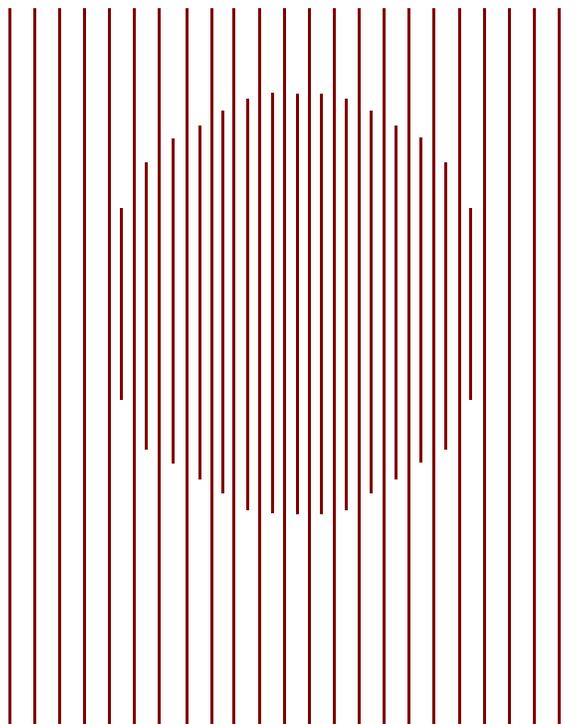


CBO PAPERS

**MILITARY PAY
AND THE
REWARDS FOR PERFORMANCE**

December 1995



CONGRESSIONAL BUDGET OFFICE

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**CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515**

PREFACE

The pay and benefits of military personnel account for roughly one-third of the defense budget. In the military, as in any organization, an important purpose of the pay system is to encourage good people to pursue a career in the organization and to work hard and perform well. The military rewards performance through promotions to successive ranks and the greater pay that goes with higher rank. Some observers have argued, however, that the rewards are inadequate.

This paper is one product of a study requested by the Chairman of the Subcommittee on Personnel of the Senate Committee on Armed Services. The paper examines the case for changing the military table of basic pay to increase the monetary incentives for service members to work hard and perform well. A forthcoming Congressional Budget Office (CBO) study will focus on the mechanisms through which military pay and allowances are regularly adjusted. In keeping with CBO's mandate to provide objective analysis, this paper makes no recommendations.

Richard L. Fernandez of CBO's National Security Division prepared this paper under the general supervision of Neil M. Singer and Cindy Williams. Ellen Breslin Davidson, Deborah Clay-Mendez, Mark Musell, and Ralph Smith, all of CBO, provided thoughtful comments on an earlier draft. CBO colleagues Shaun Black and Sheila Roquitte gave valuable assistance. The author also gratefully acknowledges the help of the staff of the Directorate for Compensation in the Office of the Assistant Secretary of Defense (Force Management Policy) and of Robert Emmerichs, director of the Eighth Quadrennial Review of Military Compensation.

Sherwood Kohn edited the manuscript, and Christian Spoor provided editorial assistance. Judith Cromwell prepared the paper for publication.

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CHAPTER I

INTRODUCTION

Higher pay can be an important incentive for workers to perform well, both in civilian employment and in the military. Members of the military receive increases in their compensation by many means—through annual across-the-board raises and periodic longevity increases, for accepting hazardous or arduous duties, even for getting married—but only the raises linked to promotion from one military rank to the next are direct rewards for performance. Private-sector employers, in contrast, may offer bonuses, merit raises, and other incentives.

Various observers have complained that the military pay system may not provide sufficient incentives for members to perform well. Among their concerns are:

- The pay system places too much emphasis on longevity and too little on promotions.
- Pay does not sufficiently differentiate between people promoted at average times and those promoted rapidly or slowly.
- Pay is too compressed; that is, the difference in pay between junior and senior personnel is too small.
- The underlying structure of the military pay system cannot adequately reward performance, requiring a thorough overhaul.

