Reward the Winners, Punish the Losers?

Performance Budgeting Reconsidered

By **Dr Miriam Allam***

The initial objective of performance budgeting is to allocate resources to funding programmes that deliver results. Performance budgeting therefore explicitly establishes a link between programme performance information and decision-making. The argument is that performance information will allow decision-makers to create a consensus on whether the programme is performing well and whether further funds should be granted. Following this reasoning it should be simple to "reward the winners and punish the losers" by means of establishing a relationship between performance and resource allocation. However, the article argues that this relationship is not as straightforward as it might appear at first glance. Given that the resource allocations on the basis of programme performance in real-life application pose some severe restrictions, the paper concludes that the initial objective of performance budgeting has to be reconsidered. This is not to claim that performance budgeting is without any merits but rather that in questioning the effectiveness of performance budgeting, it is essential to first ask for its purpose. If the purpose is not the allocation of resources in accordance to performance but to increase transparency then performance budgeting is a step into the right direction.

The underlying idea behind performance budgeting is to allocate resources to programmes and projects that deliver results.[1] Performance budgeting therefore explicitly establishes a link between programme performance information and decision-making. The basic assumption is that more information leads to better decisions.

Performance budgeting and its variants have been on the agenda of public budget management for the last few decades. Since the 1990s, it has become a top priority for budgeting reforms in advanced as well as developing and transition countries. By 2005, nearly three-quarters of OECD countries had introduced some sort of performance information on budgeting and management (Curristine 2005: 108). Performance budgeting in this respect is part and parcel of the broader public sector reforms (Robinson and Brumby 2005). These reforms were designed to address two of the most pressing problems the public sectors face: firstly, the challenge to improve the quality of public services and secondly the need to attain fiscal sustainability. Given that result-based budgeting[2] puts emphasis on both efficiency and efficacy, it is hoped that the new approach to public budget management would help to ensure accountability and to overcome the widespread public disappointment with public sector performance. In addition, fiscal austerity measures and fiscal consolidation as such require an efficient spending of limited resources, making the need to employ performance budgeting systems more apparent (cf Robinson and Brumby 2005). This is because performance budgeting is expected to bring the much needed "productivity dividend, which can be used either to keep the tax burden down, [...] to fund new service priority" (Robinson and Brumby 2005: 13) or to consolidate the aggregate public expenditure (cf Reddick 2002). It is therefore no surprise that many EU Member States have justified the introduction of performance-based budgeting by referring to their legal obligation to avoid excessive government spending and to adhere to the provisions of the stability and growth pact.

What is new about performance budgeting? Result-based budgeting promotes market solutions to problems of underperforming programmes. It endorses an incentive and sanction structure with funding rewards for good performance.[3] It therefore stands in harsh contrast to the traditional approach towards budget management which focuses on resource allocation and input control with little analysis of the actual performance of the programme. In incremental budgeting, policy objectives are usually poorly articulated and there are no constraints on the quantity and quality of outputs (Diamond 2003: 4).[4] Performance budgeting, in turn, starts at the performance level and analyses if the objectives have been met. Performance budgeting increases flexibility and removes constraints on resource management. Spending agencies are (ideally) able to reallocate funds within controls on budget line items. Thus, organisations and managers have more room to manoeuvre. In short, performance budgeting has moved "from focusing on inputs, and how they are employed, to focusing on outputs and how they fulfilled the original budget objectives" (Diamond 2003: 13).

The use of performance-based budgeting for programme management has several components of which the operationalisation of performance information is pivotal. Broadly speaking, performance information should be a) objective; b) standardised; c) indicative; and d) consistent. The four core elements of performance-based budgeting are: the focus on results (outcome), the strategy expressed in goals (outcome targets) and objectives (output targets), the output (what is done in order to achieve the outcome) and the evaluation of the activity by means of performance indicators.[5] Performance indicators can be divided into three categories: measures of efficiency (i.e. indicators measuring the quality of the service provided), effectiveness (i.e. indicators measuring whether objectives have been met) and – with varying degree of application from country to country – evaluations (i.e. indicators measuring the satisfaction of customers with the results).[6] The argument is that these indicators will allow decision-makers to create a consensus on whether the programme is performing well and whether further funds should be granted. Following this reasoning it should be simple to "reward the winners and punish the losers" by means of establishing a relationship between performance and

