Center for American Progress

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Reforming Military Compensation

Addressing Runaway Personnel Costs Is a National Imperative

Lawrence J. Korb, Alex Rothman, and Max Hoffman May 2012

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Contents

Introduction and summary

Military personnel costs have nearly doubled since fiscal year 2001 and now consume one-third of the Pentagon's base budget—about $180 billion per year.[1] If these costs are allowed to continue rising at their current rate, they will eat through the entire defense budget by FY 2039 unless the overall budget is increased to accommodate them.[2]

The Pentagon's personnel budget is composed of three major items: pay, health care, and retirement. The rapid cost growth in each of these programs presents a serious obstacle to the Obama administration's efforts to bring defense spending under control after the massive increases that occurred over the past decade. If left unreformed, increasing expenses for each of these three programs will eat up a growing share of the defense budget, diverting funds from other critical national security initiatives such as training and modernization.

The threat that mounting personnel costs pose to military readiness has not gone unnoticed by the nation's political and military leaders. In the Pentagon's FY 2013 budget request, Secretary of Defense Leon Panetta and the Joint Chiefs of Staff highlight the need for significant changes to the Defense Department's existing pay, health care, and retirement systems. In light of the pressing need to reform the military's compensation systems, this report identifies opportunities for responsible savings in each of these three areas that do not break faith with the men and women who are serving or have served. Nor will these recommendations in any way affect those who have suffered physical or mental wounds in service of the country.

Pay

Each year the Pentagon spends $107 billion on salaries and allowances, which amounts to about 20 percent of its base budget.[3] These costs have grown rapidly in the past 12 years, primarily due to a series of pay raises authorized by Congress over and above the Defense Department's budget requests.

Since 2000 active-duty compensation (excluding health care benefits) has increased by 28 percent, with the cost per service member growing from $64,606 in 2000 to $80,292 in 2012.[4] This growth is partially attributable to the costs of the wars in Iraq and Afghanistan but is primarily due to repeated increases in basic pay authorized by Congress.

To ensure the force attracts and retains high-quality recruits, the Defense Department ties basic military pay to civilian salaries as measured by the Employment Cost Index, ensuring that service members are paid in-line with comparably educated civilian employees. But in 2004 Congress mandated that military pay increase by the Employment Cost Index plus 0.5 percent through 2006 and continued authorizing these larger pay increases—against the Pentagon's wishes—through 2011.[5] Congress also ignored the fact that the Department of Defense has met or exceeded its recruiting and retention goals each year since 2006, indicating that the compensation package was very competitive and allowed the military to maintain the force it required.

By repeatedly passing pay raises above and beyond the Pentagon's request, Congress has driven military pay out of line with the Pentagon's own standards.

But by repeatedly passing pay raises above and beyond the Pentagon's request, Congress has driven military pay out of line with the Pentagon's own standards. Basic pay accounts for about half of military cash compensation—service members also receive tax-free allowances for housing and subsistence, a variety of other tax breaks, and an array of special and incentive pay. By 2006 the average service member earned $5,400 more in cash compensation than a comparably qualified civilian counterpart, and the average officer earned $6,000 more than a civilian with similar education and experience.[6] This disparity has continued to grow in the past six years. What's more, these numbers do not include the value of the generous health care benefits received by military personnel.

Whether the result of a lack of congressional understanding of the full range of military compensation or political expediency, repeatedly raising basic pay above the Employment Cost Index is fiscally unsustainable. It ignores the advice of military leadership and the recommendations of the Pentagon's own commissions such as the Quadrennial Review of Military Compensation.

To its credit, the Department of Defense has attempted to tackle this problem in its FY 2013 budget request, outlining a plan that would gradually bring military pay back in line with the Employment Cost Index without cutting any service member's pay, by slowing down military pay increases beginning in FY 2015. The Pentagon estimates that its plan would save $16.5 billion over the next five years.[7]

Congress should demonstrate political courage and allow the Department of Defense to execute this long-term plan.

Health care

The military must also face the challenge of restraining runaway health care costs. As the Center for American Progress noted its 2011 report, "Restoring Tricare: Ensuring the Long Term Viability of the Military Health Care System," the need for military health care reform is undeniable.[8] Between fiscal year 2001 and fiscal year 2012, the military health care budget grew by nearly 300 percent and now consumes about 10 percent of the baseline defense budget.[9] Most of this cost growth stems not from providing care for active-duty troops but from caring for the nation's military retirees and their dependents.

Encouragingly, the Pentagon's fiscal year 2013 budget request includes smart reforms to the military's Tricare health care program that, if implemented by Congress, would be a first step toward restoring fiscal balance to the program. The Defense Department proposes to do the following:

- Raise enrollment fees and deductibles for working-age retirees to reflect the large increases in health care costs since the mid-1990s
- Peg enrollment fees to medical inflation to ensure the long-term fiscal viability of the Tricare program
- Implement an enrollment fee for Tricare for Life, a Pentagon-run plan which augments retirees' Medicare coverage
- Incentivize generic and mail-order purchases for prescription drugs

Yet these reforms alone will not be enough even to hold the department's health care costs steady at current levels, much less reverse the cost growth that has occurred over the past decade. When Tricare was created in 1996, working-age retirees contributed about 27 percent of their health care costs; today that number has fallen to just 11 percent.[10] Should the Pentagon's recommendations be implemented by Congress, military retirees would still contribute just 14 percent of their health care costs, about half of what they did in 1996.

The Pentagon's proposals would slow the projected growth of the military's health care costs, allowing savings of $12.9 billion between FY 2013 and FY 2017.[11] But to truly restore the Tricare program to stable financial footing the Defense

Department should enact measures to reduce the overutilization of services and limit double coverage of working-age military retirees. These reforms, in addition to those in the Defense Department's budget proposal, would enable savings of up to $15 billion per year—enough to hold Tricare costs steady in the near term. It is important to note that none of these recommendations would affect disabled veterans, who receive a separate health care plan through the veterans administration.

Retirement

The final area of budgetary concern explored in this paper is military retirement. The Pentagon also calls for an overhaul of its retirement program in its fiscal year 2013 budget request. In the document, Secretary Panetta calls on Congress to authorize the creation of a Military Retirement Modernization Commission. The commission would be designed to help Congress and the Pentagon make the politically difficult decisions necessary to reform the military's outdated retirement system, which has been long criticized for its inequality, inflexibility, and high costs.

The military retirement program, which has not been significantly updated since the 1940s, adheres to a strict vesting structure—personnel with at least 20 years of service receive a substantial pension for life; personnel who serve less than 20 years receive no retirement benefits. In addition, those who qualify to receive benefits can begin collecting their pension immediately upon retiring, allowing many military retirees to begin receiving retirement pay in their late 30s or early 40s.

This type of vesting system leads to three major problems. First, the vast majority of veterans—particularly enlisted personnel—leave the service with no retirement benefits: Only 17 percent of service members remain in the force long enough to qualify for the military's retirement program.[12] Perhaps most troubling, enlisted troops in ground-combat units in the Army and the Marines—the men and women who have borne the brunt of the fighting in Iraq and Afghanistan—are among the least likely to achieve any retirement benefits.

Only 17 percent of service members remain in the force long enough to qualify for the military's retirement program. Enlisted troops in ground-combat units are among the least likely to achieve any retirement benefits.

Second, the military's retirement system restricts the ability of the Defense Department to manage the size and skillset of the force. Due to the 20-year vesting requirement, Pentagon managers are reluctant to separate personnel who have served more than 10 years but less than 20, not wanting to leave service members without a job and retirement savings. As a result, the Defense Department is forced to either separate service members early in their careers or keep them until they reach 20 years, even if they are underperforming, unhappy, or ill-suited to the immediate needs of the military.

Lastly, while the military's retirement program serves only a small minority of the force, it provides an exceedingly generous benefit, often providing 40 years of pension payments in return for 20 years of service. As a result, the program now costs taxpayers more than $100 billion per year, an exceedingly steep price tag for a program hampered by serious flaws.[13] This number is projected to double by 2034.

Certainly Secretary Panetta is right to draw attention to the military's troubled retirement system, but a third military retirement commission is unnecessary. In recent years the Defense Department has appointed two separate taskforces to study the flaws in the military retirement system, and both have already provided the Pentagon and Congress with answers to its retirement problem.

We urge Secretary Panetta to use his authority to work with Congress to reform the system by replacing the current retirement system with a 401(k)-style contribution program and implementing compensation incentives such as gate and separation pays to assist with force shaping. Under our 401(k) model—based on the recommendations of the Pentagon's Defense Business Board—the Pentagon would contribute at least 16 percent of each service members' base pay annually, about twice the average private-sector contribution. This paper details how such reforms would greatly decrease the number of veterans leaving the force without any retirement benefits, would increase the Pentagon's force management options, and would begin to address the long-term fiscal challenges facing the retirement system.

In making our recommendations we understand it is imperative that changes to the military retirement system do not negatively affect service members who have planned their retirement around these benefits. We contend, however, that it would be wrong to allow so many of the men and women who have fought in Iraq and Afghanistan to remain on a system that will deny the vast majority of them any retirement benefits, as would be the case under the current system.

