Budgeting and Investing in the Military Retirement Fund

by

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ABSTRACT

The Military Retirement Fund (MRF) was established in 1984 and accrual accounting procedures were adopted to manage it. Prior to 1984, military retirement was funded on a "pay-as-you-go" basis, meaning that annual appropriations from general revenues or borrowing were used to cover retirees' pensions. This thesis reviews the developments which led to the establishment of the MRF, the mechanics of the accrual accounting procedures, the procedures followed by Congress in budgeting for the MRF, and the investment plan and the securities chosen for investment of MRF funds. While the Military Retirement Fund and its accrual accounting system are not highly visible components of the DoD budgetary and funding process, their impact on retired military personnel, the DoD budget and the national debt is significant. In addition, the Military Retirement Fund and accrual accounting were instrumental in paving the way for the reform of military retirement benefits in FY 1986. An understanding of this system and the unique problems that it presents provides a valuable contribution to further understanding of the defense budget and its treatment within the congressional budget process.

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I. INTRODUCTION

A. BACKGROUND

In FY 1985, the Military Retirement Fund was created and accrual accounting procedures were adopted. The establishment of the Military Retirement Fund was part of a larger plan by Congress to transform the funding method for the Military Retirement System (MRS). The Defense Authorization Bill for Fiscal Year 1984 contains the reform legislation which became effective on 1 October 1984 and was the primary tool for transforming military retirement funding. Prior to FY 1985, the MRS was funded on a "pay-as-you-go" basis, meaning that annual appropriations from general revenues or borrowing were used to cover retirees' pensions. In FY 1985, this system was transformed into an accrual accounting system which utilized the Military Retirement Fund to accrue the cost of future retirees and operate it similar to a trust or pension fund.

Accrual accounting is a method of accounting which recognizes current liability activity which has not yet resulted in cash payments or outlays. The result is that accrual accounting can present a more accurate picture of the financial status of an organization or entity.

While the Military Retirement Fund and its accrual accounting system is not a highly visible component of the DoD budgetary and funding process, its impact on retired military personnel, the DoD budget and the national debt is significant. In addition, the Military Retirement Fund and accrual accounting were instrumental in paving the way for the reform of military retirement benefits in FY 1986. An understanding of this system and the unique problems that it presents will provide another window into understanding the national budgetary process.

B. OBJECTIVES

The purpose of this thesis is to describe and critique the system used by the Federal Government to budget for military retirement. A brief history of the military retirement system and the incentives which led to reform will be presented. The FY 1985 reform that shifted the government's approach from a system for paying retirement costs out of current revenues and borrowing, to an accrual accounting plan intended to achieve advance funding for this significant entitlement program will be explained. In addition, the investment strategy developed to accrue funds to pay future retirement costs will be described and the role of Congress in determining the funding level will be examined. As with any significant accounting change, problems and concerns have developed. This paper will attempt to gain an understanding of problems and concerns which have occurred subsequent to the establishment of the

Military Retirement Fund and as a result of downsizing, fiscal constraints and investment strategies.

C. THE RESEARCH QUESTION

The primary research question is this: "What changes were made in FY 1985 to the accounting procedures and budgetary process of the Military Retirement System and how does the new system accumulate funds to pay for future retirement costs?" Subsidiary questions to be addressed include:

- How did the Federal Government pay for military retirement costs prior to the establishment of the DoD Military Retirement Fund in FY 1985?
- What were the major changes incorporated in the establishment of the DoD Military Retirement Fund in FY 1985?
- What are the statutory requirements governing the management and operation of the DoD Military Retirement Fund?
- What actions have been taken by the DoD to implement this new system?
- When is the DoD Military Retirement Fund expected to be fully funded?
- How is money budgeted by Congress for the Military Retirement Fund?
- What is the investment strategy employed by the DoD Office of the Actuary in investing money budgeted by Congress?
- What are the problems or limits associated with the management of the DoD Military Retirement Fund from an investment perspective?
- How has the 1986 law, which decreased future retired military benefits, changed the flow of resources into the Fund?

- How have fiscal constraints and military downsizing affected the management of the Fund?
- Are other agencies or branches of government diverting assets from the Fund?

D. SCOPE, LIMITATIONS AND ASSUMPTIONS

The focus of this thesis will be on the mechanics of the accounting change in FY 1985 and the operation of the Military Retirement Fund. Special attention is given to the investment strategy associated with the operation of the Military Retirement Fund and the problems and concerns that have occurred subsequent to its establishment.

The data used in numerical presentations will be limited to FY 1992 and earlier due to the time lag in source document publication. Information related to problems and concerns of the Military Retirement Fund will be drawn from documents available in FY 1993 and earlier.

E. METHODOLOGY

This thesis is based on an examination of materials generated by the Department of Defense Office of the Actuary, studies and reports produced by government offices and private corporations, e.g., the Congressional Budget Office, the General Accounting Office, the American Enterprise Institute; federal legislation including statutory law and congressional reports, hearings and other scholarly materials such as journal articles and books that address the subject of budgeting for military retirement and investing public employee retirement funds.

While a majority of the congressional hearings and studies concern the high cost and benefits of the Military Retirement System and not accounting changes, they do provide great insight into the incentives and perceptions associated with the MRS which led to the reform.

F. DEFINITIONS AND ABBREVIATIONS

The following list of acronyms, abbreviations and definitions are provided in the interests of clarification.

Military Retirement System (MRS) - MRS is an acronym which refers collectively to the benefits and accounting aspects of military retirement pay.

Military Retirement Fund (MRF or Fund) - The Fund or MRF is a term used to refer to the federal trust fund, created by the reform in FY 1985, which accumulates resources for retiree pay.

Accrual Accounting - Accrual accounting is a method of accounting which adjusts accounts to reflect current activity which will result in actual cash or financial outlays at some time in the future.

Fund Liabilities - Fund liabilities represent the claims of military retirees on trust fund assets which will require payment in the future.

Unfunded Liabilities - Unfunded liabilities represent the future claims of military retirees on assets which do not currently exist within a trust fund. These liabilities are designated as unfunded.

G. ORGANIZATION OF STUDY

The thesis is divided into seven chapters presented as follows:

Chapter I: **INTRODUCTION**

Chapter II: **BUDGETING FOR MILITARY RETIREMENT OUT OF CURRENT RESOURCES: THE PRE-REFORM SYSTEM**

This chapter describes the legislative and funding history of the Military Retirement System. The congressional perception of the Military Retirement System and circumstances which drove the system to reform will be examined.

Chapter III. **THE ESTABLISHMENT OF THE DEPARTMENT OF DEFENSE MILITARY RETIREMENT FUND: THE REFORM OF FY 1985**

This chapter defines and examines the mechanics of the accounting reform in FY 1985. The statutory requirements which govern the fund will be explained and the effects on the DoD budget and federal accounting procedures will be examined.

Chapter IV. **CONGRESSIONAL BUDGETING FOR THE MILITARY RETIREMENT FUND**

The different methods by which Congress appropriates funds for the Military Retirement Fund will be studied. The

Military Retirement Reform Act of 1986, which reduced future retiree benefits, and the 1993 budget reconciliation process will be presented to illustrate how Congress reduces military retiree benefits to achieve deficit reduction.

Chapter V. **THE MANAGEMENT AND OPERATION OF THE MILITARY RETIREMENT FUND IN THE DOD: THE ORGANIZATION AND OPERATION OF THE OFFICE OF THE ACTUARY**

This chapter will describe the organization of the DoD Office of the Actuary. An outline of the methods by which the Office of the Actuary calculates the amounts to be transferred into the Fund will be presented as well.

Chapter VI. **THE INVESTMENT PLAN OF THE DEPARTMENT OF DEFENSE MILITARY RETIREMENT FUND**

This chapter will explain the timetable established for completing the payment on the unfunded liability, the investment strategy chosen and the securities selected for investment. Concerns over the MRF's current funding arrangement and the limits and problems associated with the Military Retirement Fund from an investment perspective will be discussed.

Chapter VII. **PROBLEMS AND CONCERNS OF THE MILITARY RETIREMENT FUND**

This chapter will describe a recent diversion of Fund assets and potential future diversions. In addition, the consequences of such diversions will be discussed.

Chapter VIII. **SUMMARY, RECOMMENDATIONS**

This chapter summarizes the findings and analysis presented, and makes recommendations for the operation of the Military Retirement Fund.

II. BUDGETING FOR MILITARY RETIREMENT OUT OF CURRENT RESOURCES: THE PRE-REFORM SYSTEM

A. INTRODUCTION

Essential in gaining an understanding of the evolution of military retirement funding is establishing a historical perspective from the origins of the system up to FY 1985, just before the accounting reform legislation became effective. This chapter will explore the legislative and funding evolution, and the pre-reform public and congressional perception of the Military Retirement System (MRS). This is the pre-reform era whereby funding for retiree pay came directly out of the general funds available to Congress on a "pay-as-you-go" basis.

B. LEGISLATIVE HISTORY

The beginnings of the United States Military Retirement System can be traced back to a British statute which, in 1593, granted compensation for disabled military members [Ref. 1: p. 5]. The Pilgrims at Plymouth Rock, in 1636, granted that a disabled soldier should be maintained by the colony for the duration of his life [Ref. 2: p. VII-1].

The early predecessors to current military retirement legislation come from statutes enacted by the Federal Congress. On August 26, 1776, the first national pension law granted half pay for life for disabled soldiers. Following the Revolutionary War, the disability amount was set at five dollars per month for noncommissioned officers and one-half pay for officers. From 1790 to 1855, legislation modified the disability system to increase the pension and include widows. [Ref. 2: pp. VII-1 & VII-2]

The first true non-disability military retirement legislation was passed in August 1861 and was designed to prompt older soldiers unfit for field duty in the Civil War, to voluntarily retire. In December 1861 and through-out 1862, additional legislation was passed that allowed for non-disability involuntary retirement of Army, Navy and Marine Corps officers with 45 years of service or at age 62. These officers were given monthly retired pay of approximately $36. While these laws allowed for involuntary retirement, they did not mandate it. [Ref 3: pp. 371-372]

From 1870 (post Civil War) to 1916, the non-disability retirement system continued to evolve and grow in legislative statutes. The significant legislative changes which occurred during this period are listed below. [Ref 2: pp. VII & VII-3]

- Retired pay formula based on active duty salary system.
- Mandatory officer retirement at age 64.
- Voluntary officer retirement after 30 years with 75 percent pay plus allowances.
- Enlisted retirement at 30 years with 75 percent pay plus allowances.

In 1916 legislation was passed which is the foundation of the current retirement system and has changed only slightly. The law integrated an officer "up-or-out" selective promotion plan with a monthly retirement formula. The monthly formula is as follows: 2.5 percent times the number of years of service up to 30, times the final monthly basic pay, or a maximum of 75 percent of basic pay. The law also established the enlisted Fleet Naval Reserve which by 1946 had adopted a 20 year minimum and the standard 2.5 percent formula which the officer program used. An Army reduction in strength in 1922 utilized the retirement system to help achieve its endstrength goals. Officers with as little as 10 years of service were chosen for retirement and received the standard formula of 2.5 percent of basic pay times years of service up to 75 percent of basic pay. Those officers with over 20 years of service, had a modified retirement formula which replaced the 2.5 percent multiplier with 3.0 percent. [Ref. 3: pp. 373,374]

Another early retirement program was authorized for the Army in 1935 to reduce a surplus of officers from World War I. Army officers with at least 15 years service were authorized to voluntarily retire with the standard 2.5 percent of basic pay formula. Other than its suspension during World War II, it remained in effect until 1948. [Ref. 3: p. 374]

By 1938, post World War I overmanning in the Navy resulted in legislation which allowed for officer retirement after 20 years of service. This eventually became the model for all the services and the current system.

