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POLICY BRIEF

MILITARY COMPENSATION AND RETIREMENT MODERNIZATION: *A Primer*

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Today's U.S. military includes approximately 1.4 million men and women on active duty and another 1.1 million serving in the Reserves and National Guard. Since the creation of the All-Volunteer Force (AVF) in 1973, the Department of Defense (DOD) has relied primarily on financial incentives, including compensation and nonmonetary benefits such as housing and health care, to recruit and retain the AVF. This reliance has placed a premium on the department's ability to calibrate its financial incentives to build and maintain a ready force, properly support those in uniform and their families, and compete with a dynamic domestic economy.

Military compensation stands at an inflection point today. Intense fiscal pressure both inside and outside the DOD budget touches the military personnel accounts.¹ Demographic changes within the force (and the broader population of dependents and retirees supported by military compensation)

add further pressure to the debate, particularly surrounding housing benefits and health care. The winding down of operations in Iraq and Afghanistan affects the compensation calculus, particularly surrounding recruiting and retention incentives. Beyond the military, changes in the civilian labor market are affecting the relevance and competitiveness of military compensation and its ability to attract and keep the best and brightest in uniform.

In 2013, Congress mandated the creation of a Military Compensation and Retirement Modernization Commission (MCRMC) to study these trends and make recommendations to "ensure the long-term viability of the All-Volunteer Force."² After approximately 18 months of fact-finding and deliberation, the MCRMC is poised to release its findings and recommendations to DOD, Congress and President Barack Obama in early February. This report will likely spark a debate over military pay and benefits that will continue throughout 2015 and 2016 as Congress, the president and the services struggle to reconcile competing demands for increasingly scarce fiscal resources.

This policy brief proposes a new framework for how the services, DOD, Congress and the administration can use the commission's findings and recommendations as a way to fundamentally

rethink the cost and the value of the current compensation system in meeting the recruitment and retention needs of the AVF. In particular, it provides an in-depth examination of the changes in cash compensation from 1990 through 2014-2015 and their effects on both the DOD top line and individual service members. While this brief touches on other components of military budget growth (including health care expenditures and retirement), cash compensation remains the primary focus because of the central role that base pay and allowances play in compensating and sustaining the AVF.

The analysis presents the following findings:

- The military effectively closed the gap between military and civilian compensation during the 1990s and then added an additional premium to military compensation during the past 14 years of war.
- In the post-9/11 era, end strength alone no longer fully accounts for DOD personnel outlays.
- Monetary compensation matters for practical and moral reasons, but it must be considered as part of a broader package of incentive structures, talent management systems and motivations to serve.
- The military should consider the continued viability of its “one size fits all” compensation model.

This brief is the first in a series of studies conducted by the Center for a New American Security on the AVF and how the nation can best sustain and improve this critical national security asset.

Background

Rates of military compensation and the policies surrounding them matter for a number of reasons. Military compensation signals the respect and value Americans place on military service, particularly during wartime, when the burden of service

is heavier for service members and their families. Competitive military compensation also serves a vital role in recruiting and retaining the AVF.³ In the post-9/11 era, particularly in the mid-2000s, competitive compensation (including retention bonuses, incentive pay and tax exemptions) played a critical role in enabling the services (especially the Army and Marine Corps) to consistently meet their recruiting and retention targets while fighting two protracted wars.⁴

Military compensation also reflects significant fiscal and defense policy choices by Congress and the executive branch. In the Fiscal Year (FY) 2001 National Defense Authorization Act (NDAA), Congress linked pay increases for all service members to the Employment Cost Index (ECI),⁵ plus 0.5 percent for FY 2001 through FY 2006. This choice to increase compensation above the rate of inflation reflected growing concern that military compensation lagged behind the civilian sector and was degrading readiness through low compensation's effects on morale and retention.⁶ The half-percent increase was intended to ensure that military pay would catch up to a perceived gap with the civilian sector. In the FY 2004 NDAA, Congress included additional language enabling the president to consider additional pay increases in cases of “national security or serious economic conditions affecting the general welfare.”⁷ In recent years, the impetus to slow cost growth has led to more modest increases in military pay relative to inflation.

In recent years, the service chiefs and other defense leaders raised concerns about the rate of increase for military compensation; and the extent to which personnel costs were affecting readiness across the department by putting pressure on other defense spending accounts.⁸ Driven in part by these concerns, the 2013 NDAA established the MCRMC to review compensation, with an eye toward ensuring long-term viability of the AVF, protecting quality

of life for service members and their families and modernizing the compensation and retirement systems so they are both competitive and sustainable.⁹ On September 12, 2013, Obama provided additional guidance for the commission. Under his “Principles for Modernizing the Military Compensation and Retirement Systems,” compensation and retirement must be efficient: “they should be fiscally sustainable and impose the least burden possible on the American taxpayer, consistent with maintaining a high-quality, All-Volunteer Force.” They must also be effective “in times of peace, war, and other levels of conflict.”¹⁰ As the commission releases its report, legislation prohibits any recommendations from affecting either the retirement eligibility date or the amount of retirement pay for those service members currently serving or retired. However, currently serving or retired service members are not prohibited from opting in to a possible new system. The challenge before the commission is to create greater value for service members at a lower cost to the Department of Defense.¹¹

The decision to re-examine military compensation and retirement has provoked strong reactions from a number of stakeholders, particularly (though not exclusively) those aligned with The Military Coalition, a “consortium of nationally prominent uniformed services and veterans’ organizations.”¹² Among the concerns expressed are moral (ensuring that compensation adequately meets the level of sacrifice)¹³ and practical (retaining the best and brightest in an extended period of constant combat deployments).¹⁴ More pointedly, these stakeholders have responded directly to the service chiefs’ concern by arguing that military compensation remains roughly the same percentage of the defense budget today as it was 10 or 20 years ago and that the services should focus on cutting runaway procurement programs first before looking to compensation or benefits.¹⁵

Defining Military Compensation

The military compensates service members through a number of monetary and nonmonetary incentives. Regular Military Compensation (RMC), the basis of compensation for all active-duty service members, consists of base pay, basic allowance for subsistence (BAS), basic allowance for housing (BAH) and federal tax advantages.¹⁶ Beyond RMC, some service members earn special types of pay tied to specific proficiencies or types of service, such as additional pay for service on jump status in airborne units. The services also use bonuses to incentivize retention among high-demand or highly skilled military occupational specialties, such as nuclear submariners, aviators and medical professionals.

As recognition and compensation for the sacrifices associated with wartime deployments, service members also earn special pay and incentives while deployed in support of contingency operations such as those in Iraq or Afghanistan. While deployed to combat or hazardous-duty zones, service members earn hostile-fire or imminent-danger pay (\$225/month) and a family separation allowance (\$250/month), and their RMC, bonuses, and special pays during deployment are exempt from federal income taxation.¹⁷

Beyond monetary compensation, service members earn additional benefits. The most prominent is comprehensive health care coverage for active service members and their families, provided through military treatment facilities and TRICARE networks. The government provides subsidized life insurance via the service members Group Life Insurance (SGLI) program, and long-term disability care and medical support via Department of Veterans Affairs health care and benefits programs. With respect to civilian education, eligible service members may be able to access tuition assistance to pay for education while on active duty. Service

members and their families have access to commissaries and base and post exchanges (BX and PX, respectively), providing grocery and commercial goods at tax-free, reduced prices that can save military families 30 percent or more annually on groceries.¹⁸

