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A Navy Escrow Account:
Increasing Financial Flexibility

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The proposed Navy escrow account provides a buffer for rapidly shifting requirements and budgetary shortfalls. It creates an incentive for generating cost savings and the means to redistribute those savings toward emergent financial demands or unfunded requirements.

This study outlines critical factors in creating and maintaining a Navy escrow account. Specifically, it addresses: 1) the proposed operation and functioning of the Navy escrow account 2) barriers to implementation including legal restrictions and potential congressional and Department of Defense (DoD) resistance; and 3) proposed implementation strategies including the required cultural modifications and techniques for effectively managing the change process associated with the creation of an escrow account mechanism.

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THE NAVY ESCROW ACCOUNT: INCREASING FINANCIAL FLEXIBILITY

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A NAVY ESCROW ACCOUNT: INCREASING FINANCIAL FLEXIBILITY

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Effective execution of the Department of the Navy's (DoN) budget is critical for national defense. However, political instability and the evolving demands placed upon the Navy and Marine Corps team present challenges in the execution and future planning of DoN budgets. In the current budgetary system, shortfalls are typically funded through targeted cuts while the methodologies for recapitalizing cost savings are non-existent.

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LIST OF ABBREVIATIONS AND ACRONYMS

APN	Aircraft Procurement Navy
ASN(FM&C)	Assistant Secretary of the Navy, Financial Management and Comptroller
BAH	Basic Allowance for Housing
BSO	Budget Submitting Office
CBO	Congressional Budget Office
CNO	Chief of Naval Operations
CPAM	CNO’s Program Analysis Memorandum
CPR	Chairman’s Program Recommendations
DoD	Department of Defense
DoN	Department of the Navy
DPG	Defense Planning Guidance
DUSD	Deputy Under Secretary of Defense
ESPC	Energy Savings Performance Contracts
FASAB	Federal Accounting Standards Advisory Board
FFMIA	Federal Financial Management Improvement Act
FHMP	Family Housing Master Plan
FMB	Director, Office of Budget
FY	Fiscal Year
FYDP	Future Years Defense Plan
GAO	General Accounting Office
GPRA	Government Performance and Results Act
HAC	House Appropriations Committee
HASC	House Armed Services Committee
H.R.	House Resolution
IA&I	Industrial Affairs and Installations
IMD	International Institute for Management Development

JCS	Joint Chiefs of Staff
MHPI	Military Housing Privatization Initiative
MILCON	Military Construction
MSA	Master Settlement Agreement
MUHIF	Military Unaccompanied Housing Improvement Fund
MWR	Morale, Welfare, and Recreation
NMSD	National Military Strategy Document
NMCI	Navy and Marine Corps Intranet
NSS	National Security Strategy
ODC(P/B)	Office of the Deputy Comptroller (Program/Budget)
OMB	Office of Management and Budget
O&M	Operations and Maintenance
OMN	Operations and Maintenance Navy
OSD	Office of the Secretary of Defense
P.L.	Public Law
POM	Program Objective Memorandum
PPBS	Planning, Programming, and Budgeting System
QDR	Quadrennial Defense Review
ROE	Return-on-equity
SAC	Senate Appropriations Committee
SASC	Senate Armed Services Committee
SECDEF	Secretary of Defense
SGL	Standard General Ledger
TSP	Thrift Savings Plan
TOA	Total Obligational Authority

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I. INTRODUCTION

A. BACKGROUND

This study addresses the critical factors in the establishment of a Navy escrow account. The account, as envisioned, would provide financial managers, at all levels of the Department of the Navy (DoN), with the incentive to generate cost savings and the means by which those funds could be utilized for the greater good of the Navy and Marine Corps team. The account would serve as a holding account for unobligated funds and realized savings during budget execution.

The creation of an escrow account coincides with the Navy's *Sea Enterprise* initiative, the resource enabler of *Sea Power 21*. *Sea Enterprise* builds upon the three strategic imperatives of changing the culture, changing structure and processes, and harvesting savings.[1] An escrow account would facilitate the adoption of "cost savings" initiatives from the commercial sector and provide a harvesting mechanism with the flexibility to apply savings from other *Sea Enterprise* initiatives to previously unfunded recapitalization requirements.

Although the proposed Navy escrow account represents transformational change for the financial management processes within DoN and the Department of Defense (DoD), certain functions of the account have existed in prior DoD programs. Understanding the origin of these programs, specifically the "M" and Merged Surplus Accounts, can provide insights for implementing the Navy escrow account.

1. The M and Merged Surplus Accounts

Prior to 1993, the Department of Defense (DoD) maintained the "M" Account – for obligated but unexpended budget authority and the Merged Surplus Account – for budget authority that had not been obligated.[2] Created from Public Law (P.L.) 84-798 in 1956, these accounts retained their general-purpose identity, but not their fiscal year identity. They provided a mechanism for retaining control of appropriated funds, whether unobligated or unpaid balances, within the agencies creating the obligations.

However, the intent of P.L. 84-798 was not to provide DoD with a "slush fund." The M Account was designed to expedite the payment cycle by shifting payment authority for claims from lapsed appropriations from the Department of Treasury to the obligating agency. Additionally, P.L. 84-798 allowed for the transfer of funds from the Merged Surplus Account into the M Account. This effectively eliminated the need for additional congressional action, in the form of a reappropriation, to cover upward adjustments in contract costs or similar price adjustments. At the time P.L. 84-798 was enacted, the General Accounting Office (GAO) assumed the balances in the accounts would remain relatively stable.[3]

2. M Account: Expansion and Termination

The rapid growth of the M Account mirrored the expansion of the DoD budget in the 1980's. (Figures 1.1 and 1.2) The balance within the two accounts would reach $45.9 billion by 1990 and, surprisingly, went largely unnoticed by Congress.

Figure 1.1 M and Merged Surplus Account Growth

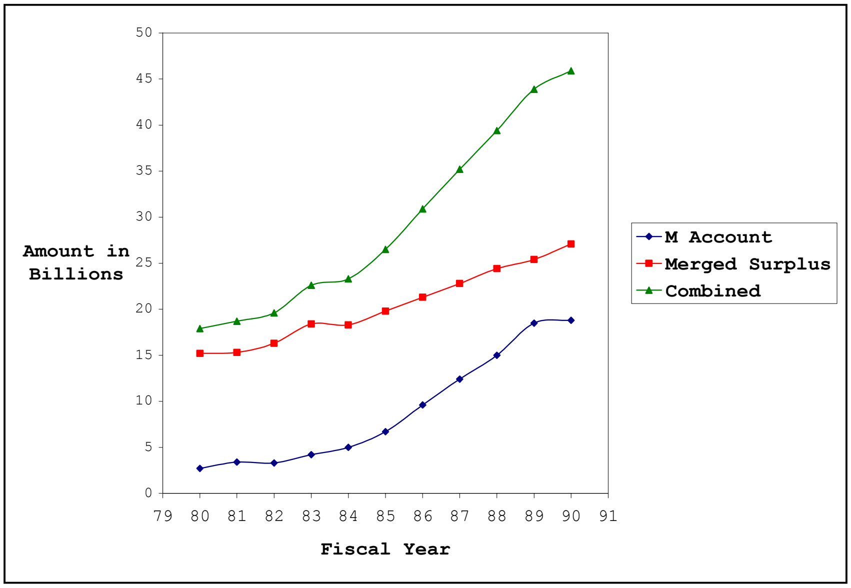
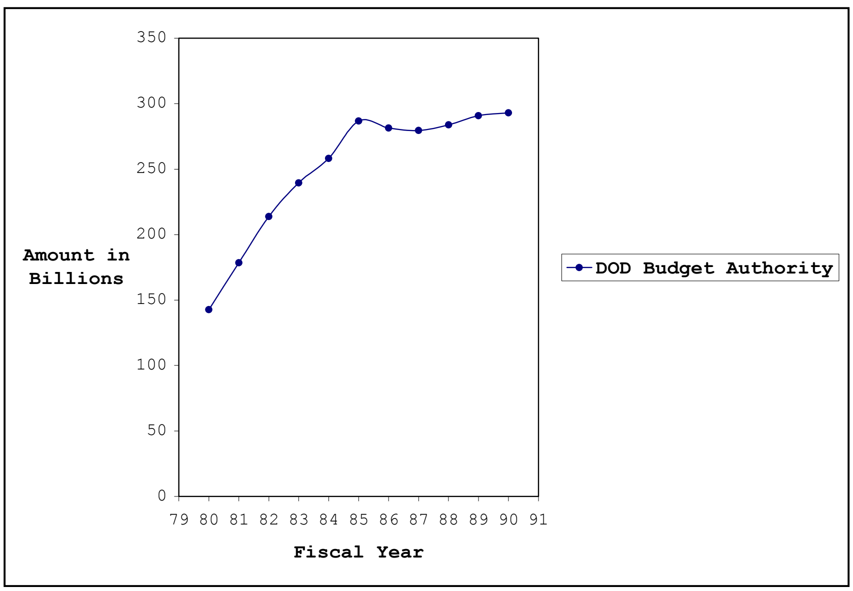


Figure 1.2 DoD Budget Authority



However, following the Air Force's admission that it planned to use roughly $1 billion from the M Account for B1-B avionics upgrades in 1989, the accounts began to draw considerable congressional interest.[4] At the center of the problem was the potential violation of the United States Constitution, Article I, section 9, clause 7:

> No money shall be drawn from the Treasury, but in Consequence of Appropriations made by law.[5]

Congress, perceiving that DoD, through the M and Merged Surplus Accounts was circumventing congressional intent by obligating funds for other than their original purposes, began the process of enacting new legislation.

The resulting legislation, P.L. 101-510 eliminated the M Account as of September 30, 1993. Additionally, it adjusted the expenditure availability period to five years after the obligation period with any unexpended balances to be returned to the United States Treasury general fund.[6]

3. Cultural Realities and Systemic Problems

There are two critical problems currently facing DoD financial managers: first, there are no incentives to generate savings and, secondly, if savings are realized, a simplified mechanism for transferring funds into other accounts does not exist.

Civilian corporations commonly use an increase in retained earnings or a higher return-on-equity (ROE) when measuring corporate success. Additionally, executive compensation is often based on financial performance, whether it is an increase in stock price or a reduction in operating costs. Within DoD, the traditional focus is on budget execution. Put simply – did you spend all that you got?

As an example, research on the monthly obligation rates for DoD-wide Operations and Maintenance (O&M) indicates a marked increase in end of the year spending. Over a 14-year fiscal year (FY) period (FY1977 through FY1990), the O&M obligation rate increased, on average, 3.52% from August to September.[7]

This approach to budget execution is the result of institutionalized cultural norms including personnel evaluations based on 100% budget execution, short tours (15 to 36 months) that rotate personnel just as they "learn" their current assignments, and antiquated legacy information systems that do not produce timely and accurate management information.

Additionally, although financial experts within DoD create the budget, responsibility for budget execution ostensibly falls on the operators. Their primary metric for success is a "zero balance" at the end of the fiscal year. In his FY2004 Defense Budget Testimony for the House Armed Services Committee (HASC), Secretary of Defense (SECDEF) Donald H. Rumsfeld commented:

> We have thousands of people focused on developing and justifying budgets, and a fraction of those focused on ensuring effective implementation and desired outcomes.[8]

However, since the demise of the Merged Surplus account, even in cases where significant savings are realized, no simple means for transferring funds into accounts facing budgetary shortfalls exists.

4. Transfer Authority and Reprogramming

With the elimination of the Merged Surplus account, the ability to redistribute funds within the DoD was significantly reduced. However, current legislation and DoD financial management procedures provide for the transfer of funds between appropriations and the reprogramming of funds within appropriations. Transfer authority between appropriations is limited in amount and purpose. The Defense Appropriations Act for FY2002 states:

> Upon determination by the Secretary of Defense that such action is necessary in the national interest, he may, with the approval of the Office of Management and Budget, transfer not to exceed $2,000,000,000...such authority to transfer may not be used unless for higher priority items, based on unforeseen military requirements...in no case where the item for which funds are requested has been denied by the Congress.[9]

Although $2 billion is a large sum, it represents roughly half of one percent of the total DoD appropriation and does not provide substantial flexibility for financial managers. Reprogramming of funds is governed by similar language:

> That no part of the funds in this Act shall be available to prepare or present a request to the Committees on Appropriations for reprogramming of funds, unless for higher priority items, based on unforeseen military requirements...and in no case where the item for which reprogramming is requested has been denied by the Congress.[10]

Additionally, thresholds are established in the DoD Financial Management Regulations, beyond which, congressional approval is required to reprogram funds. As an example, a cumulative increase of $15 million or more in O&M funds within a budget activity requires congressional approval.[11]

However, the procedures for gaining such approval have proven to be lengthy. Again, in his FY2004 Defense Budget Testimony for the HASC, Secretary of Defense Rumsfeld commented:

> The Department of Defense spends an average of $42 million an hour – yet we are not allowed to move $15 million from one account to another without getting permission from 4-6 different congressional Committees, a process that can take several months to complete.[12]

As an example of a long reprogramming timeline, the DoN's F-5 Swiss Aircraft Procurement Program, Reprogramming Action FY 03-01 PA, is outlined in Table 1.1. The program will replace 32, high flight time Navy F-5 aircraft with 32, low flight time Swiss F-5 aircraft.[13] The reprogramming request was for $500,000 from Aircraft Procurement, Navy (APN). Clearing the Director, Office and Budget (FMB) in July 2002, the reprogramming was not complete until January 2003.

Table 1.1 F-5 Swiss Procurement Program Timeline[14]

FMB	DoN	OSD
22-Jul-02	5-Aug-02	3-Oct-02
Congress	HASC	SASC
4-Oct-02	8-Nov-02	6-Dec-02
HAC	SAC	Complete
16-Jan-03	29-Jan-03	31-Jan-03

Although transfer authority and reprogramming provide a means for recapitalizing financial resources, the combination of low transfer limits (roughly 0.5%) and the length of the reprogramming process limits their utilization. The proposed Navy escrow account provides the increased flexibility desired by DoN/DoD financial mangers while mitigating the limiting effects of current transfer/reprogramming procedures.

B. OBJECTIVES

This study examines the feasibility of an escrow account as a mechanism for increasing financial responsibility and flexibility within DoD. Specifically, it examines the current statutory barriers to creating the account, existing programs that closely mirror the proposed functioning of the escrow account, the impact on the DoD's Planning, Programming, and Budget System (PPBS) process, and the required cultural changes for an escrow account to become an effective management tool.

The objective is to present a comprehensive analysis of the escrow account concept and to capitalize on the current efforts to transform DoD practices. Additionally, the study outlines proposed incremental steps to gain increased financial flexibility and acceptance throughout Congress, DoD, and DoD.

C. RESEARCH QUESTIONS

The current DoD and DoD approach to financial management provides little incentive to realize savings during the execution of a fiscal year's budget. The "spend it or lose it" mentality is, in part, the result of the system lacking a simplified means for collecting and redistributing potential savings. Implementation of an escrow account as a means of correcting this deficiency is the genesis for the research questions within this study.

The initial questions concern the barriers to implementation. Specifically:

What statutory barriers prevent the creation of an escrow account?

What incentives and cultural changes are required to get DoD financial managers to relinquish control of appropriated funds?

Secondary questions focus on those programs that possess similar functionality to the escrow account and on the control and management of the funds deposited into the escrow account. Specifically:

Are there currently any DoD programs that provide increased flexibility to the financial managers that could serve as potential models for the escrow account?

What level of control for escrow account funds provides the highest potential for generating savings, highest increase in overall DoD/DoD mission completion capability, and closest matching of fund usage with original congressional intent?

Should there be time and dollar limits imposed on the escrow account to maintain "good faith" with Congress and to avoid its demise similar to that of the M and Merged Surplus Accounts?

At the end of the escrow account "holding period," should unexpended funds be returned to the United States Treasury?

Tertiary questions address the potential impact of the escrow account. Specifically:

How would savings from one year influence the future year's budget and the PPBS process?

Should there be any relationship between savings generated and future year's budgets?

Should a single year be the basis for any change in the top-line budget of a particular program or within the DoD as a whole?

D. SCOPE AND LIMITATIONS

This study provides a broad overview of the escrow account concept envisioned as part of the *Sea Enterprise* initiative. The focus is on the barriers to implementation and the potential operational features of the account. The study does not address any projected dollar amount of savings deposited into the account or probable uses for such funds. It simply provides the foundation for further action or research into the potential creation of such an account as the concept is still in the developmental stages.

Additionally, although numerous interviews with personnel throughout the appropriation and budgetary system were conducted and opinions garnered concerning the escrow account, the study does not make any statistical inferences concerning the relative level of support for or opposition to such a budgetary mechanism.

Finally, although the study references DoD programs and policies, it is limited in its detail to DoN programs and policies. There are, of course, easy translations to the other departments within DoD. In fact, it may prove impossible to enact the escrow account concept without DoD-wide support. However, this study does not expand on those possibilities.

E. ORGANIZATION

The study is organized into eight chapters. Chapter I introduces the escrow account concept and provides the background on previous recapitalization efforts within DoD. Additionally, it delineates the objectives and methodologies for the study.

Chapter II describes the functionality of traditional and non-traditional escrow accounts. It provides the foundation for introducing the concept of a Navy escrow account.

Chapter III delineates the functionality of the Navy escrow account. It describes the potential sources of funds for the account, obligation procedures, disposition of balances, and overall fund management.

Chapter IV addresses current programs within DoD that may serve as a model for the escrow account. Although they facilitate the management of much smaller budgets and sums of money, they provide increased financial flexibility and have a similar functionality to the proposed escrow account.

Chapter V provides an examination of statutory barriers, focusing on the various United States Codes (USC) governing the DoD appropriation and expenditure process. For each law or regulation, its relevance to the successful implementation of the Navy escrow account is highlighted as well as potential solutions to mitigate the effect of the legal barriers.

Chapter VI discusses the cultural norms that dominate current financial management philosophies and the required changes in the DoD culture and incentive structure to implement the proposed escrow account. Additionally, this chapter highlights the cultural norms within Congress that serve as barriers to the implementation of such an account.

Chapter VII outlines potential implementation strategies for the escrow account including organizational and personal strategies. Additionally, the chapter highlights change management techniques and procedures that are required for the successful change to occur.

Chapter VIII provides the conclusions from the research concerning the escrow account and recommendations for further study.

II. ESCROW ACCOUNT FUNCTIONALITY

A. TRADITIONAL ESCROW ACCOUNTS

In its most commonly recognized form, an escrow account is one held by the lender into which a homeowner pays money for taxes and insurance. More specifically, it is defined as "A trust account held in the borrower's name to pay obligations."[15] A neutral third party typically manages escrow accounts. They contain documents, real estate, money, or securities to be delivered upon fulfillment of certain conditions established in a written agreement.

The organization that collects principal and interest payments from borrowers and manages their escrow accounts is termed the "servicer" or "mortgagee." The servicer collects funds for placement into the mortgagor's escrow account through the mortgagor's periodic payment for principal and interest. An escrow account has sufficient funds if there is enough to pay all bills when they come due, and it is common practice for servicers to hold an escrow cushion if the cost of any escrowed item were to increase in the future.[16]

In 1934, in response to numerous foreclosures due to late tax payments, the Federal Housing Administration (FHA) made escrow accounts mandatory for loans it insured. This then became the standard practice for all mortgages. Currently, regulation and oversight of real estate based escrow accounts are provided by the Real Estate Settlement Procedures Act of 1974 (RESPA). Section 10 of RESPA limits the amount of money a lender may require the borrower to hold in an escrow account for payment of taxes, insurance, etc. RESPA also requires the lender to provide initial and annual escrow account statements. Additionally, during the course of the loan, RESPA requires the servicer to notify the mortgagor of any escrow account shortage and return any excess of over $50 to the mortgagor on an annual basis.[17]

B. NON-TRADITIONAL ESCROW ACCOUNTS

Escrow accounts are not limited to transactions involving real estate. In 1998, the Master Tobacco Settlement Agreement (MSA) between the Attorneys General and other representatives of 46 states, Puerto Rico, the U.S. Virgin Islands, American Samoa, the Northern Mariana Islands, Guam, and the District of Columbia and the five largest tobacco manufacturers established a general escrow account.

The account will hold the $206 billion settlement to be paid by the tobacco companies, over 25 years, agreed to in the MSA. Starting in June 2000, these funds were transferred into the respective state escrow accounts for smoking cessation and education programs, health care requirements related to smoking, legal fees, etc.[18]

Within DoD, escrow accounts have been established to facilitate the sales of surplus personal property.[19] For those items and sales that provide for a bid deposit, the cash collected from bidders is initially deposited by the component command into account X6501, “Small Escrow Accounts.” The funds are held until the successful bid has been determined and a contract awarded.

Subsequent to the awarding of a contract, checks are drawn from the Small Escrow Account and returned to unsuccessful bidders. The deposits from successful bidders are credited directly if able, or placed into a suspense account until the designated account can legally receive reimbursements.

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III. NAVY ESCROW ACCOUNT

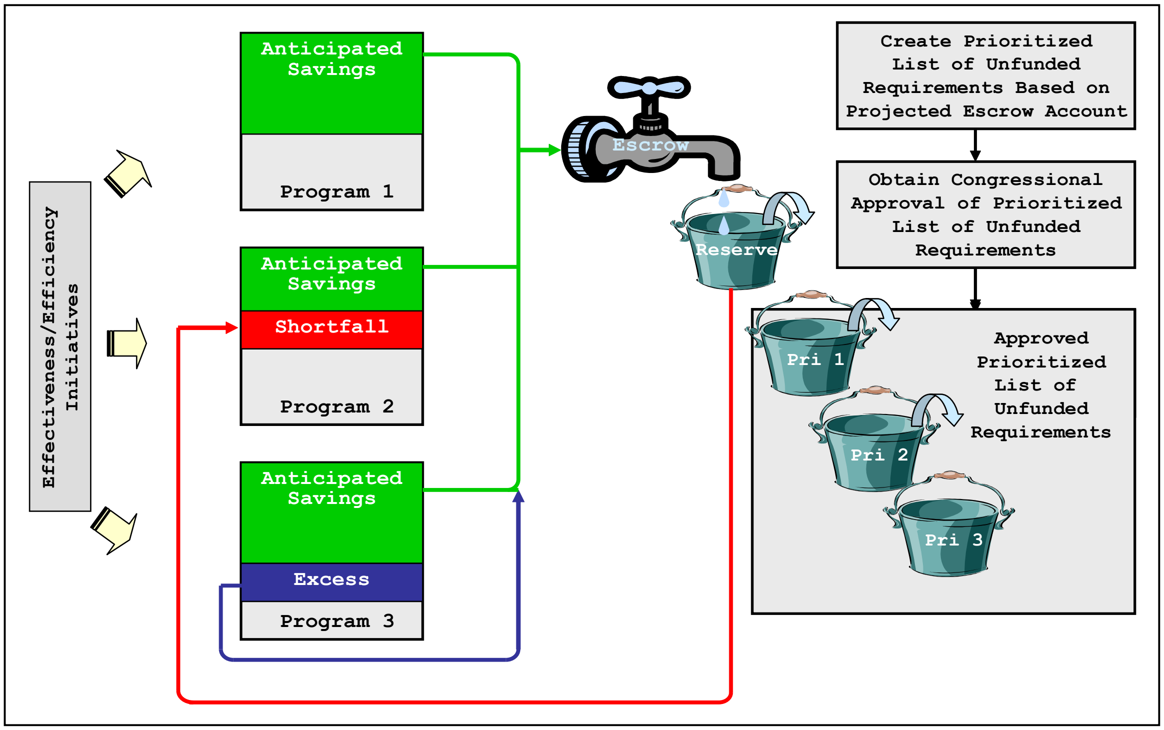
A. NAVY ESCROW ACCOUNT

Conceptually, the Navy escrow account would function in a similar manner to the traditional escrow accounts. Funds will be transferred to the account from anticipated savings, or savings in the execution phase, and held in the borrower's name for future payment of legitimate obligations. As available, unfunded programs from a congressionally approved list of prioritized requirements or programs facing shortfalls would receive additional funding from the escrow account.

