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Military Retirement: Background and Recent Developments

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Summary

The military retirement system is a government-funded, noncontributory, defined benefit system that has historically been viewed as a significant incentive in retaining a career military force. The system currently includes monthly compensation for qualified active and reserve retirees, disability benefits for those deemed medically unfit to serve, and a survivor annuity program for the eligible survivors of deceased retirees. The amount of compensation is dependent on time served, basic pay at retirement, and annual Cost-of-Living-Adjustments (COLAs). Military retirees are also entitled to nonmonetary benefits including exchange and commissary privileges, medical care through TRICARE, and access to Morale, Welfare and Recreation (MWR) facilities and programs.

Currently, active component personnel are eligible for retirement or "vested" after completing 20 years of service (YOS) and have a choice between two options (High-Three or Career Status Bonus/Redux) based on career expectations and the individual's financial situation. Reserve personnel are eligible for retirement after 20 years of creditable service based on a points system, but do not typically begin to draw retirement pay until age 60. A third category of retirement is disability retirement.

In FY2015, $56 billion was paid to approximately 2.3 million military retirees and survivors. Given the size of the program, some have viewed military retirement as a place where substantial budgetary savings could be made. However, others have argued that past modifications intended to save money have had a deleterious effect on military recruiting and retention. Military retirees, families, and veterans' service organizations closely monitor potential future changes to the retirement system. When considering alternatives to the current system, Congress may choose to consider the balance between budget constraints and the needs and concerns of this constituent group.

The National Defense Authorization Act (NDAA) for FY2013 established a Military Compensation and Retirement Modernization Commission (MCRMC) to provide the President and Congress with specific recommendations to modernize pay and benefits for the armed services. The commission recommended changing the current retirement system from a purely defined benefit system to a blended system of defined benefits and government contributions. Many of the MCRMC recommendations were adopted by Congress in the National Defense Authorization Act for FY2016 (P.L. 114-92) and amended by the FY2017 NDAA.

The blended system will allow more servicemembers to accrue retirement savings earlier in their careers through contributions into the Thrift Savings Plan (TSP) coupled with government matching and early vesting. It will also reduce the defined benefit multiplier for calculating the retirement annuity from 2.5% to 2.0%. The new multiplier will provide servicemembers retiring at 20 years of service with 40% of their base pay at retirement rather than 50% under the current system. The changes will go into effect on January 1, 2018. At that time all entering servicemembers will be enrolled in the blended system, existing servicemembers and retirees will be able to remain in the old system, and those with less than 12 years of service prior to January 1, 2018, would be able to opt into the blended system.

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Overview

The military retirement system is a government-funded, noncontributory, defined benefit system that has historically been viewed as a significant incentive in retaining a career military force. The system currently includes monthly compensation for qualified active and reserve retirees, disability benefits for those deemed medically unfit to serve, and a survivor annuity program for the eligible survivors of deceased retirees. The amount of compensation is dependent on time served and basic pay at retirement. The monthly retirement annuity is adjusted annually by a Cost-of-Living Adjustment (COLA) to ensure that the annuity is protected from the adverse consequences of inflation. Military retirees are also entitled to nonmonetary benefits, which include exchange and commissary privileges, medical care through TRICARE, and access to Morale, Welfare and Recreation facilities and programs.

The non-disability military retirement system has evolved since the late 1800s to meet four main goals.

- To keep the military forces of the United States young and vigorous and ensure promotion opportunities for younger members.
- To enable the armed forces to remain competitive with private-sector employers and the federal Civil Service.
- To provide a reserve pool of experienced military manpower that can be called upon in time of war or national emergency to augment active forces.
- To provide economic security for former members of the armed forces during their old age.

The active component retirement system provides a choice between two retirement options based on career expectations and an individual's financial situation. Eligibility is based on years of active duty, with active duty personnel generally becoming retirement eligible after completing 20 years of service. For reserve component personnel, the system is based on "points," and reservists do not generally begin to receive retired pay until the age of 60. Both the active duty and reserve component retirement systems "vest," at 20 years of qualifying service.[1] Those who separate voluntarily prior to the 20-year point generally receive no retirement benefits. However, there is a third retirement system for those who are retired with a physical disability regardless of the amount of time they have spent on active duty. Disability retirement also offers a choice between two retirement options: one based on years of service (longevity) and one on the severity of the disability.

In FY2015, $56 billion was paid to approximately 2.3 million military retirees and survivors.[2] As shown in **Table 1**, the number of military retirees and the cost of their retirement benefits have increased over the past decade. Congress grapples with constituent concerns as well as budgetary constraints in considering military retirement issues. In the past, some have viewed military retirement as a place where substantial savings could be made, arguing that the military retirement compensation is overly generous relative to pension systems in the civilian sector. In

[1] Vesting in the military retirement system is commonly referred to as "cliff vesting." Until the 20-year point, there is generally no vesting. At 20 years, the servicemember becomes fully vested. However, individuals can receive retirement benefits with fewer than 20 years of service under the disability retirement system and under Temporary Early Retirement Authority (Section 4403, P.L. 102-484, October 23, 1992).

[2] Department of Defense, *FY2015 DOD Statistical Report on the Military Retirement System*, Office of the Actuary, May 2014.

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particular, they note that active duty military personnel become eligible for retirement at a relatively young age. The average active duty non-disability[3] enlisted retiree is 42 years old and has 22 years of service at retirement while the average officer is 45 years old and has nearly 24 years of service at retirement.[4]

Others argue that the military retirement system is fair given the unique demands of military service, pointing out the high operational tempo and repetitive tours of duty in overseas combat areas that servicemembers have endured over the past 15 years. In addition, some have argued that past modifications to the system intended to save money have had a deleterious effect on military recruiting and retention, particularly in times of strong economic performance.

Table 1. DOD Retired Military Personnel, Survivors, and Program Costs, FY2005-FY2015

FY	Retired Pay Recipients & Total Program Cost	Retirees from an Active Duty Military Career	Disability Retirees	Reserve Retirees	Survivor Benefit Recipients
FY2015	2,308,073/ $56.49 billion	1,474,116/ $44.93 billion	112,260/ $1.52 billion	395,808/ $6.08 billion	325,889/ $3.96 billion
FY2014	2,297,889/ $55.13 billion	1,473,315/ $43.82 billion	107,751/ $1.46 billion	389,750/ $5.85 billion	327,073/ $3.91billion
FY2013	2,284,179/ $54.00 billion	1,470,803/ $43.09 billion	103,106/ $1.43 billion	383,490/ $5.62 billion	326,780/ $3.85 billion
FY2012	2,272,295/ $52.61 billion	1,472,087/ $42.1 billion	95,910/ $1.38 billion	376,052/ $5.36 billion	328,246/ $3.81 billion
FY2011	2,260,112/ $50.65 billion	1,471,219/ $40.5 billion	94,886/ $1.36 billion	366,823/ $5.06 billion	327,184/ $3.7 billion
FY2010	2,216,720/ $50.12 billion	1,467,936/ $40.2 billion	92,704/ $1.38 billion	356,602/ $4.89 billion	299,478/ $3.65 billion
FY2009	2,201,788/ $49.17 billion	1,468,377/ $39.54 billion	91,460/ $1.38 billion	344,393/ $4.65 billion	297,558/ 3.60 billion
FY2008	2,170,812/ $45.66 billion	1,466,706/ $37.21 billion	85,499/ $1.29 billion	328,664/ $4.31 billion	289,943/ $3.38 billion
FY2007	2,146,403/ $43.57 billion	1,461,724/ $35.89 billion	85,306/ $1.27 billion	312,647/ $4.00 billion	286,726/ $3.28 billion
FY2006	2,116,690/ $41.13 billion	1,452,505/ $34.18 billion	87,232/ $1.26 billion	293,014/ $3.60 billion	283,939/ $2.67 billion
FY2005	2,091,253/ $38.79 billion	1,441,931/ $32.44 billion	89,511/ $1.26 billion	280,680/ $3.32 billion	279,131/ $2.26 billion

Sources: Department of Defense, *FY2015 DOD Statistical Report on the Military Retirement System,* Office of the Actuary, July 2016. Statistical documents available by fiscal year for FY2005-FY2015.