Another significant incentive for career military service is the military retirement system, available to military personnel who serve for 20 years or more. Under current law, retirement is calculated through three distinct formulas (depending on date of enlistment or commissioning and service member election).¹⁹ For service members who joined the military before September 8, 1980, retired pay equals the number of years in service (20 or greater) times the multiplier of 2.5 percent times final base pay. Under this formula, a service member who leaves at year 20 is entitled to 50 percent of final base pay, payable immediately upon retirement and every year after for the rest of his or her life. These amounts may increase each year, based on a discretionary cost of living adjustment (COLA) enacted by Congress and implemented by the DOD. For those who joined after September 8, 1980, retirement pay equals 2.5 percent times the number of years in service, multiplied by the average of the last three years in income (as opposed to basic pay during the final year; this is referred to as “high-3”). Under a third formula, known as “REDUX,” service members earn less credit for their first 20 years of service and more for each year after 20 years. Thus, a retiree leaving after 20 years would get 40 percent of his or her base pay in retirement, but someone leaving after 30 years would earn 75 percent of base pay, at which point REDUX retirees break even with “high-3” retirees.²⁰

The military retirement system offers a unique incentive for career military service. Service members begin drawing retirement pay upon exiting the service, as opposed to ages 60 or 65 (when

many civilian retirees are eligible to draw their full retirement or access their retirement savings and investment accounts).²¹ According to DOD retiree data, active-duty enlisted personnel retire at an average age of 40.8; officers retire at an average age of 44.9.²² Since the creation of the military retirement system, improvements in military health and wellness, extended life spans and new patterns of employment have changed this landscape for military retirees. Today, more military retirees enter the civilian workforce, and work for longer, during their second, post-military career than when the system began.²³

Notably, the current military retirement system is a “defined benefit” system, in which the government pays a specified amount to retirees for the duration of their lives, adjusted for inflation, regardless of market conditions or other variables.²⁴ This type of system differs from a “defined contribution” system, wherein prospective retirees contribute to a retirement savings or investment account, often with some matching contribution from their employers, and earn a retirement based on the returns on this investment that are a function of market returns, inflation, currency fluctuations and other variables.²⁵ Under the current system, the government’s liability for retirement pay continues for a service member’s lifetime. Under a defined contribution system, the employer typically contributes to workers’ retirement accounts while they are employed, but has no continuing liability for retirement pay after service.

Because of the military retirement system’s basis for calculating retirement pay, there is an important link between military compensation and the long-term liabilities incurred by the government for military retirement. Changes to base pay affect the basis of calculating retirement pay, directly changing the amounts the government will pay to retirees (and accrue as liability for the system as a whole)

for decades after a service member retires.

Trends in Military Cash Compensation

The following data series follow monthly military compensation from 1990 through 2014-2015.²⁶ We chose this approximately 25-year time frame based on the availability of data, and a desire to show military compensation for the AVF during a diverse window including a short conflict (the first Gulf War), the post-Cold War drawdown of the 1990s, the peacekeeping deployments of the 1990s and the post-9/11 period of sustained conflict in Iraq, Afghanistan and other theaters of war. The period also equals the approximate career span of a

retiring service member today, given that the average active officer retires with 23.4 years of service and the average enlisted service member retires with 21.8 years of service.²⁷ The first series of charts show the overall amounts spent by the Defense Department on military compensation and the relationship between these amounts and the total end strength of the services. The second series of charts show the 25-year trends in military compensation for four paygrades: E3, E7, O3 and O6. These grades were chosen to depict trends as they affect four distinct military populations: junior enlisted personnel, senior enlisted personnel eligible for retirement, junior officers at the end of their initial

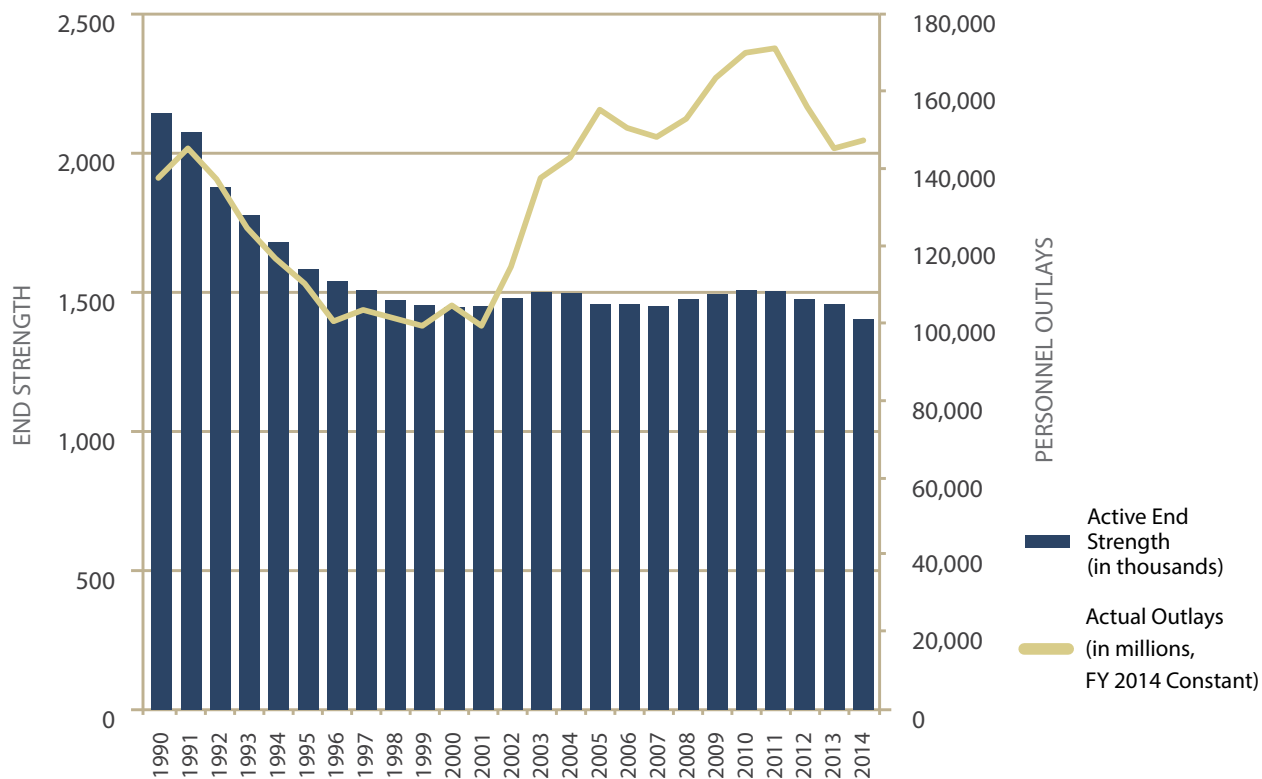


FIGURE 1: END STRENGTH VS. DEFENSE PERSONNEL OUTLAYS IN MILLIONS, 1990-2014

Source: Office of the Undersecretary of Defense (Comptroller), National Defense Budget Estimates for FY 1990-FY 2015

