PERFORMANCE BUDGETING: THE INFORMATION REQUIREMENTS

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Abstract

Performance information – indicators, evaluation, and cost information – is the basic tool used by performance budgeting to link resource allocation to results. Choosing the right performance indicators is crucial for this purpose, and this means indicators which are results-oriented and which are readily comprehensible to decision-makers. Program evaluation is also crucial, but evaluation must be timely, practical and strategically targeted at key spending areas. Accounting systems must be modified to provide information on the costs of delivering results to the community. This may be enhanced by, but does not require, accrual accouting.

Introduction and Background

Performance budgeting aims to improve the efficiency and effectiveness of public expenditure by linking the funding of public sector organizations to the results they deliver. It uses systematic performance information (indicators, evaluations, program costings etc) to make this link. The most basic form of performance budgeting is that which uses performance information systematically in the preparation of the government-wide budget. It aims, firstly, to improve expenditure prioritization—that is, to reallocate scarce resources to the services which deliver the greatest social benefit. A common tool used for this purpose is program budgeting, in which expenditure is classified in the budget by objectives (outcomes and outputs), rather than solely by economic and organizational categories. By increasing the attention paid during budget preparation to spending ministry performance, this type of performance budgeting also aims to increase the pressure on ministries to perform.

This paper is primarily concerned with the information requirements of successful performance budgeting of this type. It should, however, be borne in mind that there are a variety of forms of performance budgeting, with differing information requirements. For example, in the "purchaser-provider" model, service-delivery agencies receive funding on a per-unit basis for the outputs which they deliver to the public. This system is extremely information-intensive, because it is requires information on the costs and quantities of each specific type of service delivered to the public in order to inform the setting of relevant "prices" for those services. It is therefore not possible to discuss the information requirements of performance budgeting without being clear about the form of performance budgeting in question.

Although making systematic use of performance information to improve budget preparation may sound straightforward, experience indicates that it is not easy to achieve in practice. In a number of countries, efforts to build such systems have failed, yielding no visible improvement in expenditure prioritization and no perceptible increase in the budgetary pressure on spending ministries to use public money well. One – but by no means the only – key reason for this is the failure to produce the right type of performance information.

The systematic use of performance information in the preparation of the government's budget requires two fundamental informational tools. The first is *results* information—information about the services (outputs) being delivered by government, the intended objectives (outcomes) of those services, and the extent to which those objectives are being achieved. The second is *cost* information – that is, information about what it costs to deliver outputs and achieve outcomes. In program budgeting, this results and costs information is structured around the programmatic classification of the budget—that is, classification of expenditure by objectives (usually outcomes), rather than solely by economic and organizational categories. The idea is that, by making available this information on the cost of and benefits of services to budget decision-makers, better decisions on where to spend limited public resources will be made. In this type of performance budgeting, the link between results and funding is a loose, but nevertheless important, one. It does not require as detailed performance information as, for example, the purchaser-provider system. Nevertheless, its performance information requirements remain quite demanding, and the challenges which it raises in respect to the design and implementation of the supporting performance information systems are far from trivial.

In discussing the performance information requirements of performance budgeting, it needs to be borne in mind that performance budgeting is not – or should not be – an isolated reform. It is, rather, part of a set of broader reforms, often referred to as “managing for results, which are designed to focus public management more on results delivered, and less on internal processes. These broader reforms include civil service reforms designed to increase the motivation and incentives of public employees; organizational restructuring to increase the focus on service delivery and improve coordination (e.g. creation of agencies and reduction of numbers of ministries); and institutional change to strengthen public accountability for performance. Action on these and a range of related fronts is necessary if the efficiency and effectiveness of public expenditure is to be tangibly improved. Improved performance information is fundamental to each of these elements of MFR reform needs to be underpinned by better performance information. For example, a crucial ingredient in making the civil service more performance-oriented is the improvement of information on the activities and outputs of individuals, workgroups and agencies. The implication of this is that government-wide performance information strategy should be designed to meet not only the needs of performance budgeting, but of MFR processes more generally. It is not appropriate, for example, to attempt to develop a system of performance measurement aimed exclusively at budgeting applications, and entirely separate sets of measures used for civil service management, accountability and other purposes. The government-wide performance information system should, rather, be developed as an integrated whole.