From 1938 to 1984 significant events which helped mold the pre-reform system are listed below. [Ref. 2: p. VII-12 to VII-17]

- Mandatory retirement at age 62.
- The 20 year voluntary retirement was made available to Army and Air Force officers and enlisted.
- More stringent promotion/mandatory retirement standards.
- Reserve and National Guard added to retirement system.
- Retired pay adjustment procedures (recomputation) replaced by cost-of-living adjustments (COLAs).
- Modified retirement formula for those who entered service after September 8, 1980. Average of the highest three years of service is used instead of terminal pay in computing monthly retirement amount.

While not an aspect of the benefits legislation, Public Law 95-595 was passed in November 1978 and required that an actuarial statement be furnished to Congress with respect to military retirement. [Ref 4: p 1].

In 1983, Public Law 98-94 was passed. This law contains the accounting reform legislation which went into effect in FY 1985 and established accrual accounting and the Military Retirement Fund. The details of this significant accounting change will be fully explored in chapter three.

While they are a smaller component of the retirement system, the disability and survivors benefits programs are considered an integral part of the MRS. The disability retirement program evolved concurrently with the non-disability retirement program and its entitlements are based upon a standard schedule of disabilities established by the Veterans Administration. In like fashion, the survivors program evolved and became the Survivor Benefit Plan which was established in 1972, the substance of which is still in effect today. [Ref. 5: pp. 1-5]

The composition of MRS recipients is depicted in Figure 2.1. As of 1984, the recipients were largely non-disability

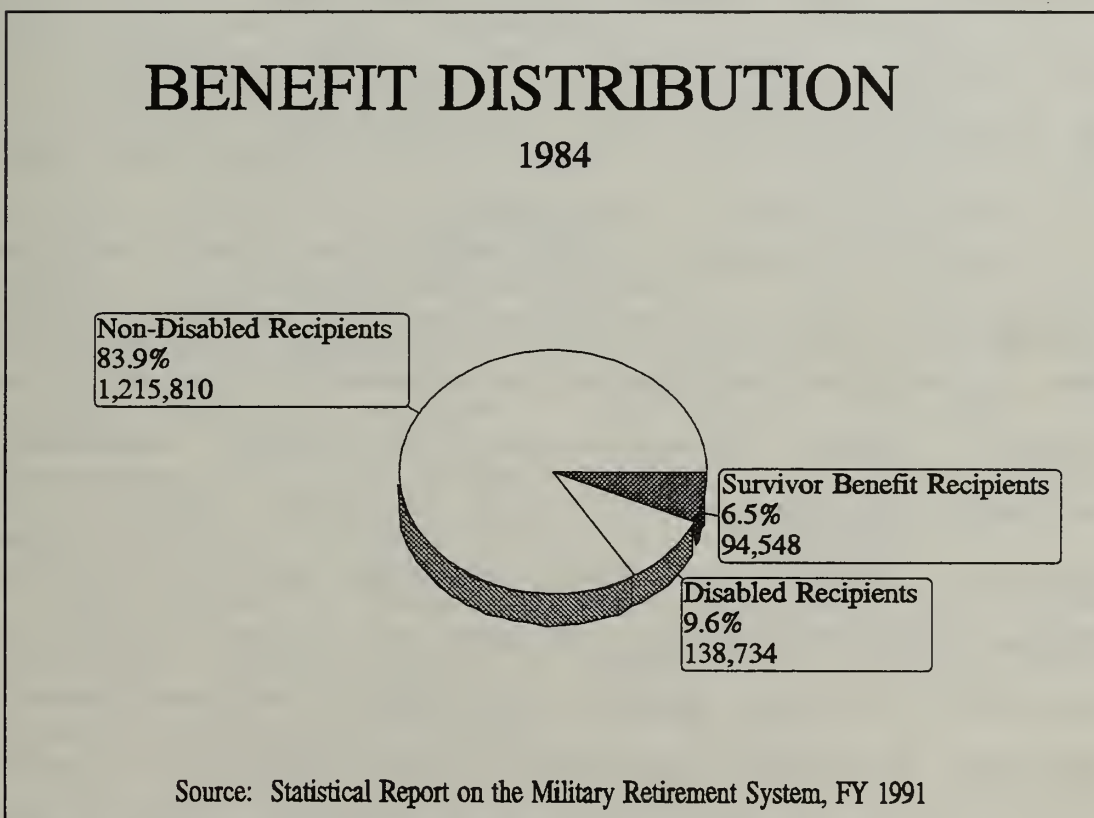

Figure 2.1 Benefit Distribution

recipients (83.9 percent), followed by disability recipients (9.6 percent) and survivor recipients (6.5 percent). [Ref. 5: p. 18]

C. FUNDING HISTORY

Initially, funds for the military disabled were provided for by the States. The Act of April 30, 1790 (1 Stat. 121) instituted the Secretary of War as the principal pension administrator [Ref 2: p. VII-1].

For a period of time, the Navy provided disability payments out of a pension fund. The income to the fund consisted of the proceeds from captured enemy or pirate ships and interest on these assets. This fund was abolished in 1935 and the MRS moved fully into an unfunded basis. [Ref 6: p. B-6].

With the exception of the Navy trust fund, which was abolished in 1935, the funding method for the MRS prior to FY 1985 can best be described as an unfunded or "pay-as-you-go" method. Annual appropriations from general revenues or borrowing were provided to cover retirees' pensions. The outlays to retirees were wholly dependent upon money obtained through taxes and the sale of government bonds. Under "pay-as-you-go" funding, payments to eligible retirees were not dependent on whether sufficient funds existed in a pension fund, but upon the legislation authorizing payments and the funds obtained through taxes and borrowing.

The most practical way of understanding the flow of funds to retirees prior to FY 1985 is through appropriation title. The budget process depicted in Figure 2.2 is described below. Under the Department of Defense budget (budget sub-function 051), five major appropriation titles existed: Military Personnel (MILPERS), Retired Military Personnel, Operations and Maintenance (O&M), Procurement, and Research, Development, Test and Evaluation (RDT&E) [Ref 7: p. 9-20].

The first step occurred when the Department of Defense submitted its annual budget which it had derived via the Planning Programming Budgeting System (PPBS). Within the annual defense budget submitted to the President was the Retired Military Personnel account request, along with the other major appropriation accounts. The annual budget was then incorporated into the President's Budget and submitted to Congress. Upon approval by Congress, in the form of annual appropriations, the DoD was granted the obligational authority to pay military retirees. Throughout the year, the disbursement of these monies would occur via the Treasury. [Refs. 2,8: pp. VII-19 & VII-20, pp. B-4 to B-8]

This method of budgeting and paying for the Military Retirement System remained in effect until modified by the accounting reform in FY 1985.

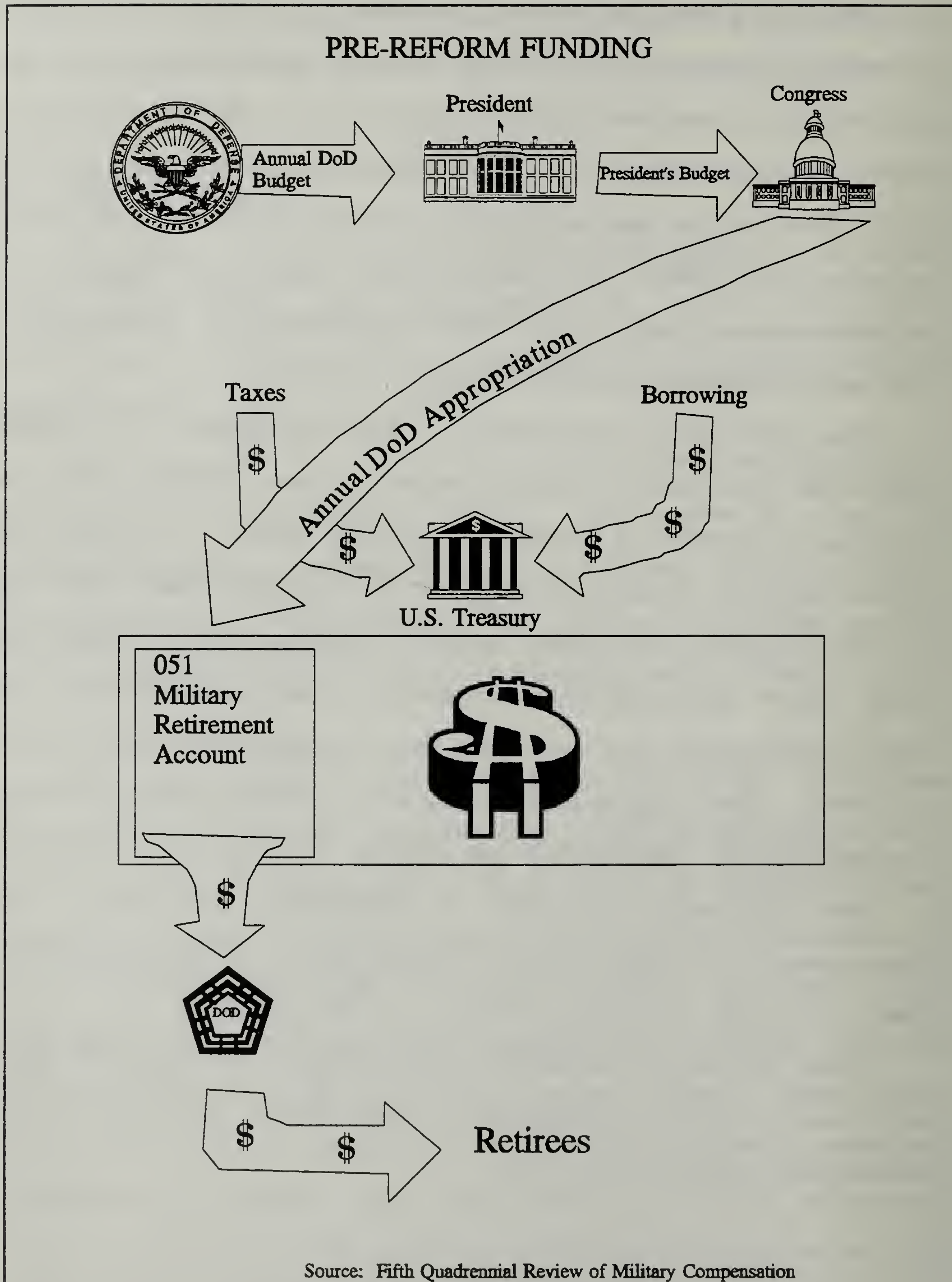

Figure 2.2 Pre-Reform Funding

D. PRE-REFORM PERCEPTIONS

> But I think it is important we do make some kind of calculation, Mr. Chairman, that we somehow figure out, rather than throwing up our hands and saying it is an impossible task, that we just don't know what these numbers are. We have to make some kind of an estimate to see really what we are going to be doing to future defense budgets if we pass these things (military retired pay recomputation).
>
> Les Aspin, 4 October 1974

> The military retirement system is wasteful in dollars and human resources.
>
> The President's Commission on Military Compensation, 1978

> Is it fair to millions of taxpayers who don't collect military pensions that we pay so much retired pay to so many retirees who aren't retired at all? This may be the ultimate special interest boondoggle. And there are more than 900,000 lobbyists working hard to see that this elite of unretirees keeps getting its subsidy.
>
> Les Aspin, 4 April 1983

> There probably is no other retirement system which is as liberal and costly as the U.S. Military Retirement System.
>
> Grace Commission, 1984

As can be seen from the above comments, the MRS had come under sharp criticism and scrutiny in the seventies and early eighties. Over a 15 year period prior to the accounting reform in FY 1985, there had been nine major proposals to revamp military retirement benefits [Ref. 9: p. 623]. As depicted in Figure 2.3, DOD retirement outlays had grown from $3.5 million in 1940 to $16.4 billion in 1984 [Ref. 5: pp. 12,13]. It was for good reason Congress and others were concerned with cost. Congress became increasingly convinced that the MRS was too costly and as then-Representative Les

