

Approaches for Adjusting Military Cash Pay

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Outline

1. Current policy for adjusting military pay

2. Alternative approaches for adjusting military pay

- Using a military-adjusted index for increasing basic pay instead of the ECI
- Using the ECI to adjust all elements of military cash pay

3. Results and implications

How DoD Currently Adjusts Regular Cash Pay

Regular cash pay has three components: **basic pay** and **allowances for housing and food**.

Since 2007, the default annual raise in **basic pay** has equaled the rate of change in the Bureau of Labor Statistics' employment cost index (ECI) for wages and salaries of private-sector workers.

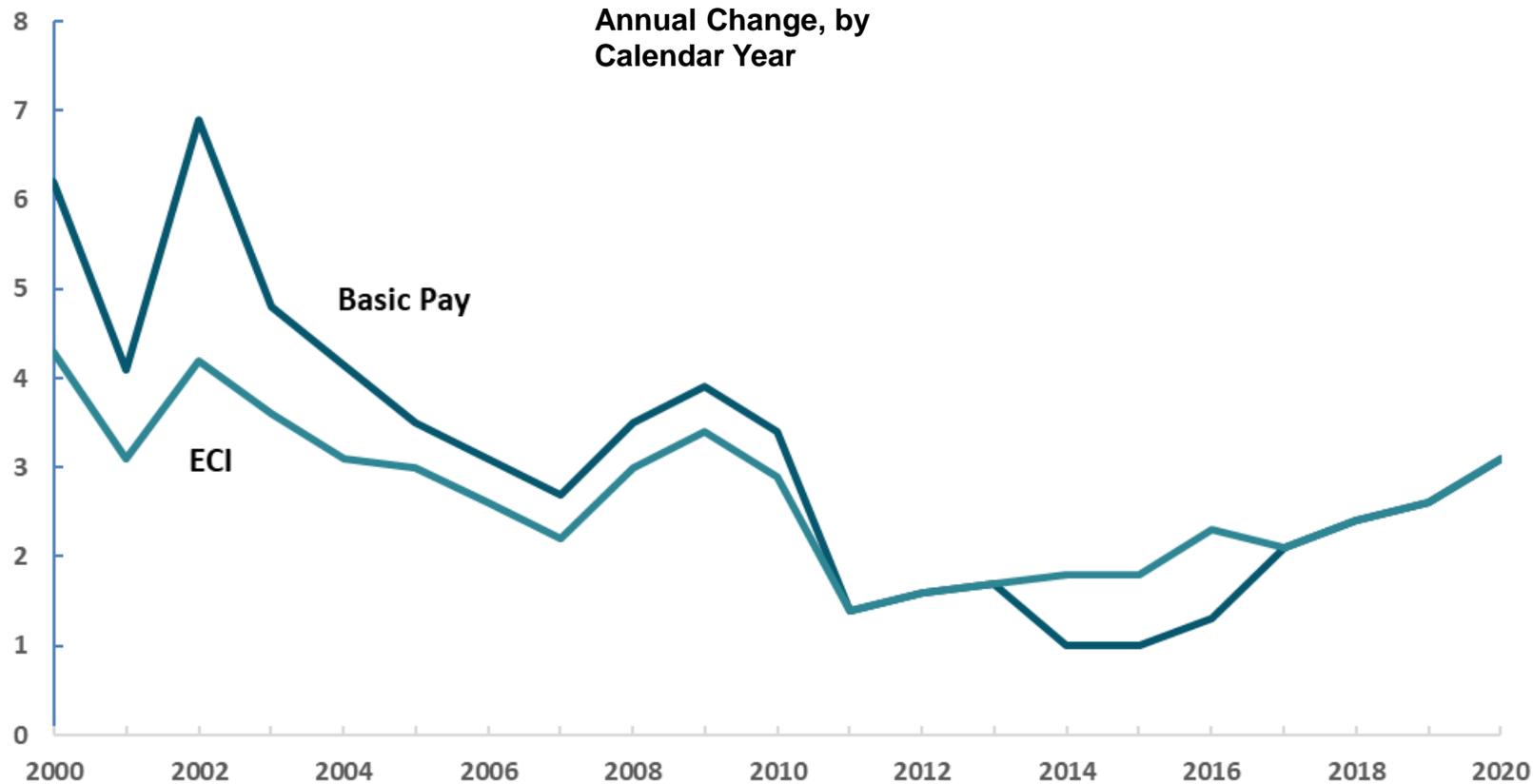
- That practice was mandated by the National Defense Authorization Act for Fiscal Year 2004.
- The President can recommend, or the Congress can specify, a different rate from that default rate.