In this context, it should be stressed that this paper is not focused on performance information systems for MFR in general. It is, rather, more narrowly focused on how to ensure that the right type of information is able to support the systematic consideration of the program costs and benefits of expenditure options during the preparation of the government-wide budget.

Results Information

The starting point in the development of systematic information on the results achieved by programs should be the development for each program of a clear statement in standard format indicating in summary form:

- Its objectives (which in most cases should be outcomes),
- The key outputs and activities through which these objectives are intended to be achieved, and the clients/subjects to whom the outputs are delivered,
- The program’s “intervention logic”—that is, the causal chain through which the program activities and outputs are seen as achieving its objectives,
- Certain supplementary information, including key new program initiatives.

Expressed differently, this information should include an explicit statement of the “production chain” for the service concerned: that is, the causal chain which runs from inputs to activities to outputs and finally to outcomes.

For central budget decision-makers, the key point is to have available a readily digestible summary of the policy purposes for which each spending ministry is using public resources. This can be useful even when there is not much accompanying information about the efficiency and effectiveness of programs. It can help central decision-makers determine whether existing programs are serving objectives which have government endorsement. And it can also facilitate the most basic type of program evaluation. This is the “desk” assessment of whether, prima facie, the program’s intervention logic is plausible: whether, the program's outputs and activities appear well-suited to achieving its intended outcomes.

The next step is information about the extent to which the stated objectives of programs are being achieved. There are, of course, a range of analytic methods which are available for this purpose, some of which can be quite sophisticated (e.g. benefit:cost analysis, longitudinal studies, DEA analysis). In practical terms, however, the two most important categories of performance information are performance measures and evaluations.

Irrespective of the technique chosen, uncertainty in the relationship between resources and results represents a major challenge for the development of good results information. This uncertainty enters particularly at two key points in the production chain, namely:

- The outcome/output relationship: the outcomes achieved through the delivery of outputs can very considerably between clients or over time as a result of "contextual factors"—characteristics of the client or of the external environment which influence the effectiveness of the service. A familiar example is the impact of student characteristics such as family background (e.g. educational and language background of the parents) on the knowledge outcomes achieved by school education.

- The relationship between outputs, on the one hand, and the inputs and activities which produce them: the same inputs and/or activities may deliver different quantities of the same output. This may occur because of a number of factors including intrinsic cost variations and "heterogeneity".[1]

This points to the desirability of accompanying the summary program information referred to above with an explicit statement of the most important factors which may create uncertainty about the outputs and/or outcomes which particular programs will deliver, including:

- The major contextual factors which might impact on the outcomes delivered by the program.

- Possible changes in the client mix or other similar factors which may impact on the average cost of services.

Performance Measures

There are a wide range of issues which need to be considered in the development of performance measures to support performance budgeting. It is possible here to discuss only a selection of the more important ones.

A crucial question is that of how to maximize the relevance of performance measures to the key stakeholders—and in particular to the budget decision-makers who are the key to successful performance budgeting?

Without seeking to cover all of the criteria for good performance indicator development here – in respect to which there is a well-developed literature – there are a number of points which can be made.

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[1] An example of the first of these is differences in the costs of providing services in more remote areas, due to (amongst other things) lack of scale economies and costs associated with distance. Heterogeneity, on the other hand, refers to the deliberate variation of the activity context of services to reflect differences in the needs of clients. An example is the more intensive treatment which might be required by an elderly person to make a full recovery from a certain medical condition (e.g. a hip fracture) than would be required by the average young person suffering from the same condition.

The indicators of most value for performance budgeting will tend to differ significantly from the objectives and indicators used for other purposes. What will generally be of greatest value to budget decision-makers in determining appropriate program funding levels will be indicators of the results achieved by programs – the outcomes that they achieve and the outputs which they deliver to achieve these outcomes. They will represent only a sub-set of the indicators used for managerial purposes by ministries, which will include not only results-oriented indicators, but also indicators focused on the internal processes, capacities and resources of the ministry. In government, as in the private sector, much stress is today placed on the need for performance indicators to cover multiple perspectives, including internal process, human resources and other such dimensions. The need for such a "balanced" set of indictors is a theme not only of the fashionable "balanced scorecard" methodology, but of other influential business performance management methodologies such as the "strategic profit impact" model and the "critical few" method. Recognition of the need for a broad spectrum of indicators is in no way incompatible with the point made here – that however essential internally-focused indicators are for agency management, they are of little value to budget decision-makers.[2]

To be useful to central decision-makers, who invariably have great demands on their limited time, program performance information also needs to be readily digestible. A couple of key program indicators are, for example, more useful than a comprehensive compendium of dozens of indicators. The detail is of more interest to program managers than to the center.

