The simulation model predicts that MFERS with a skewed pay raise can produce the same general force size and structure as REDUX but at less cost and with higher productivity. However, retention, productivity, and payroll costs are not the only important considerations in determining whether military members should be converted to MFERS. In this chapter, we discuss four other factors to consider in weighing the costs and benefits of moving military members to MFERS. Unfortunately, unlike retention, cost, and to some extent, productivity, these factors are not amenable to measurement. The first factor is the ability of MFERS to increase force management flexibility—a criticism of the current system alluded to in the introduction. The second is the degree to which MFERS would rely on involuntary separation to achieve the desired force structure. The third factor is the portability of benefits under MFERS. The final factor is the likelihood of a more stable force size and structure in the face of business cycles and other changes in the civilian labor market.

FORCE MANAGEMENT FLEXIBILITY

The current military retirement system embodies many of the features one would expect in the compensation system of a hierarchical organization. For example, the delayed benefits effectively skew total compensation toward those reaching the upper ranks, thereby maintaining the motivation and work effort of nonvested personnel. In addition, the generous nature of the benefits for those who become vested induces voluntary separations and helps minimize the
organizational influence costs that might attend the separation of senior personnel under less-generous terms.

But, as we noted in the introduction, despite these virtues of the system, a basic criticism of the 20-year system regards force management flexibility. At a very general level, the retirement system creates the implicit contract problem discussed earlier. The prospect of retirement after 20 years is a delayed “carrot” that induces personnel to invest in military-specific job skills, to accept onerous or hazardous assignments, and generally to exert work effort early in their careers. Individuals, of course, will not make such investments without a good chance that they will pay off. Therefore, beyond a certain career point involuntary separations would appear capricious and would adversely affect the incentive scheme. The services are understandably reluctant to separate mid-career personnel for fear of how such separations will affect the behavior of more junior personnel. The 20-year system creates a kind of implicit contract or guarantee of tenure to mid-careerists and, arguably, has the effect of inducing the services to “demand” more mid-careerists than they might under a different system.

That the terms of separation affect force management practices is illustrated by the Army’s Qualitative Management Program (QMP). Under QMP, a board of senior enlisted personnel meets annually to select for involuntary separation approximately 2 to 3 percent of the lowest performers in grades E-5 through E-9. However, the board selects for separation only those who are retirement-eligible. Recognizing the financial costs imposed on those who have not yet qualified for retirement benefits, the board selects for separation only those who would not be excessively financially penalized by involuntary separation. It is likely that all of the services have carried to the 20-year point many personnel who would have been separated earlier under a different system.

Retention trends during the All-Volunteer Force (AVF) era have compounded the problem. Higher first-term retention in the AVF meant larger flows into the career force and more personnel competing for promotion to the upper ranks. The implicit contract to mid-careerists limited the services’ ability to control flows of mid-career personnel and reduced promotion opportunities for younger personnel. Overall, the fraction of the enlisted forces with more than 10
years of service rose by about 25 percent over the 1974–1989 period, with the largest seniority increases in the Army (43 percent) and the Marine Corps (49 percent). In fact, the Navy and Air Force experienced little increase in the fractions of their enlisted forces with more than 10 years of service.

Although increased enlisted seniority might theoretically be welcomed on the ground that more experienced forces are more productive, it is important to note that the seniority growth occurred in the two services that profess the most need for youth and vigor in their enlisted forces. The seniority growth raised serious questions about cost and made evident the services’ inability to effectively manage their senior enlisted forces. After considerable pressure from the Office of the Secretary of Defense (OSD), in 1990 the services began applying more-stringent high-year-of-tenure rules to their enlisted forces. But these more-stringent rules affected relatively few personnel who were not retirement-eligible. It was the large force reductions that began after 1990 that forced the services to seriously consider separating significant numbers of mid-career personnel. At first, the services wanted to reduce their strengths by cutting accessions, but the implications of this policy for the future force structure soon became clear. It was only after the implementation of the Voluntary Separation Incentive (VSI) and the Special Separation Benefit (SSB) schemes that the services agreed to reductions in the mid-career force. These temporary separation payment schemes expired in 1995, but the experience with them so far illustrates how force management practices would change with different terms of separation.