[3] These figures are for all of DOD non-disability retirees, excluding reserve retirees.

[4] Department of Defense, *Fiscal Year 2015 DOD Statistical Report on the Military Retirement System*, Office of the Actuary, July 2015, pp. 101 and 126.

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Notes: Total Program Cost is the total obligations for that Fiscal Year. Survivors include the spouse, children, and others with insurable interests that are entitled to survivor benefits from the DOD Military Retirement Fund.

While congressionally mandated changes to the military retirement system have been infrequent, any potential future changes are closely monitored by current servicemembers, retirees, survivors and the veterans' service organizations that support them. In addition, there are roughly 6 million to 8 million family members, who, combined with the retirees and survivors, are generally believed to be an articulate and well-educated constituent group.

Retirement System Eligibility and Defined Benefit Pay Calculations

There are currently three separate but related retirement systems within the DOD: one for active duty members, one for reservists, and one for those who become medically disabled and are unable to complete a 20-year military career due to their disability. Each of these systems has distinct eligibility requirements and formulas for calculating the retirement annuity. Retirement pay calculations are based on the date when the servicemember first entered on active duty and their "pay base"[5] at the time of retirement. The defined benefit portion of the active and reserve component retirement systems "cliff-vest" after 20 years of service, which means that servicemembers who leave the service prior to completing 20 years of eligible service typically, will not receive that portion of the defined non-disability retirement benefit. Vesting of the defined benefit for the disability retiree occurs at their disability retirement date, regardless of years of service, and some individuals qualify for longevity retirement prior to attaining 20 years of service under Temporary Early Retirement Authority (TERA).

Active Component Retirement[6]

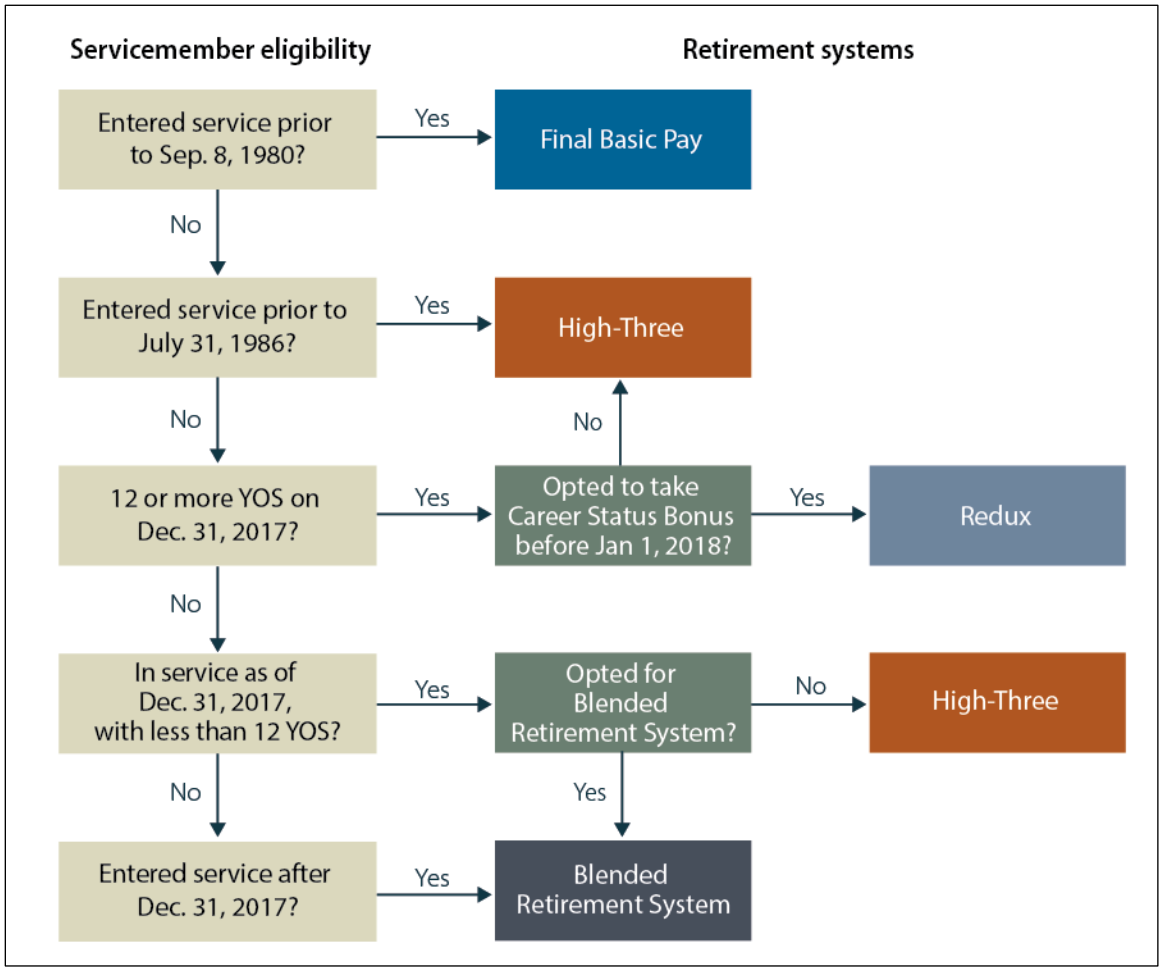
For active duty military personnel, there are four methods of calculating retired pay based on longevity: the Final Basic Pay System, "High Three," Redux, and the Blended Retirement System. The applicable retirement calculation is based on the date when the servicemember first entered active duty, their pay base at the time of retirement, their years of service, and whether they opted in to the Redux system or the Blended System. **Figure 1** shows how eligibility for retirement calculations is determined.

[5] The "pay base" is either the amount of basic pay being received at the time of retirement (for those in the Final Basic Pay System) or the average of the highest 36 months of basic pay received (for those in the High-3 System). See 10 U.S.C. §§1406 and 1407. Basic pay is the principal element of Regular Military Compensation (RMC). The other elements include the Basic Allowance for Housing (BAH) and the Basic Allowance for Subsistence (BAS), which are nontaxable allowances. Basic pay is between 65% and 75% of RMC. RMC excludes all special pay and bonuses, reimbursements, educational assistance, and any value associated with nonmonetary benefits such as health care, commissaries, and post exchanges. For additional discussion of military pay and RMC, see CRS Report RL33446, *Military Pay: Key Questions and Answers*, by Lawrence Kapp and Barbara Salazar Torreon.

[6] This is also frequently referred to as regular non-disability retirement.

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Figure 1. Active Duty, Non-Disability (Longevity) Retirement Eligibility Flowchart



Source: CRS, derived from Title 10, United States Code.

