Changing Military Retirement to Care for Service Members and Readiness

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USAWC STRATEGY RESEARCH PROJECT

CHANGING MILITARY RETIREMENT TO CARE FOR SERVICE MEMBERS AND READINESS

by

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ABSTRACT

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Recent plans to reduce the military’s budget and the size of the active duty force have again led to calls for changing service members’ compensation package to save money. Since the current version was conceived in 1949, the military’s retirement system remains a prime target for change to save the services money. Contrary to what professional organizations such as the Military Officers Association of America (MOAA) lead many to believe, changing the military’s retirement system could take care of more service members while improving the military’s readiness. Multiple studies have determined the current system costs too much, lacks equality, is not comparable to private sector systems, prevents selective retention, and fails to provide management tools for DoD senior leaders to improve readiness. A proposal in the Tenth Quadrennial Review of Military Compensation (QRMC) offered a retirement system with a combination of deferred benefits and deferred compensation as well as incentive pays which would improve the shortcomings of the current system to benefit service members and improve readiness.
With current U.S. economic conditions and looming Department of Defense (DoD) budget cuts, DoD’s senior leaders are considering options that provide the right mix of force structure and combat systems to maintain a force capable of meeting the Nation’s defense requirements in the future. Therefore, it should be no surprise the military is looking at cost savings in personnel compensation which includes the current military retirement system. But contrary to the media hype spread through articles and emails such as the “Retirement Under Siege” article on the Military Officers Association of America (MOAA) website, making changes to the retirement system is not necessarily detrimental to the All Volunteer Force or the individual service member.¹

In theory, the military retirement system is a career incentive plan designed to retain service members past 10 years of service and provide incentive for productivity.² In actuality, it is expensive, unfair to the majority of the force, not comparable to the average private sector retirement system, and negatively impacts readiness through its retention and force management inflexibility.³ Changing the current retirement system to a combination of deferred contributions and a deferred benefit with incentive pay could save the military money, benefit a greater number of service members, and provide senior leaders the right tools to improve readiness by shaping the force through selective retention. With a dwindling budget and force shaping efforts on the horizon now is the time to change the retirement system to benefit more service members and improve readiness.
Congress first established the current military retirement system under the Career Compensation Act of 1949 following WWII after a comprehensive review of military compensation by the Hook Commission. This act vested service members at 20 years of service and provided an annual payment at a rate of 2.5 percent multiplied by the number of years served, payable upon retirement. Initially, the military retirement system was designed to improve promotion opportunities for younger officers by providing older officers an opportunity to retire from the military while maintaining a young force. While, the system achieved its purpose in 1949, it has since been under continuous review with the creation of the All Volunteer Force, changes in the economy, and evolving changes in private industry retirement plans.

The overall purpose of the military retirement system as part of the military’s compensation package has expanded since 1949 and continues to be scrutinized by compensation reviews required by law and directed by the President every four years. For example, the principles of the compensation system as stated in the Military Compensation Background Papers of 2005 is to support manpower policies, be equitable to the private sector, be effective for contracting and expanding the force in war or peace, be flexible to changes in the economy, motivate service members and encourage performance. Multiple reviews of the retirement system as part of military compensation question its ability to live up to these principles and question whether the system benefits service members or the military. In fact, there was one significant change in the history of the military’s retirement system as we know it today. That change occurred in 1986 when Congress enacted REDUX and reduced the retirement benefit from 50 percent of basic salary to 40 percent for service members entering the
service after August 1, 1986. The service Chiefs successfully argued this change was detrimental to morale due to lack of equality and did so without providing any quantitative data. The military’s equality argument ultimately led to the institution of the High 3 plan and $30,000 pay out option after 15 years for service members under the Redux program. The lack of equality in itself was enough to prevent significant change to the retirement system without quantitative data. The insights provided by this attempt to change the retirement system are a warning for future change as Congress later repealed the Redux in 2000.

In theory, the military retirement system is a career incentive plan with deferred compensation and is no longer comparable to the average private industry career incentive plan of defined contribution. For example, the military retirement system is considered deferred compensation with a defined benefit as part of a career incentive plan. In a defined benefit plan such as the military’s retirement system, a service member knows exactly how much retirement income they will receive and when, once they complete the organization’s requirements, therefore defining the benefit. In the 1980s, the private sector moved away from defined benefit or pension plans in favor of defined contribution plans.

