A REPORT OF THE CSIS NEW DEFENSE APPROACHES PROJECT

Keeping Faith

CHARTING A SUSTAINABLE PATH FOR MILITARY COMPENSATION

Principal Author
Maren Leed

Contributing Author
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This report is dedicated to Mike Hix, an extremely thoughtful and experienced professional who spent both his Army career and his subsequent analytic one fully and visibly committed to personal, professional, and intellectual integrity. He has made countless contributions to the field of personnel and compensation research, of which this report is but the latest. Mike passed away just prior to the completion of this study. He will be sorely missed.

Contents

Acknowledgments

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Executive Summary

As budgetary pressures rise across the government, leaders at every level are reexamining every expenditure. This is particularly true for leaders in the Department of Defense (DoD), which represents the single greatest share of the government's discretionary spending – over $670 billion in 2012. By necessity, the costs to support the men and women of the armed forces – which total over $186 billion and have grown at rates far greater than inflation over the last 12 years – cannot be exempt from this review. Defense leaders must come to a determination about whether these expenses must continue and if the high-quality force of volunteers that has proven itself so valiantly over the past decade can be sustained at a lower cost. These are the questions this study seeks to address.

Finding answers to these questions requires understanding why the costs of military compensation have risen by almost 40 percent ($50 billion) since 2000 at the same time that the overall force has grown by only four percent. The reasons are complex and varied, and may not be what some people expect. While some cost growth is directly due to expenses associated with fighting the wars in Iraq and Afghanistan, a far greater amount was caused by increases in the amounts of and eligibility for the wide range of compensation benefits. This reality indicates that while compensation costs will fall somewhat as U.S. servicemembers return home, the cost per servicemember will continue to rise at rates beyond inflation – the analysis here indicates by at least seven percent over the next decade. To extrapolate forward, this suggests that even after planned force cuts are taken, a future military at least 60,000 personnel smaller ten years from now will cost $28 billion more than it does today. Under a best case scenario, this would represent 38 percent of DoD's total budget; under a more pessimistic but still plausible one, this could rise as high as 48 percent. While either of these outcomes is unlikely – other trades would likely be made within DoD's total resources – it is clear that at the very least, as the defense budget falls, compensation costs will be increasingly at odds with other defense spending priorities.

If Congress cannot reach agreement on core items (including such issues as entitlements and new revenues), DoD will be subject to even deeper cuts than those which have already been announced. Even if the required reductions fall somewhere short of the additional $500-600 billion that is possible under current law, cuts may be sought in personnel as well as weapons systems, either to reap savings or to forestall even larger reductions. At the same time, many are highly resistant to the notion of cuts to defense overall, and to military compensation in particular. They argue that the diversity and unpredictability of threats facing the nation raise the level of risk associated with any adjustments to military compensation to unacceptable levels. Additionally, there is strong resistance to any action that could possibly be conceived of as breaking faith with the warfighters that have been protecting the country over last decade in particular, and that remain deployed today.

These tensions are not new. Defense reductions have commenced before the conclusion of every conflict since World War II. What is new, however, is the extent to which the U.S. is de-leveraged, not only at the national level, but in state and local governments and individual households, and the intense concern the nation feels as a result. These pressures have put benefits previously held sacrosanct squarely on the table for national debate. Unions have been broken, public and private employees have been forced to agree to deals undoing decades of financial gain, and no one seems willing to confidently predict either how or when this might end.

Practically, there is no real justification for exempting military compensation from scrutiny in this environment. The easiest way to cut costs in this area is to cut the size of the force, but many believe the reductions in end strength that are already planned pose significant risks by themselves given the instability and uncertainty of the global security environment. Another option is to maintain the basic contours of the current system, but allow compensation to vary more widely across the force – e.g., for it to rise with deployments, or in certain positions – and to extract some cost from the system through this enhanced differentiation. But opponents argue that such an approach is a direct assault on one of the most precious values in military culture – a commitment to equity that underpins the willingness of individual soldiers, sailors, airmen and marines to sacrifice their lives for their comrades. A third option is to cut benefits for certain groups – such as those for dependents – but exclude consideration of some of the more politically-risky elements like benefits for retirees. Unfortunately, those expenses represent a large and growing proportion of total costs.

All of these options, and the hundreds of others like them, have proponents and detractors. This paper does not take a position on the necessary or ideal level of defense spending. It does suggest that budgetary exigencies will require adjustments to military compensation, though perhaps not immediately. It does not, however, specify how this should be done. This paper holds that the specifics of how to implement the cuts that will likely be required are tough choices to be made by our political and military leaders, not outside actors. Only the leaders, who must live with the consequences of the decisions they make, will be credible in explaining them. In a perfect world, the U.S. would be able to maintain current force levels without sacrificing elsewhere. But the reality of the current fiscal crisis may put that scenario out of reach.

This paper attempts not to advocate for any specific outcome, but instead to inform the ongoing national debate by describing how and why military compensation costs have expanded and what this means for future expenses. It then offers a high-level overview of the range of options that have been proposed for reducing those costs, an analysis of how various proposals might affect the overall health of the force, and an exploration of how well they align with military culture. It is offered in the hope that it will help to bound and clarify thinking on these issues and decisions about national priorities.

This paper offers three broad recommendations aimed at improving the quality of the debate. The first is a caution against framing the consideration of options too narrowly. Anything short of a comprehensive approach that considers the compensation – and possibly also personnel – practices as a complete system runs the risk of repeating past mistakes and failing to address the fundamental structural issues driving the continuing declines in DoD's personnel purchasing power. The second is a recommendation to explicitly account for military culture when developing any potential reforms. Establishing priorities and consistency with respect to cultural norms will improve the substance of and prospects for any proposed modifications to military compensation. The third recommendation is that defense leaders immediately apply available tools to better understand the priorities and decision factors at work in the current (and potential future) force. This information will help to mitigate the risks of any undesirable effects on recruitment and retention.

Reducing military compensation, if that is what our leaders decide is necessary, will be difficult. The system is both incredibly complex and fraught with political peril. Whatever form the discussion takes – an internal DoD working group, a broader executive branch review, a Congressional effort, or an outside commission – it must answer critical questions about the objectives such changes would seek to achieve, over what timeframe, and at what risk to the finest military in the world. These objectives can be balanced with careful and deliberate attention. Anything less would be a disservice not only to the men and women who have served, do so today, or will do so in the future, but also to the country as a whole. Finding this balance is the challenge before the custodians of defense.

INTRODUCTION

In recent years, the global financial crisis has placed severe pressure on U.S. government spending as a whole and on the defense budget in particular at the same time U.S. leaders have begun drawdown planning for Iraq and Afghanistan. In anticipation of this, then-Secretary of Defense Robert Gates announced in 2010 an "efficiency review" aimed at wringing excess spending from the Department of Defense (DoD) budget for reinvestment in higher-priority areas. Soon after that review was completed, however, the fiscal picture shifted again and the Defense Department was directed to seek additional savings. Targets for the latest round of cost-trimming efforts were formalized by the debt ceiling compromise in August 2011, which holds out the possibility of still deeper cuts absent adoption of a more comprehensive deficit reduction plan. Though the final outcome of the current budgetary turmoil is by no means settled, and thus the specific implications for DoD remain unclear, defense leaders are now fully engaged in a thorough reevaluation of every aspect of defense spending.

This reevaluation is well warranted. Newspapers are replete with stories of excessive cost growth in weapon system after weapon system, as well as reports of the still-growing total costs of the last decade's wars. A critical spotlight has also been shone on recent DoD practices such as a growing reliance on contractors, which has led to significant rises in operations and support funding.

While the growth in military compensation costs is less dramatic than in some other areas, DoD's leaders have acknowledged that these costs must now be a part of the ongoing review. Military compensation represents about a quarter of DoD's total expenses – over $180 billion – and has been rising at a clip that far exceeds inflation. Of these, former Defense Secretary Gates characterized health care costs in particular as "eating the Defense Department alive."[1] His successor, Secretary Leon Panetta, has indicated that health care as well as other areas including the military's retirement program must also be reassessed.

To assist policymakers in their efforts to reprioritize defense spending within an overall amount that all acknowledge will be smaller at least to some degree, this report examines military compensation costs in detail. While the literature on this subject is substantial and stretches back decades, what follows is a summary of the changes that have occurred over the past decade, a projection of where they are likely to be headed in the future, and an assessment of some of the main alternatives to the current system that have been put forth over decades by experts both inside and outside of government. It does not offer specific recommendations for how military compensation should be modified, as past efforts by outsiders have had little success in this regard. Instead, it highlights the main issues in evaluating such changes and makes three broad recommendations aimed at improving the policy debate and decision process going forward.

In all likelihood, military compensation in 2021 will look different than it does today. How different, and with what effects, is the challenge facing policymakers and the topic this report seeks to inform.

[1] Thom Shanker, "Gates Takes Aim at Pentagon Spending," *New York Times*, May 8, 2010, http://www.nytimes.com/2010/05/09/us/politics/09gates.html.

This report is composed of four chapters. Chapter 1 provides an overview of recent historical drivers of cost growth in military compensation. Chapter 2 describes likely future cost growth and its implications under four different budget scenarios. Chapter 3 explores and analyzes some options for slowing or reversing cost growth. Chapter 4 summarizes the report's findings and provides recommendations for how best to approach decisions about change.

The report also includes three appendices. Appendix A details the methodology used to identify Active Component, Reserve Component, and health care costs. Appendix B does the same for projections of those costs in future years. Appendix C provides methodology and background information for the health care benefit and beneficiary population expansion chart on page 19.

General notes

- Unless otherwise noted, all figures reflect total obligational authority in 2012 constant dollars.
- Unless otherwise noted, years referenced for all budgetary and legislative information are fiscal years.
- 2012 figures are drawn from the President's Budget request, and are the only figures cited that are not actuals for the given year.
- Totals in tables may not add up due to rounding.

1 EVALUATING MILITARY COMPENSATION

This study focuses on the costs to the Department of Defense (DoD) to provide military compensation to the over 2.3 million active duty and Reserve members of the United States armed forces, one of the major components of DoD's total annual expense. This analysis focuses on six major categories of military compensation, defined as follows:

- **Basic pay,** or the monthly cash payments the military services provide to all servicemembers based on grade and years of service;
- **Food,** or the amounts paid either as a cash allowance or for the direct provision of meals, and to subsidize purchases from on-base grocery stores;
- **Housing,** which includes the cash allowances to military personnel to pay either for privatized on-base housing or off-base rentals, as well as the costs of constructing and maintaining family housing on bases (which is provided in-kind to personnel with dependents);
- **Other pays, allowances, and costs.** This category includes funding for a variety of compensation elements that vary across the force, such as enlistment and reenlistment bonuses and transportation subsidies, pays to reflect the acquisition of special skills (e.g., foreign language proficiency), and tax payments to support the provision of unemployment benefits;
- **Retirement,** or the annual amount that DoD contributes to pay future retirees, as well as what it contributes to Social Security; and
- **Medical** expenses**,** or the amounts that DoD pays to provide military health care and that it contributes to a trust fund to cover the future medical costs of currently serving servicemembers who will retire with at least 20 years of service.[2]

Funding for these programs is found in multiple appropriations within the defense budget. Table 1.1 shows the total amount DoD requested for military compensation in 2012, by compensation element and appropriation title.

Table 1.1: Total Military Compensation Costs, 2012 Budget Request ($Billions)

Appropriation/ Comp Category	*Military Personnel*	*Revolving & Mgmt Funds*	*Family Housing*	*Other Defense-Wide Accounts**	*TOTAL*
Basic Pay	$77.1				*$77.1*
Food	$7.4	$1.4			*$8.8*
Housing	$20.5		$1.7		*$22.2*
Other pays, etc.	$10.9				*$10.9*
Retirement	$23.4				*$23.4*
Medical expenses	$10.8			$33.6	*$44.4*
TOTAL	**$150.1**	**$1.4**	**$1.7**	**$33.6**	**$186.8**

*These include Operations and Maintenance; Research, Development, Test and Evaluation; Procurement, and Military Construction.

Source: DoD budget justification materials 2012 and analysis by CSIS New Defense Approaches Project.

[2] Funding for military personnel providing health care services is captured in the basic pay category.

The $186.8 billion requested for military compensation in 2012 is more than 50 percent greater than the $126.8 billion spent in 2000, though the total defense budget grew even more rapidly (75 percent) over the same period. Nevertheless, the additional $60 billion that DoD is spending on military compensation today is not buying a significantly larger force. Over the 2000s, force size has remained roughly constant at about 2.3 million active duty and Reserves.

Average Compensation Costs vs. the Value of Compensation

The military compensation costs addressed here comprise only the budgetary costs incurred by the Defense Department. As a result, the per-servicemember cost figures presented should not be interpreted to represent the full value of average individual compensation. There are multiple (and substantial) elements of compensation that are paid for by other parts of the U.S. government (for example, post-service veterans' benefits whose costs are borne by the Department of Veterans' Affairs). There are also compensation costs that are "off-budget" and thus not officially captured anywhere. Foregone tax revenue from tax-free allowances and grocery sales are two examples, as are interest payments on the Military Retirement Fund, which the Treasury Department essentially pays to itself.

Why, then, are these costs rising? Beyond force size, another dynamic at work could be shifts in the ratios of active duty to Reserve personnel. Reservists serve less frequently and are not eligible for the full range of compensation that is offered to active duty personnel, so a force that has a higher active duty to Reserve ratio will cost more than one with a higher proportion of Reservists. A third potential source of growth is change in seniority or tenure. Various elements of compensation are tied to servicemembers' rank and years of service. Thus, even within the same number of personnel, increases in the average rank (either within the officer corps or enlisted ranks or if a greater proportion of the force become officers) or in average tenure will generate higher costs than a like-sized but lower-ranking force with less longevity. Finally, the amounts of some portions of compensation – housing in particular – can be affected by servicemembers' family composition. Housing allowances are higher for military personnel with dependents (usually, but not always, a spouse). Thus if the proportion of the force that is single and childless falls, DoD's compensation costs rise. (The total number of servicemembers' dependents can also affect costs, most directly by increasing the costs of any in-kind housing, increasing demand for subsidized childcare and DoD schools, and by expanding the number of eligible beneficiaries for medical care.)

Although changes in force composition will be explored in greater depth in the next section, a quick review indicates they do explain some cost growth. The total force in 2012 is projected to include 20,120 more servicemembers (1 percent) than in 2000. The percentage of that force on active duty[3] is also slightly higher than in 2000– 66 percent today, versus 64 just over a decade ago. Of the active duty force, a slightly higher percentage is officers today, and although the average rank for officers remained

[3] Active duty figures include active duty endstrength as well as Reservists serving as full time advisors to Guard and Reserve forces.

essentially constant over the 2000s, it rose slightly for enlisted personnel (who greatly outnumber officers in the force as a whole). Finally, a higher percentage of active duty servicemembers are now married than was the case in 2000, and a higher percentage of servicemembers have children.[4]

While all of these changes contributed somewhat to higher compensation expenditures, other factors were far more influential. In order to better understand the contributions of other cost drivers, the study team analyzed cost growth in each compensation element in greater depth. To do so, the study team allocated compensation costs into one of three categories: those in support of the active duty force, those in support of Reservists, and those associated with medical care.[5]

In 2012, active duty servicemembers are projected to comprise about 66 percent of the total force and to account for roughly 64 percent, or $119.4 billion, of total compensation costs (excluding health care). DoD's costs to provide health care – both the payments to fund future care for Medicare-eligible military retirees and to provide care to current beneficiaries – make up another $44.4 billion (24 percent). Costs to compensate National Guard and Reserve forces comprise the remaining 12 percent ($23.0 billion).

Figure 1.1 below shows the relative growth of each category since 2000. Reserve component compensation stayed roughly constant at about 12 percent of total military compensation costs. Of the remainder, active duty expenses fell from 73 to 64 percent of the total and medical expenses rose from 14 to 24 percent.

Because Reserve expenses represent a small proportion of total military compensation costs and because specific cost data is more difficult to obtain than that for active duty forces, the subsequent more detailed analysis that follows focuses on active duty and medical costs. This is not to suggest that Reserve compensation costs – which are substantial, have also grown significantly, and are affected by many of the same factors that have driven cost growth for active duty forces – are not worthy of additional scrutiny, and potentially modification. Indeed, some of the potential alternatives to the current compensation system that are explored in Chapter 3 would include or could be extended to Reserve forces.

The bulk of compensation costs, however, and those that have shown the most substantial growth, are those for active duty forces and those that support the provision of health care benefits to both active and Reserve forces, current and retired, and many of their dependents. The remainder of this chapter examines each area in greater depth.

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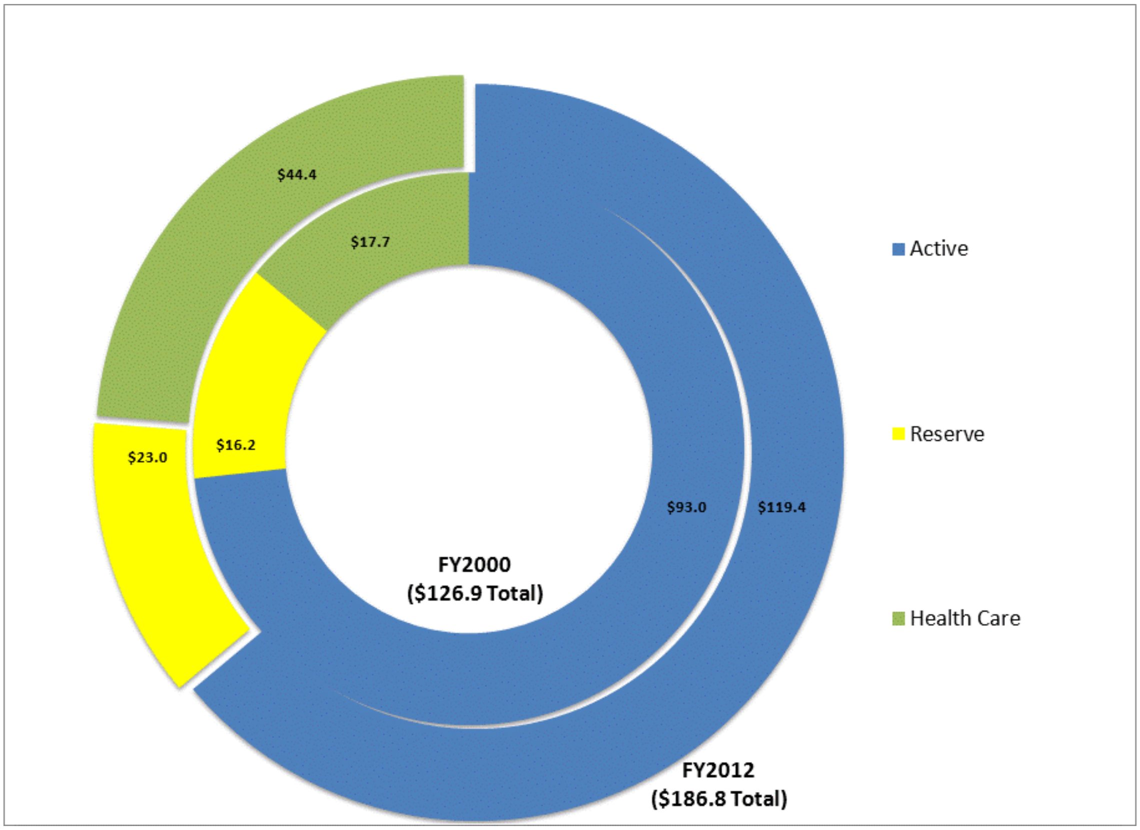
[4] 53.1 percent of the active duty force was married in 2000, compared to 55.8 percent in 2009, the latest year for which data are available. The percentage of the force with children rose from 39.9 percent in 2000 to 43.3 percent in 2009. See *Demographics 2009: Profile of the Military Community* (Washington, DC: Department of Defense), pp. 37, 101, 54 and 138.

[5] DoD's budgetary information about medical expenses is not presented in a way that allows costs to be associated with a given component (active or Reserve). Rather than artificially allocate those costs between components, the study team decided to treat health care as a separate cost category. For a more detailed explanation of how costs in each area of compensation were allocated, see Appendix A.

Figure 1.1: Change in Total Military Compensation Costs, 2000 - 2012 ($Billions)



Source: DoD budget justification materials 2000-2012 and analysis by CSIS New Defense Approaches Project.

