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INCOME REDISTRIBUTION: AN ALTERNATIVE APPROACH TO MILITARY PENSIONS

by

Peter Edward O'Connor

December 1977

Thesis Advisor: LCDR J.F. Owens, SC, USN

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Proposals have been made both within Congress and the Executive Branch to alter the structure of the military non-disability retirement system. The advocates of change, for differing reasons, view with alarm the rapidly increasing cost of military retirement. Each suggests an alternative by which the government will be able to control the growth in military retirement costs. However, these proposals require a reduction in the →ovg

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INCOME REDISTRIBUTION: AN ALTERNATIVE APPROACH TO MILITARY PENSIONS

by

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Lieutenant Commander, United States Navy
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Submitted in partial fulfillment of the
requirements for the degree of

MASTER OF SCIENCE IN MANAGEMENT

from the
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ABSTRACT

Proposals have been made both within Congress and the Executive Branch to alter the structure of the military non-disability retirement system. The advocates of change, for differing reasons, view with alarm the rapidly increasing cost of military retirement. Each suggests an alternative by which the government will be able to control the growth in military retirement costs. However, these proposals require a reduction in the value of the annuity to be paid to future retirees. An income redistribution alternative is presented which would reduce the annual cost while retaining for future retirees a present value of retirement income equal to or exceeding that provided by the existing retirement system. It was concluded that the complexity and political sensitivity of the military retirement issue precludes change in other than an incremental or indirect manner.

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I. INTRODUCTION

Senator Thomas Eagleton postulates that, unless action is taken to control the growth of military pension costs, "in future years the classic question of economic priorities could become 'guns or pensions' [Aspin 1976]." While there is little likelihood that the government will ever be faced with such a narrow choice, the Senator's statement does reflect the growing concern of Presidents, members of Congress and the leadership of the Department of Defense over the rapidly increasing cost of military non-disability retirement benefits. This thesis will examine the military retirement system and explore alternatives to current practices.

A. BACKGROUND

During fiscal year 1964, the cost of military retired pay was $1.2 billion. By fiscal year 1978, the annual cost will have risen to $9.8 billion and the Department of Defense estimates that under the current retirement system, the annual cost of military retirement will be $34 billion by the year 2000 [Military Posture 1976].

Under the present regulations governing military retirement, a service member may retire after twenty years of service and receive a lifetime annuity equal to fifty percent of active duty base pay at the time of retirement. In addition to the annuity, which is adjusted to reflect increases in the Consumer Price Index, the retiree and his dependents retain the privilege to use the military commissaries and retail stores and remain eligible to

receive free medical care at military facilities.

Military retirement benefits have been the subject of in-depth studies conducted by the Defense Manpower Commission (1976), the Inter-Agency Committee on Military Retirement (1971), and the First (1967) and Third (1976) Quadrennial Reviews of Military Compensation. All of these studies have recommended changes to the military non-disability retirement system. No major action has been taken to date to implement the changes recommended by these various study groups. Most recently, President Carter has appointed a Blue-Ribbon Committee to study the entire structure of military pay and benefits and has directed the committee tc submit their findings and recommendaticns to him by 15 March 1978.

B. STATEMENT OF THE PROBLEM

How much should military retirees receive in pension payments and other fringe benefits? How long should a serviceman be required to serve in order tc qualify fcr a pension? Dces the military retirement system provide excessive bnenfits for the service rendered? Is military compensaticn comparable to that received for similar work in private industry? If so, should retirement benefits alsc be comparable? Should the current system be changed?

These questions and the answers proposed by those involved form the basis for the current debate between the proponents of change and supporters of the status quo. While the debate rages, most frequently in an emotionally charged atmcsphere, it is apparent that the question is no longer "if" the current system will be changed , but rather "when" such changes will be legislated and what form such changes will take.

Representaive Les Aspin is not a voice in the wilderness in his determination to force a change. While his voice is

most often heard and quoted, he stands in the company of Presidents, Secretaries of Defense, Generals and Admirals who have also recommended change to current practices. During the current session of the Ninety-Fifth Congress, a proposal by Representative Aspin, in which military retirement benefits would be computed under the less liberal formula used for members of Congress, was defeated 247-148. Under the Congressional system, members contribute eight percent of their salaries in return for an annuity payable at age sixty-two. That the proposal was defeated is immaterial; that 148 members voted in favor of the Aspin resolution is evidence that there is a growing interest in the subject within Congress and that the time may be at hand when serious action will be taken to reform the laws governing retirement from the military.

C. THESIS OBJECTIVES

The validity of the proposition that military non-disability retirement benefits are excessive will not be tested in this thesis. The underlying assumption in this effort is that, rightly or wrongly, the current system will be changed in an effort to reduce the cost of military retirement. It is only in this manner that the author has the opportunity to avoid the emotional, and sometimes irrational, arguments of those debating the merits or liabilities of change. By avoiding the emotion, it is hoped that this effort results in an objective review of the current system, the rationale offered in support of change and an analysis of the impact of the various proposals upon efforts to reduce the cost of military retirement.

As a means of comparison of the relative value of benefits paid to military retirees, a review of the benefits payable to employees of industry, commerce and the non-military public sector will be presented. Judgments on

the relative generosity of the military system will be left to the reader.

In addition to a review of current and proposed retirement formulae, the thesis will present an alternative based upon the concept of income redistribution. Under such a method it is demonstrated that significant reductions in the annual cost of military retirement can be achieved while ensuring that future retirees continue to receive, in a present value sense, benefits equalling or exceeding those currently payable.

Finally, the thesis will examine alternatives to the current pay and benefits structure which would provide an economic incentive to remain on active duty beyond twenty-two years of serivce. It is beyond this point under the current system in which there exists an economic disincentive for continued service.

D. ECONOMIC ANALYSIS: THE TIME VALUE OF MONEY

Explicit in the financial analysis conducted in the development of this thesis is the recognition of the time value of money. Simply stated, a sum of money received today is worth more than that same sum of money received at some future date. Stated another way, money has value directly related to the timing of its receipt or disbursement, and this value is determined by the opportunity to earn a profit from a normal investment [Helfert 1977].

The Department of Defense recognizes the time value of money and its relationship with government expenditures. "Economic Analysis and Program Evaluation for Resource Management", a Department instruction, states

> interest will be treated as a cost which is related to all government expenditures.... This policy is based on the premise that no public investment should be undertaken without explicitly considering the alternative use of the funds which it absorbs or displaces.

The Department has adopted a discount rate policy which reflects private sector investment opportunities foregone. Currently, a ten percent rate is judged to be representative and is applied to all economic analysis performed within the Department.

The concept of the time value of money is best explained with an illustration: $1,000 invested today with a ten percent annual return will grow to $1,100 one year from now. If this investment were delayed one year, an opportunity to earn $100 would be lost. Conversely, if an investor wished to have $1,000 one year in the future, an investment of $909 today would provide the desired amount at the ten percent rate.

Comparisons shown in this thesis reflect the use of a ten percent rate of time preference or discount rate. While it could be argued that the rate is higher or lower, for consistency with current Department of Defense practices, the ten percent rate is used.

E. INFLATION

The income redistribution alternative presented in a later chapter assumes that there will be neither inflation nor pay increases in the future. These assumptions are made in order to simplify the presentation and analysis of the alternative and they are identical to the methods employed by both the Department of Defense and Representative Aspin

in their proposals to alter the military retirement system. The use of "constant dollars" provides a common and convenient base upon which to judge the competing alternatives. While these assumptions simplify the analytic argument, they in no way prejudice the outcome or alter the conclusions which may be reached.

II. HISTORY OF THE NON-DISABILITY RETIREMENT SYSTEM

Prior to the Civil War there were no provisions in the law for non-disability retirement from the military services. Typically, officers in the rank of Colonel and Lieutenant Colonel were over the age of sixty-five and it was not uncommon to encounter Captains over the age of sixty. Similar conditions existed within all of the services. Since there were no provisions for compulsory separation and thus no limit upon the length of active service, an officer could remain on active duty until death, despite incapacity because of old age.

At the outset of the war, Congress enacted a retirement law designed to remove from service those officers who, after a long career, were no longer fit for duty in the field because of advanced age. The law, "An Act for the Better Organization of the Military Establishment", permitted voluntary retirement after forty years of service, with a pension equal to the pay of the officer's grade plus a ration allowance. While the purpose of this first non-disability retirement law was to make the military services more efficient in time of war, the law contained a provision which limited the number of such retirees to seven percent of the authorized number of active officers. This restriction effectively prevented the services from achieving the desired effect of eliminating superannuated officers from the active rolls. While the law had no significant impact upon the number of aged officers, it represented the first occasion in which the Congress and a President recognized a need to provide a system in which those no longer capable of performing their military duties because of advanced age could be removed from active service. In addition, for the first time, service in the

military would be, in itself, sufficient justification for the payment of a pension. With isolated exceptions, pensions had previously been payable only tc those disabled as a result of military service or to the survivors cf those killed while in the line of duty.