Specifically, we recommend a three-part transition to a 401(k)-based retirement system:

- Military personnel with more than 10 years of service would have the option to remain in the current system or switch to the 401(k).
- Personnel with less than 10 years of service would have the option of enroll-

ing in the new 401(k) system or enrolling in a slightly modified version of the current pension system, which would vest at 10 years but provide slightly less retired pay (40 percent of base pay at 20 years, rather than the 50 percent permitted under the current system) and begin paying out at age 60.
- All new recruits would automatically enroll in the 401(k) system.

If left unreformed, military retirement costs are projected to grow to $217 billion by 2034.[14] Military pay and health care reform will allow the Pentagon to achieve substantial savings in the near term. Yet it is retirement reform that presents the greatest opportunity for savings. Implementing these recommendations would allow savings of approximately $13 billion per year in the near term. More importantly, though, these reforms would hold the government's retirement costs to somewhere between $114 billion and $146 billion in FY 2034, ensuring savings of at least $70 billion in that year.[15]

Admittedly, trying to decide on an appropriate level of compensation for those who risk their lives in service to their country and their fellow citizens is a difficult task. This is true regardless of whether it involves members of the armed forces or first-responders such as policemen, firefighters, or federal law enforcement agents. In deciding "how much is enough," the government must ensure that it recruits and retains sufficient numbers of qualified people while compensating them fairly.

Our men and women in uniform, our veterans, and our nation's military retirees deserve access to top-quality pay and benefits. But in these times of fiscal austerity, it is important to evaluate the effectiveness of the Pentagon's personnel programs, particularly given the explosive cost growth they have experienced over the past decade. Does it make sense, for example, at a time when job-training programs for veterans are facing cuts, for the federal government to bankroll a $100 billion retirement program that fails to cover more than 80 percent of veterans?

Secretary Panetta has proposed smart solutions to the Pentagon's personnel problem. Allowing military pay to return to the levels mandated by law will help the Defense Department control its personnel costs without cutting any service member's pay. Restoring Tricare's original cost-sharing balance will ensure the program remains viable for future generations of military retirees. And transitioning to a 401(k)-model retirement system, as recommended by the Defense Business Board, will expand the Defense Department's retirement program to cover a far larger percentage of veterans while containing costs to amounts the country can afford.

Does it make sense, for example, at a time when job-training programs for veterans are facing cuts, for the federal government to bankroll a $100 billion retirement program that fails to cover more than 80 percent of veterans?

A note for readers: One of our authors, Lawrence J. Korb, has spent the majority of his adult life involved with these issues (24 years of active and reserve service and five years as an assistant secretary of Defense). He is or has been a member of the Veterans of Foreign Wars, the American Legion, the Military Officers Association, the Association of the U.S. Navy, and the First Reserve Association. Therefore, he is well-aware of the hardships of military life and the needs of the men and women who have, who are, or who will volunteer to serve the country.

Korb attests without equivocation that none of the proposals made by Secretary Panetta and the Joint Chiefs of Staff or by our report will break faith with our men and women in uniform. Nor can they be characterized as a bait and switch or are they an attempt to balance the federal budget on the backs of retirees or veterans. If anything, these proposed changes will not only strengthen our national security but will also provide more benefits to those who volunteer to serve their country.

Military pay

The Department of Defense's personnel costs have risen steadily since the shift to an all-volunteer force in the early 1970s. The majority of this increase has appeared in the past 12 years as a result of rapidly rising health care costs and excessive increases in base military pay, repeatedly passed by Congress above and beyond the Pentagon's requests. Excluding funding for the wars in Iraq and Afghanistan, personnel costs within the base budget have increased by nearly 90 percent since 2001—about 30 percent above inflation—despite an increase of only 3 percent in the number of military personnel.[16] As a result, the Pentagon currently spends $107 billion on salaries and allowances—about 20 percent of the base budget.[17] If Congress does not cooperate to bring military salaries and cash allowances back in line with the Department of Defense's established guidelines, these personnel expenses will continue to consume a larger share of the total military budget, eventually diverting funds from other critical defense needs.

In order to ensure sufficient numbers of high-quality recruits for the force, the Pentagon has long tied basic military pay to civilian salaries as measured by the Employment Cost Index. This Department of Defense guideline is meant to ensure that military service members' basic pay is equivalent to the salary of civilians of comparable educational background and qualifications, thus ensuring the military remains a competitive choice for qualified candidates. Yet since 2001 Congress has eschewed the Department of Defense's standards, repeatedly awarding pay raises above the Employment Cost Index standard and beyond the Pentagon's own requests.

The ostensible reason for raising pay is to help the military meet its recruiting and retention goals and meet the personnel requirements of the force. But the uniformed services have met or exceeded their recruiting and retention numbers in each of the past five years, despite the wars in Iraq and Afghanistan. This consistency indicates that the military compensation package remains very competitive with the offerings of the private sector, rendering the pay raises authorized by Congress after 2006 unnecessary. Such raises are politically popular and may have been acceptable when the total military budget was rising, but fiscal discipline requires tough choices.

This sustained growth in salaries may stem in part from the fact that military compensation is not well-understood or widely known by most people in and out of the armed forces. Most Americans focus on basic salary as the primary means of compensation and one of the central incentives for choosing a particular job. But for the men and women in our military, basic pay represents only the most obvious form of compensation, accounting for roughly half of their cash compensation.

As a result, basic pay is not a very accurate measure of the total value of our service members' compensation. In addition to free health care for themselves and their dependents and noncontributory retirement pay if they complete 20 years' service—both of which we will discuss later in this report—active-duty service members can receive numerous special and incentive cash pays, housing and subsistence allowances, and tax exemptions. Excluding health care benefits, active-duty compensation has increased by $26.4 billion (28 percent) since 2000, with the cost per service member growing from $64,606 in 2000 to $80,292 in 2012.[18]

Basic pay is not a very accurate measure of the total value of our service members' compensation.

In its fiscal year 2013 budget, the Defense Department proposes a plan to bring military pay back in line with the Employment Cost Index by implementing reduced pay raises beginning in FY 2015, allowing military personnel time to adjust. The department estimates that this slowed pace of pay raises will save $16.5 billion over the next five years. This is a necessary move to restore military compensation to a sustainable path and will ensure that nobody's pay is reduced.

Active-duty cash compensation

Basic pay—which is awarded according to a pay table based on rank and tenure in the service—accounts for roughly half of military cash compensation. In 2012 the Department of Defense requested roughly $57 billion for basic pay to active-duty service members, up more than $9 billion from 2000, or an increase of about 15 percent. Despite a small increase in the size of the active-duty force, the cost of basic pay per service member also increased substantially, from $33,000 in 2000 to $38,000 in 2012.[19]

In addition to basic pay, active-duty military service members receive cash or in-kind allowances, which cover the necessities of daily life, including food and housing. Food is provided through the basic allowance for subsistence, either provided in-kind through the meals served on military installations or as a tax-free cash payment. In 2012 these benefits totaled $8.8 billion, or about $5,800 per person, accounting for 7 percent of total compensation.[20] The cost of feeding our men and women in uniform has grown by 30 percent in the past 12 years, largely as a result of the wars in Iraq and Afghanistan.[21] The military also subsidizes the Defense Commissary Agency, which provides discounted groceries to service members and their families, at a cost of $1.4 billion, or $917 per service member in FY 2012.[22]

Service members are also provided free housing throughout their time on active duty. Housing is either provided directly as on-base military housing or as a tax-free cash payment—that is, the basic allowance for housing. While this housing allowance varies depending on location, number of dependents, marital status, and pay grade, the overall costs of providing housing for active duty service members has risen from $13.5 billion in 2000 to more than $21 billion in 2012, up from $9,312 per person in 2000 to $13,856 per person this year.[23] This 60 percent growth is largely due to the process of privatizing the provision of military housing and represents another large, tax-free form of compensation.

Finally, military basic pay is supplemented by an array of special and incentive pays and bonuses designed to retain crucial capabilities, incentivize the acquisition and maintenance of valuable skills, reward those who face the added risks of combat, and keep experienced personnel in hard-to-fill positions. Primarily because of the need to invoke "stop loss" or to extend active duty beyond the enlistment commitment, as well as acquire added language and medical expertise due to the wars in Iraq and Afghanistan, the cost of providing these special and incentive pays has grown rapidly in the past 12 years. In 2012 the Department of Defense requested $10.4 billion for these various pays, up 36 percent from 2000 levels.[24] While these special pays have fallen somewhat from a peak in 2004, they still averaged $2,027 per service member in 2012, up from $1,597 in 2000.[25]

These special and incentive pays give the Pentagon the flexibility needed to meet its many requirements and compensate those who undertake dangerous tasks, including combat and flying. Since the 2008 review of compensation, the Department of Defense has been in the process of streamlining what had been more than 60 types of special and incentive pays, and we would encourage the completion of this paring down process. Hopefully this rationalization, coupled with the winding down of the wars in Iraq and Afghanistan, will bring personnel costs down while maintaining the required flexibility in compensation. It is important to remember the value of these pays when considering the real value of military compensation.

