United States Government Accountability Office
Washington, DC 20548

June 3, 2010

The Honorable Jim Webb
Chairman
Subcommittee on Personnel
Committee on Armed Services
United States Senate

Subject: *Questions for the Record Related to Military Compensation*

Dear Mr. Chairman:

It was a pleasure to appear before your subcommittee on April 28, 2010, to discuss current issues related to military compensation.[1] This letter responds to your request that I provide answers to questions for the record from the hearing. The questions, along with my responses, follow.

Questions from Chairman Webb

Use of Employment Cost Index as Benchmark Index for Military Basic Pay

1. **Dr. Murray and Ms. Farrell, in Dr. Murray's prepared statement, she stated that using the Employment Cost Index (ECI) as the benchmark index for annual military pay raises had its limitations, since it measured a population that tended to be older and college-educated, a population whose pay has increased more rapidly over the past decade than younger high school graduates. Is the ECI an appropriate index to use to adjust military basic pay rates annually? If not, is there a benchmark that is more appropriate?**

In our April 1, 2010 report,[2] we noted that using the Employment Cost Index (ECI) for the purpose of determining the amount of the annual basic pay raise for servicemembers has both strengths and weaknesses, but is generally reasonable to use to adjust such pay annually. It should also be noted that basic pay is just one

[1] GAO, *Military Personnel: Comparisons between Military and Civilian Compensation Can be Useful, but Data Limitations Prevent Exact Comparisons*, GAO-10-666T (Washington, D.C.: Apr .28, 2010).
[2] GAO, *Military Personnel: Military and Civilian Pay Comparisons Present Challenges and Are One of Many Tools in Assessing Compensation*, GAO-10-561R (Washington, D.C.: Apr. 1, 2010).

component of the total military compensation package. In addition to basic pay, servicemembers also receive allowances, tax advantages, as well as deferred and in-kind compensation.

The ECI is a measure of changes in wages and employer costs for employee benefits. Created in the mid-1970s, the ECI is published quarterly by the Bureau of Labor Statistics and is part of the bureau's National Compensation Survey program, which provides measures of occupational wages, employment cost trends, and benefit incidence and detailed plan provisions. Organizations use the ECI to inform their decision making in a variety of ways—including adjusting their wage rates to keep pace with what their competitors' pay or to adjust wage rates in collective bargaining agreements. In addition, the federal government uses the ECI to inform its decision making. For example, Congress included a provision in the National Defense Authorization Act for Fiscal Year 2004 tying the annual basic pay raise for military personnel to the ECI.[3] The law contains a provision allowing the President to propose alternative pay adjustments to Congress, in certain circumstances, if the President deems the standard increase required by the law to be inappropriate.

As noted, our recent work[4] has found that using the ECI to adjust military basic pay annually has both strengths and weaknesses. For example, its strengths include the following: the ECI is a nationally representative measure of labor costs for the civilian economy; it is also produced in a consistent fashion,[5] using a transparent methodology; and it provides separate data series for different occupational groups, industries, and geographic areas. With regard to its weaknesses, the ECI is not tailored to the specific segments of the civilian economy most relevant to the Department of Defense (DOD)—for example, those occupations and industries that the military services primarily compete with for workers. Also, because the ECI is constructed from data collected from surveys of employers, it does not provide data about the demographics of the civilian workforce—such as workers' education and experience, both of which are important factors that are often taken into account when setting employee pay. Nevertheless, we, as well as the Congressional Budget Office (CBO),[6] have previously reported[7] on the challenges of creating more tailored indexes. Further, none of the experts with whom we consulted, nor any reports published by other organizations that we reviewed during the course of our review, suggested that any other existing indexes or data series would provide more useful data than those provided by the ECI.

[3]Pub. L. No. 108-136, § 602 (2003), codified at 37 U.S.C. § 1009. Specifically, the law requires that all eligible servicemembers' monthly basic pay be increased annually by the annual percentage increase in the ECI, except for in fiscal years 2004, 2005, and 2006 when the law required that servicemembers' basic pay increase be equal to the annual percentage increase in the ECI, plus an additional one-half percentage point.