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resource allocation. However, this relationship is not as straightforward as it might appear at first glance. Firstly, performance information has to be interpreted and is therefore bound to the interpreter's conceptions, i.e. his/her understanding about what is right or wrong. Thus, performance budgeting is patently subjective. Secondly, legislators are not necessarily changing their behaviour in accordance with the performance-based scores. Thirdly, comprehensive performance information may never be accomplished because it simply lies beyond human cognitive capacities. Given that the resource allocations on the basis of programme performance in real-life application pose some severe restrictions, the paper concludes that the initial objective of performance budgeting has to be reconsidered.

Interpretation of performance information

Certainly, a lack of information increases uncertainty, however, as Feldman (1989) correctly points out, this does not mean that performance information can reduce ambiguity. Ambiguity is rather inherently linked with the interpretation of information. Information is always interpreted within its political and economic context; it is a political and economic context at a particular time. Thus, the interpretation of performance information is inevitably subject to contestation. In addition, the interpretation of information might be influenced by the interpreters' causal and principled beliefs while information can be used selectively. Accordingly, the outcome of the decision-making can be directed towards a given direction by choosing what information is evaluated and highlighted. Thus, "rather than present information comprehensively, giving equal balance to all, actors will highlight specific pieces of data" (Moynihan 2005: 159). Certainly, this selection is not immune from political influence and often reflects the balance of power between the organisational entities. This is even more so as performance budgeting can shift the balance of power between the actors involved. This is because performance budgeting may well serve as a tool for setting the policy agenda. For example, depending on the performance budgeting system, actors have a high degree of freedom to choose goals and measures; ergo they have space for manoeuvring and setting the policy agenda. Moreover, it should be noted that the interpretation and success of the programme information depends on the persuasiveness of the arguments made. The argument, on the other hand, becomes persuasive when it is seen to solve problems that FIT existing interests. Thus, the persuasiveness of the performance information is neither coincidental nor objective. In short, performance information cannot eliminate subjectivity because information first needs to be rated and then selected and interpreted. Thus, consistency can only be attained to a certain degree no matter how well raters are trained and how well designed the standardised questions are.

Same set of information, different recommendations?

Further questions arise in light of the actual performance itself. If a programme performs well, does this mean that it should receive more funds or does it rather show that it is sufficiently equipped with resources? Ceteris paribus, if performance is poor does this mean that the project itself is not worth pursuing or does this rather show that it needs to be redesigned and/or needs more funding in order to succeed? Faction further occurs when funding for underperforming programmes is granted on the grounds of politically pragmatic stakeholder concerns. Although performance is poor, funding in this case would increase stakeholders' trust for future projects (see Moynihan 2005: 166). Then again, if underperforming programmes get more funding there are no incentives for actors to create better performance. Moreover, performance information cannot solve problems with regards to the programme priority. What is the basis for the trade-off between programme A in favour of programme B? In addition, what if the target group does not benefit from the programme but from others? Should the performance therefore be considered as poor although it had some very useful side-effects? Further problems are associated with the choice and operationalisation of performance indicators. In fact, it is probably impossible to have good performance indicators for each operational goal. For example, for the operational goal of having more citizens choosing a healthy lifestyle, the performance indicators can vary from the percentage of non-smokers, percentage of citizens practising sports, to the level of obesity and citizens eating healthy food (but how should eating healthy food be measured?). As Curristine (2005: 97) puts it:

"The fact that countries continue to struggle with these challenges [setting clear objectives and designing measures] […] reflects that it takes time to develop meaningful measures and to collect relevant data of sufficient quality. Furthermore, the revising and updating of performance measures is a continuous process because needs and priorities are constantly evolving."

However, because in most countries, indicators are therefore reviewed and possibly changed on an annual basis (as it is, for instance, the case in the Netherlands), there might be a time gap between intended goals of a funding programme and the indicators that have changed over time.

