

IMPLEMENTATION OF PERFORMANCE BASED BUDGETING AND IT'S CHALLENGES IN IRAN

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Abstract

Iran's performance-based budgeting reform, followed a defined plan of implementation from its inception in 2002. Our objective is the implementation of performance based budgeting and discuss about its challenges and limitations. The research method is field study that researcher gathers data by the means of observation, document analysis and interview. In this paper, regarding to performed studies in 15 governmental agencies in Iran, a holistic model is demonstrated for determining cost of activities. This article discusses Iran's performance-based budgeting process through three sections. The first section outlines the rationale for reform and the basic implementation plan. The second section is implementation of performance based budgeting. The third section identifies the challenges and limits of PBB. Since, we are in the beginning steps of PBB implementation process. The results of this article can be useful to ease the implementation and reduce problems.

Keywords: Budgeting; Performance; Performance based budgeting (PBB).

JEL Classification Codes: G30.

1. Introduction

Growing from a desire to improve service and the efficient utilization of resources, performance based budgeting, sometimes called performance budgeting, has begun to penetrate all level of government. Performance budgeting links spending to result and allocate resources based on achieving specific measurable outcomes. Rather than asking, what will be needed in personnel and other cost to carry out an assigned task? The first question is what is the outcome to be achieved?

As a result of development in governments' responsibilities and increase in governmental expenses, expenditure control has lose its importance and a need in planning improvement, control and management of public resources was arisen. This expands decision makers' information about performance results and outcomes and results into government attention to economy, efficiency and effectiveness of governmental resources. This situation needs to improve budgeting methods and introduces a new aspect in governmental financial management. Performance- Based Budgeting (PBB in brief) system was introduced for review and assessment of governmental activities management. The main difference between this system and traditional budgeting system is its focus on objectives, results and benefits of resources. This article discusses Iran's performance-based budgeting process through three sections. The first section outlines the rationale for reform and the basic implementation plan. The second section is implementation of performance based budgeting. The third section identifies the challenges and limits of PBB.

Organizations have three main reasons for budgeting:

- Demonstrating financial concepts of programs
- Identifying needed resources for implementation of programs
- Acquiring efficient criteria and results control

Traditional Budgeting method doesn't give information about results of resources, efficiency and effectiveness of programs. It also has short term prospect and limitation of management authority in expenditure control. PBB is suggested to solve these problems and increase governments' responsibility.

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For implementation of PBB, we need to identify cost of activities. How cost computation, as one of its main requirements, should be done? How costs should be allocated to activities? Does current accounting system in governmental organizations, could generate sufficient information for PBB system? These are some of the questions which justify necessity of this research.

2. Literature review

The concept of budget has been evolved according to governments' development and complication of theirs duty. This evolution could be divided in four distinct stages (Farajvand; 2001):

At the first stage (from 1920 to 1935) main focus was on cost control. At the second stage, PBB was introduced that links spending to results and allocates resources based on achieving specific measurable outcomes. The third stage was started with a link between budget and program as a criterion for economic welfare assessment. At the fourth stage which was emerged as a result of organizational environment complication, using zero based budgeting was a segment of strategic planning.

PBB adds saving agents and effectiveness to traditional budgeting and distinct between efficiency and effectiveness. Efficiency deals with economical use of resources, but effectiveness is related to performance (Varmzyar; 2002). Using PBB will be an effective factor in increasing efficiency and effectiveness of credits. PBB definitions are mainly arbitrated around "the relationship between budget and performance measures, results and outcomes." Thus we can define PBB as follow:

1- PBB is an annual program with annual budget which shows the relationship between expenditures allocated to each program and outcomes achieved as a result of program. This means that the expenditure allocated to each program should contribute a set of goals.

2- PBB is a kind of budgeting which systematically uses performance indices in general resource allocation process.