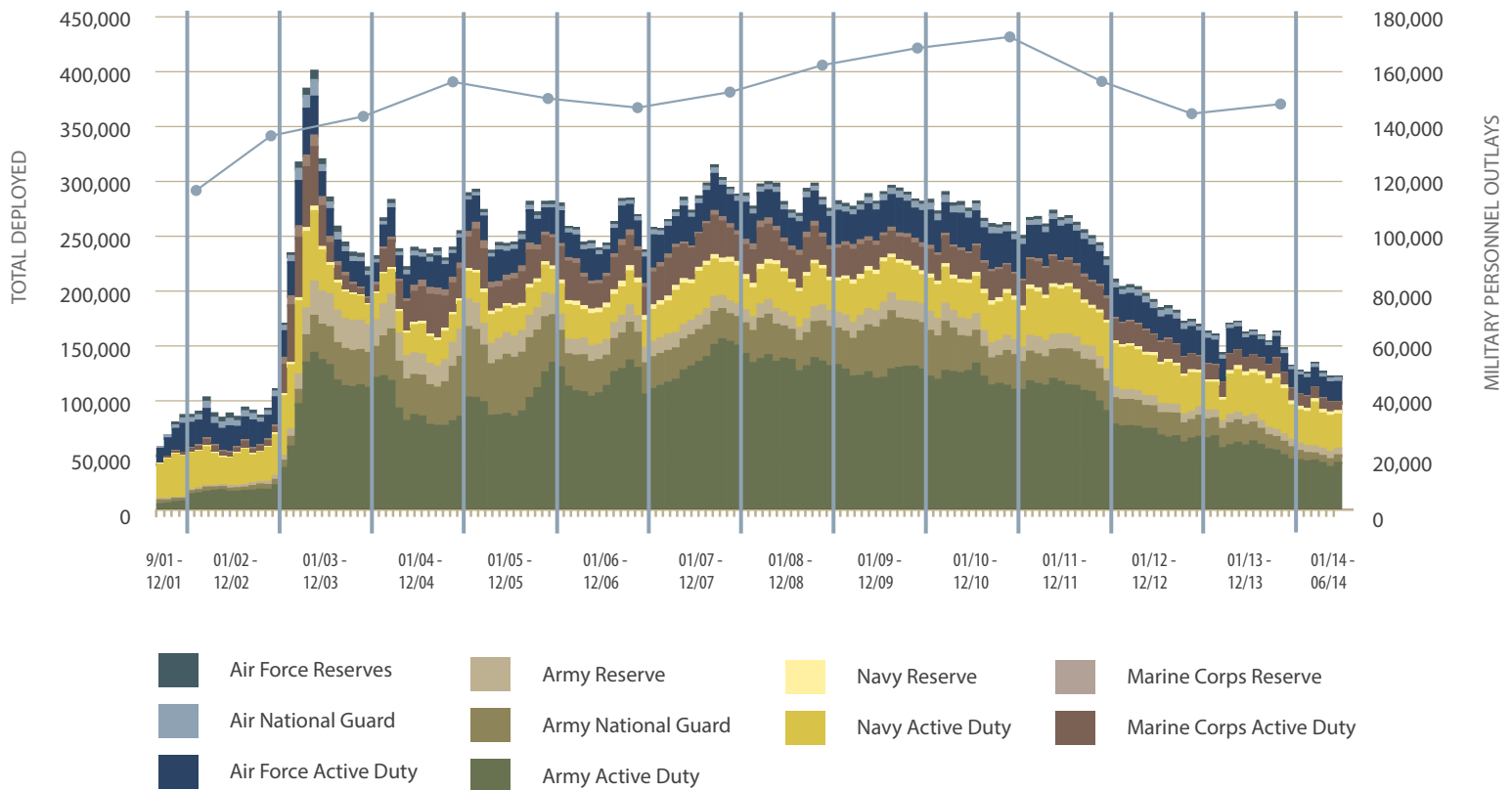


FIGURE 2: TOTAL DEPLOYED BY SERVICE VS. MILITARY PERSONNEL OUTLAYS IN MILLIONS, SEPTEMBER 2001-JUNE 2014 (FY 2014 CONSTANT)

Source: Department of Defense Contingency Tracking System, September 2001-June 2014

service obligation and senior officers eligible for retirement. All figures are presented in FY 2014 constant dollars, to enable more objective comparison of compensation data across time.

For the first half of the period we studied, from 1990 to 2000 overall military personnel outlays tracked end strength closely, as shown in Figure 1. This remained true during the first Gulf War, the post-Cold War and Gulf War drawdowns and the 1990s deployments to Somalia, Haiti, Bosnia and Kosovo, among other places. However, beginning in 2001, the relationship between end strength and defense personnel outlays changed dramatically.

End strength no longer carried the same explanatory power for personnel outlays; significant policy changes and increases in compensation did.

Compensation expenditures peaked in 2011, representing the last year of simultaneous combat operations in Iraq and Afghanistan. After that, defense personnel outlays began to decline. Although end strength also declined after 2011, as the services began to shrink to prewar levels, the relationship between personnel outlays and end strength still remains attenuated. More pointedly, it bears noting that defense personnel spending in 2015 is roughly equal to defense personnel spending

in 1990, in constant dollars, even though there are roughly 759,000 fewer active and reserve service members than 25 years ago.

This analysis suggests that something other than end strength alone is responsible for the increase in military personnel outlays during the post-9/11 era. The initial analysis suggested a working hypothesis that there might be some relationship between military deployment strength (as distinct from end strength) and the total spent on compensation during this period. We gathered aggregate deployment data from the DOD Contingency Training System to show the total number of military personnel deployed by month since 9/11 by service and component (Figure 2). This data appears to confirm the working hypothesis. With the exception of a spike in 2003 during major combat operations in Iraq, there appears to be a rough correlation between total military personnel outlays since 9/11 and the number of personnel deployed. However, the linkage between these two trends seems to degrade after 2012, possibly because actual compensation data is not yet available for 2013 and 2014.

Figure 3 shows the change in top-line military personnel Total Obligation Authority (TOA) by branch of service. The active-duty Army saw both the largest decreases in personnel expenditures during the 1990s and the largest growth in personnel expenditures in the post-9/11 era. At its lowest point (1996), the Army personnel TOA was \$29.8 billion; at its highest point (2010), the personnel TOA was \$76.5 billion. The Navy experienced less variation over the same period, with a low of \$38.6 billion in 2000, a high of \$57 billion in 1991 and a personnel TOA of \$44.9 billion in 2014. It should be noted that the Marine Corps personnel TOA is included within the Navy's personnel budget. The Air Force was also experienced less variation than the Army over time, with a low of \$30.5 billion in 2000, a high of \$46 billion in 1990 and a TOA of

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Photo by Cpl. Tommy Huynh/U.S. Navy



Photo by Sgt Brian A. Lautenslager/U.S. Marine Corps

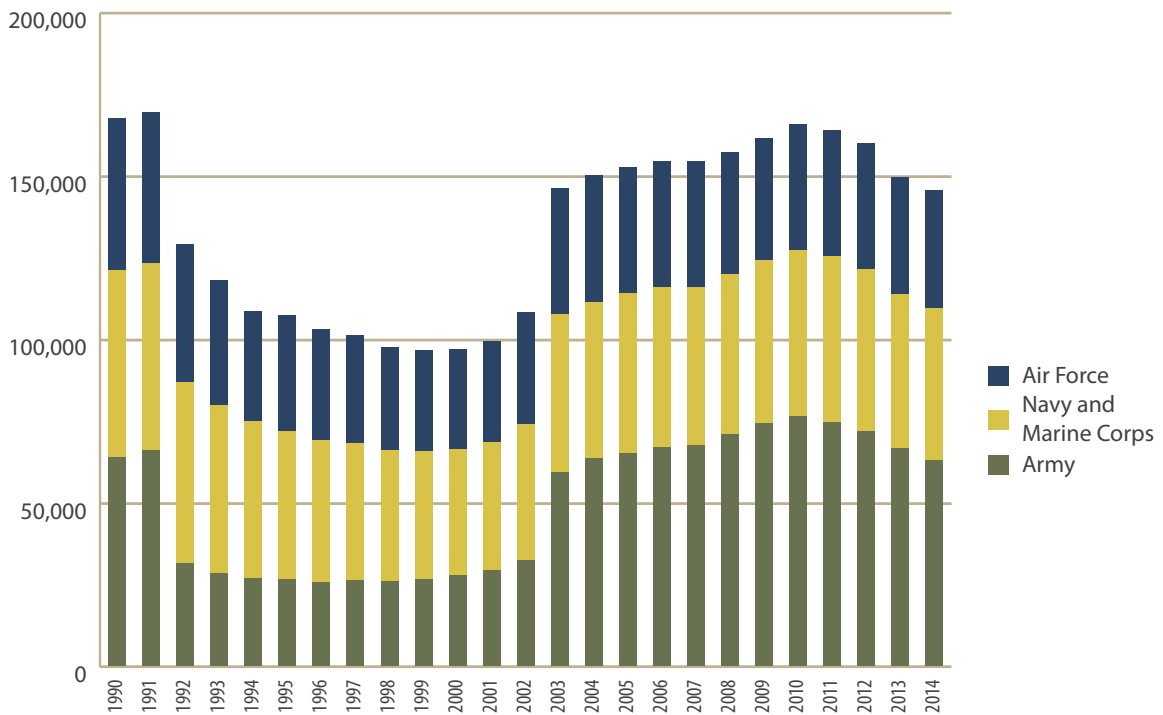


FIGURE 3: MILITARY PERSONNEL TOTAL OBLIGATION AUTHORITY BY BRANCH OF SERVICE, FY 1990-FY 2014 (FY 2014 CONSTANT IN MILLIONS)