All the preceding examples point to reasons why actors may interpret the same set of information differently and why they consequently can make different recommendations on the ground of logical arguments for either option (Moynihan 2005). It also illustrates why legislators may not necessarily change their behaviour given that optimising "the linkage between performance and budgeting remains unsolved" (Diamond 2003: 6). It becomes clear that there is in fact no systemic relationship between performance information and decision-making. Indeed, recent studies suggest that the legislature has not substantially or even weakly responded to performance information and reporting (Johnson and Talbot 2007). Sterck (2007: 189) concludes that the "performance initiatives […] have a dominant focus on changing the budget structure, but do not seem very successful in altering the budget function".

In addition, performance information and data as such do not say anything about why performance occurred, how the implementation worked and if external factors have influenced the outcome. With reference to the OECD countries, Curristine (2005: 90) summarises: "there is considerable experience with outputs, but less with outcomes although it is developing." In order to make sense of the reasons for failure/success of programmes, the information has to be contextualised. Yet, because performance budgeting needs to be contextualised, it is evident that many other factors – such as the political system and the fiscal environment – may play a pivotal role for a programme to succeed. It is therefore no surprise that the success of performance-based budgeting indeed varies from country to country and in some the outcome has been very disappointing.[7] Performance information has to be complemented by ex post evaluations that focus on attributes and causality issues. Nevertheless, the limited knowledge of the means-ends linkages and the utmost importance of external factors (e.g. economic recessions) pose severe restrictions on the evaluation of performance information. Put differently, the juxtaposition of objectives and outputs neglects the relative importance of other causal forces affecting outcomes in evidence.[8]

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In short, because of the ambiguous linkage between objectives, indicators and outputs, actors can make different recommendations on the basis of the same set of performance data. Performance information cannot guarantee consensus and therefore, legislators do not necessarily change their behaviour in accordance with the performance scores.

Bounded rationality and information costs

Performance budgeting assumes that actors possess perfect information. Performance budgeting thus hinges on rational choice theory and is therefore open to the same criticism. The policy/decision-makers may not have the capacity to develop a coherent system of knowledge on the project because performance information may simply be too complex or too time-consuming. Thus, actors may have to use proxies other than performance information to reach a decision because a "comprehensive use of performance information is beyond limited human capacities, leads to information overload, and is a distraction for policy analysts" (Moynihan 2005: 155). In addition, because performance budgeting is based on rational considerations, it also suggests that the creation of performance budgeting is motivated by the policy/decision-makers self-interests to realise gains from extrinsic incentives (i.e. rewards and sanction).[9] It therefore neglects aspects of result-based budgeting in the public sector that follow a different logic, i.e. a logic that perceives the creation of performance budgeting as an effort to follow norms. Thus, bounded rationality, normative considerations and high information costs pose strong limits and make it necessary to reconsider the fundamental pillars of the system itself.

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Critics of result-based budgeting refer to the potential threat arising from imperfect information and/or an incentive/sanction structure that leads to perverse outcomes. In fact, they argue that performance budgeting is prone to creating sub-optimal solutions. According to the opponents, this is especially the case when the focus is put on quantity rather than on quality. For example performance-based budgeting in hospitals may operate with a system that creates incentives (rewards) and (financial) sanctions on the basis of the hospital's success or failure in meeting the output targets at a given cost. Further assume that this hospital has to classify, for instance, all bone fracture patients in the same group, regardless of whether elderly patients cost the hospitals more than younger patients (cf. Robinson and Brumby 2005). This can lead to perverse incentives where hospitals either avoid treating elderly bone fracture patients or are encouraging young patients to undergo unnecessary – but for the hospital beneficial – treatment (this dysfunctional behaviour and gaming is also described as "skimping, dumping and creaming").[10] Another example is the objective of higher A-level achievements met by a lower standard of the A-level exams. Certainly, this "fit for purpose" is a consequence of a target-driven mentality. As Curristine (2005: 108) puts it:

"[t]here is always the danger that linking results to financial resources can create incentives to distort and cheat in presenting performance information. These are problems that can be particularly acute when performance information is not independently audited."

