ZERO-BASED BUDGETING

City of Houston Implementation Plan for FY2021

Mayor Sylvester Turner

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CITY OF HOUSTON

Sylvester Turner

Mayor

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To: Mayor Sylvester Turner
City Council Members

Date: October 31, 2019

Subject: Zero-Based Budgeting (ZBB) Implementation Plan for FY2021 Budget

Message from the Finance Director

This is to report the City of Houston's plan for implementing a zero-based budgeting process for Fiscal Year 2021, in accordance with the Budget Amendment 1.02. In preparation for this report, we researched literature from reputable sources for best practices, primarily from the Government Financial Officers Association. In addition, we reviewed other public sector organization's experience with ZBB including a conference call with the City of San Diego.

Theory of ZBB, its benefits and challenges as well as other alternative budgeting methods and best practices are included in this report – in order to develop the plan to implement zero-based budgeting in FY2021 for the City of Houston.

It is the City's goal to improve our financial transparency and accountability for the City of Houston as emphasized in the Mayor's Executive Order 1-53. Based on our experience with the ZBB process for Fiscal Year 2021, the Administration will make recommendations for a long-term solution to the budget process.

Sincerely,

DocuSigned by:
Tantri Emo
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Tantri Emo
Finance Director/Chief Business Officer

Council Members: Brenda Stardig Jerry Davis Ellen R. Cohen Dwight A. Boykins Dave Martin Steve Le Greg Travis Karla Cisneros
Robert Gallegos Mike Laster Martha Castex-Tatum Mike Knox David W. Robinson Michael Kubosh Amanda Edwards Jack Christie
Controller: Chris Brown

Disclaimer

The information contained within this document are intended to educate the reader on the zero-based budgeting process and the City's plan to implement for Fiscal Year 2021. The implementation steps and dates are not binding and are subject to change.

Overview

In September 2016, the City had engaged with PFM Consulting to address the financial challenges Houston faced for our long-term plan for fiscal sustainability and developed the Ten-Year Financial Plan for the City of Houston. One of the action plans that was included in the report is the continuing plan for Budgeting-For-Outcome (BFO), which supported Mayor's Executive Order 1-53 to improve financial transparency and accountability for the City of Houston while moving to eliminate the cycle of budget shortfalls.

BFO, successfully implemented in other cities, sets clear priorities and regularly monitors data to determine whether the City is meeting its set goals and allocates resources in a far more targeted way. This method of budgeting encourages cross-department collaboration and collaboration with non-City entities. However, based on PFM's report, the change in approach also requires a change in mechanics. Most budgeting systems are based on accounting at the department, division and unit level – which City of Houston currently uses. Outcome-based budgeting or BFO, frequently leads to changes that go across budget codes and across departments. Based on that requirement, and in collaboration with the Houston Information Technology Services (HITS) Department, capital funding for BFO was subsequently included in the FY2017-FY2021 Capital Improvement Plan. However, with the occurrence of Hurricane Harvey in August 2017, shifts were made to the CIP plan to prioritize Harvey recovery projects. The BFO budgeting system is currently planned for FY2020/FY2021 as stated in the FY2020-FY2024 Capital Improvement Plan.

Budget Amendment

As the City continues to face financial constraints, there is growing need for financial transparency. During the consideration of the FY2020 Adopted budget in June 2019, City Council approved Budget Amendment 1.02 which states:

> *"All City departments shall adopt a zero-based budgeting method for Fiscal Year 2021 only. Traditional incremental budgeting is based on the assumption that the "baseline" is automatically approved. By contrast, zero-based budgeting starts from a "zero base," and every function within an organization is analyzed for its needs and costs. Budgets are then built around what is needed for the upcoming period. A report from the Administration shall be delivered to Council on plans for implementation of FY21 zero-based budgeting by November 1, 2019."*

In accordance with this budget amendment, this document represents the research and recommendations for developing a Zero-Based Budgeting (ZBB) approach for the FY2021 budget cycle. One of the most comprehensive studies of ZBB for government municipalities, is a research paper published by the Government Financial Officers Association (GFOA) in 2011 titled:" Zero-Based Budgeting: Modern Experiences and Current Perspectives." (Kavanagh, 2011)[1] GFOA surveyed their

[1] https://www.gfoa.org/sites/default/files/GFOAZeroBasedBudgeting.pdf

participants and received a high response (413). Much of the information in this report is derived from this GFOA study along with our interviews of other municipalities.

