



## CHAPTER 11

### **RESERVE RETIREMENT REFORM: AN ASSESSMENT OF RECENT CONGRESSIONAL PROPOSALS**

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The extensive use of reserve forces since September 11, 2001 has created concern about reserve personnel levels and whether they will be large enough to meet staffing and deployment requirements. Reserve supply depends in part on compensation. Some argue that if reservists are used more frequently and for longer periods, they should have the same pay and benefits as active duty forces. Reservists already have the same basic pay and allowance schedules as active duty personnel, as well as some special and incentive pays. But reservists have different educational benefits, enlistment bonuses, reenlistment bonuses, health benefits, and retirement benefits. Active duty members vest in their retirement program at 20 years of service and, once vested, receive military retirement benefits immediately after leaving active duty. Reservists vest at 20 years of qualifying service, referred to as “creditable” service, but do not receive benefits until age 60.<sup>1</sup> With reservists serving side by side with active duty members on deployments, some view the difference in retirement benefits as an arbitrary and inequitable disparity that creates friction, hurts reserve morale, and weakens reserve recruiting and retention.

To make reserve benefits more equitable, Congress proposed several bills in 2004 to reduce the age at which reservists draw retirement benefits.<sup>2</sup> One bill, which we refer to as “immediate annuity” for the sake of this discussion, allowed vested reservists to receive retirement benefits immediately after leaving the reserves. A second bill, which we call “age 55,” allowed vested reservists to receive benefits at age 55 instead of age 60. A third bill, which we identify as “sliding scale,” decreased the age 60 threshold by one year for every two years served beyond 20 years. For example, under the sliding scale proposal, a reservist with 24 years of service would receive benefits at age 58.

This chapter reports the results of an assessment of these reserve retirement proposals, which sought to:

- Predict the effect of each proposal on active duty and reserve retention, as well as on the affiliation of prior active duty members with the reserves.
- Determine cost-effectiveness in terms of expected active duty and reserve career length, differentiating between the costs of current compensation and retirement benefits.
- Consider the issue of retirement benefit equity, as well as other goals of reserve retirement reform such as enhancing personnel management flexibility.
- Place the proposals within the debate on active duty retirement reform and discuss the relevance of active duty reform critiques to the reserve system.
- Identify obstacles to reforming the retirement system, drawing from recent economic analysis.

The retention and cost-effectiveness portions of the assessment required the creation of a dynamic programming model to estimate active and reserve retention. We used this model for policy simulations.<sup>3</sup>

## **Key Findings on Congressional Proposals**

The main findings on how the three reserve retirement proposals would affect retention and cost-effectiveness are summarized as follows.

For active duty personnel, there was little change in the average length of an active duty career. There was also little change in the percent of personnel reaching 10 and 20 years of service, and thereby vesting for active duty retirement benefits. In other words, although the reserve retirement proposals all serve to increase the generosity of the reserve retirement benefit system by paying those benefits earlier, and might be expected to affect active duty retention, such effects would actually be negligible or small. Interestingly, the immediate annuity proposal resulted in an increase in active duty retention among junior and mid-career personnel. Apparently, the more generous reserve retirement benefits increased the value of another year of active duty; if the member should leave active duty and join the guard or reserve, the expected earlier receipt of reserve retirement benefits is more attractive. Average years of active duty changed only slightly relative to the current system, generally remaining about the same at 7.1 years under all three proposals. The age 55 and sliding scale proposals, which are less generous, caused only a slight increase in active duty retention among junior and mid-career personnel.

There was a slight increase in prior-service affiliation for the reserves under the immediate annuity proposal. Transitions from the Army to the Army National Guard or Army Reserve rose from 21.4 percent in the current system to 21.8 percent. However, the age 55 and sliding scale proposals had no effect on transitions into the Army National Guard and Army Reserve.

Reserve retention, measured in terms of average years of reserve service, also showed small changes. Average years of Army reserve service, for instance, increased from 8.1 years in the current system to 8.2 years under the immediate annuity proposal. There were no changes under the age 55 or sliding scale proposals.

Another key metric is the percent of reservists with prior active service that qualified for reserve retirement. Because the proposals would increase the generosity of benefits, we would expect this percentage to increase, and it did under all three proposals. Specifically, under the current system, 17.5 percent of prior active service reservists qualified for reserve retirement. This figure increased to 22.8 under the immediate annuity proposal, 19.6 under the age 55 proposal, and 17.8 under the sliding scale proposal. Thus, the opportunity to claim benefits earlier encouraged more reservists to stay in service until they qualified for retirement.

