The current military retirement system dates back to 1947, when Congress implemented a common system for the military services and for officers and enlisted personnel alike. As a result of modifications in 1981 and 1986, there are actually three systems now in effect, but the basic structure has not changed: the system provides an immediate lifetime annuity to those who separate with 20 or more years of active duty, but no benefits to those who separate with less than 20 years (unless those separatees subsequently participate in the reserves long enough to qualify for a reserve pension beginning at age 60).

The three systems are structured as follows. Pre-FY 1981 entrants receive retired pay according to the formula .025*YOS*final basic pay (where YOS denotes years of service), such that 20-year retirees receive 50 percent of final basic pay and 30-year retirees receive 75 percent. Retired pay for this group is fully protected from inflation. Retired pay for those who entered between FY 1981 and FY 1986 is calculated similarly except that pay is based on the individual’s high three years’ average basic pay (high-3) rather than final basic pay. It is also fully indexed for inflation.

The Military Retirement Reform Act of 1986, also known as REDUX, implemented several important changes. First, the annuity formula was changed to [.40 + .035*(YOS - 20)]*high-3 average basic pay for the years between separation and age 62, at which time pay reverts to .025*YOS*high-3 average basic pay. Consequently, retired pay during the transition between military service and full retirement ranges between 40 percent of high three years’ average basic pay at YOS 20 and 75 percent of high three years’ basic pay at YOS 30. Second, rather than indexing retired pay for inflation, the annual cost-of-living adjustment (COLA) between separation and age 62 is 1 percent less than the percentage growth in the Consumer Price Index (CPI). At age 62, retired pay is then fully adjusted for the CPI growth since separation. Thereafter, it again increases according to the CPI-minus-1-percent rule. The 1986 reforms thus changed the system by (1) reducing the amount received at YOS 20, (2) raising the growth in retired pay for each year served after YOS 20, and (3) reducing the real value of the stream of retired pay in an inflationary environment.
From the start, the military retirement system has been the target of critical analyses by Department of Defense (DoD) study groups, presidential and congressional commissions, and independent analysts. Various critics have charged that the system is: (1) excessively costly and unfair to taxpayers, (2) unfair to the vast majority of military entrants who do not serve long enough to receive retirement benefits, (3) inefficient, and (4) inflexible.

To the general public, the two most visible aspects of the system are its cost and the relatively young ages of military retirees. The fiscal year (FY) 1994 retired pay accrual for active duty personnel was $11.7 billion. A noted defense analyst, Jacques Gansler, has noted that “The military retirement program, though politically loaded, is likely to be forced to change because of cost considerations.” Further, “more and more people have been retiring at about 40 years of age, depriving the services of their expertise and collecting retired pay for the rest of their lives.” The implication here is that retirees are departing before the services would like for them to and are receiving “excessive” benefits at the expense of taxpayers.

Other critics charge that it is unfair for 20-year separatees to receive a lifetime retirement annuity while others who serve for shorter periods receive nothing. The fact that only some 30 to 40 percent of officer entrants and 10 to 15 percent of enlisted entrants will stay for a full 20-year career and receive benefits is seen to be unfair to those who receive no benefits for time served. The military, in fact, is one of the few organizations exempted from the Employee Retirement Income Security Act (ERISA), the federal law that requires private sector employers to vest employees in their retirement systems after (usually) five years of service. Some have argued that the military should be brought under ERISA’s early vesting requirements.

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2See, for example, the reports of First and Fifth Quadrennial Reviews of Military Compensation conducted by DoD, the report of the Defense Manpower Commission (1976), the Report of the President’s Commission on Military Compensation (1978), and the Final Report of the President’s Private-Sector Commission on Government Management (1985).

3See Gansler (1989, pp. 297-298). Although Gansler wrote in 1989, the REDUX system implemented in August 1986 in fact substantially reduced benefits for those who separate with 20 years of service and has added incentives to serve beyond the 20-year mark.
Implicit in the charge of “excessive cost” is the belief that military forces of the same quality could be obtained more cheaply. In other words, the system is inefficient. Evidence suggests that personnel discount future dollars at a much higher rate than the government’s borrowing rate. It therefore follows that the same force could be obtained at lower overall cost with more reliance on “up-front” (active duty) pay and less reliance on retired pay. Taken to its extreme, the “up-front” view says that there need be no retirement system at all: the most efficient compensation system is an active-pay-only system. Of course, some advocates of this line of reasoning recognize that it would be politically infeasible to eliminate the system altogether and therefore recommend a less-generous system that conforms to ERISA guidelines for private sector pension plans.

