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Zero-Based Budgeting:
Zero or Hero?

Introduction

For many organizations, the thought of rebuilding the company budget from the ground up can be nightmare-inducing. Wiping the financial slate clean and starting from scratch would be a last resort in a worst-case scenario, never an option to be considered under normal circumstances. Yet starting around 2008, an increasing number of organizations chose to do exactly that. Faced with an economic recession, both public and private corporations began to turn towards an extreme method of budgeting known as "Zero-Based Budgeting," or ZBB.

ZBB is a budgeting process that allocates funding based on program efficiency and necessity rather than budget history.[1] As opposed to traditional budgeting, no item is automatically included in the next budget.[2] In ZBB, budgeters review every program and expenditure at the beginning of each budget cycle and must justify each line item in order to receive funding. Budgeters can apply ZBB to any type of cost: capital expenditures; operating expenses; sales, general, and administrative costs; marketing costs; variable distribution; or cost of goods sold.[3] When successful, ZBB produces radical savings and liberates organizations from entrenched departments and methodologies.[4] When unsuccessful, the costs to an organization can be considerable.

Fig. 1: Explaining Zero-Based Budgeting (ZBB)[5]

Budgets are not connected to prior year spending

- Prevents "embedding" of existing spend in the cost base
- Allows spending levels to be set based on necessary activities of a function, rather than historical trends
- Requires more work to understand activities and cost structure

Spending increases or cuts are not simply spread evenly across budgets

- Eliminates common "sandbagging" practices in budgeting process
- Allows for more strategic allocation of planned spend
- Requires more work to analyze and prioritize activities and expenditures

Budgets are tied to specific activities and levels of service

- Better aligns spending targets with required activities of a function
- Replaces "do more with less" with "do the right things with the right amount"
- Requires fairly detailed knowledge of departmental activities and willingness to do less or discontinue activities

Funding is targeted more to activities that align with the strategy

- Allows for better alignment of expenditure with overall strategy and departmental missions
- Can reduce incidence of "we've always done that"
- Prioritizing activities across various functions can be challenging

Though the private sector uses ZBB,[6] ZBB first rose to prominence in government during the 1970s financial crisis. Faced with mounting public pressure, U.S. President Jimmy Carter promised to balance the federal budget and reform the federal budgeting system using ZBB, which he had used while governor of Georgia. Though initially well received, ZBB proved not only complicated and time consuming, but also ineffectual,[7] as it was Congress and the executive branch that were ultimately responsible for deciding whether to keep or eliminate a program.[8] Additionally, the president's budget office used a variant of ZBB as agencies were asked to rank their programs within funding limits.

This forced the agencies to assign priorities and identify possible reductions. However, this meant that rather than starting from a true zero base as ZBB would suggest, the agencies would start from a "priority base" (e.g., 80-85% of the current year).[9] President Reagan abandoned the system after his election in 1980.[10] Since then, ZBB's use in both the public and private sectors has been limited due to its high level of complexity and large requisite investment that can hinder its execution.

Explaining Rising Popularity

ZBB has recently experienced a resurgence of interest in both the public and private sectors. In the public sector, this stems largely from contemporary fiscal constraints precipitated by the 2008 recession. Facing budget cuts and increased public scrutiny, government agencies have been using alternative budgeting methods such as ZBB instead of more traditional budgeting methods such as line-item and incremental budgeting.[11] A survey by the Government Finance Officer Association (GFOA) shows that over 20% of respondents are using ZBB or ZBB components, which represents a 50% increase compared to the period just before the 2008 recession.[12]

Though cost reduction is a historically common tactic for private corporations seeking to free capital for investment in growth opportunities, restrictive budgeting practices have also witnessed an uptick in the private sector. For the 85% of CFOs who report above average levels of volatility and uncertainty since the 2008 recession,[13] restrictive budgeting, including ZBB and its components, represents an opportunity to mitigate risks by using aggressive cost reduction to support growth[14] while reassessing both short- and long-term strategies.[15]

Potential Benefits

For organizations looking to grow by releasing capital through improved cost management, ZBB offers appealing possibilities for reducing costs while bringing additional value in the form of operational efficiency. In a best case scenario, ZBB may reduce SG&A costs by 10 - 25% within six months.[16] The potential impact can be especially pronounced in the public sector, where ZBB could theoretically encourage Congress to only pay for necessary and efficient programs as opposed to sanctioning automatic increases in government spending.[17]

This could be especially insightful when applied to programs and agencies that claim the biggest portions of government funding. For instance, while defense spending for 2016 was originally set at $523 billion, Congressional support for additional spending increases will bring total defense funding for that year to $619 billion.[18] This $96 billion increase will occur on top of the previous budget, without adjustment for any previous fluctuation in needs or priorities. If government agencies were to actively seek an accurate base budget before spending increases were applied, additional funding could be allocated more effectively and efficiently.

