

*Non-cash benefits may not be the best way  
to attract and retain service members.*

# Paying Tomorrow's Military

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**T**he U.S. Department of Defense (DOD) is the largest employer in the United States, with some 1.4 million active-duty service members, 880,000 paid members of the Guard and Reserve, and 650,000 civilian workers. Since conscription ended in 1973, every uniformed member of the armed services is a volunteer. While intangible factors like patriotism are important draws for many who volunteer to serve, the military relies heavily on pay and benefits—the tangible rewards for service—to maintain its competitive edge as an employer in U.S. labor markets. Good pay and benefits are crucial to attracting the right people to join the military, to stay as long as they are needed, and to do the best job they can in service to their country.

Tangible compensation for U.S. service members is a mix of immediate and deferred cash pay and noncash benefits. Immediate cash pay includes basic pay (received by every member according to his or her rank and time in service), a cash housing allowance for those members who do not receive government housing, a cash allowance for food available to members who are not required to eat in government dining halls, and a variety of bonuses and special pays that depend upon an individual's occupation, assignment, and skills. Deferred cash pay includes retirement pensions for those who serve in the military for 20 years or more and disability and other payments for eligible veterans.

Noncash benefits include health care for active-duty members of the military and their families as well as reservists called to active duty and their families; food provided in government dining halls; on-base housing provided directly by the government; subsidized child-care centers; DOD-run children's schools on some bases; shopping in subsidized grocery stores (called commissaries); and a variety of retail and recreational activities

on military bases. There are also deferred noncash benefits offered to veterans (e.g., veterans' health care and educational benefits) and to retirees and their families (e.g., health care benefits and shopping in commissaries and DOD retail stores).

Many workers in the private sector and most government workers also receive a mix of immediate cash, deferred cash, and noncash compensation. For service members, however, noncash and deferred benefits make up a much larger share of the mix than they do for private-sector or other government workers. About 51 percent of every military compensation dollar goes to noncash or deferred benefits. In contrast, such benefits typically account for only 18 percent of total compensation in the private sector and for some 33 percent of compensation costs for civilian government workers. Such large differences in the structure of compensation relative to that of other U.S. employers can make it difficult for service members to see the full value of their total compensation, thus weakening the competitiveness of the armed services as employers.

For the first time since the draft ended in 1973, the U.S. military is involved in a large and deadly operation that the Bush administration now says could continue for years. The active-duty Army has been stretched so thin that the National Guard and Reserve—once viewed as genuine reserves that would be called to federal active duty only in the case of a massive war—must supply a substantial share of troops for the operations in Iraq and Afghanistan. All the services are short of people in key occupations. The strain is reflected in weakened morale, especially in the Guard and Reserve where recruiting and retention have suffered dramatically. While retention in the active forces remains strong, recruiting for the active-duty Army has suffered in both quantity and quality.

Some observers suggest the solution is to bring back the draft. From the point of view of the military and society, that would be a mistake. Reinstating conscription would reverse what is arguably the most important transformation of U.S. forces since

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the Vietnam War—and a key enabler of the transformation in other aspects of military affairs that took place between Vietnam and the Persian Gulf War in 1991. Moreover, even with an Army doubled in size, U.S. forces could not use more than a small fraction of the nation's men and women of military age.

The better solution by far is to improve the conditions of military life and the effectiveness of the incentive structure created by the tangible rewards the nation offers to those who serve in uniform. One of the most important steps the nation could take in this regard is to rebalance the mix of cash and noncash rewards for service.

#### **THE COST OF MILITARY COMPENSATION**

Military pay and benefits are expensive. Compensation costs for uniformed members account for more than 30 percent of the DOD budget. In addition to the costs to DOD, a substantial share of the costs of military compensation—for example, those related to veterans' benefits (which are paid for through the Department of Veterans Affairs) and the tax revenues the government forgoes because some elements of cash pay and all of the benefits provided in-kind are tax-free—fall outside of the DOD's budget. The Government Accountability Office estimates that the total cost of military compensation to U.S. taxpayers in 2004 was \$158 billion, some \$112,000 per active-duty service member. Including both immediate and deferred offerings, noncash benefits today account for about 36 percent of the cost of military compensation—some \$40,000 per active-duty member.

