Thinking Differently About Budgeting

Government conducts its business through the allocation of funds to public or private delivery organizations. However, it is exactly the concept of allocation that is an inherent weakness in the traditional budget process. The problem is that an allocation is only that: an amount of money to be spent on identified issues or activities. Missing is any identification of what the money is supposed to achieve. Without clear expectations of results, neither elected officials nor the public have a good idea whether or not progress is being made on policy goals. There is no accountability as to whether the allocated money reduced poverty by an acceptable amount, increased literacy satisfactorily, or improved economic activity.

Essentially, the process is one big “faith-based initiative,” distributing money and hoping for results. It is certainly frustrating for new legislators to find that their best intentions are thwarted by an incomprehensible budget process. They discover there is no clear vision of what government intends to achieve in the next year, five years, or decade. Even more troublesome, there is no record of achievements from the last year, five years, or the last decade. The records show where money was spent but evidence of what was achieved is elusive at best.

What if this could be reversed and it was possible for legislators to know, for example, precisely how much the government is spending on poverty and when it will be a problem of the past? What if the records showed the progress made to date on the issue and not just the amount of money spent on it? What if lawmakers could identify how much the government planned to spend on economic development in terms of which programs would be funded and what each program would contribute to economic growth? In these scenarios, legislators are in the ideal position to assess past performance and make informed funding decisions based on past successes or failures.

1 The views expressed in this testimony are solely my own and are not official positions of the Mercatus Center or of George Mason University.
They can ask: Do we need to do more or less to solve this problem? If the results are not what we want, do we need to use a different approach or can we fix the existing programs? In these situations, lawmakers have the tools they need to do the job for which they were elected.

During a time of fiscal pressure across government and a climate of renewed emphasis on accountability, “faith-based budgeting” is inadequate. Instead, we need to be able to create situations like those above. Decision makers are eager to discover innovative ways to manage revenues and expenditures. The good news is that this can be done; in fact, some state and national governments are taking the lead. They have discovered that the most valuable tools in this process are greater transparency and a clear focus on producing results that improve the public benefit. The results speak for themselves: declining and disappearing deficits, more efficient allocation of resources, and high approval ratings from citizens who are happy to reward their politicians for improved accountability. Here I will discuss some of the guiding principles for developing clear and accountable budgets, and we will see how various governments have implemented these principles on a practical level. These examples may need to be adapted to apply to unique situations but there is no reason to let minor obstacles stand in the way of greater transparency and increased public confidence in the electoral system.

**Getting What You Pay For**

In order to have a transparent budget process, it is essential to clarify what you are getting for what you are paying. Governments usually know precisely how much they are spending and on what they are spending that money. But the evidence of what they expect to get in return is often poorly articulated or even totally unknown. Lack of clarity about expectations at the time of appropriation means that holding people accountable for the results produced is almost impossible. This deficit of results information means that we may be continually reinvesting money into activities that are not delivering the results we expect. We spend money on education because we believe it is good to teach children to read, write, and develop other skills. However, we should also know how many children actually learned to read, write, and compute through the programs government bought. We should know that fewer people are homeless as a result of programs aimed at reducing poverty. We should be able to ask and answer several questions:

- Is this satisfactory progress?
- Do we want greater progress?
- Should we look for more effective tools to make progress?

**Purchasing Versus Allocating**

One way to do this is to start thinking about government spending in terms of a purchase.

The idea of purchasing something immediately implies an exchange of value. The concept is

| Inputs – Costs of producing outputs. | Outputs – Goods, services, or activities produced by an agency to achieve an outcome. | Outcomes – The desired results. |
Quite familiar in daily life; in fact, everything in our economic lives is governed by purchase. In contrast, very few things are governed by grants, gifts, or allocations. It is the reverse with the way government traditionally operates. Very little government activity is analogous to a purchase; the existing appropriation process stops short of indicating what is expected in return for the money spent. However, the new mechanisms used by some governments, namely New Zealand, Australia, and Great Britain, to allow for a much more tangible link between dollars spent and results produced are built on the idea of a purchase, the exchange of money for some clearly defined benefit.

Some governments have defined this benefit as an outcome; others have defined it as the purchase of certain outputs designed to achieve the desired outcome. Regardless of the form used, the process of government purchase provides a very clear expectation of what is to be produced with the money spent. A purchase agreement extends the appropriation process by linking funding decisions to the purchase of specific goods and services designed to produce clearly defined results. Accountability is built-in; stated expectations can easily be compared with final results. Satisfactory performance can only be claimed if those results match the original intent described in the purchase agreement. By comparison, a traditional appropriation is an allocation of money to spend on a particular issue, in which the only basis for accountability is whether or not the money was spent accordingly. Satisfactory performance can be claimed by a delivery organization even if the results are disappointing or unknown.