In 1870, the Congress extended the provisions cf the earlier non-disability retirement law by authorizing voluntary retirement of Army officers after thirty years of service. Retired pay was fixed at seventy-five percent of the pay of the officer's grade. These same provisions were extended to Army enlisted personnel in 1885 and to the Navy in 1899. Retained however were provisions which limited the number of officers who could be placed on the retired list.

The limitations placed upon the number of retirees caused stagnation in the Navy officer corps ; twice prior to World War II, stagnation forced changes in the non-disability retirement laws. The first change, in 1916, established selection boards for promotion to the ranks of Commander, Captain and Rear Admiral in the Navy and authorized retirement of those officers failing selection. Retirement pay was based upon the rate of two and one-half percent cf pay per year of service, to a maximum of seventy-five percent. This marked the first time that length of service was considered in the computation of retired pay.

Again in 1938, the Navy was troubled by promotion stagnation. In order to alleviate the problem, the Congress extended the selection board process to all grades above Lieutenant (junior grade) and placed limitations upon the maximum years of service for officers in the grades of of Lieutenant Commander through Captain. Most significantly, the Congress, for the first time, permitted voluntary retirement after only twenty years of service [Defense Manpower Commission].

By the end of World War II the regulations governing retirement from the military were extremely complex, a

result of eighty-five years of "patchwork" legislation designed to cure specific problems which had arisen in each of the services. As a result, there existed different requirements and benefits associated with non-disability retirement. These varied both between the Army and Navy as well as between officer and enlisted. The Officer Personnel Act of 1947 placed the Army and Air Force under a selection process for officers similar to that in effect in the Navy. In addition, the Army and Air Force Vitalization Act of 1948 enacted standardizied retirement laws for all services, in which twenty years of service was prescribed as the minimum requirement for voluntary retirement.

The provisions of the Vitalization Act remain essentially unchanged today. However, as a result of the Servicemen's and Veterans' Survivor Benefits Act of 1956, members of the armed forces were provided coverage under the Social Security System. While the principal reason for providing this coverage was to improve the benefits payable to the families of those killed while serving in the armed forces, it also provides the retired serviceman who survives to old age the benefit of a second pension which is totally additive to that received by virtue of his military service.

Today, the Vitalization Act and the social security provisions of the Serivceman's and Veteran's survivor Benefits Act are under close scrutiny by Congress and the President as each attempts to develop an alternative system which will satisfy the dual goals of providing a fair and equitable pension benefit to the retired serviceman while retarding the growth of military pension costs.

III. THE PROS AND CONS OF CHANGE

While there are numerous peripheral issues surrounding the debate over the military non-disability retirement system, the principal area of concern is the basic retirement formula in which a serviceman can retire after twenty years of service. In return for this career of military service, the retiree is entitled to a lifetime annuity equal to two and one-half percent of his final base pay multiplied by the number of years of service to a maximum of seventy-five percent. Figures 1 and 2 list the retired pay for those retiring between 1 October 1976 and 30 September 1977.

A. THE CASE FOR CHANGE

The two arguments cited most frequently by proponents of change to the military retirement system are that military retirement benefits are excessively liberal and that the cost of maintaining retirement benefits at current levels is so great that it is having a pernicious impact upon Defense capabilities. Either the taxpayers are paying more than is necessary or the increasing cost of military pensions is siphoning off funds needed to maintain an adequate level of military preparedness. In either case, the goal of the critics is to reduce the annual cost of military retirement. In the paragraphs which follow, various factors which influence these arguments will be discussed.

ANNUAL ANNUITY

(BASED UPON 1 OCTOBER 1976 PAY SCALE)

YEARS OF SERVICE

GRADE	20	21	22	23	24	25	26	27	28	29	30
E-9	7,056	7,416	8,172	8,544	8,916	9,288	10,596	11,004	11,412	11,820	12,228
E-8	6,192	6,504	7,200	7,536	7,860	8,196	9,468	9,840	10,200	10,560	10,932
E-7	5,460	5,736	6,408	6,708	6,996	7,284	8,520	8,844	9,168	9,504	9,828
E-6	4,800	5,040	5,280	5,520	5,760	6,000	6,240	6,480	6,720	6,972	7,212
E-5	4,080	4,284	4,488	4,692	4,896	5,100	5,304	5,508	5,712	5,916	6,120
E-4	3,384	3,552	3,720	3,888	4,068	4,236	4,404	4,572	4,740	4,908	5,076
E-3	2,964	3,120	3,264	3,408	3,564	3,708	3,852	4,008	4,152	4,296	4,452
E-2	2,508	2,628	2,748	2,880	3,000	3,132	3,252	3,384	3,504	3,636	3,756
E-1	2,244	2,364	2,472	2,580	2,700	2,808	2,916	3,036	3,144	3,252	3,372

Figure 1 - ENLISTED RETIRED PAY

ANNUAL ANNUITY

(BASED UPON 1 OCTOBER 1976 PAY SCALE)

YEARS OF SERVICE

GRADE	20	21	22	23	24	25	26	27	28	29	30
0-10	-	-	-	-	-	-	-	32,064	33,252	34,440	35,628
0-9	-	-	22,488	23,508	24,528	26,304	28,476	29,658	30,660	31,764	32,856
0-8	18,984	19,932	21,720	22,704	23,700	24,684	25,668	26,652	27,648	28,632	29,616
0-7	17,172	18,024	18,888	19,740	20,604	21,468	22,320	23,184	24,036	24,900	25,752
0-6	13,152	13,800	15,300	15,996	16,692	17,388	19,608	20,364	21,120	21,876	22,632
0-5	11,892	12,480	13,536	14,160	14,772	15,384	15,996	16,620	17,232	17,844	18,468
0-4	10,296	10,812	11,316	11,832	12,348	12,864	13,380	13,896	14,412	14,928	15,444
0-3E*	9,036	9,492	9,936	10,392	10,848	11,292	11,748	12,204	12,648	13,104	13,560
0-2E*	7,644	8,028	8,412	8,796	9,180	9,492	9,948	10,320	10,704	11,088	11,472

(*: over four years enlisted service)

Figure 2 - OFFICER RETIRED PAY

1. Pay Comparability

The end of conscription and the intrcduction cf the all-volunteer concept ushered in a new era in military compensation. If the military services were to compete in the marketplace for manpower, they would be required to offer compensation comparable to that available to private sector employees. As a consequence, significant increases have been registered in the level of compensation prcvided to military personnel and the government believes that this compensation is now competitive with that available in the in the private sector.

Since military retired pay is directly linked to active duty pay, these increases in active duty pay have also spawned similar increases in the size of military pensions. In 1965, a Commander retiring after twenty years of service received an annuity of $5,600; during fiscal year 1977, a Commander retiring with the same length of service received nearly $12,000.

Prior to the advent of the all-volunteer force, active duty compensation was significantly below that available to persons of similar background in the private sector, while the military retirement system provided a benefit superior to nearly all segments cf the private sector. It was percieved that the relative generosity of the retirement benefit balanced the depressed active service compensation. Under today's conditicns of service, those serving in the military are paid at a level comparable to the private sector, but the liberal retirement formula remains unchanged. The Department of Defense has suggested

> If military perscnnel are to be the recipients of active duty pay competitive with the private sector, then some adjustments will be required to bring the military retirement system closer tc competitive practices [Meeting Leader's Guide 1973].

As stated in a previous section, money has value directly related to the timing of its receipt. It is this factor of timing which makes the military retirement system so much superior to other retirement systems. For example, a Commander retiring during fiscal year 1977 after twenty years of service received an annual pension of $11,892. From an assumed age of 43 to actuarial mortality at age 73, this pension has a present value at time of retirement of $112,096. For the majority of Americans who must wait until at least age 62 to qualify for a full pension, an annual pension of $105,550 from age 62 to age 73 would be required to equal the present value of the Commander's pension payable at age 43.

While the above illustration may not be intuitively appealing to those not familiar with the concept of "present value", it demonstrates in a dramatic fashion the impact of timing upon the value of money. Judicious investment of all or a portion of this retirement benefit provides the military retiree with the opportunity to further increase the value of his pension.

A comparison between military retirement benefits and those paid to employees of selected corporations and members of selected labor unions is provided in figure 3. As shown, the military retiree enjoys advantages both in the age at which he can retire and the size of his annual pension. In addition, few private plans currently adjust pensions to reflect increases in the cost of living. (A more complete summary of private pension plans can be found in The Digest of Selected Pension Plans , a publication of the U.S. Department of Labor). From the standpoint of comparability, it is clear that the military retirement system is more generous than nearly all other retirement systems in the United States; a review of available information indicates that only in those occupations in which there is a high risk of serious injury or death do retirement benefits approximate those available to the military retiree.