Additionally, by forcing agencies and lawmakers to actively prioritize each program, ZBB could increase organizational efficiency by encouraging stakeholders to work together to analyze operations.[19] In turn, this forces cost centers to identify their mission and priorities,[20] which helps align resource allocations with strategic goals.[21] Furthermore, by creating a budget and baseline from zero, government agencies would benefit from perceived increases in transparency and accountability both internally within their organization and externally with the public.[22]

The private sector can benefit in the same ways.[23] ZBB can help companies confront conventional thinking and resource allocations by challenging every line item and assumption. In the case of organizations that are overly complex due to mergers or acquisitions, ZBB can be especially useful. Leading global companies are currently implementing ZBB across their entire organizations to support aggressive savings strategies.[24] The private equity firm 3G has consistently used the same zero-based approach on its acquired companies, most recently with AB InBev and Heinz. In both cases, this was one of the first strategies implemented by the private equity firm: a radical change to their budgeting process with the goal of delivering and retaining significant savings.[25]

3G has continued to hit the spotlight in recent months with large deal announcements as well as its aggressive use of ZBB. In the case of Heinz, 3G moved to close plants across the country and eliminated more than 1,000 jobs.[26] Furthermore, "Unlike with typical private-equity firms, 3G's founders like to invest for longer than the standard five-to-seven-year time frame,"[27] which allows for a more systematic implementation of ZBB.

Fig. 2: Advantages and Disadvantages of ZBB[28]

Zero-Based Budgeting

Advantages

- Resulting budget is well justified and aligned to strategy
- Catalyzes broader collaboration across the organization
- Supports cost reduction by avoiding automatic budget increases, often resulting in savings
- Improves operational efficiency by rigorous challenging of assumptions

Disadvantages

- Costly, complex, and time consuming as budget is rebuilt from scratch annually, whereas simpler and faster traditional budgeting requires justification only for incremental changes
- May be cost-prohibitive for organizations with limited funding
- Risky when potential savings are uncertain
- Execution challenged by budget cycle timing constraints
- Typically requires specialized training or personnel to accomplish, and requires more resources in general
- May be disruptive to the organization's operations
- Could harm organizational culture or brand

Challenges and Risks

ZBB presents an opportunity for organizations to cut costs and improve quantitative and qualitative aspects of operations, but completing a full ZBB cycle can be both challenging and risky for most organizations. Prioritizing program needs can be threatening to some managers,[29] and can prove problematic for departments with intangible outputs. Most significantly, the process itself is costly, complex, and time consuming.[30] Especially compared to traditional budgeting, ZBB requires extra time and specialized training, both of which represent added costs to an organization that may already be pressed for resources.

Using ZBB may pose a risk to a company's brand. While ZBB in and of itself will not necessarily harm a company's brand, implementing ZBB can pose risks to customer experience and a company's ability to price at a premium. For organizations that depend on high levels of service to maintain brand and premium pricing, pivoting to a more cost-restrictive approach could cause an unintended culture shift by changing attitudes towards cost. The new cost mindset could undermine or prohibit the very enablers of the organization's former brand prestige and pricing power. Cutting costs deemed non-core to a company's operations that are in fact core to its customers' experience could harm the brand and backfire.

For the public sector in particular, it can be difficult to scrutinize all of an organization's programs within the time constraints of a budget cycle. Government agencies that use ZBB tend to pull staff/resources off of their day-to-day activities, or give them double duty to support ZBB activities. This can make an already complex process even more challenging, especially when coupled with learning how to conduct ZBB on the fly. Also, agencies often already have established processes for conducting regular program effectiveness reviews on a periodic basis (e.g. quarterly, annually, or tied to certain milestones in a program). In these instances, ZBB can be disruptive, potentially to a prohibitive degree.

In response to these challenges and constraints, both private corporations and federal agencies can and do mitigate the risks of a full ZBB cycle by adopting aspects of ZBB on a select function basis.[31] In the public sector, having a team comprised of consultants, advisors, and government personnel can accelerate the ZBB process by breaking down barriers, translating program-related information, and gathering data. The ZBB process can also be optimized by leveraging the established processes for the regular program reviews a government agency already conducts. For example, agencies can add a ZBB component to annual or periodic program reviews instead of performing a separate review.