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### Examples of New Zealand Purchase Agreements
(These are based on actual purchase agreements but have been dramatically condensed for the purposes of this publication.)

**The Ministry for Employment**

*Mission:* To improve the employability of people currently out of work.

*The Contract:* During this fiscal year, the Ministry will place into work 150,000 unemployed people. Of that 150,000 people, 56% must be long-term unemployed; 25% must be Maori; 14% must be people with disabilities; 7% must be people with acute social problems or from low socio-economic areas. The services of the Ministry must be reasonably accessible throughout the country, but priority in access and resources must be concentrated in the areas of greatest need.

*Cost:* $60 million

**The Reserve Bank**

*Mission:* To maintain price stability.

*Contract:* The governor is to contain inflation within a range of zero to two percent. Failure to maintain these targets requires the resignation of the governor, which the Government may or may not accept, at its discretion.

*Cost:* To be determined

**The Inland Revenue Service (IRS)**

*Taxpayer Audit Description:* This output involves the audit of all Classes of taxpayers, with emphasis on high risk non-compliers.

*Outcome:* Revenue is collected to help fund the work of the New Zealand Government according to law and in the most effective and efficient manner.

*Contract:* 137,000 investigations and verification checks
  58,000 GST audits and checks
  20,000 payroll audits

Tax assessed per dollar spent
  $14.00 per investigation
  $4.00 per verification
  $6.00 per GST audit
  $5.00 per payroll audit

All audits and checks must meet 100% of the standards and timeframes outlined in the National Quality Statements.

*Cost:* $117.430 million

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2 Term used in New Zealand, which first introduced purchase agreements in the early 1990’s. Since then, there has been significant evolution of the process based upon local experience and observing the initiatives of other countries. This text draws on examples from the early part of the New Zealand experience.
Portfolio Budget Statements in Australia

In Australia’s budget process, agencies identify and report to Parliament and the public of their plans for allocating resources to government outcomes for the coming budget year through Portfolio Budget Statements. These documents specify appropriations by outcomes, and outputs according to which agency in that portfolio is responsible for producing them. The details of the Portfolio Budget Statements inform Parliament and the public of the purpose of each item proposed in the appropriation bills. They are an important tool for holding the executive branch accountable to the Parliament.

Maximizing the Public Benefit in New Zealand

When I became Minister of Labor, I inherited thirty-four programs designed to put people back into work and reduce unemployment. The existing measures of success were the number of people involved in the programs and how much they liked participating. The most important measure was overlooked; namely, how good are these programs at getting people back to work? When we asked this question, we learned that only four of the 34 programs did this well.

The only responsible thing to do was to stop putting resources into the thirty unsuccessful programs and concentrate on the four programs that were making a real difference.

The result? Those four programs were able to put 300% more people back into work than before, at 40% less than the previous cost.

New Zealand purchase agreements stipulate in considerable detail the outputs the government is buying, expressed in terms of price, quantity, quality, availability, and timeliness. The agreement also estimates what the impact of these outputs will be on the desired outcome. For example: homelessness will be reduced by ten percent; inflation will be contained at between zero and two percent; the risk of successful terrorist action will be diminished by sixty percent.

The negotiations on purchase agreements take place while the budget is being prepared. These involve simultaneous discussions between the department’s minister and chief executive about which outputs should be purchased and between the minister and the

Purchase agreements were introduced in the budgeting process in New Zealand in the early 1990’s as contractual undertakings between the minister of a government agency and the chief executive of a government department or private corporation. They were implemented to increase transparency regarding the government’s plans for making progress on policy initiatives. New Zealand recognized that their existing appropriation process, like that of many other governments, was adept at directing funds but pretty abysmal at producing measurable results. The bottom line in the public sector had to be demonstrable public benefit; therefore, the process had to spell out what benefit was expected from each allocation. To achieve this specificity, the government became a purchaser of goods and services from a variety of providers.

This new procedure does not replace the established appropriation process. The appropriation process, developed to meet the constitutional requirement for the legislature’s authorization of the expenditure of public funds, must continue. “Purchase agreements” simply extend the appropriation process further by converting the appropriated funds into specific contracts with delivery organizations to purchase outputs in order to achieve successful outcomes.

