OVERVIEW OF ALTERNATIVES

In light of the Air Force’s personnel situation, the civilian labor market trends that are adverse for the Air Force, and the small differences in pay across skill areas, it is useful to consider alternatives that could improve Air Force pay and create greater pay differentiation. We consider three alternatives.

• Alter the current compensation system by better measuring civilian pay, improving reenlistment bonuses, better recognizing hostile duty, and changing the pay table to better reward individuals who have demonstrated superior capability in their skill.

• Introduce a new pay component, skill pay, which would provide compensation for demonstrated skill attainment.

• Introduce capability pay, which would be based on current and future capability in the military, particularly leadership capability.

Before discussing these alternatives, we consider a different approach to improving the compensation that Air Force personnel receive over their military careers. That approach would be to raise the career pay of Air Force personnel by modifying the promotion system and specifically by reducing the length of time it takes to reach E-5.

Because promotion to E-5 takes roughly two years longer in the Air Force than in the other services, it seems likely that the Air Force
could gain the support needed from the other services, Congress, and the Administration to speed up its promotion rate. Advancing promotion by two years would give Air Force personnel a significant pay raise. For instance, if an airman were an E-6 instead of an E-5 at YOS 10, his or her basic pay would increase by about $2,500. Faster promotion to E-5 would accumulate in higher pay over all subsequent years, increasing the present value of career pay. This could be expected to increase both first-term retention and retention at higher terms.

Speeding up promotions might require significant changes in Air Force personnel management, however. A job that today requires a new E-5 might be revised to require an E-5 with two years’ experience in grade, and so forth. Promotion criteria would also need to be revised.

One drawback of speeding up promotions is that, if such an approach were applied uniformly to all specialties, pay would be increased even in specialties where no retention problems existed. Yet if retention shortfalls were widespread and were expected to persist, this inefficiency would probably be minor. Alternatively, the Air Force could consider speeding up promotions selectively. Promotions could be accelerated in specialties where the Air Force wants to increase career length or where outside wages are highest. As a result of selectively changing promotion speed, differences in rank would no longer reflect differences in military responsibility alone but would also reflect market opportunities. This would be a significant (and not necessarily welcome) departure from the long-time policy of providing equal promotion opportunity regardless of specialty.

**ALTERING THE CURRENT COMPENSATION SYSTEM**

The potential changes in the current system discussed in this section should be put in context. They represent modest changes to the current compensation system rather than aggressive changes to the components, levels, or structure of the current system. Furthermore, the changes are not exhaustive but instead form a feasible alternative to developing entirely new types of pay such as skill pay and capability pay. As the previous chapters make clear, the success of these changes should be judged in terms of the services’ recruiting and
retention outcomes. Thus, continued monitoring of recruiting and retention success is also important.

**Measuring Civilian Pay Accurately**

During the 1990s, the annual adjustment in basic pay equaled the lagged change in the Employment Cost Index (ECI), as prescribed by law. This version of the ECI measures how wage and salary costs change among private-sector establishments. Although the ECI measures overall wage and salary growth accurately, wage and salary growth can differ for different groups. In particular, the active-duty military force differs from the labor force at large by being younger and more educated, and the wages of younger, more educated workers tended to grow more rapidly than did the ECI in the 1990s. As a result, increases in basic pay fell short of increases in the market. And because the economic expansion lasted so long, these differences mounted from year to year. Therefore, although the ECI provides a useful starting point for considering how much to adjust basic pay, it is equally or more appropriate to check wage growth for the groups whose age and education are most comparable to those of military personnel. This can be done without legislative action. Detecting faster wage growth would naturally argue for a higher adjustment to basic pay.

Not looking at civilian wage growth relevant to military personnel runs the risk of misadjusting basic pay. However, tracking the wages of multiple groups leads to multiple estimates of wage growth. These must be considered jointly in deciding on guidance for adjustments to basic pay—a more complicated procedure than using a single index. Still, one benefit of detailed wage tracking is determining the extent to which military pay appears to be out of alignment with civilian pay by age, education, or occupational specialty. Such focused comparisons can be used in developing requests for bonus budgets or adjustments in special pays.

Thus, a case can be made for close monitoring of civilian wages accompanied by periodic, in-depth analysis that might require special surveys or the acquisition of special data. The process of tracking civilian wage opportunities would be greatly assisted if DoD arranged to link the personnel records of service members with their postservice earnings. The Internal Revenue Service offers the best
potential source of information on postservice earnings, followed by
the Social Security Administration. (IRS data are preferable because
the SSA caps earnings subject to Social Security contributions.) But
confidentiality considerations may ultimately preclude interagency
cooperation. If so, perhaps the best recourse is a periodic DoD sur-
vey of veterans. The survey would have to be designed to sample
certain veterans from certain military occupational areas at higher
rates. A DoD survey could also ask about postservice training, edu-
cation, employee benefits, and other items, and the survey could re-
quest permission to link a respondent’s survey data to his or her mili-
tary personnel record. This information would help illuminate what
kind of jobs veterans took, in which occupations and industries, how
much they were paid, how long it took them to find an initial posi-
tion, and how frequently they changed jobs. It would also help iden-
tify what aspects of their military experience—training, teamwork,
leadership, know-how gained from assignments and missions—
proved most valuable.

**Improving Reenlistment Bonuses**

In hindsight, higher and more pervasive reenlistment bonuses might
have reduced the decline in Air Force first- and second-term reen-
listment rates. The Navy paid reenlistment bonuses in 1999 to 15
percent of its personnel, the Army to 11 percent, and the Air Force to
10 percent. The average bonus payments were $4,452 for the Navy,
$1,949 for the Army, and $3,167 for the Air Force. The Navy’s experi-
ence illustrates the feasibility of paying more and larger bonuses. The
Navy’s personnel leaders might be a useful source of information on
whether the bonuses have hurt Navy culture or helped it.