Active Duty Compensation and Health Care Cost Growth

In addition to the changes in force composition discussed above, there are at least three other potential explanations for cost growth in military compensation. First, the actual amount of a given element of compensation a servicemember receives can increase – for example, pay raises. A second possibility is that the benefit amount stays constant, but the costs to provide it rise – e.g., medical inflation, or increased facilities maintenance costs. A third cause can be an increase in the *use* of a given benefit or compensation element, which can happen because the pool of eligible beneficiaries is expanded, because eligible populations utilize a particular benefit at higher rates, or both.[6] As subsequent sections describe in greater detail, all four of these reasons have contributed to the significant cost growth in military compensation, though in different ways. Table 1.2 summarizes the major contributors in each of the six major areas of compensation; each is described in more detail below.

[6] Some benefits are more cost sensitive to usage rates than are others. Individual benefits such as pay or tuition assistance increase linearly with each additional user. In other cases, benefits aimed at providing services to larger groups (such as day care centers or grocery stores) can absorb some number of additional users before costs rise significantly.

Table 1.2: Major Causes of Cost Growth in Active Duty Compensation and Health Care, 2000-2012

	Increase in benefit	Increase in cost to provide benefit	Increase in benefit use	Change in force composition
Basic Pay	√			√
Food	√		√	
Housing	√	√		
Other pays, etc.			√	
Retirement		√		√
Health care	√	√	√	

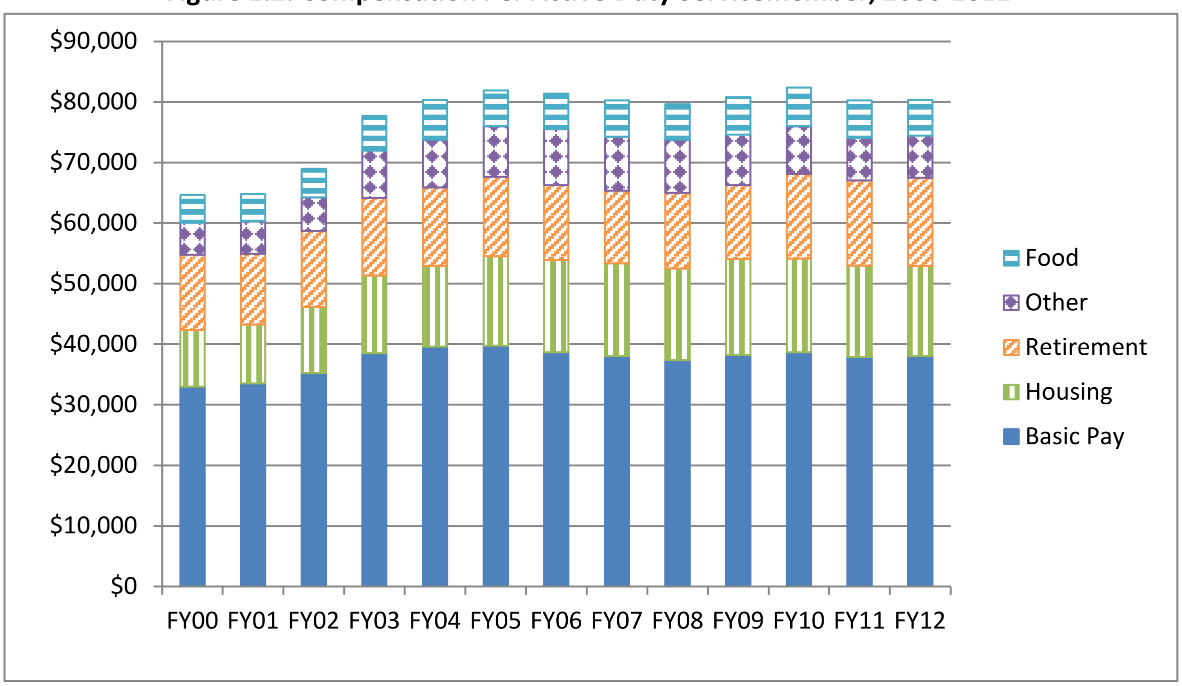
Source: Analysis by CSIS New Defense Approaches Project.

Active Duty Compensation Growth

This section examines the main causes of cost growth for active duty forces in five of the six compensation categories; the costs of medical care are addressed separately in the following section.

In total, compensation costs for active duty forces have risen by $26.4 billion, or 28 percent, since 2000. Active duty force size, on the other hand, has risen by only 4 percent (51,238). On a per servicemember basis, average compensation costs grew by almost a quarter, from $64,606 to $80,292. Figure 1.2 below illustrates that almost all of this growth occurred between 2000 and 2004. Costs have remained relatively constant since then: housing costs have continued to rise, but costs in other categories leveled off, with the exception of "other" compensation costs, which have been declining since 2006.

Figure 1.2: Compensation Per Active Duty Servicemember, 2000-2012



Source: DoD budget justification materials 2000-2012 and analysis by CSIS New Defense Approaches Project.

Basic Pay

Basic pay is the foundational building block of military compensation, and is guided by a "pay table" which prescribes monthly pay rates by rank and years of service. In 2012, DoD requested $56.6 billion for basic pay for active duty forces, $9.2 billion more than in 2000. On a per servicemember basis, costs rose about $5,000 (15 percent) from an average of just over $33,000 at the beginning of the decade.

As noted above, DoD's basic pay expenses are a function of the total size of the force, its basic composition (rank, longevity, dependent status, and family size), and the pay scale. Since 2000, the size of the active duty force grew slightly and it became slightly more senior, both in terms of a larger proportion of officers and minor increases in the average rank for enlisted members.[7] In 2007, Congress also extended the pay table from 30 to 40 years of service, in effect authorizing additional longevity pay increases for the longest-serving servicemembers.

While these changes explain some cost growth, the bulk of cost increases are due to Congressional authorization of a series of higher-than-inflation raises. Coming into the 2000s, robust economic growth in the latter half of the 1990s had bolstered civilian salaries, creating concerns about a pay gap. These arguments, coupled with concern that continued war demands might harm recruiting or retention, led to Congress enacting multiple pay raises between 2002 and 2004 that averaged between 4.2 and 6.9 percent (both across-the-board and targeted at certain pay grades).

At that point, rather than continue to take *ad hoc* annual action, Congress created an explicit statutory tie between civilian salary growth as measured by the Employment Cost Index (ECI) and basic pay increases. The 2004 Defense Authorization Act mandated that all future basic pay increases would be at least equal to ECI, and that in the short term — 2004 through 2006 —basic pay would rise at ECI plus an additional 0.5 percent. Despite the expiration of the mandate, Congress continued to add 0.5 percent to the President's proposed pay raise for another four years in recognition of the stresses the military endured as its members continued to fight two major wars.[8]

Overall, then, changes in force composition drove some cost growth in basic pay (both in total and on a per servicemember basis), but large and repeated pay raises – i.e., increases in the benefit amount – were the principal contributor to cost increases in this area of military compensation.

Food

As is the case with housing, DoD offers a food benefit that is either provided in-kind as actual meals or as a cash payment known as the basic allowance for subsistence, or BAS. DoD also provides an annual subsidy to the Defense Commissary Agency (DeCA), which operates on-base grocery stores used by active duty, Reserve, and retired servicemembers and their families. In 2012, the total cost of providing

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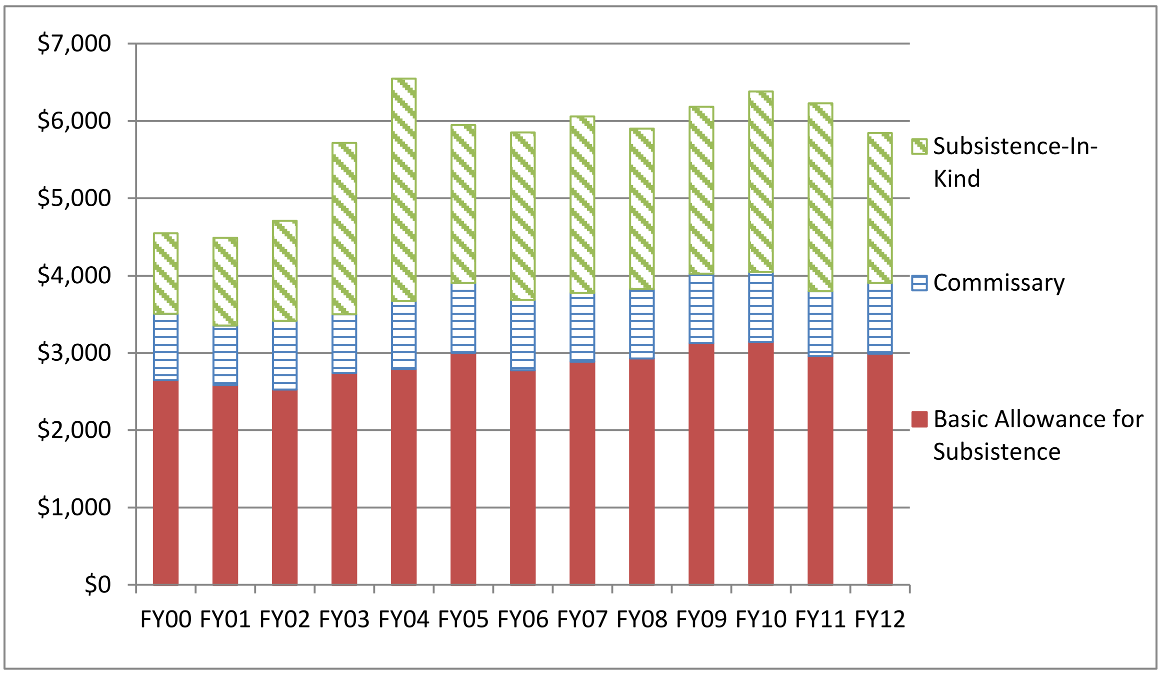
[7] The ratio of officers to enlisted rose from 1 to 5.3 in 2000 to 1 to 5.1 in 2011. The largest declines were in the Navy (1 to 5.9 in 2000, 1 to 5.1 in 2011), and the Air Force remained the most officer-intensive service (1 to 4:1 in 2000, 1 to 4.0 in 2011). Data from Defense Manpower Data Center, "Department of Defense: Active Duty Military Personnel by Rank/Grade," September 30, 2000, and May 31, 2011, http://siadapp.dmdc.osd.mil/personnel/MILITARY/history/rg0009.pdf.

[8] The 2011 pay raise was at ECI; as of this writing the 2012 outcome has not yet been determined, though an ECI-level raise appears likely.

food benefits for active duty servicemembers was $8.8 billion, or approximately $5,800 per servicemember and 7 percent of total compensation costs. This represents growth of almost 30 percent over the last 12 years.

As Figure 1.3 below shows, food costs peaked in 2004, then dropped somewhat before leveling off at an amount almost a third higher than that of 2000. This pattern is principally driven by spending on subsistence-in-kind, which grew by more than 85 percent on a per servicemember basis over the 2000s. DoD's subsistence-in-kind expenses rose from $1.5 billion in 2000 to $2.9 billion in 2012, the overwhelming majority of which is due to the costs of feeding large numbers of forces in Afghanistan, Iraq, and supporting locations.

Figure 1.3: Per Servicemember Costs for Food-Related Benefits, 2000-2012



Source: DoD budget justification materials 2000-2012 and analysis by CSIS New Defense Approaches Project.

In the late 1990s, Congress began to express concern that BAS rates had not kept pace with the costs of food, forcing servicemembers to turn to food stamps and other federal programs for support. Subsistence allowances had also become very complex, with differing rates for officers and enlisted personnel and varying eligibility criteria. Eligibility was simplified in 2002, when DoD began providing the allowance to all officers and enlisted upon completion of basic training (with the proviso that the government should then be reimbursed for any meals it provides). Congress also changed the basis upon which BAS rates are calculated, tying them to the national inflation rate for food — a more generous standard than had been used prior to 2001. That same year, Congress created the Family Subsistence Supplemental Allowance (FSSA), a new allowance designed to augment subsistence payments to servicemembers whose large families qualified them for food stamps.[9] Congress further increased BAS amounts for certain military personnel in 2003, doubling the rates for enlisted personnel

[9] For the purposes of this analysis, FSSA expenditures are included in total BAS costs.

living in on-base housing that lacked adequate dining facilities.[10] The sum total of these changes resulted in cash allowances for food growing by a substantial rate over this time period (13 percent).

In addition to providing meals and subsistence allowances, DoD also offsets some of the costs to operate grocery stores (known as commissaries) on many of its installations. The discounted groceries, in part enabled by a subsidy that helps to defray operating costs, are one of the most highly valued benefits available to active duty servicemembers, reservists, and retirees and their families.[11] While economists and other analysts frequently argue that an equivalent benefit could be provided more efficiently by the private sector, advocacy for retaining the commissary benefit is remarkably strong and has thus far proven highly successful. DoD requested $1.4 billion for the Defense Commissary Agency (DeCA) in 2012, which equates to $917 per servicemember – a 6 percent rise since 2000.[12]

In sum, DoD's costs to provide food-related benefits have grown in part because the commissary subsidy has increased, and in part because allowance amounts have risen, been made more universally available, and have been tied more explicitly to fast-growing food costs. The largest growth, however, has come because of war-related increases in the costs to provide meals to servicemembers deployed overseas.

Housing

While rising health care costs have been noted as a major area of military personnel cost growth, less attention has been paid to the substantial cost increases to provide housing benefits. In 2000, DoD spent $13.5 billion on housing for active duty servicemembers, offered either as an in-kind benefit or through a cash allowance. By 2012, this had increased by almost two thirds, and costs per servicemember had risen by almost 60 percent (from $9,312 to $13,856). These rises are the result of two major policy decisions in the mid-late 1990s: the privatization of large amounts of on-base housing and the revision and expansion of housing allowances.

Housing Privatization Programs

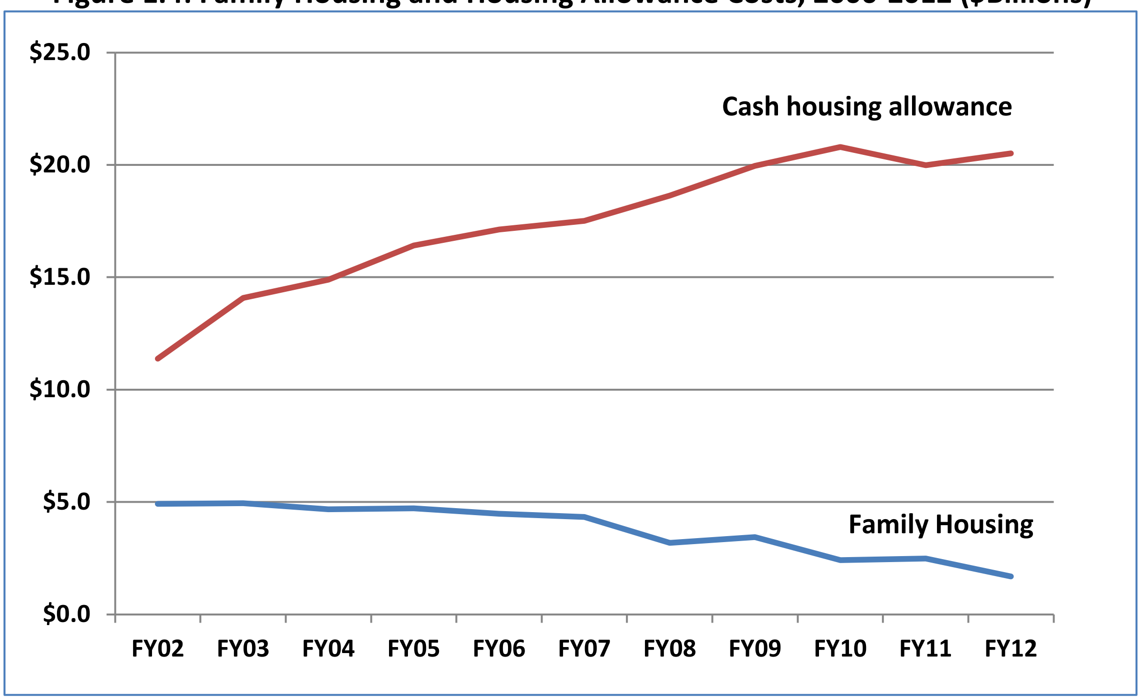
The provision to officers of free housing or a cash substitute when needed dates back to the nation's founding, though it was not explicitly extended to enlisted members until 1949.[13] For centuries, the military services met much of this obligation by building and maintaining large numbers of "family" housing units on military bases, ranging from barracks to single-family homes. In the mid-1990s, however, DoD adopted a different approach. At that point, 60 percent of DoD's family housing stock was

[10] U.S. Department of Defense, Office of the Under Secretary for Personnel and Readiness, "Military Compensation Background Papers, Sixth Edition," OUSD/P&R, Washington, DC, May 2005, pp. 190-192.
[11] Congressional Budget Office, "The Costs and Benefits of Retail Activities at Military Bases," CBO, Washington, DC, October 1997, p. 1.
[12] Commissaries are one example of an instance in which the total costs of providing a benefit exceed the amounts reflected in the DoD budget. The amount of the subsidy is the budgetary cost associated with DeCA, but state and local governments also face costs through foregone taxes and lost return on capital. In 1997, CBO estimated that providing active duty servicemembers with what they perceive as $300 million a year in benefits through the commissaries cost society as a whole $600 million – half in cash and half in deadweight loss. See CBO, "The Costs and Benefits of Retail Activities at Military Bases," pp. 18-19, 21.
[13] OSD/P&R, "Military Compensation Background Papers," pp. 103-111.

deemed inadequate, and Defense officials estimated that bringing it up to standard would cost $20 billion and take 30 years to complete. Rather than undertake this effort, in 1996 Congress approved a major set of authorities allowing DoD to access private capital to construct family housing on bases, with private entities then receiving servicemembers' housing allowances as rental payments.[14]

From a budgetary perspective, housing privatization shifted much of the costs from DoD's Family Housing (FH) accounts – an in-kind benefit – to cash housing allowances contained within the Military Personnel (MILPERS) accounts. (Some in-kind family housing persists.) Practically, this shift had an additional effect. With DoD-owned housing stock, resource managers have some latitude in determining the amounts they wish to invest in upkeep. In fact, when budgets get tight this flexibility can lead to under-investments in maintenance of the kinds that drove the prevalence of sub-standard housing noted above. With privatized housing, however, DoD lost the ability to determine (or defer) its maintenance investments. The net result was a more accurate reflection of the true costs of providing adequate housing to servicemembers, which had previously been masked by under-spending. Figure 1.4 below shows how family housing spending flattened out and even declined slightly after DoD adopted housing privatization on a broad scale, and the resulting increases in BAH accounts.

Figure 1.4: Family Housing and Housing Allowance Costs, 2000-2012 ($Billions)



Source: DoD budget justification materials 2000-2012 and analysis by CSIS New Defense Approaches Project

[14] U.S. Department of Defense, Office of the Under Secretary of Defense for Installations and Environment, "Military Housing Privatization Initiative (MHPI) – 101," Office of the Under Secretary of Defense, Washington, DC, http://www.acq.osd.mil/housing/index.htm.

Changes in Housing Allowances

The move toward privatized housing was shortly followed by adjustments to the housing allowance. In the late 1990s, DoD analyses indicated that the two major allowances intended to cover housing expenses – the basic allowance for quarters (BAQ) and the variable housing allowance (VHA) — had failed to keep pace with prevailing rental rates. BAQ was paid at a flat rate based on rank and dependent status, and was adjusted annually based on pay raises. VHA was aimed at capturing geographic differences in housing costs, and varied by duty location. The system was designed such that BAQ was intended to cover approximately 65 percent of national average housing costs and VHA an additional 20 percent, with the servicemember absorbing the remaining 15 percent. Over time, however, housing costs rose faster than pay raises, reducing the value of BAQ.[15]

To address these problems, in 1998 BAQ and VHA were combined into a single Basic Allowance for Housing (BAH). BAH varies by duty location, dependency status, and pay grade. It is also calculated differently than was its predecessor. Previous rates had been based upon what servicemembers were actually paying, which in many cases was for substandard housing. The revised standard sets BAH adjustments based on surveys of prevailing rental rates in the metropolitan area where servicemembers are stationed.

The establishment of BAH was aimed at ensuring housing allowances would keep pace with actual housing cost increases, but still with an expectation that servicemembers would cover 15 percent of actual housing costs if they wished to rent a home consistent with the national average. In 2000, the Clinton Administration announced an initiative, later endorsed and completed by the Bush Administration, to eliminate all out-of-pocket housing expenses over five years.[16] As of 2005, BAH rates were set at levels intended to reflect 100 percent of the average rental cost of housing for civilians of equivalent pay and dependent status.

