterize the public sector. In the public sector, there is no mechanism of consumer choice which directs resources to the production of the goods and services which society needs most. Competition is usually weak or entirely absent. The result is a lack of competitive pressure to be efficient.

Performance budgeting is, however, only one among a number of tools with which to address these problems. For example, many governments have been working hard to increase the degree of consumer choice in publicly financed services. Others have harnessed competitive forces by outsourcing, where appropriate, the production of such services. Moreover, as made clear in this volume, many contemporary forms of performance budgeting are part of a broader *managing-for-results* movement which calls for reforms on multiple fronts, ranging from human resource management through to organizational design, and including budgeting.

In the final analysis, all of these tools—including performance budgeting—have limitations. All too often, management reforms, including budget management reform, are oversold by their advocates. Exaggerated expectations inevitably produce subsequent disillusion. So in assessing performance budgeting, we need to take a dispassionate and critical perspective in order to identify its limitations as well as its potential benefits.

Precisely because of the limitations of reforms in the management of the public sector, it is also crucial to continually keep under review the boundaries of the state. If there is no good reason why a service should be provided by government, it is far better to leave it to private production and provision.

Although performance budgeting should not be seen as a solution to all of the performance problems of the public sector, it is my belief that well-designed performance budgeting systems which are appropriate to relevant national circumstances can do much to improve the efficiency of public expenditure. It is for this reason that the IMF is pleased to be able to offer this volume as a contribution to the work of improving the design and implementation of performance budgeting around the world.

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Glossary

Accrual Output Budgeting	Widely used to refer to government-wide budgeting systems, inspired by the *purchaser-provider model,* which were introduced, most notably, in New Zealand in the mid-1990s and in Australia in the late 1990s.
Activities	Types or categories of work undertaken in the production and delivery of outputs. The term is also often used to refer to lower-level components of the *program hierarchy* (see below).
Activity-based budgeting	The use in budget preparation of information on activity costs derived from *activity-based costing*.
Activity-based costing	A costing methodology in which input costs are allocated to categories of activity, using an allocation basis which as closely as possible reflects the real consumption of resources by those activity categories.
Administration programs	Programs which cover overhead costs of a ministry or agency, such as central management and personnel services.
Allocation basis	Formula or principle used to allocate a specific indirect cost between two or more "cost objects"—in the context of program costing, between two or more programs.
Allocative efficiency	The delivery by government of the mix of different types of services which most closely reflects social priorities, based on society's valuations of output choices.
Alternative budgeting	A variation of *zero-base budgeting* in which decisions are focused not on a zero base but on the margins near the current budget base. Usually three or more alternative budgets have to be submitted for each program. Generally, at least one of the alternatives has to be less than the current budget. Often a specific percentage reduction is mandated.
Appropriateness	The extent to which a policy or program is consistent with current government priorities. Also known as "relevance."
Capitation payment	Funding on a per-head basis or some similar proxy for expected output.
Case payments	Funding based on actual output.
Contingent capacity services	Services for which the demand is unpredictably variable, which must be supplied immediately when the demand arises, and for which it is necessary to have pre-existing production capacity if demand is to be quickly met. Emergency services (fire, ambulance) are examples.

