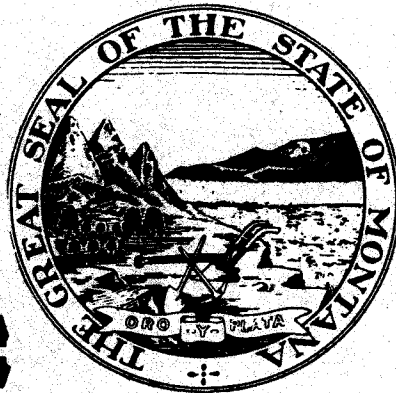
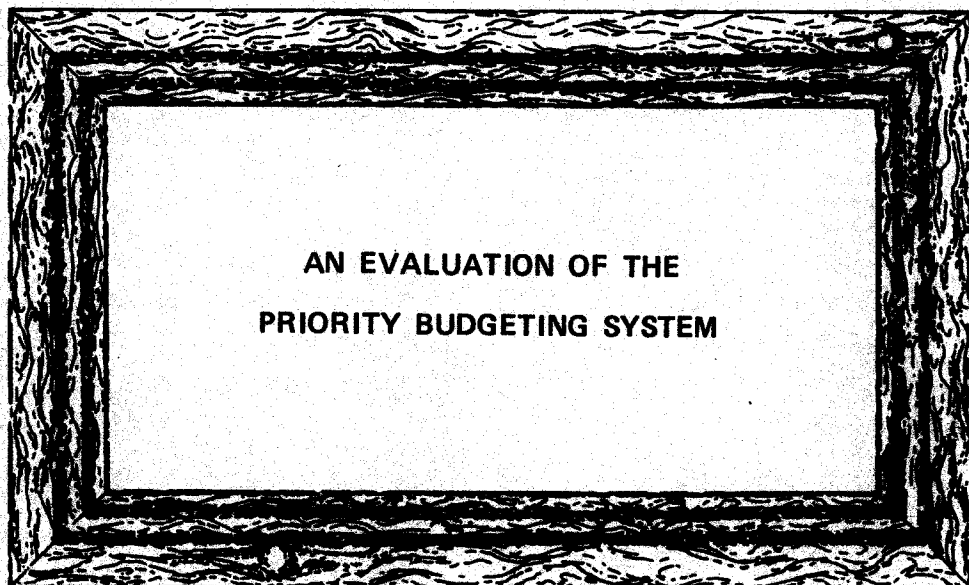


OFFICE OF THE GOVERNOR



- BUDGET & PROGRAM PLANNING -



Thomas L. Judge, Governor

AN EVALUATION OF THE
PRIORITY BUDGETING SYSTEM

Submitted By:

Eugene Huntington

Office of Budget and Program Planning

George L. Bousliman
Director

John S. Fitzpatrick, Ph.D
Deputy Director

INTRODUCTION

In 1975, the Forty-Fourth Legislative Session enacted House Bill 643, "An Act To Provide For A Program Planning and Budgeting System; To Specify Information To Be Contained In The Proposed Budget; Providing For The Submission Of Variance Reports ...". This act amended the budgeting statutes for state government in a number of ways. One change required that a Program Planning and Budgeting System be implemented, "for at least one program in representative agencies of state government." The implication of introducing budget reforms in "representative" agencies was to test the new system before it was considered for implementation throughout state government. This report sets out the results of testing the budget reforms in pilot agencies and makes recommendations regarding further implementation of the new budgeting system.

For the past three years seven state programs have operated under the "Priority Budgeting System" (PBS), the system developed by the Office of Budget and Program Planning (OBPP) to implement House Bill 643. The agencies chosen to participate in this test varied in size and function. Some programs consisted of several agencies pursuing a common goal while other programs were defined by the traditional organizational structure. The Priority Budgeting System fulfilled all of the requirements of House Bill 643, but, ultimately, resembled a zero-based budgeting format rather than the program planning and budgeting system named in the title of the legislation.

PBS required each pilot agency to go through an extensive

planning and budgeting process in preparation of the Executive Budget proposal. The Executive Budgets in the '78-'79 and '80-'81 biennia contain a special section setting out alternative levels of funding and performance indicators for the pilot agencies. Between legislative sessions the pilot agencies maintained data on program performance and spending to aid in future PBS budget preparation and to test the benefits PBS might offer to agency staff in managing programs. The Office of Budget and Program Planning has monitored the PBS system during the budget preparation and appropriation process, and how it was used by agency managers.

