

National Defense Budgeting and Financial Management

Policy and Practice

Philip J. Candreva



Foreword by
The Honorable Douglas A. Brook

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Information Age Publishing, Inc.
Charlotte, North Carolina • www.infoagepub.com

Library of Congress Cataloging-in-Publication Data

CIP data for this book can be found on the Library of Congress website:
<http://www.loc.gov/index.html>

Paperback: 978-1-68123-870-8

Hardcover: 978-1-68123-871-5

E-Book: 978-1-68123-872-2

Cover Image Credit: 160722-N-WM647-202 SOUTH CHINA SEA (July 22, 2016) Sailors signal to an MH-60S Sea Hawk helicopter attached to the "Golden Falcons" of Helicopter Sea Combat Squadron (HSC) 12 as it hovers over the flight deck of the Arleigh-Burke-class guided-missile destroyer USS McCampbell (DDG 85) during a visit, board, search and seizure training exercise. McCampbell is on patrol with the Carrier Strike Group Five (CSG 5) in the U.S. 7th Fleet area of responsibility supporting security and stability in the Indo-Asia-Pacific. (U.S. Navy photo by Mass Communication Specialist 3rd Class Elesia K. Patten/Released)

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Printed in the United States of America.

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FOREWORD

In *Public Budgeting Systems*, Lee, Johnson, and Joyce (2013) describe budgeting as

the manifestation of an organization's strategies, whether those strategies are the result of thoughtful strategic planning processes, the inertia of long years of doing approximately the same thing, or the competing political forces within the organization bargaining for shares of resources. (p. 2)

Imagine that the organization in this case operates worldwide at around 5,000 locations or sites comprising 30 million acres of land; has nearly 2 million employees; spends more in any one year than the states of California and New York combined; and is managed by a central headquarters with three (or four) operating entities located in a building of five floors and 17 miles of corridors. A good portion of its funds are committed to long-term multiyear projects but it must operate on annual budgets and has no independent revenue raising authority.

Budgets in such an organization must be strategic of course, but they are also policy documents, funding requests, operating instructions, and assessment tools. Most importantly they are decision drivers; making choices within a public budgeting system consistent with that which Lee et al. (2013, p. 1) describe as, "guided by theory, by hunch, by partisan politics, by narrow self-interest, by altruism and by many other sources of value judgment, including avarice and perceptions of the public interest." Decisions, in turn, require some sort of process. As Irene Rubin (2013) argues in *The Politics of Public Budgeting*, "The process determines who will have a say at what point in the decision making.... A successful budget process assures that decisions are made in the proper order and in a timely way" (p. 5).

When the organization in question is the Department of Defense (DoD), it is perhaps easy to conceive of the complexity of the processes involved, the number of decision makers, the diffusion of decision rights inside and outside the organization, and the overall context in which budgets are formulated, defended, enacted, executed, and evaluated. But it is much more difficult to describe accurately. Add to that the need to address the organization's financial management challenges: accounting, appropriations management, financial reporting, and auditing and you have a challenging world of budget and finance to capture in a single book.

Courses in public budgeting and their associated textbooks can be found in nearly every public administration or public policy curriculum as can courses in fiscal policy and the economics of public expenditures. Courses about Congress concerning constituency politics and legislative processes, including authorization and appropriations, can be found in many political science offerings. A flood of training courses about defense-budget processes and the minutest details of budget execution are offered within the DoD by contractors, think tanks, and online, as well as courses in financial management and financial reporting. Each can be valuable depending on individual need at the time, but collectively, they represent the disaggregation of defense budgeting and financial management when what is needed is aggregation. Defense financial literacy requires that the DoD be considered as an integrated and interrelated financial system.

This disaggregation means that educators, trainers, and practitioners alike must turn to multiple sources for information about the various aspects of defense budgeting and finance ranging from textbooks to specific DoD directives. Applications of theory and context are often lost as focus tends toward mechanistic process descriptions lacking in nuance or higher levels of understanding.

This book aims to fill the gap between general survey public budgeting texts and process-heavy training materials. It does this by placing processes in theoretical and conceptual context—explaining not just “how” but also “why” and “by whom.” The result is a robust text that is made comprehensive by addressing theory and practice in one volume.

