

CONGRESS OF THE UNITED STATES  
CONGRESSIONAL BUDGET OFFICE

# CBO

## Costs of Military Pay and Benefits in the Defense Budget



NOVEMBER 2012

---

## Notes

Unless otherwise indicated, all years referred to in this study are federal fiscal years (which run from October 1 to September 30).

Numbers in the text and tables may not add up to totals because of rounding.

On the cover: A member of the U.S. Marine Corps in Afghanistan records information before disbursing pay (photo by U.S. Marine Corps Lance Corporal Khoa Pelczar).

On pages 3 and 22, CBO's estimate of the cumulative decline in military basic pay (under the Department of Defense's plan for the 2013—2017 period) relative to projected growth in the employment cost index has been revised from what was published originally to correct an error in calculation.

---



# Contents

<b>Summary</b>	1
<b>Introduction</b>	5
Defining Military Compensation: The Service Member’s Perspective	5
Defining Military Compensation: The Budgetary Perspective	6
BOX: SUBSIDIZED GOODS AND IN-KIND COMPENSATION	9
<b>Military Compensation in the Context of the Defense Budget</b>	9
DoD’s Compensation Plans and Funding Under Current Law	9
BOX: BENEFITS PROVIDED BY THE DEPARTMENT OF VETERANS AFFAIRS	10
BOX: PROJECTIONS OF DEFENSE APPROPRIATIONS UNDER THE BUDGET CONTROL ACT	12
Two Scenarios for Military Compensation	14
<b>Current Cash Compensation</b>	16
Elements of Cash Compensation	17
How Cash Compensation Has Evolved Over Time	18
Military and Civilian Compensation Compared	20
Projected Costs of Cash Compensation	20
Controlling the Costs of Cash Compensation	22
<b>Military Retirement Benefits</b>	22
Alternative Retirement Plans	23
Other Features of Military Retirement	24
Projected Costs of Military Retirement	27
Controlling the Costs of Military Retirement	27
<b>The Military Health Care System</b>	28
TRICARE	28
BOX: INCREMENTAL HEALTH CARE COSTS RELATED TO COMBAT	30
Projected Costs of the Military Health Care System	32
Controlling the Costs of Military Health Care	35
<b>Appendix A: Enhancements to the Military Retirement System Enacted Since 2000</b>	37
<b>Appendix B: Accrual Accounting for the Military Retirement System</b>	39
<b>Appendix C: Legislative History of Cost-Sharing in TRICARE</b>	41
<b>Appendix D: Were Military Personnel Promised Low-Cost Health Care in Retirement?</b>	43
<b>List of Tables and Figures</b>	45
<b>About This Document</b>	46



# Summary

**C**ompensation of military personnel takes up a substantial portion of the nation's defense budget. In its fiscal year 2013 budget request, for example, the Department of Defense (DoD) requested about \$150 billion to fund the pay and benefits of current and retired members of the armed services. As in most recent years, that amount was more than one-quarter of DoD's total base budget request (the request for all funding other than for military operations in Iraq and Afghanistan and for related activities—often called overseas contingency operations). The compensation request involved four major areas:

- Current cash compensation for service members, consisting of basic pay, food and housing allowances, bonuses, and various types of special pay;
- Accrual payments that account for the future cash compensation of current service members in the form of pensions for those who will retire from the military (generally after at least 20 years of service);
- Accrual payments that account for the future costs of health care for current service members (under a program called TRICARE for Life) who will retire from the military and also become eligible for Medicare (generally at age 65); and
- Funding for current spending under the military health care program (known as TRICARE), excluding the costs of caring for current military retirees who also are eligible for Medicare (the latter costs are covered by the accrual payments made in earlier years, just described).

In all, about 1.4 million active-duty military personnel and about 1.1 million members of the reserves and National Guard receive current cash compensation, the largest part of compensation in DoD's budget. Cash compensation for members of the reserves and National Guard goes mainly to the 840,000 members of the

Selected Reserve—service members who are assigned to and train regularly with standing units. Second in total cost to current cash compensation, military health benefits are available to nearly 10 million people: active-duty military personnel and their eligible family members, retired military personnel and their eligible family members, survivors of service members who died while on active duty, and certain members of the reserves and National Guard.

This report does not consider the costs of the benefits provided by the Department of Veterans Affairs (VA)—about \$130 billion in that department's 2013 budget request. Those benefits include health care for veterans with service-connected disabilities and for veterans who meet certain other eligibility criteria. Other VA benefits include monthly cash payments that compensate for service-connected disabilities and GI Bill benefits that reimburse some of the costs of higher education.

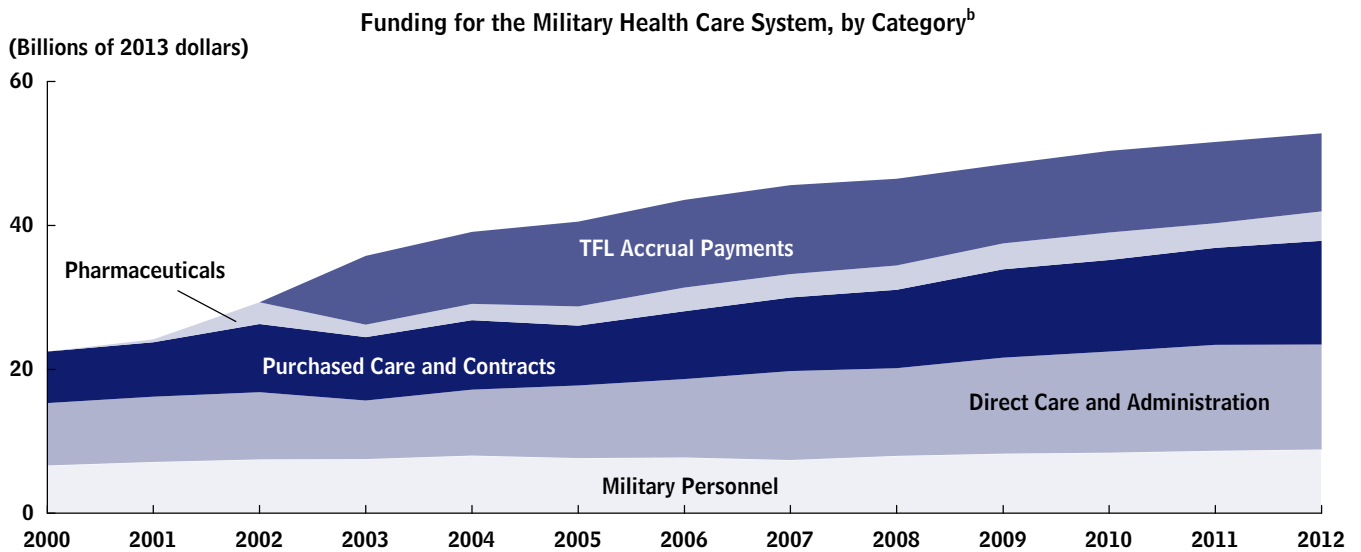
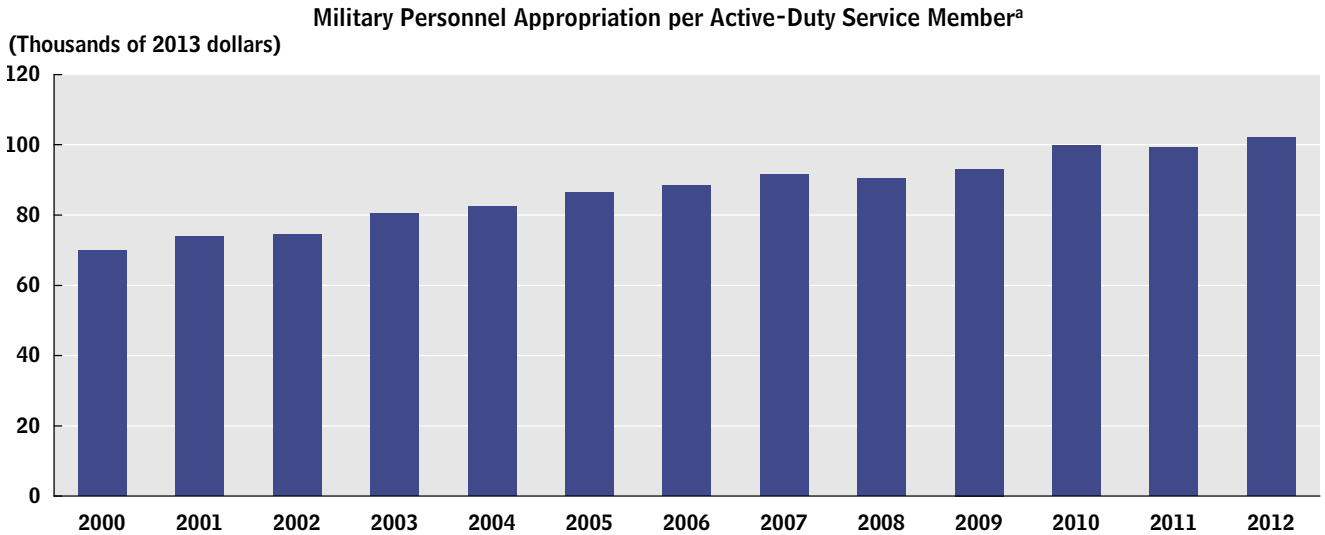
This report also does not consider the costs of pay and benefits for DoD's roughly 790,000 full-time-equivalent civilian employees, other than for the 60,000 who are assigned to the military health care system and whose compensation contributes to the estimate of the total cost of delivering military health care.

## Projected Costs

Over the past decade, the costs per active-duty service member that are funded through DoD's military personnel account (which funds current cash compensation and the accrual payments for retirees' pensions and some of their health care) and the total costs for the military health care program have increased consistently, even with an adjustment for inflation in the general economy (see Summary Figure 1). The trend in the military personnel account is attributable primarily to a series of pay raises that exceeded the general rate of inflation and, in some years, the growth rate of private-sector wages and salaries.

**Summary Figure 1.**

**Funding for Military Compensation**



Source: Congressional Budget Office based on data contained in *Long-Term Implications of the 2013 Future Years Defense Program* (July 2012).

Note: Excludes funding for overseas contingency operations.

- a. Active-duty service members are counted as of the final day (September 30) of each fiscal year.
- b. The TRICARE for Life (TFL) program began in 2002 but was not funded on an accrual basis until 2003.

Before 2001, pharmaceutical costs were not separately identifiable but were included in the costs of two categories: Purchased Care and Contracts and Direct Care and Administration. An initiative to separately identify pharmaceutical costs began in 2001, and since 2002, most pharmaceutical costs have been so identified. However, some of those costs incurred since 2003 have been included in the category TFL Accrual Payments.

In particular, the annual changes in basic military pay—the largest and most visible part of cash compensation—have since 2000 been linked to changes in the Bureau of Labor Statistics' employment cost index (ECI) for wages and salaries in private industry. The ECI historically has increased faster than prices, which are measured here using the deflator for gross domestic product (GDP). Moreover, in 2008, 2009, and 2010, lawmakers authorized military pay raises that were 0.5 percentage points above the increase in the ECI. Also at work in pushing up compensation costs were several enhancements to pension and health benefits for retired military personnel and medical costs per beneficiary that escalated more rapidly than did either general inflation or increases in per capita costs for medical care in the national economy.

DoD's plans, as reflected in the 2013 Future Years Defense Program (FYDP) submitted to the Congress in April 2012, do not include military pay raises that keep pace with the ECI from 2013 through 2017. Instead, the department's plans include a 1.7 percent pay raise for 2013. For 2014, DoD again proposes a raise of 1.7 percent, which is below the amount projected by the Congressional Budget Office (CBO) for the increase in the ECI for that year but is perhaps consistent with DoD's own projection of the ECI. For 2015 through 2017, DoD is proposing pay raises of 0.5 percent, 1.0 percent, and 1.5 percent, respectively—all smaller than the department's projection of ECI growth for those years. With those raises, basic pay would remain essentially flat in real (inflation-adjusted) terms (relative to the GDP deflator) between 2013 and 2017, and it would lose a total of 11 percentage points of growth relative to CBO's projection of the ECI for that period.

On the basis of DoD's 2013 FYDP, CBO projected that the costs of military health care that are funded by the accounts for military personnel and for operation and maintenance would rise from \$51 billion in 2013 to \$65 billion by 2017 and to \$77 billion by 2022 (all measured in 2013 dollars).<sup>1</sup> Real growth in health care costs over the decade would average 4.6 percent per year, according to CBO's projections.

DoD's fiscal situation has changed as a result of the enactment of the Budget Control Act of 2011 (BCA, Public Law 112-25). To comply with that act, the Consolidated

Appropriations Act, 2012 (P.L. 112-74), provided \$530 billion for DoD's base budget—about \$24 billion, or 4 percent, less than the department requested. CBO estimates that funding for fiscal year 2013 could drop to \$469 billion—a cut of an additional 12 percent—if all of the BCA's provisions, including sequestration (the automatic cancellation of a portion of budgetary resources), remain in force. Even if the defense budget was cut by that amount, however, the costs of military compensation probably would not decline by the same percentage. Unless current law is changed, basic pay will continue to be linked to the ECI, and military health care costs will continue to grow rapidly. Thus, to comply with the BCA, DoD might have to take such steps as reducing the number of military personnel or cutting elements of compensation that are not automatically linked to the ECI or to other external economic indicators.

## Controlling Costs

Several approaches could be taken to curtail spending on military compensation. One possibility would be to restrict basic pay raises, as DoD has proposed for 2015 through 2017. Although smaller raises could lead to fewer enlistments and faster attrition from the armed services, those consequences might be mitigated by increasing the availability of enlistment bonuses and selective reenlistment bonuses (the latter are offered to service members in hard-to-fill occupations). Reenlistment bonuses can be a useful tool for increasing retention while curbing costs because, in contrast to basic pay raises, they do not compound from year to year and they have no effect on the value of future retirement annuities.

Another approach to controlling compensation costs might be to replace the current retirement system (under which active-duty members qualify for immediate benefits after 20 years of service) with a defined-benefit system that partially vests earlier in a member's career or with a defined-contribution system under which DoD matches the service members' contributions to a savings plan or with some combination of the two systems. Those measures could cost less or more than the current system, depending on their structure and implementation. Any reductions in overall federal outlays stemming from new rules would be delayed for 20 years if all current service members remained in the current system. However, DoD could immediately begin to spend less on the accrual payments it makes to the Military Retirement Fund if the defined-benefit plan became, on balance, less generous.

1. See Congressional Budget Office, *Long-Term Implications of the 2013 Future Years Defense Program* (July 2012).

Still another way to control compensation costs would be to increase health care enrollment fees, deductibles, or copayments. Higher enrollment fees raise collections by DoD and could discourage some retiree families from relying on DoD to provide their health care (thus generating further savings); higher deductibles and copayments also act to restrain the use of medical services and thereby reduce the government's cost. As an example, in the past CBO has examined an option that would preclude military retirees who are not yet eligible for Medicare from enrolling their families in TRICARE Prime (the

TRICARE option that operates like a health maintenance organization), allowing them instead to pay to enroll in a plan that would provide access to a combination of network providers (similar to a preferred provider organization) and non-network providers (similar to a fee-for-service plan). CBO estimated that such an option could save the government as much as \$10 billion per year.<sup>2</sup>

---

2. See Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March 2011), pp. 80–81.



# Costs of Military Pay and Benefits in the Defense Budget

## Introduction

The basic pay that all military service members receive is the largest and most visible component of military compensation, and, in many recent years, annual adjustments in basic pay have been a source of contention between the Administration and the Congress. Despite that, however, basic pay accounts for only about one-third of all military compensation. The Department of Defense (DoD) relies on a complex system of current and deferred, cash and noncash compensation to attract and retain service members (see Table 1). In some areas, DoD has considerable flexibility to adjust compensation in what it deems the most effective way to attract and retain service members; in other areas, current law limits that flexibility. In all cases, current law provides the authority for DoD to structure its compensation system.

To aid the Congress in its consideration of the military compensation system, this study examines a range of issues from two perspectives: that of the service members and retirees who are compensated by the system and that of the DoD budget. Each point of view is important for elucidating the way the compensation system is operated, how much it costs, and how it affects those who receive the compensation.

## Defining Military Compensation: The Service Member's Perspective

DoD measures the largest elements of current cash compensation that all service members regularly receive by means of a construct called regular military compensation (RMC): basic pay plus allowances for subsistence (food) and housing and an estimate of the financial advantage that arises because those allowances are not subject to federal income taxes.

The basic pay component varies with a member's pay grade and years of service. Subsistence allowances are paid at one monthly rate for enlisted personnel and another for officers, and housing allowances depend not just on

pay grade but also on location and whether a member has dependents. Thus, in calendar year 2012, an enlisted member in the fourth-most-junior pay grade (E-4 or, in the Army, corporal) with between 48 months and 72 months of service earns annual basic pay of \$27,200 and a subsistence allowance of \$4,180. Housing allowances vary considerably by location, but the average for a member with dependents stationed in the continental United States is \$14,820.<sup>1</sup> With an estimated tax advantage of \$4,660, that service member's RMC for the year comes to \$50,860. An officer in the third-most-junior rank (an Army captain or a Navy lieutenant with a pay grade of O-3) with six years of service and at least one dependent earns basic pay of \$63,260; the current RMC for that service member is \$92,220.<sup>2</sup>

In addition to RMC, some service members receive other forms of current cash compensation at various points or, in some cases, throughout their careers:

- Enlistment, reenlistment, and officer accession and retention bonuses;
- Special or incentive pay for service members (such as physicians, nuclear-qualified technicians, and aviators) who acquire or retain critical skills or for those who improve proficiency (such as doctors who achieve board certification or aviators who log additional operational flying time); and

- 
1. DoD specifies notional housing profiles for various combinations of pay grade and dependency status—for example, for a one-bedroom apartment for an E-4 without dependents or for a two-bedroom townhouse for an E-5 with dependents. See Department of Defense, *A Primer on Basic Allowance for Housing (BAH) For the Uniformed Services, 2011* (January 2011), <http://go.usa.gov/y0Q>.
  2. For an online calculator, see Department of Defense, "Regular Military Compensation (RMC) Calculator" (accessed November 8, 2012), <http://go.usa.gov/y0P>.



**Table 1.**  
**Types of Military Compensation**

Cash	Noncash <sup>a</sup>
	<b>Current</b>
<ul style="list-style-type: none"> <li>• Basic pay</li> <li>• Housing allowance</li> <li>• Subsistence (Food) allowance</li> <li>• Bonuses and special pay</li> </ul>	<ul style="list-style-type: none"> <li>• Health care for service member and family</li> <li>• Subsidized groceries at commissaries</li> <li>• Subsidized consumer goods at exchanges</li> <li>• Subsidized child care</li> <li>• Fitness and recreation centers</li> <li>• Deployment support programs for military families</li> </ul>
	<b>Deferred</b>
<ul style="list-style-type: none"> <li>• Military retirement pay (Pension)</li> </ul>	<ul style="list-style-type: none"> <li>• Health care for retired service member and family</li> <li>• Subsidized groceries at commissaries</li> <li>• Subsidized consumer goods at exchanges</li> </ul>

Source: Congressional Budget Office.

a. The items shown are the major categories of noncash compensation.

- Pay for accepting difficult or dangerous assignments, such as assignment incentive pay, special duty pay, hostile fire or imminent danger pay, and family separation allowances.

For fiscal year 2013, DoD requested \$51 billion for basic pay and \$7 billion for all of those forms of special and incentive pay.

Current noncash compensation includes benefits that service members can use immediately, including health care for themselves and their eligible family members, subsidies for groceries and consumer goods sold at military commissaries and exchanges, use of recreation centers, and subsidized child care.

Deferred compensation includes both cash compensation in the form of military retirement annuities and noncash benefits such as health care for retirees and their eligible family members and continued access to the commissaries and exchanges. Other deferred benefits, funded through the Department of Veterans Affairs (VA) rather

than through DoD, include access to health care and other benefits such as monthly cash payments for service-connected disabilities and GI Bill benefits that reimburse some of the costs of higher education.