RECOMMENDATIONS

Listed below are the recommendations of OBPP for the future of the Priority Budgeting System:

1. The Program Planning and Budgeting System requirements contained in 79-1012.1-3 RCM, 1947, should be repealed. Proposed legislation that would repeal these sections is attached to this report.
2. The pilot agencies for PBS, should no longer be required to budget under the PBS system and should return to using the standard state budget format and process.
3. Future Executive Budgets should present increased data concerning program performance as well as cost data. The emphasis on performance indicators should be implemented through existing budget procedures and statutes.
4. As a part of the planning process related to the preparation of the Executive Budget, agencies should internally develop priority listings of potential program reductions as well as increases.

SUMMARY OF EVALUATION FINDINGS

In general, PBS should not be extended to other agencies or continued in pilot agencies because of the cost and paperwork involved for marginal benefits. The three-year test of the Priority Budgeting System revealed the following advantages and disadvantages:

A. Advantages

1. The prioritization of elements or packages within an agency's budget makes budget adjustments (cuts or increases) more convenient to analyze.
2. The PBS process increased the involvement of program managers in the budgeting process in some agencies that had traditionally depended on the fiscal staff to do all budgeting.

B. Disadvantages

1. The data developed through PBS was largely ignored in the legislative budgeting process.
2. PBS cannot replace the traditional line item budget but must operate in addition to the traditional system.

Constraints such as accounting systems, auditing procedures and federal funding requirements mitigate against reducing the line item budgeting requirements in favor of PBS. If PBS were to be continued, it would probably be in addition to the existing budget system rather than replacing the existing budget system.

3. The paperwork generated by PBS is extensive. Expanding the system to more agencies will increase the number of budget documents prepared for the legislature by at least four times the number used for the line item budget.
4. The measurement of program performance is in many cases difficult and in many cases inappropriate for program management. For

4. (continued)

example, in the pilot agency, Highway Maintenance Division, attempts to project need and measure program performance in the area of snow removal proved to be meaningless and almost absurd. Though all programs should be accountable for performance, the performance measurement requirements contained in the budget law did not fit many programs. Program performance measurement can also be very costly and in some cases, such as Highway Maintenance, costs may far exceed benefits.

5. Pilot agencies indicated that the performance data generated by PBS was not utilized to any great extent to make management decisions.
6. The PBS system and zero-based budgeting hold out the promise that this system will facilitate the movement of funds from programs that have a high cost to benefit ratio to programs that return many benefits. This promise was not realized by the pilot agencies. The existence of state laws, federal regulations and earmarked revenues make it very difficult to shift funds from less productive activities to other areas.
7. PBS and Zero-Based Budgeting assume that program managers will follow guidelines and theory in the construction of their budgets and rank programs in an order that places the most productive programs at the top of the priority list and the least productive program at the bottom of the list. There is always the risk that program managers will place the most popular programs at the bottom of the priority list in an attempt to guarantee the funding of the most popular programs as well as shelter from the scrutiny of the budget examiners and legislature the less popular program activities. This kind of game playing was experienced in the PBS pilot test and had the effect of impairing rather than enhancing the budget review process.

EVALUATION METHODOLOGY

The evaluation of the Priority Budget System in this report used the following sources of information:

- A. Prior to the 1977 Legislative Session, the Office of Budget and Program Planning published a report entitled, "A Review of the Priority Budgeting System". This report provided an analysis of the implementation of PBS and of the PBS budget data contained in the 1977-79 Executive Budget.
- B. A paper prepared by OBPP staff during the 1977 Legislative session provided an analysis of the performance of PBS as observed by OBPP analysts. This report was based on interviews with individual analysts and included their evaluation of the performance of PBS in the Legislative Budget process.
- C. Information and comments were collected from the pilot agencies at the beginning of fiscal '78 as OBPP reviewed the initial management reports from PBS with each pilot agency.
- D. In November, 1978, OBPP mailed each pilot agency a questionnaire asking agencies to rate PBS on a number of budgeting and management criteria. A copy of the questionnaire, with a summary of responses, is attached to this report.
- E. During the period that PBS has been tested, OBPP has collected and analyzed a number of articles from professional and government publications, that explain and evaluate Zero-Based Budgeting.

EVALUATION CRITERIA

In order to evaluate the PBS system, it was necessary to establish some initial expectations or criteria of how PBS might effect the pilot agencies. The criteria were developed by distilling out the general benefits that proponents of Zero-Based Budgeting claim for their system. An effort was also made to discern what concerns and expectations the legislature had in passing HB 643 which mandated the pilot program.