To make reenlistment bonuses into a more effective tool for short-
term response in the Air Force, there should be a prior understanding
of the conditions that would trigger an increase in funds for bonuses
*within* a fiscal year and an expectation that the funds would be made
available. We understand that the services must fund additional
bonus outlays from their own budgets and must first obtain
permission from Congress to reallocate the funds. The notion that
unexpectedly large reenlistment shortfalls can be tolerated for a year
until new budget allocations are made, and that the new budgets will
be sufficient to restore reenlistment, found limited support in the 1990s—until the dire conditions of 1999.

In principle, bonuses are a superb instrument for managing actual or impending shortfalls in reenlistment, particularly in response to temporary or cyclical variations in the factors that affect reenlistment in a particular occupational area. Because of persistent threats of shortage in some areas, bonuses tend to raise compensation in some specialties on a semipermanent basis; i.e., certain specialties tend to receive bonuses year after year. Given that bonuses provide an “equalizing differential” to make military pay more competitive with private-sector pay in these areas, it is to be expected that some of a year’s bonus budget is in effect preprogrammed. Within a fiscal year, the opportunity for adjusting bonuses often entails a choice of reducing the presence or amount of a bonus in some specialties in order to introduce or raise them in others. There may also be little willingness on the part of the leadership to move money from nonpersonnel accounts.

Another concern is that making bonus amounts and bonus budgets highly responsive to manpower supply shortfalls might induce “gaming” behavior, with some members delaying their reenlistment decisions to see whether bonuses will rise. If so, tying reenlistment bonuses to expected personnel shortfalls could be problematic.

A greater worry is that bonuses will become too prominent a component of pay. From an airman’s perspective, bonuses are temporary additions to pay for the duration of the current term. Their amount in the future is uncertain, and they do not count toward retirement benefits. But bonuses offer cash today, not deferred benefits, and many personnel do not stay for 20 years. In general, the present value of bonuses to the airman if they were counted toward retirement benefits depends on the airman’s discount rate and probability of reaching retirement eligibility at 20 years of service. With personal discount rates typically 20 percent per year and higher (Warner and Pleeter, 2001), the present value of incremental additions to retirement benefits is small. Further, it is smaller than the present value of the cost to the government of financing the benefit on an accrual basis.
From the Air Force’s perspective, the relationship of bonuses and retirement raises an issue of the optimal experience mix within a specialty area. Although it may be desirable to increase the average years of service, it may not be desirable to increase the proportion staying to 20 years or longer. The answer may vary from specialty to specialty, so the value to the Air Force of tying retirement benefits to bonus amounts would also vary by specialty.

Certainly, the bonus instrument could be made more responsive than it is today. Bonus amounts could be adjusted during the course of the enlistment term. For example, bonuses could be indexed to rise if the current bonus step rose above the level that prevailed at the time of reenlistment. This would result in higher bonus payments in areas where manning shortfalls are becoming more critical, and the higher payments should reduce within-term attrition (although such attrition is low after the first term). If personnel anticipated the indexing of their bonus payments, the expected value of staying in the military would increase, thereby improving future reenlistment rates. Moreover, uncertainty would be diminished if there were a stronger expectation that the bonus would continue into the next term, e.g., through an early commitment by the service.

Bonuses might also be modified to provide greater incentive for skill acquisition. In particular, the bonus anniversary payment could increase with skill level. Depending on how “skill” and “skill level” are defined, the role of bonuses could be expanded: They could be used not only to avoid manning shortfalls in an occupation but also to provide an incentive for skill acquisition during the term. Skill could be defined broadly to mean the skills and knowledge typically acquired within a narrowly defined (3-digit) occupational specialty, or it could be defined narrowly to mean the acquisition of particular skills and knowledge. The Air Force already designates skill levels within a narrowly defined occupation. Presumably, it would be possible to define skill steps between levels if existing levels (i.e., 1, 3, 5, 7) were thought to be too few. This would create possibilities for bonus payment increases during the term, and it would offer an additional degree of freedom in setting bonus amounts, which today depend on basic pay at the time of reenlistment. A bonus that accounts for skill level increases during the term might have the added advantage of increasing the reenlistment rate of high-aptitude high performers. In addition, Developing Aerospace Leaders (DAL)
certification standards provide another indicator of skill, and bonuses could be structured to pay an amount dependent not only on basic pay at the time of reenlistment but also on a member’s DAL certification.

Modifying reenlistment bonuses to reward skill and provide incentives for skill acquisition could also enable the Air Force to implement more-variable career lengths and YOS/grade mixes across skill areas. Such variability may be desirable when skill areas vary in the costs of recruiting and training, length of the learning curve, and value of experience to the organization. Reenlistment bonuses could be targeted to areas where longer careers are cost-effective. However, if the incentive were to remain in place and be stable in value, it might be better to consider a special pay rather than a bonus. The special pay could be “stepped” by year of service and grade.

However, using reenlistment bonuses or special pay in a way that results in more variable career lengths would require changes in the personnel management system and most likely in the Air Force culture, which seems to provide an implicit promise that careers will be quite similar regardless of skill.¹

**Reshaping the Basic Pay Table**

Capability pay is designed to reward people for demonstrating superior leadership capability in their current and future jobs. It also provides an incentive for capable personnel to stay in service. But to some extent the same outcomes could be achieved by reshaping the basic pay table. It may seem paradoxical that the basic table can be used to reward capability: The table is common to all personnel, but not all personnel are highly capable. However, changes in the structure of the pay table and personnel management methods that provide greater incentives for capability may be feasible.

