Statement of
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Committee on Armed Services
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Mr. Chairman, I am pleased to appear before your subcommittee this afternoon to discuss the military retirement system. As you know, changes in military retirement have been proposed by many studies during the past 15 years. Most recently, the Department of Defense (DoD) has submitted two alternative plans in response to a requirement stated in the fiscal year 1986 Defense Authorization Act.

In discussing DoD's plans, I will focus on three issues: whether the changes can be expected to generate the cost savings mandated by the Congress; what will be the effects of these changes on military personnel and force profiles; and how much confidence should be placed in these projections of cost savings and manpower effects.

Summary

The Department has submitted two plans for the Congress to consider. The principal features of the plans are summarized in Table 1. Both plans would reduce the retirement benefits earned for service up to 20 years and would increase the credit for service between 20 and 30 years. In addition, one plan--which I will refer to as the "COLA-Minus" plan--would reduce cost-of-living allowances. The other plan--which I will call the "High-Five" proposal--would keep full inflation protection, but would calculate retired pay on the basis of the retiree's five highest years of pay, rather than the

three highest as under current law. Both plans would apply only to those retirees who enter service after enactment of the new provisions--that is, current service personnel and retirees would be "grandfathered" and so would remain under the current system.

Let me summarize the Congressional Budget Office's (CBO's) conclusions before presenting our results in detail. Using DoD's accounting methodology, CBO estimates that the Department's proposals would generate savings that come quite close to meeting the annual savings of $2.9 billion mandated by the Congress. Indeed, CBO estimates that savings would be even closer to the $2.9 billion target if expected changes in the composition of military forces were taken into account. These changes would slow the growth of career personnel in the military services, and would eventually result in a career force roughly 3 percent smaller than under the current retirement system. Alternatively, the Congress and DoD could offset much or all of these losses of career personnel by raising reenlistment bonuses or other personnel benefits. The total cost would be considerably smaller than the savings from lower retirement benefits.

Cost Savings

Accrual Savings. In the fiscal year 1986 Defense Authorization Act, the Congress instructed the Department to report on ways to reduce the accrual

cost of the military retirement system by $2.9 billion, or 16 percent of the estimated fiscal year 1986 cost of $18.2 billion. 1/ The Department's cost estimates are based on the "entry age normal cost" of the retirement system. Normal cost can be thought of as the percentage of basic pay that would have to be set aside in a trust fund in order to build a principal amount large enough to pay future retirement benefits. The Department's calculation results in a normal cost percentage of 50.7 for fiscal year 1986 and an accrual charge of $18.2 billion in the President's budget.

The DoD proposals would reduce this accrual cost. As the upper half of Table 2 indicates, CBO estimates that the DoD plans--if applied to all those entering service in fiscal year 1986 and thereafter--would come very close to offering accrual savings of the magnitude mandated by the Congress. The "COLA-Minus" plans would save $2.7 billion annually, while

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1.   The accrual cost of military retirement appears in the Department of Defense budget function 050 as both budgetary authority and outlays. Following transfers to the Military Retirement Trust Fund (function 600) and offsetting receipts and expenditures in other accounts, total federal budgetary authority for military retirement is equal to defense budgetary authority.   Federal outlays for military retirement, however, differ from defense outlays because federal outlays are paid to current retirees, while defense outlays are set aside to pay future retirees.   The difference between defense and federal outlays accumulates in the Military Retirement Trust Fund, where it is supplemented by a payment from the defense budget (function 054) to amortize the unfunded liability of the trust fund.   For a more complete description of these accounts, see Congressional Budget Office, Accrual Accounting for Military Retirement: Alternative Approaches (June 1983).

the "High-Five" plan would save $2.8 billion. Under either plan, about $1.7 billion in savings would follow from the change in annual retirement credits, with the remainder being the results of either the reduced inflation protection or the use of "high-five" averaging.

In practice, savings might even be modestly higher. To estimate accrual cost, the DoD Actuary assumes that current patterns of military retention will persist into the future. This assumption is open to challenge. Because military retirement is a major element of the military compensation system, changes in retirement should be expected to affect retention.

If retention varied in response to the changes in military retirement, then reduced benefits for retirees would lead to a decline in the number of military personnel remaining in service long enough to qualify for retired pay. In that event, as shown in the lower half of Table 2, the reductions in the accrual cost of the retirement system would amount to $2.8 billion and $2.9 billion, respectively, under the "COLA-Minus" and "High-Five" plans.

Changes in Methodology. All of the preceding estimates of savings in accrual costs depend critically on the accounting methodology employed by DoD for fiscal year 1986. The Department estimates current accrual costs based on the retirement system in effect for personnel who enter service in 1986. Therefore, DoD estimates accrual costs only for the retirement

system that applies to new entrants--not the system for grandfathered personnel. To the extent that senior members are grandfathered under more generous retirement systems, DoD's accrual costs understate the long-term costs of military retirement.