Allowances for housing and food are adjusted according to different rules.

- The Department of Defense (DoD) determines housing allowance rates annually to provide “adequate housing.” To do that, it uses data on vacancies for selected rental housing in each local area.
- The monthly food allowance is set annually on the basis of the Department of Agriculture's index for the price of food.

Basic Pay Raises Have Been Correlated With the Rate of Change in the ECI but Have Frequently Been Higher

Percent



Basic pay raises, which were higher than the change in the ECI in the 2000s, have either matched or been lower than that change since 2011.

In the early 2000s, the Congress provided additional targeted raises to service members in certain pay grades and with certain tenures to address retention problems.

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Reasons to Consider Alternative Approaches for Adjusting Regular Cash Pay

It may be that DoD's current adjustment methods do not result in pay changes similar to those for the subset of civilian workers most representative of the military workforce.

Also, regular cash pay currently exceeds DoD's goal, and its growth has broad implications for DoD's future budgets and capabilities.

- If the current trend continues, DoD is likely to pay more than necessary for its workforce, and it consequently may be less able to address other military needs, such as weapons procurement.
- However, if pay growth is too low, regular cash pay would eventually fall below DoD's goal, which could make it difficult to achieve DoD's recruiting and retention goals.

CBO Addressed Two Key Questions

How would a military-adjusted index—that is, one that adjusts for the characteristics of the military workforce—compare with the ECI for adjusting basic pay?

- It is unclear whether the rate of change of the ECI is a good representation of the labor market that DoD competes in.
- Collectively, military personnel differ from civilians in age (or experience), education, and occupation.

What would be the implications of applying the ECI to all regular cash pay—that is, basic pay and allowances for housing and food?

- Such an approach would make increases in pay more comparable to those of civilians, whose pay has to cover the costs of housing and food (which DoD adjusts separately).

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Because the ECI Lacks Necessary Detail, CBO Constructed Wage-Growth Indexes From the Current Population Survey

The Current Population Survey (CPS) reports demographic characteristics necessary to create an index tailored for the military workforce.

CBO created two indexes:

- An all-labor-force index used as a surrogate for the ECI and
- An alternative index that adjusts for the characteristics of the military workforce.

Constructing both indexes from the CPS ensured that any difference between them would be due to the characteristics of the military population rather than to intrinsic differences between the CPS and the data underlying the ECI.

How CBO Constructed the All-Labor-Force Index

The all-labor-force index is based on monthly CPS data.

- It includes the private-sector civilian workforce (men and women at least 18 years old).
- It is constructed from the average wages of workers, not jobs, for each fiscal year and from the associated annual growth rates.

CBO allowed the industrial and occupational structure of the economy to change annually to reflect current opportunities available to service members.

- That approach differs from the one underlying the ECI.
- CBO considered fixing occupation and industry weights for the same years as in the ECI but opted not to do so, partly because doing so did not yield a markedly different all-labor-force index.

CBO's Military-Adjusted Index Adjusted for Some Characteristics of the Military Workforce

It controlled for the education levels and age of the military workforce. CBO used DoD's administrative data to categorize military personnel into educational and age groups.

It extracted wage data for civilians with corresponding characteristics from the CPS.

It did not adjust for occupation. Initial attempts to do so using the ECI's separate series for broad occupational groups did not yield a markedly different military-adjusted index.

