A FRAMEWORK FOR RESTRUCTURING THE MILITARY RETIREMENT SYSTEM

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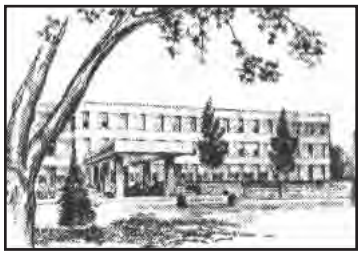

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Comments pertaining to this report are invited and should be forwarded to: Director, Strategic Studies Institute and the U.S. Army War College Press, U.S. Army War College, 47 Ashburn Drive, Carlisle, PA 17013-5010.

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FOREWORD

In an era of fiscal austerity, the current military retirement system has come under intense scrutiny. Military retirement costs continue to escalate, in part because retirees are living longer, and in part because the military must set aside accrual payments as the retirement system transitions to a fully-funded system. In response to these escalating costs, several pension reform proposals have emerged that yield significant cost savings.

The authors argue that many of these reform proposals focus too narrowly on cost containment and fail to consider how pension reforms could significantly lower the well-being of personnel and adversely affect retention. They develop a holistic framework for evaluating pension reform proposals that considers not only overall program cost, but also impacts on personnel inventory, service member well-being, and public perceptions. Using this framework, the authors evaluate: a set of reforms discussed by the Department of Defense Business Board; incremental changes to the existing pension system; and their own pension reform proposal.

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SUMMARY

For more than a century, the military has provided a defined benefit (DB) pension to service members who render 20 or more years of active-duty service. The U.S. civilian labor force has long since replaced DB pension programs with defined contribution pension programs where employers and employees contribute to a 401(k)-type account. The military, however, has continued to provide a DB pension plan worth in excess of a million dollars to veterans who retire as early as 38 years of age. With annual military retirement system outlays exceeding $50 billion, senior officials have begun calling for pension reform on the grounds that the current system is fiscally unsustainable.

In the fall of 2011, the Department of Defense Business Board (DBB) proposed several reforms to reduce military pension costs. These reforms include: establishing a 401(k)-type account with employer contributions, allowing service members to vest in this retirement account after 4 years of service; restructuring the DB portion so that individuals could not begin receiving benefits until they are 67 years of age; providing pension bonuses for deployments; and, substantial transition pays. While these reforms report significant potential cost savings of $3.65 billion (2034 dollars), service members would lose 39 percent of the value of the existing pension program.

Simply adopting best practice from the civilian sector, however, is somewhat naïve. The unique structure of the current military manpower model, which has at its basis the All Volunteer Force (AVF), demands a correspondingly unique pension plan. Military service places significant demands on its service members. Motivating individuals to volunteer for a

career of selfless service, personal sacrifice, hardship, frequent household relocations, and inherent danger requires a compensation program commensurate with the demands. Since the inception of the AVF in 1973, the military's pension plan has been instrumental in meeting military manpower requirements across the ranks. Any future pension reform must consider the second and third order impacts to military manpower, or more specifically, *personnel inventory, service member well-being, public perception, and overall program cost.*

We begin by providing a framework that addresses these four considerations as a benchmark for all future pension reform. We adopt some of the ideas presented by the DBB study, but tailor them to the framework to ensure that the military maintains its personnel inventory, promotes service member well-being, increases public perception of the military pension, and reduces overall program costs.

Our proposal is called the 10-15-55 plan. Service members and the military contribute to a 401(k) account as soon as they enter service. At any point, a service member may leave the military with his or her contributions to the 401(k). At 10 years of service, the service member controls 50 percent of what the military contributed to the 401(k). That percentage increases by 10 percentage points each year for 5 years until the service member reaches 15 years of service, at which time the service member controls 100 percent of employer contributions. In addition to the 401(k) account, service members who continue to 20 years of service also receive the DB pension plan as it currently exists, with the exception that they may not receive payments until they turn 55 years of age. While all current service members would be grandfathered under the existing pension system, new entrants would

be covered by the 10-15-55 proposal. The 10-15-55 proposal would likely be more desirable to new entrants than the existing pension plan because of the uncertainty that most new recruits face about serving a full 20-year career. When evaluated against the pension framework provided in this monograph, the 10-15-55 pension proposal has many attractive features.

A FRAMEWORK FOR RESTRUCTURING THE MILITARY RETIREMENT SYSTEM

ABSTRACT

The current military retirement system has been integral to sustaining the All Volunteer Force (AVF). Mounting federal budget challenges, however, have raised concern that the program may become fiscally unsustainable. While several restructuring proposals have emerged, none have considered the implications of these changes to the broader issue of manning an AVF. Changes to the existing system could create military personnel shortfalls, adversely affect service member and retiree well-being, and reduce public confidence in the Armed Forces. With the right analytical framework in place, however, a more holistic restructuring of the system is possible, one that avoids these negative effects while significantly reducing costs. This monograph provides both a comprehensive framework and a proposal that stand to benefit both service members in terms of value and the military in terms of overall cost savings.

INTRODUCTION

For the past 40 years, the military retirement system has been integral to sustaining the AVF. Due to mounting federal budget challenges, however, the costs of the system are increasingly viewed as unsustainable.[1] While several restructuring proposals have emerged, some are so focused upon near-term savings that they overlook longer-term costs. Potentially, these proposals could create military personnel shortfalls, adversely affect service member and retiree well-being, and reduce public confidence in the Armed

Forces. With the right analytical framework in place, however, a more holistic restructuring of the system is possible, one that avoids these negative effects while significantly reducing costs.

The U.S. military has offered vested defined benefit (DB) pensions to eligible service members since the end of the Civil War.[2] The current pension program is rooted in the Federal Employees Retirement Act of 1920, which, by the late-1950s, also served as a model for many private sector pension plans.[3] DB pension plans were designed to provide long-term retirement income to an employee, encourage tenure, and compensate for lower short-term wages. By the 1970s, however, changes in the tax code caused alternative retirement programs to emerge.[4] These incentivized employees to make contributions to tax-advantaged retirement vehicles of their own choosing, such as individual retirement accounts (IRAs) and 401(k) plans. On the one hand, this benefitted firms by shifting a significant share of retirement planning and costs to employees. On the other hand, it increased employee mobility ("I can take my retirement portfolio with me"), increasing corporate talent leakage costs.

To recoup some of these costs, private firms responded by placing greater emphasis upon mid-career and senior executive recruiting (increased lateral entry or "talent poaching"). As a result of these labor market changes, private sector pension plans no longer mirror those of the defense establishment. Instead, they acknowledge and even reinforce the trend toward greater employee mobility. For example, today's corporations typically provide a range of 401(k) matching contributions, from Walmart's 6 percent of salary to Lockheed Martin's 10 percent. They often provide stock purchase options as well, with minimal vesting periods of as little as 3 years.