The Department has announced that, beginning with the budget for fiscal year 1987, it intends to change its accounting methodology to reflect the use of different retirement systems for different groups of service members. Accrual costs for personnel who entered service prior to September 8, 1980, will be based on their terminal basic pay. Costs for members who have entered since then will be based on their "high-three" basic pay. And if a new retirement plan, such as the ones presented by DoD, is applied to members who enter in 1986 or beyond, with current personnel being grandfathered under previous systems, the lower accrual costs of the plan will be estimated only for the new groups of personnel.

When applied to the retirement plans that DoD now proposes, with their full grandfathering, this new method of cost calculation will yield much smaller savings in the early years than those noted above. In fiscal year 1987, for example, only personnel in their first two years of service would be covered by the new plan, with an accrual cost of about 43 percent rather than the 51 percent that DoD now estimates for the current system. Based on CBO's estimate of the aggregate basic pay of the different groups

of personnel, the 1987 savings would be only $500 million or so rather than $2.8 billion to $2.9 billion. In later years, savings would increase until, when all members were covered under the new system, total savings would approach the Congressional target.

Federal Outlay Reductions. The discussion above, and the cost reduction targets in the Authorization Act, are stated in terms of budgetary authority and accrual charges, which simply set aside funds to pay future retirement costs and so do not affect current federal outlays. But the plans offered by DoD would affect federal outlays, although major impacts would not be felt for many years because of the full grandfathering of current retirees and military personnel now in service. Indeed, outlays for nondisability retirement benefits would not begin to be affected until the first group of entrants under the new plan reached retirement age--20 years from now.

In the meantime, however, the change in retention incentives would alter the composition of the military forces, as I will discuss in the next portion of my statement. The new forces would be characterized by smaller outlays for current pay and benefits, because retention incentives would be weaker for senior personnel and thus the force would include a larger proportion of junior personnel. On the other hand, outlays would be higher for accession and training.

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For the first decade after enactment of a new retirement system, increased outlays for accession and training would exceed the pay savings from a more junior force. CBO estimates that these net outlays would be quite small, on the order of $10 million to $20 million annually. During the second decade after enactment, net outlay savings would be realized, but they too would be small compared with the overall cost of the military personnel system, which would continue to be well in excess of $60 billion annually (in 1986 dollars). Significant outlay savings would begin only 20 years after enactment, when the first personnel retired from active service under the new plans.

Manpower Effects

Cost is not, of course, the only criterion against which these retirement plans should be evaluated. The military compensation system has as its primary goal the maintenance of a military force of adequate size and experience, and it is widely agreed that the military retirement system is one of the principal incentives for career military personnel to remain in service.

CBO Estimates. The impact of retirement benefits on military retention has been incorporated in CBO's analyses of previous proposals to change the military retirement system, most recently in a report, Modifying Military

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Retirement, issued in April 1984. CBO bases its estimates on quantitative analysis of the link between historical changes in military compensation and retention. The same methodological approach has been used by the Department of Defense, non-Defense study commissions, and academic researchers. To focus on the effects of changes in military pay and benefits, end strength--the overall number of people in uniform--is usually held constant and shifts in the composition of the force are analyzed.

As the estimates in Table 3 show, savings cannot be realized from retirement changes without some loss of career personnel (defined as those with more than four years of service). Assuming no other changes in military pay and benefits, either of the DoD plans would eventually decrease the size of the career force by approximately 3 percent. The "High-Five" plan would also produce a slightly less experienced career force than either the current system or the "COLA-Minus" plan. Under either proposal, annual accession requirements would increase in order to maintain overall end strength.

While important, these projected changes must be placed in context. All four services have enjoyed substantial growth in the size of their career forces in recent years, with annual increases averaging 3 percent since 1978. In the absence of retirement changes, growth is likely to continue if military pay raises keep pace with those in the private sector. Reductions in

retirement benefits would slow this growth, but not halt it. Indeed, under the DoD plans, CBO estimates that in the long run the size of the military career force would still be 1 percent to 2 percent above its 1984 level.

Comparison with DoD Results. In its report on options to reduce military retirement costs, DoD concludes that personnel losses would be considerably more severe than CBO's estimates. For example, DoD projects losses of approximately 61,000 career enlisted personnel and 6,900-7,000 career officers, compared with CBO's estimate of 27,000-34,000 total career personnel. It is important to understand the differences between CBO's estimates and those of the Department, as summarized in Table 4.