An interesting development here has been the development of *summary* measures which incorporate a wide range of performance information into one or more overall performance ratings for the program. A good example of this is the measures of program performance which have been developed under the US Program Assessment Rating Tool (PART). Under the PART system, the US finance ministry (the Office of Management and Budget) set about rating all federal government programs over a period of 5 years. Each program is rated on a scale of 4 ratings, ranging from effective to not effective (there is also a "results not demonstrated" rating, used where there is insufficient information to form a judgement). These summary ratings are intended to be much more informative and readily understood than the large body of more detailed measures and evaluations which underpin them. The program ratings, and the reasoning behind them, were all made public (on the website ExpectMore.gov). Most importantly, the PART system was designed from the outset to inform the preparation of the president's budget proposal to Congress. The Obama administration is now considering the future of the PART system, but seems likely to retain it in a modified form.

PART is only one example of the increasingly widespread use of summary performance measures for MFR purposes generally. Such measures have been particularly well developed in the United Kingdom. An illustrative is the "Comprehensive Performance Assessment" (CPA) system under which a national government body (the Audit Commission[3]) prepares composite performance ratings for each local government in England on a 0-4 star scale.[4] These ratings have two MFR applications.

[2] As a concrete example, in one country I recently advised, the performance-oriented budget documentation included inappropriately internally-focused indicators such as "number of teachers' clubs"; "number of embassies electronically connected with headquarters" and "percentage of computerization usage in administrative and teaching process".

[3] Not to be confused with the National Audit Office.

[4] Composite ratings are prepared in respect to two matters: "performance against other councils" and "direction of travel" (i.e. is performance getting better?). In addition to the overall ratings of local government performance, the Audit Commission also carries out ratings of specific aspects of performance (Housing; Environment; Benefits; Culture, plus "Use of Resources". See http://www.audit-commission.gov.uk/cpa/index.asp.

The first is that of accountability: the ratings are made public, and the political pressure which may result from a bad rating can be considerable. The second application is as the basis for national government oversight of local government operations. The CPA ratings are used to decide when national government intervention may be necessary to fix particularly poor-performing local governments, as well as to determine which entities perform particularly well and can therefore be rewarded with additional regulatory freedoms. The CPA instrument builds on another very useful tool. This is a system of standardized measures covering all local government, which facilitate “like on like” comparisons of performance. The UK system now encompasses a set of 198 standard indicators developed and reported on a regular basis by the Audit Commission, all of which are publicly available.[5] Something similar has been developed in Australia to provide standardized indicators covering the functions of state government.

Summary performance measures have the enormous advantage of ready comprehensibility. They can also be far more effective than more detailed indicators in putting real performance pressure on government agencies. This should not, however, blind us to the very considerable technical challenges involved in appropriately defining summary measures. Inappropriate selection of constituent variables, or poor technical design in respect to the normalization and aggregation of these variables, can produce summary measures which are quite misleading.[6]

If performance measures are to be relevant to central budget decision-makers, it is essential that the center is closely involved in identifying the key measures which will be reported both to it and to the public. It is often, and correctly, stressed that line ministries should have “ownership” of their performance measurement systems, and that for this reason they should have considerable discretion in the selection of measures. This is certainly true, because, as mentioned in the last paragraph, each ministry’s performance information systems must serve its own management needs. The information supplied to the center (and indeed to the public) should represent only the “tip of the iceberg” of the information each agency produces. It would, however, be a grave mistake to conclude from this that line ministries should therefore be permitted full discretion to choose whatever measures they wish to supply the MoF and political executive. The obvious risk is that such discretion would be abused either to supply measures which are not very revealing, or to change the measures used so much from year to year that it becomes impossible to identify trends. This means that the center—usually the MoF—needs to be closely involved in identifying the measures it wishes to receive from each line ministries. This has important implications for the skill set and capacity of the MoF.

