



BEST PRACTICE

Measuring the Cost of Government Service (2002) (BUDGET)

Background. Measuring the cost of government services is useful for a variety of purposes, including performance measurement and benchmarking; setting user fees and charges; privatization; competition initiatives or “managed competition”; and activity-based costing and activity-based management. The full cost of a service encompasses all direct and indirect costs related to that service. Direct costs include the salaries, wages, and benefits of employees while they are exclusively working on the delivery of the service, as well as the materials and supplies, and other associated operating costs such as utilities and rent, training and travel. Likewise, they include costs that may not be fully funded in the current period such as compensated absences, interest expense, depreciation or a use allowance, and pensions. Indirect costs include shared administrative expenses within the work unit and in one or more support functions outside the work unit (e.g., legal, finance, human resources, facilities, maintenance, technology). These shared costs should be apportioned by some systematic and rational allocation methodology and that methodology should be disclosed.

The National Advisory Council on State and Local Budgeting acknowledged the importance of measuring the cost of government services in two of its recommended practices: developing a policy on cost recovery through fees and charges (4.2) and assessing how a service could be alternatively provided more efficiently (6.1). Several factors must be considered to ensure that cost data are used appropriately.

Recommendation. The Government Finance Officers Association (GFOA) recommends that governments calculate the full cost of the different services they provide.

Cost data can be extremely useful in identifying situations where a government should explore alternative service delivery options. Still, cost should not be the sole factor used to determine how a government will provide services. Efficiency and effectiveness also should be essential components of any service-delivery decision.

It is important that full cost data be used appropriately in decision making. For example, in considering privatization or other forms of external competition, a jurisdiction should distinguish avoidable costs from unavoidable costs, because only the former are relevant to a privatization decision. The concept of avoidable cost, for this purpose, encompasses not only those costs that can be eliminated immediately, but also costs that can be eliminated after a transition period. Furthermore, decisions involving privatization or other forms of external competition should take into account the cost of transition, as well as any monitoring or oversight costs that are expected to result from a change in service provider. Offsetting revenues are also a factor to be considered.

Care must be taken when comparing full cost information between governments to ensure that such comparisons are valid. The use of historical cost depreciation, for example, may significantly distort the costs reported for capital-intensive activities. For instance, activities using older assets may appear more efficient than activities that use newer assets.

Furthermore, it is important to bear in mind that the accrual basis of accounting recognizes revenues and expenses when the underlying events occur, regardless of the timing of related cash flows. Thus, rates set to recover cost on an accrual basis may not provide adequate resources on a timely basis to meet a government's financing requirement. For example, rates set to recover the cost of a debt-financed capital asset through the funding of depreciation expense may not be adequate to make timely debt service payments if the service life of the asset is longer than the maturity of the debt.

References

- *Cost Analysis and Activity-Based Costing for Government*, GFOA, 2004.

Approved by the GFOA's Executive Board, 2002.