Legislative criteria are the hardest to identify since legislative interest was expressed in the form of two broad generalities; "the executive budget does not give us enough information", and "do these programs accomplish anything?" The expectations of the executive branch were more explicit, the potential benefits of PBS were set out by the Office of Budget and Program Planning as follows:

"This approach can provide numerous benefits. First of all, the identification of one hundred percent of each activity requires each manager to carefully evaluate and consider the ongoing need for each activity and to consider different levels of effort and alternative ways for performing the activity. Secondly, based on the evaluation of alternatives, the agency has the opportunity to communicate its analysis and recommendations to the executive branch for review and consideration in determining budget allocations. Third, once activity decision packages are identified, prepared and accorded a priority ranking, changes in desired expenditure levels for program budgets do not require recycling of budget inputs, but the decision package ranking identifies those activities (decision packages) to be added or deleted. Finally, the list of ranked decision packages can be used during the operating year to identify activities to be reduced or expanded if allowable expenditure levels change or actual costs vary from the budget."¹

The expectations of the Legislature and the Office of Budget and Program Planning for the pilot budgeting agencies can be grouped into five general criteria. Those criteria are as follows:

- A. Was PBS information and analysis used in the legislative budget process to determine the budget allocations for pilot agencies?

1

"A Review of the Priority Budgeting System" 1976, Office of the Governor, Budget and Program Planning, State of Montana, PP4.

- B. Did managers carefully evaluate and consider the ongoing need for each activity and different levels of effort and alternative ways of performing the activity?
- C. Was the pilot agency budget allocation, as recommended by the executive branch, determined by PBS analysis and recommendations?
- D. Did budget reductions or increases at the executive and legislative levels respect the agency's recommended priorities?
- E. Was the new information on program outputs used by pilot agencies in managing their programs?

The pilot agencies were also asked to provide comments on PBS that did not relate directly to the above criteria.

EVALUATION FINDINGS

Listed below are the formal criteria used in evaluating the Priority Budgeting System; for each criteria the finding or observations relating to that criteria are discussed:

- A. Was PBS information and analysis used in the legislative budget process to determine the budget allocations for pilot agencies?

The PBS budget analysis was generally ignored during the 1977 legislative budget process. Interviews with OBPP staff indicated that in two out of seven agencies the information was reviewed during the budget hearing. In the two agencies that the legislature did review the PBS information, no budget adjustments resulted from the PBS information.

A survey of the pilot agencies indicated that in two out of ten agencies, the agency felt the PBS analysis was used to determine the agencies' appropriation. Four agencies felt the legislative committees had reviewed the PBS information but that it had not affected the final appropriation. Three agencies felt that the PBS information had not been reviewed during the legislative budget process. One agency did not respond on the issue of legislative use of PBS.

A factor that may have greatly contributed to neglect of the PBS budgets by legislative committees, is that the budget analysis done by the office of the Legislative Fiscal Analyst retained the traditional line item budget format. During the 1977 session, the appropriation committee frequently worked from the Legislative Fiscal Analyst's recommendations.

- B. Did manager carefully evaluate and consider the ongoing need for each activity and different levels of effort and alternative ways of performing the activity?

Many agencies commented that the most positive aspect of PBS was that it forced the agency to evaluate their programs and budget requests. The increased involvement of line program managers in the budget process was often cited by agencies as a good aspect of PBS. There is some indication that PBS would not be able to sustain the increased involvement of program managers. Interviews during and immediately after the 1977 legislative session indicated that managers had been involved in evaluating alternative budget packages in every PBS agency. Responses to the questionnaire on preparation of the '80-'81 budget proposal indicated that involvement of managers in evaluating alternatives had possibly declined. None of the pilot agencies indicated that "PBS caused managers to evaluate needs and alternatives". Only one agency indicated that "PBS was the primary criterion used to determine the amount of funds to be requested. Only one agency indicated that PBS was used to determine priorities".