3. Cost terms, concepts and costing system

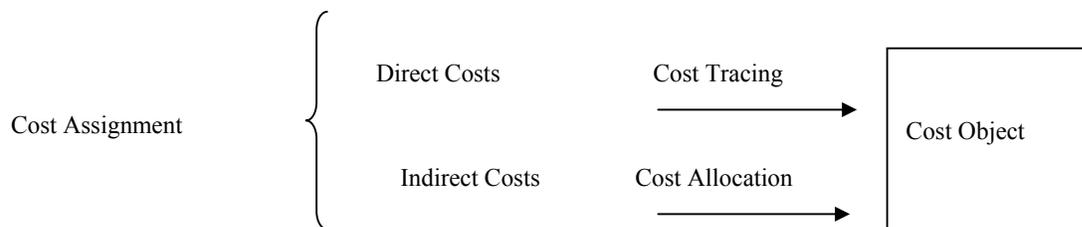
In this part at first basic concepts and terms related to cost computation will be explained briefly and will be continued with cost allocation methods of service departments to operation departments.

Cost Object which is anything for which a separate measurement of costs is desired.

Direct Costs of a Cost Object are costs that are related to the particular cost object and that can be traced to it in an economically feasible (cost- effective) way.

Indirect Costs of a Cost Object are costs that are related to the particular cost object but cannot be traced to it in an economically feasible (cost- effective) way. Indirect Costs are allocated to the cost object using a cost allocation method.

Figure 1. Kind of Cost Assignment



4. Operation departments and support departments

An operating department (also called the production department in manufacturing company) adds value to a product or service that is observable by a customer. A support department (also called a service department) provides the services that maintain other internal departments (operating departments and other support departments) in the organization.

5. Support department cost allocation methods

We now examine three methods of allocating the cost of support departments: direct, step- down and reciprocal (Hornger, et al; 2000).

Direct Allocation Method: The direct allocation method (often called the direct method) is the most widely used method of allocating support department costs. This method allocates each support department's costs directly to the operating departments.

Step- Down Allocation Method: some organizations use the step- down allocation method (sometimes called step allocation method or sequential allocation method), which allows for partial recognition of the services rendered by support departments to other support departments. This method requires the support departments to be ranked in the order which step- down allocation is to proceed.

Reciprocal Allocation Method: The reciprocal allocation method allocates costs by explicitly including the mutual services provided among all support departments. Theoretically, the direct method and step-down allocation method are less accurate when support departments provide services to one another reciprocally.

6. Related researches

Meagan M. Jordan and Merl Hackbart in 1999 did a research entitled "The Goals and Implementation Success of State Performance- Based Budgeting". Their findings suggest that program accountability as a goal, rather than budget allocation, makes a stronger foundation for determining performance-based budget success. (Jordan , hackbart,1999)

W. Mark Grain, J. Brain O' Roark in 2002 did a research entitled "The Impact of Performance- Based Budgeting on State Fiscal Performance". Their findings indicate that performances- based budgeting curtails state spending per capita by at least two percentage points. However, not all state government programs are affected equally; some budget categories experience spending increase after the implementation of performance budgeting. (Grain, 2002)

Dongsung Kong in 2005 did a research entitled "Performance- Based Budgeting: The US Experience". The research attempted to 1) provides a brief historical context of PBB in the US. 2) Identifying some challenges associated with the theoretical underpinnings and operational principles of PBB; 3) Document current Practice and research pertaining to designing and implementation and 4) discuss the prospect of PBB.

7. Research method

For this investigation we scrutinized PBB system of 14 research qualified organizations of Iran. Research team mainly used field studies which they gathered required data by means of direct observation, interview and tests. As well they analyzed documents, records and financial reports of the organizations. In view of the fact that Iran's financial and planning management system is based on concentrated method and also with regard to similarity of activities and duties in governmental organizations. it is expected that this research's result could be generalized to the whole country. In support of having exact information about existed situation of budgeting system and governmental policies in relation to PBB implementation, all the regulations and notes e. g. fourth economic, social and cultural development program regulations, budget law and official letters of Organization of Programming and Management were gathered and analyzed.

8. Performance- based budgeting in Iran

Budgeting system reform and lucid relationship between resources and operational program was noticed at third development program and as a result of that, in section B of note 23 of 2001 budget law and also in section R of note one of 2002 budget law Organization of Management and Programming was ordered to prepare the budget operationally. In section B of note four of 2003 budget law, importance of PBB was remarked to diminish the size of government and increase in cost credits.

In regard to the substance of article 138 of forth development program act, implementation of PBB was suggested as follow:

Organization of Management and Programming is ordered to reform budgeting system to a rational, operational and based on total cost system. For these objectives, it should perform the following duties up to the second year of the fourth development program:

- A: identifying the activities that the executive organizations should do.
- B: determining cost of each activity.
- C: arranging budget proposal according to activities volume and their cost.
- D: allocating credits according to annual performance and result of activities according to cost.

