CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

September 28, 1998

Proposal to Repeal the Military Retirement Reform Act of 1986

SUMMARY

This estimate addresses the budgetary impact of repealing the Military Retirement Reform Act of 1986, also known as REDUX. It assumes that the repeal would apply to everyone who entered military service after July 31, 1986. According to the Office of the Actuary at the Department of Defense (DoD), repealing that act would increase outlays for retirement annuities by $1 million in 2000 and by about $158 million over the 2000-2008 period. In addition, DoD would have to make payments, averaging about $1.7 billion a year over that period, to the military retirement trust fund to cover a portion of the increase in future liabilities for current military personnel. Additional benefits earned under the proposal between August 1, 1986, and the effective date would not be covered by DoD's payments and would add $7.5 billion to the unfunded liability of the military retirement trust fund. CBO has no basis for different estimates of these amounts. The most likely basis would be a different set of economic assumptions, but the actuaries' assumptions are reasonable.

Because the additional annuity payments would represent direct spending, pay-as-you-go procedures would apply to any implementing legislation. The increased contributions to the retirement trust fund would come from appropriated funds and would not affect the surplus or deficit.

BACKGROUND

The Military Retirement Reform Act of 1986 (REDUX) governs the retirement of military personnel who initially entered the armed forces after July 31, 1986. Under REDUX a retiree's initial annuity ranges from 40 percent to 75 percent of the individual's highest three years of basic pay. Retirees with 20 years of service will receive 40 percent, but with each additional year of service the fraction will grow until reaching the maximum at 30 years of service. When the retiree is 62 years old, the annuity is raised in most cases to equal 2.5 percent of the average of the highest 36 months of basic pay for each year of service up to a maximum of 75 percent. Also, under REDUX cost-of-living adjustments (COLAs) are based on changes in the Consumer Price Index (CPI); specifically, the COLA is the change in the CPI less one percentage point. However, when the retiree reaches age 62 the annuity is raised to reflect all of the CPI growth until that point, but thereafter annual COLAs continue to equal the CPI less one percentage point.

Current law provides two different formulas for other individuals who are not covered by REDUX and who receive a nondisability retirement benefit. Military personnel who first became members of the armed forces before September 8, 1980, receive retired pay equal to a multiple of their highest amount of basic pay; the multiple is 2.5 percent for every year of service up to 75 percent. Retirees who first became members of the armed forces between September 8, 1980, and July 31, 1986, receive retired pay based on the average of the highest 36 months of basic pay and the multiplier of 2.5 percent for each year of service. Annuities for both of these groups are fully adjusted for changes in the CPI. (This estimate assumes that any legislation to repeal REDUX would provide retirement benefits to military personnel under the system currently in place for individuals who entered service between September 8, 1980, and July 31, 1986.)

ESTIMATED COST TO THE FEDERAL GOVERNMENT

As shown in the table below, the budgetary effect of repealing REDUX for members entering military service after July 31, 1986, would have two parts—an increase in direct spending and an increase in spending subject to appropriation. According to the analysis of DoD's Office of the Actuary, direct spending costs would total about $158 million over the 2000-2008 period, but the unfunded liability would increase by about $7.5 billion. In addition, discretionary spending would rise by about $15.5 billion over that period, assuming appropriation of the necessary amounts. The estimate assumes an effective date of October 1, 1999.

Direct Spending

Direct spending would increase immediately because some individuals have received disability retirement under REDUX; a second and larger increase would occur when military personnel now covered by REDUX would begin to receive nondisability retirement annuities under the new law. Based on information from the actuaries, CBO estimates that repealing the REDUX system would increase outlays from the military retirement trust fund by about $25 million over the 2000-2008 period because of higher COLAs for those who will have retired based on a disability. Not until 2006 would military personnel begin to receive nondisability retirement under REDUX. Outlays from the trust fund for those beneficiaries would increase by only about $1 million in 2006, about $32 million in 2007, about $100 million in 2008, and increasing amounts thereafter. The annual direct spending costs would eventually be about 18 percent higher than under current law.