A related point is that when the quality of entering cohorts varies significantly, the retirement system compounds the difficulty of managing quality flows through the force. Cohorts entering the Army in the late 1970s were of poorer quality than later cohorts. High retention of these cohorts as they entered their second decade of service clogged the mid-ranks and increased the difficulty of retaining and advancing the higher-aptitude personnel in the later cohorts. The separation tools offered by the drawdown program have enabled the Army to selectively separate the less-able personnel, something it could not have done before.
The 20-year system poses difficulties at more detailed levels. The system is identical for all (active) members regardless of occupation or service and regardless of whether the individual is an officer or a member of the enlisted force. Yet occupations, services, and officer and enlisted roles are obviously different. One important way that occupations differ is in their desired experience profiles. In some occupations, notably combat arms skills, a youthful experience profile is required. In others, youth and vigor are not primary job requirements, and high training costs and/or a big payoff to job experience (such as with doctors and nurses) argue for longer than 20-year military careers. But as shown in Asch and Warner (1994b), the system produces similar force profiles across the broad spectrum of occupations. Thus, force managers seem to have little flexibility in shaping or controlling the experience profiles of the various occupations (or services).

In terms of improving force management flexibility, would MFERS be an improvement over the current system? MFERS eliminates vesting at the 20-year point and reduces the value of retirement benefits at YOS 20. Therefore, there is not the pull toward a 20-year career for mid-careerists that holds in the current retirement system. Furthermore, since MFERS allows those who leave prior to YOS 20 to get some benefits, the services are likely to be more willing to involuntarily separate personnel whom they would not separate under the current system.

However, other factors come into play here. Although they may be more willing, there are two reasons why the services would likely continue under MFERS to act as if members are serving under an implicit contract. First, the skewed pay raise that must accompany MFERS for MFERS to be an improvement over REDUX replaces the retirement system as the source of deferred compensation and therefore the source of productivity and retention incentives. The skewed pay raise gives higher raises to those in higher grades, but those who reach the higher grades are those with more years of service. The services are likely to be unwilling to involuntarily separate those in their mid-career who are “due” large raises in their later years of service. An implicit contract may be formed because of MFERS’ large deferred pay raises. Similarly, an implicit contract may be formed if the services use skewed retention bonuses rather than skewed pay raises to address retention problems that arise with
MFERS plus a 7 percent across-the-board pay raise. Just as in the skewed pay raise case, if members feel that they are “owed” the retention bonuses coming in the higher grades or years of service, the services may be extremely reluctant to separate them.

Second, the present value of the retirement benefit that a member would get under MFERS if he or she separated prior to YOS 20 is relatively small (less than one year of base pay\(^1\)), as shown in Table 6. This separation benefit is unlikely to fully compensate many members for the second-career loss associated with transitioning to the civilian sector. Some personnel whom the services would prefer to leave will opt to stay given these relatively small benefits under MFERS. If the services are unwilling to impose a financial loss on these members, even though the financial loss is smaller under MFERS than under the current system, they will continue to act as if members are serving under an implicit contract. Therefore, although MFERS addresses the implicit contract problem associated with the current military retirement system, it creates its own implicit contract problem, so that the amount of force management flexibility it would afford, especially for mid-careerists, is questionable.

Like the current system, MFERS with a skewed pay raise would be identical for all members regardless of occupation or service and regardless of whether the individual is an officer or a member of the enlisted force. Put differently, it would also be a “one-size-fits-all” system, subject to the same difficulties of force management flexibility at the more detailed level as the current system. On the other hand, if MFERS is coupled with a system of retention bonuses that could be targeted to distinct populations, then MFERS could address some of the force management flexibility problems associated with the current system. A compensation system that includes MFERS could be designed that allows the services to achieve varying experience profiles across occupations or personnel types.

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\(^1\)In comparison, the SSB program (the lump-sum separation pay program being used by the services to facilitate the drawdown) pays 1.5 times base pay.
IN VOLUNTARY SEPARATION

As discussed in the overview of the theoretical model in Chapter Four, retired pay can be used to induce voluntary separations of senior personnel. In a hierarchy without lateral entry, separation of more senior personnel is necessary to maintain promotion opportunities and provide retention and productivity incentives to more junior personnel. The military could also induce the separation of more senior personnel through involuntary means but, as discussed in Chapter Four, involuntary separations create organizational influence costs. For example, involuntary separations lower morale, which adversely affects retention of more junior personnel and possibly recruiting. To restore retention and recruiting, pay would need to be raised. The cost of the pay increase is an organizational influence cost.