Current noncash and deferred compensation is more difficult to measure than is current cash compensation, but at least three measurement concepts are of potential interest:

- The costs borne by DoD (and possibly other federal agencies) to provide a given benefit;
- The value of the benefit as perceived by service members, conceptually measured as the amount of current cash compensation a service member would be willing to accept in lieu of the benefit; or
- The savings to a beneficiary, conceptually measured as what the beneficiary would spend (for example, on out-of-pocket charges for health care) if the goods or services were not provided by the military.<sup>3</sup>

This report focuses on the first of those three concepts—the costs borne by DoD.<sup>4</sup>

### Defining Military Compensation: The Budgetary Perspective

About 1.4 million people serve on active duty in the military, and another 1.1 million are in the reserves and National Guard. Compensation costs for the latter two groups are principally for the 840,000 members of the Selected Reserve, who are assigned to and regularly train

3. The third approach—measuring the savings to the beneficiary—was presented in James E. Grefer, *Comparing Military and Civilian Compensation Packages* (Center for Naval Analyses, March 2008), [www.cna.org/research/2008/comparing-military-civilian-compensation-packages](http://www.cna.org/research/2008/comparing-military-civilian-compensation-packages). That paper was published in support of another publication; see Department of Defense, *Report of the Tenth Quadrennial Review of Military Compensation*, vol. 2, *Deferred and Noncash Compensation* (July 2008), <http://go.usa.gov/y0s>.

4. This perspective is in keeping with some earlier work of the Congressional Budget Office. See the statement of Carla Tighe Murray, Senior Analyst, Congressional Budget Office, before the Subcommittee on Personnel, Senate Committee on Armed Services, *Evaluating Military Compensation* (April 28, 2010); and Congressional Budget Office, *letter to the Honorable Steny H. Hoyer concerning an analysis of federal civilian and military compensation* (January 20, 2011).

**Table 2.**  
**DoD's Funding Request for Military Compensation, 2013**

	Billions of Dollars
Military Personnel Appropriation	
Basic pay	51.2
Other pay and allowances	37.5
Accrual payments into the Military Retirement Fund	16.4
Accrual payments into the MERHCF	6.7
Transfer of personnel costs from the OCO budget <sup>a</sup>	5.3
Subtotal <sup>b</sup>	117.0
Defense Health Program, Operation and Maintenance Appropriation	
Direct care at military medical treatment facilities and administrative costs <sup>c</sup>	14.1
Purchased care and contracts	14.2
Pharmaceuticals	3.8
Subtotal <sup>d</sup>	32.0
<b>Total</b>	<b>149.0</b>

Source: Congressional Budget Office.

Notes: All entries are for the base budget only and exclude additional funding requested for overseas contingency operations.

DoD = Department of Defense; MERHCF = Medicare-Eligible Retiree Health Care Fund; OCO = overseas contingency operations.

- a. CBO transferred into the base budget the personnel costs for the 41,000 soldiers and 15,000 marines on active duty whom DoD is planning to pay from the OCO budget.
- b. Excludes \$4.6 billion for permanent change-of-station travel and \$18.8 billion for other activities requested in the military personnel appropriation.
- c. Excludes \$8.2 billion in the military personnel appropriation for the pay and allowances of 86,000 military medical personnel who provide health care at military treatment facilities; that amount is included in the subtotal for the military personnel appropriation.
- d. Excludes \$0.5 billion for procurement and \$0.7 billion for research, development, test, and evaluation in the budget request for the Defense Health Program.

with standing units. In all, nearly 10 million people are eligible for health care benefits provided through TRICARE (the military health care program) and TRICARE for Life (TFL, the supplementary health care program for retired service members and their

dependents who also are eligible for Medicare). Those beneficiaries include all active-duty service members and their eligible family members, retired military personnel and their eligible family members, survivors of service members who died while on active duty, and certain members of the reserves and National Guard.

Researchers, policymakers, and others define military compensation in various ways, and no single definition is universally accepted. The Congressional Budget Office (CBO) developed the definitions used in this study with reference to the organization of DoD's budget, which is divided generally into six large categories: military personnel (MILPERS); operation and maintenance (O&M); research, development, test, and evaluation (RDT&E); procurement; military construction; and family housing. This study defines funding for military compensation as the sum of four parts:

- The MILPERS appropriation for pay, bonuses, and allowances;
- Accrual payments into the Military Retirement Fund, which account for future cash compensation in the form of pensions for the subset of current service members who eventually will retire from the military (generally after at least 20 years of service);
- Accrual payments into the Medicare-Eligible Retiree Health Care Fund (MERHCF), which account for the future costs of health care (under TFL) for the subset of current service members who eventually will retire from the military and also become eligible for Medicare (generally at age 65); and
- Funding from the O&M appropriation for TRICARE, excluding the costs of caring for current military retirees who also are eligible for Medicare (the latter costs are financed by outlays from the MERHCF, as described above).

Under the assumptions and definitions CBO has adopted for this report, DoD's 2013 request for military compensation was \$149 billion, or 28 percent of its total base budget request of \$526 billion (see Table 2).

The largest share of military compensation comes from the MILPERS appropriation. Other activities that CBO classifies as compensation are funded from other appropriations. In particular, the O&M appropriation provides

significant funding for military health care, with smaller amounts for health care coming from the procurement and RDT&E accounts.

The MILPERS appropriation contains the funds for basic military pay, subsistence and housing allowances, all of the various types of special and incentive pay, bonuses, and the government's share (as the employer) of the social insurance taxes that fund Social Security and Medicare benefits. Some funds from the MILPERS appropriation are used to make accrual payments to account for the future pension costs for the current active-duty population; DoD estimates those payments at roughly one-third the value of active-duty basic pay. However, CBO excludes from its definition of military compensation the funds contained in the MILPERS account that pay moving expenses for service members and their families who relocate to new duty stations (about 3 percent of that account) and other costs that are borne by DoD but not reflected in service members' paychecks (for example, the costs of apprehending military deserters). Taking all of those elements of compensation together, the requested MILPERS appropriation for 2013 includes \$117 billion for military compensation (see Table 2).

Another \$32 billion that CBO classifies as military compensation was requested through the O&M appropriation. That part of the O&M budget supports the Defense Health Program.<sup>5</sup> Specifically, those funds support direct care at military medical treatment facilities and administrative costs, purchased health care and contracts for such care, and pharmaceuticals. The \$8.2 billion cost of the pay and allowances for the 86,000 military personnel whom DoD plans to assign to the military health care system is included in the MILPERS appropriation.

In 2013, DoD also budgeted \$74 billion for the pay and benefits of about 790,000 full-time-equivalent civilian employees, mostly from the O&M appropriation but with smaller amounts coming from procurement and RDT&E funds. CBO does not consider those costs in this analysis of military compensation, except implicitly for the 60,000 civilian employees who are assigned to the

military health care system and whose compensation is included in the O&M cost of delivering military health care.

The definition of military compensation used in this report accounts for most, but not all, of the costs of military compensation in DoD's budget. It excludes such noncash benefits as fitness and recreation centers, subsidized child care, and subsidies for groceries sold at military commissaries; CBO's definition also excludes deployment support programs that provide various types of assistance to military families. (For additional discussion of noncash benefits, see Box 1.)

The definition of military compensation used in this report also greatly understates the total amount that the federal government pays for current and former military personnel. The discussion here is restricted to DoD's budget and excludes VA benefits (see Box 2 on page 10). VA's funding request for 2013 includes \$56 billion for its medical program and \$76 billion for its other programs.<sup>6</sup> The total of \$132 billion is nearly 90 percent of the amount (\$149 billion) for military compensation that CBO identified in DoD's request for the same year. In addition, the definition of compensation used here excludes the tax revenues lost to the U.S. Treasury because subsistence and housing allowances are exempt from the federal income tax, as are many types of pay and bonuses if earned in a combat zone. Finally, because of the emphasis on DoD's budget, CBO's definition of military compensation also excludes accrual payments that the Treasury (not DoD) makes to fund "concurrent receipt"—the ability of some retired military personnel to receive military retirement pay without any offset for the VA compensation they receive for service-connected disabilities.<sup>7</sup>

5. The Defense Health Program is the collection of program elements in DoD's Future Years Defense Program that funds the health care activities of TRICARE, the military health care program.

6. Department of Veterans Affairs, *Annual Budget Submission (FY 2013)* (February 2012), <http://go.usa.gov/YPDj>.

7. For alternative definitions of military compensation—also from the budgetary perspective—see Maren Leed, *Keeping Faith: Charting a Sustainable Path for Military Compensation* (Center for Strategic and International Studies, October 2011), [http://csis.org/files/publication/111118\\_Leed\\_KeepingFaith\\_WebS.pdf](http://csis.org/files/publication/111118_Leed_KeepingFaith_WebS.pdf); and Todd Harrison, *Analysis of the FY 2012 Defense Budget* (Center for Strategic and Budgetary Assessments, July 2011), [www.csbaonline.org/search/?x=0&y=0&q=Analysis+of+the+FY+2012+Budget](http://www.csbaonline.org/search/?x=0&y=0&q=Analysis+of+the+FY+2012+Budget).

**Box 1.****Subsidized Goods and In-Kind Compensation**

The availability of noncash benefits—free health care and subsidized child care, for example—increases the attractiveness of military service as a career path. And the similarity from one base to another, even in remote locations or overseas, of goods and services to be found at commissaries, exchanges, and recreation facilities reduces costs and can temper the difficulty of changing schools, finding places to shop, and acquiring housing as service members move from place to place.

Some costs of noncash benefits are easy to estimate, such as the \$1.4 billion annual appropriation to the Defense Commissary Agency that covers a portion of the agency's operating costs and, in effect, subsidizes its food sales. For other elements of compensation, such as access to fitness centers, it is conceptually difficult to separate a personal benefit—in this case, recreation—from the institutional benefit of promoting service members' readiness to perform a mission. Other types of compensation, such as on-base parking, although undoubtedly valued by service members, are not accounted for separately in budget docu-

ments. For this study, rather than including only the subset of those benefits for which costs are most easily estimated, the Congressional Budget Office simply excluded all noncash benefits other than health care.

Some observers assert that a shift from paying service members in the form of subsidies and in-kind benefits toward providing more cash compensation would allow individual service members to purchase the goods and services they value most and help the department to retain service members for a longer term at a lower total cost.<sup>1</sup> Moreover, because two-thirds of active-duty service members live off-base, as do all nonactivated reservists, on-base facilities may not serve those members as effectively as a more cash-based system might. Finally, it could be simpler for the department to direct cash incentives to the service members who are most productive or whose skills are of greatest value to the military for the long term.

1. Carla Tighe Murray, "Transforming In-Kind Compensation and Benefits," in Cindy Williams, ed. *Filling the Ranks: Transforming the U.S. Military Personnel System* (MIT Press, 2004).

## Military Compensation in the Context of the Defense Budget

The funding caps in the Budget Control Act of 2011 (BCA, Public Law 112-25) require significant cuts in DoD's budget relative to the budgetary plan expressed in the department's 2013 Future Years Defense Program (FYDP). If, as in the past, DoD continues to receive 95.5 percent of all funding in budget function 050 (national defense)—and before considering the additional reductions in funding caps that would stem from the BCA's automatic enforcement procedures—the department's base budget (net of funding for overseas contingency operations, or OCO) will decline by a total of \$22 billion (in nominal dollars) relative to its five-year plan for 2013–2017. If, further, the automatic enforcement procedures are triggered in January 2013, DoD's base budget will drop by \$52 billion more per year, CBO estimates, bringing the five-year cuts to a total of

\$282 billion, or 10 percent of the amount in DoD's plan. By 2021—the final year explicitly addressed by the BCA—the reduced cap on DoD's budget would be 15 percent lower than the real (inflation-adjusted) amount appropriated for 2012. (Box 3 on page 12 gives estimates of the trajectory for the defense budget under the terms of the BCA.) The scheduled reductions will be extremely difficult to achieve without reducing the number of military personnel, curtailing their pay and benefits, or undertaking some combination of those two actions.

### DoD's Compensation Plans and Funding Under Current Law

DoD's 2013 FYDP contained a plan to decrease active-duty end strength (the number of military service personnel on the rolls as of the final day of a fiscal year) by 72,000, or about 5 percent, over five years—from

**Box 2.****Benefits Provided by the Department of Veterans Affairs**

The Department of Veterans Affairs (VA) offers a variety of benefits to veterans of military service. The Veterans Health Administration (VHA) is responsible for health care. Many other benefits—such as disability compensation (for veterans who incur service-connected disabilities); pensions (for wartime veterans with low income who are at least age 65 or, if younger, who are permanently and totally disabled because of nonservice injuries or medical conditions); life insurance; home loan subsidies; educational assistance; and educational and vocational counseling—are provided by the Veterans Benefits Administration (VBA). The National Cemetery Administration provides veterans with burial and memorial benefits.

VA's budget request for 2013 included \$76 billion for the mandatory programs administered by VBA.<sup>1</sup> The remainder of VA's budget authority consisted of discretionary funding plus the authority to spend from the Medical Care Collection Fund (MCCF), which collects copayments from veterans for inpatient and outpatient care and for pharmaceuticals and collects third-party payments from veterans' insurance companies. VA requested \$56 billion for medical programs and associated medical research and support, including \$3 billion from the MCCF. Finally, adding \$260 million for the National Cemetery Administration and \$7 billion for department

administration brings the entire 2013 budget request to \$140 billion. (Neither the Department of Defense nor VA makes any accrual payments to account for future benefits that VA will provide to current service members when they separate or to current veterans as they age.)

Although eligibility criteria vary among VA's categories of benefits, all are contingent on the veteran's character of discharge. The military services determine whether a service member receives an honorable discharge, a general discharge under honorable conditions, a discharge under other than honorable conditions, or a bad conduct discharge. VA has developed a complex set of rules that implement the Code of Federal Regulations and determine whether a veteran's service record qualifies the veteran for particular VA benefits.<sup>2</sup> Veterans with honorable or general discharges are eligible for most VA benefits, although there are some exceptions. Veterans who are discharged under other-than-honorable conditions (but not bad conduct) are eligible for health care and related benefits for any disability incurred or aggravated in the line of duty during active service. Only veterans who receive an honorable discharge are eligible for educational assistance under the Post-9/11 GI-Bill.<sup>3</sup>

1. Spending for mandatory programs is determined through eligibility rules and other parameters in authorizing legislation rather than by appropriation of specific amounts each year. Funding for discretionary programs is provided in annual appropriation acts.

2. Department of Veterans Affairs, *M21-1MR, Compensation and Pension Manual Rewrite: Veterans Benefits Administration References*, Part 3, Subpart v, Chapter 1, Section B (updated March 7, 2006), <http://go.usa.gov/yms>.

3. Department of Veterans Affairs, "The Post-9/11 GI-Bill" (July 24, 2012), <http://go.usa.gov/ym6>.

Continued

1,392,000 in 2013 to 1,320,000 by 2017. To comply with the BCA's funding caps (before automatic enforcement procedures take effect), DoD's plan shifted the personnel costs for 41,000 soldiers and 15,000 marines on active duty from the base budget to the OCO budget in 2013 and made similar but smaller shifts for 2014 through 2016. Those changes effectively compress the number of military personnel paid out of the base budget

and accelerate the apparent savings from the planned reduction in end strength. In its analysis of the FYDP, CBO estimated the personnel costs of the service members paid from the OCO budget and transferred those costs back to the base budget (see Table 2 on page 7).<sup>8</sup>

8. See Congressional Budget Office, *Long-Term Implications of the 2013 Future Years Defense Program* (July 2012).

**Box 2.****Continued****Benefits Provided by the Department of Veterans Affairs**

Eligibility for health care from VHA also depends on other considerations. Generally, veterans of the active components of the military must have served 24 continuous months on active duty; reservists and National Guard members may be eligible if they are called to active duty under a federal order and they complete that service. Those broad criteria, however, do not necessarily guarantee access to medical treatment. VHA operates an enrollment system that assigns each beneficiary to one of eight categories to establish priority for using its health care services. Veterans with higher priority include those with service-connected disabilities, low income, or both. In January 2003, VHA imposed a general freeze (with some subsequent modifications) on new enrollments in the lowest priority group (Priority Group 8).<sup>4</sup>

The Veterans Programs Enhancement Act of 1998 (Public Law 105-368) guarantees access to VHA's health care system, after separation from active military service, to members of the armed forces who have served on active duty in combat operations since the law was enacted in November 1998; reservists and members of the National Guard who have served in combat operations are included under that guarantee. Specifically, the law gave combat veterans two years (starting from their date of separation from the military) to enroll and use VHA's health care system without requiring those veterans to document either that their income is below established thresholds or that they have service-connected disabilities—

4. Veterans in Priority Group 8 have no service-connected disabilities (or have service-connected disabilities that are ineligible for monetary compensation) and have annual income or net worth above VA's means-test threshold and regional income threshold. See Department of Veterans Affairs, "Health Benefits: Priority Groups Table" (August 20, 2012), <http://go.usa.gov/Ymff>.

requirements that noncombat veterans must fulfill. In 2008, lawmakers extended the enhanced eligibility period for care through VHA's health care system to five years.<sup>5</sup> Under those legislative authorities, VHA provides free health care for medical conditions directly or potentially related to a veteran's military service in combat operations for five years after separation. Veterans who had deployed to overseas contingency operations may continue to use VHA's services when the five-year period of enhanced eligibility ends, but their priority group for enrollment may change, depending on their disability status and income. In particular, such veterans may be moved to a lower priority group, including Priority Group 8, and incur the applicable copayments for health care services.

Eligibility for disability compensation (the most costly of the mandatory programs administered by VBA) is determined on the basis of character of discharge and the rating of disability assigned by VBA. (Veterans who claim disability compensation are exempt from minimum time-in-service requirements.) To provide monthly disability benefits, VBA must have evidence that the veteran has a current disability, that the veteran incurred or aggravated an injury or disease while on active duty, and that the current disability is attributable to that service-connected medical problem. Once a veteran is judged to have met those criteria, VBA applies a rating of 0 percent to 100 percent disabling in 10 percentage-point increments; that rating can be raised or lowered as a veteran's condition changes. Disability payments are determined by a veteran's disability rating: The greater the impairment, the larger the payment.

5. See section 1707 of the National Defense Authorization Act for Fiscal Year 2008, Public Law 110-181, 122 Stat. 493.

**Box 3.****Projections of Defense Appropriations Under the Budget Control Act of 2011**

The Budget Control Act of 2011 (BCA, Public Law 112-25) made several changes to federal programs, set caps on discretionary appropriations through 2021, and included automatic enforcement procedures that were to take effect if lawmakers failed to enact further legislation to reduce future budget deficits by specified amounts. At the time of the BCA's enactment, its caps on discretionary appropriations called for appropriations over the 2012–2021 period that would be roughly \$0.8 trillion lower in nominal dollars during that period than if appropriations grew at the rate of inflation. The BCA also stated that if legislation originating from a newly established Joint Select Committee on Deficit Reduction that was estimated to produce at least \$1.2 trillion in deficit reductions (including an allowance for interest savings) was not enacted by January 15, 2012, automatic procedures for further limits on discretionary and mandatory spending would be triggered. Because no such legislation was enacted, those procedures are now scheduled to go into effect at the beginning of January 2013.

The triggering of the automatic enforcement procedures generated two changes to the way the caps will be implemented: It allocated the overall limits on discretionary appropriations between defense and non-defense budget functions by setting separate caps for each, and it reduced the total allowed funding below the original caps. For 2013, the additional reductions in allowed funding will be achieved by automatically canceling a portion of the budgetary resources already provided to that point (in an action known as sequestration); from 2014 to 2021, the reductions will be achieved by lowering the original caps on discretionary appropriations.<sup>1</sup> Under the BCA, there are no caps on funding for overseas contingency operations (OCO) or certain other activities.