The case for changing the monetary incentives for military personnel to work hard and perform well seems to rest more on impressions and theoretical arguments than on specific evidence of poor performance. The various commissions and policy analysts who have examined military pay generally have not attempted to answer the underlying question: Are there problems of inadequate performance that could be addressed by changes in the pay system? Although individual commanders may know which of their people are performing to the best of their ability and which are not, that information does not make its way to pay analysts in any usable form. Thus, this paper also does not answer that difficult question.

The paper does, however, examine the arguments for changing the military pay system to improve the rewards for performance, exploring a number of ways of looking at incentives and focusing particularly on the work of the Seventh Quad-

ennial Review of Military Compensation (7th QRMC).¹ The 7th QRMC accepted the bases for the first two concerns—too much emphasis on longevity and insufficient differentiation based on promotion rate—but rejected the need for a thorough overhaul. It recommended changes that would increase the role of promotions in determining service members' pay and reduce the role of longevity, reflecting a view that those factors measure the pay system's rewards for performance.

Most discussions of the monetary rewards for performance in the military focus on the role of military basic pay, although that is only one of several components of a service member's total compensation. The basic pay table sets out pay levels depending on the member's pay grade (determined by military rank) and on the number of years that he or she has served in the military. Thus, the table defines both the raises that members receive upon promotion and their raises for longevity, which generally come after every two years of service. All members also receive allowances for food and housing, either as part of their regular paychecks or in the form of mess-hall meals and government-provided quarters. Because the housing allowances depend on a member's rank, although not on years of service, they also provide a pay raise when the member is promoted.

In addition to the direct elements of pay, members of the military receive two indirect monetary benefits. The first is the so-called tax advantage that results because the allowances for food and housing are not subject to federal income tax. That advantage increases in value as a member progresses through the ranks. Second, military retired pay extends the potential reward from all pay raises. That becomes particularly important as members near 20 years of service, at which time they become eligible to retire.

PROMOTIONS PROVIDE THE ONLY MONETARY REWARD

The military's reliance on promotions as the sole source of monetary rewards for good performance causes certain problems for anyone seeking to increase performance incentives. First, the pay system can differentiate among people performing at different levels only insofar as those levels are reflected in appreciably different speeds of promotion. Second, the promotion system is designed to fill openings at succeeding levels of responsibility and to select those most able to perform at those levels, rather than to reward performance.

1. In 1966, the Congress required the Department of Defense to conduct periodic studies of the military pay system, the seventh of which was completed in 1992.

The promotion system for officers offers few sharp pay differences among them through much of their careers, based on notional patterns of promotion developed by the 7th QRMC. Those patterns describe the timing of promotion for officers who are advanced slowly, with average speed, and quickly. (Promotion patterns vary among the services and over time, but the Defense Officer Personnel Management Act, passed in 1980, attempts to ensure some degree of uniformity.) In an officer's career, the first two promotions occur in lockstep at about two and four years of service. Almost all officers receive those promotions. It is not until an officer has served about 10 years—halfway to possible retirement—that an exceptional person can expect an early promotion, and then the typical pattern, according to the 7th QRMC, is advancement only one year ahead of his or her peers. Sharp differences in pay among officers with the same time in the military do not really show up until appreciable numbers do not receive the next promotion but are permitted to remain in the service. That phenomenon occurs at about 16 years of service, when officers are promoted to lieutenant colonel or Navy commander (grade O-5), and again at about 22 years, when officers are promoted to colonel or Navy captain (O-6).

Among enlisted personnel, by contrast, variations in the timing of promotions—and hence pay—are much greater than among officers. The Army offers the most extreme example; a person might reach the rank of staff sergeant (E-6) after as few as four and one-half years of service or as many as 13 years or more.

