THE COMING WAR OVER MILITARY PENSIONS

BY SYLVESTER J. SCHIEBER

It's not news that public pensions are in deep trouble. Nor should it come as a shock that a variety of factors are making it difficult for policymakers to push this long-building problem back under the rug. For one thing, the widening disparity between private- and public-sector benefits has given rise to "pension envy" – jealousy of public workers who are shielded from the consequences of financial volatility and meager personal retirement savings. For another, generous pensions are expensive, and the creative accounting used to delay the day of reckoning is becoming


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ever less tenable. Last, but hardly least, these chickens are coming home to roost just as governments are being forced to cut back services in order to balance their budgets.

Strikingly, though, pension plans for federal employees have largely escaped the media spotlight, even though many of the same factors apply. Washington, unlike states and localities, has the discretion to borrow to cover retirement obligations. But bitter partisan divisions are clearly making that harder – at least for military pensions.

The failure of the congressional deficit-reduction supercommittee to agree on trillion-dollar-plus economies last November will trigger automatic expenditure cuts totaling $1.2 trillion over a decade, beginning next year. And roughly half of those cuts are expected to come from the Defense Department budget, which Defense Secretary Leon Panetta claims would be "devastating." Larry Korb, a former Secretary of Defense in the Reagan administration, countered that Panetta "grossly exaggerates" the likely consequences. But, whether Panetta is right or not, a wide range of Defense Department outlays will soon be reviewed with a gimlet eye. And the very generous, very expensive military pension system will almost certainly figure prominently in that review.

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SYLVESTER SCHIEBER, the former chairman of the Social Security Advisory Board, is the author of the newly published book, *The Predictable Surprise: The Unraveling of the U.S. Retirement System* (Oxford University Press).

ORIGINS OF THE FALL

The roots of the U.S. military retirement system date back to the Revolutionary War. The first national pension law (1776) promised half-pay for soldiers injured in the conflict. Non-disabled officers with 40 years of service were covered in 1861. And in 1870, the system was liberalized to allow officers to retire after 30 years of service at 75 percent pay.

Then, in 1885, non-disability pensions were extended to cover Army and Marine Corps enlistees, with benefits set at 75 percent of pay after 30 years of service. And 14 years later, Navy enlistees were given equal coverage. In 1948, Congress standardized non-disability retirements with a 20-year service requirement across the Army, Navy, Marine Corps and Air Force.

Today, the Military Retirement System covers both active soldiers and reservists. There is no vesting of benefits, though, prior to the 20-year anniversary – that is, retirees receive nothing if they serve less than 20 years.

Different formulas are used to calculate benefits, depending on when the participant first joined the military. The benefit for men and women who joined prior to 1980 equals 2.5 percent of their "basic pay" – more about that below – at the time they retire, multiplied by years of service. The formula for those hired between September 1980 and July

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1986 is similar, but linked to average basic pay in their highest three years.

Those entering service since July 1986 get a second option. They can choose to stay under the old 1980-86 formula or take what the Pentagon calls a "career status bonus/redux benefit" in their 15th year of service. Soldiers who take that bonus, which is $30,000, and retire with less than 30 years of service have their retirement benefits reduced until they reach age 62. Those who remain in the service for at least 30 years, though, still get an immediate benefit upon retirement equal to 2.5 percent of pay per year of service. Retired soldiers are entitled to Social Security benefits on top of their pensions.

Note that, in addition to retirement pensions, veterans are entitled to pensions for service-related disabilities, as well as some non-service-related cases. These Veterans Administration benefits are exempt from federal income taxes.

Through 2003, the receipt of a VA benefit offset regular service-related pensions, dollar for dollar. But thereafter, Congress eliminated the offset for some and reduced it for the rest. The Concurrent Retirement and Disability Pay program will completely phase out the offsets by 2014 for veterans with at least a 50 percent disability rating and at least 20 years of service. (The offset is already a thing of the past for beneficiaries who are completely disabled or deemed unemployable due to their disability.)