The growth of personnel costs since the end of the draft

In the draft era, from 1948 through 1973, the Pentagon had a mixed force of volunteers and conscripts. During the first two years of service, volunteers, draft-induced volunteers, and conscripts were paid subsistence wages. Likewise, compensation for those who stayed beyond two years was also below comparable pay in the civilian sector. Putting this into perspective, in 1968 the average cost of an individual on active duty was $5,780, and the total military personnel budget for 3.4 million people was $19.9 billion, or 25 percent of the total military budget. In FY 2012 dollars the cost of the individual service member would be $30,415, and the total military personnel budget would be $104.7 billion for 3.4 million people.

In 1974, one year after the end of the draft, the cost per individual service member had risen to $10,895, and the total military personnel budget had increased to $24.2 billion. In FY 2012 dollars this would amount to $42,140 per individual and a total military personnel budget of $93.8 billion.

By 2000 the military personnel budget had risen to $73.8 billion—or 25 percent of the total military budget—for 1.3 million people, at a cost of $58,769 per person. In FY 2012 dollars the FY 2000 personnel budget was $95 billion, and the cost per service member was about $75,000.

By FY 2012, the personnel budget had reached $160 billion, or 31 percent of the military base budget, and the cost per individual had risen to about $115,000 per person. In real terms, this was almost four times higher than in 1968, almost three times higher than in 1974, and twice as high as in 2000.

Rising costs of cash pays and benefits

The rise in basic pay since 2000 was originally motivated by legitimate concern that the economic prosperity of the late 1990s that had buoyed civilian salaries and the outbreak of war in 2001 might render the military an unattractive and uncompetitive alternative, thus harming the quality of the force. Indeed, basic military pay had lagged behind the consumer price index, meaning service members' pay fell behind inflation in the prices of consumer goods and services for much of the 1990s (although this measure does not account for the numerous other cash and in-kind benefits service members received).[26] Congress acted on these concerns by awarding a 6.9 percent across-the-board pay raise (2.3 percent above the Employment Cost Index) in FY 2002 and a 4.7 percent across-the-board pay raise (0.6 percent above the index) in FY 2003.[27]

As a result of these actions by Congress, by 2004 basic pay—not counting assorted other cash compensation and free health care—had been brought back in line with the consumer price index, and in fact exceeded the Pentagon's own standards. In addition, Congress mandated that military pay would be required to rise at the Pentagon's standard rate—the Employment Cost Index—plus 0.5

percent from 2004 through 2006. By 2006 the Department of Defense's own Quadrennial Review of Military Compensation reported that the average service member earned $5,400 more in cash compensation than a comparably qualified civilian counterpart. This discrepancy was even more apparent moving up the pay scale, with the average military officer earning $6,000 more than a civilian of similar education and experience.[28] This series of increases to basic pay, putting it above the Employment Cost Index, continued from 2004 to 2011, as Congress continued to award military pay raises at the index level plus 0.5 percent.[29] Since 2011 military raises have reverted to the index standard.[30]

The military pay raises above the Employment Cost Index in the years after 2004 were authorized with little regard to the desires of the Pentagon's leadership, and they cannot be sustained. In 2001 a private with dependents and three years of experience deployed to a combat zone took home $26,700 in tax-free pay. By 2012 that figure had risen to $36,000. Under this same scenario, a lieutenant colonel with dependents and 20 years of experience deployed to a combat zone in 2001 brought home $84,000 in tax-free pay. By 2012 that amount had increased to $120,000.[31] Again, these cash take-home figures do not account for the value of free health care for service members and their dependents, special and incentive pays, or retirement benefits (in this case, only for the colonel who had served 20 years).

We would not argue that these salaries are exorbitant, or that the men and women of our military do not deserve to be generously compensated for their professionalism and bravery. But the trend, continued by both Democrats and Republicans in Congress, of increasing pay each year by more than the established Pentagon standard, despite the advice of military and civilian leadership, must come to an end if defense spending is to be brought under control.

Secretary Panetta's pay plan

In the Department of Defense's FY 2013 budget request, Secretary Panetta has outlined a plan to save $16.5 billion over the next five years, to re-establish the standards governing military pay, and to restore the long-term viability of the military's system of cash compensation. Under the Pentagon plan, military pay will continue to rise at the rate of the Employment Cost Index for the next two years, meaning an across-the-board increase of 1.7 percent in January 2013 and a similar raise (depending on the index and other economic factors) in FY 2014. After 2014, however, pay raises will be held down to bring military compensation back in line with the Defense Department's standards. The FY 2013 request also includes raises to the basic allowance for housing and the basic allowance for subsistence but ties the actual increases to local price analyses to be conducted by the Department of Defense and the Department of Agriculture.[32]

While many of the details of the Pentagon's proposal need to be fleshed out, the path Secretary Panetta has outlined will serve the department well in the long run. We would encourage military leadership and Congress to support the plan. We understand that the political pressures to oppose any reduction in the growth rate of military pay will be severe, but Congress should act responsibly and grant the Pentagon leadership the budget authority to execute their long-term plan. In considering this issue Congress must take into account the many forms of military cash compensation and the generous health care benefits, study the growth over the past decade, and maintain a long-term outlook. For too long, political posturing has trumped the fiscal sustainability and the long-term health of the U. S. military.

Tricare reform

As the Center for American Progress noted in its 2011 report, "Restoring Tricare," the need for military health care reform is undeniable.[33] Between fiscal year 2001 and fiscal year 2012, the military health care budget grew by nearly 300 percent, up from $19 billion in 2001 to $52.8 billion in 2012.[34]

The majority of this cost growth can be attributed to providing care not to active duty service members but rather to military retirees and their families, who are allowed to remain enrolled in the Pentagon's health care plan for extremely low fees. Under the current system, retirees under age 65 pay just $520 per year for Tricare coverage for a family regardless of size; retirees over age 65 can enroll for free in Tricare for Life, a Pentagon-run plan which augments their Medicare coverage. Congress has repeatedly blocked the Pentagon's efforts to increase these fees in order to account for rising health care costs nationwide.

Due to the unprecedented growth in the Pentagon's health care costs, nearly 10 percent of the baseline defense budget now goes to military health care. Without reform, the Pentagon's health care bill is estimated to rise by another 28 percent to $64 billion by 2015.[35] Should these costs continue to grow, health care expenses for retirees will consume an increasingly outsized percentage of the budget and will begin to divert funds away from other Defense Department programs.

To address this problem, the Defense Department's fiscal year 2013 budget request proposes a number reforms to the Tricare health care system, which, taken collectively, would be a first step toward addressing the unsustainable growth of the Pentagon's health care costs. Specifically, the Defense Department's budget request proposes:

- Higher enrollment fees and deductibles for working-age retirees to account for increased health care costs since the mid-1990s when Tricare was established
- Pegging enrollment fees to increases in medical inflation to ensure the long-term fiscal viability of the Tricare program

- Implementing an enrollment fee for Tricare for Life
- Incentivizing generic and mail-order purchases for prescription drugs

If approved by Congress, the Pentagon's proposals would slow the projected growth of the military's health care costs, allowing savings of $12.9 billion between FY 2013 and FY 2017.[36] Yet these reforms alone will not be enough even to hold the department's health care costs steady at current levels, much less reverse the cost growth that has occurred over the past decade.

To truly restore the Tricare program to stable financial footing, in addition to the proposed fee increases, the Defense Department must also reduce the overutilization of services, along with limiting double coverage of working-age military retirees. These reforms, in addition to those in the Defense Department's budget proposal, would enable savings of up to $15 billion per year, enough to hold Tricare costs steady in the near term. Moreover, these proposals would gradually rebalance the cost sharing between military retirees and taxpayers, would incentivize the responsible use of services, and would guarantee the fiscal future of the military health system.

Congress and the American public are rightly wary of asking veterans, service members, and their families to shoulder increasing health care costs when so many service members have been engaged in operations in Iraq and Afghanistan. It is important to note, however, that the Defense Department's proposals would not affect active-duty service members, who will continue to receive health care at no cost. Additionally, the proposed changes exempt the survivors of service members who died on active duty. The changes would also not impact lower-income or seriously injured veterans, who receive health coverage through the Department of Veterans Affairs rather than through the Defense Department's Tricare program.

Moreover, as we will discuss in the next section on military retirement, only 17 percent of veterans serve the 20 years necessary to achieve retirement benefits, including the right to remain on Tricare after leaving the service.[37] As a result, the vast majority of veterans would be unaffected by these reforms, yet they provide sufficient revenue to ensure the continued financial viability of the Tricare program.

The reforms outlined in this report, if implemented by the Defense Department and Congress, would begin to restore the cost-sharing balance between military retirees and the American taxpayer, a balance that was established in 1995 and has not been updated sufficiently to reflect the massive growth in the cost of health care in America or even basic inflation.