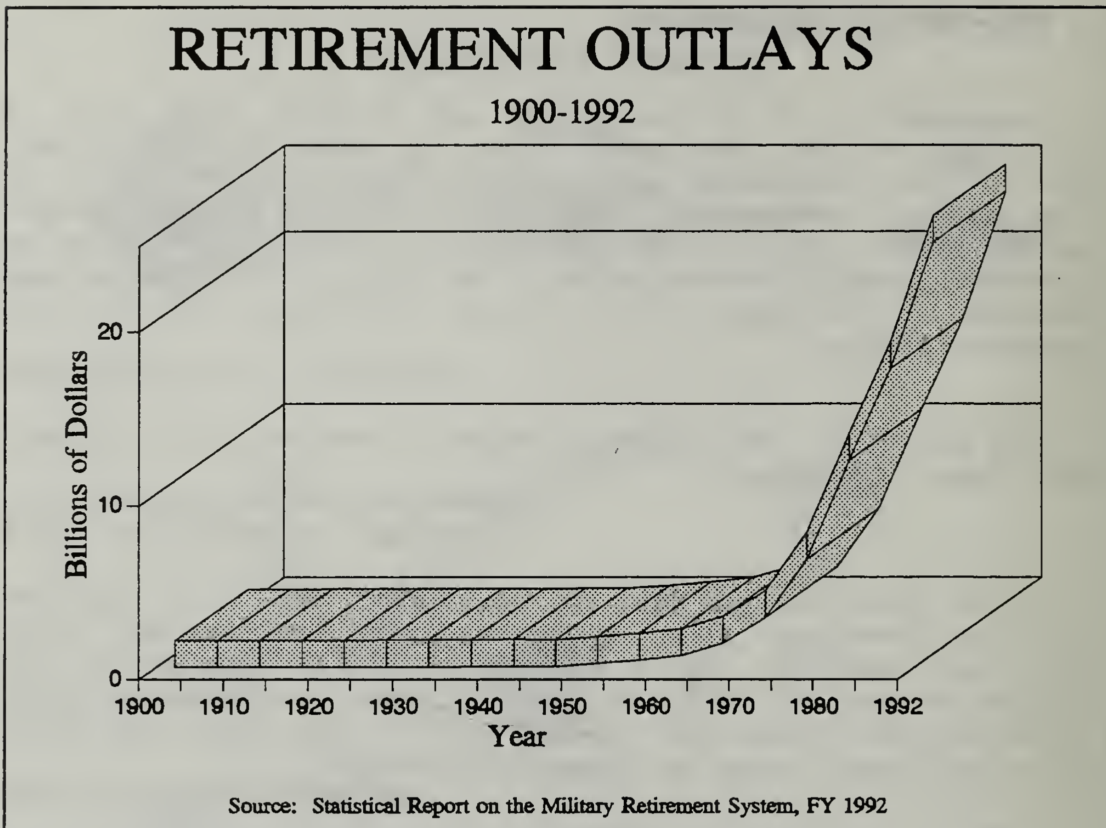

Figure 2.3 Retirement Outlays

Aspin cogently stated, there was no definitive way to come to grips with the impact of the unfunded liability created by the MRS. The projections were that it would continue to increase. As a percent of the DoD budget, retirement costs had increased from 1 percent in 1954 to 7.4 percent in 1984 [Ref 7,10: p. 9-25, p. 506].

The increase was largely attributed to four factors. These factors were: (1) a large increase in the retired population which, as depicted in Figure 2.4, had grown from 3,029 in 1900 to 1.3 million in 1984 [Ref 5. pp. 8-13]; (2) increase due to Consumer Price Index (CPI) inflation; (3)

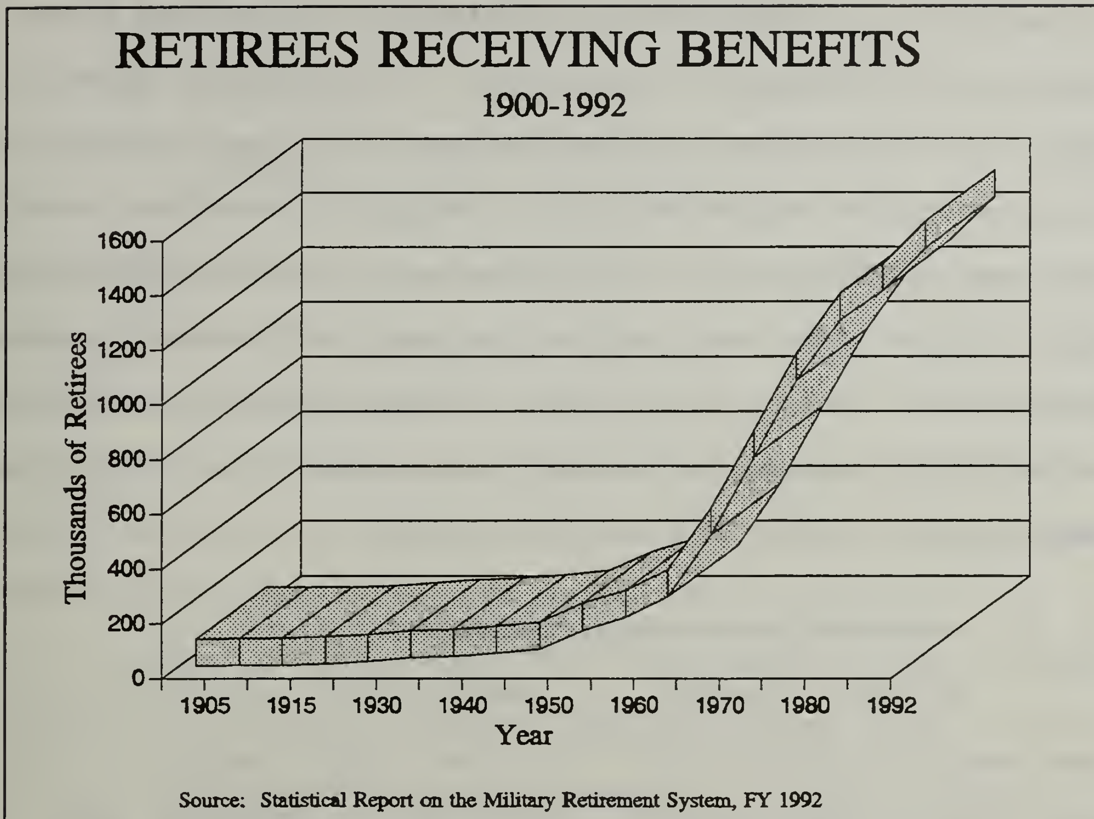

Figure 2.4 Retirees Receiving Benefits

increase due to basic pay (retired pay base); and (4) increase due to retired Cost of Living Allowance (COLA) increase. [Ref 11: p. F-1]

In addition to the perception that the MRS was too costly, a view was rapidly gaining acceptance that the MRS was outdated in two less publicized but still significant areas.

1. Lack of a Formal Pension Fund

In 1974 the Employees Retirement Income Security Act (ERISA) was passed. This act required that private pension plans prefund their retirement obligations and amortize the unfunded liabilities over a specific period of time. The intent behind this was to provide for stable and dependable retirement programs in the private sector. While the government had mandated that the private sector prefund retirement obligations, Congress was more hesitant about applying the same standards to federal retirement programs. The lack of federal conformity to ERISA repeatedly surfaced and by 1983 Congress was earnest about establishing a military pension fund. [Ref. 12: pp. 112,154,181]

2. Outdated Accounting Procedures

Arthur Andersen & Company, an accounting firm, completed a study in 1975 of Federal Government accounting practices. This report reinforced to Congress that the accounting procedures of the MRS were, as in the case of other federal pension plans as well, outdated and in need of change. The quotes detailed below succinctly make this point. [Ref. 13,14: pp.1,2, p. 1]

> ...all too often, the financial statements of government units have proven to be less than adequate for providing basic financial information.
>
> Arthur Andersen & Company, 1975

> Accrual accounting should be adopted. This was recommended by the Hoover Commission and is required by Public Law 84-863, which was passed in 1956.
>
> Arthur Andersen & Company, 1975

E. THE IMPACT OF CONGRESSIONAL PERCEPTIONS

Fully cognizant of the negative reports on the MRS, Congress became intent on coming to grips with the high costs of the retirement system. In addition, a proposal by the Carter Administration in April 1978 recommended that Congress change the accounting procedures for the MRS. The Administration's proposal for a trust fund and accrual accounting were similar to those recommended by ERISA and Arthur Anderson & Company and would provide a significant update to its accounting procedures.

In order to understand the true cost of the unfunded liability created by the MRS, Congress passed Public Law 95-595 in November 1978 which required that a financial and actuarial statement of the MRS (as well as other federal pension systems) be furnished to Congress. Actuarial and financial statements are logical steps in preparing for a pension fund. An actuarial statement provides the mortality rates for a given population. Using this information, a financial statement could then be prepared which would show the unfunded liability of a pension plan. The reasoning behind this can be seen from Les Aspin's comments. Documents which would show the actual cost of military retirement on future years would be invaluable in understanding the effects of benefit increases or decreases.

F. SUMMARY

The MRS had grown tremendously in legislation and benefits since its inception during the early history of the United States. By 1983, numerous independent studies of the MRS had been completed and the vast majority of them claimed the MRS was overly generous and even prodigal. Congressional perception of the MRS as too costly and its accounting procedures as outdated became more concrete and Congress positioned itself for change by requiring actuarial and financial statements. By 1983 the MRS was ripe for reform in both accounting procedures and benefit generosity.

III. THE ESTABLISHMENT OF THE DEPARTMENT OF DEFENSE MILITARY RETIREMENT FUND: THE REFORM OF FY 1985

A. INTRODUCTION

The creation of the Department of Defense Military Retirement Fund was the result of pressure to raise cost awareness and to update accounting procedures in the Military Retirement System. This chapter will discuss the precursors to the actual legislation and explain the accounting changes and budgetary impact brought about by the accounting reform in FY 1985.

B. LEGISLATIVE PRECURSORS

In April 1978, the Carter Administration proposed for FY 1979 the establishment of a retirement fund, accrual accounting and changes in retirement benefits for the military. The proposals for the retirement fund and accrual accounting were largely accepted by the House Armed Services Committee and H. R. 12392 was introduced. This bill, as well as a 1979 follow on, H.R. 3261, never made final passage. [Refs. 14,15: p. 1, p. 63]

On April 16, 1980, Les Aspin dropped into the hopper his proposal titled "Uniformed Services Non-Disability Retired Pay Reform Act". This proposal contained legislation for a retirement fund, accrual accounting and a major rewrite of retirement benefits. This bill also never made final passage and as Les Aspin's quote (below) predicted, raised the atmosphere of distrust for Congress by service personnel. [Ref. 16: pp. 8115-8117]

> I realize that I have been labeled a Pentagon critic and some think I am anti-military and out to 'get' the serviceman. Since this bill is not in the usual tradition of increasing benefits, I am certain it will only increase that feeling.
>
> Les Aspin, April 16 1980

By 1983, two more proposal were in the works. The first one, forwarded by the Reagan Administration, had largely adopted the Carter Administration's proposals less the benefits modifications. The second proposal was another House Armed Services Committee proposal sponsored by Les Aspin. The two proposals differed only in the technical aspects of the retirement fund. In addition, these proposals addressed only the retirement fund and accrual accounting and saved the battle over retirement benefits for another day. [Ref. 9,17: p. 3, pp. 9,10]

The House Armed Services Committee version prevailed and on Sept 24, 1983, Congress passed Public Law 98-94, also cited as the "Department of Defense Authorization Act, 1984". Under section 925 is the legislation that amended Title 10, United States Code by adding chapter 74 and established the Department of Defense Military Retirement Fund. [Ref. 18: §§ 1461-1467]

C. THE DEPARTMENT OF DEFENSE MILITARY RETIREMENT FUND

The purpose of the Military Retirement Fund is laid out straightforward by the federal code.