What is ZBB?

ZBB is a budgeting process that requires building a budget from the ground up starting from zero. All expenses most be justified for each new budget cycle. According to GFOA, ZBB promises to move an organization away from incremental budgeting, where last year's budget is the starting point. Instead, the starting point becomes zero, with the implication that past patterns of spending are no longer taken as a guarantee.

In implementing ZBB, the organization is first divided up into "decision units" as the lowest level at which budget decisions are made. In theory, managers in each decision unit then prepare a detailed description and evaluation of all activities it performs, including alternatives to current service delivery methods and the spending plans necessary to achieve the decision unit's goals. A number of "decision packages" are then created, forwarded, and reviewed. Based on available revenues, these decision packages are recommended to the board in order to reach a balanced budget. Exhibit 1 below demonstrates textbook ZBB steps.

Exhibit 1

One very important finding from the GFOA research is that textbook ZBB or ZBB systems that conform to the theoretical ideal are almost unheard of in present day financial management. Most of the organizations borrow elements of ZBB and implement into their budgeting process.

History of ZBB

According to research, ZBB dates back to the 1970s, when U.S. President Jimmy Carter promised to reform the federal budgeting system by starting from zero and making each organization justify their budget instead of incremental adjustments. However, interest in ZBB began to decline due to the large amount of paperwork and time required for the process. Additionally, economic conditions began to improve in the late 80s and 90s.

In recent years, the recommended best practice for governmental budgeting is more of a performance or outcome-based budget approach. Budgeting for results and outcomes links strategic planning, long-range financial planning, performance measures, budgeting and evaluation. It also links resources to objectives at the beginning of the budgetary process, so that the primary focus is on outcomes rather than organization structure.

Types of ZBB

According to the GFOA's case study research and survey, those describing themselves as using ZBB tend to fall into one of two major categories.

1. **Zero Line-item Budgeting** - which focuses on determining if inputs (personnel, dollars) are reasonable, given the expected output. In this method of ZBB, departments receive a blank budget request form with zeros filled in for each line item, instead of last year's budget or actual expenditures as the starting point. Departments then build their budget from the ground up justifying every line item. These request and justifications are sent to central budget where they are reviewed. Request are often accompanied by service goals for the expected output.

   This form of budgeting improves cost awareness and increases the number of in-depth discussions between budget authorities and departments about how the money is spent.

   GFOA concluded the following about zero line-item budgeting:

   - Changes the discussion about cost
   - Helpful for reallocating funding within a department
   - There are efficiency gains, but it's not systematic
   - Managers are engaged
   - Encourages more centralized control
   - More suited for smaller governments
   - Does not fully address service levels

2. **Service-level Budgeting** – which presents decision makers with different service levels and asks them to choose, thus focusing on what level of service a department should provide. This method of ZBB, focuses on the decision package feature with less attention given to the detailed estimate inputs found in zero line-item budgeting. Decision units are formed along functional or organizational lines. For example, a division within a department would be a decision unit and would be responsible for developing detailed decision packages for the programs/services they oversee.

   There are three categories of decision packages, as listed below. More than one decision package could be presented for each category as described in Exhibit 2.

Exhibit 2

Service Level	*Description*
Base Package	This is the minimal level of funding required to meet only the fundamental services to remain viable.
Current Service Package	This type describes what it takes to continue the level of service currently provided.
Enhanced Package	This category addresses resources required to expand services beyond current levels.