B. NAVY ESCROW ACCOUNT INPUT PROCESS

The funding inputs to the Navy escrow account will originate at three distinct periods within the budget cycle: during the build of the Program Objective Memorandum (POM), during the execution phase, or at the end of the fiscal year. The quality of the savings, in terms of the probability of fully realizing their value, varies at each phase. During the POM build, the savings are theorized based on efficiency measures or programs that are projected to generate savings. As such, there is a possibility that some savings will not materialize as predicted, while others, may be in excess of the forecasted levels. Alternatively, the savings realized at the end of the fiscal year (August to September timeframe) are not in question. Figure 3.1 details the shortfall and excess initial concept.[20]

Figure 3.1 Proposed Navy Escrow Account Functionality



The following paragraphs will highlight additional aspects of each funding source. Specifically, they will describe the proposed fund transfer process, the benefits associated with fund's origin, and the potential difficulties with each fund's origin.

1. POM Build Funds

During the POM build, cost savings initiatives, the application of better business practices, or the potential for programs to come in under budget may give rise to potential savings. In an idealized environment, the spenders, through detailed internal reviews and continual improvement processes independently generate these savings. However, in lieu of such efforts, top-down reductions or targeted wedges, will continue to be the source of reductions for various programs.

It is important to note that there must be an element of "good faith" in the POM process. Top-down initiatives should be achievable at local levels and bottom-up budget submissions should represent an honest assessment of true financial requirements.

Additionally, good faith must exist between Navy budgeters and the Congress of the United States – funds requested must represent the honest estimates of all parties involved. However, what ultimately represents good faith in this process? Should all projected savings be reduced from the DoN's top-line budget or should they be viewed as "potential" savings with the goal for DoN planners and financial managers then being the optimization of funds within this year's and future years' budget bases?

The most reasonable definition, and the one adopted for this research, is that optimizing the funds within the established budget base represents good faith operations. This assumption is critical not only for realizing POM build savings, but for the operation of any escrow account.

a. POM Build Harvesting Process

Through the *Sea Enterprise* initiatives, increased focus is being placed on optimizing the entire scope of business processes within the DoN and not just individual pieces. These initiatives have identified potential savings through 2009. The total savings, over $39 billion, are substantial and are highlighted in Table 3.1.[21]

Table 3.1 Forecasted Cost Savings
(Amounts shown in millions)

Initiative	2004	2005	2006	2007	2008	2009	Total
Improved Acquisition							
Multi-year/EOQ Procurements	416	341	258	343	463	317	2,138
Total	416	341	258	343	463	317	2,138
Improved Processes							
NMCI/LSR	342	394	425	426	439	433	2,459
Enterprise Resource Planning (ERP)	251	625	907	983	1,079	1,268	5,113
Strategic Sourcing	1,397	1,597	1,665	1,709	1,709	1,836	9,913
Acquisition Organization Efficiencies	304	312	261	343	353	350	1,923
eBusiness	16	25	37	39	39	39	195
Ownership Cost Reductions	192	228	233	227	234	231	1,345
Revolution in Training	-4	8	31	45	66	80	226
Land Sales	68	53	30	17	18	18	204
Total	2,566	3,242	3,589	3,789	3,937	4,255	21,378
Improved Operations							
Mission Fund Shipyards	18	18	18	18	18	18	108
Workload Validation	670	681	695	709	723	738	4,216
Performance Based Logistics (PBL)	19	20	20	21	22	22	124
LPD/DDG Workload Swap	-66	0	129	16	24	101	204
Total	641	719	862	764	787	879	4,652
Improved Infrastructure							
Claimant Consolidation/Regionalization	117	141	101	107	57	193	716
Headquarters Streamlining	45	78	80	82	84	81	450
Total	162	219	181	189	141	274	1,166
Force Structure/Program Terminations							
TACAIR Integration	86	138	160	174	197	220	975
T5 Tanker Lease Buyout	40	40	40	40	41	38	239
Weapon System Retirements	301	700	1,484	2,260	534	470	5,749
Accelerated Ship/Aircraft Retirements	656	604	857	675	426	432	3,650
Total	1,083	1,482	2,541	3,149	1,198	1,160	10,613
Grand Total	4,868	6,003	7,431	8,234	6,526	6,885	39,947

However, transferring 100% of the identified funds, whether they be internally derived or through a targeted reduction, into the Navy escrow account is not the projected process. First, it must be acknowledge that a percentage of any projected savings will be absorbed in the POM. There is extreme competition for funds during the POM process. Rarely, if ever, is there enough money to cover each program's financial needs. Savings generated from one program may simply "buy more POM."

Secondly, in those cases where funds are not absorbed in the POM, each account must be viewed independently and the quality of savings evaluated, as not all of the proposed savings will materialize through the fiscal year. Cost savings initiatives may be ineffective or they may simply take more time to implement than originally projected. Additionally, emergent requirements may negate any projected savings. Regardless of the reason for not realizing savings, it is critical that mission readiness not be sacrificed in order to meet projected savings targets.

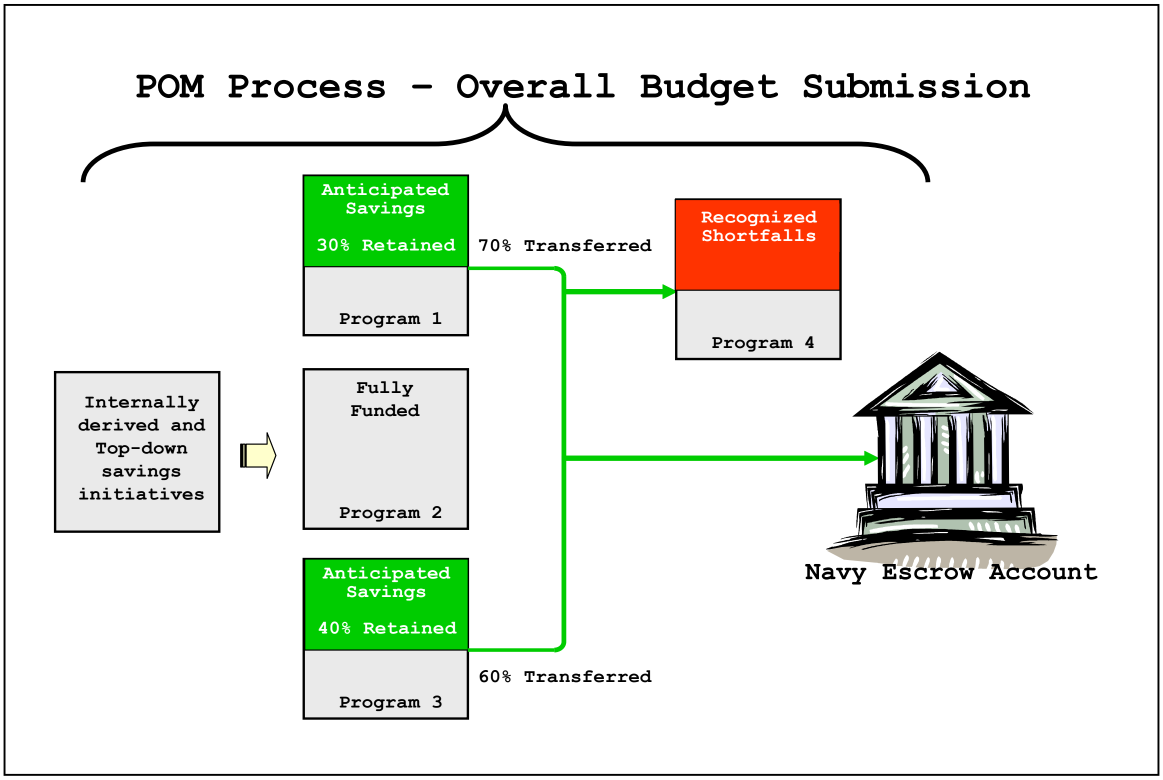
Therefore, during the POM build, budget planners will only target a certain percentage of projected savings for transfer into the Navy escrow account. Depending on the confidence in the savings potential for the specific command, more or less may be transferred. This provides a "safety net" for local commands if cost savings initiatives fail to meet expectations. Alternatively, establishing proper incentives for meeting or exceeding the projected savings may provide the means for increased escrow account utilization.

Additionally, within the proposed Navy escrow account operation, returning funds to programs facing shortfalls that made previous contributions to the escrow account is a critical incentive. Simply "doing more with less" or artificially inflating readiness numbers to meet the financial targets is unacceptable.

Figure 3.2 highlights this process. Two programs are projecting savings. Program 1 is in its second year of a cost saving initiative and has seen positive results in the previous fiscal year. In this case, 70% of the projected savings are available for transfer into the escrow account or to fully-fund other programs (Program 4).

Program 3 is projecting a significant reduction in development costs, however, those savings are not guaranteed. In this example, only 60% of available funds are transferred.

Figure 3.2 POM Build Funds Input Cycle



b. POM Build Benefits

There are three significant benefits of targeting POM build funds for transfer into the Navy escrow account. First, the reduction in funds, whether internally generated or as a result of top-down initiatives, represents a challenge for effective and efficient budget execution. By providing formal recognition for maintaining spending within the reduced limits, a Navy-wide incentive system can be established to reinforce the budget targets.

Secondly, funds harvested during the POM process can be redistributed to other programs facing potential shortfalls. This may reduce the need for across the board reductions or targeted wedges during the execution phase and increases financial flexibility from a corporate perspective.

Finally, determining an initial level of projected savings prior to budget execution provides more time for making strategically sound and financially smart decisions during the execution phase. This may include placing additional funds into recapitalization efforts or simply covering cost overruns in complex programs such as ship construction.

c. POM Build Difficulties

Designating savings during the POM build presents several significant challenges. First, a fine line separates "savings" from "excess funds" at this stage of the budget process. The game is essentially one of strategic misrepresentation or the "Intentionally planned lying and cheating justified by the view that in a competitive environment the opposition will engage to some extent in the same types of behavior."[22]

The competition, in this instance, exists at several levels, both internal and external to the DoN and the DoD. Although there will be an attempt to play the game at face value - with all players knowing the hand the others are holding (i.e., Program 1 expects to save *X*, but only 70% is being transferred), it is questionable as to what level this will actually take place. Designated savings, at times, may well become self-imposed budget reductions as other programs, especially those outside of the DoN, compete for the limited resources.

Secondly, placing any incentive on budget execution may result in the degradation of mission readiness and overall capability. As an example, assume that Program 1 was unable to meet all of its requirements with the 70% of proposed savings transferred to the Navy escrow account. The probability of Program 1 requesting a reinstatement of funds may depend on the origin of the initial reduction. If the reduction was internally generated based on a new model or forecast, career desires and the fear of admitting failure may force mission execution to suffer in order to maintain the budget.

Alternatively, externally based reductions, not fully supported by lower echelon commands, may not receive a fair trial. The initiative may be deemed a failure at the first sign of financial difficulty. A reinstatement of funds may be requested due to a lack of buy-in and support for the reductions negating the cost savings initiatives.

A final issue to be considered is the potential impact on the top-line budget for following years. The POM harvesting process includes an added element of complexity – time. Few appropriations exist for a single year. Therefore, should savings projected in one year be reflected throughout the Future Years Defense Plan (FYDP) requiring adjustments to the program's funding line?

Returning to Program 1 in Figure 3.2, should the future years reflect the same savings or should the ratio of 30% retained/70% transferred for that specific cost savings initiative be adjusted? Since each program and initiatives are different, it will be difficult to establish a single overriding policy for adjustments in the POM build and throughout the FYDP.

The following questions serve to highlight the potential difficulties in subsequent budget years:

- How many years of execution at a reduced level are required before the top-line budget is permanently reduced?
- Should cost savings initiatives be applied in future budget years using a straight-line approach or incremental adjustments throughout the FYDP?
- Will the fear of permanent reductions remove the incentive to designate potential savings based on a particularly good forecast that is not expected to exist in following years?
- Will programs that operate efficiently at a lower funding level inadvertently bring into question past abuses in lieu of focusing on the success of cost saving initiatives?

2. Execution Phase Funds

Although the greatest potential for realizing savings during execution will occur at the end of the fiscal year, funds will become available at various times throughout the year. If a particular aspect of a program were to be cancelled, a significant project outsourced, or an operational exercise postponed until the following fiscal year, the resulting savings would be available for transfer into the Navy escrow account. Additionally, for cases such as an exercise being cancelled, the account could be used a “holding mechanism” (traditional escrow account) for those funds until the next fiscal year when the exercise is to be conducted.

Harvesting these savings as they become available is an integral part of the account’s operation. As is the case with POM build funds, early recognition of savings will provide greater financial flexibility for the “corporate” Navy. However, early recognition of savings during execution presents some significant challenges.

a. Execution Phase Harvesting Process

The process for harvesting savings during execution will originate from top-down and bottom-up initiatives. The top-down initiatives, although similar to a “wedge” or “bogey” that simply delineates a percentage budget reduction, will be focused on the implementation and exploitation of cost savings programs and initiatives. For example, a specific base function may have been outsourced at one command or a cost-savings program may have been established that provided a significant savings in O&M costs. Subsequently, other bases may be directed to adopt similar programs and the forecasted savings will be transferred into the Navy escrow account.

Alternatively, bottom-up reviews at the local level may identify potential savings and earmark those funds for transfer. These savings may originate from the under-execution of obligational authority due to contractual delays or through local cost savings initiatives that have proven to be effective.

As in the current process, the Mid-Year Review will play a critical role in designating potential savings. However, for the process to be successful there must be a shift in the mental models that guide the review processes. In lieu of rushing to obligate, commands must adopt a more inclusive corporate view of budget execution.

In the corporate sector, phrases similar to "ahead of schedule and under budget" spoken in regards to any program are clear targets and signs of superior performance. Within specific DoN appropriations, such as APN or Military Construction (MILCON), this may be true. However, O&M appropriations typically require consistent execution of quarterly budgets. Title 31 U.S.C. § 1512 states:

> An appropriation subject to apportionment is apportioned by months, calendar quarters, operating seasons, or other time periods.[23]

The typical quarterly budget, or operating target (OPTAR), becomes just that...a target. Accordingly, the most commonly used metric for measuring performance among financial managers and/or commanding officers is a zero balance at the end of the quarter.

b. Execution Phase Benefits

Three significant benefits can be realized with the harvesting of execution phase funds. First, formalizing and institutionalizing a mechanism for harvesting savings during the execution phase will take a critical step taken in changing the Navy’s corporate culture. For any change to be successful, there must be buy-in at the highest levels. The Navy escrow account is a distinct signal from the top that smart fiscal management should replace the “100% obligation” paradigm. Most importantly, it will remove the penalties and negative stigma associated with not obligating 100% of available resources. Simply stated, assessing one’s financial management will no longer be solely dependent on a zero balance at the end of the quarter.

Secondly, early harvesting of savings will increase the DoN’s financial flexibility. In a perfect world, all potential savings would be realized on the first day of execution and subsequently redistributed to meet additional requirements. Although that is an impossibility, funds that manifest themselves early in the execution phase may allow for early starts on projects or, when combined with projected end of the fiscal year funds, may provide enough resources to fund a major program or acquisition effort. In these cases, harvested funds may be targeted for larger programs and the required legal and contractual efforts begun in earnest reducing the overall acquisition cycle time.

The critical aspect of providing the increased flexibility through early harvesting of savings is time: time to make the smart decisions on starting recapitalization projects or to delay the decision process until more information comes available.

Finally, by harvesting funds throughout the fiscal year, more funds may come available for recapitalization. This process is analogous to automatic deductions for savings or retirement accounts. Once deposited, the investor is less likely to go to the bank and withdraw those funds. However, had the money remained in the investor's checking account, there is a higher probability that those funds would be spent.

Similarly, commands that realize and retain savings locally during the execution year may be more likely to spend those funds as the year progresses. Whereas, those commands that transfer funds into the Navy escrow account may be more likely to remain committed to savings initiatives or to pursue new cost-reduction measures.

c. Execution Phase Difficulties

There are significant obstacles that must be overcome to harvest execution phase funds for the Navy escrow account. However, the vast majority of these problems have a common origin...a culture that is resistant to change and leery of top-down initiatives. Much of the resistance can be placed on the lack of a shared vision. Programs and initiatives commonly begin and end with the transfer of a single individual. Creating a shared vision with such high turnover is extremely difficult.

Even programs that deliver benefits to military members, such as the Thrift Savings Plan (TSP), often face an uphill battle in changing the culture. Following the first enrollment period for TSP, only 16% had enrolled in the program.[24] Personnel throughout DoD were hesitant to commit to the program...*and this was a benefit*.

For commands to recognize and transfer savings during the execution phase there must be a shared vision that rewards long-term thinking and execution vice obtaining only short-term objectives. Gary Hamel of the London Business School and C. K. Prahalad of the University of Michigan noted:

> Most managers, when pressed, will admit that their strategic plans reveal more about today's problems than tomorrow's opportunities.[25]

Designing a process that fundamentally asks financial managers to relinquish budget authority for the "greater good" must also include the parallel creation of incentives to reward such actions. In the current culture, there is an incentive to do just the opposite, as managers are encouraged to spend the funds under their control.

Creating incentives to save must be tempered with the need to maintain a given readiness level or base of operational performance. Although it is an unlikely result, any incentives to initiate greater savings throughout the DoN cannot reach a level where they threaten basic mission accomplishment.

Finally, the fear of the unknown budgetary requirement causes most financial managers to set aside some percentage of their funds for potential contingencies. Relinquishing a potential "buffer" places not only the manager's program or command at risk, but also his/her career. Although they may not receive a newly created award for transferring the most money into the Navy escrow account, in today's culture, they are certain that not placing their command in a shortfall situation will always be heralded as effective management.

3. End of the Fiscal Year Funds

With each day approaching the end of the fiscal year, the level of risk from harvesting funds decreases. Financial managers have effectively protected troubled programs and have guided their respective commands through numerous unforeseen budget dilemmas. The required funds for the remaining month, or possibly two months, is more precisely known and the focus traditionally shifts from ensuring sufficient funds exist for execution to ensuring all funds are fully obligated by the end of the year. With the Navy escrow account, unnecessary end of the year spending could be replaced by end of the year saving.

However, the rush to obligate funds at the end of the year is a well-documented phenomenon. The behavior is based on Title 31 U.S.C. § 1502:

> The balance of an appropriation or fund limited for obligation to a definite period is available only for payment of expenses properly incurred during the period of availability or to complete contracts properly made within that period of availability.[26]

The unobligated balances are then returned to the general fund of the Treasury. This loss of budget authority combined with the "zero balance" metric for measuring managerial performance creates a powerful incentive for rapidly obligating all funds towards the end of the fiscal year.

Shifting the focus from spending to recapitalization is the goal of the end of the year harvesting process. It provides an easy alternative to spending while minimizing the impact on local financial managers and their respective commands.

a. End of the Fiscal Year Harvesting Process

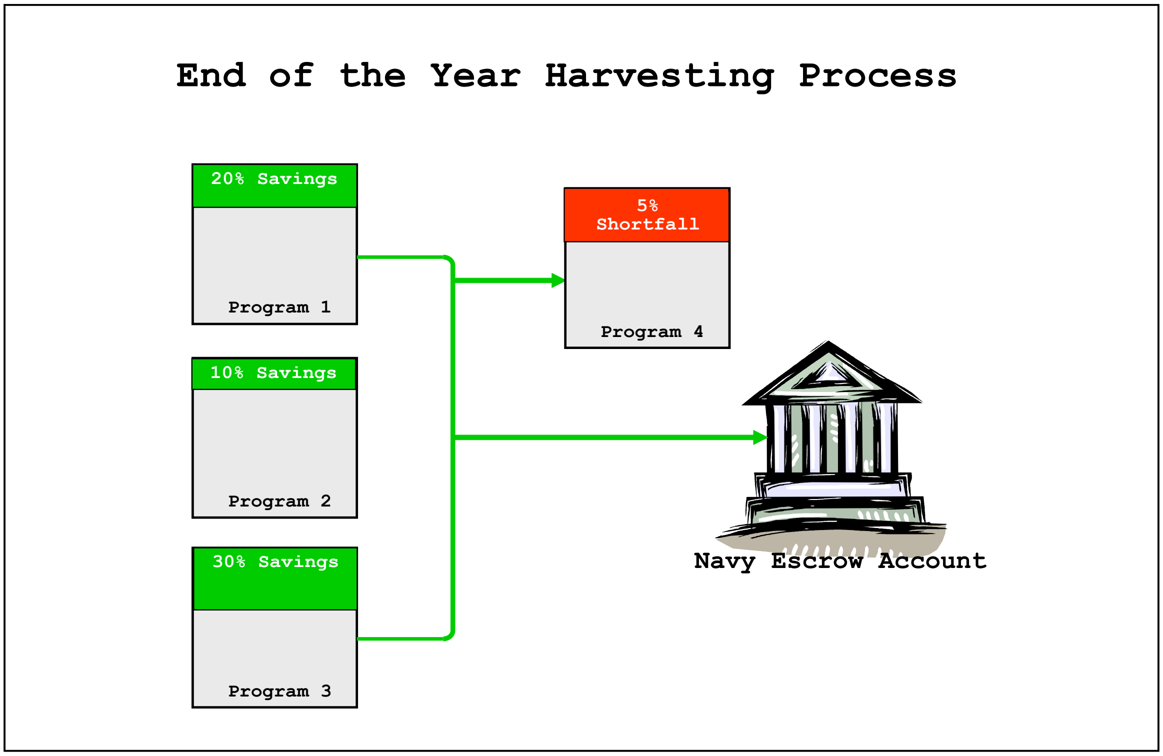
The proposed process for harvesting end of the year funds is greatly simplified when compared with the other harvesting periods. Funds not obligated at the end of the fiscal year are available for transfer into the Navy escrow account. However, if shortfalls exist within the DoN, harvested funds will first be transferred into the required appropriations, with the balance forwarded to the escrow account. Figure 3.3 highlights the flow of funds.

b. End of the Fiscal Year Benefits

The primary benefit of harvesting end of the fiscal year funds is to avoid the waste that takes place. As a point of reference, over $25 billion was in the Merged Surplus account in 1990. These funds grew during a period of unprecedented growth in the military. Granted, the rapid rise in the budget gave rise to excess. However, instead of blindly obligating funds, they were transferred to the Merged Surplus account.

It would be naïve to assume that with the demise of the M and Merged Surplus Accounts funding and spending requirements were suddenly and perfectly coordinated. On the contrary, obligating 100% of budget authority simply became the norm. The proposed Navy escrow account could provide the opportunity to recapitalizes these funds, using a corporate-wide perspective.

Figure 3.3 End of the Year Harvesting Process



The secondary benefit to harvesting end of the year funds is the inclusive nature of such an effort. With POM build and execution phase funds, the cognitive ability to examine each program and discern potential excesses or savings is limited. The budget and number of programs is simply too big to expect a consistent level of effort from every command.

However, at the end of the year, the equation is greatly simplified:

Budget Authority - Obligations = Funds Available

Finally, the presence of a recapitalization mechanism may bring more scrutiny to fourth quarter obligations (and all obligations for that matter) from financial managers and those with fund oversight.