Most of the difference stems from DoD's choice of what CBO believes to be an inappropriate starting point. The Department's report refers to the baseline as "today's force," but it is actually the force profile that would result in the long run—probably well into the next century—from a retirement system with annuities based on terminal basic pay rather than the "high-three" average. CBO believes that the "high-three" baseline is the appropriate one for any long-run comparison inasmuch as under current law all annuities will be calculated on the basis of "high-three." 2/ When DoD

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2. Terminal basic pay is the annuity computation base only for personnel who entered service before September 8, 1980.

estimates personnel changes against the baseline of a "high-three" career force, as CBO does, losses total about 4 percent, or 41,000-42,000 rather than 67,000-68,000 personnel.

Some of the remaining difference between the CBO and DoD estimates occurs because DoD's projections are based on observed military retention behavior during the 1976-1982 period when military pay consistently lagged behind civilian pay, resulting in low retention rates. CBO's projections assume that future pay increases for the military and civilian sectors will be the same; therefore, CBO used more recent retention experience as a guide.

Still other minor differences between the CBO and DoD estimates follow from technical assumptions. For example, CBO assumes a slightly higher value than does DoD for the extent of service members' preference for current over future income. We do not believe that these differences in assumptions are important for purposes of evaluating the effects of the DoD retirement options.

Because of these differences, DoD's projections show a reduction of about 4 percent in the size of the long-run career force as the result of retirement changes. CBO projects a reduction of about 3 percent. But even under DoD's more pessimistic projection, the change in military

retirement would merely halt future growth in the career force, leaving the services with about the same numbers of career personnel as are in the force today. And the full extent of the slowdown would be felt only gradually, as members made retention decisions over a period of several years.

CBO Methodology

Underlying CBO's estimates of the effects of military retirement are mathematical and statistical analyses of how the pay and benefits of military personnel affect their retention decisions. These analyses are summarized in the ACOL model, so called because its central feature is the calculation of the annualized cost of leaving military service. The validity of ACOL and similar approaches has sometimes been called in question. As you requested, I would like briefly to describe and evaluate these modeling techniques.

ACOL was originally developed to support the deliberations of the President's Commission on Military Compensation, which reported in 1978. Since then, successive versions of the basic model have been used for a number of purposes in addition to analyzing the effects of alternative military retirement systems. Among these applications are:

o   Project the change in Navy retention from increased sea pay;

o   Administer the Selective Reenlistment Bonus (SRB) program in all four services;

o   Estimate the effect of educational benefits on career retention; and

o   Assess the career force changes that would result from the "catch-up" military pay raises in fiscal years 1981 and 1982, and the "comparability" raises of recent years.

The version of ACOL currently used by CBO and underlying the estimates in Table 3 was developed by the Fifth Quadrennial Review of Military Compensation in 1983-84. This model bases its estimates of retention on comparisons between civilian wages and salaries, on the one hand, and total military compensation, including retirement and special and incentive pays, on the other. The economy's unemployment rate is also incorporated in the model's estimates.

ACOL is not the only model of military retention, nor is it without flaws. A more comprehensive analytical framework for estimating reten-tion has been developed by the Rand Corporation, but to date it has been applied only to Air Force officers. Economists at the U.S. Military Academy have used a somewhat different theoretical framework to esti-mate Army enlisted retention. Under contract to the DoD office of civilian

personnel policy, Systems Research and Applications Corporation has modified ACOL to account for the revealed preferences of civilian workers. CBO is currently pursuing application of the SRA model to a population of Navy enlisted personnel.

All of these analytical approaches agree with the general proposition that compensation is an important factor in determining retention. They differ somewhat in their estimates of the extent to which retirement changes would affect retention, while agreeing that retirement is an important career incentive. Of these various approaches, ACOL is currently the only comprehensive model available for estimating military retention.

Past estimates made using ACOL have proved to be sound bases for policy formulation. ACOL successfully projected the improvement in Navy career force manning in the wake of sea pay increases. The model accurately estimated the additional retention from the 1981-1982 pay raises. Moreover, its projections of additional separations among career force personnel desiring to use their educational benefits have been supported by survey results and observed behavior.

Unfortunately, there is no similar track record for ACOL with respect to military retirement. The most significant change in the retirement system was the switch to "high-three" averaging for retirees who entered

service after September 7, 1980. In theory, the "high-three" provision should lower the retention incentive, and indeed ACOL estimates that "high-three" will decrease the career force by 2 percent. But members who have entered service under the "high-three" provision have reenlisted at higher rates than cohorts who entered service just prior to the 1980 date.

This single instance, however, does not provide a test of the validity of ACOL to project the effects of changing retirement. Both analysis and survey results confirm that the retirement system is a powerful retention incentive primarily for those members who have completed two or more enlistments--six to eight years of service. "High-three" currently affects only those members who have completed fewer than five years of service. In any event, the experience of the last five years would not provide a good guide for the future because of the sharp fluctuations in unemployment that have occurred since 1980.