Another way private corporations and federal agencies can utilize ZBB is choosing to use only components of ZBB (such as requesting priority packages for executive evaluation) or applying ZBB irregularly or only in select departments.[32] Adopting specific aspects of ZBB that are advantageous to an individual organization can position companies and agencies to benefit immediately from restrictive budgeting practices without suffering from the potential consequences of applying a budgeting model that is partially unsuited to their needs. Cherry-picking components, however, can result in a watered-down version of ZBB that has more in common with traditional budgeting than with a full cycle of zero-based budgeting. At this point, the conversation is no longer about ZBB, but about general budgeting best practices.

Fig. 3: Advantages and Disadvantages of ZBB Based on Type of Organization

Public Sector	**Private Sector**
Advantages	
• Supports cost reduction by encouraging active resource allocation over automatic budget increases • Increases organizational efficiency by forcing government agencies to work together in order to actively prioritize programs • Improves alignment of resource allocations with strategic goals by forcing cost centers to identify their mission and priorities • Improves public perception through perceived increases in transparency and accountability, both internally within their organization and externally with the public	• Supports cost reduction by encouraging active resource allocation over automatic budget increases • Improves operational efficiency by challenging assumptions at every level, especially for organizations that are overly complex (for example, due to a merger or acquisition) • Supports implementation of aggressive saving strategies by identifying priorities at the department or project level
Disadvantages	
• The ZBB process is costly, complex, and time consuming • Implementing ZBB at all can be a major challenge for public-sector organizations with limited funding, and can constitute a major risk when potential cost is high and potential savings are uncertain • Government agencies may face extreme constraints relating to their ability to complete ZBB within a budget cycle and the availability of personnel to drive the process internally • Prioritization process may be problematic for departments with intangible outputs	• The ZBB process is costly, complex, and time consuming, • Implementing ZBB can be a risk for corporations when the potential cost is high and potential savings are uncertain • Adopting ZBB can have unintended consequences on company culture and brand in the marketplace

Assessing Suitability

For these reasons, only particular organizations stand to benefit from ZBB, and only a very small minority should consider a full ZBB cycle. In the public sector, an agency should require significant savings in order to justify the full process, and must have the resources up front to invest in the process initially. Additionally, even if an organization is able to fund the process initially, agencies in the public sector in particular may find they are not able to follow through with the resulting recommendations, exposing themselves to the risk of low or no return on investment.

For example, government agencies typically spend the largest portion of their budget on personnel, yet it is very difficult to conduct personnel reductions in force due to political influence and pressure from government officials and Congress. Also, the rules for voluntary early separation or retirement often prohibit targeting specific employee groups for buy-outs. These conditions make ZBB difficult to execute in the government because it reduces the number of levers available to reduce costs quickly and strategically. Lastly, government agencies are unlikely to benefit from an annual complete ZBB process, as returns would decrease significantly each subsequent year compared to initial savings. For smaller agencies and non-profit organizations, adopting ZBB practices on a select function basis is more common and practical[33] because it allows them to target areas of need and invest limited resources towards a specific outcome at custom intervals.

For the private sector, adoption criteria are more flexible because companies are not faced with the same constraints as federal agencies. This is evidenced by companies who have successfully adopted ZBB budgeting practices, including Texas Instruments (which pioneered ZBB in the private sector), and Xerox.[34] In response to pressure to reduce spending and increase performance (increased revenue and market share), several companies have implemented ZBB programs. These programs, along with budget cuts in business units, ultimately increased profit for these companies by as much as 60%.[35]

Critically, what worked for these companies would not necessarily work for other corporations, nor would it likely be effective in the public sector. More so than federal agencies, private corporations can afford the costs associated with implementing degrees of ZBB when and where it's needed. Furthermore, ZBB was ultimately considered successful for these companies because it grew profits by increasing revenue, criteria which may not translate directly to the public sector. For these reasons, traditional budgeting still dominates public sector organizations, as well as companies that can't afford to implement ZBB. According to a 2012 survey of budgeting and forecasting, 41% of respondents used traditional budgeting (which is defined by incremental additions to last year's financial numbers based on qualitative arguments), while 34% used a mixed budgeting approach that may have included ZBB components.[36]

Conclusion

Despite increasing popularity and interest, comprehensive ZBB cycles are not a cost-effective option for most organizations in either the public or private sectors. However, ZBB components and theory may be useful in specific sectors under specific circumstances.[37] Although the economic environment has driven renewed interest in ZBB, more practical and less costly budgeting alternatives are available that can meet organizational needs. For example, organizations can examine alternative activities, methods, and technologies that may be less costly, focuses more on the underlying cost drivers, and are more effective at enabling strategy. Organizational needs rarely merit a full ZBB exercise[38] and improvement can be made without going to extremes.

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