Final Basic Pay System Eligibility and Defined Benefit Calculations

For persons who entered military service before September 8, 1980, the pay base is the final monthly basic pay being received by the servicemember at the time of retirement multiplied by 2.5% for each year of service.[7] The minimum amount of retired pay to which a member is entitled under this formula is therefore 50% of the retired pay computation base (20 years of service times 2.5%). A servicemember who retires at 25 years receives 62.5% of the computation base (25 years of service times 2.5%). Historically, the maximum, reached at the 30-year mark, was 75% of the computation base (30 years of service times 2.5%). However, the John Warner National Defense Authorization Act for Fiscal Year 2007 (P.L. 99-348 §§601 and 642) extended the previous pay table to 40 years, allowed additional longevity raises, and provided additional retirement credit for service beyond 30 years at the rate of 2.5% per year.[8]

[7] Partial years of service are credited as well, with each month equivalent to one-twelfth of a year. Military Retirement Reform Act of 1986, Section 1405(b), P.L. 99-348, July 1, 1986.

[8] In the FY2015 Carl Levin and Howard P. "Buck" McKeon National Defense Authorization Act. (P.L. 113-291 §622), Congress reinstated a cap on retired pay of general and flag officers at the Executive Level II salary ($183,300 for (continued...)

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The Final Basic Pay cohort that entered the military before September 8, 1980, had 30 years of service in 2010. They have nearly all aged out of the system, and it was expected that all members of this group would be retired by 2016.[9]

"High Three" Eligibility and Defined Benefit Calculations

Those who entered service *on or after* September 8, 1980, and *before* January 1, 2018, are eligible to elect the High Three system. For this system the computation base is the average of the highest 3 years (36 months) of basic pay rather than the final basic pay. Otherwise, calculations are the same as under the Final Basic Pay method.

Redux Eligibility and Defined Benefit Calculations

What is now commonly referred to as the "Redux" military retirement system was initiated with the Military Retirement Reform Act of 1986 (P.L. 99-348). The Redux formula reduced the amount of retired pay that military servicemembers who entered the armed forces on or after August 1, 1986, were eligible to receive. This system was broadly unpopular and by 1997 Congress began to take note of potential recruiting and retention problems associated with the change.[10] During the fall of 1998, the Clinton Administration announced that it supported Redux repeal.[11] The National Defense Authorization Act for Fiscal Year 2000 (P.L. 106-65 §§641 and 642) contained provisions for repealing compulsory Redux; it allowed post-August 1, 1986, entrants to retire under the pre-Redux ("High-Three") system or opt for Redux plus an immediate $30,000 cash payment. Personnel who first enter service *on or after* August 1, 1986, are required to select one of the following two options for calculating their retired pay within 180 days of reaching 15 years of service.

Option 1: Pre-Redux

Eligible servicemembers can opt to have their retired pay computed in accordance with the pre-Redux formula, described above as High Three.

Option 2: Redux

Eligible servicemembers can opt to have their retired pay computed in accordance with the Redux formula and receive an immediate $30,000 cash bonus called a Career Status Bonus.[12] Those who select the Career Status Bonus (CSB) must remain on active duty until they complete 20 years of service or forfeit a portion of the bonus.

(...continued)

2015). This change applies only to years served after December 31, 2014.

[9] Department of Defense, *Valuation of the Military Retirement System, September 30, 2006*, DOD Office of the Actuary, November, 2007, p. 12.

[10] Department of Defense, *Military Compensation Background Papers: Compensation Elements and Related Manpower Cost Items, Their Purposes and Legislative Backgrounds*, April 2005, p. 707.

[11] U.S. Congress, Senate Special Committee on Aging, *Developments in Aging: 1999 and 2000, Volume 1*, 107th Cong., 2nd sess., S.Rept. 107-158 (Washington, DC: GPO, 2001).

[12] 37 U.S.C. §354. The bonus can actually be paid in several annual installments if the recipient so wishes, for tax purposes.

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The Redux Formula

Redux is different from the High Three formula in two major ways.

1. **Retirees under age 62:** First, for retirees under the age of 62, the retired pay multiplier will be reduced by 1% for each year of creditable service less than 30 years. Under this formula, a 20-year retiree will receive 40% of his or her retired pay computation base upon retirement (20 years of service multiplied by 2.5% minus 10%), and a 25-year retiree will receive 57.5% of the computation base (25 years of service multiplied by 2.5% minus 5%). A 30-year retiree, however, will receive 75% of the retired pay computation base (30 years of service multiplied by 2.5% minus 0%, the same as the High Three retiree). The Redux formula, therefore, is "skewed" much more in favor of the longer serving military careerist, theoretically providing an incentive to remain on active duty longer before retiring.
2. **Retirees 62 and older:** Second, when a retiree reaches the age of 62, his or her retired pay will be recomputed based on the old formula, a straight 2.5% of the retired pay computation base for each year of service. Thus, beginning at 62, the 20-year retiree receiving 40% of his or her pay base under the Redux formula will begin receiving 50% of his or her pay base; the 25-year retiree's annuity will jump from 57.5% of the pay base to 62.5%; and the 30-year retiree's annuity, already at 75% of the pay base under both the old and new formulas will not change.[13]

Blended Retirement System Eligibility and Defined Benefit Calculations

With the passage of the FY2016 NDAA, servicemembers who have with 12 or less years of service as of December 31, 2017, may opt into the new Blended Retirement System. The blended system will be required for individuals entering the service on or after January 1, 2018. For these servicemembers, the computation base for the defined benefit will be the average of the highest three years (36 months) of basic pay, as in the High Three system; however, the multiplier is reduced to 2.0 from 2.5. This means that the pay base is the high three average at the time of retirement multiplied by 2.0% for each year of service. Therefore a servicemember retiring at 20 years would receive 40% of his/her pay base under the new formula and a 30-year retiree would receive 60% of his/her pay base. The blended system also includes, for the first time, defined contributions including government matching contributions that are discussed in more detail in the section "Reforming the Military Retirement System".

The Blended Retirement System also allows servicemembers to receive a portion of their retired pay in a lump sum. An individual entitled to retired pay may, no later than 90 days before the date of retirement, elect to receive

> A lump sum payment of the discounted present value at the time of the election of an amount of the covered retired pay[14] that the eligible person is otherwise entitled to

[13] Note that this change is an increase in monthly retired pay, not a lump sum at the age of 62.

[14] Covered retired pay is defined as retired pay under title 10, title 14, the National Oceanic and Atmospheric Administration Commissioned Officer Corps Act of 2002 (33 U.S.C. §301 et seq.), and the Public Health Service Act (42 U.S.C.§201 et seq.)

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receive for the period beginning on the date of retirement and the date the eligible person attains the eligible person's retirement age.[15]

For those who elect to receive a lump sum payment, after reaching the eligibility age for social security, they will again receive 100% of their regular monthly annuity, which will be adjusted for annual cost of living increases.

Calculating the Lump Sum Payment

An eligible retiree can elect one of two options for calculating the lump sum.