Moreover, this book makes room for the fluidity of defense-budget processes and defense-budget issues. For instance, while the framework of the planning-programming-budgeting-execution system (PPBE) has endured for 6 decades, secretaries and deputy secretaries often tinker with structures within PPBE for budget review and decision making. Similarly the relative balance of emphasis between, say, programming and budgeting tends to fluctuate. One can get caught up in essentially ephemeral details. This book aims to address the timeless aspects of key defense

budget processes without sacrificing today's reality. It may chose not to bog down in the process preferences of current DoD leaders but it does address today's most pressing issues in both current detail and in a broader context. So we find discussions of fiscal stress as illustrated by sequestration and the spending caps under the Budget Control Act; base budget distortions resulting from multiple continuing resolutions and the widening application of Overseas Contingency Operations accounts; and the financial management challenges associated with achieving auditability of financial statements.

A succession of defense leaders, including NPS curriculum sponsors, have stressed the need to enhance and improve the financial literacy of both civilians and military members throughout the department. This has been an elusive goal, with definitions of such literacy varying among its beholders. Certainly, however, defense financial literacy requires that DoD be considered as an integrated and inter-related financial system consisting of theory, context and process, as well as the more familiar numbers and legal and operational frameworks of budget execution. This book makes a important contribution toward greater financial literacy as both a textbook and reference guide. For budget practitioners and defense managers this book is practical and relevant. It should be on their bookshelves as a handy reference and refresher.

For those of us who teach defense budgeting and financial management this book answers our need for a single textbook because of its content and in its supporting pedagogical structure. The organization is well-suited for classroom use: it establishes learning objectives, provides the material for student to achieve them, and includes study questions and exercises for use as homework or classroom discussions. The chapters can be taken up in whatever order an instructor cares to organize a course. For those of us who teach public policy and public budgeting this book is useful as a primary or supplementary text. For example its presentation and application of policy theory in a budgetary context could be found more useful to a public budgeting course than a disassociated general policy paper.

Finally a word about the author and the style and tone of the book. Phil Candreva is arguably the preeminent defense budget scholar of our time. He has extensive practitioner experience having served a full military career as a Navy Supply Corps officer in assignments afloat and ashore. He also worked in the office of the Assistant Secretary of the Navy (financial management and comptroller) as special assistant observing and participating in defense budgeting at the highest levels. He is an accomplished researcher on defense budget issues and has published widely in academic and practitioner journals. He has taught multiple different courses on defense budgeting and financial management over 100

times to nearly 2,500 students in graduate and executive education programs making the Naval Postgraduate School the center of budget education and scholarship within the DoD.

Because of the author's extensive professional and scholarly background, you will find the book to be high in content quality while conversational in tone. The result is an authoritative work presented in a way that can be comfortably read and understood.

—The Honorable Douglas A. Brook

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PREFACE

WHY THIS SUBJECT IS IMPORTANT

The FY2017 Budget of the United States projects that the nation will spend \$3.02 trillion on national defense between FY2017 and FY2021. That is 600 billion dollars a year on average; or \$67 million an hour, 24 hours a day, 365 days a year. Defense spending is 15% of the federal budget in 2017, and 3.2% of the nation's gross domestic product. Only Social Security is a larger part of the budget.

Defense spending accounts for as much of the federal government's budgetary outlays as the Departments of Veterans Affairs, Agriculture, Transportation, Education, Labor, Homeland Security, Housing and Urban Development, Justice, Energy, State, Interior, Commerce, and NASA combined. Defense spending alone is 46 times as much as the cost to run the entire legislative and judicial branches of the federal government, combined.

And the department is enormously complex. It not only runs several air forces, it designs and builds the planes, trains the pilots, and operates the airports—some of which move across the sea atop nuclear reactors. In addition to the operational units, the military runs educational institutions, housing complexes, hospitals, factories, public works departments, and accounting and auditing organizations.

The military performs one of the most essential missions of any government: protecting the state against threats to its existence, and asserting the state's will on those who would harm its interests. Those threats are constantly evolving, and include other nations and nonstate actors who invest tremendous sums in developing their own capabilities. All of

which requires the U.S. military to continuously innovate and adapt to stay ahead.

And being slightly ahead is not the goal. The U.S. military never wants to fight a fair fight; it wants to win decisively, quickly, and with overwhelming force. That strength serves as a deterrent to would-be adversaries.

