



THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: June 23, 2016

IBA Report Number: 16-16

City Council Docket Date: June 28, 2016

Item Number: 338

Zero-Base Budgeting Concepts and Examples

OVERVIEW

In 2006, the City Council adopted a financial training program to provide Councilmembers with relevant information on important areas of government finance. In accordance with this program, the Financial Management Department (FM) and the Office of the IBA will present information on Zero-Base Budgeting (ZBB) to the City Council on June 28, 2016.

Early in 2015, Councilmembers Scott Sherman and Chris Cate issued a memorandum discussing ZBB as an alternative approach to traditional budgeting practices. They requested a ZBB pilot program be undertaken for the FY 2017 Budget to explore the potential for increasing transparency and accountability in the City's budget. In response, FM utilized a ZBB service-based budgeting approach to develop budgets for the Performance & Analytics and Public Works General Services departments for the FY 2017 Proposed Budget.

On May 2, 2016, FM issued a memorandum discussing ZBB and the results of incorporating ZBB principles in developing these budgets. Although this information was made available immediately before the scheduled public budget hearings for the two City departments, the Council did not have the opportunity to learn about the ZBB processes used in the development of these budgets. FM is also tracking staff time for both the ZBB pilot and the current budget development process. This information will be incorporated into a cost-benefit analysis that will be included in a ZBB update report that FM plans to release in September 2016.

In an effort to supplement the information provided in FM's memorandum, the IBA has researched other jurisdictions who are either currently using or have used ZBB principles to develop their annual budgets or review programs and services.

The intent of this financial training is to allow FM and the IBA to present information in their respective reports to the City Council, and allow Councilmembers to ask any questions they may have about ZBB.

FISCAL/POLICY DISCUSSION

Of the ZBB articles and analyses reviewed by our Office, perhaps the most comprehensive was a research paper published by the Government Finance Officers Association (GFOA) in 2011 entitled “Zero-Base Budgeting: Modern Experiences and Current Perspectives.”¹ The GFOA surveyed their members about ZBB and received 413 responses. Much of the information below is drawn from the 2011 GFOA paper.

ZBB – What is it?

ZBB calls for developing a budget from the ground up, starting from zero. In theory, an organization’s entire budget needs to be justified and approved, as opposed to focusing on the incremental change from the prior year’s budget. ZBB moves an organization away from incremental budgeting, where last year’s budget is the starting point. Instead, the baseline is zero, implying that past patterns of spending are no longer a given. Renewed interest in ZBB in today’s environment of fiscal constraint may be due to the notion that the “zero” in ZBB sends a powerful message that taxes and spending will be held in check.

Brief History of ZBB

ZBB in government rose to prominence in the 1970s when U.S. President Jimmy Carter promised to balance the federal budget in his first term and reform the federal budgeting system using ZBB. President Carter had used a ZBB system while serving as governor of Georgia. At the time, federal spending was perceived by many to be out of control, with much of it no longer subject to annual appropriations, but driven by permanent entitlement programs and multi-year budgetary authority. Interest in ZBB subsequently declined in part because it required extra time and paperwork to implement, and due to doubts about the method’s ability to fully meet its theoretical promises. Additionally, economic conditions improved from the low points of the late 1970s and early 1980s, which reduced the perceived need for what was largely regarded as a “cutback budgeting” method.

How ZBB Works in Theory

In an effort to better allocate limited fiscal resources, ZBB divides an organization into “decision units” – the lowest level at which budget decisions are made (e.g., a program or division of a department). Managers in each decision unit then prepare a detailed description and evaluation of all the activities it performs, including alternatives to current service delivery methods and the spending plans necessary to achieve the decision unit’s goals. Each decision unit should propose at least three decision packages, which show marginal spending level differences that represent varying levels of effort and cost. For example, there could be a bare-bones base service package, a status quo service package, and an enhanced service package. In addition to detailed information on inputs (dollars, personnel, etc.), each decision package includes specific performance measures to help explain the impact of the package on service levels.