Texaco

Normal Retirement Age:	65
Benefit Formula:	The average of the highest salary for three years times 1.5% times years of service. Minimum benefit; $120 x years of service.
Remarks:	Plan is non-contributory; benefit is integrated with Social Security.

Eastern Air Line

Normal Retirement Age:	62-65
Benefit Formula:	Average of highest three years times 1.4% times years of service. Minimum benefit: $144 x years of service.
Remarks:	Non-contributory; no integration.

United Steelworkers of America
(Agreement with United States Steel)

Normal Retirement Age:	65
Benefit Formula:	Average monthly earnings for the highest five consecutive years from among the last ten years times 33%, plus 1.2% times years of service in excess of thirty years. Minimum benefit: $352.50 plus $14 x years in excess of thirty.
Remarks:	Non-contributory; benefit cannot exceed the amount of Social Security received by the retiree.

Ford Motor Company
(Salaried Employees)

Normal Retirement Age:	65
Benefit Formula:	Years of service times $10. Factor varies with salary scale.
Remarks:	Non-contributory; no integration.

Teamsters
(Central States, Southeast and Southwest States)

Normal Retirement Age:	60
Benefit Formula:	$550 per month. Requires twenty years of service.
Remarks:	Non-contributory.

Figure 3 - SELECTED PENSION PLANS

2. The Cost of Military Pensions

As stated previously, During fiscal year 1964 the cost of military retired pay was $1.2 billion. By fiscal year 1978, the annual cost will rise to $9.8 billion and the Department of Defense estimates that under the current retirement system, the annual cost of military retirement will be $34 billion by the year 2000.

In its report to the President in 1970, the Blue Ribbon Defense Panel estimated the annual cost of military retirement in the year 2000 to be only $12.8 billion. Since the time of their report two factors have combined to change radically the rate of increase in retired pay: first, the compensation provided to military personnel has been increased dramatically from artificially depressed levels to a level of comparability with the private sector; second, the cost of living has risen at an unprecedented rate during the 1970's. Since the annual cost of retired pay is a function of both active duty pay and adjustments to reflect increases in the cost of living, increases in either cause corresponding increases in retired pay.

Senator Thomas Eagleton has recently warned that

> American taxpayers are sitting on top of a "financial time bomb" in the form of unfunded pension plans for military personnel and government civilians at local, state and federal levels [Navy Times January 26, 1976].

Grouping all public employee pensions together, Representative Les Aspin raises the specter of the federal government being forced to choose between defaulting on its obligations or increasing taxes, the choice faced by the City of New York [Harper's December, 1976]. While such a situation can and does exist at the state and local level, to imply that the federal government faces a similar crisis is to exaggerate greatly potential problems facing

Washington. Since few of New York's creditors are also residents of the city, the creditors are able to escape the taxing powers of local government. However, at the federal level, only a small fraction of the public debt is in the form of obligations to non-residents of the United States; thus, if required, citizens may be taxed to pay the government's obligations to other citizens. In the federal situation, such taxation represents a redistribution of income among citizens, while the same situation at the state or local level represents a transfer from within the community to creditors outside the system.

In the discussion over the cost of military retirement, the problem is not one of economics, but rather a problem of the realities of politics. Given that both the Congress and the President desire to restrain growth in the cost of government, choices must be made among programs competing for scarce dollars. It is the opinion of Representative Aspin and many military leaders that military retirement benefits are not of sufficient priority to warrant continued unbridled growth. While their reasoning in support of change to the laws governing military retirement may be different, their goal is the same: to reduce the annual cost .

For military leaders, the increasing cost of manpower, including military retirement, has an adverse impact upon Defense capabilities. In his annual report to the Congress for fiscal year 1977, Defense Secretary Donald H. Rumsfeld stated

> we must slow the growth of defense manpower costs to ensure an adequate level of resources for procurement, research and development, maintenance and operations.

Retired pay represents an uncontrollable outlay, an expense which must be paid whatever the impact upon other programs. These payments result in no direct contribution to current

or future military preparedness, and during periods of fiscal austerity can drain needed funds from support of the active forces. Military leaders recognize that there is a finite limit to the size of the Defense budget both in terms of the amount a President will request and the amount which a Congress will appropriate. If Congress or the President desires to hold the line on overall Defense spending while manpower costs continue to rise, there will be fewer funds available to operate, maintain and equip the active forces. This situation currently exists and faced with the choice between "guns or pensions", the Department of Defense has no alternative but to place its highest priority upon those programs directly supporting the defense capabilities of the military services.

3. Changing Times

Veterans of World War II picture combat as a brute strength confrontation between opposing armies of foot soldiers on the plains of Europe or the jungles of the South Pacific in which artillery and bombers played only secondary roles in support of the foot soldier. In those days physical strength and vigor, key elements of youth, were a basic requirement if armies were to be victorious in the field and it was appropriate to retire from active service those no longer possessing these qualities. Today, while the foot soldier retains a prominent role in the success of a combat force, around him has grown a new military force based upon a technology in which mental prowess, not physical strength, is the dominant characteristic. The demands upon these two segments of the armed forces - the technician and the foot soldier - are radically different and it has been suggested by the Defense Manpower Commission that the military retirement system be altered to reflect these differences. In today's highly technical environment, the Commission found that

> the high cost of specialized training and the importance of skills and insights developed only through experience have made forced high turnover through early retirement an expensive and disruptive practice for many military occupations.

In order to alleviate this problem, the Commission made the following recommendations on the determination of retirement eligibility:

> A normal military career should be a minimum of thirty years, but should allow for continued service as great as forty years in some occupations and early retirement with as few as twenty years in other occupations, primarily those combat jobs requiring considerable youth and vigor. Assuming a full career of thirty years, eligibility for retirement on an immediate annuity would require thirty 'retirement points'.... Every job would be assigned an incentive multiplier according to its mission, with a minimum of one and a maximum value of one and one-half. Most non-combat jobs could be assigned an incentive multiplier of one, while a rifleman in an infantry rifle company, for example, would be assigned the maximum.

B. THE CASE AGAINST CHANGE

As stated at the outset of this paper, it is assumed that the retirement system will be changed. The purpose of this section is to call attention to factors which should be considered in the development of an alternate benefit structure. Those responsible for developing this new structure would be well advised to consider the advice contained in the following bit of Americana philosophy: "There's no such thing as a free lunch."

Critics of the military retirement system base their arguments in favor of change upon their belief that the benefits paid to military retirees are overly generous when compared to other retirement systems. One cannot refute the premise that the system is generous, but unanswered is the

question of how much the military system must offer if the services are to attract and retain personnel in sufficient quantity and quality to meet the manpower requirements of national defense. Before action is taken to alter the retirement benefits structure, this question must be addressed. The military can ill afford to be placed in a position in which the benefits it can offer in the marketplace are deemed inadequate by potential employees. In the paragraphs which follow, possible impediments to change will be discussed.

1. Competition in the Labor Marketplace

When the President, with the consent of the Congress, decided that the military's manpower requirements would no longer be met through the practice of conscription, there was created a requirement for military service to provide a level of compensation sufficient to attract potential employees in the labor marketplace.

The government has adopted the concept of "pay comparability" in an effort to provide government employees, both civilian and military, with a level of pay and benefits competitive with those available in the private sector for similar occupations. While the Civil Service appears able to satisfy its manpower requirements under this practice, the military services continue to experience difficulties recruiting sufficient numbers of qualified employees to satisfy all requirements. If this has been the case when the military enjoys one of the most liberal retirement systems in American society, one can only speculate on the potential manpower problems which may be encountered if the retirement benefit is reduced to a level of comparability with the private sector.

Historically, a career in the military, particularly the enlisted career, has never been percieved by our society as an attractive alternative to employment in more traditional occupations. In the private sector, in order to

attract people to the less desirable but essential occupations, employers are required to offer premium compensation rates. Construction workers, bus drivers and sanitation workers, among others, require little education or formal training, yet command these premium wages. Police and firemen, as well as others in high risk occupations, are paid a premium for their risk taking. If the military pay structure is to be competitive and comparable in the labor market, it may be necessary to provide the serviceman with a premium to compensate for risk, where applicable, and for the perception that military service is an undesirable alternative to civilian employment.

The high cost of military retirement may be the premium which must be paid if the services are to be successful in their competition with the private sector for employees.

2. Conditions of Service

The introduction of the all-volunteer concept, and the attendant requirement for the military to compete in the labor marketplace for required manpower, has brought into focus the variances between the demands of private sector employers and those of the military employer.