The Tricare military health care system

The Department of Defense provides high-quality health care coverage to 9.6 million service members, retirees, and their dependents through the Tricare system. It is important to be aware of the three basic categories of beneficiaries to understand the primary fiscal challenges facing the system:

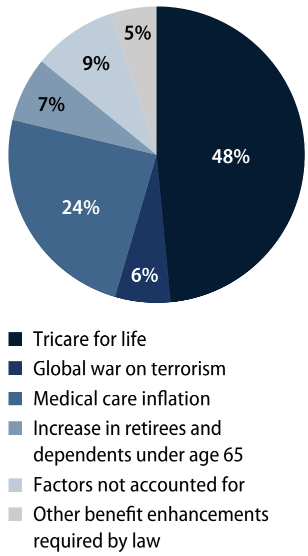
- Active-duty military personnel and their dependents
- Military retirees younger than 65 years of age (who have served 20 years or more) and their dependents
- Military retirees older than 65 years of age (who have served 20 years or more) and their dependents

The costs and benefits of coverage vary depending on a beneficiary's career stage (active duty, working-age retiree, or retiree older than 65) and on his or her Tricare plan (Prime, Extra, Standard, or Tricare for Life). Next we examine in greater detail the health care options currently available to military personnel and their dependents at each stage in their careers.

FIGURE 1

Tricare for Life has been a significant cause of rising military health costs

Defense Department estimates of factors contributing to defense health case spending increases, FY 2000 to 2005



Source: U.S. Government Accountability Office, "DOD's 21st Century Health Care Spending Challenges," p. 14, available at http://www.gao.gov/cghome/d07766cg.pdf

Health insurance for active-duty personnel and their dependents

As we've already noted the Department of Defense funds top-quality health care for active-duty personnel and their families at little to no cost. Active-duty service members and their families are automatically enrolled in Tricare Prime, an HMO-type option under which enrollees receive treatment primarily at military facilities. For active-duty personnel and families covered by Tricare Prime, health care is essentially free. Service members and their dependents don't pay enrollment fees, deductibles, or monthly premiums for health care under this plan.

Active-duty service members are required to use Tricare Prime, but their dependents can choose to enroll in either of the other two Tricare plans—Tricare Extra or Tricare Standard. Both plans offer greater flexibility in choosing doctors in exchange for slightly higher costs in the form of deductibles and co-pays.

Military health insurance for retirees under age 65 (working-age retirees)

Members of the military who serve at least 20 years become eligible for generous retirement benefits, chief among which is access to excellent, inexpensive health care coverage. All retirees regardless of length of service and their dependents also remain eligible for free treatment at military treatment facilities, subject to availability. But military retirees who have served at least 20 years in the armed forces are allowed to remain on Tricare. They become responsible for small annual enrollment fees for the plan of their choice and for co-pays for care at civilian facilities. Under this option, for example, retirees younger than 65 choosing Tricare Prime coverage beginning January 2013 will pay an enrollment fee of only $260 for individuals and $520 for families per year.

These enrollment fees have been raised only once since Tricare was first implemented in 1995.[38] Had the fees been adjusted to reflect nationwide increases in health care costs, the family enrollment fee would have risen from $520 in 1995 to something closer to the average U.S. worker contribution in 2011 for an employer-sponsored family plan: $4,129.[39]

The Department of Defense illustrates the gap between Tricare costs and retiree contributions by pointing out that, "In 1996, when TRICARE was fully implemented, a working-age retiree's family of 3 who used civilian care contributed on average roughly 27 percent of the total cost of its health care. Today that percentage has dropped to only 11 percent."[40]

Military health insurance for retirees 65 and over

All military retirees aged 65 or older become eligible for Tricare for Life, a health insurance plan created in 2001 that supplements Medicare for military retirees. There are currently no enrollment fees for Tricare for Life, but plan participants must purchase Medicare Part B and pay the premiums required for that plan. Tricare for Life pays for most expenses not covered by Medicare, ensuring that retired military personnel have access to inexpensive, top-quality health care for life.

The requirement to purchase Medicare Part B premiums means Tricare for Life beneficiaries have experienced some cost increases since the program's creation in 2001, unlike working-age retirees who have experienced no fee increases since 1995. Because Medicare Part B premiums have been increased over time, military retirees older than 65 "have faced the same substantial premium increases as civilian Medicare participants," according to the Defense Department's 10th Quadrennial Review of Military Compensation in 2008. Paradoxically, retirees younger than 65, "who typically have higher incomes than their older counterparts," have enjoyed stable fees over the same period, the quadrennial review found.[41]

Federal civilian versus military health care

Federal civilian employees and retirees receive coverage through the Federal Employees Health Benefits program. Federal civilian health benefits are generous and are, according to the U.S. Office of Personnel Management, "a significant piece of [each employee's] compensation package." Unlike military health care, however, civilian health premiums have been adjusted over the past decade in order to compensate for the dramatically increased cost of health care.[42]

Federal civilian health insurance premiums grew by 65 percent from 2000 to 2005. Tricare premiums, on the other hand, have only been raised once—by $5 per month for a family and $2.50 per month for an individual—since the program's inception in 1995. That means that for an annual enrollment fee of just $260 per individual or $520 per family, military retirees get coverage that would cost a civilian federal retiree approximately $5,000 annually.[43]

Reasons for rising health care costs

The majority of the U.S. military health care budget goes to providing health care for military retirees and their dependents, not for active-duty troops. In 2007, for example, more than half of the military health system budget was spent caring for retirees over age 65 and their dependents, while only 20 percent was spent on active-duty service members and their families.[44] As a result, the cost growth in the military health care system stems primarily from programs for retirees.

Outdated fees for working-age retirees

Despite skyrocketing health care costs nationwide, the Department of Defense has raised enrollment fees for working-age retirees only once since the creation of Tricare in 1995. In the fiscal year 2012 budget, former Secretary of Defense Robert Gates requested and Congress approved an increase in enrollment fees by $2.50 per month for individuals and $5 per month for families. While this marked the only fee increase for the program since its inception, the actual increases were so small that they were largely symbolic. The resulting enrollment fees for working-age retirees rose from $460 a year to $520 a year for family coverage, and from $230 a year to $260 a year for individual coverage.[45] These fees do not come close to accounting for the rise in the costs of providing health care. As we noted earlier, in 1996 a working-age military retiree paid for 27 percent of their families' health care costs; today this portion has fallen to 11 percent.[46]

Double coverage

Because of these extremely and artificially low enrollment fees, retired service members increasingly choose to stay on military health insurance, even if they are eligible for civilian plans. "Over 85 percent of retirees 45–49 years of age and 50 percent of retirees between 60–64 years of age had access to other group health insurance, but many choose Tricare instead," according to the Department of Defense.[47] This group has included retirees making six-figure salaries with defense companies and even a member of Congress.

Tricare is designed to be supplementary insurance for retirees with other health care coverage, but there's no law preventing working-age retirees from declining civilian coverage entirely in favor of Tricare (although it is illegal for employers to give military retirees incentives to choose Tricare rather than the company plan). Fully three-quarters of the nation's 4.5 million military retirees and their dependents have access to civilian plans. Two million of these retirees, or about 45 percent, choose to accept military coverage, saving themselves and their companies thousands of dollars per year per person but costing the Pentagon and taxpayers billions.[48]

Tricare for Life

A major source of the growth in the military health care budget stems from Congress's 2001 decision to expand Tricare eligibility to military retirees older than 65 through the Tricare for Life program and to provide more benefits for members of the reserve component. These expansions, supported by both the George W. Bush and Clinton administrations, also lowered fees for active-duty military families.[49] The 2007 Task Force on the Future of Military Health Care reported that the Tricare for Life program accounted for 48 percent of the increase in military health care expenditures from FY 2000 to FY 2005.[50]

Free health care for life, a bargain never struck

Asking retirees to share costs with taxpayers often invokes claims of a "broken promise." Retirees and their lobbyists, including the Military Officers Association of America and the American Legion, argue that free care is among the benefits they were promised in exchange for at least 20 years of service in the armed forces.[55] Tricare for Life and the other Tricare programs ensure that retired service members and their dependents have access to affordable top-quality health care for life. Further, in 2002 the courts ruled that the federal government has never made a commitment to provide free health care to military retirees.