Under a defined contribution plan which has become common in private industry and is used by federal employees, the employee and the employer contribute to a retirement investment vehicle that is tax deferred and not withdrawn until reaching retirement age, but in some circumstances can be borrowed against. Both retirement systems defer compensation into the future but under the military’s system of defined benefits, service members vest at 20 years and can draw retirement pay immediately
upon retirement from the military. Under private industry retirement plans of defined contribution, vesting occurs at five to seven years and benefits are not withdrawn until the employee reaches the federal retirement age. However, most private industry plans are transferable between employers and some employers contribute funds to employee’s retirement accounts too. Both are career incentive plans designed to retain a workforce and maintain individual productivity through an employee’s final day of employment.

Under the military’s career incentive plan, a combination of promotions and deferred compensation is designed to ensure the workforce remains productive. This is done through increased pay for promotion and through retirement as deferred compensation. One could argue the potential for promotion and increased pay is not enough to ensure service members are retained and work through their final day. For example a senior leader such as a Colonel or Sergeant Major in the Army with 22 years of service and 8 years before mandatory retirement may lack the incentive to remain productive because their chances for promotion and additional pay raises are limited. In theory, deferred compensation retirement plans such as the military retirement system provide incentives for service members to remain productive until their last day. On the other hand, what deferred compensation has done in the military is modify retention behavior beyond 10 years of service. After the ten year mark service members are more likely to remain in the military until 20 years of service to ensure they become vested. However, as the military maintained its defined benefit plan, such plans have become less common in private industry since the 1980s.
As a result, changes in how Americans perceived their future in the workforce led to changes from defined benefit to defined contribution retirement plans in private industry. For the American workforce the model career was staying with the same employer an entire career, learning new skills, being promoted, and finally retiring early from the original company where they started. This trend shifted in 2002 as over 50 percent of Americans 62 to 64 years of age remained in the workforce which enabled employers to develop more flexible retirement plans and shift to defined contribution plans.

Several life events contributed to the change to include the trend of working to an age of being eligible for full social security benefits, the successful economy of the 1990s where employees could risk unemployment to change jobs, and the increase in the number of dual income households where increased incomes of women offset the risk of unemployment for men in the same household. However, changes in private industry retirement plans did not translate into changes in the military retirement system, despite government studies recommending change.

The government conducted over 18 extensive studies of the retirement system as part of military compensation since establishing the current military retirement system in 1949 and adding a provision to law in 1965 requiring military compensation to be reviewed every four years. Beginning as early as 1971 just prior to implementing the All Volunteer Force, the Second Review of Military Compensation began calling for an extensive reform of the military retirement system due to perceived inequities, the need for improved management tools, and increased costs. In 2006 a RAND study conducted on past proposals for retirement reform concluded that recommendations
from multiple military compensation reviews could be categorized into five major arguments for reform which remain relevant today: cost, equity, civilian comparability, selective retention, and force management flexibility.  

The cost of funding a defined benefit pension plan for 20 years of service continues to receive scrutiny when most of private industry has moved to defined contribution plans. Even though Congress’s and military senior leader’s concerns over growing military personnel costs change as economic conditions change, their focus is on what proportion of DOD’s military compensation budget is devoted to military retirement payments due to an increasing retiree population created by a 20 year retirement system. According to the *Tenth Quadrennial Review of Military Compensation*, in 2008, over seven percent of active duty personnel costs are paid to the military retirement account at a price tag of 13 billion dollars annually. For example, with over 900,000 retired Soldiers and an additional 26,000 retiring annually from the Army, these costs will continue to rise for a retiree force that already significantly out numbers the active duty population. The more money spent on deferred compensation in a fiscally constrained environment reduces the funds available to the military for current programs and ultimately impacts readiness. Furthermore, a RAND study that reviewed economic models of compensation determined the cost of a future benefit is not as a valuable to a service member as current compensation, making pensions or defined benefit plans a costly reward system.