The government claim that its military employees are paid at levels comparable to those in the private sector must now stand the test of close scrutiny by potential employees. In the past, family separation, long working hours and dangerous working conditions were considered "part of the job" and, under most conditions, not worthy of payment of a premium. Under current retirement laws, it can be logically argued that the relative generosity of the military pension adequately compensates for these less desirable conditions. But what will happen when the retirement system is changed so that it is more comparable with the private sector?

It follows that if military compensation is to be truly comparable, then the government should be prepared to provide premium wages to those required tc perform duties beyond the societal norm. As examples, servicemen should expect, and may demand, payment for all overtime work, for all periods of forced family separation and for work performed under dangerous conditions or in an inhospitable environment.

As noted in the previous section, the high ccst of military retirement may be the premium required to compensate fcr the conditions of service. if the retirement laws are made less liberal, then new forms cf compensation will be required. Before decisions are made on alterations to the retirement laws, the costs of these new premium payments must be weighed against the potential savings in retirement. The pay and benefits structure of the military is extremely complex and before attempting to change cne factor, such as retirement, one must consider the impact of such adjustments upon the entire system. It is evident that neither the Department of Defense nor representative Aspin has considered the impact of their proposals to change the laws governing retirement. The Blue Ribbon Committee appointed by President Carter has been tasked to review the entire pay and benefits structure, but it is unlikely that, in the three months remaining before they must report to the President, the committee will be able to conduct the needed in-depth review.

IV. DEFECTS IN THE MILITARY COMPENSATION SYSTEM

The military compensation system, while providing generous benefits to those who serve to retirement eligibility, is plagued by numerous defects which detract from the overall effectiveness of the system. In the paragraphs which follow, two principal defects will be reviewed and alternatives to current practices will be offered. While neither of these problems directly impacts upon the cost of military retirement benefits, each may influence the individual serviceman's retirement decision. Because of this reason, it is appropriate that these deficiencies be included in a discussion of retirement modernization.

A. SERVICE BEYOND RETIREMENT ELIGIBILITY

A principal concern of many members of Congress is the tendency of most flag and general officers to leave the service prior to the statutory retirement age [Navy Times May 23, 1977]. What is rarely considered is the fact that there is no economic incentive for career servicemen, be they admirals or petty officers, to remain on active duty beyond the point of maximum return in terms of the present value of their retirement income. As depicted in figure 4, for both officers and enlisted personnel, the present value of this income declines after twenty-two years of service.

One could argue, in the case of officers, that there are adequate, although non-economic, incentives for many to remain beyond twenty-two years. In the Navy, it is at this point and beyond that the "successful" naval officer reaps the rewards of sustained superior performance with

prestigious assignments such as command of capital ships, command of major shore activities and positions of significant responsibility in headquarters staffs. It may be that such non-economic incentives are adequate to retain sufficient numbers of quality senior officers, at least until the non-economic incentives dissipate. However, there are few "prestigious" assignments for senior enlisted personnel. The lack of non-economic incentives is reflected in the retention profile presented in figure 5, which shows that only 1.1 percent of enlisted personnel entering the service will remain on active duty for twenty-five years, versus 13.4 percent for officers [Congressional Budget Office 1977].

Beyond twenty-two years, the active duty pay schedule provides only one increase for years of service. This increase, for service beyond twenty-six years, is modest and for the serviceman contemplating a thirty year career, it provides an average annual increase during this eight year period of 1.4 percent for an E-8 and less than 1.1 percent for an O-6. In terms of either real dollars or the present value of military compensation, there is simply no economic incentive to remain on active duty. Given the choice of remaining at a personal economic loss or leaving the service at an early age to pursue a second career, the overwhelming majority choose the latter alternative.

If the services desire to retain greater numbers of officers and enlisted personnel for full careers (thirty or more years), economic incentives to remain on active duty must be offered. The Retirement Modernization Act, described in Chapter V, has proposed a negative incentive by penalizing the retiree for leaving prior to the completion of thirty years active service; similar provisions have been offered by the Defense Manpower Commission. While such approaches might provide the desired effect in the long term, the problem exists today and it should be met with a solution which will provide more immediate results.

As an alternative to current practice, the military services should propose a change to the military compensation system by which basic pay rates would be increased for each two years of service beyond twenty years, to a maximum at thirty years. Accompanying such a change would be a requirement for the services to identify those officers and enlisted personnel who should be invited to remain on active duty beyond retirement eligibility. Both past performance and future potential value to the services would be considered in the screening process, a practice currently observed in the Navy's continuation screening for Flag Officers. In this manner, the services could select those whose continued presence will be most beneficial to its needs and they will be able to provide the needed economic incentive to the individuals so selected. Such a program would improve the services both by retaining many more of the competent servicemen who currently retire at the earliest possible date and by retiring at the earliest possible date those marginal performers who currently remain beyond the point of continued useful service.

B. CEILINGS UPON MILITARY PAY

Implicit in the structure of all federal pay schedules is a ceiling which cannot exceed the salary payable to members of the Congress. Such an artificial limitation is counter-productive , particularly in the military services, where retirement is possible after as few as twenty years of service. While there have been efforts to ensure that the pay of most lower level employees is generally comparable to that available in the private sector, the pay of senior officials has been depressed in order that it remains below that of Congress. As a consequence, senior military officers and civil servants are asked to remain in government service at a real economic loss and to pass up

the opportunity to participate in a second career in which the remuneration, for positicns similar to those held in the federal service, far exceeds that currently available within the government. Many state and local governments have long recognized the need to decouple the salaries paid to non-elected executives from those of elected representatives. In order to attract and retain qualified executives, the federal government must offer compensation competitive with the private sector. The cost of such a change would be insignificant, but the potential for improved management of governmental operations would be immense.

OFFICERS			ENLISTED		
YEARS SERVICE	GRADE	PRESENT VALUE	YEARS SERVICE	GRADE	PRESENT VALUE
20	0-5	43,216	20	E-7	20,218
21	0-5	40,984	21	E-7	19,233
22	0-6	45,364	22	E-8	21,845
23	0-6	42,805	23	E-8	20,686
24	0-6	40,261	24	E-8	19,500
25	0-6	38,132	25	E-8	18,375
26	0-6	38,726	26	E-9	21,446
27	0-7	41,198	27	E-9	20,093
28	0-7	38,410	28	E-9	18,796
29	0-7	35,707	29	E-9	17,695
30	0-7	33,555	30	E-9	16,483

Figure 4 - THE PRESENT VALUE OF RETIREMENT INCOME

YEARS OF SERVICE	NUMBER REMAINING	
	OFFICERS	ENLISTED
0	1000	1000
5	411	194
10	329	121
15	327	97
20	318	89
25	134	11
30	43	3

Source: Congressional Budget Office, The Cost of Defense Manpower: Issues for 1977.

Figure 5 - RETENTION OF OFFICERS AND ENLISTED

V. THE WASHINGTON ALTERNATIVES

In this chapter, three alternatives to the current military retirement system will be reviewed. The first, the Uniformed Services Retirement Modernization Act, has been proposed by the Department of Defense. The Defense Manpower Commission, in its report to the President, has offered an alternative not significantly different in concept from that proposed in the Retirement Modernization Act. The third proposal, authored by Representative Les Aspin, is a much more radical departure from the current practice; so much so that it is highly unlikely that his proposal will ever receive serious attention in its present form. However, his proposal is consistent with the pension plans offered by most private corporations and for this reason it should not be ignored.

The reader is cautioned that neither the Defense Department proposal nor that of the Defense Manpower Commission is unique, for each has its genesis in the recommendations contained in the Interagency Committee's 1971 report to the President on their study of the military retirement system. In nearly every instance, the recommendations contained in these two current proposals differ only in an incremental manner from the original recommendations of the 1971 report.

Absent from all three is an assessment of the potential impact of a reduction in the value of military retirement benefits upon the ability of the services to attract and retain the required number of quality volunteers. In an era in which the available manpower pool is shrinking, it is of paramount importance that any proposal to change a component of the military compensation system include an analysis of the impact of the change upon recruitment and retention.

A. THE RETIREMENT MODERNIZATION ACT

The Retirement Modernization Act contains little original thought on the subject of military retirement; it simply represents the sum of the Defense Department's incremental adjustments to the earlier recommendations of the Interagency Committee. Rather than attempt to develop a new approach to the problems associated with the rapidly increasing cost of military retirement, perhaps because of time limitations, the general concepts presented in the Interagency Committee report were accepted as the baseline by the DoD Study Group [DoD Retirement Study Group 1972].

