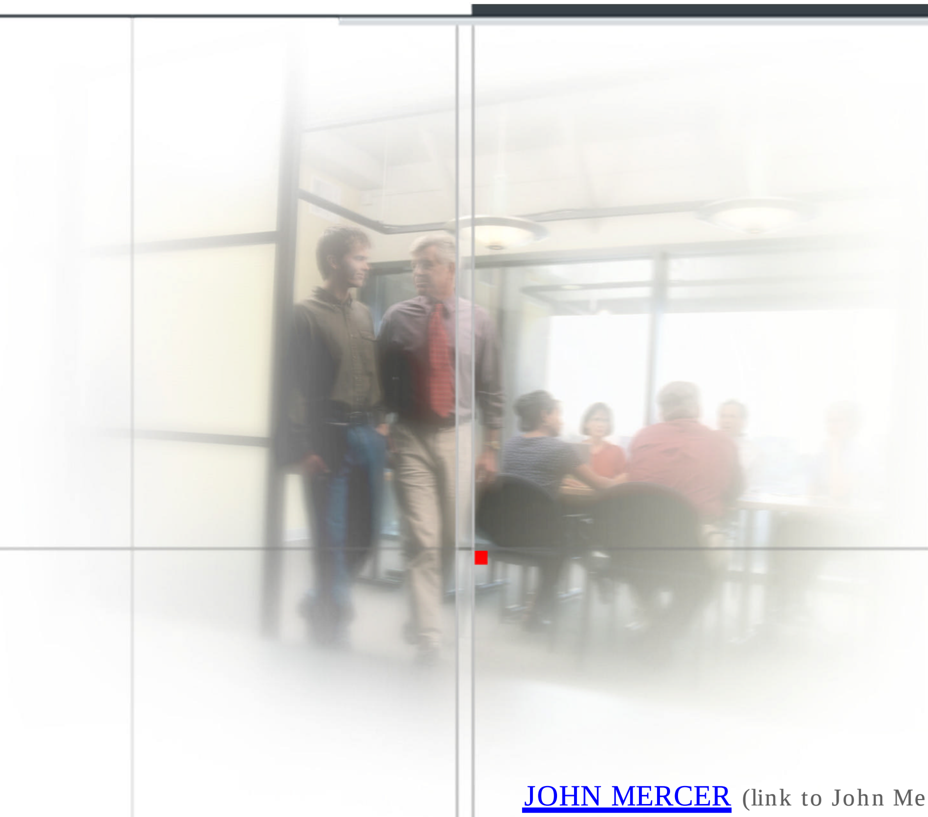
International Business and Technology Consultants

Performance Budgeting for Federal Agencies

A Framework



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Performance Budgeting for Federal Agencies

During the past 10 years, there has been increasing emphasis on improving management across federal agencies. Major legislation has been passed (e.g., CFO Act, GPRA, and FFMIA); oversight organizations such as GAO, FASAB, and JFMIP have increasingly required greater accountability; and the Clinton administration stressed improved financial management.[1] The Bush administration has taken an even stronger leadership position in improving the overall management of federal agencies. This is clearly and forcefully articulated in the President's Management Agenda initiatives.

Federal agencies must demonstrate to Americans that they are spending taxpayer dollars efficiently and effectively.

The 2003 budget, submitted in February 2002, reflects the desire by the administration to improve the efficiency, effectiveness, and usefulness of federal programs. The Office of Management and Budget (OMB) rewarded those agencies that demonstrated a strong linkage between resources consumed and results achieved. The Women, Infants, and Children (WIC) and the Job Corps programs received funding increases because they demonstrated their effectiveness. In the same budget submission, OMB graded federal agencies on their progress toward meeting the President's Management Agenda initiatives. As evidence of the how much improvement is necessary, of all grades given 85 percent were failing.

Performance budgeting is an important component for ensuring the efficient and effective use of federal funds.

The focus of this paper is to provide a framework for federal financial managers who need to understand the concepts behind performance-based budgeting. We believe that this understanding will help those managers improve financial management in their agencies and achieve the goals established in the President's Management Agenda.

We begin with a brief definition of a performance budget and then explore why performance budgeting is important to federal managers at all levels. We next highlight the administration's emphasis on managing for results. Included is a brief outline for creating a performance-based budget, followed by a discussion of the benefits and challenges of implementing a performance-based budget. The paper concludes with a discussion of the importance of taking quick action to comply with the President's Management Agenda initiative on budget and performance integration.