Projects that may have been approved in prior years when few, if any, options existed may be disapproved when viewed under a corporate lens. Approaching funding decisions in such a manner will help avoid the routine increase in September spending (the 3.52% increase in September O&M spending, previously mentioned, would equal over $1.35 billion in the FY2003 O&M Navy (OMN) appropriation).[27]

c. End of the Fiscal Year Difficulties

The difficulties associated with harvesting end of the fiscal year funds are significantly reduced when compared to POM build or execution phase funds. However, the basic problem associated with under-executing designated budget authority previously discussed remains:

> If they don’t spend their entire budget by the end of the fiscal year, three things happen: they lose the money they have saved; they get less next year; and the budget director scolds them for requesting too much last year. Hence the time honored rush to spend all funds by the end of the fiscal year.[28]

Although transferring the funds to the Navy escrow account may prevent some of the problems highlighted above, it may create others. Due to the potential for increased scrutiny and oversight placed on late, fourth quarter spending, some valid projects may be cancelled or delayed. The valid and often delayed purchases of computers, furniture, or MWR related items, may suffer due to corporate requirements. Caution must be taken to ensure there is a fair and balanced approach taken towards approving or negating such projects.

C. NAVY ESCROW FUND USES

Utilization of Navy escrow account funds fall into three distinct categories: funds to cover unexpected shortfalls, funds to resource previously unfunded requirements, and funds to be applied to future obligations. From the standpoint of gaining widespread acceptance, specifically from Congress, covering shortfalls with internally derived resources is a critical aspect of fund utilization.

Although the concept of covering existing shortfalls as the first priority seems logical, this has not always been the practice. During the 1980's, as the Merged Surplus account continued to grow, DoD received over $11.25 billion in six supplemental appropriations. Table 3.2 compares the balance in the Merged Surplus account with the supplemental appropriations throughout the 1980s.[29]

1. Funding Shortfalls

The size of DoD shortfalls over the past 11 years has continued to increase, paralleling the greater deployment and application of military force as an extension of diplomacy.

Table 3.2 Comparison of the Merged Surplus Account and Supplemental Appropriations
(Amounts show in millions)

Fiscal Year	Merged Surplus Balance	DoD Supplementals
1980	15,200	0
1981	15,300	6,900
1982	16,300	435
1983	18,400	470
1984	18,300	332
1985	19,800	0
1986	21,300	0
1987	22,800	720
1988	24,400	0
1989	25,400	2,400
1990	27,100	0
Total Appropriated		11257

Table 3.3 highlights the supplemental appropriations through 2001 (not including the DoD portion of the $40 billion supplemental follow September 11).

Although much of the supplemental appropriations were designated for emergent military operations such as Desert Storm and Kosovo, O&M accounts throughout DoD face consistent shortfalls. Exacerbating this problem is the present tempo of operations worldwide. Deployed forces are at record levels and this trend is unlikely to change in the near future.

With these emergent requirements, it is easy to label the funding required for such events as additional funding or funding in excess of the amount in the original appropriation. They represent extraordinary events beyond the control of DoN/DoD financial managers. As such, an argument could be made that any escrow account funds are excluded for use to cover those costs normally covered by a supplemental appropriation.

Table 3.3 DoD Supplemental Appropriations
(Amounts shown in millions)

Fiscal Year	DoD Supplementals
1991	42,600
1992	4,100
1993	0
1994	1,497
1995	0
1996	982
1997	2,100
1998	4,659
1999	10,900
2000	6,500
2001	5,460
Total	78798

However, to legitimize the existence of a Navy escrow account in the eyes of Congress and the taxpayers, the first claimant on any funds transferred must be those programs facing current shortfalls during ordinary operations and, possibly, those accounts designated as part of any supplemental appropriation.

There are two risks associated with this philosophy. First, financial managers may rush to obligate escrow account funds as the world situation makes the need for supplemental appropriation appear imminent. In this environment, the wasteful spending the account was to prevent may have only been delayed. Secondly, use of escrow funds creates the possibility that internally generated savings will become bill payers for additional requirements and subsequently, a negative incentive to recapitalize savings.

2. Unfunded Requirements

The second claimant on escrow funds will be unfunded requirements. These requirements may be in the form of a congressionally pre-approved and prioritized list or simply an emergent requirement (e.g., additional Joint Direct Attack Munitions).

As an example, assume that two additional FA-18Es were on the approved unfunded list. With sufficient funds in the Navy escrow account, those aircraft could be added to the current or future years acquisition. Within this scenario, however, are several potential difficulties. First, the impact on the DoN programming and budgeting phases of the PPBS process, the Office of the Secretary of Defense (OSD) and the Office of Management and Budget (OMB) reviews, and eventual congressional debate are unknown.

Due to this potential uncertainty, the gaming or strategic misrepresentation of actual requirements and budget authority may become more prevalent. The following (albeit, oversimplified) dilemmas may be faced at various phases of the PPBS process and congressional budget debates:

- Would Congress fund 20 FA-18Es when DoN requests 22 with the expectation that internally derived savings from the Navy escrow account will fund the remaining two aircraft?

- Will the Navy escrow account simply become a bill payer for previously "funded" requirements that are shifted to the unfunded requirements list?

3. Future Years' Obligations

The third manner in which Navy escrow account funds may be utilized is in their application towards future years' obligations. This line of funding may adopt two different forms: funding in excess of the DoN proposed top-line or funding to be applied to the DoN top-line.

In terms of creating an incentive for cost saving initiatives, the ability to carry over funds from one year to the next is critical. This serves as a reward to the DoN for prudent financial management as DoN can redirect those savings towards necessary or additional mission requirements.

These funds may then be used to buy additional aircraft, weapons, and computers as part of a future year's acquisition, or be applied toward additional MWR related projects. In order to maintain the proper congressional control, a notification process of 15 or 30 days may be required.

On the other hand, if the balance in the Navy escrow account is simply deducted from the top-line of DoN's budget, the incentive is lost. The cost savings initiatives, for all intents and purposes, are returned to the general Treasury. In this case, the respective financial managers are better off, from an asset and morale standpoint, by obligating 100% of their resources within their respective commands.

4. Additional Considerations

Although the proposed escrow account could be used to fund any emergent requirement, there are two areas that should be considered for exclusion: military pay and MILCON. First, some of the previous military pay increases have been accomplished through a combination of additionally supplied congressional funds and internally produced DoD funds through targeted reductions of other programs. Excluding the escrow account from such a use may help pay raises receive full funding from Congress. Without such a rule, the escrow account may be used as a congressional bargaining chip to force DoD budget reductions to make pay increases viable.

Secondly, MILCON appropriations can potentially carry significant political baggage. Unlike O&M accounts, which are not typically site specific, MILCON projects provide specific benefits to a single district or state. Using escrow account funds for such projects may create unnecessary tension during the congressional notification process. Therefore, consideration could be given to restricting MILCON projects from receiving escrow funds, although they could contribute to the account.

D. BALANCE ADJUDICATION

Resolving many of the potential problems facing the use of Navy escrow account funds is directly linked to the final adjudication of the fund’s balance at the end of the fiscal year. The ideal situation for the Navy escrow account is to have all transferred funds lose their fiscal year identity and original purpose. With this increased flexibility, decisions based purely on the needs of the service, in conjunction with the overarching (NSS), can be made to meet the forecasted requirements. With any restrictions on time or purpose, the capabilities of the account to recapitalize the aging assets or to improve infrastructure will be diminished.

There are unlimited possibilities for the adjudication of escrow account funds. However, three basic scenarios are highlighted in the following sections.

1. Fiscal Year Carryover – No Year – No Color

The most flexible option for DoN financial managers is to have the funds, once transferred, lose their fiscal year identity and purpose. The account then becomes an open checkbook for covering emergent expenses or investing in recapitalization efforts.

The critical aspect with such an account is maintaining congressional intent. This may require a nominal notification period, as previously discussed, or a more significant approval process, possibly the approval of the House and Senate Armed Services Committees (HASC and SASC) and the House and Senate Appropriations Committees (HAC and SAC).

Contrasting the proposed process with the actions from the corporate sector, distinct parallels can be drawn. From a pure corporate standpoint, funds saved from a given project or fiscal year can be reinvested in other capital projects, applied to future years' operational requirements, held as retained earnings, or distributed to the investors in the form of dividends.

In most corporate situations, an elected board of directors makes decisions for the shareholders as to the best use of their capital. Similarly, Congress is acting as the elected board of directors serving the taxpayers. In this role, they are the final authority for the obligation of funds from the escrow account. However, with a greatly simplified process, nominally a short notification period, DoN managers could make timely and more informed financial decisions as to the obligations of available funds.

2. Share Ratio

The second potential process for fund adjudication is to return any balances at the end of the year to the general Treasury. As a strategy, in and of itself, this proposal fails to provide any incentives for local financial managers to derive any savings. However, if the funds were returned on a shared basis, similar to share ratios established in contracts, the process could prove popular with both Congress and DoD/DoN officials.

With a share ratio, a given percentage would remain with the respective department within DoD (Army, Navy, etc., assuming all departments would participate). Initially, it would be desirable for all funds to remain within each department. In time, funds may be distributed between other departments within DoD, and eventually, the share ratio could be adjusted to include the other discretionary accounts within the federal government or returned directly to the general Treasury.

Another tactic may be to start with a higher share ration in an attempt to garner congressional support. The percentage may initially be 50/50, with 50% staying within the DoN/DoD for its utilization and the other 50% returning to the general Treasury. As confidence in the DoN/DoD's ability to responsibly generate and reapply savings consistent with congressional desires, the share ratio may be increased or eventually eliminated.

3. Obligation Period and/or Balance Limit

A third possibility is the creation of obligation periods and/or balance limits. Under this scenario, funds transferred into the Navy escrow account may be available for obligation for a designated time-period. This methodology is more applicable if the funds retained their purpose (i.e., APN funds could be used for APN purposes only, O&M funds could be used for O&M purposes only, etc.).

Funds would be transferred with a specific date tag and originator that would result in a given obligation period for the funds. The obligation periods may be similar to existing limitations such as one year for O&M or three years for APN from the time they are transferred into the escrow account. By maintaining their purpose with the additional time limitation, congressional approval may be easier to garner.

An additional option is to place a balance limitation on the account. In reviewing the problems that resulted in the demise of the M and Merged Surplus accounts, it was the amount of the request, nearly $1 billion, which drew the initial congressional attention. Subsequently, once it was discovered that the two accounts had a combined balance approaching $45 billion, Congress had little choice but to take action.

Imposing a limit, whether a specific dollar amount or percentage of total obligation authority (TOA) for a given fiscal year, will provide a level of oversight that will prevent the account from becoming a slush fund of unlimited proportions.

E. LEVELS OF CONTROL

There would be two separate controls for the Navy escrow account: those internal to the DoN and those external. Within the DoN, control of Navy escrow account funds would require balancing the need for local incentives that encourage cost savings initiatives while providing a greater corporate perspective to optimize the utilization of available resources.

External controls would primarily be concerned with gaining OSD and congressional approval for proposed applications of escrow funds. In both cases, successful applications of escrow account funds would be contingent on timely and requirements based (vice politically motivated) decision making on the part of all involved parties.

1. Internal Levels of Control

The greatest potential for generating savings would exist if all funds generated would remain under the control of the respective command that created the savings. Then, as new or additional requirements emerge, funds could be returned from the escrow account to cover the new requirements. This, of course, fails to address the larger issue of recapitalizing the Navy’s aging ships, aircraft, and infrastructure.

To achieve the maximum benefit for the DoN as a whole, the Navy escrow account will have to be under corporate control. As noted by the Chief of Naval Operations (CNO), Admiral Vern Clark:

> What would make a local commander think he has a better use of [generated] savings, than corporate headquarters?[30]

It would logically follow that the proposed spending would be in line with the following documents:

- National Security Strategy – NSS.
- National Military Strategy Document – NMSD.
- Chairman’s Program Recommendations – CPR.
- Chief of Naval Operations Program Analysis Memorandum (CPAM).
- Defense Planning Guidance (DPG).

The proposed process would have the respective Program Sponsors submitting proposals based on fleet inputs to the Resource Sponsors, who would then present a unified plan to the Deputy Chief of Naval Operations (Resources, Requirements and Assessments - N8) for submission to the Office of the CNO. This process has the potential, as seen in reprogramming battles, to be lengthy. However, mitigation of escrow decisions and creation of an unfunded requirements list could be made in a fashion similar to current budget decisions.

As such, the CNO, Commandant of the Marine Corps, FMB, Assistant Secretary of the Navy (Financial Management and Comptroller)(ASN(FM&C), and the Secretary of the Navy would play active roles in the final review of the unfunded requirements list. Reducing the decision-making time and internal battles for increased budget authority is clearly one of the most difficult, internal challenges to successful implementation.

The other significant internal challenge is creating the incentives for generating savings. If "all politics are truly local," then some incentive must exist for local managers to relinquish control of budget authority. For top-down generated savings initiatives or wedges, this may not be as critical. However, to achieve genuine compliance and bottom-up support for the program, there must be some reward. Awards for top financial managers, share ratios, or other programs may provide the requisite motivation.

2. External Levels of Control

The external levels of control, in theory, would provide limited oversight in the form of OSD review and congressional notification. Figure 3.4 outlines the proposed internal control and external oversight processes.

There are a few assumptions that facilitate the rapidity at which funds from the Navy escrow account may be utilized. First, internally derived requirements must be in line with the overall military objectives established in the NSS and NMSD. Proposed uses for the funds will not include frivolous items, but will be destined to cover shortfalls, unexpected cost overruns, or items from the unfunded requirements list.

Secondly, OSD review does not become a process by which funds from possible Air Force or Army escrow accounts are reviewed collectively and subsequently distributed outside of the contributing service. Although there is merit in adopting this DoD-wide perspective, the fight for control of the available funds and potential for losing control of internally derived savings would seriously diminish any incentive to contribute to the program.

However, DoD oversight, at this level, may be the necessary external control that pushes the program to its ultimate approval. Mitigating the negative effects of long reviews or a detailed justification process may require the addition of spending thresholds, possibly specific to each appropriation or Resource Sponsor, which would establish differing levels of review dependent on the amount and purpose of proposed spending.

The other aspect of external review is congressional notification and the relevance of the proposed spending to the original intent of Congress. The Navy escrow account could operate in a fashion similar to the Family Housing Improvement Fund (FHIF) (discussed in Chapter IV), which requires congressional notification 30 days prior to transferring funds into the FHIF from under-obligated accounts.

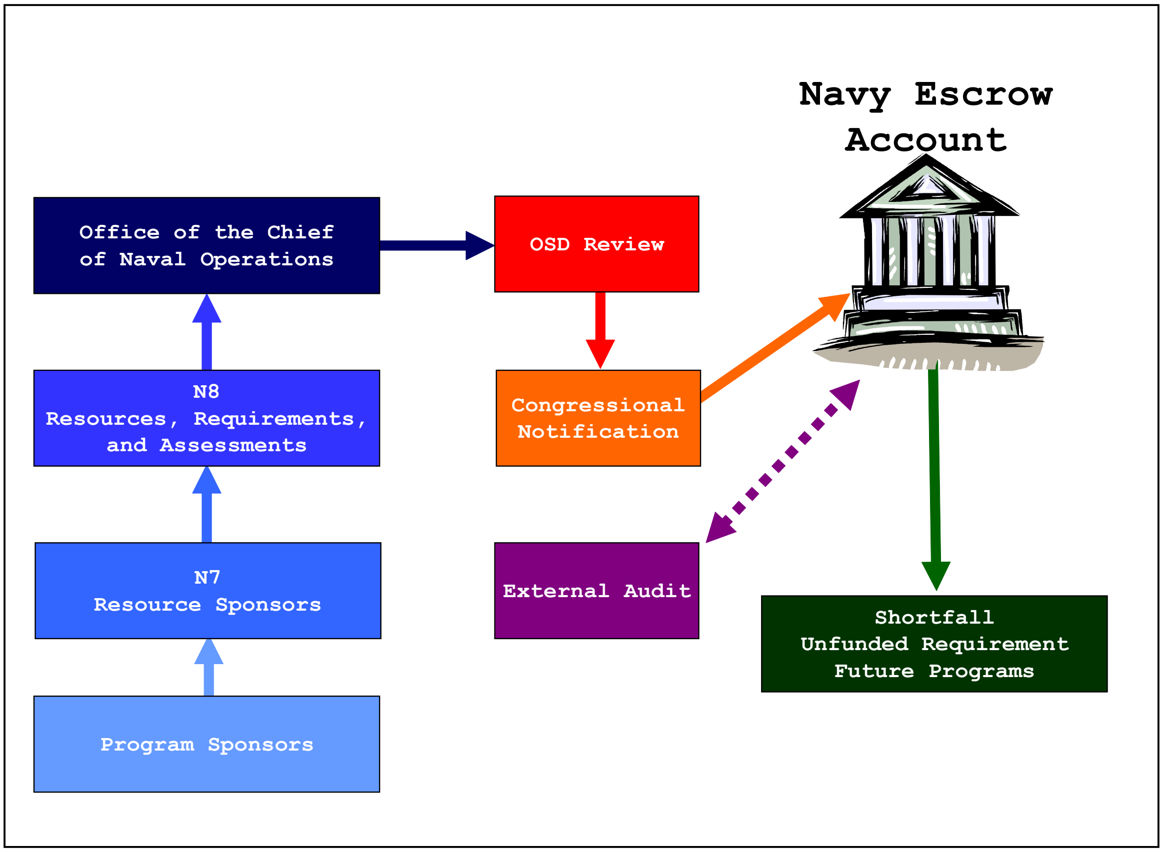
The goal in congressional notification is to avoid detailed congressional review and, possibly, congressional testimony. Similar to an OSD review, mitigating the difficulties with congressional review may require the addition of spending thresholds and/or different levels of review dependent on the originating appropriation and destination appropriation for Navy escrow account funds.

The final level of review is the presence of an external audit and standardized reporting procedures. These requirements are in response to several legislative actions designed to improve financial accountability within the federal government. Of specific relevance to the Navy escrow account:

- Government Management Reform Act of 1994 (GMRA) - established the requirement for annual audited financial statements.
- Federal Financial Management Improvement Act of 1996 (FFMIA) – directed compliance with the use of the Standard General Ledger (SGL), the Federal Accounting Standards Advisory Board (FASAB) guidelines, OMB A-11, and that all systems have adequate security controls.[31]

Maintaining adequate external control and oversight through effective audits will help prevent the problems that facilitated the end of the M and Merged Surplus accounts.

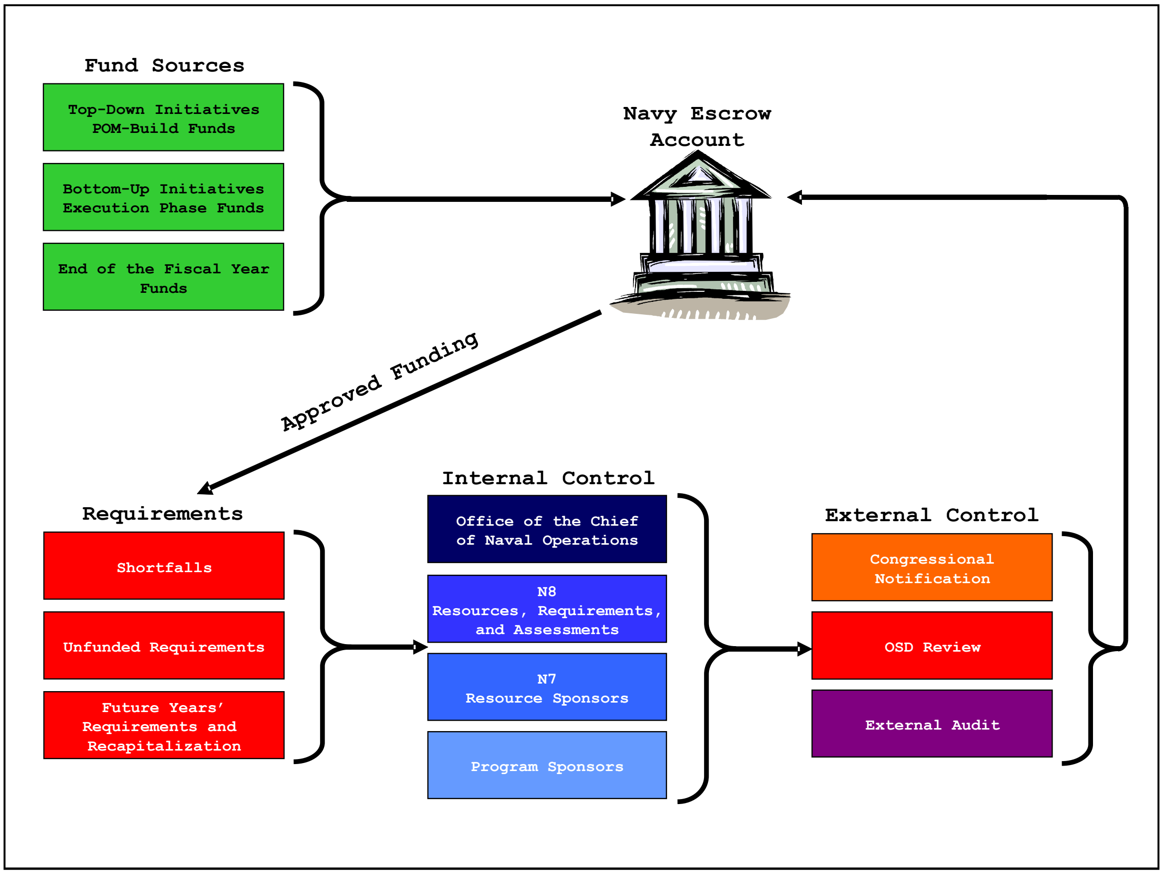
Figure 3.4 Internal and External Control Processes



F. SUMMARY OF OPERATIONS

A Navy escrow account could possess numerous operational possibilities including the sources of funds, levels of control, and destination for transferred funds. The combination of the various elements is highlighted in Figure 3.5.

Figure 3.5 Navy Escrow Account Operations Diagram



IV. MODEL PROGRAMS

A. POTENTIAL MODELS WITHIN DOD

One of the easiest ways to start a new program is to copy one that is already in existence. This is especially true within the federal government and DoD as many of the regulations governing a similar program are the same for the one being considered. Although there is no one existing program that contains all of the functionality desired in the Navy escrow account, several programs have established precedence, within the federal system, for the recapitalization or future application of actualized savings.

The goal in reviewing existing programs is to stimulate thought, make applicable comparisons, capitalize on existing frameworks, and to build upon a commonly accepted and agreed upon contextual framework. Each of the following programs will be generally defined, the source and disposition of "savings" or "funds" is discussed, and the program's relevance to the Navy escrow account is highlighted.

B. BUDGET PREPARATION – MILITARY PERSONNEL

Budget preparation within the DoD is a difficult task. Due to the complexity, pieces are reviewed individually, and subsequently combined, becoming the collective budget. Reliance on in-depth analysis gives way to an incremental approach to budget preparation – this year's budget will be close to next year's budget with some small, or incremental, increase or decrease. The concept of incrementalism, most often credited to Aaron Wildavsky, stems from the complexity of the budget and our limited cognitive abilities.[32] Adroitly processing the volume of information contained in any one budget has thus become a nearly impossible task. The difficulty of budgeting, specifically in-depth analysis of individual line items is compounded by the high personnel turnover within DoD.