Source: Undersecretary of Defense (Comptroller), National Defense Budget Estimates for FY 2014

\$34 billion in 2014. As with the department-level data presented earlier, there appears to be a close relationship between end strength and military personnel budget levels during the 1990s, and a disconnected relationship between these two things during the past 14 years of war.

Figures 4 and 5 show total military personnel outlays as a proportion of the total defense budget in terms of expenditures and percentage of the budget, respectively. These figures support statements from major stakeholder organizations, such as the Military Officers Association of America (MOAA), which frequently comment that personnel expenditures have remained relatively constant over the past 25 years as a proportion of the defense budget.²⁸

However, the proportion of the total defense budget made up by personnel costs does not tell the whole story. Fluctuations in end strength and deployment tempo resulted in substantial growth in the average cost of compensation per service member by branch (Figure 6). The average compensation expenditures per Army soldier grew from \$41,130 in 1990 to \$124,746 in 2010, before settling in at \$122,067 in 2014. The average compensation expenditures per Navy sailor or Marine grew from \$34,369 to a high of \$92,052 in 2012, before resting at \$89,780 in 2014. The average compensation spending per airman grew from \$40,679 to a high of \$113,431 in 2014. Several factors account for the disparity between services, including differences in the paygrade distribution, years-of-service distribution, officer/enlisted distribution and use of targeted incentive

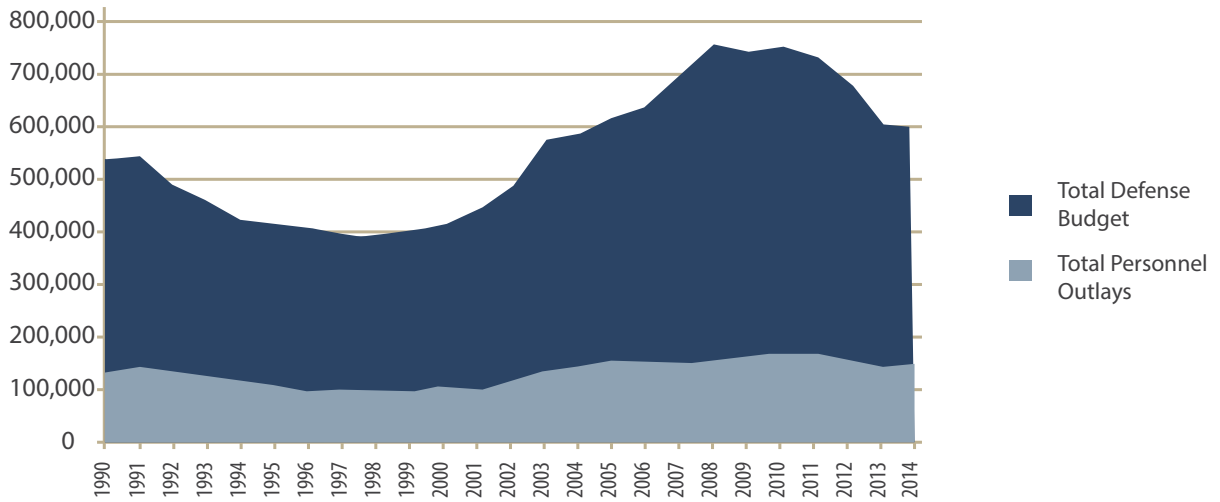


FIGURE 4: TOTAL MILITARY PERSONNEL OUTLAYS VS. TOTAL DEFENSE BUDGET, 1990-2014 (FY 2014 CONSTANT, IN MILLIONS)

Source: Undersecretary of Defense (Comptroller), National Defense Budget Estimates for FY 2014

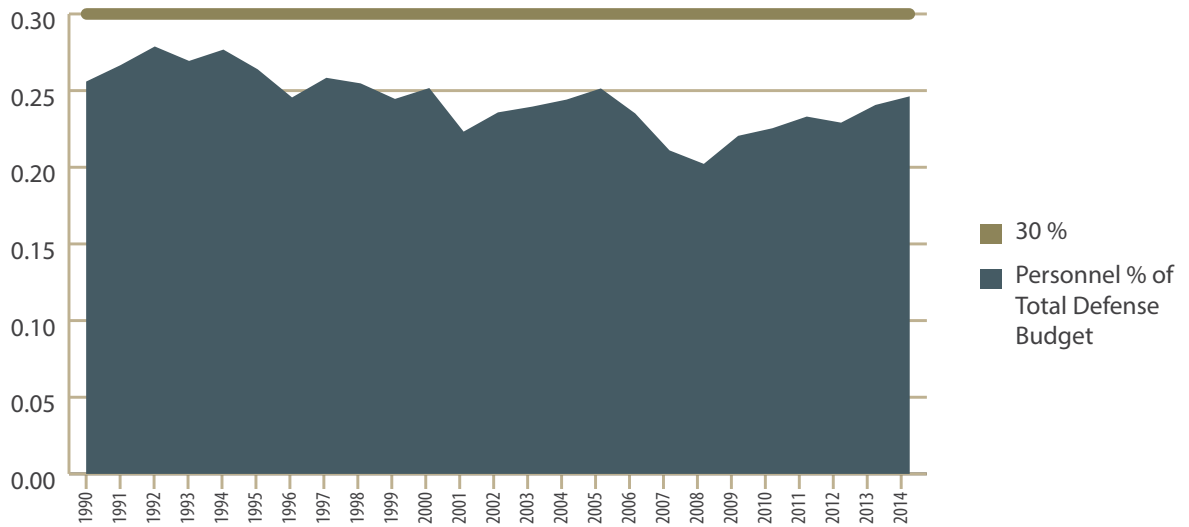


FIGURE 5: PERSONNEL OUTLAYS AS A PERCENTAGE OF THE TOTAL DEFENSE BUDGET BY YEAR, 1990-2014

Source: Undersecretary of Defense (Comptroller), National Defense Budget Estimates for FY 2014