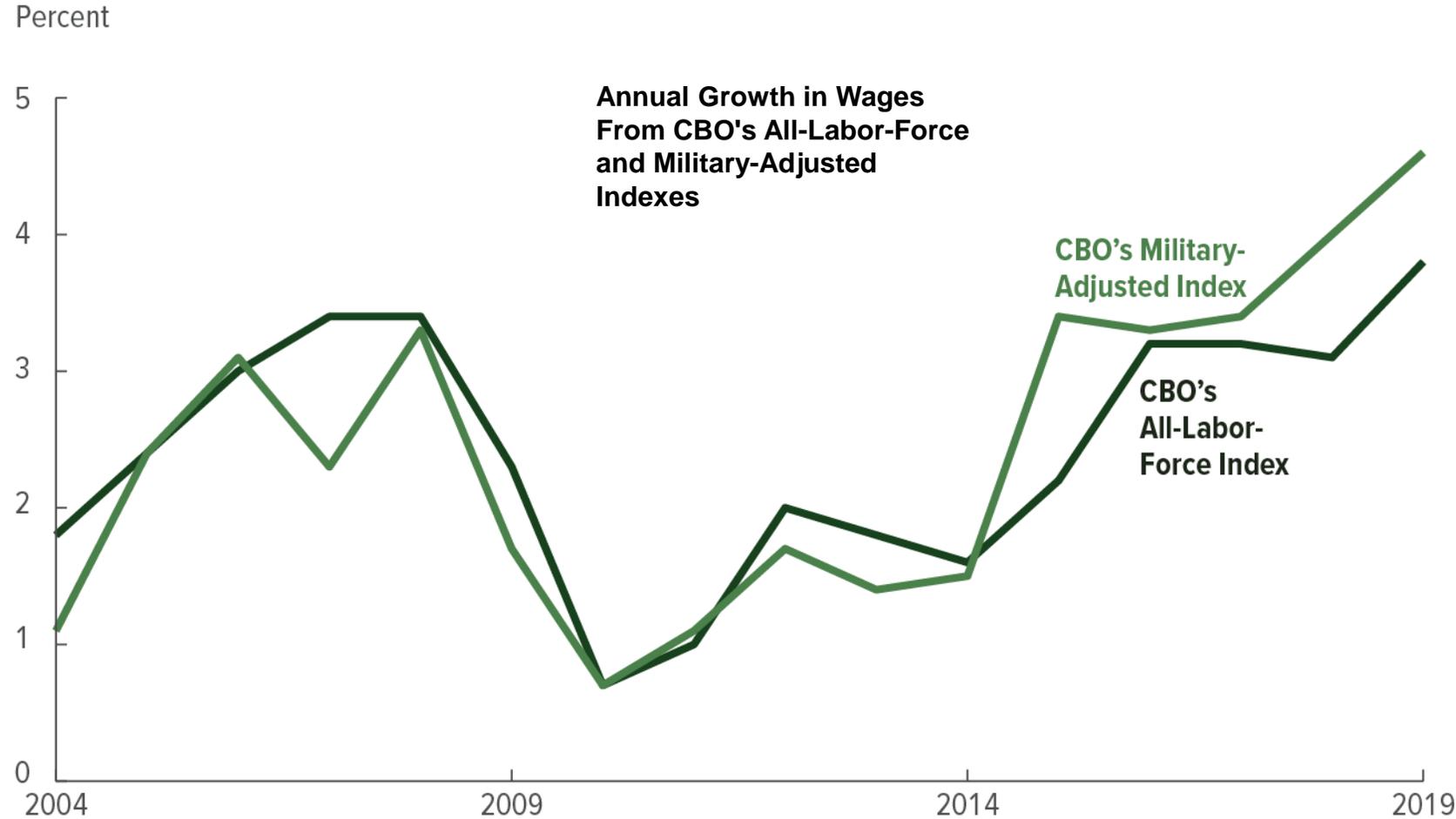
CBO's All-Labor-Force Index Behaves Similarly to Other Pay Indexes over Time



The annual rate of change in the all-labor-force index and the ECI increased from 2004 to 2008, dipped sharply from 2008 to 2010, and then began to rise after 2010. Although the average annual change is almost identical for 2004 to 2019, CBO's index is more volatile than the ECI.

The annual rate of change is larger in the Atlanta Federal Reserve's index, which follows workers who have not changed jobs during the year, but it reflects a broadly similar pattern.

