This document considers two possible changes to the Air Force compensation system: skill pay and capability pay. Skill pay is pay for designated skills, and capability pay is pay based on individual capability. The Air Force asked RAND to consider these pay concepts and bring to bear information on whether the Air Force should adopt them and in what form. To learn more about what role these pays might play, we reviewed the Air Force’s manpower situation, considered underlying causes of problems, tracked relevant trends in civilian wages, and examined data on the level and composition of military compensation. With this information in mind, we identified possible changes in the current compensation system and addressed the potential benefits and implementation issues of introducing skill pay and capability pay instead.

INCREASED STRESS IN THE AIR FORCE PERSONNEL SYSTEM

The Air Force personnel system appears to have been under considerable stress. The percentage of “high-quality” recruits declined during the 1990s, as did first- and second-term retention rates and midcareer officer continuation rates—although first- and second-term retention rates improved from 1999 to 2000. In addition, during the latter part of the 1990s, the Air Force was less likely to keep its first-term high performers compared to its first-term lower performers. The same indications of personnel stress also occurred in the Army, but the Navy and Marine Corps showed either less adverse change or outright improvement during this period. The Navy and
Marine Corps were also more likely to retain their high performers relative to their lower performers.

Air Force personnel are increasingly called upon to participate in peacetime operations. The increase in the percentage of personnel who had any episode of deployment involving hostile duty rose during the post–Gulf War 1990s, as did the expected number of such episodes. However, we found that the increase in hostile episodes probably had little effect on first-term reenlistment.

**COMPARING CIVILIAN AND MILITARY PAY**

The supply of personnel to the Air Force, like that to the other services, has been affected by cyclical and long-term factors. The strong civilian economy hurt recruiting and retention. Low unemployment rates meant plentiful civilian job opportunities, and civilian wages grew steadily. The increase in civilian wages during the second half of the 1990s was faster than the increase in basic military pay. FY00 legislation called for basic pay raises half a percentage point larger than usual—i.e., larger than the increase in the Employment Cost Index. The scheduled raises, along with high enlistment and reenlistment bonus budgets, should help recruiting and retention, but the pay raises will not be fully implemented until 2006.

In addition to the fact that the civilian economy was at the top of the business cycle in the late 1990s, recruiting was affected by the long-term upward trend in college enrollment. This reduced the relative size of the traditional recruiting market and increased pressure on the services to improve recruitment from the college market. Another long-term trend was the faster pace of wage growth for persons with four or more years of college. Their wages grew unusually fast in the 1980s, and although this pace slowed in the 1990s, it was still faster than the wage growth of persons with only a high school diploma. The college wage trend encouraged college enrollment and created attractive civilian job opportunities for new college graduates and for military people with a college degree, especially officers. Looking to the future, it seems likely that civilian wages will remain high for college graduates, although the year-to-year increase in their wages might slow even more as the economy absorbs the increase in the supply. In addition, wage trends occurred in particular civilian labor markets: For example, wages rose rapidly for workers in information
technology and employment opportunities were abundant for aircraft pilots.

Most of the difference in military pay among personnel at a given year of service is due to differences in rank and in pays and allowances related to location or circumstance; e.g., overseas cost of living allowance, Family Separation Allowance, and Hostile Fire Pay. When we compare the average pay over the career of Air Force personnel across broad occupational areas, the pay profiles are nearly identical. On average, the Air Force provides very similar career and pay opportunities within these occupational groupings. Within a grouping there is some variation in pay resulting from bonuses and special pays, yet these amounts are typically a small fraction of annual cash pay. This is not to overlook the large bonuses or special pays in certain occupational areas such as aviators, doctors, and nuclear-trained personnel that do in fact result in large pay differentials.

STRENGTHENING THE CURRENT SYSTEM

Given this background information, the Air Force may want to consider steps that could strengthen the current compensation system, in addition to considering skill pay and capability pay. We suggest four possible ways this could be done. First, the decline in Air Force recruiting and retention might have been lessened if more-timely and more-accurate information about civilian wages had been available. This information might have been useful in formulating budget requests, seeking a reprogramming of funds already appropriated to the Air Force, and developing more-precise information about the market forces that made recruiting and retention harder. We suggest the Air Force establish the capability to monitor civilian wages closely and with minimal lag. As part of this effort, it would be valuable to establish a capability to monitor the civilian wages of personnel who have left the Air Force. This should be done on a regular basis, e.g., as an annual survey of former members in their civilian jobs, with stratified sampling by specialty to assure sufficient sample sizes and with survey responses linked to members’ service records.

Second, the basic pay table could be reshaped to make basic pay grow increasingly rapidly with respect to rank. Making the pay table more “skewed” toward higher pay for higher grades should cost-
effectively increase retention, increase the incentive to exert effort and perform effectively, and encourage the retention of the most capable enlisted and officer personnel. Higher-percentage pay increases for middle and high-ranking personnel than for junior personnel would be a step in this direction.

Third, selective reenlistment bonuses could be restructured to make them worth more, with rewards more connected to skill level and grade level; and bonus budgets could be increased. In particular, anniversary bonus payments could depend on one’s skill level and grade, which would create greater incentive to reach higher skill levels and be promoted faster. Tying bonuses to skill level requires a system that designates the particular “skills” and “skill levels” to be rewarded. The skill levels might or might not differ from the Air Force’s skill level designator for enlisted personnel (i.e., 1, 3, 5, or 7).

Fourth, Hostile Fire Pay/Imminent Danger Pay could be revamped from its current form of $150 per month for any hostile duty or exposure to imminent danger during a month. The level of Hostile Fire Pay could be made to depend on the number of hostile episodes. Hostile Fire Pay for the current episode would be higher the greater the number of previous hostile episodes; personnel called on the most for hostile duty would be rewarded the most. This should help prevent lower reenlistment and could increase reenlistment among those who are called upon more often to perform this duty.