It is questionable whether the military’s career incentive plan actually retains the best qualified service members. It might be that the military actually incentivizes service
members to remain on active duty because they lack opportunity for better pay in the private sector due to work habits or lack of a marketable skill.\textsuperscript{29} For example, a study conducted by the Defense Department in 2003 determined the wages of military retirees seeking a second career following retirement were below the wages of their civilian counterparts.\textsuperscript{30} Though not conclusive, the study suggests the lower paying jobs were related to retirees needing less income to supplement their retirement pay.\textsuperscript{31} Barring any conclusive data, it is feasible the military retirement system is not retaining the best qualified personnel which could explain the lower wages paid to military retirees compared to the national average. Therefore, it is possible the military retirement system fails to support the majority of the force as a talent retention tool.

With an all or nothing approach to retirement benefits the majority of service members who serve receive nothing at the end of their service due to the 20 year vesting requirement. As identified in the \textit{Tenth QRMC}, only 15 percent of Army enlisted Soldiers and 47 percent of officers achieve 20 years of service and qualify for a military retirement benefit.\textsuperscript{32} Theoretically, if the military retirement system mirrored a private sector plan, a large number of the 85 percent of military enlisted personnel and 53 percent of military officers who left service before reaching 20 years could have retirement accounts to transfer to their next employer but do not because the military system vests service members at 20 years.\textsuperscript{33} The 20 year vesting requirement also impacts the military due to the lack of comparability to the private sector when service members are making career decisions.

A 20 year vesting requirement and non-transferable military retirement benefit not only lacks comparability to private sector plans, but could eventually impact
recruiting and retention. The Employee Retirement Income Act of 1974 governs private sector pension plans and ensures private sector workers vest at five to seven years of employment. Unlike the military, a civilian employee can change jobs after vesting at five to seven years and still retain the funds contributed toward their retirement. The military’s retirement plan also lacks comparability to the federal civilian sector where federal civilian employees receive defined contributions paid by the government under the Thrift Savings Plan.

The 20 year vesting system and the lack of comparability to private industry retirement systems could make it difficult for the military to compete with the civilian labor market for potential service members and impact recruiting and retention in the future. Congress attempted to rectify this by allowing service members to contribute to the Thrift Savings Plan (TSP) under the National Defense Authorization Act of 2000. Allowing service members to contribute a transferable tax deferred annuity provided some comparability to the civilian sector. However, unlike federal employees those accounts lack government contributions. Additionally, the military retirement system remains a deferred benefit that service members can only receive for serving at least 20 years of service. Therefore, when service members depart the military prior to serving 20 years, monetarily they would receive only what they contributed to the TSP.

Another concern expressed by studies conducted on the military retirement system is retention. The current retirement system is successful as a retention tool at the mid career grades, however, it lacks quality control and is not effective at senior career grades. As a rule, the current retirement system is attractive enough at the mid career grades to entice service members after 10 years of service to remain on active
duty to become retirement eligible. However, senior leaders lack a personnel management tool to separate underperformers. Using involuntary separation to separate underperformers and establish quality control could impact recruiting and retention as the military would be seen as less desirable as a career choice. Furthermore, at the senior grade levels selective retention of shortage skills past 20 years of service continues to be a challenge created by the current 20 year retirement.

Historically, service members normally depart the military at the 20 year mark once they are eligible for retirement. Congress attempted to alleviate this with the addition of the 2.5 percent multiplier for every year served past 20 years of service. The change was successful in improving retention past 20 years of service, however, this generic approach fails to target specific required skill sets to properly manage the force. Therefore, the military competes with private businesses to retain service members past the 20 year mark. The allure of drawing full retirement benefits and a salary from a civilian career is hard for the military to compete with when their biggest selling point is a 2.5% increase per year on retirement benefits. As a result, the military potentially loses a significant amount of talent at the 20 year mark. Personnel managers lack the tools to retain the right skills and quality of service members past 10 years of service. This is compounded with an inability to provide incentives to retain the needed skills past 20 years of service leading to a lack of tools available to senior leaders to manage the force and maintain readiness.