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[1] The following are the full names for the laws and organizations indicated in the paragraph: Chief Financial Officer Act (CFOA), Government Performance and Results Act (GPRA), Federal Financial Management Improvement Act (FFMIA), General Accounting Office (GAO), Federal Accounting Standards Advisory Board (FASAB), and Joint Financial Management Improvement Program (JFMIP).

What Is a Performance Budget?

A performance budget is an integrated annual performance plan and annual budget that shows the relationship between program funding levels and expected results. It indicates that a goal or a set of goals should be achieved at a given level of spending. An effective performance budget does more than act as an object class, program, or organizational budget with anticipated outcomes. It identifies the relationships between dollars and results, as well as explaining how those relationships are created. This explanation is key to managing the program effectively. As variances between plans and actuals occur, managers examine the resource inputs and how they relate to outcomes to determine program effectiveness and efficiency.

A program performance budget defines all activities, direct and indirect, required by a program for support, in addition to estimating activity costs. For example, if the measure for the “conduct criminal investigations” activity within a government agency is the number of completed investigations, then the next series of steps links the resources ultimately to outcomes. The following figure outlines this process. By tracking the cost and number of units for each activity, output, and outcome, unit cost information also may be generated.

$$$ ⇨ Activity ⇨ Output ⇨ Outcome

Regardless of agency level, managers must have accurate and timely cost and performance information to manage their resources most effectively. This applies to administrative support as well as program officials. In certain cases (e.g., computer services), managers require this information to establish unit prices. In other cases, managers simply want to ensure that every dollar supporting a program is spent wisely.

What’s the administration’s interest in performance budgeting?

President Bush first signaled the administration’s interest in performance budgeting in the fiscal year (FY) 2002 budget update in April 2001. The budget addressed the issue as follows:

Quote from budget update (April 2001)

> Bringing about a better linkage between performance and budget information will be a priority of this Administration . . . Over the coming year, the Administration will take a number of steps to strengthen the linkage between budget decision-making and program performance.

This section of the budget announced specific steps planned by the administration to further link the performance planning and budgeting processes. These steps included developing agency performance budgets that integrated program performance and budget information. This section of the budget also advocates reforms that would lead to more accurate assessment of program costs. The budget described these steps as follows:

Quote from budget update (Apr 2001)

> **Formally integrate performance with budget decisions:** … [A]gencies will be advised of specific performance targets that are compatible with funding levels, and program managers will be held directly accountable for managing to the targets. In future years, policy officials at all levels of the Executive Branch will be expected to set out targets to match funding levels for selected programs.
>
> **Develop legislation to enable managers to be charged for support services, capital assets, and employer benefits:** If program managers are going to be more accountable for the achievement of output targets, they should be given accurate information on the cost of their programs and flexibility in choosing service providers. Legislation will . . . address their problem by changing the way support services, capital assets, and employee benefits are budgeted.

In August 2001, OMB released the President’s Management Agenda for FY 2002. This document included Budget and Performance Integration as one of the five major governmentwide initiatives. OMB described the problem and its response as follows:

Quote from President’s Management Agenda for FY 2002 (August 2001)

> [Problem] . . . Agency performance measures tend to be ill-defined and not properly integrated into agency budget submissions and the management and operations of agencies . . . [OMB Response] To provide a greater focus on performance, the Administration plans to formally integrate performance review with budget decisions. This integration is designed to begin to produce performance-based budgets starting with the 2003 Budget submission.

In October 2001, OMB released a set of standards for success for each of the five initiatives on the President’s Management Agenda, followed in December by a scorecard that rated departmental compliance. The five core criteria for receiving a “green” rating for Integrating Budget and Performance are quoted as follows from the OMB memorandum:

Quote from OMB memorandum (October 2001)

- Integrated planning/evaluation and budget staff work with program managers to create an integrated plan/budget and to monitor and evaluate its implementation.

- [A] streamlined, clear, integrated agency plan/budget sets forth outcome goals, output targets, and resources requested in context of past results.

- Budget accounts, staff, and specifically program/activities are aligned to support achieving program targets.

- Full budgetary cost is charged to mission accounts and activities. Cost of outputs and programs is integrated with performance in budget requests and execution.

- Agency has documented program effectiveness. Analyses show how program outputs and policies affect desired outcomes. Agency systematically applies performance to budget and can demonstrate how program results inform budget decisions.

The President and OMB recognize that state and local governments have employed performance-based budgeting successfully as part of their improved service to the citizenry. The administration believes that the lessons learned at the state and local level apply equally to federal agencies; hence, examples exist that agencies can use to improve their ability to link resources with performance. In fact, the President's budget for FY 2003 spotlighted the California city of Sunnyvale's success in linking resources to program outputs and ultimately to program outcomes: "Sunnyvale . . . has become internationally recognized for performance budgeting—allocating funding for tasks rather than for personnel, equipment, and supplies, with quantified objectives that are expected to be achieved with the funding." OMB noted that a key to Sunnyvale's success is the fact that the city uses the information derived from the performance budget to manage its business on a daily basis.