Performance Targets

Another way of increasing the relevance of performance measures for central budget decision-makers is to build a system of *performance targets* linked to the budget process. The UK Public Service Agreement (PSA) system is the international model *par excellence* for this. Under this system, which has operated throughout the period in office of the Labour Party, several hundred high-level targets are set every three years as part of an “expenditure review” process in which multi-year ministry budgets are set. The exercise of selecting a small number of key performance targets for each ministry for which the government will be accountable, and in respect to which considerable pressure will be applied to ministries, is one which greatly encourages care and effort in the selection of decision-relevant key performance measures.

[5] See http://www.audit-commission.gov.uk/performance/, and http://www.local-pi-library.gov.uk/index.html.

[6] For a good discussion of these issues, see Franceschini, Galetto and Maisano (2007), chapter 2.

Target-setting currently enjoys enormous popularity internationally as an element of MFR. Somewhat problematic is the fact that, in most cases, there is little relationship between the targets which are set and the level of resources provided to the agency concerned. Expressed differently, target-setting and budgeting have all too often been unrelated processes.

Another problem with target-setting is that, in most cases, there is little follow-up of agency performance against target and, as a consequence, the targets seem not to have been taken very seriously. Here again, the UK experience has been impressive and exceptional. There the government been very serious in monitoring and acting on performance relative to the PSA targets. Special attention has been given to monitoring and following up on – including by means of managerial intervention when necessary – performance on the fifty most important PSA targets, via a “service delivery unit” reporting directly to the Prime Minister. The British experience also underlines that, if targets are to be taken seriously, it is crucial that they are set selectively and that they relate to results which matter to the public and politicians and not, for example, to purely internal process matters.

Target-setting may be enormously popular internationally, but it is also controversial. In the view of some critics, setting targets is dangerously counterproductive. Rather than leading to genuine performance improvement, targets lead to “perverse effects” (deteriorating performance) and “gaming” (manipulation or falsification of the indicators upon which the targets are based). These claims are based in significant measure on theory – it is, after all, well established in theory that targets may produce such consequences. The most familiar theoretical point is there are some key dimensions of performance – such as quality – which are notoriously hard to measure, and tend therefore not to be captured in targets. The fear then is that what is not measured will be sacrificed to what is measure. In addition, theory points to the possibility that agents might pursue the easiest means of fulfilling their targets, with undesirable consequences.[7]

Unsurprisingly, the debate on target-setting has been most vigorous in UK. Critics have charged that the targets are “arbitrary”, “demotivating”, “focus people upon the wrong things”, and have even suggested that they represent a revival of failed Soviet central planning techniques.

The empirical evidence, however, does not support this level of critique. Evidence of perverse effects is, in fact, quite limited. An excellent recently published paper by Kelman and Friedman (2007) on the responses to the 4 hour target for treating patients in UK hospital accident and emergency rooms provides a strong antidote to target fear-mongering. Kelman and Friedman conclude that “that waiting-time performance improvement was dramatic and that dysfunctional responses, as far as we can tell, entirely absent.” They add that “none of the hypotheses predicting effort substitution or gaming in connection with attaining this target has been confirmed”, and that in fact dimensions of performance not captured in the targets appear to have improved. Bevan and Hood (2006) and Hood (2006) have undertaken important research which provides some limited examples of perverse effects, but which at the same time suggest that targets have worked well in raising performance (in Hood’s words, the evidence “strongly suggests that targets made a marked difference in reported performance”).

[7] For example, if educational targets are set in terms of minimum levels (e.g. of literacy and numeracy) to be achieved, teachers might in theory be encouraged to focus their efforts disproportionately on marginal students who can be raised with the least effort to the required level. In doing so, they might neglect students with major intellectual disabilities (for whom it may be impossible or very difficult to attain the target thresholds), as well as gifted students (who have already attained the target levels).

So limited is the empirical evidence for perverse effects that what would appear to requires explanation is why, despite the theory, perverse effects on a large scale have apparently not occurred. It can be suggested that the risk of perverse effects is greatly reduced to the extent that other aspects of the governance system—including the quality, morale and motivation of the civil service—are strong.[8]

Taking a pro-target view does not, however, necessarily imply that all countries should seek to establish target-setting regimes. To the contrary, it is still possible to argue that many countries should largely avoid target-setting. This might seem like a heretical statement today, because there is apparently a quite widespread assumption that as soon as you develop performance measures, you should start setting targets for those measures. It is, however, worth bearing in mind that:

- Target-setting requires a firm basic of good, timely and verified performance indicators. In countries such as the UK, good performance indicator systems took decades to develop. Most countries – and in particular most low and middle income countries – do not have such systems.