Purchase agreement defines exactly what is being purchased, at what price, and with what expected result.
Public Service Agreements in Great Britain

Great Britain’s public service agreements (PSAs) are three-year agreements between the main departments and the Treasury. Their purpose is to indicate what results the public can expect from each government expenditure. Each PSA lays out the department’s “high-level aim,” its objectives under that aim, and key outcome-based performance measures.

Treasury on the level of funding available to purchase those outputs. Because the purchase agreements are available to legislative committees at least in draft form during appropriation debates, it is very clear what results the appropriation will buy, as well as what the consequences will be for changing budget recommendations. After the budget has been approved, the purchase agreements will be adjusted according to the legislature’s decisions. Less funding means that either the quantity or quality of the outputs will be lower than they would have been under the proposed funding level; purchase agreements will be altered to reflect this. The purchased outputs can be any goods or services that an agency produces for external use, including policy advice, assessment of grants, payment of benefits, licensing, inspection, publishing, or revenue collection. They do not all have to be provided by government agencies; purchase agreements may be contracted with the private sector as well.

Once signed, the purchase agreement is a legally binding public document. The department is required to do only what is specified in the agreement. Therefore, the legislature cannot ask the department to take on additional activities during the year, unless it is prepared to grant extra resources or cancel some current purchases and reallocate the funds. This prevents departments from being saddled with unfunded mandates or held accountable for producing outputs that received no funding. The intent of purchase agreements is to provide maximum transparency and maximum accountability.

With the clarity that a purchase agreement provides, a very strong basis for accountability exists. The outcome the government intends to achieve and how the agency plans to achieve it are apparent to both policymakers and the public. Good or poor performance is immediately identifiable. The minister of the department is held accountable for the government’s policy decisions, while the chief executive is responsible for the delivery of the services as stated in the purchase agreement. Failure to deliver the outputs indicated in the agreement is grounds for dismissal of the chief executive. On the other hand, if the agency fully delivers the contract but the desired outcome (public benefit) does not materialize, the policymakers are responsible. They bought the wrong goods and services and can be held accountable by the public, which is now equipped to evaluate the performance of their government. New Zealand is not the only country to experiment with tools that clearly demonstrate how the public benefits from government expenditures and greater clarity about government progress.

Putting the Public Benefit First

Much of what is said about budget reform revolves around saving money, which translates into budget cuts somewhere, anywhere, or everywhere. Focusing on reductions means spending time and energy determining which programs can go without creating too much upheaval. Hard political sells are avoided, whether or not the programs actually work. Instead of concentrating
only on saving money, the real emphasis should be on using money effectively. This means putting the public benefit first and foremost when considering budget reforms. After all, the citizens and taxpayers are the primary government stakeholders. Every decision should be held up to the standard of whether or not it increases the public benefit in a tangible way. This means that decision makers need to know if government programs are producing the best results or if they are hampering the creation of the maximum public benefit. How can elected officials make informed budget decisions without knowing this?

Unfortunately for all of us, the most common barometer for measuring political commitment to progress on societal issues is whether more or less money is spent on them. The budgeting process takes for granted that increased public benefit will follow the expenditure of additional monies, therefore little formulation of intended outcomes or accountability for actual results produced is considered. But dollars spent do not equal evidence of success. A good case study is a simple examination of the U.S. food stamp program. In 2005, we were spending 31 times the amount we spent at the program’s inception in 1969, in constant dollars. Yet far more people receive food stamps now than in 1969. In terms of population growth, the disparity is even more worrisome. While those on the food stamp rolls in 1969 represented about 1% of the total population, today the number is closer to 8% of the total population. Is this evidence of success? It makes one wonder what we are trying to achieve with this program, because the logical outcome, i.e., erasing hunger, does not seem to be materializing. It is hard to believe that this is the best we can do, but as long as we are unaware or inattentive to whether programs are living up to expectations, maybe it is.

We should not be judging how much our elected leaders care about an issue by measuring increases or decreases in the money they spend, but instead we should be measuring the difference they make. This difference should be expressed in terms of public benefit. Measures of progress should be accounted for by demonstrating that the public benefit has improved or deteriorated. After all, we the public want to know if more people have jobs as a result of government action or if more children have achieved a reading age equal to their biological age. In other words, the public interest is in the outcome.