These two major changes - the shift toward privatized on-base housing and efforts to make the housing allowance both more accurately reflect market costs and more generous – led to major increases in BAH accounts, and despite offsetting declines in Family Housing appropriations, to DOD’s total housing costs overall.

Other Pays, Costs and Allowances

In addition to basic pay and the housing and subsistence allowances that are common across the force, some servicemembers receive additional allowances or special and incentive pays. These can include cash bonuses for additional service commitments, pays to encourage the acceptance of positions that are deemed “hard to fill” or that face particular shortfalls, and “skill-based” pays to reward the acquisition or maintenance of skills that are of particular military value (e.g., foreign languages, flying proficiency, or other forms of specific technical expertise). DoD also incurs additional costs to provide servicemember (and in some cases, their dependents’) education benefits, unemployment insurance,

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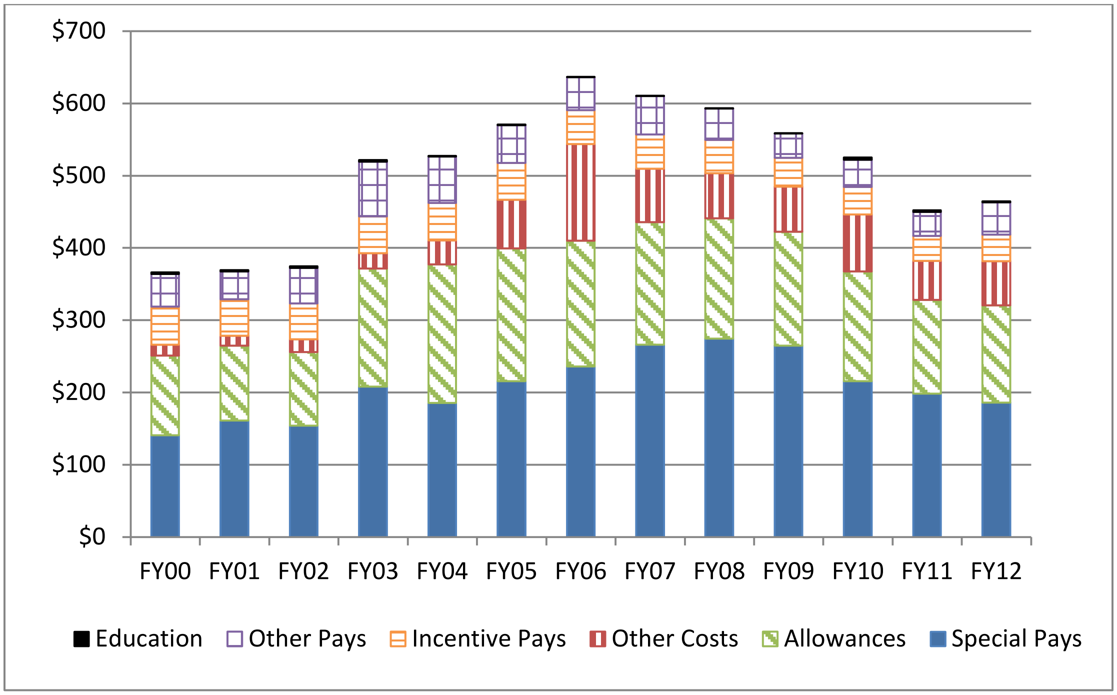
[15] U.S. Department of Defense, “Basic Housing Allowance Frequently Asked Questions (FAQ),” www.defensetravel.dod.mil/ Docs/perdiem/browse/Allowances/BAH/PDF/1998/Bahfaq98.htm.

[16] Jim Garamone, “Proposed Budget Aims to Attack Housing, Medical Problems,” American Forces Press Service, February 7, 2000, www.defense.gov/news/newsarticle.aspx?id=44573.

adoption expenses, death gratuities, and to cover other expenses. DoD requested a total of $10.4 billion for these programs for active duty servicemembers in its 2012 budget, an increase of 36 percent over 2000 levels.[17]

Figure 1.5: Growth in Other Pays, Costs and Allowances, 2000-2012



Source: DoD budget justification materials 2000-2012 and analysis by CSIS New Defense Approaches Project.

Figure 1.5 above shows the relative costs of the various elements of this category on a per servicemember basis. Special pays and allowances comprise the bulk of the expense, and overall costs are higher than they were in 2000 but have been falling from the high reached in 2006. There were two main drivers of sustained cost growth in this category – an almost 250 percent rise in "other costs" and growth in special pays of over a third.

Other Costs

The amount DoD requested in the sub-category of "other costs," though small ($1.4 billion in 2012, or less than one percent of total compensation costs), was more than quadruple the 2000 level of $321 million. This account funds a wide range of activities, from survivor benefits to adoption expenses to transportation subsidies. Most of these programs experienced periods of both expansion and contraction over the 2000s. One, however, experienced steady and dramatic growth: the amounts DoD pays for unemployment compensation. These costs more than tripled over the last 12 years, from $278 million to $833 million.

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[17] Within the DoD budget, this category also contains the costs to move servicemembers and their families between assignments as well as other small costs associated with administering the force. Because they are not directly aimed at compensating servicemembers, these costs are excluded from this analysis.

There were four main contributors to this trend. First, conditions were set by a 1991 law that extended unemployment benefits for prior military members and others to 26 weeks and shortened the number of days Reservists had to spend on active duty to qualify for the benefits from 180 to 90 days. Second, in 2002, Congress authorized an additional 13 weeks of benefits once the 26 weeks had expired.[18] The third factor affecting costs was the substantial use of Reservists in particular in support of Operation Enduring Freedom and Operation Iraqi Freedom, many of whom collected at least some unemployment upon their release from active duty. The fourth contributor to rising costs was the much more challenging job market that resulted from the global recession in 2007, and that persists today. The net result of both increases in total benefit amounts and expansion of eligibility, higher separations driven by greater reliance on the Reserves and high unemployment overall has greatly increased unemployment insurance costs for DoD as a whole, and for the Army in particular.

Special Pays

The other main source of growth within this category was special pays. Over time Congress has authorized a wide range special pays for a variety of purposes. Some offer financial recognition for the attainment or maintenance of special knowledge or skills. Others are aimed at rewarding those who face the greatest risks during periods of conflict. These special pays – particularly those for servicemembers in hostile environments where they face imminent danger, when they are in locations or conducting missions that are particularly arduous, or are involuntarily extended beyond their service commitments – have been given to large numbers of servicemembers deployed to operations overseas, and totals have only recently started to decline as the nature of operations in Iraq have begun to change and as overall levels of deployed forces have begun to fall. On a per servicemember basis, special pays increased from $1,597 in 2000 to $2,027 in 2012, a 27 percent rise, but were as high as $2,863 in 2004.

Overall, growth in this category of “other” compensation costs was principally due to the demands of the wars and the effects of a weakened economy. Increased use of the Reserves, coupled with poor post-activation job prospects and expanded benefit amounts, led to higher unemployment insurance costs. These factors combined with greater use of special pay authorities tied to war-related conditions expanded DoD’s compensation budgets. Thus both the amounts and the use of benefits in this category increased over time.

[18] The 1991 law was the Emergency Unemployment Compensation Act of 1991 (Public Law (PL)102-164). The 2002 law was the Job Creation and Worker Assistance Act of 2002 (PL 107-147); the 13-week extension in this bill was continued by the Emergency Unemployment Compensation Act of 2009 (PL 111-92). See U.S. Army, “Army Military Personnel Justification Book, Fiscal Year 2012 Budget Estimates,” Department of the Army, Washington, DC, February 2011, p. 152.

Retirement[19]

The final major element of military compensation is retirement. DoD contributes to servicemembers' retirement benefits directly through the military pension program and, like all employers, through contributions to the Social Security Administration. Together, DoD requested $23.4 billion in 2012, 21 percent more in real terms than in 2000: $4.3 billion for social security taxes, and $19.1 billion for military retirement.

On a per servicemember basis, from 2000 to 2012 annual social security taxes rose in real terms by 15 percent (from $2,492 to $2,879), due to the increases in basic pay discussed above. Per servicemember costs of the military retirement benefit are also much larger now ($12,500 in 2012), and have experienced greater growth (19 percent) since 2000 than has social security. To be clear, these costs do not represent the costs of paying those already retired. Instead, the program is funded on an accrual basis in which DoD actuaries estimate the future retirement costs of the current force. DoD then makes payments which, with (Treasury Department-paid) interest, should cover the future liability. Payments are made into the Military Retirement Fund (MRF), which is maintained by, and also receives contributions from, the Department of the Treasury. Each year, actuaries make projections about likely retirement rates and patterns, life expectancies and mortality rates, future pay levels, and other factors that will determine retirement pay obligations in the future, taking previous years' experiences into account.[20] These projections are then distilled into a rate that determines a percentage of basic pay that DoD contributes to the MRF for the future obligations to both active and Reserve retirees.

There are four major drivers responsible for the growth in DoD's MRF contributions for future active duty retirees over the 2000s. The first is the "multiplier effect" of the increases in basic pay, which serve as the basis upon which servicemembers' future retirement pay is calculated.[21] The second factor is two key changes in the retention behavior of the current force. Servicemembers with less than ten years of service began leaving service at lower rates, increasing DoD's future retirement liability. Further, a larger number of servicemembers achieved 20 years of service, becoming retirement-eligible, and of those, a higher percentage decided to serve longer. As Figure 1.6 below illustrates, almost 60 percent of those eligible to retire in 2000 chose to do so. By 2010, the latest year for which data is available, almost 60 percent of those eligible to retire were instead opting to stay. As a result, the MRF's calculations of future liability changed, raising the amount of DoD's required contributions.

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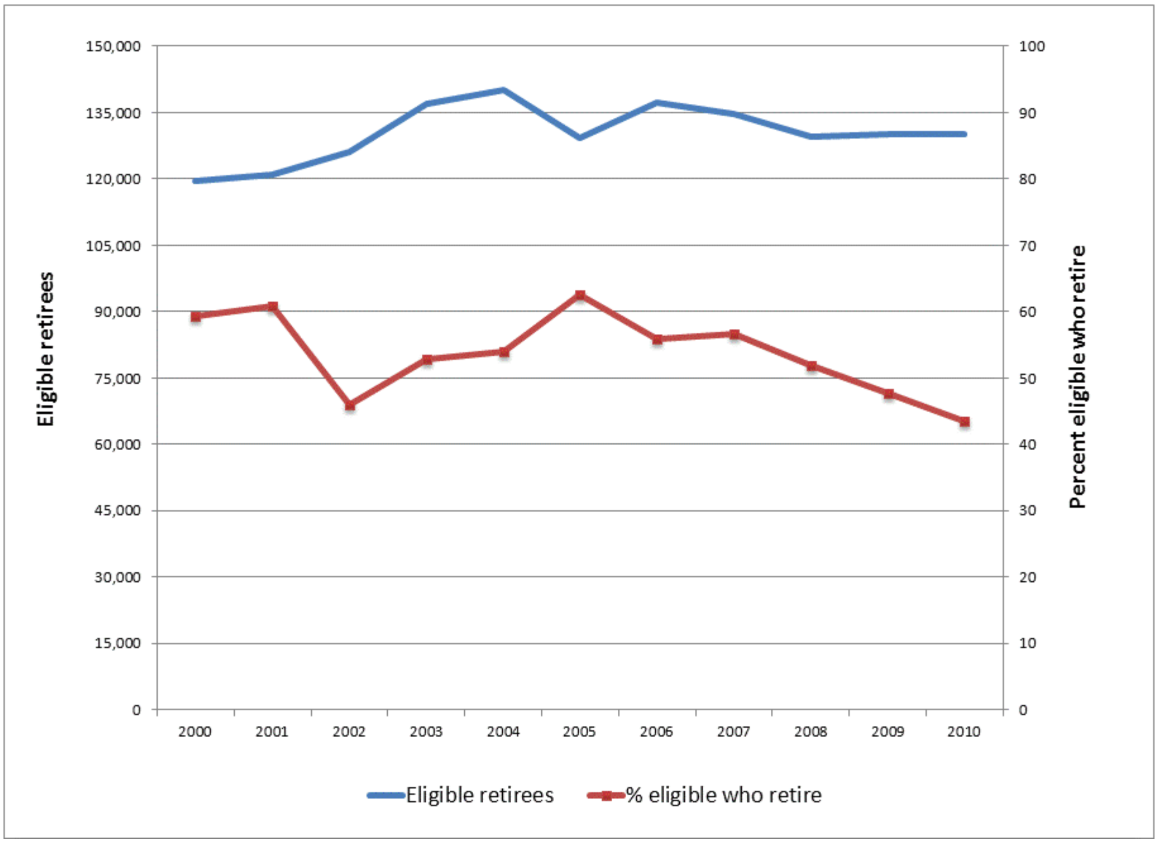
[19] Although not discussed here because the costs fall outside of DoD, a major change over the last decade that affected the total costs to the U.S. government to provide military retirement was the 2004 adoption of a ten-year plan aimed at phasing out the prohibition on military retirees with service-connected disabilities from receiving the full values of both DoD and VA disability benefits (known as "concurrent receipt"). This initiative added billions to the total costs of military retirement, but Congress directed that those costs be borne by the Department of the Treasury.

[20] U.S. Department of Defense, Office of the Actuary, "Valuation of the Military Retirement System September 30, 2009," Office of the Actuary, Washington, DC, December 2010, http://actuary.defense.gov/valbook2009.pdf, *passim*.

[21] Retired pay is based on years served and one of two measures of basic pay. For those who joined prior to September 8, 1980, the basic pay rate used to calculate retirement pay is that of their final month of service. For those joining in after that date, it is the average of the highest three years' pay rate (referred to as the "high three" system).

A third reason for growth in the size of DoD's MRF contribution is that military retirees, like the rest of the population, are living longer than they did in the past. (They also live longer than those who have never served).[22] Finally, since 2005 DoD actuaries have twice modified their assumptions about the likely interest rates that the MRF corpus will earn downward, increasing the amount that DoD must contribute to make up the resulting shortfall in future benefit payments.[23]

Figure 1.6: Military Retirement Patterns, 2000-2010



Source: Analysis by CSIS New Defense Approaches Project, derived from data found in DoD Office of the Actuary, "Statistical Report on the Military Retirement System Fiscal Year 2010," May 2011, p. 166.

In sum, cost growth in military retirement is primarily due to increases in the amount of the benefit (because of the basic pay "multiplier effect", but also because retirees are projected to both serve and live longer), and to higher costs associated with providing the benefit (because of lower amounts of projected interest earned on contributions to the MRF).

[22] In 2009, DoD actuaries estimated that life expectancy at age 60 was an additional 24 years for Reserve Retirees, 33.1 years for active duty retirees, and just under 20 years for civilians. Tom Philpott, "Active Duty Retirees Die Sooner than Reservists, Actuaries Say," *Stars and Stripes*, January 17, 2009, www.stripes.com/news/military-update-active-duty-retirees-die-sooner-than-reservists-actuaries-say-1.87277.

[23] DoD assumed a 6.25 percent interest rate between 2000 and 2005. This was revised to 6.0 percent in 2006 and 2007 and to 5.75 percent in 2008, where it remains. See U.S. Department of Defense, Office of the Actuary, "Valuation of the Military Retirement System" reports, 2000-2009.

Health Care Cost Growth

While other costs of military compensation have risen significantly, by far the most expansive growth has occurred in the area of military health care. In 2000, DoD spent $17.7 billion on medical benefits; 12 years later this has grown by over 150 percent, to $44.3 billion. This dramatic rise can be attributed to four basic causes:

- shifts in health care accounting practices;
- the expansion of benefits and of beneficiary populations;
- capped or reduced patient cost shares; and
- changes in coverage, utilization, and general medical inflation.

Health Care Accrual

One major contributor to DoD's medical cost growth occurred in 2003. In an attempt to make the future costs of today's force more visible to policymakers, DoD switched to accrual budgeting for some deferred healthcare expenses. Previously, health care for Medicare-eligible retirees was paid for in the year in which services were delivered, which allowed policymakers to increase future benefits without seeing any immediate budgetary impact. In October 2002, DoD began making payments into a Treasury-maintained fund — the Medicare-Eligible Retiree Health Care Fund (MERHCF) – based on actuarial estimates of future costs and the amounts needed today (with assumed interest) to cover them. This shift in accounting practices added almost $10 billion — $7.7 billion for active duty retirees and $2.0 billion for Reserve retirees — to DoD's health care costs in 2003, immediately becoming the most expensive single piece of the military medical system.

Not all medical cost growth can be attributed to changes in budgeting practices, however. Taking accrual into account, defense health costs increased by 151 percent between 2000 and 2012. When accrual amounts are excluded, costs still grew by 90 percent over the same period, for the reasons explained below.

Expansion of Benefits and Beneficiary Populations

A primary driver of military health care cost growth has been the expansion of both the number and type of benefits offered and of the eligible beneficiary population. Throughout the 2000s, DoD and Congress created new programs, added new benefits to existing programs, and extended eligibility to new categories of beneficiaries. DoD's health program (the Defense Health Program, or DHP) currently includes over 9 million eligible beneficiaries (though not all eligible beneficiaries utilize their benefits), more than 3 million more than in 2000.

Many of these steps were taken to recognize the sacrifices being made by servicemembers and their families, to include Reservists who were being called to service in large numbers over an extended period of time, sometimes repeatedly. They were also motivated by battlefield realities that resulted in unprecedented physical and mental injuries. A growing scientific understanding of some of the psychological effects of war not only on servicemembers but also their families, together with advances in medical science, resulted in the creation of new programs and approval of new treatments. New programs and techniques were also created for servicemembers experiencing physical injuries at previously unseen levels of severity and prevalence.

Clearly identifying and allocating these various changes is not possible through publicly-available budget data. Most, however, are captured within the growing costs of providing care, both in-house and private sector, and in rises in medical research funding.

Chart 1.3 on the next page illustrates some of the changes in medical benefits and benefit eligibility that took place in TRICARE between 2000 and 2012. In every category of benefit type – e.g., dental, prescriptions, and preventive care – at minimum, additional procedures or drugs were covered, and/or costs to beneficiaries declined (either because they haven't been adjusted for inflation since the mid-1990s or because they were explicitly waived by Congress). Another key difference between 2000 and 2012 is that in 2000, the majority of health care benefits accrued to active duty servicemembers, activated Reservists, and their family members. Twelve years later, almost every benefit had become available to almost every category of beneficiary, whether current active duty or Reserve (activated or inactivated), retired or retired Reservist — as well as the current, former, or surviving family members of the above.[24]

Capped and Reduced Patient Cost Shares

As mentioned above, a further contributor to military medical cost increases has been a relative decline in the percentage of total costs borne by beneficiaries. This is in large part due to co-pays, cost shares, and enrollment fees that either failed to increase with inflation or were lowered or waived by Congress. For example, the annual enrollment fee in TRICARE Prime, DoD's managed care program, was set at $460 per family in the mid-1990s and has not been adjusted for inflation since, leading to a real decline in its value of 19 percent – 19 percent that was added to DoD's costs. Further, though active duty servicemembers are required to be in Prime and have always received their care free of charge, it was not until 2001 that active duty family members in Prime (where co-pays were required for all private sector care and MTF inpatient stays) as well as those in Standard/Extra (where all care required co-pays, and much higher ones than in Prime) had their co-pays waived, leaving nominal fees for prescriptions filled outside MTFs the only out of pocket costs paid by this beneficiary group.[25] (This trend may soon change, however. In its 2012 budget request, DoD proposed a $60 per year increase to the Prime family enrollment fee, and that all TRICARE fees be indexed to the National Health Expenditures (NHE) index.[26] Though the legislative outcome is not yet certain, it appears that if the increase is adopted it will likely be tied to a more slowly-rising measure of inflation.)

