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***Public Policy & Administration in India***

**TOPIC: Different Approaches to Budgeting**:

Following are some if the widely used approaches of budgeting:

**(1) Incremental Approach of Budgeting**

The incremental approach is the most common method of budgeting as widely used in government and not for profit organisation. It takes last year’s actual figures and adds or subtracts a percentage to obtain the current year’s budget. It means that in budget appropriation which needs merely to justify proposed expenditure in excess of the previous budget. Incremental budgeting is appropriate to use if the primary [cost drivers](https://corporatefinanceinstitute.com/resources/knowledge/accounting/cost-driver/) do not change from year to year.

**Advantages:** Following are some of the advantages of this approach:

1. The incremental approach is relatively easy to implement as financial records of prior periods, the ground where this method is based upon, are usually available.
2. The approach simplifies the budget process by considering only the increments in the previous budget items.
3. The incremental budgeting facilitates a steady flow of fund into every facet of the organisation’s activities and functions.

**Disadvantages:** Following are some of the problems of this approach:

1. A major disadvantage is that existing waste and inefficiencies could escalate year after year.
2. Critics pointed out that there is perpetuated resource allocation in incremental budgeting. In incremental budgeting, different departments tend to have the same percentage rise in share over the years; as such the approach fails to adjust the allocation of resources to accommodate their various needs.
3. The method only studies the slight changes from the previous budget at the expense of any number of radical changes in the external drivers of activity and performance. Incremental budgeting ignores any external factors and simply assumes the cost will grow.
4. The approach is criticised for being conservative and averse to innovation. As conservativeness is a trait that lies at the root of incremental budgeting, as it does not foster or reward innovative ideas.
5. Another problem is that there are incentives to manipulate the budget by **underestimating**revenue growth or exaggerating expenditure so that the variance between the two is in their favour.

**(2) Activity-Based Approach:**

Activity-based approach is a top-down budgeting approach. It calculates the total cost needed to hit the target of the anticipated level of activities. This top-down method first calls for the identification and thorough scrutiny of all the activities that drive cost. This analysis will then give grounds for allocating resources to achieve the level of activities that was anticipated beforehand. It determines the amount of inputs required to support the targets. It allocates resources by studying the efficiencies of the activity that is under review.

Thus, activity-based budgeting predicts cost of budget objective by adding all cost of the activity cost drivers that each product or service is budgeted to consume. In evaluating the proposed budget, management would focus their attention on identifying the optimal set of activities rather than just the output or input relationship.

**Advantages:**

1. The activity-based approach provides efficiency and a complete picture of the organisation by linking every function and department with their spending.
2. It provides visibility of the organisation and helps to identify the performance gap or opportunities that may arise.
3. The approach delivers better cost containment by improving the bottom line taking into account each and every activity that incurs costs.
4. Another advantage is that any kind of non-value-added activity or function can easily be diagnosed for taking corrective measure or removing them.

**Disadvantages:**

1. Like a few other approach the activity-based approach increase workload with structural implications.
2. It requires the huge manpower and financial resources.
3. Critic pointed out another shortcoming of this approach is that it emphasizes on the contemporary goal rather than the long-term strategy.

**(3) Value Proposition Budgeting Approach:**

Value proposition budgeting is really an effort about making sure that everything that is included in the budget delivers value for the business. The value proposition budgeting aims at avoid unnecessary expenditures. Although it is not as precisely aimed at that goal as our final budgeting option, zero-based budgeting. In value proposition budgeting, the budgeter considers the following questions:

1. Why is this amount included in the budget?
2. Does the item create value for customers, staff, or other stakeholders?
3. Does the value of the item outweigh its cost? If not, then is there another reason why the cost is justified?

**(4) Rolling (Continuous) Budgeting approach:**

Rolling budgeting is a rigorous budgeting approach. The approach as its name indicates that it continuously adds a new budget period to replace the previous one as it expired. This may lengthen the budget allocation and mainly its period.

Advantages:

1. One major advantage of this approach is that the rolling forecast keeps you stay on top of all changes, threats and opportunities.
2. This approach allows for the refinement of the financial plan and the broader strategy.
3. The approach supports scenario planning, and thus, drives decision-making.
4. The approach helps in aligning planning and budgeting process with any strategic goals.

**Disadvantages:**

1. The approach is time-consuming as it adds new budget periods.
2. The approach transforms budgeting into a monthly or quarterly activity instead of being done once a year.
3. The budget consumes resources for long periods.