CBO's Military-Adjusted Index and All-Labor-Force Index Exhibit Broadly Similar Trends



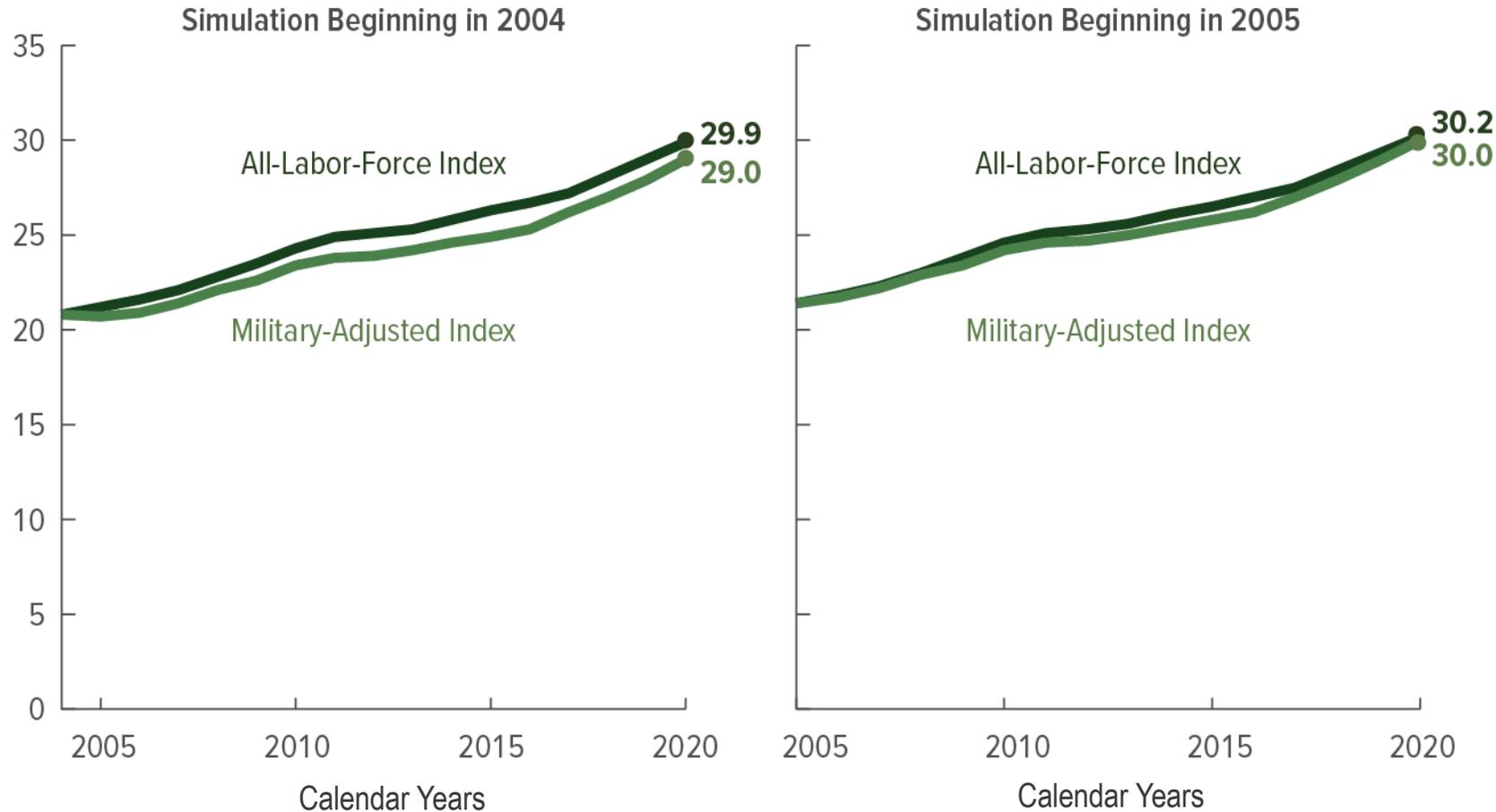
After a sharp decline during the 2007–2009 recession, the annual rate of change for both indexes increased beginning in 2011.

In recent years, the earnings of workers with a high school diploma have grown at a rate similar to or slightly higher than that of workers with a college degree, which partly explains the higher growth in the military-adjusted index after 2014.

Both the all-labor-force index and the military-adjusted index grew an average of about 2.5 percent annually from 2004 through 2019.