GFOA concluded the following about service-level budgeting:

- Decision-packages have to provide detailed service level
- Articulating service levels may be difficult
- It is paperwork intensive
- Include revenue impacts in decision-making process
- Efficiency is not addressed directly
- Good performance data is helpful to getting the most of the process
- Makes implications of cutback decisions clear
- Often connected to strategic planning

Pros & Cons

There are several advantages and disadvantages to the ZBB methods as listed below. Based on our review of available literature, the theoretical ZBB is very rare in practice. However, several jurisdictions had used the 'concepts' of ZBB in their budgeting process.

Advantages:

- Moves organizations away from incremental budgeting
- Rationalizes budget cuts
- Makes the trade-offs between inputs and outputs more transparent
- Can be used to centralize budget decision-making
- Can be effective for re-allocating resources within the department

Disadvantages:

- More time consuming than incremental budgeting
- Managerially driven
- More effective when good performance measures are in place
- Paperwork intensive
- Does not address alternative service delivery
- Does not address efficiency of services

ZBB in Practice

As part of our research in implementing ZBB, in addition to reviewing available literatures, we also reached out to several cities to learn about their experiences with this budget process. One of the most informative discussions we had was with the City of San Diego on their pilot ZBB process. Below is a re-cap of their experience:

Background:

In Fiscal Year 2017, the City of San Diego implemented a ZBB pilot process for two departments, Performance Analytics (P&A) and Facilities. They chose to use a more programmatic form of ZBB similar to the service line-item process. The ZBB pilot process involved manual data collection due to the budget and financial system not being structured for program-based budgeting but rather structured by organizational units. This structure is similar to that of the City of Houston. This data included department, division, program, activity, and service summaries. P&A and Facilities thoroughly examined each program, activity, or service budget need and prioritized them by decision packages. The ZBB pilot process required P&A and Facilities to develop the following as part of their decision package submissions:

- Supporting documentation in each decision package
- Expected service-level results
- Narrative describing impact of the decision package
- Prioritization of the decision packages

Benefits:

According to the City of San Diego's budget team, one of the primary benefits identified in the ZBB pilot process was the detailed insight into services and programs performed by the two departments. It provided decision makers with a better understanding of the core services of those departments compared to the incremental process.

Challenges:

The ZBB process requires more than starting from zero. One of the biggest challenges the City of San Diego encountered is that their financial system is not designed to handle the ZBB process. All ZBB data was collected outside of the budget system in a manual, spreadsheet-based process. System integration of ZBB would require a significant amount of resources (e.g. staff time and cost to explore and implement a software solution). It was also difficult to collect data from departments and train them on the process. Additionally, without a strong performance management structure, it is difficult for a department to know exactly where to allocate or reduce.

Future Considerations

After concluding the FY2017 budget cycle, the City of San Diego decided not to pursue the ZBB process going forward. They determined that there is currently insufficient capacity to effectively implement the process. As reflected in the analysis of staff time, the level of effort and resources needed to replicate ZBB for an entire department (or large division) is sizeable without anticipated costs savings to justify the effort. Additionally, they determined that the process would be costly and a huge strain on existing resources.

City of Houston - Implementation Plan

Budget Overview

City of Houston is the nation's fourth most populous City with approximately 2.3 million residents. In FY2020, the total citywide operating budget of $5.5 billion, comprised of multiple funds i.e. General Fund, Special Funds, and Enterprise Funds.

General Fund makes up the largest portion of the City's budget. The source of funds in General Fund includes property and sales taxes, franchise fees, licenses and permits, charges for services and other miscellaneous sources. The available funds are used to pay for the City's operations to accomplish its goals and priorities that includes public safety, services & infrastructure, complete communities and sound financial management. There are twenty-three departments that are funded in General Fund.

Scope:

The ZBB implementation for FY2021 budget cycle will be focus on ***General Fund*** only.