Despite the evolution in private sector retirement programs, the military has made only minor adjustments to its pension plan in the form of benefit calculation factors, vesting requirements, and annual growth rates.[5] It continues to bear full responsibility for service member retirement planning, and for good reason. The military profession entails significant risk to life and limb for its practioners, who manage the legal application of lethal force. Consequently, it demands a workforce ethic that takes years to produce, which in turn requires higher personnel retention to achieve. This precludes large-scale lateral entry, demanding instead a stable and tenured workforce that moves smoothly through the talent pipeline across a career of service.[6]

Calls to revamp the military retirement system have increased under the country's current fiscal situation. In the fall of 2011, the Defense Business Board (DBB) provided several recommendations based on best practices in the private sector that offer significant cost savings to the military's retirement system.[7] While the study helped raise the public debate over military retirements, it did not consider the implications of these changes to the broader requirements of manning the AVF. This monograph leverages many of the ideas from the DBB's recommendations, but places them in a framework that considers a more expansive perspective of military manpower.[8]

RESTRUCTURING MILITARY RETIREMENT— A FRAMEWORK FOR FUTURE PENSION PLANS

Given the fundamental differences between uniformed and civilian workforces described above, care must be exercised in any military retirement restructuring, or unintended consequences could result. In

particular, benchmarking too directly from civilian retirement system practices should be avoided. An approach tailored specifically to the unique requirements of the military labor market must guard against negative impacts in four areas: *personnel inventory, service member well-being, public perception*, and *cost*.[9] These four items serve as a framework from which to benchmark current and all future pension proposals.

Personnel Inventory.

Today's retirement system (no vesting until the 20-year mark) provides predictable separation rates across careers spanning up to 30 years of service. This makes it possible to manage manpower to meet force structure requirements. Figure 1 shows the pattern of enlisted and officer separations over a 5-year period. While most attrition occurs after the initial term of service, nearly 70 percent of personnel who serve past 10 years end up reaching retirement eligibility. The sharp spike in separations as soon as individuals are retirement eligible suggests that providing earlier retirement benefits will undoubtedly affect continuation behavior.

In addition to the differences in attrition trends that exist between officers and enlisted personnel as seen in Figure 1, there are important differences in the promotion systems. For example, while the Army promotes enlisted personnel to requirements, officers follow a standardized promotion timeline, which leads to the inventory excesses and shortages seen in Figure 2.

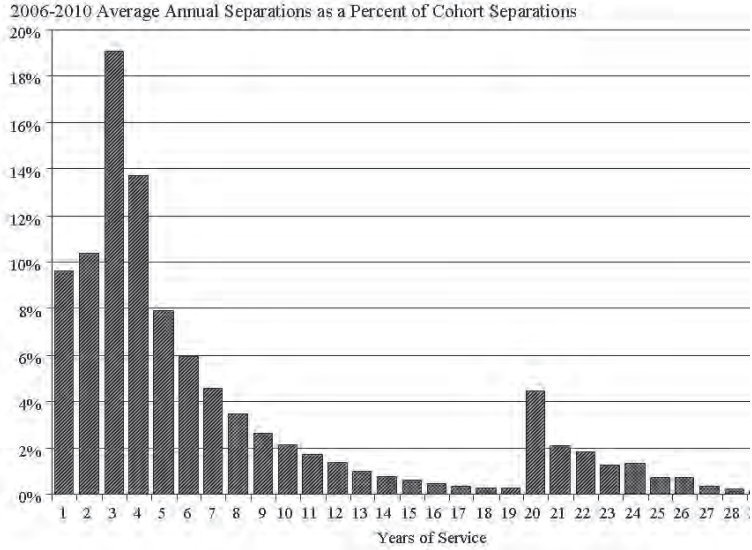

Figure 1A. Enlisted Average Annual Separations as a Percent of Enlisted Personnel Leaving Active-Duty Service During the Past 5 Years.

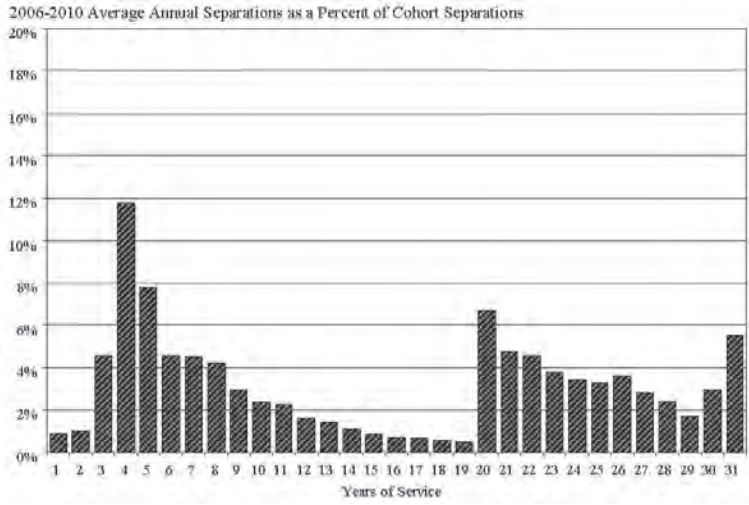

Figure 1B. Officer Average Annual Separations as a Percent of Officers Leaving Active-Duty Service During the Past 5 Years.

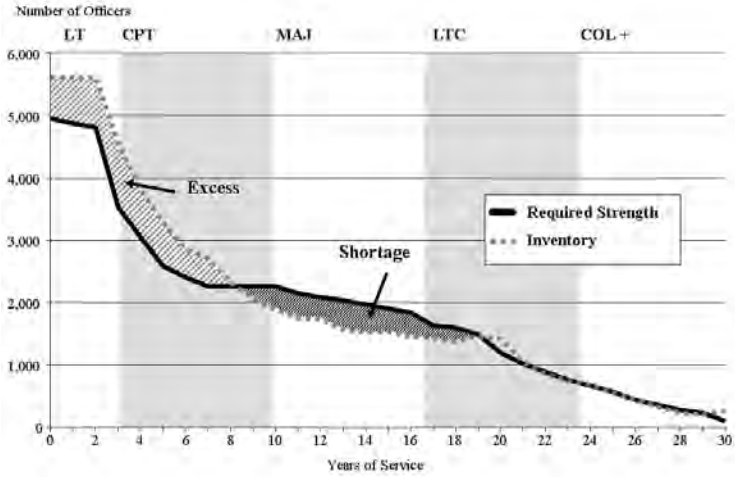

Figure 2. Officer Inventory Excess and Shortage.