The U.S. Court of Appeals for the federal circuit made this ruling in William O. Schism and Robert Reinlie v. United States: The court ruled that the government was not obligated to provide free care despite the promises made by unscrupulous recruiters because "Congress—and only Congress—can authorize the benefits that a retired federal employee, whether civilian or military, is entitled to receive." The court found that while Congress had repeatedly exercised its authority to prescribe military benefits, it had never authorized defense officials to create benefits outside of those guaranteed by law—and that existing law did not obligate the Defense Department to provide free lifetime care, something the military lobby is well aware of.[56]

Prescription drugs

The cost of prescription drugs is increasing nationwide. These prescription drug costs are among the most sharply rising elements of military health spending, according to the Congressional Research Service.[51] Over the past decade, the amount the Defense Department spends on prescription drugs has increased by 400 percent, from $1.6 billion in 2000 to $8 billion in 2011.[52]

Congressional inaction

The Department of Defense has sporadically attempted to control costs in the past decade, primarily by recommending increases in Tricare fees. In President George W. Bush's budget for fiscal year 2009, for example, the Pentagon asked Congress to slightly raise the fees for Tricare services, which would have saved $1.2 billion in that year alone.[53] These measures have not been aimed at active-duty troops. Rather, they have been directed at controlling costs for dependents and retirees, who account for the majority of military health care spending.[54] Nevertheless, Congress has thus far blocked such proposals, with the exception of the token increases in the fiscal year 2012 budget. Given the fiscal problems facing the Tricare program, however, it is imperative that Congress enacts the reforms the Pentagon proposed in its FY 2013 budget request.

We have outlined the reasons for rising health care costs, the fiscal unsustainability of the current military health care system, and the legal and moral basis for reform. Yet the question remains: How then can we deliver excellent medical services to military retirees, restore the system to firm financial ground to provide for future active-duty service members and veterans, and ensure fair treatment for the American taxpayer?

Secretary Panetta's reforms

In our 2011 report, "Restoring Tricare," we surveyed the various proposals to reform military health care in an effort to identify common guiding principles. The Pentagon's 2007 Task Force on the Future of Military Health Care, the 2008 Quadrennial Review of Military Compensation, the Congressional Budget Office's analysis of military health care options, and President Barack Obama's deficit commission all identified four basic strategies for crafting a sustainable military health care system. To do so, they all argued that Congress and the Department of Defense must:

- Restore a fair cost-sharing balance between taxpayers and beneficiaries
- Establish procedures to ensure fair future cost sharing
- Limit double coverage for working-age retirees above a certain income level
- Create incentives to reduce the overuse of Tricare for Life services

The proposals outlined in the Department of Defense's fiscal year 2013 budget request to Congress would go a long way to restore a fair cost-sharing balance between taxpayers and military retirees and to ensure that this balance will not again become skewed. Specifically, the Pentagon proposes a number of responsible fee increases on military retirees based on their ability.

But addressing only two of the core problems facing the Tricare system will not be enough to restore the long-term fiscal health of the program. If the Defense Department and Congress are truly serious about solving the military's Tricare problem, they must also limit double coverage for wealthy working-age retirees, as well as tackle the overutilization of services.

Restore a fair cost-sharing balance

In 2007 the Defense Department's own Task Force on the Future of Military Health Care said, "health coverage for military retirees should be very generous, but not free."[57] The Pentagon this year has requested authority to increase the contributions expected of working-age military retirees, as advocated by the Defense Department's own task force, the Congressional Budget Office, and the Center for American Progress. The Defense Department proposes to increase the Tricare Prime enrollment fee, institute an enrollment fee for Tricare Standard and Extra, and increase deductibles for Tricare Standard and Extra.[58]

The new Tricare Prime fees and deductibles will be phased in over four years and tiered based on the level of the beneficiary's military retirement pay, while the Tricare Standard and Extra programs will be phased in over five years.[59] Perhaps most importantly, in the future these fees will be indexed to medical inflation so administration and congressional inaction will never again threaten the financial integrity of the military health care program. These stipulations will mean that military retirees can contribute in line with their ability to pay and will allow beneficiaries and their families the time to adjust to increased payments.

Secretary Panetta's proposed fee increases are significantly larger than the token increases implemented in 2011 and, if implemented by Congress, would be a major step toward bringing military health care costs under control. Under the Pentagon's proposal, working-age retirees with annual pensions of more than $45,179 would pay $2,048 per year for health care.[60] As a result, even the wealthiest military retirees would continue to pay far less than their civilian counterparts for health care. Yet these modest fee increases will help to ensure that the military health care program remains fiscally viable in the long term. Retirees who make $22,589 or less annually in retiree pay would pay only $893 for health care for a family each year.

Once again, it is important to note that these changes will affect only working-age retirees, not active-duty service members, medically retired service members, retirees older than 65, the survivors of members who died in active duty, or wounded or disabled veterans.

Additionally, for military retirees over the age of 65 using the Tricare for Life program, the Pentagon would introduce a modest annual enrollment fee of between $158 and $475 per year, based on the beneficiary's retiree pay. Again, these fee increases would be phased in over four years. If enacted, this would keep the military health system from footing the entire bill for what is essentially free "Medigap" coverage—coverage that would cost an individual about $2,100 a year in the civilian sector.[61]

Establish procedures to ensure fair future cost sharing

The Defense Department recognizes that one-time fee increases for retirees will not by themselves control future cost growth in the military health care system. The department has likewise eschewed proposals to move to high-deductible health plans in combination with health savings accounts and subsidies to retirees who choose civilian insurance. Therefore the FY 2013 plan would ensure fiscal sustainability by linking military health care costs to civilian premiums.

Under the new proposed plan, fees for Tricare Prime, fees and deductibles for Tricare Standard and Tricare Extra, and fees for Tricare for Life would all be indexed to increases in medical inflation as measured by the National Health Expenditures.[62] Again, these changes reflect the findings of the Defense Department's own 10th Quadrennial Review of Military Compensation.[63]

Estimated savings of revised cost-sharing: Up to $6 billion per year

The cost-sharing reforms proposed by the Pentagon will save $12.9 billion between FY 2013 and FY 2017.

Next steps

The cost-sharing reforms proposed by the Pentagon will save $12.9 billion between FY 2013 and FY 2017. If implemented, these reforms to Tricare would represent a very important and politically difficult step for the Department of Defense and Congress. But $13 billion over four years won't be nearly enough to hold Tricare costs steady. As a result, the Defense Department should also implement provisions to limit double coverage for wealthy military retirees and reduce overutilization of Tricare services. Implementing these reforms could enable savings of an additional $9 billion per year.

Limit double coverage for working-age retirees above a certain income level

Virtually all retired service members, many of whom are in their early 40s or 50s, pursue second careers after leaving the military. These working-age retirees can remain on Tricare under current rules even if they are eligible to receive coverage through their civilian employers or through their spouse's employer-sponsored health care plan. Given the high-quality and low cost of Tricare, it is understandable that many retirees do in fact choose that option.[64] The 2007 defense task force on health care costs cited survey data showing that "the majority (60 percent) of retirees who are eligible for private insurance through their employer are instead using Tricare."[65]

That means American taxpayers are footing the health care bills of retired service members who have and can afford other options—effectively subsidizing health care costs for their private employers.

The Center for American Progress has long proposed that Congress and the Pentagon explore means testing of retired service members who accept military health care. The Defense Department and Congress can and should mandate that working-age retirees above a certain income level be allowed to enroll in Tricare only if they don't have access to other plans through their employer or spouse. Such a requirement would reduce Tricare expenses while ensuring that low-income or unemployed veterans retain access to health care.

While the fiscal year 2013 budget request goes a long way toward repairing the balance of costs between beneficiaries and taxpayers, and proposes a more rational approach to payments by introducing tiered contributions, it does not address the problem of double coverage for employed retirees. Still, increased fees do at least address the worst symptoms of the problem of double coverage by cutting the losses it imposes on the financially stretched military health care system and will provide some incentives for retirees to enroll in their employer health care plans.

Estimated savings: Up to $5 billion a year

Create incentives to reduce the overuse of Tricare services

Tricare for Life resembles private "Medigap" insurance in that it supplements Medicare coverage. By dramatically reducing enrollees' out-of-pocket expenses, however, Tricare for Life eliminates disincentives to unnecessary care and leads to inflated expenses. While the Pentagon's 2013 proposals introduce annual enrollment fees for the Tricare for Life program, these annual fees do not alter the basic incentives to encourage responsible use. This is an area where more can and should be done.

To address this issue, President Obama's Bowles-Simpson deficit commission recommended modifying Tricare for Life so that it wouldn't cover the first $500 of an enrollee's out-of-pocket expenses and would only cover 50 percent of the next $5,000 in Medicare cost sharing. That would reduce the overuse of care, saving money for both Medicare and Tricare, the commission concluded.[66]

The Congressional Budget Office analyzed a similar proposal in which Tricare for Life would not cover the first $525 of out-of-pocket expenses and would only cover 50 percent of the next $4,725 in costs. It found that this proposal would "reduce the federal spending devoted to TFL beneficiaries by about $14 billion through 2014 and by about $40 billion through 2019."[67]

The Defense Department's FY 2013 proposals do a better job incentivizing the responsible use of pharmacy and prescription drug benefits. The plan would gradually adjust the pharmacy co-pay structure for retirees and active-duty family members to encourage the use of mail order and generic drugs. Under the plan prescriptions would still be filled at no cost to beneficiaries at military treatment facilities, and the fees would not apply to active-duty service members. As with the rest of the proposed program, these changes would be phased in over the next five years.[68]

Estimated savings: Up to $4 billion per year

The need for reform of the military health care system is readily apparent. Tricare must be placed on firm, sustainable fiscal footing to ensure quality, affordable care for future active-duty service members and their families, veterans of past and present conflicts and their dependents, and military retirees of all ages. Reform is not just necessary to maintain medical excellence and fiscal discipline but also to ensure our national security.