The recommendations of the Defense Department have been translated into proposed legislation which has been presented to the Congress annually since 1972. Despite objections by members of Congress and the Defense Manpower Commission to some of the Defense Department proposals, it remains essentially unchanged since it was first described to the House Armed Services Committee in hearings conducted in October, 1972. Again in 1977, the legislation had been prepared for submission. However, submission has been deferred pending Presidential review of a new Blue Ribbon Committee's study of the entire military compensation system. It appears unlikely that any proposal to change the military retirement system will be submitted by the Executive Branch to Congress before 1979. The prospects for change are discussed in Chapter VII.

1. Principal Changes

a. Incentives for Continued Service

Under the existing system, the retirement annuity is computed by multiplying the retiree's final basic pay times a factor equal to 2 1/2 percent for each year of

service. Under the Retirement Modernization Act, this multiplier factor will be increased from 2 1/2 percent to 3 percent for service beyond twenty-four years. The maximum payment will be raised from seventy-five percent for thirty years of service to a new maximum of seventy-eight percent.

b. Reduced Annuity Payments

Those servicemen serving in excess of twenty years, but less than thirty years, will have their annuity multiplier reduced by fifteen percent. This reduction will remain in effect until their years of service plus their years on the retired list total thirty years or until the member becomes sixty years of age. As an example, a retiree with twenty years of service will have his multiplier reduced from 50 to 35 percent for a period of ten years. In terms of the effect of this multiplier reduction's impact upon the dollar value of the annuity received, the twenty year retiree will have his annuity reduced by thirty percent for a ten year period. For the servicemen retiring after twenty-eight years of service, this reduction equates to a twenty-one percent reduction in the monetary value of the annuity for a period of two years.

c. Social Security Integration

When a retiree receives any social security old age insurance benefit, his annuity will be reduced by one-half of the social security benefit which is attributable to the period of his military service. The use of an offset is a common practice in the private sector and reflects the employer's contribution to the social security benefit. In effect, the use of an offset provision compensates the employer for the requirement to pay one pension benefit directly to a former employee while subsidizing another.

d. Annuity Base

The annuity of a retiree will be computed from the average amount of basic pay received during the twelve month period of highest earnings. With few exceptions, this period is represented by the final twelve months of service. Under existing statutes, the annuity is computed from the basic pay rate in effect upon the date of retirement.

e. Vesting

Under the current system, a serviceman must serve until he is eligible for retirement before qualifying for some sort of pension. No existing private pension plans are so restrictive in their vesting requirements. The Retirement Modernization Act would provide for vesting of a pro rata share of retirement benefits for voluntary and involuntary separation before retirement eligibility. For members involuntarily separated, they would qualify for inclusion after completion of five years of service. Those who voluntarily leave the service would qualify after ten years.

2. Estimated Savings

Because the new retirement system would be phased in over a period of approximately twenty years, there will be no near term savings. The Department of Defense had estimated a cumulative savings of $10.6 billion through the year 2000. The estimate assumed an effective date of October, 1977 so that if implementation were delayed until 1979, the cumulative savings would be reduced to approximately $8 billion through the year 2000.

B. THE DEFENSE MANPOWER COMMISSION

Created by an Act of Congress, the Defense Manpower

Commission was charged to conduct a broad and comprehensive study and investigation of the overall manpower requirements of the Department of Defense. A principal concern of those who supported the creation of the Commission was and remains the rising cost of military manpower [Defense Manpower Commission 1976]. In the two years of its existence, the Commission conducted a comprehensive study of all aspects of Defense manpower and produced a superior report for the President and Congress to use as a background for future deliberations over the future course of military manpower planning and costs. The Commission's recommendations for changes to the current retirement system are detailed in the Commission staff study entitled New Initiatives for the Military Estate Program .

1. Principal Changes

a. Retirement Eligibility

The Commission recommends that a normal military career be a minimum of thirty years, but should allow for continued service for as long as forty years in some occupations and early retirement with as few as twenty years in those occupations requiring youth and vigor.

In order to qualify for an immediate annuity, a serviceman would be required to acquire thirty "retirement points." Occupations would be assigned an "incentive multiplier" based upon the type of mission, with a minimum value of 1 to a maximum of 1.5. Non-combat positions would receive the minimum multiplier while certain combat positions would be assigned the maximum. Each day of active duty would earn retirement points equal to 1/365 times the "incentive multiplier."

b. Annuity Base

The annuity of a retiree would be computed from the average amount of basic pay received during the highest

three year period. For most retirees this will be represented by the final three years of service.

c. Computation of Retired Pay

The Commission offered for consideration a retirement multiplier equal to 2 2/3 percent for each retirement point earned to a maximum of eighty percent for thirty retirement points. Although retirement would be permitted at any time after thirty retirement points are earned, thirty years of service would be required to receive an immediate, unreduced annuity. If less than thirty years of service has been performed, the retiree could choose between an actuarally reduced annuity upon retirement or could defer receipt of the annuity until the date when he would have completed thirty years.

d. Social Security Integration

Under the Commission's proposal, there would be no explicit integration of retired pay and Social Security benefits. However, they suggest that the value of these benefits be considered when a determination is made of the appropriate levels of retirement multipliers.

e. Vesting

The Commission recommends that vesting rights be granted only to those members who serve for a minimum of ten years. A serviceman voluntarily separated would receive a deferred annuity; those involuntarily separated would receive an immediate cash payment for readjustment plus the choice between a deferred annuity or a second cash payment.

2. Estimated Savings

The Defense Manpower Commission did not estimate the potential savings associated with their recommended changes. It would appear however that adoption of this proposal would provide savings in excess of those offered by the Retirement

Modernization Act because of the requirement to acquire thirty retirement points. Since few, if any, spend their entire career in combat positions, the time required to qualify for an immediate annuity (full or reduced) will exceed twenty years. Consequently, the number of years in which annuity payments will be made to a serviceman will be reduced.

C. REPRESENTATIVE LES ASPIN

Representative Aspin's proposal to change the military retirement system is contained in H.R. 15775, entitled the "Uniformed Services Nondisability Retired Pay Reform Act." This bill was submitted to the second session of the Ninety-Fourth Congress. While no action was taken on this bill before adjournment, there is every reason to believe that it will be resubmitted in its present form in the future. A step-by-step comparison with the other two alternatives is provided in Guns or Pensions , his study on the military retirement system. His principal argument in support of change is his belief that the military retirement system is excessively generous.

1. Principal Changes

a. Vesting

Under this proposal, all personnel would be eligible for a deferred annuity after completion of five years of service.

b. Qualifying Age for Pensions

For those personnel who leave active service

between five and nineteen years of service, payment would commence at age sixty-two. The eligibility age is reduced to sixty for those with twenty to twenty-nine years of service and at fifty-five for those with thirty or more years.

c. Annuity Base

The proposed base is the average Regular Military Compensation received during the highest three years. Regular Military Compensation is defined as the sum of basic pay, quarters allowance, subsistence allowance and the tax advantage of the two allowances. The use of this base is related to Representative Aspin's efforts, reflected in other proposed legislation, to have military compensation provided in the form of a salary with all allowances and basic pay combined into a single pay item.

d. Computation of Retired Pay

The benefit formula would provide 1.25 percent for each of the first five years, 1.75 percent for service between six and ten years and 2 percent for each year beyond ten. The total of these percentages would be multiplied by the average Regular Military Compensation to provide the monthly benefit payable to the retiree.

e. Social Security Integration

At the present time, the proposal does not include recommendations for integration. However, from the information provided in the Aspin study, such a provision may be included in the future.

f. Contributory Retirement

The Aspin proposal would require contributions to a retirement fund by both the serviceman and the

services. The serviceman's contribution would be phased in over an undefined period of years, rising to a maximum of seven percent of Regular Military Compensation.

2. Estimated Savings

At Representative Aspin's request, the Defense Department estimated the savings if all future retirees received a deferred annuity at age sixty for twenty to twenty-nine years of service and at age fifty-five for thirty years of service. According to the Department's estimate, the Aspin proposal would result in savings in excess of $110 billion by the year 2000 as compared to a cumulative savings of $10.6 billion under the Retirement Modernization Act [Military Posture 1977].

D. SUMMARY

While each proposal addresses many of the defects in the current system and offers solutions to these problems, the principal goal of each is to reduce the annual cost of military retirement. the most liberal formula is contained in the Department of Defense proposal, but even this alternative would result in a reduction in the amount of the retirement annuity for all but those serving for a thirty year career. Neither the Department of Defense proposal nor that of the Defense Manpower Commission provides an adequate economic incentive for service beyond twenty-two years because the present value of these benefits continues to decline beyond this point. The proposal by Representative Les Aspin is designed solely to reduce the cost of retirement and contains no positive incentives for continued service, only negative ones. In Chapter VI, an alternative will be presented which would, if enacted, reduce the annual

cost of military retirement while preserving or enhancing the present value of the benefit received by the annuitant.