Beyond sheer numbers, the structure of a retirement program also affects retention of high performing service members. This is because reducing the differential between military and corporate benefits changes the opportunity cost of military service for high performers, who generally have the highest earnings potential outside of the military. As the difference between benefits decreases, these service members are most likely to separate, reducing Department of Defense (DoD) performance and productivity. The current cliff-vested military retirement pension may encourage the military to retain service members who are not sufficiently productive simply so that they may receive a retirement benefit.[10] Conversely, portable retirement benefits can negatively affect retention rates, but they also provide invaluable culling flexibility. As a general rule, pension programs should not be the military's sole retention tool, but neither should they engender increased retention risk.

Service Member Well-Being.

Any reduction to pension benefits must be considered within the larger context of total compensation. Providing guaranteed retirement benefits affords the military the ability to set current wages lower than comparable civilian wages. In effect, the nation must decide how much it wants to compensate its military personnel for a full career of service, dividing that amount between current wages and retirement benefits. Any reduction of military pensions effectively reduces overall compensation and must be considered in that context.

The current military pension plan greatly reduces economic risk to service members in several ways. First, it limits exposure to market volatility. Consider, for example, the way stock market downturns can diminish the value of retirement accounts invested in equities. Second, it addresses the tendency for individuals to overconsume in the present at the risk of undersaving for the future. Third, by providing a monthly retirement benefit for life, it ensures against the risk that an individual will live long enough to deplete all retirement savings. Finally, it mitigates the long-term deleterious effects of military service. Consider those veterans who, in service to their country, have experienced physical and emotional traumas that may reduce their later wage earnings and savings potential. While many of these traumas may not meet the threshold for service-connected disability compensation, they nonetheless degrade a veteran's quality of life. By providing a level of automatic savings or benefits, the current retirement system fulfills its centerpiece intent. It provides a guaranteed

retirement income to veterans. In sum, mitigating economic risk is an important feature to any military pension program.

Public Perceptions.

As described earlier, growing concern over soaring national debt has placed considerable budgetary pressure on the DoD. Concerns over national security, unemployment, and election campaigns will likely limit the military's ability to realize savings through significant cuts in the number of military personnel. Instead, the DoD will have to find other budget economies, to include *all* personnel benefits (retirement or otherwise). Public perception will shape the approach taken for several reasons. First, less than 1 percent of Americans serve in the military, which increases national appreciation for those who serve in uniform.[11] Second, the military has just endured more than a decade of persistent conflict with over 57,000 casualties.[12] Third (as previously discussed), military service can increase financial and emotional stress for service members and their families. These facts are not lost on the public, Congress, and the media, all of whom are unlikely to countenance any benefit reductions aimed at service members or veterans.

Any restructuring of the military pension system can potentially affect service member morale and retention. In fact, without a grandfathering provision, it is hard to conceive of a plan that does not create significant negative perceptions. The notion of transparency is also critical. Yet some pension restructuring proposals attempt to obfuscate deep cuts with special pays such as combat and lump sum amounts to ease transition from the military. This is both disingenuous and counterproductive. Compensation

must be tied to its intended purpose. Wages should be paid for current production, hostile fire pay should be tied to deployments, and pensions should be aligned with retirement programs. Efforts to combine these in complicated compensation schemes make it difficult for service members to understand and evaluate their value. Such an approach increases skepticism and breeds mistrust.

Another issue with perception implications is the length of service required for retirement benefit eligibility. The notion of offering a "portable" retirement benefit to service members who serve 10 years or more, but are uncertain whether they wish to serve a full 20-year career, may improve perceptions of military service. This portability is commensurate with most corporate retirement programs and would afford service members comparable benefits, should they leave the military between 10 and 20 years of service. It is safe to assume that at initial service entry, most military members do not know how many years they will serve and therefore would be willing to pay a premium for a portable retirement component. Additionally, offering new personnel the option to choose the current DB plan or a hybrid plan (portable individual retirement account plus reduced DB pension) would likely reduce traditional pension plan participation without adversely affecting perceptions.

Costs.

Any restructuring of the current pension plan must provide significant cost savings. The key is to find the margins that offer such savings without negatively affecting personnel inventories, individual well-being, or public perceptions. The first area to consider

is the age at which service members become benefit eligible. Current eligibility is at retirement (as early as 38 years of age). Increasing the age at which retirees become benefit eligible offers significant cost savings with minimal negative impact. For example, keeping retirement benefits at current levels while increasing eligibility age by just 1 year saves $551 million (in 2034 dollars) per retirement cohort.[13] Other areas to consider are: the pension benefits multiplier, which is currently 2.5 percent times years of service; adjustments to retirement cost of living adjustments (COLA); the growth rate of base pay; implementing a "High-5" instead of "High-3" formula for retirement benefits; and, the medical benefits component.[14]

Assuming that there is a grandfathering provision to any pension restructuring, the primary source of short-run savings will be lower accrual costs. The military currently pays slightly more than $0.34 into the pension fund for every dollar it pays in wages, based upon the estimated cost of retirement for current members of the military.[15] If estimated retirement costs are reduced beginning with this year's new recruits, the amount paid into the retirement accrual accounts will be reduced almost immediately, even if those service members will not draw retirement benefits for 20 years or more. Since this is a DoD program, a majority of the current costs are borne by the Army, the most manpower intensive branch, which will therefore enjoy commensurately larger savings. As years pass and a larger share of the force requires the lower accrual amount, the military will realize increased retirement savings as entrants under the new program matriculate through their careers.

As we have argued above, the unique nature of military manpower suggests that these four areas,

personnel inventory, servicemember well-being public perception, and *cost* provide a reasonable framework from which all future pension proposals should be evaluated.

A RETIREMENT PROPOSAL— THE "10-15-55" PLAN

Restructuring retirement benefits to reduce costs without diluting their positive effects upon the military and its people must be informed by the framework areas discussed previously. In accordance with that framework, we propose a plan with the following features.

First, there is a 401(k) account established upon entry. With the service member's first military paycheck, the military automatically contributes 5 percent of base pay and will contribute up to an additional 5 percent of pay, dollar for dollar, matched to employee contributions.[16] Service member contributions to the 401(k) account are always controlled by the service member. Second, there is partial 401(k) vesting at 10 years of service (YOS). The service member controls 50 percent of military contributions and 100 percent of personal contributions in a portable 401(k) plan. Between 11 and 15 YOS, vesting in employer 401(k) contributions increases 10 percentage points per year, to 100 percent at 15 years. This means that the service member will control 100 percent of both military and personal contributions in a 401(k) account at 15 YOS. Third, the DB plan vests at 20 YOS. At this point, service members will control 100 percent of the 401(K) and are also eligible to receive a DB pension of 50 percent of High-3 pay when they reach the pension receipt age. However, DB pension payments and full

medical health insurance coverage will not begin until age 55. Between retirement and age 55, military health care coverage is available only as a second provider. Retirees may begin drawing from their 401(k) at 59.5 years of age. Note, military health care coverage as a second provider both compensates for the portability component and motivates gainful employment from the point of retirement through 55 years of age. This restructuring would *not* apply to current service members or retirees and would be implemented at initial entry for new service members at some future point. Figure 3 provides a timeline of key features of the 10-15-15 proposal.