Former Chairman of the Joint Chiefs of Staff Michael Mullen deemed the national deficit the single greatest threat to U.S. national security, and former Secretary of Defense Robert Gates said health care costs are "eating the Department of Defense alive."[69] Restoring fair cost sharing to Tricare can play a part in addressing this problem. Reform can also address the potential for long-term health care costs to consume an outsize portion of the defense budget, which would potentially squeeze spending on essential weapons systems, operations and maintenance, and research and development.

There are also fundamental questions of fairness to future veterans, to the American taxpayer, and to those who leave the military before reaching 20 years of service. While America's military retirees deserve access to excellent, affordable health care, it was never supposed to be free. Nor should the American taxpayer be forced to foot the entire cost of health insurance for those with access to an employer's health plan, which essentially subsidizes private health insurance and private-sector employees.

While America's military retirees deserve access to excellent, affordable health care, it was never supposed to be free.

It is clear that the current system does not meet these requirements. Tricare as it stands is not sustainable over the long term. The Pentagon has recognized this and taken a very important step with its fiscal year 2013 proposals. These proposals would reintroduce a fairer cost-sharing balance between military retirees and the American taxpayer. They would do so without affecting active-duty service members, wounded veterans, low-income veterans, or the survivors of service members who have died in active duty. What's more, the proposed changes to retiree benefits are tiered according to levels of retired pay and still represent a very affordable option for those who have served our country.

We applaud the military leadership for having the courage to address these difficult problems and ensure that the military personnel and future veterans can continue to enjoy excellent and affordable health care. Yet there is more work to be done if Congress and the Pentagon are serious about restoring the Tricare program to stable fiscal ground. Reducing double coverage and combatting overutilization both provide sensible avenues to reduce Tricare costs while still ensuring all military retirees have access to top-quality, affordable health care for life.

For too long, political expediency has trumped sober, forward-looking consideration of the challenges facing the military health care system. Congress should give full and immediate consideration to the proposals outlined in the fiscal year 2013 Defense Department budget request and act to ensure the future health of our nation's military service members and veterans.

Military retirement

In its fiscal year 2013 budget request, the Department of Defense calls on Congress to authorize the creation of a Military Retirement Modernization Commission. Modeled after the Base Realignment and Closure Commissions of the past three decades, the new deliberative body would be designed to ensure that Congress and the Pentagon make the politically difficult decisions necessary to reform the military's retirement system, which has grown increasingly unwieldy, ineffective, and expensive in recent decades.

The Pentagon leadership's decision to include retirement reform in its FY13 budget request undoubtedly stems in part from the budgetary pressures that it is facing. But rising costs are only one factor driving the need for reform.

Under the current system, military personnel who serve at least 20 years receive a substantial pension for life. Service members who retire after 20 years, for example, receive a lifetime annual benefit of 50 percent of their base pay, while those who retire after 35 years receive 87.5 percent of their base pay.[70] Both of these amounts are indexed for inflation.

Military personnel who serve less than 20 years, however, receive no retirement benefits. Due to this structure, the military retirement system suffers from three problems—inequality, inflexibility, and high costs.

Inequality

Currently, only 17 percent of military personnel serve for 20 years or more.[71] As a result, the current retirement system covers only a small percentage of the force, leaving 83 percent of veterans without retirement benefits when they leave the service. Perhaps most worrisome is the fact that enlisted troops in the Army and the Marines, who bore the brunt of combat in Iraq and Afghanistan, are the least likely to remain in the force long enough to receive retirement benefits.[72] In fact, less than 10 percent of those brave young men and women in the Army and the Marines will serve the full 20 years required to receive a pension.

Inflexibility

The one-size-fits-all nature of the retirement program limits the Defense Department's ability to shape the size and skillset of the armed forces. Force managers are therefore cautious about separating mid-career service members who have not yet achieved 20 years in the force for fear of leaving them without a job or retirement savings. This rigidity leaves the retirement program particularly ill-suited for periods in which the force is shrinking significantly, as it is today in light of our fiscal problems and the end of the War in Iraq. Further, in some specialties a service member's value and performance may peak after 20 years, when the retirement program provides a strong incentive for men and women to leave the force.

Unsustainable costs

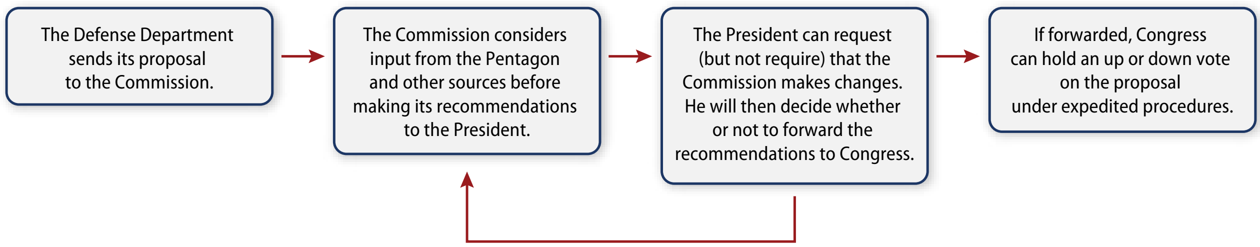
The military's retirement system costs the federal government more than $100 billion each year—$50 billion to pay the pensions of the nation's 2.3 million current retirees, another $20 billion put into the Pentagon's accrual fund to pay for the cost of future retirees, and $22 billion in interest for the money borrowed to help pay for those already retired.[73] This cost is projected to grow to $217 billion per year by 2034, when the retirement program's total liability will exceed $2.7 trillion, up from $1.3 trillion today.[74] Unless the defense budget is allowed to continue growing significantly in real terms—a move which would add to the country's deficit— or retirement reform occurs, retirement costs will consume an increasing percentage of the defense budget and begin diverting funds away from other key national security priorities such as weapons acquisition or research and development.

Secretary Panetta is right to call for reform of the military retirement system, which has remained unaltered not because of its effectiveness but rather due to the political difficulties involved in modernizing entitlement programs for military personnel. An independent commission, however, is a slow solution to an immediate problem, and the process proposed by Department of Defense provides too many opportunities for politics to prevent reform. If the Defense Department is to achieve responsible retirement reform, it is imperative that Pentagon officials take the lead in guiding the process as soon as possible.

FIGURE 2

Slow and uncertain progress

Proposed Commission to revamp military retirement



Source: Department of Defense, "Overview – United States Department of Defense Fiscal Year 2013 Budget Request," p. 5-5, available at http://comptroller.defense.gov/defbudget/fy2013/FY2013_Budget_Request.pdf (2012).

While an independent commission may provide political cover, it is not the most efficient way to drive retirement reform. More significantly, the Defense Department already has the answers to its retirement problem. In the past five years, two separate taskforces created by the Pentagon—the Defense Business Board and the 10th Quadrennial Review of Military Compensation—have provided the Pentagon with fiscally responsible reforms to its retirement system that do not break faith with our men and women in uniform.

We urge Secretary Panetta to use his authority to work with the Congress to implement the following menu of recommendations, which builds upon the work of the Defense Department's own taskforces:

- Introduce a 401(k)-type contribution plan, as recommended by the Defense Business Board, under which the Pentagon will contribute 16 percent of each service member's base pay (about twice the private sector average) into a retirement account
- Implement compensation incentives such as gate pays and separation pay to assist with force shaping

The transition

It is imperative that changes to the military retirement system do not negatively affect service members who have planned their careers and retirement around these benefits. But it would be wrong to allow so many of the men and women who have fought in Iraq and Afghanistan to remain in a system which denies the vast majority of them any retirement benefits.

As a result, the Center for American Progress recommends a three-part transition to a 401(k)-based retirement system:

- All new recruits would automatically enroll in the new system.
- Military personnel with at least 10 years of service would have the option to transition to a 401(k) or to retain their current benefits.
- Personnel with less than 10 years of service would transition either to a 401(k) or enroll in a slightly modified version of the current pension system. This pension would vest at 10 years—thereby greatly increasing the number of veterans who qualify for benefits—but provide slightly less retired pay (40 percent of base pay at 20 years, rather than the 50 percent permitted under the current system) and would pay out those benefits no earlier than age 60.

In a country that trumpets its commitment to its men and women in uniform, an astonishing 83 percent of service members leave the military with no retirement savings, including nearly 90 percent of enlisted people. Adopting the Defense Business Board retirement scheme and transitioning to a 401(k) plan will dramatically expand the military's retirement program to include all service members. Moreover, the elimination of the 20-year vesting model and implementation of gate and separation pays will provide Pentagon officials with additional tools to manage the size and makeup of the force. Finally, these recommendations will help bolster the long-term fiscal viability of the military retirement system, thereby ensuring that future generations of military retirees will continue to have one of the nation's most generous retirement plans. Adopting the reforms outlined in this report will enable annual savings of up to $13 billion in the near term and as much as $70 billion annually by the mid-2030s.