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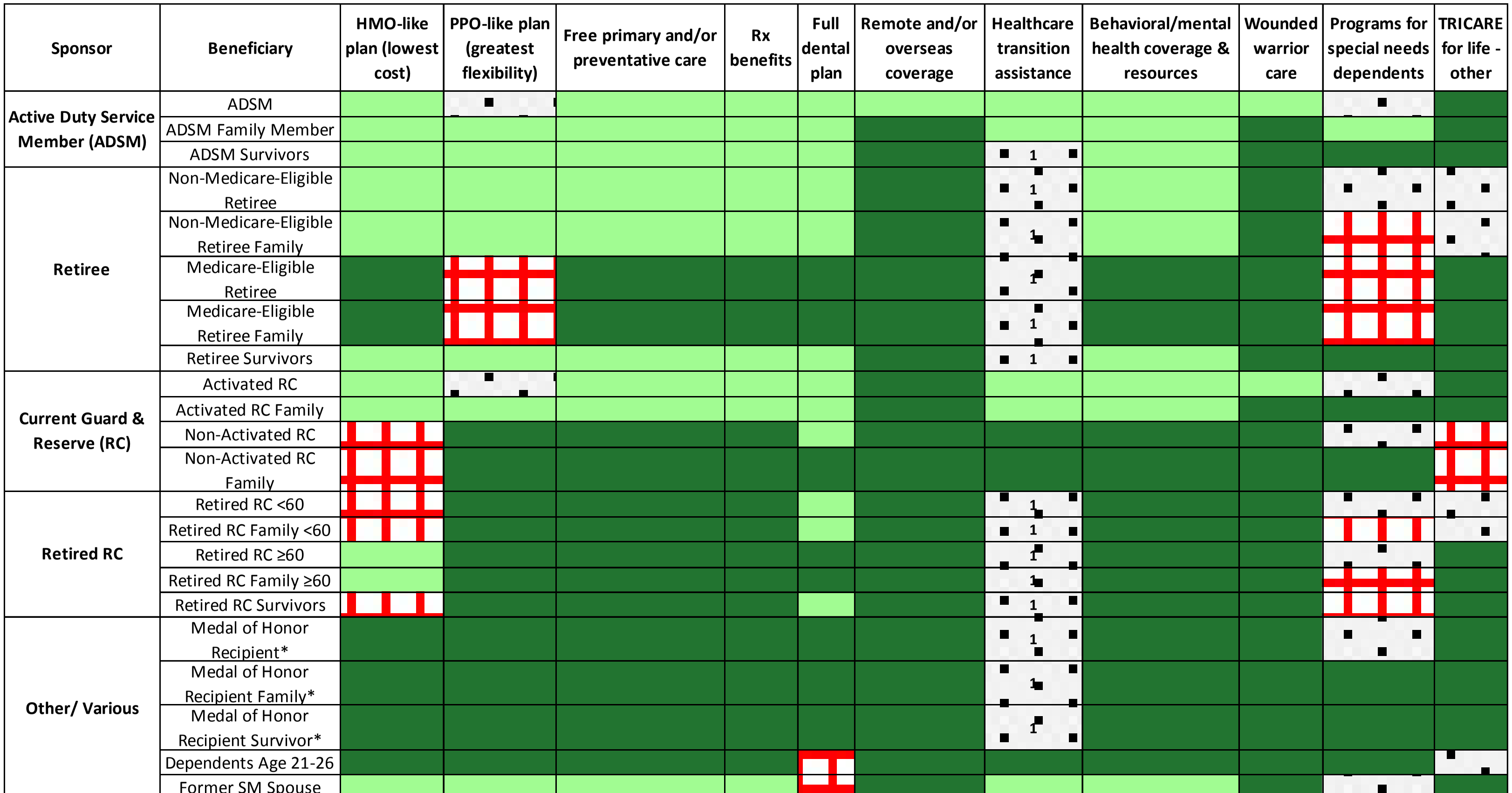
[24] Expansion of coverage to current and surviving family members has been wide-ranging. Only former spouses of active duty members meeting certain criteria are eligible for TRICARE coverage. See Appendix C for an explanation of former servicemember spouse benefit entitlement and other notable changes in eligibility and benefits.

[25] See U.S. Department of Defense, Office of the Assistant Secretary of Defense/Health Affairs (OASD/HA), "Evaluation of the TRICARE Program FY2002: Report to Congress," OASD/HA, Washington, DC, 2002, pp. 2-10; and "Evaluation of the TRICARE Program FY2006: Report to Congress," OASD/HA, Washington, DC, March 2006, pp. 13.

[26] A small increase in Prime enrollment fees took effect at the beginning of 2013, bringing them to $260 per year for individuals and $520 per year for families — an increase of $30 and $60 per year respectively.

Chart 1.3: Changes in the Military Medical Benefit, 2000-2012



1Transition assistance coverage is not applicable because eligibility for TRICARE coverage, though it may change, will not expire for these groups -- with the exception of coverage for surviving spouses who remarry or children who age out of the system.

* Being a Medal of Honor recipient did not confer additional TRICARE benefits on servicemembers in FY00. Prior to the change in the law, recipients and their dependents qualified for benefits using the same criteria as the rest of the force.

To qualify for a given benefit in this chart, the beneficiary may need to meet additional inclusion criteria or select a specific plan.

Beneficiary had access to a less-expansive version of this benefit in FY00 and retained access to it in its new form in FY12.

Beneficiary has access to this benefit in FY12 and did not in FY00.

Benefit is not applicable to this beneficiary (e.g., the beneficiary is an ADSM and the program is solely for dependent children).

Beneficiary does not have access to this benefit.

Trends in Coverage, Usage, and Private Sector Costs

Finally, three trends converged in the last decade to cause substantial increases in the number of beneficiaries actually exercising their military health care benefits. The first, as noted above, was the growing population of those eligible for benefits. The second was the growing attractiveness of those benefits as private healthcare costs increased dramatically and costs borne by DoD beneficiaries stayed constant or declined. The third was increased joblessness as the national economy faltered, increasing the need for retirees who may previously have had access to private plans to enroll in DoD-sponsored care.[27] The net effect of the migration from private plans to the DHP was that substantial costs previously borne by beneficiaries and their private sector employers were shifted to the Department of Defense.

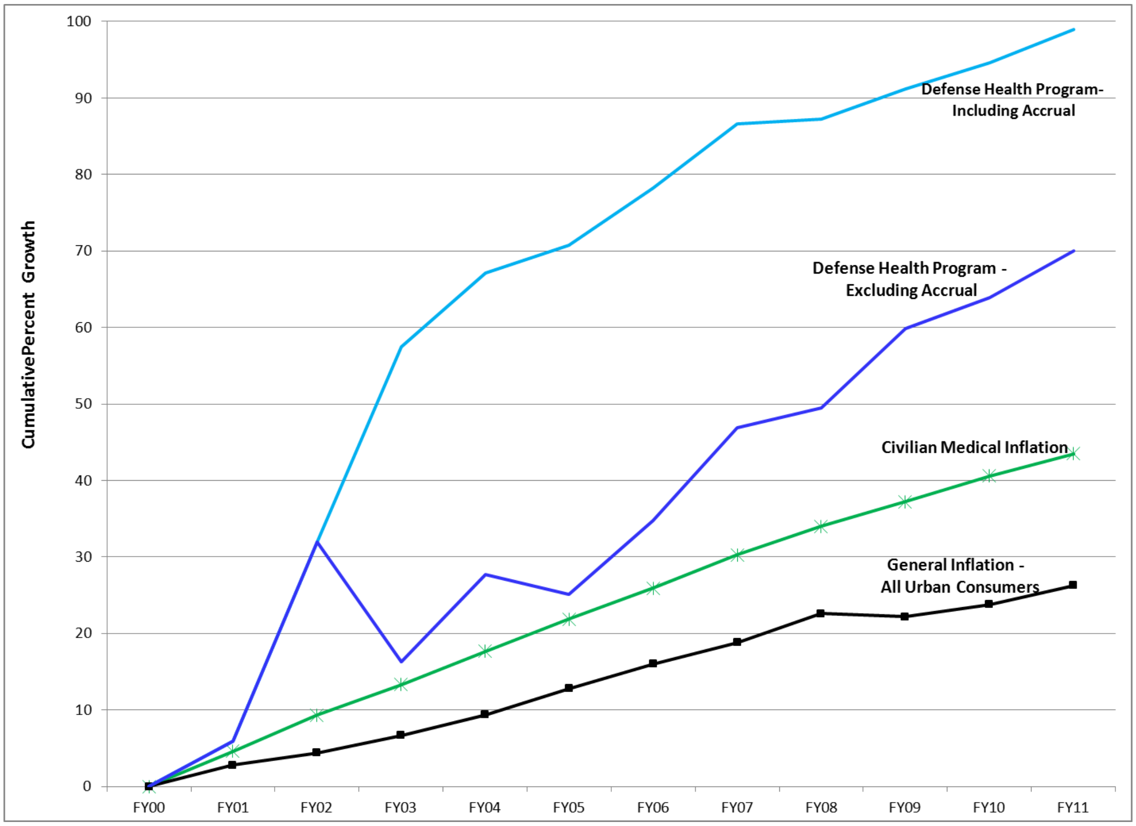
Not only did more eligible beneficiaries opt to utilize the benefit, but beneficiaries also changed how they used it. The Defense Health Program pays for care provided directly, through DoD-run Military Treatment Facilities (MTFs), and indirectly, through regional networks of contracted private sector providers. Throughout the 2000s, growing beneficiary populations and declining MTF capacity resulting from the Base Realignment and Closure (BRAC) process began to push increasing numbers of people – many whose preference was to remain in the MTF — out to the private sector for care, where the costs to the beneficiary are unchanged but the cost to DoD is significantly higher. As more care shifted to the private sector, DoD became further exposed to rates of medical inflation over which it had no control. Those rates grew at almost twice the rate of overall inflation over the 2000s.

Finally, a growing number of users also resulted in a growing number of prescriptions. For TRICARE beneficiaries as a whole, there was a 156 percent increase in the average number of annual prescriptions filled between 2000 and 2010, almost exclusively driven by retirees over 65 and their dependents.[28] Further, those prescriptions were increasingly filled in the most expensive manner possible. Consistent with overall provision of care, access to and thus use of MTF pharmacies fell, and filling prescriptions by mail-order failed to catch on to a significant degree with beneficiaries. Instead, as the number of prescriptions rose, the use of retail pharmacies — the most expensive option for both the beneficiary and DoD — exploded.

Figure 1.7 shows the cumulative impact of these factors. It compares growth in the consumer price index for all urban consumers (CPI-U) as a measure of overall inflation, the CPI-medical care index as a measure of the rising costs of medical care for civilians, and the cumulative percentage growth of military medical costs over the 2000s, with and without the costs of retiree health care accrual.

[27] U.S. Department of Defense, Office of the Assistant Secretary of Defense/Health Affairs (OASD/HA), "Evaluation of the TRICARE Program FY2011: Report to Congress" OASD/HA, Washington, DC, February 2011, pp. 78.
[28] OASD/HA, "Evaluation of the TRICARE Program" reports to Congress, 2000-2011, and analysis by the CSIS New Defense Approaches Project.

Figure 1.7: Comparison of Inflation Measures, 2000-2011



*Uses average annual percentage change values for inflation measures and includes half-year CPI data for Fiscal Year 2011.
Source: DoD budget data 2000-2011; Bureau of Labor Statistics June 2011 Consumer Price Index Detailed Report; and analysis by CSIS New Defense Approaches Project.

In sum, DoD's medical costs grew because the Department assumed greater current responsibility for future costs, the amounts of individual benefits rose (as did the costs of providing them), and the number of people using them increased substantially, as did their usage rates. The cumulative result was a massive increase in the total cost of providing this element of military compensation, far greater than in any other area of benefits.

Summary

In the 2012 defense budget, 27 cents of every dollar goes toward military compensation – 11 cents for basic pay, 7 for medical care, 3 cents each for retirement and housing, 2 for other costs, and 1 for food benefits. In every one of these areas, military compensation costs grew by at least 15 percent over the decade, and in two cases – housing and health care – the growth was far more substantial.

These increases occurred for one or more of the following reasons:

- **Growth in benefit amounts.** The value of individuals' basic pay, food, housing, and (in-kind) medical care all increased in real terms, principally due to Congressional initiatives aimed at correcting perceived insufficiencies and/or in recognition of the sacrifices the military community has made in conjunction with the wars in Iraq and Afghanistan;

- **Growth in DoD's cost to provide benefits.** The cost to DoD for providing housing, retirement and health care also all rose, though for varying reasons. For housing, DoD had been underfunding the construction and maintenance of military-owned barracks and homes; the switch to privatized housing made the true costs more visible, and also unavoidable. For both retirement and Medicare-eligible retiree health care, adopting accrual accounting practices brought costs that had previously been borne by other parts of the government onto DoD's books. More recently, reductions in the assumed interest earned on accrual contributions have also raised current payment amounts. Finally, additional health care cost growth occurred because of DoD's growing reliance on private sector care, which experienced inflation at rates far beyond that in the overall economy;
- **Increased benefit use.** In addition to any other changes, the "take rate" for food, "other" areas of compensation, and health care benefits rose as well, and the pool of eligible beneficiaries for medical care expanded significantly. As deployments to combat zones rose, a greater proportion of the force received meals in military facilities, increasing food costs; special pays associated with operational duties increased as well, as did rates of unemployment insurance. The rise in usage rates for health care benefits was in part due to the wars, but also because benefits were extended to new populations and this larger pool of beneficiaries increasingly exercised their DoD-provided benefits as outside medical costs rose.
- **Changes in force composition.** Over the last twelve years, the military became slightly larger, slightly more active duty, slightly higher ranking, and slightly longer serving, all of which increased DoD's basic pay expenses. As basic pay rose, DoD's payments into the retirement accrual fund and for social security taxes did as well.

Due to the combined effect of all these causes, increases in DoD's military compensation costs have been significant. At least some of this growth is due to operations in Iraq and Afghanistan and thus can be expected to fall as force levels in both countries decline. Most, however, is structural and will therefore persist. Chapter 2 examines likely trends in future compensation cost growth and the potential budgetary implications. Chapter 3 then assesses alternatives for slowing or reversing some of that growth.

2 FUTURE GROWTH IN MILITARY COMPENSATION COSTS

Projecting Future Growth

The last chapter explored the level and causes of cost growth in six major categories of military compensation: basic pay; food; housing; other pays, allowances and costs; retirement; and health care. This chapter extends that analysis into the future, examining whether, absent policy changes, these trends will continue, and if so, what the budgetary implications might be.

Basic Pay

The future costs of basic pay will be partially determined by force size, which, depending on security conditions in Afghanistan, is currently projected to fall by 67,000 over the next four years.[29] On a per servicemember basis, costs affected by shifts in the composition of that force – officer to enlisted ratios, average years of service, and average rank – are difficult to predict, but no plans have been announced that would have significant effects.[30] The largest determinant of per servicemember cost – the pay table – is now indexed to civilian wage inflation (the Employment Cost Index-Wage, or ECI-W) by law. The Congressional Budget Office (CBO) notes that ECI-W has exceeded overall inflation for most of the last two decades, and anticipates that it will continue to do so in the future.[31] Based on available information, the CSIS study team's best estimate is that DoD is likely to continue to experience between one and two percent annual real growth in the per servicemember costs of basic pay, apart from any other changes in force size or composition.

Food

Over the 2000s, DoD's per servicemember food costs grew in all three sub-elements: cash allowances, the provision of meals, and the amount of the commissary subsidy. Examining each, subsistence-in-kind costs should decline as U.S. forces leave Iraq this year, and as commitments to Afghanistan are scaled back. Growth in cash allowances is determined by the rate of food inflation in the overall economy, which has been somewhat higher than general inflation as the downturn continues and oil prices remain

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[29] Beginning in 2012, the Army plans to eliminate 22,000 "temporary" positions authorized to help meet wartime demands. See U.S. Army, *Military Personnel Justification Book* (Washington, DC: Department of the Army, February 2011), http://asafm.army.mil/Documents/OfficeDocuments/Budget/BudgetMaterials/FY12/milpers// mpa.pdf, p. 8. In addition, the Army is scheduled to cut another 27,000 soldiers and the Marine Corps up to 20,000 positions in 2015 and 2016, dependent on security conditions in Afghanistan. See "Long-Term Implications of the 2012 Future Years Defense Program," Congressional Budget Office, Washington, DC, p. 11, http://www.cbo.gov/ftpdocs/122xx/doc12264/06-30-11_FYDP.pdf (hereafter referred to as "Long-Term Implications").

[30] The one exception is DoD's announced intention to eliminate, reallocate or reduce in rank 140 of DoD's 952 general officer positions in the near term, which will reduce basic pay costs by minimal amounts. See Robert Gates, "Track Four Efficiency Initiatives Decisions Memo," March 14, 2011, http://www.acq.osd.mil/dpap/pdi/pc/docs/3-14-2011_Track_Four_Efficiency_Initiatives_Decisions.pdf. How the Army and Marine Corps implement their planned force reductions could either increase or decrease average per servicemember costs of basic pay, though the effect would also be small.

[31] "Long-Term Implications," p. 16.

high.[32] Going forward, then, costs for the basic allowance for subsistence may continue to experience some real growth. With respect to commissaries, the amount DoD contributes to the operations of its grocery stores has risen by an average of about one percent annually over the last decade, though year-to-year changes have fluctuated. This slow steady growth will likely continue if policymakers remain reluctant to shift a greater portion of total actual costs onto commissary patrons.[33] On the whole, then, the study team projects that DoD's food costs are likely to grow at rates slightly above inflation over the next decade.

Housing

Looking back, the large rises in DoD's housing costs over the last 12 years were primarily due to the shift to privatized housing and increases in housing allowance amounts. One result of privatization is that a much larger portion of DoD's housing costs are now tied to market-based housing rental rates. However, unlike civilian rents, this is only true for increases – nine years ago Congress passed "individual rate protection," which ensures that individual servicemembers' housing allowances in a given location will not fall even if rental rates decline. (They can fall, however, if a servicemember moves to a new, less expensive duty location.) Further, some experts CSIS interviewed suggest that the method used to calculate DoD's housing allowances, particularly in areas with high military concentrations, result in higher-than-market rates.[34] As a result, DoD's per servicemember housing costs may well continue to experience real growth in the future, though by how much will depend on the pace of the housing market's recovery.

Some portion of any increases will be offset, however, by real declines in the provision of in-kind housing. DoD projects cuts of nine percent to family housing accounts over the next five years, an estimate which seems likely to hold as the latest round of base closures and realignment moves comes to completion and DoD's total housing stock declines. (These costs will level out at some point in the future, however, as some level of investment in barracks and the maintenance of historic homes in particular will persist over the long term.) Based on the above, on net CSIS projects that low levels of real growth in DoD's total housing costs will persist in the future.

Other Pays, Allowances and Costs

The range of expenses in this category is so wide that anticipating future changes is very difficult. As the economy continues to struggle, unemployment insurance costs are unlikely to fall much and could even continue to rise as more troops return home from Iraq and Afghanistan and as overall force levels are

[32] Food inflation has exceeded general inflation in six of the last ten years, according to food price indexes from the Department of Agriculture Economic Research Service (available at: www.ers.usda.gov/Briefing/CPIFoodAndExpenditures/Data/cpiforecasts.htm) and the percent change in the Gross Domestic Product deflator (available from Department of Commerce's Bureau of Economic Analysis, www.bea.gov/national/nipaweb).
[33] Defense leaders have made some attempt to constrain cost growth in the subsidy amount. For example, in March 2011 Secretary Gates approved a variety of staff reductions and changes in business practices. The projected cost savings associated with those decisions, however, are small, and unlikely to have a major effect on the overall size of the subsidy going forward. Robert Gates, "Memorandum: Track Four Efficiency Initiatives Decisions," Department of Defense, Washington, DC, March 14, 2011, pp. 7-8.
[34] CSIS project team interviews with Department of Defense military personnel experts, March-April 2011.

cut. On the other hand, broader economic challenges, for as long as they persist, will also allow DoD to reduce its expenses for recruiting and retention bonuses, and lower force numbers in combat zones will decrease amounts spent on hostile fire and imminent danger pays, among others. DoD is also in the process of consolidating its special and incentive pay authorities — one aim of which is to allow for better targeting of resources to shifting needs — and eliminating some of the existing inefficiency. On the whole, it seems likely that "other" compensation costs will continue the downward trajectory of the last six years, though some sub-elements may continue to experience real growth.

Retirement

DoD actuaries foresee significant growth in DoD's retirement payments for the foreseeable future, as many of the conditions that have driven past growth will persist. First, real growth in basic pay will also be reflected in increased retirement contributions. Second, life expectancies continue to rise, increasing the retirement fund's liability for both current and future retirees. Third, for as long as poor economic conditions persist, more servicemembers may seek to stay in uniform until retirement, and fewer retirement-eligible servicemembers may leave after 20 years of service. Both behaviors will further add to the retirement fund's total liability, and thus increase DoD's required contributions. Finally, as projected interest rates remain low (and may fall still further), DoD will need to increase its contributions to account for unrealized gains from interest revenue. Over the last five years, DoD's retirement accrual payments have averaged almost five percent annual real growth. The latest actuarial report projects about three percent annual growth going forward, though the factors above suggest this may continue to be revised upward.