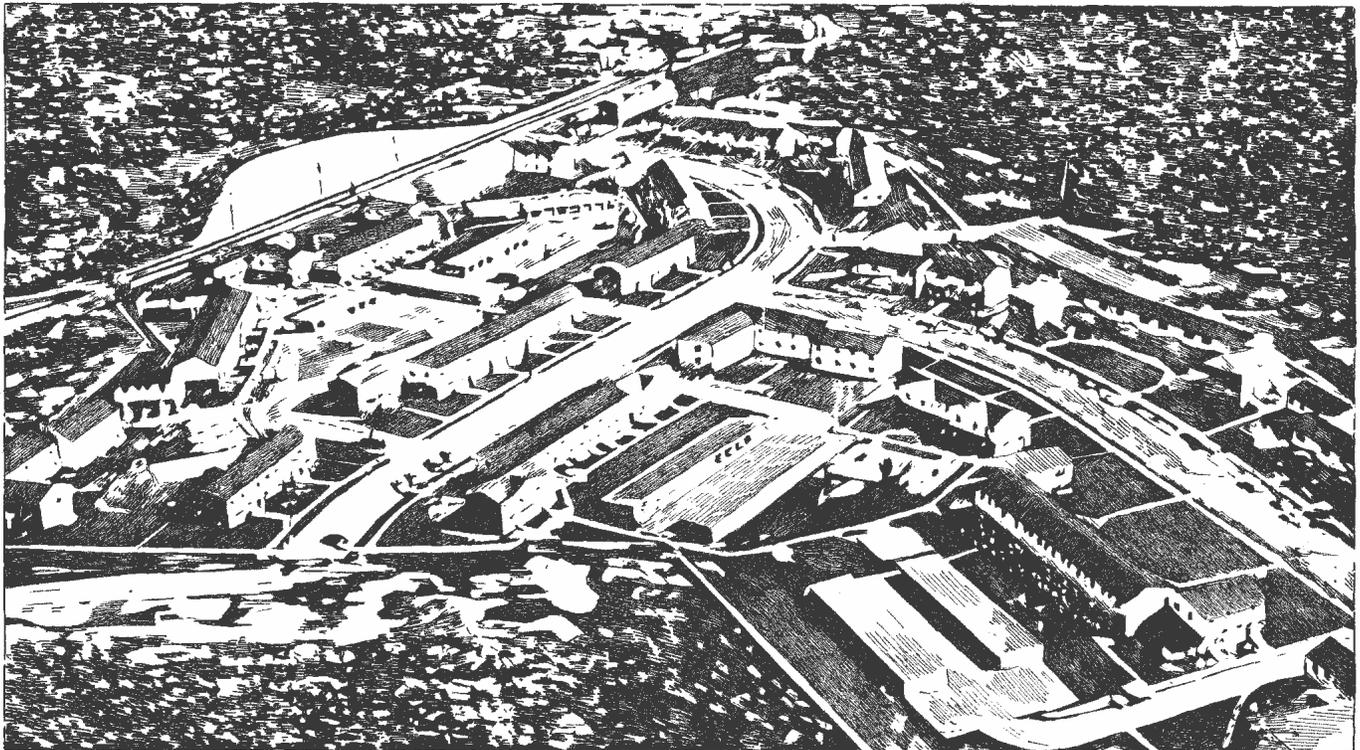
The cost of military pay and benefits has risen sharply in recent years. The total cost to the government rose by 28 percent in real terms between 2000 and 2004—well over twice the percentage increase for compensation in the private sector. About one-half of that growth came from increases in noncash and deferred benefits (see Table 1).