Proponents of Zero-Based Budgeting claim that ZBB forces agencies to "focus both on different ways of performing the same activity and on alternative levels of effort that could be exerted in performing an activity".² (The PBS

2

Granof, Michael H. and Kinzel, Dale A., Zero-Based Budgeting: Modest Proposal For Reform, The Federal Accountant, 1976

experience to date would indicate that this type of budgeting does force agencies to assess alternate levels of funding.) Agencies were asked in 1976 to analyze both alternative levels of funding and alternative ways of performing the activity. The executive in some cases selected alternative levels of funding. There were no pilot agencies that recommended lower levels of funding. Given the nature of the budget process is not surprising. What may be more noteworthy is that after analyzing alternative methods of performing activities, there was no agency that recommended any changes in the way the agency carried out the activity. This would seem to indicate either that the agency analysis was perfunctory or that these agencies have approached the pinnacle of program perfection. In an article reviewing the success of ZBB at the federal and state levels, Allen Schick states, "Evidence from state and local ZBB experiences suggest that the managerial system does generate expenditure shifts within budgets, but it does not lead to any basic re-examination of programs".³

- C. Was the pilot agency budget allocation, as recommended by the executive branch, determined by PBS analysis and recommendations?

The survey of budget analysts in 1977 indicated that in only two agencies did analysts feel that the PBS analysis was used to determine the agency's recommended budget allocation. The final amount that was recommended for the pilot agencies usually resulted from the projected amount of revenue available. Five out of the ten agencies surveyed felt that the PBS analysis had no effect on the amount of funds appropriated to their agencies in fiscal '78-'79. Three agencies felt that PBS had "some effect" and two agencies felt PBS has "a great deal of effect".

ZBB would appear to offer a tremendous opportunity to not only reallocate funds within agency budgets but also between agency budgets. For example, program A, in agency I, which has a low cost-benefit ratio could be dropped to fund program C in agency II which has a favorable cost-benefit ratio. Such

3

Schick, Allen, The Road From ZBB, Public Administration Review, March/April 1978, pp. 177-180.

an opportunity for funding tradeoffs never materialized with the PBS pilot agencies and it appears that such a situation within state government would be rare for two main reasons. The major problem with tradeoffs at the state level involves all the entanglements surrounding each agency's funds such as statutory earmarking and federal matching fund requirements. It is the exception, rather than the rule, to find a program from which funds can be removed across agency lines, without violating state or federal earmarking restrictions.

A second problem with funding tradeoff is that it overestimates the budget office and legislative abilities to precisely measure and compare cost-benefit ratios. Funding tradeoff arguments assume that cost-benefit ratio comparison is the only criterion in establishing budget recommendations. In 1962 the U.S. Department of Agriculture experimented with ZBB. These efforts were subsequently evaluated by Aaron Wildavsky and Arthur Brown who found: "The first conclusion would be that comprehensive budgeting vastly overestimates man's limited ability to calculate and grossly underestimates the importance of political and technological constraints".⁴

D. Did budget reductions or increases at the executive and legislative levels respect the agency's recommended priorities?

This criterion was used to determine if claims of ZBB proponents were founded, that their system allows agency staff a greater voice in what programs should be cut or expanded. In 1977 the budget analysts who worked with pilot agencies felt that, in all but one agency, the agencies priorities had been respected in making budget adjustments.

Comments from agencies generally indicated that the agencies felt that the agency rankings had been used to determine which programs were to be cut. Some agencies felt that by ranking

4

Wildavsky, Aaron and Hammond, Arthur, Comprehensive Versus Incremental Budgeting in the Department of Agriculture. Administrative Science Quarterly, December 1965, pp. 322-346.

programs for budget purposes, they received cuts that they would not have received through the traditional budget process.

E. Was the new information on program outputs used by pilot agencies in managing their programs?

The survey of pilot agencies in November, 1978, indicated that the information on program outputs and impacts generated by PBS was not utilized by program managers. Two pilot agencies indicated that the PBS information was useful in making management decisions. Six agencies indicated "PBS information was reviewed but had little effect on management decisions". Two agencies felt the information was of no assistance.

In order to satisfy statutory requirements for variance reports pilot agencies developed quarterly reports that matched program expenditures with program output measurements, at a program package level. This report requires translation of accounting information from the line item budget format to the PBS budget format. This translation was a time consuming process and most agencies indicated that the resulting information was not worth the effort.

The pilot agencies indicated through the survey that the output information reported in the variance report was an accurate reporting of the agencies' performance. Three agencies indicated the information reported was accurate and very reliable. Six agencies felt the information was relatively accurate and one agency stated the information was not very reliable.

F. Other information and observations collected from the PBS evaluation.

The pilot agencies were polled on whether PBS should be continued; nine agencies responded that it should not be continued, one agency said it should be continued only if it were applied to all agencies. Agencies were asked in the survey to best characterize the attitude of program managers toward PBS, the response was as follows: no agencies were "very favorable", one agency "favorable", two agencies

"no opinion", five agencies "negative" and two agencies "very negative".