- A lump sum of 50% of the discounted present value of retired pay between the date of retirement and the date of social security eligibility and a monthly annuity of 50% of the monthly retired pay they are otherwise entitled to. So for example, if a retiree aged 50 was entitled to $4,000 per month in retired pay, and was eligible for social security retirement at age 62, he/she could elect to receive a lump sum of the discounted present value[16] of $2,000 multiplied by 12 months multiplier by 12 years (age 62 minus age 50) plus a monthly annuity of $2,000 per month.
- A lump sum of 25% of the discounted present value of retired pay between the date of retirement and the date of social security eligibility and a monthly annuity of 75% of the monthly retired pay they are otherwise entitled to. So for example, if a retiree aged 50 was entitled to $4,000 per month in retired pay, and was eligible for social security retirement at age 62, he/she could elect to receive a lump sum of the discounted present value[17] of $1,000 multiplied by 12 months multiplied by 12 years (age 62 minus age 50) plus a monthly annuity of $3,000 per month.

The law also allows retirees to take their lump sum payment as a single payment or in installments.

Reserve Component Retirement[18]

There are many similarities between the active and reserve retirement systems. First, reserve component members[19] must also complete 20 "qualifying" years of service to become eligible for a defined retirement benefit. Second, the reserve retirement system also accrues at the rate of 2.5% per "equivalent year" of qualifying service (explained below) at retirement eligibility for those who enter service prior to January 1, 2018, and 2.0% for those who enter on or after January 1, 2018. The primary differences between the two systems are the point system used to

[15] P.L. 114-92 §633. "Retirement age" has the meaning given to the term in Section 2016(1) of the Social Security Act.

[16] This will be calculated by the DOD Office of the Actuary using average personal discount rates in accordance with accepted actuarial principles and taking into consideration cost-of-living-adjustments.

[17] This will be calculated by the DOD Office of the Actuary using average personal discount rates in accordance with accepted actuarial principles and taking into consideration cost-of-living-adjustments.

[18] Also referred to as nonregular retirement. For additional information on reserve pay and benefits, see CRS Report RL30802, *Reserve Component Personnel Issues: Questions and Answers*, by Lawrence Kapp and Barbara Salazar Torreon.

[19] Reserve component generally describes the six reserve components of the Department of Defense: the Army National Guard, the Army Reserve, the Navy Reserve, the Marine Corps Reserve, the Air National Guard and the Air Force Reserve.

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calculate "qualifying years" and equivalent years of service, as well as the age at which the retirement annuity begins. Also, Redux is not an option for reservists.

For retirement purposes, a year of "qualifying" service is a year in which a member of the Reserve earns at least 50 retirement "points." Points are awarded for a variety of reserve activities:

- One point for each day of active service, which includes annual training.[20]
- Fifteen points a year for membership in the Ready Reserve.
- One point for each inactive duty training (IDT) period.[21]
- One point for each period of funeral honors duty.
- One point for every three satisfactorily completed credit hours of certain military correspondence courses.

With multiple opportunities to earn points, it is relatively easy for a participating member of the selected reserve to accrue the requisite 50 points per year and thus earn a qualifying year for retirement. The maximum number of points per year, exclusive of active duty, has varied over time but is currently capped at 130 points.[22] When active duty points are added to this total, the reservist cannot earn more than 365 points a year. The number of points is critical in determining both the number of years of qualifying service and the number of equivalent years of service for retired pay calculation purposes.

A reservist may retire after completing 20 years of qualifying service; there is no minimum age. However, the reservist will usually not become eligible for retired pay until age 60,[23] at which time he or she also becomes eligible for military medical care. Upon retirement, the individual is normally transferred to the Retired Reserve and is entitled to a number of military benefits to include commissary and exchange privileges; access to Morale, Welfare and Recreation programs and facilities; and limited space available travel on military aircraft. Reservists in the Retired Reserve but not yet retired pay eligible are referred to as "Gray Area" retirees. Time spent in the Retired Reserve counts for longevity purposes and ultimately results in higher retired pay. For example, a lieutenant colonel who transitions to the Retired Reserve at age 45 will have their retired pay at age 60 calculated on the basic pay of a lieutenant colonel with an additional 15 years of longevity.

The date the reservist became a member of the armed forces determines whether their retired pay is calculated based on the Final Basic Pay, High Three, or Blended Retirement System. Those entering before September 8, 1980, will retire under the Final Basic Pay system while those entering after September 8, 1980 but before January 1, 2018, will retire under the High Three system. Those who first perform Reserve Component service (with no prior regular or reserve service) on or after January 1, 2018, will retire under the Blended Retirement System. Those

[20] Annual training is a two-week period of active service that usually results in 14 or 15 retirement points.

[21] A day of inactive duty for training typically includes two Unit Training Assemblies (UTAs). The normal drill weekend consists of four UTAs and therefore results in four retirement points. A year of weekend drills earns 48 UTAs/retirement points.

[22] P.L. 110-181 §648

[23] Section 648 of the FY2008 National Defense Authorization Act reduced the age for receipt of retired pay by three months for each aggregate of 90 days of specified duty performed after January 28, 2008 (the date of enactment of the FY2008 NDAA). This authority was not made retroactive to September 11, 2001. The retired pay eligibility age cannot be reduced below 50 and eligibility for medical benefits remains at age 60.

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reservists with prior service who have accumulated less than 12 years of *equivalent years of service* (< 4,320 points) may opt into the Blended System.

The actual calculation parallels the active duty system but requires adjustment to reflect the part-time nature of reserve duty. For example, consider a reserve component lieutenant colonel with 5,000 points who joined the military in January 1980, and transferred to the Retired Reserve in 2000 after completing 20 qualifying years of service. In 2015, he turned 60 years of age and became eligible for retired pay. The process for calculating his retired pay is to divide the total points by 360 to convert the points to years of equivalent service (5,000 / 360 = 13.89). Next multiply the equivalent years of service by the 2.5% multiplier (13.89 times 0.025 = 0.3472). Using the Final Basic Pay option, the 2015 pay base for a lieutenant colonel with 35 years of service (20 years of qualifying service plus 15 years in the Retired Reserve) is $8,762.40 per month.[24] Multiplying the pay base by the retired pay multiplier ($8,762.40 times 0.3472) produces a monthly retirement annuity of $3,042 per month.

Number of Non-Disability Retirees by Retirement System

Table 2 reflects retirees by service and by retired pay system. There are very few now serving in the military that are eligible to retire under the Final Pay system since the junior member of that cohort who is still on active duty had at least 35 years of service in 2015. Although the numbers for High Three and Redux should continue to increase, these figures show that Redux is the least popular retirement system with fewer current retirees selecting this option.

Table 2. Active Duty and Reserve Non-Disability Retirees by Category and Service

(as of September 2014)

	Army	Air Force	Navy	Marine Corps	Total
Final Pay	599,991	539,243	368,717	85,747	1,593,698
High Three	178,554	131,333	116,624	34,979	461,490
Redux	17,238	15,348	15,852	3,710	52,148
Total	784,548	684,924	501,193	124,436	2,107,336

Source: Department of Defense, Office of the Actuary. Data provided to CRS on March 26, 2015.

Notes: Totals include all of those eligible to receive non-disability retired pay including those who are eligible but not receiving retired pay due to 100% VA offset for disability or gray area reserve retirees.

Disability Retirement[25]

Servicemembers determined to be unfit for continued service and who have a permanent and stable disqualifying physical condition may qualify for disability retirement, commonly referred to as a Chapter 61 retirement. Eligibility is based on having a permanent and stable disability, rated at 30% or more by DOD, and the disability was not noted at the time of entrance on active duty.[26] As a result, some disability retirees are retired before becoming eligible for longevity retirement while others have completed 20 or more years of service.