GRADE	YEARS SERVICE	RET AGE	YEARS TO MORTALITY[1]	ANNUITY (% OF BP)	ANNUAL ANNUITY[2]	TOTAL PAYMENT IN LIFETIME	PRESENT VALUE[3] OF ANNUITY
O-4	20	43	30	50	10,296	308,880	37,416
O-5	20	43	30	50	11,892	356,760	43,215
O-6	22	45	28	55	15,300	428,400	43,364
O-6	24	47	26	60	16,692	433,992	40,261
O-6	26	49	25	65	19,608	490,200	38,726
O-8	30	53	22	75	29,616	651,552	38,589
E-7	20	39	34	50	5,460	185,640	20,218
E-8	22	41	32	55	7,200	230,400	21,845
E-9	26	45	28	65	10,596	296,688	21,446
E-9	30	49	25	75	12,228	305,700	16,483

Notes

1: Rounded to nearest year. Source: U.S. Bureau of the Census, Statistical Abstract of the United States: 1976.

2: Based upon 1 October 1976 pay scale.

3: For officers, the present value is computed from age 33; for enlisted it is computed from age 29. For each, the age represents that at which the typical officer or enlisted will enter his eleventh year of service.

Figure 6 - RETIREMENT BENEFITS - CURRENT SYSTEM

GRADE	YEARS SERVICE	RET AGE	YEARS TO MORTALITY	ANNUITY (% OF BP)	ANNUAL ANNUITY	BONUS PAID	TOTAL PAYMENT IN LIFETIME	PRESENT VALUE OF ANNUITY
O-4	20	43	30	35	7,205	14,134	230,284	37,416
O-5	20	43	30	35	8,324	16,922	266,642	43,215
O-6	22	45	28	41	11,407	16,922	336,318	46,787
O-6	24	47	26	47	13,076	16,922	356,898	44,504
O-6	26	49	25	53	15,989	16,922	416,647	44,543
O-8	30	53	22	65	25,670	16,922	581,662	46,413
E-7	20	39	34	35	3,823	7,912	137,894	20,218
E-8	22	41	32	41	5,373	7,912	179,848	22,364
E-9	26	45	28	53	8,643	7,912	249,916	23,555
E-9	30	49	25	65	10,600	7,912	272,912	20,351

Figure 7 - RETIREMENT BENEFITS - INCOME REDISTRIBUTION

GRADE	YEARS SERVICE	TOTAL LIFETIME PAYMENTS CURRENT - REDISTRIBUTION = SAVINGS	PRESENT VALUE OF ANNUITY CURRENT - REDISTRIBUTION = SAVINGS/(COST)
0-4	20	308,880 - 230,284 = 78,596	37,416 - 37,416 = 0
0-5	20	356,760 - 266,642 = 90,118	43,214 - 43,215 = 0
0-6	22	428,400 - 336,318 = 92,082	43,364 - 46,787 = (3,423)
0-6	24	433,992 - 356,898 = 77,094	40,261 - 44,504 = (4,243)
0-6	26	490,200 - 416,647 = 73,553	38,726 - 44,543 = (5,817)
0-8	30	651,552 - 581,662 = 69,890	38,589 - 46,413 = (7,824)
E-7	20	185,640 - 137,894 = 47,746	20,218 - 20,218 = 0
E-8	22	230,400 - 179,848 = 50,552	21,845 - 22,364 = (519)
E-9	26	296,688 - 249,916 = 46,772	21,446 - 23,555 = (2,109)
E-9	30	305,700 - 272,912 = 32,788	16,483 - 20,351 = (3,868)

Figure 8 - CURRENT SYSTEM VS. INCOME REDISTRIBUTION

VI. INCOME REDISTRIBUTION: A NEW APPROACH

While the proponents of change speak not only of reducing the cost of military retirement but also of improving manpower management, a review of available literature on this topic clearly reveals that improved manpower management is only a peripheral issue. These critics view the rapidly rising costs of military pensions either as a threat to the national economic welfare (Representative Aspin), or as a threat to the military's ability to carry out its mission because of the drain of resources from programs directly supporting the defense of the nation (The Department of Defense).

The alternatives presented by both the Defense Manpower Commission and the Department of Defense will provide long term savings. However, the savings, while large, become nearly insignificant when compared to the annual expense which will be experienced at the time these savings ultimately materialize. Lacking in all proposals, including that of Representative Aspin, is a consideration of the potential impact of a reduction in military retirement benefits upon the ability of the services to attract and retain quality personnel. As discussed in an earlier chapter, a generous retirement beneift may be the premium which must be paid to keep the ranks filled with adequate numbers of quality personnel.

If the goal of the critics is, as it appears to be, a reduction in the annual cost of military retirement, there are an infinite variety of alternatives available which could satisfy this objective without resulting in the situation in which future retirees are worse off than their predecessors. The alternative presented in this chapter describes a proposal for income redistribution in which a

reduction in the annual cost of military retirement can be achieved without adversely impacting upon the present value of the annuity received by the retiree. The alternative also proposes a solution to the difficulties encountered in attracting personnel to remain in the service beyond the retirement eligibility point.

A. ECONOMIC INDIFFERENCE

If a person is rational, in an economic sense, he will be indifferent to the manner in which payments are made to him, so long as the present value of the benefit received is maintained at the desired level. The underlying assumption in the development of this alternative is that military personnel are rational and can be made indifferent to changes in their future pension benefits. By preserving an equality between the present value of income streams under the proposed alternative and the present value of income streams under the current system, such indifference can be achieved.

B. PRESENT VALUE

The concept of present value was discussed in Chapter I, but because an understanding of the concept is so critical to this presentation, it will be reviewed before proceeding further.

The application of present value analysis to an economic problem is no more than a recognition of the time value of money; it is a straightforward concept which contains no magic and is one which is encountered daily in all sectors of society. Simply stated, a sum of money received today is worth more than that same sum of money received at some future date. Stated another way, money has value directly

related to the timing of its receipt or disbursement, and this value is determined by the opportunity to earn a profit from a normal investment [Helfert 1977]. To illustrate, $1.00 invested today would, with an annual return of ten percent, be worth $1.61 after five years; at ten percent, a $1.00 return five years in the future would require only a 62 cent investment today.

Since neither Congress nor the Defense Department has demonstrated an interest in other than a reduction of annual costs, paying a retiree $1.00 today rather than $1.61 five years from now would satisfy their objective. Preserving the present value of that future payment would satisfy the objective of the economically rational retiree.

C. WHY INCOME REDISTRIBUTION?

1. Benefit to the Individual

Lester C. Thurow's theory on the optimal distribution of consumption expenditures, verified by statistical analysis, states that the actual income distribution over a lifetime does not satisfy the desired distribution of the recipient. The data presented by Thurow shows that prior to age forty-seven, and beyond age seventy, optimal income exceeds that actually received. In the intervening years, income exceeds the optimum. Thurow suggests that alternatives can be developed which adjust actual income patterns to the optimum levels suggested by the data [American Economic Review 1969]. The proposed retirement alternative can satisfy the objective of income redistribution.

The determination of the manner in which income should be redistributed is based upon the author's judgment of when, in the military career, the difference between actual and desired income is at its maximum. From

observation and personal experience, it is estimated that this difference is maximized at two points during a career. At approximately age thirty-three, the typical officer is faced with a need for a large sum of money with which to finance the purchase of a home. This money can be representative of the down payment upon the first home purchased or the large increment beyond current savings required to enter the housing market in the high cost areas such as Washington, D.C., Hawaii or California. The second period of maximum need, which occurs near age forty, is related to the additional income required to finance the higher education of his children.

Under this alternative, a portion of the money currently received as retirement income can be provided at those ages when the need is greatest. In return for the redistribution of what would have been a portion of a retirement pension to these pre-retirement points, the retirement annuity would be reduced a commensurate amount. However, a strict equality would be maintained between the present value of retirement income under the present system and the present value of the pre-retirement payments and reduced retirement annuity under the alternative.

2. Benefit to the Government

If, as previously discussed, the Congress and the Department of Defense have as their goal the reduction of the annual costs of military retirement, then the benefit to them under this alternative is the achievement of such a reduction in the immediate future.

D. PRINCIPAL CHANGES

1. Reduced Annuity

In consideration of the bonus payments described in the next section, the annuity payable for completion of twenty years of service will be reduced to thirty-five percent of the annuity base. The annuity base could be calculated from the average of the highest twelve month period, highest three years or from the basic pay on the final day of service. The calculations to be presented assume a continuation of the current practice of computing the annuity from the basic pay rates in effect on the last day of service. Regardless of which annuity base is selected, the redistribution alternative remains valid in its achievement of the stated goal of reducing the annual cost of military retirement.

2. Bonus Payments

The key factor in the redistribution of retirement income is the payment of bonuses in lieu of some portion of the future retirement annuity.