Below is a list of departments and elected offices that will follow the ZBB process:

Administration and Regulatory Affairs
City Controller
City Council
City Secretary
Department of Neighborhoods
Finance Department
Fire Department
General Services
Housing & Community Development
Houston Emergency Center
Houston Health Department
Houston Information Technology Services
Houston Public Works
Human Resources
Legal
Library
Mayor's Office
Municipal Courts Department
Office of Business Opportunity
Parks and Recreation
Planning & Development
Police Department
Solid Waste Management

Approach & Methodology:

Based on the GFOA research and the City of Houston's financial organizational structure, the Administration recommends implementing a "zero line-item budgeting" approach that will incorporate some aspects of "service level" principals for the FY2021 budget.

This approach will add additional time to Houston's budget process, but it would be the most practical approach.

Implementation plan for FY2021 Budget:

Step 1

Establish City Priorities

Step 2

Departments will receive a blank budget form with zeros filled in for FY2021

Step 3

Departments will need to determine core services within their current cost center structure

Step 4

Finance will provide departments with cost drivers

Step 5

Departments will build decision packages

Step 6

Finance will estimate the available resources

Step 7

Available resources will be allocated to decision packages

Step Details:

Step 1 – Establish City Priorities

- Priorities set the foundation for what is important to the City and its citizens. Resource allocation should be based on those priorities.

Step 2 - Departments will receive a blank budget form with zeros filled in for FY2021

- Instead of receiving a target that starts with last year's budget as the base, departments will receive a blank template with zeros filled in for FY2021. Line-item justification will be compared to the average 3-year actual spend and not last year's budget. Departments will also have to link service contracts to line-items.

Step 3 - Departments will determine core services within their current cost center structure

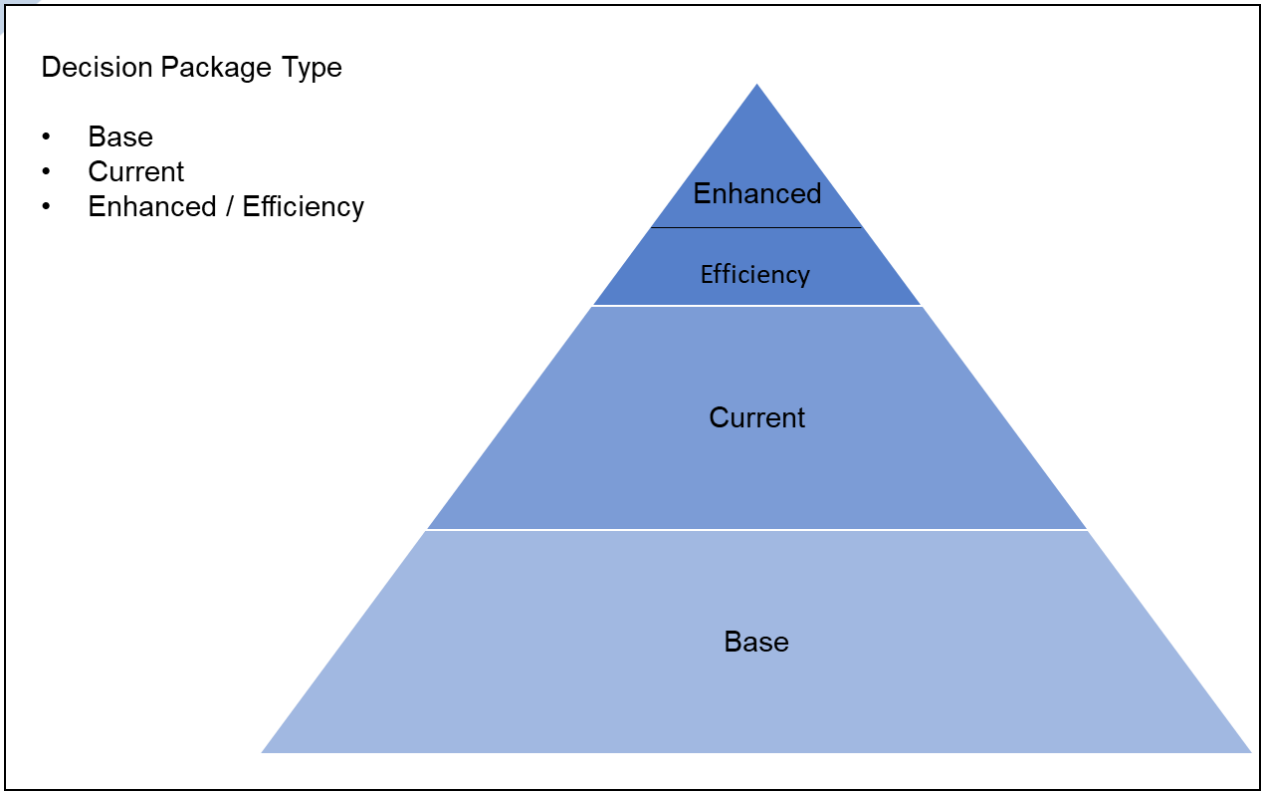
- This step will potentially be the most time consuming. Our current budgeting process is based on organizational structure (e.g. fund, business area, division, cost center) and not services and programs. Budgeting by services and programs is not currently supported by our financial system which will create a lot of manual work in spreadsheets to accomplish.

