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REPORT TO THE CHAIRMAN OF THE TASK FORCE ON NATIONAL DEFENSE SENATE BUDGET COMMITTEE

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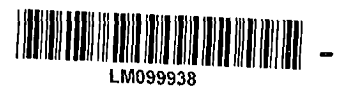

A Contributory Retirement System For Military Personnel

Department of Defense

Military retired pay costs are increasing sharply. In fiscal year 1965 there were 462,000 military retirees receiving $1.4 billion. For fiscal 1976, the military retired population had more than doubled to 1.1 million members receiving about $6.9 billion. Proposed legislative reform of the military retirement system does not include a contributory feature. GAO reviewed and summarized the material available on the issue of a contributory military retirement system. This report identifies the advantages and disadvantages, the cost implications, and the issues to be resolved.

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FPCD-76-43

MARCH 4, 1976

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-125037

The Honorable Ernest F. Hollings
Chairman, Task Force on
National Defense
Committee on Budget DLG00696
United States Senate

Dear Senator Hollings:

In response to your request of September 5, 1975, we are reporting on the issue of a contributory retirement system for military personnel. Informal comments only were obtained from Department of Defense so that we could meet your required reporting date.

We are sending copies of this report to the Secretaries of Commerce, Defense, Transportation, and Health, Education, and Welfare; the Director, Office of Management and Budget; and the Chairmen, House and Senate Committees on Armed Services, Budget, Appropriations, and Government Operations.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

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ABBREVIATIONS

CPI Consumer Price Index

DOD Department of Defense

ERISA Employment Retirement Income Security Act

GAO General Accounting Office

RMC Regular Military Compensation

SBP Survivor Benefit Plan

Glossary

Actuarial assumptions	Assumptions made to tentatively resolve uncertainties concerning future events which will affect pension cost, e.g. mortality rate, employee turnover, compensation levels, and investment earnings. (See p. 20.)
Actuarial valuation	A process for determining the liability of a pension plan and the periodic contributions required to provide future benefits.
Amortize	To settle a debt by making periodic payments, generally over a specific period of time.
Consumer Price Index	A series of numbers whose ratios measure increases or decreases in the cost of living.
Cost of living	The relative prices at various times of a selected group of goods and services typically bought by urban families.
Entry-age normal method	A method of computing normal costs by assuming that (1) every employee enters the plan at the time of hiring or at the earliest time of eligibility entry age and (2) contributions have been made on this basis from the (entry age) to a given date. Annual contributions are set at the level which, if accumulated at an assumed rate of interest, would result in a fund covering the value of retirement pensions for the employees who survive to that date. The annual contribution under this method ordinarily comprises (1) the normal cost and (2) an amount for past service cost. The latter may equal

only the interest on the unfunded liability or may also include an amount intended to reduce the unfunded liability.

Fiduciary	Relating to responsibility for the custody or administration, or both, of property belonging to another.
Funding	A method of paying for benefits by collecting and investing contributions.
Normal cost	The annual cost of future pension benefits assigned under an actuarial cost method to years subsequent to a particular valuation date of a pension plan.
Pay-as-you-go	A method of recognizing pension cost only when benefits are paid to retired employees.
Pension	A series of periodic payments, usually for life.
Recomputation	The recomputation system provided in general that a military member's retired pay would be computed as a percentage of the active-duty basic pay being paid for his or her rank and grade at the time of retirement, and such retired pay would be recomputed thereafter from time to time to allow the same percentage of current active-duty basic pay provided for members of the same rank and grade in the active service. Each member would get an increase in retired pay based on increases of active-duty basic pay provided from time to time by statute.
Regular military compensation	A definition of military pay, consisting of basic pay, quarters

	allowance, subsistence allowance, and the tax advantage accruing because these allowances are not subject to Federal income tax.
Terminal funding	Funding of future benefit payments when an employee retires, by either purchasing an annuity or contributing to a trust.
Unfunded actuarial liability	The unfunded actuarial liability (sometimes called the unfunded liability) of a retirement system is the present value of future benefits less the present value of future normal costs and the assets of the pension fund.
Vesting	The right of an employee to part or all of the benefits of a pension plan due to him or her on leaving.

COMPTROLLER GENERAL'S REPORT TO THE CHAIRMAN, TASK FORCE ON NATIONAL DEFENSE SENATE BUDGET COMMITTEE

A CONTRIBUTORY RETIREMENT SYSTEM FOR MILITARY PERSONNEL
Department of Defense

D I G E S T

Proposed legislation reforming the military retirement system does not include a contributory feature.

At the request of the Task Force on National Defense of the Senate Budget Committee, GAO reviewed and summarized the material available on the issue of a contributory military retirement system and identified

--the advantages and disadvantages,

--the cost implications, and

--the issues to be resolved.

THE MILITARY RETIREMENT SYSTEM

This report describes the three types of military retirement benefits presently available to members--nondisability retirement, disability retirement, and survivor benefits. (See pp. 3 to 5.)

DOD has identified defects in the present nondisability retirement system and has proposed legislative revisions. (See p. 6.)

ADVANTAGES AND DISADVANTAGES OF A CONTRIBUTORY SYSTEM

The basic philosophy behind contributory plans is that shared costs create mutual responsibility for providing benefits that are advantageous to both employee and employer. (See pp. 11 and 12.)

Employee contributions are advantageous from the employer's standpoint because they augment the total funds available to pay retirement benefits. (See p. 11.)

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Contributory plans benefit employees by providing leverage to enforce their rights to benefits and a basis for insisting on adequate employer contributions. (See pp. 11 and 12.)

The most widely acknowledged disadvantage to employees is that Federal tax law does not permit them to claim tax deductions for contributions made to pension plans, as can employers. (See p. 12.)

Generally, the same advantages and disadvantages of contributory retirement plans in the non-Federal sector apply to the uniformed services.

COST COMPARISON OF CONTRIBUTORY VERSUS NONCONTRIBUTORY MILITARY RETIREMENT

The Accounting Principles Board (Opinion No. 8) and the Cost Accounting Standards Board specify that the cost of pension plans, whether funded or not, should be recognized annually. Costs should be determined using acceptable and consistent actuarial methods, assumptions, and techniques. The pay-as-you-go system used for military retirement does not meet these criteria because all retirement costs, including these accruing for active duty members, are not recognized. (See p. 18.)

In our calculations we used the following assumptions (see pp. 20 and 21):

--Current pay and retirement systems continue.

--The fund earns 7-percent interest.

--Basic pay increases 5-1/2 percent per year.

--Retired pay increases 5 percent per year.

--Members departing before retirement have their contributions returned, without interest.

Establishing a retirement fund would require a normal cost of $5.3 to $6.0 billion and an annual cost to amortize the unfunded liability over a 40-year period

of $14.4 to $14.9 billion--for a total annual cost to the Government of approximately $20 billion. (See pp. 22 to 24.)

The Government's annual cost for a funded contributory system in which members contribute 7 percent from their current basic pay would be about $850 million less than the annual cost for a funded, noncontributory retirement system. (See p. 23.)

The Government's annual cost for a funded contributory system in which pay is increased by an amount equal to the members' contribution would be about the same as the annual cost of a funded noncontributory system. However, the Government would also have an outlay for the pay increase of about $1.2 billion the first year. (See p. 24.)

If no retirement fund is established, and members are required to contribute 7 percent of their basic pay towards retirement costs, a savings can be achieved over the present noncontributory system--$1.034 billion the first year, cumulating to $37.4 billion by the year 2000. (See pp. 24 to 26.)

If no retirement fund is established and basic pay is increased by an amount equal to the members contribution of 7 percent of basic pay, the Government cost would be $37.9 billion <u>more</u> than the present system through the year 2000. (See pp. 24 to 26.)

<u>ISSUES TO BE RESOLVED BEFORE CHANGING TO A CONTRIBUTORY RETIREMENT SYSTEM</u>

If the military retirement system is converted to a contributory system the following issues need to be resolved:

--How should members' contributions be computed? (See pp. 28 and 29.)

--Should a military retirement fund be established? (See pp. 30 and 31.)

--Should pay be increased to offset members' contributions? (See pp. 31 to 34.)

--Should vesting rights be granted earlier? (See p. 34.)

--Should the two retirement programs covering military members, the military retirement system and social security, be integrated? (See p. 35.)

CHAPTER 1

PERSPECTIVE

Military retirement costs are increasing sharply. In fiscal year 1965, 462,000 military retirees received $1.4 billion. For fiscal year 1976, the military retired population had more than doubled to about 1.1 million receiving about $6.9 billion. Because of this growth, the portion of military pay devoted to retirees in 1976 will equal 42 percent of active duty basic pay. That is, for every $10 in basic pay of active members, $4.20 is paid to retirees. This cost increase is partly attributable to pay increases which raised the base on which retired pay is calculated, increases in the Consumer Price Index (CPI), and an increase in the retired military population caused by the sudden growth of the active duty force during and following World War II.