As with any performance rewards, military promotions only provide incentives if the links between performance and promotions are clear. In the officer ranks, in particular, that may not always be the case. Officers who receive the “correct” set of assignments, including appropriate command responsibilities and professional education, seem to have better chances of being promoted than those who do not. Although some observers may criticize this system as “ticket punching,” the rationale is presumably that the individual's potential for future performance in more demanding positions is dependent on his or her past experience. Whatever the reason, if there is an element of chance in whether a member receives the correct assignments, the effort (and ability) of individuals will only partly determine whether they are promoted.

As service members look forward to a possible promotion, performance incentives may be weak if past events can affect members' chances of advancement. For example, officers who graduated from a service academy may be seen by others as being unduly favored. A very different sort of example comes from the services' tendencies to regard certain kinds of mistakes as “career ending,” meaning that the member can expect no further promotion. In both cases, a lessened chance of promotion translates into a lower expected monetary reward for hard work.

Maintaining performance as the chances for promotion lessen is a potential problem for a system that provides monetary rewards for performance solely through promotions. A typical service member's chances of promotion to successive ranks decline naturally as he or she progresses through a career. As economists Beth J. Asch and John T. Warner emphasize in a recent theoretical study, that decline may mean that pay differentials between succeeding grades must increase to compensate.² Differentials designed around average promotion probabilities, however, can do little to motivate people who believe that their own chances of another promotion are much worse than average. That may be a particular problem in the later stages of some members' careers, especially in light of the strong incentive that personnel have to complete 20 years of service and qualify for retirement benefits even if their future promotion and earnings prospects in the military are poor.

SUMMARY

Pay is not the only factor that may motivate members of the military to excel. Higher rank in the military confers a degree of status and privilege that has few counterparts in civilian employment. The military personnel system also discourages poor performance through an "up-or-out" system, which discharges people who are not promoted to successive ranks within set periods.

A common approach to examining the monetary incentives for performance in the military is to compare the increases in basic pay that stem from promotions with those that come from longevity. By that measure, the current basic pay table appears to reward promotion weakly in comparison with longevity. The 7th QRMC recommended changes to the pay table that were designed to shift the balance. The panel did not, however, include allowances in its comparisons. Doing so sharply lessens the appearance of longevity outweighing promotions in determining military pay levels.

Perhaps more important than the emphasis on promotion rather than longevity is how successful the military pay system is in giving more to people who are promoted rapidly than to those promoted at average rates, and more to people who progress normally than to those who lag behind. By that measure, the current pay system seems moderately successful, at least in the enlisted ranks, where "rapid" and "slow" have real meaning. Officer promotions occur nearly in lockstep, so the pay system does not effectively distinguish among officers until they reach the higher ranks, where the chances of promotion begin to decline. At that point, the military

2. Beth J. Asch and John T. Warner, *A Theory of Military Compensation and Personnel Policy*, MR-439-OSD (Santa Monica, Calif.: RAND, 1994).

retirement system adds a further monetary incentive by, in effect, extending the period during which the officer enjoys the higher pay associated with a promotion.

If the pay system does not provide sufficient performance incentives, perhaps the differentials between people at successive pay grades are too small—that is, military pay could be too compressed. Comparisons with average earnings in the civilian economy seem to suggest that compression should not be a problem, but various pitfalls lessen the usefulness of that common comparison. Impressions that military pay is too compressed have probably been shaped, to a great extent, by the changes in pay differentials that were made in the early 1970s in anticipation of the end of conscription. From a longer perspective, however, it is apparent that for the most part those changes merely offset years of stagnation in the pay of new recruits.

Proposals for changing the military pay system to improve incentives for performance range from the modest to the radical. One option is to make no change at all, because the evidence that the current pay system does not adequately reward performance is at best indirect and because any change would involve some cost and disruption. A second possibility is to work within the structure of the current system, as the 7th QRMC recommended in its proposal to tie more of pay to promotion raises and less to longevity increases. Significantly enlarging the pay differentials among people promoted at different speeds, however, probably requires a more thorough overhaul than the 7th QRMC proposed. A pay table that based longevity increases on a member's time in a pay grade, rather than time in the service, could result in greater differentials. Further increasing the monetary incentives for excellence could require introducing means in addition to promotions for recognizing merit, such as linking longevity increases to some measure of an individual's performance. Generating such a measure, however, could prove difficult.

