

Changes in Military Compensation

Background Paper
OSD(PA&E)/IDA 6th Annual Defense Economics Conference
September 28-29, 2000

INTRODUCTION

This paper provides an overview of changes in U.S. military compensation over the past three decades. The bulk of the paper describes the primary components of military compensation and briefly discusses some of the changes each has undergone since the advent of the All Volunteer Force (AVF). The remaining sections place military compensation in a broader context by comparing it with key pay and benefit trends in the civilian sector and raise questions about future challenges in managing military compensation while remaining competitive with civilian employers.

OVERVIEW OF MILITARY COMPENSATION

The basic structure of the current military compensation system dates back to the 1949 Career Compensation Act, which was based largely on the work of the Advisory Commission on Service Pay (the Hook Commission).¹ This Act combined the previously disparate pay systems of the various services into one uniform system, the major components of which include:

- *Regular Military Compensation (RMC)*, which is made up of basic pay, subsistence and housing allowances, and the federal income tax advantage;
- *Special and Incentive Pays*, which include, for example, flight pay, sea pay, and jump pay, as well as recruiting and retention bonuses;
- *Other Allowances*, for example, clothing and family separation; and
- *Other Benefits and Entitlements*, which include shopping privileges at commissaries and exchanges, health care, educational assistance, and retirement pay.

This basic framework, designed in the post-World War II years to reflect the then-demographics of the force (largely young, single conscripts) remained in place even after the switch to a volunteer force. Periodic, mandated reviews of compensation have taken place since 1967, some of which have led to reforms; however, the fundamental structure remains.²

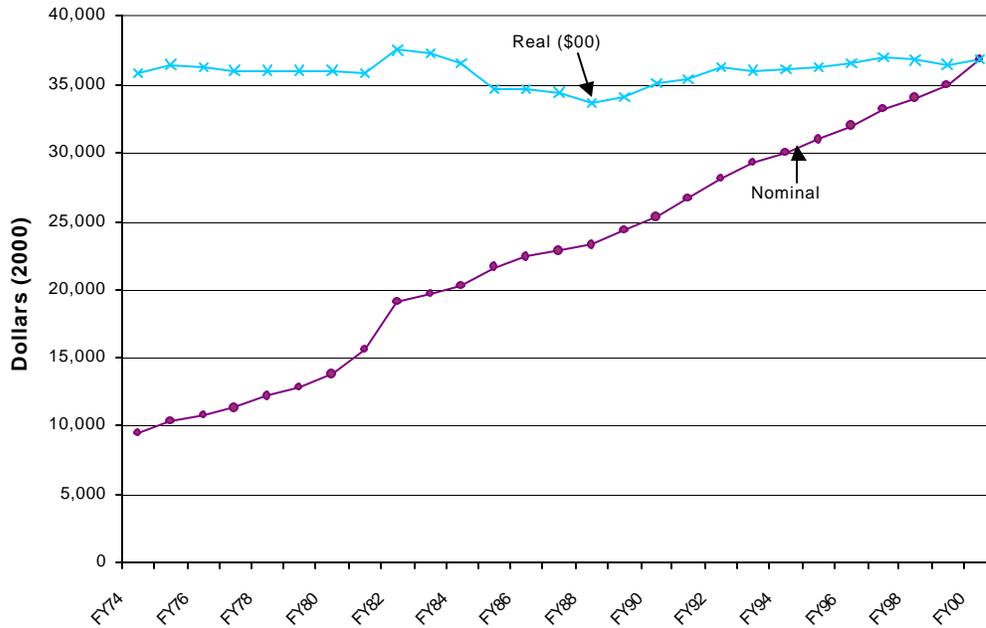
Regular Military Compensation (RMC)

RMC comprises the pay and in-kind benefits common to all military members. Figure 1 shows that since the advent of the AVF, average real RMC has remained relatively constant, but has been rising slowly since the late 1980s. The ratio between the elements of RMC has also remained stable over the last 20 years, as shown in Figure 2.

¹ *Report of the Seventh Quadrennial Review on Military Compensation* (Office of the Assistant Secretary of Defense for Force Management and Policy: Washington, DC) August 21, 1992: p. 17.

² Legislation stipulates that “not less than once each four years [the President] shall direct a complete review of the principles and concepts of the compensation systems for members of the uniformed services.” 37 U.S.C. §1008 (b).