The problem of finding waste or potential savings within the budget routinely becomes a "top-down" initiative. "Targeted wedges" or other cuts are commonly distributed throughout DoN, forcing the scrutiny of individual accounts and programs. Alternatively, "bottom-up" generated reductions are less common as the savings realized may result in future budget authority lost. Creating an incentive for such efforts is often the catalyst for increased budget scrutiny and realized savings.

1. Military Personnel Budget Guidance

Secretary of the Navy Richard Danzig in his statements to the SASC in 1999 discussed his "Smart Work" concept:

> [Smart Work is] designed to lessen the demands upon our Sailors and Marines by increased automation, better design, and more appropriate investments in equipment.[33]

As a special initiative of the Smart Work program, a budget process mechanism was established to increase managerial flexibility. In preparation for the FY2001 and FY2002 budgets, Budget Submitting Offices (BSOs) were encouraged to review manning requirements for the various commands under their auspices.[34]

The program enabled Commanders to eliminate non-essential billets or those that did not optimize mission accomplishment. The critical mechanism and incentive within the program was an ability to reapply any savings achieved to unfunded approved program requirements.

Proposals for reapplying savings were evaluated in the budget review process and subsequently approved if they were consistent with manpower management goals and departmental and service priorities.[35]

2. Relevance to the Navy Escrow Account

The success of the Navy escrow account will depend, in part, on the success of the budget process. Within this process, creating the incentive for detailed budget analysis, in conjunction with the continued transformation of the force structure and related processes, is essential.

There are three incentive possibilities in the budgeting process for realizing savings: allow all savings to stay "local," place all realized savings in the corporate level Navy escrow account, or, allow some savings to be utilized locally based on a share ratio.

Allowing the savings to remain within the BSO's cognizance or at the specific command level provides the greatest incentive in the budget process. In some cases, these efforts may be in-line with the Navy's overall recapitalization efforts. Alternatively, localized savings may not produce the requisite dollar amounts for any significant increase in capability or recapitalization of infrastructure (another FA-18, childcare center, etc.).

As oversight for any reapplication will be required, retaining the savings locally may place an excessive justification burden on the local command as well as their respective chain-of-command. Additionally, if all savings stay local, there may be a push to obligate those funds similar to that seen at the end of the fiscal year.

The second option for harvesting savings in the budget process is to transfer all funds directly into the Navy escrow account. Although this provides the greatest flexibility on a corporate level, the incentive for any BSO or lower echelon commands to generate savings relies on the ethical altruism of their respective personnel. Not only would funds be forfeited in the upcoming year, there would be a significant probability of the funds being lost in future years.

There are several possibilities to help alleviate these fears. First, the contributing command could have a lien against the funds placed into the Navy escrow account to cover any unforeseen shortfalls. Secondly, an assessment period of two, three, or even five years may be required prior to making any “reductions” in budget authority permanent. Thus, when projected savings in one budget year materialized, a deduction in the command’s budget authority would not automatically become permanent. Finally, one cannot overlook the power of properly marketing the proposed changes and the use of community specific change agents. Simply requesting cuts without outlining the projected benefits will prove to be ineffective. Additionally, the messenger is almost as important as the message itself. Using well-respected leaders in the individual communities will increase acceptance.

The third option for harvesting savings in the budget process is to allow some savings to be utilized locally based on a share ratio. As an example, the ratio may allow 20% of the savings to be reapplied locally from an approved unfunded requirements list while the remaining 80% is transferred into the Navy escrow account. This limits the bureaucracy while providing an incentive for scrutiny of budget submissions.

Regardless of the exact nature of the incentive, harvesting savings in the budget process is one of the first steps in funding the Navy escrow account. The Military Personnel initiative provides the grounds on which to build a similar mechanism.

C. BUDGET EXECUTION - FAMILY HOUSING IMPROVEMENT FUND

The National Defense Authorization Act for FY1996, P.L. 104-106, established the Military Housing Privatization Initiative (MHPI) and the Family Housing Improvement Fund (FHIF).[36] MHPI enables the DoD to work with the private sector to build and renovate military housing. Upon project completion, under the MHPI, DoD personnel occupy privately built and maintained housing with their Basic Allowance for Housing (BAH) serving as the rental payment. The FHIF (provides the financial mechanism for enacting projects within the MHPI (A second account, the Military Unaccompanied Housing Improvement Fund (MUHIF) is similar in functionality to the FHIF and was enabled via P.L. 104-106.[37] For this discussion, the FHIF will be the primary focus).

1. Source of FHIF Funds

Funds deposited into the FHIF originate from four sources:

- Direct appropriations.
- Transfer of appropriated Family Housing construction funds.
- Proceeds from the sale or lease of DoD property or facilities.
- Income and gains from investments and return of invested capital.

Currently most funds are provided through the transfer of appropriated Family Housing construction funds. Upon being transferred, the funds lose their fiscal year identity. However, the account is limited to a total budget authority of $850 million ($150 million for the MUHIF) and all transfers must be for a defined project and at the full, appropriated value of the project. Funds are subsequently earmarked for specific projects. Simply "banking" expiring funds for a project that has yet to be defined is prohibited.

Additionally, the potential for realizing income or gains from investments such as limited partnerships, purchase of stocks and/or bonds does exist, providing the purpose of the investments is to obtain or improve housing. In theory, this can provide an external stream of income (outside the federal government) for future housing projects.

2. FHIF Utilization

The FHIF provides the financial support for administering and executing contracts, loan subsidy cost payments, differential and annual lease payments, and investments in nongovernmental entities previously discussed.

The Family Housing Master Plan (FHMP) provides the framework for FHIF utilization. However, within the plan, considerable flexibility exists. For example, assume DoN has contracted for a series of single-family homes to be constructed in San Diego. In the contract, $20 million was earmarked to support the project. However, the contractor, through realized efficiencies or additional external financing only requires $10 million in government support to complete the project. The remaining balance from the project, in this case $10 million, can now be spent on a project from the FHMP in the same or different location based on the needs of the Navy.

Additionally, government owned and operated installations with improvements or modifications funded in the out-years that are subsequently privatized can provide a source of savings. These savings can then be applied against projects on the FHMP. If no emergent projects exist, the realized savings remain in the FHIF, lacking any fiscal year identity.

For FHIF projects requiring the transfer of funds into the FHIF, the following steps are required:[38]

- Upon approval to proceed by the DUSD(IA&I), the component sponsoring the project submits a request to the Military Construction Directorate, Office of the Deputy Comptroller (Program/Budget) (ODC(P/B) identifying the amount and source of funds and the applicable apportionment and reapportionment schedules.
- ODC(P/B) provides congressional notification (30-day period).
- ODC(P/B) notifies OMB (15-day period – to be satisfied within the 30-day congressional notification period).

For FHIF projects not requiring the transfer of funds into the FHIF (funds already exist within the FHIF), similar steps are required with only minor adjustments. Upon approval for the project by the DUSD(IA&I), notification and justification for the project is conducted by DUSD(IA&I) and not the component sponsoring the project.

3. Relevance to the Navy Escrow Account

Two aspects of the FHIF are particularly relevant to the Navy escrow account. First, the ability and flexibility to realize savings and to apply those savings in a manner that "recapitalizes" the DoN infrastructure is the core procedure of the Navy escrow account. The FHIF possesses the required mechanisms and procedures to allow for the transfer and/or utilization of funds for recapitalization projects. Although the transfer funding process for the FHIF can be "Laborious in its bureaucracy," as described by Mr. Rick Flansburg at the Navy Facilities Headquarters, it typically does not become a major issue.[39]

Secondly, the funds within the FHIF lose their fiscal year identification. It is important for savings to be realized that the time element associated with the appropriations process be mitigated. Without such a capability, the annual "rush" to obligate all expiring balances could not be prevented and savings would be difficult, if not impossible, to realize. For the Navy escrow account, the same logic holds true.

The FHIF is not a perfect model. There are two critical differences between it and the proposed Navy escrow account. First, the FHIF is ostensibly an account that funds a single program – family housing. Maintaining congressional intent between savings realized on Project A and subsequent spending of those savings on Project B is not difficult. In fact, since Project B is on the FHMP, the account expedites the execution of congressional intent. This may not be the case with the Navy escrow account as O&M savings may fund the acquisition of an extra FA-18E in the following fiscal year.

Secondly, the FHIF is fiscally constrained. This is not to imply that the Navy escrow account, unlike the previous M and Merged Surplus accounts, cannot be similarly constrained. However, the limit, whether it is a specific dollar amount or possibly a percentage of the overall DoD appropriation, should not be so low as to preclude the additional harvesting of efficiencies or savings when they come available.

D. BUDGET EXECUTION – ENERGY AND WATER CONSERVATION

The DoD currently consumes more than three-fourths of the Federal government's energy use. In 2001, the DoD spent $6.8 billion on energy use.[40] Attempting to control costs, Congress enacted several measures to encourage the conservation of energy and water at DoD facilities:[41]

- Title 10 U.S.C. § 2865 – Energy savings.
- Title 10 U.S.C. § 2866 – Water savings.
- Title 10 U.S.C. § 2867 – Proceeds from sales.
- Title 42 U.S.C. § 8287 – Energy Savings Performance Contracts (ESPC).

Included in these measures are provisions for retaining portions of the savings beyond the current fiscal year and obligating those savings towards unrelated, but defined, projects and/or programs.

1. Energy Savings

The enabling legislation, Title 10 U.S.C. § 2865, allows the retention of two-thirds of the appropriated funds resulting from the energy cost savings initiatives remaining at the end of the fiscal year.[42] An annual recurring provision contained in the DoD appropriations acts allows the remaining balance to be available for obligation into the following fiscal year.

The savings not obligated in the current fiscal year are subsequently transferred into an extended availability account. They are available for expenditure for five years following the year in which the funds expired for obligation at the end of the year of extended availability – a total of six years.

One-third of the savings may be applied to additional energy conservation measures, including water conservation. The department or agency primarily responsible for realizing such savings may designate the buildings or installations to receive the additional conservation measures.

Additionally, one-third of the savings must be used at the installation where the savings were realized, at the discretion of the Commanding Officer. Notably, the funds can be used for improvements to existing family housing, unspecified minor construction improving the quality of life for personnel, and any morale, welfare, or recreation (MWR) facility or service.

2. Water Savings

Title 10 U.S.C. § 2866 provides the same functionality in terms of water conservation saving as Title 10 U.S.C. § 2865 does for energy conservation. The application of savings is the same: one-third of the savings may go towards conservation initiatives and one-third must go towards programs at the installation realizing the savings.

However, unlike the energy savings provided in 2865, 2866 funds are not approved for extended availability. Therefore, all funds as the result of cost saving initiatives must be obligated during the period for which they were originally obligated.

3. Proceeds from Sales

Title 10 U.S.C. § 2867 provides for the proceeds from sales of electricity to a public or private utility be credited to the appropriation account of the department concerned for the supply of electrical energy. The specific accounts are credited are at the discretion of the appropriated service branch Secretary.

As is the case with funds generated through water conservation efforts, funds through the proceeds of energy sales are not approved for extended availability. There are also provisions on the applications of the funds generated through the sales of electricity:

- Military construction projects under energy performance plans in conjunction with the provisions of Title 10 U.S.C. § 2865(a).
- Minor military construction projects authorized by Title 10 U.S.C. § 2805 designed to increase energy conservation.

Congressional notification is required 21 days prior to the commencement of such projects by the appropriate service Secretary. Included in the notification is the project's justification as well as the estimated cost of the project.

4. Energy Savings Performance Contracts (ESPC)

Title 42 U.S.C. § 8287 is an amendment to Section 736 of the National Defense Authorization Act for FY1989. Section 736 addresses ESPCs, which enable Federal agencies to improve the energy efficiency of their facilities without depending on congressional appropriations for capital improvements. As compensation for the capital investments, the private firms are awarded a share of the savings during the term of the contract (not to exceed 25 years).

The contract includes a guaranteed savings amount and the level of compensation to be paid to the contractor. Since 1988, federal agencies have used ESPCs to leverage over $800 million in private-sector investment to improve facilities and to meet federal reduction goals.[43]

The total cost savings realized during the first five years of the ESPC are available for obligation. Not more than 90 days after the end of each of the first five years of an ESPC program, the amount of energy cost savings attributed to the respective ESPC must be determined by the Secretary or his designee. However, unlike Title 10 U.S.C. § 2865, the funds are not open to an extended period of availability.

Of the funds generated through an ESPC program, one-half of the amounts may be used for the acquisition of an appropriate energy conserving measure. Additionally, one-half may be used for any MWR facility or service or for any minor military construction project enhancing the quality of life of military members at the installation at which the savings were realized.

5. Relevance to the Navy Escrow Account

There are two factors in the savings application mechanisms inherent to the energy and water conservation initiatives that are pertinent to the implementation of the Navy escrow account. First, the extended period of obligation provided by Title 10 U.S.C. § 2865 is noteworthy. Although the funds do not completely lose their fiscal year identity, in that they have an additional five years to be obligated, the precedent for removing the fiscal year identity of funds would be a core feature in the design of the larger Navy escrow account.

Secondly, the application of funds towards programs outside of what would normally be considered consistent with the respective fund's initial congressional intent is a key characteristic desired in the Navy escrow account. Although the scope of the deviations away from conservation related projects is limited to housing, quality of life, and MWR related programs, the funds are outside the normal O&M appropriations.

Creating similar functionality with the Navy escrow account will require a more extensive congressional notification process and/or greater attention placed on the unfunded requirements list. However, the basic process has been effectively applied within the conservation initiatives. Subsequently, they provide a foundation, upon which, the Navy escrow account may be built.

E. DEPARTMENT OF HOMELAND SECURITY

In the creation of the Department of Homeland Security, it was recognized that a certain degree of flexibility would be required. As noted by Senator Fred Thompson, (R – TN):

> The bill to create a Department of Homeland Security consolidates 22 Federal agencies comprising 170,000 employees, 17 different unions, 77 existing collective bargaining agreements, 7 payroll systems, 80 different personnel management systems. It is a monumental job under any circumstances...we all agree that flexibility is needed.[44]

As the new department was attempting to counter a poorly defined and unconventional threat, there was considerable congressional concern that the conventional appropriations process and execution constraints may not provide the ability to react quickly and effectively to emerging threats. However, that concern was tempered with an understanding of the difficulties with such proposals as noted by F. James Sensenbrenner Jr., (R - WI), Chairman of the House Judiciary Committee:

> It's going to get a bumpy ride. You're dealing with conflicting recommendations and the protection of turf...I think we know where we're going to get – from Point A to Point B - but how straight the road will be remains to be seen.[45]

1. Homeland Security Act of 2002

The Homeland Security Act of 2002, P.L. 107-296, was signed on November 25, 2002. Within the original bill, House Resolution (H.R.) 5005, was a provision to provide increased financial flexibility for the Secretary. Section 733, paragraph (b) states:

> Except as otherwise specifically provided by law, not to exceed five percent of any appropriation available to the Secretary in any fiscal year may be transferred between such appropriations, except that not less than fifteen days notice shall be given to the Committees on Appropriations of the Senate and House of Representatives before any such transfer is made.[46]

This bill was introduced by House Majority Leader Richard K. Armey (R - TX), who was forced to appease leaders of the House Appropriations Committee, who opposed the White House's plan to give the head of the new department such spending discretion. Representative Armey lowered the discretionary transfer authority to 2 percent, and only for the first two years of the department's existence, in an attempt to make the clause more acceptable. Although this satisfied some members of the House, specifically the House Appropriations Committee Chairman, Representative C.W. Bill Young (R - FL), the final version of the bill as it left the Senate contained no such clause.[47]

2. Relevance to the Navy Escrow Account

Successful implementation of similar programs provides a positive model for the Navy escrow account. As important as these may be, failed attempts to achieve financial flexibility may offer more insight into the problems facing the establishment of such an account. In the case of P.L. 107-296, two issues must be considered: congressional control of appropriated funds is almost sacrosanct and any legislation that surrenders such control is setting an unwelcome precedent.

The sanctity of congressional control is not an absolute as demonstrated by the capabilities within the energy and water conservation programs and the FHIF. However, those programs are limited in scope and scale. In terms of Homeland Defense, with its $40 billion budget, a five percent discretionary spending authority would have provided a $2 billion fund for which, Congress has ostensibly no control. Even at a two percent limit, $800 million in spending would be at the discretion of the Secretary. Without additional bounds (excluding the 15 day notification requirement), such control, as in this example, may prove impossible to obtain.

The second issue that must be recognized is the reluctance of Congress to set such a spending precedent. The successful implementation of any program that provides large-scale discretionary spending of appropriated funds within the federal government may be perceived as relinquishing too much control from a congressional frame of reference. Understanding these concerns and providing sufficient controls on any "flexible" spending will be critical for the successful implementation of the Navy escrow account.

Chapter V provides the historical foundation that has helped shape the currently held congressional beliefs with regards to control of appropriated funds.

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V. STATUTORY BARRIERS

A. PRECEDENCE FOR CURRENT LAWS AND REGULATIONS

A proper understanding of the current laws and regulations governing the appropriations process requires a review of the events and sequential steps that brought about their development. Of specific relevance is the need to maintain congressional oversight and intent in the spending of the nation's financial resources.

The establishment of a legislatively controlled appropriations process dates back to 1215 with the signing of the Magna Carta. Within the document's 69 articles, resides the foundation for the current process:

> No scutage on revenue shall be imposed in the kingdom unless by the Common Council of the Realm.[48]

The concessions were forced upon King John of England by a group of rebellious barons who had taken up arms. Originally outlined in a document known as the "Articles of the Barons,"[49] they formed the foundation of the Magna Carta, which would separate the power of the purse from the Crown.[50] However, it did not mandate the intent of funds authorized for the King's use. Such restrictions would not exist until the middle of the fourteenth century when Parliamentary bills included provisions for the intent of spending, rules for fund disbursement, and penalties for violating the prescribed practices.[51]

Uniquely American attempts to enact spending controls started prior to the Revolutionary War. Colonial legislatures established the salaries of the Royal Governors through an annual authorization while appropriation language included the specific purpose for the utilization of funds.[52]

Following the Revolutionary War, during the formation of the new government and throughout the debates that framed the Constitution, separating the Executive branch from the control of government funds was a priority. As the leading architect of the United States' financial management system, Alexander Hamilton, wrote during this period:

> The House of Representatives cannot only refuse, but they alone can propose, the supplies requisite for the support of the government. They, in a word, hold the purse.[53]

Although congressional control of the appropriation process was secured through the Constitution, preventing the transfer of funds between appropriations and maintaining specific congressional intent proved problematic. The Federalist's favored lump sum appropriations, while the Republicans, led by Thomas Jefferson, favored line item specificity.[54]

Throughout the following century, numerous budgetary problems arose: deficiency appropriations, surpluses carried forward, transfers between military departments, and expenditures made without legal precedence.[55] The process remained substantially unchanged until the passing of two specific pieces of legislation. First, in 1921, the passage of the Budget and Accounting Act, created the Bureau of the

Budget (the predecessor to OMB) and the requirement for the Executive branch to submit an annual budget. Although this act increased financial accountability, it shifted some of the financial power to the Executive branch and away from Congress.

The second piece was the Congressional Budget and Impoundment Control Act of 1974. This act shifted the budget power back to Congress with the creation of the House and Senate budget committees and the Congressional Budget Office (CBO), giving Congress an analytical arm to help review and develop budgets and to stay within preset budget limits.[56] Additionally, the legislation established the reconciliation process whereby Congress changes existing laws to conform to tax and spending levels (balancing of revenues and expenditures).

The absolute nature of congressional power was demonstrated in 1981 when, for the first time, they established binding targets for taxing, spending, and debt.[57] The evolution of this power, with its roots in the unfair practices of the English monarchy and nurtured from the earliest days of the newly created United States, is critical to understanding the statutory limitations facing the creation of a Navy escrow account.

The following paragraphs outline the specific laws and regulations that present barriers to the implementation of such an account. The text of the law is provided with a brief description of its relevance to successful implementation of the escrow account and potential solutions to mitigate the problems.

B. CURRENT LAWS AND REGULATIONS

Within the various codes that govern the financial practices of the United States Armed Forces, there are two distinct categories: codes that define the appropriation process and codes that define the obligation/expenditure process. In both instances, there are similarities between the statutory requirements that present common problems. Viewed on a whole, the number of specific codes limiting the appropriation, obligation and expenditure processes seem insurmountable. However, because of the uniformity within various restrictions, there reside clear solutions for mitigating the problems they pose in the implementation of the Navy escrow account.

Additionally, the Defense Appropriation Act, by itself, does not provide the authority to incur obligations. Only through an annual Defense Authorization Act does the DoN/DoD gain authority to obligate appropriated funds. The authorization act defines the programs, amounts, and end-strength numbers to be provided by an appropriation.[58]

In the operation of the proposed escrow account, the authority to obligate appropriated funds is paramount. Mitigating this requirement could be accomplished through the inclusion of the unfunded requirements list in the Defense Authorization Act. Another option would be to include “authorization” as part of the congressional notification process. In either case, authority to obligate appropriated funds must be part of the escrow account equation.

The following sections of this chapter discuss the numerous codes that govern the appropriation and obligation processes and provide possible solutions for the challenges they present.

1. Appropriations Process

The overarching restriction applicable to the appropriations process and the foundation for many of the other relevant codes is found in the United States Constitution. Building upon similar language to that found in the Magna Carta, the Constitution outlines the process by which money is withdrawn from the general Treasury. Contained in Article I, section 9, clause 7, the text is as follows:

> No money shall be drawn from the treasury, but in consequence of appropriations made by law; and a regular statement and account of receipts and expenditures of all public money shall be published from time to time.[59]

The requirement for "authorization in law" is additionally found throughout Title 10 U.S.C.. Defining the specific requirements for the armed forces, Title 10 contains numerous applicable sections that prohibit the flexibility desired in the Navy escrow account.

Title 10 U.S.C. § 114 adds further definition to the limitations imparted by Article I, section 9, clause 7, of the United States Constitution. The applicable text is as follows:

> (a) No funds may be appropriated for any fiscal year to or for the use of any armed force or obligated or expended for:
>
> > (1) procurement of aircraft, missiles, or naval vessels;
> >
> > (2) any research, development, test, or evaluation, or procurement or production related thereto;
> >
> > (3) procurement of tracked combat vehicles;
> >
> > (4) procurement of other weapons;
> >
> > (5) procurement of naval torpedoes and related support equipment;
> >
> > (6) military construction;
> >
> > (7) the operation and maintenance of any armed force or of the activities and agencies of the Department of Defense (other than the military departments);
> >
> > (8) procurement of ammunition; or
> >
> > (9) other procurement by any armed force or by the activities and agencies of the Department of Defense (other than the military departments);
>
> unless funds therefore have been specifically authorized by law.[60]

Title 10 U.S.C. § 114, as compared to the Constitution, has a higher degree of specificity in its description of the requirements for expending funds for supporting the armed forces. However, even with its encompassing language and absolute clarity, there are additional sections within Title 10 that provide more detail as to what constitutes military spending. For example:

- Title 10 U.S.C. § 2802 - further defines the scope of actions characterized as military construction.
- Title 10 U.S.C. § 2821 – details additional requirements for authorization of appropriations for construction and acquisition of military family housing.

a. Relevance

From the United States Constitution to the increasingly detailed sections within Title 10 U.S.C., the overarching requirement for all funds utilized by the DoD to be appropriated and/or subsequently transferred by law is clearly stated. Although the funds originate as a result of congressional action through each year's Defense Appropriation, the legal connection between those funds and funds generated because of savings initiatives or reduced spending does not exist.

