



ZERO BASED BUDGETING

The 2007 Comprehensive Spending Review will include a set of zero-based reviews of baseline expenditure in Government departments, aimed at assessing their effectiveness in delivering the Government's long-term objectives, and contributing further to the Efficiency Programme. Departments will need to identify elements of their DEL for these reviews. This note is intended to provide an introduction to the zero-based concept.

Zero Based Budgeting (ZBB) is an approach to budgeting that starts from the premise that no costs or activities should be factored into the plans for the coming budget period, just because they figured in the costs or activities for the current or previous periods. Rather, everything that is to be included in the budget must be considered and justified.

This initially appears to be a very resource hungry approach, and if applied in this simplistic form, would quickly fall foul of the law of diminishing returns. However, the application of practical common sense to the ZBB concept quickly identifies potential gains, and it will be seen that ZBB also aligns closely to current initiatives, including the Efficiency Agenda, and to performance measurement.

ZBB is not new – it first appeared in the 1960's – and indeed it is not surprising that dissatisfaction with a purely incremental approach to budgeting has been one of the main drivers in attempting to find budgeting models that actually serve the purposes and objectives of the organisation.

In its pure form, ZBB involves the preparation of operating budgets on the assumption that the organisation is starting out afresh in the new planning period – it is as if the life of the organisation exists as a series of fixed term contracts. However, it is usually used most effectively where the activities involved are wholly or mainly discretionary in nature. But it is very easy to fall into the trap of assuming that something is non-discretionary, for no other reason than the activity has been carrying on at a similar level for a number of years.

ZBB can be applied usefully to budget heads such as repairs, maintenance or equipment costs. The traditional incremental approach often pays scant attention to these heads, perhaps at best looking at trends over 2 or 3 years, and very often simply taking "last year plus x%". But it is often possible for service priorities to be proposed, discussed and established without reference to previous years. If proposals for resource allocations are presented with options for service level and predicted outcome, funds can then be allocated on the basis of best value for money. ZBB is there to question set assumptions, and to provide a tool for systematically reviewing, reprioritising, and perhaps withdrawing from long term activities that no longer align properly with an organisation's objectives.

Successful use of ZBB relies upon the effective involvement of all executive managers. Like all good budgeting processes, it requires that the organisation's objectives are determined and clearly stated. Where it differs from the traditional route, and adds value to the budget process is in the next stage, where different ways of achieving those objectives are explored and assessed, so that the resources associated with the preferred option can be actively justified.

Milestones in the introduction and implementation of ZBB

A – Developing Decision Packages

The "decision package" is a term associated with ZBB, and refers to an analysis of each discrete activity, according to cost and purpose. The analysis should also extend to considering the benefits of the activity, alternative courses of action, how to measure performance, and the consequences of not performing the activity.

Decision packages should relate to activities that are stand-alone; a good test is whether a decision could be made to sub-contract, or to abandon the activity altogether, without materially affecting the deliverability of another activity. This is a "could it be

done" question, rather than "should it be done". If such a decision could not be made, the activity is likely to be part of a larger decision package.

This milestone can be broken down further:

Stage 1 – Defining the Scope of ZBB

Decide which parts of the organisation are to be assessed using ZBB. For complex, multi-function organisations, it may be helpful to pilot the approach in a few areas where activities are closely aligned to organisational structure.

It is essential that the activities to be assessed have clearly defined objectives, and wherever possible, measurable outputs and outcomes.

Stage 2 – Identify the resources

This stage falls into 2 parts:

The identification of the schedule of input resources that will be required in order to deliver the outputs

The identification of the individuals who will take responsibility for assessing the various options.

Stage 3 – Objective matching stage

It is possible that objectives may be deliverable at different service levels, and in these cases, the review should identify, as a minimum:

- Basic level of service (usually, in a public sector context, that which is required to meet statutory duties)
- Current level of service
- Any step changes in service

Options for delivering each level may differ and will need to be identified. Clearly, it is essential to be able to analyse costs between fixed and variable elements.

B – Ranking the decision packages

The decision packages should be evaluated and ranked in order of importance. Performance

measurement tools including cost/benefit analysis are clearly a very important component, but it is also appropriate to apply a level of subjectivity. This is because few activities are capable of reduction to a manageable number of measures, while some ideal measures may not be practical because of difficulties in real world application, or simply because of the costs of data collection. For example, managers may believe that there would be a “feelgood” factor in taking a particular course of action. This could never be accurately quantified.

C – Allocating resources

The ranking list then results in a priority order for the allocation of resources. The most important

activities are funded, whether they are existing ones, or new. The final budget will be made up of the decision packages that have been approved for funding, reallocated into the appropriate operational units.

The Pros and Cons of ZBB

ZBB can offer a number of advantages when it is applied intelligently. As mentioned above, it is a potentially very useful tool in terms of the current Efficiency Agenda, and parallels much of the thinking that underlies this initiative, and the approach to the Spending Review process. Top management can expect to have available the detailed information that will enable decision-making, and that will highlight redundant activities or duplications of

effort within an organisation. The key benefit, though, is that ZBB serves to focus attention on the actual resources that are required in order to produce an output or outcome, rather than the percentage increase or decrease compared to the previous year. It is a practice which in fact should be more user friendly to operational managers than the traditional incremental budget model. It moves the process away from the bookkeeper’s number crunching spreadsheets, and engenders a balanced partnership between the finance professionals and the budget holders in the analytical and decision-making processes.

The advantages and disadvantages of ZBB can be summarised quite concisely, as in the table below:

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| Questions accepted beliefs | Adds to the time and effort involved in budgeting |
| Focuses on value for money | May be difficulties in identifying suitable performance measures and decision criteria |
| Clear links between budgets and objectives | Questioning current practice can be seen as threatening – careful management of the “people” element is essential |
| Involves operational managers actively, and can lead to better communication and consensus | May be uncertainty about costs and resources of options other than current practice |
| Is an adaptive approach to changing circumstances | |
| Can lead to better resource allocation | |

In practice, the balance can be optimised through:

- A phased introduction of ZBB, concentrating initially on less complex areas, in order to build up a foundation of skills and experience
- Containing the use of ZBB to activities that are truly discretionary
- Adapting the approach, so that it becomes a consideration of the impact on service delivery of step changes up or down in resource provision.