In addition, when the services rely on involuntary separations, personnel are likely to engage in practices to loosen the policy—in the hope of coercing the services to make fewer involuntary separations. If the services respond to this pressure, it will result in a superannuated or older force and, to the extent that the services desire “youth and vigor,” a less productive force. The lower productivity of the force is another organizational influence cost. If the services paid separation pay to trim the force, the cost of separation pay would be an organizational influence cost.

A compensation system that defers compensation in the form of a retirement benefit that provides an immediate benefit upon separation saves these organizational influence costs. The current military system is such a system. A distinct advantage of the current system is that the separation of more senior personnel is voluntary.

A disadvantage of a front-loaded compensation system such as MFERS is that it relies upon involuntary separation. Under MFERS, the military would rely more on HYT rules and other forms of involuntary separation to maintain a youthful force. Table 14 shows that in the absence of HYT rules, our simulation model predicts that MFERS with a skewed pay raise would generate a more senior force than would REDUX. For example, comparing the top and bottom panels, survival to YOS 30 would rise to 1.9 percent under REDUX but would rise to 4.1 percent under MFERS with a skewed pay raise. The
Other Considerations

Table 14
Predicted Effects of REDUX and MFERS with a Skewed Pay Raise without HYT Rules

I. REDUX

<table>
<thead>
<tr>
<th>YOS</th>
<th>Grade-by-YOS Distribution</th>
<th>Survival to Start of</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>E-1-E-3</td>
<td>E-4-E-6</td>
</tr>
<tr>
<td>YOS 1-4</td>
<td>.288</td>
<td>.187</td>
</tr>
<tr>
<td>YOS 5-10</td>
<td>.006</td>
<td>.230</td>
</tr>
<tr>
<td>YOS 11-20</td>
<td>.001</td>
<td>.138</td>
</tr>
<tr>
<td>YOS 21-30</td>
<td>.000</td>
<td>.021</td>
</tr>
<tr>
<td>Total</td>
<td>.295</td>
<td>.576</td>
</tr>
</tbody>
</table>

II. MFERS with a Skewed Pay Raise

<table>
<thead>
<tr>
<th>YOS</th>
<th>Grade-by-YOS Distribution</th>
<th>Survival to Start of</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>E-1-E-3</td>
<td>E-4-E-6</td>
</tr>
<tr>
<td>YOS 1-4</td>
<td>.282</td>
<td>.187</td>
</tr>
<tr>
<td>YOS 5-10</td>
<td>.006</td>
<td>.238</td>
</tr>
<tr>
<td>YOS 11-20</td>
<td>.000</td>
<td>.118</td>
</tr>
<tr>
<td>YOS 21-30</td>
<td>.000</td>
<td>.000</td>
</tr>
<tr>
<td>Total</td>
<td>.288</td>
<td>.543</td>
</tr>
</tbody>
</table>

The fraction of the force in YOS 20 to YOS 30 would rise to 8.2 percent and 10.0 percent under each system, respectively. The implication of the results in Table 14 is that to achieve the same force profile as the current system, MFERS with a skewed pay raise must subject more individuals to HYT rules—to involuntary separation.

Although those who are involuntarily separated under MFERS would receive some benefit—MFERS vests personnel as early as YOS 3—the services are still likely to face more organizational influence costs under MFERS than they do under the current system. The reason is that the size of the retirement benefit under MFERS is relatively small, as noted above, so that some of those who would leave voluntarily under the current system will not leave voluntarily under MFERS. Of course, the services may desire to retain some of these individuals, particularly those for whom a longer than 20-year career is appropriate. But to maintain the structure of the force, other individuals will need to be involuntarily separated, a policy that will give rise to organizational influence costs. How large the organizational...
influence costs will be under MFERS is unclear. The problem of involuntary separations in the senior YOS may be self-limiting to some extent since retirement from service is mandatory at YOS 30 (except by special waiver), and many members will begin their search for a second career around YOS 25. Their incentives will depend critically on how civilian opportunities change from age 45 to age 50 and on the variance in civilian opportunities. Still, since the cost differential between MFERS with a pay raise and the current system is not large, the organizational influence costs associated with involuntary separation do not need to be large before they eliminate the MFERS cost advantage.