Partly because of this cost increase, the Department of Defense (DOD) has proposed legislative reform of the military retirement system. The proposal will allow DOD managers to closely control the number of members becoming eligible for military retired pay. Exercise of this control should eventually reduce retired pay costs.

Another way to decrease retired pay costs is to have military members contribute to their retirement. However, DOD's legislative proposal does not include a contributory feature. (When both the employee and employer contribute the plan is termed contributory.)

Noting that military retired pay represents a large and continuing obligation of the Defense budget, the Task Force on National Defense of the Senate Budget Committee was interested in exploring contributory retirement for the military. This report attempts to assist the task force by addressing for such a system

--the advantages and disadvantages,

--the cost implications, and

--the issues to be resolved.

Our discussion of these issues is based on information obtained from DOD studies, congressional hearings and reports, Congressional Research Service studies, related GAO reports, published sources outside of the Federal Government, and our cost projections of disability and nondisability military retirement. Informal comments received from DOD were considered in the report.

We are not making a recommendation on whether to adopt a contributory retirement system for the military. We believe that certain issues require more consideration before such a recommendation can be made. (See ch. 5.) These issues should not be addressed in isolation. We believe a contributory system for the military could be considered in hearings and included in the proposed Retirement Modernization Act if it is found desirable. However, such questions as whether or not a retirement fund should be created for the military might best be resolved in the context of other, Government-wide compensation and retirement issues.

Our report, "Federal Retirement Systems: Key Issues, Financial Data, and Benefit Provisions," (B-179810, July 30, 1974) pointed out that the benefit structures of Federal retirement programs have evolved and developed in a piecemeal fashion without central monitoring, and the interrelation ships and the costs of these systems have not been centrally monitored. In time, the Congress should respond to these deficiencies and enact an overall Federal retirement policy providing objectives and principles to guide the development and improvement of Government retirement systems. When it does so, it could address some of the issues that we have identified.

CHAPTER 2

DESCRIPTION OF THE MILITARY RETIREMENT SYSTEM

Military members are eligible for retirement benefits from three principal sources: the military retirement system, social security, and the Veterans Administration. Military members contribute to their social security benefits. Benefits from the Veterans Administration are offset against benefits from the military retirement system. In this report we concentrate on the noncontributory military retirement system. We do not address reserve or nonregular retirement under the provisions of chapter 67 of title 10, United States Code, because data was insufficient to make accurate and reliable cost projections.

Some aspects of the present military retirement system are traceable to laws enacted before the Civil War. However, the current system is based primarily on portions of legislation enacted in the late 1940's. Generally, the laws authorizing retirement for members of the uniformed services are codified in titles 10, 14, 33, and 42 of the United States Code.

Participation is automatic for members of the uniformed services, which include the Army, Navy, Air Force, Marine Corps, Coast Guard, the commissioned officers corps of the Public Health Service, and the National Oceanic and Atmospheric Administration. The Department of Defense administers the system for the Army, Navy, Air Force, and Marine Corps, while the Coast Guard, Public Health Service, and the National Oceanic and Atmospheric Administration systems are administered by the Departments of Transportation; Health, Education, and Welfare; and Commerce, respectively.

TYPES OF BENEFITS

The military retirement system is unfunded; that is, a pension fund is not built up to pay for future benefits. The Congress makes annual appropriations to meet current benefit payments on a "pay-as-you-go" basis, and uniformed service members make no contributions. The system provides length-of-service or nondisability retirement, disability, and survivorship benefits.

Nondisability retirement

The original purpose of nondisability retirement was to provide financial security for superannuated (disqualified by advanced age for active duty) members withdrawing from the Nation's labor force. However, the present purpose

of this type of retirement is to achieve a physically vigorous force by separating members at an early age, thereby insuring that the military forces are staffed by young members.

Regular and Reserve commissioned and warrant officers may be retired upon application and approval by the service Secretary after 20 years of active service, at least 10 of which must be commissioned service for commissioned officers. Enlisted members may also request retirement after 20 years of service. Few members serve beyond 30 years.

Retired pay is computed by multiplying the terminal basic pay of the grade of the retired member by 2-1/2 percent of the number of years "creditable service," to a maximum of 75 percent of basic pay. "Creditable service" for enlisted men is active service only. All officers are credited with active service and some officers may receive credit for inactive or constructive service. The retired grade of the member is usually the grade, whether temporary or permanent, in which he or she is serving on the date of retirement. An enlisted man or warrant officer retiring with less than 30 years of service who temporarily held a higher grade than the grade in which he retired receives retired pay in the lower grade until his total service (active plus retired) reaches 30 years.

Monthly nondisability retirement benefits are periodically adjusted with changes in the CPI.

Disability retirement

Disability retirement benefits are designed to provide financial security for military members disabled while in the service.

A member who has a disability of 30 percent or more (according to the Veterans Administration rating schedule) may be retired for permanent disability if physically unfit to perform the duties of his or her grade. If the disability is not permanent, the member is placed on temporary disability retirement and is subject to physical examinations at least every 18 months. After 5 years, the member must either be retired for permanent disability, removed from the temporary disability list and returned to active duty, or separated (often with severance pay).

The disability benefit is determined by multiplying the basic pay for the member's retired grade by the percent of disability. If the member is eligible for nondisability retirement pay which would be greater than this

amount, he or she receives that amount instead. Retired pay for a permanent disability is restricted to from 30 to 75 percent of basic pay; however, the minimum is 50 percent while on the temporary disability retired list. A member may waive military disability retired pay and receive disability compensation from the Veterans Administration.

Survivorship

The survivor benefit plan (SBP) effective September 21, 1972, is designed to protect the survivors of retired members of the uniformed services who so desire. Annuities may be payable to: (1) the surviving spouse of a member who remained on active duty after qualifying for retirement, (2) the designated survivor of a member who chose before retiring to participate, (3) the designated survivor of a member who (a) was unmarried when retiring but who, before retiring, elected coverage for an individual having an insurable interest in him or her or (b) chose to participate within 1 year after acquiring a spouse and/or dependent children, (4) the designated survivor of a member who retired before September 21, 1972, and chose to participate, and (5) certain widows of retired members who died before September 21, 1973, and were not SBP participants.

The benefit paid to the survivor is 55 percent of the base amount and is adjusted for changes in the CPI. The base amount can be any amount of retired pay between $300 and the full amount of retired pay. This benefit is reduced by Veterans Administration dependency and indemnity compensation payments and by the social security survivor benefit attributable to military service. If children are eligible beneficiaries, the payment is divided equally among them.

The cost to the member of providing the survivor benefit to a spouse is 2-1/2 percent of the first $300 of the base amount plus 10 percent of the remainder of the base amount. This cost continues for the life of the member. Cost for an annuity that flows to the spouse until the spouse becomes ineligible and then to the children is the same as for the spouse plus an actuarial charge which depends on the age of the member, the spouse, and the youngest child. Cost for an annuity for children only is based on an actuarial charge of about 3 percent of the annuity payable. The monthly cost of providing an annuity to a person with an insurable interest would be 10 percent of the member's full retired pay, plus an additional 5 percent of the member's full retired pay for each full 5 years that the named beneficiary is younger than the retiree; however, the total cost may not exceed 40 percent of the member's retired pay.

Payments to the surviving spouse terminate upon death or upon remarriage before age 60. Payments to eligible children cease at age 18 or at age 22 for a student.

PROBLEMS WITH THE RETIREMENT SYSTEM

The Department of Defense Retirement Study Group identified certain defects in the present nondisability retirement system. As part of the compensation system, the system provides

- --no vesting of retirement benefits for members who leave before 20 years of service,
- --less than competitive annuities for members with long service, and
- --underemphasis on paying for services when rendered but overemphasis on providing retirement benefits.

As part of the personnel management system, the system provides

- --inappropriate separation payments for most members,
- --inefficient methods of attracting and retaining personnel for short periods of service, and
- --insufficient financial incentive to continue on active duty after 20 years of service.

The Department of Defense Retirement Study Group believed certain changes to the nondisability retirement system should eliminate the above defects. A bill to revise the system, entitled the Uniformed Services Retirement Modernization Act, was introduced in the 93rd Congress and reintroduced in the 94th Congress. We did not analyze the recommended changes to ascertain whether they are the best solutions to the identified defects.