> There is established on the books of the Treasury a fund to be known as the Department of Defense Military Retirement Fund (hereinafter in this chapter referred to as the 'Fund'), which shall be administered by the Secretary of the Treasury. The Fund shall be used for the accumulation of funds in order to finance on an actuarially sound basis liabilities of the Department of Defense under military retirement and survivor benefit programs.
>
> 10 U.S.C. § 1461

The Fund was given a budget sub-function code of 602 under the Income Security Group (function 600). Outlays from the Fund are therefore contained outside of the defense function (050) and the DoD military budget. However, when the national budget is listed by agency, the Fund is listed under the Department of Defense-Civil [Ref. 19: p. Appendix-525]. The net result is that outlays from the Fund are contained outside the defense function, but there is also a recognition that Fund outlays are attributed to the military. The Fund and its accrual accounting system became effective on 1 October 1984 (FY 1985). The assets of the Fund come from three sources as depicted in Figure 3.1 and as detailed in the below sub-sections. [Ref. 17: pp. 2-11]

1. Funds Received by the Department of Defense

The Secretary of Defense is required to pay into the Fund at the end of each month a contribution designed to fund the future retirement liability created by military personnel

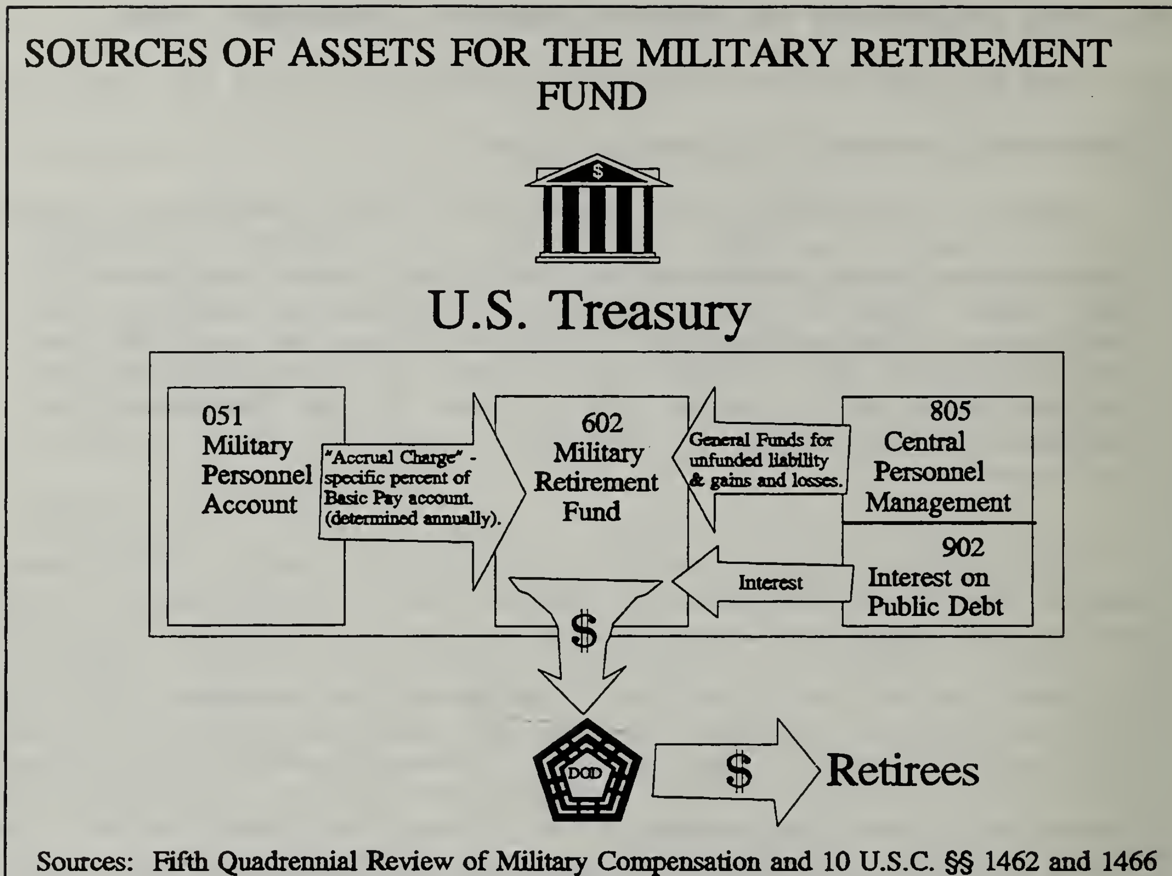

Figure 3.1 Sources of Military Retirement Fund Assets

currently on active and reserve duty [10 U.S.C. § 1466]. This contribution to the fund is referred to as the "retirement accrual charge" or "normal cost" of the Military Retirement System. This contribution is computed, using actuarial techniques, as a percentage of the total basic pay paid that month to members of the armed forces (the U.S. Coast Guard is under a separate retirement system). In FY 1985, this number came to approximately 51 percent of basic pay. In FY 1992, the normal cost was 40 percent of basic pay due to changing economic assumptions and modifications in benefits for future retirees. In order to pay for this retirement accrual charge for current active and reserve forces, Congress increases the annual appropriation account for military pay by what ever percent is determined necessary to fund the future liability of retirees. [Ref. 3,6: p. 604, pp. 18,19]

The effect on the DoD Military Personnel (pay and benefits) account can be seen in Table 3.1 based upon the FY

TABLE 3.1 ACCRUAL CHARGE IMPACT ON MILITARY PAY ACCOUNT

Accrual Charge Impact FY 1983-1985
(FY 1984-1985 estimates)

(outlays in millions of dollars)

	1983	1984	1985
051 DoD-Military Military Personnel	45,523	48,040	67,324

Source: President's Budget FY 1985

1985 President's Budget. The FY 1985 budget is an ideal year to capture the impact on the Military Personnel account since it shows the two years before the change and the year the accrual charge was to take effect. President's Budgets submitted after FY 1985 recompute the Military Personnel account to include the accrual charge. As Table 3.1 shows, the difference between FY 1984 and FY 1985 is approximately $19 billion. Of the $19 billion, two billion was for pay raises and $17 billion was transferred to the Military Retirement Fund (sub-function 602). The $17 billion is 51 percent of the basic pay account but only 35 percent of the Military Personnel account since basic pay is only a part of the entire pay and benefits a service member receives. [Ref. 7: p. 9-25]

2. Funds Received from the U.S. Treasury

At the beginning of each fiscal year, the Secretary of the Treasury pays into the Fund an amount certified by the Secretary of Defense. These assets, which are General Government funds, are transferred by the Secretary of the Treasury from the Central Personnel Management account (sub-function 805) to the Military Retirement Account (sub-function 602). [10 U.S.C. § 1466]

The purpose of these funds is to amortize the original unfunded liability of the Military Retirement System and account for cumulative gains and losses to the MRF. The original unfunded liability is the money needed to pay for the retirement cost of members of the armed services for their service prior to FY 1985. This is a group of service personnel that contains both active and retired personnel. [10 U.S.C. § 1465] The original unfunded liability was determined to be $528.7 billion and is currently being amortized over 60 years [Ref. 3,6: p. 604, p. 12]. Gains and losses to the Fund result as a consequence of changing benefits, actuarial assumptions and experience changes[1]. These gains and losses are amortized and added to or subtracted from the unfunded liability payment to make the annual Treasury payment [Ref 6: pp. 12, O-10].

Prior to FY 1985, the unfunded liability was being paid by the Retired Military Personnel account on a "pay-as-you-go" basis. Once the Fund was established, the Retired Military Personnel account was phased out and funds for retirees are now being paid out of the Military Retirement Fund. The effect on these accounts is highlighted by Table 3.2.

TABLE 3.2 EFFECT ON RETIRED PAY ACCOUNT

IMPACT ON RETIRED MILITARY PAY ACCOUNT
(1984 and 1985 estimate)

(outlays in millions of dollars)

	1983	1984	1985	1986
051 DoD Military Retired Pay	15,941	16,505	20	---
602 Military Retirement Fund	----	---	17,245	17,622

Sources: President's Budget FY 1985 - 1987 and the DOD Statistical Report On The Military Retirement System FY 1991

[1]Gains and losses as well as the unfunded liability will be discussed in greater detail in Chapters V. and VI.

3. Funds Received as Interest on Assets

The third source of assets for the Fund is the interest earned by the Funds's resources. This is clearly laid out by the federal code.

> The Secretary of the Treasury shall invest such portion of the Fund as is not in the judgment of the Secretary of Defense required to meet current withdrawals. Such investments shall be in public debt securities with maturities suitable to the needs of the Fund, as determined by the Secretary of Defense, and bearing interest at rates determined by the Secretary of the Treasury, taking into consideration current market yields on outstanding marketable obligations of the United States of comparable maturities. The income on such investment shall be credited to and form a part of the Fund.
>
> 10 U.S.C. § 1467

When interest is earned from the securities held by the Fund, the interest is transferred from the Treasury's account titled "Interest on Public Debt" (sub-function 901) into the Fund (sub-function 602).

D. THE BOARD OF ACTUARIES

> There is established in the Department of Defense a Department of Defense Retirement Board of Actuaries (hereinafter in this chapter referred to as the 'Board'). The Board shall consist of three members, who shall be appointed by the President from among qualified professional actuaries who are members of the Society of Actuaries.
>
> 10 U.S.C. § 1464

To provide oversight of the Fund, Congress provided for this independent Board appointed by the President and serving for 15 years. The Board has several functions which are listed below.

- Report to the Secretary of Defense annually on the actuarial status of the Fund.

- Report at least every four years to the President and Congress on the status of the Fund.

- Approve all actuarial methods, assumptions and amortization schedules used in determining the DoD contribution to the Fund.

- Approve all actuarial methods, assumptions and amortization schedules used in determining the amount given to the Secretary of the Treasury to meet the unfunded liability amortization.

In fulfilling their role as independent actuaries, the actuaries work closely with the Department of Defense Office of the Actuary. This office produces the annual DoD Statistical Report On The Military Retirement System and the annual Valuation Of The Military Retirement System. All data used by the Board are draw from these two offices and their records. [10 U.S.C. § 1464]

E. SUBSIDIARY ACCOUNTING CHANGES

The accounting changes which provide for fund transfers from Military Personnel (sub-function 051), Central Personnel Management (sub-function 805), and Interest on Public Debt (sub-function 901) into the Military Retirement Fund (sub-function 602) produce a chain reaction of subsidiary accounting transactions. The reason for these subsidiary accounting transactions is to prevent double counting in the unified budget. For example, when funds (budget authority) are transferred from the Military Personnel account to the

Fund, it is charged against the Military Personnel account (hence U.S. Treasury) as an outlay. In reality, this is not a federal outlay since the transfer is intragovernmental. To compensate for this outlay and prevent double counting, offsetting receipts are created in another account [Ref. 7,17: pp. 9-20 to 9-27, pp. 12,14]. In addition, when the Fund purchases a security and the Treasury sells the security, this also is considered an intragovernmental transfer [Ref. 6: p. 16]. Table 3.3 demonstrates how offsetting receipts are implemented to prevent double counting in the unified budget.

F. PAYMENTS FROM THE FUND

The assets of the Fund are available to three basic groups of retirees.

- Personnel on the retired list of the Army, Navy, Air Force and Marine Corps and the Fleet Reserve and Fleet Marine Corps Reserve list.
- Survivors of Members of the armed forces.
- Former members (disabled) of the armed forces.

These assets are transferred from the services via the Fund, to eligible retirees.