Implementation of the Navy escrow account requires legal authority to obligate and expend funds that, in the letter and intent of the law, have been legally appropriated for use by the Congress of the United States.

b. Possible Solutions

There are several possibilities for creating a mechanism that complies with the letter and intent of the existing laws governing the appropriations process. For each corrective action, there is an associated probability of gaining congressional approval and a respective increase in overall DoD/DoN flexibility. Figure 5.1 highlights the continuum of possibilities to be described in the following paragraphs.

The first option, and the one that maintains the highest level of congressional control, is to include specific provisions into the subsequent year's Defense Appropriations Act that appropriates Navy escrow account funds. Although this provides the legal authority to utilize the funds, it significantly limits the flexibility for DoD/DoN financial managers.

A similar option is to include the funds from the Navy escrow account in a type of supplemental appropriation. This may be an escrow account specific appropriation, or part of an omnibus Supplemental Appropriation. This increases the timeliness of Navy escrow account utilization, but still limits overall flexibility as the Supplemental Appropriation may be delayed due to other riders contained in the legislation.

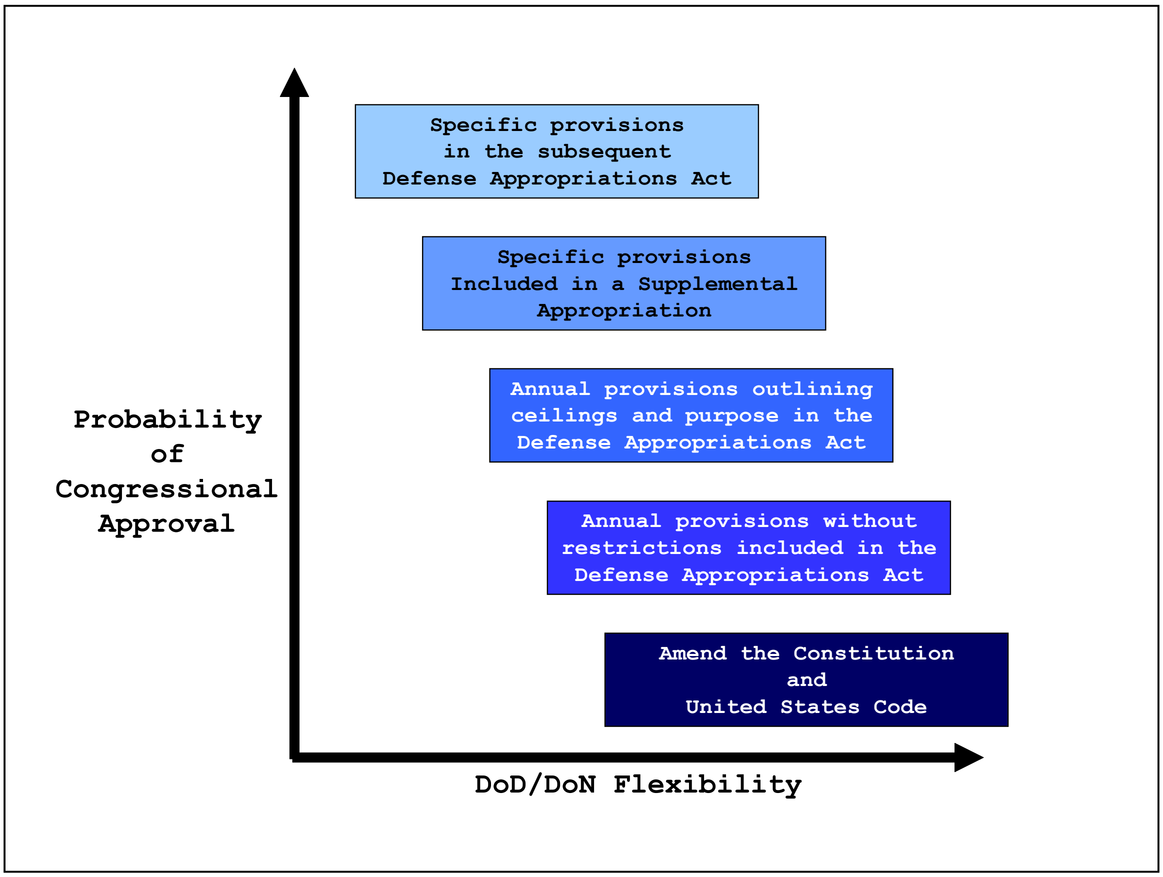
A third option is to include a Navy escrow account general provisions in each Defense Appropriations Act. Because appropriations commonly provide funds for a particular fiscal year, it is presumed that general provisions are likewise for a particular fiscal year. However, in some cases, the provisions can clearly state that it is to remain in effect permanently (i.e., the provision shall remain in effect "hereafter").[61]

Extending general provisions is simplified with the inclusion of the "hereafter" terminology, or through the inclusion of a given provision in each fiscal year's appropriations act. As an example, each Defense Appropriation contains the following clause:

> No more than 20 percent of the appropriations in this Act which are limited for obligation during the current fiscal year shall be obligated during the last 2 months.[62]

This provision, commonly known as the "twenty-two rule" is a general provision of each appropriation.[63]

Figure 5.1 Statutory Mitigation Possibilities



For the Navy escrow account, the provisions could be somewhat restrictive in nature, highlighting specific appropriations and spending ceilings or limits such as:

- Not more than $500,000,000 for APN.

- Not more than 25% may be applied to O&M.

Alternatively, the provisions may be more general in nature, providing the legal authority for the expenditure of accumulated funds. As an example:

- Funds contained within the Navy escrow account are hereby appropriated for obligation per the procedures defined in Title 10 U.S.C. § 9999...

The final option is an amendment to the existing laws governing the appropriation process. Although this provides the greatest flexibility for DoD/DoN financial managers, the relinquishing of this budgetary control by Congress is unlikely. Additionally, the establishment of the Navy escrow account and/or DoD wide account sets the precedence for internal control of appropriated funds. Such a mechanism is likely to be researched and requested by each agency receiving federal funds. Open-ended legislation will be perceived as "opening the flood gates" to a significant loss of congressional control and may not be favorably received by the members of the House of Representatives, Senate, or their constituents.

In the examination of mitigation possibilities, the greatest level of flexibility that can be reasonably expected is the inclusion of an annual general provision with limited restrictions. The restrictions, such as congressional notification as outlined in Chapter III, provide Congress with an ability to approve or disapprove proposed spending. If the procedures call for a 30-day notification procedure with possibly, ten days for congressional review within the HASC and SASC, the increased flexibility for DoD/DoN financial managers and sufficient congressional oversight may be achieved.

2. Obligation and Expenditure Processes

The statutory limitations governing the obligation and expenditure processes are contained in Title 31 U.S.C. The individual sections provide guidelines as to the purpose, time, and amounts available for obligation. Accordingly, they each present a different challenge in the implementation of the Navy escrow account.

a. Color of Money

Title 31 U.S.C. § 1301 establishes the requirement to maintain the application or purpose of appropriated funds. Commonly referred to as the "color of money" statute, the applicable text of the code is as follows:

> (a) Appropriations shall be applied only to the objects for which the appropriations were made except as otherwise provided by law.[64]

Relevance. Title 31 U.S.C. § 1301 prohibits the obligation of appropriated funds for purposes other than originally intended. Currently, appropriated funds may be transferred between appropriations with notification of OMB and Congress.[65]

As discussed in Chapter III, some, all, or none of the original purpose of the funds transferred may be retained as part of an incentive to promote savings or maintain congressional intent. However, to achieve the desired operation and greatest flexibility for the Navy escrow account, removal of the purpose tag from transferred funds is required.

Similar in function to Title 31 U.S.C. § 1301 is Title 31 § 1532, which governs the withdrawal of funds from one appropriation and the subsequent crediting to another fund. The procedure, unless authorized by law, is prohibited. The applicable text is as follows:

> An amount available under law may be withdrawn from one appropriation account and credited to another or to a working fund only when authorized by law. Except as specifically provided by law, an amount authorized to be withdrawn and credited is available for the same purpose and subject to the same limitations provided by the law appropriating the amount.[66]

Possible Solutions. Removing the purpose or "color of money" tag from appropriated funds and allowing their transfer between appropriations may take place during the initial transfer of funds into the Navy escrow account or during the congressional notification process prior to the funds being obligated. If the process is designed such that funds are considered "colorless" once placed into the escrow account, an additional congressional notification process may be required to provide transfer authority. Figure 5.2 highlights the proposed process.

Alternatively, the funds may be transferred into the escrow account, retaining their identity, until they are obligated. Then, during the congressional notification process and without congressional objections, the funds may be considered "colorless" as they are credited to the new appropriation account. Figure 5.3 highlights the scenario for removing the color tag at fund obligation.

Figure 5.2 Color Tag Removed During Initial Transfer

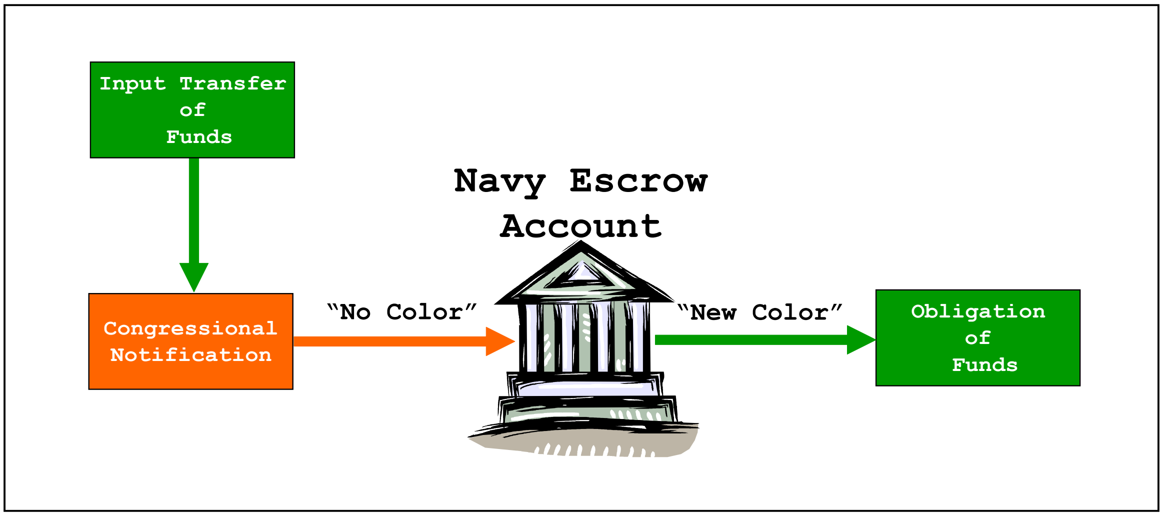
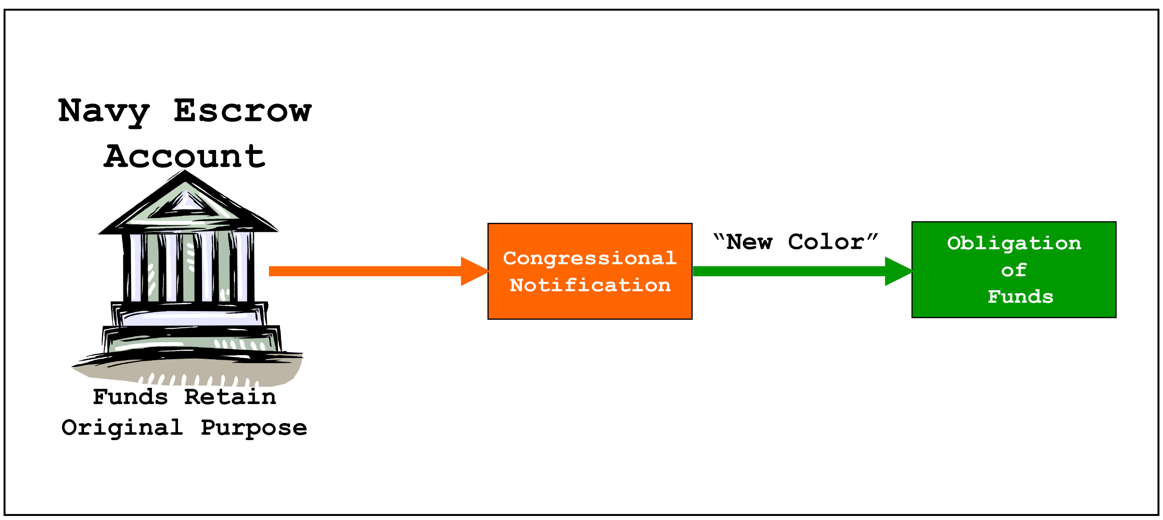


Figure 5.3 Color Tag Removed During Obligation



In either scenario, whether the "color is removed" during initial transfer or fund obligation, the legislation creating the Navy escrow account will need to include a provision that removes the purpose tag. As an example:

- Funds delineated for transfer into the Navy escrow account, upon congressional approval, will remain without a specific purpose until obligated per Title 10 U.S.C. § 9999...

or

- Funds delineated for transfer into the Navy escrow account retain their original purpose and will be tracked accordingly until delineated for obligation. At that time and with congressional approval, the funds will be considered transferred to the new appropriation per Title 10 U.S.C. § 9999...

b. Limitations on Expenditure

Title 31 U.S.C. § 1341 and § 1517 define the limitations on expending and obligating amounts. Title 31 U.S.C. § 1341 applies to appropriations, while Title 31 U.S.C. § 1517 applies to apportionments and is the primary section defining the "Anti-deficiency Act." The applicable text of U.S.C. § 1341 is as follows:

> (a)(1) An officer or employee of the United States Government or of the District of Columbia government may not:
>
> (A) make or authorize an expenditure or obligation exceeding an amount

> available in an appropriation or fund for the expenditure or obligation;
>
> (B) involve either government in a contract or obligation for the payment of money before an appropriation is made unless authorized by law.[67]

The applicable text of U.S.C. § 1517 is as follows:

> (a) An officer or employee of the United States Government or of the District of Columbia government may not make or authorize an expenditure or obligation exceeding:
>
> (1) an apportionment; or
>
> (2) the amount permitted by regulation prescribed under section 1514(a) of this title.[68]

Relevance. Title 31 U.S.C. § 1341 and § 1517 prohibit the obligation of funds in excess of the amount available in the respective account. This requirement, in accordance with the letter of the law and in context of the Navy escrow account, will prohibit the obligation of escrow account funds.

Similar to new programs starts at the beginning of a fiscal year where the Defense Appropriations Act has yet to be signed, the various programs and/or contracts awaiting Navy escrow account funds will need to be placed on-hold pending the formal notification and review process.

Possible Solutions. In the provisions that establish the Navy escrow account, every effort must be made to comply with the applicable U.S.C. sections. In the hierarchy of legislative challenges, Title 31 U.S.C. § 1341 and § 1517 present minor hurdles. However, they must be accounted for in any legislation establishing the Navy escrow account.

To increase financial manager flexibility, the legislation should include provisions that permit the transfer of funds into the accounts receiving funds and provide for direct payment from the Navy escrow account utilizing a separate funding line. Additionally, the legislation must clearly state the need for the notification and review process to be complete prior to the recipient obligating the proposed funds.

Combined, these provisions included in new legislation would facilitate financial managers compliance with prevalidation requirements (the validation of existing obligations over a given amount prior to making a disbursement) resulting from the DoD Appropriations Act of 1995.[69] (The current threshold, established with the FY2000 Appropriations Act, is $500,000).

c. Time Aspect of Appropriations

There are three specific codes within Title 31 that add the element of time to appropriations. Title 31 U.S.C. § 1502, § 1552, and § 1553 define various aspects of the obligation period and the procedures required when the availability period expires. The obligation period, or the time in which valid obligations can be made, varies and is dependent on the type of appropriation. As an example, O&M funds can be obligated for a period of one year, while MILCON funds have a five-year obligation period. The applicable text of Title 31 U.S.C. § 1502 is as follows:

> (a) The balance of an appropriation or fund limited for obligation to a definite period is available only for payment of expenses properly incurred during the period of availability or to complete contracts properly made within that period of availability and obligated consistent with section 1501 of this title. However, the appropriation or fund is not available for expenditure for a period beyond the period otherwise authorized by law.
>
> (b) A provision of law requiring that the balance of an appropriation or fund be returned to the general fund of the Treasury at the end of a definite period does not affect the status of lawsuits or rights of action involving the right to an amount payable from the balance.[70]

The applicable text of Title 31 U.S.C. § 1552 is as follows:

> (a) On September 30th of the fifth fiscal year after the period of availability for obligation of a fixed appropriation account ends, the account shall be closed and any remaining balance (whether obligated or unobligated) in the account shall be canceled and thereafter shall not be available for obligation or expenditure for any purpose.
>
> (b) Collections authorized or required to be credited to an appropriation account, but not received before closing of the account under subsection (a) or under section 1555 of this title shall be deposited in the Treasury as miscellaneous receipts.[71]

The applicable text of Title 31 U.S.C. § 1553 is as follows:

> (a) After the end of the period of availability for obligation of a fixed appropriation account and before the closing of that account under section 1552(a) of this title, the account shall retain its fiscal-year identity and remain available for recording, adjusting, and liquidating obligations properly chargeable to that account.[72]

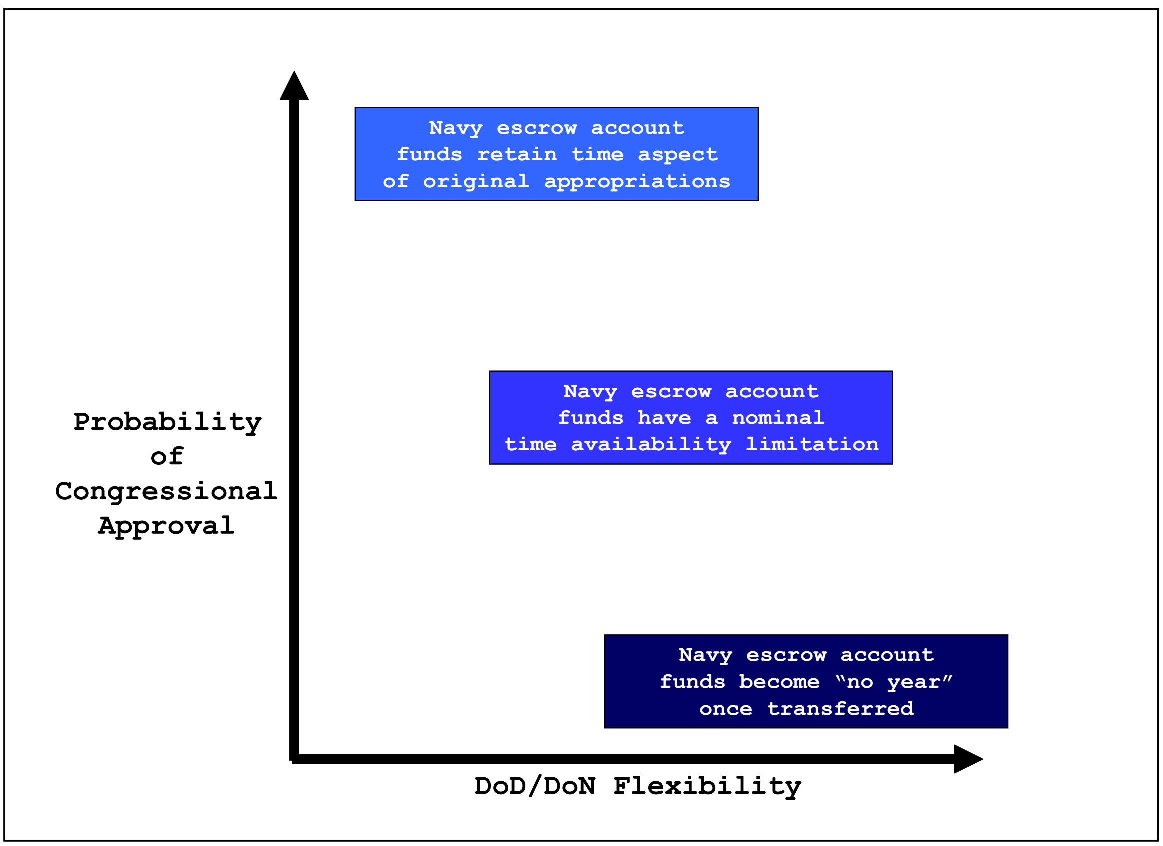
Relevance. The combination of Title 31 U.S.C. § 1502, § 1552, and § 1553 present one of the critical barriers to Navy escrow account implementation. Although the account would still provide increased flexibility without the ability to remove the time aspect from appropriated funds, it would not fully leverage the ability to recapitalize savings. Assuming that funds had to retain their time aspect, an increase, similar to existing obligation patterns, would continue to exist approaching the end of each fiscal year.

One of the goals of the Navy escrow account is to prevent the end of the year rush by spending when it is a smart business decision and saving when greater requirements fail to materialize. The account will only realize its full potential when funds, once transferred, become "no-year" funds.

Possible Solutions. Crafting effective legislation to remove the time aspect of appropriated funds will be a challenging problem. The desired no-year aspect makes it difficult to argue that congressional intent is being maintained. However, if the process does include congressional notification as designed, one can argue that significant problems or difficulties with the manner in which the account is being managed could be brought into a public forum for debate and eventual reconciliation with the current desires of Congress.

Within the continuum of possibilities for new legislation enacted, as part of the establishment of the Navy escrow account, there are the two extremes: the funds retain their fiscal year identity or the funds lose their fiscal year identity. Figure 5.3 highlights the relationship between flexibility and probability of gaining approval for the various options.

Figure 5.4 Time Aspect of Transferred Funds



Between the two extremes, reside a myriad of possibilities including:

- Single period for all transferred funds.
- Retaining and resetting the original obligation period for the transferred funds (e.g., APN funds once transferred into the account are available for three years).
- Creating a balance limit that transfers unobligated balances in excess of the limit to the general Treasury, regardless of the time aspect of the funds.

Finding an effective solution to the challenges presented by Title 31 U.S.C. § 1502, § 1552, and § 1553 is the second critical task that must be completed for the Navy escrow account to gain the requisite support. The continuum in Figure 5.3 may not only represent the range of possibilities for mitigating the problems, but also a series of incremental steps to be taken. Starting with the retention of the time aspect of each fund transferred and, over a period of years, with an honest effort to obligate escrow account funds in a manner that maintains the intent of Congress, the account may evolve into the no-year account desired.

d. Reserve Fund Requirements

Title 31 U.S.C. § 1512 delineates the requirements for maintaining reserve funds for those appropriations available for apportionment. Although the

Navy escrow account is derived from savings initiatives, the first application of account funds, as shown in Figure 3.1, is to cover unexpected shortfalls. Since the shortfalls could clearly exist in accounts such as O&M (subject to apportionment), for all intents and purposes, the account could be considered a reserve under this statute.

Additionally, although Title 31 U.S.C. § 1512 allows for maintaining reserves as a method for achieving savings, the scope of the Navy escrow account exceeds the intent originally envisioned.

The applicable text of the code is as follows:

> (c) (1) In apportioning or reapportioning an appropriation, a reserve may be established only:
>
> (A) to provide for contingencies;
>
> (B) to achieve savings made possible by or through changes in requirements or greater efficiency of operations; or
>
> (C) as specifically provided by law.[73]

Relevance. The primary challenge presented by Title 31 U.S.C. § 1512 is the requirement for the holding of reserves to be validated by public law. This is especially true for the Navy escrow account as savings expected and subsequent "reserves" will cover various appropriations, some subject to apportionment, and others, not so delineated.