How well the military pay system encourages hard work and good performance is not just an issue for academics and commissions. The pay and benefits of military members account for roughly 30 percent of the defense budget, and active-duty members make up more than one-third of all federal employees. If the pay system was not efficiently achieving its goals, taxpayer dollars would be wasted in as real a sense as if the services were buying weapons they did not need or keeping open bases with no missions.

CHAPTER II

THE STRUCTURE OF MILITARY PAY

The pay of a member of the military consists of at least four components. All members receive basic pay, the amount of which depends on the member's pay grade—based on military rank—and on the number of years that he or she has served. Pay grades range from E-1, for a new enlisted recruit, to O-10, for the highest ranking generals and admirals (see Table 1). All members also receive two basic allowances, for quarters (BAQ) and for subsistence (BAS), although for many members those payments are made in kind, as government-supplied housing or mess-hall meals. The amount of the BAQ increases with rank (but not with years of service) whereas the BAS is paid at one rate for all officers and another rate for enlisted personnel. Members stationed in the United States who receive BAQ are also eligible for the variable housing allowance (VHA), which varies with local housing costs. The payment rates for both BAQ and VHA are higher for members with dependents than for single members. Finally, members receive an implicit payment—generally called the federal “tax advantage”—because the allowances are not subject to federal income tax.

The term regular military compensation (RMC) refers to the combination of basic pay, BAQ and BAS, VHA (or its overseas equivalent), and the federal tax advantage (see Box 1).¹ RMC provides a basis for a member to compare his or her military pay with that offered by civilian employers, exclusive of fringe benefits such as health insurance, retirement benefits, and employer-subsidized day care or, in the case of the military, shopping in commissaries. The average RMC for groups of members also provides a convenient way to compare pay within the military—for example, to compare the pay of a private with that of a sergeant.²

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1. Separate allowances apply to members stationed overseas. The housing component of the overseas allowances, called the overseas housing allowance or the station housing allowance, is part of the RMC of members stationed overseas. In calculations of the average RMC of members, however, average VHA rates often replace the overseas housing allowance—see, for example, Department of Defense, *Selected Military Compensation Tables January 1995 Pay Rates*. This paper generally ignores the overseas allowances, focusing on the situation of typical members stationed in the United States.
 2. Taking averages for groups requires placing a value on quarters that the government provides. For members with dependents, the calculations of RMC in this paper include the average rate of VHA for members who receive quarters allowances in cash—the prevalence of waiting lists for government quarters suggests that married members value those quarters at least as much as the combined BAQ and VHA they give up. Single members, however—especially junior enlisted members—often do not have the choice of living off-post. Thus, the calculations of RMC for junior members without dependents do not attribute VHA to the large number who receive quarters allowances in kind.