Health Care

Anticipating future health care costs is a highly complex proposition. The Congressional Budget Office (CBO), however, has conducted a detailed analysis that forms the basis for the projections used here. Based on historical patterns, CBO expects DoD's costs for pharmaceutical, direct, and purchased care, as well as its contributions to the accrual fund for Medicare-eligible retirees, to rise at annual rates of over 4 percent over the next decade.[35]

Implications for the Defense Budget

Based on the analysis above, military compensation will continue to experience real growth, though at a slower rate than over the last decade.[36] In the aggregate, costs per active duty servicemember are likely to rise by at least 7 percent over the next ten years, from about $80,300 today to $85,800 in 2021. This growth will be driven by increases of over 10 percent in both basic pay and retirement, which together comprise two thirds of individual compensation costs. Even after accounting for planned force reductions, this means that DoD's aggregate active duty compensation costs will rise by almost 3.5 percent – another $4.1 billion – over the next decade. The same trends will drive increases of over $3,600 (12 percent) per Reservist, adding another $1.8 billion to DoD's total compensation bill.

[35] "Long-Term Implications," pp. 18-19.

[36] Additional detail about the specific assumptions behind the future costs presented here can be found in Appendix B.

Health care, however, will remain the fastest growing element of total compensation costs, far outpacing cost growth in other areas.[37] Total health care expenses represent almost a quarter of DoD's military compensation costs today; ten years from now, they will be almost a third. Average annual growth rates of over four percent through 2021 mean DoD's health care expenses will rise by another $20.8 billion – almost fifty percent – to reach over $65 billion that year.

While past increases in military compensation have been able to be accommodated within DoD's overall budget growth, the future looks very different. Figure 2.1 below shows the scale of projected growth in active duty, Reserve, and health care compensation costs over the next decade relative to a number of potential budget scenarios. The first is the defense budget projected in this year's budget submission through 2016, held at no real growth thereafter. While a political consensus has emerged indicating that this level will be reduced, it represents the amount Defense Department leaders felt was necessary to support the current defense strategy. The second, third, and fourth scenarios all begin at the same point: the 2011 enacted level, which is the amount agreed to in the August 2011 Budget Control Act (BCA) – the debt ceiling deal.[38] From there, the second scenario projects an annual reduction of 6 percent from the levels planned in the 2012 President's Budget (PB), which results in "savings" consistent with the reported targets for "Phase 1" of the BCA.[39] In the third scenario, planned defense resources are cut by 12 percent each year, yielding savings that are roughly equivalent to those foreseen by Phase 2 of the BCA, should sequestration be invoked. Finally, some have suggested that defense budget reductions either should or may need to go still deeper.[40] The fourth scenario, therefore, posits reductions of 20 percent over the next decade from the latest official plan, which would result in over $1 trillion less for DoD than is currently envisioned.

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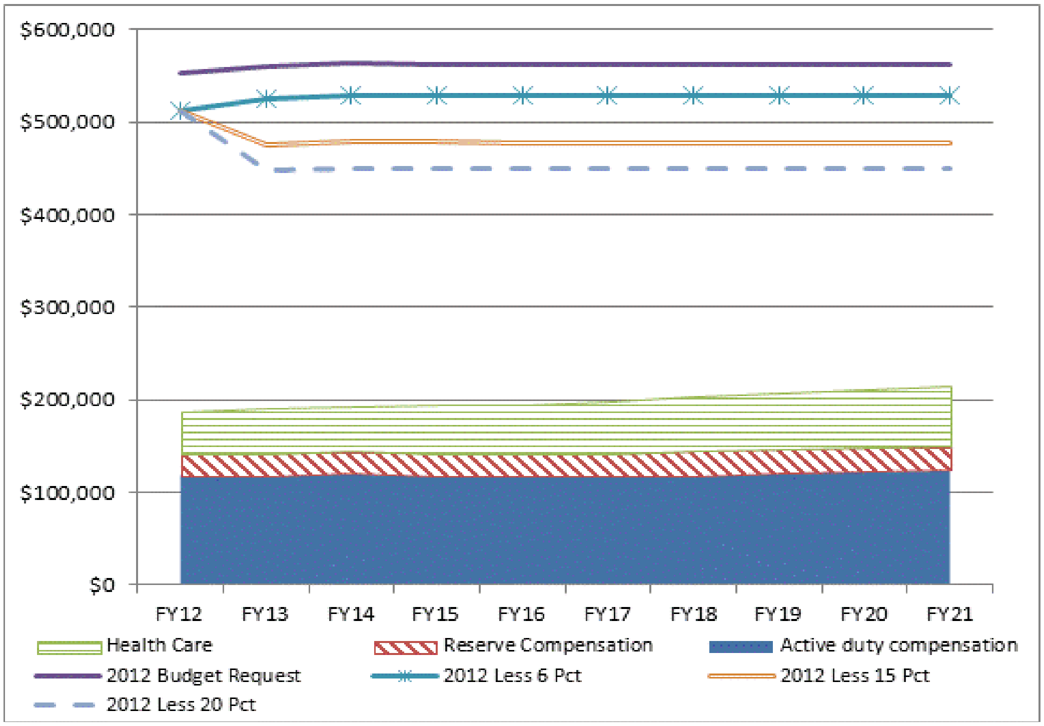
[37] As previously mentioned, per-servicemember calculations do not include health care due to the impossibility in available data of separating out the amounts that go to active duty versus Reserve personnel and their dependents.

[38] "Summary: Department of Defense Appropriations Act, 2012," press release, Senate Appropriations Subcommittee on Defense, Washington DC, September 15, 2011, http://appropriations.senate.gov/news.cfm?method=news.view&id=ac72ee37-9641-4e7a-8f72-3031e55ac730.

[39] The BCA called for two rounds of spending reductions, though the exact appropriations from which they would be drawn were not specified. Phase I involves cuts agreed to with passage of the Act, which amount to $420 billion over ten years from "security" accounts (of which DoD is the largest). If, by the end of 2011, Congress fails to pass additional legislation outlining another $1.5 trillion in deficit savings, automatic reductions of another $600 million from defense accounts (the vast majority of which fall under DoD) would be triggered. Jack Lew, "Security Spending in the Deficit Agreement," Office of Management and Budget, Washington, DC, August 4, 2011, http://www.whitehouse.gov/blog/2011/08/04/security-spending-deficit-agreement?utm_source=wh.gov&utm_medium=shorturl&utm_campaign=shorturl.

[40] See, for example, Benjamin Freeman, "The US Should Cut Military Spending in Half," *Christian Science Monitor,* April 27, 2009, http://www.cato.org/pub_display.php?pub_id=10152; and "Debt, Deficits, and Defense: A Way Forward," Sustainable Defense Task Force, Washington, DC, June 11 2010, http://www.comw.org/pda/fulltext/SDTFreportexsum.pdf.

Figure 2.1: Future Military Compensation Costs Relative to Potential DoD Toplines ($Billions)



Source: Department of Defense budget materials and analysis by CSIS New Defense Approaches Project

Irrespective of whichever scenario eventually comes to pass, as military compensation costs continue to grow and overall defense resources fall, the former will clearly be in increasing competition with other defense priorities. Excluding war-related costs, military compensation currently claims about a third of total defense spending. Absent change, in ten years this will rise to between 38 percent (under the plan in the 2012 budget request, the likely "best case") and 48 percent (under a 20 percent reduction scenario) of total defense resources.

One obvious way to reduce those costs is to cut the number of military personnel (and reductions in active duty forces generate greater savings than do reductions in Reserves). To some extent, this strategy is already being employed: recent force reductions were announced in conjunction with Defense Secretary Gates' efficiency initiatives.[41] As DoD's budget environment worsens, further reductions are apparently under consideration as well.

While additional cuts appear almost inevitable, ideally they would be made in the context of larger adjustments to U.S. security and defense strategies, rather than being driven solely by budgetary pressures. Further, savings achieved just by cutting numbers rather than addressing the structural factors that underpin past growth (and that will continue to drive future increases) may produce the desired short-term results but this approach will not address the fundamental issue of declining purchasing power. Without taking on this challenge more directly, future leaders will be faced with

[41] Robert M. Gates, "Statement on Department Budget and Efficiencies," Department of Defense, Washington, DC, January 6, 2011, http://www.defense.gov/Speeches/Speech.aspx?SpeechID=1527.

some of the same choices of making further cuts to force size to accommodate persistent cost growth. In essence, the dilemma that will persist is that the amounts spent to compensate 18 active duty servicemembers today (even excluding health care) will only pay for 17 a decade from now, irrespective of the total size of the force.

Given this reality, as defense leaders weigh future trades it is worth examining the possibilities for reducing compensation costs *per servicemember* while still maintaining overall force quality. If feasible alternatives exist, pursuing them could free up resources for other priorities, whether they be shifting spending outside of DoD altogether, maintaining a larger force than might otherwise be possible, investing in future technologies or systems to help preserve U.S. military advantages in the future, or some combination of all three. Fortunately, this terrain is well-trod: the range of alternatives to current compensation practices is the subject of a large and long-standing literature. The next chapter describes the basic features of some of the primary options and assesses their implications for cost, recruitment and retention, and alignment with military culture.

3 OPTIONS FOR CHANGE

Chapter 1 described the main causes of growth in military compensation over the past decade, and Chapter 2 evaluated how those trends might continue to play out over the next one. This chapter briefly summarizes the main features of potential changes to that future that would reduce DoD's military compensation costs.

Evaluating Alternatives

While cost reduction is important, it is not the only relevant factor when assessing alternatives to current military compensation practices. Most importantly, any change that undermines compensation's fundamental purpose – the ability to recruit and retain quality personnel over time – would be foolhardy. Practically, it is also important to consider the degree to which any particular proposal might conform with or run counter to military culture, which can shed light on the overall feasibility of any particular approach.[42]

The next section reviews various compensation proposals and their fiscal implications, as well as how they might affect force health and how well they align with military values.

> ***Return to the Draft?***
>
> *In recent years, discussions of whether the U.S. should return to a conscription-based force have reemerged. Arguments tend to follow one or more of four basic lines of reasoning: (1) that a conscription force would spread the burdens (and benefits) of service more equitably across American society; (2) that a draft-based force would be more representative of the nation, improving civil-military relations; (3) that a draft-based force would better ensure a full debate prior to any U.S. forces being committed to future operations; or (4) that conscription would be a cheaper (to DoD) alternative to a volunteer military, though probably not if the same level of quality is desired. This study assumes that the nation's commitment to an All Volunteer Force remains strong, and thus does not specifically address the conscription alternative.*

Reducing DoD's Military Compensation Costs

There are literally hundreds of cost-saving proposals that have been made to reform the current military compensation system. (This in itself serves as an indication of how inefficient current practices are.) Because this analysis is specifically focused on alleviating budget pressures within the Department of Defense, the focus here is on alternatives that would have this effect. (There are others that might

[42] Although these three are the focus of the analysis that follows, there are numerous other objectives that could be considered as well. Almost every study of military compensation remarks upon its inflexibility. Any option that would enhance the ability of force managers to better match personnel with mission needs would improve overall efficiency as well as improve effectiveness. As a result, all other things equal, alternatives that offer the greatest amount of management flexibility should be preferred over others. Some experts also include productivity and force quality as key objectives by which compensation options should be assessed (see, for example, Asch and Warner, 1994, or Wardynski, Lyle and Colarusso, 2010). It is difficult to meaningfully generalize about the implications of changes for many of these other areas. This study therefore focused on the most basic and critical set of objectives, but any of these or other factors could be added to an analysis of particular proposals should they be considered an additional priority.

reduce total costs to the government, or to other government Departments – e.g., modifications to GI Bill benefits, which would affect Veterans' Affairs costs, but those are not specifically addressed here.)

Even with that narrow focus, there are a number of important aspects to consider. They include whether costs would go down in the short- and/or long-term, and, of particular import of late, how they would affect the national deficit.

Options to Reduce Military Compensation Costs

With those criteria in mind, this section offers an overview of the types of alternatives that have been proposed to DoD's current compensation practices. Proposals generally target four areas: cash compensation (i.e., basic pay, the housing and food allowances, and other cash payments); non-cash compensation (e.g., in-kind housing, food or educational subsidies); retirement, and health care. Before turning to an examination of each of these areas in more depth, this section begins by discussing another approach, one that is not aimed at any one area of compensation but could be pursued for the specific objective of reducing overall costs – modifying force composition.

Changing the Composition of the Force

Cutting the overall size of the force is the most immediate way to reduce compensation costs. In fact, reductions beyond currently planned levels are highly likely given the magnitude and timing of the budget cuts to which Congress and the President have already agreed. Beyond a certain point, however, cutting end strength poses significant risks to the military's ability to conduct its assigned missions. Although opinions about where that point is vary widely, there is a broad consensus within the defense community at least that the demands of the future strategic environment will continue to call for a force that is at least 75 percent as big as (and some would argue much larger than) the current force.

It may be that cutting the overall size of the force is the favored approach. It would produce the desired savings, and does not require change that might be even more difficult. One downside, however, as earlier chapters make clear, is that this approach fails to address the fundamental decline in DoD's personnel purchasing power, eroding the value of the nation's investments over time.

Getting to the root of this problem necessitates taking actions that bring down costs on a per servicemember basis. Some changes in the composition of the force would have that effect. Shifting to a force with a greater proportion of Reservists, for example, would lower compensation costs (though it might increase costs in other areas such as training or equipment). Similarly, "downgrading" the assigned ranks for many functions, or lowering the ratio of officers to enlisted personnel would result in unit-level savings.

A more expansive option would be to undertake broad reform of the military personnel system as a whole, considering such proposals as eliminating the current "up-or-out" promotion system and opening up the labor market. Many versions of these reforms would produce both reductions in overall personnel numbers and a more efficient allocation of people to job needs, thus reducing compensation costs. There is a major body of analysis focused on changes to the military's personnel management system that is too broad to summarize here.[43] For the purposes of this study, it is sufficient to note that many advocate a broad overhaul of the military's personnel management system for numerous reasons, one of which is a presumed reduction in compensation costs.

It may be that the current desire for savings provides sufficient impetus to pursue some of these more ambitious changes. This was the recommendation, for example, of the 2010 Quadrennial Defense Review Independent Review Panel.[44] But there are multiple other options that are more directly aimed at reducing compensation costs, rather than achieving a more expansive set of policy aims. It is that set of alternatives that is briefly reviewed below.

Cutting the Costs of Cash Pays

Many of the simpler approaches to cutting the costs of basic pay apply more generally to the full range of cash compensation elements – food and housing allowances, and special, incentive, and other pays and costs.

One of the most straightforward ways to reduce the costs of basic pay, housing, and/or subsistence allowances would be to change how they are adjusted. Each is increased annually on a slightly different basis. Basic pay is tied to the Employment Cost Index (ECI)-Wages and Salaries, housing allowances are tied to prevailing rental rates in local housing markets, and BAS is adjusted according to national food inflation rates. Options here include:

- retaining the current adjustment indices but decrementing them by some amount (for example, ECI less a certain percentage for future pay raises);
- implementing temporary freezes in adjustments for one or more years;
- eliminating an explicit statutory adjustment standard altogether and making annual changes through the legislative process;[45]
- arbitrarily setting a standard, e.g., housing allowance adjustments of 3 percent a year, or as needed but no more than 3 percent;

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[43] The Center for Naval Analyses and RAND, in particular, have all conducted decades of in-depth research in the area of military personnel management, issuing dozens, if not hundreds, of reports. They can be found at www.cna.org and www.rand.org. Multiple researchers from within the military services and academia have made substantial contributions in this area as well. Some examples include: David Day, Michelle Harrison, and Stanley Halpin, *An Integrated Approach to Leader Development* (New York: Routledge, 2009); David Day, Stephen Zaccaro, and Stanley Halpin, eds. *Leader Development for Transforming Organizations* (Mahway, NJ: Lawrence Erlbaum Associates, 2004); Jeffrey McCausland, *Developing Strategic Leaders for the 21st Century* (Carlisle, PA: Strategic Studies Institute, 2008); Michael Meese and Sam Calkins, "Back to the Future: Transforming the Army Officer Development System," *Forum* 4, no. 1 (2006); Phillip Rotmann, David Tohn, and Jaron Wharton, "Learning Under Fire: the U.S. Military, Dissent, and Organizational Learning Post-9/11," Student Paper Series (Cambridge, MA: Belfer Center for Science and International Affairs, 2008); and Donald Vandergriff, *Path To Victory* (Novato, CA: Presidio Press, 2002).

[44] *The QDR in Perspective: Meeting America's National Security Needs in the 21st Century*, Final Report of the Quadrennial Defense Review Independent Review Panel (Washington, DC: Department of Defense, July 2010).

[45] Given the political difficulty of voting against compensation increases for the military, this option could in fact result in much more rapid growth rather than produce savings.

- selecting alternative indices that might result in slower annual growth; or
- lengthening the period between adjustments (e.g., biennial instead of annual).

Another approach could be to decrease the amount of the benefit directly rather than slow the rate at which it grows. Examples of such alternatives include:

- replacing the paytable with a paybanding approach;
- maintaining the pay table but reforming it such that total costs are reduced (i.e., introducing variable pay cuts based on current military-civilian pay comparability assessments);
- returning to a housing allowance amount that reflects something less than 100 percent of average housing costs;
- eliminating the housing and/or subsistence allowances outright (a less extreme version could convert some portion of the amount into additional basic pay); or
- eliminating the "family premium" (i.e., the higher level of the benefit for those with dependents) for the housing allowance.[46]

Potential to Decrease Costs

Evaluating the fiscal impact of changes in cash pay is difficult, given the degree to which specific versions of any particular approach could vary. Together, basic pay and other forms of cash pay for both active and Reserves total over $110 billion in the 2012 budget, 60 percent of total compensation costs. In the aggregate these costs will be at about the same level a decade from now, primarily due to cuts in force size. On a per servicemember basis, however, they are projected to grow by six percent for active duty forces and 12 percent for Reservists, and in 2021 will still represent more than half of total compensation costs.

The specifics of any particular proposal would have a huge effect on the cost impact. For example, a one-year freeze in basic pay would save almost $850 million from those accounts alone, plus additional savings from reduced social security taxes and retirement accrual. More generally, any combination of changes that reduced the costs of cash compensation by an average of 10 percent annually would result in about $76 billion in savings over the next ten years, or seven percent of the over $1.1 trillion that can reasonably be expected under current plans.

Reducing Non-cash Compensation

Non-cash compensation, though the smallest proportion of total compensation costs, may represent the greatest opportunity for cost savings. This is primarily because non-cash benefits are very inefficient[47]

[46] If DoD chose to do this by raising the single members' payments to the "with dependents" rate, it could remove an incentive to marry early and thus result in lower benefit costs for future servicemembers (housing, health care benefits, other family benefits). CBO, "Evaluating Military Compensation," Congressional Budget Office, Washington, DC, June 2007, http://www.cbo.gov/doc.cfm?index=8271&type=0&sequence=1.

and frequently significantly undervalued. For example, one military survey found that almost half of the respondents underestimated the true costs to DoD of providing their non-cash benefits by nearly 40 percent.[48]

These noncash benefits are particularly inefficient because they are not targeted at the populations that value them most.[49] Some servicemembers may place an extremely high value on access to the commissaries, for example, while for others it may be only marginally useful or irrelevant. Because DoD lacks a solid understanding of this variability and, more importantly, how it relates to servicemembers' decisions, it is difficult if not impossible to reliably determine how much over- or under-invested DoD might be in any given area (particularly relative to other ways of increasing servicemember satisfaction).

One approach that could help shed some light on the relative importance of various non-cash compensation elements would be to establish so-called "cafeteria plans." Under this alternative, servicemembers could choose between various in-kind benefits and cash. Such plans have the potential to reduce servicemember satisfaction in some areas, because for at least some it would restrict use of non-cash compensation elements that are currently unconstrained. But for others that either don't use or place a very low value on some or all of their in-kind benefits, it could have little negative effect, even increasing their cash income. The net result would be decreased use (or potential for use) of some in-kind benefits, allowing DoD to cut overhead and "right-size" the infrastructure associated with a variety of benefit types.

With respect to the specific non-cash benefits examined in this study – the commissary benefit, as well as in-kind housing and food – options to cut costs exist, but are relatively limited. Some studies have recommended preserving the monetary value represented by the discounted groceries the commissaries provide through establishment of special relationships with commercial providers for military members and retirees. It also may be possible to further reduce expenses for family housing, but in general these accounts are highly scrutinized. DoD could in theory further reduce its family housing stocks, but any savings could well be offset by increases in cash housing allowances. Opportunities to reduce the costs of in-kind food are also probably limited. There may be options that would cut the per unit costs of meals, but because the use of these meals is primarily driven by needs independent of typical management controls, there are likely to be few opportunities that would produce significant savings.

