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TECHNICAL
R E P O R T

Reserve Retirement Reform

A Viewpoint on Recent Congressional Proposals

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Prepared for the Office of the Secretary of Defense

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SUMMARY

A consequence of the more intensive use of the reserve components in national defense in recent years has been greater attention paid to the adequacy and efficiency of the reserve compensation system. A key component of this system is the reserve retirement plan that pays, beginning at age 60, an annuity to qualified reservists who have completed 20 years of creditable service (YCS). Four bills were introduced in Congress in 2003 to reduce the age when reservists can begin to receive retirement benefits. One proposal would allow reservists to begin receiving retirement pay immediately upon completing 20 YCS, with the last six years as a member of a reserve component. Two related proposals would lower the retirement annuity age to 55. Another would set the retirement age on a sliding scale that depended on years of service (YOS); those with more YOS can retire earlier, as early as age 53.

This paper draws from past research as well as from our ongoing project on military retirement to provide input regarding these proposals and the broader issues surrounding reserve retirement reform. We argue that the issues surrounding the reform of the active and reserve retirement systems must go beyond the single consideration of the age of benefit entitlement. To that effect, we discuss the relative merit of reserve retirement alternatives in light of a range of enduring objectives related to reserve personnel management, such as equity, cost-effectiveness, and improved force management. We find that the case for proposed reforms based on equity is ambiguous; given the differences in the demands of active and reserve service, one would not expect an equitable reserve retirement system to treat reservists and active-duty members identically. Furthermore, increasing reserve retirement benefits is neither the only nor necessarily the most equitable way to compensate reservists for the risk of added deployments. Our assessment of the cost-effectiveness of proposed reforms argues in favor of providing compensation on a current rather than deferred basis. At the same time, there are potential benefits to deferring some portion of compensation (e.g., to encourage the recruitment and retention of individuals who intend to stay with the Reserves). In addition, our review of the work of past commissions and study groups devoted to the study of military

retirement suggests that a wider range of proposed reforms should also be considered. In particular, to support the total force concept, reserve retirement reform will need to be integrated with active reform, although the resulting systems need not be the same for each component. The remainder of this summary expands these arguments by discussing the rationale behind reserve retirement reform in light of five broad objectives of the reserve compensation and personnel management system. These objectives are then used to assess potential reforms.

Objective: Increase the equity of reserve retirement benefits relative to active-duty benefits

Rationale: One reason for reducing the reserve retirement annuity age is the argument that, although reservists are a fundamental part of the total force, they receive much less in retirement benefits than do active duty since the amount of reservist benefits is determined based on pro rata YOS and the payout does not begin until age 60. Given the increasingly important role of reservists in the total force and the fact that retirement benefits are based on actual service, it is unfair, the argument goes, to begin reserve retirement benefits at age 60 when active benefits begin immediately upon retirement from active duty.

Assessment: The concept of equity has many facets beyond placing years of military service on a pro rata basis or reducing the age of benefit entitlement. Among these are the demands of full-time active duty in terms of readiness, deployment, frequent absences, permanent change of station (PCS) moves, the inability to have a full-time civilian job, and the impact of the military regimen on the family and the employment and earning opportunities of the military spouse.

In addition, the calculation of basic pay in determining retirement benefits favors reservists. Basic pay for a retired reservist is the value of basic pay in effect when the reservist turns 60, not the value of basic pay in effect in the year when the reservist separated plus the cost-of-living adjustment to age 60. This favors the reservists because basic pay typically rises faster than the cost of living. Furthermore, one purpose of active-duty retirement benefits is to help the retired active-duty member establish a civilian career, whereas reservists typically already have a civilian career and a retirement benefit plan with their employer.

Finally, the choice of age 55 as well as the formulas for computing the sliding scale in the various congressional proposals are ad hoc and would do comparatively little to enhance nominal equity because there are no comparable age requirements in the active retirement system. Furthermore, these proposed changes are also ad hoc when judged from the benchmark of the two civil service retirement systems, the Civil Service Retirement System (CSRS) and the Federal Employees Retirement System (FERS), because CSRS is being phased out and the annuity age for FERS is rising to age 57.