Incentives for increasing effort and retention and for sorting capable members into influential positions could be strengthened by restructuring the basic pay table to make pay grow increasingly rapidly with

¹This is a generalization. An obvious exception is the management of Air Force pilots, where there are special pays (Aviation Career Incentive Pay, Aviation Officer Continuation Pay) as well as service commitments.
rank. Such a change would “skew” the table with respect to rank because each promotion would result in an increasingly larger pay increase. By creating nonlinearly higher rewards, skewness increases the incentives for effort and retention at any lower rank and, most important, maintains strong incentives as personnel move up through the ranks.² Highly capable members should benefit because, if they exert effort, they are likely to progress faster. In turn, this benefits the Air Force by ensuring a supply of highly capable members to high-ranking positions, where decisions can have greater consequences. A skewed pay structure is appropriate in an organization where the probability of promotion declines with each successive promotion (a pyramid-shaped hierarchy).

Microsimulation modeling of retention and productivity among Army enlisted personnel showed that increasing the skewness of the basic pay table increases effort incentives and the retention and sorting of high-ability personnel (Asch and Warner, 1994). The same model was used to analyze the components of the FY00 pay legislation and their effects on retention and productivity. The model predicted that the pay action would have a large positive effect on both retention and productivity (Asch and Hosek, 1999). This result is not surprising given that the legislation included pay table reform (which was subsequently implemented in July 2000). The reform gave pay raises to midcareer personnel in a way that generally rewarded promotion over longevity.

The microsimulation model showed that it is theoretically feasible to increase the capability of the military force through restructuring the pay table. While it is also possible to increase capability by raising basic pay across the board, the simulation modeling demonstrated that skewing is more cost-effective because it targets basic pay to higher-grade and therefore more-senior personnel, who are less numerous.

²To maintain effort incentives among midcareer personnel and to maintain retention incentives among the most capable officers and enlisted personnel, the reward to promotion should rise with rank. This is also necessary because there are fewer promotions to achieve in the future, as individuals ascend the ranks. To maintain incentives, the “contest prize” or promotion reward needs to increase with rank to offset the fact that there are fewer performance “contests” in which to participate.
The mechanism by which a restructured pay table would result in greater pay for capability is promotion, an event that may occur infrequently and depends on one’s current rank and years of service. When promotions are infrequent, the discounted present value of the future higher pay associated with promotion is smaller. Therefore, the degree of pay skewness must increase when promotion speed is slow, in order to offset the effect of slow speed on expected future pay.

One disadvantage of relying on promotion to implement greater pay for capability is that promotion speed either may not vary much across skill or occupational areas or it may vary in a way that does not adequately reflect the differential demands for capability across occupational areas. Air Force culture puts a premium on providing individuals with equal promotion opportunity, regardless of occupation. If the pay table were restructured to become more skewed and, therefore, to reward and provide incentives for capability, the similarities in promotion speed across Air Force occupations will result in little differentiation in pay. Alternatively, varying promotion speeds across skill or occupational areas would differentiate pay.

Pros and Cons of Improving the Current System

The previous paragraphs discussed how the pay table and bonuses could be modified to strengthen incentives for retaining and motivating high-capability members, for acquiring skill, and for creating careers of different expected lengths. These changes seem compatible with the Air Force’s culture of equal promotion opportunity regardless of occupation.

There are a number of reasons why pay policies to achieve these goals should build on the current compensation system rather than on entirely new types of pays or pay systems. Probably the most compelling is that the current system has been in place since the Hook Commission issued its report in 1948, and—who the system has been subject to some criticism—service members and policymakers have demonstrated enormous confidence in it by their reluctance to change it. It has stood the test of time, including the transition from a draft force to a volunteer one, from a post–World War II peacetime force to a wartime force during the Korean and Vietnam eras, and from a Cold War to a post–Cold War force. These forces
have varied in size, personnel experience, skill, and aptitude. Nonetheless, the basic structure of the compensation system has changed relatively little, and there appears to be considerable consensus that the system has worked well enough, with a few occasional adjustments, throughout the past 50 years.

**The Common Pay Table.** One reason for the longevity and popularity of the current system, and why building on it by improving the current bonus system makes sense, is that the current system uses a common pay table for all personnel. It thus provides concrete evidence of the value of a common culture in the military, and it recognizes the equal value placed on patriotism and service, regardless of the member’s particular skill area or branch of service. Furthermore, a common pay table helps make the compensation system transparent to the entire military community, including the reserve components, and makes changes clear and open. Movement through the pay table depends on promotion criteria that are also widely known, and a promotion process that, we think, is perceived by members as fair. The salary and merit systems used in the private sector are often much less transparent.³

A common pay table in which longevity increases are automatic and where promotions occur periodically and are based on demonstrated ability and achievement also has desirable features from an efficiency or cost-effectiveness standpoint. First, automatic longevity increases save the Department of Defense and the taxpayers the cost of conducting annual performance reviews for all military members. If the military moved to a merit-based system or a skill-based system that required periodic, perhaps annual, adjustments that could differ across small groups or even individuals, the cost of administering such a review system might be prohibitive. Administration of the system would require the time and effort of supervisors to provide input, Air Force coordination of the information, distribution of the information to salary review boards, meetings of salary review

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³Because workers usually do not know others’ salaries, they may believe, rightly or wrongly, that they are underpaid relative to their coworkers. Still, openness would not necessarily stop criticisms of a firm’s compensation system. Workers might question why one group is paid more than another, or why certain workers should have merited promotion to a higher grade.
boards, and justification of the reviews to individual members.\(^4\) Furthermore, once a significant part of an individual’s annual pay adjustment fell under the jurisdiction of immediate supervisors and was not necessarily tied explicitly to easily measured or well-known benchmarks, individuals could take actions to influence the supervisor’s assessment to ensure a positive assessment. Such “influence” activities would be in the organization’s best interests if they resulted in improved performance on appropriate tasks, but would not be if they were intended only to make a person appear productive without any genuine increase in performance. In addition, individuals who were unhappy with their salary action might write letters to their congressional representatives complaining about the system, resulting in a perception that the system did not work, even when it did.