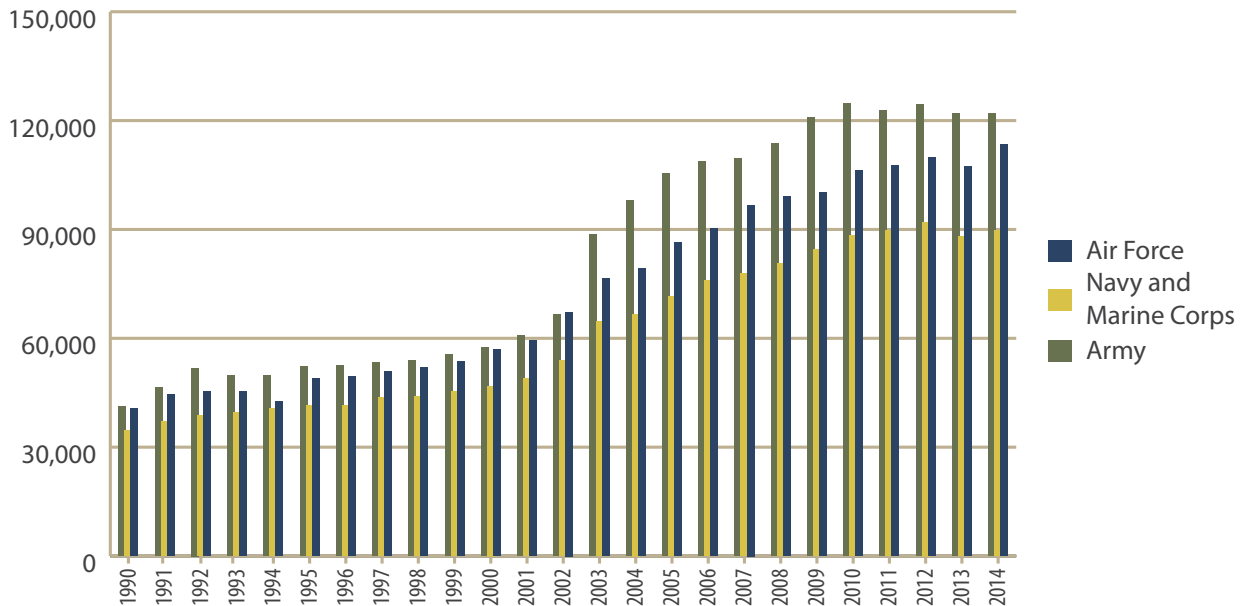


FIGURE 6: AVERAGE COST OF COMPENSATION PER SERVICE MEMBER BY BRANCH, FY 1990-FY2014 (FY 2014 CONSTANT)

Source: Undersecretary of Defense (Comptroller), National Defense Budget Estimates 1990-2014

pays for each of the services. Nonetheless, the overall trend is the same for all four services: an average 178 percent increase in per-service-member compensation spending since 1990.²⁹

Trends in Service Member Compensation

The data presented above describes the effects of compensation policy at the department and service level. The data series below describe the trends in military compensation at the service member level. We chose to analyze this based on four classes of service member: E3 with three years of service, representing junior enlisted personnel; E7 with 10 years of service, representing midgrade and senior enlisted personnel; O3 with four years of service, representing junior officers; and O6 with 22 years of service, representing senior officers. Our

analyses below aim to explore the effects of military compensation increases on individuals, as shown by the amount paid to service members in these four paygrades, in constant dollars, between 1990 and 2014.

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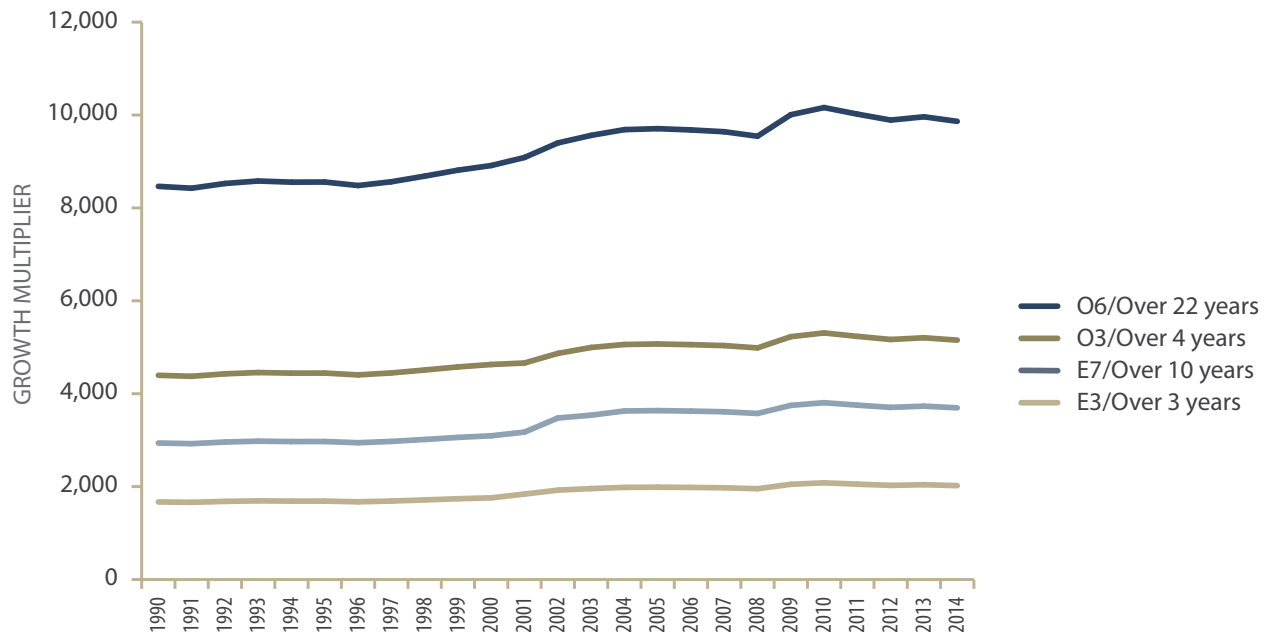


FIGURE 7: MONTHLY BASE PAY, 1990-2014 (FY 2014 CONSTANT)

Source: Department of Defense, Defense Finance and Accounting Service Pay Tables, 1990-2014

This data shows substantial increases in monthly military base pay over the 25-year time frame, above and beyond the rate of inflation.³⁰ Professional noncommissioned officers, represented in our sample by E7s with more than 10 years of service, received 25.6 percent more in base pay in 2014 than they did in 1990, the largest increase during this period of any group we studied. Junior enlisted personnel received the next largest bump, seeing their base pay rise by 20.8 percent during this period. Officers fared well too, seeing their compensation rise an average of 16.9 percent in this period.

We also measured the changes in service member compensation over this period against changes in civilian compensation, to assess how military compensation fared against the U.S. economy generally. This comparison matters because of the need for the military to offer adequate compensation relative to civilian pay in order to recruit and retain top talent, and for normative reasons as well relating to the relationship between society and its military, and the extent to which society recognizes and rewards military service. Interestingly, service members fared significantly better than median U.S. civilian workers aged 25-34 with respect to

TABLE 2: MONTHLY BASE PAY 1990-2014

RANK	MONTHLY 1990 BASE PAY (2014 CONSTANT)	MONTHLY 2001 BASE PAY (2014 CONSTANT)	MONTHLY 2014 BASE PAY (2014 CONSTANT)	REAL GROWTH, 1990-2014	REAL GROWTH, 2001-2014
E3 OVER 3 YEARS	\$1,684.41	\$1,854.02	\$2,034.90	20.8%	9.75%
E7 OVER 10 YEARS	\$2,952.77	\$3,187.86	\$3,709.80	25.6%	16.4%
O3 OVER 4 YEARS	\$4,410.59	\$4,675.66	\$5,167.80	17.2%	10.5%
O6 OVER 22 YEARS	\$8,478.83	\$9,100.48	\$9,878.40	16.5%	8.5%

Source: Department of Defense, Defense Finance and Accounting Service Pay Tables, 1990-2014