[4]GAO-10-561R.

[5]We do note, however, that adjustments to the methodology have been made from time to time. For example, in 2006 the Bureau of Labor Statistics changed the way the ECI classified industries and occupations to reflect new industry and occupational classification systems and rebased the index, among other changes.

[6]Congressional Budget Office, *Evaluating Military Compensation* (Washington, D.C.: June 2007),

7GAO-10-561R; GAO, *Poverty Measurement: Adjusting for Geographic Cost-of-Living Difference*, GAO/GGD-95-64 (Washington, D.C.: March 9, 1995); and GAO, *Developing a Consumer Price Index for the Elderly*, GAO/T-GGD-87-22 (Washington, D.C.: June 29, 1987).

Questions from Senator Graham

Sufficiency of Pay Raise and the Pay Table

1. **Mr. Carr, Ms. Farrell, Dr. Murray, and Dr. Hosek, the proposed pay raise for Fiscal Year (FY) 2011 is 1.4 percent, but this matches last year's rise in the ECI. Increasing this percentage would cost an additional $350 million in FY11, and much more over time, as you have all noted in your testimony. Please explain what the impact on the Defense budget would be if Congress directed an increase in the pay raise by one percent, or half a percent without offsets.**

Any increase in basic pay—whether it is equivalent to the ECI or some percentage above the ECI—results in additional near-term and long-term costs to compensate servicemembers. The National Defense Authorization Act for Fiscal Year 2004[8] included a provision tying the annual basic pay raise to the annual percentage increase in the ECI and, for fiscal years 2004, 2005, and 2006, the law required that servicemembers' basic pay increase be equal to the annual percentage increase in the ECI plus an additional one-half percentage point. That law also contains a provision allowing the President to propose alternative pay adjustments to Congress, in certain circumstances, if the President deems the standard increase required by the law to be inappropriate. For fiscal year 2011, the President and DOD have requested a 1.4 percent increase, which is equivalent to the percentage increase in the ECI.

In recent years, the additional one-half percentage point has been added in order to reduce a perceived gap between military and private-sector pay. However, as our recent work comparing military and civilian compensation asserts, we do not believe that comparing changes in the ECI with changes in the rates of basic pay shows there is a difference, or "pay gap," between the two, or that such comparisons facilitates the assessment of how military pay rates compare with what civilian employers provide. In our view, and as officials at CBO noted,[9] such a comparison does not reveal a pay gap because, among other reasons, it assumes that basic pay is the only component of military compensation that should be compared with changes in civilian pay. While basic pay represents the largest portion of military compensation, servicemembers may also receive allowances for housing and subsistence. By excluding these allowances, comparing changes in the ECI with changes in the rates of basic pay simply illustrates how a portion of military compensation—basic pay—has changed over time.

2. **Mr. Carr, Ms. Farrell, Dr. Murray, and Dr. Hosek, is there a better metric than the ECI to gauge what an annual pay raise should be?**

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[8]Pub. L. No 108-136, § 602 (2003), codified at 37 U.S.C. §1009.

[9]Congressional Budget Office, *Statement of Carla Tighe Murray: Evaluating Military Compensation*, CBO (Washington, D.C., Apr. 28, 2010); CBO, *Evaluating Military Compensation* (Washington, D.C.. June 2007); and CBO, *What Does the Military "Pay Gap" Mean*? (Washington, D.C., June 1999).

As we have reported[10] and as noted above, using the ECI for the purpose of determining the amount of the annual basic pay raise for servicemembers has both strengths and weaknesses but is generally reasonable to use to adjust such pay annually. It should also be noted that basic pay is just one component of the total military compensation package. In addition to basic pay, servicemembers also receive allowances, tax advantages, as well as deferred and in-kind compensation.