Retention patterns and the lack of permanent management tools prevent senior leaders from aligning the force and maintaining the best available readiness across the military. The challenge is once service members reach the 10-12 year mark they are
more likely to remain in service and senior leaders and supervisors are less likely to separate non-performers that are within 10 years of vesting.43 This blanket approach to retention prevents personnel managers from targeting the needed skills and qualities required for maintaining military readiness and meeting changing requirements. During the wars in Iraq and Afghanistan senior leaders used temporary personnel management tools such as retention bonuses, incentive pays, and multiple tours to provide temporary relief to support military organization changes and strength increases which demonstrated the requirement for permanent force management tools.44 Senior leaders require permanent tools to meet changing force structure requirements in order to maintain the readiness of a force that is continuing to become smaller. They also require permanent management tools to develop and retain senior leaders from within and across the armed forces.

As a career incentive plan, the retirement system lacks the tools to ensure the military receives the most benefit from its senior leaders after 20 years of service. With limited time left before retirement, the current retirement system lacks incentive for senior officers and noncommissioned officers to perform at the same levels past the 20 year vesting.45 It is not because these senior officers and noncommissioned officers do not perform but the incentive for them to perform does not exist. Unlike the private sector where non performers are separated, at the senior officer and noncommissioned officer level of the military, this is not likely to happen. Providing incentive to these senior officers and noncommissioned officers would be consistent with a career incentive scheme and ensure the military receives the most out of its senior leaders.
In addition, many contend the military retirement system falls short of its full potential in meeting the principals of compensation as laid out in the *Military Compensation Background Papers* of 2005. The system does not provide true equality to the civilian system of compensation due to the 20 year vesting requirement. It lacks personnel management tools to efficiently contract and expand the force in war and peace by not providing tools to retain the right quality and quantity of service members. Finally, it fails to motivate service members and encourage performance which it is specifically designed to do as a career incentive plan. The shortfalls laid out in multiple studies of the retirement system to include the increasing cost, equality, comparability to the civilian sector, selective retention capabilities, and force management flexibility are the reasons that the system continues to be reviewed. For example, to improve the shortfalls of the current military retirement system, a hybrid option between the civilian and federal employee programs of defined contribution and the current military model of defined benefit plans has been studied.

The members of the *Tenth QRMC* studied the effects of incorporating a defined contribution and defined benefit program with a combination of incentive pays to enhance the military’s retirement system in an attempt to address the shortfalls noted in previous studies. The result was a hybrid retirement system that combined a modified defined benefit plan similar to that currently used in the military with a modified defined contribution plan that is similar to that used in the civilian and federal workforce. Under this hybrid plan, retirement pay would equal 2.5 percent of the high-3 annual basic pay multiplied by the number of years of service. Also, service members would vest at 10 years and they would generally receive benefits at age 60, unless they completed 20
years of service which would allow them to receive benefits at 57. This plan also includes a defined contribution plan in which the service contributes up to five percent of annual basic pay into a retirement account. This option would use a combination of gate and separation pay to shape the force. Gate pay is a monetary incentive paid to entice service members to remain on active duty and separation pay is a monetary incentive to entice service members to depart the military.

In 2008, RAND published Assessing Compensation Reform, Research in Support of the 10th Quadrennial Review of Military Compensation which was a study to model effects of the QRMC proposal and determine the effects on the military. The challenge of the QRMC proposal would be the retention of service members past 10 years once they are vested without the draw of full retirement payments being available once they achieved 20 years. Besides replicating retention patterns the key to any effort to change the retirement system is how it stands up to the finding of previous studies and its ability to improve on cost, equity, civilian comparability, selective retention, and force management flexibility.

RAND’s modeling predicts the QRMC proposal would be more cost effective than the current retirement system. The basis for the cost savings would come from paying the service member in current cash such as gate pays and separation pay and paying less into the retirement accrual account. Under their model, RAND determined the QRMC proposal reduced the active duty cost per man year by 6.9 percent. The model also predicts the military could actually reduce accessions by varying gate pays to entice service members to remain on active duty longer. The premise behind the theory is that service members value a dollar received now more than they value a
dollar they could receive in future retirement pay. Thus implying, the military would get more for its money using it for gate and separation pays instead of placing funds into a retirement accrual account for future retirement pay. Therefore, the QRMC proposal, as modeled, would benefit both the service member and the military more than the current retirement system.