- Setting appropriate and credible performance targets is quite difficult. Selecting which measures to turn into targets is difficult, and the challenge of setting the quantitative targets which are neither too difficult nor too easy is quite considerable. Setting targets which are too easy, or impossibly difficult, is worse than setting no targets at all.

- In countries with major governance problems, including civil service motivational and performance problems and weak performance accountability mechanisms, the “perverse effects” problem could turn out to be quite a serious one if targets were made to matter.

This suggests not only that the decision to move to a target-setting regime should be taken with care, but also the development of performance measures and the setting of targets should be thought of as two quite distinct stages in the evolution of performance budgeting and MFR systems.

Evaluation

Precisely because of the limits on performance measures, good program evaluation is fundamental to successful performance budgeting. Good evaluation makes use of performance measures, relevant theory, analytic reasoning and other techniques to form a best judgment about program performance.

Evaluation had a bad name for a while, reflecting problems which arose during the last wave of enthusiasm for evaluation in the 1970s and 1980s. Arguably, evaluation at that time too often went off the tracks, becoming an industry driven by its own internal dynamics rather than by the needs of decision-makers. There was a widespread tendency for evaluations to take too long to complete—so that often decision-makers were forced to act prior to getting their results—and to be too inconclusive to be of much practical use. They were often too “academic” in the sense of being reluctant to draw conclusions about program efficiency and effectiveness unless the evidence was completely conclusive, which in the real world it rarely is. Sometimes, the main recommendation of evaluations would be that further research be conducted!

Evaluation—and evaluation linked to the budget process—is now enjoying a new wave of popularity. The pioneer was Chile, which first introduced its system of evaluations to inform budget preparation in 1997. More recently, a broader trend seems to have been emerging, with other countries following Chile’s lead. An example of this is the “Strategic Review Framework” introduced in Australia in 2007.

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[8] See on these issues Paul and Robinson (2006).

Under this framework, a selection of key program and cross-cutting reviews are being conducted each year as a tool for aligning expenditure more closely with government priorities and increasing flexibility in the face of pressures for the growth of government expenditure. Similarly, in Canada, a new system of "Strategic Reviews" is being introduced under which program expenditure is being reviewed, under the direction of the Treasury Board, with the express objective of improving expenditure prioritization, as well as efficiency and effectiveness more generally. One of the aims of this system is to identify the lowest-performing 5 percent of programs and reallocate the resources concerned to higher priorities.

Key themes of the "new" evaluation include an emphasis on timely, practical, decision-relevant evaluations. As with performance measures, the strategic role of the center in identifying what should be evaluated in order to inform budgeting, and how and by whom it should be evaluated, is crucial. These matters cannot be left to the spending ministries alone if central decision-makers are to obtain the information they need.

An important issue in this context concerns the strategy for determining what is to be evaluated. One possible approach—which was, for example, that adopted by Australia for a period in the 1990s—is to say that all government programs shall be evaluated over a defined multi-year time period (in Australia's case, over 5 years). This puts the selection of programs to be evaluated on auto-pilot, with every program coming up for (re)evaluation every, say, 5 years.

The opposite approach is for the center to be deliberately selective about the programs which it wishes to see evaluated, and to target these based on its own policy considerations. For example, central decision-makers might identify certain program areas for review because, prima facie, they appear to be low priority—or, alternatively, because performance problems have surfaced. Such a "strategic" approach has obvious advantages, but it equally has the disadvantage that unobtrusive programs might escape attention for long periods of time.

Of course, meeting the needs of central budget decision-makers is not the only reason to conduct program evaluations. Spending ministries may well—in fact, should—wish to continue other, often more in-depth, evaluations of their programs for their own managerial purposes.

Cost Information

As noted above, the core information requirement on the cost side is good program costing. For performance budgeting purposes, program costing is not something which is done only for the ex post information purposes. The aim is, instead, that the budget is prepared and executed on a programmatic basis. This means, for example, that ministry budget "bids" should be presented in program format. It will usually mean also that the legal budget appropriations will be based on programs. For these reasons, it will also be necessary that budget execution can be monitoring on an ongoing basis during the fiscal year on a program basic. That is, both the spending ministry and the MoF should be informed on a regular (preferably real time) basis of how much has been spent under each program heading.