Defense appropriations are defined as appropriations for budget function 050 (national defense), which includes the military activities of the Department of Defense (DoD), the nuclear weapons activities of the Department of Energy and the National Nuclear Security Administration, and the national security activities of several other agencies.<sup>2</sup> On average, during the past 10 years, funding for DoD has represented 95.5 percent of total funding for budget function 050.

Under the allocation of the BCA's caps on discretionary appropriations stemming from the automatic enforcement procedures—but before the reductions in the caps resulting from those procedures—total funding for national defense during the 2013–2021 period would be \$290 billion less than what would have been provided if appropriations increased with inflation starting from the amount appropriated in 2012. The automatic reductions will lower the caps on discretionary funding for national defense by an additional \$492 billion over the 2013–2021 period, with the reduction spread evenly at nearly \$55 billion per year. The resulting caps start at \$491 billion in 2013 and rise to \$589 billion in 2021; the cap for 2021 is 15 percent lower than the amount appropriated for 2012, adjusted for inflation.

If DoD was assessed the same share of the \$55 billion per year in automatic reductions for national defense as the department has received in funding historically, its budget authority would be reduced by about \$52 billion each year. For 2013, sequestration will apply both to the base budget and to funding for OCO, and the effect on the base budget alone is unclear; the amounts discussed here are estimated as though sequestration applied only to the base budget.

1. For more information on those reductions, see Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022* (August 2012), Box 1-1.

2. For information about the caps on discretionary budget authority for national defense, see Congressional Budget Office, *Final Sequestration Report for Fiscal Year 2012* (January 2012), Table 2.

Continued

**Box 3.**

**Continued**

**Projections of Defense Appropriations Under the Budget Control Act of 2011**

**DoD's Funding Projected Under the Limits of the BCA**

(Billions of dollars)

	Budget Control Act									
	Future Years Defense Program					2018	2019	2020	2021	2022
	2013	2014	2015	2016	2017					
<b>Nominal Dollars</b>										
2013 FYDP and Extension <sup>a</sup>	526	534	546	556	567	607	620	641	661	680
Estimate of DoD's Funding Under the BCA Caps										
Before automatic reductions <sup>b</sup>	521	531	540	551	563	576	588	602	615	632 <sup>c</sup>
After automatic reductions <sup>d</sup>	469	479	488	499	511	524	536	549	563	578 <sup>c</sup>
<b>2013 Dollars</b>										
2013 FYDP and Extension <sup>a</sup>	526	527	529	529	530	556	556	563	570	575
Estimate of DoD's Funding Under the BCA Caps										
Before automatic reductions <sup>b</sup>	521	524	524	525	526	527	527	529	530	534 <sup>c</sup>
After automatic reductions <sup>d</sup>	469	472	473	475	477	480	481	483	485	489 <sup>c</sup>

Source: Congressional Budget Office, *Long-Term Implications of the 2013 Future Years Defense Program* (July 2012), Table 1-4.

Note: DoD = Department of Defense; BCA = Budget Control Act of 2011; FYDP = Future Years Defense Program.

- a. For 2013 to 2017, funding amounts correspond to DoD's 2013 FYDP. For the extension of the FYDP (2018 to 2022), CBO projects the costs of DoD's plans using the department's estimates of costs to the extent they are available and costs that are consistent with CBO's projections of price and compensation trends in the overall economy where the department's estimates are not available.
- b. This estimate assumes that DoD would receive 95.5 percent of the funding limit for national defense *before* reductions arising from the BCA's automatic enforcement procedures, on the basis of DoD's average share of that funding in base budgets from 2002 to 2011.
- c. CBO estimates this value as the value for 2021 plus an adjustment for expected inflation. Discretionary funding related to federal personnel is inflated using the employment cost index for wages and salaries; other discretionary funding is adjusted using the gross domestic product price index.
- d. This estimate assumes that DoD would receive 95.5 percent of the funding limit for national defense *after* reductions arising from the BCA's automatic enforcement procedures, on the basis of DoD's average share of that funding in base budgets from 2002 to 2011.

DoD's base budget request for 2013 (net of OCO costs) exceeds estimated funding under the caps, before the automatic enforcement procedures are applied, by \$5 billion (assuming DoD receives its historical share of funding for national defense). Through 2017, DoD's budgetary plan exceeds its estimated share of those caps by a total of \$22 billion in nominal terms (compare the first and second rows of the table for the years 2013 through 2017). The annual gap widens to \$46 billion by 2021 (the final year explicitly addressed by the BCA) because the Congressional Budget Office's extension of DoD's

plan incorporates military and civilian pay raises that keep pace with the employment cost index, health care costs that track with national trends, and other sources of cost growth that are not accommodated by the caps. Assuming that the additional cuts that would result from the BCA's automatic enforcement procedures would be structured so that DoD continues to receive its historical share of funding for national defense, the cuts faced by DoD would be \$52 billion per year—which would push funding far below the amounts in DoD's plans (see the third row of the table).



Although DoD has proposed basic pay raises of 1.7 percent for 2013 and 2014—which are perhaps consistent with its projections of the employment cost index (ECI) for private-sector wages and salaries compiled by the Bureau of Labor Statistics—the department is planning to cap the pay raises at 0.5 percent in 2015, 1.0 percent in 2016, and 1.5 percent in 2017. Between the 5 percent cumulative reduction in end strength and the caps on pay raises, CBO projects that, on average, between 2013 and 2017, the MILPERS account will increase by 0.7 percent per year in nominal terms but decline by 1.0 percent per year in real terms.

### Two Scenarios for Military Compensation

CBO has formulated a pair of scenarios that illustrate what could happen to the military personnel appropriation (and to the broader construct of military compensation) if all of the BCA's provisions—including sequestration (the automatic cancellation of a portion of budgetary resources) in 2013 and automatic reductions in the caps on funding for defense in 2014 through 2021—unfolded as written in current law. CBO developed an extension of DoD's 2013 FYDP using (to the extent they are available) the department's estimates of program costs or (where DoD estimates are not available) estimates that are consistent with the price and compensation trends that CBO projects for the overall economy. Full implementation of the BCA would require cuts relative to DoD's 2013 FYDP that average 10 percent per year over the department's five-year planning period; relative to the 2013 FYDP and its extension, the cuts would average 12 percent per year through 2022. This report does not include a corresponding analysis for a scenario in which the original BCA caps remain in place but sequestration and the subsequent automatic reductions are avoided. In such a case, the cuts would average less than 1 percent per year relative to the 2013 FYDP through 2017 and about 4 percent per year relative to the FYDP and its extension through 2022.

Under CBO's first scenario, cuts are made in equal proportion to DoD's RDT&E and procurement appropriations—the composite category that DoD calls *acquisition*—and all other appropriations remain as they are under the 2013 FYDP. To comply with the BCA, the RDT&E and procurement appropriations would be cut by 37 percent each over the 2013–2022 period relative to the 2013 FYDP and its extension. The procurement account, which stood at \$105 billion in the base budget for 2012, would be cut by an average of about \$50 billion

a year (in nominal dollars) over the next decade. Under CBO's second scenario, across-the-board cuts are implemented that average 12 percent annually for all major appropriation accounts over the 2013–2022 period. Procurement funding between 2013 and 2022 would average about \$80 billion (in nominal dollars) per year under the first scenario and about \$110 billion under the second scenario.

Those scenarios are purely illustrative, and many other approaches and outcomes are plausible. For example, one could conceive of scenarios that disproportionately cut military compensation relative to the other portions of the defense budget, in turn requiring even larger reductions in end strength but preserving more funding for procurement. In the extreme, the same overall savings could be achieved if all other appropriation accounts remain as they are in the 2013 FYDP and its extension but military compensation is cut by an average of about 45 percent per year. All of the scenarios that would achieve the amount of savings that the BCA requires relative to the 2013 FYDP would have significant implications for the ability of the U.S. military to accomplish its missions.

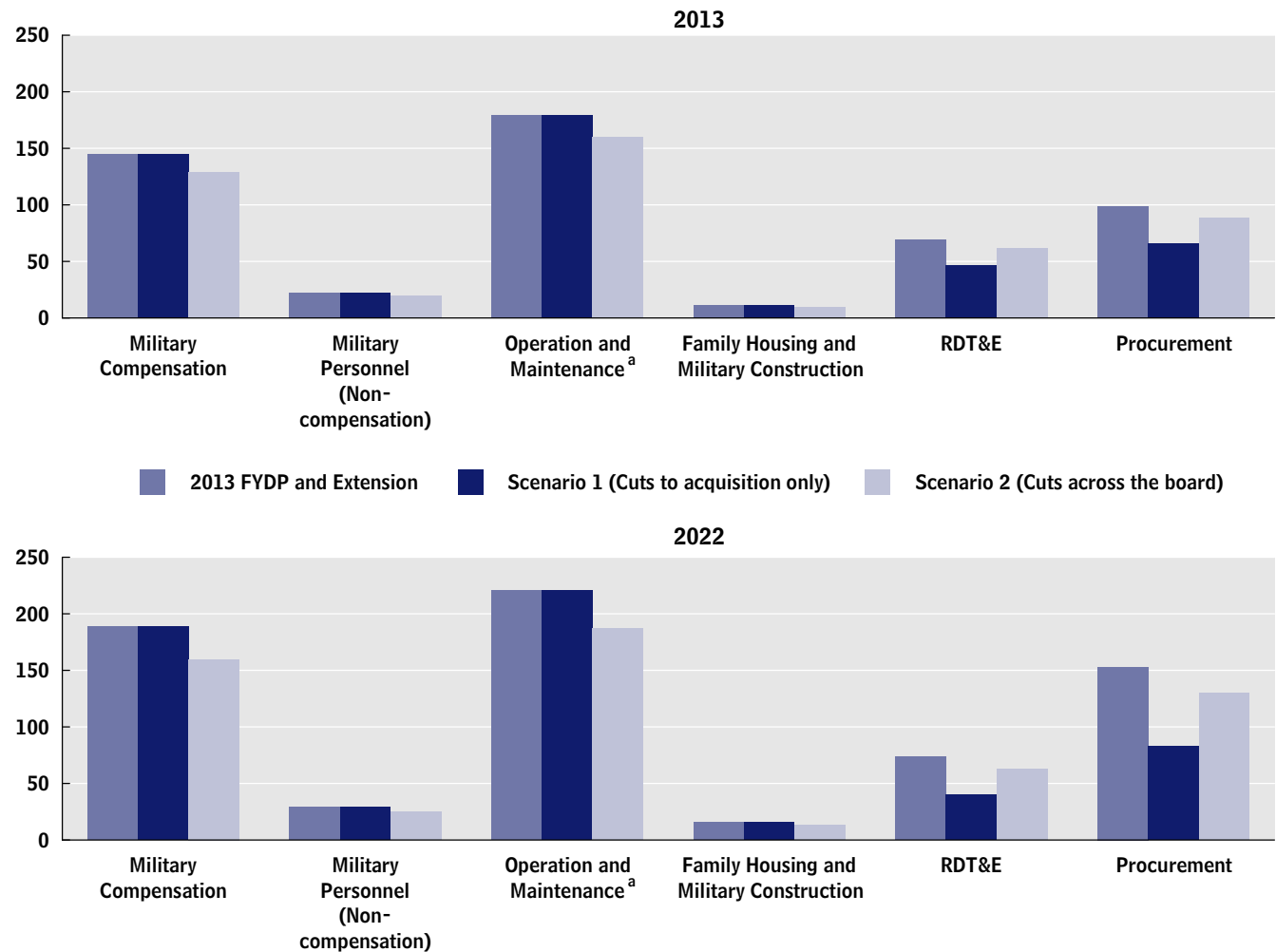
**Acquisition-Only Cuts.** Under CBO's first scenario, all cuts mandated by the BCA would be made in equal proportion to the two acquisition appropriations: RDT&E and procurement. In contrast, the MILPERS and O&M appropriations (and therefore all elements of military compensation) would evolve according to DoD's FYDP for 2013. The procurement appropriation would be cut by an average of about \$50 billion per year (in nominal dollars) or by 37 percent over the 2013–2022 period relative to the 2013 FYDP and its extension; the RDT&E appropriation would be cut by the same percentage, amounting to an average cut of about \$25 billion per year (see Figure 1).

Although CBO has not developed a list of specific changes to DoD's procurement programs that could achieve those savings, it is clear that DoD would need to curtail or cancel many programs. For example, the Joint Strike Fighter (F-35) is DoD's largest procurement program. The three variants of the F-35 would replace, respectively, the Air Force's F-16s, the Navy's and Marine Corps' F/A-18s, and the Marine Corps' AV-8Bs. Because those aircraft are approaching the ends of their design lifetimes, DoD would almost surely purchase some other aircraft if procurement of F-35s was canceled.

**Figure 1.**

**2013 FYDP and Two Scenarios for the Defense Budget**

(Billions of dollars)



Source: Congressional Budget Office.

Notes: The 2013 FYDP and its extension are described in Congressional Budget Office, *Long-Term Implications of the 2013 Future Years Defense Program* (July 2012).

FYDP = Future Years Defense Program; RDT&E = research, development, test, and evaluation.

a. Excludes costs for the Defense Health Program because they are included in the category Military Compensation.

CBO estimated last year that if DoD canceled the F-35 program and instead purchased additional F-16s for the Air Force and F/A-18s for the Navy and Marine Corps, the net savings in outlays through 2021 would be \$48 billion. That sum would constitute 11 percent of the total by which the procurement appropriation would need to be cut relative to the 2013 FYDP under this scenario.<sup>9</sup> (Net savings would be \$78 billion if the entire

planned fleet of F-35s—not all of which would be purchased by 2021—was replaced with F-16s and F/A-18s.)

**Across-the-Board Cuts.** Under CBO’s second scenario, all major appropriation accounts would be cut in equal proportion—by about 12 percent per year over the 2013–2022 period relative to the 2013 FYDP and its extension—to comply with the BCA (see Figure 1). The impact on the procurement appropriation is not nearly as dramatic as under the first scenario, declining in this instance by an average of \$16 billion (in nominal dollars)

9. See Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March 2011), pp. 86–87.

relative to the FYDP and its extension over the next 10 years; RDT&E would fall by an average of \$8 billion. Military compensation costs also would be cut by 12 percent. DoD has a range of options for achieving those savings: Trim end strength (beyond the declines already planned in the FYDP), reduce pay and benefits per service member, or pursue some combination of those two approaches.

Achieving those savings by reducing the number of service members would require more than a 12 percent reduction in end strength because such large reductions would take several years to complete and only a fraction of the eventual savings would be available during the transition years. For example, if the drop in end strength was phased in evenly over the next five years, a 17 percent cut in 2017 and later (relative to the 2017 value for end strength in the 2013 FYDP) would be needed to achieve savings that average 12 percent over the period through 2022. In all, that would mean shrinking the force by more than 240,000 people—more than currently serve in the Marine Corps (about 200,000). Achieving the same savings instead by reducing pay and benefits per service member gradually over a five-year period would require DoD to cut compensation by a similar percentage. Achieving the same savings through a combination of reductions to end strength and reductions in pay and benefits would result in smaller cuts to each.

## Current Cash Compensation

Current cash compensation for military personnel includes regular military compensation and numerous types of special pay and bonuses. Cash compensation changes over time according to formulas and in keeping with legislative action. Lawmakers authorized military pay raises for January 2008, 2009, and 2010 that each exceeded the percentage increase in the ECI for wages and salaries in private industry—a common benchmark—by 0.5 percentage points.<sup>10</sup> Beginning more than a decade ago, the housing allowance also has been restructured. In 2000, service members typically paid

about 20 percent of their own housing costs, but by 2005, out-of-pocket expenses for the average military family had been eliminated. DoD reports that, as a result of those and other actions between January 2002 and January 2010, basic pay for the average service member increased by 42 percent (in nominal dollars), housing allowances increased by 83 percent, and the subsistence allowance increased by 40 percent.<sup>11</sup> CBO estimates that cash compensation increased by 52 percent overall during that period, whereas private-sector wages and salaries rose by 24 percent.

Consistent with those increases in cash compensation, year-to-year continuation rates (the proportion of enlisted personnel serving on active duty in the preceding year who are still in an active-duty status during the year in question) were higher at the end of the last decade than they were at the beginning. The services saw declines in continuation rates of various degrees in the middle of the decade that were associated with lengthy deployments to Iraq and Afghanistan (see Figure 2). The Army partially mitigated its decline by using “stop-loss” policies to involuntarily extend soldiers’ contracts.<sup>12</sup> The declines in continuation rates for all four services were reversed later in the decade when the U.S. economy worsened, deployments to Iraq tapered off, and increases in cash compensation continued to mount. Higher continuation rates help the military services to maintain or increase the number of people in the force and its readiness. In doing so, they increase the average tenure of the force, in turn boosting the compensation bill because the basic pay table rewards both pay grade and longevity.

Policies that limit annual raises could slow future growth in cash compensation. Those policies could take the form of capping increases in the basic pay table below the projected increase in the ECI, as DoD proposed in its 2013 budget submission. Alternatively, DoD has the authority to set certain types of special pay, bonuses, and allowances

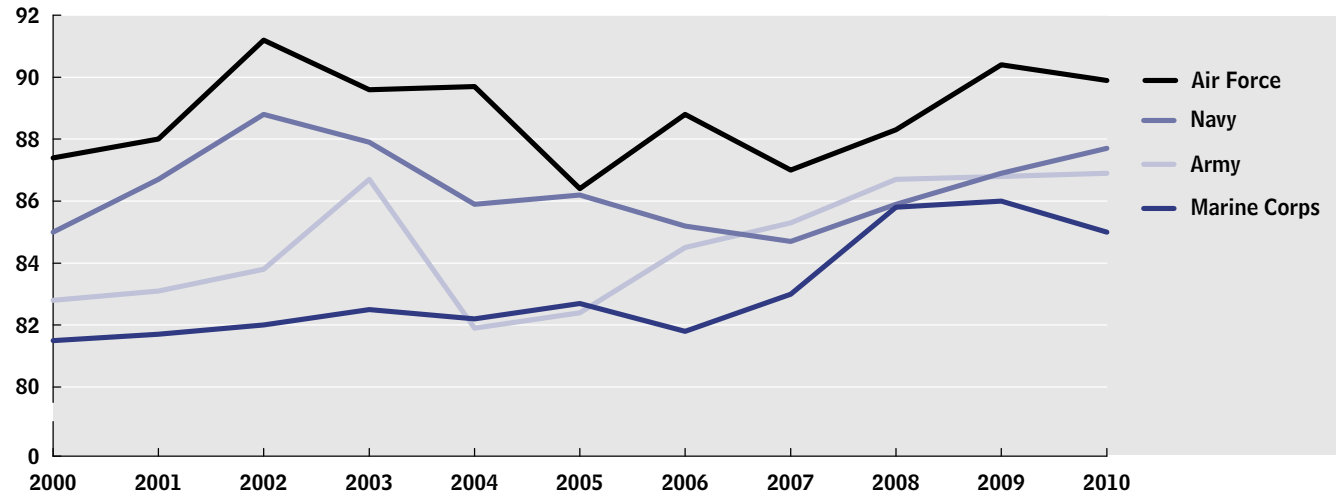
10. The annual pay raises are tabulated in Charles A. Henning, *Military Pay and Benefits: Key Questions and Answers*, CRS Report for Congress RL33446 (Congressional Research Service, updated May 13, 2011). The pay raise that took effect on January 1, 2007, included an across-the-board increase that matched the 2.2 percent rise in the employment cost index, supplemented by an additional targeted pay raise that ranged from 2.5 percent for E-5s to 5.5 percent for E-9s but delayed until April 1, 2007.

11. Statement of William J. Carr, Deputy Under Secretary of Defense for Military Personnel Policy, before the Subcommittee on Personnel, Senate Committee on Armed Services (April 28, 2010), <http://go.usa.gov/yNp>.

12. See Congressional Budget Office, *Recruiting, Retention, and Future Levels of Military Personnel* (October 2006). During 2005, the Army had an average of 7,000 enlisted soldiers who were involuntarily kept in the service past their contracted separation dates. Almost all left when their stop-loss orders expired.