As noted above, soldiers who leave before 20 years of service do not qualify for any military pension unless they qualify for a disability benefit. The vast majority of those retiring after 20 years qualify immediately for a benefit that is 50 percent of their basic pay. At 30 years, this increases to 75 percent, and at 40 years to 100 percent.

It's worth noting that "basic pay" for military personnel is not equivalent to salaries that private-sector (and most public-sector) workers receive. Housing and subsistence allowances, which are routinely paid, are not part of the former.

All told, military compensation is pretty good these days. In 2010, the average monthly basic pay – that is, not including allowances – of an enlistee who was 40 years old and had been in the service for 20 years was $4,216; 45-year-old officers with 20 years of service averaged $7,830. Housing allowances, which vary by rank and location, are paid to soldiers not housed on a military base. They are intended to cover reasonable costs of a home (adjusted for service rank), based on survey evidence from the towns where the military personnel live.

For example, in 2010, the housing allowances paid to soldiers stationed at Offutt Air Force Base (outside Omaha) ranged from around $730 per month for a new recruit with no dependents to about $1,900 for a

STATUS OF THE MILITARY RETIREMENT SYSTEM, SEPTEMBER 2009

COVERED POPULATION	
Active duty personnel	1,480,142
Reservists	770,565
Total personnel accruing benefits	**2,250,707**
Non-disability retirees	1,812,771
Disability retirees	91,539
Survivors	290,902
Total annuitants	**2,195,212**
Liabilities ($, billions)	
Actuarial accrued liability	$1,186.9
Actuarial value of assets	278.4
Unfunded liability	**$908.5**

SOURCE: Department of Defense, Office of the Actuary

high-ranking officer with dependents. For soldiers stationed in San Francisco, the rates ranged from $2,000 to $3,800. That same year, the separate allowance for “subsistence” ranged from $223 to $324 per month.

Since the allowances are substantial relative to basic pay, comparing military benefit levels tied to basic pay with pension benefits granted by other employers is complicated. A military retirement benefit that is equivalent to 50 percent of basic pay may look generous compared to a government or private pension equal to 40 percent of salary, but may replace less of pre-retirement income. However, other features of the military system are exceptionally generous:

• The annual accrual rate – 2.5 percent of earnings per year – is higher than the rate offered in almost all other pension plans.

• Full retirement benefits can be claimed relatively early in life.

• Monthly checks are fully indexed to the cost of living, a perk that is virtually never offered outside federal employment.

• Unlike many other public-sector retirees, retired military personnel are entitled to Social Security benefits.

Military.com, a comprehensive Web portal for military personnel, describes the benefits this way:

> The military retirement system is arguably the best retirement deal around. Unlike most retirement plans, the Armed Forces offer a pension, with benefits, that starts the day you retire, no matter how old you are. That means you could start collecting a regular retirement pension as early as 37 years old. What’s more, that pension check will grow with a cost-of-living adjustment each year.

JUST THE FACTS, SIR

As the table on page 31 shows, there are nearly as many military retirees as there are personnel serving full-time or as part-time reservists. This often happens as retirement systems mature. And with a history dating back more than a century, the military pension system is clearly a mature one. But the burden is partly due to the early-retirement feature; dumping younger beneficiaries into the pension pool inevitably lengthens the time that the benefits are paid and swells the size of the group relative to the active force.

The military claims the system is “funded.” But that is semantic sleight-of-hand. Accumulated obligations to existing participants at the end of fiscal year 2009 were just shy of $1.2 trillion, yet there was less than $280 billion in government bonds in the trust funds to cover the liability. That left an unfunded obligation of about $900 billion.

No matter what color glasses you view it through, however, this still looks like a very expensive program in comparison with private (and other public) pensions. In fiscal 2009, the Defense Department contributed 32.7 percent of basic payroll for full-time participants and 24.5 percent of basic pay for the part-time reserve force. However, that is not the full cost. As part of the deal in which disability benefit offsets to military retirement pensions are phased out, the Treasury must pick up part of the charge for the added accruing benefits. This brings the charges for currently accruing benefits to 40.9 percent of basic pay for the full-time force and 27.7 percent of pay for part-timers.