The significance of rising costs to taxpayers is obvious. Perhaps less obvious is the magnitude of the problem they pose for the armed forces themselves as the nation makes increasing demands on people in uniform: soldiers are becoming too expensive to hire. To avoid the high costs, the nation is turning increasingly to contractors to fill military roles. For activities like facilities upkeep, accounting, jet engine repair, and pediatric medical care, where the private sector offers a competitive marketplace, such outsourcing is a healthy choice. Turning key jobs over to contractors can raise serious concerns on the battlefield, however, as criticisms from U.S. soldiers during the first weeks of the Iraq War demonstrated.

Another problem for the services is that when budgets are tight, high levels of spending for personnel drain resources from other defense priorities, including training, upkeep, and equipment modernization. In recent years, total defense budgets rose sharply, thus accommodating the swift rise in the costs of military people without depleting funds for other priorities. Few observers believe such increases are sustainable in the future, however, and DOD's own plans call for budgets to rise only a bit more than the rate of inflation during the next six years. In response to the expected budget squeeze, the Navy and Air Force each plan to shed tens of thousands of troops during the next several years. Unless the rapidly rising costs of people can be brought under control, the services will have to reduce their forces even further, scale back their plans for equipment modernization, or both. A better mix of cash and non-cash pay and benefits could help DOD stretch its resources to get more out of each compensation dollar.

#### **ADVANTAGES AND DISADVANTAGES**

The mix of military pay and benefits has important consequences for three key constituencies: service members and their



families, the military as an institution, and taxpayers. Proponents of noncash benefits often argue that they are a boon for all three constituencies. The situation is more complicated than that, however, and the noncash benefits provided to service members by the U.S. government today have serious drawbacks.

**SERVICE MEMBERS** Noncash benefits offer several advantages to the individuals who serve. The most obvious is that such benefits can save them money. For example, the 800 child-care centers the DOD runs at 300 military installations provide subsidized care for the children of service members; on average, their parents pay only 50 percent of the operating costs and none of the capital costs of the centers. The Defense Commissary Agency (DeCA), the government entity that runs the Defense Department's chain of 273 grocery stores, says its commissaries save customers an average of 30 percent compared to prices at local civilian stores. Many young service families, according to DeCA, "could not make ends meet without the price savings provided by the commissaries." The military's health care program is virtually free to the families of active-duty members, a substantial savings compared to medical insurance programs generally offered to individuals or by private-sector employers. As will be discussed later, however, the cost of these benefits to the government often exceeds their savings to individuals; thus most (but not all) individuals would be better off financially if the government provided cash instead of in-kind benefits.

Noncash benefits may also help to promote a good quality of life beyond financial savings, especially for the youngest service members and their families. Advocates of noncash benefits argue that the youngest service members generally lack life skills such as finding an apartment and negotiating on price with the landlord, obtaining quality medical care, managing finances, or obtaining other goods and services they need. Another argument often advanced for noncash benefits is that they provide convenient access to goods and services for service members stationed abroad or in isolated locations in the United States. (While that argument may have made sense when on-base offerings burgeoned during the 1950s and 1960s, today there is a thriving private-sector marketplace just outside the gates of most U.S. military installations for housing, health care, groceries, retail items, recreation, and other goods and services typically offered on-base.)

Noncash offerings have their downside where service members are concerned, however. Perhaps the most important is that many members do not receive them. For example, on-base offerings like commissaries, retail stores, child-care centers, and recreational facilities can be valuable to members, families, and military retirees who live on or near a military base, but

not to those who live farther away. Child-care centers and free family health services may be valued greatly by members with families but are of no use to single members. Only about 15 percent of enlisted members serve for 20 years or more and thus become eligible for the very generous health care plan offered to military retirees. Such disparities can make the offerings seem unfair to those who do not receive them.