**SKILL PAY AND CAPABILITY PAY**

While we think the changes just suggested merit attention, they do not obviate the need to consider skill pay and capability pay.

*Skill pay* is intended to provide higher pay for certain skills. Presumably, the emphasis is on skill, not occupation; personnel with designated skills would receive skill pay regardless of their duty assignment and regardless of whether they used the skills in their assignment. It would be necessary to define “skills” and to establish a program to maintain skills and certify that they had been maintained. Skill pay would help conserve a *stock* of designated skills that are valuable for military capability and that might be costly and time-consuming to replace. These skills might also be in high demand in the private sector, although not necessarily. In contrast,
bonuses help manage the flow of personnel in selected specialties in order to prevent current manning shortages due to such temporary factors as the business cycle. The personnel in those specialties might have varying levels of a skill. Compared with bonuses, skill pay has the advantage of being a more stable component of pay that would continue during a member’s service career (or a designated portion of that career).

There are various ways to set skill pay. Skill pay might be a flat monthly amount or a percentage of basic pay with the percentage rising with rank, year of service, and perhaps time in grade. The skill pay table might designate a start point and an end point for skill pay, such as a certain year of service. The information system to help manage skill pay would presumably include data sources relevant to the Air Force’s requirements for the skill; short- and long-run cost of replacing personnel with the skill, including the time to acquire the skill; and private-sector employment and earnings opportunities for those with the skill.

Special pays for aviators and physicians exemplify skill pay: The skill communities are well defined, have obvious civilian counterparts, and are costly to replace when shortages occur. In these cases, the occupational specialty and the notion of skill seem to overlap. In contrast, it seems less obvious which maintenance skills, administrative skills, or intelligence skills to include for skill pay. This suggests that each occupational specialty or skill area, however defined, would need to be handled on a case-by-case basis. Overarching criteria for the designation of skills that qualify for skill pay would then emerge through practice. Stability in a skill pay table, compared with year-to-year uncertainty, would also be advantageous. Special pays such as Sea Pay, Flight Pay, and Medical Officer Pay are revised infrequently and tend to be fixed additions to basic pay. If skill pay were set high enough, it would avert retention difficulties. But if skill pay were not regularly adjusted, it could become excessively costly if it is too high—and ineffective if it is too low.

*Capability pay* is intended to provide compensation and incentives for superior individual capability, especially current and prospective future leadership potential. The leadership potential could be for becoming a general officer; for heading a community such as acquisition, logistics, or intelligence; or for both. Capability pay has two po-
tential advantages within the current compensation system. First, given the value associated with making military pay more skewed, capability pay could be designed to increase nonlinearly with rank. Personnel who qualified for capability pay would then face a pay table that in effect was more skewed. Second, the basic pay table and special or incentive pays are not presently designed to provide higher pay to more capable personnel, holding constant rank and year of service. Capability pay could do so. Skewed capability pay would therefore be expected to help retain the most capable personnel within a rank or year of service. It would encourage personnel to exert effort in order to qualify for capability pay and to reach higher levels of capability pay—which would not necessarily be tied to higher ranks. As a result, capability pay could help support a larger pool of highly capable candidates for the highest-ranking positions, compared with the current pay system. It would also provide personnel managers with more flexibility because they would have other ways to reward capability than through a promotion.

A capability pay system requires an accurate means of assessing performance to infer capability. A member’s performance might be judged relative to the performance of peers, a set of standards, or both. To keep budget and administrative costs down, capability pay assessments of performance might not begin until, say, the eighth year of service for officers and until the rank of E-5 for enlisted members. The implementation of capability pay must be perceived as fair. Members should believe that the system gives all members an equal chance of being awarded capability pay, regardless of their assignment or occupational area. The award should be based on a member's performance as assessed by superiors.

If the system is perceived as fair, then capability pay can be paid to selected, high-performing members rather than to all members. For instance, supervisors could be told that only half the members under review could be recommended for capability pay. Even though the assessments would not be flawless, the repeated operation of the assessment process from year to year should work in favor of systematically identifying high performers. The current performance assessment system would presumably be used, but it would have to be adapted to map a given performance assessment to a capability pay award. Moreover, certification standards are being developed as part of the Development of Aerospace Leaders (DAL) program, and the
attainment of DAL certification could be a factor in awarding capability pay.

Capability pay might be implemented as a smaller increment in pay over the remaining years of service, or as a larger increment over a shorter period. The level of pay could rise with rank, year of service, the level of capability pay already attained, or some combination. Including the level of capability pay already attained serves to multiply the rewards for high performance, thereby providing a strong incentive to excel at the beginning of a career.

Skill pay and capability pay may be helpful to the Air Force in both the short run and the long run, although more information and analysis are needed to determine the form, effects, and cost of these pays. Specific alternatives would need to be assessed in terms of the benefits and costs of alternative implementation strategies, their overall effects on recruiting and retention, their likely effects on pay levels relative to civilian pay, and their likely effects on incentives and on capability in different skill areas.

Alternative methods are available to analyze both proposals, including microsimulation modeling, experimentation, and survey methods. These approaches have been used successfully in the past to understand the effects on recruiting or retention of entirely new, “never-been-tried” personnel policies in the military.

In designing and considering alternative skill and capability pay proposals, it is important to recognize that long-term manning goals may be quite different from the goals of the past. The services are recognizing the advantages both of more-flexible career management across skill and occupational areas and of new methods of managing personnel, including greater use of lateral entry and outsourcing. These potential future changes imply that alternative proposals such as skill pay and capability pay deserve further consideration. Such proposals should be assessed using criteria that take into account the range of future Air Force manning requirements.