In a country that trumpets its commitment to its men and women in uniform, an astonishing 83 percent of service members leave the military with no retirement savings.

The current military retirement system

The structure of the military retirement system has remained virtually unchanged for six decades since it was established by the Career Compensation Act of 1948, when active-duty pay was very low, very few people served on active duty for 20 years, Medicare did not exist, and life expectancies were comparatively short. The Pentagon currently offers a noncontributory retirement program that provides military personnel who serve at least 20 years with a defined benefit or pension for life. Those leaving the force with less than 20 years of service are currently not covered by the military retirement program.

As it now stands, service members who are eligible for retirement benefits may begin collecting their retirement pay immediately after leaving the force, regardless of their age. Because many service members begin their careers in their late teens or early 20s, enlisted personnel generally reach the 20-year benchmark between the ages 38 and 40; officers most commonly achieve 20 years of service in their early 40s.[75] The vast majority of military retirees who elect to leave the service in their 30s or 40s go to on to have second careers while simultaneously receiving military retirement pay and generous government health care benefits.

Pension size is based on the basic pay of the individual service member as well as their length of service. For most retirees, the formula used to calculate the size of this pension is 2.5 percent of the average of the retiree's "high-three," or three highest years of pay in the service, multiplied by the number of years served.[76] A service member with 20 years in, for example, would earn 2.5 percent of their "high-three" pay multiplied by 20 (years), or 50 percent of their "high-three" pay each year. For the average enlisted personnel with an E-8 pay grade, a 50 percent pension would come to $23,700 per year; for an average officer, an O-4 would receive a pension of $37,000 annually.[77] Military personnel with 35 years of experience would receive 2.5 percent of their "high-three" average multiplied by 35, or 87.5 percent of their "high-three" pay. These amounts are indexed for inflation. According to a 2007 law, a four-star general or admiral retiring after 43 years of service can receive 100 percent of his or her salary, up to $272,892 every year for the rest of his or her life.

FIGURE 3
Calculating military retirement benefits

Retirement pay	=	2.5 percent	x	Number of years served	x	High-3 pay				
Retirement pay at 20 years	=	2.5 percent	x	20 years	x	High-3 pay	=	50 percent	x	High-3 pay
Retirement pay at 35 years	=	2.5 percent	x	35 years	x	High-3 pay	=	87.5 percent	x	High-3 pay
Retirement pay at 43 years	=	2.5 percent	x	43 years	x	High-3 pay	=	100 percent	x	High-3 pay

Source: U.S. Department of Defense, *Report of the Tenth Quadrennial Review of Military Compensation: Volume I.*

Service members who entered the force prior to 1980 do not fall under the "high-three" system; rather, their retirement benefits are calculated based on their pay in their final year in the military. Service members who enlisted after July 31, 1986 were supposed to receive only 2 percent of their average high-three years. But this was changed back to 2.5 percent in 1999 because of pressure from the military leaders and the military lobby. Additionally, some military personnel elect to enroll in the REDUX program, under which they receive a $30,000 cash bonus upon reaching 15 years in the service in return for accepting a lower retirement payout in the future.[78]

Reservists, similar to active duty troops, must also serve at least 20 years in order to receive retirement benefits. Reservists, however, do not become eligible to receive their pensions until age 60 unless they have been deployed since 2008.[79]

The current retirement system does an incredibly good job of taking care of service members who remain in the force for at least 20 years—the Defense Department essentially pays them 40 years of retirement for 20 years of service. In addition, for those who receive them, military retirement benefits are 10 times greater than those in the private sector.[80]

Moreover, the 10th Quadrennial Review of Military Compensation notes that the 1948 Career Compensation Act never intended to make a 20-year retirement standard:

> *For although the legislation authorized the Services to confer an immediate retirement benefit to member with 20 years of service … the Services indicated that the 20-year retirement option would be used sparingly. As initially envi-*

> *sioned, personnel typically would have to achieve 30 years of service before they would be granted an immediate retirement benefit.*[81]

This, however, has not proven to be the case. Because of indifference on the part of the Pentagon leadership, virtually any individual who requests retirement after 20 years of service is automatically allowed to leave.

While the military retirement program does a good job of taking care of a select few, this expensive program covers only a small minority of the force while presenting the Defense Department with long-term force-shaping and fiscal challenges.

Not only does the military retirement system fail to cover more than four out of five veterans, it also disproportionately favors officers.

Problems with the military retirement system

The military has recognized for nearly half a century that its retirement system was in trouble. Efforts to improve the retirement program date back to the Defense Department's first Quadrennial Review of Military Compensation in the late 1960s.[82] This long-term dissatisfaction with the program stems from its serious failings. The military's current retirement system does not provide for the vast majority of veterans, restricts the Pentagon's management decisions, and comes at a tremendous cost to the federal government.

The push for reform has intensified in recent years, as a diverse chorus of voices—including two Defense Department task forces (the Defense Business Board and 10th Quadrennial Review of Military Compensation), the Heritage Foundation, and now the Center for American Progress—has called for the modernization of the Pentagon's retirement program. Each of these groups focuses on the same three structural flaws with the current system: inequality, inflexibility, and rising costs.

Inequality

Under the current system, a staggering 83 percent of men and women who serve end up leaving the force with no retirement benefits.[83] The military's retirement program only covers such a small percentage of veterans due to its 20-year vesting period.

Not only does the military retirement system fail to cover more than four out of five veterans, it also disproportionately favors officers. Forty-three percent of officers serve the 20 years necessary to retire, compared to just 13 percent of enlisted troops.[84] Because officers tend to be vastly better compensated and better educated than most enlisted personnel while in the service, the retirement program fails to take care of the veterans with the highest risk of suffering from poverty, unemployment, or homelessness upon leaving the service.

Additionally, enlisted ground troops who perform what are termed "youth and vigor" occupations such as ground combat and who have borne the brunt of the fighting in Iraq and Afghanistan tend to have shorter careers, making them among the least likely to qualify for retirement benefits.[85]

Under federal law, private employers are required to vest at 80 percent for their employees within five years of service and fully after seven years.[86] First-responders, who, similar to military personnel, are government employees serving in high-risk positions, also usually vest after five years. Clearly our men and women in uniform deserve equal treatment.

Force shaping

The inflexible structure of the military retirement program also restricts the ability of Defense Department officials to manage the size of the force. Due to the 20-year vesting requirement, Pentagon managers are reluctant to separate personnel form the armed forces who have served more than 10 years but less than 20 years, not wanting to leave service members without a job or retirement savings. As a result, the Defense Department is forced to either separate service members early in their careers when they still have time to save for retirement in another occupation or to keep them until they reach the 20-year benchmark, even if they are underperforming, unhappy, or ill-suited to the immediate needs of the military.

But a 20-year career is not ideal or even realistic for many specialties within the military. Ground combat troops, for instance, are unlikely to remain in active duty into their late 30s or early 40s. Fully 75 percent of Marines, for example, leave after one four-year stint. As a consequence, force managers are reluctant to keep young service members on past their first term, not wanting to be forced to let them go with no retirement benefits eight or 10 years in.[87] Similarly, pilots rarely continue flying for more than 15 years.[88] The upshot is that the Pentagon must choose between forcing people out without retirement savings or keeping on men and women who are no longer capable of contributing to the mission as they once did.

While the military retirement system encourages service members to stay in the force for at least 20 years, it also provides them with a strong incentive to leave upon reaching 20 years of service, when they become eligible to begin collecting their pensions. Seventy-six percent of service members who serve 20 years end up leaving before reaching 25 years of service.[89] Yet in some specialties, service member performance may actually peak after 20 years, exactly when the current program provides a strong incentive for men and women to leave the force.

There is a consensus that retirement benefits should not continue to play such an outsized role in the Defense Department's management decisions. There is also a shared acknowledgement that retirement reform will allow Pentagon managers to base their decisions on national security needs with the knowledge that the United States will take care of all of its veterans.

In 1968 the average compensation cost for a man or woman in the service was $30,000, adjusted for inflation. Today it is more than $100,000.

Unsustainable costs

Implemented in 1948, the military retirement system was designed for the draft era, yet it has remained virtually unaltered despite the transition to an all-volunteer force. Not only were lifespans shorter in the mid-20th century, but military pay also remained extremely low during the era of conscription, even for those service members who volunteered to stay beyond the two years required by the draft. In 1968 the average compensation cost for a man or woman in the service was $30,000, adjusted for inflation. Today it is more than $100,000. Because retirement compensation is calculated based on a service member's basic pay, these increases have resulted in retirement pensions that are significantly larger than initially envisioned. The increases in military pay passed by Congress since the September 11 terrorist attacks, as discussed earlier in this report, also contribute to the Pentagon's increasing retirement costs.

