Chapter III

The Uses of Cost Information in Government

Cost information has as wide a variety of potential uses in government as it has in the private sector, where cost data is used as the basis for a majority of management decisions. Knowledge about costs is an essential ingredient in effective decision-making and contributes to improved planning, implementation, and analysis of every aspect of endeavor. Cost analysis provides a tool for understanding what services are being provided; what they cost; why they cost what they do; and what can, and should, be changed.

A Lesson from the Private Sector

Much of the discussion in the public sector about accounting issues has as a “background” assumption the idea that the accounting records in a jurisdiction can be reported in only one way. Thus, one can find a great deal of discussion of whether Generally Accepted Accounting Principles (GAAP) take precedence over legal compliance requirements (typically state laws), or vice versa.

The private sector faces similar problems and resolves them very effectively by reporting the same transactions differently depending on the particular reporting requirements. The underlying reality remains the same in each case; what changes are the procedures for summarizing and reporting that reality. The same revenues and expenditures can appear very differently in reports to the Internal Revenue Service, the Securities and Exchange Commission, the company’s stock holders, and internal management.

Unfortunately, the focus in the public sector on “compliance” accounting — assurance that funds have been raised and disposed of in a legal manner — has tended to obscure the fact that the public sector needs other forms of accounting information in addition to appropriate representations of conformance with applicable charters, laws, and regulations. Cost analysis is one technique for using the financial database of a jurisdiction to develop information that addresses a government’s management needs other than assuring compliance.

Management Functions

Most management functions can be grouped by whether their focus is forward-looking, present period and near-term, or historically oriented. Strategic (long-range) planning provides an example of a management function that looks to the future. Budgeting (near-term financial planning) and controlling (guiding what is happening to guarantee the proper stewardship of resources) are primarily focused on what is happening now, while reporting (financial and programmatic) and program evaluation (assessing the degree to which a program has achieved its goals) provide information necessary to understand what happened in the past.
Whatever the time-focus of a management function, cost analysis can be a tool for improving its effectiveness, allowing a government to get better results for the same tax dollars.

### Examples of Costing Analysis Applications

Sample applications of each of the types of management functions mentioned above and examples of how cost analysis can contribute to management decisions are presented below.

<table>
<thead>
<tr>
<th>Management Function</th>
<th>Example of Management Function</th>
<th>Example of How Cost Analysis Might Contribute to Improved Decision Making</th>
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<tr>
<td>Planning</td>
<td>Outlining a multi-year course of action coordinated with established goals.</td>
<td>Estimating the likely price inflation for construction costs for the next five years in order to determine the impact of delays in starting capital construction on total project costs.</td>
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<tr>
<td>Budgeting</td>
<td>Estimating revenues, expenditures and service levels for the police department for the ensuing year.</td>
<td>Determining the cost of police recruit training for various sizes of classes and for different lengths of training periods in order to provide management with information on available alternatives.</td>
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<tr>
<td>Controlling</td>
<td>Determining that refuse collection activities are efficiently conducted.</td>
<td>Analyzing the costs of refuse collection by route to identify those routes that have atypical unit costs and to determine why these variances occur.</td>
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<td>Evaluating</td>
<td>Determining whether the performance of purchasing activities meets established goals.</td>
<td>Using cost analysis to determine the unit cost of preparing a purchase order and comparing it with the goal planned for the year.</td>
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<tr>
<td>Reporting</td>
<td>Establishing the financial or programmatic results of street sweeping activities and presenting those results to appropriate parties.</td>
<td>Determining the cost per mile of street sweeping for the last year and reporting it in the budget.</td>
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<tr>
<td>Pricing</td>
<td>Determining the total cost of providing a service and the appropriate fee or service charge to recover a pre-determined portion of the total cost.</td>
<td>Determining the correct fee for the recovering of direct costs at a recreational facility.</td>
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Cost Analysis and Policy Makers

The applications of cost analysis are not limited to meeting the needs of management. The analysis of cost data promotes understanding of government expenditures. Thus, policy makers are a prime audience for the results of cost analyses. Understanding why services cost what they do helps those setting the overall policies with respect to the generation and allocation of resources make more rational decisions. Because cost analysis focuses on services and their costs, it can translate abstract “appropriations” into concrete services with which the policy makers can deal more effectively.