Currently, the promotion system provides a periodic performance review. However, promotions are generally viewed as a successful tool to pay members more and provide them with an incentive to work hard and attain the skills necessary to gain a promotion. The promotion system is not viewed as having excessive administration costs, given the value it provides in sorting and selecting personnel, and personnel do not seem to complain unduly about promotions. In large part, the perceived fairness of the promotion system rests on the fact that promotions are based on well-known criteria that all individuals have a relatively equal opportunity of meeting.

Another important fact to note about promotions: Despite the common pay table, pay can vary across individuals because of differences in promotion speed. Promotion speed operates to differentiate pay among individuals.

**Arguments for Changing the System.** There are also strong arguments against building on what some critics view as a flawed system. Although a common system—particularly a common pay table—has merits, it is criticized as a “one-size-fits-all” system that inhibits force management flexibility. Bonuses and other special and incentive pays create some pay differentiation among military personnel. In

\(^4\)Not all promotions require centralized overview. For instance, enlisted promotions to lower grades can be made at the discretion of the local commander.
addition, they help prevent low retention and thereby tend to keep retention profiles more similar across occupations than they would otherwise be. The result is a high degree of consistency in the career length and experience mix of personnel across occupations. However, bonuses and special pays could be used to create more-varied career lengths and experience mixes. That is, an old tool could be used in a new way. Career lengths are also heavily influenced by basic pay and retirement benefits. We have discussed the potential advantages of adding skewness to the basic pay table, which might be thought of as a major modification to the table. A more radical change would be to alter the retirement system.

**The Retirement System and Flexibility in Force Management.** Arguably the biggest impediment to managing the force flexibly is the military’s 20-year retirement system. Regardless of occupational area, the system tends to lock mid-career personnel in “golden handcuffs” until YOS 20 and gives them an incentive to leave at 20 years of service and begin collecting benefits. The services have come to accept the retention lock-in as a commitment that must be maintained to keep faith with successive cohorts of personnel. This can be viewed as an equilibrium situation. Service members are willing to commit to high retention given their beliefs about the stability of the compensation system, especially the commitment to retirement benefits. In addition, the services are willing to commit to sustaining the compensation system given their beliefs about how service members’ retention and commitment to duty respond to it. Any move to deviate from the commitment threatens to destroy the current equilibrium. Any system will have flaws, and criticism of the current system is inevitably destabilizing if it is not accompanied by the presentation of positive alternatives for change. To gain acceptance, alternatives not only must hold promise of being superior when fully implemented but also require a transition plan that conserves the interests of incumbent personnel who otherwise would be affected by the scope of change or pace of transition.

That said, the role of compensation is so important in meeting national security manpower requirements that a periodic critical evaluation is in the nation’s interest. Past studies, including most recently a report from the Defense Science Board, recommended restructuring the military retirement system. A restructured system would vest retired pay earlier—say, at YOS 10 or YOS 5—and the new
retirement system would resemble a thrift savings plan, where both the member and the government contributed to the investment fund and the retirement benefit depended on the level and timing of contributions. These studies also recommended making the military compensation system more cost-effective by putting a larger fraction of military compensation into basic pay and other up-front forms of pay such as bonuses. Cost-effectiveness would be improved because service members, who on average are quite young, value pay that occurs earlier in their career far more than pay that comes in the form of retirement, whereas the cost to the government would not change as much. Pay actions, such as the FY00 legislation that offers a $30,000 bonus to members at YOS 15 who choose to stay until YOS 20 and retire under REDUX, and actions that increase basic pay and the role of bonuses, are policies that can help improve the overall cost-effectiveness of the military’s compensation system.

Because of the current system’s limitations, it is useful to contemplate other approaches to implementing greater pay differentiation in the Air Force while also addressing the Air Force’s recruiting, retention, and pay issues. The next sections consider two alternatives: skill pay and capability pay.

SKILL PAY

Skill pay would provide remuneration for designated skills. Skill is not synonymous with occupation. A skill and an occupation might be the same, a skill might be present in several occupations, or it might be present among only some members of an occupation. To understand the prospective role of skill pay, we have found it useful to contrast skill pays with reenlistment bonuses. We have done this in Table 4.1. As the table suggests, a key rationale for skill pay is to protect a valuable stock of current and future human capital when replacing that stock is costly and time-consuming. This rationale contrasts with that of SRBs, whose purpose is to prevent or address shortages in the flow of personnel currently needed to meet manning requirements in certain specialties. The emergence of bonuses as the chief retention incentive had occurred by the mid-1970s, as bonuses supplanted proficiency pay.
It is instructive to review the history of proficiency pay, if only because “proficiency” sounds closely related to “skill.” The purpose of proficiency pay and its companion, special duty assignment pay, was to induce the retention of enlisted personnel who were “required to perform extremely demanding duties or duties demanding an unusual degree of responsibility,” and to induce “qualified personnel to volunteer for such duties” (p. 477).

Proficiency pay resulted from the deliberations of the Defense Advisory Committee on Professional and Technical Compensation (also called the “Cordiner Committee”). In 1957 it recommended a change in the pay structure that would allow the promotion of a member to a higher pay grade without promotion to a higher rank. The Uniformed Services Pay Act of 1958 permitted the service secretaries “to choose such a ‘proficiency pay grade’ method for compensating members ‘designated as . . . specially proficient in a military skill’” (p. 477). It also permitted the service secretaries alternatively to pay a flat rate of up to $150 per month as proficiency pay. They chose the latter method and never used the proficiency pay grade method; that is, the secretaries elected not to sever the connection between pay grade and rank.