Moreover, unlike cash, benefits delivered in-kind limit choice to whatever the government decides to offer. The choices may be exactly what some members want, but they will not be suitable for others. For example, the services' "base exchange" department stores have a reputation for stocking high-end merchandise attractive to retired officers and their spouses, but avoiding lesser-quality goods that would be affordable to families of young enlisted troops. As a result, young families often complain that they are better off at a local big-box store, and active-duty families generate only about one-half of the sales in exchange stores in the United States.

For some individuals who serve, the quality-of-life feature of military noncash offerings may have a flip side related to pri-

TABLE 1

## Compensation Costs, FY 2000 and 2004

In Billions of 2004 Dollars

Components of Compensation	FY 2000	FY 2004	Percentage Change
<b>Cash</b>			
Cash pay and allowances	\$54.0	\$70.6	31
Tax advantage from nontaxable elements of cash pay	5.3	6.4	22
Total cash	59.3	77.0	30
<b>Noncash benefits</b>			
Health care	8.7	9.7	11
Family housing and barracks	3.2	3.1	-3
Subsistence in kind	1.2	3.5	185
Installation-based benefits	4.4	5.2	20
Education	0.4	0.7	68
Other	10.3	10.0	-3
Total noncash benefits	28.2	32.2	14
<b>Deferred benefits</b>			
Retired pay accrual	12.2	12.8	5
VA compensation and pension	9.0	11.1	5
VA health care	8.4	10.3	23
VA other	0.9	1.1	23
Health care accrual	5.1	13.6	48.9
Total deferred benefits	35.6	48.9	38
<b>Total compensation</b>	<b>\$123.1</b>	<b>\$158.1</b>	<b>29</b>

SOURCE: Adapted from GAO-05-798.

NOTES: Some 100,000 reservists were paid out of the cash compensation indicated for FY 2004.

Installation-based benefits include commissaries, exchanges, childcare, DOD dependent schools, and other personnel and family benefits delivered on military bases.

Education benefits include education, off-duty voluntary education, and education benefits under the GI Bill.

Other noncash benefits include separation pay, partial dislocation allowance, transportation subsidy, permanent change of station, adoption expenses, savings deposit program, Social Security tax, VA home loan, death gratuities, survivor benefits, and other costs.

vacy and independence. For members who live in military housing, the boss is also the landlord, and family problems call spill over to the workplace more readily than for members living off-base. The very features of on-base life that look like helpful support for many military families feel like intrusive paternalism to others.

**THE MILITARY** Noncash offerings can also benefit the military as an institution. Fitness centers, for example, promote military readiness by providing a well-equipped environment where troops can work out. Advocates of noncash compensation say that family-oriented offerings are also important to military readiness: when families are happy, secure, and cared for in a military setting, troops are less likely to be burdened with family problems when they deploy. For example, DeCA says that on-base commissaries support “warfighters’ peace of mind, knowing their families have secure and affordable access to American products.” Child-care centers are said to improve the readiness of troops by ensuring convenient, high-quality care for their infants and young children.

Noncash benefits, particularly those provided on-base, may also help to promote military values and create a sense of solidarity within the ranks. On-base fitness centers clearly promote the military value of physical fitness. Housing, health care, commissaries, and government-run schools and child-care centers can be viewed as evidence of the military “taking care of its own.” On-base offerings are also a magnet for military retirees, who often see visiting the commissary or clinic as a way to continue to connect with the traditions of the institution. In addition, advocates of military housing have long touted the neighborliness of military communities (though a 1999 RAND survey found that most military families saw little difference in neighborliness between on-base and off-base communities, and scoffed at the importance of having military neighbors).

Perhaps the most important advantage of today’s noncash offerings to the military as an institution is the role they are said to play in retention. Military leaders believe that the family plays an important role in a soldier’s decision to continue in service after the first term. “Recruit the soldier, retain the family” is an important slogan of the all-volunteer force, and family-friendly noncash benefits are seen as key to making the slogan a reality. High levels of retention beyond the first term are crucial to making the all-volunteer force work. Keeping members for eight years instead of the four required under most initial service contracts increases the experience level of the force and lowers the requirement for new recruits, thus cutting the costs of recruitment and training.