Possible Solutions. The creation of the Navy escrow account, in and of itself, should provide the requisite legal authority to satisfy the requirements in

Title 31 U.S.C. § 1512. Although the specific language needed to satisfy such a requirement is beyond the scope of this paper, it must incorporate the issues and terminology a layperson would quantify as "semantics," such as reserve account, escrow account, recapitalization account, etc.

C. SUMMARY

Although the list of statutory barriers is long, they are all designed to protect, at some level, congressional intent. In the formulation of strategies for the implementation of the Navy escrow account and in the language placed in any enabling legislation, maintaining congressional intent is the key to be embraced, not the requirement to be circumvented in the fog of "legalese."

Ultimately, there are only two questions to be asked: is the money being spent as desired by Congress... and is the money being spent in the timeframe allotted by Congress? The success or failure of the Navy escrow account, to a great extent, hinges on the ability to answer these two questions within the framework of the proposed escrow accounts operation.

VI. CULTURAL BARRIERS

A. CULTURAL DIFFICULTIES

The previous chapter presented the statutory barriers to the implementation of the Navy escrow account. Although they are significant, they represent only a portion of the implementation equation. The second aspect, and part of the strategic imperatives associated with the *Sea Enterprise* initiative, is changing the culture.[74]

For cultural change to be successful, on the magnitude envisioned with the creation of the Navy escrow account, the development of a shared vision throughout DoN is required. Peter M. Senge, the founder and director of the Center for Organizational Learning at the Massachusetts Institute of Technology provides this definition for a shared vision:

> A shared vision is not an idea. It is not even an important idea such as freedom. It is, rather, a force in people's hearts, a force of impressive power. It may be inspired by an idea, but once it goes further – if it is compelling enough to acquire the support of more than one person – then it is no longer an abstraction. It is palpable. People begin to see it as if it exists.[75]

Creating shared visions within large organizations is possible. Companies such as Canon, Honda, and Apple Computers all faced exceptional competition within their respective industries. By building a genuinely shared vision throughout their organizations, they achieved unparalleled success.[76]

Critics may view the ability to create a shared vision within DoD or DoN with some skepticism. Efforts such as Total Quality Leadership in the early 1990's or the attempts in the mid 1990's to create a more substantive physical fitness program were only minimally effective. In many circles, the initiatives failed. They never became shared visions, neither with top management nor with the sailor standing the watch.

Failures such as these, combined with the legendary "$400 dollar hammers," would make one believe that the best business practices must reside outside of DoD. However, in discussing business practices with top leaders in American industry, Vice Admiral Charles W. Moore, Jr., Deputy Chief of Naval Operations for Readiness and Logistics (N4), was routinely asked:

> Why are you calling us...we copy your operations.[77]

The question highlights DoD's ability to operate. In less than a month in Afghanistan, United States forces were victorious when two previous attempts by Great Britain and the invasion by the Soviet Union ended in failure.[78] Again, in the same amount of time and with phenomenally low casualties, United States forces were able to liberate Iraq.

Although it is easy to point to superior training and equipment, one must not overlook the ability for operational commanders to create a shared vision. In our operations, and what industry leaders strive to emulate, is an unparalleled shared vision. Personal agendas are removed and the focus is on achieving a collective victory.

In the design of the proposed Navy escrow account, it is important to highlight the cultural barriers that exist. Whether internal to the DoN, between the DoN and the DoD, or within Congress, cultural barriers, regardless of statutory changes, will prevent the adoption of the shared vision required for the success of the Navy escrow account concept.

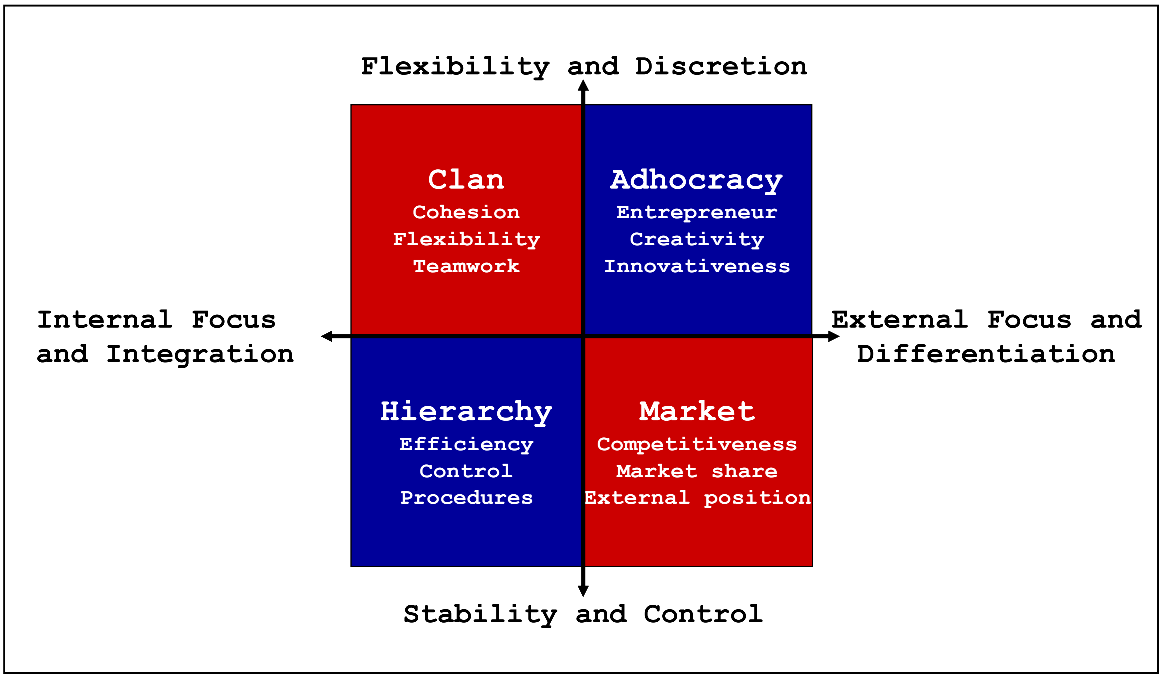
B. CULTURAL BARRIERS IN THE DEPARTMENT OF THE NAVY

The culture within the DoN varies on several levels. There are distinct differences between aviation squadrons and surface vessels. Within the aviation community, there are further distinctions between the strike-fighter squadrons and helicopter squadrons; and again, within the strike-fighter communities, FA-18 squadrons possess a different culture than do F-14 squadrons. Although there is a high degree of variability, some generalizations can be made.

Kim Cameron and Robert Quinn highlight four major culture types existent in organizations. They define cultures based on a continuum of competing priorities: the competition between an internal or an external focus and the competition between flexibility and control.[79] Figure 6.1 highlights their divisions between clan, hierarchical, adhocracy, and market cultures.

For the DoN, and the military in general, the aspects of the hierarchical and clan cultures are most relevant. In general, military organizations are extremely hierarchical. They establish their structure and procedures around control, stability, and standardized procedures leading to greater efficiencies in their operations. In these organizations, change is slow and follows the creation of a new set of rules by which the game is to be played.

Figure 6.1 Competing Cultural Frameworks



Organizations with clan cultures function in a fashion similar to a family. There are shared values and cohesion, the organizations are held together by loyalty and tradition, and because of the inherent teamwork, they can adapt to changes in their environment.

The differences between the clan and hierarchical cultures, as alluded to earlier, are most prevalent when comparing the operational Navy (on deployment/in combat – clan) with the administrative Navy (business aspects –

hierarchical). The importance of highlighting these divisions is not to show they exist, but to demonstrate the proven capability for the DoN to be extremely flexible, within a given set of constraints. The key to the successful implementation of the proposed Navy escrow account is leveraging the "can do" operational attitude within the clan culture, combined with the hierarchical culture's desire for order, without exploiting the honest efforts of the men and women operating in the new environment.

In the subsequent sections, the three most significant cultural barriers within the DoN will be discussed: the "spend it or lose it" mentality, the use of budget execution as a management tool, and the reluctance to relinquish control of available funds.

1. "Spend It or Lose It" Mentality

The prevailing "spend it or lose it" mentality throughout all government organizations is well documented. The common anecdotal belief is that any funds unobligated in the current year of execution will be instantly reduced from next year's budget. With the extreme competition for funds, it is not unreasonable for financial managers to assume that unobligated funds place their programs at risk for future funding.

This problem is not restricted to the end of the fiscal year. Approaching any program or mid-year review, unobligated funds are at risk of being transferred to those facing shortfalls. Not only are the financial managers protecting the future budgets, they must often fight to protect their current line of funding.

With certain appropriations, specifically O&M, the obligation rates are extremely high. From FY1977 to FY1990, 99.833% of the TOA, throughout the DoD, was obligated.[80]

Unfortunately, the nature of this spending, especially late in the fourth quarter, often provides little value added towards operational readiness or future capabilities. Aviation squadrons have launched sorties with the specific purpose of "burning the remaining OPTAR." Although there can still be value in conducting such operations, it is often little more than a sightseeing, morale builder.

At the center of the "spend it or lose it" mentality is a lack of trust between the players involved. Specifically, those executing the budget do not trust those charged with its creation. They fear any reduction in obligation rates, regardless of reason or circumstances will result in a reduction in future budget authority. This places the program at risk as the environment next year could require more, while the available funds are less.

a. Relevance

A financial manager's fear of exposing his program to future risk may prevent him from generating the internally derived savings for transfer into the proposed Navy escrow account. In terms of incentives, protecting his respective program, both in the current year of execution as well as future years may be prove to be a stronger incentive than supporting the Navy’s corporate requirements.

This dilemma places the two cultures at odds with each other. On one hand, the financial manager realizes the needs of the corporate Navy should outweigh his own personal desires (clan culture). Alternatively, he wants a guarantee or formal instruction (hierarchical culture) that will ensure his cost savings efforts this year will not result in a degradation of capabilities next year.

b. Possible Solutions

Building trust between individuals is difficult; building trust between entire groups is even more challenging. Confronting these problems requires tangible procedures and safeguards as well as exceptional leadership. This two-front approach to overcoming the “spend it or lose it” philosophy includes the development of a system of checks and balances for budget adjustments and the creation of a shared vision for financial management throughout the DoN.

The series of checks and balances can be at several levels, providing different protections against the degradation in capabilities. As an example, a command may adopt a cost savings initiative that proves successful during its first year of implementation. However, before those savings are removed from the program’s top-line budget, the command should be given a voice for expressing their opinion on the permanence of such savings.

In other cases, a command or program may transfer funds into the escrow account based on decreased operational requirements. In these cases, the funds would not be removed from their top-line budget. However, to preclude each subsequent year from being classified, once again, as a "slow year" by the local financial manager attempting to protect funding, the use of three-year averages, or some other time period, may allow those savings to become permanent (as well as updating the possible models that are used to develop the funding lines).

The final requirement, and one that may be the most effective in removing the barrier, is an ability to recoup contributed funds if required. Although this function exists, albeit in an indirect fashion (if funds contributed create a shortfall, the program would move to the top of the list for escrow account benefits), assurances to that effect would greatly reduce the apprehension with the transfer of funds.

The other piece not to be overlooked is the importance of leadership. To change the mindset that truly believes in the "spend it or lose it" mentality will require changing the mental model that governs the process. However, this process is difficult to overcome and can prevent even the most beneficial of changes. As noted by Senge:

> The inertia of deeply entrenched mental models can overwhelm even the best systemic insights.[81]

Creating an environment in which this transformational change can occur requires a significant effort on the part of leadership to build the shared vision required for success. The steps for transforming the mental models and taking the DoN from apathy to commitment will be discussed in Chapter VII.

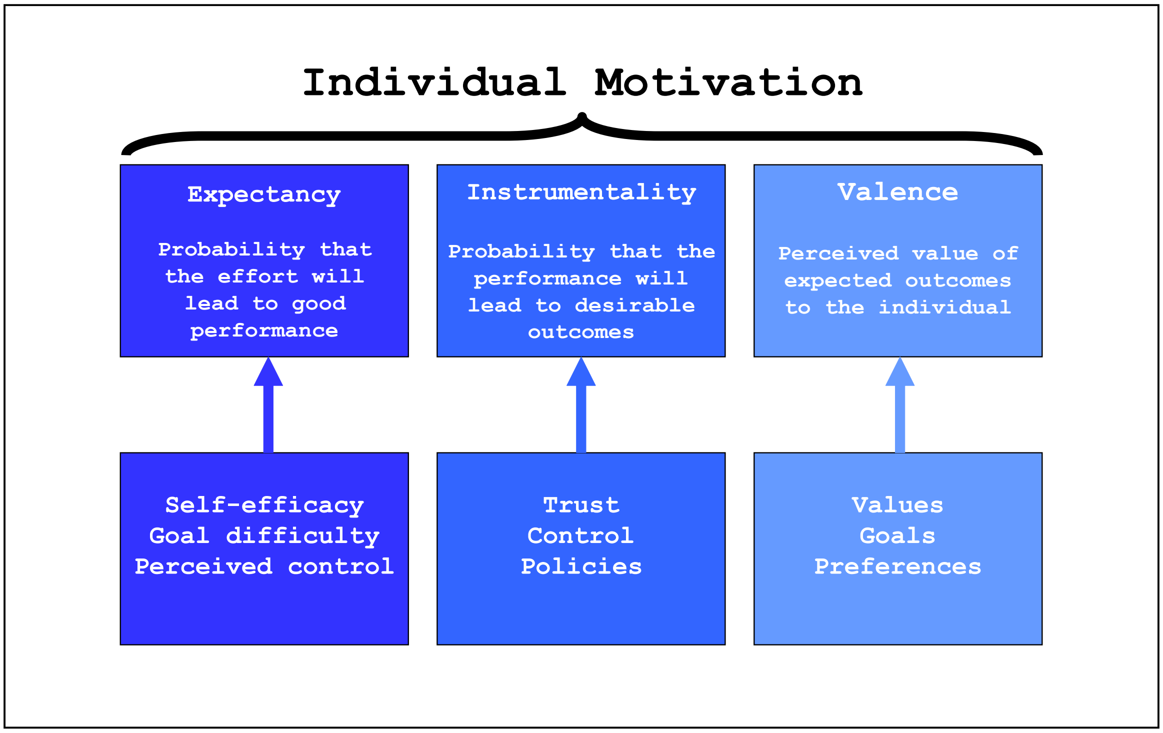
2. Budget Execution as an Evaluation Tool

Within the DoN's current evaluation system, there is not a standard block for evaluating the financial management performance of the officers charged with budget execution.[82] The level of effort placed on evaluating this skill set, excluding comptrollers, budget officers, large program managers, etc., consists of nothing more than checking the balance in the account at the end of the fiscal year. If the account is empty, the officer with the responsibility for that account is deemed successful. Although this is an oversimplification, it is close to the truth for many operational commands.

This zero balance baseline as the single financial management metric, combined with the "spend it or lose it" mindset has created a culture that does not fully value adroit management skills. Much of this can be placed on the volume of tasks being asked of fleet operators. Not only are they expected to be tactical experts, but also superb managers and leaders of people. In prioritizing where the level of effort will be placed, the typical commanding officer will look at those items that have an intrinsic or extrinsic reward.

Expectancy Theory, or the understanding of the level of motivation any one person will apply to any specific tasks is based on the idea that motivation is a product of an individual's perceived ability to produce a desirable outcome that will produce some benefit to him/her that is of value. Figure 6.2 graphically depicts the equation.

Figure 6.2 Expectancy Theory[83]



Depending on the type of organization, there may be differing levels of motivation for actively managing the budget process from the corporate Navy's perspective. On one extreme, the commanding officer of an aviation squadron may have little control of his/her budget and may have a direct superior who sets a policy requiring 100% utilization of OPTAR. In this scenario, it is unlikely that there would be any perceived reward for any effort to institute cost saving initiatives or to generate savings. Therefore, time will be allocated toward improving the squadron's war fighting skills and developing the personnel under his/her command, while financial management will focus on driving the budget to a zero balance, without exceeding obligational authority or OPTAR, by the end of the fiscal year.

Alternatively, the commanding officer of the air station and the base comptroller may be pursuing several initiatives designed to control costs and generate savings to fund additional projects for the people stationed at the base. Beyond the intrinsic value of helping out his/her fellow service members, there may be a series of extrinsic rewards presented to them personally, or indirectly awarded to the air station.

a. Relevance

Although, the lack of emphasis placed on financial management skills may seem irresponsible, especially when one considers the size of the budgets being executed, the importance of the other requirements facing operational commanders places the managing of finances on a somewhat lower level.

In the assessment of the zero balance baseline as a management performance tool, it is important to place it in its proper context. Do we expect our operational leaders to exert as much effort on scrutinizing their budgets as they would their war plans? Obviously not; however, do we expect them to look for better ways to utilize the resources under their control? The answer is, of course, yes. In the search for a solution, it is important to look for the proper balance, one that maintains the operational focus required and the financial management skills desired.

b. Possible Solutions

The solution to the zero balance dilemma requires addressing each element of the expectancy equation: expectancy, instrumentality, and valence. Thus, described in more detail, the DoN should provide the educational tools to the financial managers, place them in an enabling system and environment, and create an incentive system that provides desired rewards. The process begins with education.

The knowledge required by DoN financial managers is based on the same principles that govern their personal finance. The piece that is missing or significantly subdued, is a sense of urgency. It is assumed that the government will always find the money. The quote, attributable to many, summarizes a common mental model when funds get short:

> What are they going to do, not send us on cruise?

Unfortunately, the funds required to operate today are being delivered at the expense of the recapitalization efforts designed to build the force for tomorrow.[84] In the education process, it is important not only to detail the possibilities and constraints within the budget system, but also to clearly state the urgency behind the effort. This raising of a “corporate conscience” is critical for changing the currently held beliefs.

Secondly, the system needs to institutionalize the importance of smart financial management principles. The creation of an escrow mechanism will significantly enhance this possibility. It will provide an "approved" and desired outlet for excess funds, as opposed to the current zero balance baseline, which punishes managers for not performing in a potentially wasteful manner. Additionally, the system by which the DoN evaluates financial management has to be formally embraced and not just given token acceptance. This must occur at the highest levels before it can ever trickle down to effect the attitudes of the masses.

Senge outlines the possible attitudes that can form towards a given vision.[85] Table 6.1 highlights the various attitudes developed from his research.

In order for the system to adopt the principles and structure that will seek to reward smart financial management decisions, it will take true commitment from the senior leadership and at a minimum, genuine compliance from the local commands. The senior leadership must look for more than just a zero balance at the end of the fiscal year, while the local commanders should not have the impression that a zero balance, regardless of circumstances, is all that is expected.

The final aspect of the expectancy equation is the creation of incentives that reward, at some level, the desired behavior. In creating these incentives, it is important to strike the proper balance. The incentives need to be substantive, but, in no way, can they be enticing to the point of jeopardizing operational readiness. In simple terms, the propensity to spend on readiness must be greater than the propensity to save.

Table 6.1 Possible Attitudes Toward a Vision

Possible Attitudes Toward a Vision	
Commitment	Wants it. Will make it happen. Creates whatever "laws" or structures needed.
Enrollment	Wants it. Will do whatever can be done within the "spirit of the law."
Genuine compliance	Sees the benefits of the vision. Does everything expected and more. Follows the letter of the law.
Formal compliance	On the whole, sees the benefits of the vision. Does what is expected and no more.
Grudging compliance	Does not see benefits of vision but does not want to lose job. Does just enough of what is expected but lets it be known that he is not really on board.
Noncompliance	Does not see benefits of vision and will not do what is expected.
Apathy	Neither for nor against the vision. No interest. No energy. "Is it five o'clock yet?"

The fear, of course, is a commander electing to pursue the newly created "Strike-Fighter Wing Pacific Golden Calculator Award for Financial Management Excellence" in lieu of properly training and preparing his/her squadron for combat.

Although this fictitious example is extreme, it serves to highlight a real concern. There is a safety net associated with commands spending the money appropriated. For the most part, a given amount of money for conducting flight operations in one squadron will produce the same level of readiness as an equal amount of funds provided another squadron. Removing the safety net, not only places an additional burden on the local commands, but it removes some of the focus from the war fighting requirements.

The perfect reward would be intrinsic in nature, born out of a commitment to the escrow account vision. This is unrealistic, at least, at the initial stages of implementation. In the early stages of operation, creating valence for the local commanders may require the modification of our fitness report and evaluation procedures, or, it may require some direct reward or share ratio, as previously discussed.

3. "All Politics Are Local"

Former United States Speaker of the House, Thomas "Tip" O'Neil once said:

> All politics are local.[86]

Within his famous quote, reside exceptional insights into the dynamics that function within any organization. In his role as Speaker of the House, there was a delicate balance between taking care of his constituents and serving the greater good of the country. In the lower levels of government and within the DoN, the same principles apply. Financial managers will attempt to optimize their respective organizations, and, toward the end of one fiscal year, they will take the required steps that place their organizations in a better position for the upcoming year.[87]

This is represented by the end of the year purchases of furniture, computers, etc., or the rush to spend the remaining fuel money. They will take the steps to optimize their commands, which may or may not be an optimal use of available funds from the corporate perspective.

a. Relevance

The importance of understanding the relationship between those in positions of authority and the people for whom they serve is critical for the implementation of the escrow account concept. The operation of the account requires local sacrifices for the greater good. To that extent, there are two issues to be addressed.

First, asking for a collective effort to support a pooled effort commonly results in the diffusion of responsibility as everyone's efforts are pooled into the team enterprise. Without a financial target or direct accountability, people may not feel the need to perform or contribute (deindividuation).[88]

Secondly, because this diffusion may exist, people may be tempted to spend available funds on local initiatives. They may provide a greater personal benefit or reward to the people under his/her command, or there may be no one consequence associated with such actions. As an example, would more people donate to a charity or church if they were publicly held accountable for their actions?

The ability to maintain the status quo, without penalty, and to provide more for the people in their respective agencies or commands, makes financial managers more likely to view the proposed escrow account through a set of "locally focused" lenses. Addressing these effects in the design of the operational procedures and implementation strategy will be critical for removing the associated barriers.

b. Possible Solutions

Finding an answer to the problem of local politics influencing decisions that should be made to support a greater good is not going to be easy. However, failing to address the issues in the development of a Navy escrow account would be a significant oversight. As was highlighted in the discussion of Expectancy Theory, finding answers to these problems usually requires a multi-level approach.

The answers, once again reside in the education of personnel that drives their vision beyond local concerns, the adoption of a formal structure for institutionalizing the measurement of financial performance, and the creation of an incentive system that provides commensurate rewards.

D. CULTURAL BARRIERS IN CONGRESS

The power of Congress in controlling the federal funds is absolute. In the evolution of its power base, documented in Chapter V, a plethora of checks and balances, controls and regulations have been created to support congressional control.

In recent years, significant attempts have been made to expand the levels of control and accountability:

- Federal Manager's Financial Integrity Act of 1982 (FMFIA) – created a formal process for Presidential and congressional reports as well as a process for identifying problems within each agency.
- Chief Financial Officer's Act of 1990 (CFO Act) – requires the DoD to improve financial reporting and improve internal controls.
- Government Performance and Results Act of 1993 (GPRA) – required federal agencies to develop five-year strategic plans and submit annual performance reports.
- Government Management Reform Act of 1994 (GMRA) - established the requirement for annual audited financial statements.
- Federal Financial Management Improvement Act of 1996 (FFMIA) – directed compliance with the use of the SGL, FASAB guidelines.[89]

Within the legislation is a common theme, focused on increasing the DoD's accountability to the Congress for the funds they appropriate. This trend is based on a series of financial management errors, omissions, and failures to correct existing discrepancies including millions of dollars erroneously charged to government credit cards, processing fees more than purchasing fees, and an inability to account for over a $1.2 trillion in transactions within the DoD.[90]

These problems have continued to foster a climate of skepticism at a minimum, and in some cases, outright mistrust. The cultural barriers center on two issues: the erosion of the congressional power base, including their ability to maintain the intent of the original appropriations, and the reality that they are elected officials, responsible to their constituents and susceptible to a changing political environment.