Three types of proficiency pay were established: shortage specialty proficiency pay, special duty assignment proficiency pay, and superior performance proficiency pay. Shortage specialty proficiency pay was displaced by the SRB in 1975 and phased out rapidly. By 1977, only 7,000 personnel were receiving shortage specialty pay, compared with 135,000 in 1975. In 1982, the shortage specialty pay program was absorbed into the special duty assignment pay program. Superior performance proficiency pay was authorized until 1976 and then terminated. Special duty assignment proficiency pay was paid to “personnel performing such voluntary duties as recruiters, drill instructors, or reenlistment NCOs” (p. 478). In 1985,
Table 4.1
Features of Reenlistment Bonuses and Skill Pays

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<th>Feature</th>
<th>Reenlistment Bonus</th>
<th>Skill Pay</th>
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<td>Rationale</td>
<td>Prevent manning shortages in critical specialties. Shortages occur when the flow of personnel in a specialty is too far below the current requirements for personnel in that specialty. Assessments of shortage are done by “zone”; i.e., by year of service range.</td>
<td>Prevent loss of critical skills, even if those skills are not used on current assignment and/or are not in short supply in critical specialties. Skill pay helps to conserve human capital that would be difficult, costly, or time-consuming to replace and is deemed vital to maintain the capability necessary to meet readiness requirements.</td>
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<tr>
<td>Amount</td>
<td>Bonus amount is the product of bonus step, basic pay, and term length. Bonus step ranges from 0.5 to 6.0 in increments of 0.5.</td>
<td>To be determined. The amount is presumably a function of the value of the skill to the service and the cost of replacing the skill in the short run and/or in the long run. The amount may also depend on the value of the skill in the private sector.</td>
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<tr>
<td>Duration and payment schedule</td>
<td>Payable over the term of service. The initial bonus payment is made at the time of signing the enlistment contract and typically equals 50 percent of the bonus amount. The remainder of the bonus is paid in annual installments on the anniversary date of signing.</td>
<td>To be determined. For example, skill pay could be a flat dollar amount per month or a percentage of basic pay. The percentage could rise as basic pay increased over a career. Duration of payment would depend both on the member’s eligibility and on the service’s determination that the skill should receive skill pay. For instance, at some future date the service might determine that the skill is no longer eligible. Also, the payment schedule could be designed to have an end point, e.g., YOS 20 or YOS 25, and a start point.</td>
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<td>Eligibility</td>
<td>The member must be eligible to reenlist. The service must determine that the specialty is critical and has a current shortage.</td>
<td>The member must demonstrate that the skill has been obtained and maintained. The service must determine that the service's stock of the skill is critical to readiness and would be less than the desired stock if skill pay were not paid.</td>
</tr>
<tr>
<td>Adjustment</td>
<td>The service can change the bonus multiple at its discretion. Changes are typically not made more than quarterly.</td>
<td>To be determined. Skill pay would presumably be paid to all personnel possessing an eligible skill (not just to the personnel who reenlist at a given time). Adjustments would therefore affect all such personnel. Frequency of change in skill pay level would depend on a periodic assessment of the internal and external value of the skill and its replacement cost.</td>
</tr>
<tr>
<td>Harmonizing skill pay with other pays</td>
<td>Other pays include bonuses, proficiency pays, Aviation Career Incentive Pay, Career Sea Pay, and others. These pays affect the retention of personnel. It may be that personnel who possess an eligible skill are in specialties or assignments where retention is high. Payment of skill pay to these personnel would not be needed to protect the stock of skill but might nevertheless be made. Other personnel who possess an eligible skill may be in specialties or assignments where retention is low. Here, skill pay would help protect the stock of the skill. Targeting skill pay conditional on retention would lower the cost of skill pay.</td>
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<td>Harmonizing skill pay with other pays</td>
<td>But targeting would make the receipt of skill pay, and its amount, more uncertain to the member, reducing its value as an incentive to obtain and maintain the skill. If skill pay were paid to all members with an eligible skill, it might be possible to reduce bonus amounts in some cases.</td>
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<tr>
<td>Stability over a career</td>
<td>The bonus is valid for the duration of the term. There are no guarantees that a bonus will be available at the next reenlistment point.</td>
<td>Presumably, skill pay would be highly stable over a career. The set of eligible skills would probably be stable over time. The payment schedule would be stable, e.g., a percentage of basic pay or a rising percentage of basic pay. And the end point of payment, e.g., YOS 25, would also be stable.</td>
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<tr>
<td>Flexibility</td>
<td>Bonuses are highly flexible. Bonus multiples can be changed frequently, and service members are aware of this.</td>
<td>Frequent or large changes would undercut the value of skill pay. But the service would ultimately have to retain flexibility to make changes. Rigid pay schedules would be inefficient in the long run if the need for a skill diminished. If payment level were maintained even though the need for the skill had decreased, members might come to view skill pay as unjustifiably inequitable.</td>
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<tr>
<td>Equity</td>
<td>On average, there is a high degree of horizontal equity in military pay. Given grade and year of service, bonuses create a fairly small difference in pay, e.g., $1,000–$3,000 per year among enlisted personnel. For most enlisted</td>
<td>Skill pay would create persistent differences in pay depending on a member’s skills. The size of these differences would depend on the skill pay schedule, which remains to be determined. Small inequity already exists in military pay, and it is reasonable</td>
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<td>Equity personnel, this is less than 10 percent of their RMC. Officer pay is also highly equitable, granted an exception for special and incentive pays related to aviation and medicine.</td>
<td>to expect that small additional inequity would be acceptable if the reasons for it were well known and perceived to be valid. A large increase in persistent inequity could be cause for concern. Service members might doubt why, in times of war or during peacetime operations, their value to the service should be less than that of a member in a designated skill.</td>
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new proficiency pay authority limited such pay to special duty assignments. Special duty assignment pay was payable to members “when required to perform ‘extremely difficult’ duties or duties ‘involving an unusual degree of responsibility in a military skill’” (p. 478). The word “proficiency” was dropped.