The organizational influence costs under MFERS will depend on whether MFERS is coupled with a skewed pay raise, as analyzed in Chapter Four, or with a 7 percent pay increase and a system of retention bonuses. They are likely to be larger in the former than in the latter case. The services can induce some voluntary separations in the latter case that would not occur in the former case by simply turning the retention bonuses off at the appropriate time. Thus, some of the separations that would occur involuntarily under MFERS with a skewed pay raise would occur voluntarily under MFERS with a system of retention bonuses. Organizational influence costs are likely to be smaller then because fewer separations occur involuntarily when MFERS is coupled with retention bonuses.

On the other hand, bonuses operate only at the margin. When the services turn off the bonuses, some personnel will leave voluntarily (those at the margin), but those with a strong taste for military service will stay despite the reduction in bonus income. The services will have to eventually involuntarily separate these high-taste individuals. Involuntary separations will be necessary even when MFERS is coupled with retention bonuses.

**PORTABILITY**

There is limited evidence on the number of veterans who transition into the civil service upon separating from the military. Anecdotal evidence suggests the number is high. DMDC data suggest that some 10 to 15 percent of military retirees—those who reach at least
20 years of service—enter the civil service. Because of these numbers, integration of the military and civil service retirement systems would seem particularly advantageous. If the systems were integrated, members could transfer their fund accumulations to the new system with no penalty when they changed jobs. An obvious advantage of converting military members to MFERS is that it would allow the integration of MFERS with FERS—the military with the civil service systems.

A related advantage of converting military members to MFERS is that FERS is already in place for federal employees. A political barrier to the implementation of any new military system is that the system is untried. MFERS is less subject to this problem than other proposed systems.

**FORCE STABILITY**

Because the military does not allow lateral entry into the upper grades, the services must grow their career forces. Those in the career force who leave too early either create an undesirable vacancy or necessitate quicker-than-desired promotions from the lower ranks to fill the vacancy. Thus, premature losses from the career force impose a cost on the services.

Why do premature losses occur? One reason is that there may be random fluctuations in the civilian labor market that make civilian employment more attractive than anticipated. Similarly, higher-than-expected retention may occur during business downturns that make civilian employment less attractive.

The number of premature losses (or amount of unexpectedly high retention) will depend on the military compensation system. Evidence shows that turnover is reduced when some compensation is deferred, such as in the form of a pension (see for example, Mitchell [1982]). A distinct advantage of the current military retirement system is that a large fraction of military compensation takes the form of deferred retired pay. The expected value of retired pay is

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2Specifically, 14.8 percent of those who retired from the military in 1983 were in federal civil service in 1995, and 9.2 percent of those retiring in 1989 were in federal civil service in 1995.
greatest for those in the senior grades. The current retirement system therefore buffers the services from unexpected personnel losses in the senior force resulting from random fluctuations in the civilian labor market. Empirical studies of first- and second-term enlisted retention indicate that retention for more junior personnel is sensitive to civilian opportunities. Thus, stability of the current force is achieved primarily for the more senior personnel. Of course, a cost of having this greater stability is that during economic downturns, retention among this group may be greater than desired.

MFERS front-loads compensation to a greater extent than does the current system and so is less likely to buffer the services against retention fluctuations. On the other hand, when MFERS is coupled with an across-the-board pay raise, it might give added protection against retention fluctuations among more junior personnel. Also, when MFERS is coupled with a skewed pay raise, much of compensation would still be deferred in the form of large raises in the senior grades. Thus, the system would still tie senior personnel to the military in the face of random economic fluctuations as well as junior personnel who anticipate remaining in the service. As discussed above, the large raises in the senior grades create an implicit contract that is likely to buffer the services from fluctuations in retention. It is therefore unclear whether MFERS—with either skewed pay or an across-the-board pay raise and skewed bonuses—creates more or less force stability relative to the current retirement system in the face of changing civilian opportunities.