For the most part, the proposals would have little effect on active duty personnel costs, including regular military compensation and the present value of the retirement benefit liability. The cost of regular military compensation falls slightly because the average length of active duty service changes only slightly. For the Army, costs fell by 0.8 percent, 0.2 percent, and 0.2 percent, respectively, under the immediate annuity, age 55, and sliding scale proposals. The cost of active duty retirement benefits fell by 5.3 percent, 1.2 percent, and 0.9 percent under the immediate annuity, age 55, and sliding scale proposals.

With respect to the reserves, the cost of regular military compensation increased by 4.8 percent under the immediate annuity proposal because average years of reserve service increased from 8.1 to 8.2. There were increases in regular military compensation costs under the age 55 and sliding scale proposals, too, but only 0.7 and 0.5 percent, respectively.

The cost of reserve retirement benefits increased under all three proposals. The sliding scale proposal produced the smallest increase at just 10.6 percent. The incentive it would create to stay in the reserves longer than 20 qualifying years is apparently small, so the cost of reserve retirement benefits would rise only slightly. The age 55 proposal increased reserve retirement cost by 41.2 percent, and the immediate annuity proposal nearly tripled the cost of reserve retirement—a 220.8 percent increase.

To put the costs in a different perspective, we computed the average outlay per man year, including regular military compensation and the expense of retirement benefits. This computation captures the fact that the proposals would affect the experience mix of personnel as well as total cost. Holding the total number of man years in the active Army constant, i.e., holding “end strength” constant, active duty cost per man year fell by 1.2, 0.3 percent, and 0.2 percent under the immediate annuity proposal, the age 55 proposal, and the sliding scale proposal, respectively. For instance, Army active duty cost per man year was \$46,700 under the current system, \$46,100 under immediate annuity, \$46,500 under age 55, and \$46,600 under the sliding scale proposal. In the reserves, without holding reserve strength constant (it changed by a very small amount), cost per man year increased under all three proposals: relative to the base case of \$6,900, the cost per man year was \$10,500 under immediate annuity, \$7,600 under age 55, and \$7,600 under sliding scale.

The increase in cost per man year suggests that the proposals are not cost effective. Reserve years and the percent of individuals who joined the reserves after leaving active duty both increase, but only slightly. Costs rise more than reserve man years.

Overall, the policy simulations indicated that subtle, total force effects could be generated. Although the proposals would generate modest changes in military compensation for the reserves it is doubtful that the best means to generate higher reserve retention is to increase the generosity of reserve retirement benefits compared to a more direct approach such as the use of retention bonuses in the reserves. It seems that the biggest benefactor of these proposals would be reserve members under the immediate annuity proposal. The analysis indicates that they would serve very slightly longer in the reserves, but would be able to draw their reserve retirement benefits immediately after leaving reserve service. The reserves benefit slightly because of the increase in the percent of individuals who leave active duty and join the selected reserve and the increase in average years of reserve service. But as mentioned, these effects are small.

Under the age 55 and sliding scale proposals reservists would also benefit, though only marginally; more reservists would qualify for retirement benefits, and retirement benefits would be received somewhat sooner. But the costs for the reserves would be higher while there would be no change in the percent of active duty members who leave and join the selected reserves and virtually no change in years of reserve service. Perhaps unexpectedly, the immediate annuity proposal would benefit the active duty component by increasing retention in the junior and mid-career years. But again, it is not obvious that this represents a cost-effective way of increasing active duty retention. Indeed, that was not even an announced goal of the reserve retirement reform proposals.

## **Equity of Reserve Retirement Benefits Relative to Active Duty Benefits**

The congressional proposals described previously sought to improve the equity of reserve retirement benefits by reducing the reserve retirement annuity age. However, reserve service time is *already* counted equitably. Reserve service time is calculated on a point system, and reservists earn a point for each day of active duty, whether for activation or training, and one point for each period of inactive duty such as drilling. A reservist may perform two drills in a single day, which is typical. (Two points per drilling day gives members of the reserves a slight edge in counting their service time.) A year of active duty service counts as one year, and 100 points of reserve service count as 100/360 of a year. Thus, the main inequity is that reserve retirement benefits begin at age 60, while active duty benefits begin immediately upon separation after 20 or more years of service.

But equity comparisons should consider more than just when retirement benefits start. Active duty and reserve service differ in important ways. Active duty personnel serve full time and are always on call for duty. They are likely to face more frequent, longer deployments, and thus long hours of work and long absences from home and family. Personnel in units that directly support deployed units are subject to long working hours as well. Active duty members cannot hold a full-time civilian job and therefore do not accumulate retirement benefits through a civilian employer. Active duty members are frequently relocated, uprooting them from their friends and community, while diminishing the employment and earning opportunities of the military spouse.