**(5) Minimal level Approach:**

The minimum level approach indicated that an organisation establish a base amount for budget items and requires explanation or justification for any budget amount above the minimum or base. This base notably less than the base used in the incremental approach. It is likely is the minimum amount required to keep a program or organizational unit viable. Some organisation, especially units of Government employ a variation of the minimum level approach, named as ‘Zero-base-budgeting’. In fact, the budgeting for objective is a variation on the minimum level approach that combines elements of activity-based and zero-based budgeting with a need to live within fixed financial constraints. The approach its own merits as it improve on the incremental approach by questioning the necessity for cost included in the base of the incremental approach. Again, the approach can be used in budget research and development. But the approach is criticised as it is very time consuming.

**(6) Zero-Based Budgeting (ZBB)**

The ZBB also originated in the USA and was created in 1969 by Peter A. Pyhrr, a manager of a private industry. It was introduced in the USA by President Jimmy Carter in 1978. Like the performance budgeting, the ZBB is also a rational system of budgeting. Under this system, every scheme should be reviewed critically and re-justified totally from zero before being included in the budget. Thus, it involves a total re-examination of all schemes afresh instead of following the incremental approach to budgeting which begins with the estimation of the current expenditure. The budget making for the ensuing year should be started from zero instead of treating the current budget as the base or the starting point.

**Advantages:**

1. The ZBB ensures that every apartment is catered with the exact amount of resources and funds they need.
2. The approach eliminates or minimizes the low priority programmes.
3. It improves the programme effectiveness dramatically.
4. It makes the high impact programmes to obtain more finances.
5. It reduces the tax increase and facilitates critical review of schemes in terms of their cost-effectiveness and cost benefits.
6. It provides for quick budget adjustments during the year.
7. It increases the participation of the line personnel in the preparation of budget.

**Disadvantages:**

1. The approach can be an extremely time-consuming approach; so many companies only use this approach occasionally.
2. The ZBB falls short when it comes to determining the budget for activities or departments having intangible outcomes such as Marketing and Research & Development, an issue that remains unresolved.
3. The preparation of ZBB and its execution is a cumbersome work and resource consuming. It is concerted effort of manpower, substantial investment money, besides endless paperwork and reports, making the practice an intimidating nuisance.

**(7) Performance Budgeting**

Performance based budgeting is another advanced approach where budget and funds are associated with specific objectives. It is said that performance budgeting is of recent origin. Although performance budgeting is of recent origin it has become an integral part of modern budgeting. It has brought about reformation in the Financial Administration which has a profound significance. The concept of performance budgeting has originated in the USA. It was first experimented in the Municipal Government in the United States. In fact, the term performance budget was originally coined by the ‘Hoover Commission’ in the United States in 1949. Since then the USA Government adopted performance budgeting. As a result, many countries of Asia, Africa and Latin America opted for it in their Financial Administration.

In India, the movement for performance budgeting gained momentum in the mid-50s. The Estimate Committee for the first time recommended for the adoption of performance budget in its 73rd report in 1960. The Administrative Reforms Commission (ARC) Report submitted in 1968 also recommended the adoption of performance budgeting. In 1968, the Central Government agreed to accept the recommendations. In 1977-78 about 38 Development Department in the central Government adopted performance budgeting. Subsequently, several states government has also introduced it in their selected departments.

**Meaning:** The term ‘Performance Budgeting’ is known by different names. Earlier it was called ‘functional budgeting’ or ‘activity budgeting’. The most popular and extensively used term is ‘programme budgeting’. The meaning of the performance budgeting becomes clear from the following definitions:

1. The Indian Administrative Reforms Commission (ARC) defines a performance budget as, *“a technique for presenting government operation in terms of functions, programmes, activities and projects.*”
2. The Mayor Committee of New York chooses the term ‘programme budget’ for ‘performance budget’. In the words of this Committee, “*A programme budget tells in advance what activities the Department and Government as whole are authorized to carry forward in terms of expenditure for a given year.”* It emphases on the work to be done.
3. The meaning of performance budgeting becomes very clear from the definition of Burkhead. He says, “*performance budgeting can be most appropriately associated with a budget classification that emphasis the things which Government does, rather than the things which government buys. Performance budgeting shifts the emphasis from the means of accomplishment to the accomplishment itself.”*
4. The Hoover Commission of the USA also explains the concept lucidly in the words as, “the whole budgetary concept should be refashioned by the adoption of budget based on functions, activities and projects, this we designate as a performance budget.”

Thus, an analysis of the above definition reveals that performance budgeting is a process that seeks the implementation and control of programmes through budget allocation. It starts by analyzing the objectives of an organisation and deciding under what generally heading its expenditure can best be analysed functionally.

**Objective of performance budgeting:** The Working Group of the ARC of India stated the following primary objectives of the performance budgeting:

1. To co-relate the physical and financial aspects of every programme or activity;
2. To improve budget formulation, review and decision making at all levels of management in the government machinery;
3. To facilitate better appreciation and review by the legislature;
4. To make possible more effective performance audit;
5. To measure progress towards long term objectives as envisaged in the plan;
6. To bring annual budget and development plans closely together through a common language; and
7. To pave the way generally for an overall efficient financial management in the government.