1. Erosion of Constitutional Authority

The proposed Navy escrow account is a return to the principles of Alexander Hamilton and the Federalists who argued for lump sump appropriations back in the earliest days of the United States.[91] It represents, to some extent, an open checkbook for the DoN and a mechanism for bypassing congressional intent and may pose a threat similar to that of the M and Merged Surplus Accounts previously discussed. More importantly, it may be perceived as an attack on the overall control of federal funds on the part of Congress.

The desire for control not only exists between Congress and the DoD, but also between Congress and the Executive Branch. The Impoundment Control Act of 1974, which requires the President to obtain the support of both houses within 45 days in order to rescind funds,[92] was a result of perceived impoundment abuses by President Nixon.

Another area where Congress has fought to maintain its control over legislation and the Executive branch concerns the Line Item Veto. First proposed by Ulysses S. Grant in

1876, many bills and proposed constitutional amendments have been introduced and subsequently rejected over 200 times.[93]

P.L. 104-130 passed in 1996 giving President Clinton the ability to veto specific spending or certain taxing provisions of legislation. However, on June 26, 1998, the Supreme Court, in a 6-3 decision, ruled the line-item veto unconstitutional.[94]

Although Congress has relaxed control over the budget process and allowed power to shift to departments or the Executive branch, it commonly follows these periods with legislation returning its original authority. As was the case with the proposed 2% discretionary spending in the Homeland Security Bill, a perceived loss of control is met with bi-partisan opposition and will commonly face a difficult road to passage.

a. Relevance

In the beginning of this study, the probability of creating a Navy only escrow account was questioned as approval for one service may likely require approval for the DoD as a whole. With a budget approaching $400 billion for FY2004,[95] if the DoD manages to transfer only half of one percent of its budget authority, around $2.0 billion dollars is now perceived to be at risk of losing its original congressional intent, even though a congressional review process would be part of the process.

However, assuming the escrow account mechanism is approved for use by the DoD, what is stopping the Energy, Commerce, or Justice Departments from requesting, if not demanding, a similar account? With $775 billion proposed in discretionary spending, if only half of one percent is transferred into various escrow accounts, $3.875 billion would be out of the control of Congress. In addressing the issue of control and intent, it is important to view the proposed escrow account for what it is, but also, for the precedent it establishes.

Although the proposed escrow account has the potential to transform current business practices, increase financial accountability, and to provide the maximum benefit for dollars invested, it comes as the result of reduced congressional control. Therefore, a well-crafted strategy that includes concessions that balance increased DoD flexibility with the requisite level of congressional oversight is absolutely essential for overcoming this barrier.

b. Possible Solutions

In the proposed operation of the escrow account covered in Chapter III, the requirement for congressional notification was included as part of the external review. The goal of notification serves two purposes. First, it may prevent the problems associated with the M and Merged Surplus Accounts, which operated largely outside of the normal bounds of congressional control. Following the Air Force's admission of using $1 billion for upgrades to the B-1B, Representative Andrew Ireland (D – FL) testified before the United States Senate expressing the outrage at the loss of oversight:

> Evidently, the Air Force must no longer rely on Congress to appropriate funds for projects that it wishes to pursue. If the Congress says no to a given project, the Air Force can simply use expired M Account authority to keep the project going.[96]

As was discussed in Chapter I, this Air Force request brought about the demise of the two accounts. In designing the congressional notification process for the proposed escrow account, significant attention must be given to making it more robust in order to avoid surprising Congress with an excessively large bill or a request for funds utilization contradictory to known congressional intent. The notification process may be further improved by developing an accurate, pre-approved unfunded requirements list as the basis for escrow account utilization.

Secondly, notification provides Congress with the authority to prevent any spending that does not fit with its current priorities. Although this capability existed with the M and Merged Surplus Accounts, the procedures were essentially buried and unknown to Congress. Escrow account operation must be designed in a fashion that eliminates the ability for the DoN/DoD proposals to slip by congressional notice or to contain purposefully vague or confusing language.

Overcoming congressional reluctance to relinquish any control will require a new set of rules for the budget game. Strategic misrepresentation of facts and figures must be replaced with an honest effort to divulge the nature and intent of each request for the utilization of escrow account funds.

2. "All Politics Are Local"

The pressure for elected officials in Congress to please their constituents is a matter of political survival. Whether they are in the House of Representatives and face reelection campaigns every two years or the Senate, with six years between campaigns, their constituents are afforded the opportunity to voice their approval or disapproval through their votes. Not surprisingly, members from agricultural districts vote for agricultural spending while members with large military bases generally support increased military spending.[97]

However, within the Tip O'Neil quote, "all politics are local," reside other "localities" that demand congressional attention. One area is the pattern of voting along party lines on controversial issues or in committees controlled by powerful chairmen, while another concerns the issues that have personal valence for the elected official such as congressional pay, campaign finance reform, or term limits.

Thus, in the budget battles that produce the various appropriation acts, decisions are often made specifically to satisfy the needs of constituents, committee chairmen, party leaders, or even personal desires. The process is complex and the desire to satisfy one or more of the players opens the debate for deals and compromises to be struck.

a. Relevance

Political debate, deals and compromises are a large part of the American political machine. With the President's signature, deals made in committees or on the floor of the House or Senate become the laws that govern the United States. In the eyes of the Congress, the budget represents not only their personal intent, but also the intent of the people they represent.

The proposed Navy escrow account, however, places those deals and compromises in jeopardy. Although the possibility of large scale changes in budget authority from one state or district to the other is small due to escrow account operations, the procurement of an additional aircraft or construction of a significant facility may be present on the unfunded requirements list or be requested by the DoN. This has the possibility of shifting the balance between party leaders or state representatives reached during congressional debate on the budget.

As an example, assume a construction project in Mississippi is cancelled freeing $100 million. Those funds are then transferred into the escrow account and designated to fund a similar project in California. However, one of the critical issues in the legislation passing was the construction of this facility in the state of Mississippi. This scenario presents several questions:

- Will changes in the location of spending influence the congressional notification process?
- If there is a single DoD-wide escrow account, will there be significant lobbying efforts of

congressional members to approve or deny certain escrow account expenditures that could delay the review and approval process?

- Will the proposed obligations using escrow account funds be affected by partisan or "local" politics?
- Will debates create undue delays in the obligation of funds?

As discussed in Chapter III, the exclusion of MILCON from receiving escrow account funds may remove some of the potential battles over turf. However, the political realities must be accounted for in any potential escrow operation.

b. Possible Solutions

Solving the challenges presented by partisan politics, local priorities, and personal agendas is beyond the scope of this, or possibly, any paper. Moreover, for every antagonist that appears as the result of a proposed obligation from an escrow account, there will surely be a "local" champion. In the design of the proposed escrow account, the goal may be to create a process that minimizes the potential for congressional conflict or specifically targets projects with significantly strong support.

Mitigating potential conflicts may be best accomplished through a prioritized hierarchy of escrow account utilization, the development of an annual, pre-approved unfunded requirements list, and a notification period that provides sufficient time for congressional debate and the timely transfer of required funds.

The hierarchy of fund utilization, as discussed in Chapter III, is as follows:

- Shortfalls.
- Unfunded requirements list.
- Future year programs.

Maintaining consistency in the prioritized obligations of escrow funds is essential. In terms of shortfalls, this will have to include the complete utilization of the account prior to any Supplemental Appropriations being passed. As, in theory, it would be hard for the DoN/DoD to argue for an escrow mechanism and then attempt to avoid using those funds during periods requiring supplemental funding (e.g., Kosovo operations). However, regardless of the reason for the shortfall, conducting good faith operations is essential for escrow account success.

The second aspect of the account that will mitigate the effect of politics during the congressional notification period is the use of a pre-approved unfunded requirements list. Items pulled directly from the list should be quickly approved and celebrated as a more effective use of the taxpayer’s money by all stakeholders.

Finally, to minimize the potential for lengthy congressional debate, establishing a set schedule, enforced by binding legislation, will help prevent proposed escrow account obligations from being unduly delayed. The length of the period may depend, in part, on the nature of the congressional notification procedure. Possible variables include:

- The number of committees (HAC, SAC, HASC, SASC, or more).
- The length of time allotted for each committee.
- Will the committees review the items in the parallel or sequentially?

The time-period selected, must balance the need for formal debate, if required. However, it must also take into account the need for timely resolutions on the part of the respective DoD agency. A period of 30 days, commensurate with other programs discussed in Chapter IV, may be appropriate. Moreover, the length of review could also vary based on the amount requested. Requests under $100 million may be authorized 30 days, while obligation requests in excess of $100 million may be given 45 days.

In addressing the various aspects affecting congressional barriers, it will be important to work closely with congressional leaders to design a system based on inclusion and not exclusion. Unlike many negotiations that start with both sides at polar extremes, the creation of the escrow account must start with significant concessions toward congressional concerns.

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VII. IMPLEMENTATION STRATEGY

A. TRANSFORMATIONAL CHANGE

The proposed operation of the Navy escrow account represents a transformational change for the United States military and possibly, all financial processes within the federal government. Although the idea of transformation within the DoD had begun with earlier reviews of operational processes and procedures, SECDEF Donald H. Rumsfeld, upon assumption of the office, conducted an independent review of the United States military. His findings were included in the development of the Quadrennial Defense Review (QDR).[98]

SECDEF Rumsfeld, through the QDR, brought the concept of transformation to the center of the new "War on Terrorism" and to DoD operations in general. As he commented in April of 2002:

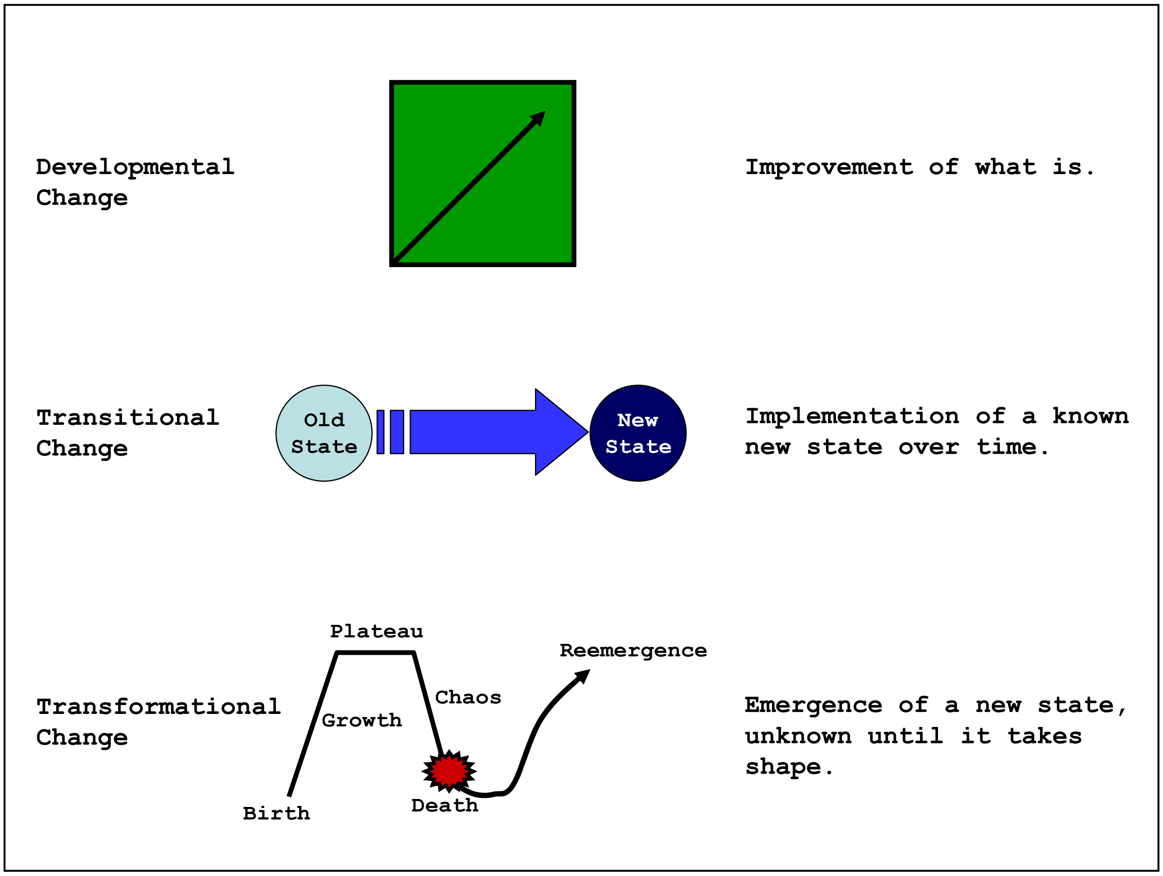
> Transformation is an attitude...it is a willingness to not be risk-adverse and to try new things.[99]

In defining transformational change, it is important to understand its characteristics. Typically, this type of change, as opposed to developmental or transitional change, is often initiated when other options appear to have failed. Figure 7.1 highlights the differing perspectives of change.

Although the DoD had not failed in financial terms, the situation was reaching crisis level prior to September 11, 2003.[100] However, following the attacks on the World

Trade Center and subsequent events in Afghanistan and Iraq, the DoD has been given a temporary reprieve from the financial abyss it was facing with its aging assets, deteriorating infrastructure, and the increased competition for federal resources to correct these deficiencies.

Figure 7.1 Three Perspectives on Change[101]



Although the radical transformation of current financial processes, including the implementation of an escrow account mechanism, would provide increased flexibility to DoN/DoD financial managers, is it the correct type of change desired? In developing an implementation strategy involving change, Todd D. Jick of the Harvard Business School recommends an organization assess the following questions:

- How far do we want to go? Is that too far – not far enough?
- Are we contemplating the “path of least resistance,” or a direction that is needed?
- What kind of results do we want – short or longer term?
- Do we want permanent change – or will that risk inflexibility making future change more difficult?
- How much change can the organization absorb? At once? Cumulatively?
- Can the changes contemplated be presented positively to all parties? If not, why not?
- What happens if we do not change at all?[102]

In terms of the proposed Navy escrow account, determining the most suitable answers to many of these questions is not overly difficult. However, others, such as the amount of change the DoN/DoD and Congress can absorb and the ability for the changes to be presented positively to all parties may prove more problematic. Collectively, the answers to these questions can be used to provide direction for development of an implementation strategy. Specifically, they help define the desired end state in terms of the pace, scope, and depth of change, and should provide the required sense of urgency important for building a shared vision of why change is required.

B. PREFERRED END STATE

The first question in strategy formulation should address the desired end state. What does the program, environment, or process look like when the change is complete? Specifically, what is the desired form of the Navy escrow account?

As the fully functioning account, defined in Chapter III, represents a long-term goal for DoN/DoD financial managers and provides the most implementation challenges, it will be assumed that the answers to the questions in the previous section suggest a single-step implementation strategy is desired. Accordingly, the Navy escrow account will include the following features:

- The account will be fully functional at the start of the next fiscal year with supporting legislation authorizing the various aspects associated with its operation.
- An ability to transfer funds during the POM build, execution phase, and at the end of the fiscal year.
- The funds will lose their fiscal year and purpose identity upon transfer.
- Funds will be used to fund shortfalls, items from a congressionally pre-approved, unfunded requirements list, and desired future programs.

- As an incentive, 10% of funds marked for transfer will remain available at the local command level.
- The remaining funds will be controlled at the corporate level, within the Office of the CNO.
- For funds to be obligated, a 30-day congressional notification period is required.

These features define a more flexible and DoN/DoD desirable end state. In developing a successful strategy for implementation, it may be required to begin on a much more limited scale. This may include operating a small test program within a single appropriation such as O&M. However, since establishing a fully functional account presents more challenges for DoN/DoD leadership, it is the focus of this implementation discussion.

C. STRATEGIES FOR CHANGE IMPLEMENTATION

On a macro level, there are two distinct challenges to be confronted in the implementation of a Navy escrow account: overcoming the statutory barriers and overcoming the cultural barriers. General strategies for gaining congressional approval were outlined in Chapter V. They may include a congressional liaison throughout the development phase and during budget execution to ensure the intent of Congress is being maintained. However, developing a more specific strategy for enacting the required legislative changes is outside the scope of this paper.

The focus of the following sections is on designing effective strategies for implementing the escrow account within the DoN/DoD. Specifically, they provide a detailed discussion of implementing change at organizational and personal levels.

1. Organizational Strategies for Change

A common mistake in the development of change related strategies is to view the change from a technical perspective. That is, focusing all of the attention on the technical aspects of change. For the Navy escrow account, this may include the procedures for transferring POM build funds, the specific processes required for congressional notification, or the annual audit requirements. Although these factors will be significant and require extensive changes in legislation, they fail to address a critical aspect that is often omitted in the management of change – the human changes associated with innovations.[103]

In a discussion of the challenges presented by the transformation of the DoN, the CNO, Admiral Vern Clark, commented on the importance of proper change management:

> Understanding the management of change is absolutely critical for today's leaders and essential for success.[104]

The management of change at an organizational level has been extensively researched. One of the leaders in the field, John P. Kotter of the Harvard Business School, has outlined eight steps for successful transformational change.[105] In his review of over 100 companies, including Ford, General Motors, and British Airways, the success or failure of change efforts were largely dependent on the firm’s ability to sequentially and effectively:

- Establish a sense of urgency.
- Form a powerful coalition.
- Create a vision.
- Communicate the vision.
- Empower others to act on the vision.
- Plan for and create short-term wins.
- Consolidate improvements and produce more change.
- Institutionalize the new approaches.

Addressing each of the eight steps, referencing the proposed Navy escrow account will provide the basis for the implementation strategy.

a. Phase 1 – Establishing Urgency

With a proposed budget approaching $400 billion for FY2004, creating a sense of urgency based on an impending financial crisis and the need to further “tighten the belt” and to pursue ways to generate savings is easier said then done. In his research on transformational change, Kotter found over 50% of the companies failing in this first phase.[106]

Creating a sense of urgency requires a detailed explanation of the true nature of the problem. Unfortunately, budget discussions concerning the recapitalization problems are often limited to the Pentagon and the people working the budget. Although this may be desirable from the fleet's perspective, it does little to build a sense of urgency. When budget discussions are pushed to a fleet level, they are often met with skepticism and disparaging remarks made toward the "bean counters at the Pentagon." However, since much of the equipment currently in operation is older than the equipment's operators (B-52s, CH-46s, etc.), there is an unique opportunity to leverage the age of assets and the dire need to replace these aging systems to create the requisite sense of urgency.

The current world environment presents additional challenges. With forces deployed in record numbers, the focus and rightly so, is on operations. Asking deployed forces or those returning from combat operations to generate savings because the corporation is facing "hard times" will not be met favorably.

However, the current environment also presents certain opportunities. For the first time since 1991, there are a significant number of combat proven leaders, well respected throughout their subordinate commands, who could be used as effective change agents. In many cases, it is not the message or the situation that fails to create a sense of urgency. It is the messenger.

Whether it is the successful image of President George W. Bush landing aboard the USS Abraham Lincoln (CVN 72) upon the carrier's return from a ten-month deployment or the failed efforts of Governor Michael Dukakis riding in a tank during the 1988 Presidential election, the messenger is often the primary determinant as to the success or failure of the message.

For creating the required sense of urgency for the proposed escrow account, employing well-respected leaders within the community (e.g., aviators talk to aviators, submariners talk to submariners, etc.) to introduce the escrow account, "Escrow Road Shows," may be the most effective tool. However, delivering the message to a small number of individuals is not sufficient. In Kotter's research, he found an effective sense of urgency was reached when roughly 75% of the firm's management is honestly convinced that conducting business-as-usual is unacceptable.[107]

b. Phase 2 – Create a Coalition

For change efforts to be successful, a coalition of individuals within the organization must actively support the effort. Applying Kotter's 75% rule, in regard to those at the rank of commander or higher, produces a coalition approaching 7,500.[108] Due to the legislation required to create an escrow account, the program will receive a substantial volume of free advertising announcing its arrival. This unfortunately, will not be sufficient to build a coalition. Effective tools in this regard include face-to-face meetings, video teleconferences, and/or off-site retreats. This is not to suggest that an off-site for all commanding officers and local officers-in-charge is the answer. However, the answer surely does not reside in Navy message traffic or briefs delivered electronically.

Although commitment through all ranks is desired, it is critical for senior leadership to be firmly united in the effort. The creation of an escrow council to create a standardized vision and to discuss the differences in opinion may be an effective starting point. Composition on the council could consist of a small executive committee to develop the specific vision and strategy, as well as a larger implementation committee with extensive fleet representation.

Most failures in phase two result from an underestimation of the difficulties associated with affecting change.[109] In doing so, organizations fail to build a coalition of sufficient size and power based on the perceived ease of incorporating the new process.

c. Phase 3 – Creation of a Vision

Successful transformation efforts commonly result from the creation of a clear picture of the desired end state, or vision that was clearly communicated to the various stakeholders.[110] Defining this picture of the future can be difficult. For the escrow account concept, the challenge is to create a vision that accurately and, in a standard fashion, describes the expectations for individual commanding officers, comptrollers, etc.

With the current culture centered on executing 100% of obligational authority, changing the mental models to focus on generating savings and implementing cost saving initiatives is challenging. The desired vision requires the correct balance of operational excellence and budgetary acumen. Because these two requirements are often on the opposite sides of the spectrum, interpretation of the vision may vary greatly.

In many unsuccessful transformation efforts, management has a clear idea of what the desired end state is and how it should look. Unfortunately, because it is not universally interpreted, the vision, at the organization level, becomes too complicated to be useful. Within the DoN, differences in interpretation or expectations between communities (aviation or surface) or even within the same community but on different coasts (east coast or west coast) may result in the program failing.

Creating a uniform vision may be more difficult with the DoN than in the other services. Throughout the Navy, there are variances in local policies or interpretations of existing procedures that differ based solely on community or geographic location. Many of these differences are the result of centuries old naval traditions.

Prior to the development of radio communications, commanding officers maintained significant independence as they operated for long periods without receiving formal instructions or updates to existing orders. When orders were received, they often provided the "when" and "where" details, but the "how" was commonly left to the discretion of the commanding officer. Whereas, in the other services, procedures and policies tend to be more standardized and uniform.

Although the days of sail have long departed, the tradition of independence among commanding officers is still very much alive. The critical aspect is to create a standardized vision, prior to the program being introduced to the fleet.

In order to create an unambiguous vision, Kotter suggests a simple rule of thumb: if the vision cannot be communicated to someone in five minutes or less while generating understanding and interest, this phase of the transformation process is not complete.[111]

Once created, spreading and maintaining the vision requires effective communication, across various levels and mediums.

d. Phase 4 – Communicating the Vision

Effective communication allows a vision to move from theory to reality. Although many good ideas or visions should have succeeded, as they possess intrinsic and extrinsic merit, they ultimately fail due to insufficient communication. It may have been the message itself, the messenger, the medium, or the amount of communication concerning the vision.

In recent DoN history, the failure of the initial TSP enrollment efforts can be attributed, in part, to a failure in communication. Information on TSP was typically distributed electronically and few face-to-face sessions were established to educate service members on the program’s potential benefits. Using very little of the DoN’s communication potential resulted in very low enrollment rates.