Another important consideration for DOD senior leaders is that the QRMC proposal would make the military retirement system comparable to plans in private industry while benefiting a greater number of service members. As modeled, the QRMC proposal would vest service members at 10 years which is closer to the five to seven year vesting systems in private industry.54 By reducing the number of years for vesting from 20 to 10, the model also suggests the number of service members who become vested would more than double.55 Furthermore, the QRMC proposal provides a transferable deferred contribution plan similar to private and federal employee retirement systems.56 Therefore, when a service member departs from the military prior to 20 years they could transfer their retirement savings account, including government contributions once vested, into a private sector account.

Additionally, the majority of service members would benefit because their gate and separation pays would be paid directly to them rather than going into an accrual account for a retirement benefit they may never receive. This is especially relevant because the military’s current system pays into an accrual account for every service member by year group with the assumption they will all retire.57 However, research indicates this is not the case, therefore reducing the funds paid into the military retirement accrual account by moving the payout to age 57, the military could provide
current cash to more service members through gate and separation pays at a reduced cost.\textsuperscript{58}

In addition, to reducing costs and improving equity, the 2008 QRMC model maintained retention rates comparable to the current system by providing gate and separation pays as selective retention incentives. The model demonstrated that 10 year vesting is an incentive for service members to remain in the military until the 10 year mark.\textsuperscript{59} However, modeling also showed retention would drop after 10 years causing the military to increase accessions when only a defined benefit and defined contribution plan were incorporated with vesting at 10 years.\textsuperscript{60} Therefore, adding gate pays with current cash at different increments during a military career enticed service members to remain in service, thus maintaining the retention rate, and increased the average number of years new recruits served to potentially reduce military recruiting requirements.\textsuperscript{61} While improving selective retention, the use of gate pay and separation pay would also provide additional management tools for senior leaders and managers.

Perhaps most importantly, gate and separation pays add permanent tools enabling senior leaders to manage the force through selective retention to improve readiness. The current retirement system lacks flexibility for senior leaders and managers to adjust military forces based on changing requirements as the environment changes but the addition of gate pay and separation pay could provide these tools.\textsuperscript{62} By mixing gate pays and separation pays to achieve different retention rates for different career fields, senior leaders could improve force readiness by incentivizing specific skills and grades.\textsuperscript{63} For career fields requiring higher strengths at senior grades, personnel gate pay can be offered to entice service members to remain in the military.
Similarly, the military could entice service members through separation pay to depart the military earlier for those career fields requiring less senior grade ranks. Skills in high demand such as the medical skills could be offered gate pays to encourage service members to remain past 20 years.

Changing the military retirement system based on modeling is risky given the complexity and size of DoD. The development of the QRMC proposal is based on modeling which relies heavily on historical data and assumptions. However, what modeling cannot account for are individual decisions and what RAND terms as “shocks” or an event or action that changes the appeal of available choices. Identifying potential effects changing the compensation and the retirement system for the active duty force is a complicated issue when dealing with a population exceeding a million service members. Now, facing budget cuts and a reduced force size, it may be time for DOD to implement a retirement system to benefit more service members and give senior leaders the management tools needed to improve military personnel readiness.

From a DoD leader’s perspective, the 2008 QRMC’s proposal saves DOD money in the long run and benefits more service members. The cost savings of roughly 6.9 percent for each man year can have a significant impact on DoD’s budget. For example, for the Army’s budget alone, personnel costs are projected to consume 32% of the budget in Fiscal Year 2012. The cost benefit is better understood when one realizes that 20 percent of the Army’s personnel budget or 9 percent of the Army’s overall budget for FY12 must be paid into a military retirement accrual account which will only pay benefits to 15 percent of former enlisted Soldiers and 47 percent of former officers. Under the proposed QRMC plan, the military could reduce the amount
submitted into the accrual account by pushing out the number of years before service
members can withdraw retirement funds. Furthermore, DoD could use funds saved
from reducing payments to accrual accounts for gate and separation pays to benefit
more service members by using the military’s money today rather than saving for the
future when it is worth less.