Objective: Increase compensation because of more frequent, longer reserve deployments

Rationale: Reserve deployments increased during the 1990s and have risen even more because of operations in Iraq and Afghanistan and the war on terrorism. More generous reserve retirement benefits would help to compensate for the added burden of deployment.

Assessment: Increasing the generosity of reserve retirement benefits is an inefficient, poorly targeted, and unfair way of compensating for the higher burden of deployment. It is inefficient because reservists most likely have a higher rate of interest than the government rate of interest. Theory suggests that an individual's rate of interest is about equal to the individual's rate of time preference (willingness to trade off consumption today for consumption tomorrow, also called *personal discount rate*), provided consumption is not changing much from year to year. Estimates of military members' rate of time preference are of 20 to 30 percent per year. This compares with a government interest rate of 3 percent or 4 percent (rates adjusted for inflation). At a 3.5 percent rate of interest, the government would need to set aside \$0.71 now in order to pay \$1 in ten years. But from the viewpoint of a reservist with even a 10 percent rate of time preference, the present value of that dollar to be received ten years from now is \$0.39, and at a 20 percent rate it is only \$0.16. Therefore, the present value of the benefit cost to the government (\$0.71) is much higher than the present value of the benefit to the reservist (say \$0.39).

Using retirement benefits to address the stress of greater deployment is poorly targeted because more generous retirement benefits would potentially reward all reservists, even those with little or no deployment. A majority of reservists have not been mobilized in recent

operations, including Operations Noble Eagle, Enduring Freedom, and Iraqi Freedom, in Iraq and Afghanistan. Furthermore, embedding compensation in retirement benefits is also unfair because most of the reservists who deploy are younger personnel, and most of the younger personnel do not stay in the Reserves long enough to qualify for these benefits.

Objective: Ensure adequate supply of reserve personnel

Rationale: Reserve deployments have been far more extensive than reservists expected, and the dates of departure for and return from deployment have been uncertain. Reservists might not be willing to be away from home as often as now anticipated (9 to 12 months every 4 to 5 years rather than every 7 to 8 years). Also, employers might become wary of placing reservists in positions of significant responsibility; recognizing this, some reservists might opt to leave the Reserves rather than jeopardize their civilian career advancement.

Assessment: Increasing the generosity of reserve retirement benefits is an inefficient and poorly targeted way to improve reserve retention or recruiting. Even if reserve retirement benefits started around age 55 instead of at age 60, the present value to reservists (and potential recruits) age 20 to 40 would be small, and the effect on their recruiting and retention would be small. Older reservists near 20 YOS would reap the biggest gain from an increase in retirement benefits, but their retention rates are typically quite high, so for them too the increase in retention would be small. The fact that many junior reservists will not stay in the Reserves long enough to qualify for retirement benefits implies that an increase in retirement benefits will be of little consequence to them. In contrast, an increase in current pay would be of full and immediate value to a reservist and therefore can be expected to have a much greater effect on the retention and recruiting of junior personnel.

Objective: Increase flexibility of managing reserve personnel

Rationale: Reserve deployments have been far more extensive than reservists expected, and the dates of departure for and return from deployment have been uncertain. Some reservists might not be willing to accept a continuation of the high rates of deployment and long tours that have occurred under Operation Iraqi Freedom and Operation Enduring

Freedom.¹ Also, employers might become wary of placing reservists in positions of significant responsibility; recognizing this, some reservists might opt to leave the reserves rather than jeopardize their civilian career advancement.

Assessment: The reserve compensation and personnel management systems are stable, visible, scalable, and equitable in providing similar compensation and career advancement opportunity to personnel given their YOS and responsibility and regardless of their military occupation. These systems have resulted in highly similar retention profiles by occupation.

As the active-duty and reserve components transform, it may be preferable to encourage longer careers in some occupations and to create greater opportunities and incentives for innovation in every occupation. Doing this may require changes in the compensation and personnel management systems. The current reserve retirement benefit system, like the active-duty retirement benefit system, encourages similarity and conformity in careers, retention, and incentives. In particular, it encourages personnel to complete 20 YCS, and it offers weaker incentives to serve more than 20 years. As long as retirement benefits depend only on pay grade and pro rata YOS, they will not be a means of inducing greater variation in reserve careers and retention. Also, because reservists discount retirement benefits, a \$1 increase in retirement benefits will have less incentive effect than a \$1 increase in current compensation. On net, increasing the generosity of reserve retirement benefits does not provide a direct or cost-effective way to increase the flexibility of personnel management, whereas increasing current pay through special and incentive pay and revising the personnel management system can increase that flexibility.