Critics also charge that the military retirement system inhibits force management flexibility. The services are well aware of the financial costs imposed on mid-careerists who are involuntarily separated prior to the 20-year vesting point. As a result, beyond a certain grade or YOS, personnel are treated as if they have an implicit contract. The services are reluctant to separate all but the poorest performers for fear of the effect of involuntary separations on morale. That is, the services’ “desired” force structures reflect the actual retention patterns that emerge as a result of the current compensation system. Without the constraint of the current retirement system, the “desired” force may differ significantly.

In response to the various criticisms levied against the retirement system, numerous changes to the retirement system have been proposed. In this report, we evaluate one alternative that would convert the current military retirement system to a system similar to that covering federal civil service employees—the Federal Employees Retirement System, or FERS. We call this retirement plan MFERS (Military Federal Employees Retirement System).4 Since MFERS would require members to contribute to their retirement plan, it would be coupled with a 7 percent across-the-board pay raise to compensate members for these mandatory contributions and their tax implications. A system of retention bonuses would also be im-

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4As discussed in Chapter Two, MFERS differs from FERS in several minor ways. Asch and Warner (1994b) analyzes other options for changing the military retirement system.
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implemented to offset any retention problems the services might experience under this plan.

Since MFERS would vest workers significantly earlier than the current 20-year system (as early as after three years of service), it would offer benefits to military personnel who are ineligible for benefits under the current system. Thus, on face, MFERS would appear to address the criticism that the current system is unfair to those who separate before year 20. MFERS would also decrease the expected value of retirement benefits to military members since it is a less valuable plan. To keep military personnel equally well off under MFERS relative to the current system given that members must contribute to the retirement plan, MFERS would be coupled with a 7 percent across-the-board pay raise and a system of retention bonuses. By converting the military system over to MFERS, the military compensation would be more “front-loaded”—a greater proportion would be up-front in the form of active duty pay and less would be deferred in the form of retired pay. This front-loaded system would reduce costs, and thus would seem to address the criticisms that the current system is excessively costly and inefficient.

To address criticisms about the appropriateness and efficiency of the military retirement system and to evaluate alternative systems such as MFERS, a theory or model is needed that recognizes the military’s manpower goals, incorporates the essential features of the military organization, and predicts the behavioral responses of personnel to alternative compensation and personnel policy. Until recently, such models have narrowly focused on the relationship between compensation and retention behavior and the resulting years of service structure of the force and have ignored the other consequences of the military’s personnel and compensation system. In particular, less attention has been paid to questions of productivity: (1) whether the system induces the most able personnel to stay and seek advancement to the highest ranks, and (2) whether the system encourages personnel to work hard and effectively.

In two earlier reports, we developed a theoretical model that allows an analysis of these issues (Asch and Warner [1994a]), and an empirical version of that model (Asch and Warner [1994b]) that we can then use to analyze various military retirement system reform proposals. In this report, we use the empirical model and the theoretical in-
sights derived from the theoretical model to analyze the implications of converting the military retirement system to MFERS. Since our empirical model can not easily accommodate retention bonuses, we analyze the case in which MFERS is coupled with, on average, a pay raise higher than 7 percent and no bonuses. Our focus is on the implications for active duty personnel. We derive results not only in the steady state—when all members would be under the new system—but in transition to the steady state. We consider two alternative strategies for transitioning to the steady state. In particular, we consider the case where all current members are “grandfathered” (i.e., would remain) under the current system(s) and only new members would participate in MFERS, and the case where current members would be allowed to voluntarily convert to MFERS.

Chapter Two discusses the MFERS alternative in detail. Chapter Three presents an overview of the theoretical and empirical models developed in our earlier papers. Chapter Four presents our steady-state results, and Chapter Five presents our results relating to the transition to the steady state. In Chapter Six, we discuss other factors that may be important in considering whether to convert the military system over to MFERS. Policy implications and conclusions are discussed in Chapter Seven.

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5Essentially, we are addressing any retention problems created by MFERS with a pay raise rather than with bonuses. As discussed in Chapter Four, pay and bonuses differ in several respects, but are similar to the extent that using them results in a more front-loaded compensation system.