The President's FY 2003 budget prominently features the administration's emphasis on budget and performance integration, known as the Integration Initiative. Under this initiative, agencies are "urged to improve program performance and to improve evidence of effectiveness and linkage with program cost." Noting that the lack of such information "is the result of long-standing barriers in agency organizations and reporting systems," the budget stated that "[a]gency reporting systems must be able to report on these goals, objectives, and costs in an integrated information system." OMB's scorecard published in the budget, however, gave 23 of the 26 agencies a rating of "red" on performance budgeting integration.

In addition, FASAB developed a governmentwide standard for managerial cost accounting, specifically addressing the need to relate resources to performance. See FASAB Standard No. 4, "Managerial Cost Accounting Concepts and Standards for Federal Agencies," Paragraph 35: "Measuring cost is an integral part of measuring performance." Specifically, FASAB notes that an important purpose of managerial cost accounting is to "provide a method for identifying the unit cost of all government activities."

How do you create a performance budget?

The development of a performance budget is a simultaneous top-down and bottom-up process. Senior planners and policy officials must articulate program goals and objectives. They also must outline the levels of resources that they anticipate allocating to support those goals and objectives. These same officials should identify outcome measures that tend to determine whether goals were met and resources spent effectively; however, the goals, objectives, resource levels, and outcome measures must be developed with and validated by lower level managers.

These managers and their subordinate organizations are in a position to apply a level of realism to the planners and policy officials' annual performance plan. These managers understand the mechanics of their programs and can assist policy officials proactively as they refine the agency's annual performance plan. In addition, by working closely across organizational lines, planners and policy officials may be assured that managers at all levels not only understand the integration between an annual performance plan and a performance budget but also are committed to its success.

An example

To illustrate the effective integration of budget and performance by a government organization, a sample approach is provided. Praised by OMB for its use in operational management, this approach involves five steps for identifying the day-to-day activities of program staff and using these activities as the bridge between budgeted funds and the program's hierarchy of goals and measures.

***Step 1**: Every activity, as conducted by organizational staff, is defined within a program.*

When an agency's responsibilities include investigating certain types of criminal conduct, the agency may define the activity as "conduct criminal investigations," or it may choose to break that activity into multiple types of criminal investigations, particularly if different sets of performance goals relate to different types of criminal investigations.

***Step 2**: Each activity is measured in units.*

The unit of measure for the activity also is defined. In this scenario, it might be defined as “an investigation completed.” Behind each activity is a set of standard operating procedures that specify, among other things, how this activity is measured. In the investigation example, it may define exactly what each type of investigation means and under what circumstances an investigation is considered “completed.” The agency then estimates how many investigations it will conduct during the next year. This estimate may be based on a number of factors, such as the number of investigations conducted during the previous year, trend lines or situational changes, alterations in strategies, and changes in resource levels.

***Step 3**: Every full-time equivalent (FTE) is converted to the appropriate number of work hours (e.g., 2,080 hours per year) and is linked to a specific activity.*

An estimate is made of how many work hours of the activity will be used during the next year. If the agency uses 100 investigators in a program, and these investigators are expected to spend 25 percent of their time on average conducting a certain type of investigation, then the number of hours is calculated as follows:

100 investigators x 2,080 annual work hours x 25% = 52,000 hours

Sometimes the unit of measure for an activity is simply the number of work hours (e.g., when the activity is “program administration”). This may serve as a useful fallback measure when no other unit of measure is meaningful or feasible. Care should be taken, however, to use this only as a last resort because the number of anticipated work hours will be shown in the budget for every activity in any event.

Activities may be defined broadly or narrowly, depending on meaningfulness, usefulness, and practicality. “Provide customer service” could provide an appropriate level of detail for one program, whereas another program could break it down further to “process grant applications” or “answer telephone inquiries.” The agency also may create subactivities, which are useful to a specific program or office; however, the agency may wish to include subactivities as part of a more broadly defined activity.

***Step 4**: Every dollar of operating cost is charged against a specific activity.*

The budget costs for each activity then are calculated using the managerial cost accounting methodology of activity-based costing. A variety of costing approaches may be used, from precisely tracing the costs to making reasonable approximations (e.g., allocating utility costs based on square footage of office space); however, full cost accounting is critical. Under this principle, both direct and indirect costs are charged to each activity, and every dollar in the operating budget is charged against an activity.