CHAPTER 3

CONTRIBUTORY GOVERNMENT PLANS

In our report entitled "Federal Retirement Systems: Key Issues, Financial Data, and Benefit Provisions" (B-179810, July 30, 1974) we reviewed 10 Federal retirement systems including the uniformed services'. Seven of the systems were contributory, requiring employee contributions of 6 to 8 percent of their pay. The uniformed services, the Federal judiciary, and the U.S. Tax Court had noncontributory systems, the latter 2 covering only 519 employees as of June 30, 1973. We concluded that an overall Federal retirement policy, which would provide objectives and principles to guide future development and improvement of Government retirement systems, would be useful.

In the following sections we describe

--the civil service retirement system because it is the largest contributory system for Federal employees,

--State systems because they include State police and firemen whose duties are sometimes compared with military duties, and

--the Canadian military retirement system because it is an example of a contributory system covering military members.

FEDERAL RETIREMENT

Ninety percent of all civilian employees of the Federal Government and the District of Columbia are included in the civil service retirement system. Temporary and intermittent employees are covered by social security. Employees generally contribute 7 percent of their salary towards retirement costs. An annuity is based on the employee's highest average annual pay for any 3 consecutive years and on length of service, with the maximum annuity being 80 percent of the average. Employees retiring at age 55 with at least 30 years' service, age 60 with at least 20 years' service, or age 62 with at least 5 years' service are eligible for an immediate annuity. Retiring employees may also assure annuities to their survivors by electing, at the time of retirement, to accept a reduced annuity.

After completing 5 years' service, an employee has vested rights to retirement benefits. If service is terminated after 5 years but before eligibility for an immediate annuity, the employee is eligible for a deferred annuity

beginning at age 62. An immediate disability annuity is available at any age after 5 years. If an employee dies before retiring and after at least 18 months of service, certain survivors are entitled to annuities.

Section 8340 of title 5, U.S. Code, provides that annuities will be adjusted whenever the CPI increases as much as 3 percent over the CPI at the time of the previous annuity adjustment and remains at the higher level for 3 consecutive months. The annuity increase would be the highest CPI percentage increase attained during the 3-month period. Subsection 8340(b) of title 5 provides that such increases will be further increased by an additional 1 percent.

STATE AND LOCAL GOVERNMENT RETIREMENT SYSTEMS

The State plans are generally contributory (3 to 8 percent of pay), provide vesting after 5 to 15 years of service, and begin paying full annuities to employees at age 60. The typical State system bases pensions on final 3- or 5-year average pay using a benefit amount of 1-1/2 to 2 percent, without regard to social security benefits. Automatic cost-of-living adjustments are common, usually with a limit, such as 3 percent in any single year.

State retirement programs for police and fire personnel are more liberal than other State retirement systems. Typically, the pension benefits for police and fire groups are 2 to 2-1/2 percent of final pay per year of service and are usually payable in addition to social security. Retirement benefits are frequently available after only 20 years of service at between 50 and 55 years of age, far earlier than under the typical State retirement program. The police and fire programs usually require heavier employee contributions than other State systems, thus partially offsetting the costs of earlier retirement. As with other State systems, vesting is provided after 5 to 15 years of service. Automatic post-retirement benefit increases are also quite common.

It should be noted that not all police, fire, and State government systems are funded on a full actuarial cost basis, whereas Public Law 93-406, the Employee Retirement Income Security Act of 1974 (ERISA) (approved September 2, 1974, 88 Stat. 829), requires funding on an actuarial basis for all industrial pension plans. A congressional task force created by ERISA will be studying funding practices in public retirement plans in 1976.

CANADIAN MILITARY RETIREMENT SYSTEM

Under the Canadian Forces Superannuation Act, each member of the Canadian Armed Forces must contribute part of his or her pay toward retirement. Contributions are deducted at the rate of 6-1/2 percent of pay for male members and 5 percent of pay for female members. The retirement benefit is 2 percent of average annual pay during the 6-year period of highest earnings for each year of service, to a maximum of 70 percent. Canadian Forces Superannuation Act annuities are protected against inflation by cost-of-living adjustments, as provided under the Supplementary Retirement Benefits Act. Contributions required under this act are 1/2 percent of pay for both male and female members. Only members serving more than 10 years are eligible for annuities (vested). Members with less than 10 years of service are entitled to the return of their contributions.

Canadian Forces members also contribute 1.8 percent of the first $7,400 of salary to the Canada Pension Plan or the Quebec Pension Plan, which together cover most of the Canadian labor force. Disability income and survivor income benefits are available from the Canada Pension Plan in addition to the retirement annuities.

Comparison of Major Provisions of the Canadian and U.S. Military Retirement Systems

	United States	Canada
Are contributions required?	No	Yes, contributions under the Canadian Forces Superannuation Act are deducted at the rate of 6-1/2% of pay for male members and 5% for female members.
When are benefits vested?	After 20 years of service	After 10 years of service (Members who retire with less than 3 years of service have their contributions returned; if service is 3-10 years members will receive the greater of their contributions or the cash termination allowance.)

	United States	Canada
At what age can a member retire?	Any age after 20 years service	Depends on rank and age: Rank / Age Captain 45 Major 47 Lt. Col. 51 Col. & above 55
What is the retirement benefit?	50% of final basic pay plus 2.5% for each year of service beyond 20, up to 75%	2% of average annual pay during the 6-year period of highest earnings for each year of service, up to 70%
Are benefits subject to cost-of-living adjustments?	Yes	Yes
Must the member contribute a portion of his pay to be eligible for cost-of-living adjustments?	No	Yes, 0.5% contributions under the Supplementary Retirement Benefits Act
Is there an age requirement for cost-of-living adjustments?	No	Yes, the adjustments are payable (1) at age 60 or (2) as early as age 55 with 30 or more years of service.
Do servicemen participate in any other government-sponsored plan?	Yes, social security	Yes, Canada or Quebec Pension Plan
How much must the member contribute to these plans?	5.85% of the first $15,300 of annual basic pay	1.8% of the first $7,400 of salary
Are these benefits integrated with the military retirement plan?	No	Yes, Canadian Forces Superannuation Act annuities are reduced by benefits from the Canada or Quebec Pension Plans.

CHAPTER 4

ADVANTAGES AND DISADVANTAGES OF CONTRIBUTORY RETIREMENT

Establishing a retirement plan requires determining whether or not employees shall contribute toward retirement benefits. When both the employee and employer contribute the plan is termed contributory. Plans financed solely by the employer are termed noncontributory.

IN THE PRIVATE SECTOR

The trend in the private sector is clearly toward noncontributory pension plans. According to a 1975 study of corporate pension plans by Bankers Trust, 67 percent of conventional plans do not require or permit employee contributions, compared with 56 percent of 1965-70 plans and 50 percent of 1960-65 plans. None of the "pattern plans" in the survey (those negotiated by international unions throughout a major industry) required employees to contribute in order to receive benefits.

Contributory plans are still the general rule in the public sector, however. This difference in practice is thought to indicate a consistent adherence by most public employee retirement systems to the philosophy that once prevailed in all plans--joint financing of retirement benefits.

Advantages

First, some employers favor contributory systems because employee contributions increase total retirement funds, allowing employers to decrease their contributions or offer greater benefits.

Second, where the employees and employers share in increased costs, there may be a natural check on too liberal benefit increases which threaten to make the system unduly costly. That is, the employer's share of the cost of any benefit increase will reduce profits and the employees' share will reduce take-home pay.

A related advantage to employees is the leverage contributions might give them in obtaining vested rights to benefits and insisting on adequate employer contributions. According to a study by the Wyatt Company concluded April 30, 1975, for the Department of Defense, recognition of this leverage may have been a factor in the decision to eliminate employee contributions in certain States. These

States apparently believed that overly generous benefits would be harder to reduce when employees had contributed heavily to the program.

In contributory plans, employees leaving the company may withdraw their own contributions in cash, sometimes with interest, without having to satisfy any other conditions, or they may leave their contributions in the fund and eventually draw an annuity at a predetermined age. This protection was included in ERISA, which covers most private pension plans. Because of this feature, contributory plans are less likely to bind employees to their jobs. Proponents of the economic value of a mobile labor force find merit in this aspect of contributory plans.

Many employees believe that a contributory retirement plan places a heavier obligation on the employer to provide benefits than a noncontributory plan. Consequently, contributory plans frequently give employees a greater sense of security.

Disadvantages

Federal tax law does not permit employees to deduct contributions to private pension plans. That pension contributions must come out of employees' income after taxes is the most widely cited disadvantage of a contributory system and may be a major reason for the decline of contributory plans among businesses. Since employers are permitted to treat pension contributions as a business expense, their contributions are not taxed. The result is that employees must use more of their income for pension contributions than the employers use to contribute equally.

As an illustration, assume an employer pays the employees' share of the pension contribution (as in a noncontributory plan) and reduces the employees' salary by an equal amount. Each employee's net income is increased by the amount of taxes on the contribution. Thus, an employee in a contributory plan who earns $10,000 and contributes 5 percent of his salary to the pension fund would pay taxes on $10,000 and contribute $500 to the pension fund. If the employer assumed his contribution and reduced his salary by an equal amount, the employee would receive and pay taxes on $9,500.