In substance 144 instead of process control, the most emphasize is put on result control; therefore managers have enough authority to perform their activities.

9. A Model for calculation of cost in PBB system

Based on studies and surveys in governmental organizations of Kerman province by the research team, PBB stages were recognized as follow:

- *Determining Organizational Goals and related activities and programs.*

Regarding to macro- economical policies, each governmental organization should have long term and short term objectives. These objectives which are prepared according to prosperity and resources should be accessible. The most important parameter for PBB is program. Program is a set of activities or projects under surveillance of a specific organization which help it in achieving to its goals. Operational objectives of each program should be estimated. Budgeting and accounting should be in a way that decision makers are aware of costs and returns of each program.

- *Determining Quantitative Goals of each Program.*

After defining programs and activities, quantitative objectives should be determined, e. g. how many activities should be done by the organization in a period of time? It should be mentioned that these quantitative objectives should be consistent with recourses and necessity of them. For determining these objectives exactly, organization should have enough information about past periods and future goals. It should be considered that for determining objectives we shouldn't rely on past information merely; because this information may be incomplete and another reason is that the future is different from past.

- *Determining Governmental Executives Cost List.*

In this stage all type of costs in organization are identified and listed. An expense recognition criterion is based on expense nature, e.g. payable salary to personnel call and classify as salary expenses. Expense classification based on expense nature is performed in all governmental agencies similarly. Cost classification based on their natural characteristics is shown in table 1.

Table1: Cost classification based on natural characteristics

1	Salary expenses	17	Computer repairs
2	Overtime work	18	Vehicle maintenance
3	New year's gift	19	Vehicle fuel
4	Education	20	
5	Internal mission	21	Supply
6	Wedding and burying subsidy	22	Official reforms
7	Education rewards	23	Internet
8	Financial assistance	24	Expenses related to public relations
9	Contracted Services	25	Housing subsidy
10	Food	26	Expenses related to war handicapped
11	Kindergarten subsidy	27	Telephone expenses
12	Retirement expenses	28	Gas
13	Retirement reward	29	Water
14	Personnel debts payment	30	Electricity
15	Vehicle insurance	31	Maintenance

- *Predicting Needed Expenditure for Achieving the Quantitative Objectives.*

In this stage all segments of governmental agencies should predict their expenses in cooperate with budget units. Expense estimation should be in the scope of nature of the expense. It should be mentioned that expense prediction could be done according to past years information and next year planning.

- *Verifying Support Departments.*

Support departments are the departments which don't carry out the main affair of the organization, but they support operational departments and without them organization could not achieve its goals. Surveys showed that in governmental organization, support departments are similar. Support departments and their allocation basis are brought in table 2.

Table2: Support departments and their allocation basis

Support departments	Allocation basis
1- Management unit	Number of Employees
2- Secretariat	Number of Correspondences
3- Transportation	Used Time or Km
4- Purchasing Unit	Number of Purchasing Requests
5- Official and Employment Unit	Number of Employees
6- Financial Accounting Departments	Number of Employees and Each Unit Credits
7- Law Department	Operation Volume
8- Public Relations	Number of Employees
9- Guarding	Number of Employees
10- Statistics Unit	Operation Volume
11- Informatics and Computer Unit	Number of Computers
12- Filing	Number of Filed Records
13- Stores	Number of Request Sent to Stores
14- Telecommunications	Number of Employees

- *Identifying Operational Departments.*

Operational departments are the departments which perform the main duty of the organization and add value to a product or service that is observable by a customer, e. g. in Trade Organization, surveillance on merchandise and services unit and smuggled goods detection are operational departments. These units are recognized in all research organizations, but they are too many to put them in this article.

- *Classification of Expenses into Direct and Indirect Costs.*

In this phase all the recognized costs are divided into direct or indirect costs. As it said before direct costs are costs that are related to the particular cost object and that can be traced to it in an economically feasible way, e. g. public relations cost which are directly related to public relations office or salary costs of X operational unit are related to that specific unit. Indirect Costs are costs that are related to the particular cost object but cannot be traced to it in an economically feasible way. For example energy expenses are divided based on criteria such as square meters or number of staff.