After decision packages are completed, they are ranked from highest to lowest priority within the organizational unit in which the decision unit resides. A department director may then rank all of

¹ The full GFOA paper is available online: <http://www.gfoa.org/sites/default/files/GFOAZeroBasedBudgeting.pdf>

the decision packages within their department together, or decision packages within divisions/programs of their department. A director's ranking of decision packages is then used by the central budget authorities (e.g., budget office, chief executive, governing body) to make final budget decisions.

Cited Advantages Associated with Theoretical ZBB

- The foremost theoretical advantage of ZBB is that it offers a rational and comprehensive means for reducing the budget in difficult economic times—as opposed to across-the-board budget cuts that do not differentiate between the value of one service versus another.
- Requires a more detailed scrutiny of all expenditures, which allows for a better comparative evaluation of different services based on the perceived value to the organization or public.
- Enhances transparency and decision-making by more comprehensively looking at the entire budget rather than focusing on the incremental change over prior year spending.
- Provides management and the legislative branch with better insight into the detailed activities of departments, and their related costs.
- Focuses on performance measures and results for various decisions/programs.

Drawbacks Associated with Theoretical ZBB

- Requires the development of numerous decision packages, which requires substantial time commitments from staff and management to develop, review, and rank decision packages.
- Reluctance of managers to suggest decision packages below current spending levels.
- Managers who do not buy-in to the ZBB approach may attempt to “game” the system. For example, department managers may offer few decision packages to limit budgetary options, or give low rankings to services with high public appeal knowing that budget decision makers will refuse to cut such services thereby sparing services the department had ranked higher.
- ZBB decision package options are often driven/shaped by management perceptions and preferences, and may not reflect the views and long-term priorities of elected officials or the communities they represent.

ZBB in Practice

GFOA research indicates that theoretical ZBB, as described above, appears to be very rare in practice. Rather the label of ZBB is often applied to budgeting methods that borrow elements of pure ZBB, but do not conform to the theoretical model. Like most budget reforms that promise to bring more rationality and comprehensive decision-making to budgeting, ZBB has limitations that may, or may not, justify the additional time and effort that is required. However, it should be noted that several jurisdictions effectively employ elements of ZBB to more comprehensively review all budget expenditures over time and more thoughtfully make public service choices during times of fiscal constraint.

Our Office has researched and interviewed other jurisdictions that are using, or have used, elements of ZBB to develop their budgets and/or review their programs. This information is presented in the sections that follow. For each jurisdiction, we provide background information for context, describe the ZBB elements employed, and highlight associated benefits and challenges.

Georgia

The zero-based budgeting program conducted in the State of Georgia is not a traditional ZBB effort. Instead, it is a systematic review of each program's activities "against its statutory responsibilities, purpose, cost to provide services, and desired performance outcomes." Georgia's most recent ZBB effort was passed into law by the General Assembly in 2012, and will sunset in 2020 unless it is reauthorized.

In conjunction with its annual budget process, Georgia conducts a review of, on average, 14% of its programs. Beginning in April of each year, Georgia's Office of Planning and Budget (OPB) develops a list of programs and agencies for review, taking into consideration the priorities of the Governor and General Assembly. This list is then shared with the House Budget and Research (HBR) Office and the Senate Budget and Evaluation Office (SBEO) to determine if other programs or agencies should be added to the list. OPB issues a report outlining the procedures for ZBB analysis², and begins working with the agencies to conduct the review.

The four step process includes:

1. Identifying and evaluating key activities within the program/agency under review
2. Developing and evaluating performance measures
3. Analyzing the program budget (including historical expenditures) to assess cost effectiveness/ROI when compared to targeted performance measure outcomes
4. Summarizing the analysis and utilizing it to develop budgetary recommendations

The final report is issued in January along with the Governor's budget.