[24] 2015 Military Pay Chart at http://www.dfas.mil.

[25] For additional information on DOD's disability process, see CRS Report RL33991, *Disability Evaluation of Military Servicemembers*, by Christine Scott and Don J. Jansen.

[26] 10 U.S.C. §1201 (b) (3) (B). Prior to the FY2008 NDAA (P.L. 110-181 §1641), disability retirement required at least (continued...)

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A servicemember retired for disability may select one of two available options for calculating their monthly retired pay:[27]

1. **Longevity Formula.** Retired pay is computed by multiplying the years of service times 2.5% or 2.0% (for those joining on or after January 1, 2018) and then times the pay base (either final pay or high three, as appropriate).
2. **Disability Formula.** Retired pay is computed by multiplying the DOD disability percentage by the pay base.

The maximum retired pay calculation under the disability formula cannot exceed 75% of basic pay.[28] Disability retirees are not authorized to receive a lump sum payment under the Blended Retirement System.

Retired pay computed under the disability formula is subject to federal income tax unless the disability is the result of a combat-related injury or if the individual was a member of the Armed Services or eligible to receive disability payments prior to September 25, 1975.[29] Retired pay under the longevity formula (for those entering after September 24, 1975) is taxable only to the extent that it exceeds what the individual would receive for a combat related injury under the disability formula.

Military Retired Pay, Social Security, and Federal Income Tax

Current military personnel do not contribute a portion of their salary to help pay for military retirement benefits. However, they have paid taxes into the Social Security trust fund since January 1, 1957, and are entitled to full Social Security benefits based on their military service. Military retired pay and Social Security are not offset against each other. Military retirees receive full Social Security benefits in addition to their military retired pay.

Military retired pay is not subject to withholding for Social Security tax. However, all non-disability retired pay is subject to withholding of federal income tax. A portion of the Social Security benefit may also be subject to federal income tax for individuals who have other income.

Change in Military Retiree Pay Dates

Monthly pay for most military retirees occurs through direct deposit to a financial institution on the first day of the month. In the past, if the first day of the month was a weekend or national holiday, the pay would not be deposited until the first business day of the month, which could actually be the second or third day of the month.

In response to numerous complaints from military retirees about not receiving their pay on the first and with support from veterans' service organizations, the Ike Skelton National Defense Authorization Act for Fiscal Year 2011 (P.L. 111-383 §646) required that military retiree pay be

(...continued)

eight years of service or a disability that resulted from active duty or was incurred in the line of duty during war or national emergency.

[27] 10 U.S.C. §1401.

[28] 10 U.S.C. §1401.

[29] 26 U.S.C. §104.

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processed on the first day of the month. When that day falls on a weekend or holiday, the pay date is moved to the previous business day. This change resulted in calendar year 2011 having 13, rather than the normal 12, military pay dates and the potential tax implications associated with increased annual income. From tax year 2012 and beyond, military retirees will receive their normal 12 payments.

Retired Pay and the Cost-of-Living Adjustment (COLA)

Military retired pay is protected against inflation by statute (10 U.S.C. §1401a). The Military Retirement Reform Act of 1986, in conjunction with changes contained in the FY2000 National Defense Authorization Act (P.L. 106-65), provides for COLAs as indicated below. Congress has not modified the COLA formula[30] since 1995. However, COLA modifications are regularly discussed among policymakers, typically with the aim of reducing costs and hence the payments to retirees. COLAs for 2007 to 2016 are shown in **Table 3**.[31]

Table 3. Cost-of-Living Adjustments 2007-2016

Year	Pre-Aug. 1986 COLA	Post-Aug. 1986 COLA	Year	Pre-Aug. 1986 COLA	Post-Aug. 1986 COLA
2007	2.3%	2.3% w/o CSB 1.3% w/ CSB	2012	1.7%	1.7% w/o CSB 0.7% w/ CSB
2008	5.8%	5.8% w/o CSB 4.8% w/ CSB	2013	1.5%	1.5% w/o CSB 0.5% w/ CSB
2009	0.0%	0.0% w/o CSB 0.0% w/ CSB	2014	1.7%	1.7% w/o CSB 0.7% w/ CSB
2010	0.0%	0.0% w/o CSB 0.0% w/ CSB	2015	0.0%	0.0% w/o CSB 0.0% w/ CSB
2011	3.6%	3.6% w/o CSB 2.6% w/ CSB	2016	0.3%	0.3% w/o CSB 0.0% w/ CSB

Source: Office of the Under Secretary of Defense (Comptroller), DOD 7000.14-R Financial Management Regulation, Vol. 7B, Chapter 8, April 2016.

Note: CSB = Career Status Bonus. The COLA increase for most retired pay is effective on December 1 of the year it is announced and reflected in the next scheduled payment. For example, the COLA effective December 1, 2016 will apply to payments through calendar year 2017.

COLAs for Pre-August 1, 1986, Entrants

For military personnel who first entered military service before August 1, 1986, each December a COLA equal to the percentage increase in the Consumer Price Index (CPI) between the third quarters of successive years will be applied to military retired pay for the annuities paid

[30] The actual index used to adjust COLA is the CPI-W; the index for urban wage earners and clerical workers. It represents the buying habits of approximately 32% of the noninstitutional population of the United States, *Military Compensation Background Papers*, Seventh Edition, November 2011, p. 637.

[31] For a discussion of proposed and actual COLA changes from FY1983 to FY2005, see CRS Report 98-223, *COLAs for Military Retirees: Summary of Congressional and Executive Branch Action, 1982-2004 (FY1983-FY2005)*.

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beginning each January 1. For example, assume that the CPI rises from 230.3 in the period July through September 2013 to 234.2 in the period July through September 2014, an increase of 14.4 points or 1.7% of 400.0. The monthly retired pay that accrues beginning December 2014, that will actually be paid to retirees on January 1, 2015, would be increased by 1.7% above that amount paid the previous month.

COLAs for Personnel Who Entered Service On or After August 1, 1986

For those personnel who first entered military service on or after August 1, 1986, their COLAs will be calculated in accordance with either of two methods, as noted below.

Non-Redux Recipients

Those personnel who opt to have their retired pay computed in accordance with the pre-Redux (High Three) formula will have their COLAs computed as described above for pre-August 1, 1986, entrants.

Redux/$30,000 Cash Bonus Recipients

Those personnel who opt to have their retired pay computed in accordance with the Redux formula, and receive the $30,000 cash bonus, have their COLAs computed using a different formula. Annual COLAs are held one percentage point below the actual inflation rate. Retirees covered by this COLA formula thus receive a 2.6% increase (rather than 3.6%) in their military retired pay under the hypothetical example described in the preceding example for Pre-August 1, 1986, entrants. When a retiree reaches the age of 62, there is a one-time recomputation of his or her annuity to make up for the lost purchasing power caused by the holding of COLAs to the inflation rate minus one percentage point. This recomputation of COLA, in combination with the recomputation of the retired pay multiplier (discussed earlier), restores the member's retired pay to that of a similarly retired member who did not take the Bonus/Redux option. After the recomputation at age 62, however, future COLAs continue to be computed annually on the basis of the inflation rate minus one percentage point.