Surveys showed that indirect costs are as follow:

- A: water expenses
- B: electricity expenses
- C: gas expenses
- D: maintenance expenses
- E: building insurance

- *Tracing Direct Costs to Their Departments.*

As it said above, direct costs such as print and copy costs and car maintenance costs are traceable and related to the user departments, Print and copy unit and transportation department. Sum of all direct costs of each operational and service department, will be calculated at the end of this stage.

- *Determining Suitable Basis for Indirect Costs and Divide Them.*

In order to allocating indirect costs between support and operational departments, a basis should be selected that have more relation with indirect costs. In other words with increase in basis, indirect costs

also increase. After identifying the basis, indirect costs are allocated according to this basis. Based on researches in governmental organization, suitable basis for each indirect cost areas came in table 3.

Table3. Indirect costs and their allocation basis

Indirect Costs	Allocation Basis
1- Building Depreciation	Square Meter
2- Water Expenses	Number of Staff
3- Electricity Expenses	Square Meter
4- Gas Expenses	Square Meter
5- Maintenance Expenses	Square Meter
6- Building Insurance	Square Meter

- *Calculating Costs of Each Support Departments.*

In this phase total identified and allocated costs to the support departments are calculated. Consequently we can allocate these total accumulated costs in support departments into operational departments in a suitable way.

- *Determining a Suitable Method for Allocating Service Departments Costs to Operational Departments*

As the main affair of organization is done by operational departments, thus total accumulated cost in support departments are allocated on operational departments. For this we use allocation methods as follow:

- Direct allocation method
- Step- down allocation method
- Reciprocal allocation method

For calculation simplicity we preferred direct allocation method.

- *Calculation Cost of Operational Departments and divide them into direct and indirect Cost*

Allocation records keeping should be in a way that direct and indirect costs rate are determined. It should also be determined that how much of total accumulated operational costs are unavoidable personnel costs and other costs.

- *Determining Related Activities with Operational Departments.*

As we said before, each organization has a set of programs activities to reach its goals. In this step we determine activities and programs of each operational department. This can be performed by skilled personnel and under supervising of organization manager.

- *Allocating Costs of each Operational Department to Activities and Determining Activities Costs.*

After determining the operation percentage of each operational department, we multiple this percentage to cost accumulated of operational departments. So we could calculate cost of each activity. An operational department may perform several activities or it is also possible that a specific activity is performed by several departments. When an activity is done by different departments, it should exactly be determined that which percentage of the activity is performed by a specific department. After determining cost of activity it should be determined that how much is related to unavoidable salary and other costs. Then we can add cost of activities related to each program to compute cost of the program. For example consider the accumulated cost of X operational department is 100,000 dollars. It is determined that the 60 percents of activities is spent on "A" activity, 30 Percents is spent on "B" activity and 10 percents is spent on "C" activity. Also consider this activities are done merely by X operational department. So costs of activities are calculated as follow:

Cost of "A" activity: $\$100,000 * 60\% = 60,000$

Cost of "B" activity: $\$100,000 * 30\% = 30,000$

Cost of "C" activity: $\$100,000 * 10\% = 10,000$

10. Challenges and limits of performance based budgeting

A number of factors can be seen to have influenced reform implementation and ultimately to have limited progress. Some factors arose as part of the normal evolutionary process of an adjustment to a new budgeting system. Others were more structural as changes in state leadership changed the focus of performance-based program budgeting, moving from an emphasis on outcomes and the benefits of public programs and placing a greater emphasis on efficiency and the conservation of scarce public resources. The main challenges of PBB implementation are :

Lack of consistent leadership

Iran's PBB reform was driven by statute. Although the reform had the support of many legislators, however, no one person or office oversaw its implementation. In the Legislature, responsibility for performance-based program budgeting was split between the appropriations committees and substantive committees, with appropriations committees overseeing the identification of programs and substantive committees overseeing the identification of performance measures.

Lack of agreement about the purpose of PBB

Without a clear leader for performance-based budgeting, different agencies and legislative employees had different opinions about the purpose of performance-based budgeting. Some believed that the primary purpose of the budget reform was to show the effect of government programs on societal problems such as teenage pregnancy or unemployment rates. These employees tended to focus on high-level performance measures, even though performance on these measures was likely to be affected by factors other than pro-program performance. Others believed that the emphasis should be controlling and holding agencies accountable for performance. These employees tended to focus on lower-level process, output, or efficiency measures over which agencies had greater control.