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[47] In general, noncash benefits are inefficient chiefly because they are not fungible – they can't be exchanged for any other good desired by the recipient as could a cash payment. Since preferences and needs vary, the value of a noncash benefit provided to a group will likewise vary. Studies in the Human Resources Management and Economics literature also indicate that there is a value assigned to the very act of choosing what one's money is spent on, another reason that noncash benefits are inefficient means of compensation.

[48] *Report of the 10th Quadrennial Review of Military Compensation, Volume II* (Washington, DC: U.S. Department of Defense), pp. 2, 92, http://www.defense.gov/news/QRMCreport.pdf (hereafter "10th QRMC, Vol. II").

[49] This and other points throughout this section are drawn from Carla Tighe Murray, "Transforming In Kind Compensation," in *Filling the Ranks: Transforming the U.S. Military Personnel System*, ed. Cindy Williams (Cambridge, MA: MIT Press, 2004), pp. 189-212.

Potential to Decrease Costs

The costs of the specific elements of non-cash compensation explored here total almost $6 billion in 2012, or 3 percent of total compensation costs. Because in-kind food costs are projected to decline, this amount is expected to fall. Notwithstanding that expectation, the potential for cost savings still exists. The largest single component of these costs is the commissary. If DoD were to negotiate an alternative arrangement with commercial grocery stores, this could allow the elimination of the commissary subsidy,[50] saving over $15 billion over the next decade.

Pursuing a cafeteria plan or similar approach for a broader set of non-cash benefits could result in savings as well. Estimates of the costs of these benefits vary depending on the scope of what is included, but one DoD study found that the 2007 costs of non-cash benefits were almost $1 billion (excluding the commissary).[51] The introduction of cafeteria plans would not eliminate these costs, but could reduce them substantially.

Changing the Military Retirement Benefit

The cost implications of any change to the military retirement system are largely determined by their impact on how the overall benefit is structured. Retirement is also funded differently than most other compensation elements, which also has a major impact on where any savings would be reflected in the budget.

Overview of the Military Pension Plan

There are three features of the military's retirement program that affect its total cost. First, it is a defined benefit, rather than defined contribution plan. Under a defined benefit plan, the retiree is guaranteed to receive a set annuity and the government assumes all fiscal risk. Defined contribution plans, on the other hand, specify an amount that is regularly contributed to a pension plan (by the employer, employee, or both), but the eventual payout is dependent on market or interest variation (so financial risk is borne by the beneficiary).

Second, military retirement is "cliff vested" at 20 years of service. Unlike most civilian retirement plans, under which employees' pensions vest gradually over time, servicemembers who serve less than 20 years receive nothing at all, and those that serve 20 years or longer receive a sizeable benefit. Depending on total years of service, annuity payments range from 40 to 105 percent of basic pay upon retirement.[52]

Third, for active duty retirees the plan offers immediate, rather than deferred, annuity payments. Because many servicemembers retire in their early- to mid-40s, on average, payments are made over a period of 40 years or more, greatly increasing the total cost. For example, the lump sum equivalent of the retirement payment for the average Lieutenant Colonel with 20 years of service retiring today is

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[50] It is possible that some commissaries would remain open in a limited number of cases for which there are few comparable alternatives nearby (e.g., at overseas or very remote installations).
[51] 10th QRMC, Vol. II, p. 89.
[52] Additional detail on how these amounts are calculated is below.

$1.1 million.[53] By contrast, most plans do not begin annuity payments until beneficiaries reach their mid-60s (though for military Reservists, payments begin at age 60).[54]

Total U.S. Government Costs for Military Pensions

In 2012, DoD requested $19.1 billion to cover the future retirement benefits of the currently serving force. There are substantial additional costs, however, that are borne by the Treasury Department. The first is the cost associated with what is known as "concurrent receipt." Beginning in 2005, Congress reversed the past practice of decrementing total benefit amounts for retirees eligible for both disability and retirement payments. Treasury contributes to the Military Retirement Fund (MRF) to cover the resulting increase in retirement payments, which in 2010 was $5.0 billion. Treasury's budget also includes an appropriation to buy down the $527.8 billion unfunded liability for past retirees' benefits that resulted from the creation of the MRF in 1984. In 2010, that amount was $61.4 billion.[55] Finally, Treasury pays interest on the government securities bought by the MRF. In 2009, the latest year for which data are available, the Fund earned $4.7 billion on securities it sold, and an additional $15.3 billion in interest on securities it continued to hold.

Options to Cut the Costs of Retirement

The majority of proposals to reform the military retirement system can be boiled down to various ways in which the amount DoD provides for any individual benefit would be reduced, thus reducing total costs. Proposals generally focus on changing one or more elements of how the retirement benefit is structured, calculated, or adjusted.

Altering the benefit structure could take one or a combination of various forms, most of which fall into one of four basic categories:

- move to a defined contribution plan, or to a combination of defined benefit and defined contribution;
- adopt gradual rather than cliff vesting;
- delay when retirement benefits begin to be paid out; or
- offer a lump-sum buyout.

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[53] U.S. Department of Defense, Office of the Actuary, *Statistical Report on the Military Retirement System, Fiscal Year 2010* (Washington, DC: Department of Defense, May 2011), p. 273.

[54] There is one small exception. Beginning in 2008, Reservists who deploy for war or national emergencies can begin drawing benefits earlier (3 months earlier for every 90 days of deployed time in 2008 or later).

[55] U.S. Department of Defense, Office of the Actuary*, Valuation of the Military Retirement System September 30, 2009* (Washington, DC: Department of Defense, December 2010), pp. 13-14 and M-1. The unfunded liability is currently projected to be fully amortized by 2025, at which point these payments will cease.

Adopt a defined contribution approach

The primary advantage of a defined contribution rests on the assumption that the stock market will provide a greater return than will government securities. If true, DoD can reduce its retirement contributions (and thus its costs) while maintaining (or even potentially improving) the financial well-being of future retirees. Various proposals envision different combinations of DoD and servicemember contributions, and many include features that would involve additional "incentive" contributions tied to various behaviors that force managers might wish to encourage (e.g., for service in combat zones or hard-to-fill positions). As such, they would offer an alternative to other types of cash incentives currently used for these purposes, reducing costs elsewhere in the budget. There are some proposals in which the servicemember would have the sole responsibility for contributions to his or her retirement fund, or where some level of defined benefit is maintained but a portion becomes defined contribution. Servicemember contributions could be mandatory or voluntary, and the option for DoD to make contributions if elected by the servicemember in lieu of another less-desired benefit could be maintained.

Change to gradual vesting

Another feature of military retirement that could be changed is to move away from cliff vesting to a system that allows servicemembers to vest at lower percentages over time. Most civilian retirement packages are structured this way, with employees eligible to receive increasingly larger percentages of employers' contributions over time (in addition to the contributions they make on their own). The cost implications of this approach are highly variable, but if DoD were to adopt this approach in isolation, to achieve savings the benefit amounts of current retirees – i.e., the most senior servicemembers – might have to be reduced fairly substantially in order to cover making the smaller payments to a much larger population. The likelihood of achieving cost savings under this approach is much greater if combined with a switch to defined contribution plan. Advocates for changing vesting typically focus on the force management advantages it would provide – greater flexibility and efficiency — and its greater equity relative to the current system, in which only 17 percent of servicemembers eventually retire with benefits.

Delay annuity receipt

Yet another feature that could be altered is to make active duty retirement more closely resemble that for Reservists, who do not begin receiving payments until much later (60 years of age, with some exceptions). This would also be more in line with civilian retirement plans. The higher the age at which payments begin, the smaller the total annuity amounts would be (and the larger the amounts DoD would save).

Many proposals contain combinations of the above approaches, and also include additional "gate pays" and/or separation pays. Gate pays are offered to all servicemembers who reach a certain number of years of service, typically based on some multiplier of basic pay. Separation pay is offered as a large cash payment upon leaving service. Both represent alternatives that would help encourage retention and offset some of the negative effects associated with providing a lower defined retirement benefit. Such additional pays would be given in cash so as to maximize their value to the servicemember.

Offer lump-sum buyouts

Rather than paying a retirement annuity over time, DoD could offer servicemembers the option of a lump sum payout upon retirement. To achieve cost savings, the amount would have to be something less than the full net present value of the current benefit; how much less would determine the magnitude of associated savings.

Change how benefits are calculated and/or adjusted

Either instead of or in addition to structural changes to the pension plan, DoD could make adjustments to the basis upon which annuity amounts are determined, or to how they are adjusted to account for inflation. These alternatives are a more indirect way of reducing servicemembers' total lifetime annuities, and could reduce DoD's costs significantly. Options here include:

- changing the pay basis in the retirement annuity calculations (e.g., adopt an average of the 60 highest months (5 years) of basic pay, or "High Five");
- reducing the multipliers; or
- lowering automatic cost of living adjustments.

Under the current system, there are three different retirement benefit formulas in use, known as Final Pay, High-3, and Career Status Bonus (or CSB/REDUX). Personnel who entered service prior to September 1980 fall under the Final Pay system, which uses a base amount of final basic pay and applies a multiplier equal to 2.5 percent times years of service. (Thus those who retire at 20 years of service receive 50 percent of final basic pay, and so on.) Those who joined the military between September 1980 and July 1986 fall under the High-3 system, which uses an average of the 3 highest years of basic pay as the base amount to which the multiplier is applied. Retirees under both systems have their annuities adjusted annually, tied to average wage increases in the overall job market (as measured by the Consumer Price Index, or CPI).

Those who joined in August 1986 or later can choose between High-3 and the CSB/REDUX system. Under REDUX, at 15 years of service personnel receive a $30,000 bonus, contingent upon serving at least another five years. Upon retirement, their annuity is computed based on their three highest years of basic pay, but if they retire with less than 30 years of service they pay a multiplier penalty.[56]

Any one of these aspects could be adjusted to produce savings. For example, DoD could lengthen the period over which average final pay is calculated (e.g., "high five"), or adopt an adjustment to final pay of a set amount (e.g., "high 3 less 10 percent"). Another alternative would be to lower the multipliers for some or all of the force.

[56] Specifically, under REDUX COLAs are set to CPI minus one percent until age 62. At that point there is a one-time adjustment to the full amount that would have been payable under a full COLA, and partial COLAs are then resumed.

Finally, DoD could lower the COLA by adopting a different inflation adjustment measure, or by determining a set amount (e.g., one percent annually). The most extreme version of this approach would be to eliminate inflation adjustments, which would cause significant declines in the real value of the annuity. More moderate versions include setting the rate at ECI minus a certain percentage (a feature of the REDUX system), changing the basis to an index that typically grows more slowly than ECI (e.g., the GDP deflator), applying adjustments less frequently, or eliminating a predetermined standard altogether, letting the amount be determined annually through the legislative process.

Potential to Decrease Costs

Over the next ten years, DoD is projected to spend almost $225 billion on military retirement. Treasury's costs will rise even more significantly, and the collective liability of the government is projected to more than double to over $2.7 trillion by 2034.[57] Any number of permutations of the options above would reduce these costs, in some cases substantially. An additional factor that would have a substantial impact on total costs is how any particular proposal might affect each of three populations: those already retired, those currently serving for whom some retirement contributions have already been made, and future servicemembers. It is politically easiest to make benefit changes that would only affect those who have not yet joined, but any savings would phase in slowly over time. On the other hand, the largest and most immediate savings could be realized by changes that would reduce DoD's costs to provide benefits to those already retired. Thus decisions about the point at which any new system would take effect have a significant impact on the likelihood of the new system getting approved, the total amount that would be saved, and how quickly costs would fall.

The primary effects on costs of switching to a defined contribution system are twofold. First, assuming that DoD's contribution levels would be set at levels lower than they are at present, the total savings would depend on much lower those contributions are set. At present, DoD contributes an average of 33 percent of active duty pay to the Military Retirement Fund. Reducing contribution levels to 27 percent, for example, and putting them in market-based accounts would generate over $31 billion in savings over the next decade, offset by whatever size of continued payments might be required to cover remaining obligations to those still in uniform. (That is, if DoD were to design a plan in which those with ten years of service or more would retain the prior defined benefit annuity, it would continue to incur costs associated with that benefit that would reduce the net effects of savings from lower contributions to private accounts for younger servicemembers.)[58]

The other more significant cost savings from a switch to a defined contribution system would be realized by the Treasury Department. Under these plans, assets are invested in the stock market (the assumed higher rate of return is what would allow DoD contributions to decline while the value of servicemembers' benefits is protected or even enhanced). As a result, Treasury would no longer have to

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[57] Defense Business Board (DBB), "Modernizing the Military Retirement System," Task Group Final Briefing, July 21, 2011, p. 20.

[58] One other advantage to DoD to moving to a defined contribution system is that it would break the link between increases in basic pay and the amount of required contributions to an accrual fund. Eliminating the "multiplier effect" would decrease budgetary churn, and would allow more efficient decisions because elements of compensation would be more independent.

pay the interest it would otherwise have owed on the securities bought by the MRF. Over time, these costs are projected to rise exponentially, into the hundreds of billions. Thus there is significant cost avoidance to the government as a whole associated with adoption of a privatized defined contribution plan.[59]

With respect to vesting, the primary arguments for eliminating cliff vesting are not cost-based. DoD's costs could fall under a gradual vesting arrangement, but again, depending on the specifics of any given plan, it is possible that DoD's costs could rise, at least in the short term. This is particularly likely in any formulation that protects current benefits for those already retired and a large proportion of the currently-serving force. If DoD continues to be responsible for paying those expenses, but must also fund contributions for shorter-tenured and incoming members of the force, its costs could rise over the period that both systems were in effect.[60]

If a defined benefit system is maintained, delaying retirement pay could have a substantial effect on total costs. For example, a typical current annuity is based on payments that stretch over 40 to 45 years (e.g., from retirement in the early 40s to death at 85). Starting payments at age 60 would decrease the total annuity amount by 30 percent or more. Under an accrual system, liabilities would fall by an even greater percentage, as compound interest over time would cover a greater proportion of the total annuity than it does today. Under this option, DoD's costs would be greatly reduced (again, depending on the timeline for implementation). Treasury's costs would also fall, but by proportionately less, as it would still maintain a substantial interest liability.

The cost effects of a lump-sum buyout would be heavily dependent on how much less than the current benefit is offered and how the plan would be phased in. Assuming that at least some servicemembers already retired would remain under the current system, the transition period — when some numbers of retirees are under both systems — could increase current outlays, potentially substantially. The current assets of the MRF could in theory cover some, but by no means all, of the associated costs. As a result, expenses associated with maintaining the current system would continue for some period of time concurrent with those to fund buyouts. Over the long term, minimizing that overlap would involve the least expense, but short-term costs could be very high if the time period was compressed.

In theory, buyouts would increase DoD's outlays, adding to the deficit. Like switching to privately-held retirement accounts, the primary cost advantages would accrue to Treasury, which would not have to pay interest.

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[59] That said, technically those savings do not result in a reduction of the deficit. Because Treasury's interest owed on the Retirement Fund is an inter-governmental transfer (essentially a credit that the government owes to itself), it falls outside of deficit calculations. Thus a defined contribution option would reduce the national *debt* (defined as the total liability of the government), but not the national *deficit* (i.e., the difference between incoming revenues and outgoing payments). In fact, a shift to a defined contribution plan would in all likelihood *increase* the deficit, at least in the short term. This is because the MRF would continue to make payments to current retirees, but DoD or Treasury would also have to make payments for new accounts into entities outside the government, increasing total government outlays and adding to the deficit.

The cost effects of proposals to adjust how retirement pay is calculated are more straightforward. Changing the basis for the base pay amount to which a multiplier is then applied reduces the total annuity amount. The savings associated with shifting to a "High 5" base, for example, could save up to $11 billion over 20 years.[61] Changing the multiplier could also have a major impact, as the compounded savings from lower monthly payments across the entire retiree population would be substantial – relatively small for older retirees but much higher for recent and future retirees. The same holds for setting a lower COLA. Again, the magnitude of the short-term savings is highly dependent on the degree to which changes apply to those who have already retired or are currently in uniform.

Altering the Military Healthcare Benefit

Military healthcare reform proposals, similar to those made for retirement, generally advocate change in one or more of three core ways. These include decreasing the amount of the benefit; incentivizing or forcing less use of the benefit; and reducing DoD's costs to provide it.[62] Most proposals include recommendations designed to address all three categories, though options to reduce the benefit in different ways are the most common. Some of the options proposed to decrease the amount of the benefit include:

- restoring the original cost-sharing relationship between DoD and the beneficiary;
- indexing all out of pocket costs to a measure of inflation;
- offering a lump-sum payment equal to some percentage of future health care costs at the time of retirement, in exchange for forfeiting retiree TRICARE benefits;
- requiring enrollment fees or premiums in plans that currently do not have them;
- cutting the list of covered procedures, which underwent a massive expansion over the past decade; or
- increasing co-pays for doctor's visits, hospital stays, or prescription drugs.

Second, many proposals advocate that DoD institute reforms that result, through altering incentive structures or instituting policy changes, in lower utilization of the benefit. These reforms can be targeted at specific programs with high usage rates, to certain categories of care (e.g., that received from private providers), or across the board. Some ways to lower usage rates include:

- Cutting eligibility. To decrease use, DoD could tighten eligibility rules. No one questions the need for active duty service members (ADSMs) to receive comprehensive health care, at a

[61] DBB, "Modernizing the Military Retirement System," p. 18.
[62] There is some overlap between the first two categories, as the benefit's generosity and expansion over the past decade is one of the causes of the extremely high and rising utilization rates. For example, people are more likely to go to the doctor when visits are free. Since 2000, all Defense Health Program beneficiaries, including many who weren't covered at all at the beginning of the decade, have seen an expansion in the care they're provided completely free of charge. Active duty family members, regardless of what plan they are in, and many survivors now pay zero out of pocket costs for covered services (with the exception of nominal copays for prescription drugs). The same is true for everyone in Tricare for Life.

minimum because it is necessary to preserve force readiness. That consensus weakens, however, the further one gets away from the servicemember. Many argue that providing care to immediate family members helps ensure peace of mind, which can have a major effect on readiness. This has been extended to the dependent parents and parents-in-law of ADSMs and certain divorced spouses of servicemembers, who are eligible for a lifetime of TRICARE at very low rates. Retirees of any age, Guard and Reservists in any duty status, and the dependents of all the above have also seen their eligibility for coverage greatly expand since 2000. Visiting foreign military personnel and certain U.S. politicians are also currently eligible for free and lowest-cost care in military treatment facilities.

- Changing incentive structures so that the option cheapest for DoD is also cheapest for the beneficiary, and, crucially, the other options become markedly more expensive. For example, DoD could structure co-pays in its prescription drug benefit so that the mail order pharmacy – by far the most cost-effective for DoD, and well-regarded by the small percentage of beneficiaries who have used it – is the most financially attractive option for beneficiaries, while providing a wider range of medicines than the overworked and increasingly inconveniently-located Military Treatment Facilities. A more extreme alternative would be for DoD to discontinue the retail pharmacy benefit entirely except for a limited number of emergency prescriptions per year, forcing beneficiaries to use the remaining cost-efficient options;
- Instituting co-pays for overutilized services for some or all beneficiaries; or
- Requiring that retirees under 65 with access to outside healthcare use that as their primary coverage, with DoD-provided care as a supplement. It has also been proposed that retirees under 65 only be allowed to have DoD-provided care as a primary payer if their employer reimburses the government for the employer contribution to the plan.

Third, DoD could enact reforms that reduce its overhead costs to provide medical benefits. Some of these options include:

- reforming fraud identification and reduction programs;
- standardization and coordination of case management;
- prioritization of preventative care and wellness;
- improving the procurement process by prioritizing acquisition within the TRICARE management activity;
- streamlining handoffs from DoD healthcare to the VA; or
- reorganizing the military medical system to a joint medical command.[63]

[63] Two options include a joint command composed of: 1) a TRICARE component and a medical readiness component; or 2) a TRICARE component and components for each of the services. See RAND National Defense

Potential to Decrease Costs

Over the next decade, DoD is projected to spend over $5.4 trillion on health care. Specific options to reduce costs are numerous, and it is clear that many of them could result in significant savings. (As might be expected, however, those that would produce the most savings are also those likely to be the most controversial.)