Because the military spends 1 dollar of every 6 in the nation's budget and performs an essential task in a dynamic environment, the decision-making processes of the military and its civilian leaders is of grave importance. Bad decisions waste resources and weaken the military. Good decisions that are poorly justified go unfunded and weaken the military. Poorly performing acquisition programs and operations lower the nation's willingness to pay for those systems and the associated training, weakening the military.

This book is intended for several audiences. First are midcareer military officers whose careers are transitioning from being primarily operational to primarily managerial. Officers who will drive ships, tanks, and aircraft less often in the future and who will instead drive a desk in an acquisition program office, a hospital administration wing, a headquarters staff, a depot, an installation, or a budget office. The book is also applicable to their civilian counterparts. Civilians are doing the day-to-day business of managing programs, and managing the resources of the Department of Defense (DoD). Every midgrade (and above) officer and civilian needs to possess a basic level of financial literacy in order to be effective. Not all get a chance to serve in a financial management position and find themselves in leadership positions lacking some basic skills. This book is useful for them, too.

Financial literacy is the knowledge of how funds are acquired and managed. This book is designed to provide varying degrees of fiscal literacy, depending on how it is used. It addresses topics such as:

- how funds are allocated to programs;
- how to request funds and defend the request when it is scrutinized;
- the participants in the Pentagon and major commands who are most influential in those decisions;
- the roles and influence of actors outside the DoD who affect spending;
- the laws, regulations, and norms governing the use of funding;
- the controls on funding processes that constrain management actions, and the tools of flexibility that allow managers to address contingencies;

- how to balance fiduciary responsibilities with mission accomplishment;
- how to think of broader financial implications of decisions; and
- how to put into context the limited financial experience an officer or manager has.

A DoD workforce with greater financial literacy will, hopefully, better align resources, manage them effectively, sustain accountability, and strengthen the military of the United States.

STRUCTURE OF THE BOOK

This book is organized into three parts. Part A lays a foundation for the rest of the book's content. This part begins with a theoretical and conceptual foundation for what follows. The author takes the position that defense budgeting is a specific instance of public budgeting, and public budgeting is a specific instance of public policy. In order to fully understand how the nation budgets for defense, Part A explores the various ways in which governments budget for anything.

Part A describes the functions of budgets, public budgeting theories, and the systems of budgeting that governments might employ. It also describes the characteristics of effective public budgeting—standards against which defense budgeting can be compared.

Before even providing a theoretical view of budgeting, the chapter presents models of the public policy process in general. Public policy is about the actions of government and budgeting is one of those actions. Several models of the policy process are presented, but the chapter focuses on the stages model, primarily because it neatly parallels the defense department's Planning, Programming, Budgeting and Execution (PPBE) system.

Complementary to Chapter 2's theoretical and conceptual foundation, Chapter 3 provides an empirical foundation to the study of defense budgeting. It describes the structure and content of the federal budget. It provides data on trends in federal government spending and revenue, it distinguishes mandatory from discretionary spending, discusses deficits and surpluses and the accumulated effects on the national debt. Similarly, it describes the structure and content of the defense budget, providing data on the trends in defense spending for the past 60 years: trends by military department, mission area, appropriation, and other categories. It describes the various appropriation types: operation and maintenance; research, development, test and evaluation; procurement; military personnel; and construction.

Where Part A provides a theoretical and empirical foundation, Part B provides a political and policy context for defense budgeting. In order to understand why, for example, the Navy chose not to budget for any more E/A-18G Growler aircraft in FY2015, but Congress added funds for 15 of them, requires an understanding of the broader federal budget process, and the role of Congress.

Chapter 3 describes that broader federal process. It explains the constitutional and legal framework for budgeting and spending. It traces the four phases of the federal budget process in the executive and legislative branches. It distinguishes among budget authority, obligations, and outlays. It describes the treasury process. Finally, it provides a primer on the types of taxes used at the federal level and describes how tax policy is another tool of public policy.

Chapter 4 looks at the legislature's role in defense budgeting. It begins with a detailed look at the constitutional allocation of power over defense policy and funding. It describes the organization of Congress and the varied perspectives on defense. It delineates Congress' two main functions, legislation and oversight. With respect to legislation, it distinguishes the authorization and appropriations processes. The chapter concludes by outlining Congress's capacity to exercise oversight of defense and its propensity to use tools of oversight and control to manage defense through the budget process.

Given the foundation laid in the first five chapters, Chapter 5 explores whether defense budgeting is different from other functions of government. And where it is different, whether the difference is a matter of type or degree. The chapter is organized into policy differences such as the significance of international influences, and process differences such as the DoD's unique budget relationship with the Office of Management and Budget.

