

Zero Base Budgeting

By
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The use of budgeting, a single most important management tool, has been very new to public enterprises in India. It was only after the acceptance of the Administrative Reforms Commission's Report on Public Undertakings and the repeated recommendations of the Committee on Public Undertakings, that public enterprises took the initiative of installing budgeting systems during the early 70's. The main objective of budgeting in public enterprises is to enable the managements responsible for the use of resources to project their ideas into future, and concurrently to look back and review the actual performance as compared with promises and intentions. The study of procedures and practices of budgeting in public enterprises have, however, revealed that the attainment of these main objectives of budgeting is far-off from sight.

Budgeting in public enterprises suffers from a number of deficiencies. The present techniques of estimation for preparing various forecasts are crude. The absence of sufficiently long perspective is another weakness. The nature and style of budgeting are also unbusiness-like in that budgets are imposed from the top level and the performance element is not accorded its true importance. Wide variations between budget estimates and actuals have become common. One of the reasons responsible for the failure of budgeting has been the utter lack of motivation.

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Indian economy is characterised by the presence of public sector monopolies in the core sector. In view of their captive market, these undertakings are able to pass on the burden of their inefficiency to the consumers. The harsh truth is that the performance of state owned undertakings in the critical areas of power, steel, coal, fertilisers and rail transport is still sub-optimal. Therefore, it becomes all the more important for these undertakings to adopt some kind of mechanism to review and evaluate their activities on a continuous basis to improve their performance.

In an attempt to make the exercise result-oriented and incorporating the performance element into budgeting, there is a need on the part of the Government to prepare a white paper on the objectives of public enterprises in India. *Secondly*, too much anxiety about the expenditure control should be replaced by concern for achieving the ends. *Thirdly*, budgeting should be made a participative affairs. *Fourthly*, crude techniques for estimation have to give way to sophisticated techniques. *Fifthly*, the introduction of "flex" approach is a must in place of "fixity". *Finally*, comprehensive cost and internal control systems should be introduced to make the budgetary control a reality. The implementation of these suggestions will considerably bring down the gap between the budget philosophy and budgetary controls in public enterprises. The application of Zero Base Budgeting (ZBB) technique incorporates most of the above suggestions if not the all. Being essentially a planning and decision making techniques, ZBB can prove to be very useful to the management not only in improving the performance of public sector undertakings but also in meeting the challenges of rising prices and reviving sick units.

The idea of having zero base in budgeting first originated in the mind of an English Budget Authority E. Hilton Young as early as 1924 when he advocated rejustifying budget programmes annually. In 1962, the U. S. Department of agriculture used a "ground up" budgeting technique which included a revaluation of all the departments programmes. But it was Peter A. Phyrre who gave the present popularity to the idea when he crystalised it in a book named "Zero Base Budgeting"(1973). That is why this new concept owes its origin and present level of development to Peter A. Phyrre. According to him "ZBB is an operating, planning and budgeting process which requires each manager to justify his entire budget request in detail from scratch (hence zero-base) and shifts the burden of proof to each manager to justify why he should spend any money at all".

ZBB does not advocate a new philosophy. It is a natural follow-up of traditional budgeting techniques. Every activity and funding is to be evaluated afresh from the scratch. Past, wherever possible is to be forgotten for a while and no activity or level of funding is assumed to be essential. Under this budgeting process a manager has to re-examine all the activities (current as well as new) of his department and justify the proposed expenditure on them in terms of objectives of the business. This is done everytime a new budget is prepared. The approach is different from conventional budgeting wherein the manager starts with a

given base (expenditure incurred last year) and is required to justify only the additional expenditure he wants to incur during a budget period. Besides, no review and evaluation of on-going activities is undertaken everytime a new budget is prepared under the conventional budgeting. ZBB in addition to making decisions about new programmes, also reconsider from time to time, the appropriateness of on-going programmes. Often such studies focus on responsibility centres particularly those responsibility centres in which the amount of discretionary costs is relatively large.

The main purpose of ZBB is to help management evaluate expenditures and make trade offs among current operations, development needs and profit for decision making and allocation of resources. Like a good budgeting system ZBB give options and the best possible description of the cost consequences of each. It is structured to provide a practical mechanism for making trade offs. It requires—

- identification and sharpening of objectives;
- examination of various alternative ways of achieving those objectives;
- selecting the best alternative through cost benefit and cost effectiveness analysis;
- prioritisation of objectives and programmes;
- switching of resources from programmes with lower priority to those with higher priority; and
- identification and elimination of programmes which had outlived their utility.

ZBB Process—

The budget making exercise under ZB involves the following steps—

- A. *Formulation of decision packages.* Every manager is required to prepare a separate decision package for each of the activities to his department which are necessary for achieving the objectives of business. Developing decision package requires (i) identification and evaluation of the alternative methods of doing the activity with the help of cost benefit analysis and (ii) specification of the minimum level of effort (base decision package) and incremental levels of effort (incremental decision package) to perform the activity or operation.
- B. *Banking of the packages.* The incremental decision packages are ranked in order of decreasing benefit to the company and the cost-benefit analysis is carried out at each level of additional effort.

- C. *Allocation of resources.* To ensure the best allocation of resources, it is necessary that all the decision packages should be reviewed and judged by the top management. Once the decision package have been approved by the top management, the budget unit managers can then draw up detailed budgets for their units by adding up the costs identified on each package.