For these purposes, the starting point is good program classification, so as to ensure that the programs are decision-relevant. Because programs are intended to be a tool for improved decision-making, programs should as far as possible reflect the key allocative choices which face government. This means, amongst other things, that they should all be defined by reference to clear shared expenditure objectives. Ideally, this will mean that programs bring together expenditure aimed at achieving a common outcome. The technical challenge of good program costing is a considerable one, in which a number of distinct issues arise.

A particularly important challenge is that of *indirect cost attribution*.[9] As just noted, best practice would be for all programs to be defined in terms of outcomes and outputs delivered to the public. If this is done, then the costs of the internal support services of ministries (such as human resources, information technology, ministry financial management, senior ministry management etc) should ideally be attributed to the outcome/output based programs in accordance with the contribution which these support services make to the services delivered to members of the public. Expressed differently, there would ideally be no “administrative” programs grouping together such support services, because these services merely support the deliver of the final products which matter to society.

However, to the extent that this best practice principle is followed, the challenge arises of ensuring that the costs of these support services are allocated to programs in a way which reflects, with an acceptable degree of accuracy, the contribution which each support service makes to the ministry’s final products. If indirect costs are allocated in an essentially arbitrary way, as all too often happens, the resultant program costings can be seriously distorted. There are well-developed accounting methodologies and technologies, of various degrees of sophistication to deal with the cost allocation challenge. Activity-based costing is one of the most important of these. However, in low and even some middle income countries, the financial and human resource costs of introducing and operating such accounting systems can be prohibitive, so a careful judgment needs to be made about whether and when to introduce them.

For this reason, it will often make sense in such countries to accept the second-best solution of creating administrative programs which cover ministry support services, and thus reduce enormously the magnitude of the indirect cost allocation challenge.

Because of the centrality of the program basis to budget preparation and execution, it is necessary to modify the chart of accounts and the accounting system more generally to incorporate programs. This raises, in turn, the question of the relation of performance budgeting to financial management information systems (FMIS). Of course, much of the core information captured by a good FMIS is for financial control purposes which are unrelated to performance budgeting (e.g. registering commitments and controlling payments). However, the introduction of a performance budgeting will make it essentially that the FMIS is designed so as to be compatible with a programmatic budget format. Moreover, in more sophisticated systems, the key performance measures for each program will also be integrated into a module of the FMIS.

These remarks underline the significance of the managerial accounting task arising from the cost information requirements of performance budgeting, and the consequent need for significantly increased technical capacity and staffing within spending ministries and the MoF itself.

Accrual Accounting and Performance Budgeting

In discussion the cost information requirements of performance budgeting, the question of accrual accounting inevitably arises. Accruals can strengthen a performance budgeting system. Some people even argue that it is impossible to have effective performance budgeting without accrual accounting, which is certainly true in respect to certain versions of performance budgeting (such as the purchaser provider model mentioned above). So what is the link between the two, and are accruals really essential if the aim is to integrate the use of performance information – costs and benefits of services – into budget preparation to make the budget more results-oriented?

[9] For a more detailed discussion of these questions, see the “Cost Information” and “Program Classification” chapters Robinson (2007).

Firstly, a little background. Accrual accounting is a financial reporting system. In other words, it is a specific methodology by which organizations report their financial transactions and position. Accrual accounting is the dominant form of accounting within the private sector, because it is conceptually well attuned to the reporting of profit. Within the public sector, accrual accounting has long been used by government business enterprises for precisely that reason. What is *much* newer is the adoption of accrual accounting in the budget-dependent core of government (i.e. in the so-called 'budget sector'). Traditionally, governments around the world have used so-called *cash accounting* (or a mixture of cash and *commitments* accounting) in their budget sectors. But in recent decades quite a few governments moved to replace cash accounting with accrual accounting. A handful (Australia, New Zealand, Denmark, Switzerland and the United Kingdom) have gone further and adopted accrual budgeting, in which the legal budget appropriations given to government ministries are expressed in accrual terms.