**Important characteristics:** Following are some of the important characteristics of performance budget:

1. It represents the major purpose for which funds are allocated and sets measurable objectives.
2. Performance budgeting tends to focus on changes in funding rather than on the amount appropriated for the previous budget cycle.
3. Performance budgeting mainly emphasis on the results to be accomplished.
4. Performance budget presents greater managerial suppleness by providing the program or department manager a fixed lump sum distribution that may be used for various needs in order to accomplish the agreed upon results in service delivery.
5. It identifies programs and agencies that are seeking similar outcomes, thereby drawing such inter-relationship to the legislature’s attention.
6. Performance budgeting tries to resolve issues related to decision making problems.
7. Another characteristic of the performance budget procedure is the identification of the objectives of the budget management to be incorporated with overall responsibility, so that good budgetary performance is compensated and impose restriction for poor performance.

**Categories of Performance Budgeting:**

There are four main categories of performance budgeting. They are-

1. Performance reporting budgeting: It provides performance information as part of the budget documentation, but budgetary players do not use it for recourse allocation.
2. Performance informed budgeting: This is another type of budgeting process that take program performance into account, but uses the information only as minor factor in decision making.
3. Performance based budgeting: This means that performance information has vital role in resource allocation, but does not assess the amount of resource allocated.
4. Performance determined budgeting: In this budgeting procedure allocation of resources directly and explicitly related to units of performance.

**Stages of performance budgeting:** The implementation of performance budgeting involves the following important steps:

1. Establishing a meaningful functional programme and activity and classification of government operations (for example education is a classification and elementary education is a programme, training of elementary teachers is an activity and the construction of a school to impart educational service is a project).
2. Bringing the system of accounting and financial management in accordance with the classification made.
3. Estimating the quality of physical resources like personnel materials, services etc.
4. Developing standard norms for work units of performance and unit costs.

**Factors in performance budgeting:** The success of performance budgeting is conditioned by a number of factors. Some of them are:

1. Development of suitable yardsticks, for an objective measurement of work and performance.
2. The setting up of a system of reporting on the progress of each activity or programme. Such a system should be established in each government department to monitor the work performance.
3. The development of an appropriate and scientific accounting system is another prerequisite for the successful functioning of performance budget. For this there should be a proper integration of budgeting and accounting classification.
4. Another requirement for the success of performance budgeting is the proper classification of public expenditure of each major activity or project, and
5. Above all, an efficient organisation for programme management is also needed to take full advantage of the benefit of performance budgeting.

Thus, performance budgeting is a tool, which ensures, efficiency in government financial operation. In modern times performance budgeting is recognized as an efficient tool of fiscal management. Performance budgeting is rather a fiscal tool to review the efficiency of existing operations and provides vital information for planning future operations. It provides a sense of accountability and transparency in government expenditure programmes.

**Merits (advantages):** A performance budget becomes a very sensitive tool of planning control management. The most important advantages of performance budgeting is as follows:

1. It can be judged from a performance budget what was done in the previous year and what cost both unit wise and programme wise.
2. Performance budgeting renders performance audit more purposeful and effective. Performance budget helps a better understanding and review of the budget by the legislature.
3. It makes control and policy making more meaningful and makes budget more informative and understandable to the tax payer.
4. By performance budgeting, we can fix the responsibility very precisely. From this budget one knows very clearly who is responsible for what.
5. A performance budget provides a clear and true picture of spending and revenue alternatives.
6. A performance budget presents more clearly the purpose and objectives for which the funds are sought.
7. Performance budgeting serve as a convenient tool of management. Because it helps administrators to prepare their budget on the basis of what they hope to accomplish.
8. Performance budgeting is an excellent instrument for translating long-term programmes and plans into reality.
9. It is a better means to exercise control over Financial Administration.

**Disadvantages:** According to ARC, the performance budgeting has some limitations or demerits. They are-

1. Performance budgeting enables only a quantitative and financial evaluation of programmes and activities. It fails to facilitate qualitative evaluation.
2. The usefulness of the measuring technique of performance budget is somewhat limited in respect of activities that are not measurable in any precise manner such as research, law and order, defense etc.,
3. The success of performance budgeting depends upon well organised departments and agencies identified with programmes and activities. However, precise categories of functions and corresponding to organizational units are rather difficult to achieve.
4. Performance budget provides no remedy for the administrative deficiency in the budget process. It has no panacea for administrative and organizational short-budgeting.
5. Performance budgeting has limitations particularly in the context of developing countries where there is no co-relation between inputs and outputs, setting of targets and measuring of performance is not very rational.

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