The Difference Between the Indexes' Results for Basic Pay in 2020 for E-4s Depends on the Starting Point

Thousands of Nominal Dollars per Service Member



When CBO's simulation used 2004 as the starting point, the gap in basic pay for 2020 between the two indexes was about 3 percent, or about \$1 billion for the entire force. That gap shrank to less than 1 percent, or a total of about \$200 million, when 2005 was the starting point. The gap would be reversed if 2014 was the starting point.

CBO's Results Differed in Some Ways From RAND's

The RAND Corporation recently updated its own military-adjusted index: the Defense Employment Cost Index (DECI).

- The DECI grew markedly more slowly than the ECI during the 1980s.
- The gap between those indexes' average annual growth rates narrowed from an average of 0.8 percentage points between 1982 and 2004 to 0.4 percentage points between 2004 and 2019. That gap is even smaller in the most recent years
- In the most recent years, the DECI grew more quickly than the ECI did.

In contrast, CBO found only a negligible gap between the average annual growth rates of its military-adjusted index and its all-labor-force index from 2004 to 2019. That difference is probably due to differences in analytical methods.

- RAND adjusted for sex in addition to age and education; CBO did not.
- RAND calculated wages for full-time civilian workers; CBO calculated them for full-time and part-time civilian workers.

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CBO Analyzed the Implications of Using the ECI to Adjust All Components of Regular Cash Pay

Under current policy, DoD links only basic pay (which accounts for about 70 percent of regular cash pay) to the ECI. The two other major components of regular cash pay (housing and food allowances) are adjusted at different rates.

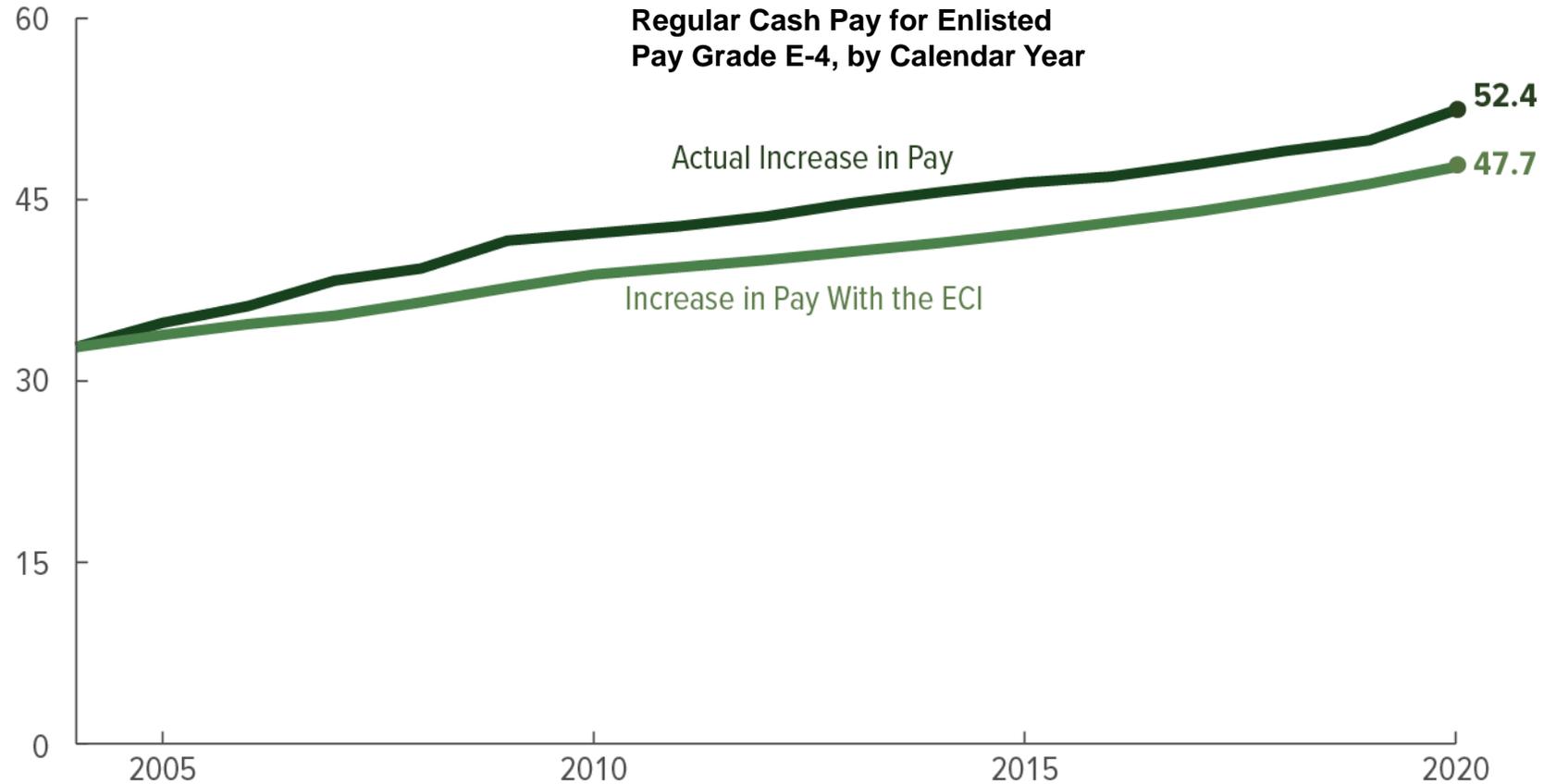
Increasing all components by one index would help make the method for increasing military pay more comparable to that for civilians.