A key rationale for the adoption of accrual accounting in core government lies in the importance of the proper measurement of the costs of the services provided by government to the community. In order to enable businesses to appropriately measure their profit results, accrual accounting offers a method by which they can appropriately measure their costs of production. Even if one does not need to measure profit – as is the case for ministries and other core government agencies – accrual accounting can thus form the starting point in the derivation of output cost information which may be of great value in performance management and performance budgeting. The reasons why accrual accounting delivers a much better measure of the costs of service delivery are outlined in an Appendix at the end of this paper.

Accrual accounting is potentially of considerable assistance in achieving the performance budgeting objective of improved expenditure prioritization. Expenditure prioritization means decisions about the relative priority which should be given to one program versus another. Such decisions will be best made if the results achieved by each program are compared to the *most accurate* measure of program costs—and, in particular, with full awareness of all of the costs of each program. Accrual accounting can facilitate better prioritization between programs by making sure that relevant costs are not omitted when program costs are measured—and, conversely, that certain irrelevant expenditures are not included. This is because accrual accounting includes in its measure of expenses any costs of production for which payment is deferred to future years. For example, when government employs people, part of the costs of the services which those people deliver to the public in any given year takes the form of entitlements to pension payments in future. These pension costs are clearly a variable cost. An accrual measure of program costs will include these deferred employment costs, whereas a cash accounting measure will not. Failing to take such deferred costs into account may make programs look cheaper than they actually are, and this effect will be greater for those programs which are most public employment intensive. Because such omission can distort program choices, it is desirable that these and other deferred costs be taken into account when making decisions about program priorities.

The same distortion of decision making may clearly impact on the technical efficiency of production via its impact the mix of inputs used to deliver services: at the margin, the understatement of civil service labor costs creates, other things being equal, an incentive to produce services in a more civil service labor-intensive manner than may be optimal. This may also impact on "make or buy" decisions – that is, decisions about whether the government should produce the service or contract out service delivery to the private sector – producing an inappropriate bias against the outsourcing of service provision.

It is exactly for this reason that governments which have adopted accrual see a close connection between this and their performance budgeting and management reforms, as shown in the box.

The Link between Accruals and Performance Budgeting

"One of the key elements of the new resource based [i.e. accruals] approach is that it requires ministries to undertake more accurate costing of activities, with expenses and income allocated to each of a ministry's objectives. This will assist the Government in ensuring that resources are allocated to priority services in line with the Government's objectives." (HM Treasury, 2002, p.7)

"The introduction of cost [i.e. accruals] principles into government budget planning and accounting has to do with improving government effectiveness through visibility, transparency, and cost-conscious behavior. … Transparency of costs provides politicians and administrative leadership a better basis for prioritizing use of resources." (Danish Ministry of Finance, 2006)

The conclusion that accrual budgeting assists performance budgeting should not, however, be interpreted as meaning that accrual accounting is a prerequisite for the introduction of performance budgeting. The distortions in the measurement of costs which result from the use of cash accounting are probably often not large. There is, moreover, a long history of performance budgeting—particularly program budgeting and variants thereof—operating in the context of cash-based accounting and budgeting systems.

It should therefore not be assumed that performance budgeting and accrual accounting need to be introduced simultaneously. Decisions about the introduction and sequencing of accrual accounting need to be taken carefully, bearing in mind a range of considerations apart from any moves to performance budgeting. These include the substantial resource implications of accrual accounting, whether basic public expenditure systems (for example, enforcement of budgetary spending limits and commitments control) are working well, and a number of other potential uses for accrual accounting information (for example, for aggregate fiscal policy). It should also be noted that accrual budgeting can create some fiscal control risks of its own – unless the budgeting system is extremely strong – although it is not possible to discuss these here.

Overarching Issues of Performance Information Strategy

The development of performance information systems is not simply a matter of developing the best and most comprehensive results and cost information possible. Rather, it is about a benefit/cost judgment. Performance information does not come free. It is costly both in financial and human capacity terms to design, build and then operate on a continuing basis the systems concerned. So careful judgments need to be made about how far to go in respect to choices such as:

- the number of performance measures to be developed,
- the selection of programs for evaluation,
- program evaluation methodology,
- the sophistication of costing methodologies and the associated design of the program classification system.