In short, performance information runs the risk of achieving sub-optimal/poor results because a wrong incentive/sanction structure may create imperfect outcomes and because the vast amount of information misspends civil service energies. Government attempts to increase programme efficiency by means of performance information creates a target-driven mentality that is in itself anti-democratic. By simply meeting the indicators to secure further funding, local democratic decisions can be overruled with a clear conscience. There are many important aspects of funding programmes that are not and cannot be captured by performance budgeting. These aspects may be normative and intangible in nature (e.g. projects that touch upon human rights aspects) and therefore very difficult (or impossible) to operationalise and measure (Keenan 2000). For these programmes to succeed, targets may well have unintended and perverse effects. Indeed, it is the focus on quantified measures and the direct performance budgeting that encourage a wrong incentive structure. Programmes do not fail because they are not measured. They fail when public administrations are not accountable, transparent and well run. Modernising the public sector requires parallel steps into different directions and politicians and officials first need to get the basics right, i.e. they need to have tight input controls.[11] Performance budgeting is appealing, however, it requires major changes in the managerial culture and it depends to a large extent on the political and professional commitment. If the managerial conditions are poor and

"discourage performance, the budget will not be oriented to performance. One implication of this hypothesis is that it is futile to reform budgeting without first reforming the overall managerial framework" (Schick 2003: 100).

Performance-based budgeting is "only one of the drivers of change, and not always the most important one" (Schick 2003: 88). It should be clear that other factors, such as effective leadership, reporting and audit systems are equally important.

However, this is not to say that performance budgeting is without any merits. Result-based budgeting has the potential to usefully complement spending figures and increase transparency. In fact, if the initial purpose of performance budgeting is revisited and changed to a focus on transparency rather than on the resource allocation of performance programmes, then performance-based budgeting may help to improve the budget process and management.

Reconsidering the objectives

Given that the resource allocations on the basis of programme performance remains a distant and even risky undertaking, it is time to reconsider the initial objective of performance-based budgeting. The original definition has been challenged by different interpretations of the term and practitioners as scholars are deeply divided over the extent of the role played by performance budgeting in the budget process. On the basis of the results of a recent OECD survey, Curristine (2005; 2007) categorises performance budgeting in accordance with the use of performance information in resources allocation. She distinguishes three types of performance budgeting:

1) *Presentational performance budgeting:* There is no formal mechanism to use performance information for the allocation of resources to programmes that deliver results. As is the case in Denmark, Sweden and Canada,

in this form of performance budgeting "performance information is included, at best, as background information only" (Curristine 2005: 102).

2) *Performance informed budgeting:* Performance information is used along with other information in the budget allocation process. In this form of performance budgeting, resources are linked indirectly to results. This implies that results "are being actively and systematically used to inform budget decision", however, performance information "does not necessarily determine the amount of resources allocated" (Curristine 2005: 102-03). The UK, for instance, is loosely linking performance to funding. In fact, the majority of OECD countries "engage in performance informed budgeting – that is, the performance data is used to inform but not determine budget allocations" (Curristine 2005: 114).
3) *Direct performance budgeting:* Funding is directly related to performance results. This form of performance budgeting is very rare and applied only in a limited number of sectors/countries (e.g. in Denmark, Sweden, Hungary, Norway, Sweden and the UK, mainly in higher education and/or health).[12] However, it should be noted that the OECD survey on performance budgeting concludes: "performance information – performance measures and evaluation – is rarely or never used to eliminate programmes or cut expenditure, or to reward agency heads"[13] (Curristine 2005: 108).

The reason why underperforming programmes are not eliminated is because most countries are using performance informed budgeting (category 2). In fact, as stated above, the use of performance information by the legislature, executive and citizens is at best "patchy" (Pollitt 2006; Johnson and Talbot 2007; Sterck 2007). "True" performance budgeting is politically very hard to accomplished as

"politicians often have to turn the other cheek if managers fail to perform according to expectations. They cannot close down the department of education or sack thousands of teachers" (Schick 2003: 90).

Nonetheless, this does not mean that no action at all is taken. In most OECD countries, underperforming programmes are then more closely monitored. The realistic approach to performance budgeting is thus not to use it as a system to link expenditure to programmes that deliver result but to inform budget allocation and to use performance information to signal underperforming programmes that may need to be reviewed and monitored more carefully.