**Figure 2.****Year-to-Year Continuation Rates Among Active-Duty Enlisted Personnel**

(Percent)



Source: Congressional Budget Office based on Department of Defense, Personnel and Readiness, *Population Representation in the Military Services, Fiscal Year 2010* (2011), Table D-32, <http://go.usa.gov/ye8>.

Note: Year-to-year continuation rates measure the proportion of personnel serving on active duty in the preceding year who are still in active-duty status during the year in question.

within limits set in current law. DoD could reduce some of those rates of pay on its own initiative, or lawmakers could reduce those rates through legislative action.

### Elements of Cash Compensation

DoD has used regular military compensation as a fundamental measure of military pay at least since 1962.<sup>13</sup> (RMC consists of basic pay plus subsistence and housing allowances and an estimate of the financial advantage that arises because those allowances are not subject to federal income taxes.)<sup>14</sup> All active-duty personnel (including guard and reserve personnel serving on active duty) are entitled to receive RMC.<sup>15</sup> That compensation does not include most special pay, incentive pay, and other allowances that service members can receive. Special and incentive pay usually are awarded for obtaining particular skills or for performing hazardous duty, including

deployment and combat. Members also can earn bonuses when they reenlist for several years, especially if they possess occupational skills that are in short supply.

DoD offers more than 60 types of special pay and bonuses, although an individual member might receive none or only a few at any time. For example, military personnel currently earn special pay at the rate of \$225 per month (prorated daily for partial months) to

13. See Department of Defense, *Report of the Ninth Quadrennial Review of Military Compensation*, vol. 1 (March 2002), p. 29, <http://go.usa.gov/yNw>. See also the statement of Carla Tighe Murray, Senior Analyst, Congressional Budget Office, before the Subcommittee on Personnel, Senate Committee on Armed Services, *Evaluating Military Compensation* (April 28, 2010); and Congressional Budget Office, *Evaluating Military Compensation* (June 2007).

14. RMC does not include tax advantages that arise when a service member declares residence in a state that has an income tax if that state excludes certain types of military pay from taxable income. RMC also excludes other tax benefits, such as the exclusion from federal income tax of many types of pay and bonuses (up to certain limits) if earned in a combat zone. For an explanation, see Department of Defense, "Combat Zone Exclusions" (accessed November 8, 2012), <http://go.usa.gov/yNw>. For this analysis, CBO has not estimated the magnitude of those tax advantages.

15. Single enlisted members in their first few years of service may live in barracks and not receive a housing allowance. In earlier work, CBO estimated an imputed value for barracks housing, which was slightly higher than the housing allowance for junior personnel. Substituting that value for the allowance would increase the cash compensation for junior enlisted members, but the increase would be small. See Congressional Budget Office, *Evaluating Military Compensation* (June 2007), p. 13.

**Table 3.**  
**Procedures for Updating Military Compensation**

	<b>Basis for Update</b>
Basic Pay	Percentage change in ECI (in accordance with the 2004 NDAA, unless overridden in the current session of Congress). <sup>a</sup>
Basic Allowance for Housing	Annual survey of rental prices for housing, including utility costs and renter's insurance, by size of residence and geographical area.
Pays and Allowances in Permanent Law (For example, family separation allowance, hazardous duty pay, and sea pay)	Payment amounts (rates and caps) set in law (Title 37, United States Code); subject to periodic legislative revision.
Bonuses and Special Pays Subject to Annual Reauthorization (For example, enlistment, reenlistment, and officer accession and retention bonuses)	Payment amounts (rates and caps) set in law (Title 37, United States Code). Lawmakers must reauthorize in each annual NDAA and may also periodically revise payment rates or caps. <sup>b</sup>

Source: Congressional Budget Office.

Notes: ECI = employment cost index for wages and salaries (the Bureau of Labor Statistics' index for the private sector); NDAA = National Defense Authorization Act.

- The percentage change in the ECI is measured over the four quarters ending with the third quarter of the calendar year immediately preceding the budget submission (37 U.S.C. 1009, Adjustments of monthly basic pay). For example, the percentage change from the third quarter of 2009 to the third quarter of 2010 determined the pay raise for the 2012 budget submission; that budget was submitted in February 2011, and the pay raise took effect in January 2012.
- The 2008 NDAA initiated a process under which lawmakers would set caps on broad groups of bonuses and forms of special pay, ceding to the Department of Defense the authority to set eligibility criteria and detailed pay levels consistent with those caps. Implementation of that authority is phased in over 10 years from the date of the NDAA's enactment and thus will be completed by January 28, 2018.

serve in areas posing "imminent danger of being exposed to hostile fire or explosion of hostile mines." In addition, service members may be paid up to \$225 per month (not prorated, at DoD's discretion) if "exposed to hostile fire or a hostile mine explosion event" for even one day in a month.<sup>16</sup>

In its base budget request for 2013, DoD included \$7 billion in special pay, incentive pay, and allowances (other than those for housing and food) for active-duty service members, amounting to about 6 percent of the department's proposed total payments to those members from the MILPERS appropriation.

### How Cash Compensation Has Evolved Over Time

DoD can boost some elements of cash compensation within statutory limits, other elements are adjusted annually on the basis of the increase in a specified price index

or other external metric, and still others require explicit legislative action (see Table 3).

The basic housing allowance is authorized through permanent law; DoD adjusts the amounts each year on the basis of local surveys of housing prices, without requiring either an explicit policy decision by the department or legislative action. Separately, lawmakers must explicitly act to renew various authorities that expire at the end of each year, such as those for bonuses to personnel trained in particular specialties. For example, the National Defense Authorization Act (NDAA) for Fiscal Year 2012 granted one-year extensions of authority to award certain bonuses and special pay to reserve forces, health care professionals, nuclear-qualified officers, and aviation officers.<sup>17</sup> That law also extended DoD's authority under title 37 of the United States Code to pay enlistment, reenlistment, and officer accession and retention bonuses; assignment incentive pay and special duty pay;

16. Section 616 of the National Defense Authorization Act for Fiscal Year 2012 (P.L. 112-81) instituted the proration of imminent danger pay. Imminent danger pay and hostile fire pay are codified in 37 U.S.C. §310 (2006 & Supp.), Special pay: duty subject to hostile fire or imminent danger.

17. Sections 611 through 615 of the 2012 NDAA, P.L. 112-81, 125 Stat. 1449-1451.

and skill incentive pay and proficiency bonuses.<sup>18</sup> Other forms of pay and allowances, such as hazardous-duty pay and the family separation allowance, stay as they are currently until lawmakers adjust them.

The 2000 NDAA indexed annual increases in basic military pay through 2006 to the percentage increase in the ECI. In 2004, that temporary measure was overridden and a permanent link was established between the military pay raise and the percentage increase in the ECI.<sup>19</sup> As noted earlier, however, in enacting annual defense authorizations and appropriations, lawmakers often adjust the basic pay table by a percentage that deviates from the ECI, almost always in a direction that exceeds it (not since 1998 has the pay raise been smaller than the percentage increase in the ECI).

Various groups have advocated for such pay raises to rectify a perceived gap between basic military pay and the wages and salaries of comparable civilian workers. They generally begin with the presumption that the relatively large increases in military basic pay that were enacted in the early 1980s resulted in military pay scales that, by 1982, were largely comparable to those for equivalent work performed in the private sector.<sup>20</sup> They often go on to observe that the cumulative increase in basic pay since 1982 has fallen short of the cumulative increase in the ECI and draw the conclusion that military compensation is falling behind that for comparable civilian jobs.<sup>21</sup> In 1998 and 1999, the difference between the two cumulative increases—called the pay gap—peaked at

13.5 percent. The 11 military pay raises in excess of the ECI between January 2000 and January 2010, however, closed most of the gap, which stood at slightly more than 2 percent in 2010. That value was unchanged after the January 2011 and January 2012 pay raises, which just equaled the respective increases of 1.4 percent and 1.6 percent in the ECI for those years.

However, neither the concept nor the measurement of the pay gap is straightforward. First, the presumption that military and civilian pay were comparable or equivalent in 1982 is open to question. During Congressional testimony in advance of the 1982 pay raise, a department official in effect pushed the problem back 10 years by asserting that DoD's 1982 budget request would restore the comparability between military and civilian pay that existed in 1972.<sup>22</sup> However, the all-volunteer force had not been established by 1972; draft-era military pay, at least in the junior ranks, was set well below the pay scales that prevailed in civilian labor markets.<sup>23</sup> Therefore, the basis for measuring changes in relative pay starting from 1982 is tenuous.

Second, focusing on a single component of cash compensation—basic pay—gives an incomplete picture of the magnitude of the total cash portion of military compensation. Even assuming that pay comparability prevailed in 1982, the pay gap reversed its sign in 2002 when recomputed using the more comprehensive and appropriate measure of regular military compensation. By January 2010, the cumulative increase since 1982 in RMC had exceeded the cumulative increase in the ECI by 11 percent.<sup>24</sup>

18. The 2008 NDAA (P.L. 110-181, 122 Stat. 163) initiated a process under which lawmakers would set caps on broad groups of bonuses and forms of special pay, ceding to DoD the authority to set eligibility criteria and detailed pay levels consistent with those caps. Implementation of that authority is phased in over 10 years from the date of enactment and thus will be completed by January 28, 2018.

19. Section 602 of the 2000 NDAA (113 Stat. 644), superseded by section 602 of the 2004 NDAA (117 Stat. 1498, 37 U.S.C. §1009 (2006)), Adjustments of monthly basic pay.

20. That presumption on the part of various groups has been reported by James Hosek, "A Recent History of Military Compensation Relative to Private Sector Compensation," in Department of Defense, *Report of the Ninth Quadrennial Review of Military Compensation*, vol. 2 (March 2002), p. 65, <http://go.usa.gov/yNv>.

21. For example, that view is expressed in Military Officers Association of America, "Military Pay Comparability" (accessed November 8, 2012), [www.moaa.org/Main\\_Menu/Take\\_Action/Top\\_Issues/Serving\\_in\\_Uniform/Military\\_Pay\\_Comparability.html](http://www.moaa.org/Main_Menu/Take_Action/Top_Issues/Serving_in_Uniform/Military_Pay_Comparability.html).

22. See the statement of Major General Dean Tice, Deputy Assistant Secretary of Defense (Military Personnel Policy), in U.S. House of Representatives, *Department of Defense Appropriations for 1982*, hearings before the Subcommittee on the Department of Defense of the Committee on Appropriations (June 1, 1981); reported in Congressional Budget Office, *What Does the Military "Pay Gap" Mean?* (June 1999), pp. 49–51.

23. President's Commission on an All-Volunteer Armed Force, *Report of the President's Commission on an All-Volunteer Armed Force* (February 1970).

24. See the statement of Carla Tighe Murray, Senior Analyst, Congressional Budget Office, before the Subcommittee on Personnel, Senate Committee on Armed Services, *Evaluating Military Compensation* (April 28, 2010); and Congressional Budget Office, *Long-Term Implications of the 2011 Future Years Defense Program* (February 2011), Figure B-1.

### Military and Civilian Compensation Compared

DoD has set a goal for the educational attainment of its enlisted personnel: At least 90 percent of those recruited to active duty in each service branch who have had no prior military service are to be high school graduates (a percentage that does not include recruits who hold the GED certificate), and at least 60 percent in each branch are to have scores above the national median on the Armed Forces Qualification Test, a screening instrument used by all branches of the military to assign enlisted personnel to specific military occupations. The services met all of the testing goals for the past decade, although the Army did so just barely in 2006, 2007, and 2008. The Army missed its goal for recruiting high school graduates in 2005 through 2008; in 2009, the Army rebounded, and 95 percent of its recruits were high school graduates (see Figure 3).

DoD has asserted that it does not expect to meet its goals for recruit quality unless RMC for enlisted personnel is set at the 70th percentile of earnings for civilians with some college education (many enlisted personnel go on to earn some postsecondary credits).<sup>25</sup> CBO's most recent detailed analysis, for calendar year 2006, showed that, on average, RMC exceeded the 75th percentile of earnings for comparably educated civilians, surpassing DoD's goal.<sup>26</sup> Thus, roughly three-quarters of civilians with comparable education had earnings that were lower than average RMC, and one-quarter had earnings that were higher. DoD recently updated that analysis, finding that average RMC in 2009 had risen relative to the civilian wage distribution. The average RMC for enlisted personnel reached the 90th percentile relative to the combined comparison group consisting of civilians with high school diplomas, those with some college, and those with two-year degrees; the average RMC for officers reached the 83rd percentile relative to the combined group of civilians with bachelor's degrees and those with a master's degree or higher.<sup>27</sup>

If the value of current noncash and deferred compensation (such as pensions and current and future benefits for health care) is included, total compensation for military personnel appears higher still than that for civilian workers in the economy. DoD has estimated that the value of current noncash and deferred compensation about equals that of RMC, effectively doubling the current cash pay of military personnel.<sup>28</sup> CBO's estimates are similar: For example, in 2006, noncash and deferred cash pay together boosted cash pay by about 80 percent for an unmarried sergeant (pay grade E-5 with six years of service) and by about 115 percent for a married sergeant.<sup>29</sup> By contrast, CBO has estimated that current noncash and deferred benefits (such as paid leave, health insurance, and retirement benefits) add an average of about 45 percent to the value of cash pay for civilians with a high school diploma or less and the same percentage for those with some college.<sup>30</sup>

### Projected Costs of Cash Compensation

DoD's 2013 base budget included a request for a \$135 billion MILPERS appropriation. The department plans to reduce active-duty end strength by a total of about 5 percent over the five years spanned by the 2013 FYDP, from 1,392,000 in 2013 to 1,320,000 by 2017. However, DoD proposes that, in 2013, the personnel costs for 41,000 soldiers and 15,000 marines on active duty be shifted from the base budget to the OCO budget; the costs of the remaining 1,336,000 active-duty personnel in 2013 would be paid from the base budget. That procedure is followed, to a lesser degree, in the later years of the 2013 FYDP so that the steady-state force of 1,320,000 active-duty personnel is paid from the base budget starting essentially as early as 2014 and a diminishing number of personnel are paid from the OCO budget: 47,000 in 2014, 29,000 in 2015, and 12,000 in

25. DoD's goal of paying at the 70th percentile was first stated in Department of Defense, *Report of the Ninth Quadrennial Review of Military Compensation*, vol. 1 (March 2002), <http://go.usa.gov/yNv>; that goal was based on the findings of James Hosek and others, *An Analysis of Pay for Enlisted Personnel* (RAND Corporation, 2001), [www.rand.org/pubs/Documented\\_briefings/DB344.html](http://www.rand.org/pubs/Documented_briefings/DB344.html). The recruiting goals are further explained in Department of Defense, *Report of the Tenth Quadrennial Review of Military Compensation*, vol. 1, *Cash Compensation* (February 2008), pp. 3–5, <http://go.usa.gov/VPQ>.

26. See Congressional Budget Office, *Evaluating Military Compensation* (June 2007), pp. 12–13.

27. James E. Grefer and others, "Military and Civilian Compensation: How Do They Compare?" in Department of Defense, *Report of the Eleventh Quadrennial Review of Military Compensation*, vol. 2, *Supporting Research Papers* (July 2012), <http://go.usa.gov/wZ1>.

28. See Department of Defense, *Report of the Tenth Quadrennial Review of Military Compensation*, vol. 2, *Deferred and Noncash Compensation* (July 2008), p. xi, <http://go.usa.gov/y0s>.

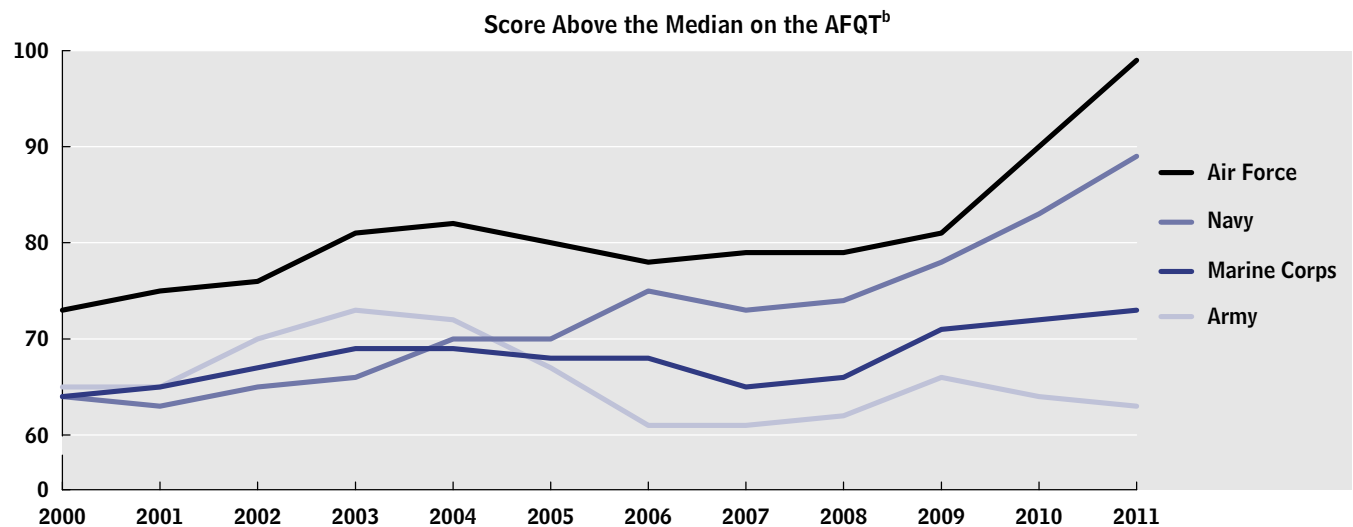
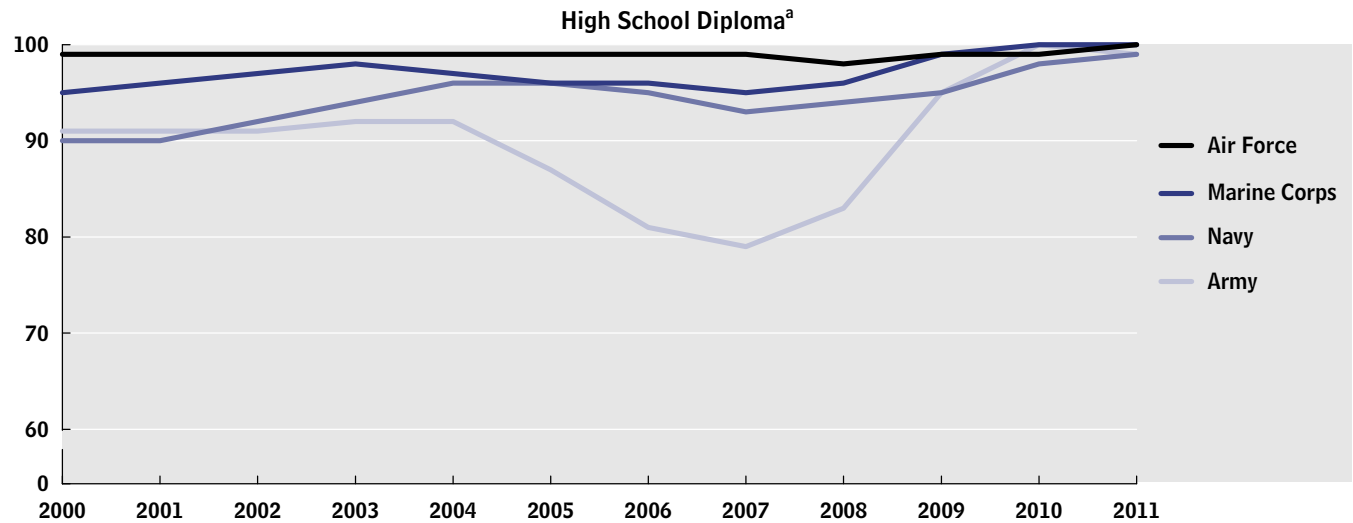
29. See Congressional Budget Office, *Evaluating Military Compensation* (June 2007), p. 7.