Bipartisan Budget Act of 2013

The Bipartisan Budget Act of 2013 (P.L. 113-67 §403) modified how COLAs are computed for current and future retirees under the age of 62. Under the new formula, if the CPI used in computing the COLA is 1% or greater, then that CPI amount is reduced by 1% during each year the retiree is under age 62. For example, if the CPI is determined to be 2.5%, a CPI of 1.5% would be applied. If the CPI in any year is 1.0% or less than 1%, it is considered to be zero and no COLA occurs (i.e., there cannot be a negative COLA). Upon reaching age 62, for the purposes of computing future retired pay, retired pay is re-computed as if the full CPI had been used each year while the retiree was under age 62. This formula was intended to go into effect on December 1, 2015 for all current and future servicemembers.

However, in response to concerns about potential effects, Congress first restored full CPI COLA adjustments for disabled military retirees and survivors in the Consolidated Appropriations Act of 2014 (P.L. 113-76). Congress has since amended the provision twice; first in 2014 (P.L. 113-82 §10001; formerly known as South Utah Valley Electric Conveyance Act) to apply only to servicemembers joining on or after January 1, 2014, and then again in the Carl Levin and Howard

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P. "Buck" McKeon National Defense Authorization Act for Fiscal Year 2015 (P.L. 113-291 §623) to apply only to servicemembers joining on or after January 1, 2016.[32]

Section 631 of the FY2016 NDAA repealed the reduced cost of living adjustments for members under the age of 62.

Reforming the Military Retirement System

Leading up to the FY2016 authorization of the Blended Retirement System, there were several recent efforts to modify the military retirement system. A number of these previous studies have noted that the military retirement system should be more flexible, equitable, and efficient.

10th QRMC Recommendations

Every four years, the President is required by law[33] to direct a comprehensive review of the military compensation system and to forward the review, along with his recommendations, to Congress. In the 10th Quadrennial Review of Military Compensation (QRMC), one of the directed areas of assessment was "the implications of changing expectations of present and potential members of the uniformed services relating to retirement."[34] To accomplish this, the QRMC suggested a major revision of both the active and reserve retirement systems highlighted by the following:

1. A defined benefit plan similar to the current High Three system but that would "vest" at 10 years of service and not be payable until age 60 for those who retired with less than 20 years of service or at age 57 for those with 20 or more years of service. Retirees could opt to receive the retirement annuity immediately upon retirement but the annuity would be reduced by 5% for each year under age 57.
2. Combined with the above defined benefit plan would be a defined contribution plan that would require the services to contribute up to 5% of annual base pay into a retirement account for each servicemember. The contribution would start at 2% for those with two years of service and increase incrementally until it reached 5% for those with five or more years of service. This plan would also vest at 10 years of service but withdrawals could not begin until age 60.
3. A system of "gate" pays would be established at specified career points to retain selected personnel in specified skill areas.
4. Separation pay would be used to encourage personnel in over-manned skills to separate prior to qualifying for a normal 10- to 30-year retirement.

11th QRMC Recommendations

The DOD submitted the 11th QRMC final report in June 2012. While this QRMC did not have the same focus on the entire retirement system as the previous QRMC, DOD recommended more closely aligning active and reserve retirement systems with the goal of eventually transitioning to

[32] For more information on military retirement COLAs and the Bipartisan Budget Act of 2013, see CRS Report R43393, *Reducing Cost-of-Living Adjustments for Military Retirees and the Bipartisan Budget Act: In Brief*, by Amy Belasco and Lawrence Kapp.

[33] 37 U.S.C. §1008(b).

[34] Presidential memorandum, Subject: Tenth Quadrennial Review of Military Compensation, August 2, 2005.

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a "total force" single-system approach for both the active and reserve components. The report recommended the following modification to the reserve retirement system:[35]

> Reserve component members who have attained 20 qualifying years for retirement benefits could begin receiving retired pay on the 30th anniversary of their service start date or at age 60, whichever comes first. Reserve members would receive one retirement point for each day of service, and the points needed for a qualifying year would be reduced from the current 50-point requirement to 35.

Neither the executive branch nor Congress has taken any action to modify the military retirement system based on the recommendations of the 10th or 11th QRMC.

Military Compensation and Retirement Modernization Commission (MCRMC)

The National Defense Authorization Act (NDAA) for FY2013 (P.L. 112-239) established a Military Compensation and Retirement Modernization Commission (MCRMC) to provide the President and Congress with specific recommendations to modernize pay and benefits for the armed services. In terms of retirement the commission was mandated to provide recommendations to "Modernize and achieve fiscal sustainability for the compensation and retirement systems for the Armed Forces and the other Uniformed Services for the 21st century."[36] Notably, Section 674 of P.L. 112-239 mandated that the commission comply with conditions that would grandfather existing servicemembers and retirees into the existing retirement system, stating:

> (i) For members of the uniformed services as of such date, who became members before the enactment of such an Act, the monthly amount of their retired pay may not be less than they would have received under the current military compensation and retirement system, nor may the date at which they are eligible to receive their military retired pay be adjusted to the financial detriment of the member.
>
> (ii) For members of the uniformed services retired as of such date, the eligibility for and receipt of their retired pay may not be adjusted pursuant to any change made by the enactment of such an Act.

The commission delivered its final report and recommendations to Congress on January 29, 2015.

The Blended Retirement System

Congress adopted many of the MCRMC's recommendations in the FY2016 NDAA. **Table 6** summarizes all systems currently in use including the changes that will be implemented when the blended system goes into effect in 2018. The biggest change is a shift from a purely defined benefit system to a blended defined benefit, defined contribution system. The commission found that under the existing system of "cliff-vesting," which is contingent on a 20-year career, 83% of enlisted and 51% of officers do not receive retirement compensation for their service.[37] This is at odds with retirement benefits in the private sector where firms increasingly offer a variety of

[35] Report of the 11th Quadrennial Review of Military Compensation, June 2012.

[36] National Defense Authorization Act for FY2013, P.L. 112-239 subtitle H, 126 Stat. 1632, 1787 (2013).

[37] Military Compensation and Retirement Modernization Commission Final Report, January 2015. p. 23.

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defined contribution packages and are required by law to vest employees within a much shorter time period.[38]

Years of Service Requirement

The MCRMC did not make any recommendations changing the 20-year eligibility for retirement; however, it recommended that the Secretary of Defense be given authority to modify the year of service requirement to shape the force profile as long as it does not impose involuntary changes on existing servicemembers. DOD expressed opposition this proposal and Congress did not adopt a provision based on this MCRMC recommendation. The 20-year eligibility remains in current law.

Eligibility for the Blended Retirement System

Existing servicemembers in active duty, reserve status, and retirees will be "grandfathered" into whatever retirement system they currently have selected; however, those with 12 or fewer years of service on December 31, 2017, will have the opportunity to opt into the blendedsystem. The logic behind this eligibility requirement is, for those with more than 12 years of service, opting into the blended system might put them at a financial disadvantage as they would see a reduction in their multiplier at 20 years of service, but have not had the benefit of matching government contributions into the TSP system. However, servicemembers at the beginning of their career, particularly if they are unsure of completing a 20-year career, would likely benefit from opting in to the blended system.

Reduced Multiplier for Defined Benefit

The commission recommended changing the current system from a defined benefit system to a blended system which includes a defined contribution element. In the resulting legislation, the defined benefit in the Blended Retirement System would remain similar to the High Three system, but the multiplier would be reduced from 2.5% to 2.0% per year of service. Thus, an active duty servicemember with 20 years of service under the blended system would receive 40% of base pay (2.0% times 20) rather than 50% (2.5% times 20) under the current system. For reserve component personnel, the same multiplier would be used although reserve years of service would continue to be calculated under the points system mentioned earlier in this report.