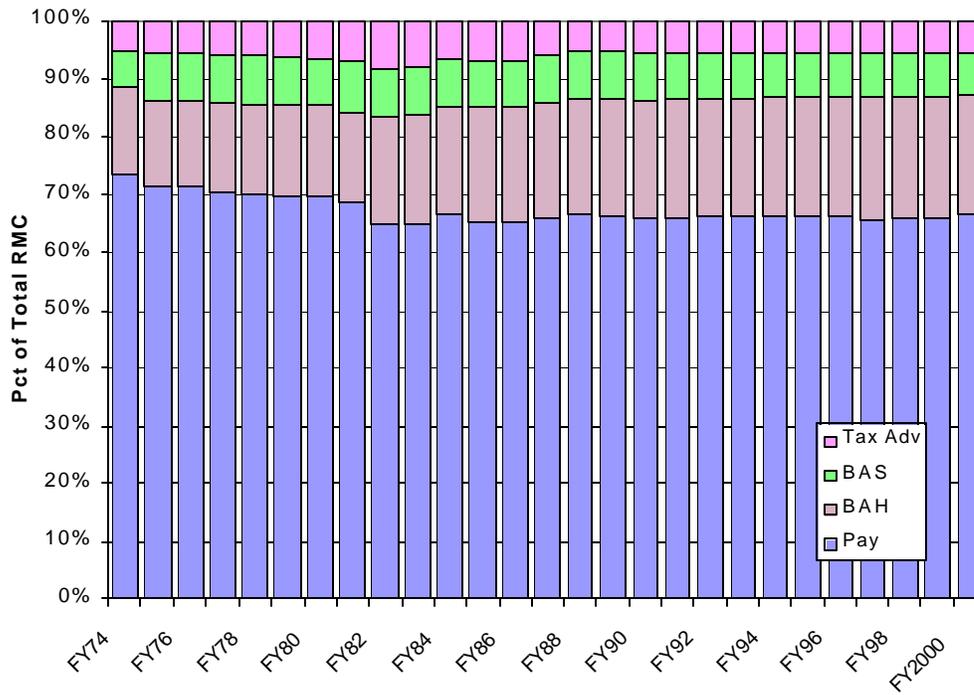
Figure 1. Changes in Regular Military Compensation, FY74-FY00



Source: "Detailed RMC Tables," *Selected Military Compensation Tables* (Department of Defense, Directorate of Compensation) FY74-FY00.

Notes: Totals represent averages across all pay grades. Real values computed using the FY00 military pay deflator (Office of the Under Secretary of Defense (Comptroller)). 2000 pay figures reflect the July, 2000 pay raise.

Figure 2. Ratio of RMC Elements, FY74-FY00

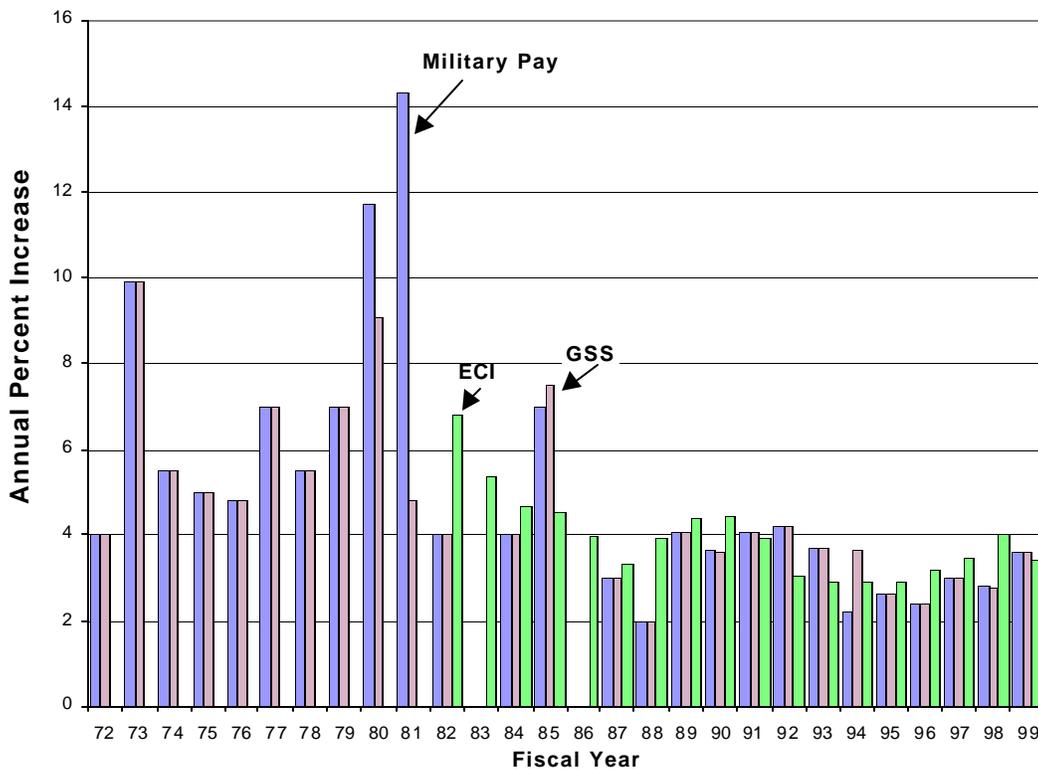


Source: *Selected Military Compensation Tables*, FY74-FY00.

Note: Totals represent averages across all pay grades.