Examples of the magnitude of these savings include:

- Almost $870 million in 2012, or $10.6 billion over the next decade, for an alternative that would offer those retiring this year the option to receive a lump sum payment equal to half the present value of their future TRICARE for Life coverage in return for forfeiting their right to said coverage. If ten percent of retirees took this option, the Congressional Budget Office estimates it could save as much as eight percent of health care accrual costs;[64]
- Hundreds of millions of annual costs avoided if active duty servicemembers' family members were offered a "cafeteria plan" that extended to health care. Under such a plan, family members would be offered a cash allowance that they could spend on medical benefits provided by one of DoD's current plans, a new (cheaper) "lower" option (after paying for which they could keep the difference), or co-pays associated with their outside health insurance, which they would elect in lieu of Tricare.[65] Savings would be even greater if cafeteria plans included other non-cash benefits such as childcare;
- Over $22 billion over five years if Congress implemented DoD's 2009 proposals to increase co-pays and enrollment fees for retirees both over and under 65 (by different amounts) and raise prescription co-pays for all but active duty servicemembers.[66]

Implications of Compensation Changes for the Health of the Force

The primary caution against changes to compensation practices is the potential to undermine compensation's most fundamental purpose – to attract and retain quality personnel. If recruiting and retention falter, the military services could prove unable to generate sufficient numbers of soldiers, sailors, airmen and marines capable of performing their assigned missions.

Unfortunately, anticipating these effects is complicated by the fact that DoD's insight into why people either join the military or choose to stay in it is relatively limited. In some areas of compensation, relating behaviors to compensation changes is relatively straightforward. This is particularly true for bonuses and special pays, which are flexible pays typically used in response to or in anticipation of

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Research Institute, "Research Brief: The Military Health System: How Might it Be Reorganized?" RAND, 2002, http://www.rand.org/content/dam/rand/pubs/research_briefs/2005/RB7551.pdf.

[64] The $22 billion represents 2009 estimates, which would presumably be larger today. CBO Growth in Medical Spending by the Department of Defense, September 2003, pp. 18-19.

[65] "Growth in Medical Spending by the Department of Defense," Congressional Budget Office, September 2003, p. 19.

[66] "The Effects of Proposals to Increase Cost-Sharing in TRICARE," Congressional Budget Office, 2009, p. 4.

shortfalls in a particular specialty, function, or skill area. DoD leaders can relatively easily determine whether those payments are increasing retention, for example, to the necessary levels, and if not, can increase the amounts offered.

In other areas, tying policy changes to behavioral changes is more complex. Assessing the impact in changes to benefits that are universal (e.g., basic pay, or housing or food allowances) is complicated by the plethora of other factors that contribute to individuals' decisions about serving. The same is true for changes to many in-kind benefits. Effects may take time to materialize, and it is challenging to tease out whether the closure of a day care center, for example, contributed to high attrition rates at a particular installation (and if so, by how much), or whether frustration with local traffic congestion (or any other number of factors) played a role.

Force managers do have a number of increasingly sophisticated models built on past experience to help better assess the likely effects of compensation changes. This approach is best suited for policy alternatives that hew closely to current practices (or those that might have been in place in the past). But as the degree of departure rises, so does uncertainty about the models' results.

Surveys represent another major source of DoD's understanding of recruiting and retention decisions, but their timeliness can be a concern. Administering surveys and analyzing the results can take months, if not years. As a result, by the time the information is available to inform decisions, the degree to which attitudes may have shifted is unknown. Another limitation is that surveys typically measure attitudes, but lack a mechanism to determine how closely those attitudes conform to actual behavior. Thus while a survey may report that six percent of the force intends to leave the military, for example, and six percent actually do so, there is no way to determine whether they are the same personnel. In general, then, DoD lacks a systemic and reliable mechanism for relating attitudes about compensation with the behaviors that they implicitly assume compensation helps to shape – specifically, decisions to join or stay in the force. Again, although there are some sophisticated models that attempt to replicate the decision process,[67] they contain a number of assumptions that may not hold under certain conditions.

This might not matter so much if it were not for a key feature of the military personnel system. The military operates as a closed labor market – people come in at the bottom and more senior ranks are filled almost entirely from below, with very limited opportunities for lateral entry. As a result, if recruiting or retention fall in unanticipated ways, the effects can be severe, and can take up to a generation to work their way through the system. In the interim, the military services face shortages and/or job-skill mismatches, which could make accomplishing military missions more difficult or more costly, either in human or financial terms. This reality – that the consequences of misjudgments about recruiting or retention effects are much more severe in the military than in private sector labor markets – significantly compounds the level of risk aversion to any change that has even a small potential of a deleterious effect.

[67] One of the most robust is RAND's dynamic retention model. See Beth Asch, James Hosek, Michael Mattock, and Christina Panis, "Assessing Compensation Reform: Research in Support of the 10th Quadrennial Review of Military Compensation," RAND, Santa Monica, CA, 2008.

With respect to particular approaches outlined above, options that would reduce cash pay probably have the greatest potential to negatively affect recruiting. On the other hand, changes to pensions that would make the benefits available earlier might work in the opposite direction. Under current practices, changes in non-cash and deferred benefits (particularly health care and retirement) would probably pose the greatest risks to retention, particularly for those with 10 or more years of service.[68]

Accurately predicting the effects of change is probably least certain with respect to changes in non-cash compensation, the value of which is less well-understood by Defense policymakers. Some analysis suggests that at least portions of the force place a higher value on some elements of non-cash compensation (e.g., health care or commissaries) than their actual cost.[69] If cutting those benefits or restricting access to them contributes to those personnel's decisions to leave, the resulting costs of recruiting and training replacements could exceed those "saved." It may be prudent, therefore, for policymakers to develop a more robust understanding of the degree to which these benefits affect servicemembers' decisions about service before making major adjustments in these areas.

With respect to force health, the situation in which DoD currently finds itself – looking to reduce the force in a time of very high unemployment nationwide – offers both opportunities and pitfalls. DoD may be able to realize short-term cost savings by taking steps that, in a better economy, would lead people to leave service. But these cost savings could be partially or fully erased if, when the economy improves, DoD faces large numbers of departures and/or significant difficulties in attracting volunteers. Again, because the military labor market is closed, such disruptions have long-lasting effects that take years if not decades to play out.

Fundamentally, the most relevant concern here may not be whether recruiting and retention risks actually exist, but how comfortable policymakers are that they have been accurately identified. If that level of confidence is high, proposals can be modified to include elements specifically targeted at mitigating expected negative effects. Indeed, many proposals already incorporate such features. But if *perceived* risk is high, it may either preclude change altogether or reduce the degree of change (and associated savings) that can likely be realized.

Cultural Alignment

Even if cost savings seem clear and risks to force health appear manageable, proposals that run counter to military culture can be very difficult to implement successfully. Simply put, culture matters. History is replete with examples of organizational change that, though entirely logical in their justification, ran afoul of deeply held cultural norms and thus fell short or failed.[70] And while there are no comprehensive

[68] DBB, "Modernizing the Military Retirement System"; CBO, Evaluating Military Compensation, 2007, p. 25.
[69] 10th QRMC, Vol. II, p. 92.
[70] There is at least one other reason to explicitly examine the cultural implications of various options that is of particular relevance in the military context: a large and growing number of recruits are drawn from families with prior military service. See Gary Schmitt and Cheryl Miller, "The Military Should Mirror the Nation," *Wall Street Journal*, August 26, 2010, http://www.aei.org/article/102457. This may make younger people, who are typically more open to change, more resistant to departures from current practice. In addition, there is a risk that any proposed changes that are broadly perceived as inconsistent with military culture will alienate former

empirical measures of military culture, there are a few broadly held tenets that can inform how potential modifications to the current system will be received. One is equity, the other fidelity. (Both are present in every one of the four military services, although how they manifest themselves and the depth of feeling about specific applications of these values varies among them.)

Equity is one of the most highly prized military values, and is deeply rooted in the exigencies of warfare. When lives are at stake, perceptions that risks are not fully shared or of "haves and have nots" can undermine the unit cohesion that is critical to mission success. Thus the principle of equity is deeply engrained in all aspects of military life, and is a major part of the military's self-identity.

In the context of military compensation, the desire for equity clearly contributes to inefficiencies. In essence, it drives the system to develop solutions that will satisfy the highest common denominator, and then extends that to the group. While some variation exists, there is a strong preference to treat people within groups – a given rank or specialty, for example – as uniformly as possible, and the standard for creating additional differences across groups tends to be high.

There is one area of military compensation where the equity principle is turned almost completely on its head, however – the retirement system. As recent studies have highlighted, the current pension benefit accrues to only 17 percent of the force, while the remaining 83 percent receive no provision for their post-work future other than contributions to social security. Alternatives to expand retirement benefits to a broader segment of the force through gradual vesting would help to redress the unfairness of the current approach, bringing into better alignment with military culture.[71]

Past efforts to introduce variability (e.g., through reverse auctions that allow personnel to "bid down" special pays for hard to fill assignments) have challenged this norm. Many of the pilot programs are no longer being used, because even though they are clearly more efficient, in the face of discontent, leaders have been unwilling to support personnel of same rank and specialty being paid differently for the same job. The experiences serve as a clear indication that any proposal that features increased variability within groups is likely to meet with resistance, perhaps strong resistance.

Another key cultural value is fidelity to the group. This too is rooted in the demands of war, when lives are at risk. A shared commitment to "leave no one behind" underpins individuals' willingness to sacrifice for the good of the group. In return, the group assures each member that he or she is highly and equally valued, and that they will remain part of that group, dead or alive. Military leaders must be perceived as "looking out" for their people, because they will then be willing to sacrifice in return.

In-kind compensation benefits in particular are one manifestation of this fidelity, particularly for those that are believed to contribute to maintaining the readiness of the force. Personnel that are

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servicemembers to such a degree that they influence potential future recruits to make career choices that do not include the military.

[71] The typical counter-argument to this contention, which sometimes extends to any proposal that is seen as making military service more "civilian-like," is frequently expressed as a belief that such steps will undermine the uniqueness of the military profession. The benefits associated with cliff vesting are viewed as a reward consistent with the distinction between those who are serving in the military for some brief period and those who have chosen it as a profession. Eliminating or weakening this distinction is seen by some to pose a major threat to a profession that relies, at least in part, on defining itself as a higher calling.

unhappy, or medically or physically unfit, jeopardize the entire unit should it be called to action. Thus the military makes substantial investments, both financial and otherwise, to help servicemembers with personal problems and to maintain physical well-being. These activities reinforce the mutual bond between the organization and the individual, and actions perceived to weaken it are viewed as detrimental to the fundamental *raison d'être* of the force.

The value placed on fidelity also helps to define how proposals that would affect the benefits of military retirees will be received. Options that are seen as reneging on past commitments are viewed by many as a direct affront to this principle, and not only by those that would be directly affected. An extension of this concept is the visceral reaction by many military members, past and present, to proposals that would remove or reduce the government guarantee of future retirement benefits. For many, the potential that retirees could end up destitute, even as a result of their own choices, represents a breach of the contract between the nation and its armed forces, and is unacceptable as a matter of principle. This view leads to great distaste for retirement options that include any element of privatization and shift any financial risk at all to individual servicemembers.

Neither equity nor fidelity adequately explains one other aspect of military compensation that has outsized cultural import: the commissary. The commissary benefit is prized by both current servicemembers and retirees for reasons to a degree that appears to outweigh its costs, for reasons that are not entirely clear. But changes here, even if they were to offer a monetarily equivalent benefit, would likely be highly controversial.

In sum, the challenge in modifying military compensation practices is not to develop a new approach, but to select among the almost infinite combinations that have already been proposed. Assessing the effects of any given proposal or combination of proposals requires an examination of how it might likely affect recruiting and/or retention, an outcome that can be influenced by how well the approach aligns with key cultural principles.

4 SUMMARY AND RECOMMENDATIONS

If nothing else, the preceding chapters have illustrated the complexity of the current military compensation system, as well as the myriad challenges facing policymakers seeking to alter it. But alter it they must, or face the continued erosion of buying power that is completely at odds with the security needs of the nation. Military compensation costs rose by $50 billion over the last decade, in part due to the demands of the war, but mainly due to structural changes that expanded how much compensation each individual receives. As a result, as servicemembers return home, DoD will not see a proportional decline in compensation costs. Indeed, while the rate of growth will slow and the force is planned to shrink, paying a smaller number of military personnel will require at least an additional $28 billion over the next ten years.

Given the current fiscal climate, this reality clearly argues for change. But in determining the path ahead, leaders in DoD, the White House, and Congress must resolve some critical and interrelated questions. These include:

- Whether the ultimate aim is to reduce DoD's costs, or those of the government's as a whole. If the focus is on DoD, this suggests a priority on reducing the per-servicemember costs of basic pay, and on finding savings in military healthcare. A broader government-wide look would suggest that reforming military pensions should be the priority, though most options would not result in deficit reduction;
- Whether the priority is to reduce costs in the short term or over a longer period, and if so, how long. A short-term focus would place greater emphasis on steps like pay freezes that affect cash payments to the current force , while a longer-term view might give greater weight to options that reduce deferred benefits for current or future retirees; and
- The degree to which cultural resistance should be taken into account. Put differently, how much inefficiency is worth paying for to preserve intangible aspects of military service that could affect the integrity of the force and its performance when it matters most, in wars.

As some of these questions imply, difficult decisions will have to be made about whether the shifts that occurred over the past decade should be reversed or maintained. The net result of many of the changes to compensation is that DoD spends a smaller proportion to support current servicemembers, and more on family members and retirees. Further, while at least some of the benefit expansion was prompted by a desire to recognize the sacrifices of a decade's worth of tough fighting, those benefits were offered widely. Very few of them were actually directed to those who have borne and are bearing the majority of the burden.

While budget pressures are intense, the fact that some force reductions have already been announced helps to avoid the greater pressure that policymakers would be facing were that not the case. There is an imperative for change, but not one so immediate that it precludes thinking through things in a deliberate and thoughtful way. A national debate is rapidly taking shape that is forcing choices between defense needs and other priorities. Part of coming to a sensible and sustainable solution involves determining how much of a premium Americans are willing to pay for the unlimited liability contract undertaken by the men and women who serve in the military, and whether that premium can be reduced without placing force at risk. The decisions will not be easy, nor could they be more important.

This report does not come to a conclusion about the optimal path. Instead, it is intended to clarify the steps that have already been taken and illuminate the basic orientation of the ones that lie ahead. Determining exactly which direction should be taken necessitates a broader national discussion, to which this report can hopefully contribute.

In support of that aim, this report makes three recommendations, the adoption of which will improve both the quality and the feasibility of future reform proposals.

1. **Policymakers should approach changes to military compensation comprehensively, rather than through the prism of any one (or more) of its component parts.** The clear lesson from the past is that "fixing" any single element of compensation – housing, retirement, health care, or anything else – fails to fully leverage the power of the vast range of compensation elements. A clear contributor to the dramatic cost growth of the last decade was the adoption of a piecemeal approach to reform. Avoiding this pitfall going forward may be one of the key determinants of success. It is true that some problems become intractable if they are scoped too broadly. But the various elements of military compensation are remarkably intertwined, increasingly by accident rather than design. Striking the appropriate balance between cost savings, short- and long-term risks to the health of the force, and military culture necessitates an examination of the whole and should not be compromised.

   Achieving substantial savings may also require addressing reforms to the personnel management system as part of this effort. The military personnel management system is intimately tied to compensation costs, and suffers from being ill-suited to the demands of the future. Policymakers will have to carefully weigh whether the prospects for meaningful reform are better if modifications to compensation and personnel are sought all at once, or if a comprehensive and integrated approach to the compensation piece – the more immediate budgetary concern – stretches the bounds of tolerance for change.

2. **The impacts of and effects on military culture should be explicitly accounted for in any reform initiative.** Whatever form a forum for developing alternatives might take, policymakers must identify up front the cultural principles that will guide decisions and ensure that the communication of any resulting proposals acknowledges and addresses culturally-based concerns. This step would not only enhance the quality of the decisions and the overall prospects for success, but also help to mitigate risks to recruiting and retention.

3. **To better inform an integrated approach, DoD should take immediate steps to enhance its understanding of the bases for servicemembers' decisions about wearing the uniform.** While existing compensation models are useful, their ability to truly influence change depends on how broadly their results are accepted. Further, they lack adequate representation of the complex decision processes that people undertake both when deciding to join the military and then to

remain in service. This is particularly true for various elements of non-cash compensation, but also for motivators that are not compensation-related at all. Multiple studies have shown that servicemembers are motivated by factors other than compensation – from intangible psychological benefits to choice of duty location.[72] These realities, which help to influence the very process that compensation is designed to influence, are generally under-represented or absent altogether from compensation decisions.

These things are now knowable, however, and can be known quickly. Commercial marketers and human resource professionals have harnessed computing power and decision science in a way that offers very large scale, real-time insights, on an individual and aggregate level, about how much different factors play a role in decisions. With appropriate senior level attention, these approaches could be rapidly applied within the Defense Department. Within a matter of months, senior leaders could have a much more robust understanding of how much certain benefits, monetary and non-monetary, matter to people's decisions about entry into or continuation of military service. Over time, these attitudes could be tracked to behaviors, supporting a very sophisticated and deep understanding of the force and the both internal and external factors that affect it over time.

This information would be a useful addition to the debates to come on its own, and it can also make important contributions to the level of confidence leaders have in existing models. It may also help to overcome some manifestations of cultural resistance.

All of these recommendations, if adopted, would improve the outcome of any process established to determine how best to modify military compensation. That process will be painful, but it also holds promise. That promise is of a move toward a rationalized system that better meets the needs and desires of servicemembers, treats them fairly, and rests on a firm fiscal foundation that also allows DoD to fund the support and equipment servicemembers need to succeed on the battlefield. Keeping faith with the military is possible, and they and the country deserve no less.

[72] For example, Diana Lien and Michael Hansen, with Michael Moskowitz and Ian MacLeod, *Compensation and Voluntary Participation in a Continuum of Service* (Alexandria, VA: Center for Naval Analyses, March 2006), and Ryan D. Stitt, *Identifying the Cost of Non-Monetary Incentives (ICONIC)* (Monterey, CA: Naval Postrgraduate School, December 2009).

Appendix A: Methodology for Identifying Active Duty, Reserve Component and Health Care Costs

Budgetary information was principally drawn from publicly-available information on the OSD(Comptroller) website: http://comptroller.defense.gov/. Actual TOA figures for two years prior were drawn from each year's budget, and then adjusted to 2012 constant dollars using the deflators appropriate to the respective appropriation from the relevant "National Defense Budget Estimates" (DoD Greenbook, available at the Comptroller website above). For example, FY10 actuals were taken from the FY12 budget documentation. Most of the cost data was taken from Excel versions of the downloadable Military Personnel Programs (MILPERS) (or other appropriations account, as appropriate) budget tables. These tables break out spending by Service and Component in some, but not all, of the compensation categories used in this analysis. When active and Reserve costs were not specified, the study team estimated cost shares as is explained further below.

Basic pay: DOD budget tables contain a sub-activity category entitled "Basic Pay," all of which falls into active component Account Titles (this includes pay for cadets and midshipmen at the military academies and the pay of RC members serving on active duty federal orders). All of these entries were allocated to active duty costs. Reserve training (and associated pay) all fall under Reserve Personnel and National Guard Personnel Account Titles for each of the military services. All of these pay and training costs were allocated to Reserve costs.

Food: Within the MILPERS budget tables, costs for the basic allowance for subsistence, subsistence-in-kind, and the family supplemental subsistence allowance all fall under active duty Account Titles, and are thus allocated to active duty costs. The same is true for the total amount of the DeCA subsidy. While both active duty and reservists are eligible to use the commissary, the benefit is principally aimed at support for active duty members. Reserve food allowances and subsistence-in-kind costs are not specified in DoD-level budget materials within the broader training costs captured in the categories that fall under basic pay above.

Housing: Active duty housing costs are captured in the MILPERS budget tables under the active duty Account Titles and one of three sub-activity categories: Basic Allowance for Housing, Variable Housing Allowance, and Basic Allowance for Quarters. All of these entries were allocated to active duty costs. There are no housing allowance entries in Reserves or National Guard Account Titles in the DoD-level budget documentation; Reserve component housing allowances are included in the larger Reserve training entries captured in the basic pay categories above. All of the Family Housing appropriation expenses are allocated to active duty costs.