The largest complaint from agencies about PBS was the great amount of time and resources the system required. Eight agencies responded that the process required a great deal more effort than the traditional process. Two agencies felt the PBS required about the same effort as the traditional process. The cost involved in collecting output information and in translating accounting information forced the Maintenance Division of the Department of Highways to discontinue the PBS system for preparing the '80-'81 budget request.

Many of the problems encountered with the PBS are laid out in a letter from the Centralized Services Division Administrator of the Department of Business Regulation, which has been attached to this report.

----- Kent Kleinkopf

February 18, 1977

David Lewis
Deputy Director of Budget
Budget & Program Planning
Office of The Governor
Capitol Building
Helena, Montana 59601

Re: Zero Base Budgeting

Dear Dave:

Since this Department was selected as a pilot agency for the Priority Budgeting System for the 1977-79 Biennium, I would like to convey some of our reactions to the overall process.

First of all, realizing that this was the first effort made to budget under the Zero Base System we recognize that it took considerably more time and effort to prepare it, if for no other reason than it was a totally new concept. Any changes naturally are met with somewhat of a negative attitude, however, we were very pleased to think that this Department had been selected.

Some of the problems that we encountered from the very first are as follows:

1. In order to establish a base which would be representative of Level B under the Zero Base System, we found that it was necessary to prepare a total Department Budget using the historical method to establish the foundation to work from.

2. We also found that it was necessary to prepare Budget Modifications under the historical method of budgeting in order to determine the costs of any additional requests over and above current level operations which would be representative of Level C, D, E, F, etc. under the Zero Base System.

In total we found it necessary to actually prepare a complete budget package based on the historical method before we could determine the dollars involved and proceed with the Zero Base.

Our next exercise was to analyze each Program to determine the "Activity Packages". In our case, each Program in this Department is rather small, so with the help of the Analyst assigned to this agency, we determined what functions should be

David Lewis
Page 2
February 18, 1977

appropriately grouped into activities. As an end result this Department, with 5 major programs and a current level of 52.25 FTE's, ended up with 13 activities.

Pursuant to HB643 each of these activities had to be budgeted at 3 package levels, Alternative A (80% or less), Alternative B (current level inflated), and Alternative C (current level plus). In some cases it was necessary to prepare additional packages thus bringing our total number of packages to 43.

In some areas we did not want or need additional funding in an activity over current level but to keep in compliance with the Legislative mandate we were forced to do so. This in itself caused a bottom line budget request that was greatly inflated and not the true or correct needs of this Agency.

Just as a note of interest, it was determined that Centralized Services Program should have three main activities, namely: (1) Top Level Management, (2) Administrative, and (3) Legal Services.

What actually happened was that the only FTE for the Top Level Management function was the Director of the Department. When it came to proposing a package at the 80% level there was no other alternative than to recommend that the position of the Director of the Department be eliminated. To say the least, this Program was re-analyzed and the end result was that we would formulate two activities, namely: (1) Department Administration, and (2) Legal Services.

Now to the more serious problems of Zero Base Budgeting.

In order for this agency to know what figures were actually used in arriving at the totals for any level of operation (Level A - Level B - Level C, etc.) it is necessary to keep accurate work sheets of all costs such as salaries, benefits, operational expenses and equipment because the Zero Base only indicates the total number of dollars to accomplish a specific out-put of an activity with a specified number of FTE's.

When the Office of Budget and Program Planning condensed our Priority Budgeting Package for incorporation into the Executive Budget it appears that they added all moneys requested in packages over and above Level C into the total of Level C or "Alternative C (Agency Request)", but did not include the total

David Lewis
Page 3
February 18, 1977

number of FTE's as indicated in these additional packages. This in itself distorted the relationship of FTE's to costs in performing the activity.

In addition, the priority table as condensed is very misleading. It would be next to impossible for a Legislator or anyone else to determine what is included in a package from Level B on. It appears that each Programs' packages from Level C on were added together and called "Level C (Agencies Request)". From this condensed version even the agency has some difficulty in determining what they have included. If a Program has a new function created by Federal Legislation this function is developed into an activity package. Since this would be new there would not have been any costs included in the Alternative B (current level inflated) therefore, this type of request is identified by 80% or less as "Package C"; the current level of the level required to do minimum level out-put would be identified as "Package D" and the 100% plus package to do a maximum level out-put would be identified as "Package E".

It would appear that if all levels or packages from the "Alternative B (current level inflated)" were listed separately in order of ranking as submitted to the Office of Budget and Program Planning by the Agency, it would be easier to follow but I am certainly not implying that it would be understandable to anyone who had not worked directly with the concept to begin with.