Basic Pay. Basic pay, which varies by rank and years of service, makes up about two-thirds of the average service member's military income.³ In January 2000, basic pay averaged \$19,800 per year for enlisted members and \$47,520 for officers.⁴ Figure 3 tracks annual percentage increases over the past three decades in military basic pay, the General Salary Scale (GSS), and, beginning in 1982, the Employment Cost Index (ECI) for Wages and Salaries (the growth in labor cost for nonmilitary civilians). While basic pay raises are frequently compared to the ECI, some analysts have noted that this comparison distorts the true picture. For example, the basic pay-ECI comparison may not provide a true indication of the value of military compensation (because basic pay is just one component).⁵ Despite drawbacks, policymakers and proponents commonly compare basic pay with the ECI.

Figure 3. Annual Increases in Basic Pay, the General Salary Schedule, and the Employment Cost Index



Source: "Military and Civilian Pay Increases Since 1945," *National Defense Budget Estimates for FY 2001* (Office of the Under Secretary of Defense (Comptroller): Washington, DC), March 2000, and Bureau of Labor Statistics (www.stats.bls.gov/ecthome.html, accessed July 26, 2000).

³ "Pay and Benefits," Office of the Assistant Secretary of Defense for Force Management Policy (dticaw.dtic.mil/prhome/paybenef.html, accessed August 10, 2000).

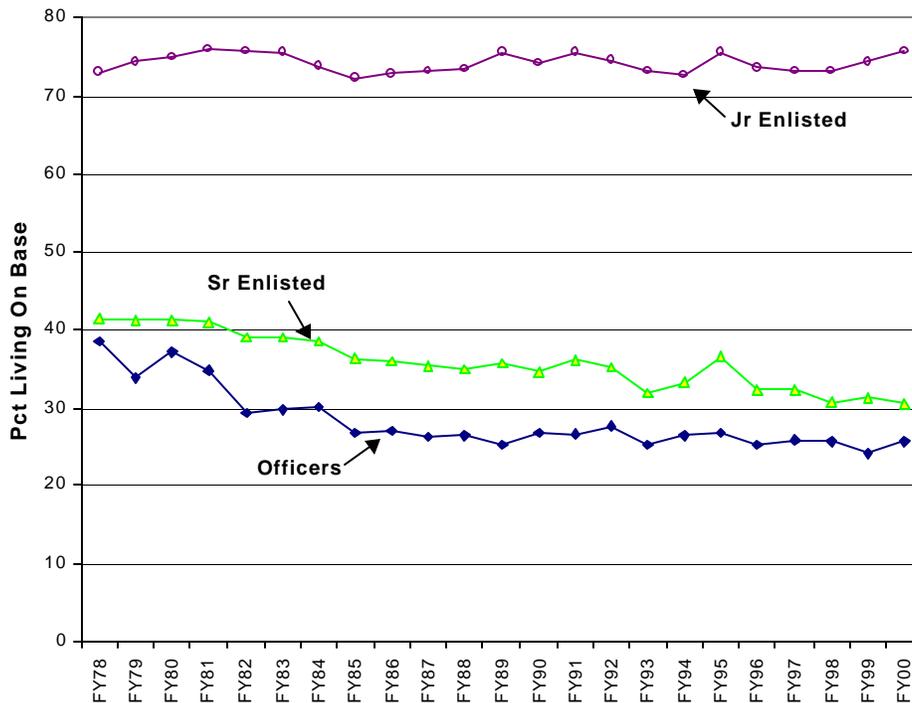
⁴ These figures include the across-the-board increase of 4.8 percent provided for FY00, but do not reflect the targeted raise for specific grades and years of service of up to an additional 5.5 percent that took effect on July 1, 2000. The targeted raise was aimed primarily at mid-grade officers and noncommissioned officers, and was intended to provide greater rewards for promotion versus longevity.

⁵ For a more complete discussion of the limitations of comparisons with the ECI, see Beth Asch and James Hosek, *Military Compensation: Trends and Policy Options* (RAND: Santa Monica, CA), 1999; and *What Does the Military "Pay Gap" Mean?* (Congressional Budget Office: Washington, DC), June 1999.

Basic Allowance for Subsistence (BAS). The second component of RMC is the BAS, which was originally designed to provide a cash equivalent of the approximate cost to the government of feeding military personnel. This relationship became more tenuous over time, but recent reforms have reinforced the relationship to food costs (by tying future increases to food price indices) and mandated transition to a system where all military members will receive a cash allowance. (Previously some enlisted personnel received food as an in-kind benefit, but all will now receive BAS for food purchases). The average constant dollar value of BAS has declined throughout the course of the AVF from about \$3200 (in FY00 dollars) in FY74 to roughly \$2600 in FY00.

Basic Allowance for Housing (BAH). The third element of RMC is BAH, or the Basic Allowance for Housing, which is paid to military personnel living off base. Figure 4 shows that the average percent of officers and senior enlisted members living on base has fallen over the last 22 years, but that the overwhelming majority of junior enlisted members continue to live on base. On-base housing is provided as an in-kind benefit, while cash allowances are provided to those living off base to help defray their housing costs. Enlisted members living on base reside in barracks, in Bachelor Enlisted Quarters, or in family housing, depending on rank and dependency status. Single officers residing on base live in Bachelor Officer Housing, while officers with dependents occupy family housing.