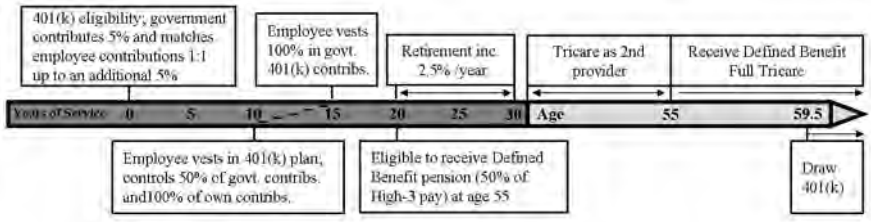

Figure 3. The "10-15-55" Proposal.

BENCHMARKING AGAINST THE PENSION FRAMEWORK

We have made the case that the unique nature of military manpower requires a pension framework that addresses four key areas: *personnel inventory, servicemember well-being, public perception,* and *cost.* The rest of this monograph evaluates how the 10-15-55 proposal holds up against the pension framework provided in this monograph, particularly as it relates to the current pension plan and the DBB proposals.

Since the DBB pension study did not advocate a particular pension plan, we compiled many of their recommendations into a single proposal as a basis for comparison. As a first step toward understanding the differences in these proposals, Table 1 contains present value comparisons and cost savings of the current pension with the DBB proposal and the 10-15-55 proposal for both officers and personnel who retire at 20 years of service (YOS).[17]

	Officer with 20 Years of Service (YOS): Retires at Rank of LTC*			Enlisted with 20 YOS; Retires at Rank of SFC*		
Retirement Benefits	**Current**	**Defense Business Board (DBB)**	**10-15-55**	**Current**	**DBB**	**10-15-55**
Age of Receipt of Benefit	Retirement	67	55	Retirement	67	55
Net Present Value (NPV) Benefit (DB) Pension at Retirement	$1,750,095	$287,103	$909,135	$962,462	$130,591	$411,217
NPV of Employer-Provided Thrift Savings Plan (TSP) Contributions		$514,452	$428,710		$273,650	$228,041
NPV of Employee TSP Contributions			$214,355**			$114,021**
Transition Pay at Retirement		$317,756	$95,327		$167,568	$50,270
Total NPV of Employer-Provided Retirement Benefits	$1,750,095	$1,119,311	$1,433,172	$962,462	$571,809	$689,528
Percent of Current Pension	100%	64%	82%	100%	59%	72%
Aggregate Cost Savings for 2033 Retirement Cohort		$1.62 Billion	$1.15 Billion		$2.03 Billion	$2.71 Billion

*Note: LTC-Lieutenant Colonel (Paygrade O5); SFC-Sergeant First Class (Paygrade E7); YOS-Years of Service

1. Current retirement system: 50% of High-3 pay: vest at 20 YOS; eligible for pension receipt at retirement

2. Defense Business Board proposal: 40% of High-5 pay at age 67; 12% of base pay employer TSP contribution; one month transition pay for each YOS; full vesting in TSP and transition pay at 4 YOS

3. 10-15-55 Proposal: 50% of High-3 pay at age 55; 5% of base pay employer TSP contribution with 1:1 match on employee contributuions (up to 5% of base pay); 50% vesting in employer TSP contributions at 10 YOS, increasing linearly to 100% vesting at 15 YOS; transition pay equal to highest 6 months pay at 20+ YOS

**Not included in retirement benefit value calculations.

Table 1. Comparison of Current Pension with Restructuring Proposals.[18]

Several key issues explain the differences between the three pension plans. Both the DBB and 10-15-55 proposals delay the receipt of pension benefits, thus reducing the present value of the military pension. The DBB proposal delays receipt until age 67, a value reduction of roughly 85 percent. It also changes the benefits formula by using a High-5 rather than High-3 pay computation (reducing the value of the pension by roughly 5.5 percent) and lowers the benefits multiplier from 2.5 percent of base pay per year of service to 2 percent (reducing the value of the pension by slightly more than 20 percent). By comparison, the 10-15-55 proposal delays receipt of pension benefits only until age 55 and leaves the pension benefits formula unchanged. To compensate for the reduction in the present value of the traditional military pension, both proposals provide 401(k)-style retirement accounts.

The DBB proposal assumes an annual contribution of 12 percent of base pay, with the service member fully vesting in the account at 4 years of service. The 10-15-55 proposal, however, is similar to the 401(k) plan offered to Federal Government employees in the Federal Employees Retirement System (FERS): it incorporates a mandatory employer contribution of 5 percent of base pay and provides a further incentive to employees by matching their contributions at a 100 percent rate up to an additional employer contribution of 5 percent. The 10-15-55 proposal assumes that personnel will maximize the employer match, for a total employer contribution of 10 percent of base pay. It does not vest service members until 10 years of service, and then only at a 50 percent rate. Under 10-15-55, full vesting of the 401(k) component does not occur until 15 years of service.

Finally, both proposals include a severance (transition) pay component. The DBB proposal provides

transition pay equal to the highest month's salary multiplied by years of service. For this analysis, service members are assumed to vest in this benefit at 4 years of service. For an O5 retiring with 20 years of service in 2034, the value of the transition payment is almost 18 percent of the current retirement benefit. In essence, the severance pay provides a lump sum payment at separation, and these funds are immediately available. The 10-15-55 proposal provides more modest transition pay equaling 6 months of pay for service members who serve 20 or more years.

Since both pension reform proposals reduce the value of the current military pension and supplement it with portable 401(k) retirement accounts, the present value of all benefits provided under the restructuring proposals must be compared to the present value of the current pension system. The DBB proposal reduces the value of retirement benefits received by 36-40 percent, largely by delaying receipt of pension benefits to age 67. In contrast, the 10-15-55 proposal reduces the value of retirement benefits by just 18 to 28 percent.[19] In the aggregate, the DBB proposal generates cohort cost savings of approximately $3.65 billion (2034 dollars) compared to the $3.84 billion (2034 dollars) of cohort cost savings under the 10-15-55 proposal.[20] Because the DBB proposal provides generous transition pay and portable retirement benefits to all service members who serve 4 or more years, the cost savings from the reduced pension provided to career service members are nullified. This structure promotes equity but actually raises aggregate costs of the future retirement benefit.

Looking beyond aggregate cost savings, the DBB and 10-15-55 pension reform proposals create mark-

edly different outcomes across the four pillars of the pension framework outlined in this monograph.

Personnel Inventory.