Contrary to what MOAA advocates to service members changing the military
retirement system actually benefits service members. It seems such professional
organizations could be doing a disservice to service members by asserting that DoD
leaders are hurting the military by reviewing the military’s compensation packages
based on announced budget cuts. If the model holds true, changes to the retirement
system should actually benefit more service members through current cash, earlier
vesting, and a transferable deferred contribution plan. With only 15 percent of today’s
enlisted force receiving retirement benefits, arguing not to explore changes to the
military’s retirement system may be contrary to taking care of service members. Also,
aside from taking care of service members, the potential to provide DoD the
management tools to shape the future force and improve readiness also outweighs the
risk associated with changing the system.

In a constrained budget environment with ever changing threats, the military
should do more than retain service members past the 10 year mark. As a career
incentive scheme the current retirement system works to retain service members past
10 years but has done little to improve readiness. Readiness of the force is more than
maintaining end strength. The military requires the right skill sets in the right jobs to
maintain true readiness. However, with constantly changing force structure, human
resources managers are challenged to maintain the right fills for skill sets and ultimately end up only maintaining personnel end strength overall.

The QRMC proposal offers senior leaders management tools that have the potential to improve readiness in the military. The ability to offer specific skill sets and grades an incentive to remain in the military through gate pay will provide human resources managers the tools to improve military readiness by maintaining strengths by skill and grade. Selective retention through the use of gate pay and separation pay could allow force managers to influence readiness in an unprecedented manner. Gate and separation pay tools can also enable them to improve readiness through improving the quality of the force.

With service members more likely to remain in the military and leadership less likely to separate after 10 years of service, the military could use the combination of separation and gate pay to make retirement a career incentive scheme and improve the quality of service members retained. The theory behind the retirement system as a career incentive scheme that entices service members to work up until the last day can be realized under the QRMC proposal. By offering gate pay to the best qualified members of a skill set the military has the potential to improve quality. Furthermore, under 20 year vesting, service members lose incentive to continue to produce at the same level because their promotion potential sharply decreases at the higher grades once they have achieved 20 years of service. With the potential of receiving gate pay, these service members could be enticed to continue to perform at a higher level. Lastly, when service members are no longer performing, they can be offered separation pay to
make room for younger service members and increased promotions. Improving readiness through improved quality is another benefit of the QRMC proposal.

Given numerous past studies with similar recommendations, understanding why the military has not changed its retirement system yet is a key to setting the conditions to lead the change. The current system does not benefit the majority of service members, it is not the most beneficial career incentive scheme, and it hinders readiness through the lack of personnel management tools. Yet in the history of the military retirement system only one significant change occurred and that was the implementation of REDUX. That change was quickly overturned by unsubstantiated claims to Congress of inequality and poor morale by military leaders who provided no evidence to support such claims.

As the military looks at changing the retirement system, strategic communications and equality must be at the forefront of any change. The military must lead off with the facts of retirement which are that only a minority of the force actually receives retirement benefits and true equality can only be achieved through increasing that number. Professional organizations are already leading a strategic information campaign to prevent changes to the retirement system. The DoD should begin to convince military leaders that change is necessary to take care of service members and improve readiness of the force. The challenge is that 47 percent of these leaders actually will serve long enough to become vested at the 20 year mark under the current system. Convincing those that stand to lose the most can only be done by protecting the current forces retirement system and implementing changes to new year groups. However, unless leaders accept the change and are able to communicate the benefits,
the military will once again face the calls of inequality as year groups mature and rise in the force.

There is no doubt that service members currently serving have earned the retirement benefits they were promised when they originally joined the military. However, numerous studies have reached the same conclusion; the current retirement system does not benefit the majority of service members or the military as an institution. As budgets and force size decrease DoD’s senior leaders must convince their leaders change is beneficial to service members and necessary to improve the readiness of the institution. Without their support, change will not occur and it could be at the detriment of service members and the institution they profess to love.

Endnotes


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6 Ibid., 695.


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62 Ibid., 35-36.


64 Ibid., 16.


66 Ibid., 52.