Figure 4. Percent of Officers, Senior, and Junior Enlisted Personnel Living On Base, FY78-00

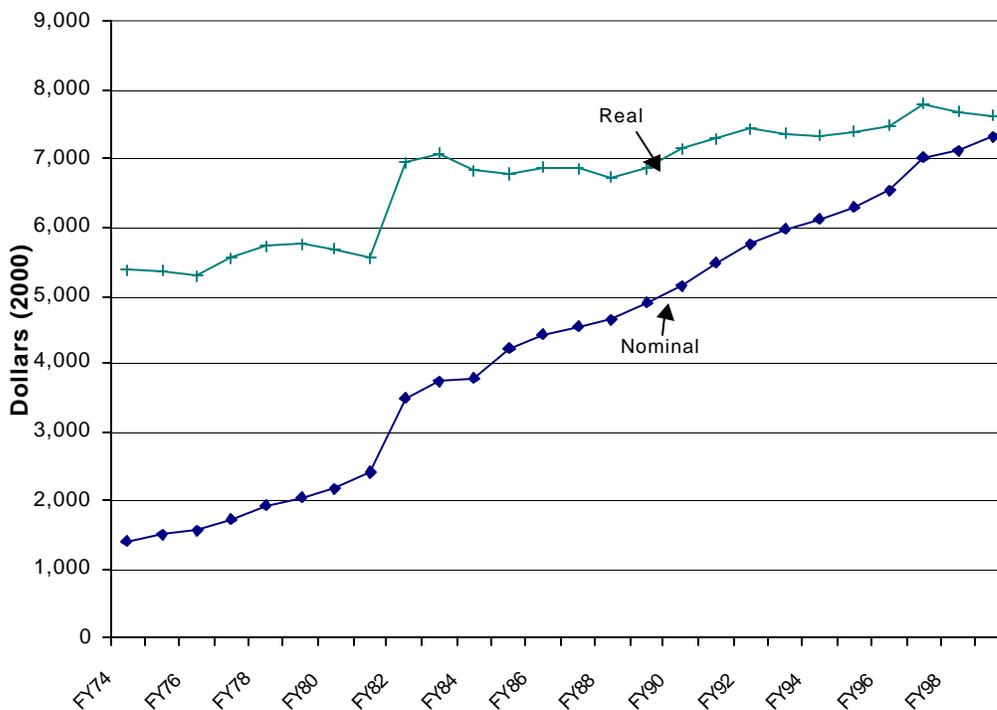


Source: *Selected Military Compensation Tables*, FY78-FY00.

Notes: Officers are O-1 through O-6, senior enlisted are E-5 through E-9, and junior enlisted are E-1 through E-4. Totals represent averages across pay grades.

The purpose of BAH is to compensate military personnel for the housing costs they incur when government quarters are unavailable. Although this purpose has not changed, the method of delivery has varied over time. Prior to 1997, DoD provided housing allowances in two forms. All members living off base received a Basic Allowance for Quarters (BAQ), which was later supplemented in high-rent areas with a Variable Housing Allowance (VHA). BAQ was offered at a flat rate for all members of the same grade and dependency status; it was determined by national median housing costs and was indexed to increases in basic pay. These increases did not keep pace with the growth in housing costs, however, and those living off base faced steadily increasing out-of-pocket expenses, especially in high cost locations. VHA was established in 1980 to alleviate this problem by providing an additional allowance to those residing in expensive areas. VHA rates were determined from a survey of military members' housing expenditures in various locales. In 1997, the BAQ/VHA combination was replaced with a single allowance, the BAH. Increases in BAH are indexed to local housing costs rather than to pay raises, and rates are determined from a survey of market prices rather than from military members' actual expenditures. Rates vary by location, pay grade, and dependency status. On average, the real value of BAH has increased by almost 50 percent since FY74, as shown in Figure 5.

Figure 5: Annual BAH Rates, FY74-FY00



Source: Defense Finance and Accounting Service, "Military Pay Tables" (www.dfas.mil/money/milpay, accessed August 15, 2000). Real values computed using the FY00 military pay deflator (op. cit.).

At present, BAH covers about 80 percent of off-base housing costs, and service members pay the residual amount themselves. (For a given individual, the actual out-of-pocket expense can be greater or lower, depending on the housing option that is chosen.) Recent reforms,

however, are aimed at eliminating this “gap,” in that planned BAH increases would capture 100 percent of median housing costs by 2005.⁶

Federal Income Tax Advantage. The final component of RMC is the federal tax advantage. As far back as 1862, legislation provided for the taxation of payments made to military members. In 1925, the U.S. Court of Claims restricted the portion of military income subject to taxation by ruling that the *pay* elements of military compensation are taxable, but that *allowances* are exempt. For tax purposes, then, allowances such as BAS, BAH, clothing, and family separation are not taxable; taxable income comprises basic pay, bonuses, and other special pays.