¹The possibility of a continuation of higher deployments is inherent in the testimony of Lieutenant General Helmlly, chief of the Army Reserve: "We are committed to achieving a capability ratio that will manage Army Reserve deployments to once every four or five years." This statement is also an indication of the effort within the Army Reserve to transform into a more readily deployable force. Whether the future will actually require deployments once every four or five years, versus a longer period, is an open question. (Statement by LTG James R. Helmlly, Chief, Army Reserve, Department of the Army, before the Subcommittee on Personnel, Committee on Personnel, United States

Objective: Ensure cost-effectiveness of reserve compensation system

Rationale: A compensation system should be cost-effective. If it is not, then the cost of personnel is higher than it needs to be.

Assessment: Because of the difference between a reservist's interest rate and the government's interest rate, the present value of \$1 of deferred compensation will be far less to the reservist than the present value of the government's cost of providing it. This argues in favor of providing compensation on a current basis rather than on a deferred basis.

Using data on reserve personnel for fiscal years (FY) 1999 and 2000, we computed the per-capita present discounted costs and present discounted values of the congressional retirement proposals to reduce the annuity age for enlisted and officer retirees assuming a real government interest rate of 2.5 percent, a rate of real-wage growth of 1 percent, and a 10 percent personal interest rate. We found that the per-capita cost of the current retirement system is dramatically less than the per-capita cost under the immediate annuity and age-55 proposals (\$144,516 versus \$219,415 and \$179,677). The per-capita cost of the sliding-age alternative is the least expensive of the three alternatives (\$155,573), reflecting the low prevalence of new retirees below age 60 with sufficient YOS to qualify for retirement at ages below 60 on the sliding-age scale. The discounted present values of the alternatives are substantially lower than the cost figures. For example, the present value of the current system for a retiree is \$45,845, much less than the \$144,516 cost. Clearly, the typical retiree values retirement benefits less than what it costs to provide them, and, depending on the personal interest rate, the difference is substantial.

These results argue in favor of providing compensation on a current basis rather than on a deferred basis. On the other hand, it is important to recognize that it can be cost-effective to defer some portion of compensation. Deferred compensation can encourage the recruitment and retention of individuals who intend to stay with the Reserves; provide an incentive for complying with organizational norms of behavior and behavior standards (versus being dismissed for improper or insubordinate behavior); provide an incentive to exert effort and seek promotion (because retirement benefits are higher); and induce the

most senior personnel to separate, clearing the promotion channels for junior personnel. Increasing the generosity of reserve retirement benefits would strengthen the capability to perform these roles. However, there are also alternative approaches. Current compensation and personnel management can be structured to create greater incentives for recruiting, retention, effort, and separation. Finding the right balance between current and deferred compensation therefore requires an analysis of the costs and effects of specific policy alternatives.

Finally, from the perspective of congressional action in a tight budget situation, increasing the generosity of reserve retirement benefits is a way of acting today on behalf of reservists while deferring the payment for the action until tomorrow. That is, increasing *deferred* military compensation might be politically more attractive than (further) increasing current military compensation.

Toward the Development of Retirement Reform Alternatives

Numerous study groups and commissions have discussed reforms to the military retirement system, especially the active system, to address problems of cost, equity, and management flexibility. Concerns have focused on such issues as the cost of providing retirement benefits immediately as active members transition from the military to their second career in the civilian sector; the lack of retirement benefits for members who serve but not long enough to be eligible for military retirement; the differences between the defined benefit plan provided by the military and those plans prevalent in the civilian sector; and the one-size-fits-all retirement system. These issues are also relevant to though not always in the forefront of discussion about reserve retirement reform.

Moreover, to support the total force concept, it is clear that retirement reform for both the active and reserve components must work in concert to achieve their respective personnel goals. Assessments of alternative reforms must also consider how to address obstacles to reform, such as the lack of a consensus for change.