In the last two years the review process has been modified. Originally, the Governor's proposed budget included recommendations resulting from that year's ZBB review. However, this did not give the legislature time to weigh in on which recommendations it supported. In order to increase the involvement of the legislature, ZBB recommendations are now released as a separate report when the budget is released in January. This allows the legislature to weigh in on the recommendations it would like incorporated into the budget, and those changes are implemented in the following year's budget.

Benefits

Georgia has developed a number of budget reduction and efficiency recommendations as a result of using ZBB. For instance, in the first year of reviews, 10% of the State's budgetary programs were assessed, and budget revisions resulted in \$8.9 million in savings in FY 2013. Additionally, the legislature has passed four bills that resulted in streamlined operations as a result of the ZBB reviews, including a bill that restructured the Soil and Water Commission's Board and administratively put it under the oversight of the Department of Agriculture.

² The State of Georgia's *Procedures for Zero Based Budget Analysis: Fiscal Year 2018* is available online: https://opb.georgia.gov/sites/opb.georgia.gov/files/related_files/site_page/FY%202018%20ZBB%20Procedures%20-%20Agency.pdf

Another benefit of Georgia's ZBB process is that it allows agencies to be examined at the program level, which provides legislators with a better understanding of agency activities. When feasible, OPB has broken large agency evaluations into smaller component reviews and spread the reviews over several years. This has reduced the time and work burden on OPB and state agency staff.

In general, OPB staff found that the ZBB process has been effective as a method for improving the organization and structure of agencies, and has helped them assess if agencies and programs are following state policies.

Challenges

The ZBB process took effect after the last recession. During the recession, agency expenditure budgets were reduced significantly due to lower revenues. As a result, OPB has found it hard to identify additional large budget reductions during the ZBB process.

Another challenge of ZBB is convincing agency and program directors to buy-in to the process. Staff found that if agency heads did not see the value in the process, it was difficult to get valuable information and make meaningful changes.

Although Georgia's ZBB process provides for larger agencies to be divided into programs for review, Georgia's Government Code required that the entire Department of Education undergo ZBB before presentation to the General Assembly in January 2013. OPB was also required to review the entire Department of Transportation. These two large departments consumed a considerable amount of budget staff time.

While OPB staff has found value in the ZBB reviews, they noted that many of these efficiencies would likely have been found through the normal budgeting process.

Lessons Learned

Georgia staff identified the following lessons learned:

- Delaying implementation of ZBB review recommendations until the next budget gave the General Assembly an opportunity to weigh in on the reviews' proposed changes.
- Requiring agencies to submit budget requests at various percentages of the previous year's budget (e.g. 95%, 100%, and 105% of current levels), was not an effective approach because some agencies identified efficiencies that would not be cut (e.g., they were either statutorily required or priority programs of the legislators/Governor). Instead, OPB got better information when it asked which programs and services are statutorily required, and which are grant funded and have specific requirements. Further, requesting that agencies tie their activities back to their missions made it easier to identify efficiency opportunities.
- Conducting ZBB on a division or two of larger departments instead of the entire department can reduce the burden on departments and budget staff.
- ZBB will not be successful unless the leadership takes it seriously (from the Governor down to the agency heads/managers participating the process).
- Including a sunset provision is helpful because there are diminishing returns when comprehensive reviews are repeatedly performed in consecutive years.

- ZBB will not be successful if it is focused solely on reducing spending. Identifying opportunities to improve programs and services, and developing improved performance measures were critical components of Georgia’s ZBB effort.

Seattle, Washington

In September 2014, Seattle’s Mayor unveiled his FY 2015-2016 proposed budget, which included a transition to performance-based budgeting as well as a zero-based budgeting exercise for two City departments. Seattle’s Office of Housing and Office of Sustainability and Environment were selected for the ZBB pilot. The City Budget Office (CBO) describes this approach as a “baseline budget review,” as opposed to traditional ZBB. The ZBB exercise was coordinated by the CBO with the goal of better understanding departments’ baseline budgets, and included a concerted effort to connect the planning activity of budgeting to the actual receipt, expenditure, and reservation of dollars contributing to the services provided.