One application of cost analysis specifically geared to the needs of policy makers is for the development of “fiscal notes.” A “fiscal note” is an estimate of the cost of a new service or of a policy change to an existing service prepared for use in deciding the fiscal implications of a proposed piece of legislation. Some legislative bodies routinely request that the administration provide such estimates for all proposals before the body takes any action on them. “Fiscal notes” are currently being required by the U.S. Congress and many state legislatures.

The benefits of a systematic policy of requiring estimates of future costs of new or altered programs BEFORE those programs or policies are implemented can be substantial. At a minimum, the time that it takes to conduct such a cost analysis can be used to facilitate a more reasoned deliberation during which the legislative body actually determines whether or not the proposal is in the long-term interest of the jurisdiction. In addition, in times of tight finances, knowing in advance the cost of a proposal can change what initially sounded like a good idea into a nice idea that costs too much.

Rationality and the Political Process

Claims have been made that governmental budgeting — and resource allocation decisions in general — are a purely political process on which the rule of reason has little or no impact. The distribution of political power at any moment is the complete determinant of who gets what and who pays what, or so the theory goes.

The reality of political pressure from special interest groups of every persuasion cannot be denied. Such pressure has always existed and is not likely to disappear. However, it is a distortion of government decision making processes to suggest that objective analyses, conducted in a craftsman-like manner and effectively presented, cannot influence decision makers. The impact of an impartial presentation of a reasoned study can make the difference between the hasty adoption of an ill-advised course of action or the wise stewardship of scarce public resources.

Cost analysis as a management process provides a methodology that facilitates the objective evaluation of what has occurred in the past (reporting, analyzing), what is occurring in the present (the stewardship of resources), and what might occur in the future (estimation, anticipation of events). As such, cost analysis is a tool to improve the impact of reason on decision-making.

It should be remembered that in the absence of a sound analysis of an issue, the political process will probably result in decisions based on “who” rather than on “what.” While objective analyses will not always win the day, if no attempt is made at objectivity, no result but one based on politics can be expected.
Understanding Government Expenditures

The systematic use of cost analysis has a significant benefit that is but infrequently recognized: It facilitates an understanding of what a government does and how it does it. Governments are complicated organizations that generally have evolved over long periods of time. Very often the history of how a particular service delivery system was developed has never been documented. This can result in procedures that are little understood and less than efficient.

Cost analysis offers an opportunity to understand how a service is delivered and why it costs what it costs to deliver the service. This last point — why a service costs what it costs — can assist policy makers in improving the quality of their decision-making processes. To cite but one instance, determining the cost of operating and maintaining a facility before it is built can affect the decision regarding whether or not the facility should be built. In addition, a legislative body that understands that tomorrow’s operation, maintenance and replacement costs (OM&R) can be reduced by today’s design decisions will be inclined to ask the right questions at the right time.

Cost Analysis and Management Decision Makers

Cost analysis provides management with a powerful tool for understanding the service delivery reality and for changing it in positive ways. By relating outputs to inputs, associating services delivered with their costs, cost analysis facilitates comprehensive rather than piecemeal decision-making. Management actions that are supported by facts can be both explained to the public and defended from attacks by special interest groups.

Service Charge Limitations and Cost Analysis

Since the passage of Proposition 13 in California, much attention has been devoted to Tax and Expenditure Limitations (TELS). A lesser known consequence of a number of these limitations is that many government service charges are now limited to the cost of delivering the service. Proposition 4 in California and Proposition 2 1/2 in Massachusetts, for example, require service charges to be related to the cost of providing the service.