Step 4 - Finance will provide departments with cost drivers

- There are certain calculations that Finance will have to provide departments in order to build their budget. These cost drivers include fringe benefit rates, employee union pay increase percentages and restricted account estimates (i.e. electricity cost, fuel, IT related cost, etc.). This will require service chargeback departments to build their budget earlier than the normal budget cycle and coordinate with departments on their needs.

Step 5 – Departments will build decision packages

- In this step, departments will build their decision packages. Each decision package must include:
    - Description of services/programs
    - Supporting documentation
    - Performance measures
    - Should be prioritized
- Each decision package will be broken down in to 3 sections.
    1. Base Level Package - This level includes the department's core services that are mandatory. These are services that are established by local, state, or federal authorities.
    2. Current Level Package –Built onto the base level package and combined should represent all current services provided.
    3. Enhanced/Efficiency – Built onto the current level and represents expanding current service levels or finding efficiencies and savings from current level.



Step 6 – **Finance will estimate the available resources**.

- In this step, Finance will determine how much money is available by forecasting the estimated funding sources for FY2021. The primary sources of funds include property and sales taxes, franchise fees, licenses and permits, charges for services and other miscellaneous sources. This does not include any one-time land sales.

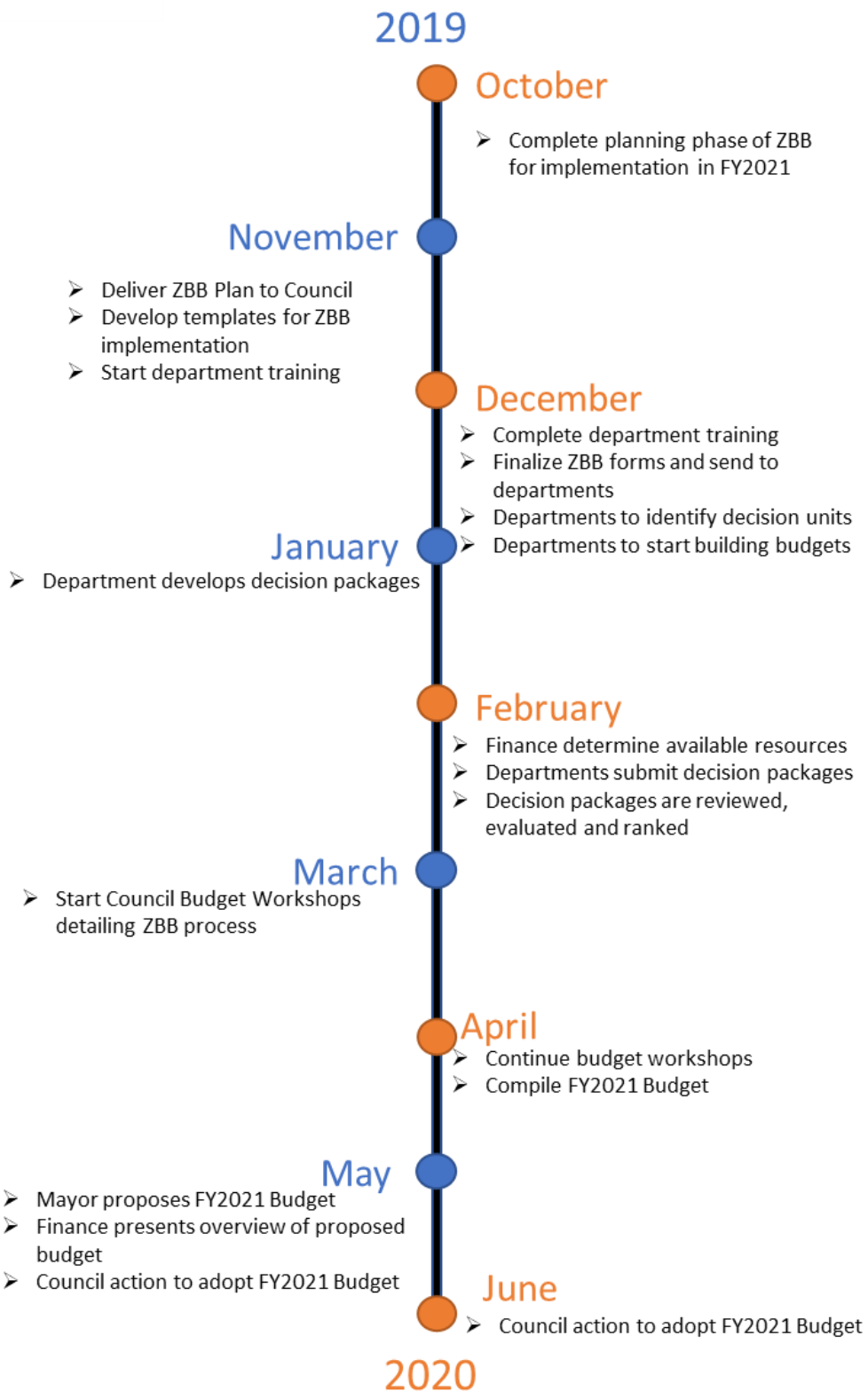