Benefits

According to the CBO, the baseline budget review was a helpful reminder to integrate a baseline review of revenues and expenditures with incremental budgeting. Seattle’s baseline budget review was beneficial in two ways: 1) it helped them align each department’s budget with how the City’s accounting system was allocating funding; and 2) it made it easier for a reader of the budget to see each department’s “lines of business” or the programs and activities for the fiscal year.

For example, in the CBO’s review of the Office of Housing (OH), staff realized that the City’s accounting system did not match how the Office was actually spending its funding. Additionally, the baseline budget review helped the CBO identify OH’s major activities and programs, and the costs affiliated with each activity. This information was also useful for improving the Council’s (and public’s) understanding of the range of services provided by OH.

The CBO also used the baseline budget review to look more closely at budget line items such as contracts to gain a better understanding of these expenditure categories, and identify areas of funding flexibility.

Challenges

Seattle has decided to delay additional ZBB pilots until the implementation of a new accounting system in 2018. The City is considering how it will utilize ZBB concepts in the future, but has preliminarily discussed reviewing a few departments each year as part of a regular review cycle. The CBO may also conduct its future reviews separately from the budget cycle to provide time for an adequate assessment of each department.

Lessons Learned

The CBO noted that a zero-based review can be intimidating for departments, and it is therefore important to have a well-articulated project plan, clear objectives, and an understanding of who the stakeholders are. During the pilot, the CBO made it clear to pilot departments that this was not a budget reduction process. By providing this information to departments in advance, and making

it clear that the departments were partners in the process, they were able to work together to build a clearer understanding of each department's baseline budget.

Montgomery County, Pennsylvania

Montgomery County, Pennsylvania used a mission-based form of ZBB to develop its 2013 budget. The tool was pursued after political control of the Board of Commissioners switched party hands for the first time in roughly 140 years. Prior administrations had relied heavily on incremental budgeting, basing the annual budget on the previous year's adopted budget, and assigning an arbitrary level of growth or cuts to each department. Previous budgets also lacked transparency, and did not reflect the true cost of delivering county services. Publically presented budget materials did not include actual expenditures from previous years, and there were a number of items that were significantly underfunded or not included in the budget at all. The incoming Board of Commissioners was concerned, and challenged these practices. Actual previous year spending levels were subsequently incorporated into budget materials, and a mission-based ZBB approach was used to examine expenditures.

Montgomery County's mission-based approach to ZBB was implemented in two phases.

In phase one, departments were required to:

1. Describe their core mission
2. Identify performance measures to achieve that mission
3. Identify how well current activities met the mission (e.g. was the County providing services that were not critical to the mission? Were there any services that the County should be providing that it was not?)
4. Design an ideal organizational structure to accomplish the mission

The Finance Office and Chief Operating Officer first met with each department to go over the results of phase one. In phase two, they identified the department's forecasted revenue and expenditures and evaluated if they were aligned with the department's mission and services.

Benefits

According to the former Chief Financial Officer (CFO) who implemented the program, mission-based ZBB was and continues to be successful in Montgomery County. By reviewing actual revenues and expenditures, the County Board of Commissioners gained better insight into the true fiscal state of the County. For example, the resulting information helped identify areas where the Board was spending significantly more on outside legal fees than were budgeted each year.

The County also used mission-based ZBB to identify duplicative services, or services the County was providing that were not mission critical. For instance, through ZBB they found the County's Office of Economic Development was duplicating the efforts of other departments. By examining each department's mission and services, the CFO identified the redundant effort and was able to restructure Economic Development to eliminate the duplication.

In another instance, the County had been operating a nursing home for over 70 years. The nursing home had become a financial drain on the County, and through mission-based ZBB it became apparent that operating the nursing home was not in keeping with the County's mission. The County sold its nursing home to a private company for \$41 million, and was able to pay the facility's remaining expenses and debt, and place the remaining \$20.1 million into its reserves.

Challenges

As cited by other governments, the ZBB process in Montgomery County was extremely time consuming, and faced resistance from some departments.