G. IMPACT ON BUDGET OUTLAYS

The establishment of the Fund and its accrual charge has served to decrease outlays in the defense function. When the DoD assumed responsibility for the retirement accrual charge,

TABLE 3.3 OFFSETTING RECEIPTS

OFFSETTING RECEIPTS			
Intragovernmental Transfer			Offsetting Receipt
051 Military Pay $1	⇒⇒⇒	602 Military Retirement Fund $1	951 Undistributed Offsetting Receipts -$1
805 Central Personnel Management $1	⇒⇒⇒	602 Military Retirement Fund $1	809 Deductions for Offsetting Receipts -$1
901 Interest on Public Debt $1	⇒⇒⇒	602 Military Retirement Fund $1	902 Interest Received by Trust Funds -$1

Sources: President's Budget FY 1993 and the Congressional Budget Office

the Military Retired Pay account was eliminated and the responsibility was transferred to the U. S. Treasury (Central Personnel Management) and the Income Security Group (Military Retirement Fund). The actual difference to the DoD budget can therefore be determined by comparing the DoD accrual charge to the cost of actual outlays from the Fund. The difference that the accounting reform has made for the DoD budget function is summarized by Figure 3.2.

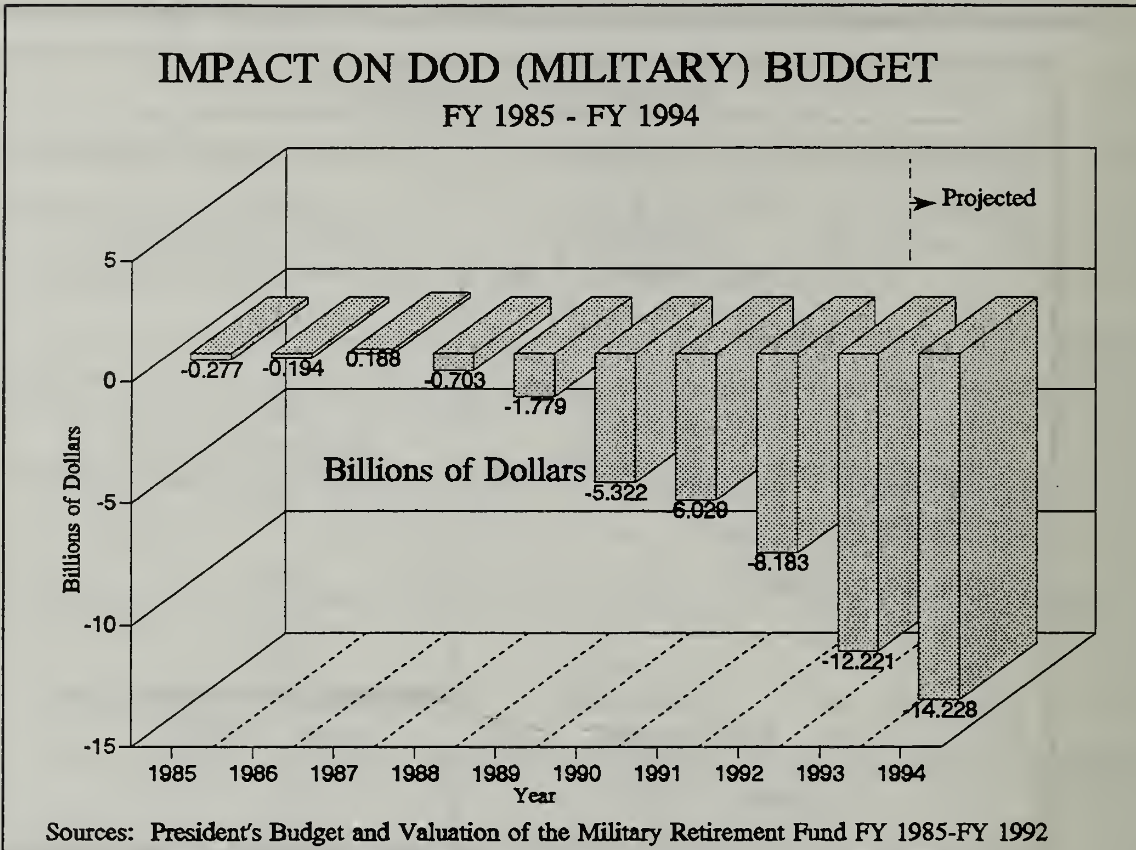

FIGURE 3.2 Impact On DoD (military) Budget

These decreases are largely attributed to military downsizing and the FY 1986 reduction in future retiree benefits. These two factors reduce the monthly accrual charge that the military must pay for current service members.

Because the accrual charge immediately responds to the number of personnel in the DoD and any retirement benefit changes, the visibility of defense manpower decisions--and the incentive to economize on manpower--is increased [Ref. 14,17: p. 15, pp. 10,11]. Under the pay-as-you-go system, retirement costs were not necessarily considered for new service members since the cost did not show up for another 20 or more years.

Under the current system, policymakers now automatically consider the impact of future retirement costs when they make manpower decisions [Ref. 6: p.18]

It is significant to note, however, that the Fund makes no difference on unified budget outlays. Outlays to retirees are unchanged by the creation of the Fund and the intragovernmental outlays supporting the Fund are compensated by offsetting receipts. What is changed, is the national debt which has increased by the amount of assets contained in the Fund. The assets in the Fund are federal debt instruments and thus increase the federal debt through the Fund's recognition of MRS liabilities.

H. SUMMARY

The Military Retirement Fund became effective in FY 1985 and serves to pay for the costs of military retirement. The accounting reform arranges the cost of military retirees into two separate categories. The normal cost of future retirements is given to the DoD and the cost of the original unfunded liability is given to the U.S. Treasury. To deal with intragovernmental fund transfers, offsetting receipts were incorporated for both of the above costs and interest on the Fund's assets. While the Military Retirement Fund has no direct effect on federal outlays, it has raised the federal debt, decreased defense function outlays, increased outlays from the Treasury's General Fund and increased the awareness and visibility of DoD manpower decisions.

IV. CONGRESSIONAL BUDGETING FOR THE MILITARY RETIREMENT FUND

A. INTRODUCTION

> "...no money shall be drawn from the Treasury but in consequence of appropriations made by law...
> Article 1 Section 9, U.S. Constitution

While the Constitution states that money drawn from the Treasury must be appropriated by Congress, there are varying methods by which Congress can appropriate money for government functions. This chapter presents the current funding flow and the different methods by which Congress appropriates money for the Military Retirement Fund and military retirees. The Military Retirement Reform Act of 1986, which reduced future retiree benefits, will be explained. In addition, the 1993 budget reconciliation will be presented in detail as an example of how Congress reduces Military Retirement Benefits (MRB) to achieve deficit reduction.

B. ANNUAL APPROPRIATIONS

An appropriation creates obligational or budget authority to fund authorized programs or functions. Programs which fall under the annual appropriation process must be appropriated each year in order to sustain their funding [Ref. 20: pp. 46,47]. Annual appropriations are mostly made up of discretionary spending. Because the military's retirement accrual charge is linked to the Military Personnel account, which is under the annual appropriation process, the accrual charge for retirement funding also goes through the annual appropriation process. This can be seen in Figure 4.1 which shows the overall funding flows and the various appropriations for the Fund.

The legislation which provided for the Military Retirement Fund makes it clear that the accrual charge should go through the annual appropriation process.

> The Secretary of Defense shall determine each year, in sufficient time for inclusion in budget requests for the following fiscal year, the total amount of Department of Defense contributions to be made to the Fund during that fiscal year under section 1466(a) of this title.
>
> 10 U.S.C § 1465

Because funds for the Military Personnel account are largely based on legislation governing pay and allowances, Congress cannot change the level of funding for personnel pay and allowances without changing the laws governing them. If Congress lowered funding for the Military Personnel Appropriation, it would also have to change the laws which mandate a specific pay level for service members. In this sense, the Military Personnel appropriation can be considered an entitlement.

However, because the Military Personnel appropriation is a function of endstrength and pay levels, which must be authorized annually, the Military Personnel appropriation must also be appropriated annually. And in this sense, this

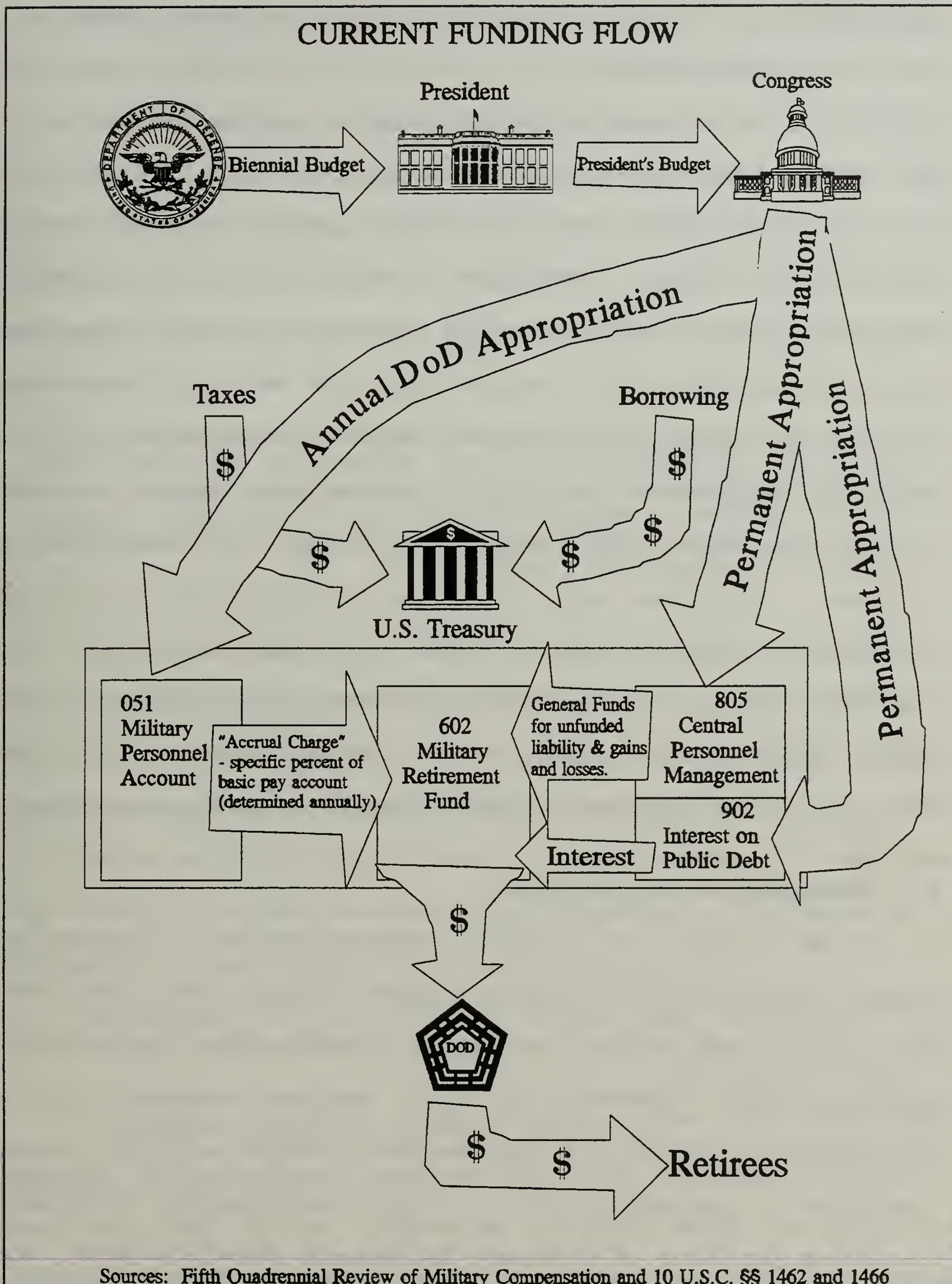

Figure 4.1 Current Funding Flow

appropriation--like the remainder of the defense budget--is entirely discretionary.