The first payment would be made during the eleventh year of service. For officers, the bonus would be payable only after selection for promotion to the rank of Lieutenant Commander; for enlisted, upon incurring a contractural obligation for cumulative service totaling sixteen years.

The second bonus would be payable during the sixteenth year of service. For officers, failure to be selected for promotion to Commander would require a reduction in the size of the second bonus to ensure that the total present value of the lifetime benefit would not exceed that currently paid. Similar criteria would be established for enlisted personnel. The years during which bonus payments would be made were selected arbitrarily by the author. The exact timing of these payments is not critical

to the proposal, although the timing does affect the amount payable under this alternative because of the time value of money. For illustrative purposes, payments were computed at these two career points.

Each bonus payment would be equal to one-half of the present value of the reduction in the retirement annuity: one-half of the difference between the value of the retirement annuity under the current system (fifty percent for twenty years of service) and its value under this alternative (thirty-five percent for twenty years). For example, if the present value of the annuity reduction were equal to $1,000, the first bonus payment would be equal to $500 while the second , assuming payment five years after the first, would be equal to $805. The second bonus has been increased at a ten percent rate to reflect the time value of money over the five year period between payments.

This scheme will be illustrated in subsequent sections of this chapter.

3. Incentives for Continued Service

In addition to the earlier stated recommendation that the basic pay schedule be adjusted to provide increases for each two years of service beyong twenty years, the benefit formula would be changed to provide an increment of three percent per year for each year beyond twenty years, to a maximum of sixty-five percent after thirty years.

4. Vesting

The alternatvie does not address the question of changes in the laws governing when a servicemen acquires a vested interest in the military retirement system. In a present value context, the cost of vesting for those leaving the service prior to attainment of retirement eligibility is insignificant because of the long term deferral of the payments.

5. Lump Sum Payments

In addition to the savings potential offered by the redistribution alternative, further savings could be realized by the institution of a lump sum payment program. The value of this payment would, as with the bonuses, equal the present value of the retirement annuity displaced. Three illustrative examples will be presented in subsequent sections of this chapter.

E. ASSUMPTIONS

In preparing this alternative, a number of assumptions were made to simplify the presentation of illustrations. There are, however, two assumptions whose validity is critical to the alternative: economic indifference and the rate of time preference.

1. Economic Indifference

Military personnel can be made economically indifferent to changes in their future pension benefits if the present value of future income streams under the proposed alternative equals the present value of future income streams under the current system.

2. Rate of Time Preference

The rate of time preference, the personal discount rate, for both officers and enlisted is ten percent. One could argue that the rate is higher for those whose current income does not equal desired levels, but the assumed rate is consistent with that used within the Department of Defense for present value analysis.

3. Inflation

The illustrations assume no inflation. This assumption is made only for ease in calculations and has no impact upon the validity of the concept under conditions in which inflation is present.

4. Ages and Ranks

a. Officers

Calculations are based upon an assumed age of thirty-three upon completion of ten years of service. The officer will achieve the rank of Commander (O-5) within twenty years of service. Failure to be selected for promotion to Commander will result in a reduction in the size of the second bonus, but the present value of the lifetime income stream for the rank achieved will be maintained when compared to the present system.

b. Enlisted

Calculations are based upon an assumed age of twenty-nine upon completion of ten years of service. The enlisted retiree will achieve the grade of Chief Petty Officer (E-7) within twenty years of service. Failure to be selected for promotion to Chief Petty Officer will result in the same type of reduction as that applied to officers. Those promoted to E-8 or E-9 prior to the receipt of the second bonus would have this payment enhanced to reflect the increased value of their retirement income stream.

5. Life Expectancy

The life expectancy of the retiree is based upon data reported in the Statistical Abstract of the Inited States: 1976 . Computations are based upon the life expectancy at the earliest retirement date.

6. Retiree Distribution

The calculations assume that 26.3 percent of the retirees are officers and 73.7 percent enlisted. The typical retiree is a Commander or a Chief Petty Officer with twenty years of service.

7. Retiree Population

The retiree population is assumed to number 1,300,000. (The estimated population for fiscal year 1978 is 1,221,000).

F. SAMPLE COMPUTATION

For this illustration, the sample serviceman is an officer, age 33 who has been selected for promotion to Lieutenant Commander. He will retire as a Commander upon completion of twenty years of service. He will be 43 years old at retirement, with a life expectancy of thirty years.

1. Current System

- Final base pay: $1,981.80.
- Annuity: fifty percent of final base pay, $11,892 per annum.
- Total lifetime payments: $11,892 x 30 years = $356,760.
- Present value of lifetime income stream at a ten percent discount rate, present value computed from age 33: (9.779 - 6.145) x 11,892 = $43,215.

2. Redistribution Alternative

- Final base pay: $1,981.80.

- Annuity: thirty-five percent of final base pay, $8,324 per annum.

- Annuity reduction: $3,567.60 below current system.

- Present value, of reduction, at age 33: (9.779 - 6.145) x 3,567.60 = $12,965.

- Two bonus payments to retain equality with the present value of retirement income under the current system. The first payment, totalling $6,482, would be made during the eleventh year of service; the second , $10,440, would be made during the sixteenth year. The total of these payments represents the amount of money which is required to maintain the strict equality between the old and new systems. The differences in the size of the payments reflects the time value of money for the five years between payments.

- Total lifetime payments: $6,482 + 10,440 + (8,324 x 30) = $266,642.

3. Savings

Total lifetime payments under the redistribution alternative will equal $266,642, compared to $356,760 under the current system. The redistribution alternative will save $90,118 in terms of actual cash expenditures from the Treasury. Under both systems, the present value of the income stream is the same: $43,215. The redistribution alternative is compared with the existing system in Figures 6, 7 and 8.

G. ESTIMATED SAVINGS

The income redistribution alternative could be phased in over a period of ten years. When fully implemented, it would provide annual savings of $2.4 billion. The estimate is based upon the assumed retiree population and distribution.

H. ADDITIONAL POTENTIAL SAVINGS

At the time of retirement, the government could offer the retiree lump sum options similar to the following:

- A single payment equal to the present value of the annuity payable over the retirement lifetime.
- A lump sum payment equal to a percentage of the present value of the annuity (e.g. 25 and 50 percent) plus a reduced annuity.

1. Sample Computations

For illustrative purposes, the retiree is assumed to be a forty-three year old Commander with twenty years of service. He is retiring under the income redistribution scheme and has already received two bonus payments.

Note : The present value computations are made from his current age to reflect the value of the net income stream on the date of his retirement.

a. Alternative 1

A lump sum payoff.

Present value of annuity at age 43: 9.427 x 8,324 = $78,470.

Potential savings: 249,720 - 78,470 = $171,250.

b. Alternative 2

Immediate payment of twenty-five percent of the

annuity, with a reduced annuity payment.

Present value of twenty-five percent of the annuity at age 43: 9.427 x 8,324 x 0.25 = $19,618.

Reduced annuity: 6,243 x 30 = $187,290.

Potential savings: 249,720 - 187,290 - 19,618 = $42,812.

c. Alternative 3

Immediate payment of fifty percent of the annuity, with a reduced annuity payment.

Present value of fifty percent of the annuity at age 43: 9.427 x 8,324 x 0.50 = $39,235.

Reduced annuity: 4,162 x 30 = $124,860.

Potential savings: 249,720 - 124,860 - 39,235 = $85,625.

I. THE ALTERNATIVES COMPARED

If , as has been assumed in this presentation, the goal of those who desire to alter the current retirement formula is to reduce the annual cost of military retirement, the income redistribution alternative will provide the desired results. If the goal of change is to reduce both the annual cost and the present value costs of the retirement system, income redistribution will not, as presented, provide a solution.

VII. THE PROSPECTS FOR CHANGE

As stated at the outset, it is apparent that the question is no longer "if" the current system will be changed, but rather "when" such changes will be legislated and what form such changes will take. However, one should not assume that the changes to be legislated will be enacted without significant controversy and resistance. Change is a traumatic experience under the best of circumstances and will always face resistance, most intensely from those who feel most threatened by the change.

Two factors will significantly influence the debate over the proposed alteration of the military retirement system. On the economic side of the argument is the concern that the rapidly rising cost of military retirement will have a pernicious impact upon the government. Representative Aspin and Senator Eagleton point toward an ever increasing burden upon the taxpayers and the specter of increased taxes or economic ruin, as was experienced by New York City. The Department of Defense expresses concern over the diversion of funds from programs which directly support the defense of the nation in order to support retirement needs. On the personnel side, there exists the possibility that , under an all-volunteer system of military service, significant reductions in the value of military retirement benefits may adversely influence the decisions of prospective employees. Unanswered at this time is one critical question: what price must be paid if the services are to attract and retain sufficient numbers of quality personnel?