Lessons Learned

The following are recommendations and lessons learned by the former CFO:

- ZBB is only successful when leadership is committed to the process and is willing to use the resulting information to make tough and sometimes politically difficult decisions.
- If ZBB is done correctly the first time, it should not need to be repeated as intensely each year because there will be a new baseline and a system in place to ensure that added or changed activities fit with the mission.
- Budget enough time for ZBB (Montgomery County dedicated a full year for the effort), and develop a well-articulated plan before beginning the process.
- Avoid using outside contractors for ZBB because it can negatively impact the buy-in from departments.
- Avoid setting arbitrary percentages (e.g. telling Departments they need to cut 5% of their budget). Departments will identify better service improvements if they feel like their needs and concerns are heard.
- Avoid a piecemeal approach to ZBB. Montgomery County found it was most effective to use ZBB with all departments at once.
- ZBB is more than just a cost-cutting measure. It can help identify mission-critical services that are not being provided, as well as inconsistencies in budgeting practices.

Chicago, Illinois

Chicago began implementing a zero line-item approach to ZBB for its non-personnel expenditures (NPE) in FY 2015. The budget process begins in June with each City department assessing its personnel and non-personnel expenditure needs. In the case of NPE, each line item is zeroed out from the previous year, and Chicago's Office of Budget and Management (OBM) asks departments to justify the requests for each line.

Benefits

Chicago's OBM found that most departments took the process seriously and thoughtfully examined their baseline non-personnel expenditures. Benefits included the identification of expenditures that were categorized incorrectly, and numerous opportunities for savings. For instance, in FY 2016, using a ZBB process for NPE resulted in \$21.7 million in savings that Chicago was able to use to address its operating budget shortfall.

Challenges

Chicago has not yet been able to implement ZBB for its personnel expenditures (PE). OBM found that addressing PE in this manner would be too complicated with over 34,000 employees, and with an older accounting system that was not equipped to handle it. OBM is beginning to consider ways to use ZBB for PE, like zeroing out vacancies each year and asking departments to justify their vacancies. However, there are numerous hurdles the City must address before considering ZBB for PE.

Lessons Learned

The Budget Director in Chicago's OBM noted that implementing textbook ZBB is not practical. Every government has different budgetary needs, and capacities to implement ZBB. Chicago assessed what areas they thought would benefit from ZBB, and only adopted elements that made sense for the City. In Chicago's case, they recognized that implementing ZBB on NPE could help them identify opportunities for savings, but looking at PE was too complicated, and would not work without major system modifications.

Calgary, Alberta

Calgary uses a zero-based review (ZBR) program to conduct service reviews of business units outside of the regular budget process. Calgary began in 2012 with a pilot of two business units, but is now conducting three reviews a year. Calgary uses ZBR to take a thorough look at business units to identify changes to service level or delivery that would:

- Achieve cost savings or mitigate future cost increases (efficiency improvements)
- Improve results or outcomes (effectiveness improvements)

The Corporate Initiatives Division of the Chief Financial Officer's department coordinates each ZBR. It begins by working with business units to collect data (e.g. service descriptions, financial data, business unit structure, key performance indicators, benchmarking information, results of citizen/customer surveys, relevant policies and legislation). Second, it conducts a high-level review of the business unit's services and works closely with the unit to identify potential areas for improvement. The recommended areas of focus are then presented to a Steering Committee³ for approval.

An external consultant conducts the in-depth analysis of the identified service areas and prepares a report that includes recommendations for improving the effectiveness and efficiency of the service areas. The administration prepares a response to the external consultant's proposed recommendations, and both reports are presented to Council for its decision on which recommendations should be implemented.

Reviewed business units report back to Council a year after the ZBRs are completed to detail their implementation plans for adopted recommendations.

³ The Steering Committee includes the General Manager and Director of the business unit under review, leaders from other departments, and a non-voting member of the Corporate Initiatives Division.