The military's retirement system now costs taxpayers more than $100 billion each year—$50 billion to pay the pensions of the nation's 2.3 million current retirees, $20 billion to the Pentagon's accrual fund for future retirees, and $22 billion in interest.[90] This amount is projected to grow to $217 billion in 2034, when the retirement program's total liability will exceed 2.7 trillion, up from $1.3 trillion today.[91] The retirement program currently has an unfunded liability of nearly $1 trillion.[92]

Despite this enormous investment the federal government is not getting a tremendous amount of bang for its buck. Money accrued in the military retirement trust is invested in low-yield government bonds.[93] Private-sector companies that contribute to their employees' 401(k) accounts can get a much larger return on this investment, particularly if the employee chooses to invest in higher-interest bonds and equities.

Recommendations

In spring of 2010, as part of his initiative to find efficiency savings in the Pentagon budget, then-Secretary of Defense Robert Gates ordered the Defense Business Board to undertake a review of the Defense Department's overhead expenses.[94] The Defense Business Board is a 25-member panel within the Department of Defense that brings business leaders together to analyze the efficiency of the department through a private-sector lens. As part of its study, the board chose to evaluate the efficiency of the military retirement system and released its findings in July 2011.

The Defense Business Board's retirement plan presents a responsible vision for the future of the military retirement system. In recent decades most private-sector employers have switched from defined benefit, or pension, plans to defined contribution, or 401(k), plans in order to manage their personnel costs more effectively.[95] The board and the Center for American Progress advocate that the Defense Department mirror this transition, leaving behind its troubled pension system in favor of a more modern, flexible, and sustainable 401(k) program modeled after the federal government's Thrift Savings Plan.

Benefits of a 401(k) model

Continued high quality of retirement benefits

Under a well-designed 401(k) system, military retirees would continue to have some of the most generous retirement benefits in the country. We recommend that the Pentagon contribute at least 16 percent of base pay into a service member's retirement account. This contribution is about twice the average received by workers in the private sector, and it could be increased for personnel who serve on hardship tours, in combat, or in certain specialties.[96] For example, the Defense Business Board proposes double contributions for time spent in combat zones.[97]

Expanded coverage

Additionally, the 401(k) plan would dramatically expand the number of veterans who receive retirement benefits. As noted above, the 20-year vesting structure of the current system fails to serve 83 percent of veterans. The type of 401(k) plan we recommend should vest after three to five years of service, thereby expanding the retirement system to serve a much greater percentage of veterans. Service members who chose to leave the force would be able to transfer their 401(k) accounts to the private sector, and their benefits would become payable between ages 60 and 65.

Improved flexibility

By leaving behind the 20-year vesting period, the Pentagon managers would be better able to alter the size and makeup of the force. Most significantly, managers will be able to make personnel decisions without worrying about leaving a service member without retirement benefits.

Moreover, while shifting to a shorter vesting period will eliminate the current incentive for troops to remain in the service at least 20 years, compensation incentives such as gate pay can be used to accomplish this goal more effectively. The Defense Department's 10th Quadrennial Review of Military Compensation argues that gate pays—which are "paid to members who reach specified years-of-service milestones"—could be used to effectively encourage service members to remain in the force.[98] Moreover, these gate pays would be far more flexible than the one-size-fits-all incentive of the 20-year vesting period and could also be varied by specialty. To illustrate the point, let's consider combat troops. For them, the 20-year model makes no sense because they are often forced out of service before 20 years. Instead, to retain experienced troops for as long as makes sense for their position, the Pentagon could offer ground troops gate pays at eight years. In other specialties in which long careers are desirable, gate pays could be offered at 20 years of service or beyond. Similarly, the Pentagon could offer separation pays to encourage service members such as pilots or flight engineers to leave the force before they reach 20 years.

Controlled costs

This year the Pentagon will set aside $20 billion into an accrual fund to cover the future retirement costs of those currently serving. This is in addition to the $50 billion the federal government will pay out as pensions to current military retirees.[99]

Hypothetically speaking, if all military personnel transitioned to a 401(k) system immediately, the federal government would cut these accrual payments to $9 billion this year. The Defense Department requested $57 billion for basic pay this year, so assuming the government contributes 16 percent of basic pay to service members' retirement accounts, these payments would come to $9 billion.[100] Therefore, an immediate transition to a 401(k) system would begin saving the Defense Department about $13 billion per year.

As we detail in the next section, we recommend a gradual transition to a 401(k) retirement system. (see below for details) As a result, implementing our retirement recommendations would save about $6 billion per year, beginning immediately.

Moreover, these savings would grow over time as the number of military retirees still on the old pension system declines. Without reform, military retirement costs are projected to grow to $217 billion per year by FY 2034, with a total liability of $2.7 trillion.[101] If all active-duty troops were to transition to the 401(k) system immediately, the retirement costs would be just $114.5 in FY 2034.[102] Should Congress and the Defense Department chose to grandfather in all currently serving troops—a decision which would ensure that 83 percent of yet another generation of veterans will leave without any retirement benefits—the military retirement system will cost the federal government $146 billion in FY 2034.[103]

Without reform, military retirement costs are projected to grow to $217 billion per year by FY 2034, with a total liability of $2.7 trillion.

We recommend a gradual transition to the 401(k) system. As a result, the military retirement system will cost the government somewhere between $114 billion and $146 billion in FY 2034, ensuring savings of at least $70 billion that year.

The transition

We can't stress strongly enough the imperative that changes to the military retirement system do not negatively affect service members who have planned their retirement around these benefits. But it would be wrong to allow so many of the men and women who have fought in Iraq and Afghanistan to remain on a system which will deny the vast majority of them any retirement benefits.

As a result, the Center for American Progress recommends the following three-part transition to a 401(k)-based retirement system:

- All new recruits would automatically enroll in the new system.
- Military personnel with at least 10 years of service would have the option to transition to a 401(k) or retain their current benefits.

- Personnel with less than 10 years of service—who have not yet made a decision to make the military a career—would transition either to a 401(k) or have the option to enroll in a slightly modified version of the current pension system. This pension would vest at 10 years but provide slightly less retired pay (40 percent of base pay at 20 years rather than the 50 percent permitted under the current system) and would pay out no earlier than age 60.

We recommend a gradual transition to the 401(k) system. As a result, the military retirement system will cost the government somewhere between $114 billion and $146 billion in FY 2034, ensuring savings of at least $70 billion that year. We believe this gradual transition will allow all of those currently serving to receive a generous pension at a cost the country can afford, and it will update the military retirement system to ensure that it remains fiscally viable for the 21st century.

We cannot stress strongly enough the imperative that changes to the military retirement system do not negatively affect service members who have planned their retirement around these benefits. But it would be wrong to allow so many of the men and women who have fought in Iraq and Afghanistan to remain on a system which will deny the vast majority of them any retirement benefits.

It is clear that the current military retirement system is broken. It was designed for an era when the average person in the military made about $30,000 per year. Today that serviceman or servicewoman makes more than $100,000. It is a system that primarily benefits officers, about half of whom serve at least 20 years, and discriminates against enlisted personnel, particularly those in ground combat units in the Army and the Marines, most of whom are forced out before 10 years of service.

Moreover, it gives people an incentive to leave after 20 years regardless of whether they serve in specialties in which they could provide effective service for another 10 years to 15 years. What's more, we do not need a commission to tell us what has to be done. The answers we need are in plain sight. The Defense Department should begin its transition to a 401(k)-type retirement system immediately, as private-sector companies have done over the past 30 years.

Conclusion

Undoubtedly, any attempt to alter military pay and benefits will most likely meet resistance from the military and veterans lobbies, who will label it as unfair to those who have fought or are fighting the wars in Iraq and Afghanistan. But as we have pointed out repeatedly, most of those bearing the burden of those conflicts will not get retirement benefits from the military. Therefore they will not be affected by any changes to health care benefits for military retirees, and, in fact, they will actually be helped by our recommended retirement reforms.

There is no doubt that this nation has deployed too many people who have volunteered to defend the country on too many occasions. Yet this is not a situation that can be rectified when we, as a nation, are providing unsustainable pay and benefits to a few select retirees.

What is required is that our military and political leaders recognize—just as the Joint Chiefs of Staff did in 1981 when they tried to convince then-President Ronald Reagan not to fulfill his campaign promise to end draft registration—that an all-volunteer military is a peacetime force. Wars, they said, require selective service mobilization.

Our political and military leaders who failed to carry out the selective service mobilization have committed a moral outrage and have attempted to make up for this dereliction of duty by throwing money at the problem. This lack of moral courage and failure to do the right thing has created problems for our military volunteers and for the country. Moreover, as we noted throughout this report, the current health care and pension systems for military retirees do nothing to support the majority of those who have borne the brunt of the fighting over the past 10 years.

The deployment of men and women without sufficient time at home has resulted in higher incidence of mental problems, domestic violence, alcoholism, and suicide. Further, by raising pay and benefits to unsustainable levels, they have jeopardized the nation's ability to modernize and train the force for future missions. This paper has dealt with the second problem, but the American people must demand that our elected and appointed leaders never allow the first situation to arise again.

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