Another problem which we consider very serious is the fact that all dollars are added into a running cumulative total. In our case this would include Earmarked Revenue as well as General Fund moneys. It would appear that from the Legislative standpoint it would be impossible to know, without going back into the individual packages, where to trim if the General Fund requests had to be reduced.

Some of the more serious hazards involved in Zero Base Budgeting are having functions encompassed into "neat little packages", to-wit:

1. Salary. The Grade and Step of the positions are not identified, therefore it would be almost impossible to project a cost of living overlay if authorized by the Legislature.
2. The cost of preparing a document of this nature is very expensive. It is estimated that the Priority Budget as submitted from this Department cost around \$8,000. (Please keep in mind that the budgeting had to be done using historical methods first before we could begin the Zero Base structure.)

David Lewis

Page 4

February 18, 1977

3. All activities within a program must have administrative supervision. Using the Zero Base method the administrative supervision is incorporated into the "Administrative Activity Package" for that Program and all other activity packages must stand on their own merit. It is not reasonable to assume for example that activity package "Audit and Investigative" could function without direction from the "Administrative Activity Package" but this is not addressed. It would be interesting to see a wheel (Program) with spokes (Activities) roll without a hub (Administrative Supervision).

4. If the Zero Base concept should be adopted the costs of monitoring it in the Accounting System would be extremely high. It would appear that the total computerized design of the system would have to be completely changed.

5. If the Zero Base concept should be adopted it would require more personnel at the agency level in preparing claims for payment. An example of this would be in the Weights and Measures Division where the field men are assigned to regions. Each field person has overlapping activities so when a travel claim is prepared it would have to be pro-rated and coded to the time, travel, etc., spent on each activity that the person was involved in during that period of time. This in turn would have to be coded into the ICC so the proper charges would be made to the activity where the work was actually done. I would estimate that it would take at least triple the personnel to prepare claims for payment and to check the monthly computerized print-outs to see that they are correct.

6. All salaries would have to be pro-rated to the activity if the duties were in more than one activity area. This would cause accounting difficulties at the agency level and create many problems for budgeting. The Legislature has already mandated that we have Position Control but it would be next to impossible to maintain an accurate control program if the positions were spread over two or more activities.

It is interesting to note that during this Departments' hearings before the Appropriation Sub-committee that the material used by the Legislative Fiscal Analyst was from the historical method of budgeting. Not once during our two day presentation was the word "Zero Base" used from either the Analyst or any members of the Sub-committee even though we were a pilot program.

David Lewis
Page 5
February 18, 1977

All recommendations of the Legislative Analyst were based on specific items such as salaries, benefits, contracted services, communications, travel, etc., If the sub-committee sees fit to reduce any item in any given program, how is this agency going to know what "Activity" or what "Level of Activity" this reduction is supposed to come from?

I would like to recommend that the new approach to historical budgeting and forms used by the Office of Budget and Program Planning this year be permanently adopted as it is the best approach to budgeting I have seen to date. These forms provide detailed information by programs, actual costs and agency requests for the biennium. If a request is trimmed at least we know where it is and the adjustments that will have to be made at the agency level.

The Director of the Department is fully aware of the problems and concurs.

Sincerely,

Isabelle Pistelak, Administrator
Centralized Services Division

IP/rmh

SUMMARY OF RESPONSES

OFFICE OF BUDGET AND PROGRAM PLANNING

NOVEMBER 1978 PBS EVALUATION QUESTIONNAIRE

N=10

I. PBS Budget (check one response)

A. In preparing the 1980-81 Agency budget, was information and analysis required for the PBS system used in determining the amount of funds requested by the agency?

- 1 The information and analysis used for PBS was the primary criteria used to determine the amount of funds to be requested
- 3 PBS information and analysis was one of several criteria used in determining the amount of the agency request
- 3 PBS had little to do with determining the amount of the agency request
- 3 PBS had nothing to do with determining the size of the agency request

B. In preparing the '80-'81 budget request, did PBS assist your agency in setting priorities?

- 1 PBS was used to determine priorities
- 5 PBS was of some assistance in determining priorities
- 4 PBS had no affect on agency priorities

C. As a result of PBS, did program managers evaluate needs and alternatives for each activity for which funds were requested?

- 0 PBS caused managers to evaluate needs and alternatives
- 6 In some cases PBS caused managers to more carefully evaluate their requests
- 4 PBS did not affect the way in which managers prepared their requests