Cost-effectiveness	The achievement of intended outcomes at the lowest possible cost.
Cost function	Functional relationship between outputs and cost, assuming technical efficiency.
Cream-skimming	The deliberate avoidance by providers of complex, and therefore high-cost, clients/cases. May be used as a strategy to maximize profits or avoid losses under an output-based payment systems where there is significant client/case *heterogeneity*.
Diagnosis related group	A system for classifying hospital services (outputs) originally introduced for performance measurement purposes, which has subsequently been used as the basis for output-based funding systems.
Economy	The acquisition of inputs at appropriate prices. An element of (technical) efficiency.
Effectiveness	The degree of success of an output in delivering its intended outcomes.
Efficiency	See *technical efficiency*, for which it is an equivalent term in the public administration literature.
Evaluation	Analytic assessments typically addressing the cost-effectiveness or appropriateness of public policies, organizations, or programs.
External factors	Factors outside the control of government which influence the outcomes achieved by public programs—that is, which impact on the effectiveness of programs. External factors may be either client/case characteristics or aspects of the context in which the program is delivered. Sometimes these are also referred to as "contextual factors."
Formula funding	When used as a performance budgeting tool, formula funding is a system in which funding provided by government to a public sector agency is an explicit (that is, algebraic) function of measures of expected and/or actual results—that is, of measures of outputs and/or outcomes.
Forward estimates	Projections by a central budget agency of aggregate expenditures over a fixed term (usually budget plus three years) on a no policy change basis. Forward estimates are the basis for medium-term fiscal planning and may also be used as the basis for imposing expenditure limits.
Heterogeneity (of an output)	The deliberate variation in the amount and/or types of activities delivered to different clients/cases receiving the "same" service, particularly in response to difference in client/case characteristics. For example, more intensive teaching activity directed to students with disabilities.

High-powered incentives	Incentives are more "high-powered" the more strongly and more directly they are linked to measured results and conversely more "low-powered" the weaker and more indirect that link.
Higher-level outcomes	The more indirect outcomes of outputs, which arise as a consequence of the achievement of proximate outcomes. For example, in education, the proximate outcome of higher numeracy and literacy contributes to the higher-level outcome of better economic performance. Also sometimes known as "end" or "ultimate" outcomes.
Impact	Term used by some to refer to outcomes, or to higher-level outcomes.
Incentives	Material rewards and sanctions linked to desired behaviors.
Incrementalism	Budgeting that is characterized by "inattentiveness to the (budgetary) base"—in other words, that budgetary decision-makers take the budgetary base more or less for granted as the starting point in budget formulation, and focus their attention primarily on the size of the increment (or, occasionally, decrement) in agency or program budgets, mainly by a process of adjusting budgets for cost changes.
Indirect cost	In the context of costing programs, costs of inputs or activities which contribute to more than one program. More generally, shared costs which need to be allocated between a number of "cost objects."
Input controls	Controls imposed either in the appropriation legislation, or by regulation on the part of the Ministry of Finance, over the manner in which a line agency's expenditure is to be allocated between different input types (setting, for example, a limit for expenditure on salaries).
Inputs	Resources used in the carrying out of activities to produce outputs (for example, labor, equipment, buildings).
Intermediate outcome	See *proximate outcomes*.
Intermediate output	Goods or services which are supplied to an internal user rather than to the external client/customer. For example, IT support services delivered by ministry IT staff to staff of the ministry.
Internal motivation	Behavioral motivation independent of any immediate external pressure or inducement. Can be of two types—moral motivation and intrinsic motivation.
Intervention logic	A planning methodology that uses "cause and effect" hierarchies to map logic links between outputs, proximate outcomes, and outcomes.

Intrinsic motivation	Motivation which derives from the enjoyment of work—that is, from pleasure in undertaking work activities one enjoys or producing results in which one takes pleasure or pride.
Line-item budgeting	Budgeting in which agencies are provided with budget appropriations specified in terms of input categories (that is, by economic classification).
Managing-for-results	The use of formal performance information to improve public sector performance across the board, including in human resource management, in strategic planning and budgeting. Sometimes also referred to as "performance management."
Mandatory expenditure	Expenditure which occurs by virtue of standing legislative provision ("standing appropriation"), as opposed to allocation in the annual budget. Most social security expenditure is usually of this type.
Moral motivation	Internal motivation driven by a desire to behave in accordance with one's moral beliefs and values.
Outcome	Changes brought about by public interventions upon individuals, social structures, or the physical environment. Expressed differently, the impacts of public services.
Output	A good or service provided by an agency to or for an external party.
Performance auditing	Audit of the efficiency and effectiveness of public expenditure.
Performance budgeting	Public sector funding mechanisms and processes designed to strengthen the linkage between funding and results (outputs and outcomes), through the systematic use of formal performance information, with the objective of improving the allocative and technical efficiency of public expenditure.
Performance indicator	See *performance measure*.
Performance information	Information on results achieved by public expenditure and/or on the costs of achieving those results.
Performance measure	Ratings or quantitative measures which provide information on the effectiveness and efficiency of public programs.
Performance targets	Quantitative statements of the output and/or outcome an agency or subordinate unit is expected to deliver.
Planning, Programming, and Budgeting System	The original form of program budgeting introduced in the United States in the 1960s.
Processes	The means by which inputs are transformed into outputs.
Productivity	The degree of technical efficiency.

