



# CENTER ON BUDGET AND POLICY PRIORITIES

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## **MILITARY PENSIONS AND PAY BILL WOULD BE VERY COSTLY**

### **Senate to Consider Bill on February 22 Without Waiting for Soon-to-be-Released Reports on These Issues**

On February 22, the Senate is scheduled to consider S. 4, legislation to increase military pay, pensions, and educational benefits that the Senate Armed Services Committee approved February 2. A Congressional Budget Office cost estimate released February 12 shows this legislation is very costly. The legislation also raises other serious substantive concerns. For example, its military pension provisions could induce skilled personnel whom the military needs to retain to leave the armed forces early.

Major studies on military pay and pension issues by CBO, the GAO, and the Defense Department are nearing completion. A CBO study on military pay is expected to be released in March, while a second CBO study — this one on military pensions — is due in late spring. A GAO study on retention issues in the armed forces is scheduled for release in June. A Pentagon study on retention and military pensions also is nearing completion.

Prudent policymaking would defer action on this legislation a few months until these reports are released so Members of Congress can better judge the needs in these areas and how best to respond to them. Prudent policymaking also would defer action until Congress can act on the budget resolution; the budget resolution establishes overall budget parameters and priorities within which legislation such as this should be considered. Instead, the legislation is being rushed to the Senate floor before these reports are available and before consideration of a budget resolution. Moreover, the legislation contains no offsets to pay for its costly provisions.

The bill is spurring something of a bidding war. First, the Administration proposed expensive increases in military pensions that many analysts believe to be excessive. Then Senator John Warner, Chairman of the Senate Armed Services Committee, introduced a bill more expansive than the Administration's. Subsequently, amendments making the bill still more costly were added in Committee from both sides of the aisle.

- The bill increases *both* discretionary spending and entitlement costs. According to CBO, the legislation *increases discretionary spending by \$40.8 billion over the next 10 years*, with the costs rising each year. The costs reach \$6.5 billion a year by 2009 and would continue to rise for a number of years after that.
- The bill *increases entitlement costs by \$13.2 billion over the next 10 years* and also loses close to \$1 billion in revenues over this period, *bringing the bill's total cost to \$55 billion over 10 years*. Furthermore, the \$13.2 billion figure for the bill's added entitlement costs does not reflect its true costs when fully in effect. Most of the bill's increased entitlement costs for military pensions do not occur until *after* the end of the 10-year budget period.

CBO estimates that when the bill's costs reach their full dimensions, entitlement costs for pensions would rise 11 percent above the baseline, *which would result in increased costs of about \$5 billion a year*. Entitlement costs for veterans readjustment benefits (essentially educational benefits) also would rise rapidly. By 2009, costs for this program would jump \$2.5 billion a year, an increase of 170 percent over what CBO projects the program would cost under current law.

- When fully in effect, the bill as a whole would be very expensive, *costing about \$15 billion a year or more*.

The bill includes no offsets for these costs. On the discretionary side of the budget, other discretionary programs would have to be cut to accommodate these increased costs and keep discretionary spending within the statutory limits the 1997 budget agreement placed on such spending. On the mandatory side of the budget, the bill ultimately could help trigger a sequester of mandatory programs, including Medicare, if its costs are not offset in the months ahead by cuts in other mandatory programs or tax increases. (Whether the bill would help trigger a sequester would depend on the status of the "pay-as-you-go scorecard" at the end of the Congressional session.<sup>1</sup>)

The bill could affect other defense programs as well as domestic programs. Because of its high costs, there is a risk it could eventually squeeze out some other defense expenditures more vital to the defense of the nation.

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<sup>1</sup> A small amount of funding is currently available on the pay-as-you-go scorecard but could be consumed by other legislation, such as tax-cut legislation.

## The Military Pension Provisions

The provisions of the legislation dealing with military pensions are especially questionable. These provisions would largely repeal bipartisan reforms in the military pension system that were enacted in 1986 and were designed to retain more skilled personnel in the armed forces. A brief review of the developments leading up to the 1986 reforms is in order.