The ECI is a nationally representative measure of labor costs for the civilian economy and is used by businesses and other organizations to, among other things, adjust wage rates to keep pace with competitors. In our view, using the ECI to determine the amount of the annual basic pay raise has both strengths and weaknesses, but it is generally reasonable to use it to adjust basic pay annually. As mentioned earlier, the strengths include the following: the ECI is a nationally representative measure of labor costs for the civilian economy; it is produced in a consistent fashion,[11] using a transparent methodology; and it provides separate data series for different occupational groups, industries, and geographic areas. However, the ECI is not tailored to the specific segments of the civilian economy most relevant to DOD—for example, those occupations and industries that the military services primarily compete with for workers. Also, because the ECI is constructed from data collected from surveys of employers, it does not provide data about the demographics of the civilian workforce—such as workers' education and experience, both of which are important factors that are often taken into account when setting employee pay. Nevertheless, we, as well as CBO,[12] have previously reported[13] on the challenges of creating more tailored indexes. Further, none of the experts whom we consulted nor any reports published by other organizations that we reviewed during the course of our review suggested that any other existing indexes or data series would provide more useful data than those provided by the ECI.

3. **Mr. Carr, Ms. Farrell, Dr. Murray, and Dr. Hosek, several years ago, the Department proposed targeted changes to the pay in certain grades with certain longevity, which was designed to relieve pay compression, and provide greater incentives for promotion. Does the current pay table need adjustment?**

While we have not previously assessed whether the current pay table needs adjustment, we have for over three decades reported[14] that the current military compensation package has been the result of piecemeal changes and adjustments

[10]GAO-10-561R.
[11]There are adjustments in the methodology from time to time. For example, in 2006 the Bureau of Labor Statistics changed the way the ECI classified industries and occupations to reflect new industry and occupational classification systems and rebased the index, among other changes.
[12]Congressional Budget Office, *Statement of Carla Tighe Murray: Evaluating Military Compensation* (Washington, D.C., Apr. 28, 2010) and *Evaluating Military Compensation* (Washington, D.C., June 2007).
[13]GAO-10-561R, GAO/GGD-95-64, and GAO/T-GGD-87-22.
[14]GAO, *Military Personnel: DOD Needs to Improve the Transparency and Reassess the Reasonableness, Appropriateness, Affordability, and Sustainability of Its Military Compensation System*, GAO-05-798 (Washington, D.C.: July 19, 2005) and *The Congress Should Act To Establish Military Compensation Principles*, GAO/FPCD-79-11 (Washington, D.C.: May 9, 1979).

over time and lacks overall guiding principles. Specifically, in 1979, we evaluated DOD's military compensation system and concluded that piecemeal adjustments and a lack of overall guiding principles of compensation were a problem in establishing a basis for evaluating changes to the total compensation system. More recently, in 2005, we noted that some of the same underlying problems that we identified in 1979—including a lack of explicit compensation principles and difficulty in making major changes to compensation—still existed.

In discussions with DOD, officials indicated that the department previously adjusted the basic pay table in order to make pay at all ranks and years of service more in line with the 70th percentile—as recommended by the 9th Quadrennial Review of Military Compensation (2004). That review recommended that regular military compensation be set to equal the 70th percentile of comparable civilian compensation. At that time, the department found that for some ranks and years-of-service, compensation was close to the 70th percentile, but for other ranks and years-of-service it was not so close. As a result, according to DOD officials, the department relied on targeted pay increases to raise the level of pay for certain ranks and years-of-service in the pay table from about the year 2000 through 2005. However, according to one of these officials, 2005 was the first year in which pay for all ranks and years of service was increased in lockstep to bring pay more in line with the 70th percentile.

Regarding targeted changes to pay, we have reported that across-the-board pay increases fail to target resources where they are most needed and they affect a variety of other costs—such as retired pay. Rather, the targeted use of compensation—such as special pays and bonuses for particular occupational skills—tends to maximize limited resources and help make recruiting and retention gains in needed areas. Our prior work[15] recognizes DOD's ability to use the more than 60 different special and incentive pays—including reenlistment bonuses and hazardous duty pay, as well as other pays for specific duties like aviation and medical, and incentives for servicemembers to take certain assignments, among others. Because most compensation is determined by factors such as tenure, rank, location, and dependent status, these special pays and allowances are the primary monetary incentives DOD has for servicemembers other than promotions and are used to influence certain behaviors, such as extending a service contract or filling critical shortage occupations.