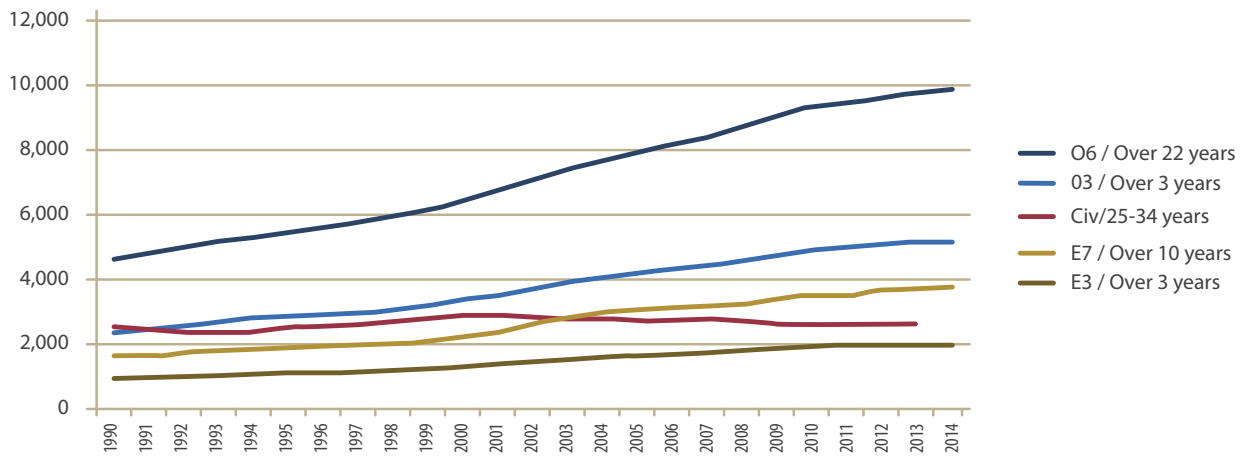


FIGURE 8: MILITARY BASE PAY VS. MEDIAN CIVILIAN COMPENSATION, 1990-2014 (FY 2014 CONSTANT)

Source: Defense Finance and Accounting Service; U.S. Census Bureau income statistics

compensation.

Over roughly the same period as our look at military compensation, civilian compensation fared poorly by comparison. Median civilian earnings for the 25- to 34-year-old age group rose slowly during the 1990s, plateaued and then began to drop in approximately 2006, settling at roughly the same amount (in constant dollars) in 2013 as in 1990. According to Census historical data, the median income for a 25- to 34-year-old in 1990 was \$29,526 (in 2013 dollars); in 2013 it was \$30,759, an increase of just 4 percent. During this same time, military compensation rose an average of 17 percent in inflation-adjusted constant dollars. In military personnel terms: the civilian median income for 25- to 34-year-olds was slightly below O3 pay in 1990; the same civilian saw that gap widen considerably, to the point where the median civilian income is far closer to base pay for an E3 instead of an O3.

As service member base compensation rose in real terms, so too did Basic Allowance for Housing, the separate, tax-free pay to service members who do not live in government quarters. BAH is calculated by location, based on housing cost surveys conducted by the government for those local housing markets. Over the study period, BAH has been set as a matter of policy at various levels, from 80 percent to 100 percent of the surveyed housing costs by location. Because BAH is tied to housing markets, general increases in the cost of housing across the nation have driven much of the increase in BAH. However, so have policy changes, such as the decision by DOD in 2000 to adjust BAH from covering 80 percent of surveyed housing cost to covering 100 percent.³¹ The net result is that BAH has increased across the board in nearly all locations by a considerable amount for service members and has contributed to overall personnel outlays. In an effort to curb cost growth, the most recent defense bill proposed adjusting BAH to 99 percent

of surveyed housing costs, effectively passing a 1 percent out-of-pocket cost to service members living off base.³² The prospects for this legislative change are unclear.

The data above shows real growth in inflation-adjusted dollars for BAH across 12 major military communities for 1998-2014.³³ In all but one of these areas, housing allowances increased the most for junior enlisted personnel, with the next largest increase going to midgrade and senior enlisted personnel. Officers saw more modest increases in their housing allowances by comparison. It's important to note that this additional cash compensation is additive to base pay. To the extent that military pay has diverged from — and begun to exceed — comparable civilian pay, these housing allowance increases exaggerate that trend, constituting a unique benefit for service members at a time when housing costs consume roughly 30 percent of the typical American family budget.³⁴

Observations and Conclusions



Photo by Mass Communication Specialist 1st Class Larry S. Carlson/U.S. Navy

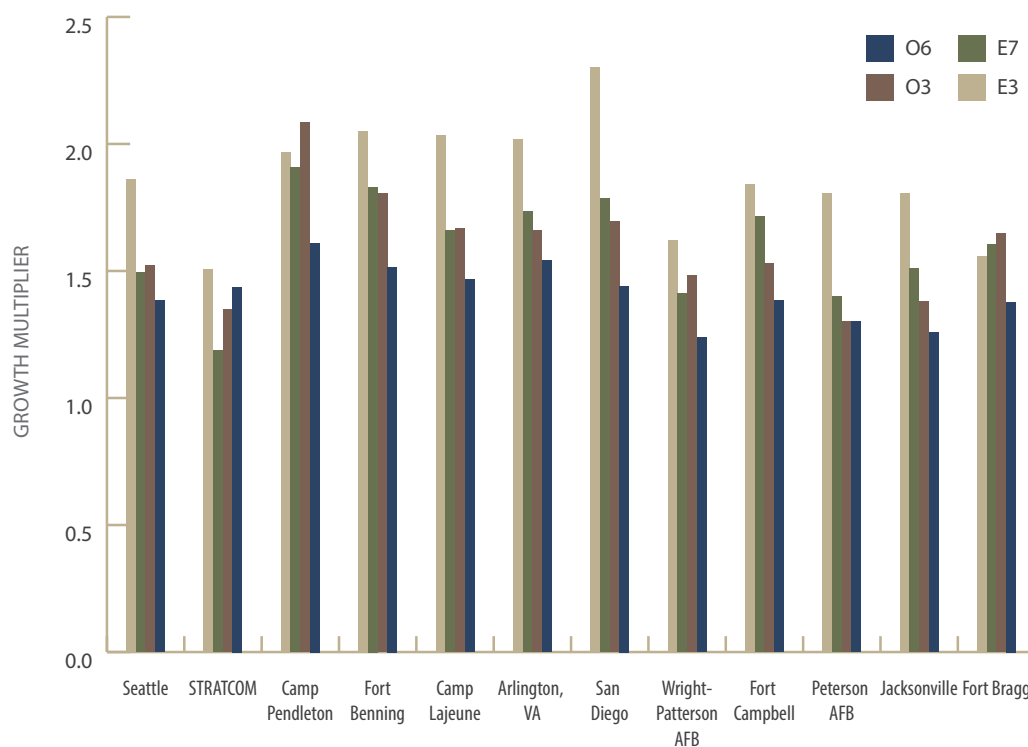


FIGURE 9: REAL GROWTH IN BAH FOR SELECT DUTY STATIONS, 1998-2014 (FY 2014 CONSTANT)

Source: Department of Defense, Defense Finance and Accounting Service BAH tables, 1998-2014

Our review of military compensation data and comparisons of this data to civilian compensation data suggest a number of conclusions and questions for further exploration and discussion, summarized below.

1. **Personnel Cost Growth.** It is true that military personnel outlays, as a percentage of the DOD budget, have remained relatively constant at just under 30 percent. However, it is also indisputable that total personnel outlays, measured in dollars spent, have increased and that DOD now spends nearly three times as much per service member on compensation as it did 25 years ago.
2. **Driving Factors for Cost Growth.** Between 1990 and 2001, there was a near-perfect correlation between end strength and military personnel

outlays. Beginning in 2001, this linkage deteriorated, such that increases or decreases in end strength no longer explain (or strongly relate to) the annual amounts spent on military compensation. Our analysis suggests several other factors (besides end strength) that are driving the increases in personnel outlays and the tremendous increase in military pay expenditures per service member. These include significant increases in base pay, increases to housing allowances and other special pays, wartime mobilization and full-time pay for large numbers of reserve component personnel, and use of retention bonuses and other financial incentives to recruit and retain personnel during the height of the Iraq and Afghanistan wars.

