Fact Sheet

South Carolina Policy Council
1323 Pendleton St., Columbia, SC 29201 ● 803-779-5022 ● scpolicycouncil.com

Collaborative-Strategic Budgeting for Cabinet-Level Agencies

By Simon Wong, with Dr. Jameson Taylor

For the past few decades, states have experimented with various forms of zero- and performance-based budgeting practices as a means of making state agencies more efficient and accountable. Many states, for instance, employ a limited form of zero-based budgeting that requires agencies to create a budget from a zero base and then justify each program and expenditure. Many states also require agencies to use various performance measures aimed at demonstrating how agency programs and funding are producing desired results. Yet, these reforms have had only limited success in reducing state spending.

Enter collaborative-strategic budgeting.

Collaborative-strategic budgeting is based on the common corporate practice of creating and negotiating over a buffer budget. When combined with a modified zero-based budgeting approach that also employs performance-based budgeting practices, collaborative-strategic budgeting forces agencies to work together to ensure taxpayer dollars are only funding high-priority projects.

A Strategic-Based Budgeting Approach

As described here, strategic budgeting is a method that combines the advantages of both zero-based budgeting and performance-based budgeting. As for the first, while zero-based budgeting has its merits, zero-basing agency budgets is a time-consuming process. For this reason, states that tend to use it only do so on a limited basis (as applicable to select agencies, for instance).
Indeed, according to the National Conference of State Legislatures, "Aside from recent executive orders to use zero-based budgeting in Idaho and New Hampshire, it is not clear that any state uses zero-based-budgeting as its primary budgeting technique."[1]

A better alternative to zero-based budgeting is strategic budgeting, also known as modified zero-based budgeting. In this approach, a set portion of each agency budget – for instance, 50 percent – is treated as a base budget, leaving only the remaining part of the budget (i.e., the other 50 percent) to be built from the ground up.

Most states that use zero-based budgeting also employ performance-based budgeting techniques. Generally, these refer to budgeting tools that use objective performance measures as a means of determining the return on investment (ROI) derived from various agency and program activities. Florida, for instance, uses a performance-based program budgeting (PB2) process that links funding

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[1]Similarly, a 2004 report by The Association of Government Accountants (AGA) suggested that 47 states had adopted performance budgeting requirements based on surveys from two different academic journals (*Public Administration Review* and *Public Budgeting & Finance*); however, AGA determined only 10 states actually met their definition of performance-based budgeting.

to agency products, services and results. The process requires each agency to provide information on its legislatively approved performance measures and standards using long-range program plans. Each agency must justify and explain the pursuit of goals and programs that deviate from the performance metrics set by the governor and the legislature. Other states, such as Arkansas, Missouri, Oregon, Texas and Washington use various programmatic performance measures in crafting their budgets.[2] These reforms, though, have produced mixed results, suggesting that performance-based budgeting needs to be pushed to the next level.

Identifying Core Activities

Collaborative-strategic budgeting represents the newest generation of strategic budgeting techniques and, in various forms, has been used in the private sector for some time. In short, it is a strategic budgeting process that employs a collaborative model in which state agencies work together in crafting their budgets. The purpose of collaborative-strategic budgeting is to eliminate waste by adding a buffer layer when agencies exceed their initial base budget. In other words, it forces agencies to justify spending on non-core, and even core services, when such expenditures exceed a pre-set base budget. The process has two steps.

The first phase requires each state agency to:

1) Prepare a base budget capped at 50 percent of the prior fiscal year's budget. The idea here is that about half of an agency's budget is dedicated to funding essential core services and programs – classified as Tier 1. In any case, these programs would not be analyzed using a zero-based budgeting method.[3]
2) Justify from the ground up all Tier 2 and Tier 3, less essential services that make up the remaining 50 percent of the proposed agency budget.

In effect, this is a modified zero-based budgeting approach that forces each agency to prioritize its activities by classifying each program as Tier 1, Tier 2 or Tier 3. As indicated, Tier 1 activities are essential; Tier 2 and Tier 3 activities are less so. The assumption here is that strategic budget cuts will come from Tier 2 and Tier 3 programs – activities, in effect, that are less essential to the agency's core mission.[4]

Many variations on the model presented here are possible. For instance, Tier 2 activities could be funded at 51 percent to 75 percent of the agency's prior year's budget. That said, a two-tier process seems to work best as it forces agencies to make a basic distinction between essential and nonessential programs.

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[2]The National Association of State Budget Officers (NASBO) reports that as of FY2008, 25 states used some form of performance measure in their "budget approach"; 17 states also used some form of zero-based budgeting in drafting their state budget. South Carolina is counted in both of these lists, which is to say that the criteria for inclusion are quite broad. Although the state may employ performance-based techniques in very limited ways and areas, South Carolina does not craft its overall budget using a performance-based budgeting model. See our recent report on state spending for more information.

[3]Granted, this means inefficiencies in the way these programs are run will not be addressed in a systematic manner. This makes it all the more important that agency Tier 1 activities be aligned with specific executive and operational metrics.