Program appropriation	The appropriation of funds in the budget on the basis of programs.
Program Assessment Rating Tool	Technique developed by the US Office of Management and Budget from 2004 in order to rate program performance for use in the budget process. Programs rated in five categories ranging from "effective" down to "ineffective" and "results not demonstrated."
Program budgeting	The systematic use of performance information to inform decisions about budgetary priorities between competing programs, based on the program classification of expenditure (see *programs*).
Program hierarchy	Classification which breaks programs into component sub-programs, and in turn breaks these into lower-level components. In one common version of the program hierarchy, programs are broken into sub-programs, which are in turn broken into activities.
Program structure	The manner in which an agency classifies its expenditures into objective-based programs and other elements (sub-programs, and so on) of its *program hierarchy*.
Programs	Objective-based categories of expenditure, where objectives should generally refer to the intended outcomes of the expenditure. As used in this book, generally refers to the highest level of the program hierarchy.
Proximate outcomes	The more direct or immediate impacts of outputs. For example, in education, student knowledge (such as, higher numeracy and literacy) is a key proximate outcome.
Public Service Agreements	System developed in the United Kingdom from the late 1990s, under which high-level performance targets are set for each ministry as part of a biennial spending review process which defines multi-year agency budgets. Targets have evolved over time from being primarily output focused to primarily outcome focused.
Public service motivation	An altruistic motivation to serve the interests of the community, as perceived by public employees.
Purchaser-provider systems	Funding systems under which government agencies are paid "prices" for the results (usually outputs) which they deliver.
Quality	The extent to which the characteristics of an output—in the case of a service output, the activities delivered and their timeliness—are such as to increase its potential capacity to achieve its intended outcome. Not to be confused with the outcome itself.

Risk adjustment	Fine-tuning a case payment or capitation payment system so that funding more closely reflects the variability of client/case costs due, in particular, to *heterogeneity*.
Scissors approach	Implementation strategy which combines pressure from above to encourage managers to change, with action from below to increase their capacity to change.
Skimping	Deliberate underservicing of more complex clients/cases; for example, as a response to an output-based payment system in which the quality of the output delivered is imperfectly measured.
Social motivation	Behavior motivated by the desire of individuals to build certain types of social relationship (in the context of this book, in the workplace), such as the acceptance and approval of others, or power and status.
Substantive performance auditing	Audit to assess the efficiency and effectiveness of a program or agency.
Systemic performance auditing	Auditing of management systems to gauge their capacity to contribute to the efficiency and effectiveness of public expenditure.
Technical efficiency	Production of an output at minimum cost while holding quality constant, given prevailing input prices. Requires both the avoidance of waste and the choice of the least-cost combination of inputs.
Unit costs	Cost per unit of output. Can refer to average cost or average variable cost.
Virement	Shifting of funds between appropriation categories.
Zero-base budgeting	A system of performance budgeting in which expenditure is broken down into, and analyzed in terms of, “decision packages” (also known as “service increments”) which constitute a series of optional funding levels from the presumed base of zero to and beyond the current level of service. Priority rankings are attached to these decision packages, and these rankings are used to ensure that the available level of revenue funded those decision packages which are of highest priority.