	By Fiscal Year, in Millions of Dollars									
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
DIRECT SPENDING										
Retirement Annuities										
Spending Under Current Law										
Estimated Budget Authority	32,390	33,564	34,570	35,676	36,768	37,884	39,006	40,149	41,306	42,482
Estimated Outlays	32,296	33,477	34,484	35,585	36,677	37,791	38,913	40,054	41,210	42,383
Proposed Changes										
Estimated Budget Authority	0	1	1	2	2	3	3	5	36	105
Estimated Outlays	0	1	1	2	2	3	3	5	36	105
Spending Under the Proposal										
Estimated Budget Authority	32,390	33,565	34,571	35,678	36,770	37,887	39,009	40,154	41,342	42,587
Estimated Outlays	32,296	33,478	34,485	35,587	36,679	37,794	38,916	40,059	41,246	42,488
SPENDING SUBJECT TO APPROPRIATION										
DoD Payments to the Military Retirement Trust Fund for Accrual Costs										
Spending Under Current Law										
Estimated Authorization Level	10,563	10,574	10,698	10,902	11,177	11,458	11,781	12,076	12,378	12,726
Estimated Outlays	10,563	10,574	10,698	10,902	11,177	11,458	11,781	12,076	12,378	12,726
Proposed Changes										
Estimated Authorization Level	0	1,260	1,370	1,526	1,611	1,700	1,797	1,935	2,080	2,209
Estimated Outlays	0	1,260	1,370	1,526	1,611	1,700	1,797	1,935	2,080	2,209
Spending Under the Proposal										
Estimated Authorization Level	10,563	11,834	12,068	12,428	12,788	13,158	13,578	14,011	14,458	14,935
Estimated Outlays	10,563	11,834	12,068	12,428	12,788	13,158	13,578	14,011	14,458	14,935

NOTE: The direct spending costs of this legislation would fall within budget function 600 (income security). Spending subject to appropriation action falls within budget function 050 (national defense).

In addition, the proposal would increase the unfunded liability of the trust fund by an estimated $7.5 billion. That liability would represent the long-term cost of the additional benefits provided under the proposal and earned by military personnel between August 1, 1986, and the effective date of the repeal. Under current practices, the Treasury would pay the trust fund that amount over many years, but those intragovernmental transfers would have no net budgetary impact. The budgetary impact would occur as outlays from the trust fund (direct spending) when the benefits traceable to the liability would be paid to retirees or survivors.

Spending Subject to Appropriation

The military retirement system is financed in part by payments from appropriated funds to the military retirement trust fund based on an estimate of the system's accruing liabilities. Repealing REDUX would increase payments from the military personnel accounts to the military retirement fund (a DoD outlay in budget function 050) to finance the increased liability to the fund resulting from additional years of service under a more generous system. The resulting increase in discretionary spending is estimated to be about $1.3 billion in fiscal year 2000 and about $15.5 billion over the 2000-2008 period. The costs to DoD would increase each year because not all military personnel are covered by REDUX. Under current law the percentage of the force covered by REDUX will grow until everyone in the force will have entered military service after August 1, 1986.

Accrual costs also depend on other factors, including endstrengths, projected years of service at the time of retirement, grade structure or salary history, and projected rates of military pay raises, inflation, and interest rates. (The estimates assume that in the long run annual pay raises are 4.0 percent, changes in the CPI are 3.5 percent a year, and interest rates for the trust fund's holdings of Treasury securities are 6.5 percent annually.) DoD's actuaries have the necessary information and models to make reliable estimates of the retiree population and its relevant characteristics. Pay raises, inflation, and interest rates are more likely to vary from the assumptions that the actuaries used in computing the accrual costs because of inherent uncertainty over their long-run course. Nevertheless, the assumptions used for these calculations are reasonable.

PAY-AS-YOU-GO CONSIDERATIONS

Section 252 of the Balanced Budget and Emergency Deficit Control Act of 1985 sets up pay-as-you-go procedures for legislation affecting direct spending or receipts. The net changes in outlays that are subject to pay-as-you-go procedures are shown in the following table. For the purposes of enforcing pay-as-you-go procedures, only the effects in the current year, the budget year, and the succeeding four years are counted.

	By Fiscal Year, in Millions of Dollars									
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Changes in outlays	0	1	1	2	2	3	3	5	36	105
Changes in receipts					Not applicable					

ESTIMATE PREPARED BY: Valerie Barton

ESTIMATE APPROVED BY:

Robert A. Sunshine
Deputy Assistant Director for Budget Analysis