Such a system would also be more like the private sector, in which pay is typically not divided into separate categories for housing and food. DoD's fixed categories are inherently inflexible and do not fully reflect the adjustments that people in the private sector make, such as shifting consumption between housing and food when relative prices change.

CBO analyzed historical data and projected costs to illustrate the implications of adopting the approach.

Regular Cash Pay Would Have Been Lower If All Components Had Grown With the ECI

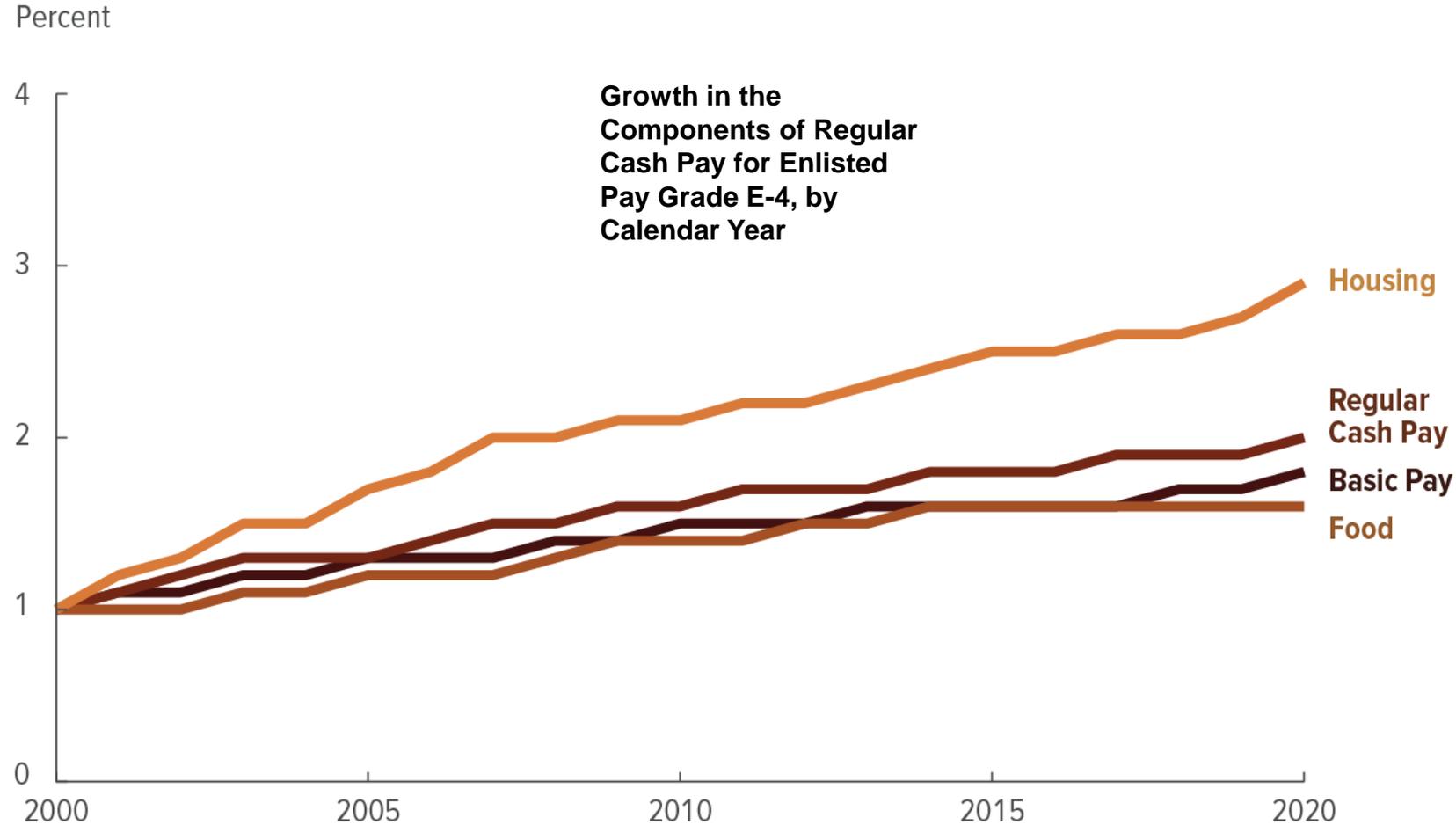
Thousands of Nominal Dollars per Service Member