Benefits

Calgary has found a number of advantages to using a ZBR process, including:

- Removing the review from the budgeting process has allowed the City to conduct a “deeper dive” into the business units and identify valuable efficiency and effectiveness improvements.
- After several years of reviews, business units now see the value in the process. The Corporate Services Division has worked hard to make ZBR non-confrontational, and provides opportunities for the business units to get credit for their work.
- ZBR provides tools for business units to become stronger. For example, external consultants examine industry standards and may provide recommendations for strengthening performance measures, or improving capital planning methods.
- Council originally requested ZBR, and is actively engaged throughout the process.

Challenges

Calgary highlighted the following challenges:

- ZBR requires a significant amount of work, and can be expensive. Calgary budgets approximately \$1.35 million each year for ZBR, including \$750,000 for external consultants (\$250,000/ZBR).
- The ZBR process is lengthy; the initial review of a business unit can take more than a year to complete.
- Some business units are more resistant than others, but slowly the units are beginning to see value in the process.

Lessons Learned

Calgary staff highlighted the following lessons learned:

- Engaging the Council in the process is important (e.g. there is value in: interviewing City councillors at the beginning of the process to see what concerns they have; bringing recommendations back to them for approval; and having business units report back a year after ZBR with implementation plans).
- Because some business units were resistant to the effort, it was important to make sure they felt engaged and had a voice in the process.
- There is no one-size-fits-all approach for ZBR.
- It is useful to conduct a pilot with business units that will succeed in the process. For instance, choosing business units that collect useful information, and buy-in to the process is helpful.
- ZBR is useful for more than just the identification of service efficiencies. The process can provide a way to strengthen business units based on lessons learned in other municipalities.

CONCLUSION

This report provides background on zero-base budgeting, as well as comparative information about how other governments have utilized elements of ZBB to review their departments, agencies, and services. Based on our review of the literature and discussions with other jurisdictions, it is clear that theoretical ZBB is very rare in practice. However, we found several jurisdictions that use ZBB concepts to develop portions of their annual budget or to periodically review programs and services.

As noted in this report, there are potential advantages and drawbacks associated with using elements of ZBB. These include:

Potential Advantages

- Provides management and the legislative branch with better insight into the detailed activities of departments, and related costs.
- Offers a more rational way to make budget cuts when necessary—as opposed to across-the-board budget cuts that do not differentiate between the value of one service versus another.
- Involves a more detailed review of all expenditures, which helps ensure accountability.
- Enhances transparency and decision-making by more comprehensively examining the entire budget rather than focusing on the incremental change over prior year spending.
- Focuses on performance measures and results for various decisions/programs.
- Provides more than just an opportunity to cut costs; it can improve performance by identifying efficiencies, and help strengthen an organization by offering lessons learned from other municipalities.

Potential Drawbacks

- Requires substantial time commitments from staff, management, and the legislative body.
- Managers may be reluctant to prioritize services or offer efficiencies.
- Managers who do not buy-in to the ZBB approach may attempt to “game” the system thereby diminishing its potential effectiveness.
- ZBB budget decisions are often driven/shaped by management perceptions and preferences, and may not reflect the views and long-term priorities of elected officials or the communities they represent.
- If ZBB is viewed only as a budgetary cutback process, effective implementation may be challenging.

Implementation Considerations

- If ZBB is to work well, it is critical to have support and commitment from both government leadership and department, division, and program managers.
- Consider using ZBB processes that are practical and can be reasonably expected to meet identified budget objectives.

- Rather than implementing ZBB reviews for all departments, it may be more feasible to selectively conduct ZBB reviews for certain departments/programs on a rotating basis.
- Outside subject matter experts can be retained to assist with ZBB reviews, although this can increase costs and result in concerns/differences of opinion with departmental staff.

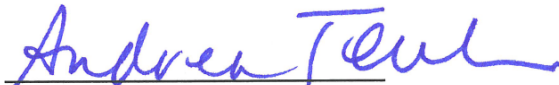
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