The annual appropriation process for the MRF is similar to that which existed prior to the accounting reform in FY 1985. The first step occurs when the Department of Defense submits its biennial budget, derived via the Planning Programming Budgeting System (PPBS). Within the defense budget submitted to the President is a request for the Military Personnel account, a specified portion of which is designated for the Military Retirement Account. The defense budget is then incorporated into the President's Budget and submitted to Congress. Congress authorizes the DoD endstrength and pay adjustments and then appropriates the funds associated with the endstrength for the Military Personnel account. The annual appropriation grants DoD budget authority to make monthly accrual payments into the MRF for service personnel.

C. PERMANENT APPROPRIATIONS

As an alternative to annual appropriations, Congress can create legislation which makes budget authority available each year without new action required by Congress [Ref. 8: p. C-8]. Appropriations created by this method account for a considerable portion of the federal budget and are termed "permanent appropriations". Many entitlement programs, including portions of Military Retirement Benefits (MRB), are funded through permanent appropriations [Ref. 20: p. 49]. The two large arrows on the right side of Figure 4.1 identify the permanent appropriation flows going into the MRF.

The cost of the original unfunded liability for military retirement is funded through permanent appropriations. When general funds (budget authority) are transferred from the Treasury to the Military Retirement account, no annual appropriation is required, as inferred by federal statutory law:

> ...the Secretary of the Treasury shall promptly pay into the Fund from the General Fund of the Treasury the amount certified to the Secretary by the Secretary of Defense under paragraph (3). Such payment shall be the contribution to the Fund for the fiscal year...
>
> U.S.C. Title 10 Chapter 74, § 1466

Because actual cash outlays from the Fund to retirees consist of funds received through annual and permanent appropriations, Congress saw no point in requiring further appropriations and simply made the assets of the Fund available to eligible retirees. In this sense, assets from the Fund pay out as permanent appropriations. The below quote reflects congressional intent on this issue:

> The assets of the Fund are hereby made available for payments under subsection (a).
>
> 10 U.S.C. § 1463

One other permanent appropriation goes into the Fund, namely, the interest received from the Treasury securities held as Fund assets. Because interest must be paid and federal interest costs will fluctuate as interest rates change, Congress has determined that it would be pointless to appropriate for this purpose every year. Therefore, Congress created legislation which permits interest payments to be made without requiring annual appropriations. [Ref. 21: p. CRS-5]

While the above paragraphs describe the different appropriations which fund the MRS, they also reveal that Congress has different options and appropriation channels to choose from should it become necessary to reduce retirement outlays as part of a larger effort to reduce spending to lower the deficit.

D. THE MILITARY RETIREMENT REFORM ACT OF FY 1986

As detailed in the previous section, Congress can target annual or permanent appropriations to achieve savings in the portion of annual spending devoted to military retirement. In 1986, Congress focused on reducing MRB costs by reducing the annual appropriation flow into the Fund.

After the accounting reform in FY 1985, Congress continued the battle over the high cost of the MRS. Because of the accounting reform, the accrual charge (normal cost) could be targeted separately from the payment for current retirees. One consequence of this separation was to increase the political feasibility of cutting payments for military retirees. [Ref. 9: p. 623]

On April 4, 1985, then-House Armed Services Committee Chairman Les Aspin opened the debate by calling for a four billion dollar cut in the President's $18 billion request for future military retirees. The Pentagon was required to come up with proposals to change current legislation to accommodate Aspin's cut. Furthermore, Congress wanted the cuts to have a "grandfather" clause which would protect those currently retired or about to retire. The cut was supposed to immediately reduce outlays in the defense function because it was to target (reduce) the accrual charge going into the Fund by changing future retiree benefits. However, it would be many years before the unified budget would see the reductions because those already retired and those who entered military service prior to 1 August 1986 would not be affected. [Ref. 9: p. 623]

The result of the drive to reduce retirement costs was the Military Retirement Reform Act of 1986 (Public Law 99-348). While the initial impact on the DoD budget was modest, the impact over the long run produces significant savings.

The means by which the Retirement Reform Act of 1986 achieves its savings is by reducing two elements of retirement benefits for those entering military service on or after 1 August 1986.

1. Penalty for Years Less Than 30 Retirement

Those entering military service on or after 1 August 1986, and who retire with fewer than 30 years of service, receive a temporary penalty until age 62. Monthly retired pay is computed by multiplying terminal basic pay or the average of the last three years (for those who entered after September 8, 1980) of basic pay times a multiplier. The multiplier prior to 1986 was as follows: 2.5 percent times the number of years of service up to 30. For retirees entering the military service after 1 August 1986, the multiplier is reduced by one percentage point for each full year under 30. For example, the multiplier for a 20 year retiree is 40 percent (50 percent minus 10 percent) as compared to 50 percent under the old system. At age 62, their retired pay is recomputed without the penalty. [Refs. 5,6: p. 2, p. A-2]

2. Cost of Living Reductions

Retirees who entered prior to 1 August 1986 typically receive an annual COLA based upon the Consumer Price Index (CPI). This is commonly referred to as full CPI protection. The Retirement Reform Act of 1986 altered this, so that Retirees first entering military service on or after 1 August 1986 receive the annual full CPI increase minus one percent. At age 62 the benefits are restored to the amount that would have been payable had full CPI protection been in effect. After this restoral, partial indexing (CPI minus 1 percent) continues annually. [Ref 5: p. 1]

E. THE EFFECTS OF THE MILITARY RETIREMENT REFORM ACT OF 1986

When the Senate Armed Services Committee forwarded the bill containing the substance of the Military Retirement Reform Act, the Committee expressed its intent to bring to a conclusion the controversy and strife over the appropriate level of military retirement pay.

> The continuing uncertainty about the future of military retirement benefits has undermined morale in the Armed Services, led many of our fine young men and women in uniform to pursue careers elsewhere, and created an atmosphere of distrust for the Congress by our service personnel. It may well be that this uncertainty has had more adverse effects on retention in the Armed Forces than will the changes to military retirement now recommended by the Committee. In making this recommendation, the Committee intends to end the long debate over the appropriate level of benefits provided under the military retirement system. [Ref. 23: p. 9]

The effect of the Military Retirement Reform Act of 1986 was to reduce, relative to what it would have been, the flow of annual appropriations into the Fund. This law reduces DoD outlays, but will not affect outlays in the unified budget until those service personnel who entered after 1986 achieve retirement status. The Act also produces a subsidiary effect on the permanent appropriation coming from the Treasury. The 1986 law reduced future benefits and caused the Fund to experience an immediate gain. Because the Treasury's annual payment includes amortized gains or losses to the Fund, the Treasury's annual payment is reduced by the amortization of the 1986 benefit change.

While the Military Retirement Reform Act of 1986 ended a heated debate over retired pay, fiscal pressures have continued to bring retired pay and its COLA back into budgetary scrutiny.

F. BUDGET RECONCILIATION IN 1993 AND MILITARY RETIREMENT BENEFITS

While the Military Retirement Reform Act of 1986 mainly targeted the annual appropriation side of funding for retiree benefits, a different approach occurred in 1993. As part of the large deficit reduction goals set forth by President Clinton, entitlement spending was targeted for major reductions. The procedural mechanism Congress uses to cut entitlement programs is budget reconciliation. Because the reconciliation process affects entitlement programs, the permanent appropriations component of Military Retirement Benefits was subject to reduction [Ref 21. p. CRS-22]. Figure 4.2 depicts the 1993 budget reconciliation process as it changed Military Retirement Benefits (MRB). The subsections below correspond to the circled numbers in Figure 4.2 and explain the methods employed in reducing MRB as part of reconciliation in 1993.

1. The President's Budget

Traditionally, the President's Budget is delivered in early February; however, President Clinton's Budget was not delivered until April 8, 1993. Despite this, Congress was able to commence work on the budget because in his February 17 address and in his report "A Vision of Change for America," President Clinton had outlined a plan that formed the basis of the budget. In his address to a joint session of Congress on

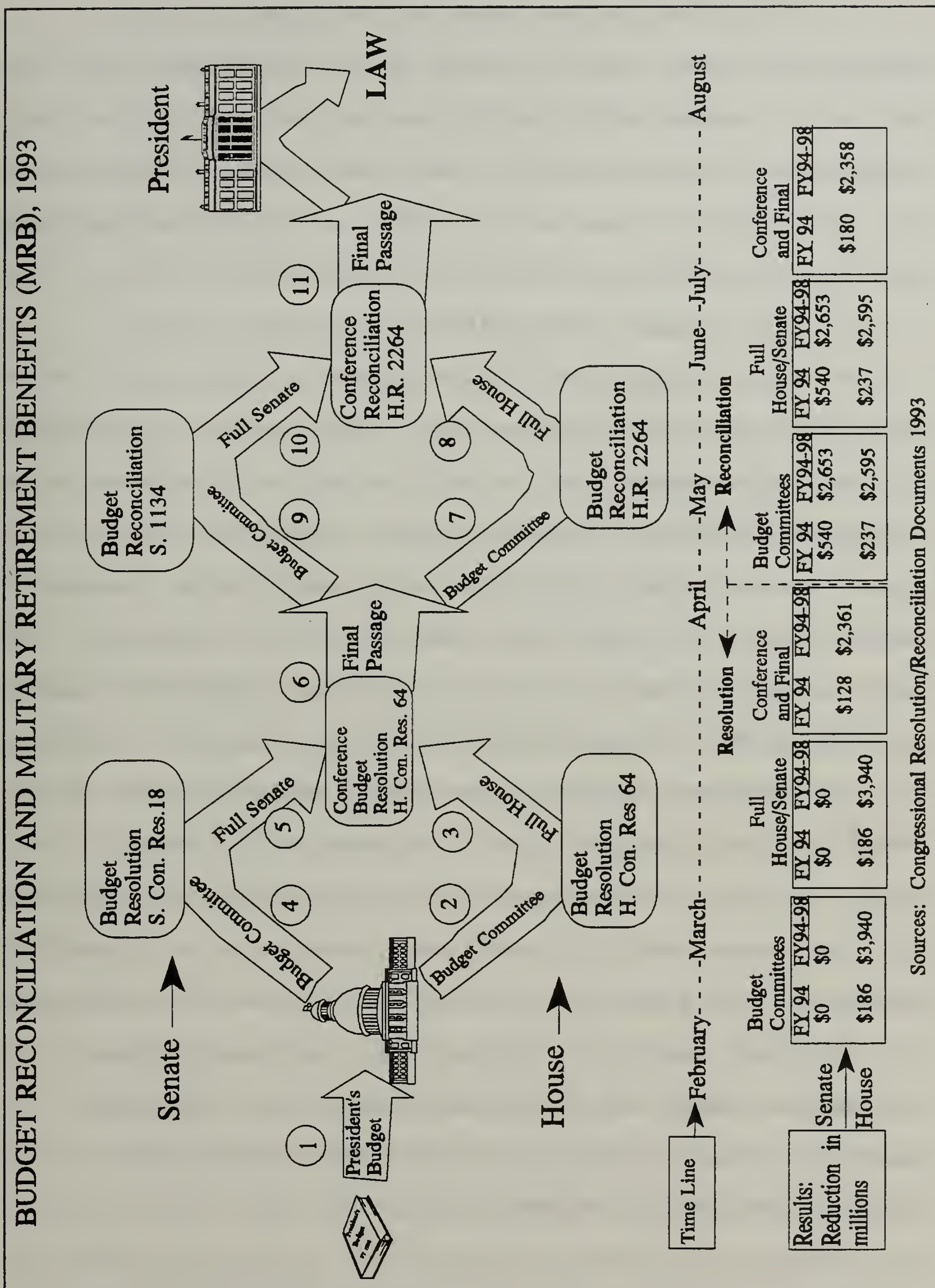

Figure 4.2 Budget Reconciliation and Retirement Benefits

February 17, 1993, the President cited federal pay and COLAs as one of the sources of deficit reduction [Ref. 24: p. 401]. Congress took this to heart in the 1993 reconciliation process and specifically targeted a number of federal entitlement programs, including the military retiree COLA.