TABLE 1. PAY GRADES AND CORRESPONDING MILITARY RANKS, BY SERVICE

Pay Grade	Army	Navy	Marine Corps	Air Force
Commissioned Officers				
O-10	General	Admiral	General	General
O-9	Lieutenant General	Vice Admiral	Lieutenant General	Lieutenant General
O-8	Major General	Rear Admiral (Upper Half)	Major General	Major General
O-7	Brigadier General	Rear Admiral (Lower Half)	Brigadier General	Brigadier General
O-6	Colonel	Captain	Colonel	Colonel
O-5	Lieutenant Colonel	Commander	Lieutenant Colonel	Lieutenant Colonel
O-4	Major	Lieutenant Commander	Major	Major
O-3	Captain	Lieutenant	Captain	Captain
O-2	First Lieutenant	Lieutenant Junior Grade	First Lieutenant	First Lieutenant
O-1	Second Lieutenant	Ensign	Second Lieutenant	Second Lieutenant
Warrant Officers				
W-5	Chief Warrant Officer	n.a.	Chief Warrant Officer	n.a.
W-4	Chief Warrant Officer	Chief Warrant Officer	Chief Warrant Officer	n.a.
W-3	Chief Warrant Officer	Chief Warrant Officer	Chief Warrant Officer	n.a.
W-2	Chief Warrant Officer	Chief Warrant Officer	Chief Warrant Officer	n.a.
W-1	Warrant Officer	n.a.	n.a.	n.a.
Enlisted Personnel				
E-9	Command Sergeant Major/Sergeant Major	Master Chief Petty Officer	Sergeant Major/Master Gunnery Sergeant	Chief Master Sergeant
E-8	First Sergeant/Master Sergeant	Senior Chief Petty Officer	First Sergeant/Master Sergeant	Senior Master Sergeant
E-7	Sergeant First Class/Platoon Sergeant	Chief Petty Officer	Gunnery Sergeant	Master Sergeant
E-6	Staff Sergeant	Petty Officer First Class	Staff Sergeant	Technical Sergeant
E-5	Sergeant	Petty Officer Second Class	Sergeant	Staff Sergeant
E-4	Corporal/Specialist 4	Petty Officer Third Class	Corporal	Sergeant/Senior Airman
E-3	Private First Class	Seaman	Lance Corporal	Airman First Class
E-2	Private	Seaman Apprentice	Private First Class	Airman
E-1	Private	Seaman Recruit	Private	Airman Basic

SOURCE: Department of Defense.

NOTE: n.a. = not applicable.

BOX 1.
ALLOWANCES AND REGULAR MILITARY COMPENSATION

The military services have traditionally fed and housed their members either directly or, where that was not possible or desirable, by paying cash allowances. The current “basic” allowances—for quarters (BAQ) and subsistence (BAS)—were established by the Career Compensation Act of 1949. In 1974, the Congress defined regular military compensation (RMC) as including both basic pay and basic allowances as well as the tax advantage that members receive because the allowances are not subject to federal income tax. That action formalized the understanding, already prevalent, that for purposes of comparison with pay in the civilian economy, military compensation must include the allowances that all members receive either in cash or in kind. Thus, BAS and BAQ, which began as reimbursements for expenses that the government was not able to cover directly, have become part of military pay. In effect, cash allowances are viewed as the norm, to be forfeited when members live in government quarters or eat in government messes (enlisted and officer subsistence allowances are treated differently).

When the Congress established the variable housing allowance (VHA) in 1980, it redefined RMC to include both this new payment and the housing component of the existing overseas station allowance. The services pay VHA to members stationed in areas of the United States where housing costs exceed the BAQ by a certain amount—the overseas housing allowance covers the full housing costs, up to a limit, of members stationed outside the United States.

The rates at which BAQ and VHA are paid depend both on a member’s pay grade and on whether he or she has dependents, but not on the number of years that the person has served in the military. The combined payments rise with pay grade and are greater for members who have dependents than for single members. The totals do not rise as fast with pay grade, however, as does basic pay.

The subsistence allowance does not differ by pay grade, except that the rate for officers is different from that for enlisted personnel. All officers receive BAS at the rate (in 1995) of \$146.16 a month and must pay for any meals eaten in government messes. The enlisted BAS has three forms, the most common being that paid to members who are authorized to mess separately or who are on leave. The rate for that form is \$6.98 a day, or about \$212 a month. Roughly two-thirds of enlisted personnel receive the allowance in cash rather than in kind. Single enlisted members in the lower pay grades, who generally are expected to live in government quarters, typically are not paid the allowance in cash, nor are those on sea or field duty because they are fed by the government.

Calculations of the tax advantage, unless they are made by the individual involved, are necessarily approximations. The tax advantage depends on the person’s marginal tax rate, which depends in turn on many factors that an outside observer—the Department of Defense (DoD), for example—cannot readily measure. The calculations that DoD reports assume that members and their families have no income other than military pay and that they take the standard deduction.