Acceptance of this thesis means that we should look at government programs as tools designed to produce public benefit. If improved government programs are created then old or obsolete programs should be retired in favor of that activity that will produce the maximum public good. Programs should not be allowed to develop the mantra of an institution deserving of preservation in their own right but should constantly be evaluated against all other activities directed at that public benefit with only the best surviving.

Officials should clearly articulate throughout the budget process what progress they intend to make on each issue and then be held accountable for the end results. In fact, until government organizations know what is expected of them and are held responsible for meeting or exceeding expectations, satisfactory progress is unlikely to occur. While it can be difficult to measure government progress in some areas, it is not impossible. A statutory purchasing process similar to those outlined above is a good start, but more must be done to fully implement accountability into the budget process.
Maximizing Public Benefit

Government should be buying goods and services from the best providers, and if it does not, there will almost certainly be benefit foregone. Some public benefit that would have otherwise existed has been lost forever because the most effective and efficient way to produce that good was not identified. This is not only a monetary loss, but also a social loss. The consequence of public benefit being foregone is that some people remain unemployed, illiterate, or hungry.

The way to spot the best providers is to introduce competition into the public sector. Competition is a marvelous force constantly at work in the marketplace; the effect is that the products and services we use are getting better and cheaper all the time. (Just think of the cellular phone today versus the cellular phone of 1985.)

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Budgeting for Outcomes: David Osborne’s Steps

Another method that has been successfully implemented in the states of Washington and Iowa, the cities of Azusa and Los Angeles in California, and the city of Spokane is David Osborne’s “Budgeting for Outcomes Process.” The steps are straightforward and easily adaptable to local situations:

1) Set the price of government. How much are citizens willing to pay for the results they want from their government?
2) Set the priorities of government. Define the results that matter most to the citizens.
3) Set the price of each priority. Total revenue divided among the priority outcomes according to their relative value.
4) Develop purchasing plan for each priority. Which factors/activities matter most for delivering a certain result?
5) Solicit offers from providers to deliver the desired results. Who can deliver the most results for the money?
6) Buy from the best providers, until the funds are used up. This is the budget.
7) Draw up performance agreements with the providers. This builds accountability into the budget.

The results of this process in the localities that are applying it are a compelling endorsement. In Washington, the new way of doing things was widely accepted by both the public and the legislature, even though it involved making hard choices.

The savings are adding up too: Iowa saved $35 million annually in its Department of Transportation alone, by reorganizing to focus on maximizing results.

Creating Internal Markets in Government

Competition fosters creativity and discovery, continuously providing better value for the same dollar. This innovative process can be introduced in the public sector, to the advantage of both citizens and elected officials.

Governments can use competition as a reliable tool for ensuring that results are being achieved instead of special interests being served. Implementing competition in the public sector means purchasing goods and services from the best providers only, not any and all providers.

Results-oriented analysis singles out the programs that are producing the best results and rewards that achievement.

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Competition is proven to be the best mechanism to achieve best quality, best price, and best service.

Competing Activities Within Programs

To accomplish optimal performance, all activities that claim to have a beneficial impact on a certain goal should be compared. Those with the greatest impact should be rewarded with continued funding, while those that cannot meet that level of achievement lose their funding. Alternatively, based on convincing evidence that a program that has not performed as well as it should to date can reach the desired level, conditional funding might be given for another year.
Study of Vocational Training Programs in the United States

This was a Mercatus study in the year 2000 of federal vocations training programs in the United States.

- Purpose: to aid people into work
- Forty-five activities were identified
- Twelve departments involved
- Various ranges of success in placing people into work
- Total cost: $8.2 billion
- Cost per person placed into work: between $270 and $29,000
- Total of 2.8 million people into jobs
- Using the 3 most effective programs, there would be 14.2 million people into jobs
- Status quo means 11.4 million people don’t get jobs (benefit forgone)
- Maintaining current public benefit of 2.8 million into work with the most effective programs would free up $6 billion to be spent on other priorities.

Conclusions

Dramatic improvements in budgeting outcomes are possible. There are plenty of processes and procedures available to follow. The greatest barrier to progress is the fear of change itself.

Budgeting for Results Checklist

- Know what public benefit each appropriation is supposed to produce.
- Allocate funding based on a clear measure of the public benefit that will be produced.
- Insist on measures that tell you if that public benefit is being created.
- Review performance to see if it is meeting expectations.
- Use performance reviews to influence the next year’s funding decisions.
- Conduct the whole process with the greatest possible transparency so that expectations of what is to be delivered, and possible future improvements are apparent to all.