

# Why zero-based budgeting makes sense again

Advanced digitization, enhanced behavioral understanding, and smarter organizational and governance models spark a renaissance for a decades-old methodology.

*by Hanspeter Hueter, Carey Mignerey, and Tao Tan*

**After first making a splash** in the 1970s and then fading in popularity over the ensuing decades, zero-based budgeting (ZBB) is making a comeback. At its best, ZBB brings remarkable spending visibility, helps achieve relentless cost discipline, encourages managers to reallocate resources in an agile fashion, and unleashes a culture of continuous improvement. Those benefits apply to organizations in all stages of the corporate cycle, from mature (and often profitable) companies still budgeting under “same old, same old” methodologies to more nimble, posttransformation firms trying not to slide back to their former “business as usual.”

To have maximal impact, ZBB needs to be more than just a rote implementation of the process’s textbook definition; namely, to build a completely new budget each year, function by function and project by project, by starting from a zero base (rather than by starting from the prior year’s expenses). Fortunately, advances in understanding the psychology behind ZBB; the availability of newer, digital-based tools; and the power of singular purpose within an organization—including the right messaging from senior leaders

and appropriate incentives to walk the talk—are making it easier than ever to bring ZBB back to the fore, and to sustain its improvements for the long term.

### **ZBB: WHY NOW?**

ZBB is designed to scrutinize every dollar. In a low-growth environment, it's easy to see why keeping costs down would be especially attractive. But the fundamentals of P's & L's have largely been ever thus, and today's ZBB renaissance comes from more than just typical margin forces at work. In fact, the current climate of disruption is unique because it has brought a heightened scrutiny about which business models make the most sense (even when that means a dramatic shift from the company's traditional focus) and how resources should be allocated to best effect. Decisions must be made faster, results are expected more rapidly, and performance details are laid bare to a broader audience than ever before.

Fortunately, today's challenges have brought new advances to meet them. That, too, represents a change from the "same old, same old." For many years, ZBB was tedious and time-consuming—certainly, more difficult than rules of thumb such as "last year's budget *plus or minus*" some percent. Let's face it: budgeting can be a chore, and finance departments at large corporations must collect, collate, review, and revise budgets from hundreds—if not thousands—of cost centers. That can be frustrating both to the businesses, which rely on the allocated capital, and, even more, for the workers forced to align by hand a vast array of differently formatted spend requests. Ironically, the introduction of user-friendly spreadsheet software actually exacerbated the problem. Familiar desktop-spreadsheet software's versatility and flexibility simply does not scale well and enables different managers to produce an almost infinite variety of templates, which make aggregating them an even more manual and error-prone ordeal.

New digital tools, however, now readily available commercially, virtually eliminate this pain point. Effective cloud-based digital-budgeting products, while no less intuitive than offline spreadsheets, are programmed to compel disciplined data entry. This forces managers to align their inputs to formats that synthesize instantly. The result is a budgeting godsend. At one consumer-packaged-goods (CPG) company, for example, one globally deployed cloud-based tool replaced more than 10,000 offline spreadsheets, vastly freeing up the time and capacity of the finance function. The tools—fast, scalable, and easy to deploy and configure—also helped the company integrate business rules and data validation into the budget-planning process, and enabled different cuts of financial data suitable for different purposes. Perhaps most important, the advances made finance assumptions

more clear, fostering a consistent approach throughout the organization. That helped everybody to work from the same ZBB playbook.

## **TURNING ‘WHY’ INTO ‘HOW TO’**

It’s important to recognize why ZBB is significant again, and it’s encouraging to know that digital advances are opening new possibilities. But actually pulling off a transition to ZBB—and better yet, sustaining the shift—requires a deeper understanding of how ZBB can gain acceptance, and what leaders must do to keep it the new normal.

## **ZBB and how our brains work**

ZBB is at its core about building a culture of cost and performance management. As such, it works best when it accords with how people think and behave. In our experience, managers of effective ZBB implementations often succeed because they harness and channel employees’ own hardwired behavior. Sometimes, the secret of success may seem a mystery—but if we understand the will behind the way, it doesn’t have to be.

One normal human bias is loss aversion, also known as “the endowment effect.” This phenomenon—our ingrained preference to avoid losses more than to acquire equivalent gains—is deeply rooted in human evolution. For example, losing one’s daily food ration could lead to illness or death, but gaining one additional ration will have only limited benefits. Our default psychological setting thus is to guard what we need, rather than to gamble on acquiring something we may not.