The history of proficiency pay suggests that much of the intent of the Cordiner Committee was lost along the way. The committee sought to create a pay for members who were “specially proficient in a given skill.” In practice, proficiency pay served to increase retention in specialties with shortages—even though the shortages might be completely unrelated to a member’s skill proficiency. Proficiency pay also compensated for particular assignments that, again, were not necessarily related to skill proficiency. Only superior performance proficiency pay seems closely related to the spirit of the Cordiner Committee’s recommendation, in the sense that superior performance is a demonstration of proficiency.

In any case, it appears that neither proficiency pay nor bonuses had the purpose of conserving the stock of a particular skill. So skill pay represents a departure from the domain of both those pays.

Skill pay could enable the Air Force to give explicit recognition to the differing external market opportunities available to personnel in various skill areas. It could provide a means of explicitly rewarding and providing incentives for acquiring and maintaining skills that are
essential for military readiness and difficult or costly to replace. Arguably, all skills are essential for military readiness, but some skills are particularly costly or time-consuming to replace. Because skill pay could vary across specialties or skill areas, it could create a means of varying career pay profiles across specialties or skill areas and thus result in different retention profiles and career lengths. Skill pay would be paid to those who have a given skill, even if they are not using that skill on their current assignment. The rationale for this approach is that it enables the Air Force to prevent the loss of critical skills and to maintain a ready inventory of the skill in case of loss of that skill or unexpected demand for it in the future.

Skill pay has some disadvantages. Once established, skill pay should be varied only gradually. Otherwise, pay would become less predictable for a given member, and the pay system could appear capricious. But problems can also arise if skill pay becomes too rigidly established. If changes in military technology and strategy bring changes in skill requirements, the skills covered by skill pay should change—but might not. Similarly, if the external civilian labor market shifts toward new skill areas, the ability of the Air Force to meet these shifts would be hampered by a system that defined too rigidly which skills qualify for skill pay.

Implementing skill pay would require that both the Air Force and Congress define how skill pay would operate. For instance, skill pay can be a flat amount per month regardless of rank and year of service, or a flat amount varying by rank and year of service, or a percentage increment to basic pay where the percentage might vary by rank or year of service. If it were implemented as a flat amount regardless of rank or YOS, skill pay would resemble proficiency pay or hazardous duty pay, such as Parachute Duty Pay. Those pays are a flat amount paid to compensate for the danger and skill associated with such duty, regardless of rank or experience.

There are two potential problems with defining skill pay as a single, flat amount. First, the value of the pay erodes over time with inflation. Although its value can be indexed (and Congress has implemented indexing for some military-related benefits, such as the Montgomery GI Bill), indexing is not currently used to maintain the value of S&I pays. Therefore, to ensure that the value of flat-rate skill
pay is maintained, attention would need to be paid to indexing its value.

Second, an important goal of the military’s compensation system is to provide incentives for individuals, especially high-quality personnel, to work hard and effectively. Currently, this goal is primarily achieved by means of promotion pay increases that exceed longevity increases in the basic pay table. For incentives to be maintained throughout a military career, it is critical that the pay be skewed with respect to grade. By *skewed*, we mean that the pay increase associated with promotion rises with each successive promotion so that, for example, the monetary reward for a promotion to E-9 exceeds that of a promotion to E-8. The problem with flat dollar amounts of pay is that they reduce the skewness of the pay system, thereby reducing the incentives for performance and productivity. Flat dollar amounts are a larger percentage of pay for individuals in lower ranks than for those in higher ranks. Thus, they flatten the pay system and reduce the relative rewards for higher promotion, dampening incentive. In contrast, skill pay that is a percentage increment to basic pay, where the percentage might rise by rank or year of service, could enhance incentive by increasing the degree of skewness and increasing the relative rewards to higher promotion.

The skill pay percentages could be designed to vary by skill group, so that different groups differed in their rewards for promotion versus experience versus time in grade; that is, skill pay could break the link between rank and grade.

Skill pay would create persistent differences in pay across members and would thus decrease pay equity. The military pay system has a high degree of pay equity, although there are pay differences due to special and incentive pays and allowances. Small increases in inequity probably would not be disturbing, especially if members understood the reasons for the change in pay structure. However, large increases in inequity might create tensions. Pay inequity is difficult to explain on the battlefield when everyone is at risk and performing as a team is crucial. That said, some difference in pay might be cost-effective in assuring that manning requirements are met; i.e., that the right mix of personnel reaches the battlefield.
In addition to specifying the skill pay table and determining the mechanism for adjusting skill pay, the implementation of skill pay would require defining which skills to reward, assuring the skills have been acquired and maintained, and determining if and when skill pay terminates. The amount of skill pay could be based on pass/fail certification or on criteria assessing the breadth and depth of skills and possibly proficiency in their use. Some of the implementation costs are set-up costs and periodic fixed costs, e.g., for reviewing the skill pay schedules and the criteria for selecting skills. Other costs are recurrent, for example, assurance of a service member’s skill acquisition and maintenance.