The value of the tax benefit is defined as the additional cash income a service member would have to receive if allowances were in fact taxable, in order for that member to be as well off in post-tax income as he or she is under the current system. The specific value of the tax advantage varies by individual, but in January 2000, the average annual value was \$3,698 for officers and \$1,761 for enlisted members.⁷

Special and Incentive Pays

Special and incentive pays are additional monthly cash allowances that are granted to selected classes of military personnel. These payments fall into two broad categories. The first consists of allowances that provide extra compensation for duties performed under stressful or potentially dangerous conditions during peacetime. These duties include flying, serving at sea or on submarines, parachuting, diving, serving in areas subject to hostile fire or imminent danger, or demolition duty. Many of these allowances have taken on an additional “force balancing” purpose, in that they are aimed at ensuring that available supplies of personnel by skill type and experience level meet or exceed demands. This second category includes special pay for physicians, nurses, veterinarians, and dentists, as well as foreign language proficiency pay and more general accession and reenlistment bonuses. The amounts vary widely, but special pays can add significantly to a military member’s total compensation package.

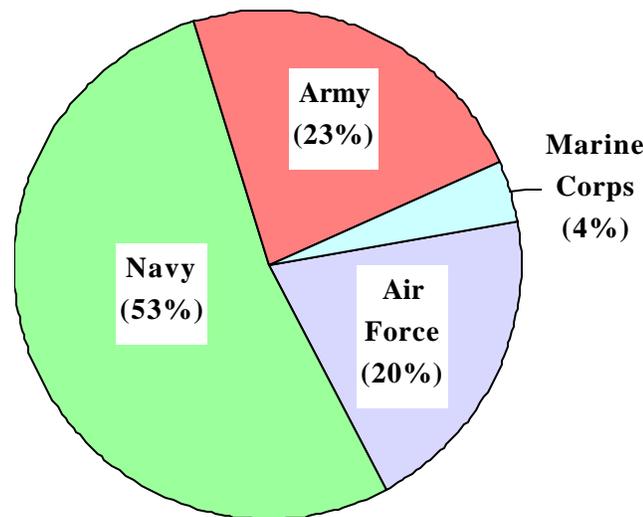
Currently, approximately 43 percent of military personnel receive one or more special or incentive pays.⁸ Allowances for deployed naval forces (“sea pay”) are one of the most widely used, as reflected by the fact that Navy personnel accounted for 53 percent of the service members who received some form of special pay in 1996 (see Figure 6).

⁶ “Housing Allowance: Frequently Asked Questions” (www.dtic.mil/perdiem/bahfaq.html, accessed July 26, 2000).

⁷ “*Selected Military Compensation Tables*, January 2000.

⁸ “Military Pay and Benefits” (www.dticaw.dtic.mil/prhome/paybenef.html, accessed August 9, 2000).

Figure 6. Distribution of Special Pays by Service, 1996



Source: *Trends in Active Duty Military Compensation Accounts, 1990-1997* (General Accounting Office: Washington, DC), 1997.

Enlistment and reenlistment (recruiting and retention) bonuses are another key source of additional military income. Eligibility criteria and dollar values of these bonuses are determined by the individual military services, based on projected manning requirements in specific specialties or career fields. Enlistment bonuses date back to the Civil War, but were rarely used subsequently until 1971, when the Army and Marine Corps began offering additional pay to recruits entering the combat arms (infantry, armor, and artillery). Since then, the authority for enlistment bonuses has been extended repeatedly to allow all of the military services to draw recruits into “critical” areas, although the Air Force and Navy traditionally use the program less frequently than do the Army and Marine Corps. Tight recruiting markets have encouraged growing reliance on enlistment bonuses, however, as reflected in the Army’s recent increase in the ceiling from \$12,000 to \$20,000, and the Navy’s turn to seasonal bonuses to attract more recruits during periods of lower recruiting in the spring. All of the services also use Selective Reenlistment Bonuses (SRBs) to aid in meeting retention objectives. They use SRBs as monetary incentives to encourage personnel to remain in the military, especially in fields with high training costs or manning shortages.

Other Allowances

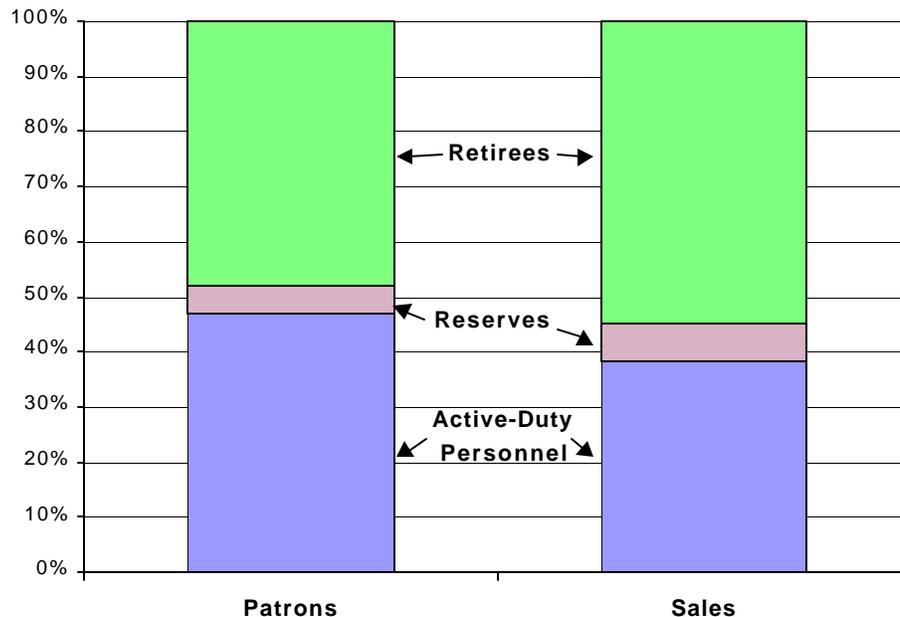
In addition to the pay and benefits discussed above, military members also receive other allowances. These include a clothing allowance; the Family Separation Allowance (FSA), which is offered to members serving on temporary duty or in overseas locations when they are not accompanied by their dependents; the Overseas Housing Allowance (OHA); a Cost of Living Allowance (COLA), intended to help offset expenses for those serving in high-cost locations; and a Temporary Lodging Allowance (for expenses in conjunction with moves overseas) or Temporary Lodging Expense (for moves within the continental United States). Again, the amount of these allowances varies widely, but they can add significantly to service members’ income.