There is a wide gap between the inflation-adjusted increase in base pay and the inflation-adjusted increase in per-service-member military compensation outlays by the department. Base pay rose an average of 17 percent in constant dollars between 1990 and 2014. Outlays for military compensation per service member rose 178 percent across all services, and 197 percent for the Army, from \$41,130 to \$122,067, during the same period. Base pay increases alone obviously do not explain this large increase. Instead, our analysis suggests that BAH increases, as well as other forms of cash compensation that make up the military compensation budget line (including special pays, recruiting and retention bonuses, etc.) used during the wartime period of 2001 to 2014, explain this large jump. Further, it appears that there is a connection between deployment tempo and this increase in military compensation. Although military compensation to the active military did not change substantially as the result of deployments (notwithstanding the addition of certain deployment-related special pays), it did change substantially for reserve component personnel, who were used heavily in Iraq, Afghanistan and other theaters of war and whose compensation grew from part time to full time for the length of their mobilizations. This suggests that compensation growth is likely to slow with the end of large-scale operations in Iraq and Afghanistan. However, remaining factors such as increases in housing allowances and other pays will continue to drive some cost growth for the foreseeable future.³⁵

3. Military Pay vs. Civilian Pay. The comparison between military and civilian pay is a perennial question in the field of military personnel policy, because of the need for competitive compensation to maintain the AVF and for normative reasons as well. The data suggests that the military effectively closed the gap between military and

civilian compensation during the 1990s and then added a premium to military compensation during the past 14 years of war. This data can be interpreted in multiple ways based on one's perspective. Post-9/11 pay increases may be the cost of sustaining the all-volunteer force in wartime. Economists might agree with that characterization but also suggest this says less about military compensation than the extent to which American middle-class fortunes and income inequality have grown worse since 2001. Budget hawks might interpret the data to say the military is overcompensating its workforce based on the civilian labor market. We believe that some element of each argument may be true but that additional analysis may be necessary, particularly that which compares military compensation by rank and specialty (including special pays) with civilian compensation data by occupation, education and locality.

4. The Effect of Military Pay Increases on

Retirement Outlays. The federal government effectively pays twice when it increases military base pay. Base pay increases translate into immediate increases in military personnel outlays for currently serving personnel. Increases to base pay also affect the amounts the government will pay to military retirees, whose future retirement pay is based on the amount they earn during their last years on active duty. In the decades to come, the retirement liabilities for DOD will continue to grow, driven by base pay increases that affect the basis for calculation, increasing life expectancy and the addition of cost-of-living adjustments (COLAs) linked to the rate of inflation.³⁶ DOD currently supports 2.3 million retirees, including 1,470,803 active retirees, 103,160 medical retirees and 383,000 reserve retirees, as well as 326,780 military survivors receiving annuity payments from DOD.³⁷ This population now exceeds the size of the active military and will soon exceed

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the size of the active and reserve force. If current cost trends continue, and considering both retirement pay and retirement health benefits, DOD will soon pay more to support its retired military population than its current force.³⁸

Framing the Debate

The forthcoming Military Compensation and Retirement Modernization Commission report presents an opportunity for the nation to assess its social contract with the AVF and adjust (if necessary) to preserve the force and meet the national interest. As Obama outlined in his “Principles for Modernizing the Military Compensation and Retirement Systems,” the MCRMC is being asked not only to address the trajectory of military compensation, but also to “consider and examine: our Nation’s ability to sustain the All-Volunteer Force; the retention of our most experienced and qualified service members and the alignment of compensation and management to achieve this end; our current promotion system and associated force shaping tools; and our responsibilities to the American taxpayers.”³⁹

Early reports suggest the commission will produce modest recommendations for reform of military compensation, focusing on changes to the

calculation of base pay, special pay and retirement pay.⁴⁰ These proposals may have more likelihood of enactment in the near term, based on the difficult political environment that currently surrounds military compensation. However, these ideas will not adequately reach the core questions that now face the military compensation system as the AVF enters its fifth decade.

Values and Value

1. Balancing Cash Compensation With Other

Levers to Maintain the AVF. The explicit premise of the AVF since its inception has been the use of market incentives – primarily monetary compensation – to recruit and retain talent. However, survey data suggests that cash compensation may be necessary but insufficient to retain talent in the 21st century, particularly for millennial and post-millennial service members who say they are motivated by other considerations when making career choices. A recent Pew Research Center report found that 88 percent of post-9/11 veterans say that “serving their country was an important reason they joined the military,” while 75 percent joined to get educational benefits, and 58 percent who joined on or after 9/11 say that the terrorist attacks were an important reason they volunteered.⁴¹ Similar results have been obtained by the Kaiser Family Foundation and Washington Post survey in 2013, and a Center for Strategic and Budgetary Assessments study in 2012.⁴² Monetary compensation matters for practical and moral reasons, but it must be considered as part of a broader package of incentive structures, talent management systems and motivations to serve. If the commission does not report on some of these broader trends, this should become an area of inquiry for DOD and other stakeholders as they consider how to preserve and support the AVF in decades to come.

2. New Models for Compensation. Although the actual dollar amounts for base pay, special pay,

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retirement pay and other compensation matter, so too do the structures for determining eligibility for and apportioning these pays. The current military compensation system treats most service members the same – an E4 servicing IT systems earns the same as an E4 leading an infantry team, regardless of the differing educational requirements, hardships or market demand for each position. The services do provide special compensation (such as jump pay or flight pay) for certain kinds of duty, and they do recognize market demand and educational differentials with varying levels of retention incentives. However, the military should consider the continued viability of its “one size fits all” compensation model that determines base pay as a function of paygrade and years of service, without more granular consideration of education, work, market demand and performance.

3. New Models for Retirement. The military retirement system cost DOD \$38.6 billion (in 2013 dollars) in 1990 in payments to retirees. In 2013, DOD spent \$54 billion in payments to retirees, a 40 percent increase in inflation-adjusted dollars over that time period. This cost growth is likely to continue based on the linkage of retirement pay to base pay growth, addition of COLAs and increasing longevity of retirees, and will be compounded by increasing outlays for DOD retiree

health care as well. This cost growth alone suggests DOD needs to consider alternate models of retirement for its active and reserve populations. However, beyond cost growth, the imperative to recruit, manage and retain the best talent possible for the AVF also suggests a review of the current military retirement system. DOD should consider alternative models, including defined contribution systems, which would enable better portability of benefits, more career flexibility, and movement between the public and private sectors – or within the government sector – over the course of a military career, consistent with emerging career patterns for today’s generation of service members and those who will follow.