Some advocates of contributory plans believe employees should be permitted to deduct their contributions from taxable income. They say the current tax rules have had an

undesirable influence on the source of contributions to pension plans. In Canada, where employee contributions to registered pension plans are tax deductible, contributory plans are much more common, covering over 60 percent of private employees under retirement plans. However, if all U.S. employees presently contributing were to deduct their contributions, substantial tax revenue would be lost.

Opponents of contributory plans consider the employer responsible for pensions to protect employees against insecurity. They believe the cost of pensions should be treated as a normal business expense, no different from the cost of maintaining and replacing the plant and machinery.

Deductions from earnings are a source of irritation to employees. This is especially true of younger employees who are many years away from retirement. Where the employees are primarily young, the employer may be pressured to increase salaries rather than improve retirement benefits.

Contributory plans are thought to be harder and costlier to administer. Payroll deductions and additional recordkeeping are usually required. In addition, contributory plans have historically provided more liberal vesting 1/ and eligibility requirements as well as stricter funding arrangements. Since the passage of ERISA, however, all private pension plans must meet Federal participation, vesting, funding, and fiduciary standards, along with provisions for administration and enforcement. The cost disadvantage of administering contributory plans may be less apparent once ERISA standards are met by private plans.

FOR THE UNIFORM SERVICES

Generally, the same advantages and disadvantages of contributory retirement plans in the non-Federal sector apply to the uniformed services. However, the military's unique compensation structure and personnel management policies introduce some factors which should be considered in applying the above advantages and disadvantages to the military.

1/The term vesting refers to the right of an employee to part or all of the benefits of a pension plan due to him or her on leaving.

Visibility of compensation

Visibility of compensation refers to how well military members recognize their compensation. In a contributory system, where costs are shared and recognized, employees and employers alike tend to be aware of benefit costs. When members have a more accurate perception of benefit costs, the visibility of their compensation should be improved.

We examined Defense personnel surveys to see what military members thought of their compensation. The results of our analysis are discussed in "Need to Improve Military Members' Perceptions of Their Compensation" (October 10, 1975, FPCD-75-172). We found a widespread lack of visibility of military compensation among members. Total compensation (basic pay, allowances, and fringe benefits) was perceived to be lower than our estimate by 65 percent of enlisted personnel and 61 percent of officers. Converting to a contributory system and recognizing annual pension costs, where costs are shared, should increase the visibility of military retirement benefits and military pay.

Acceptance by military members

The military retirement system has always been noncontributory. This fact has been mentioned frequently to encourage enlistment and reenlistment, and changing to a contributory system might seem to be a breach of faith.

In testifying on this issue before the Special Subcommittee on Retired Pay Revisions, on October 5, 1972, the Deputy Assistant Secretary of Defense for Military Personnel Policy, expressed his personal opinion that many people in military service would actually prefer a contributory system. He continued:

> "Many people feel uneasy when they see the rising costs of retirement, not just for the military system, but for the other agencies in Government that have separate retirement systems.
>
> "And there is a concern on the part of many thoughtful military people that the time is coming when these costs are going to be of such great concern that who is to say what changes might be made in the system.
>
> "In the absence of a vested right to the military member, which is one of the great benefits

of a contributory system, there is a great concern that they may lose a significant part of their benefits.

"I personally think that fear is unfounded. I don't believe that the Congress has ever in its history done that to individuals. But I can understand their concern.

"If we were starting from scratch, Mr. Chairman, I would put it this way: I think they would accept a contributory system, but the problem of superimposing it, or changing the present system, makes it a much more difficult proposition."

Members' acceptance would ease the implementation of a contributory retirement system.

Member rights to retirement benefits

In a 1961 University of Michigan study of the military retirement system, researchers found that military members already believed they had a contractual right to certain future benefits. The researchers stated that contributing a small fraction of the total retirement costs probably wouldn't strengthen that belief very much.

In Special Subcommittee on Retired Pay Revisions hearings in 1972, retired servicemen expressed a similar belief. The Congress and the courts have not always shared this view. Before 1958, retired pay was recomputed when active duty pay was increased. Recomputation provided that retired pay would be computed as a percentage of the active duty pay being paid members of the same rank and grade in the active service. When the Congress abolished recomputation, the courts failed to support the servicemen's position that recomputation was a contractual right. (See Abbot v. United States 200 Ct. Cl. 384 (1973) Cert. denied, 414 U.S. 1024 (1973).)

Other witnesses at the 1972 hearings, including Congressmen and personnel from associations of service retirees, preferred a contributory retirement system. They said recomputation could not have been abolished under a system supported by employee/employer contributions.

A Congressman stated in his testimony to the Special Subcommittee:

"* * * you know that something very definite happens when you require somebody to contribute to a program. As a matter of general law a person then has a right to sue if he doesn't get what he was going to get under the original system. In other words if he pays in a penny under a system and you change the system it becomes a contractual relationship and the law has held many times you have the right to insist that the thing is not derogated in any way."

A representative testifying for the Retired Officers Association, Retired Enlisted Association, and the National Association of Armed Forces Retirees, testified:

"I think retirees today would be better off had they contributed. I think what we have referred to here as the ethical or moral obligation would be more readily apparent had we been paying."

Military members believe they have certain rights to retirement benefits, but the Congress and the courts have not always agreed.

Incentive to control costs

Members' contributions should be set high enough to substantially offset costs and to motivate employers and employees to keep costs down.

The University of Michigan study stated the following:

"At first glance it would appear that if the employees contribute toward the cost of a pension plan the cost to employer will be less. Before discussing the question of whether this is a real or an illusory saving, let us consider its possible magnitude. The cost of providing a lifetime pension of $175 per month to a person retiring at the E-7 grade is $43,300. Had this enlisted man contributed 6-1/2 percent of his salary during the previous 20 years, assuming a normal progression through the ranks and the current base pay level, the total of this accumulated contributions with interest would be about $4,650. Correspondingly, a lieutenant colonel retiring after 20 years with a pension of $372.50 per month, costing almost $85,000

would have contributed, including interest, about $9,500 had a 6-1/2 percent contribution been deducted from his pay at the current levels for the last 20 years. The accumulated contributions in each case would provide only about 11 percent of the cost. It can be seen from these illustrative figures that no major saving to the government would be possible through the establishment of a contributory system."

Based partly on the above illustration, the University of Michigan researchers concluded that the Congress should not adopt a contributory retirement system for the military.

Our cost projections show that if military members contribute 7 percent of their basic pay, this would pay about 18 percent of the normal cost of benefits (7 percent divided by 39.82 percent). 1/

A contributory system should place responsibility on both employer and employees to insure that benefit costs do not become unreasonable. If the employer contributes an excessive share, this mutual responsibility is diminished, since the cost to employees of an attractive benefit improvement may be minor.

Proponents of contributory plans stress that the joint ownership and mutual responsibility aspects of contributory systems serve to curtail too liberal benefits which threaten to make the system unduly costly to either party. Increases in benefits should measurably increase employee contributions, or an important advantage of a contributory retirement system may be lost. If a contributory system is to be seriously considered, military retirement benefits should be studied to determine a level of benefits and a cost-sharing ratio which will sufficiently motivate both parties to keep costs down while providing retirees with sufficient financial security.

1/Normal cost was calculated for disability and nondisability retired pay. (See p. 23.)

CHAPTER 5

COST COMPARISON OF CONTRIBUTORY VERSUS NONCONTRIBUTORY MILITARY RETIREMENT

METHODS FOR ESTIMATING PENSION COSTS

Pension costs should be estimated with sound accounting principles and acceptable actuarial cost methods. Costs should be recognized annually, whether funded or not, and the actuarial cost method should be consistently applied from year to year.

The Accounting Principles Board (Opinion no. 8) 1/ and the Cost Accounting Standards Board specify that the cost of a pension plan should be accounted for on the assumption that the company will continue to provide benefits called for in the pension plan. This assumption implies a long-term undertaking, the cost of which should be recognized annually, whether funded or not.

The Accounting Principles Board (Opinion no. 8) and Cost Accounting Standards Board have identified common methods acceptable for determining pension costs. Such a method should be rational, systematic, and consistently applied, to reasonably measure pension costs from year to year.

Two methods of accounting for pension costs--terminal funding and pay-as-you-go, have been deemed unacceptable because they do not recognize pension costs before the employee retires. (See glossary.)

The pay-as-you-go system recognizes pension costs as annuities when they are paid to retired employees. In the terminal funding system, an employer funds an amount for future benefits at the time an employee retires.