Despite the fact that performance budgeting has failed to meet its initial objectives (category 3), it is not without any merits. For example, performance information assists in searching for alternative options for decision-making and fosters the dialogue between the actors involved in a common and unified framework. In addition, performance information reduces uncertainty (but not necessarily ambiguity). Performance budgeting addresses the main shortcomings of the traditional budget such as the fact that it is difficult to read for non-specialists, that it does not indicate levels of efficiency, that it does not show the costs by activity and that it does not link the resources to goals. Performance budgeting has the potential to make communication among and between departments and parliament more meaningful and may support a focus on essentials (i.e. a thinner policy agenda/budget articles) and a higher quality of goal formulation. The most important positive effect, however, is that performance budgeting encourages more transparency given that unlike in the traditional budget method, the costs for each activity are clearly stated.[14]

To conclude, in questioning the effectiveness of performance budgeting, it is essential to first ask for its purpose. If the purpose is to directly link funding to performance then performance budgeting has so far failed to achieve its objective – in a sense, this is advantageous given that direct performance budgeting is susceptible to data manipulation and to creating perverse incentives. If the purpose is not the allocation of resources in accordance to performance but to increase transparency then performance budgeting is a step into the right direction. Thus, rather than discarding performance budgeting all together, countries that have a fitting managerial framework supported by a strong political commitment should evolve their own performance approach.

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NOTES

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1 The OECD defines performance budgeting as "a form of budgeting that relates funds allocated to measurable results" (OECD 2003: 7).

2 In this paper the terms result-based budgeting, performance budgeting, performance-based budgeting and performance-informed budgeting are used interchangeably.

3 The incentive structure to motivate agencies may include financial rewards and sanctions, the increase/decrease of managers' flexibility with regards to input controls and the recognition of performance results by publicly identifying good performance and naming and shaming underperformers (e.g. league tables for schools, universities or hospitals).

4 It should be distinguished between outputs and outcomes. Outputs refer to measures of productions, e.g. the number of schools or kilometres of highways built. Outcomes refer to measures of output impact, thus to the desired changes, e.g. more pupils qualified for A-levels, less traffic jams and road accidents. Outputs are therefore usually associated with efficiency (the goods and services provided by the government) while outcomes are linked to effectiveness (the impact of the outputs on society). Certainly, it is easier to evaluate outputs than outcomes.

5 Targets should be designed in accordance to the SMART criteria, i.e. they should be Specific (is the target clear and to the point?); Measurable (is the target measurable; are data available?), Attainable (is the target realistic?); Relevant (is the target a priority for the organisation?) and Tangible (is the target time-bound; when should it be attained?).

6 It should be noted that it is possible to have performance indicators without targets and instead use standards or baselines (see for example the 2007 UK Public Sector Agreements (PSA).

7 It should be noted that most of the surveys on performance budgeting have been conducted in the United States. For an excellent review on the empirical literature see Robinson and Brumby (2005). For a recent survey on performance budgeting in OECD countries see Curristine (2005; 2007).

8 In the same vein, it would be a fallacy to infer that outputs and outcomes are sufficient measures for government performance. They "are snapshots of what government is doing or accomplishing at a particular time; they do not uncover the factors that contribute to or retard the results, nor do they indicate whether government will have the capacity to perform in the future" (Schick 2003: 74).

9 For a fuller development of this point see Frey (1997).

10 Evidently, critics of performance-based budgeting therefore repeatedly refer to the experience of Soviet central planning, where, for example, "the nail factory […] found it was easier to achieve its annual production target – which was specified in weight terms – by producing absurdly large and unusable nails" (Robinson and Brumby 2005: 16).

11 Thus, performance-based budgeting is not a panacea and may even be a risky tool for countries in transition that are just moving away from detailed line item classifications to a programme basis. For a discussion on the effects of complex performance regimes on transition and development countries see Schick (1998).

12 In the UK, for example, universities receive funding in accordance to their score in the Research Assessment Exercise (RAE) that evaluates academic departments every five years on the basis of students graduated, number of students per teacher, number of books and impact-point relevant articles published by the staff. Denmark, Finland and Sweden use a formula where the number of graduated students release funding for universities (cf. Curristine 2005: 103-05).

13 Indeed, 96% of the OECD countries rarely or never eliminated poor or underperforming programmes.

14 For an opposing view see Sterck (2007).