2. House Budget Resolution

Upon receipt of the President's plan, the Budget Committees of the Senate and House began formulating strategies in response to the deficit reduction targets set by President Clinton. The House Budget Committee completed its work on March 10, 1993 by approving House Concurrent Resolution 64 (H. Con. Res. 64) [Ref. 25: p. 708]. The instructions in H. Con. Res. 64 required the House Armed Services Committee report changes in laws governing military retiree benefits which would produce savings of $186 million in FY 1994 and $3,940 million of savings in FY 1994-1998 [Ref. 26: pp. 86,261]. The assumption of the House Budget Committee was that these savings would be produced by a "diet-COLA" proposal. The substance of the plan was that retirees under age 62 would receive only half of the annual COLA. When retirees turned 62, full COLAs would be restored. In addition, a cap of $400 per retiree was to be placed on COLAs for FY 1994. [Refs. 26,27: p. 51 p. 1]

3. Full Passage of the House Budget Resolution

On March 18, 1993 the full House of Representatives adopted H. Con. Res. 64 [Ref. 25: p. 708]. While H. Con. Res. 64 was modified in other areas, the targets for MRB reduction remained unchanged at $186 million in FY 1994 and $3,940 million for FY 1994-1998 [Refs. 25,26: pp. 698,700 p. 261].

4. Senate Budget Resolution

The Senate Budget Committee completed its work on March 11, 1993, approving Senate Concurrent Resolution 18 (S. Con. Res. 18) [Ref. 25: p. 708]. The instructions in S. Con. Res. 18 to the Senate Armed Services Committee required no reduction in MRB [Ref. 28: pp. 9,47]. When S. Con. Res. 18 was reported out by the Senate Budget Committee, Senate Democrats warned that they were not pleased with the results and that it would require modification [Ref. 29: p. 653].

5. Full Passage of the Senate Budget Resolution

True to their words, Senate Democrats amended S. Con. Res. 18 on the floor. However, when S. Con. Res. 18 was passed by the Senate on March 25, 1993, none of these amendments affected the amount of saving to be achieved through cuts in MRB. [Refs. 30,31: p. 786 p. S 3704].

6. Budget Resolution Conference And Final Passage

To resolve the difference between the Senate and the House on this issue and on many others, the Budget Resolution Conference was held. The conference committee completed work near the end of March and produced a conference report which accompanied H. Con. Res. 64 [Ref. 32: p. 1]. The conference report required both the House and Senate Armed Services Committees to report to their respective Budget Committees changes in MRB laws which would produce savings of $128 million in FY 1994 and $2,361 million in FY 1994-1998 [Ref. 32: pp. 17,19]. The full House adopted the conference report on March 31, 1993. Final passage of the budget resolution occurred on April 1, 1993 when the Senate adopted the conference report. [Ref. 33: p. 872]

7. House Budget Reconciliation

On May 12 1993, the House Armed Services Committee (HASC) submitted to the House Budget Committee its proposal to meet the required MRB savings mandated by the Budget Resolution. Instead of the "diet-COLA" proposal, the HASC approved a "roll-back" plan which would delay rather than cut the COLAs [Refs. 34,35: p. 1208 p. H 3040].

The House Budget Committee completed work on its version of the reconciliation bill and approved House Resolution 2264 (H.R. 2264) on May 20, 1993. The MRB reduction goals from the House Budget Committee were now $237 million in FY 1994 and $2,595 million in FY 1994-1998. These numbers were obtained by accepting the substance of the House Armed Services Committee "roll-back" plan which delayed the COLAs [Ref. 36,37: p. 1391, pp.5,14]. For FY 1994 the COLA, which retirees normally receive in January, would be delayed until April. The additional COLA delays for FY 1995-1998 are listed below [Refs. 35: p. H 3040].

- FY 1995 - July
- FY 1996 - October
- FY 1997 - January 1998
- FY 1998 - April 1999

8. Full Passage of House Reconciliation Bill

The House reconciliation bill, H.R. 2264, was taken to the full House and passed on May 27, 1993. The MRB reduction targets of $237 million in FY 1994 and $2,595 million in FY 1994-1998 were unchanged as was the COLA "roll-back" plan used to achieve these numbers. [Ref. 37: pp. 5,14]

9. Senate Budget Reconciliation

In early June 1993, the Senate Armed Services Committee (SASC) submitted to the House Budget Committee its proposal to meet the required MRB savings mandated by the Budget Resolution. As in the House, the SASC approved a "roll-back" plan for COLAs rather than the "diet-COLA" proposal. For FY 1994-1997 the COLA, which retirees normally received in January, would be delayed until Oct 1. For FY 1998, the COLA would occur on Sept 1. [Ref. 38: p. 1460]

The Senate Budget Committee completed work on the Senate version of reconciliation and approved Senate Resolution 1134 (S. 1134) on June 18, 1993. The MRB reduction targets as reported by the Senate Budget Committee were now $540 million in FY 1994 and $2,653 million in FY 1994-1998. These numbers were obtained by acceptance of the Senate Armed Services Committee "roll-back" plan which would delay COLAs for nine months in FY 1994-1998 and eight months in FY 1998. [Ref. 37,39: pp. 5,14 p. 1616]

10. Full passage of Senate Reconciliation Bill

The Senate reconciliation bill, S. 1134, was taken to the full Senate and passed on June 24, 1993. The MRB reduction targets of $540 million in FY 1994 and $2,653 million in FY 1994-1998 were unchanged, as was the SASC's COLA "roll-back" plan used to achieve these numbers. [Ref. 37,40: pp. 5,14 pp. S. 7994,7986]

11. Budget Reconciliation Conference and Final Passage

The conference convened to resolve the difference between the reconciliation bills passed by the Senate and House started work on July 15 and reported a bill on August 5, 1993 [Ref. 41: p.2127]. The MRB reduction for FY 1994 was agreed upon at $180 million, and the FY 1994-1998 target was put at $2,358 million. The method of obtaining these numbers was also a compromise. The delay in retiree COLAs for FY 1994 is three months, while the delays for FY 1995-1998 are nine months [Ref. 42: p. 8]. The full House passed the conference report on August 5, 1993, with the Senate following the next day. President Clinton signed the bill into law on August

10,1993 [Ref. 41,43: p. 2127 p. 2220].

According to the provisions of H.R. 2264, only those who entered military service prior to 1 August, 1986 are subject to cuts, since those who entered after 1 August, 1986 already had their COLAs reduced as a result of the Military Retirement Reform Act of 1986. The adjustment applies to all service retirees except disabled retirees and dependent survivors. [Refs. 40,42: p. S 7994 p.8]

G. THE IMPACT OF MILITARY RETIREMENT COLA DELAYS

The effect of the COLA delay on federal spending will be an immediate reduction in outlays from the baseline, or projected spending for MRB. This reduction is the result of changing laws which govern the permanent appropriations (payment on the original unfunded liability) going into and coming out of the Military Retirement Fund.

It should also be acknowledged that there may be a subsidiary effect on the annual appropriations (accrual charge) going into the Fund. Because the accrual charge is based upon economic assumptions, one of which is the expected COLA, the COLA delay in FY 1994-1998 may also reduce a portion of the accrual charge required by the DoD [Ref. 6: p. 20].

To gain perspective on the size of the spending reductions in MRB in relation to total deficit reduction produced by the 1993 reconciliation act, a breakdown of the savings is provided. According to the Office of Management and Budget, The Omnibus Budget Reconciliation Act of 1993 will reduce budget deficits by a total of $504.8 billion over the period between FY 1994 and FY 1998. Of this $504.8 billion, $250.1 billion, or roughly half of the total deficit reduction, results from tax increases. The remaining $254.7 billion comes from cuts in spending and interest payments.

The spending cuts consist of $107.7 billion in discretionary programs and $71.3 billion in entitlements. Of the $71.3 billion in entitlement cuts, $11.5 billion come from federal retirement programs, of which $2.36 billion are the result of the cuts in Military Retirement Benefits. Thus, MRB reductions account for 0.5 percent of the total deficit reduction accomplished by the 1993 reconciliation bill.

Figure 4.3 depicts the relative size of the MRB's contribution to deficit reduction compared to total deficit reduction produced by the Omnibus Budget Reconciliation Act of 1993. [Ref. 44: pp. 20-22]

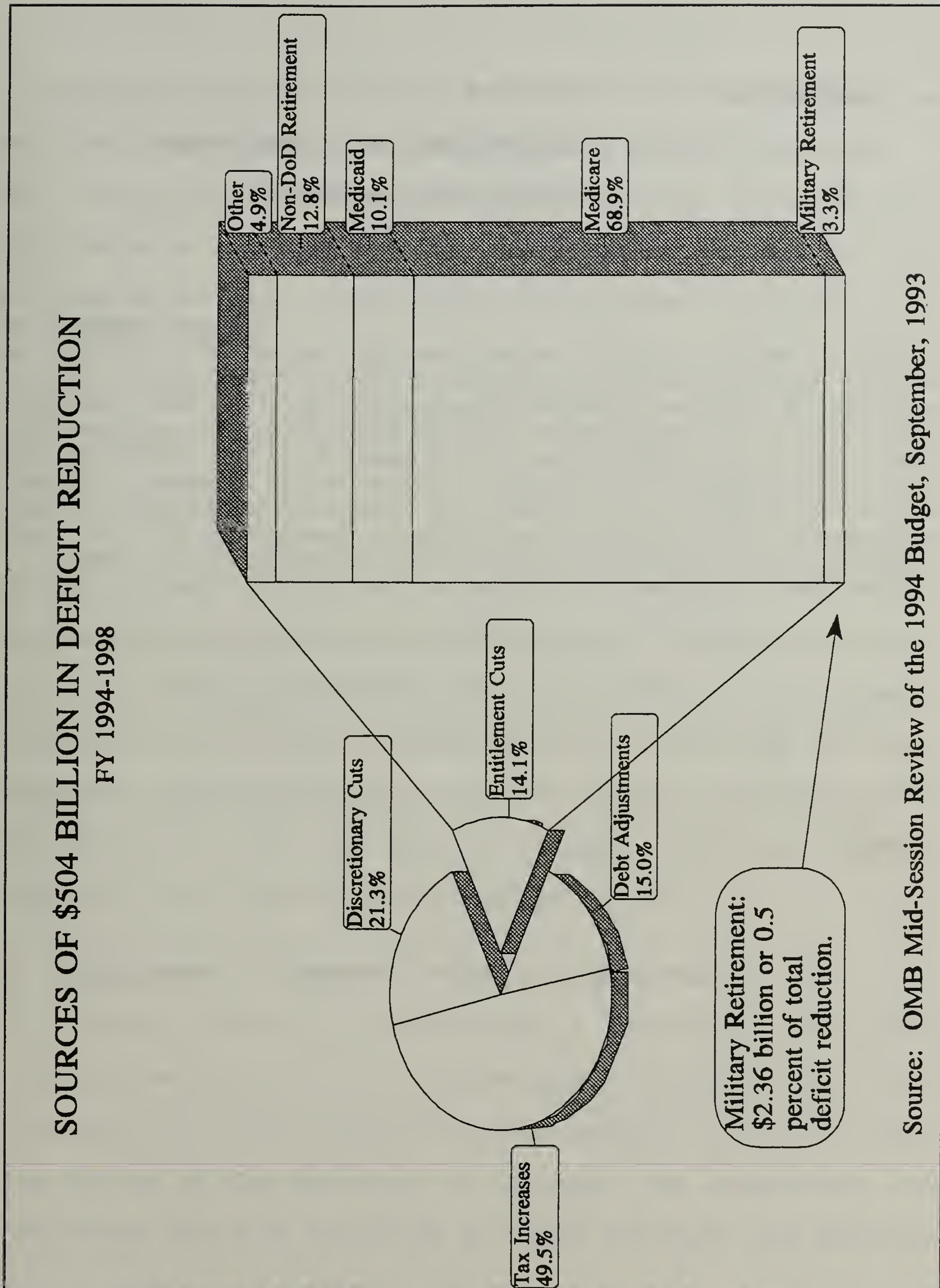

Figure 4.3 Sources of Deficit Reduction

H. CONCLUSION

The assets which flow to the Military Retirement Fund come from permanent appropriations and annual appropriations. The Military Retirement Reform Act of 1986 provides an example of how the annual appropriation flow was targeted to produce savings, while the 1993 budget reconciliation act provides an example of how the permanent appropriation flow was targeted. The creation of the Military Retirement Fund has increased the fiscal flexibility available to Congress as federal budget constraints continue to require the containment of costs.