Part C is the largest section of the book, containing half the chapters. Its emphasis is formulating and managing the defense budget. Chapter 6 describes the budget process participants and organizations. Understanding the process is often easier if the student understands who is performing portions of that process and where they sit in the organization.

Chapter 7 describes the Planning, Programming, Budgeting, and Execution (PPBE) system that the DoD has used for over 50 years to link defense strategy and war plans, to the need for financial resources, the allocation of those resources, and management of them. This is the system that creates the annual defense budget that enters the broader federal processes described in Chapters 3 and 4. The typical student of this book will one day perform some part of that PPBE process: strategic planning, capabilities assessment, requirements determination, analyses of

alternatives, acquisition planning, resource allocation, budget justification, or program execution.

Chapter 7 focuses primarily on the planning and programming phases which is where the greatest discretion exists and when fundamental questions (roles, missions, strategies) are addressed. The budget formulation and execution phases are constrained by those processes and are less strategic and more managerial. Because a book cannot be all things, it deliberately does not go into great detail into the strategy setting, operational planning, systems analysis, or requirements generation tasks that characterize the first stages of PPBE. It also does not address the Defense Acquisition System. This book is primarily intended for general managers and financial managers. As such, there are individual chapters that dive deeply into the budget formulation and review tasks (Chapter 8) and budget execution (Chapter 9), the latter two phases of PPBE.

Chapter 8 is organized around the two main types of budgets: budgets for expenses such as operating and support costs, and budgets for investments such as procurement of new weapon systems. It describes the process of budget formulation for those two categories and the process of reviewing the budget at the service budget offices, up through Office of Management and Budget and the White House.

Chapter 9 covers budget execution. Once the budget is submitted, authorized and appropriated, the program manager has a duty to achieve the assigned mission while being responsible for complying with fiduciary responsibilities. The chapter is organized around those two ideas and covers topics such as basic fiscal law, the midyear review process, reprogramming actions, and the end of year close-out. It also looks at intragovernmental business (reimbursable transactions) and the working capital funds.

Chapter 10 shifts emphasis from the budget as resources and policy-making to the accounting and financial management functions. Specific attention is paid to the audit requirement. As this book was being written, the DoD was still not “audit ready.” This chapter explains the audit requirement and the actions the DoD has taken to get ready.

The final chapter covers special situations in defense budgeting and financial management. They fall into three categories. First, it describes the macrocycle of the defense budget and how resource management changes between times of growth and times of decline, and the microcycle that occurs each year. Second, it analyzes the history of the use of Overseas Contingency Operations funding and its political and budgetary effect. The third part is entitled, Managing Financially and covers four topics that are designed to help a financial manager or commander manage more effectively by considering financial matters. It looks at the distinction between cost and spending, the importance of internal controls,

techniques for dealing with fiscal stress, and questions a commander should ask the comptroller to better understand the command's financial resources and processes. This chapter synthesizes and applies material from throughout the book.

Throughout the book, key terms are identified in **bold** type. The book closes with a helpful glossary of terms and list of acronyms.

HOW TO USE THIS BOOK

This book was written specifically to support the public policy and budgeting classes at the Naval Postgraduate School in Monterey, California. Naval Postgraduate School provides graduate-level education to naval officers and the officers of other services and allied nations in a wide variety of disciplines. The principal financial management program is found in the Graduate School of Business and Public Policy, but students in many other programs (e.g., systems analysis, information systems technology, cost estimating, program management, and contract management) also take budgeting classes. This book could be used in all of them, but it is not expected that any given course would use the entire book.

By virtue of my professional experience, the book tends to use more Navy examples than Army or Air Force, but it is applicable throughout the department. Where significant differences exist between the services, it is noted. The book also focuses on the processes associated with budgeting and financial management. Related processes that govern the validation of requirements for new military capabilities or the acquisition of weapons systems are not discussed in detail.

I have taught every one of the school's budgeting classes in each of the degree programs, and professional development courses. I have also taught using every mode of delivery at the university: short courses, face-to-face resident, synchronous video tele-education, synchronous web-based, and asynchronous online. At the time of writing the book, I had taught just over 100 courses to over 2,500 students. I am also involved in executive education, raising the financial literacy of senior military officers and civilians. Most of the chapters, questions, and exercises were "beta tested" with some or all of the students before being published here. Based on this experience, I recommend the book be used as follows.