30. See Congressional Budget Office, *Comparing the Compensation of Federal and Private-Sector Employees* (January 2012).

**Figure 3.**

### Quality Trends Among Enlisted Recruits in the Active Military Who Did Not Have Prior Military Service

(Percent)



Sources: Congressional Budget Office based on Department of Defense, Personnel and Readiness, "Military Recruiting Results, Recruit Quality by Year Since FY 1973" (accessed November 8, 2012), <http://go.usa.gov/V96>; and James Hosek and others, *Should the Increase in Military Pay Be Slowed?* (RAND Corporation, 2012), [www.rand.org/pubs/technical\\_reports/TR1185.html](http://www.rand.org/pubs/technical_reports/TR1185.html).

Note: Accessions into the National Guard and the reserves are excluded.

- a. The group with a high school diploma excludes recruits who hold alternative certification, such as the GED (General Educational Development) credential.
- b. The Armed Forces Qualification Test (AFQT) is used to screen recruits to all branches of the military and to assign enlisted personnel to specific military occupations. Some high schools use the test to gauge students' interest in the military and other careers. The AFQT comprises arithmetic reasoning, mathematics knowledge, paragraph comprehension, and word knowledge. Percentile scores measure aptitude relative to the entire U.S. population between the ages of 18 and 23. Recruits who score above the national median are classified by the military into percentile categories relative to the U.S. population: I (93rd to 99th percentile), II (65th to 92nd percentile), or IIIA (50th to 64th percentile)



2016. Incorporating DoD's plan for small increases in basic pay (discussed below), the 2013 FYDP projects MILPERS costs that are essentially flat at \$135 billion (in 2013 dollars) over the period through 2017.

In its analysis of the 2013 FYDP, CBO estimated the personnel costs of the service members proposed to be paid from the OCO budget, and the agency shifted those costs back to the base budget.<sup>31</sup> As a result, CBO shifted about \$5 billion in MILPERS costs back to the base budget in 2013, enlarging the MILPERS account from \$135 billion to \$140 billion in that year. With that procedure repeated for subsequent years, MILPERS costs would not be flat, CBO projects, but would decline from \$140 billion in 2013 to \$135 billion by 2017 (a real decline averaging 1 percent per year) as end strength falls throughout the five-year period.

Much of the historical increase in the cost per service member stems from increases in basic pay that have kept pace with or exceeded the growth rate of the ECI, which in turn grew more rapidly than the implicit price deflator for gross domestic product (GDP)—a common measure of overall inflation—in all but four years between 1981 and 2012. In contrast, DoD's plans for the 2013–2017 period do not include military pay raises that keep pace with the ECI. The department's plans include a 1.7 percent pay raise for 2014, which is below CBO's projection of the increase in the ECI for that year but is perhaps consistent with DoD's own projection of the ECI. For 2015 through 2017, DoD is proposing pay raises of 0.5 percent, 1.0 percent, and 1.5 percent, respectively—all deliberately smaller than the department's projection of ECI growth for those years. With that series of pay raises, basic pay would remain essentially flat in real terms (relative to the GDP deflator) over the FYDP period and lose a total of 11 percentage points of growth relative to CBO's projection of the ECI over those years. If, contrary to DoD's current plans, lawmakers restored pay raises at the ECI benchmark starting in 2014, CBO estimates that the MILPERS appropriation—instead of falling from \$140 billion in 2013 to \$135 billion (in 2013 dollars) by 2017—would increase to \$145 billion by 2017, or by a total of almost 3 percent over the period.<sup>32</sup>

31. See Congressional Budget Office, *Long-Term Implications of the 2013 Future Years Defense Program* (July 2012), p. 15.

32. *Ibid.*, p. 4.

### Controlling the Costs of Cash Compensation

Because basic pay is the largest element of cash compensation, policy alternatives that would limit annual raises hold considerable potential to slow growth in costs. Although retention of military personnel might suffer, that effect could be mitigated by boosting the amounts available for selective reenlistment bonuses (SRBs, which are offered to service members in hard-to-fill occupations). In the past, CBO has estimated budget options that would save roughly \$6 billion in outlays over 5 years and \$17 billion over 10 years by capping the annual increase in basic pay at 0.5 percentage points below the increase in the ECI for four years while increasing SRBs.<sup>33</sup> If a more stringent cap was applied or the same cap was maintained for a longer period, more could be saved.

One advantage of shifting some portion of cash compensation from basic pay to SRBs is that such bonuses are paid only to service members who have come to the end of an obligated term of service and are deciding whether to reenlist. That makes SRBs much more cost-effective than providing a pay raise to the entire force as a way to retain some fraction of the total. Furthermore, the services routinely award larger SRBs to people in military occupations in short supply; each branch is appropriated an annual SRB budget and is free to adjust allocations among the various occupations as conditions change during a given year. Finally, unlike pay raises, SRBs do not compound from one year to the next nor do they affect the value of retirement annuities.

### Military Retirement Benefits

The military retirement system—predominantly a defined-benefit system that requires no contributions from employees—is a significant part of military compensation. The retirement system requires most military personnel to have 20 years of service for vesting, although disability retirement is sometimes granted sooner. As they approach retirement, service members can choose between one defined-benefit plan that offers a stated monthly payment and another that initially provides a lump-sum bonus during the member's 15th year of active service but then makes a smaller monthly payment once the member has retired. Active-duty retirees receive benefits immediately upon retirement, regardless of age—

33. See Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March 2011), pp. 76–77.

in some cases as early as age 37. Retirees from the reserves generally do not begin to collect benefits until they reach the age of 60. Since 2001, service members also have been eligible to participate in the federal Thrift Savings Plan, or TSP—a defined-contribution plan that is similar to a private-sector 401(k) plan—although generally without any matching contributions from the government.

To fund the retirement system, DoD sets aside an amount equal to a predefined percentage of basic pay in accrual payments while service members are on active duty. Future costs are dictated by the structure of the benefits, the mix of people receiving them, and inflation in the economy that determines the annual cost-of-living adjustment (COLA). For the future, costs could be managed by changing the vesting period, by changing the mix of defined benefits and defined contributions, or by some other means.

### Alternative Retirement Plans

The defined-benefit portion of the military retirement benefit takes the form of an immediate annuity that is paid to military personnel who retire after at least 20 years. To protect against inflation, that annuity is boosted by a COLA equal either to the annual percentage change in the consumer price index for urban wage earners and clerical workers (CPI-W) or to that quantity minus 1 percentage point, depending on the retirement plan chosen by the service member.

**High-3 Retirement Plan.** For people who entered military service between September 8, 1980, and July 31, 1986, the annuity for a 20-year career has been set equal to 50 percent of the member's "High-3" basic pay, which is computed as the average of the 36 highest months of basic pay in the service member's career (the 50 percent factor is called the multiplier). The annuity increases with additional years of service, but until the end of 2006, the amount was capped at 75 percent of High-3 basic pay for members who retired after 30 or more years of service; that cap was subsequently lifted for people who retired after December 31, 2006.<sup>34</sup>

**REDUX Retirement Plan.** The Military Retirement Reform Act of 1986 (P.L. 99-348) created the REDUX retirement system for all personnel entering military service on or after August 1, 1986. The REDUX multiplier is 40 percent (rather than 50 percent) of a member's High-3 basic pay after 20 years of service, but it increases

to 75 percent of basic pay after 30 years of service. REDUX also provides only partial insulation from inflation rather than the full protection offered by the High-3 system. Until age 62, a retiree's annual COLA under REDUX equals the annual percentage increase in the CPI-W minus 1 percentage point. At age 62, the annuity payment is recomputed so that the retiree receives the same payment in that year under the REDUX system that would be paid under the more generous High-3 system: The multiplier is reset to the value it would have been under High-3 (for example, boosted from 40 percent to 50 percent for a 20-year career); the new multiplier is applied to the retiree's original highest 36 months of basic pay; and the current retirement annuity is recalculated by applying a full COLA (based on the cumulative growth of the CPI-W since the member's retirement, without the 1 percentage-point penalty). After the retiree passes age 62, the retirement annuity is again subject to a COLA equal to the increase in the CPI-W minus 1 percentage point (see Figure 4).

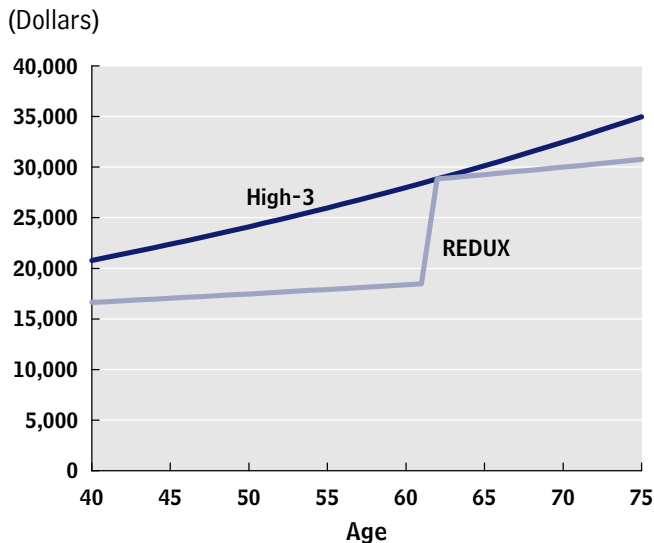
The first cohort of service members that would have been affected by REDUX began to retire in 2006. However, the 2000 NDAA preempted its implementation by giving military personnel a choice between two plans, both more generous than REDUX as initially conceived: the original High-3 plan or an enhanced REDUX plan.<sup>35</sup> Service members who anticipate retirement may choose during their 15th year of service either the High-3 plan or the less generous REDUX formula; those who choose the latter receive the Career Status Bonus, a lump-sum payment of \$30,000, in the same year.<sup>36</sup> A service member who accepts that bonus but does not complete 5 more years to attain the full 20 years of military employment must repay a prorated share of the bonus as a penalty for separating early.

34. The 2007 NDAA (120 Stat. 2259, 10 U.S.C. §1409(b)(2006 & Supp.)) increased the amount in determining the annuity for non-disability retirement from the active military. The multiplier for most active military personnel who retired after December 31, 2006, was reset at 2.5 percent times the years of service credited—without the cap—so that very senior personnel (those with more than 30 years of service) could retire at more than 75 percent and conceivably more than 100 percent of their High-3 basic pay.

35. Sections 641 through 644 of the 2000 NDAA, P.L. 106-65, 113 Stat. 662–664 (1999).

36. See Department of Defense, "CSB/REDUX Retirement System" (accessed November 8, 2012), <http://go.usa.gov/yRp>.

**Figure 4.**  
**Illustration of Military Retirement Pay, by Year of Age, Under High-3 and REDUX**



Source: Congressional Budget Office.

Note: Under the High-3 plan, monthly retirement pay after 20 years of service equals 50 percent of the average of the 36 highest months (three years) of basic pay in the service member's career; the 50 percent factor is called the multiplier. In the example shown, average pay for the highest three years of service is \$41,550, and annual pay in the first year of retirement (at age 40) is half of that amount, or \$20,775. Under the REDUX plan, the service member receives a Career Status Bonus, a lump-sum payment of \$30,000 in the 15th year of military service, and the multiplier is 40 percent after 20 years of service. In the example, annual pay under the REDUX plan for the same service member in the first year of retirement is reduced to \$16,620. Under High-3, retirement pay is adjusted annually on the basis of the consumer price index for all urban wage earners and clerical workers (CPI-W); under REDUX, retirement pay is adjusted annually by the CPI-W minus 1 percentage point, except for a one-time catch-up at age 62. Calculations were made under the assumption that the service member retired in 2011 at age 40 after 20 years of military service having served the final three years at pay grade E-6 (staff sergeant) and that the CPI-W increases at the rate of 1.5 percent per year starting in 2011.

The rationale for setting the Career Status Bonus at \$30,000 is not clear. That sum is not actuarially fair—it does not financially compensate the military retiree for what could easily be four decades of smaller annuity payments under the REDUX formula. The bonus has become smaller relative to forgone annuity payments over time because life expectancy has increased and because

the bonus amount is not indexed to inflation and has been fixed at \$30,000 since its inception. The bonus is taxable except when a service member's election of the REDUX option is finalized during a month in which the member is serving in a designated combat zone.<sup>37</sup> One report estimates that to achieve an actuarially fair outcome, the military retiree (unless serving in a combat zone) would need to have opportunities to invest the \$30,000 bonus (net of applicable taxes for the year in which the bonus was received) at before-tax rates of return ranging from 10 percent to 20 percent (the exact rate would depend on the person's age, years of service, and pay grade at retirement). The same report also states that the number of marines choosing the REDUX option fell from 57 percent in 2001 to 15 percent in 2010, reflecting erosion in the inflation-adjusted value of the \$30,000 bonus and, perhaps, a growing awareness among service members about the REDUX option's drawbacks.<sup>38</sup> (That report contains no data on the retirement choices made by soldiers, sailors, or airmen.)

#### Other Features of Military Retirement

Several other features of the military retirement system are noteworthy. The system offers a defined-contribution option, but DoD has decided not to exercise its authority to match service members' contributions. Active-duty personnel are generally vested in the defined-benefit component of their retirement plan after 20 years of service. Those who retire after 20 years may begin to draw retirement pay immediately, but those who separate earlier do not receive any retirement benefits. That dichotomy has a major influence in shaping the military's force structure: It provides a strong incentive for midcareer personnel to remain in the military until they have completed 20 years of service but a much weaker incentive for those who have completed 20 years to continue their service into a third decade.

**Thrift Savings Plan.** An optional defined-contribution component for retirement saving, the TSP was made available to service members under the 2001 NDAA.<sup>39</sup>

37. See Department of Defense, "Combat Zone Exclusions" (accessed November 8, 2012), <http://go.usa.gov/yR6>.

38. Aline Quester and others, *Retirement Choice: 2011* (Center for Naval Analyses, February 2011), [www.cna.org/research/2011/retirement-choice-2011](http://www.cna.org/research/2011/retirement-choice-2011). That study was first published in 2003 and has been revised periodically since then.

39. See Department of Defense, "Thrift Savings Plan (TSP)" (accessed November 8, 2012), <http://go.usa.gov/yRe>.

Military personnel may make tax-deferred contributions to TSP accounts that are equal to any percentage (1 to 100) of their basic pay, subject to annual dollar limits set by the Internal Revenue Code. Service members also may contribute up to the full amount of a Career Status Bonus or any reenlistment bonus received in a designated combat zone, subject to the combat-zone tax exclusion.<sup>40</sup> During 2011, about 40 percent of active-duty service members participated in the TSP. (See Appendix A for a description of various other enhancements to the military retirement system enacted since 2000.)

The military services do not currently match service members' TSP contributions, as the federal government does for civilian employees, so the only cost to DoD is for administration. (The Army had a pilot program offering TSP matching contributions as an enlistment incentive from April 1, 2006, to December 31, 2008. The Army suspended the program in 2007 after analyzing its results.) Because TSP contributions are made from before-tax income, the program also reduces federal revenues.

**Vesting.** Members of the U.S. military are "cliff vested" in the retirement system. That is, they become eligible to receive benefits only upon reaching 20 years of service; there are no incremental vesting steps along the way. As a result, many people leave the service before attaining eligibility and so, apart from their own TSP accumulations, most service members earn no military retirement at all. On the basis of the continuation rates that have been observed over the past few years, DoD currently estimates that 49 percent of active-duty officers and 17 percent of active-duty enlisted personnel will stay in the service long enough to earn nondisability retirement benefits.<sup>41</sup>

According to one estimate of the value to military personnel of those benefits, a service member would be willing to accept an immediate payment equal to 28 percent of the government's cost today of providing a dollar of

retirement benefits in 10 years, even if he or she is certain to remain in the military until retirement.<sup>42</sup> The valuation of the retirement benefit would be smaller still for service members who are earlier in their careers and uncertain whether they will serve a full 20 years. However, the valuation steadily increases during the second decade of service, acting as an incentive to complete the full 20 years and qualify for retirement benefits. Evidence of the draw of retirement vesting (possibly along with other factors) is found in the annual continuation rates estimated from a cross section of enlisted personnel during 2010. Those rates exceeded 90 percent for people with at least 9 years of service, and they climbed to more than 97 percent for people with at least 15 years of service (see Figure 5). (The notches in Figure 5 at 4 years of service and again at 8 years reflect the proportion of people who choose not to reenlist at the end of the typical 4-year enlistment and reenlistment periods.) The continuation rate plummets to 63 percent during the 20th year because more than one-third of service members retire essentially as soon as they become eligible.

**Accrual Funding.** To account for its future liabilities in defined-benefit pensions for current service members, DoD makes accrual payments to the Military Retirement Fund for service members while they are still on active duty.<sup>43</sup> (See Appendix B for additional information regarding accrual accounting for the military retirement system.) The payments from the services' military personnel appropriations are assessed as a percentage of each member's basic pay, known as the normal cost percentage. DoD established normal cost percentages of 34.3 for active-duty personnel and 24.3 for reserve personnel in

40. The elective deferral limit for 2012 is \$17,000. However, under section 415(c) of the Internal Revenue Code, military personnel may exceed that limit if they are receiving pay under the combat-zone tax exclusion.

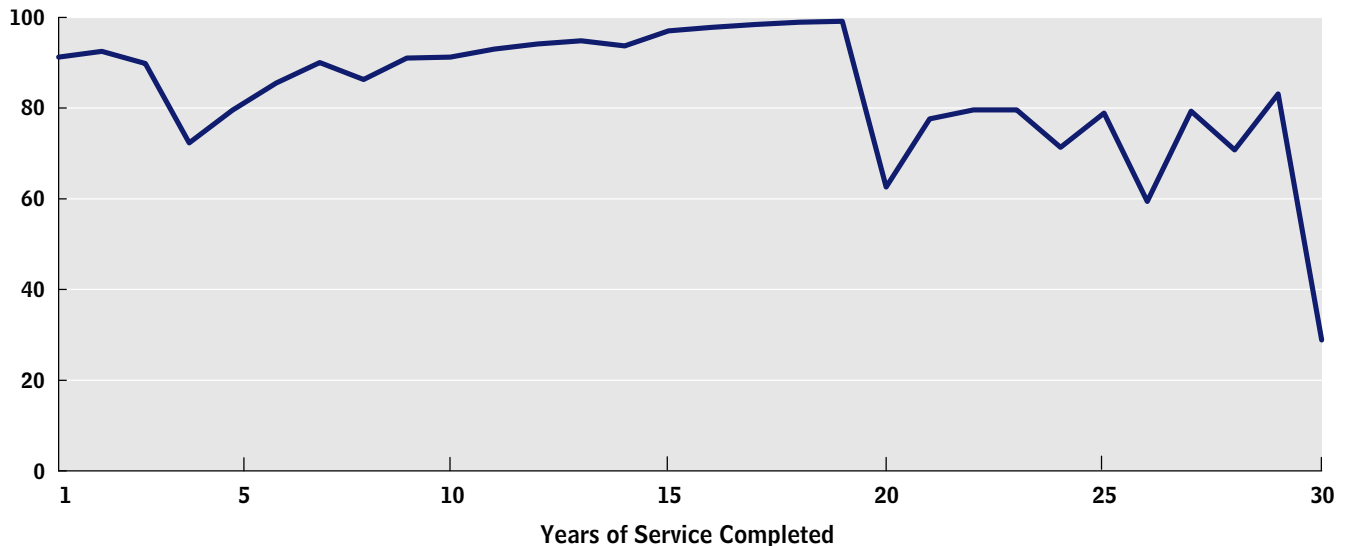
41. Department of Defense, Office of the Actuary, *Valuation of the Military Retirement System, September 30, 2010* (January 2012), p. 24, <http://go.usa.gov/vqZ>.

42. That calculation uses nominal discount rates of 17 percent per year for service members and 3 percent per year for the federal government's borrowing costs. Estimated discount rates for service members are from John T. Warner and Saul Pleeter, "The Personal Discount Rate: Evidence from Military Downsizing Programs," *American Economic Review*, vol. 91, no. 1 (2001), pp. 33–53.