In this chapter, these factors will be discussed as viewed from the Congress, the Pentagon and the Presidency.

A. THE CONGRESS

Members cf Congress are concerned not only with the cost and the cost trend of military retirement, but also with those of the Social Security system and the Civil Service retirement system. A Congressional staff member told the author that the mood of the Congress has changed over the past few years since the Retirement Modernization Act was first submitted. He suggested that the time may be at hand for serious Congressional action on the questicn of retirement costs. As evidence of the changed mood and heightened interest, he cited the 1976 Congressional action which eliminated the provisions in the varicus retirement laws which had permitted cost of living adjustments to exceed the actual increase by one percent. The "one percent kicker" had been designed to compensate annuitants fcr the delay between the rise in the cost of living and the receipt of the adjusted annuity. The staff member cautioned that Congressional action cculd be limited to a review of the military retirement system with an emphasis upcn an evaluation of the effectiveness and efficiency of the system in fulfilling its goals.

The changes prcposed are certain to produce conflict because the issue is of direct interest to millicns of voters. The two million active servicemen and the 1.2 million retirees, plus their dependents and the lobbyists who represent their interests will ensure that tremendous pressure is brought to bear upon key members of Congress. In an Air Force Times interview in 1975, Representative Samuel S. Stratton acknowledged that modernization of the non-disability retirement system is necessary, but stated that he is reluctant to come to grips with the prcblem. "I'm a little hesitant", he said, "... we will get a lct of flak on it as another reduction of benefits ...." These remarks were in anticipation of pressure, not the result of a lobbying effort by servicemen or special interest groups.

Active advocates of change or supporters of the status quo within the Congress are few and their positions are reported in detail only in service oriented publications. However, judging by the number of Congressmen who voted in favor of Representative Aspin's proposal to place the military under the less generous Congressional retirement formula, there is sentiment favoring some modification of the existing laws.

A factor which will influence the timing of Congressional action is the relative priority attached to proposed legislation for retirement modernization. Since President Carter has submitted, or will submit within the next year, proposed legislation on the problems of energy, government reorganization, tax reform and welfare reform, as well as the Panama Canal Treaties, all of which are extremely complex issues of greater social and economic importance to the nation, there appears little likelihood that proposals to reform the military retirement system, if submitted, will receive attention during the Ninety-Fifth Congress.

B. THE PENTAGON

It is the Department of Defense, more than any other critic, which supports change in the method for computing military retirement. Under pressure from both Congress and the President to retard the growth of military spending, they face the dilemma postulated by Senator Eagleton: the choice between guns or pensions. Previously cited was the statement of then Secretary of Defense Donald Rumsfeld that the cost of manpower must be slowed if there is to be an adequate level of resources available to support those programs which contribute to the development, procurement, operation and maintenance of the machinery of national defense.

While the Pentagon champions the Retirement Modernization Act, it appears that they will support any reasonable attempt to control the growth of manpower costs, particularly retirement costs. In a recent address to the students at the Naval Postgraduate School, Vice Admiral James D. Watkins, the Chief of Naval Personnel, spoke of the difficulties associated with the taking away or reduction of benefits already in existence. As an alternative, he suggested that schemes such as the recent practice of diverting twenty-five percent of a cost of living pay increase into the basic allowance for quarters could provide the desired effect upon the growth in retirement costs without causing an outcry from the servicemen affected. Another alternative which had been used successfully on occasion by Presidents Nixon and Ford is to recommend cost of living raises which are below the actual increase in the cost of living.

The amount of money available to the Department of Defense is, and will continue to be, finitely limited. Charged with the responsibility to provide for the active defense of the country, they will continue to support efforts to limit the amount of resources allocated to those who by reason of age are no longer active participants in the defense effort.

The Department of Defense could enhance the prospects for change if they would develop proposals which could satisfy the objectives of the Department, the President, Congress and the military retiree. Income redistribution is one alternative which can satisfy the objectives of all those who have an active interest in the subject of military retirement. Regardless of the form which a proposal to alter the military retirement system takes, a simple and straightforward alternative which avoids the conflict generated by earlier proposals, is sensitive to the desires of the retirees, and satisfies the goals of the Department and others to reduce retirement costs would attract early

action from the Congress. It is the Pentagon which controls the fate of retirement modernization: a solid proposal can be enacted without much debate , a resubmission of the Retirement Modernization Act in its current form will ensure continued delay and perhaps failure.

C. THE PRESIDENT

While addressing the subject of military retirees being employed by the federal government after retirement, President Carter clearly stated his concern about the cost of the military retirement system. He said:

> We need to make sure that we cut down on the future costs of the retirement system in the military. Quite often they are excessive and I don't think it is right for the taxpayers of our nation to have someone go into the Army or Navy at the age of 21, serve 20 years, retire at the age of 41, draw a substantial retirement and then get a full time job working with the federal government [Navy Times April, 11, 1977].

His concern over the rising cost of military retirement echoes the sentiments of his immediate predecessors. President Carter has appointed a Blue Ribbon Committee to study all aspects of the military compensation system and charged them to report their findings and recommendations to him by 15 March 1978. If the report is submitted to him on time, it is improbable that their review will have consisted of anything more than a cursory review of the existing system and the currently active recommendations for change. Under these circumstances, there will most certainly be additional studies commissioned by the Defense Department.

As with the Congress, the President must decide upon the relative priority of his legislative program. Proposals to change the military retirement system will face stiff opposition from special interest groups representing both

the retiree and active duty populations. With so many major problems demanding attention, he may choose to defer action on the question of military retirement modernization until much later in his term of office.

D. TIME FOR A CHANGE?

The President, the Defense Department and Congress view retirement modernization as an idea whose time has come. All are in agreement , yet no one can devise a formula upon which all can agree. The First Quadrennial Review of Military Compensation, the Interagency Committee, the DoD Retirement Study Group, the Retirement Modernization Act, the Defense Manpower Commission, the Third Quadrennial Review of Military Compensation, the Aspin proposals and now the Blue Ribbon Committee: military retirement may be the subject receiving the most attention and least action in Washington.

One reason for all of these studies is the conflict between those who desire to save money and those who must ensure that the services remain competitive in the labor marketplace. No proposal which has yet been made can guarantee satisfaction of both objectives. For all proposals, the bottom line always equals a reduction in the value of military retirement benefits for the future retiree.

It may be time for a change, but change might best be accomplished under a formula which both saves money and retains the value of the retirement benefit. Such a formula is made possible by a Congress which measures the cost of programs in terms of actual dollar expenditures rather than by measurement of the time value of the money expended.

VIII. CONCLUSIONS

A. SHOULD THE SYSTEM BE LESS GENEROUS?

To the question "should the military retirement system be less generous?", there is no easy answer. At this time there are too many factors which remain unquantified, too many doubts about the impact of such a change upon the services' ability to attract employees from the labor market. At the present time the services are experiencing difficulty in filling their recruiting goals. The number of men and women qualified to serve is declining and as the population stabilizes, the competition with the non-military sectors will become more intense.

Economically, the much touted "comparability" of military compensation with the private sector is not readily visible to potential employees, particularly those who have an opportunity for employment in the private sector. A recent article on the employment opportunities available to 1977 high school graduates reported that in one Ohio community, many non-vocationally trained graduates were finding employment with local companies at wages which range from $3.50 to $4.40 per hour, while those with a vocational background were being hired for positions paying in excess of $6.00 per hour. One new employee had expressed an interest in joining the military but decided against it because employment opportunities, at higher wages, were available in his community [Wall Street Journal August 16, 1977]. An annual wage of $8,000 commands a lot of attention

from an eighteen year old , especially if the alternative is a position in the military where an unmarried E-1 has a gross salary, exclusive of benefits, of less than $4,500.

B. WILL THE SYSTEM BE CHANGED?

The final question brings us back to the initial and underlying assumption of this thesis. The system will be changed; what remains to be decided is when such changes will be implemented and the form such changes will take.

Because the solution to the problem of military retirement costs will be the result of a political decision, there is little likelihood that the new order will be a radical departure from current practice. Neither Representative Aspin's proposal, which would save in excess of $100 billion by the year 2000, nor the redistribution alternative, with its $30 billion savings over the same period, are close enough to current practice to gain widespread support, although each warrants study. Politics is called "the art of compromise" and it is most likely that the final product will appear as the middle ground between opposing alternatives.

The more obvious inequities, such as enlisted personnel of the Navy and Marine Corps receiving retirement credit for early enlistments, will be eliminated and perhaps there will be a change to an annuity based upon the average of the final three years basic pay. However, after ten years of studies and special commissions, the "new" retirement system will most likely be only incrementally different from the old. When all the speeches have been made and all the words written, we will be able to conclude that the entire episode was "much ado about nothing."

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