In 2020, regular cash pay for service members at pay grade E-4 would have been about 9 percent lower, on average, if DoD had adjusted it with the ECI instead of using the current method. The difference occurred largely because housing allowances grew at a faster rate than the ECI.



Housing Allowances Grew More Quickly Than Regular Cash Pay During the Past Two Decades



For service members at pay grade E-4, housing allowances grew at an average annual rate of about 5.5 percent, compared with an average annual increase in basic pay of nearly 3 percent. The largest average annual growth in housing allowances, about 11 percent, occurred between 2000 and 2005. However, the growth in the average housing allowance was higher than both the ECI and the consumer price index of housing costs, even between 2006 and 2015, when there were fewer policy changes.

CBO Projected All Regular Cash Pay Using the ECI

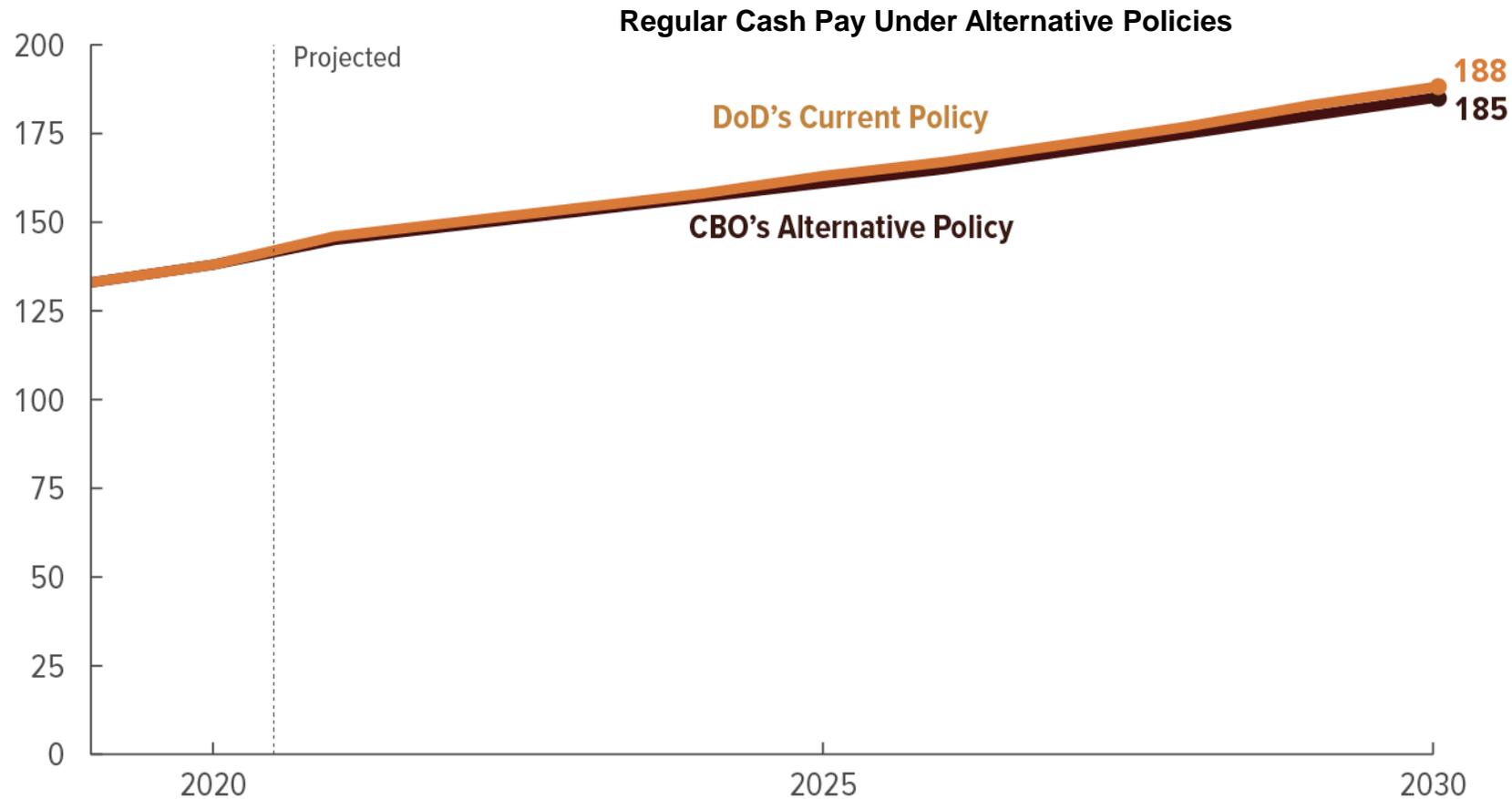
CBO's **base-case scenario** follows DoD's current policy of adjusting regular cash pay with separate indexes.