Defined Contributions

The defined contribution element is intended to make up the shortfall incurred with the blended multiplier and would be deposited through the Thrift Savings Plan (TSP). Under the blended system, servicemembers entering after January 1, 2018, will be automatically enrolled in the TSP at a level of 3% individual contribution from his or her monthly basic pay or inactive duty pay beginning the first pay period after the member's 60th day of service. At that time, the services will also begin monthly contributions of 1% of basic pay automatically into the servicemember's TSP account. In addition, DOD will make matching contributions of up to 4%[39] of the

[38] The Employee Retirement Income Security Act (ERISA) requires firms to vest employees in company-provided defined benefit retirement plans either gradually over a period of seven years or by five years for cliff-vesting. In addition, a defined contribution plan must cliff vest within three years or up to six years for gradual vesting.

[39] This does not include the 1% contribution, therefore the total government contribution would not exceed 5% of the member's basic pay.

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servicemember's basic pay from two years and one day after the member first enters service and ending at 26 years of service. The servicemember will need to make individual contributions of 5% in order to receive government matching of 4% (see **Table 4** for government matching percentages). The servicemember will be fully vested after two complete years of service and will be able to take ownership of the 1% contributions as well as any subsequent matching contributions. Any earnings on government contributions are immediately vested when they accrue. Servicemembers are immediately fully vested in any personal TSP contributions.

Table 4. Government Automatic and Matching Contributions

Individual Contribution Rate of Basic Pay or Inactive Duty Pay	Government Automatic Contribution Rate of Basic Pay or Inactive Duty Pay	Government Matching Contribution Rate of Basic Pay or Inactive Duty Pay	Total Rate of TSP Monthly Contribution of Basic Pay or Inactive Duty Pay
0%	1%	0%	1%
1%	1%	1%	3%
2%	1%	2%	5%
3%	1%	3%	7%
4%	1%	3.5%	8.5%
5%	1%	4%	10%

Source: Department of Defense, *Guidance for Implementation of the Blended Retirement System for the Uniformed Services*, Memorandum from the Deputy Secretary of Defense, January 27, 2017.

Notes: Click here and type the notes, or delete this paragraph

The services will also automatically enroll new servicemembers in the TSP program for individual contributions at a default amount of their basic pay unless the servicemember opted out. If the servicemember declines to make individual contributions, he or she will automatically be reenrolled every year at the default amount of 3% individual contribution.. This will require the individual to make an active decision every year to not contribute to the TSP.

Lump Sum Payments

Another change proposed by the MCRMC and adopted in the FY2016 NDAA was that servicemembers could choose to receive their retirement annuity in various forms as discussed in the previous section "Calculating the Lump Sum Payment":

- A monthly payment beginning at their retirement date;
- A 50% discounted lump sum amount at retirement, combined with a reduced monthly payment until eligibility for full social security payments, at which point the full monthly annuity would begin; and
- A 25% discounted lump sum amount at retirement, combined with a reduced monthly payment until eligibility for full social security payments, at which point the full monthly annuity would begin.

Continuation Pay

In order to provide mid-career retention incentives under the blended system, the MCRMC proposed continuation pay for members who reach 12 years of service, in return for a four-year service obligation. Congress adopted this proposal in the FY2016 NDAA (Sec. 634), and

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amended it in the FY2017 NDAA to provide more flexibility in the timing of this pay as "not less than 8 and not more than 12 years of service." Section 633 of the FY2017 NDAA also requires a minimum of 3 additional years of service following acceptance of continuation pay. The pay may be distributed in a lump sum, or in a series of not more than four payments.[40]

The law will allow an active duty (regular component) member or reserve component member who is performing Active Guard or Reserve duty[41] to receive a minimum amount of continuation pay equal to 2.5 times their monthly basic pay. For reserve component members not on active duty, the minimum continuation pay is equal to at least 0.5 times the monthly basic pay of an active component member of similar rank and longevity.

The law also authorizes an additional amount of continuation pay, at the discretion of the Secretary concerned. For active component members that would be the amount of monthly basic pay multiplied by no more than 13.[42] For example, using 2016 pay scales, an active duty O-4 with over 10 years of service could receive continuation pay of at least $16,864.50 (2.5 times monthly base pay of $6,745.80) and at most $104,559.90 ($16,864.50 plus 13 times monthly base pay of $6,745.80).[43] An active duty E-6 with over 10 years of service could receive continuation pay of at least $8,521.50 (2.5 times monthly base pay of $3,408.60) and at most $52,833.30 ($8,521.50 plus 13 times monthly base pay of $3,408.60). This flexibility awarded to military department Secretaries on the amount of additional continuation pay is intended to aid force-shaping by allowing the Secretaries to offer higher continuation payments to those in occupational specialties that are undermanned.

Table 5. Potential Continuation Pay Multipliers

(by Component and Active Duty Status)

Component and Status	Minimum Continuation Pay	Additional Discretionary Continuation Pay
Active Component	2.5 times monthly base pay	Up to 13 times monthly base pay
Reserve Component on Active Duty as defined in 10 U.S.C. §101(d)(6)	2.5 times monthly base pay	Up to 6 times monthly base pay
Reserve Component *not* on Active Duty as defined in 10 U.S.C. §101(d)(6)	0.5 times monthly base pay	Up to 6 times monthly base pay

Source: 37 USC §356

Notes: Monthly base pay for reservists is calculated as the monthly base pay of an active component member of similar rank and longevity.

[40] 37 U.S.C. §356(d).

[41] As defined in 10 U.S.C. §101(d)(6).

[42] Section 634 of P.L. 114-92 states, "(b) AMOUNT.—The amount of continuation pay payable to a full TSP member under subsection (a) shall be the amount that is equal to—(1) in the case of a member of a regular component—'(A) the monthly basic pay of the member at 12 years of service multiplied by 2.5; plus ''B) at the discretion of the Secretary concerned, the monthly basic pay of the member at 12 years of service multiplied by such number of months (not to exceed 13 months) as the Secretary concerned shall specify in the agreement of the member under subsection (a). (2) in the case of a member of a reserve component—(A) the amount of monthly basic pay to which the member would be entitled at 12 years of service if the member were a member of a regular component multiplied by 0.5; plus (B) at the discretion of the Secretary concerned, the amount of monthly basic pay described in subparagraph (A) multiplied by such number of months (not to exceed 6 months) as the Secretary concerned shall specify in the agreement of the member under subsection (a)."

[43] 2015 Military Pay Chart at http://www.dfas.mil.

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Under the blended system, reserve component members within the window of eligibility would receive the minimum continuation pay as discussed above (2.5 or 0.5 times the monthly basic pay of an active component member), plus an additional amount at the discretion of the Secretary concerned that would be the amount of monthly basic pay multiplied by no more than six. For example, a Reserve O-4 with over 10 years of service and performing active duty could receive continuation pay of at least $16,864.50 (2.5 times monthly base pay of $6,745.80) and at most $57,339.30 ($16,864.50 plus six times monthly base pay of $6,745.80). A Reserve O-4 with over 10 years of service who is not on active service that the time of accepting continuation pay would receive at least $3,372.90 (0.5 times monthly base pay of $6,745.80) and at most $43,847.70 ($3,372.90 plus six times monthly base pay of $6,745.80).