In the early 1980s, the military pension system was widely considered to be bloated and inefficient. OMB director David Stockman called it a scandal. The Grace Commission called for reforms in it. So did the Pentagon's own Quadrennial Review of Military Compensation. Not surprisingly, the military services resisted. Eventually, some reforms were passed, reforms considerably more modest than those the Grace Commission and various other reformers had recommended.

Prior to the 1986 reforms, the military pension system was not only exceedingly generous but also functioned in a way that undermined the goal of keeping skilled personnel in the military for more than 20 years.

- The median age at which pensioners began collecting these benefits was 43. Fewer than one in six pensioners were 65 or over.
- Military personnel could retire after 20 years and immediately draw a benefit equal to 50 percent of their final basic pay. There was no requirement for a retiree to reach a minimum age such as 55 before drawing benefits and no reduction for retiring at an early age. The pension benefits were fully indexed to the CPI.
- Military personnel thus could retire in their early 40s and begin drawing generous pension benefits while taking a job in the private sector (often for a defense contractor) that brought its own pension benefits. Eventually, they could draw military pensions, private pensions, and Social Security simultaneously.
- Military pensions started at a younger age, lasted for more years, and paid higher benefits than virtually any other major pension system in the United States, public or private. Moreover, military personnel do not contribute anything toward these pensions. The federal government pays all pension costs.
- These generous military pensions did *not* benefit most members of the armed forces. Fewer than one in five officers and enlisted personnel

served long enough to qualify. The pensions went to a relatively elite group within the military.

- Nor do the pensions go primarily to personnel with modest incomes. A *National Journal* analysis of Census data for 1982 found that 60 percent of all military pension benefits went to the wealthiest fifth of U.S. households. Some 83 percent of the pension benefits went to the top two-fifths.
- Of particular importance, this system created strong incentives for skilled personnel to leave the military in their early 40s, begin drawing a military pension, and take a private-sector job providing good pay and its own pension benefits. Indeed, the military pension system was expressly

#### **Past Calls for Reform**

"Military retirement is paid neither to the indigent nor, in most cases, to the retired."

- The late Les Aspin, then Chairman,  
House Armed Services Committee

"...the high cost of specialized training and insights developed only through experience have made forced turnover through early retirement an expensive and disruptive practice for many military occupations."

- The Ford Administrations' Defense  
Manpower Commission

designed many decades ago *to induce officers to retire from the military in their early 40s* so that younger, more physically fit men could take their place. That made sense decades ago when the military was far less technological and ground combat far more common. By the mid-1980s, it had become counter-productive, since today the military needs to retain highly skilled specialized personnel in their early 40s rather than lose them. This is one of the principal reasons the 1986 reforms were enacted.

#### **The 1986 Pension Reforms**

The 1986 reforms made two significant changes in the pension structure. First, those who entered the military after August 1, 1986 and retired after 20 years will receive a pension equal to 40 percent of final basic pay rather than 50 percent. (It should be noted that the pension level for those retiring after 30 years remains unchanged at 75 percent of final pay. The 1986 reforms were designed to enlarge

substantially the increase in pension levels that members of the armed forces would receive if they remained in the service after the 20-year point.)

Second, pensions for those who entered after August 1, 1986 will be indexed by the Consumer Price Index minus one percentage point, with a full catch-up at age 62, rather than by the full CPI. This reduction will have its largest effect on those who retire and begin to draw pensions at the youngest ages.

The 1986 reforms had a significant flaw in their design. Instead of phasing in these changes in the pension structure over a number of years, the law simply applied the new structure to those entering the armed forces after the August 1, 1986 date. Thus, those who entered in July 1986 are to receive pensions under the old structure, while those entering the service just a few weeks later will receive significantly lower pension benefits. The legislation thus created a large "notch" or cliff and generated considerable resentment within the armed forces as a result.