To increase the communication, senior leadership must incorporate the messages into their daily routines.

This is not to suggest that concern over saving money should outweigh tactical considerations. However, communication concerning the escrow account, financial responsibility, and improving business operations should not be a once a year discussion item similar to the Navy and Marine Corps Relief Society or the Combined Federal Campaign.

All communication channels available, personal lectures by community selected change agents, video teleconference, message traffic, newsletters and publications, and the Navy and Marine Corps Intranet (NMCI) must be exploited on a routine basis. The goal is to make the thought processes that look for cost savings initiatives part of the daily culture and not just an after thought or during times of financial difficulties.

Typical failures in phase four are often the result of underestimating the communication requirements by a factor of ten.[112] Because of the globally dispersed nature of military units, the necessity to build effective and consistent communication channels is even more critical.

It is also imperative that the beliefs of senior leadership remain in congruence with the vision. For if there becomes a diversity of views or conflicting visions (east versus west, surface versus aviation), in either words or actions, the vision may prematurely fade. Additionally, if compliance with the vision begins to absorb too much time or thought, the vision will once again be placed at risk.[113]

e. Phase 5 – Empower Others to Act

Even if the vision is effectively communicated, people may still not feel empowered to act upon the vision until the obstacles are clearly removed. Some of these exist in the organization, the zero balance mindset or the "spend it or lose it" philosophy. There will be considerable skepticism approaching the end of the first fiscal year an escrow account mechanism is available. Local commanders and comptrollers may be wondering what the real outcome will be after they fail to obligate 100% of their appropriated funds. Will they receive a negative fitness report/evaluation or will morale in the command suffer as the new furniture purchase was presently deemed unnecessary?

One of the most damaging errors in this phase occurs when a single executive who publicly appears to support the initiative, privately makes demands that are inconsistent with the overall effort. This not only provides a setback to local efforts, but the ability for negative information to disseminate quickly throughout the Navy is impressive. With only one story of an individual receiving a negative evaluation for failing to obligate all available funds, the implementation of the escrow account will be significantly damaged.

The transformational change proposed in the escrow account makes this phase especially challenging. It must include the formal adaptation of current performance appraisal systems, not only in theory, but also in real actions. The local commands must feel free to operate within the guidelines of the system and to make the most appropriate financial decisions based upon the current environment. If the situation permits the savings of 5% of a command's O&M funds and the commanding officer or comptroller transfers those funds in the escrow account, he or she should be commended for proper management of available resources.

Alternatively, if the situation does not permit the generation of savings during a given cycle, the system should not punish an individual for fully obligating the funds available. The process of empowerment requires that senior leadership not only remove the barriers that impede such actions, but also reward those actions desired in the transformation process.

f. Phase 6 – Create Short-Term Wins

Transformation efforts take time to develop significant traction within an organization. If in the process of change, setbacks are encountered or any chance of even a slim victory seems distant, the change effort is placed at risk. In his research, Kotter found the most effective firms with transformational change requirements were those that actively pursued short-term wins or performance improvements.[114] For the proposed escrow account, short-term wins should be targeted for both Congress and the DoN/DoD.

First, from the congressional perspective, the account needs to provide an early victory that can be heralded as such from congressional leaders and the constituents they represent. Funds transferred into the escrow account must cover part of a required Supplemental

Appropriation or an unforeseen shipbuilding or conversion overrun. Essentially, the account would be shown to provide a buffer against increased annual expenses that are commonly absorbed through additional congressional appropriations. Thus, Congress, by delivering new legislation, has effectively achieved greater total benefits for the American people without increased spending.

Secondly, from the DoN/DoD perspective, an early victory such as an ability to fund the purchase of additional aircraft or to begin construction on a ship ahead of schedule would help sustain corporate momentum for the account. However, local commands may need to see a new childcare center or improved galley facilities before the account would be deemed a success. The early challenge facing the Navy escrow account management team within the Office of the CNO is the active creation of these early victories for each stakeholder.

Within this sixth phase, the most common error is to wait for successes vice aggressively pursuing it. In this pursuit, the implementation plan may require more early "congressional victories" than desired to gain the complete trust of congressional leaders as to the benefits associated with operating an escrow account mechanism. This may require consistent adjustments to the top-line budget to reflect expected savings or possibly, returning some funds directly to the Treasury as part of a "good faith" effort.

g. Phase 7 – Consolidate Improvements

As the operation of an escrow account mechanism enters its second, third, or fourth year, it will be easy to declare the program a success. Usually at points such as these, the guard is relaxed and hard fought gains are assumed part of the current system.

However, these can be the most crucial times for an organization. Those firmly committed to the change may wrongly assume the changes are institutionalized, while detractors from the program may take advantage of the relaxed atmosphere to reintroduce old habits or paradigms. Then, as time passes, the old procedures continue to make their way back into the system and the gains are lost.[115]

The correct strategy is to leverage the early successes by addressing problems that are even more complex. This may produce a call for a top-down review of budgetary requirements within a program or across the DoN/DoD. Alternatively, a bottom-up review may highlight required procedural changes that eliminate levels of oversight and significantly streamline business practices.

It is also important to avoid actions that would be perceived as overstepping the intended bounds establish by Congress. Specifically in the budgeting phase, DoN/DoD budgeters must avoid the temptation of providing additional funds to congressionally favorable programs. Then, as savings are realized, use the funds transferred into the escrow account for pet projects or personal agendas.

h. Phase 8 – Institutionalize Changes

The final phase of transformational change is to institutionalize the programs and procedures developed as part of the change effort. Kotter defines two factors that are critical for making changes part of the daily operations within an organization.[116] First, are the public pronouncements that outline how the new procedures, attitudes, and behaviors have improved performance. In conducting the "Evaluation Road Shows," it is important for the corporation to draw accurate links between individual actions and performance that will help solidify the new program with the organization's culture.

For the Navy escrow account, this may include the creation of several individual and unit awards for cost saving initiatives, fleet wide presentations that link one command's efforts with the acquisition of a new weapons system, or significant leadership presence at the grand opening of new medical facilities built as a result of escrow account funds.

Internal to the DoN/DoD, the public pronouncements will demonstrate an increasingly positive working relationship between operators, financial managers, and budgeters, helping to eliminate the cultural barriers that have existed between the various groups. Externally, it will be important to allow congressional leaders to enjoy the benefits of the account's success and to exploit the increasing level of trust building between the parties.

The second factor is to ensure that the next cycle of leaders is truly committed to the changes implemented. Within the military, this problem is especially challenging. The rapid turnover of personnel makes the institutionalization of any change a difficult process. Not only are tour lengths short by corporate America's standards, but also, due to the size of the military, ensuring continuity in values, ideals, and visions from commanding officer to commanding officer is next to impossible.

In addressing the problem of high turnover within the military, SECDEF Donald Rumsfeld has begun questioning the current rotation practices. In his words:

> I like people to be in their jobs long enough so that they can see their own mistakes and clean them up themselves.[117]

In his observations of the United States military, he has seen the rapid turnover of personnel put critical programs at excessive risk simply due to the standard rotation practices common to all services. For the escrow account to succeed, there will need to be long-term continuity of vision. Since evaluating each rotation of personnel for similarities in beliefs and business practices is unrealistic, maintaining continuity in the program will require a greater education in the business practices of the DoN/DoD throughout an individual's career. The goal should be to obtain a level of financial understanding and education commensurate with the level of tactical understanding and education and officer receives during his/her career.

2. Personal Strategies for Change

The previous sections addressed change from an organizational level. Although few transformation efforts can be successful without formal direction or through the creation of new organizational structures, at some point, the burden of change is placed on the shoulders of the organization's people. As resistance to change is common, even in the most benign change environments, it is important to not only address the organization, but also the individual.

In his research on the resistance to change, Paul R. Lawrence found that the technical aspects of change, physically doing something different, had little effect on the success of the change effort. However, when the existing relationship between employees was threatened, including the manner in which they were perceived as critical to the change and the manner in which they were evaluated in their work, signs of resistance developed, performance suffered, and readiness for more change decreased.[118]

At the center of the problem is fear, fear of losing the long-standing and comfortable working relationships that have existed in the past. In addressing change, the CNO, Admiral Vern Clark commented:

> If you want to succeed as a leader, you must have the courage to change.[119]

The courage to leave behind the comforts of past procedures, policies, and relationships often leads to organizational and personal paralysis. Paul Strebel, Professor of Strategic Change Management at the International Institute for Management Development (IMD), defines three dimensions of personal change based on the mutual obligations and commitments that exist between employees.[120] These relationships, or compacts, are formal, psychological, and social.

a. Formal Dimension

The formal dimension defines the basic relationship between an individual and his or her employer. It establishes the tasks and performance expectations for employees.[121] Typically, they are included as part of formal instructions or developed informally over time. The compact provides the answers to basic questions such as:

- What am I supposed to do for the organization?
- What help will I get to do the job?
- How will my performance be evaluated?

In the implementation of the Navy escrow account, answering these questions is critical as the account complicates long-standing financial practices and places many commanding officers and financial managers in an unfamiliar environment. For many senior leaders, their professional financial management knowledge consists of two general principles: spend all of your money by the end of the year and do not spend more than is in your account. From their perspective, this simple advice has worked well and enabled them to be promoted within the DoN "corporation."

The sudden requirement to manage a budget where success is not measured by a zero balance at the end of the year poses a significant threat. The rules, in their perception, will have changed midway through the game and some may not possess the required tools to play in the new environment.

Overcoming these problems will require substantive efforts to increase the immediate level of education at senior officer levels, as well as a beginning education at junior officer levels. However, if one approaches the ability for any one person to manage both operational and financial requirements as a zero-sum-game, this problem becomes more difficult. For every effort towards improving the financial management procedures within a command, there could come a commensurate decrease in operational focus. The danger, of course, from an organizational perspective, is shifting the balance of attention away from operational excellence towards financial performance.

This dilemma will undoubtedly create frustration among commanding officers, comptrollers, and their subordinates. Oversimplified, it will become a question of winning the war or balancing the budget. In creating the new formal compact for any escrow account structure, the true expectations of the DoN/DoD must be clearly stated and enforced/rewarded in a standardized fashion.

b. Psychological Dimension

The psychological dimension addresses the implicit aspects of the employee relationship.

Specifically, it helps frame the level of commitment expected by management for the organizations programs, ideals, and objectives.[122] The psychological compact provides the answers to basic questions such as:

- How hard will I really have to work?
- What level of personal satisfaction or reward will I get for my efforts?
- Are the rewards worth it?

In answering these questions, the relationship between a given employee and his or her immediate supervisor may be the most critical. For the implementation of the Navy Escrow Account, this is not only an issue of leadership providing motivation for the program, but also for being open during the early stages of the program for answering questions concerning the level of effort required for implementing the program.

Addressing the expectations for individual commands is critical for defining the required level of effort. Will the prevailing approach within DoN/DoD consist of a "save what you can" attitude or will it implicitly expect a 3% transfer of funds into the escrow account at year's end? Although the expectations may vary between commands, the level of effort to reach the desired goals should be consistent throughout the DoN/DoD (i.e., no one command should "suffer" more than another command).

The other aspect of the psychological dimension is the reward system. The existence of an award for the command or individuals generating the most savings is not the issue in this instance. Rather, is compliance with the objectives formally incorporated in the evaluation process and to what extent? On one extreme, an additional block could be added on the fitness reports/evaluations to comment on an individual's effort in this area. On the other, the evaluation process may maintain the status quo, with barely a reference to financial management acumen included in performance evaluations.

Although the long-term goals of the escrow account concept would indicate a need to institutionalize the evaluation of financial management skills, the immediate inclusion of such performance may unfairly punish those lacking a formal education in financial management principles. Because of this limitation, a phased approach towards evaluations may be required. In either case, fair and consistent evaluations based on clearly stated expectations will help redefine the psychological compact.

c. Social Dimension

The social dimension addresses the cultural aspects of personal compacts. It is formed by comparing the words and instructions defining a given program or change with the actions, attitudes, and practices of those in management positions.[123] The social compact provides the answers to basic questions such as:

- Are my values similar to those of others in the organization?
- What are the real rules that determine who gets what in the organization?

The social dimension provides the foundation for discerning the "real" rules of the game from the "theoretical." In many instances, this dimension is the most difficult to control. It can be greatly affected by hearsay and anecdotal evidence. Just as the "spend it or lose it" mentality became an almost binding instruction through stories of funds being cut, the approach to generating savings for any escrow account will be based on the actions of senior leaders.

Upon implementation, personnel throughout the DoN/DoD will be looking for the real effects of the account in terms of personal reward. Evaluations, promotion decisions, and selection boards will become management's indirect conduit for reinforcing the desired behavior throughout the DoN/DoD. If a trend develops where financial management skills are rewarded, the program will increase in valence. If, on the other hand, there is ambivalence towards supporting the escrow account from senior leadership, the program may be at risk as another well-intentioned idea that simply fades away.

D. IMPLEMENTATION TIMELINE

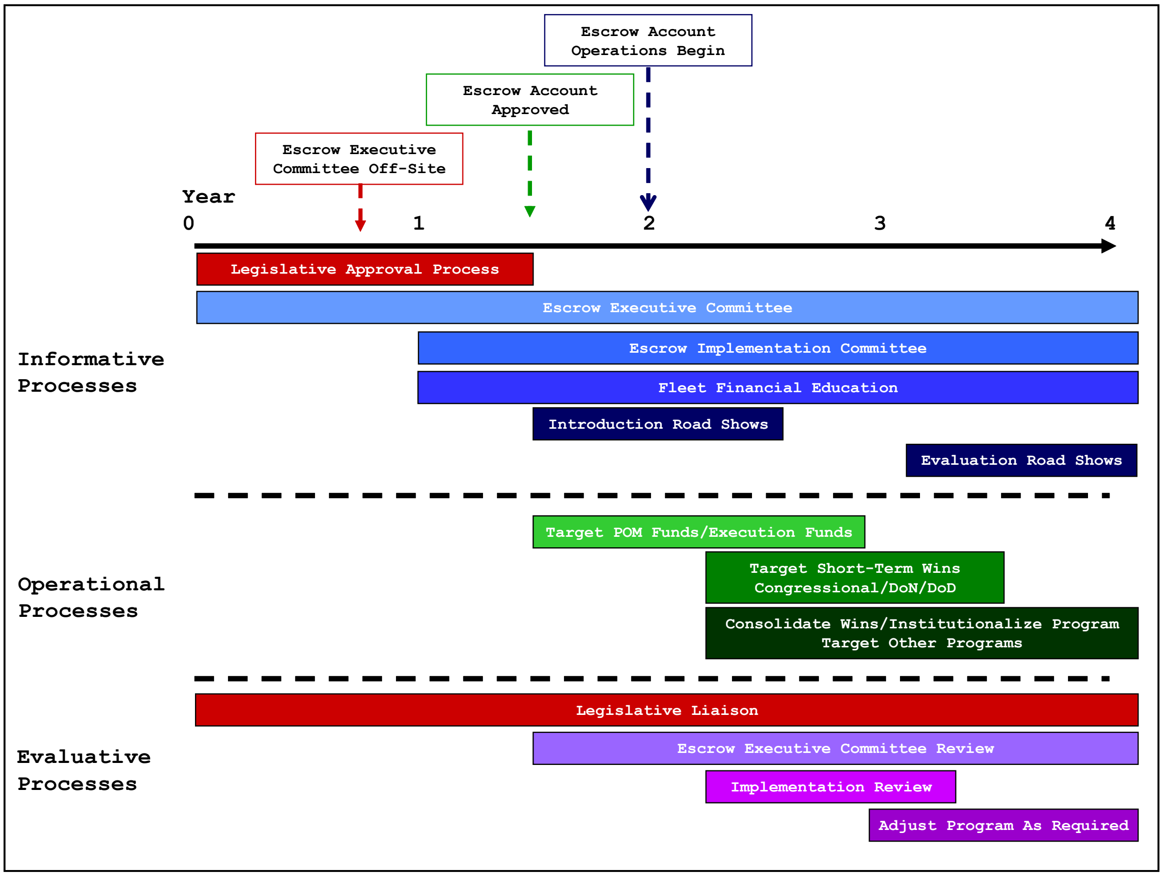
Figure 7.2 provides a graphical depiction of the implementation possibilities outlined in this chapter. The creation of a Navy escrow account, with its required changes in legislation, will provide substantial time for designing an effective and thorough implementation strategy. The implementation elements can be grouped into three process categories: informative, operational, and evaluative.

During the informative period, congressional debate and deliberations will be taking place. This will provide time for an Escrow Executive Committee to work closely with the Legislative Liaisons to develop a coherent and unified vision for the escrow process. Additionally, once it is determined that congressional approval is assured, Escrow Road Shows can begin providing information on the process, and, more importantly, begin building the sense of urgency. The Escrow Implementation will be developing the local strategies and fleet education requirements.

The operational period is focused on the processes that are required for the account to function including funds transfer and the active pursuit of short-term gains that can provide benefits for Congress, the DoN, and the DoD as a whole.

During the evaluative period, the operations and implementation will be thoroughly reviewed and updated as required. Additionally, an assessment should be made on the cultural aspects of the escrow account operation to determine the remaining barriers to implementation or to address unpredicted cultural problems discovered in the first year of operation.

Figure 7.2 Implementation Timeline



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VIII. CONCLUSIONS AND RECOMMENDATIONS

A. ESCROW POSSIBILITIES

The proposed Navy escrow account, as envisioned, would provide financial managers with the incentive to generate cost savings and the means by which those funds could be utilized for the greater good of the DoN. Although the account, in many respects, has been addressed as a "Navy only" mechanism, the escrow account concept would most effectively be applied to all military departments within DoD.

By providing the means by which unobligated funds may be retained, transferred, and subsequently obligated, the escrow account will help eliminate the often-wasteful practices that occur at the end of each fiscal year. Instead of rushing to obligate funds for fear of losing budget authority in future years, prudent financial stewards may recapitalize those funds to replace an aging fleet of ships, aircraft, and facilities. Additionally, by establishing targets during the POM build and allowing for transfer of funds throughout the year of execution, the account provides the DoN/DoD increased flexibility to actively manage budget execution and to gain the most benefit from the funds appropriated.

In researching the barriers to implementation, programs that are similar in function to the proposed escrow account, and potential account operations, five strategic imperatives standout as being critical. Collectively, they provide the focus for successfully lobbying Congress, designing an implementation strategy, and controlling the funds within the escrow account.

1. Make Congress an Ally

The United States was founded on principles that effectively gave Congress complete control of the appropriations process. Any attempt to circumvent or sidestep that control will be viewed as a threat to congressional power, if not the Constitution.

As such, it is important to understand the hesitancy of Congress with approving such a mechanism. Whether the account is initially approved for only the DoN or the entire DoD, it establishes a precedence for relinquishing control of the appropriations and expenditure process. As was mentioned in Chapter VI, an escrow account made available throughout the federal government, with only half of one percent transferred, would result in \$3.875 billion available for redistribution in FY2004. Although limited congressional oversight is proposed, the existence of \$3.875 billion in a "slush fund" may not create a congressionally desirable image.

In seeking approval, it is imperative to include congressional oversight in the design of the escrow account's operation. Additionally, the oversight capability must be actively marketed to Congress. It should include a notification procedure and utilization of a pre-approved requirements list, prior to any funds being obligated.

Moreover, the operation of the account must truly be above board. The hierarchy of fund utilization, shortfalls, pre-approved unfunded requirements, and future year programs must be maintained. For example, arguing for additional funding from Congress while the escrow account maintains a balance would appear to contradict the intent of the account.

2. Focus Must Remain on Operational Excellence

The events in Afghanistan and Iraq undeniably prove the power and effectiveness of the United States Armed Forces. Under no circumstances can this ability be jeopardized or placed at risk. In the implementation strategies discussed in Chapter VII, the need for increased knowledge in the area of financial management for fleet operators was deemed a necessity. This is certainly true. However, the associated level of effort exerted by operational commanders on cost saving initiatives cannot be allowed to detract from training and readiness.

Determining the balance between the two tasks, financial and operational, must be thoroughly researched and developed in an inclusive forum. Good ideas from one command must be leveraged across the fleet and ineffective initiatives or strategies must be highlighted to avoid repetition of errors.

3. Control of Funds

Controlling escrow account funds must occur at the corporate level. The recapitalization of fleet assets, ships, aircraft, and facilities, is reaching crisis levels. Without centralized control of escrow account funds, smaller, less significant projects would be funded. This would effectively eliminate the benefit of the escrow account operation. However, the use of a share ratio may provide the needed incentive to generate increased savings.

The control of funds should be internal and external to the DoN. Internally, the control should capitalize on the existing channels (N7, N8, and the Office of the CNO). Externally, including an OSD and congressional notification will provide the proper level of oversight.

4. Communication and Education

Financial accountability, on the level proposed in the operation of the Navy escrow account, is unprecedented within DoN/DoD. Conveying the vision of the escrow account operation and the requirements for individuals controlling funds is imperative. In addressing a transformational change of this magnitude, it will be impossible to overestimate the level of consistent and clear communication required.

The introduction of the escrow account to the fleet, as well as discussing the urgent need for radical change, must be accomplished by a selected group of community specific change agents. Unlike TSP or other initiatives, the escrow account must be discussed by the most competent and well-respected individuals available. Additionally, every medium available must be exploited to maintain a consistent vision among senior leaders to include the desired level of participation in pursuing cost saving initiatives and the expectations of their commanding officers and comptrollers.

Education will need to be a major part of the communications effort, not only in the introductory briefs, but also in the establishment of educational materials on the financial management practices of the DoD that are made available to officers and civilians at much earlier stages of their respective careers.

5. Actively Manage Change

The cultural barriers to implementation within the DoN require the change efforts be actively managed. Within the current culture is considerable skepticism of top-down initiatives, a lack of trust between those executing the budget and those controlling the purse strings, and a high personnel turnover rate that makes institutionalizing any changes extremely difficult.

Additionally, the personal aspects of change must be addressed including the fitness report and evaluation system. The requirements for personal success and the level of effort expected with the escrow account must be fair and balanced throughout the DoN. Differences in the reward or evaluation process between commands, communities, or coasts, whether real or perceived, as a result of the escrow account, will increase the resistance to change. Alternatively, if the system does not reward the desired behavior, the program may simply fade into obscurity.

In the initial operation of the escrow account, actively targeting the program for early success is critical. All efforts must be expended to manage the environment such that an early victory and its associated benefits may be publicly demonstrated to Congress, the DoN, the DoD, and the tax paying citizens.

B. RECOMMENDATIONS FOR FUTURE RESEARCH

This study provides an overview of the proposed Navy escrow account. However, the driving force behind the study is a basic need to transform the manner in which the DoD receives and obligates appropriated funds. Assuming an escrow account provides the only means in which this can be accomplished would be closing the door on several possibilities. Specifically:

- Could transfer and reprogramming thresholds and procedures be sufficiently modified to provide the needed flexibility?
- Could budget preparation and execution be improved by a multi-year budget process?
- Could the adjustment of obligation periods provide the proper balance of congressional control and increased flexibility for DoD financial managers?

Within the study of the escrow account concept, there are several areas for conducting supporting research. Specifically:

- Within each appropriation, how much money is made available, on average, at the end of the fiscal year that could be transferred into an escrow account?

- At what level should the concern for implementing cost saving initiatives extend for operational commanders? Ship? Battle group? Type wing? Combatant commander?
- What level of financial management education would be required for the average fleet operator to implement and fully exploit the escrow account concept?
- Could a smaller scale operational test, possibly within a single appropriation, be developed to prove the escrow account concept?

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