CAPABILITY PAY

The Air Force must conserve the supply of personnel who have demonstrated their capacity for effective decisionmaking and leadership. Leadership is important in determining the effectiveness of an organization, and individuals differ in their leadership capability. Leaders in the highest ranks hold positions of greatest authority and responsibility; by implication the decisions made by high-ranking leaders can affect the efficiency and morale of all personnel under that authority. Timely, effective, cost-effective decisions have a direct bearing on military capability. Resources can be efficiently allocated to activities, or they can be misallocated—resulting in higher cost, lower output, and less capability. Good leadership can build cohesion, communicate objective and mission, and inspire personnel to peak performance. Weak leadership, even when cloaked in a “command profile” and stentorian voice, may result in wastage, lower performance, cynicism, the loss of personnel, and an unwillingness or lack of incentive to pass undistorted information from lower echelons to the top. These comments apply especially to officers, whose decisions can affect wide portions of the organization, and to senior enlisted personnel, whose role in accomplishing missions is equally vital.

The concept of capability pay, as we understand it, rests on the notion that personnel differ in their leadership capability. We assume that a person’s leadership capability depends on skills, knowledge, and experience, which in turn depend on opportunities, incentives, effort, and aptitude. Although an organization cannot provide a per-
son with talent for leadership, the organization can make people into better leaders by providing leadership training, relevant assignments, and incentives.

Capability pay is not implementable without an empirical basis for determining leadership capability. We do not have studies or evidence on the topic of what constitutes leadership capability, how it can be measured (e.g., in junior or midgrade officers and midcareer [E-5 and E-6] enlisted members), and how effectively such measures are put into practice. It is a difficult challenge to come up with objective criteria on what constitutes leadership capability, verify their accuracy and reliability, and provide assurance that they can be implemented without a heavy or excessive administrative burden. In some ways, the challenge is already being met through the process that determines who is promoted and who is selected for career-building assignments. What must be added to this process are the objective, implementable criteria for leadership capability.

A person’s accumulation of skills, knowledge, and experiences relevant to positions of high responsibility—e.g., command positions—might be either a coincidental by-product of coming up through the ranks or the result of careful, planned personnel management. The Air Force’s Developing Aerospace Leaders (DAL) initiative, for instance, represents a move toward careful planning. Further, an organization can provide incentives to induce personnel to pursue a path to develop their leadership capability. The incentives should induce high levels of effort and commitment and be at least strong enough to retain personnel in sufficient quantities to create an adequate-sized pool of future leader candidates. From these points it follows that developing leadership capability depends both on personnel management and on the structure of compensation.

Symptoms of concern about a system’s capacity to create future leaders include a lack of breadth and depth of experience among personnel. For instance, personnel might not be assigned to the full set of assignments thought to provide the best preparation, and they might spend too little time on an assignment to learn it in detail. These symptoms are closely connected with the personnel management system. Two other symptoms are low retention (e.g., high loss rate of captains) and a lack of incentive to solve systemic problems (e.g., an officer may avoid actions because they could be disruptive in
the short run, even though they may yield benefits after his assignment is over). These symptoms relate to the compensation system, including performance evaluation.

Capability pay would recognize superior individual capability—both current and prospective—presumably as revealed through current and past performance. Capability pay seems worth considering when the basic concern is either low retention of highly capable personnel, including future leaders, or inadequate incentive for effort. That is, stronger incentives to perform and increased retention rates are two reasons to introduce capability pay. Thus, capability pay would be based on performance, much like performance-based pay. By itself, capability pay will not directly solve problems related to a lack of breadth and depth of experience, which lie in the province of personnel management. But it could help in solving them by inducing personnel to select leadership tracks. Leadership tracks can point in various directions—e.g., being a general officer or holding high-level command positions in such fields as logistics, intelligence, acquisition, communications, or space. Thus, unlike performance-based pay, which directly links pay with current performance, capability pay also recognizes the potential for superior performance in the future.

When pay level is largely dictated by rank and year of service, as under the current pay system, there is no immediate reward for exceptional performance. Instead, the reward is deferred (future promotion) or indirect (e.g., selection for a prize assignment or location). As discussed earlier, the size of the reward must be larger if the reward is deferred (i.e., the degree of skewness must be larger), not only because the value of the reward is discounted but also because the probability of promotion to higher ranks is low. Offering capability pay is an alternative to restructuring the pay table: Capability pay could differentiate pay among individuals given their rank and year of service, and it could be structured to provide incentives for high performance throughout a service career.

Capability pay may also help retain high performers. These personnel form the pool of future leaders, and retaining and motivating personnel who perform exceptionally well today will confer a future benefit on the organization in the form of improved selectivity in choosing leaders. A large pool of well-qualified personnel increases
the expected capability of the person chosen, reduces the chance of having to settle for a below-par selection, and increases the chance of finding a high-quality replacement if the original choice turns out to be below par. The assurance of having a well-qualified pool of leaders has enormous value because leaders make decisions affecting many tiers of the organization and numerous individuals in what can be life-threatening situations. This point is important in an organization like the Air Force, which has no lateral entry, because leaders cannot be hired off the street but must be selected from personnel in the lower tiers of the organization. Without lateral entry, personnel in those tiers must be capable of performing their current jobs and must have the potential to fill more-responsible, higher-ranking jobs in the future. For the Air Force to fill its leadership positions with well-qualified, high-performing individuals, it must hire them at the lowest ranks and retain and develop them over time within the organization.

The importance of retaining high performers in the Air Force makes the retention trends shown in Table 2.5 worrisome. Those trends suggest that the Air Force has been struggling to retain high performers in its enlisted force.