Whether or not a government wishes to institute or raise a service charge, if the charge for the service may not exceed the cost of the service, it is incumbent on the government to be able to show that its charges for services are not in violation of the law. In this case, cost analysis is an effective method of demonstrating compliance with applicable national, state and local law.

Sharing Overhead with Enterprise Funds

In theory, an enterprise fund is asserted to be a financially independent entity which “pulls its own weight.” In reality, many enterprise funds receive a hidden subsidy in the form of free or under-priced services from the other funds of the jurisdiction. Accounting support, investment management, and data processing are but a few of the services which many governments provide to their enterprise funds possibly without recapturing the full cost. Cost analysis provides a methodology for determining the cost of delivering these and other services and thus provides a basis for an informed pricing decision.

It is appropriate to note that knowing what it costs to deliver a service does not automatically determine what an appropriate price for that service should be. Cost is only one aspect of what should be a multi-faceted decision-making process. Other factors that need to be considered in any pricing decision are the directness of the benefit received; the existence of other, nonpaying, beneficiaries; the equity of the price; and the desirability of encouraging consumption of the service. Although cost is an important factor in the pricing
decision, and one that most likely has been too lightly weighted in the public sector, even in times of great need it should not be overemphasized.

**Cost Analysis and Analysts**

Whatever the title — Budget Analyst, Personnel Analyst, Planner, Administrative Analyst, etc. — the analyst can use cost analysis as an effective technique to address a wide range of significant issues. Because it relates the cost of a service to the substance of the service delivered, a cost analysis can be used to provide an approach that associates inputs with outputs, thus allowing comparisons over time and across agencies.

Cost analysis provides an excellent diagnostic tool because it can be used to study service delivery results (unit costs) over time. Cost trends naturally raise questions whose answers can provide valuable insights into the nature of what is really happening. With insight, cost analysis can be used to identify problems before they are out of hand, thus allowing management additional time to work out solutions.

Whether it’s the analysis of variance of service costs over time, with the private sector, or with other jurisdictions; developing accurate total costs as input to a more elaborate cost/benefit analysis; or forecasting unit costs, cost analysis is the principal analytical tool available to analysts.

**Cost Analysis and Program Managers**

Program managers can use cost analysis in a variety of ways. Whether it is the need to control expenditures, the desire to increase productivity, or the value of justifying program inputs, cost analysis provides a methodology that can be used to address a wide range of problems central to the effective provision of public services.

It is important for program managers to be able to contribute their knowledge and communicate their needs to other divisions and departments within the government at a point which is early enough in the decision-making process to make a real difference. Cost analysis provides a tool by which one program manager can communicate to another program manager the consequences of decisions made by one which will affect the other.

An example of this type of cooperation might be a transit manager providing transit cost analyses to zoning and planning committees to evaluate the implications for the transit system of alternative development sites. Other things being equal, development sited along existing routes may minimize future increases in transit deficits. Development plans can have a significant impact on future transit subsidy needs. It’s a case of think now or pay later.

Cost analysis can be an effective tool for controlling costs and increasing productivity because it provides a methodology for understanding what is actually happening. A cost analysis does more than flag a problem; it provides a basis for understanding the problem and its causes. A problem that is understood is a problem that can be solved.

**When to Use Cost Analysis: A Rule of Thumb**

It is not practical to attempt a cost analysis every year on every service that a government provides; choices must be made. Because cost analysis associates effort (cost) with results (services), it is a particularly appropriate tool whenever a service shows such chronic symptoms of low productivity as:

- high overtime costs,
• substandard service performance, or
• deteriorating labor relations.

The objective of a cost analysis is to achieve an understanding of service costs that is clear and accurate plus a determination of what costs can be changed by management action. As a consequence, the basic measure of a cost analysis is the usefulness of the information it produces.

Cost analysis provides an analytical tool whose wide range of uses share a common characteristic — the use of factual cost data as a basis for informed decision making in government.