For the military as an institution, today’s noncash benefits have their disadvantages, however. Noncash benefits are more complicated to deliver than cash, and the work of providing them can draw leaders’ attention away from core military missions. Running a military base can be like running a small city. A military commander with responsibility for getting troops ready for war may find himself distracted by the service’s responsibilities as landlord, hospital administrator, infant care provider, and grocer. Dealing with the aging infrastructure related to on-base benefits—housing, commissary and retail

buildings, children’s schools and teen centers—is also a challenge, both for local commanders and for military and civilian defense leaders in Washington, D.C.

Another drawback is that the rich menu of family-friendly benefits appears to attract people with families and encourage early marriage and family formation. Some 10 percent of active-duty recruits enter the military with at least one dependent; 5 percent have more than one dependent when they enter. Service members also marry sooner and have children at younger ages than their counterparts in the private sector. Whether family benefits draw individuals who already know they want to form families early or encourage those already in to marry and form families, the large number of young families has consequences for the services as institutions.

Most Americans form families sometime, and studies show that marriage can have a positive effect on an individual’s productivity in the workplace. But the presence of young children can impede the readiness of service members to deploy, and caring for the needs of young families can distract the attention of commanders from other duties. Furthermore, concentrating goods and services on military bases can wall military people off from the rest of American society—a situation that could have profound implications for an all-volunteer force that depends crucially on deep and lasting public support.

Even the strong retention figures said to result in part from generous noncash family benefits can have their downside. While keeping many service members for at least two terms pays off in reduced turnover and lowered costs for recruitment and retention, the budgetary costs to the services of keeping them until they are eligible for retirement are high and growing rapidly. Unfortunately, noncash benefits are not targeted to those people the services especially want to keep for a full career. Instead, they are offered to any eligible member or family with access to them. Benefits targeted directly at members the services wish to keep would be more effective in helping them to shape the forces to put the right people into the right jobs at the right time.

In fact, in many military occupations, the advantages that the services reap from members’ longer experience may not be worth the high costs of their immediate pay and retirement benefits—costs that rise for every year the individual remains in service. The nation may have gone too far in encouraging members to stay in service.

Finally, as discussed in the next section, the costs of noncash benefits are rising rapidly. Nearly 80 percent of the costs of immediate and deferred noncash benefits are borne directly by the DOD. As total defense budgets flatten, the rising costs of health care, housing, child-care centers, and other noncash benefits are expected to drain resources from other defense priorities, including weapons procurement, upkeep of facilities and weapons, and training.

If the value of noncash benefits to those who serve were as great as their costs to DOD, then the military’s noncash offerings could be the powerful tools their advocates say they are, enhancing recruitment, retention, readiness, and cohesion at lower cost than an equivalent amount of spending in cash. They would be worth the cost. Unfortunately, however, non-

cash benefits are often a source of criticism from members and families who do not value them as highly as they would value the cash the government pays for them. On-base housing, much of which was built during the early years of the Cold War, is particularly prone to such criticism. Sacrificing key service priorities for the sake of benefits that are not valued in proportion to their cost makes little sense.

The high cost of noncash offerings is complicated by the fact that they are generally not included in the services' military personnel budgets, but rather are scattered across Defense Department and other federal accounts. Only about 53 percent of the costs of military compensation to the federal government in 2004 showed up in the Military Personnel account; the remainder of the costs were borne elsewhere—in other elements of the defense budget, in budgets for veterans affairs, or even as revenues forgone because of the tax advantages on some elements of military compensation. For military or civilian defense leaders considering an expansion of the force or a change in personnel entitlements, making sense of the cost implications can be daunting.

The lack of visibility into costs can make it difficult for members to perceive the value of their compensation package, thus watering down the effectiveness of the money the services spend on people. In addition, because it makes people seem less expensive than they actually are, this lack of cost transparency can distort leaders' decisions about the size of the force.