***Step 5**: Every activity is linked to a single output measure (or small set of output measures) in the hierarchy of goals and measures.*

Each activity in the performance budget is linked to outputs at the lower levels of the performance plan. Sometimes each activity may be linked to a single output-type measure, in which case several activities may be shown collectively to generate a single output. In other cases, especially when a single activity affects more than one output, several activities might be linked to a group of outputs. The groupings of activities and outputs should not become too large; otherwise, it becomes difficult to see how an activity impacts results.

How are these steps integrated across an agency?

As stated above, creating a performance budget is both a top-down and bottom-up process. Policy and program officials identify goals, objectives, resource levels, and outcome measures in an annual performance plan. Program activities at the lower level must be linked to an agency's overall performance plan, and therefore agencies must define goals, objectives, and performance measures in collaboration with subordinate organizations. Each organization within an agency then must ask the following questions:

- What are the goals, objectives, and performance measures of our higher-level organization?
- How do our own goals, objectives, and performance measures support those of the higher-level organization?
- Are these goals, objectives, and performance measures consistent with the mission and capabilities of our own lower level organizations?
- What do we need to do on a daily basis to achieve our goals?

When raising these questions, keep in mind that a performance budget presents a general indication of how dollars are expected to generate results, which facilitates resource allocation decisions by suggesting the potential effect of budget increases and decreases. Creating a performance budget does not always involve a clear-cut, cause-and-effect relationship, nor can the outcome be mapped with scientific precision.

What are the benefits of performance budgeting?

Performance budgeting is an ongoing process that involves every manager within an agency, from an agency head to individual managers of programs and organizations within an agency. This includes a feedback cycle, which provides senior managers at all levels with improved information to manage their activities. A performance budget ultimately leads to more effective use of an agency's resources. Managers are able to deploy resources more effectively so that the outcomes anticipated in the budget may be achieved.

Provides a valuable diagnostic tool

Performance budgeting is a valuable diagnostic tool for developing a fundamental understanding of the integration between resources applied and performance achieved. Program officials have the opportunity to examine the intricate interplay between resources and desired outcomes. This experience ideally improves the overall management of a program.

Helps justify your budget

An effective performance budget lends greater transparency to a program's operational performance than a conventional budget for a program, organization, or object class. Using well-defined, fully costed activity measures as the foundation for the structure of program outputs and performance goals, a performance budget provides a valuable tool for assessing how spending changes affect results.

Serves as the foundation for a comprehensive performance management system

Establishes a starting point for monitoring organizational effectiveness

Once created, a performance budget may become the foundation for building a comprehensive performance management system within the context of an agencywide strategic plan. A performance budget suggests how dollars affect program performance (e.g., activities, process measures, and outputs) and how this performance affects the desired end results (e.g., outcomes). A well-crafted performance budget provides agency managers with a starting point for monitoring organizational performance.

Allows programs to have two part goals

A performance budget presents an opportunity to create two-part goals to measure dimensions of cost as well as results. One part of a goal could relate to a desired outcome (e.g., 80 percent placement of job program trainees). The second part of a goal could be to run a program at a certain unit-cost rate (e.g., cost per trainee is $3,000). These two parts then are joined to ensure that the goal itself makes sense. Also, it is sometimes the case that increasing the success rate of a program may require a disproportionately large additional investment. This implies that there is no realistic way to improve. By using unit-cost information from the performance budget, improved performance may be defined in terms of reducing the cost per unit. Experience has shown that this use of governmental performance budgeting gives program managers a strong incentive to find innovative ways to cut costs while achieving better results. This is particularly true when a pay-for-performance system is in place.

Provides comparative unit costs

A performance budget also generates useful comparative information. If one regional office is achieving unit-cost performance at a level lower than the norm, agency leaders may identify the innovative best practices that led to such savings and then share lessons learned. Program managers also may use comparative information for a better understanding of their own operations. By identifying the various factors that drive program costs, managers can consider alternative processes and strategies that may be more cost-effective.

Supports more informed and objective decisions

Performance budgeting facilitates more informed and objective decisions about outsourcing service delivery. Government agency managers should know the total cost of a function (including all indirect and overhead costs) as well as the level of result presently achieved. With no hidden costs behind its own figures, an agency may judge more confidently whether a particular performance-based contract provides a cost-effective way to improve program performance.

What are the challenges to implementing performance-based budgeting?

Implementing performance-based budgeting systems that effectively integrate budget and performance information and provide meaningful guidance for day-to-day operations takes time and leadership. The challenges are real but may be overcome if understood and addressed proactively.