A portable retirement benefit, common to both pension reform proposals, can provide valuable flexibility to the military in managing its personnel inventory. Under the current retirement system, personnel with significant time in service whose talents are not needed are nonetheless retained so that they can continue to the 20-year mark and receive retirement benefits. By providing a portable retirement benefit for those with 10 or more years of service, both proposals allow the military to cull unneeded talent, while providing a portable retirement benefit on par with 401(k) accounts offered in the private sector.

DBB Proposal. First, the DBB proposal does not contain a grandfathering provision. If placed into effect as written, it would have an immediate and negative effect upon the military's personnel inventory. Second, the DBB proposal provides payments to *all* separating personnel with 4 or more years of service. Coupled with generous transition pay, this will engender talent flight from the military, positioning it as a stepping stone to other professions. While this could increase the attractiveness of first-term military service, any benefit would be more than offset by lowered longer-term retention. Consider that under the DBB proposal, an officer with 8 years of service faces the choice of serving an additional 12 years to qualify for a pension worth less than *one-sixth* of the current military pension at retirement, or leaving with a 401(k) that is significantly larger than the average comparable 401(k) account in the civilian sector.[21] In

addition, the transition payment to enlisted ($44,350) and officers ($84,770) leaving the Army at the 10-year mark would be nearly an entire year's pay. By reducing deferred compensation and providing significant separation compensation, the DBB proposal will substantially reduce retention rates for personnel with 5-10 years of service and encourage the flight of high-potential talent.

10-15-55 Proposal. In contrast, the 10-15-55 plan does not provide benefits until service members have served for at least 10 years, so it is attractive to individuals who are considering a career of service. The portable nature of the 401(k) component will also appeal to new entrants, while the modest delay in the DB component will likely have a neutral effect on accessions. By requiring 10 years of service to partially vest in the portable retirement benefit, the 10-15-55 plan should improve retention rates to 10 years of service. Each year the initial vesting time is reduced (from 10 to 9 or 8 years of service) reduces both cost savings and retention benefit. The incremental increase in vesting to 100 percent at 15 years of service further mitigates mid-career retention risk. Those who choose to depart military service at mid-career will have a 401(k) plan comparable to that of the civilian sector yet not excessive as in the DBB plan. There is also no transition pay offered in the 10-15-55 plan until 20 years of service. In sum, talent flight is much less of an issue in this proposal because there are still generous DB components encouraging service through 20 years.

Service Member Well-Being.

To generate cost savings, both proposals introduce reforms to the current military pension that lower its present value to those choosing military service as a career. To partially offset reductions in the value of the military pension, both proposals also provide a portable retirement savings account, similar to 401(k) plans owned by nearly 50 million civilian workers.[22] These retirement accounts represent a replacement of 25 to 30 percent of the value of the current military pension. Replacing DB pension dollars with defined contribution 401(k) dollars is far from a neutral trade, however. As discussed earlier, these plans shift several types of risk onto the service member: investment risk from market volatility, employment risk from inability to stay gainfully employed with aging, longevity risk from outliving retirement savings, and time inconsistent behavior that drives individuals to consume more now with lower regard for the future. The two plans approach these risks differently.

DBB Proposal. Viewing the pension component in isolation, the DBB proposal reduces the present value of the pension for those serving to 20 years by nearly 85 percent. Additionally, individuals under the DBB plan have slightly less than half of their retirement benefit in the riskier defined contribution component.[23] Lastly, in terms of personal value, the DBB plan reduces an individual's total retirement benefit by 35 to 40 percent.

10-15-55 Proposal. For those serving to 20 years, the 10-15-55 proposal reduces the value of the traditional pension by approximately 50 percent. It also has slightly less than one-third of the retirement benefit in the riskier defined contribution component. Lastly,

the 10-15-55 plan only reduces individual total retirement benefits by 18 to 28 percent.

Perception.

Any change to the existing plan must be handled carefully, so strategic communications for both internal and external audiences are critical to unveiling a new pension plan. See Appendix 2 for an example of strategic communications that use our 10-15-55 proposal as an example. One potential approach is to allow incoming service members to decide whether they want to enter into the existing pension system or a new one that offers some form of portable pension component that they can obtain without serving 20 years.

DBB Proposal. The DBB proposal is likely to be negatively perceived by most stakeholders, particularly service members and the public. Contemplating an immediate transition to a new retirement system—particularly for those with substantial time in service—is a breach of the implicit social contract between the Nation and its service members. The DBB proposal radically modifies every facet of military retirement, from retirement eligibility age to the pension benefit multiplier, making it more difficult to explain or understand. Reducing the value of the pension and including transition pay for service members with 4 or more years of service illustrates this complexity. It is unclear why payment that is received immediately upon separating from the military, even *before* pension eligibility, belongs in a military retirement policy. This confounding mix could cause key stakeholders, particularly service members, to reject the proposal outright. If they do not understand the personal financial

risks inherent in the proposal, they may fail to plan adequately for their own financial future, deepening service member pessimism and alienation.

10-15-55 Proposal. The 10-15-55 proposal represents evolutionary rather than radical reform. Other than pension eligibility age (shifted to age 55), all elements of the existing pension are preserved. Because it maintains benefits for current military personnel and retirees while leaving the retirement system largely intact for new entrants, the proposal conforms to the existing social contract with the Nation's service members. The 10-15-55 plan is also transparent and understandable, in large part because of its close relationship to the current retirement system.

Cost.

Both proposals achieve savings in pension costs by reducing the value of retirement benefits for personnel who serve 20 or more years. The primary differences in cost savings between the two proposals are the result of the age difference (67 versus 55) at which retirees receive pension benefits and the years of service at which service members vest for retirement accounts and are eligible to receive transition pay.[24]

DBB Proposal. The DBB proposal lowers the value of retirement benefits by nearly 40 percent. In the aggregate, the DBB proposal yields cohort retirement savings of approximately $3.65 billion in 2034 dollars.[25]

10-15-55 Proposal. The 10-15-55 proposal lowers the value of retirement benefits by approximately 25 percent. Against smaller reductions in pension value at retirement, the 10-15-55 proposal yields cohort retirement savings of $3.84 billion, also in 2034 dollars.

Cost savings in the short run will result from the military's ability to lower the accrual amount that it contributes to the pension fund. The short-run savings will be partly offset by the 401(k) contributions. Although we are unable to provide an accurate accrual estimate for both the DBB and 10-15-55 proposals, the accrual rate will be significantly lower for the DBB program. Both the substantial transition pay and 401(k) contributions, however, will entail significant short-run costs for the DBB proposal. In contrast, the 10-15-55 proposal has lower 401(k) contributions, and there is no transition pay until new program entrants "matriculate" at 20 years of service. In both proposals, long-run accrual savings will rise as the number of new program participants comprises an increasing share of active service members.