In addition, the basic pay calculations that determine retirement benefits favor reservists. Benefits for a retired reservist are based on the value of basic pay in effect when the reservist turns 60, not the value of basic pay when the reservist separated plus the cost of living adjustment to age 60. This favors the reservist because basic pay typically rises faster than cost of living adjustments. Furthermore, the active duty retirement benefit may help the retired service member transition into the civilian workforce and establish a civilian career, whereas a reservist typically already has an established civilian career.

## **More Frequent, Longer Reserve Deployments**

Reserve deployments increased during the 1990s and have continued to do so during operations in Iraq and Afghanistan. One argument for increasing reserve retirement benefits hinges on the added burden of these deployments—which, as with active members, entails separation from home and family, in addition to absence from civilian employment. To expand on this point, the shift toward using the reserves on a rotational basis has increased the expected burden of reserve service. If reservists

were not overly compensated previously, and if “marginal” reservists did not want more activation time, then the increase in reserve usage would require an increase in reserve compensation—either monetary or intrinsic—to maintain the size of the reserve force. But what form should the increase in compensation take?

Increasing the generosity of reserve retirement benefits appears to be inefficient, poorly targeted, and unfair. It is inefficient because the value of the benefit to reserve members is lower than the cost to the government of providing the benefit. This difference is due to the fact that most individuals are likely to have a higher interest rate (20 to 30 percent) than the government (3 or 4 percent).<sup>4</sup> At an interest rate of 3.5 percent, the government must set aside \$0.71 now in order to pay \$1 in 10 years. To a reservist, this dollar may be worth as little as \$0.16 to 0.39 depending on his or her time value of money.

Using retirement benefits to address the stress from greater deployment is not well targeted, because more generous retirement benefits reward all reservists whether deployed or not. Many reservists have not been mobilized in Operations Noble Eagle, Enduring Freedom, or Iraqi Freedom—the operations conducted in Iraq and Afghanistan. Further, embedding compensation in retirement benefits is unfair because most deployed reservists are younger personnel who do not stay in the reserves long enough to qualify for these benefits. Still, from the perspective of Congress, an increase in reserve retirement benefits is unquestionably a sincere desire to “do something for the reserves.” Further, the budgetary cost of this action in today’s dollars is small because the benefits will be paid in the future and only to reservists who qualify.

## **Increased Flexibility of Managing Reserve Personnel**

Given the changing and diverse nature of today’s military missions, the services are seeking ways to employ their assets far more flexibly than in the past. For manpower, steps in this direction could include new career paths as well as greater variation in career length for different occupations. But the reserve retirement benefit system, like the active duty system, promotes similarity and conformity in careers, retention, and incentives for performance. It encourages personnel to complete 20 or more years of qualifying service, and offers few incentives to serve more than 20 years. As long as retirement benefits are only tied to pay grade and pro rata years of service, they will not be a means of encouraging greater variation in careers and retention. Furthermore, increasing the generosity of reserve retirement benefits would not provide a direct incentive to shorten some careers and lengthen others, or to reward retraining, multi-skill training, or high proficiency. In contrast, increasing current special and incentive pays could increase flexibility in managing personnel.

## **Toward Broader Reform of Military Retirement**

It is worthwhile to consider reserve retirement reform with respect to past debates over active duty reform. Numerous congressional and presidential commissions and study groups have studied military compensation and active duty retirement benefits. They have analyzed the cost of active duty benefits, the inequity of paying benefits only to those who serve 20 years, and the lack of management flexibility tied to the one-size-fits-all career path and the 20-year cliff-vesting rule. These issues are increasingly relevant to the reserves, given the current and planned increase in reserve usage. But they have not been at the forefront of discussions surrounding reserve personnel management, compensation, or retirement benefits. Achieving a compensation system that supports the seamless integration of reservists called to active duty will require coordination of reserve and active retirement reform. That said, the resulting systems should not necessarily be identical.

The active duty retirement benefit system has changed little since World War II. Therefore, we sought to identify obstacles to reform, as well as factors that might improve the prospects for success.

In addition to cost, the key obstacle may be a lack of consensus for change among the services, DOD, service members, and retirees. The services themselves have not called for reform of either the active or reserve retirement system. They apparently do not perceive an unmet need for flexibility; the retirement systems have performed well by delivering a stable supply of experienced manpower. The high rate of retention between 10 and 20 years of service can be seen as a result of vesting at 20 years. The services have grown accustomed to this steady flow of personnel, but it is not clear that they actually need it. There is some question over whether current personnel requirements result from an independent assessment of manpower needs, or whether the services simply accept the volume of personnel produced by the retirement benefit system. We speculate that tasks and jobs have been designed to accommodate the retention profile produced by the compensation system, promotion system, and vesting at 20 years of service.