Table 6. Comparisons of Current Retirement Systems and the Blended Retirement System

	Final Basic Pay	High Three	Redux	Blended Retirement System
Applies to	Servicemembers entering before September 8, 1980	Servicemembers entering from Sept. 8, 1980, through July 31, 1986, and persons entering after July 31, 1986, but opting not to accept the 15-year CSB	Servicemembers entering after July 31, 1986, and accepting 15-year Career Status Bonus with additional five-year service obligation	Servicemembers entering on or after January 1, 2018, and those with 12 or fewer YOS on December 31, 2017, who choose to opt in.
Basis of Computation	Final rate of monthly basic pay	Average monthly basic pay for the highest 36 months of basic pay	Average monthly basic pay for the highest 36 months of basic pay	Average monthly basic pay for the highest 36 months of basic pay
Defined Benefit Multiplier	2.5% per YOS	2.5% per YOS	2.5% per YOS, less 1% for each year of service less than 30 (restored at age 62)	2.0% per YOS
Defined Contribution	Individual contributions to TSP, no matching	Individual contributions to TSP, no matching	Individual contributions to TSP, no matching	1.0% minimum contribution into TSP from Service with up to 4.0% matching contributions
Lump Sum Option	Monthly annuity only	Monthly annuity only	Monthly annuity only	Option for partial lump sum payment at retirement with full monthly annuity restored at eligibility age for full social security payments
Additional Continuation Benefit			$30,000 CSB payable at the 15-year anniversary w/five-year obligation to remain on active duty	Minimum incentive pay between 8 to12 YOS w/3-year service obligation

Source: Adapted by CRS from *Military Compensation Background Papers*, Department of Defense, Seventh Edition, November 2011, and FY2016 NDAA.

Notes: YOS = Years of Service; CSB = Career Status Bonus.

The commission had also proposed that the services budget additional funds for continuation pay in addition to the recommended basic continuation pays to maintain the current force profile and to allow flexibility in adjusting force profiles to meet future changes in manpower requirements. Based on the retention model used by the commission, it projected a need to offer continuation pay of up to 4.8 times basic pay for active component enlisted personnel and up to 15.9 times

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basic pay for officers.[44] The commission also recommended that all base and additional continuation pay should be paid from an authority used only for the purpose of continuation pay and should be budgeted as a new budget line item.

Redux Sunset

The FY2016 NDAA includes a provision that would sunset the 15-year career status bonus under the Redux system. After December 31, 2017, no new bonuses would be paid under the Redux program.

Military Retirement Budgeting and Costs

Military retirement costs, which include all payments to current retirees and survivors, have been rising modestly each year, due to a predictable, slow rise in the number of retirees and survivors coupled with cost of living increases. All DOD budgets through FY1984 reflected the costs of retired pay actually being paid out to personnel who had already retired. That is, Congress appropriated the amount of money required to pay current retirees each year as part of each annual defense appropriations bill, commonly referred to as "pay-as-you-go" or "PAYGO."

Since FY1985, the "accrual accounting" concept has been used to budget for the costs of military retired pay. The unfunded liability resulting from the change in accounting practices is discussed in the next section. Under the accrual accounting system, the DOD budget for each fiscal year includes not the amount of retired pay actually paid to retirees, but rather, a contribution to the military retirement fund sufficient to finance future retirement payouts to current uniformed personnel when they retire. These annual "accrual" contributions accumulate in the military retirement fund, along with interest earned on them.

The amount that the Defense Department must contribute each year to cover future retirement costs is determined by an independent, presidentially appointed, Department of Defense Retirement Board of Actuaries, which decides how much is needed to cover future retirement costs as a percentage of military basic pay. Once military personnel retire, payments to them are made from the accumulated amounts in the military retirement fund, not from the annual Department of Defense budget.

Estimated future retirement costs are modeled based on the past rates at which active duty military personnel stayed in the service until retirement, and on assumptions regarding the overall U.S. economy, including interest rates, inflation rates, and military pay levels. The model helps determine the level percentage of basic pay for each active servicemember that must be contributed from the DOD budget every year to cover future retirement costs – approximately 30 cents on every dollar of basic pay. This is called the normal cost percentage (NCP) shown in **Table 7**. Changes in the FY2016 NDAA that created the blended retirement system are estimated to decrease the FY2017 full-time NCP by 2.9 percentage points and the part-time NCP by 0.8 percentage points.

[44] MCRMC Final Report, pp. 29-30 and Table 2. The commission projected the Navy would require the highest multiples of continuation pay for enlisted personnel (4.8 times monthly basic pay) and the Air Force would require the highest multiples of continuation pay for officers (15.9 times monthly basic pay) to maintain their active component force profiles.

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Table 7. DOD's Normal Cost Percentages for FY2015

Benefit Formula	Full-Time	Part-time
Final Pay	35.2%	24.3%
High-3	32.0%	22.9%
CSB/Redux	31.4%	NA

Source: DOD Office of the Actuary, *Valuation of the Military Retirement System*, September 30, 2014, rev. June 2016.

DOD budget authority and outlays in each fiscal year that pay for the estimated cost of future retirees are transferred in a paper transaction to a Military Retirement Fund, located in the Income Security Function of the federal budget. The Military Retirement Fund also receives (paper) transfers from the General Fund of the Treasury to fund the initial unfunded liability of the military retirement system. This is the total future cost of military retired pay that will result from military service performed prior to the implementation of accrual accounting in FY1985. Money is disbursed from this Military Retirement Fund to current retirees. Individual retirees receive their retired pay from the Defense Finance and Accounting Service (DFAS). Technically, however, because this money paid to individuals comes not from the DOD budget, but from the fund, it is paid out of the Income Security function of the federal budget. Actual payments to current retirees thus show up in the federal budget as outlays from the federal budget as a whole, not from DOD. Under accrual accounting, therefore, total federal outlays for each fiscal year continue to reflect only costs of payments to military members who have already retired, as was the case before accrual accounting began. Accrual accounting only changes the manner in which the federal government accounts for military retired pay; it does not affect actual payments to individuals in any way.

Unfunded Liability

Current debates over both federal civilian and military retirement have included some discussion of the "unfunded liability" of both. As noted above, the military retirement system's unfunded liability consists of future retired pay costs incurred before the creation of the Military Retirement Fund in FY1985. The initial unfunded liability as of September 30, 1984 was $528.7 billion.[45] The unfunded liability at the end of FY2014 was $885.1 billion. These obligations are being liquidated by the payment to the fund each year of an amount from the General Fund of the Treasury and are now expected to be fully amortized by FY2026.[46]

Some concerns have been voiced about the amount of unfunded liability. However, (1) the hundreds of billions of dollars of unfunded liability is a cumulative amount to be paid to retirees over the next 50 years, not all at once; (2) the population of retirees who served under the pre-accrual system is slowly declining due to deaths; and (3) unlike the private sector, there is no way for employees to claim immediate payment of their future benefits. An analogy would be that most homeowners cannot afford to pay cash for a house, so they get a mortgage. If the mortgage had to be paid in full, almost no homeowners could afford to do so. However, spread out over 30 years, the payments are affordable. Similarly, the unfunded liability of federal retirement

[45] Department of Defense, *FY2014 Valuation of the Military Retirement System*, Office of the Actuary, September 2014, p.23.

[46] Ibid., p. 24.

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programs is considered to be more affordable when federal retirement outlays are spread over many decades.

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