In addition, agencies and legislative staff disagreed over how much flexibility the legislature would give agencies in exchange for greater accountability.

Agencies wanted greater budgetary flexibility, believing that they could use this flexibility to improve efficiency. This led them to propose very large pro-grams for the new budgeting process. However, the legislature was reluctant to provide this flexibility, preferring instead to continue to appropriate funds under the same budget structure it had used in the past. Consequently, it tended to approve smaller programs than those proposed by agencies. However, it also allowed agencies with a number of small programs to cluster these programs together.

Uneven performance measures

Poorly defined programs and disagreements about the purpose of performance-based program budgeting made the development of performance measures challenging. As a basic requirement of the PBB reform, agencies were mandated to develop input, output, and outcome measures for each identified program.

Inputs were defined as "the quantities of resources used to produce goods or services," outcomes as "indicator(s) of the actual impact or public benefit of a service," and outputs as "the actual service(s) or product(s) delivered by a state agency."

Misaligned program and budget structures

Another challenge of PBB reform was the difficulty in bringing the system into the state's mainstream budgeting and accounting processes. Cost data allows the Legislature to weigh the benefits of a program against its costs. Cost data would also provide decision makers with better costs of providing higher levels of service or improving program performance. Currently, most agencies lack unit cost data. Instead, agencies usually account for their spending by organizational units or by funding sources, rather than by programs or services.

Problems with creating performance-based incentives

Another challenge experienced early in the reform process was that incentive schemes associated with the reform were not being activated. Larry Fuchs, who headed up the Department of Revenue, said in 1998 that organizational devices like performance-based incentive schemes would "give the agency a management tool" that it did not "share with the private firms it benchmark(ed) itself against."

However, incentive schemes have been largely limited to the education sector of the state. For example, as previously mentioned, the legislature created a performance funding system for vocational programs under which schools would earn a portion of their funding based on post-training student employment. In addition, the legislature allowed students of failing public schools to obtain vouchers they could use to go to private schools. However, the use of performance incentive schemes has been limited, with performance-based incentives seen as less widely accessible and “less comprehensive than PBB” itself.

Computing of activity cost

Increasing of indirect costs and need to suitable cost driver for allocation of cost cause to computing of cost be complicated.

11. Conclusion

Most of developed and also developing countries, are trying to revolutionize their budgeting system into performance- based budgeting which the relationship between resources and results is perceivable. PBB offers reliable information for government and parliament budgeting decision. The goal of this system is directing government expenditure. Implementation of PBB requires cooperation of all managers, personnel and policy makers. Also sufficient motivation for effective implementation should be generated.

Effective PBB provides more clearness about programs and organizations performance in contrast with traditional budget. This method with the use of activity costing provides a valuable tool for results appraisal. In this research, we compute activity cost with the use of departments costing system. We faced some limitations in computing activity cost, such as: the subject was new, being deficient in skilled personnel, using cash method instead of accrual by the organizations.

Cost computation can endow managers with comparable information. For example if a provincial unit calculate its activity costs lower than the average (predicted cost), organization managers, could discover creative efforts which results into expense saving and grant it to other organizations as a successful experience. Program managers also can use this comparable information for better direction of their efforts.

Implementation of PBB needs to use a costing system for activity cost calculation. Cost- benefit analysis and comparability of performance evaluation are not possible without activity cost computation. For increasing efficiency, effectiveness and economy of this system, plans and activities should be accessible, suitable, directive and precisely defined.

Activity measurement indices should be determined in a way that is effective for unit activity cost computation and performance measurement. Using the costing system and identifying programs and activities are inseparable components of PBB. Implementation of PBB as the most advanced budgeting method is a gradual process and it needs suitable organizational culture and employees’ collaboration. Continues education of concepts, procedures and techniques of PBB should be performed broadly and seriously. In this process we can benefit from professional counselors and especially academic society. Organizations’ financial system should be reviewed and reformed. Financial information system should be able to collect and process the data which are needed for PBB, that current system is incapable to do this. Since governmental accounting system is lawful, required rules and regulations should be approved by legislators and a suitable financial information system should be designed and performed.

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