- CBO used DoD's plans for basic pay raises and increases in allowances through 2025.
- For the next five years, CBO applied rates of growth for each component of regular cash pay, using relevant national indexes.
 - Basic pay rose with the projected growth of the ECI.
 - Because DoD's method of calculating the housing allowance focuses on the subset of housing units that meets its standards, CBO increased the growth of housing costs by 1 percentage point above the economywide rate, which is consistent with historical growth in several years that did not experience large policy changes.

Under the **alternative scenario**, CBO adjusted all components of regular cash pay with the projected increase in the ECI.

CBO's Projections Indicate That DoD Could Slow the Growth of Regular Cash Pay If It Adjusted All Components With the ECI

Billions of Nominal Dollars



Regular cash pay would be lower by roughly \$3 billion, or 1.7 percent, in 2030 if all components grew at the ECI rate. Those savings would grow over time as long as DoD's housing rate exceeded the ECI.

Regular cash pay includes the basic pay of active-duty members and trainees and the housing and food allowances. In addition, CBO includes associated expenses that are linked to basic pay, such as reservists' drill pay, DoD's contributions for retirement contributions, and the cost of Social Security taxes.

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Implications of CBO's Findings

The evidence supporting the adoption of a military-adjusted index is mixed.

- The effects on regular cash pay would have been relatively small if DoD had used CBO's military-adjusted index instead of the ECI, starting in the mid-2000s.
- The difference between the indexes' results appears sensitive to the methods used to construct the indexes and the starting year for the comparison.
- Making a transition to such a customized index would entail some administrative costs and require buy-in from stakeholders.

Implications of CBO's Findings (Continued)

Applying the ECI to all regular cash pay could help slow the growth of compensation costs.

- It would have resulted in savings in the past and helped narrow the gap between actual cash pay and DoD's goal.
- It could reduce annual spending for regular cash pay each year; savings could rise to about \$3 billion, or 1.7 percent, by 2030.

DoD could still address selected recruiting or retention problems—which could result from slower pay growth—with tools such as targeted bonuses for specific grades or occupational groups.

Matching the growth of cash pay to that of civilians would not bring regular cash pay down to DoD's goal. Achieving that goal would probably require several years of raises that were smaller than the ECI growth rate.