Leaders can frame ZBB to neutralize loss aversion by presenting it as building up from a zero base; that is, as a no-risk spending gain instead of a painful cost cut. Case in point: one company kicked off its cost-reduction drive with a line-by-line review of its upcoming investment projects. Management’s introductions were to cancel, defer, or decrease spending wherever it could. The executives tasked with identifying potential cost cuts initially came up with a reduction of less than 5 percent. But when they blanked out the reductions and challenged the team to justify *adding* to the corporate base budget project by project—thus avoiding the appearance of loss—the same executives were able to achieve more than 40 percent savings. The same business leaders approached the problem with an open mind to fundamentally changing how business was being done. After a few rounds of back and forth to resolve cross-dependencies, leadership successfully shifted mind-sets away from the psychological framework of loss aversion and toward a sense of coming out ahead.

A second ingrained behavior is status quo bias, otherwise known as the “path of least resistance.” One illustration is the organ-donation rate in Germany and Austria. Germany requires organ donors to actively “opt in,” while Austria assumes all drivers automatically consent to organ donation, but permits them to affirmatively “opt out.” Despite an extensive (and expensive) awareness campaign in Germany, the country achieved a mere 12 percent organ-donor rate. In Austria, by contrast, the organ-donor rate is 99 percent. That’s because people tend to stick with the status quo.<sup>1</sup>

To encourage a zero-based approach in your organization, plan for ZBB to be the default outcome. For example, consider making underperforming products or business lines “sunset” automatically, subject to an accountability exception, such as renewing spending only if a manager actively stumps for it. Designating a new status quo helps unleash previously untapped creativity and frees managers to invest more time and attention in exploring alternative, digital options—and makes cost discipline the path of least resistance.

A third demonstrable trait is that people behave more accountably when they perceive—consciously or subconsciously—that someone else is watching. One of many examples is an experiment conducted by psychologist Melissa Bateson, who placed an “honesty box” along with a price list for tea and coffee in a university commissary. Next to the price list, depending on the week, she placed either a picture of flowers or a picture of eyes. Average payments were about three times higher during the weeks when pictures of eyes were displayed. There were no supervising personnel and no security cameras, yet the mere suggestion of being “watched” caused the commissary users to adjust their behavior.<sup>2</sup>

People being people, this dynamic plays out in corporate settings as well. We have found that the simple exercise of submitting spending requests to one’s manager serves to tamp budgets down—not because managers are predisposed to reject the increases, but because the perception that someone else is paying attention induces employees to exercise self-restraint. To take another example, one company we know eliminated 20 percent of its printing costs merely by posting the previous month’s costs next to the

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<sup>1</sup> William Samuelson and Richard Zeckhauser, “Status quo bias in decision making,” *Journal of Risk and Uncertainty*, 1988, Volume 1, pp. 7–59; Jacob Nebel, “Status quo bias, rationality, and conservatism about value,” *Ethics*, 2015, Volume 125, Number 2, pp. 449–76, [philpapers.org](http://philpapers.org).

<sup>2</sup> Melissa Bateson, Daniel Nettle, and Gilbert Roberts, “Cues of being watched enhance cooperation in a real-world setting,” *Biology Letters*, 2006, Volume 2, Number 3, pp. 412–14, [rsbl.royalsocietypublishing.org](http://rsbl.royalsocietypublishing.org).

stationery area. Another openly discussed in leadership meetings the cost of the printing for that specific meeting—very quickly, presenters declined to bring printed documents knowing that their audience would know the cost (and environmental impact) they incurred. This visibility makes employees take note of the amounts being spent and helped foster a “Do I really need this?” mind-set.

### Aligning personal with process

For all of the personal, psychological reasons why ZBB should gain acceptance, we’ve found that the greatest obstacles often arise from the institutional workings of individual companies themselves. Too frequently, ZBB’s detailed budgets can come off as one more burdensome to-do—even more so when the budgets are implemented as a series of rote directives according to a prescribed script. And when companies fail to come out of the gate quickly, budget misses tend to compound, becoming progressively more difficult to overcome. Who wouldn’t resist under those circumstances?