<u>Effects of Cliff Vesting</u>

4. **Mr. Carr, Ms. Farrell, Dr. Murray, and Dr. Hosek, various study groups in recent years have questioned the wisdom of the military's traditional 20-year requirement to earn retired pay, suggesting that vesting at an earlier milestone in a career—say 10 years—would more effectively help to achieve DOD's personnel goals. However, assuring retention of mid-level personnel beyond their first or second terms of service—especially in wartime—would seem to justify reliance on this approach. What do you think the effect of reducing the requirement for entitlement to retired**

[15] GAO-10-666T, GAO-10-561R, *Military Personnel: DOD Needs to Establish a Strategy and Improve Transparency over Reserve and National Guard Compensation to Manage Significant Growth in Cost*, GAO-07-828 (Washington, D.C.: June 20, 2007), and GAO-05-798.

pay below 20 years would be on the ability to retain the personnel we need in leadership positions in the Armed Forces?

In the absence of any identified weaknesses in the overall recruiting and retention rates, it is difficult to determine if problems exist that would be best corrected through changes to the current retirement system. Further, our prior work[16] has shown that benefits, especially deferred benefits like retirement, are a relatively inefficient way to influence recruiting and retention, as compared with cash pay. Efficiency, as defined by DOD, is the amount of military compensation—no higher or lower than necessary—that is required to fulfill the basic objective of attracting, retaining, and motivating the kinds and numbers of active duty servicemembers needed. However, the efficiency of some benefits is difficult to assess because the value that servicemembers place on them is different and highly individualized. Therefore, understanding the effect of reducing the vesting requirement below 20 years requires an understanding of how servicemembers value retirement benefits, in general. Because the current military retirement benefit is (1) a defined benefit plan with a 20-year cliff vesting requirement and (2) a promise of future retirement payments made over the remainder of the servicemember's lifetime, calculating the value today—the present value—is difficult. In calculating the present value of the retirement benefit, two factors are critically important: the probability of staying in the military until retirement and the discount rate used to calculate the present value of retirement.

DOD's current retirement system is meant to create a strong incentive for military personnel who stay beyond 8 to 10 years to complete 20 years and leave soon thereafter. Specifically, under DOD's current retirement system, according to the department's Office of the Actuary, only 15 percent of enlisted and 47 percent of officers become eligible to receive retirement under the current plan that requires 20 years of service to vest.

If a military career is viewed as a continuum, retention rates will typically rise just before the point at which servicemembers may vest, and will subsequently decline on the far side of that point. As noted, under the current retirement system, servicemembers vest after 20 years and may immediately retire. Thus, moving the vesting milestone from 20 years to 10 years makes sense if the perceived challenge is getting people, who otherwise might have left after 5 years, to stay until 10 years, and/or getting people to leave after 10 years. However, moving the vesting requirement would eliminate a major incentive for servicemembers with 10 years of service to stay on until 20 years. Therefore, retention rates of experienced servicemembers with 10 years-of-service or more may decline. Lastly, vesting servicemembers at 10 years is likely to be less powerful in affecting behavior because the stakes are lower—specifically, a servicemember who leaves the service at 9 years-of-service under 10-year vesting forfeits much less than someone who leaves after 19 years-of-service under 20-year vesting. However, these effects may differ based on the extent to which changes are made to the retirement system—for example, if changes are made solely to the vesting requirement but not to the number of years required to reach retirement eligibility. Another approach that would yield different results would maintain the immediate retirement standard at 20 years, but

[16] GAO-05-798.

allow servicemembers to vest at an earlier point in their careers (e.g., 10 years) and make it a deferred vested benefit that servicemembers would receive at, for example, 65 years of age.