Furthermore, past study groups have not demonstrated that there is an excess supply of senior personnel, nor have they provided quantitative evidence on how reforms would improve flexibility or defense capability. If the services have adapted job structures to the retention profile, there would be no apparent excess supply. Lacking clear evidence of the benefits, the services have not been strong advocates of retirement reform. Veterans and retiree groups have also refrained from calling for reform; revamping the retirement system could lead to a slippery slope of benefit cuts and broken trust with service members.

The lack of consensus also comes from differing views about the objectives of the retirement systems. DOD officials and analysts believe the retirement system has a force management role, while retirees and like-minded groups view the system as a reward for past service and an aid to transitioning into the civilian economy. In truth, it is both.

We made use of an economic theory of compensation reform under political constraints and adapted it to the issue of retirement reform.<sup>5</sup> The theory provides insights on what factors determine whether reform happens, as well as strategies for increasing the likelihood of successful reform.

In the adapted model, taxpayers want greater efficiency in producing national defense from the military, an outcome that can only be achieved through compensation reform. Congress acts as an intermediary that collects taxes and pays members. Political reform is possible only if a large enough proportion of service members, and lobbying groups, such as retirees, accept the new compensation scheme. The budget must also be balanced so that payments from taxpayers equal payouts to members. To promote acceptance of reform, taxpayers must compensate members who are worse off under reform, which increases costs. This “buy-off” is a necessary expense to achieving greater likelihood of reform. At some point, however, this cost exceeds the benefit of reform and is thus not cost effective.

Based on the model used in this analysis, key strategies to address obstacles to reform include:

- Identifying the chief constituents involved in the retirement reform process, such as service members and department leadership, as well as their different objectives.
- Assessing the gains and losses of reform to the constituents. For example, one could provide the services with information on how retirement reform would improve defense capability.
- Recognizing that the buy-offs that make reform more palatable are a necessary cost of reform. Buy-offs should only be paid up to the point where they begin to outweigh the cost-effectiveness of reform.
- Providing a menu of reform schemes to improve the feasibility of reform and reduce the cost of buy-offs.

Regarding a menu of choices, we considered a case study of a government retirement reform effort that was highly effective, namely, the transition of federal employees in the 1980s from the Civil Service Retirement System (CSRS) to the Federal Employees Retirement System (FERS). Based on the CSRS-FERS case study, we add the following lessons about effective reform. It is important to:

- Provide members with a menu of choices, including the existing retirement system as well as the new retirement system. This ensures that existing employees are as well off after reform as before.
- Give existing service members multiple open enrollment opportunities to switch to the new retirement system, so the menu is an ongoing choice.
- Design the new retirement system to be more generous for new and junior employees, but less generous for existing senior employees, thereby minimizing the amount of switching among senior personnel.
- Design the new system so that it is portable to other jobs.

The Defense Advisory Commission on Military Compensation and the Tenth Quadrennial Review of Military Compensation are the latest groups to review the adequacy of military compensation. One of their objectives was to consider whether military compensation is properly balanced between current and deferred compensation, including retirement. What is apparent from past experience is that addressing the obstacles to reform will be as important as developing a set of recommendations. It will also be essential to assess the cost-effectiveness of reform proposals for retaining personnel in the active and reserve components. The active/reserve dynamic retention model developed as part of this research provides a powerful tool to make such assessments. Thus, retirement reform should be pursued, but it must be balanced against the conditions described here.

## Notes

1. A year of qualifying service is each year in which the member has earned at least 50 retirement points. Points are earned at a rate of one point for each day of active service (active duty or full-time National Guard duty), one point for each period of inactive duty (commonly referred to as “drill” or “unit training assemblies”), and 15 points for each year an individual is a member of a reserve component.
2. It should be noted that since this assessment was performed, the law was amended in 2008 (Section 647 of Public Law 110-181, January 28, 2008) to reduce the age at which a reserve component member is eligible to receive retired pay below age 60 by three months for each aggregate 90-days in a fiscal year in which a member of the ready reserve performs (1) active duty or (2) full-time National Guard duty when authorized by the President or Secretary of Defense for the purpose of responding to a national emergency. Currently, only duty performed after January 28, 2008, can be used to reduce the age of receipt of retired pay below age 60.
3. For details of the model, data, estimation method, and results, see Beth Asch, James Hosek, Daniel Clendenning, and Tina Panis, *An Analysis of Reserve Retirement Reform*, RAND, Santa Monica, Calif., forthcoming in 2009.

4. 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) provided consumption is not changing much from year to year.
5. Gabrielle Demange, and Pierre-Yves Geoffard, "Reforming Incentive Schemes Under Political Constraint: The Physician Agency," Centre for Economic Policy Research, CEPR Discussion Paper 3589, 2002.