**TAXPAYERS** Under some circumstances, noncash benefits can keep taxpayers' costs down. One such circumstance might be when the government saves money by buying in bulk. For example, by purchasing health care insurance and thus pooling risk across a large pool of beneficiaries, the government could provide individuals with coverage at a cost lower than what they would have to pay for equivalent policies as individuals. (This is not the case for today's health benefit, however, as will be discussed below.) Noncash benefits can also be cost-effective if they are used only by a relatively small segment of the military population. For example, before the advent of the all-volunteer force, the fraction of service members with families was substantially smaller than it is today. The Army saved money by paying entry-level soldiers—most of whom were conscripts—much less than it would cost to support a family, and providing family housing for the few who needed it rather than raising every soldier's pay to market rates.

Advocates often argue that noncash benefits are still a bargain to taxpayers. In general, however, most noncash benefits are inefficient, costing taxpayers substantially more than their value to recipients. One reason is that the military's noncash offerings often depend on government-run monopolies that are not responsive to market competition.

For example, the military's health care system combines a direct-care network of 75 military hospitals and 461 clinics with care purchased from the private sector through a government-financed health insurance program. Like most government-run businesses, the direct-care network costs taxpayers more than private-sector care. Government-run housing also costs taxpayers substantially more to build and operate than it would cost to rent similar housing in the private sector.

Another source of inefficiency in the DOD's noncash offerings is that they typically rely on subsidies, some of which remain hidden from view outside of the department's budget. For example, DeCA advertises that its commissaries save service families two dollars for every dollar taxpayers spend on the commissary appropriation. That calculation leaves out important non-budgetary subsidies, however, including the revenues forgone because the stores are exempt from sales and excise taxes and receive tax-free access to federal capital. Those advantages amount to an off-the-books annual subsidy in excess of one-half billion dollars.

Whether hidden or visible in federal budgets, subsidies distort the effectiveness of government spending by making goods and services seem cheaper than they actually are. The usual result is overuse by the consumers who benefit from them and extra costs for taxpayers.

For example, the commissary subsidy encourages people to purchase goods they would otherwise forgo, thus raising taxpayer costs. Hidden subsidies in the DOD's retail system also encourage the use of slot machines, alcohol, and cigarettes, as well as the overuse of gasoline.

**HEALTH CARE** The military's most expensive case of overuse is the defense health program (DHP). Today, some 9.2 million people are eligible to receive medical care through the program: 1.8 million uniformed personnel, 2.5 million family members, 3.2 million retirees and dependents under the age of 65, and 1.7 million retirees and dependents who are age 65 or older and thus eligible for Medicare.

DOD's subsidy of health care benefits for those beneficiaries significantly exceeds the subsidies civilian employers typically offer their workers or what the DOD provides its civilian employees. Active-duty members typically pay no share of the costs. Other beneficiaries pay only 12 percent of the total costs of the system through premiums and other out-of-pocket costs. In contrast, beneficiaries in the health insurance program offered to federal civilian workers pay about one-third of the cost of their program.

One result is that beneficiaries of DHP use 40 to 50 percent more health care than people in comparable civilian programs. Another result is that increasing numbers of eligible beneficiaries are migrating into the military program.

Many eligible beneficiaries of DHP have other health coverage options available to them. For example, some 80 percent of military retirees under age 65 are still in the workforce, and most of their civilian employers offer health benefits. More than half of all military spouses are employed in the workforce, where they may be eligible for individual and family coverage. In recent years, however, increasing numbers of eligible beneficiaries have shifted away from civilian options and into the defense health program. Even more troubling, civilian employers are beginning to offer cash incentives for DHP-eligible employees to turn down the civilian health care benefit in favor of the DOD's offering, thus shifting the cost burden onto taxpayers.