Step 7 – **Allocate available resources.**

- In this step, funding decision are made. The allocation of funds is based on the ranking of decision packages.

Timeline:

ZBB is a time-consuming process and the City will have to modify our typical budget time-line to accommodate implementation for FY2021. See Exhibit 3 for estimated timeline (note subject to change).

Exhibit 3



* Note – Dates are subject to change.

Alternative Budget Process

In addition to ZBB and incremental budgeting there are other alternative budget processes. In recent years more governments are shifting focus to a priority-based budget. According to GFOA this is one of the fastest growing types of budgeting reform and their recommended best practice for budgeting. Priority budgeting or Outcome Based Budgeting (OBB) is a process where governments first determine how much revenue it has available and then allocate those resources to the community priorities rather than the departments.

In 2017, the City of Houston begin laying the foundation for outcome-based budgeting. Finance lead workshops with City departments to discuss the concepts and principals of OBB. Unfortunately, Hurricane Harvey stalled progress and increased the strain on the limited resources available. The plan remains to explore transitioning the City to a performance-based budget.

Conclusion

As required by Budget Amendment 1.02 and detailed in this document, the City of Houston will implement ZBB for all General Fund Departments as part of the FY2021 budget process. With any budget process there are advantages and disadvantages. Based on our experience with the ZBB process for Fiscal Year 2021, the Administration will make recommendations for a long-term solution to the budget process.