Other Benefits and Entitlements

In addition to military compensation, DoD provides a number of other benefits that contribute to service members' total compensation package. This section reviews some of the largest or most valued benefits.

Commissaries and Exchanges. Both commissaries and exchanges are exempted from state and local taxes, have a monopoly over on-base retail sales, and use federal capital without paying interest.⁹ In addition, commissaries receive about \$1 billion annually in appropriated funds. Commissaries provide food and common household items at below-market prices (prices are set at cost plus a 5 percent surcharge), which the Defense Commissary Agency estimates results in an average of 27 percent savings over commercial grocery stores.¹⁰ Commissaries are open to all military personnel (active duty, reserves, or retired) and their families.¹¹ As shown in Figure 7, retirees profit the most from commissary savings, accounting for over 50 percent of total sales.

Figure 7. Commissary Use and Sales, 1993



Source: *The Cost and Benefits of Retail Activities at Military Bases* (Congressional Budget Office: Washington, DC), October 1997, p. 5.

Exchanges provide services similar to the commissary system, but offer durable goods. Exchanges are subject to legislative restrictions on the items they may offer for sale (for example, they must limit their selection of electronic goods, jewelry, and furniture) in order to limit competition with off-base stores. At present, there is no routine DoD estimate of the value

⁹ *The Cost and Benefits of Retail Activities at Military Bases* (Congressional Budget Office: Washington, DC), October 1997.

¹⁰ *Exchange and Commissary News*, "2000 Yearbook Issue," July 15, 2000, p. 87. A CBO analysis states that the method used to generate the DoD estimate of commissary savings overstates its true value, however (CBO, 1997, p. 24).

¹¹ Reservists are authorized 24 visits annually, in addition to unlimited use while they are on active duty.

of exchange purchases to military members, although federal subsidies allow exchanges to provide goods at prices lower than those found in commercial stores. Some of the resulting profits are reinvested in the community, supplementing funding for the Department of Defense's Morale, Welfare, and Recreation (MWR) programs.

Educational Assistance. Beginning in World War II, Congress enacted a number of laws providing educational assistance to veterans in order to speed their reintegration into civilian life. These "GI Bills" offered support for various costs associated with textbooks, tuition, and/or other academic fees, and varied by the type of training, the amount of time spent in the program (e.g., partial or full-time), number of dependents, and so forth. In 1976, Congress established the Veteran's Educational Assistance Program (VEAP) to provide educational assistance to all military members who entered the armed forces after January 1, 1977. It was the first educational program that required service members' contributions as a condition of entitlement. In 1986, VEAP eligibility was limited to those who had joined the force prior to June 30, 1985. Service members entering after that date were offered the Montgomery GI Bill (MGIB), which allows active-duty members to contribute some portion of their pay and to accrue a fixed monthly educational benefit, based on a minimum of three years of service. Recently, some Members of Congress have proposed allowing the educational benefit to be transferred from the service member to spouses and/or children, which, though expanding the benefit, would also greatly increase its cost.

Beyond the GI Bill, the military services have been responding to increasing demands for education with new options for potential recruits and current members. For example, in June 2000 the Army announced a new educational initiative giving service members the opportunity to take on-line classes during their standard four-year enlistment, so that they earn degrees while meeting their service obligations. The Navy has established a College Assistance/Student Headstart ("CASH") program that allows recruits in certain skill areas to enlist and receive military pay and benefits while attending school full time, prior to beginning their service.¹² Additionally, the military services are experimenting with various programs to assist with tuition costs and repayment of student loans.

Health Care.¹³ For over 200 years, the armed forces have supplied medical care to active-duty members. An 1884 law mandated that medical care also should be provided "whenever possible" to military family members and retirees, a provision that was formally extended on a "space available" basis in 1956. Ten years later, Congress greatly expanded the Defense Secretary's authority to contract with outside health care organizations for additional care, which resulted in the creation of the Civilian Health and Medical Program of the Uniformed Services (CHAMPUS) in 1967. Dependents of active-duty members bore some share of the costs of authorized care provided under CHAMPUS, although they were not required to pay a premium.