Any cost savings effort necessarily entails changes to the existing pension program. We have highlighted how the differences between the DBB proposals and the 10-15-55 proposal fit within the pension framework outlined in this monograph to a lesser or greater extent. However, both proposals target the same basic levers. Although we believe the 10-15-55 proposal brings the potential pension policy levers in line with the pension framework, there may be interest in adjusting it along relevant margins. Accordingly, we provide sensitivity analysis to the existing pension plan so that policymakers can see the cost savings with minor adjustments to each of the potential pension policy mechanisms:

1. Delaying receipt of pension benefits by one additional year saves 3.77 percent. Therefore, adjusting the pension benefit eligibility age from 55 to 67 (12 years) represents a cost savings of nearly 45 pecent versus the current program.

2. Reducing the pension benefit multiplier from 2.5 percent times years of service to 2 percent times years of service (for all pension benefit calculations) saves 20.4 percent.

3. Permanently lowering the annual increase in military pay by 1 percentage point saves 16.1 percent.

4. Reducing the COLA downward by 0.25 percentage points saves 3.5 percent.

5. Shifting from a High-3 to High-5 pay calculation yields a cost savings of 5.2 percent.

The discount rate—the Federal Government's cost of raising funds—also impacts cost savings from any pension reform. Savings are particularly sensitive to the discount rate, since pension reforms that reduce the value of the traditional DB component reduce future outlays, whereas government contributions to individual retirement accounts generate current outlays. The higher the discount rate, the lower the present value of reduced future pension outlays.

1. A 1 percentage point reduction in the discount rate increases cohort cost savings arising from the 10-15-55 proposal by more than 3.8 percent.

Pension reforms that introduce defined contribution plans with individual retirement accounts expose service members to asset market risk; the value of one's retirement account depends on market returns for the investments selected.

2. A permanent 1 percentage point decline in asset returns lowers the value of the employer's contributions to the TSP retirement account by roughly 8.25 percent for service members who take full advantage of the 100 percent employer match rate over a 20-year service career under the 10-15-55 plan.

Table 2 contains a summary of pension proposals evaluated against the pension framework.

Criteria	Current Military Pension Program	Defense Business Board (DBB) plans (combines all DBB proposals)	10-15-55 Plan (Defined Benefit [DB] at age 55 for 20 years of service, 401[k] with 5% match)
Inventory: Accessions	Attractive only to career minded candidates	Attractive to individuals using Army as stepping stone	Attractive to mid-career and career minded individuals
Inventory: Retention	Known effects	Unknown effects in critical areas	Predictable effects
Inventory: Quality	High opportunity cost for exiting helps attract and retain highest quality personnel	Reduced pension value and portable 401(k) allow high-potential personnel to exit	Tiered vesting in portable 401(k) increases opportunity cost of exit at critical retention points, retaining higher quality personnel
Well-being: Total Compensation	Provides significant compensation for full military career; no compensation for partial career	Provides modest compensation for full military career and generous compensation for partial career	Provides comparable compensation with current plan for full military career and modest compensation for partial career
Well-being: Economic Risk	Full protection from economic risk; insured against employment risk; protection from time inconsistent behavior	No protection from economic risk; retiree bears all employment risk until age 60; little protection from time inconsistent behavior	Partial protection from economic risk; retiree bears employment risk to age 55; basic protection from time inconsistent behavior
Well-being: Value	Highest value (100% of current plan)	Lowest value (60-65% of current plan); value decline difficult to overcome with individual savings	Competitive with the top public and private retirement plans
Perceptions: Public	Continued commitment to veterans	Military service valued equivalent to private sector employment; does not value conditions unique to military career	Military service valued at levels comparable to public and private professions with similar risk and hardship profiles
Perceptions: Military Transparency	Easy to understand benefits and plan for retirement	Complex; multiple changes to existing pension	Moderate; only alteration to existing pension is age at benefits receipt
Perceptions: Length of Service	No benefit until 20 years of service	Benefits received after 4+ years of service; pension eligibility at 20 years of service (receipt delayed to age 67)	Partial benefits received at 10 years of service; pension eligibility at 20 years of service (receipt delayed to age 55)
Savings: Potency	None	Large impact with significant effect on personnel inventory, individual well-being, and perceptions	Modest impact with marginal effects on personnel inventory, individual well-being, and perceptions
Short-Run Cost Savings	No change	Large reduction in accrual costs	Modestly lower accrual costs
Long-Run Cost Savings	No change	Large	Modest

Table 2. Evaluation of Proposals by Criteria.

CONCLUSIONS

Fiscal austerity may have created the need to consider alternative pension proposals, but if done correctly, it may end up being a blessing in disguise. Crafting pension reform in line with the pension framework provided in this monograph stands to provide greater flexibility in how the military manages its manpower. Adding a portability component stands to reduce accessions costs and allows the Army to remove low performing talent earlier than the current system, which tends to hold service members through 20 years of service, despite their performance levels. While the DBB proposals have been invaluable for providing a straw man to get the discussion going, they did not fully consider the unique aspects of the military's labor construct. Collectively, the pension reforms advanced by DBB entail very high personnel inventory risk, drastically reduce service member well-being, and create substantial perception issues. In contrast, the 10-15-55 proposal improves personnel inventory predictability and quality, provides a sufficiently transparent and robust benefit to engender service member well-being, and is far more likely to be perceived by all stakeholders as consistent with both individual and military requirements.

If the military wants to get pension costs under control, it must consider making reforms. Such reforms must be made within the context of the broader military manpower paradigm. This monograph provides a reasonable framework for consideration. The 10-15-55 proposal is just one example of how policymakers should go about meeting the tenets of the pension framework provided in this monograph. There may be others worth considering, but each should be carefully benchmarked against our proposed framework.

ENDNOTES

1. Office of the Actuary, *Statistical Report on the Military Retirement System: Fiscal Year 2011*, Washington, DC: Department of Defense, May 2012. Fiscal Year (FY) 2011 military retirement outlays were roughly $50.6 billion and include retirement benefits paid to nondisabled active duty and reservist retirees, temporary and permanent disability payments to retirees, and survivors' benefits. Annual military retirement system costs quoted in the media frequently report on inflows into the Military Retirement Fund. For FY 2011, inflows totaled $107.4 billion, including: the $19.8 billion service payment from Department of Defense (DoD) (34.3 percent of base pay); $61.4 billion from the Treasury for amortizing the unfunded liability in the Fund; a $4.8 billion Treasury contribution for concurrent receipt of disability and retirement benefits; and, investment income of $21.4 billion from the Fund's holdings of Treasury securities. See *Costs of Military Pay and Benefits in the the Defense Budget*, Washington, DC: Congressional Budget Office, November 2012, p. 40.