Actuarial valuations and assumptions

An actuarial valuation is a process for determining the liability of a pension plan and the periodic contributions required to provide future benefits. Although annual valuations of pension plans are, perhaps, the rule, valuations are sometimes made at less frequent intervals. The

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1/Opinions of the Accounting Principles Board adopted before June 30, 1973, constitute established accounting principles, unless superseded by action of the Financial Accounting Standards Board.

calculation is ordinarily made for the closed group--employees presently covered by the plan, former employees having vested rights, and retired employees currently receiving benefits. The steps in making a valuation are to compute (1) the present value of current fund assets and future income and (2) the present value of retirement benefits to be paid. The contributions required for the retirement fund during the period being examined are estimated.

Such a valuation involves a number of future uncertainties. Actuarial assumptions in estimating pension plan costs relate to (1) interest returned on invested funds, (2) administrative expenses, and (3) amounts and timing of benefits to be paid to retired employees, vested former employees, and present employees.

Estimating the amounts and timing of future benefits requires several assumptions as follows:

--Benefits under some pension plans depend in part on future compensation levels. Based on the employer's experience, pay increases from the progression of employees through the various earning categories are estimated.

--To protect the purchasing power of retirement annuities, some plans provide for adjusting them from time to time to reflect variations in a specific index, such as the CPI.

--Retirees' yearly probabilities of dying are important factors in estimating the cost of the benefit payments and are estimated using mortality tables.

--Some plans provide for early retirement in case of disability, and most plans permit it at the employee's option under certain conditions.

--Employees who leave employment before fulfilling vesting requirements forfeit their rights to receive benefits; therefore, an estimate for the effect of turnover is made.

--For plans that reduce pensions by all or part of social security benefits, the effect of future changes in social security benefits must be considered.

The above assumptions should be revised from time to time, as experience and judgement dictate.

CONTRIBUTORY VERSUS NONCONTRIBUTORY MILITARY RETIREMENT

Assumptions made

Key assumptions that we made in comparing the normal 1/ and total costs of the current noncontributory military retirement system with contributory systems were:

--Future retirees and new entrants would be the same in both systems.

--The base pay and allowance system would not change.

--Members departing before becoming eligible for benefits would have their contributions returned, without interest.

--Retirement provisions would not change.

We excluded the SBP annuities because no actuarial data was available. Also, cost projections consider only disability and nondisability retirement costs.

Military retirement system costs are now recorded on a pay-as-you-go basis. That is, budget estimates of retirement costs reported annually to the Congress represent the sum of retired pay due during the budget year.

The Accounting Principles Board (Opinion no. 8) and Cost Accounting Standards Board do not consider the pay-as-you-go method acceptable for recording pension costs, because it does not accurately measure pension costs from year to year. Further, it generally shows an increasing cost pattern due to the increasing number of retirees, CPI increases, and pay increases which ultimately show up in retired pay. The following table of military retired pay costs from 1965 to 1976 illustrates the increasing cost pattern.

1/The normal cost is the annual cost of future pension benefits assigned under an actuarial cost method to years subsequent to a particular valuation date of a pension plan.

FY	Basic pay (note a)	Retired pay (note b)	Retired pay as a percent of basic pay (note c)
	(millions)		
1965	$ 7,626	$1,324	17.4
1966	8,579	1,523	17.7
1967	9,476	1,753	18.5
1968	11,077	2,004	18.1
1969	11,508	2,339	20.3
1970	12,306	2,733	22.2
1971	12,545	3,056	24.4
1972	13,145	3,766	28.7
1973	14,705	4,182	28.4
1974	14,954	4,485	30.0
1975	15,186	5,447	35.0
1976	15,489	6,559	42.3

a/Budget figures.

b/Actual costs for FY 1965-70, budgeted costs for FY 1971-76. Excludes retired pay under chapter 67, title 10, U.S. Code, and survivor benefits.

c/For FY 1970 and beyond, based on budget requests for active duty basic pay and military retired pay (excluding retired pay under chapter 67, title 10, U.S. Code).

Source: House Armed Services Committee Report Number 94-5, p. 122.

For the last 11 years, the average annual increase in retired pay has been about 15.4 percent; in total basic pay, about 6.6 percent. The increase in military members during and following World War II, the frequency and size of cost-of-living adjustments to retired pay, and the general pay increases have produced this effect on retired and basic pay.

Since the pay-as-you-go military retirement system does not adequately recognize military retirement costs, we had to recompute retirement costs using sound actuarial methods, techniques, and assumptions. Our actuarial assumptions are similar to those that might be used in a valuation of a private pension plan.

Alternatives considered

We compared three alternatives for allocating retirement costs between service members and DOD.

1. The present system is retained.

2. Members contribute 7 percent of their basic pay.

3. The Government increases basic pay by about 7.5 percent, and members contribute 7 percent of their basic pay.

Alternative three was studied because many military members and DOD personnel believe that basic pay is depressed by 7 percent to allow for the noncontributory nature of the military retirement system. (See pp. 31 to 34.) Basic pay must be increased by about 7.5 percent to equal a member contribution of 7 percent of the new basic pay. 1/

We determined costs if DOD (1) established a retirement fund and reported retirement costs using actuarial assumptions and techniques or (2) continued the pay-as-you-go approach without a fund.

With a retirement fund

The following tables compare the cost of a funded military retirement system under the present noncontributory system and the two contributory systems we studied. The normal cost of basic pay was computed using the entry age normal method and the following actuarial assumptions: an interest rate of 7 percent, yearly basic pay increases of 5-1/2 percent, and annual CPI-based increases of 5 percent.

We assumed a 7-percent interest rate would be earned over the long term for a new fund invested in Government securities. We assumed a basic pay increase of 5-1/2 percent after reviewing the discussions on estimating future pay increases at recent Society of Actuaries' meetings. We assumed that the CPI would increase approximately 4 percent a year. This would result in yearly retired pay increases of about 5 percent, assuming the current adjustment, which includes 1 percent more than CPI increases, is continued.

Also, the active duty life mortality and other decrements are based on an experience study for 1964-65, while postretirement mortality rates are from the 1937 Standard annuity table.

1/ $100-7=93;\ 93 \times 1.075 \approx 100.0$

Using these assumptions we computed the normal cost as a percent of basic pay, the Government's share of costs, the amount the Government should pay in interest and the 40-year amortization of the current unfunded liability, and the total cost to the Government for fiscal year 1976.

An Actuarial Assessment of the Normal Cost of Military Retirement (note a) for FY 1976

Type of plan	Total: Amount (millions)	Total: Percent of payroll (note b)	Government's share: Amount (millions)	Government's share: Percent of payroll	Government's share: Unfunded liability (billions)
Noncontributory (present)	$5,986.0	37.16	$5,986	37.16	$194
Contributory:					
Without pay increase	6,414.6	39.82	5,287	32.82	192
With pay increase	6,887.9	39.82	5,684	32.82	198

a/Includes disability and nondisability retired pay.

b/Normal cost percentages are different because of the return of contributions, without interest, in the contributory systems.

FY 1976 Government Contributions Required to Fully Fund the Military Retirement System

	Present non-contributory system	Contributory systems: Without basic pay increase	Contributory systems: With basic pay increase
	(millions)		
Government's share of normal cost	$ 5,986	$ 5,287	$ 5,684
Payment required to amortize the current unfunded liability over 40 years at 7-percent interest	14,552	14,402	14,852
Annual Government contribution	$20,538	$19,689	a/$20,536

a/Does not include the cost of increasing basic pay by about $1,212 million.

The most economical of the three retirement systems we studied was that in which members would contribute 7 percent of their current basic pay to a retirement fund. When all retirement costs are recognized, the funding or reported cost would be about $19,689 million, including a normal cost of $5,287 million and $14,402 million to amortize the unfunded liability at 7-percent interest over 40 years. Compared with the noncontributory retirement system, for fiscal year 1976 the Government's share of normal cost would be decreased by about $700 million and the fully funded cost by about $850 million.

The most expensive of the three alternatives studied was that in which members would contribute 7 percent of basic pay that would be increased 7.5 percent, since the Government's share of normal cost, 32.82 percent of basic pay, does not reflect the cost of the basic pay increase. In fiscal year 1976 the basic pay increase of 7.5 percent would cost about $1,212 million. This amount would increase each year due to annual pay increases. With our assumption of pay increases of 5-1/2 percent, the additional cost would be $1,266 million in fiscal year 1977 and $4,311 million in fiscal year 2000. Increased levels of basic pay also result in increased annuities.

Without a retirement fund

The following table compares the retired pay for selected years, for the three systems, under the pay-as-you-go approach. In our calculations we again assumed annual pay increases of 5-1/2 percent and annual CPI adjustments of 5 percent.