In addition to the components of RMC, members of the military may receive a variety of special pays based on their duties or occupational specialties. Examples include hostile fire pay, flight pay, selective reenlistment bonuses, and special pay for health professionals. Although one or more of these pays may constitute a large part of some members' compensation—health professionals in particular—in total they cost less than just the cash component of BAS. This paper ignores the special pays because it focuses on incentives common to all military specialties. For certain specific occupations, however, consideration of the pays would be an important part of an analysis of compensation.³

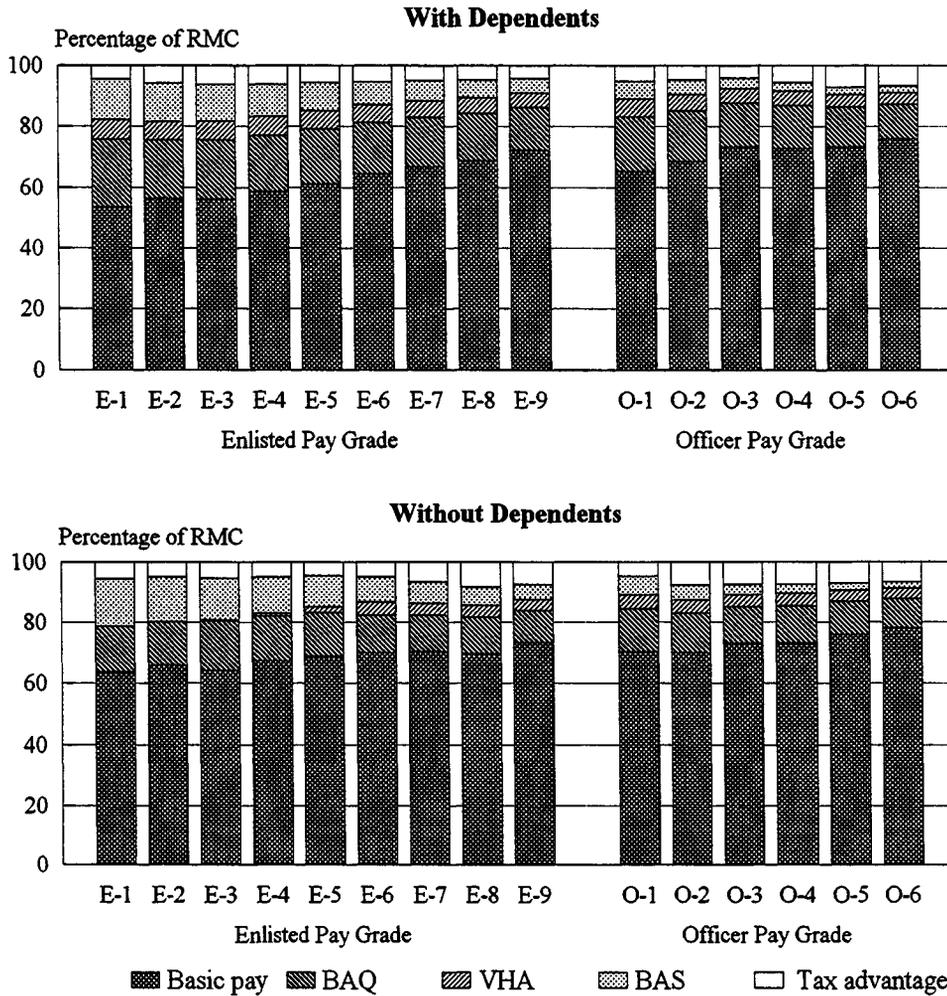
Basic pay is the largest and most visible component of regular military compensation. For typical married members in midcareer, basic pay accounts for roughly three-quarters of an officer's compensation and just under two-thirds of an enlisted member's earnings (see Figure 1). A new recruit with a family could receive barely half of his or her compensation in basic pay, but reaching the grade of E-5 (generally, at four to six years of service) would push that fraction above 60 percent. The next largest component, the basic allowance for quarters, accounts for 10 percent to 20 percent of RMC—less than 15 percent for most single members. A majority of married members receive BAQ (and VHA) in cash, but for almost all single enlisted personnel in the lower ranks the payment of housing allowances is only implicit because they must live in government quarters. The basic allowance for subsistence makes up a sizable portion of RMC for very junior members, but the share of BAS in total compensation falls rapidly as a member progresses through the ranks because the rate at which BAS is paid does not change. Finally, the tax advantage, which ranges from about 5 percent to 8 percent of RMC, is generally invisible to the member.