Evaluation of ZBB

ZBB offers the following benefits to an enterprise-

1. Identification, evaluation and justification of all activities proposed-rather than just the increases or decreases from the current operating level-promote a more effective allocation of resources because managers have evaluated the need for each function and have considered different ways of-and levels of effort for-performing each activity.
2. By helping to evaluate the performance of an agency against its budget, managers will be forced to perform a more thorough analysis of the actual problem. They will be forced to examine in detail how cost-effective the individual programme areas are.
3. As managers at all levels in the organisation are involved in the process of budget-making, they develop a sense of greater responsibility for budgets and related accomplishment. The process will also identify overlapping or related functions performed by various agencies.
4. The entire budgeting process need not be repeated when expenditure levels must be changed.
5. It provides management a convenient reference plan that can be used for controlling activities during the budget period.
6. Managers at all levels become more knowledgeable about the role of their functions within the overall organisation and more cognizant of basic inter-relations within the organisation structure.
7. Since decision packages are to be examined in more depth by higher levels of management the budget unit managers make all out efforts to identify inefficient or obsolete activities within their areas of responsibility. This in turn, enables top management to make cuts in the budget without affecting the efficient operations.

8. Top management can readily test the budget estimates against the operating plan since it is looking at an evaluation in terms of priorities rather than numbers.

ZBB provides a performance analysis for different levels of spending. It enables establishment of a financial phase prior to the preparation of the fiscal year budget. Budgetary guidelines are available to allocate limited resources to satisfy goals and objectives. It is an improvement in the quality of management information. It increases the involvement of personnel at the activity level in the budget process.

Like any other system, ZBB also has some disadvantages. It puts too heavy a burden on the budget making process thus adding substantially to the time and effort involved. Phyr, however, disagrees with this and states that effectively planned and properly managed ZBB can reduce the burden of budget making while significantly improving management decision making and allocation of resources.

Another drawback of ZBB is that its installation involves additional cost which may carry over in decreasing amounts to the subsequent budget periods. Besides a new process also means some disruption of normal operation as personnel of the enterprise familiarise themselves with the procedure. But the added cost and temporary disruption are, in effect, an investment in better budgeting in the long-run and better corporate planning. However the applicability of ZBB is limited as it cannot be applied to an entire budget.

The success of ZBB would depend upon : (a) the willingness on the part of top management to use this technique and to provide the support needed for its implementation; (b) the effectiveness of the design of ZBB; and (c) the effective management of the system of ZBB.

Here, the question arises is : should ZBB be done every year ? The answer is not very simple. The main argument against the repetition of ZBB is that major benefit is achieved in the first year by reviewing and evaluating the activities and as such no additional benefit is expected to flow next year. Moreover, since programmes do not change drastically every year, we can have the same decision package every year. Therefore, there is no need for yearly reviews of activities as suggested by ZBB.

On the other hand, if ZBB is not done every year, the organisation will face the problem of preparing the budget in those years when ZBB is not done. Allocation of limited funds to provide for increases in the outlay of existing activities or for new programmes and activities would also pose another serious problem, in the absence of ZBB. Besides managers will fall back into their old practice of justifying additional funds requested for on-going activities and will not continue to evaluate in detail the effectiveness and efficiency of their activities. This will defeat the very purpose of ZBB.

Hence, there is no universally correct answer to this question and the issue in fact boils down to the question whether it is worth while to repeat ZBB process every year. The answer, however, depends upon the facts and circumstances of each individual organisation. The problem of repeating ZBB every year can perhaps be resolved by continuing ZBB every year until the mechanics of the procedure and type of analysis required become ingrained into the thought process of managers through-out the organisation. It may take two or more successive budget years. After this has been done each organisation should continuously evaluate the cost versus benefit of continuing the process every year and take a decision accordingly.

The users of ZBB abroad have given a mixed reaction to its application. The process is basically sound and workable and is extremely helpful to middle and senior management. In addition to improving communication and understanding between management levels in the setting up of priorities it is very useful in reevaluating the basic objectives of various functional activities and in identifying critical areas of weakness in the corporate planning process. It is applicable to all actionable or discretionary activities, programmes or costs. It can be applied to all administrative, technical and commercial functions. However, it cannot be directly applied to items associated with production operations. It is adaptable to discretionary cost areas in which service and support are the primary outputs i.e., wherever spending alternatives exist in the service and support functions. While private corporations use it for overhead expenses, Government agencies use it for programme expenditure and to support costs.

As far as India is concerned the technique is yet to gain popularity. The need is great particularly in Government sector where in favoured proposals are funded without giving regard to objective assessment and the same is continued for the following years, resulting in non-funding of other proposals which on any objective basis should probably command priority. This results in waste of limited funds and contradictory situations. Useless but favoured proposals are funded while useful proposal but less favoured by the boss are not implemented for want of funds.

The application of this technique in India shall help in eliminating wastage of funds. The reason being that ZBB tries to uncover what is really going on in an organisation, why it is being done, what better ways might be available and which activities are really important-as well as what they cost. If one knows what these efforts are, how they relate to each other and also to the broader goals of the organisation, one has a powerful tool to manage and allocate scarce resources (in the best possible manner) and in so doing achieve the objectives. However, one thing should be very clearly noted that ZBB is only a tool and cannot be taken to be a solution for all the problems of management.

India decided to switch over to zero budgeting in 1986 to help both in the judicious allocation of scarce resources and in deriving the optimum benefit out of the resources thus allocated. It was decided to introduce the technique in union budget making exercise in a phased manner to ensure a smooth transition from the traditional budgeting. Accordingly one third of the budget for 1987-88 was zero based and the budget for 1989-90 will be fully zero-based. As the technique is still in its introduction stage and has not remained operational for sufficient time, it would be premature to say anything about its success or failure at this juncture.