One final issue concerning ACOL and other models of military retention addresses the technical assumptions that must be made in order to estimate the effects of policy changes. Among the significant factors are: the discount rate that expresses service members' preference for current over future income; the "baseline" retention that would occur if there were no changes to the current compensation system; and the underlying quantitative relationship between retention and compensation.

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Analysts differ as to the specific assumptions that should be made. But while the specific quantitative results in Tables 2 and 3 would be different under alternative assumptions, the qualitative conclusions would not change. That is, CBO would still find that the DoD plans for military retirement would result in some career force losses in terms of both size and average experience, and thus in some additional accessions to maintain a constant end strength. Both plans would lead to sizeable savings in accrual charges, on the order of the $2.9 billion mandated by the Congress.

Finally, even if the ACOL projections should prove wrong and the manpower consequences should be more adverse than estimated, the Congress and the Department would have many remedies at hand in addition to raising retirement benefits. The options for maintaining career force size and experience would include:

o   Raising current pay, as was done successfully in 1981 and 1982;

o   Increasing bonuses and special and incentive pays, as the Congress has done regularly; and

o   Improving military benefits such as travel reimbursements, housing, and "quality of life" programs.

The costs associated with any of these policy changes obviously would offset some of the savings from reducing retired pay. But net savings should

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remain, because some of these alternative elements of pay and benefits--particularly bonuses and some special and incentive pays--are more efficient retention incentives than retirement. In all likelihood, the additional costs of increasing bonuses or special pays would not amount to more than a small fraction of the $2.9 billion (in constant 1986 dollars) that would eventually be saved each year under the DoD plans.

Conclusion

CBO's evaluation of the military retirement plans submitted by the Department of Defense suggests that both of the DoD plans would result in estimated accrual savings quite close to the $2.9 billion specified in the fiscal year 1986 Defense Authorization Act, based on the costing methodology employed by the DoD Office of the Actuary. Under either plan, career force losses would eventually total approximately 3 percent, slowing but not halting the growth in the career force and gradually leading to annual accession increases of 3 percent in order to maintain constant end strength.

These conclusions stem from applying CBO's models of military retention and personnel cost. There is an element of uncertainty in any such model, and CBO's are no exception. But the ACOL model has successfully projected manpower changes resulting from many different compensation

policy initiatives, and it provides the best available estimate of the effects of the proposed retirement changes.

Mr. Chairman, this concludes my prepared statement. I will be happy to try to respond to your questions.

TABLE 1.   DOD RETIREMENT PLANS

	Current System	"High-Five" (Structural) Plan	"COLA-Minus" (Combination) Plan
Multipliers: (percent)			
Years 1-20	2.5	2.15	2.2
Years 21-30	2.5	3.20	3.1
Maximum Percentage	75.0	75.0	75.0
Retired Pay Computation Base	Average of Highest Three Years' Basic Pay	Average of Highest Five Years' Basic Pay	Average of Highest Three Years' Basic Pay
Inflation Protection	Full COLA for All Retirees	Full COLA for All Retirees	CPI Minus 1 percent for All Retirees; Restoral at 40th Anniversary of Entry into Service

SOURCE: Congressional Budget Office

TABLE 2.   COST SAVINGS FROM RETIREMENT CHANGE
(Change from current system)

Methodology	"High-Five" (Structural)	"COLA-Minus" (Combination)
Assuming Constant Retention (DoD Methodology)		
Change in Normal Cost Percent	15.3	14.9
FY 1986 Savings (billions of dollars)	2.8	2.7
Assuming Variable Retention (CBO Methodology)		
Changes in Normal Cost Percent	16.0	15.5
FY 1986 Savings (billions of dollars)	2.9	2.8

SOURCE: Congressional Budget Office

TABLE 3.   MANPOWER EFFECTS OF RETIREMENT CHANGES

Category	Current System	"High-Five" (Structural)	"COLA-Minus" (Combination)
End Strength	2,228,000	2,228,000	2,228,000
Career Force Size	1,128,000	1,093,000	1,101,000
Average Experience of Career Force (Years)	11.9	11.7	11.8
Annual Accessions	331,000	342,000	339,000

SOURCE: Congressional Budget Office

TABLE 4.   COMPARISON OF CBO AND DOD ESTIMATES OF
PROJECTED CAREER FORCE LOSSES
(In thousands)

Estimates	"High-Five" (Structural)	"COLA-Minus" (Combination)
DoD Estimate (High-Terminal Basic Pay; 1976-82 Average Retention)	67.9	67.8
Adjusted for High-Three Instead of High-Terminal Pay	41.6	41.5
Adjusted for Current Instead of 1976-82 Average Retention	39.7	40.1
CBO Estimate (High-Three Basic Pay; Current Retention)	34.1	27.0

SOURCE: Congressional Budget Office