[4]For example, assuming that education is the core mission of the Education Department, then instruction and instructional costs would be classified as Tier 1 activities for this agency. In turn, administration might be classified as a Tier 2 activity. Under this system, budget cuts would thus reduce the administrative budget and not the instructional budget.

It perhaps goes without saying that the prioritization process undertaken by each agency works best when complemented by strong executive branch leadership. Ideally, the governor would outline and define 5 to 10 key metrics that give broad guidance to agencies as they craft their budgets. In turn, agency heads would use the governor's key executive metrics to develop operational metrics within the agency to streamline program delivery and cost structure. Programs that closely match the key operational metrics and governor's executive metrics would be classified as Tier 1 programs.

Setting Priorities Together

In the second phase of the collaborative-strategic budgeting process, agency heads meet to set priorities together and negotiate over spending. The primary benefit of this process comes from agency heads working together as a team to identify and fund high-priority programs. Doing so also allows for savings achieved by one agency to be used to fund essential expenditures by another. This is how the process works:

1) All agency expenditures that are not Tier 1 expenditures (i.e., exceed 50 percent of the agency's prior year budget) are placed into a "group buffer budget." In theory, this pot of money is to be shared by the agencies and allocated by mutual agreement.
2) Requested expenditures taken from the buffer budget must be justified by each agency. This justification must be found to be compelling by other agency heads and/or the governor.

Throughout the negotiation and discussion process, agencies will be called on to demonstrate which Tier 2 programs are most closely aligned with the governor's key metrics, which presumably reflect the needs of the state as a whole. Doing so will require that agency heads track program performance so as to continuously gauge effectiveness and show how each program and activity is furthering agency operational metrics.

Benefits of Collaborative-Strategic Budgeting

The primary benefit of collaborative-strategic budgeting is that it discourages the "silo-effect" whereby agencies only consider priorities within the context of their own activities, rather than the needs of the state as a whole. The process also encourages checks and balances among agencies by introducing a degree of competition for state tax dollars. These checks and balances translate, not only into lower spending, but also more transparency and accountability. Other benefits of collaborative-strategic budgeting include:

> *Refocusing on what's important.* The collaborative-strategic budgeting process holds agency heads accountable for both achieving their agency's core mission and furthering the good of the state as a whole, as articulated by the governor's key metrics. Doing so encourages agencies to look beyond any one program and consider the impact and cost of this program in light of other statewide priorities and resources. This approach also helps ensure agency heads are clearly communicating to the governor how their specific operational metrics are furthering the needs of the state. In turn, this communication should translate into better communication with staff, who will better see how their jobs are contributing to the overall mission of making South Carolina more free and prosperous. The bottom line is that the working culture within each agency will be refocused on what's important (Tier 1 activities) while less important activities (Tier 2) will be placed in proper perspective. Ideally, this new focus on results will also encourage agency heads to reward staff for meeting performance goals below budget.

Sharing best practices. The second phase of the collaborative-strategic budgeting process invites agency heads to deliberate the merits of each proposed program and evaluate the effectiveness of each program. As part of this process, agencies will be able to learn from one another's successes and failures. Agency heads can also share what performance measures work best and get insights on what programs will best further the governor's strategic goals.

Safeguarding agencies from arbitrary cuts. Collaborative-strategic budgeting also safeguards high-performing agencies from arbitrary cuts. For instance, let's say the Department of Health & Environmental Control (DHEC) and the Department of Transportation (DOT) are vying for appropriations from the buffer budget. Perhaps DHEC can show that its entire requested buffer budget is being used to fund high-priority items (in other words, DHEC Tier 2 expenditures are more justifiable than DOT Tier 2 expenditures in the overall scheme of things). The result is that DHEC's buffer budget would be funded in full while DOT's buffer budget would be cut proportionately. This is a better outcome than simply making across-the-board cuts to both agencies, especially if one agency can justify its expenditures while another cannot.

Reducing compliance costs. Finally, collaborative-strategic budgeting is much easier to implement than zero-based budgeting, in terms of time and resources. It also reduces the need to justify activities that are clearly core services, thus freeing up agency heads to take a closer look at marginal activities that produce little return on investment.

Conclusion

It is important to realize that collaborative-strategic budgeting is not a mechanism for dictating specific legislative appropriations. Rather, it is an exercise exclusive to the agency budget writing process and is to be used as agencies prepare their budgets to submit to the governor and General Assembly. (For instance, the final state budget would not include a "group buffer budget.")

All this is to say that, in itself, collaborative-strategic budgeting is unlikely to reduce state spending. Instead, it is meant to be a tool that should be employed once lawmakers have made the decision to reduce spending. For this reason, collaborative-strategic budgeting is an ideal complement to an effective spending cap – or, even, an agency spending cap. As such, it is a dynamic approach to budgeting that can be used to cut spending in a way that preserves high-priority programs and rewards agencies and programs that are doing good work. As an exercise for state agencies, it can also create momentum for better budget practices and make agency heads more accountable to their peers and the governor.

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