The mechanism behind those shifts is obvious. Beneficiaries' share of DHP costs shrank dramatically during the past decade, from about 27 percent in 1995 to 12 percent today, because of

a greatly expanded benefit for retirees of Medicare age, the elimination of some copayments, and decisions not to raise premiums after 1995. During the same decade, however, the cost to beneficiaries of civilian programs rose dramatically. As a result, many eligible beneficiaries of DHP—who in previous years would have relied on health-care coverage provided by other employers—opted into the DOD system.

The result for taxpayers is expensive. Health costs come to about \$33 billion—eight percent of DOD’s budget—in 2006, and by 2015 they can be expected to rise to \$64 billion—12 percent of DOD’s budget—absent changes in policy. Taxpayers spend 55 cents on health care for every dollar of cash compensation offered to military personnel, compared with less than 10 percent among private-sector employees.

### **CONCLUSIONS AND RECOMMENDATIONS**

Good compensation is an important part of the nation’s compact with its men and women in uniform. Compensation also constitutes a system of incentives that the armed services can use to shape the forces as needed, getting people with the appropriate skills and experience into the right jobs.

The total cost of military compensation to taxpayers in 2004 came to about \$158 billion—a substantial investment in military people. At about \$112,000 per active-duty member for a force with a mean age of about 28 years, it is crucial that taxpayers and the services get the most out of every dollar spent for pay and benefits.

In contrast to the private sector or other government employers, the nation spends a large share of its military compensation dollar for noncash benefits. Such benefits have marked advantages over cash for some members and may benefit the services as institutions to some extent. But they are extremely inefficient from an economic point of view, costing taxpayers substantially more than they are typically worth to either the individuals who receive them or the services as institutions. Their high costs are draining resources from other service priorities.

Decisionmakers should consider the following recommendations:

- Convert in-kind benefits to cash.
- Increase the beneficiary share of costs for the defense health program.
- Improve the cost-effectiveness and responsiveness of government-operated businesses providing goods and services to military personnel and families.
- Make the costs of in-kind benefits more transparent.

The most useful change would be to convert as many in-kind benefits as possible into cash benefits. Installation-centered benefits like family housing, subsidized military grocery stores, and on-base child care centers would be especially appropriate for such “cashing out.” Another area where a cash alternative would be appropriate is in the defense health program. Giving active-duty families a choice between DHP and a cash allowance would allow them to take advantage of less expensive plans while reap-

ing a cash reward, saving taxpayers hundreds of millions of dollars a year according to the Congressional Budget Office.

To stem the rampant cost growth of the DHP, the DOD should increase the premiums and copayments charged to families of active-duty members and retirees. That step would put DHP’s costs on a more equal footing with the health plans of civilian employers, potentially ending the migration of eligible beneficiaries out of their civilian plans and into DHP’s. In addition, added copayments should help to control the overuse of health care by DHP beneficiaries. Modest increases in the share of costs borne by retired beneficiaries could save billions of dollars annually, according to DOD.

To provide whatever in-kind offerings the Defense Department keeps, the nation must make its government-owned and -operated businesses more cost-effective and responsive to customers. One way to do that is to put them on a more even footing with private contractors (e.g., make them pay taxes like civilian firms) and to open their activities to private-sector competition.

In addition, both policymakers and service members need a better understanding of the costs of the benefits provided to them. The DOD provides service members with information about the total value of their compensation in a “Personal Statement of Military Compensation.” Unfortunately, service members typically find the statement confusing or not believable. The military as an institution and its members and their families would benefit greatly from a more comprehensive effort to educate individuals about what their compensation costs and how it compares with pay and benefits in the private sector.

Improving the transparency of the costs of military pay and benefits may also help policymakers understand the full costs of decisions they make about expanding the size of the military or adding new entitlements for military personnel. Recently, the Congressional Budget Office and the Government Accountability Office have provided greater clarity into the total costs of military compensation. A comprehensive annual accounting by the Office of Management and Budget of the total cost to taxpayers of military compensation could greatly improve transparency for policymakers and make it easier for experts to track the effects of policy changes. **R**

### **READINGS**

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