43. The balance in the Military Retirement Fund is held in special-issue (nonmarketable) U.S. Treasury securities. That balance is an asset for the military retirement system but a liability for the rest of the federal government. Payments from the fund count as federal spending; the accrual contributions and payments from the Treasury to amortize the unfunded liability are intergovernmental transactions that have no net effect on federal outlays.

**Figure 5.****Annual Continuation Rates Among Active-Duty Enlisted Personnel, 2010**

(Percent)



Source: Congressional Budget Office based on Department of Defense, Personnel and Readiness, *Population Representation in the Military Services, Fiscal Year 2010* (2011), Table B-40, <http://go.usa.gov/ye8>.

Note: Continuation rates measure the proportion of personnel serving on active duty in the preceding year who are still in an active-duty status during the year in question.

2012.<sup>44</sup> Thus, for example, an active-duty E-4 (corporal) with between 48 months and 72 months of service will earn basic pay of \$27,200 in 2012, for which DoD will make an accrual payment of \$9,330 ( $0.343 \times \$27,200$ ).

If a retiree chooses the enhanced REDUX option, the Career Status Bonus of \$30,000 is paid immediately out of the military personnel appropriation for the fiscal year in which the service member makes his or her decision. If the service member instead chooses the High-3 option, both the multiplier and the COLA that determine the retirement annuity are higher than they would have been had REDUX been implemented as conceived in 1986; the eventual costs will be higher as well, so larger accrual

payments are made. Using data from DoD's Office of the Actuary, CBO estimates that by 2017, the costs of the replacement for the REDUX system (the combined costs of the Career Status Bonus under the enhanced REDUX option and the larger accrual payments under the new High-3 option) will reach \$2.3 billion (in 2013 dollars)—some 10 percent of the total retirement accrual and 1.6 percent of the projected MILPERS budget for that year.

The choice of a flat normal cost percentage for all active personnel is essentially arbitrary. Moreover, it has been argued that the current accrual system leads to an ineffective allocation of resources because, for example, marines are less likely than members of the other services to reach retirement, yet the Marine Corps must apply the accrual rate used by the other services when it prepares its annual budget. On the basis of its analysis of data for a cross section of enlisted personnel during 2010, CBO estimates that only 40 percent of Marine Corps recruits will remain on active duty after the first four years of service, compared with more than 50 percent of Army recruits and more than 60 percent of recruits in the Navy and the Air Force.

44. The quoted normal cost percentages do not include the additional amounts that are attributable to concurrent receipt—the fact that, since 2004, military retirement pay for some retirees is no longer reduced dollar for dollar by the amount of disability compensation those retirees receive from the Department of Veterans Affairs. The 2004 NDAA (P.L. 108-136, 117 Stat. 1515) requires that the Treasury, not DoD, make the accrual payments to fund concurrent receipt. See also Department of Defense, *Valuation of the Military Retirement System, September 30, 2010* (January 2012), p. 27, <http://go.usa.gov/vqZ>.

By using the same demographic data on the military population and the same projections of continuation rates used by the Office of the Actuary, it would be possible to design accrual schedules in which the accrual rate varies with the member's years of service. In particular, the accrual rates could be calibrated to reflect the fact that personnel with more seniority are more likely to remain in the military for the (fewer) additional years required to qualify for retirement. Decisions to increase the seniority mix of the force would then be tempered by the higher likelihood of incurring future retirement costs for those more senior personnel. However, such a system might be more cumbersome for the Office of the Actuary to maintain or for the military services to apply in their annual budgeting processes.

### Projected Costs of Military Retirement

DoD's Office of the Actuary has estimated that outlays from the Military Retirement Fund to current beneficiaries will total \$51.7 billion during 2012. Outlays are expected to increase to about \$55 billion by 2017 and to \$59 billion by 2022 (all in 2012 dollars).<sup>45</sup> Those estimates are based on a particular set of assumptions; even if the military's retirement policy remains stable, actual outlays could differ from projections to the extent that economic variables (such as interest rates) or demographic variables (such as life expectancy) deviate from their assumed values.

Policy changes would have additional effects. For example, if the military services changed their policies in ways that increased the seniority mix of their forces, more service members probably would complete the 20 years necessary to earn nondisability retirement benefits. Or if a series of larger-than-planned pay raises was given, there also would be an increase in service members' High-3 basic pay, which determines annuity values for new retirees. Either policy change would lead to larger outlays from the Military Retirement Fund. Although the effects on outlays would occur gradually over the long term as increasing numbers of service members reach retirement under the new policies, DoD's Office of the Actuary would probably adjust the accrual rates in the short term.

45. Department of Defense, *Valuation of the Military Retirement System, September 30, 2010* (January 2012), p. 30, <http://go.usa.gov/vqZ>.

### Controlling the Costs of Military Retirement

Several proposals have been made for replacing the military's current system with a defined-benefit plan that partially vests at earlier points in a service member's career, or with a defined-contribution plan under which DoD would match a service member's TSP contributions, or with a combination of those two plans. Those proposals could cost less or more than the current system, depending on how they were structured and implemented. They also would affect the seniority mix of the armed forces, potentially damping the incentive for service members in their second decade of service to stay for a full 20 years.<sup>46</sup>

A potential drawback of a change from a defined-benefit system to (at least partially) a defined-contribution system is that the financial risk shifts to retirees, whose resources in retirement are no longer guaranteed by the federal government but instead depend on returns available in financial markets. Moreover, reductions in federal outlays that stem from retirement reform would be delayed for 20 years if all current service members were retained in the current system, as was the case with the introduction of REDUX. However, if the defined-benefit plan were made less generous on balance, then DoD's Office of the Actuary would probably reduce the accrual rates, and DoD would begin to see more immediate relief in the form of lower accrual payments to the Military Retirement Fund. DoD has not proposed any changes to its retirement system recently, but it has requested legislative language under which the Congress would establish a commission to review the retirement system and send recommendations to the President.<sup>47</sup>

46. See Beth J. Asch and others, *Assessing Compensation Reform: Research in Support of the 10th Quadrennial Review of Military Compensation* (RAND Corporation, 2008), [www.rand.org/pubs/monographs/MG764.html](http://www.rand.org/pubs/monographs/MG764.html). That report supports the policy options explored in Department of Defense, *Report of the Tenth Quadrennial Review of Military Compensation*, vol. 2, *Deferred and Noncash Compensation* (July 2008), <http://go.usa.gov/y0s>. For a more recent policy proposal, see Defense Business Board, *Modernizing the Military Retirement System*, Report FY11-05 (October 2011), <http://go.usa.gov/ynF>.

47. Department of Defense, *Fiscal Year 2013 Budget Request: Overview* (February 2012), p. 5-5, <http://go.usa.gov/ynJ>.

## The Military Health Care System

Health care as provided under TRICARE is a noncash benefit for active-duty and retired service members; in fact, it is the most significant (and costly) deferred non-cash benefit for retirees. Over the next decade, the cost per capita of providing TRICARE benefits is projected to increase at a rate substantially greater than inflation. Costs could be reduced by making changes in enrollment fees, deductibles, copayments, or other aspects of the benefits.

### TRICARE

TRICARE health benefits are provided by a coordinated effort of the medical commands of the Army, Navy, and Air Force, under the supervision of the Assistant Secretary of Defense for Health Affairs. TRICARE offers various options, some of which are similar to employer-based health insurance plans:

- TRICARE Prime operates much like a health maintenance organization (HMO);
- TRICARE Extra is a preferred-provider network;
- TRICARE Standard is similar to a traditional fee-for-service plan;
- TRICARE Reserve Select is a premium-based health plan available to some members of the Selected Reserve and their families; and
- TRICARE for Life is a supplement for military retirees and their family members who also are eligible for Medicare.

Not all of those plans are available to all categories of beneficiaries, however. All 1.4 million active-duty military personnel are automatically enrolled in TRICARE Prime. In 2011, 2.0 million of the 2.4 million eligible family members of active-duty personnel (84 percent) were enrolled in Prime, as were 1.6 million of the 3.5 million retirees and family members who were not yet eligible for Medicare (45 percent). The roughly 2 million retirees and family members who are eligible for Medicare are not eligible to enroll in Prime or to use Extra or Standard, but they do qualify for the TRICARE for Life benefit.<sup>48</sup>

### Active-Duty Personnel and Their Family Members.

Active-duty military personnel receive all of their health care free of charge through TRICARE Prime, either at military medical treatment facilities (MTFs) or by referral from MTFs to civilian providers. CBO treats as compensation all of the costs for health care for active-duty personnel that are paid out of the base budget. CBO does not include in its tally any costs for medical care that are funded instead by the parallel budget for overseas contingency operations (see Box 4 on page 30).

Active-duty families may enroll in TRICARE Prime without paying an enrollment fee, and each enrollee is assigned a primary care manager—an individual provider or team of providers—either at an MTF or within the TRICARE network of civilian providers. All covered services are free to family members (with no deductibles or copayments other than for prescription drugs) as long as participants receive care either directly or by referral from the primary care manager. The civilian networks in the continental United States are managed under three regional contracts.<sup>49</sup>

**Military Retirees and Their Family Members Who Are Not Yet Eligible for Medicare.** Retired personnel who are not yet eligible for Medicare (generally people between the ages of 37 and 64) pay annual enrollment fees and copayments for most services. DoD has estimated that, in 2011, a typical military retiree and his or her family enrolled in TRICARE Prime paid \$420 in copayments and other fees in addition to the \$460 enrollment fee, for a total cost of \$880. By contrast, DoD estimated that a civilian in the general U.S. population who enrolled in a family HMO plan offered by an employer would typically pay \$4,010 in premiums (not including any share paid by the employer); with deductibles and copayments that average \$980, that family would pay a total of \$4,990 over the course of the year. Thus, the family

48. Department of Defense, *Evaluation of the TRICARE Program: Access, Cost, and Quality, Fiscal Year 2012 Report to Congress* (February 2012), p. 16, <http://go.usa.gov/de7>.

49. Those contracts represent a consolidation over time from 10 contracts originally. The first was awarded to Foundation Health Federal Services in March 1995 to cover Washington, Oregon, and six counties in northern Idaho. By June 1998, the entire country was under one contract or another.

**Table 4.**

**Average Annual Out-of-Pocket Costs for Military Retiree Families Under TRICARE Plans and for Civilian Counterparts with Employment-Based Insurance, 2011**

(Dollars)

	Premium or Enrollment Fee	Deductibles and Copayments	Total Annual Out-of-Pocket Costs
TRICARE Prime	460	420	880
Civilian HMO	4,010	980	4,990
TRICARE as a percentage of civilian plan	—	—	18
TRICARE Standard or Extra	0	1,000	1,000
Civilian PPO	4,020	1,360	5,380
TRICARE as a percentage of civilian plan	—	—	19

Source: Department of Defense, *Evaluation of the TRICARE Program: Access, Cost, and Quality, Fiscal Year 2012 Report to Congress* (February 2012), pp. 78 and 80, <http://go.usa.gov/de7>.

Note: HMO = health maintenance organization; PPO = preferred provider organization.

enrolled in TRICARE Prime would have total out-of-pocket costs that are about 18 percent of what a similar family would pay in a civilian HMO (see Table 4).<sup>50</sup>

A corollary of the lower deductibles and copayments (totaling \$420 versus \$980) is that TRICARE Prime enrollees use that system significantly more than comparable civilian beneficiaries use their health care systems. Including not only the retiree families described in this section but also active-duty families (who pay essentially no out-of-pocket costs), DoD estimates that the rates of use for inpatient, outpatient, and pharmacy services are much higher among Prime enrollees than among enrollees in civilian HMOs.<sup>51</sup> DoD’s information is consistent with the results of studies of civilian health insurance showing that copayments, deductibles, and the

restrictions of managed care can significantly decrease spending on health care. Those studies also show that, up to a point, increased cost sharing may reduce unnecessary use of health care without adversely affecting beneficiaries’ overall health.<sup>52</sup>

Military retirees are increasingly relying on TRICARE as the primary source of health care coverage for their families. The migration of retirees from private health insurance to TRICARE is one contributor to the rapid increase in TRICARE spending in the past decade. The family enrollment fee for TRICARE Prime, while remaining fixed at a nominal value of \$460 per year, declined in real terms (accounting for inflation) by 21 percent between 2001 and 2011. (As of October 1, 2011, annual enrollment fees for new enrollees were boosted to \$260 for singles and \$520 for families; the enrollment fees for all enrollees will be set at those amounts plus an inflation adjustment starting October 1, 2012. See Appendix C for the legislative history of the TRICARE benefit.) At the same time, the average employee’s share of the family premium for an

50. Department of Defense, *Evaluation of the TRICARE Program: Access, Cost, and Quality, Fiscal Year 2012 Report to Congress* (February 2012), p. 78, <http://go.usa.gov/de7>. An independent source shows amounts similar to those estimated by DoD and reported here; see Kaiser Family Foundation and Health Research and Educational Trust, *Employer Health Benefits: 2011 Annual Survey* (September 2011), <http://ehbs.kff.org/pdf/2011/8225.pdf>. According to that report, the average employee’s share of a family HMO premium was \$4,148 in 2011 (p. 76). The average annual deductible among HMO plans with an aggregate family deductible (as opposed to plans with separate amounts for each family member and a limit on the number of family members required to reach that amount) was \$1,487 (p. 106). The latter amount only approximates DoD’s estimate of \$980 that the average family paid toward its deductible and copayments because some families do not reach the annual deductible whereas others surpass it.

51. Department of Defense, *Evaluation of the TRICARE Program: Access, Cost, and Quality, Fiscal Year 2012 Report to Congress* (February 2012), pp. 62, 67, and 72, <http://go.usa.gov/de7>.

52. See W. Manning and others, “Health Insurance and the Demand for Medical Care: Evidence from a Randomized Experiment,” *American Economic Review*, vol. 77, no. 3 (1987), pp. 251–277; and R. Brook and others, “Does Free Care Improve Adults’ Health? Results from a Randomized Controlled Trial,” *New England Journal of Medicine*, vol. 309, no. 23 (1983), pp. 1426–1434.



**Box 4.****Incremental Health Care Costs Related to Combat**

Some medical care currently provided by the Department of Defense (DoD) consists of treatment for combat injuries and other conditions associated with deployment, and some of that care is funded not in DoD's base budget but rather in its budget for overseas contingency operations. Although the Congressional Budget Office (CBO) does not include the incremental costs for wartime medical care in the agency's definition of military compensation, at least some of those costs represent noncash compensation that is conceptually equivalent to cash pay for hazardous duty, which is included in the definition. (The analysis in this study includes only the health care provided by DoD while service members are on active duty; it excludes the care provided by the Department of Veterans Affairs to members who have left the service.)

It is difficult to comprehensively estimate the amount that DoD spends on wartime medical care. Some of that care—provided at mobile field hospitals and aboard hospital ships, for example—is under the jurisdiction of the Army, Navy, and Air Force medical commands rather than the centralized Defense Health Program, and it is not readily identifiable in the budget documents of the various service branches.

Incremental care under the jurisdiction of the Defense Health Program has several other elements:

- Transport of service members from Landstuhl Regional Medical Center in Germany (the staging area for evacuation from Iraq or Afghanistan) to the United States,
- Treatment of combat injuries at military treatment facilities in the United States,
- Hiring of civilian and contractor personnel at U.S. treatment facilities to cover for military personnel who are deployed,
- Administration of pre- and postdeployment medical examinations, and
- Provision of medical and dental care to members of the reserves and the National Guard who are mobilized for wartime deployment and who otherwise would not be eligible to receive free care.

The Defense Health Program budget request for 2013 included \$1.0 billion for operation and maintenance costs associated with combat operations.<sup>1</sup> CBO does not include those costs in its tally of military compensation, which is restricted to costs paid out of the base budget.

1. Department of Defense, Defense Health Program, *Fiscal Year (FY) 2013 Budget Estimates—Operation and Maintenance, Procurement, Research, Development, Test and Evaluation*, vol. 1, *Justification of Estimates* (February 2012), pp. 132–135, <http://go.usa.gov/p5q>.

employment-based insurance plan in the private sector increased by 80 percent in real terms.<sup>53</sup> Concurrent with those developments, the proportion of military retirees with private health insurance dropped by half, from about 50 percent to 25 percent, and the proportion enrolled in TRICARE Prime increased from about 30 percent to 50 percent. (The remaining one-quarter of retirees had neither private health insurance nor were

enrolled in TRICARE Prime, although many relied on TRICARE Standard or Extra or had access to other federal programs.) DoD estimates that about 730,000 more retirees and family members under age 65—some 45 percent of the 1.6 million enrollees in that category—now rely primarily on TRICARE Prime (and not private health insurance) than would be the case if the relative premiums and out-of-pocket costs in the two sectors remained as they were in 2001.

53. Department of Defense, *Evaluation of the TRICARE Program: Access, Cost, and Quality, Fiscal Year 2012 Report to Congress* (February 2012), pp. 76–77, <http://go.usa.gov/de7>.

Military retirees under the age of 65 who do not choose to enroll in TRICARE Prime may receive benefits under

TRICARE Extra or Standard without paying an enrollment fee, and they are eligible for space-available care at MTFs. Participants in TRICARE Extra or Standard must pay an annual outpatient deductible of \$150 (for single coverage) or \$300 (for family coverage). During 2011, a typical family in those plans paid about \$1,000 in TRICARE deductibles and copayments, whereas a civilian family in an employment-based preferred-provider plan would typically pay \$4,020 in premiums (not including the share paid by the employer) and, including deductibles and copayments that average \$1,360, a total of \$5,380 over the course of the year. Thus, the family that relies on TRICARE Extra or Standard would pay total out-of-pocket costs that are about 19 percent of what a civilian family would pay in a preferred-provider plan (see Table 4).<sup>54</sup>

DoD pays for health care provided to non-Medicare-eligible retirees and their family members contemporaneously; the department does not make accrual payments to fund future costs for that beneficiary group.

**Military Retirees and Their Family Members Who Are Eligible for Medicare.** In 2002, DoD introduced a new benefit, TRICARE for Life, to supplement Medicare for military retirees and their family members who also are eligible for Medicare (a group known as dual-eligibles).<sup>55</sup> Before TFL was created, retirees and their families would lose access to the civilian portion of their TRICARE benefits once they became eligible for Medicare, although they retained their eligibility for in-house care at MTFs (so long as there was space available) and access to free prescription drugs dispensed by MTF pharmacies. Several military retirees filed lawsuits against the federal government, claiming variously that they had been promised low-cost or free health care for the remainder of their lives; that they were entitled to receive that care at

military treatment facilities; and that if such care was not available at MTFs, the federal government was obliged to purchase that care on their behalf from the private sector. The courts consistently ruled that, although military recruiters may have enticed recruits with promises of free lifetime medical care, those promises did not bind the military to provide such care; only the Congress and the President could establish permanent health care benefits. (See Appendix D for a discussion of whether DoD was legally bound to provide military personnel with low-cost health care in retirement.) Lawmakers then acted to establish TFL.

With the introduction of TFL, TRICARE became the second payer to Medicare for those beneficiaries. Dual-eligibles now must enroll and pay the monthly Medicare Part B premium to remain eligible for TRICARE. (Medicare Part B covers doctors' services, outpatient care, home health services, and other medical services including some preventive services.) Having done so, when people in that group receive medical services that are covered by both Medicare and TRICARE, Medicare pays the portion of the service's cost allowed under its rules, and TRICARE pays most, if not all, of the Medicare deductibles and coinsurance. When dual-eligibles receive medical services that are covered by TRICARE but excluded by Medicare, TRICARE covers most of the costs, although beneficiaries may still be responsible for some cost sharing.