**Mechanisms to Implement Capability Pay**

There are various ways to implement capability pay. Design questions include:

- Over what range of grades and years of service would capability pay be payable?
- Would all personnel in the range receive some capability pay, or only a portion of personnel?
- How large would the pay be on average for each grade or YOS?
- How wide a variation in pay would exist, if any?
- Would capability pay be counted toward retirement?
- How often would personnel be evaluated?
- In what ways would the current performance evaluation systems for officers and enlisted personnel need to be modified?
The design choices affect the incentive structure created by capability pay, and the incentive structure affects the retention of personnel, their willingness to exert effort, and the extent to which highly capable high performers are sorted into positions of the greatest influence and responsibility. The latter will determine the transitional and steady-state cost of capability pay, as well as its harder-to-measure benefits. For purposes of discussion, we will describe a possible design for capability pay. In our view, however, it is too early to be confident that any given design is best.

Capability pay could be payable to officers after completion of their initial service obligation, around the sixth to eighth year of service. It could be payable to enlisted personnel after five years of service, which for most personnel is after the first reenlistment. From these starting years, capability pay could be payable over the remainder of one’s service career. By delaying the start of capability pay to these points, its direct and administrative costs are reduced. In addition, it can be difficult to discern a service member’s performance and potential during the first years of service because there is small scope for individual initiative. Furthermore, during the initial obligation, random factors may play a relatively large role in measures of performance, making it harder to extract a signal of the member’s actual capability. Finally, the initial years of service can be a period of rapid learning for personnel. Officers who might begin their careers with less skill, knowledge, and experience, due to differences in, say, commissioning source, would have an opportunity to catch up during these years and would not be penalized if capability pay was payable only after the initial obligation.

With respect to whether all personnel in the “payable” range would receive capability pay, we distinguish between eligibility and amount of award. Although capability pay could be limited to the top third or top half of performers, we identify several problems with such a cutoff. First, some personnel will be misclassified; i.e., some high performers will be incorrectly cast as low performers and vice versa. Second, highly capable personnel who feel as though they can comfortably qualify for capability pay would have little incentive to improve their performance in order to qualify. Third, personnel who received no capability pay might infer they had poor career prospects and might consider leaving the service, even though capability pay was supposed to improve incentives and retention. Furthermore, the
fact that some but not all personnel in a unit received capability pay might prove divisive, perhaps hurting morale and productivity.

Given the importance of equity as a factor in setting compensation, capability pay should be implemented in a way perceived as fair. “Fair” could mean that capability pay is spread among more individuals, or that only some individuals receive it but everyone is believed to have equal opportunity of receiving it.

As capability pay is spread over more personnel with a given budget, either the total cost rises or the average award declines. Moreover, even if capability pay were paid to all personnel, those receiving a low award could infer a negative signal and some might leave. On the other hand, personnel receiving a high award would presumably appreciate the pay and recognition.

There are different approaches to paying a capability award based on the service member’s current performance. It could be a single annual award, in effect a bonus. It could be a pay increment over future years. Or it could be a larger amount paid over a shorter period. In addition, if the award were paid over the remaining years of service, it would be more valuable to those intending to remain in service longer. Also, the award structure could be designed such that for any given level of future performance, the size of the award was a function of one’s previous awards. For instance, the award could be higher the higher the level of capability pay being received. This would have the effect of compounding the value of a capability pay award, because a higher award today would automatically lead to higher awards tomorrow, given tomorrow’s performance level. Moreover, the structure of awards could be skewed so that as performance level rose, capability pay rose nonlinearly with performance.

In sum, the capability pay table could be two-dimensional, depending both on the current performance level and on the current level of capability pay, which in turn would reflect past performance levels. The table could be skewed in both directions, with disproportionately higher increases to higher current performance and to a higher level of capability pay from past performance.

This design has another possible advantage. It would enable pay differentiation among personnel at the same rank and year of service.
By implication, it would weaken the link between rank and pay, permitting pay to be higher for personnel who have a strong record of performance in their current grades. These personnel may be highly productive in their current grades and positions and may not want to strive for the very highest ranks. Equally important, a service may want to keep these personnel in their current grades and positions rather than be forced to promote them to increase their pay. Thus, capability pay becomes a means of rewarding officers for their leadership capability in areas requiring a high level of technical competence as opposed to their general leadership capability. This possible role for capability pay intersects with the role of skill pay. By the same token, however, capability pay might also be a means of extending the time an officer spent in a position (longer time on assignment) even though he or she was on a general officer track.

Modeling and empirical work are required to evaluate alternative structures for capability pay. The analysis would consider how retention, productivity, and cost varied across different structures. Through policy simulation of these effects, it would then be possible to see whether high-ability personnel were more likely to be retained longer under certain pay structures. It would also be valuable to conduct focus groups and surveys to learn whether officers and enlisted personnel would be receptive to capability pay and in what form.

Although capability pay has potential benefits, it also has significant administrative costs. As mentioned above, a working definition of “leadership capability” must first be determined. A person’s performance would be evaluated periodically—say, annually—and ranked against the performance of others and/or against a standard with respect to leadership capability. In many positions, judgment and initiative are important, and of course personnel do not follow a regime of repetitive activities. Careful, subjective evaluation of performance is required. We assume the evaluation system would be built on that used in the promotion system. So it seems likely that performance would be assessed relative to that of peers. The evaluator would have to operate under guidance prohibiting awarding the highest rating too frequently. One way of constraining the evaluator is to assign a “point budget.” This should cause the evaluator to return good relative rankings of personnel by their performance. There could be a separate point budget for each rank (or rank/year of service, etc.), thus allowing higher point assignments for higher-ranking person-
nel, for example. There also must be a mechanism for translating points into capability pay awards; the relationship might not be the same every year or across all occupational areas. Finally, if officers and enlisted personnel perceived the evaluations to have a large random component, the incentive effects of capability pay would be diminished.