Compare those numbers to the “actuarially required contribution” rates calculated under the Governmental Accounting Standards Board rules for pensions in a few of the states that have been in the news for attempting to control “unsustainable” programs: the figure is 12.6 percent for California, 14.1 percent for Illinois and 16.1 percent for New Jersey. Note, moreover, these “required” contribution rates

include an amortization payment for unfunded obligations. By contrast, "normal" contributions to the Military Retirement System do not include cash to amortize the system's $900 billion unfunded liability.

THE PRETENSE OF FUNDING

In the early 1980s, Congress debated whether the Military Retirement System should continue to run on a pay-as-you-go basis (where benefits were simply a line-item expense in the annual budget), or whether it should be funded as an actuarially sound pension program under rules similar to those applied to private pension plans that are regulated by the Department of Labor. To its credit, Congress chose to acknowledge the full cost of funding. But then it fudged the method.

Since 1984, each branch of the military has been charged with its normal cost contribution to the pension fund to cover currently accruing obligations. Total normal cost contributions in fiscal 2010 amounted to $23.5 billion, of which $4.5 billion was from the Treasury to cover the phaseout of the disability pension offset. That sum amounted to 39 percent of covered pay. None of these figures, by the way, include the cost of disability pensions paid by the Veterans Administration and charged to the VA budget. In fiscal 2009, payments for income security for veterans from the VA budget totaled $44.7 billion.

Meanwhile, the cost of the 1984 change in funding policy fell to the Treasury Department rather than the Department of Defense. The Treasury's separate amortization payment for fiscal 2010 was $58.6 billion – an astounding 97.2 percent of that year's covered pay.

That's where the smoke and mirrors really come in. All of the funding of the Military Retirement System is composed of special-issue federal securities. The contributions that go toward paying for the benefits are "deposited" in the U.S. Treasury, which then issues a security to the trust funds in the amount of the bookkeeping deposit. These securities become assets of the trust fund in which they are deposited, but are a liability for the Treasury. Since both the trust fund and the Treasury are creatures of the federal government, the expense of the contribution and the gain in trust fund balances equal each other and net to zero in government-wide financial statements. So in a pension-financing context, the bonds securing the benefits (and the interest that they earn) are a claim against the same taxpayers who would be on the hook for the benefits if they were funded on a pay-as-you-go basis.

In economic terms, then, it makes no difference to taxpayers whether this system was funded or not. When a bond is issued to the trust fund this year, it is not costing taxpayers a cent in current terms. It will, however, cost our children either additional taxes or a reduction in other things that government can buy when today's bonds are cashed to cover the benefits that were earned this year but will be paid 20 or 30 years from now.

One way to think about the bonds that are being accumulated in the military pension trust fund (and other federal pension trust funds, including the one for Social Security) is to consider them as pension-obligation bonds that will be either sold into the financial markets at some point in the future or cashed out using tax revenues when the money is needed. The White House Office of Management and Budget acknowledges that these trust funds are available to pay future benefits only in a bookkeeping sense. The holdings of the trust funds are not assets of the government as a whole that can be drawn down in the future to pay for benefits. Instead, they are claims on the Treasury. From a cash perspective, when

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trust fund holdings are redeemed to authorize the payment of benefits, the Department of Treasury finances the expenditure in the same was as any other federal expenditure – by using current tax receipts or by borrowing from the public.

RETHINKING THE SYSTEM

In the fall of 2010, the Defense Business Board (a panel of business executives that advises the Secretary of Defense), submitted a report on the Military Retirement System. This analysis was undertaken at the request of then Defense Secretary Robert Gates, who stated that he was concerned about the department's ability "to continue critical modernization of military capabilities given the current and projected fiscal climate."