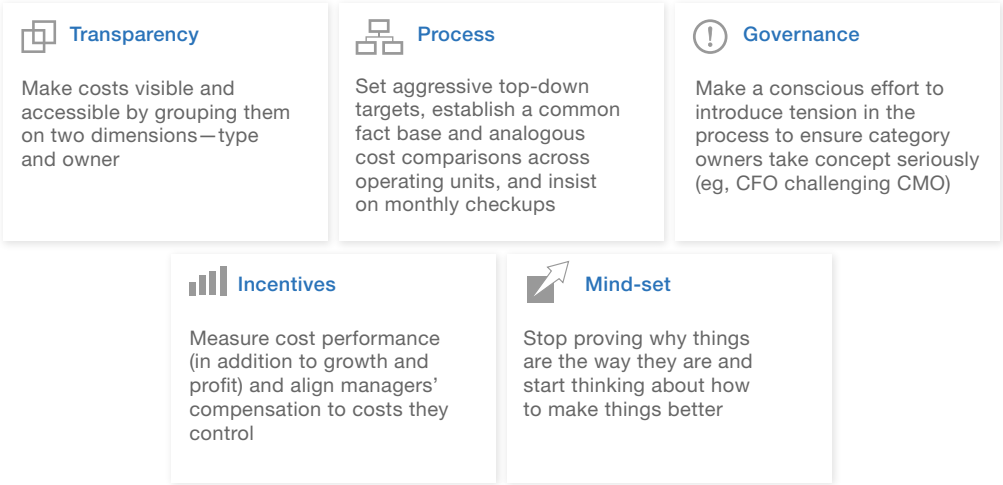
Rather than try to ram ZBB through organizational inertia, leaders should, as we’ve discussed, turn human biases into a force for positive change: present ZBB not as a loss but as a gain; make ZBB the path of least resistance; and tap the power of transparency. Add to that, as well, the very human preference for order above chaos—now addressable through powerful, intuitive digital tools that simplify, expedite, and put everyone on the same budgetary page—and the likelihood for success is even greater.

But to really drive the changes home, organizations must build a cost culture—which means, in turn, that additional measures are critical (exhibit). A crucial step is to align compensation with ZBB conviction. We’ve found that rewarding high-performing business leaders—with both hard and soft incentives aligned to controllable performance elements—is essential. At one multinational corporation, for instance, senior executive compensation was changed so that, in order for an executive to receive the maximum variable portion, he or she would first have to meet a specific threshold for performance on the management of operational expenditures. Thoughtfully controlling costs went from being a “side job” to one of the core focus areas for the senior-leadership team.

In addition, the entirety of senior management must present a unified front of support and discipline about prioritizing spending (even if doubts and candid debate continue). Too often, C-suite leaders make loud commitments to close an expense gap, even as other executives unilaterally proceeded to

Exhibit

Building a cost culture involves more than just budgeting from zero.



approve new spending, often justifying an exception as a “no-brainer—we’ll find the money somewhere.” That type of mixed messaging invariably reverberates throughout an organization and can ultimately knock cost-cutting initiatives off the rails. Successful efforts, by contrast, insist on a “no hall-pass” policy.

For example, one global CPG company put in place two parallel processes as part of its ZBB program—all spend had to go through that. The first process approved spending for “business as usual,” which could include no incremental reinvestment—and that freed up about 22 percent of their total fixed-cost base. The second process was established for *all* incremental spending and reinvestment that were centrally reviewed across business units—think *Shark Tank* for a large corporation. The result was visibility into spending, clear linkage to strategic priorities, and ultimately margin expansion driven by thought-filled and deliberate discussions.

Finally, it’s vital to stand firm on the point that the pivot is not the whole story. In fact, it’s just the first chapter. Far from being simply a tactic to save costs, ZBB forces companies to strategically reevaluate their priorities on an ongoing basis. Our research confirms that companies that regularly

and aggressively reallocate their investments achieve higher returns to shareholders over the long term.<sup>3</sup>

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It's not unusual for business methodologies to go in and out of style. Times change, and companies must continually adapt. But the fundamental imperative of keeping costs down—and allocating resources to maximum effect—remains a first principle. Advanced understandings of human behavior, dramatic improvements in digital tools, and an ever-growing body of empirical evidence for budgetary success sustained over time is leading many companies to take a fresh look at ZBB. Chances are, they'll like what they see. (Q)

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<sup>3</sup> Stephen Hall, Dan Lovullo, and Reinier Musters, "How to put your money where your strategy is," *McKinsey Quarterly*, March 2012, McKinsey.com.

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