Retired Pay Costs
Without a Pension Fund
(notes a and b)

FY	Present non-contributory system	Contributory systems (note c) Without basic pay increase	Contributory systems (note c) With basic pay increase (note d)
	(millions)		
1975	$ 6,226	$ 5,192	$ 5,114
1980	9,207	8,293	8,387
1985	12,899	11,771	12,050
1990	17,602	16,116	16,660
1995	23,513	21,585	22,506
2000	30,607	28,093	29,510

a/Retired pay includes disability and nondisability retired pay.

b/Dollar amounts reflect current dollars, which includes annual pay increases and CPI adjustments.

c/Includes return of contribution, without interest, based on turnover rate from the 1964-65 experience study.

d/Does not include the cost of increasing basic pay.

As shown by the table, if military members began contributing 7 percent of their basic pay towards the cost of retired pay, DOD's savings would be substantial. For example, first-year savings would be about $1,034 million and would increase to an annual savings of $2,514 million by the year 2000. (See app. II for yearly estimates.)

Using our assumptions, we computed the cumulative Government retired pay costs of the three systems for fiscal years 1975-2000.

Military Retired Pay
Costs Through FY 2000
(note a)

Government costs of	Present non-contributory system	Contributory systems: Without basic pay increase	Contributory systems: With basic pay increase (note d)
	(millions)		
Retired pay	$424,557	$387,163	$400,244
Increasing basic pay	-	-	62,259
Total	$424,557	$387,163	$462,503
Increase or decrease (-) over present system		$-37,394	$ 37,946

a/Dollar amounts reflect current dollars, which includes annual pay increases and CPI adjustments.

The table shows that if members contribute 7 percent of their current basic pay towards retired pay, DOD could save about $37.4 billion over the present system by the year 2000. Also shown in the table is the total DOD cost if basic pay is increased by 7.5 percent and then the members contribute 7 percent. The cost of increasing basic pay results in total pay increases of about $62.3 billion and total rêtired pay of 400.2 billion by the year 2000. This cost is about $37.9 billion over the present noncontributory system and $75.3 billion over a contributory system without a pay increase.

These estimates do not reflect the costs of a fully funded system, that is, normal cost plus amortization of the unfunded liability over 40 years at 7-percent interest. With the pay-as-you-go system, the unfunded liability will continue to grow because no monies are being set aside to provide for future benefits.

With a fund, the Government might be required to contribute its share of the normal cost and the 40-year amortization of the unfunded liability--about $20,538 million total. This amount should not be compared with the actual retired pay of $6,226 million (see p. 25.) under the pay-as-you-go system, because

retired pay does not reflect actual retirement costs of the system.

Total retirement costs applicable to military members

Effective January 1, 1957, the Servicemen's and Veterans' Survivor Benefits Act made future military retirees eligible for social security benefits. Uniformed service members and their agencies now contribute to social security, and these contributions should be considered when assessing the impact of a contributory military retirement system on member take-home pay and total Government retirement cost.

The following schedule shows the estimated first-year retirement (social security contributions plus retired pay) costs for servicemen and the Government for the three systems we studied, with no retirement fund.

	Present non-contributory system	Contributory systems: Without pay increase	Contributory systems: With pay increase
	(millions)		
Member costs:			
Military retired pay (note a)	$ -	$1,034	b/$1,112
Social security	868	868	c/933
Total	$ 868	$1,902	$2,045
Percent of basic pay	5.5	12.1	12.1
Government costs:			
Military retired pay (note a)	$6,226	$5,192	$5,114
Social security	868	868	933
Total Government cost	$7,094	$6,060	$6,047
Percent of basic pay	45.0	38.4	35.7

a/Includes disability and nondisability retired pay.

b/This is also an additional cost to the Government, since basic pay is increased by 7.5 percent.

c/Estimated using new basic pay.

CHAPTER 6

ISSUES TO BE RESOLVED BEFORE CHANGING TO A CONTRIBUTORY RETIREMENT SYSTEM

Converting from a contributory to a noncontributory plan poses few problems for an employer. The employer who assumes his employees' pension contributions is able to increase their take-home pay at less cost than with an equivalent, taxable wage increase. As a result, most transitions from contributory to noncontributory plans that offer essentially the same benefits are accomplished with little opposition.

Unfortunately, converting from a noncontributory to a contributory plan is not so easy, since employee contributions come out of take-home pay. The employer can thus expect some employee dissatisfaction unless pay is increased or some other adjustment is made to offset employee contributions. As a result, care is necessary in planning such a transition.

In planning for transition to a contributory military retirement system, we believe the major issues are:

--How should members' contributions be computed?

--Should a military retirement fund be established?

--Should pay be increased to offset members' contributions?

--Should vesting rights be granted earlier?

--Should the two retirement programs covering military members be integrated?

HOW SHOULD MEMBERS' CONTRIBUTIONS BE COMPUTED?

Surveys of contributory plans in the public and private sectors show that employee contributions are usually related to earnings. Some plans express employee contributions as a percentage of total earnings, while others require contributions on earnings up to a specified limit.

The majority of public employee plans base contributions on the members' total basic earnings, excluding overtime pay or any other special allowances. This method is considered the most economical for administering payrolls and has the additional advantage of simplicity. Despite

these benefits, many public employee systems limit the earnings on which contributions are based. This limit often coincides with the social security wage base. Still other systems require employees to contribute at a specified rate on all earnings over a given amount.

According to the 1975 Bankers Trust study, half the corporate pension plans with mandatory contributions base them on total earnings. The other half base mandatory contributions on earnings over a given sum. Thus an employee receiving less than the stated amount usually earns benefits but once pay rises above the set amount he must contribute to receive any increased benefits.

Since military members' earnings are not expressed as a salary or wage rate, a base would have to be selected to compute employee contributions. Basic pay is the only cash element of military pay to which all members are entitled. It is also the base used for computing social security contributions. But basic pay is only one element of military members' compensation packages.

Regular military compensation (RMC) consists of basic pay plus quarters and subsistence allowances and the tax advantage which accrues because these allowances are not subject to Federal income tax. Its primary use is as the military equivalent of a civilian salary. It has a drawback as a basis for computation, because some elements are received "in kind" or as a tax advantage, rather than in cash. Thus military members may view cash contributions based on RMC as particularly burdensome. RMC poses another problem as a base because retirement benefits are computed according to basic pay. It is generally considered desirable to preserve the relationship between contributions and benefits by using a single base for both.

In the civil service retirement system, employees' contributions equal 7 percent of salary and defray approximately 25 percent of the normal cost of their retirement benefits, assuming future annual pay increases of 5 to 5-1/2 percent and CPI increases of 4 percent. If military members contributed 25 percent of the normal cost of their system (see p. 23), their contributions would total about 10 percent of basic pay (one-fourth of normal cost--39.82 percent of basic pay).

If military members contributed 7 percent of their basic pay to military retirement, as most civil service employees contribute from their salaries, their total contributions, including 5.85 percent to social security, could reach 12.85 percent of basic pay or about 10 percent

of RMC. In appendix I we present the effect of this rate of contribution on the disposable incomes of three enlisted men.

SHOULD A MILITARY RETIREMENT FUND BE ESTABLISHED?

The current military retirement system is unfunded; that is, no funds are accumulated to pay for future retirement benefits. Each year the Congress appropriates only enough money for the military to meet current retired pay.

A contributory retirement system might require the Government to review its position on funding the military retirement system, in order to provide a visible expression of benefit security. If a pension fund is established, certain issues would have to be resolved.

Private pension plans, unlike public plans, must meet the requirements of ERISA. This act includes provisions governing the funding of private pension plans and establishing fiduciary standards. The funding sections of the act provide minimum standards which include the amortization of past service liabilities. The part concerning fiduciary responsibility includes fiduciary liability, prohibited transactions, diversification of assets, and limitations on investment.

Public retirement plans, including the Federal Government's, are not subject to the provisions of ERISA.

Whether any public employee retirement system should be funded is subject to considerable debate. The following arguments are often used to justify or attack funding of non-Federal public employee retirement plans.

The primary argument against funding is the financial hardship imposed on the government. Funding of a pension plan forces the government to divert current tax revenues to a fund, while the government may have vital projects for which it must borrow money. With a choice between funding a pension plan or a vital project, a government may frequently choose not to fund its pension plan.

Funding critics also argue that non-Federal employees do not need the protection of a large pension fund since governments have access to "theoretically unlimited taxing power."

Another objection to funding a public non-Federal retirement plan is that the government's return may not be enough to justify investing money rather than spending it.

Funding of a pension plan requires systematically accumulating assets to meet future retirement obligations. A strong argument for funding is that it creates a sound financial arrangement to meet the costs of the retirement plan when they are incurred. Funding permits the government to spread a pension plan's cost fairly evenly over its duration. Adequate funding may protect the employee against default. It is said that the "unlimited taxing power" funding critics refer to can prove to be very limited when a government is under financial stress.