The board raised a number of issues that boiled down to an overarching concern that the system was outdated – that it was "designed in an era when life spans were shorter, draft-era pay was substantially less than civilian sector pay, second careers were less common, and skills acquired during military service were not transferable to the private sector."

In 1940, a typical soldier retiring at age 40 could expect to draw a pension for 30 years. One retiring at that age today will likely be on the rolls for 40 years. Current enlistees' pay levels, moreover, place them in the top quarter of men with high-school educations who are working in production and craft occupations. Officers' pay levels put them in the top quarter of men with college degrees who are working in professional or technical occupations.

The board noted that while the risks of military service might be used to justify the 20-year retirement option, only 12 to 13 percent of enlisted troops serve a full two decades. Among officers, the rate is higher – around 43 percent. But officers leaving the military in their 40s have generally developed skills that are prized by private employers, and thus are likely to have other sources of income in midlife. The pension system, moreover, doesn't offer richer rewards to personnel who are exposed to wartime risks.

The reality that the great majority of people serving in the military will leave before 20 years, and will thus receive no benefit from the pension plan, raises basic issues of fairness. Congress was sufficiently concerned about such inequities in the private labor market to require that pension plans fully vest benefits within five years. Why do solders merit less protection?

If we were still operating under a military draft, where large cross-sections of society were required to serve for a couple of years and then moved on, that would be one thing. But when we are asking people to volunteer, and the retirement plan constitutes about 40 percent of compensation, the 20-year, all-or-nothing hurdle is deeply problematic. The equity issue will only be compounded if the current budgetary realignment leads to downsizing, and some of the people who intended to stay to grab the brass ring are forced to retire a few years short of the magic 20-year mark.

Then there is the issue of efficiency – of getting and keeping the best soldiers for the

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least money. Under the current system, turnover falls to virtually nil as soldiers approach 20 years of service. Yet three-quarters leave between the 20- and 25-year mark – behavior that cannot be in the best interests of a military that needs experienced soldiers and has invested heavily in their technical skills.

The Defense Business Board recommended that the existing system be replaced with a "uniformed personnel thrift savings plan" that would be integrated with the total compensation package. It would be largely financed by the government, though individuals would be able to make supplemental contributions in much the way private-sector workers can now participate in their 401(k) plans. In drafting its proposal, the board assumed that the government would spend 16 percent of basic pay on the system. But contributions could vary by length of service, combat status or other factors.

The proposal calls for early vesting, so shorter-term soldiers would receive some deferred compensation for their service. Benefits that have been earned to date under the old system would be protected, and those already retired would not be affected at all. (Soldiers who become disabled in service would still be covered under the existing VA program.)

This disinclination to change horses in midstream is understandable. But it points to the problems we face in getting where we want (and need) to go. If soldiers' pension rights are grandfathered, one would expect that most of them who planned to stay 20 years would opt for the more lucrative benefit package. It follows that the pay-as-you-go costs of the existing system would not change much. But providing benefits to short-time soldiers would generate new net costs during the lengthy transition. We might still reduce pension costs 25 or 30 years down the road. But the budget crunch is immediate.

Continuing to deny any benefit now accruing to active-duty soldiers with less than 20 years of service is hard to justify. In light of budget constraints, though, so is continuing the practice of providing fully indexed retirement benefits to 45-year-olds.

Rather than just abandoning the defined-benefit, guaranteed-monthly-check-for-life model, it might be better to move to a hybrid system that combines a more modest traditional pension with a 401(k)-like savings plan. The traditional pension could be made much more affordable by beginning to increase the eligibility age and service requirements, with special credits given for combat tours – especially for front-line soldiers.

In an era in which the trend toward earlier retirement is being reversed by the harsh realities of the bottom line, such changes would begin to bring the military system into closer alignment with civilian practices. They could also dramatically reduce the cost of the existing system while continuing to provide a superior benefit for career military personnel.

Plainly, the politics of reneging on promises made to any soldier are highly problematic. The only reason to believe it might happen is that the politics of failing to deal with the deficit are even more problematic.