In the 1980s, governmental efforts to improve health care quality, access, and efficiency led to various demonstration projects to explore new health care options, including the CHAMPUS Reform Initiative (CRI), which began in 1988. This initiative led to the eventual replacement (phased in nationwide by 1998) of CHAMPUS by TRICARE, a tripartite system

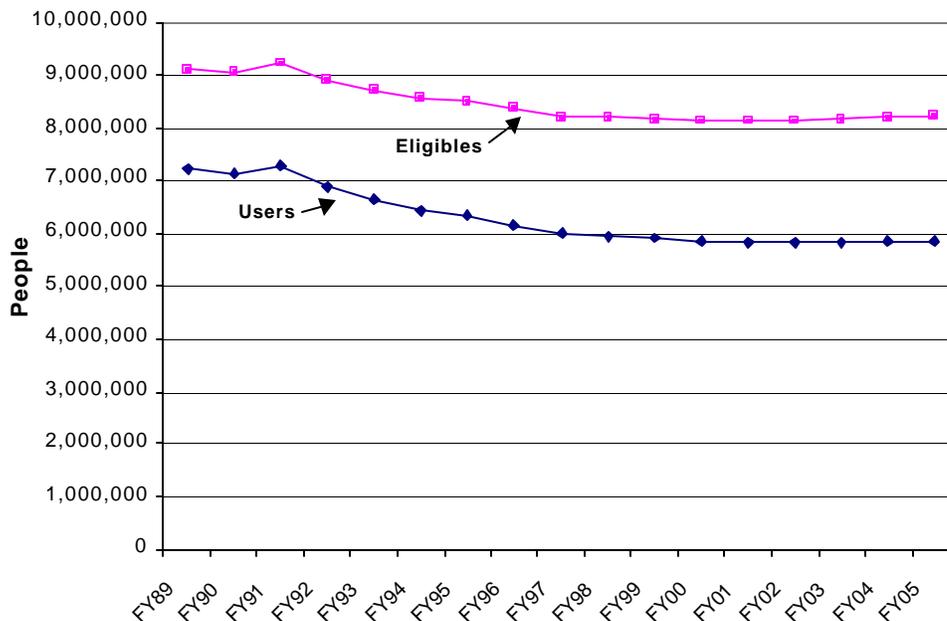
¹² "Money for College," www.navyjobs.com/html/highschool/college.htm, accessed August 21, 2000.

¹³ This section is based on *MCBP*, pp. 857-862, and "The History of CHAMPUS and its Evolving Role in TRICARE" (www.tricare.osd.mil/factsheets/historyoftricare.htm, accessed August 15, 2000).

comprising TRICARE Prime, Extra, and Standard (equivalent to the old CHAMPUS system) options that offer varying degrees of coverage (at varying costs) for plan participants.

Figure 8 shows the number of past and projected military members, retirees, and dependents who are both eligible for and elect to use military health care (some have other coverage), over time, based on current eligibility rules. Recent congressional debates have focused on whether military retirees are entitled to free lifetime health care. Although there appears to be no statutory basis for this claim, the Congress may opt to extend such benefits to “make good” on what many argue was promised by recruiters in earlier decades. The estimated costs of various proposals to achieve this goal range from roughly \$4 billion to \$9 billion annually.¹⁴

Figure 8. Eligible and User Populations of Military Health System, FY89-05^a



Source: Office of the Assistant Secretary of Defense for Health Affairs.

^a Figures for FY01 and beyond are projections.

Retirement. The military retirement system has been in existence for over a century, although it did not become uniform across the services for both voluntary and involuntary retirees until 1980.¹⁵ That same year, the Defense Authorization Act modified the basis for retirement pay, which had been computed relative to basic pay at the time of separation, by replacing it with a “high three” retirement pay base, calculated as the average of a service member’s highest-paying 36 months (three years). Under High Three, as under the previous system, each year of service increases the retirement multiplier by 2.5 percent (so that 20 years of service results in 50 percent retirement pay). The multiplier is applied against the high three-year base pay average, with annual cost-of-living adjustments set equal to the Consumer Price Index (CPI). Six years later, the system was again modified with the creation of “REDUX.” Under REDUX, the retirement multiplier is 2 percent for each year up to 20 years of service,

¹⁴ Dale Eisman, “Senate Set to Broaden Military Retiree Care,” *Norfolk Virginian-Pilot*, June 7, 2000.

¹⁵ This was included in the Defense Officer Personnel Management Act (DOPMA). DOPMA continued the long-standing eligibility requirement for voluntary retirement of 20 years of service.

after which it jumps to 3.5 percent for each additional year up to 30 (thus at 30 years of service, both High Three and REDUX offer 75 percent retirement pay). COLAs under REDUX are slightly lower, at CPI minus 1 percent. At age 62, however, REDUX multipliers and inflation adjustments are modified to create equality in base retirement salary with that of High Three annuitants; future COLAs for REDUX remain set at CPI minus 1 percent.