Earnings from retirement funds invested will help meet the costs of the pension plan. If, through sound investment of the fund, increases in the rate of return occur, the surplus can be used to reduce contributions. A widely used rule of thumb states that a 1-percent increase in the pension fund's investment return can produce a 20-25-percent reduction in contributions.

SHOULD PAY BE ADJUSTED TO OFFSET MEMBERS' CONTRIBUTIONS?

Converting from a noncontributory to a contributory retirement system will decrease members' take-home pay unless wages are increased to compensate. However, before pay is increased, data is needed to assure that members are being paid the proper amount. Two items affecting military pay have never been resolved:

--Has basic pay been reduced to allow for the noncontributory retirement system?

--What is the military pay standard?

Resolving these two questions should indicate whether or not an increase in basic pay is needed to make military retirement contributory.

Has military pay been depressed to allow for a noncontributory retirement system?

Military members have never made explicit contributions from their pay for military retirement. Whether their pay has been reduced to allow for implicit retirement contributions has not been established. When the Uniformed Service Pay Act of 1963 was enacted, DOD did not tell the Congress that the military pay levels were lowered to allow for an imputed military retirement contribution.

In 1965, DOD proposed (1) a 5-percent increase in military pay levels for personnel with over 2 years' service and (2) a 2.7-percent cost-of-living increase for remaining personnel. The increase was requested to maintain the 1963 relationship between military and civilian pay. The proposal was rejected by the House Armed Services Committee, which performed its own study. The study found "beyond a reasonable doubt" that military pay increases had lagged behind civil service increases by 10-11 percent between 1952 and 1964.

The House passed a bill that increased basic pay by an average of 10.7 percent. In presenting the bill, the Commitee emphasized in House Report No. 89-549 (June 24, 1965):

> "* * * that, in the development of the proposed new basic pay scales, * * * it has attempted to give appropriate and full consideration to both the tax advantage, * * * and to the non-contributory nature of the military retirement system."
>
> * * * * *
>
> "After determination was made of the level of pay (including allowances) considered appropriate for each military grade, account was taken of an imputed 6-1/2 percent contribution to retirement on basic pay * * *, and the amount of the estimated Federal income tax advantage * * *."

The above statement indicates that the House was attempting to document the amounts by which their proposed military pay scales were lowered due to the noncontributory retirement system. The Committee then proceeded to develop a complete set of tables identifying the imputed retirement contribution and the amount of tax advantage.

The Senate Armed Services Committee did not agree with the House's pay levels but took no position in defining what was included in military compensation (Senate Report 544, August 6, 1965).

Public Law 90-207, passed in 1967, required that RMC be increased by the average percentage increase granted General Schedule employees. The law was intended to maintain a comparable relationship between military pay and General Schedule salaries. However, RMC, the selected equivalent of a civilian salary, did not include an imputed retirement contribution, nor was such a factor mentioned.

In 1971, the imputed retirement contribution was discussed again before the House Armed Service Committee on February 25, 1971. The Assistant Secretary of Defense testified:

> "The military pay standard is constructed so that it recognizes that military pay does not include a retirement contribution; instead the competitive level of compensation which would be appropriate under a contributory retirement system is depressed by 7 percent as an imputed contribution toward the member's retirement."

The House Committee's Report Number 92-82 (March 25, 1971) stated:

> "The RMC is based on a military pay standard so constructed that it recognizes that RMC does not include a specific retirement contribution. In other words, the military compensation is depressed by 7 percent to reflect an imputed contribution towards the member's retirement."

The Senate Committee again did not agree with this position in its Report Number 92-93, May 5, 1971:

> "Finally it should be pointed out that since there is no accepted comparability system linking various military and civilian pay grades it cannot therefore be reasonably said that military basic pay is being depressed by any percentage as an imputed contribution toward reducing military retired costs."

Our legislative research failed to find any agreement between the House and Senate Armed Services Committees on whether military pay is depressed to account for the noncontributory nature of the military retirement system. Also, in 1965 the House considered depression of basic pay, while in 1971 the depression discussed was related to RMC.

However, DOD continues to state that the retirement contribution is imputed, as in the statement accompanying its retirement reform proposal--the Uniform Services Retirement Modernization Act. In the proposal, DOD indicated a contribution by service members is implicit.

Establish a military pay standard?

There is no agreed standard for measuring the adequacy of military compensation. If there were, the amount by which current military compensation failed to meet the standard might be construed as the members' imputed contribution towards retirement.

In our report, "Information and Observations on the Need to Revise the Method of Increasing Military Pay" (B-163770, March 14, 1974), we stated that a fundamental problem in the military compensation system was the lack of an external pay standard.

A 1967 DOD study emphasizing the lack of a military pay standard, "Report of the First Quadrennial Review of Military Compensation: Modernizing Military Pay," considers this the most important shortcoming of the military compensation system.

DOD has constructed internal pay standards and used them to assess the adequacy of military pay. But to date, the Congress has not enacted such a standard. If a contributory retirement system is adopted, a pay standard could be necessary to assure members of fair pay.

SHOULD VESTING BE GRANTED EARLIER?

Under the current military retirement system, those who resign before 20 years of service receive no benefits. If military personnel begin contributing part of their pay for retirement, vesting rights more comparable with those of other employees may have to be considered. Under ERISA, private plans must provide full and immediate vesting in benefits derived from employee contributions. With respect to employer contributions, the plan must meet one of three vesting standards: (1) full vesting after 10 years' service, (2) 25-percent vesting after 5 years service, with 5 percent added each of the next 5 years and 10 percent added each year thereafter until 100-percent vesting is achieved after 15 years, or (3) 50-percent vesting when age plus credited service totals 45, with an additional 10 percent for each of the next 5 years thereafter.

The proposed Uniformed Service Retirement Modernization Act bill provides for a deferred annuity of 100 percent of the accrued benefit in the event of separation aftr 10 years. This is equivalent to the first ERISA requirement. This provision and other vesting provisions should be evaluated for military retirement, especially if a contributory retirement system is adopted.

SHOULD THE TWO RETIREMENT PROGRAMS COVERING MILITARY MEMBERS BE INTEGRATED?

The Government contributes to two retirement systems for military personnel--military retirement and social security. The cost to the Government for military retired pay and social security will be about 45 percent of basic pay during fiscal year 1976. (See p. 27.) This cost has encouraged defense managers to consider less expensive alternatives to the current system.

When military members came under social security in 1957, lowering military retired pay to compensate for benefits or the Government's added costs was not considered.

DOD's proposed Uniformed Service Retirement Modernization Act addresses this problem by recommending a complex offsetting of military retired pay when each member begins receiving social security. Recent studies show that about 40 percent of private employers' pension plans deduct for social security benefits. The Internal Revenue Service has ruled that no more than 50 percent of social security benefits can be offset. ERISA specifies similar restrictions.

The question of integrating the military and social security retirement systems needs to be evaluated at an early date.

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Resolution of the above issues is a critical first step in evaluating the desirability of a contributory retirement system for the military. For example, if the Congress decides that pay should not be adjusted to offset members' contributions, then savings can result with a contributory system. (See ch. 5.) However, if the Congress concludes that pay should be adjusted upwards, then a contributory system would be more costly then the current system. Since cost implications have an important bearing on the desirability of a contributory system, the pay adjustment issue, as well as the other issues, need to be addressed before a recommendation can be made.

ANNUAL DISPOSABLE INCOME UNDER THREE DIFFERENT RETIREMENT SYSTEMS

The Effect on an E-1 s Annual Disposable Income Under Three Different Retirement Systems (note a)

	Present	Contributory: Without pay increase	Contributory: With pay increase
Basic pay	$4,129	$4,129	$4,439
Basic allowance for quarters (note b)	1,328	1,328	1,328
Basic allowance for subsistence (note b)	880	880	880
Tax advantage	401	401	431
RMC	$6,738	$6,738	$7,078
Withholding for:			
Federal income tax	$ 81	$ 81	$ 87
Social security	242	242	260
Retirement	-	289	311
Total withheld	$ 323	$ 612	$ 658
Total withholdings as a percent of:			
RMC	5	9	9
Basic pay	8	15	15
Disposable income (note c)	$6,014	$5,725	$5,989
Change in disposable income:			
Dollars	-	$ -289	$ -25
Percent	-	-5	-1

a/For an enlistee with less than 1 year of service and a family of three. Based on pay, Federal income tax, and social security rates in effect October 1, 1974.

b/Received in cash.

c/Excluding tax advantage, which is not a cash item.