It is important, however, to consider all potential effects[17] of such a change. For example, reducing the requirement for vesting eligibility would potentially result in higher percentages of officers and enlisted servicemembers vesting and thus receiving a retirement pension, which could have significant cost implications for the department in the future. Furthermore, the uniformed services are unlike nearly all other organizations in that (1) they have closed personnel systems—that is, DOD relies almost exclusively on accession at the entry level (E-1 or O-1), and on its higher-ranking members being retained and promoted from lower ranks; and (2) according to DOD, there is no private-sector labor market from which the military can hire for certain unique occupations—such as an infantry battalion commander. By contrast, most other organizations can and do hire from the outside at all levels. Thus, the failure to meet recruiting or retention goals at lower levels in a given year can have significant consequences for a service's ability to produce experienced leaders for years to come.

Questions from Senator Collins

Commissary Benefits

1. **Ms. Farrell, according to a Pentagon survey, 90 percent of military personnel utilize commissary benefits. Last year, the Navy Exchange Service Command generated more than $45 million in dividends. These figures seem to indicate that commissary and exchange benefits are not especially costly to DOD and that service members place a high value on these benefits. How can these figures inform the Department in maintaining a competitive cash and non-cash compensation package for service members and providing it in such a way that is affordable to the Department?**

While these figures are informative in terms of servicemember use of the commissary and the cost of operating the commissary, in the absence of additional data and information on how servicemembers value the commissary, these figures cannot appropriately inform DOD on affordably maintaining a competitive cash and noncash compensation package for servicemembers. We have previously reported[18] that military compensation includes a mix of cash, noncash benefits, and deferred compensation, and has been one of the primary tools used by DOD to recruit and retain servicemembers since the military transitioned to an all-volunteer force in 1973. The commissary benefit is just one of the noncash benefits available to servicemembers. In our recent report,[19] we noted that 90 percent of military

[17]In 2005 and 2007, we provided Matters for Consideration that asked Congress to consider the long-term affordability and sustainability of any additional changes to pay and benefits for military personnel and veterans, including the long-term implications for the deficit and military readiness. Such a change to the current retirement system would most certainly have long-term implications for affordability and sustainability. See GAO-05-798 and GAO-07-828.
[18]GAO-10-666T, GAO-10-561R, GAO-07-828, and GAO-05-798.
[19]GAO-10-561R.

personnel responding to the 2007 Status of Forces Survey for Active Duty Personnel indicated that they utilize commissary benefits. However, while these survey results show that 90 percent—a large majority—of respondents reportedly used the commissary, the survey does not contain a question that asks about the value the individual places on the commissary benefit; therefore, the results of the survey could not take into account the value that an individual servicemember places on the commissary benefit.

In addition, the Navy Exchange Service Command is meant to provide quality goods and services at a savings and to support quality of life programs by providing dividends to Navy Morale, Welfare and Recreation (MWR). In 2008, the Navy Exchange Service Command had total annual sales of $2.52 billion and generated more than $45 million in dividends for MWR quality of life programs. While this figure gives an indication of the command's profitability, it does not take into account the value that a servicemember places on the benefit. Further, as we reported in 2005, servicemembers may not understand the full extent (i.e., the value) of their benefits—in this case, the commissary benefit.

As noted previously, DOD's compensation package is a mix of cash and noncash benefits—the commissary benefit being one of the noncash benefits available to servicemembers. However, in 2005,[20] we reported that DOD's mix of compensation (i.e., the ratio of cash to noncash to deferred benefits) was highly inefficient for meeting near-term recruiting and retention needs. We further reported that cash pay in the present is generally accepted as a far more efficient tool than future cash or benefits for recruiting and retention.

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If you or your staff have any questions on the matters discussed in this report, please contact me at (202) 512-3604 or farrellb@gao.gov. Contact points for our Offices of

[20] GAO-05-798

Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions are listed in enclosure I.

Brenda S. Farrell

Brenda S. Farrell
Director, Defense Capabilities and Management

Enclosure 1: GAO Contact and Staff Acknowledgement

GAO Contact

Brenda S. Farrell, (202) 512-3604 or farrellb@gao.gov

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