In 1999, the system was revised again. First, those previously covered under REDUX, as well as all new (and future) service members, will be given a choice (at 15 years of service) of participating in either the old retirement system (High Three) or REDUX. Second, a \$30,000 one-time career retention bonus will be given to those choosing REDUX, provided they make a commitment to serve 20 years. High Three is the default option; that is, incoming military members are enrolled in High Three unless they choose to take the REDUX option. Basic features of the two plans are summarized in Table 1.

Table 1. Comparison of High Three and REDUX Retirement Plans

	“High-Three”	REDUX
Eligibility	Entered service between 1980 and 1986; optional if entered after 1986	Optional if entered after 1986
Multiplier	2.5 percent of average basic pay for each year of service	2.0 percent of average basic pay for first 20 years of service, 3.5 percent for each year beyond 20
Average Basic Pay	Average of three years with highest basic pay rates	Average of three years with highest basic pay rates
COLA	Equal to Consumer Price Index (CPI)	CPI minus 1 percent
Bonus	None	\$30,000 (taxable) lump-sum payment
Change at age 62	None	Multipliers and average basic pay adjusted to equal High Three levels (then CPI – 1 percent thereafter)

The Department of Defense (DoD) has been seeking other ways to provide financial options modeled after those available to civilians. For example, the FY00 Defense Authorization Act provided for the creation of a Thrift Savings Plan (TSP) for military members. The TSP would allow service members to contribute a percentage of their basic pay to a special account, where principal and earnings would be tax-free until withdrawn. There is some possibility that some matching funds would be provided as a retention incentive. The plan should be offered beginning October 1, 2001.

CIVILIAN TRENDS¹⁶

As discussed above, the military provides a wide array of pay, allowances, and benefits as part its total compensation package. While the basic elements of the package are largely unchanged since World War II, the scope of the benefit within each element has expanded since the advent of the AVF. Over the same period, however, many private firms have offered similar pay and non-pay packages. Research indicates that private employers have opted more frequently for raising non-wage incentives than for increasing compensation. For example, a 1994 survey found that three out of four employers reimburse their employees for educational expenses, and almost as many provide training in computers, teamwork, and other key areas. This training is concentrated, however, at middle levels, with younger and older employees deriving less benefit. Military training is concentrated at younger members. Studies also show that less-skilled workers may be reaping fewer of the benefits from higher levels of civilian training.¹⁷ Following the military's lead, however, civilian employers are also now reaching into younger markets to develop relationships with potential employees at earlier ages. For example, Charles Schwab and CISCO Systems both work with high school students to provide job training and work experience. This sort of program is not an isolated phenomenon: a 1997 survey of 7,000 employers found that 74 percent were participating in school-to-work partnership programs, and almost a quarter offered internships.

The private sector is also more frequently making use of other forms of non-wage compensation, including signing bonuses, which are increasingly offered to a wider range of employees beyond upper-level management and skilled technicians. While the military offers initial and re-enlistment bonuses, whether these will prove sufficiently generous to compete with those offered by private firms remains an open question.

One key tool available to private companies for which there is no public-sector corollary is stock options. In 1994, for example, 35 percent of employers reported offering stock options to their workers. Government agencies do have the potential to provide tax advantages for employee stock ownership plans, but whether this would be perceived as an adequate alternative to private-sector options is unknown.

FUTURE CHALLENGES AND ISSUES

The first section of this paper described how the major elements of the military compensation system have grown in scope over time. These changes, responding to both internal (i.e., composition of the force) and external (i.e., competition from civilian firms) shifts, may or may not have produced a system that continues to be the most efficient or effective in meeting the needs of the current and future force. One of the most visible manifestations of this concern is the ongoing debate over the "pay gap."¹⁸ As the All Volunteer Force heads toward its fourth decade, interesting questions abound. For example:

¹⁶ This section is based largely on Robert Lerman and Stefanie Schmidt, *An Overview of Economic, Social, and Demographic Trends Affecting the US Labor Market* (The Urban Institute: Washington, DC), August 1999.

¹⁷ Ibid, p. 49.

¹⁸ Most recently, see Cindy Williams, "The G.O.P.'s Pay Gap," *New York Times*, August 17, 2000, p. A-18, and the response by retired Army Chief of Staff Gordon Sullivan, "Now Close the Gap in Military Pay," *New York Times*, August 20, 2000, p. A-20.

- Does the 1992 finding of the 7th Quadrennial Review on Military Compensation that “the current compensation system *can* support the force structure of the 21st century” continue to hold?¹⁹ Have subsequent modifications changed this conclusion?
- To what extent can or should the military compete with the private sector in terms of pay and/or benefits, and to what extent does the military’s comparative advantage lie in some of the “intangible” benefits of service?
- Has the national willingness to pay for a force of volunteers been exceeded by the potential costs?

These are just a few of the important issues confronting defense policymakers, who must find a way to develop a strategic approach for the future.

¹⁹ *Report of the Seventh Quadrennial Review of Military Compensation*, p.4.