Although it is not part of a member's current compensation, military retired pay can make up a substantial part of lifetime earnings and have important effects on members' career choices. The military retirement system is "cliff-vested" at 20 years of service; that is, members receive nothing unless they complete 20 years, which is also the minimum number of years at which they may retire.⁴ Under the system applicable to members who entered before September 8, 1980, a person retiring after completing 20 years receives a monthly payment equal to one-half of his or her final basic pay. For each additional year of service, the fraction of final pay increases by

3. See, for example, Congressional Budget Office, "Pilot Retention Bonuses in the Air Force," CBO Memorandum (June 1995). For a complete catalog of the special pays, see Department of Defense, *Military Compensation Background Papers*, 4th ed. (November 1991). Recommendations for changes are included in Department of Defense, *Report of the Seventh Quadrennial Review of Military Compensation* (August 21, 1992).

4. In 1992, the Congress enacted a provision permitting the services to offer early retirement to members with as few as 15 years of service, at reduced levels of retired pay. That program, which was intended to assist the department in making personnel reductions, is scheduled to expire on October 1, 1999.

FIGURE 1. COMPONENTS OF 1995 REGULAR MILITARY COMPENSATION FOR TYPICAL MEMBERS WITH AND WITHOUT DEPENDENTS, BY PAY GRADE (In percent)



SOURCE: Congressional Budget Office and Department of Defense, *Selected Military Compensation Tables January 1995 Pay Rates*.

NOTES: RMC = regular military compensation; BAQ = basic allowance for quarters; VHA = variable housing allowance; BAS = basic allowance for subsistence. Tax advantage refers to the implicit payment because the allowances are not subject to federal income tax.

Pay distributions are for members who have the median years of service for the pay grade. Median years are derived from 1990 data to avoid being affected by the large personnel reductions of later years.

Allowances are attributed to all members regardless of whether they are received in cash or in kind, with one exception: no VHA is attributed to enlisted members below the grade of E-6 who do not have dependents and are living in government quarters. VHA amounts for all other members are the average amounts, by pay grade, paid to eligible members.

2.5 percentage points, up to a maximum of 75 percent (30 years or more). Changes made in the system in 1980 and 1986 reduced the value of retired pay, but retained the basic feature that retired pay is calculated as a percentage of basic pay.

Although all of the components of military compensation play a role in determining the monetary rewards for performance, the basic pay table is generally the focus of attempts to change those rewards. The table sets out the pay level for each member, based on his or her pay grade—determined by military rank—and years of military service (see Figure 2). Enlisted pay grades range from E-1, for a new recruit, to E-9; officer grades range from O-1 (second lieutenant or ensign) to O-10 (four-star general or admiral). Promotions are rewarded with both an immediate raise in pay and larger increases for subsequent longevity. Members who perform well enough to be retained but not to receive continued promotions eventually stop receiving longevity increases. Separate lines in the basic pay table define the pay of officers who served four years or more in the enlisted ranks. Without those lines, such officers might suffer a pay cut when they were commissioned and would quickly pass the last longevity increase for their grade.

The general structure of the pay table is essentially the same as that established by the Career Compensation Act of 1949. Changes in the table over the years altered relative pay levels within it, but because some of those changes were offsetting, today's table is remarkably similar to the 1949 version, although the current table reflects the substantial inflation since 1949.