2. Lee Craig, "Public Sector Pensions in the United States," Robert Whaples, ed., *Economic History.Net Encyclopedia*, 2003, available from *eh.net/encyclopedia/article/craig.pensions.public.us*. These pensions were available to officers who served a career (originally 40 years) in the Army. Veteran pensions, offered to soldiers who served in periods of conflict, have been implemented by Congress dating back to the Revolutionary War. See also Hugh Rockoff, "The Changing Role of America's Veterans," Cambridge, MA: National Bureau of Economic Research Working Paper No. 8595, November 2001; and Sung Won Kang and Hugh Rockoff, "After Johnny Came Marching Home: The Political Economy of Veterans' Benefits in the Nineteenth Century," Working Paper No. 13223, Cambridge, MA: National Bureau of Economic Research, July 2007.

3. Samuel H. Williamson, *The Development of Industrial Pensions in the United States During the Twentieth Century,* Washington, DC: World Bank Policy Research Department, 1995, pp. 4-8. Employer-provided pensions were uncommon throughout much of the 19th century; instead workers used private savings (including voluntary contributions to relief/benefits societies), transfers from children, and the purchase of tontine insurance

to finance retirement. Railroads were the first to offer employer-provided pensions broadly, and the Pennsylvania Railroad's pension, created in 1900, served as the standard bearer for many subsequent company pension plans. The pension provided universal coverage, was entirely financed by employer contributions (on a pay-as-you-go basis), and set mandatory retirement at 70 years of age. Although the original plan did not set a minimum years of service requirement, the firm subsequently imposed a maximum hiring age of 35.

4. The first tax-deferred retirement accounts available to individuals were Keough plans (for the self-employed) in 1962. The 1974 Employment Retirement Income Security Act provided tax-deductible IRAs to individuals not covered by a private pension, and the 1978 Revenue Act allowed for tax breaks on employees' deferred income, creating the 401(k) plan. In 1981, IRA eligibility was extended to all individuals.

5. Stephen Blakely, "Pension Plan Participation," Washington, DC: Employment Benefit Research Institute Fast Facts #225, March 28, 2013. In 2011, only 3 percent of private sector workers participated exclusively in a defined benefit (DB) pension plan, with an additional 11 percent of workers participating in both defined contribution and DB plans.

6. This is similar to the workforce requirements of other public protection sectors, which also provide DB pension programs. For example, the New York Police Department and Pennsylvania State Police provide retirement pensions of 50 percent base salary at 20 years of service (including 401[k] contributions and full medical coverage). By comparison, federal civilian employees enjoy more mobility in exchange for reduced long-term benefits. The Federal Employees Retirement System (FERS) provides a DB pension (1 percent of High-3 average pay times years of creditable service) at a minimum retirement age of 57, complemented by a defined contribution benefit Thrift Savings Plan (TSP) with a maximum employer contribution of 5 percent of basic pay.

7. The Defense Business Board (DBB) evaluated a number of reforms, from a substantial reduction in the value of the DB pension (achieved mainly through the delay in benefits receipt until age 67) to complete replacement of the DB pension, with individ-

ual defined contribution retirement accounts managed within the Federal Government's TSP. Employer contributions to defined contribution accounts are designed to offset the reduction in the DB pension. Nonetheless, the military's wage structure and extensive use of nonwage compensation render it difficult for most service members to make sizable contributions to these individual accounts while young, limiting their ability to take full advantage of the power of compound interest over time.

8. *Modernizing the Military Retirement System*, Report FY11-05, Washington, DC: Defense Business Board, October 2011. While very useful, the DBB report insufficiently accounts for the unique nature of a military labor force. The report outlines the impact of increases in life expectancy and reforms to military compensation on the value of military retirement benefits; highlights the inefficiencies and inequities arising from today's DB military pension; evaluates cost savings of incremental reforms to the current military retirement benefit (delaying retirement age, adjusting benefits multiplier, and calculating "High" pay over a longer averaging period); and suggests shifting from a DB plan to a defined contribution plan. With such a shift, the services would make contributions to individual accounts held in the government's TSP, with employee contributions governed by federal laws concerning tax-advantaged retirement saving. The DBB report also proposes calibrating employer contributions to the TSP to compensate for risk and undesirability of military jobs (e.g., deployments, overseas posting separating the service member from spouse and family). While we are not in complete agreement with all of the DBB's recommendations, our pension restructuring proposals incorporate several of them.

9. Although each branch of service is different, our analysis uses U.S. Army data, as it is the most manpower intensive branch.

10. Department of Defense, *Tenth Quadrennial Review of Military Compensation, Vol. II: Deferred and Noncash Compensation*, Washington, DC: U.S. Government Printing Office, July 2008, pp. 10-11.

11. Gallup Poll, "Confidence in Institutions Survey, June 7-10, 2012," available from *www.gallup.com/poll/1597/confidence-institutions.aspx#1*, accessed on February 25, 2013. In 2012, Gal-

lup's "Confidence in Institutions" poll showed the military as the top rated American institution, with 75 percent of respondents expressing a "great deal" or "quite a lot" of confidence in the military and Congress polling lowest at 13 percent.

12. Defense Manpower Data Center, "Defense Casualty Analysis System: U.S. Military Casualties—GWOT Casualty Summary by Casualty Type," available from *www.dmdc.osd.mil/dcas/pages/report_sum_reason.xhtml*.

13. Cohort cost savings depend on the timing of retirement for service members who remain in the military 20 years or longer.

14. Although we provide a recommendation for potential changes to health care benefits, we do not provide cost savings estimates or conduct any sensitivity analysis on this portion of the retirement program.

15. Congressional Budget Office, pp. 25-26. The normal cost percentage for active-duty personnel in 2012 is 34.3 percent.

16. Recognizing that many junior enlisted soldiers may be liquidity constrained and to incentivize individual contributions to the portable retirement account, the military could increase the match rate for soldiers in their first 5 years of service.

17. A detailed accounting of all modeling assumptions is contained in Appendix 1.

18. All calculations use 2006-10 average annual separations by Years of Service (YOS) to forecast cohort savings from retirement benefits reform proposals. Assumptions: Personnel with greater than 20 YOS at separation are "loaded onto" the 20 YOS category for these calculations, as proposed pension reform is assumed to take effect in FY 2014. Under the DBB composite proposal, transition pay benefit is paid only to those fully vested (4+ YOS), and transition pay formula is YOS multiplied by highest monthly base pay. Under 10-15-55 proposal, transition pay is equal to the highest 6 months of base pay for service members serving 20 or more years. A 401(k) would provide the following benefits: government contributes 5 percent of base pay to TSP and provides a 100 percent match on service member contributions up to a maximum

of 5 percent of a service member's base pay. A service member who contributes 5 percent of base pay in a year would see a total TSP contribution (government and employer) of 15 percent of base pay.

Discount rate = 6.5 percent, Inflation rate = 2.5 percent
Retirement contributions in TSP account earn an annual return of 8.5 percent.
Conditional Mortality = 80 years
Survivor Benefit Plan replaced with 401(k) transferability.