A survey course in defense budgeting would want to concentrate on Chapters 2, 3, 6, 7, and 9. Depending on the audience, the instructor might augment with cases or contemporary examples that would resonate with the particular class. For example, someone teaching the budget class in the MS (program management) curriculum would want to illustrate

class principles using acquisition examples and may wish to use some materials from the Defense Acquisition University.

The two-course budget sequence (policy and practice) in the school's defense-focused MBA, systems analysis, cost estimating, and Executive MBA programs would want to use the entire text across both classes. The policy course would focus on Chapters 1–5, 7, portions of 9, and 10. The class might end with seminar-type sessions on the topics in Chapter 11. The practice class will dive more deeply into the applied portions of the book: Chapters 6, 8, all of 9, and portions of 11. That implies that students would purchase the book to be used in more than one course. Instructors should coordinate their syllabi accordingly.

Each chapter lists learning objectives that may be employed entirely or in part in a given course, depending on the course's and the program's intended learning outcomes.

The chapters also contain study questions and exercises. The more conceptual courses would employ the study questions that require application of theory or models, explanation of current events by applying the concepts and theories, predictions of behavior, or discussions arguing for or against a position. The more practical courses would employ the case studies on fiscal law, budget review exercises, working capital fund rate setting computational questions, and the like. The fiscal law exercises are all based on actual Comptroller General decisions, with noncritical facts changed to masquerade them from students with strong Google skills. The author is happy to share with other faculty the sources for those exercises. He is also glad to discuss the rationale behind study questions.

I firmly believe this book has retention value, based on what former students have retained. As such, it may also have a broader appeal in the defense budget and financial management community. I believe it can help raise a uniformed or civilian manager's financial literacy. There are tens of thousands of general managers and financial management career employees who potentially may benefit from this text. I hope many of them do.

ACKNOWLEDGMENTS

An endeavor as bold as writing a book is not undertaken lightly or alone. There are a lot of people to whom I am indebted. First, I want to acknowledge the hundreds of students who “beta tested” draft chapters of this book and who provided invaluable feedback to make it more understandable, interesting, and effective in helping them learn. I thank those hundreds of students who passed through my classrooms who taught me as much as I taught them. Some of them are doing great work out there in the world of defense budgeting. Special “shout outs” go to Capt. Pamela Theorgood, Cdr. Tiffany Hill, and Jim Moser, the latter two provided specific and valuable input to this text. I thank those students who encouraged me to see this project through to completion because they perceived the retention value of this text.

Second, I must acknowledge my colleagues at the Naval Postgraduate School whose own work, feedback, and criticism were priceless. If they bother to read this, they will have bestowed a great honor and they will hopefully recognize themselves between the lines. In particular, I must credit the influences of Capt. Lisa Potvin, Wythe Davis, Cdr. Matt Jacobs, Capt. (Ret.) John Mutty, the late Vice Admiral (Ret.) Tom Hughes, and Professors Jerry McCaffery, Larry Jones, Natalie Webb, Dick Doyle, Robert Eger, and Spencer Brien.

I must single out the special influence of the Honorable Douglas Brook, PhD. He once referred to me as “friend, shipmate, coauthor, coconspirator, collaborator, special assistant, whatever!” He was my dean, my colleague, and my boss. Whether in an academic setting, or sitting in his office on the E-ring of the Pentagon, he has uniquely influenced who I am as an academic and budgeter.

Third, there are former and current leaders of defense budgeting who influenced me, whether they knew it or not, whether they remember me or not. I include in that set: The Honorable Bob Hale, Mark Easton, Wes McNair, Charlie Cook, Gaye Evans, Neil Hogg, Vice Admiral (Ret.) Stan Szemborski, Vice Admiral (Ret.) Terry Blake, Vice Admiral Joe Mulloy, Vice Admiral Bill Lescher, Rear Admiral (Ret.) Stan Bozin, Rear Admiral (Ret.) Barry Bruner, and Rear Admiral Deitrich Kuhlmann.

Finally, there are countless others in the trenches of defense financial management with whom I worked over the years who also must be recognized. Because they are too numerous to list individually without risking omitting someone important, I will offer a global “thank you” to those who taught me, coached me, supported me, tolerated me, and cleaned up after me in operational commands, and at places like the Naval Air Systems Command and the Fleet Material Support Office.