As of April 1, 2001, beneficiaries who are at least age 65 are eligible for the full TRICARE pharmacy benefit if they also are enrolled in Medicare Part B; otherwise, their drug benefits are limited to the prescriptions available at MTF pharmacies. Medicare-eligible beneficiaries also can enroll in prescription drug plans under Medicare Part D, but they need not enroll in such a plan to exercise their TRICARE pharmacy benefits. No copayments are assessed for formulary drugs (generic and brand-name drugs that DoD encourages its clinicians to prescribe and that it provides to beneficiaries free or at a reduced out-of-pocket cost) dispensed at MTF pharmacies or for formulary generic drugs obtained by mail order; other types of drugs (including all drugs obtained from retail pharmacies) entail modest copayments.<sup>56</sup>

During fiscal years 2000 and 2001—just before the introduction of TFL—88 percent of Medicare-eligible

54. Ibid., p. 80. Again, similar amounts were reported elsewhere. See Kaiser Family Foundation and Health Research and Educational Trust, *Employer Health Benefits: 2011 Annual Survey* (September 2011), <http://ehbs.kff.org/pdf/2011/8225.pdf>. According to that source, the average employee's share of a family PPO premium was \$4,072 in 2011 (p. 76). The average annual deductible among PPO plans with an aggregate family deductible (as opposed to plans with separate amounts for each family member and a limit on the number of family members required to reach that amount) was \$1,521 (p. 106), which approximates DoD's estimate of \$1,360 in deductibles and copayments.

55. Sections 712 and 713 of the Floyd D. Spence National Defense Authorization Act for Fiscal Year 2001 (P.L. 106-398, 114 Stat. 1654A-176).

56. Department of Defense, *TRICARE Pharmacy Program Handbook* (September 2011), <http://go.usa.gov/YEeF>.

**Table 5.****DoD's Funding Request for the Defense Health Program, 2013**

	Billions of Dollars
Military Personnel	
Pay and allowances of medical personnel	8.2
Accrual payments into the MERHCF	<u>6.7</u>
Subtotal	14.9
Operation and Maintenance	
Direct care at military medical treatment facilities and administrative costs	14.1
Purchased care and contracts	14.2
Pharmaceuticals	<u>3.8</u>
Subtotal	32.0
Military personnel and operation and maintenance	46.9
Procurement	0.5
Research, Development, Test, and Evaluation	<u>0.7</u>
<b>Total, Defense Health Program</b>	<b><u>48.1</u></b>

Source: Congressional Budget Office.

Notes: All entries are for the base budget only and exclude additional funding requested for overseas contingency operations.

DoD = Department of Defense; MERHCF = Medicare-Eligible Retiree Health Care Fund.

military retirees purchased Medicare supplemental insurance (in addition to Medicare Part B) or were covered by Medicaid. By “wrapping around” the Medicare benefit, TFL would seem to make it unnecessary for those families to continue to pay for Medicare supplemental insurance. Although purchases of supplemental insurance have fallen precipitously, DoD reports that as recently as 2011, almost 20 percent of dual-eligible families still purchased either a Medicare supplement (apart from TFL) or used some other alternative to the combination of Medicare and TFL. Those families continued to purchase such policies perhaps because they were unaware of or lacked confidence in the TFL benefit or because they wanted to have overlapping coverage.<sup>57</sup> Another possible explanation is that some participants might be Medicare-eligible

57. Department of Defense, *Evaluation of the TRICARE Program: Access, Cost, and Quality, Fiscal Year 2012 Report to Congress* (February 2012), p. 82, <http://go.usa.gov/de7>.

military retirees who are still employed in the civilian sector and choose to retain employment-based family coverage in order to continue coverage for a spouse who is not yet eligible for Medicare; dropping an employment-based plan in favor of a combination of Medicare and TFL could leave those spouses without any ready source of medical insurance.

**Military Reserve Personnel.** Members of the reserves and National Guard become eligible for TRICARE and receive the same benefits as active-duty service members when they are activated (called or ordered to active duty for more than 30 consecutive days). They also may qualify for up to 180 days of a “preactivation benefit” if they receive advance orders to report to active duty at a future date.

Some members of the Selected Reserve may enroll in the TRICARE Reserve Select program. DoD sets the premium equal to 28 percent of the actuarial cost of coverage, and it updates that premium annually on the basis of the program’s costs during the preceding calendar year. Members of the Retired Reserve who are qualified for a nonregular (deferred) retirement but have not reached age 60 are eligible for the TRICARE Retired Reserve program, but they must pay 100 percent of the actuarial cost of their coverage; there is no government subsidy.

### Projected Costs of the Military Health Care System

The largest element in DoD’s \$48 billion request for the Defense Health Program in 2013 is \$32 billion in O&M funding: \$14.1 billion for direct care provided in MTFs and other administrative activities, \$14.2 billion for purchased care and contracts, and \$3.8 billion for pharmaceuticals (see Table 5). Although they are not shown separately, the costs of pay and benefits for the 60,000 full-time-equivalent civilian employees who are assigned to the military health care system to provide health care and administrative services are included in the O&M total in Table 5. In addition, DoD plans to assign some 86,000 military personnel to the military health care system; the cost of their pay and benefits—\$8.2 billion—would be collectively borne by the MILPERS accounts of the Army, Navy, and Air Force.<sup>58</sup> DoD also requested

58. Department of Defense, Defense Health Program, *Fiscal Year (FY) 2013 Budget Estimates, Operation and Maintenance, Procurement, Research, Development, Test and Evaluation*, vol. 1, *Justification of Estimates* (February 2012), pp. 16 and 56–57, <http://go.usa.gov/p5q>; and Department of Defense, *Fiscal Year 2013 Budget Request, Overview* (February 2012), p. 5-2, <http://go.usa.gov/ynj>.

funding for health care of less than \$1 billion each for the procurement and RDT&E appropriations.

Finally, in 2013, DoD plans to contribute \$6.7 billion from the MILPERS accounts into the Medicare-Eligible Retiree Health Care Fund to account for the future health care of current service members. DoD projects that the cost for the department to provide health care to Medicare-eligible retirees and their families will exceed the accrual contribution. Specifically, DoD anticipates outlays of \$9.7 billion from the MERHCF in 2013 to reimburse TRICARE providers and MTFs for care delivered to that group of beneficiaries.

DoD has set annual accrual rates for the MERHCF of about \$4,400 for active-component personnel and \$2,400 for reserve-component personnel for 2013. Those rates are roughly \$1,000 less than prevailing rates in 2012 because of two recent policy changes and one adjustment to the economic assumptions of DoD's Office of the Actuary. Specifically, DoD achieved full implementation of a program to collect rebates from drug manufacturers at retail pharmacies, and it implemented section 708 of the 2012 NDAA, which places certain limitations on enrollment of military retirees in the Uniformed Services Family Health Plan.<sup>59</sup> Also, during 2011, the Office of the Actuary lowered its estimate of the nominal growth rate in per capita medical spending for dual-eligibles, from 6.25 percent to 5.75 percent per year.

As part of its budget request for 2007, DoD made a set of proposals that it labeled "Sustain the Benefit" that increased the amount beneficiaries would pay out of pocket for medical care; the department subsequently submitted amended versions of that plan in its 2008 and 2009 budget requests. The 2009 proposal would have substantially increased the annual enrollment fee for TRICARE Prime for military retiree families who were not yet eligible for Medicare, increased various copayments under TRICARE Prime, instituted an annual enrollment fee for TRICARE Extra or Standard, and increased the annual family deductible under TRICARE Extra or Standard. All of the Sustain the Benefit proposals were blocked by Congressional action (see Appendix C for more details).

59. The Uniformed Services Family Health Plan, a variant of TRICARE Prime, is available to family members of active-duty service members and to military retirees and their family members in six narrowly defined geographic regions.

DoD's budget requests for 2010 and 2011 did not call for higher TRICARE fees, but the 2012 request led to an increase—from \$460 to \$520 per year—in the family enrollment fee for TRICARE Prime. DoD's budget request for 2013 reprises several aspects of its earlier Sustain the Benefit proposals:

- Institute an annual fee for Medicare-eligible military retirees who enroll themselves or their families in TFL;
- Increase the annual fee that military retirees who are not yet eligible for Medicare pay to enroll themselves or their families in TRICARE Prime;
- Institute an annual fee for non-Medicare-eligible military retirees to enroll themselves or their families in TRICARE Standard or Extra;
- Increase the annual deductibles for non-Medicare-eligible military retirees who enroll themselves or their families in TRICARE Standard or Extra; and
- Adjust the pharmacy copayments for active-duty family members and for retirees and their families as an incentive to purchase mail-order and generic drugs.<sup>60</sup>

DoD estimated that, over the period from 2013 through 2017, those initiatives could save \$5.5 billion in the department's O&M appropriation and \$7.4 billion in accrual payments into the MERHCF. The House of Representatives' version of the 2013 NDAA rejects DoD's proposal.<sup>61</sup> The full Senate has not yet voted on its version of that NDAA.

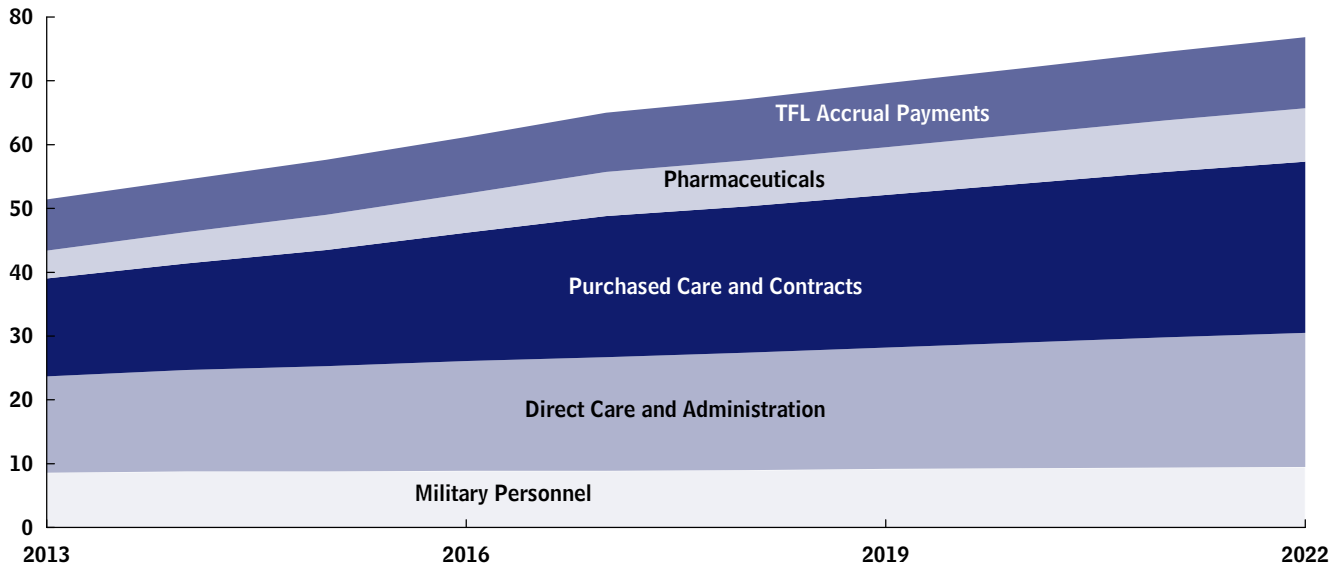
CBO has projected DoD's health care costs through 2022. CBO based its projections of costs in part on average growth rates within the military health care system between 2006 and 2011, which, in most categories, have been significantly higher than the corresponding rates in the national economy. For example, DoD's spending per user for purchased care and for direct care at MTFs increased at real rates of 4.2 percent and 3.2 percent per year, respectively, compared with a national average of 1.3 percent per year for a comparable composite category

60. Department of Defense, *Fiscal Year 2013 Budget Request: Overview* (February 2012), pp. 5-2 to 5-5, <http://go.usa.gov/ynJ>.

61. See H. Res. 661, National Defense Authorization Act for Fiscal Year 2013, Section 4501 (passed on May 17, 2012).

**Figure 6.****Projected Costs of the Military Health System**

(Billions of 2013 dollars)



Source: Congressional Budget Office, *Long-Term Implications of the 2013 Future Years Defense Program* (July 2012).

Note: TFL = TRICARE for Life.

of hospital care and physician and clinical services in the broader economy.<sup>62</sup> However, CBO does not view the faster growth rates within military health care as likely to continue unabated. Instead, CBO expects DoD's costs to decelerate, eventually reaching a growth rate in 2030 (a year that is beyond the horizon of the current analysis) of around 1 percentage point above the growth of per capita GDP, an assumption that is roughly consistent with estimates in CBO's *The 2012 Long-Term Budget Outlook*.<sup>63</sup>

DoD requested \$48 billion for the military health system in 2013, but lawmakers have a long history of denying the department's requests to increase out-of-pocket costs paid by TRICARE beneficiaries. Therefore, CBO used the assumption that DoD's proposed fee increases would not take effect and thus would produce no savings, and the agency's projection is for health care costs of \$51 billion in 2013. CBO projects that health care costs will rise

to \$65 billion (in 2013 dollars) by 2017, reflecting an average real growth rate of 6.0 percent per year over the next five years (see Figure 6). (In contrast, DoD projected that the average real growth rate would be about 2.6 percent during the same period.) The 6.0 percent real growth rate embodies several effects beyond the growth rates in annual spending per user for certain medical services delineated above. CBO projects that spending on other categories of care, such as pharmaceuticals, will increase more rapidly than spending on patient care. Also, because the enrollment fees and copayments under TRICARE remain below the amounts that many military retirees would pay under their employment-based insurance plans, CBO projects that the number of retirees who will choose to enroll in TRICARE Prime will continue to increase (albeit slowly) for several years into the future, adding still more to the total costs for that group.

CBO projects that the faster cost growth within DoD will taper off in the second half of the next decade, averaging 3.4 percent per year between 2017 and 2022. That rate implies an overall average rate of growth between 2013 and 2022 of 4.6 percent per year, in turn implying that military health care costs will reach \$77 billion by 2022.

62. The DoD growth rates are from Congressional Budget Office, *Long-Term Implications of the 2013 Future Years Defense Program* (July 2012), pp. 20–23. The economywide growth rate was reported by the Centers for Medicare and Medicaid Services.

63. See Congressional Budget Office, *The 2012 Long-Term Budget Outlook* (June 2012), p. 53.

### Controlling the Costs of Military Health Care

Several proposals have been made for controlling the costs of military health care by raising enrollment fees, deductibles, or copayments. Depending on the details, those proposals could save DoD as much as \$10 billion per year.

Higher enrollment fees mean larger collections by the government, and they also could encourage some retiree families to turn to employment-based health plans, which would save money for the government. Higher deductibles and copayments could lower the government's costs both by encouraging participation in employment-based plans and by trimming the use of medical services among the remaining TRICARE participants.

CBO estimated that the 2009 Sustain the Benefit proposal, if enacted, would have reduced DoD's spending by

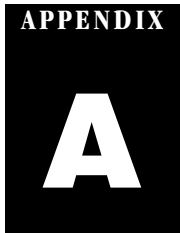
\$5 billion in 2011, the third year covered by the proposal and the first year in which all fees would have reached their new (higher) amounts.<sup>64</sup> In the past, CBO has estimated that DoD could reduce its spending on military health care by increasing the out-of-pocket costs paid by military retirees who are not yet eligible for Medicare (saving \$10 billion in outlays over 5 years and \$28 billion over 10 years) or by precluding that same group from enrolling in TRICARE Prime altogether, allowing them instead to pay to enroll in TRICARE Standard or Extra (saving \$37 billion in outlays over 5 years and \$105 billion over 10 years).<sup>65</sup>

---

64. See Congressional Budget Office, *The Effects of Proposals to Increase Cost Sharing in TRICARE* (June 2009), p. 16.

65. See Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March 2011), pp. 78–81.





## Enhancements to the Military Retirement System Enacted Since 2000

**T**he National Defense Authorization Act for Fiscal Year 2000 (NDAA, Public Law 106-65) gave military personnel a choice between the “High-3” retirement plan and an enhanced REDUX retirement plan. Military personnel who chose the latter plan could retire after 20 years of service at 40 percent of their basic pay and receive partial insulation from inflation (the High-3 plan offered a 50 percent annuity and full inflation protection); they also would receive a \$30,000 lump-sum payment during their 15th year of service.<sup>1</sup> Four other components of military retirement have changed as a result of legislation enacted since 2000:

- The Social Security offset for the Survivor Benefit Plan has been eliminated,
- Certain reservists are now eligible to receive retirement pay before reaching the age of 60—the age to which that pay had previously been deferred,
- The rules regarding concurrent receipt of disability and retirement benefits have been changed, and
- The cap on the multiplier for regular military retirement pay has been raised.

### Survivor Benefit Plan

Military retirees can elect to pay a premium that will allow their surviving spouses to continue to receive a portion of their retirement pay. In the past, once the surviving spouse reached the age of 62 and became eligible for Social Security benefits, payments under the Survivor

Benefit Plan were cut from 55 percent to 35 percent of the retirement pay that the service member would have received. However, the 2005 NDAA (P.L. 108-375, section 644) phased out the reduction in payments below 55 percent of retirement pay; implementation was spread over five increments beginning on October 1, 2005, and ending on April 1, 2008.<sup>2</sup>

### Early Receipt of Retirement Pay by Certain Reservists

The 2008 NDAA (P.L. 110-181, section 647) changed the ages at which some reservists who have served in Iraq, Afghanistan, and elsewhere become eligible to receive retirement pay.<sup>3</sup> Regular active-duty military personnel qualify for full retirement benefits after 20 years of service, regardless of age. By contrast, most reservists with 20 years of qualifying service must wait until reaching the age of 60 to receive retirement pay and health care benefits.

The 2008 NDAA created a new formula to allow some retired reservists to receive retirement pay before reaching age 60. Specifically, for every 90 days within a fiscal year that a reservist is on active duty or performs active service, the traditional eligibility age is reduced by three months. Although the period of service need not be continuous, credit is given only in 90-day increments. So a reservist who serves a six-month tour (180 days) may draw retirement pay at age 59½ instead of waiting until age 60 (and if the tour lasts 200 days, the reservist would still draw retirement pay at 59½).

---

1. Sections 641 through 644 of the 2000 NDAA (P.L. 106-65, 113 Stat. 662–664 (1999)).

---

2. 10 U.S.C. §1451 (2006 & Supp.).

3. 10 U.S.C. §12731 (2006 & Supp.).



The provision applies only to reservists who are activated under the statutory authorities specified in the 2008 NDAA and to service that occurred after the law's enactment on January 28, 2008. No reservist may receive retirement payments before age 50; the earliest age of eligibility for medical benefits remains at 60.

### Concurrent Receipt

Through calendar year 2003, military retirement pay was reduced dollar for dollar by the amount of disability compensation a retiree received from the Department of Veterans Affairs. (Many eligible retirees still chose to receive disability compensation because those benefits are not subject to federal income taxes.) As a result of successive pieces of legislation, starting with the 2003 NDAA (P.L. 107-314), several classes of retired military personnel now can receive military retirement pay without any offset for compensation for service-connected disabilities. For example, under a program that will be fully phased in by January 2014, retirees with 20 or more years of service who are rated at least 50 percent disabled will face no offset between the two benefits.<sup>4</sup> The 2004 NDAA (P.L. 108-136) further requires that the U.S. Treasury, rather than the Department of Defense, make the accrual payments to fund concurrent receipt.<sup>5</sup> The Treasury made accrual payments of \$4.8 billion in 2011, an amount projected by the Office of the Actuary in the

Department of Defense to grow to \$5.6 billion (in 2012 dollars) by 2017.<sup>6</sup>

### The Cap on the Multiplier for Regular Retirement

The 2007 NDAA (P.L. 109-364) lifted the cap on the multiplier, which had been set at 75 percent of basic pay, that is used to set the annuity amount for nondisability retirement from the active military.<sup>7</sup> The multiplier for most active military personnel who retired after December 31, 2006, was reset at 2.5 percent times the years of service credited—without the cap—so that very senior personnel (those with more than 30 years of service) could retire at more than 75 percent, and conceivably at more than 100 percent, of the average of their highest 36 months of basic pay (the High-3). Also, section 601 of the same law modified the basic pay table to include longevity increases for continued service into the fourth decade for very senior enlisted personnel (E-9, the highest pay grade), warrant officers (W-5, the highest rank), and commissioned officers (O-8 through O-10, or two-star through four-star generals and admirals). Those longevity increases were perpetuated in subsequent across-the-board increases to the basic pay table.