19. The greater reduction in present value of retirement benefits for enlisted personnel under the 10-15-55 proposal occurs because enlisted personnel face longer average delay to age 55. Lowering the age of benefits receipt for enlisted personnel to age 51 or raising maximum government contributions to 14.5 percent of base pay will equalize the reduction in benefits.

20. These figures do not include savings from reduced accrual contributions. The DBB proposal to replace today's DB pension with a defined contribution retirement account (with 16 percent of base pay employer contribution and 1 month of transition assistance for each year of service to all personnel serving 4+ years) would generate a retirement benefit worth $0.533 million (2034 dollars) for an E7 with 20 YOS and a retirement benefit worth $1.004 million (2034 dollars) for an O5 with 20 YOS. Under this retirement reform, total cohort cost savings in 2034 dollars would be $4.35 billion, generating a 12.69 percent saving over the 10-15-55 proposal.

21. Jack VanDerhei, Sarah Holden, and Luis Alfonso, *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2009*, Issue Brief No. 350, Washington, DC: Employee Benefits Research Institute, November 2010, pp. 12, 21.

22. *Ibid*., p. 5. In 2009, 49 million workers (slightly less than one-third of the work force) were active participants in 401(k) plans. These plans are the most widespread employer-sponsored retirement plan in the private sector.

23. Service members contributing to the TSP retirement account can choose their asset allocation based on their tolerance for risk, to include a 100 percent allocation in Treasury securities (the TSP government securities [G] fund).

24. Relaxing the assumption that all personnel separate at 20 years of service, we also estimate cost savings using average annual separations from 2006-10 for enlisted personnel and officers with 20 or more years of service. Due to delay in age at pension receipt and lower benefits multipliers, cohort cost savings for the DBB proposal ($3.07 billion 2034 dollars) are greater than cohort cost savings under the 10-15-55 proposal ($2.34 billion 2034 dollars). Replacing the DB pension with an employer funded TSP account (16 percent of base pay) would generate future cohort cost savings of $4.47 billion (2034 dollars).

25. Recall that a shift to a pure defined contribution account with the military contributing 16 percent of base pay to individual TSP accounts will generate 13 percent more savings than the 10-15-55 proposal, but at the cost of entirely removing the DB pension. A retirement cohort includes all personnel who separate in a single fiscal year. Estimates in this monograph are from average annual separations from 2006-10.

APPENDIX I

MODELING ASSUMPTIONS

Discount Rate	In determining the cost of future outlays on retirement benefits, the relevant discount rate is the government's cost of borrowing. From 1983 to 2012, the annual yield on 10-year Treasury bonds averaged 6.21 percent, and the annual yield on 30-year Treasury bonds (when they were traded) averaged 6.86 percent. We selected a discount rate of 6.5 percent, which lies in between these two measures of government borrowing costs in the long run.
Return on Retirement Accounts	All pension reform proposals that include a defined contribution account feature individual retirement accounts invested through the Thrift Savings Program (TSP). Annual historical return information on the TSP government securities fund (G Fund), fixed income securities fund (F Fund), and common stock fund (C fund) is available for 1988 to 2012. Average annual returns over this time period were 5.62 percent for the G Fund, 7.11 percent for the F Fund and 11.12 percent for the C fund. Using these annual returns, we constructed a TSP portfolio containing 20 percent government securities, 30 percent fixed income, and 50 percent common stock. The compound annual return on this portfolio was 8.39 percent per year from 1988 to 2012. We selected a rate of return on TSP contributions of 8.5 percent for our analysis.
Annual Base Pay Increases	From 2000 to 2012, military base pay grew on average by 3.74 percent, more than 1.25 percentage points higher than the average annual increase in the Employment Cost Index for private industry workers of 2.47 percent. We selected an annual base pay increase of 3.5 percent for our analysis.
Annual Inflation Rate	From 1983 to 2012, average annual personal consumption expenditures (PCE) inflation was 2.6 percent, while the average annual increase of the gross domestic product (GDP) implicit price deflator was 2.5 percent. We selected an annual inflation rate of 2.5 percent for our analysis.

APPENDIX II

STRATEGIC COMMUNICATIONS

Regardless of the changes made to the military retirement program, strategic communications are essential. Backlash to the Defense Business Board (DBB) proposal from multiple stakeholder segments demonstrates the degree to which clumsy messaging can compound resistance to any proposal. We provide the following strategic talking points by critical stakeholder segments for the 10-15-55 plan as an example:

a. For service members:
   - Current service members and retirees retain current retirement benefit eligibility.
   - The new retirement system applies to all personnel entering service after October 1, 2014.
   - The military will automatically contribute 5 percent of base salary each month into a 401(k) plan managed within the Thrift Savings Program (TSP). This is a tax-deferred account that will grow at a rate commensurate with market conditions. Service members may contribute up to the annual amount for a 401(k) (currently $17,500 for those less than age 50 and $23,000 for those age 50 and older), and the military will continue to match dollar for dollar up to an additional 5 percent of base pay.
   - Service members leaving the service at any point will own and control their own 401(k) contributions.
   - At 10 years of service, service members will become partially vested in the government

contributions and can separate with 50 percent of government contributions. This percentage increases by 10 percentage points each year through 15 years of service, at which time service members can separate with the full 401(k) value to date.

- Service members who serve through 20 years of service receive their 401(k) and modest transition pay, as well as a DB component.
- The DB portion is identical to the existing program with one exception. You still can retire with 50 percent of base pay, and that amount still increases 2.5 percentage points each additional year of service beyond 20. However, retirees do not begin to receive payments or full Tricare coverage until they are 55 years of age. They may receive Tricare coverage as a second provider from retirement through 55 years of age. Limiting Tricare coverage to second provider status both compensates for the portability of the 401(k) and incentivizes gainful employment following military service through 55 years of age.

b. For the public:
   - The new retirement system has three main components: an altered DB, a portable 401(k), and medical coverage.
   - These changes were necessary to improve the quality of life provided to all veterans, while still providing one of the most dependable and robust retirement programs in the world.
   - The social contract with our service members is maintained—they will receive ample

retirement benefits to protect them from economic risk and ameliorate the financial disadvantages incurred by their selfless service.

c. For the Federal Government:
   - 83 percent of all service members will depart military service before reaching retirement eligibility. The new retirement system addresses this by providing a portable 401(k) component.
   - The 10-15-55 proposal realizes *substantial* savings in retirement costs (roughly 33 percent compared to the current retirement benefit) without jeopardizing the well-being of our service members in the long run. Simultaneously, it ensures that the military will continue to enjoy a stable population of talented, career-minded professionals who believe the government is appropriately compensating them for the personal and financial risks inherent in the profession of arms.

U.S. ARMY WAR COLLEGE

Major General Anthony A. Cucolo III
Commandant

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