The Effect on an E-4's Annual Disposable Income Under Three Different Retirement Systems (note a)

	Present	Contributory: Without pay increase	Contributory: With pay increase
Basic pay	$5,990	$5,990	$6,439
Basic allowance for quarters (note b)	1,537	1,537	1,537
Basic allowance for subsistence (note b)	880	880	880
Tax advantage	513	513	551
RMC	$8,920	$8,920	$9,407
Withholding for:			
Federal income tax	$ 361	$ 361	$ 388
Social security	350	350	377
Retirement	-	419	451
Total withheld	$ 711	$1,130	$1,216
Total withholdings as a percent of:			
RMC	8	13	13
Basic pay	12	19	19
Disposable income (note c)	$7,696	$7,277	$7,640
Change in disposable income:			
Dollars	-	$ -419	$ -56
Percent	-	-5	-1

a/For an enlistee with more than 4 years of service and a family of three. Based on pay, Federal income tax, and social security rates in effect October 1, 1974.

b/Received in cash.

c/Excluding tax advantage, which is not a cash item.

The Effect on an E-5's Annual Disposable Income Under

Three Different Retirement Systems (note a)

	Present	Contributory: Without pay increase	Contributory: With pay increase
Basic pay	$6,826	$6,826	$7,338
Basic allowance for quarters (note b)	1,756	1,756	1,756
Basic allowance for subsistence (note b)	880	880	880
Tax advantage	553	553	594
RMC	$10,015	$10,015	$10,568
Withholding for:			
Federal income tax	$ 497	$ 497	$ 534
Social security	399	399	429
Retirement	-	478	514
Total withheld	$ 896	$ 1,374	$ 1,477
Total withholdings as a percent of:			
RMC	9	14	14
Basic pay	13	20	20
Disposable income (note c)	$ 8,566	$ 8,088	$ 8,497
Change in disposable income:			
Dollars	-	$ -478	$ -69
Percent	-	-6	-1

a/For an enlistee with more than 8 years of service and a family of three. Based on pay, Federal income tax, and social security rates in effect October 1, 1974.

b/Received in cash.

c/Excluding tax advantage, which is not a cash item.

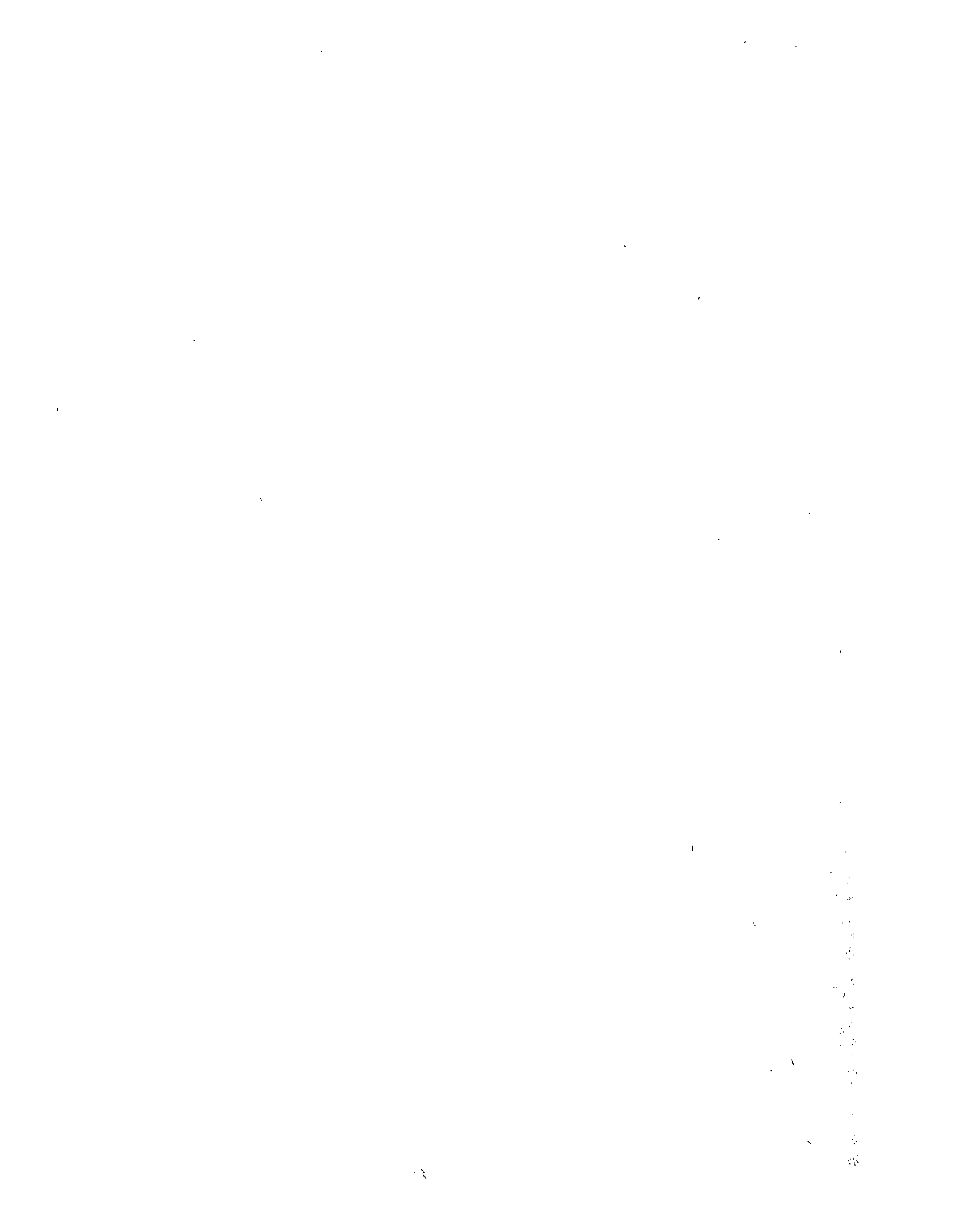
CONTRIBUTORY RETIREMENT SYSTEM WITHOUT BASIC PAY INCREASE

Contributions and Refunds, Without Interest, for the Military Retirement System

FY	Average no. of members	Basic pay	Contributions (note a)	Amount of refunds	Net contributions	Number of refunds	Average refunds
	(thousands)	(millions)				(thousands)	
1975	2,134.5	$15,753.0	$1,102.7	$ 68.5	$1,034.2	334.2	$ 205
1976	2,102.9	16,107.8	1,127.5	188.5	939.0	326.3	578
1977	2,088.2	16,823.2	1,177.6	306.9	870.7	337.7	909
1978	2,088.2	17,687.2	1,238.1	370.9	867.2	315.5	1,176
1979	2,088.2	18,639.4	1,304.8	415.0	889.7	307.8	1,348
1980	2,088.2	19,659.4	1,376.2	462.7	913.5	312.1	1,483
1981	2,088.2	20,721.7	1,450.5	523.0	927.5	324.2	1,613
1982	2,088.2	21,841.3	1,528.9	545.6	983.3	313.6	1,739
1983	2,088.2	23,051.2	1,613.6	577.1	1,036.5	310.1	1,861
1984	2,088.2	24,339.0	1,703.7	618.8	1,085.7	311.6	1,983
1985	2,088.2	25,693.3	1,798.5	670.7	1,127.8	316.1	2,122
1986	2,088.2	27,126.8	1,898.9	702.0	1,196.9	310.3	2,263
1987	2,088.2	28,648.7	2,005.4	734.2	1,271.2	306.7	2,394
1988	2,088.2	30,231.2	2,116.2	776.0	1,340.2	306.7	2,536
1989	2,088.2	31,857.8	2,230.0	825.8	1,404.2	308.4	2,678
1990	2,088.2	33,563.6	2,349.5	863.7	1,485.8	305.7	2,825
1991	2,088.2	35,368.7	2,475.8	909.1	1,566.7	305.1	2,979
1992	2,088.2	37,283.1	2,609.8	965.2	1,644.6	306.9	3,145
1993	2,088.2	39,322.6	2,752.6	1,026.3	1,726.3	309.0	3,322
1994	2,088.2	41,491.0	2,904.4	1,082.5	1,821.9	309.1	3,502
1995	2,088.2	43,808.6	3,066.6	1,139.1	1,927.5	307.8	3,701
1996	2,088.2	46,256.2	3,237.9	1,206.3	2,031.6	309.0	3,904
1997	2,088.2	48,805.3	3,416.4	1,279.4	2,137.0	311.0	4,114
1998	2,088.2	51,476.7	3,603.4	1,343.3	2,260.1	309.7	4,338
1999	2,088.2	54,309.4	3,801.7	1,413.4	2,388.3	309.1	4,572
2000	2,088.2	57,277.3	4,009.4	1,495.1	2,514.3	310.4	4,817

a/Contributions of 7 percent.

APPENDIX II



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