Defining activities for each program

Defining the activities for each program will be a challenging initial task for many agencies. Decisions must be made about defining each activity (e.g., broadly or narrowly). This will depend on what level of detail is meaningful for managerial and accountability purposes. If a system for charging work hours against each activity does not exist, agency managers may need to create one. Some agencies have such a system in place; however, with the new budget structure linking activities to goals, managers may wish to combine, divide, or redefine some activities.

Identifying the cost of each activity

Identifying activity costs is complex and requires a significant level of effort. Agencies already should have started down this path by developing systems that comply with the managerial cost accounting standard. GAO points out, however, in its October 2001 report ("FFMIA Implementation Critical for Federal Accountability") that while such cost accounting systems are essential for GPRA implementation and performance budgeting, few agencies have the required systems:

> A major cornerstone of FFMIA is good cost accounting information that program managers can use in managing day-to-day operations. Managerial cost accounting is aimed at providing reliable and timely information on the full cost of federal programs, their activities, and outputs . . . Developing the necessary information, which is needed as well to support GPRA implementation, will be a substantial undertaking . . . Our sense is that today few agencies may have good cost accounting information . . . Further, the move to implementation of performance-based budgeting highlights the need for cost accounting information at the program level.

Mapping budget justification to the Annual Performance Plan

Agency managers should integrate the annual performance plan with the budget and the congressional budget justification. This requires careful planning to ensure that performance information is not lost in the larger budgeting process. A cross-referencing system between performance budget information and backup material in other budget documents is one way to achieve this coordination.

Changing appropriations or budget structures

Performance budgets may require a change in the appropriation and budget account structure. Any such change requires the coordinated support of OMB, the agency, and Congress. OMB recommends that agencies consider changing the budget accounts to facilitate linkages to annual plan goals. Agencies should use any restructuring of their budgets to improve the ability of Congress to use the GPRA plans and reports during the congressional budget, appropriation, and authorization processes.

Encountering resistance

Managing for results requires that the performance budget facilitate comprehensive performance management, which involves more than the budget and strategic planning offices. The budget could be used as a resource for establishing performance agreements with program managers. These managers may resist such agreements. To be most effective, program managers must learn to use cost accounting and other financial information to administer their programs.

Upgrading information technology (IT) systems

A major challenge is upgrading IT and financial management systems to support performance management. Setting goals for program outputs, unit costs, and outcomes in the performance budget amounts to only part of the solution; providing managers with a steady stream of timely, accurate, and useful program performance data throughout the year is critically important.

Why should agencies begin implementing performance budgeting now?

Despite the challenges, performance budgeting is achievable at the federal level, particularly now that the requisite management reforms are in place. Agencies should take action now. They should develop an understanding of what needs to be done, develop a plan, and get started. These initial efforts will be improved in subsequent years. As managers use performance budgets and the supporting information systems to steer their programs, they will demand better and more timely performance data, which will drive further improvements in performance budgeting.

OMB has mandated it.

Those who go first may be used as models by OMB.

You may more easily win at the budget table.

OMB has mandated that federal agencies begin integrating performance planning with budgeting; however, OMB is relying on agencies to develop the details behind this mandate. Those who go first and show credible results are likely to be at an advantage when dealing with OMB. These agencies also will be spotlighted as examples for other agencies to emulate. The agencies that wait, however, may suffer during budget negotiations and may be told to adopt someone else's performance budgeting model. In this area, there is surely an advantage to being first.

Implementing performance budgeting will help agencies move from "red" to "green."

The actions required of an agency to develop an effective performance budget match precisely with OMB scoring criteria for receiving a "green" on the initiative for integrating budget and performance. Moving all the way up from a "red" or "yellow" score may not be accomplished within the first year, but significant progress may be made.

What initial steps should agencies take?

Agencies should begin by ordering an objective assessment of areas in which they fall short of meeting OMB's criteria for performance-based budgeting. This objective assessment should include the steps required to achieve effective compliance. A comprehensive plan then should be fashioned to address all of these issues, integrating each of the necessary steps and resources. The agency may begin with a focused set of pilot projects, followed by a broader effort during the second year. With all tasks, process improvements, deliverables, and timetables specified, the agency then may act on these plans and make meaningful progress.

This is the future—plan for it.

Meeting legislative mandates and this Administration's requirements to improve management will drive the future of every federal agency. We can see a real effort now by OMB to make federal agencies accountable not only for the resources provided to support programs but for the overall success of their programs. This requires performance-based budgeting processes. Those agencies that embrace linking resources to outcomes will be winners. They will have the tools to improve their performance, document their results, and justify their budgets.