The appropriate remedy would appear to be to eliminate the notch by phasing in the reduction in pension levels from 50 percent to 40 percent over a 10-year or a 20-year period. (This would be similar in a sense to the approach taken with regard to Social Security in 1983 when Congress phased in over 22 years the increase in the age at which beneficiaries can retire and receive full Social Security benefits from 65 to 67.)

Unfortunately, political pressures now seem to have precluded this more-moderate, less-costly approach. The Clinton Administration proposed in its new budget simply to repeal the reduction from 50 percent to 40 percent in pension levels. The Senate Armed Services Committee then went further; the bill it passed and sent to the Senate floor would give armed forces personnel the choice between receiving benefits under the pre-1986 pension structure — with *both* the 50 percent pension level *and* full CPI indexing restored — and receiving benefits under the pension structure enacted in 1986 supplemented by a \$30,000 lump-sum payment upon reaching 15 years of service.

The bill coming to the Senate floor also would make veterans' readjustment (i.e., educational) benefits much more generous than under current law. By 2009, the bill would increase the cost of veterans' readjustment benefits by \$2.5 billion a year, with the costs continuing to grow in years after that. In addition, the bill would provide military pay raises in 2000 that would be well above the general inflation rate in the U.S. economy,<sup>2</sup> along with pay increases at levels exceeding inflation in years after that.

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<sup>2</sup> The pay increase would be 4.8 percent in 2000. OMB projects the CPI will rise 2.3 percent in 2000; CBO projects the CPI will rise 2.6 percent.

## **Are Changes Warranted That Are This Costly?**

There are serious doubts about whether changes this costly are warranted. Members of Congress will be in a better position to judge these issues when a series of soon-to-be-released studies by CBO, GAO, and the Pentagon are issued. One CBO study is examining whether a military pay gap exists and, if so, what its dimensions are. A second CBO study is examining the impact of military pensions on retention. The GAO is looking into the reasons for retention problems and possible solutions. All of these studies are expected to be released by June.

Unfortunately, the Senate Armed Services Committee acted, and now the full Senate plans to act, before these reports are available. Acting on legislation this intricate and costly before the best assessments of the issues at hand are available to policymakers is not sound policymaking.

It also may be noted that those seeking to repeal the 1986 pension reforms tend to use the same arguments as were advanced by those who resisted the reforms at the time the reforms were enacted — namely, that the generous pensions provided under the pre-1986 law are needed to attract personnel into the armed forces and retain them. In the mid-1980s, those arguments were subject to close scrutiny and found to be weak. For example:

- Surveys of first-time enlistees in the early 1980s found the military retirement system to be low on the list of reasons cited by recruits for joining.
- The Pentagon estimated in the early 1980s that 13 percent of officers and enlisted personnel would serve long enough to receive a pension. If the retirement system were truly a strong enlistment incentive, one would have expected a larger percentage of the recruits to remain in the service long enough to qualify. If the vast majority of recruits never received retirement pay, it is unlikely the pension system was a major recruitment tool.

Furthermore, a recent study by Dean Dudley, an economist at West Point, found the more generous pensions in place for those entering the armed forces before August 1986 to have little effect on retention. Dudley examined 2,263 Army officers commissioned in 1987, a group that includes some officers entitled to 50 percent pensions after 20 years due to earlier connection with ROTC or military academies, and

some entitled to 40 percent pensions. Dudley's study found retention rates between the two groups have been nearly identical so far.<sup>3</sup>

## **Conclusion**

There were sound reasons for the 1986 reforms in terms of controlling long-term entitlement costs, curbing excesses in what seems to have been a gold-plated retirement program, and reducing disincentives for skilled personnel to leave the military in their early 40s. These changes resulted from years of study and hearings. They should not be discarded, and other expensive new benefits added, without even waiting for forthcoming studies on these issues. Furthermore, if these changes are enacted and the overall defense budget is limited at some future point, the magnitude of the added costs for these benefits could squeeze out expenditures that are more critical for the national defense.

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<sup>3</sup> Bradley Graham, "Military Pension Maneuvers: Costly Rush to Misjudgement?" *Washington Post* February 11, 1999, p. A35.