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Reforming Military Compensation

Addressing Runaway Personnel Costs Is a National Imperative

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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.

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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.

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

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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.

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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.

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