These choices face even the wealthiest countries. But they are particularly pressing for countries with more limited financial and skilled human resources. Such countries should be particularly selective and strategic in the development of performance measures. They should, in many cases, make use of quite simple program evaluation methodology—often desk evaluation based on an assessment of the intervention logic of the program together with whatever information on results achieved which may be available. And, as mentioned above, they should avoid going down a path which requires more complex managerial accounting. The temptation of adopting what appear at the time to be cutting-edge OECD practice—whether it be accrual accounting and budgeting at present, or purchaser-provider models ten years ago—should be studiously avoided.

Even if careful strategic judgments about the scale of the performance information system are made, the challenge of capacity development is a considerable one. It demands, in particular, great change in the skill set and competences of the MoF. Rather than being and exclusively economic/accounting body, the MoF must develop competence in policy analysis and in the development of performance information to support that policy analysis. Only in this way can it develop the capacity to advise executive government well about expenditure priority choices, in order to make effective performance budgeting possible.

Ensuring that Performance Information is Used

The availability of the right performance information is a necessary, but not sufficient, condition for the success of performance budgeting. The performance information also has to be actually used in the budget process. There have been a number of examples of member economies which have made great efforts to develop the necessary performance information—placing the budget on a program basis, and developing indicators and perhaps evaluation as well—but have then failed to make any significant use of that information when deciding the budget.

In some cases, the reason for this is political—the political leadership has limited interest in improving expenditure prioritization, or performance more generally. Where this is the case, no implementation strategy can be expected to succeed.

A more tractable, but nevertheless quite widespread, obstacle to the successful implementation of performance budgeting is the absence of the right processes to facilitate the use of performance information during budget preparation.

Experience shows that, in order for performance budgeting to work, there needs to be formal routines for the reconsideration of spending priorities integrated into the budget process, and these routines need to be designed so as to make maximum use of available information on program performance. It is not enough to simply produce performance information and assume that it will be used in the budget process.

National experience tells us something about the types of expenditure prioritization process which work best. It suggests that planning alone is not sufficient. Many economies have government-wide planning processes, but have nevertheless had difficulty translating the priorities identified in the planning process into the allocation of resources in the annual budget. The nature of these planning processes varies. In some economies, planning commissions/ministries formulate bulky five or ten year plans which are intended not only to guide public expenditure, but to steer the development of the national economy as a whole. At the other end of the spectrum are economies in which the output of the planning process is simply a short statement of key government priorities.

Planning tends to be insufficient for good expenditure prioritization because, while it may be good at identifying purposes for which the government should spend more, it is not typically designed to identify where spending could be cut back to make room for these priorities. Moreover, where the planning process is institutionally separated from the budget process, budget decision-makers may not take the priorities identified in the plan seriously.

For good expenditure prioritization, it is therefore necessary also to have good “expenditure review” processes integrated into the budget preparation process, in which existing programs are systematically reviewed in order to identify those which are low priority and/or ineffective. These processes should be designed to make maximum use of performance information (including the results of the type of strategic evaluations discussed above). Useful expenditure review models include:

- The British Spending Review system which has operated for the past ten year, under which a major spending review is undertaken every three years, resulting in the setting of three-year budgets for spending ministries.

- The Australian Expenditure Review Committee system, first established in the 1980s, under which expenditure is reviewed under the leadership of a cabinet committee chaired by the Prime Minister and including the finance minister and a selection of other senior ministers.

Expenditure review—and successful performance budgeting more generally—depends critically on the work of the finance ministry. The policy analysis skills of finance ministry officials are therefore crucial. The finance ministry has to become the government's principal advisor on expenditure priorities, and to do this it cannot remain a narrowly-focused accounting/financial management institution. Closely related to this is the need to address the obstacle to good prioritization which is posed in many economies by the institutional separation between ministries of finance and planning ministries, referred to above.

Conclusions

Good performance information is critical to the success of performance budgeting. However, because performance measures, evaluation and costing systems are demanding of human and financial resources, strategic decisions need to be taken about what type of information should be developed. This is particularly true in the early days of performance budgeting, when it is important to resist the temptation to immediately develop thousands of indicators and the most sophisticated evaluation and costing systems. The way in which performance information is presented to key budget decision-makers – at both the political and civil service level – is also critical. Top decision-makers do not have time to carefully consider hundreds of indicators and long evaluation reports. The information therefore needs to be presented in a readily digestible summary form. In certain contexts, summary performance rankings can be very useful for this purpose.

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