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ENDNOTES

1. Chuck Hagel, "Remarks by Secretary Hagel" (National Defense University, Fort McNair, April 3, 2013).
2. Public Law 112-239, National Defense Authorization Act for Fiscal Year 2013, January 2, 2013, Section 671, http://www.treasury.gov/resource-center/sanctions/Programs/Documents/pl112_239.pdf.
3. For a history of the AVF and the role that compensation has played in its creation and maintenance since 1973, see Bernard Rostker, *I Want You!: The Evolution of the All-Volunteer Force* (Santa Monica, CA: RAND Corporation, 2006), <http://www.rand.org/pubs/monographs/MG265.html>.
4. David W. Barno, Nora Bensahel, Jacob Stokes, Joel Smith and Katherine Kidder, "The Seven Deadly Sins of Defense Spending" (Center for a New American Security, June 2013), 29; and Beth J. Asch et al., "Cash Incentives and Military Enlistment, Attrition, and Reenlistment" (RAND Corporation, 2010).
5. The ECI is a "quarterly measure of the change in the price of labor, defined as compensation per employee hour worked." The index compares the cost of wages across industries, providing the basis for cross-sectoral analysis. For more information, see Department of Labor, *Employment Cost Index technical note*, <http://www.bls.gov/news.release/eci.tn.htm>.
6. Public Law 106-65, National Defense Authorization Act for Fiscal Year 2000, October 5, 1999, Section 602(a), <http://www.gpo.gov/fdsys/pkg/PLAW-106publ65/pdf/PLAW-106publ65.pdf>.
7. Public Law 108-136, National Defense Authorization Act for Fiscal Year 2004, November 24, 2003, Section 602, <http://www.gpo.gov/fdsys/pkg/PLAW-108publ136/pdf/PLAW-108publ136.pdf>.
8. General Martin Dempsey, Chairman of the Joint Chiefs of Staff; Admiral James A. Winnefeld, Vice Chairman of the Joint Chiefs of Staff; General Raymond T. Odierno, Chief of Staff of the Army; Admiral Jonathan W. Greenert, Chief of Naval Operations; General Mark A. Welsh III, Chief of Staff of the Air Force; General James F. Amos, Commandant of the Marine Corps; and General Frank J. Grass, Chief of the National Guard Bureau, testimony to the Armed Services Committee, U.S. Senate, May 6, 2014; and Adm Gary Roughead (USN, Ret.) and Kori Schake, "National Defense in a Time of Change" (Brookings, 2013), <http://www.ngaus.org/sites/default/files/HamiltonProjectBrookingsRougheadPaper2013.pdf>.
9. Public Law 112-239, Section 671.
10. President Barack Obama, "Principles for Modernizing the Military Compensation and Retirement Systems," September 12, 2013.
11. Public Law 112-239.
12. Kristina Wong, "Pentagon meets resistance on benefit cuts," *The Hill*, Dec. 30, 2014, <http://thehill.com/policy/defense/228218-pentagon-meets-resistance-on-benefit-cuts>.
13. The Military Coalition, "The Uniformed Services Retirement System," statement to the Subcommittee on Military Personnel, Armed Services Committee, U.S. House of Representatives, October 25, 2011.
14. The Military Coalition, "The Uniformed Services Retirement System," 4.
15. See Norbert R. Ryan Jr., "Blunt-Force Military Cuts Need Revisiting," *The Wall Street Journal*, Dec. 29, 2014, <http://www.wsj.com/articles/norbert-r-ryan-jr-blunt-force-military-cuts-need-revisiting-1419898707>.
16. BAS is provided to "defray a portion of the cost of subsistence" and is tied to the U.S. Department of Agriculture food cost index. BAH is defined as an "allowance that enables military personnel to obtain adequate civilian housing for themselves and their dependents when government quarters are not available or provided," and the allowance is nontaxable. Military Compensation and Retirement Modernization Commission, *Interim Report* (July 2014).
17. Defense Finance and Accounting Service, 2015 Military Pay Chart.
18. Defense Commissary Agency, "New price study validates 30% savings," Department of Defense, January 9, 2014, http://www.commissaries.com/press_room/press_release/2014/DeCA_01_14.cfm.
19. For more background on the military retirement system, see David F. Burrelli and Barbara Salazar Torreon, "Military Retirement: Background and Recent Developments," RL34751 (Congressional Research Service, May 28, 2014), <https://www.fas.org/sgp/crs/misc/RL34751.pdf>.
20. The Career Status Bonus/REDUX // Can we delete "Career Status Bonus"? It's not mentioned in the main text // retirement system applies to a relatively narrow class of service members who entered service on or after August 1, 1986, and received a \$30,000 retention bonus at their 15th year of service.
21. By contrast, retirees from reserve service may earn a retirement after 20 years of active reserve service, based on a point system, but not be eligible to begin drawing retirement pay until they reach age 60.
22. See DOD Office of the Actuary, *Statistical Report on the Military Retirement System: Fiscal Year 2013* (May 2014), <http://actuary.defense.gov/Portals/15/Documents/statbook13.pdf>. Reserve personnel tend to retire later, because of how the reserve retirement points system works; including reservists increases the average retirement age to 43.9 for enlisted personnel and 49.1 for officers.
23. Defense Business Board, *Report to the Secretary of Defense: Modernizing the Military Retirement System*, Report FY11-05 (2011), 5.
24. Retirement pay does generally increase each year with the application of a cost-of-living adjustment that is authorized by Congress.
25. Service members can also participate in the Thrift Savings Plan, the federal government's "defined contribution" retirement savings plan, by contributing

their post-taxation earnings — although without any matching contribution from the military. From a system standpoint, the primary difference between the two systems is when the liability accrues to the employer.

26. The time frames used for our analyses reflect the latest date for which data is available. Where possible we use 2015 data, but in some cases our analysis may reach only 2014, or 2013 in a couple of cases.

27. See DOD Office of the Actuary, *Statistical Report on the Military Retirement System: Fiscal Year 2013*.

28. Mike Hayden, "Fact vs. Fiction: Will your military pay and benefits 'break the bank?'" (Military Officers Association of America, November 2012), http://elpasomaa.org/Files/11-12Fact_vs_Fiction.pdf.

29. These increases amount to a 197 percent increase for the Army, a 161 percent increase for the Navy and 179 percent increase for the Air Force in per-service member compensation costs over the preceding 24 years.

30. Our methodology used constant 2014 dollars for this analysis. By converting all compensation figures into constant dollars, we adjusted these figures to account for inflation in each year, using the Consumer Price Index. Because of this conversion, any percentage increase or decrease in compensation shown in constant dollars necessarily means an increase or decrease above or below the rate of inflation.

31. Kathleen Rhem, "Cohen Proposes Cutting Out-of-Pocket Housing Costs," Department of Defense, January 7, 2000, <http://www.defense.gov/news/newsarticle.aspx?id=44518>.

32. Andrew Tilghman, "Pentagon will have to hammer out details of new BAH cut," *militarytimes.com*, December 10, 2014, <http://www.militarytimes.com/story/military/benefits/2014/12/10/bah-cuts-details/20187553/>.

33. BAH data is available for all duty stations from 1998 through the present day.

34. Karen Weise, "Housing's 30-Percent-of-Income Rule Is Nearly Useless," *businessweek.com*, July 17, 2014, <http://www.businessweek.com/articles/2014-07-17/housings-30-percent-of-income-rule-is-near-useless>.

35. Congressional Budget Office, *Growth in DOD's Budget from 2000 to 2014* (November 2014), <http://www.cbo.gov/publication/49764>.

36. "With military retired pay protected from inflation by annual adjustments due to the COLA, retirement costs will continue to increase." David F. Burrelli and Barbara Salazar Torreon, "Military Retirement: Background and Recent Developments." However, the formula used to calculate inflation has recently become the subject of great scrutiny. In 2013, a joint congressional budget committee proposed reducing the COLA to save money in future years and enacted this reduction into law, only to have this reduction repealed by subsequent legislation after significant protest from the military stakeholder community.

37. DOD Office of the Actuary, *Statistical Report on the Military Retirement System: Fiscal Year 2013*.

38. See Todd Harrison, "Rebalancing Military Compensation: An Evidence-Based Approach" (Center for Strategic and Budgetary Assessments, 2012).

39. Obama, "Principles for Modernizing the Military Compensation and Retirement Systems."

40. See Chris Carroll, "Military compensation report out by Feb. 1," *Stars and Stripes*, December 30, 2014, <http://www.stripes.com/news/us/military-compensation-report-out-by-feb-1-1.321710>.

41. "The Military-Civilian Gap: War and Sacrifice in the Post-9/11 Era" (Pew Research Center, October 5, 2011), 33.

42. The Washington Post and Kaiser Family Foundation, "After the Wars: Post-Kaiser survey of Afghanistan and Iraq war veterans," *washingtonpost.com*, November 12, 2014; and Harrison, "Rebalancing Military Compensation: An Evidence-Based Approach."

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