Other pays, allowances, and costs: DoD-level budget tables do specify Reserve component education expenses, which are allocated to Reserve costs. They do not, however, specify an Active-Reserve split between the costs for special and incentive pays, allowances, transportation benefits, or unemployment benefits, which all fall under active component Account Titles. Some portion of most, if not all, of these cost categories is expended on Reserve forces, but in the absence of additional information it was not clear how to appropriately allocate them. (They are unlikely to be proportional to the force split.) All of these costs (apart from education, which is specified) are therefore allocated to active duty costs.

Retirement: DoD's contributions to the Military Retirement Fund are levied as a proportion of total payroll, based on actuarial calculations. Each year, there is a percentage – referred to as the "Normal Cost Payment, or NCP – specified for full-time (active duty) and part-time (Reserve) contributions. DoD's MILPERS budget tables only contain a single sum for retirement accrual payments for each service that is not broken out between components. While imperfect, the study team therefore utilized the past and projected future full- and part-time NCP ratios in the most recent actuarial report to proportionally allocate the annual retirement contribution between active duty and Reserve costs.[73] The other component of retirement is social security payments. These are also included solely in active component Account Titles. To estimate active and Reserve contributions, the study team multiplied the total social security cost in each year by the ratio of active duty basic pay to Reserve training costs.

Health care: DoD's health care costs have two major components. The first, funded within MILPERS, is a fund dedicated to support liabilities associated with retiree health care programs for Medicare-eligible beneficiaries. Within the budget tables, these costs are captured in a budget sub-activity entitled "Defense Health Program Accrual" for fiscal years 2003-2005 (it began in 2003), and in an Account Title labeled "Medicare-Eligible Retiree Health Care Fund" (MERHCF) in subsequent years. The sub-activity or Account Titles make clear which costs are associated with active, Guard, and Reserve forces. The other major component of health care expenditures is for the Defense Health Program (DHP). These costs are not specified in a manner that allows for identification of active duty- and Reserve component-associated costs. Because the medical care benefit has experienced such dramatic expansions (and associated cost growth) over the last decade, and because the costs are not generally distinguishable by beneficiary population, health care is treated as a third category of total compensation costs in this analysis.

[73] Ratios were calculated from the Normal Cost Payment amounts found in "Table 10: Military Retirement System Past and Projected Payroll and Normal Cost Payments," *Valuation of the Military Retirement System – September 30, 2009* (Washington, DC: Department of Defense Office of the Actuary, December 2010), pp. 22-23.

Appendix B: Methodology for Projecting Future Active Duty, Reserve Component and Health Care Costs

CSIS's projections of future compensation costs are based on data from previous years and projections made by the Congressional Budget Office (CBO) and the Department of Defense Board of Actuaries. With the exception of the Defense Health Program, the growth rates below were applied on a per servicemember basis (unless otherwise noted, the same assumptions were used for both Active and Reserve costs).

- **Basic pay:** CSIS utilized CBO's projections of 1.1 percent annual growth through 2016, rising to 1.15 percent after that.[74]
- **Food:** For subsistence in kind, CSIS assumes declines of 0.5 percent annually through 2014 (the currently planned end date for major operations in Afghanistan), and no real growth subsequently. For cash allowances, CSIS estimates that food inflation will remain higher than overall inflation by 1.0 percent through 2016; assuming economic recovery by then, CSIS estimates no real growth in 2017 and beyond. CSIS estimates continued average annual growth of 1.0 percent for DoD's contributions to supporting commissary operations, based on historical experience.
- **Housing:** CSIS estimates modest (0.25 percent) growth in cash housing allowances due to rate protection requirements and higher-than-market rates in military monopsony locations. For in-kind housing, CSIS assumes the same rates of decline as reflected in DoD's 2012 budget request through 2016, followed by no real growth in subsequent years.
- **Other pays, allowances and costs:** Based on averages over the last five years, CSIS projects real annual declines of 5.2 percent in per servicemember costs of other pays, allowances and costs through 2016. Assuming the economy has recovered somewhat by then, CSIS anticipates decreased expenses associated with unemployment insurance, offset by potential increases in recruiting bonuses, the net result of which will be no real growth in 2017 and beyond.
- **Retirement:** CSIS uses the DoD actuaries' projections for the percentages of full-time servicemembers' basic pay that will go toward future retirement to calculate growth in per servicemember retirement accrual payments (32.7 percent of basic pay through 2015 and 32.6 percent thereafter for active duty forces, 24.3 percent over the whole period for Reserves).[75] For social security, CSIS assumes the same growth rates as for basic pay above.
- **Health care:** For accrual payments to fund future care for the estimated number of Medicare-eligible retirees, CSIS assumes 4.6 percent growth through 2016, 4.2 percent growth for 2017-2019,

[74] "Long-Term Implications," CBO, p. 16.
[75] Office of the Actuary, "Valuation of the Military Retirement System, September 30, 2009," Department of Defense, Washington, DC, December 2010, p. 23.

and average annual declines that result in reaching a real growth rate of 1.0 percent by 2034.[76] For DHP, CSIS assumes annual growth of 4.4 percent.[77]

For all but the Defense Health Program, the growth rates above were applied to 2012 per servicemember costs in order to develop estimates of future average individual costs for both Active Duty and Reserve forces. Costs per active duty service member were then multiplied by projected future active duty endstrength numbers (not including temporary endstrength, the costs for which would presumably be contained in additional contingency funding appropriations). These numbers included the planned reductions of 47,000 active duty Army and Marine personnel through 2016, and no change beyond that. (Levels of full-time Reservists are assumed to remain at 2012 levels. They are included in active duty totals for per servicemember calculations for all but retirement accrual, when (because they receive Reserve, not active duty, retirement benefits) they are included in Reserve totals.)

For Reserve Components, CSIS assumes the same average annual rates of per servicemember cost growth as for Active Duty forces. Total costs are calculated by multiplying annual costs per Reserve or Guardsman by Reserve component force levels, which are assumed to remain constant at 2012 levels.

Health care costs include the total costs of Medicare-eligible retiree care accrual (both Active and Reserve, based on the projected inflation rates above multiplied by Active and Reserve endstrength projections in each year), and the total costs of the Defense Health Program, based on the CBO growth rates noted above.

[76] "Long-Term Implications, CBO, p. 19.
[77] Based on CBO's more detailed projections. See "Long-Term Implications," CBO, p. 19.

Appendix C: Healthcare Benefit and Beneficiary Population Expansion Chart Methodology and Background

The chart detailing the expansion in the DoD healthcare benefit and beneficiary populations from FY00 to FY12 (see page 19) tracks 11 benefit categories and 22 different types of beneficiaries. This appendix explains what is included in each benefit category, defines certain important terms used in the chart, and explains the variation in TRICARE eligibility within some of the beneficiary categories.

Benefit Categories

1. **HMO-like plan (lowest cost)** – Included in this category is access to TRICARE Prime as well as the US Family Health Plan (USFHP), a Prime option available in specific geographic areas in the CONUS. TRICARE Prime is based on the civilian HMO model and offers the lowest out of pocket costs to beneficiaries of all TRICARE options; it is also the most cost-efficient plan for DoD. Access to Prime was originally limited to ADSM and their families; 17 of the 22 beneficiary categories on this chart are eligible today.
2. **PPO-like plan (greatest flexibility)** – The majority of TRICARE plans in existence today fall into this category. When the DoD healthcare system was revamped in the 1990s, TRICARE Standard/Extra was established as the successor program to CHAMPUS, a PPO-like option based originally on the Blue Cross/Blue Shield High Option Plan provided to Federal civilian employees. Standard/Extra then became the model for many of the new health benefit programs DoD subsequently introduced, including TRICARE Reserve Select (TRS), TRICARE Retired Reserve (TRR), TRICARE Young Adult (TYA), and the revamping of the Continued Health Care Benefits Program (CHCBP) – all of which profess to provide TRICARE Standard-equivalent care. By FY10, only ADSM (including activated Reservists) – who are required to be in Prime – and Medicare-eligible retirees and their family were without access to a plan in this category.
3. **Free primary and/or preventative care** — Active duty servicemembers in TRICARE Prime have long received their medical care in MTFs free of charge. Active duty dependents, Guard and Reserve personnel, and retired military personnel and their dependents have also long been able to get low-cost or free treatment in MTFs on a space-available basis. However, over the 2000s, the number of beneficiaries that qualified to receive some or all of their primary and preventative care for free grew sharply, as did the volume and complexity of the benefits provided to them at no charge. Three trends are represented in this category: 1) the elimination of out-of-pocket costs for certain categories of beneficiaries (e.g. the waiving of all copays for ADFMs in any TRICARE plan in FY01 or the waiving of the Standard/Extra deductible for families of activated Reservists in FY05); 2) the systematic removal of cost shares for certain primary and/or preventative care procedures for all TRICARE beneficiaries throughout the decade; and 3) the introduction of TRICARE for Life (TFL), which pays the deductible and cost-shares for Medicare-eligible beneficiaries – making all care covered by both Medicare and TRICARE effectively free (it does other things as well, and they are reflected in the last entry in this section, TRICARE for Life – Other).

4. **Rx benefits** – This column represents access to the TRICARE Pharmacy program. By FY12, all TRICARE-eligible beneficiaries had access to the full range of prescription options, regardless of plan. Some groups were eligible for TRICARE prescription drug benefits even without health plan eligibility, including the dependent parents and parents-in-law of ADSMs and foreign military members stationed in the United States. Beneficiaries can fill prescriptions at MTFs at no cost (though non-formulary drugs are not available); through the TRICARE Pharmacy Home Delivery for the lowest non-MTF out-of-pocket rates; or at TRICARE retail network pharmacies with a higher required copay.

5. **Full dental plan** – Today there are four separate DoD dental plans: the TRICARE Dental Program (TDP), the Active Duty Dental Program (ADDP), the TRICARE Retiree Dental Program (TRDP), and the TRICARE Dental Program Survivor Benefit Plan. The first two plans work in tandem. ADFMs and members of the Guard and Reserves and their families – regardless of duty status – are eligible for TDP. Upon activation, a Reservist's enrollment is automatically transferred to ADDP and his or her family members immediately qualify for reduced rates in TDP for the duration of the activation period. When the sponsor leaves activated status, the higher TDP Guard and Reserve rate is reapplied to his or her family's coverage and the sponsor's ADDP coverage is automatically transferred back to TDP.

   The third plan, TRDP, has a somewhat deceptive name. It covers military retirees of any age – including Guard and Reserve retirees – and their families, but also the survivors of ADSM and retirees, Medal of Honor recipients and their dependents, and the dependents of would-be sponsors who are ineligible for TRDP for a qualifying reason. The last option, the TRICARE Dental Program Survivor Benefit Plan, is separate insurance that provides 3 years of TDP-equivalent coverage for the survivors of a sponsor who dies while on active duty and who was enrolled in TDP at the time of his or her death. None of the above dental plans existed in FY00, and their precursors offered far fewer benefits at much higher cost to beneficiaries.

6. **Remote and/or overseas coverage** – This category represents TRICARE's remote, overseas, remote overseas, and worldwide plans. The first of these plans was TRICARE Prime Remote, which was made available to ADSMs in FY00 and expanded to ADFMs in FY02. In FY03, TRICARE Global Remote Overseas was introduced, greatly expanding the options available to ADSMs and their command-sponsored dependents while stationed abroad. By FY12, Prime Remote was open to qualifying ADSMs and ADFMs (including activated Guard and Reservists and their families) in the CONUS and when abroad, TRICARE beneficiaries had a range of options. ADSMs had Prime Overseas and Prime Remote Overseas; ADFMs and some survivors had Prime Overseas, Prime Remote, and Standard Overseas; Retirees and their dependents, Medal of Honor recipients and their dependents, and former Servicemember spouses had access to Standard Overseas; and TFL, TRS, TRR and TYA were all worldwide benefits, meaning that beneficiaries in those plans living or traveling abroad were able to file claims through the Standard Overseas infrastructure.

7. **Healthcare transition assistance** — This column represents the Transition Assistance Management Program (TAMP) and the Continued Health Care Benefit Program (CHCBP), two

programs that provide additional periods of healthcare coverage for certain former TRICARE beneficiaries in periods of transition. TAMP was created in 1990 as a very limited benefit – 60-120 days of continued healthcare eligibility for a small group of involuntarily-separated and retiring personnel, based on the length of time spent on active duty. In FY04 it was expanded to temporarily provide 180 days of such eligibility for a larger group, including all RC members leaving a period of active duty; in FY05 the 180 day extension was made permanent and applied to all qualifying circumstances. By the end of the decade, TAMP was available for all honorable involuntary separations; all Guard and Reservists coming off a greater than 30 day activation period in support of a contingency operation; those separating after being subject to stop loss orders; those separating after agreeing to stay on AD for a period of less than a year in support of a contingency operation; those separating from AD and going directly into the Selected Reserve; and those separating with a sole survivorship discharge. Those electing TAMP coverage in FY12 received 180 days of Standard/Extra benefits for themselves and their dependents at the ADFM rate.

CHCBP was introduced in 1993 to fill what Congress saw as a need for additional transition assistance beyond that available from TAMP. It originally provided 12 months of COBRA-style health coverage after TAMP expired. By the end of the decade, separated ADSMs and their families, members of the Selected Reserve and their families, unremarried former Servicemember spouses, and certain former dependent children who no longer qualify for TRICARE were eligible for between 18-36 months of coverage.

8. **Behavioral/mental health coverage and resources** – TRICARE did cover some inpatient and outpatient behavioral and mental health services in FY00, though coverage and resources were limited and co-pays relatively high. In the wake of the wars in Iraq and Afghanistan, DoD committed significant resources to expanding its behavioral and mental health resources, augmenting behavioral and mental health coverage for all TRICARE beneficiaries and implementing two new programs: the TRICARE Assistance Program (TRIAP) and the TRICARE Telemental Health Program. This category represents the total impact of these three efforts.

   TRIAP provides 24/7 online access to unlimited, free and confidential behavioral health counseling for eligible beneficiaries. The TRICARE Telemental Health program uses teleconferencing technology to conduct consultations, psychiatric diagnostic exams and interviews, one-on-one psychotherapy and medication management sessions. All TRICARE-eligible beneficiaries are eligible for this program, though out-of-pocket cost per appointment ranges from free to 20% of the total bill, depending on TRICARE plan and beneficiary group.

9. **Wounded warrior care** — This category reflects TRICARE's respite care program for the primary caregivers of seriously wounded ADSMs as well as the programs in each TRICARE region that were established to coordinate the healthcare needs of all wounded warriors, regardless of duty status, and provide counseling and guidance for their families and survivors (e.g. the Warrior Navigation Assistance Program, the Warrior Care Support Program, etc.). These programs began operations in FY08.

10. **Programs for special needs dependents** — This column represents access to the Extended Care Health Option (ECHO), ECHO Home Health Care (EHHC), and EHHC Respite Care. ECHO provides additional benefits not available in TRICARE Prime or Standard/Extra as well as monthly financial assistance to eligible beneficiaries with at least one of three qualifying conditions. In FY10, the ECHO yearly maximum payment was set at $36,000 per eligible family member, over a threefold increase from its predecessor program in FY00. Eligibility for these programs was originally limited to ADFMs with moderate to severe mental retardation, but with the introduction of TAMP in FY05 two qualifying conditions were added (a serious physical disability or a physical or psychological condition making the beneficiary homebound) and the benefit was opened to dependents of reservists activated for greater than 30 days, transitional survivors, children or spouses of former servicemembers who suffered physical or emotional abuse, and those eligible for TAMP coverage. Eligible children do not age out of ECHO at 21/23; benefits continue as long as the sponsor and dependent both qualify for coverage; the sponsor provides over half the child's support; and the child remains unable to care for his or herself.

    EHHC provides additional benefits to home-bound beneficiaries – care from a skilled nurse, home health aide, physical, occupational or speech therapist, or other qualifying health professional as well as coverage of medical supplies and other education or training programs. The EHHC Respite Benefit provides 8 hours of respite care five days a week and was designed to allow the primary caregiver time to sleep. The maximum amount TRICARE will pay for this benefit is equal to the cost in the beneficiary's region of full-time residence in a skilled nursing facility.

11. **TRICARE for life – other** — This column represents TFL coverage beyond paying all the out-of-pocket costs for Medicare beneficiaries' primary and preventative care (which is represented in column 3). TFL also provides additional coverage of procedures and things like durable medical equipment that Medicare denies. Furthermore, TFL (unlike Medicare) is a worldwide benefit. While abroad, TRICARE becomes the primary payer for TFL beneficiaries, who pay TRICARE Standard Overseas cost shares for any care received.

Definitions

1. **"Family," "family member," or "dependent(s)"** – eligible family members include sponsors' spouses, dependent children and stepchildren (until they reach a certain age, which varies based on the TRICARE plan and is different for children with disabilities or who have full-time student status), and dependent parents or parents-in-law. Access to benefits for spouses and qualifying children under 21 is equivalent except in cases of some counseling and behavioral/mental health services that are only open to beneficiaries over the age of 18. Access to benefits for dependent parents and parents-in-law is much more limited, extending only to space-available MTF care, TRICARE Plus, and TRICARE Pharmacy benefits.

2. **"Medicare-eligible"** – Beneficiaries can become eligible for Medicare based on age or disability. Plans like TRICARE for Life kick in once the beneficiary – whether sponsor or dependent – becomes Medicare-eligible.

3. **“Retiree”** – here, when we refer to retirees we are speaking of military servicemembers who have retired with at least 20YOS and are thus eligible for immediate retirement pay and healthcare benefits for themselves and their dependents. Likewise, “Retired RC” sponsors are members of the Reserve components that have retired with 20 years of creditable service, though they and their dependents do not become eligible for the same health benefits as other retiree families until the sponsor’s 60th birthday.
4. **“Survivors”** – dependents of ADSMs, retirees, reservists, and retired reservists whose sponsor has died.
5. **“Activated” or “non-activated”** – Activated members of the Guard and Reserves are those who are serving on federal active duty orders for a period greater than 30 days. TRICARE eligibility varies for RC members and their dependents depending on whether the sponsor is in non-activated, activated, deactivated (coming off of a period of activation), or retired status.

Variation in Eligibility within Beneficiary Categories

In general, beneficiaries may need to meet additional inclusion criteria or select a specific plan for which they are eligible in order to receive the benefits depicted on our chart. For example, different ADSM dependents often have different eligibility; for example, if one dependent child in a family is 21 and not in college, he may only be eligible for healthcare transition assistance programs like CHCBP, while his sister, age 23 and enrolled at least part time in college, would be eligible for PPO-like care as well as HMO-like care through the two variants of TRICARE Young Adult. Another eligible dependent in the same family – a dependent mother-in-law, perhaps, would be eligible for none of the options mentioned above, but could enroll in TRICARE Plus to gain access to primary care at an MTF under the same access standards as regular TRICARE Prime beneficiaries. This beneficiary would also be eligible for full prescription drug benefits under TRICARE Pharmacy.

One beneficiary category in which eligibility varies significantly is survivors. Survivors’ eligibility for continued coverage under TRICARE depends on many factors, including whether the sponsor died while on active duty; which health and dental plans had been elected at the time of the sponsor’s death; the age the deceased sponsor would have been at a given point after his or her death (in the case of survivors of retired RC members); and the amount of time that has passed since the death occurred. Some survivors’ TRICARE eligibility never expires, though it may change over time (e.g. unremarried widows of servicemembers killed while on active duty); other survivors’ eligibility lasts a set amount of time (e.g. until the dependent children of a deceased sponsor age out of TRICARE, or, for survivors of non-activated RC members covered under TRICARE Reserve Select at the time of the sponsor’s death, six months).

Another category with notable differences in eligibility is former Servicemember spouses. While the majority of former Servicemember spouses are only eligible for 36 months of continued TRICARE coverage through CHCBP, under certain circumstances coverage may be extended indefinitely. Eligibility for former spouses varies based on several factors: the length of the marriage that ended in divorce; the overlap between the marriage and the sponsor’s period of creditable service; the date that the divorce or annulment was finalized; and whether or not the former spouse has remarried. For care to be extended indefinitely, the "20/20/20 rule" must be met, meaning that not only must the former spouse remain unmarried, but 1) the marriage in question must have lasted at least 20 years; 2) the servicemember must have at least 20 years of service; and 3) the marriage and the service must overlap by at least 20 years. Marriages that met the "20/20/15 rule" – same requirements except only 15 years of the marriage and service must overlap – and ended in divorce prior to September 29, 1988 also entitle the former spouse to indefinite eligibility. Marriages that ended on or after that date only entitle the 20/20/15 spouse to an additional year of TRICARE.

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