4. The rules for concurrent receipt have been relaxed successively in section 636 of the 2003 NDAA (P.L. 107-314, 10 U.S.C. §1413a (2006)), as amended by section 642 of the 2004 NDAA (P.L. 108-136, 117 Stat. 1516) and section 641 of the 2008 NDAA (P.L. 110-181, 122 Stat. 156).

5. P.L. 108-136, codified at 10 U.S.C. §1466(b)(2)(D), Payments into the [Military Retirement] Fund.

6. Department of Defense, *Valuation of the Military Retirement System, September 30, 2010* (January 2012), p. 30, <http://go.usa.gov/vqZ>.

7. 120 Stat 2259, 10 U.S.C. §1409(b) (2006 & Supp.).

## Accrual Accounting for the Military Retirement System

**A**ccrual accounting is a method of accounting in which revenues are recognized in the period earned and costs are recognized in the period incurred, regardless of when payment is received or made.<sup>1</sup> Proponents assert that accrual accounting leads to better-informed decisionmaking because the full costs of a policy become apparent during the year in which that policy is adopted. If an increase in the number of military personnel is under consideration, for example, the full costs—including the future retirement costs of those additional personnel—become part of the decision calculus.

On October 1, 1984, the Department of Defense (DoD) adopted accrual accounting for the military retirement system. The Military Retirement Fund was established “in order to finance on an actuarially sound basis liabilities of the Department of Defense under military retirement and survivor benefit programs.”<sup>2</sup>

The flows of money into the fund come from several sources:

- Amounts paid into the fund by DoD or by the U.S. Treasury;
- Any amount appropriated to the fund; and
- Any return on the assets of the fund, which are invested in U.S. Treasury securities.

Payments out of the fund are made to military retirees and their survivors. Although participants in the other

uniformed services—including members of the Coast Guard, officers of the Public Health Service, and officers of the National Oceanic and Atmospheric Administration—are covered under retirement systems that are similar to that of DoD, those systems are separate from the Military Retirement Fund.

Not all payments into the fund are made by DoD. The National Defense Authorization Act for Fiscal Year 2004 requires that the Treasury, rather than DoD, make the accrual payments to fund concurrent receipt—the ability of several classes of retired military personnel to receive military retirement pay without any offset for payments they receive from the Department of Veterans Affairs in compensation for service-connected disabilities.<sup>3</sup> Thus, under a program that will be fully phased in by January 2014, retirees with 20 or more years of service who are rated at least 50 percent disabled will face no offset between the two benefits.

The balance in the Military Retirement Fund is held in special-issue (nonmarketable) Treasury securities. The Secretary of the Treasury determines the interest rates for those securities, taking into consideration current yields for marketable Treasury securities of comparable maturity. The balance in the fund is an asset for the military retirement system but a liability for the rest of the federal government. As such, it is a measure of the amount that the government has the legal authority to spend on military retirement payments under current law, although it has little relevance in an economic or budgetary sense. Payments from the fund to beneficiaries count as federal spending; the accrual contributions and the amortization

1. Department of Defense, *DoD Financial Management Regulation*, DoD 7000.14-R, Volume 4, Chapter 10, <http://go.usa.gov/YEu5>.  
2. 10 U.S.C. §1461 (2006 & Supp.), Establishment and purpose of [Military Retirement] Fund; definition.

3. Section 641 of the National Defense Authorization Act for Fiscal Year 2004 (Public Law 108-136, 117 Stat. 1515), codified at 10 U.S.C. §1466(b)(2)(D) (2006 & Supp.), Payments into the [Military Retirement] Fund.

payments from the Treasury are intergovernmental transactions that have no net effect on federal outlays.

When accrual accounting began, no funds had been set aside for service members who had already retired, and many who were serving at the time remained in the military long enough to retire. Starting in 1985, DoD made accrual payments on behalf of that latter group, but the payments started too late to fully fund the group's retirement benefits (including survivors' benefits). The Treasury makes accrual payments to fund the remaining liability for that group plus the liability for service members who had already retired by 1985. DoD estimated the initial unfunded liability at \$529 billion (in 1984 dollars) as of September 30, 1984.<sup>4</sup> That balance could have been amortized in several ways. DoD's Board of Actuaries at first determined that it could amortize the unfunded liability by making 60 annual payments, each equal to 33 percent of the total DoD had spent on basic pay in 1983. On several subsequent occasions, in light of legislative changes to retirement benefits and changes in economic assumptions, the board revised the payment amounts and the period over which the unfunded liability would be amortized.<sup>5</sup> As of September 30, 2010, the unfunded liability stood at \$904 billion (in 2010 dollars).

However, the payment schedule is fundamentally arbitrary, so flows into the fund do not provide a useful measure of how much military retirement is costing the federal government in a given year. DoD's Office of the Actuary reports that outlays from the Military Retirement Fund totaled \$50.8 billion during 2011. On the

other side of the ledger, flows into the fund consisted of \$19.8 billion from DoD, \$4.8 billion from the Treasury to cover payments to military retirees under concurrent receipt, \$61.4 billion from the Treasury toward amortizing the unfunded liability, and investment income of \$21.4 billion (in all, \$107.4 billion).<sup>6</sup> The size of the Treasury's amortization payment—the largest single flow into the fund and more than half of the total—is an artifact of the current plan to fully amortize the unfunded liability by 2025. A faster amortization schedule would require a larger annual contribution from the Treasury, and a slower schedule would require a smaller annual contribution.

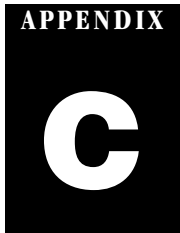
The distinction between outlays from the Military Retirement Fund and flows into the fund is not always clear in policy discussions of the military retirement system. For example, the Defense Business Board—an internal advisory panel within DoD—has issued a study on the military retirement system that proposes use of the total inflow of \$107.4 billion as a metric for comparing the current defined-benefit system with an alternative defined-contribution system.<sup>7</sup> Yet the emphasis on flows into the fund rather than outlays from the fund turns attention away from federal spending. Furthermore, the Treasury's amortization payment depends on a policy decision regarding the length of the amortization schedule that is separable from the fundamental question of whether the current defined-benefit system is a cost-effective vehicle for delivering retirement benefits to military personnel and their survivors.

4. Department of Defense, *Valuation of the Military Retirement System, September 30, 2010* (January 2012), p. 24, <http://go.usa.gov/vqZ>.

5. *Ibid.*, p. 25.

6. *Ibid.*, p. 30.

7. Defense Business Board, *Modernizing the Military Retirement System*, Report FY11-05 (October 2011), Tab C, pp. 10 and 20, <http://go.usa.gov/ynF>.



## Legislative History of Cost Sharing in TRICARE

**P**atients in TRICARE, the military health care program, generally pay smaller shares of the costs of their care than do participants in most employment-based insurance plans. In recent years, lawmakers have blocked the attempts by the Department of Defense (DoD) to increase cost sharing by patients in an effort to control the costs of the program.

The fee for enrolling in TRICARE Prime (which operates like a health maintenance organization) charged to military retirees who are not yet eligible for Medicare was fixed at \$230 per year for individual service members and at \$460 per year for families from 1995 until October 1, 2011, when the fees for new enrollees were raised to \$260 and \$520, respectively (starting October 1, 2012, all enrollees pay those amounts plus an inflation adjustment). Moreover, out-of-pocket expenses have been reduced over time in two areas. The Floyd D. Spence National Defense Authorization Act (NDAA) for Fiscal Year 2001 (Public Law 106-398, section 752) eliminated outpatient copayments for active-duty family members under TRICARE Prime that had been \$6 for the families of junior enlisted personnel (pay grades E-4 and below) and \$12 for all others. Section 759 of the same legislation reduced the catastrophic cap (the maximum out-of-pocket liability per family for copayments, cost sharing, and deductibles over the course of a fiscal year) under TRICARE Standard from \$7,500 to \$3,000 for retirees, survivors, and former spouses.

At various times, DoD has proposed increasing out-of-pocket costs for military retirees who are not yet eligible for Medicare. The first proposal came in February 2006, in the form of a program, Sustain the Benefit, that was part of DoD's budget request for 2007. DoD submitted

amended versions of that plan in its budget requests for 2008 and 2009. Several provisions of the 2009 proposal would have affected military retirees who were not yet eligible for Medicare:

- The annual enrollment fee for TRICARE Prime would have increased from \$460 per family to an amount between \$1,100 and \$2,140 (in three tiers, on the basis of the amount of retirement pay) over a three-year adjustment period, and fees thereafter would have been indexed to the annual growth rate in the military's health care costs;
- The charge for office visits would have risen (from \$12 to \$28), as would various other copayments under TRICARE Prime, and all would be adjusted again for inflation every five years;
- For the first time, annual enrollment fees would be assessed for TRICARE Extra (which operates as a preferred-provider network) and Standard (a traditional fee-for-service plan), which would rise over three years to \$150 per family and then be indexed thereafter to the annual growth rate in the military's health care costs; and
- The annual family deductible under TRICARE Standard or Extra would have increased over a three-year period in three tiers as a function of the amount of retirement pay.

All of DoD's Sustain the Benefit proposals were blocked by lawmakers. The 2007 NDAA prohibited, through September 30, 2007, any increases in certain health care charges for military beneficiaries along with any increases

in copayments under DoD's retail pharmacy system.<sup>1</sup> In particular, the NDAA contained the following provisions:

- Enrollment fees, deductibles, and copayments paid by retirees, their eligible family members, and their survivors for health care purchased from the private sector were frozen;
- The daily copayment amount was capped at \$535 for inpatient care provided at private-sector facilities under TRICARE Standard;
- Premiums for the TRICARE Reserve Select program and the TRICARE Retired Reserve program were frozen; and
- Copayments for 30-day prescriptions filled at retail pharmacies were kept at \$3 for generic drugs, \$9 for brand-name drugs in the TRICARE formulary, and \$22 for drugs not listed in the formulary.

The 2008 NDAA extended those provisions through September 30, 2008, and the 2009 NDAA extended them again through September 30, 2009.<sup>2</sup> DoD's budget requests for 2010 and 2011 did not call for any increase in TRICARE fees, but the 2010 NDAA nonetheless

---

1. Section 704 of the 2007 NDAA (P.L. 109-364, 120 Stat. 2280–2284).

extended, through September 30, 2010, the cap on the copayment for inpatient care under TRICARE Standard.<sup>3</sup> The 2011 NDAA extended, through September 30, 2011, the freeze on enrollment fees, deductibles, and copayments made by retirees, their eligible family members, and their survivors, and it extended the pharmacy copayments that had been established four years before.<sup>4</sup> The freeze on premiums for the TRICARE Reserve Select program has expired; DoD now sets the premium equal to 28 percent of the actuarial cost of coverage, and the department updates the premium annually, in keeping with the program's costs realized during the preceding calendar year.<sup>5</sup> Current law requires beneficiaries enrolled in the TRICARE Retired Reserve program to pay 100 percent of the actuarial cost of their coverage with no government subsidy.<sup>6</sup>

---

2. Sections 701 and 702 of the 2008 NDAA, P.L. 110–181, 122 Stat. 187 and 122, Stat. 188; and sections 701 and 702 of the 2009 NDAA, P.L. 110–417, 122 Stat. 4498.

3. Section 709 of the 2010 NDAA, P.L. 111–84, 123 Stat. 2378.

4. Sections 701 and 705 of the 2011 NDAA, P.L. 111–383, 124 Stat. 4244 and 124 Stat. 4246.

5. 10 U.S.C. §1076d(d)(3) (2006 & Supp.). For information, see “Your Profile: TRICARE Reserve Select” (July 25, 2012), <http://go.usa.gov/mEk>.

6. See “Your Profile: TRICARE Retired Reserve” (July 25, 2012), <http://go.usa.gov/mE0>.

## Were Military Personnel Promised Low-Cost Health Care in Retirement?

**M**uch debate has concerned whether retired military personnel and their families have been promised (and are legally entitled to) low-cost or free health care for life. Military recruiters are said to have promised free lifetime health care in some cases as an inducement to people considering military service. The courts, however, have consistently ruled that any such informal promises do not constitute a contract for the military to provide lifetime health care and that only the Congress and the President could establish such a benefit. In October 2000, lawmakers authorized the TRICARE for Life (TFL) program, which supplements Medicare for military retirees and their family members who are eligible for Medicare and largely eliminates their out-of-pocket medical expenses.<sup>1</sup> In 2011, the Department of Defense (DoD) made accrual payments of \$11 billion for TFL, and the department spent an additional sum that the Congressional Budget Office estimates at between \$14 billion and \$18 billion to provide health care to military retirees and their families who were not yet eligible for Medicare.

Before TFL was created, retirees and their families would lose access to the civilian portion of their TRICARE benefits once they became eligible for Medicare, although they retained the right to obtain in-house care at military treatment facilities (MTFs) when space was available and to fill prescriptions without any copayment at MTF pharmacies.

Specifically, the Dependents' Medical Care Act of 1956 states that retired military personnel “may, upon request,

be given medical and dental care in any facility of any uniformed service, subject to the availability of space and facilities and the capabilities of the medical and dental staff.”<sup>2</sup> However, DoD has closed several military hospitals over the years—including, for example, three closed on the recommendation of the 1993 Defense Base Closure and Realignment Commission; thus the amount of space available has shrunk somewhat.<sup>3</sup> Some military retirees have argued that when such care is no longer available, the federal government is obliged to purchase care in the civilian sector on behalf of retirees and their families.<sup>4</sup>

In the years leading up to the introduction of TFL, lawmakers addressed military retirees' claims that they had been promised lifetime health care but did not go so far as to authorize any new health care benefits for that group. The National Defense Authorization Act for 1998 (Public Law 105-85), states the following:

(a) Findings.—Congress makes the following findings:

(1) Many retired military personnel believe that they were promised lifetime health care in exchange for 20 or more years of service.

1. Sections 712 and 713 of the Floyd D. Spence National Defense Authorization Act (NDAA) for Fiscal Year 2001 (Public Law 106-398, 114 Stat. 1654A-176).

2. Ch. 374, 70 Stat. 250, 253; codified at 10 U.S.C. §1074(b)(1) (2006 & supp.), Medical and dental care for members and certain former members.

3. The 1993 commission's recommendations led to the closing of the naval hospitals in Charleston, South Carolina; Oakland, California; and Orlando, Florida. See *Defense Base Closure and Realignment Commission: 1993 Report to the President*, <http://go.usa.gov/YEJ4>.

4. For a comprehensive review of these issues through 2005, see David F. Burrelli, *Military Health Care: The Issue of "Promised" Benefits*, CRS Report for Congress 98-1006 (Congressional Research Service, updated January 19, 2006).

- (2) Military retirees are the only Federal Government personnel who have been prevented from using their employer-provided health care at or after 65 years of age.
  - (3) Military health care has become increasingly difficult to obtain for military retirees as the Department of Defense reduces its health care infrastructure.
  - (4) Military retirees deserve to have a health care program that is at least comparable with that of retirees from civilian employment by the Federal Government.
  - (5) The availability of quality, lifetime health care is a critical recruiting incentive for the Armed Forces.
  - (6) Quality health care is a critical aspect of the quality of life of the men and women serving in the Armed Forces.
- (b) SENSE OF THE CONGRESS.— It is the sense of Congress that—
- (7) the United States has incurred a moral obligation to provide health care to members and former members of the Armed Forces who are entitled to retired or retainer pay (or its equivalent);
  - (8) it is, therefore, necessary to provide quality, affordable health care to such retirees; and
  - (9) Congress and the President should take steps to address the problems associated with the availability of health care for such retirees within two years after the date [November 18, 1997] of the enactment of this Act.<sup>5</sup>

Concurrent with Congressional interest, several parties filed lawsuits against the federal government in an attempt to enforce military retirees' claims that they had been promised lifetime health care. In a case first filed in December 1996 (*Schism and Reinlie v. United States*), the

5. Section 752 of the 1998 NDAA, P.L. 105-85 (111 Stat. 1823).

plaintiffs alleged that the federal government had breached its implied-in-fact contracts by requiring the plaintiffs to purchase Medicare Part B (which covers doctors' services, outpatient care, home health services, and certain other medical services) to replace the civilian portion of their military health benefit (the Civilian Health and Medical Program of the Uniformed Services—CHAMPUS—the precursor to TRICARE that reimbursed a portion of the costs of health care that military retirees and their family members purchased from the private sector) once they became eligible for Medicare. That case was settled in November 2002 in the U.S. Court of Appeals for the Federal Circuit. On a vote of nine to four, the court ruled that although military recruiters may have enticed recruits with promises of free lifetime health care, those promises did not bind the military to provide such care; only the Congress could establish such a health care benefit, and it had not done so at the time those promises were made:

Of course, had Congress legislated that the military secretaries could contract with recruits for specific health care benefits, the situation would be different. However, because Congress (1) has enacted statutes for over 100 years that govern the level and availability of health care benefits for active and retired members of the armed services and their dependents; and (2) has never provided funds for contracts made by the secretary with recruits to grant health care, the inescapable conclusion is that Congress simply did not intend to delegate its authority over health care benefits for military members. Rather, it intended to occupy the entire field. In that context, one cannot reasonably infer that by empowering service secretaries to run their respective departments, Congress was silently authorizing them to grant health care benefits via oral promises to recruits by the service's recruiters.<sup>6</sup>

Toward the end of the six-year period during which *Schism and Reinlie v. United States* was disputed, lawmakers authorized the TFL program. TFL began to offer benefits in 2002.

6. *Schism and Reinlie v. United States*, 316 F.3d 1259, 1271 (Fed.Cir. (2002)).

# List of Tables and Figures

## Tables

1. Types of Military Compensation	6
2. DoD's Funding Request for Military Compensation, 2013	7
3. Procedures for Updating Military Compensation	18
4. Average Annual Out-of-Pocket Costs for Military Retiree Families Under TRICARE Plans and for Civilian Counterparts with Employment-Based Insurance, 2011	29
5. DoD's Funding Request for the Defense Health Program, 2013	32

## Figures

S-1. Funding for Military Compensation	2
1. 2013 FYDP and Two Scenarios for the Defense Budget	15
2. Year-to-Year Continuation Rates Among Active-Duty Enlisted Personnel	17
3. Quality Trends Among Enlisted Recruits in the Active Military Who Did Not Have Prior Military Service	21
4. Illustration of Military Retirement Pay, by Year of Age, Under High-3 and REDUX	24
5. Annual Continuation Rates Among Active-Duty Enlisted Personnel, 2010	26
6. Projected Costs of the Military Health System	34



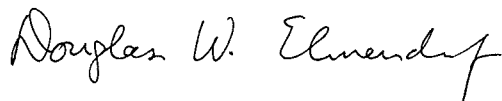
## About This Document

**T**his Congressional Budget Office (CBO) study was prepared at the request of the Chairman of the House Committee on the Budget. In keeping with CBO's mandate to provide objective, impartial analysis, this study makes no recommendations.

Matthew S. Goldberg of CBO's National Security Division prepared the study under the general supervision of David Mosher. Elizabeth Bass, William Carrington, Heidi Golding, Sarah Jennings, Joseph Kile, T.J. McGrath, Carla Tighe Murray, Allison Percy, Dawn Sauter Regan, Chayim Rosito, and Matt Schmit of CBO provided helpful comments on the study.

William Carr (an independent consultant) also reviewed the study. The assistance of an external reviewer implies no responsibility for the final product, which rests solely with CBO.

Kate Kelly edited the study, Maureen Costantino and Jeanine Reese prepared it for publication, and Maureen Costantino designed the cover. An electronic version is available on CBO's Web site ([www.cbo.gov](http://www.cbo.gov)).



Douglas W. Elmendorf  
Director

November 2012