V. BUDGETING FOR THE MILITARY RETIREMENT FUND IN THE DOD: THE ORGANIZATION AND OPERATION OF THE OFFICE OF THE ACTUARY

A. INTRODUCTION

The Department of Defense Office of the Actuary is the primary DoD office responsible for determining the appropriate level of assets to be budgeted for the Military Retirement Fund in the President's budget and through the Treasury's annual payment. This chapter will describe the organization of the Office of the Actuary and the role it plays in the DoD. An outline of the methods by which the Office of the Actuary calculates the annual accrual charge for the DoD Military Personnel appropriation and the annual amount transferred from the Treasury into the Fund for payment on the original unfunded liability will be presented as well.

B. DEPARTMENT OF DEFENSE OFFICE OF THE ACTUARY

The DoD Office of the Actuary is located in Arlington, Virginia and consists of nine personnel, seven of which are actuaries. The Office of the Actuary works for the DoD within the Office of the Secretary of Defense. An independent DoD Retirement Board of Actuaries provides oversight and approves all actuarial assumptions and methods used by the Office of the Actuary [Ref. 6: p. iv.].

The Office of the Actuary produces two documents each year which are important to the DoD. These documents are the DoD Statistical Report on the Military Retirement System and the Valuation of the Military Retirement System. The DoD Statistical Report on the Military Retirement System presents a statistical breakdown of DoD retirement recipients. This report provides information such as the age groups of DoD retirement recipients, where they live, their ranks, how much money they receive, their sex, what service they were in, and more. Most of the information for this report is abstracted from files submitted to the Defense Manpower Data Center (DMDC). [Ref 5. pp. a-d]

The Valuation of the Military Retirement System provides information crucial to the DoD's budgeting for military retirement and is described in the following subsections. In addition, Figure 5.1 is provided to give the reader an understanding of the size of the accrual charge and unfunded liability payment in relation to the entire Military Retirement System.

1. Balance Statements on the Assets of the Fund.

The Valuation of the Military Retirement System incorporates several different balance sheets which describe and analyze the assets contained in the Fund. The market

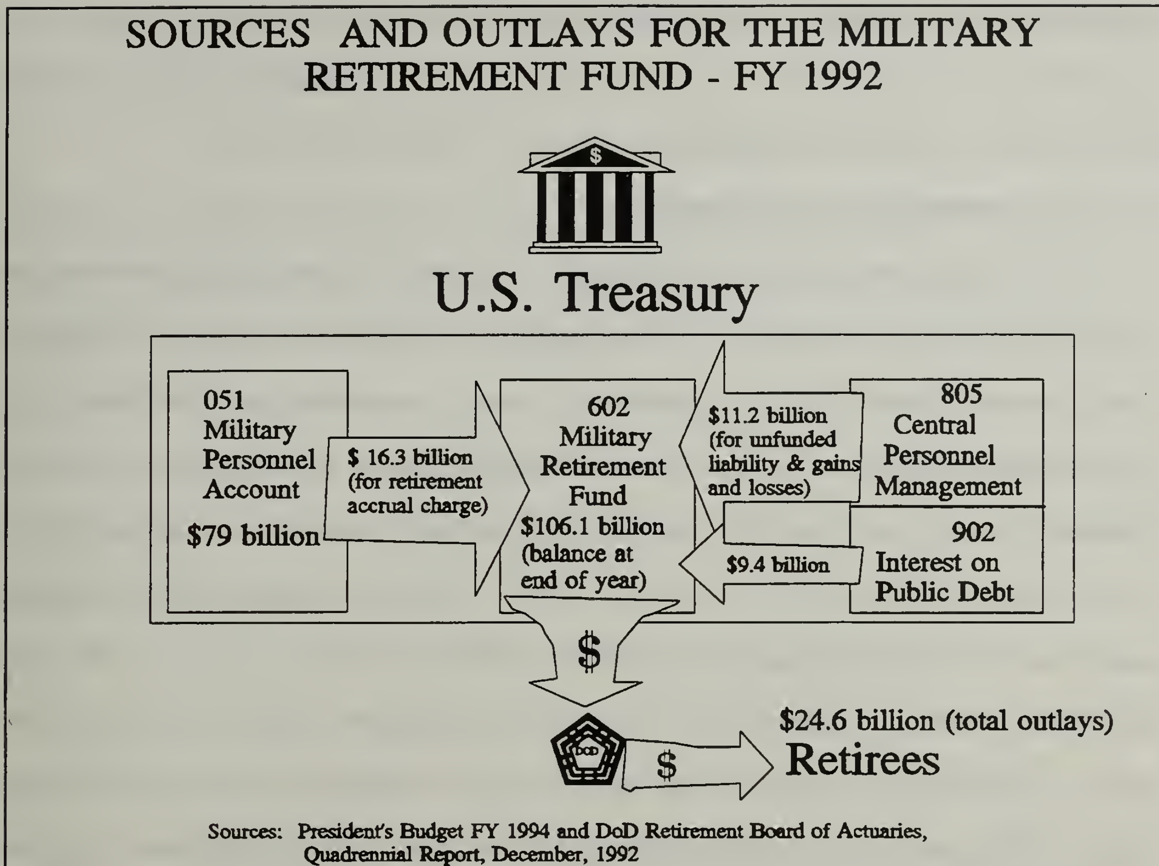

Figure 5.1 Sources and Outlays for the MRF in FY 1992

value of the Fund's assets is presented, as well as a comparison of the Fund's present value with the present value of benefits payable. These balance statements are prepared to show federal compliance with Financial Accounting Standards Board (FASB) statements. The financial standards provided by FASB require that private sector pension plans present a table of "Net Assets Available for Benefits" and a "Statement of Changes in Net Assets Available for Benefits" [Ref. 6: p. n-2]. These statements provide for accountability and auditing. The financial statements in the valuation document also provide information concerning gains or losses to the Fund which must be taken into account when developing the annual unfunded liability payment.

2. Normal Cost Payments.

Another important feature of the valuation document is a projection of normal cost payments (the DoD accrual charge) for future years. The normal cost payment is the monthly contribution transferred into the Military Retirement Fund by the DoD. It can be defined as the level percent of basic pay, contributed annually to an interest bearing fund, necessary to pay for the future retirement benefits of a group of new entrants [Ref. 6: p. 8]. As indicated in Figure 5.1 above, $16.3 billion was transferred into the MRF for this purpose in 1992. Projected normal cost payments are significant to the DoD since they determine the retirement accrual charge component of the annual Military Personnel appropriation. The method by which the Office of the Actuary determines the accrual charge is outlined below.

a. Calculation of the Normal Cost Payment

The primary question which the Office of the Actuary answers while determining the annual normal cost payment is this: How much must the DoD lay aside each year in order to provide for the future retirement of DoD personnel currently serving? The basic question involved is one of *present value,* but the actual calculations become quite involved due to the complexity and size of the DoD retirement system [Ref. 45: p. 49].

The actuarial method required to be used by the Office of the Actuary is the "aggregate entry-age normal cost method" [10 U.S.C. § 1465]. This method allows the Office of the Actuary to group (aggregate) the participants into cohorts. It then calculates the normal cost (as a constant or level percent of basic pay) from the date the member, or cohort, first became an employee, to the estimated retirement date [Ref. 45: p. 82].

The Office of the Actuary mathematically calculates the normal cost payment by use of a sophisticated computer model called "GORGO" run on a mainframe computer. This computer model takes the military population which falls under the normal cost system and projects their basic pay into the future. The projected basic pay is subjected to the relative percentages of separate benefit formulas. This value is then discounted back to its present value which is used to determine the normal cost percentage and payment. [Ref. 6: p. 8, 13, G-2]

Of prime significance in this computer model are the economic assumptions used in determining projected basic pay. For accuracy, the economic assumptions are broken down into short term and long term economic assumptions. Table 5.1 shows the short and long term economic assumptions provided in the 1991 Valuation of the Military Retirement System. [Ref 6: pp. iv., 20, G-3,5]

TABLE 5.1 ECONOMIC ASSUMPTIONS

ECONOMIC ASSUMPTIONS				
	Year	COLA	Basic Pay	Interest
Short Term	1992	3.7%	4.2%	7.5%
	1993	3.0%	3.7%	7.5%
	1994	3.2%	4.7%	7.5%
	1995	3.2%	4.7%	7.5%
	1996	3.2%	4.5%	7.5%
	1997	3.1%	3.5%	7.5%
Long Term	1998+	5.0%	5.5%	7.5%

Source: Valuation of the Military Retirement System, September, 1991

There are also several non-economic assumptions that affect the projections. These assumptions can be categorized as listed below [Ref 6. pp. 5, G-3,5].

- Active duty and reserve decrement rates (the rate at which current service personnel leave the military)
- Retiree decrement rates (mortality rates)
- Internal computer program parameters (member spouse-age difference, disability factors, etc.)
- Other rates (divorce, remarriage, survivor mortality and mortality improvement)

3. Unfunded Liability Payment.

The Valuation of the Military Retirement System also presents the projected annual payments for the unfunded liability component. This payment is the contribution that the Secretary of the Treasury makes out of its general funds, into the MRF. This payment is for those personnel who, when the Fund was created, had not had any previous funds accrued for their future or current retirement. As of September 30, 1984, this unfunded liability totaled $528.7 billion. This amount and its interest is being amortized over a 60 year period. [Ref. 6: p. 12]

From a budgeting perspective, the projected payments on the unfunded liability are significant to the DoD because, at the beginning of each fiscal year, the Secretary of Defense must certify the appropriate annual payment for the unfunded liability. This certified dollar figure is then given to the Secretary of the Treasury who deposits the specified amount in the Fund. The size of this payment is determined by the projected unfunded payment presented in the Valuation of the Military Retirement System. The method by which the Office of the Actuary determines the annual unfunded liability payment is outlined below.

a. Calculation of the Annual Unfunded Liability Payment

In a manner similar to the calculations used to determine the normal cost payment, the "GORGO" computer program is used to obtain the projected unfunded liability payment. The benefits for current active and retired military personnel are projected over the rest of their lifetimes. The projected value is then discounted to determine its present value, which is used to calculate an initial current year payment for the unfunded liability. The retirement benefits for these military personnel are based on their total military service time and applicable benefit formulas and basic pay increases. [Ref. 6: p. 13]

The value of the Fund fluctuates because of modifications in benefit formulas, unexpected gains and losses, and changing actuarial assumptions[2]. The changes to the Fund are generally referred to as gains and losses and are amortized over 30 years to provide stability [Ref. 6: p.12]. The annual amortization payment for each change is added to or subtracted from the initial unfunded liability payment to arrive at the total for the current year's Treasury payment [Ref. 6: p. O-10].

For example, from Table 5.2, the initial projected FY 1992 unfunded liability payment was $18.2 billion. The FY

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[2]"Fund" in this case refers both to the assets held in the Fund and the amount of the unfunded liability.

TABLE 5.2 TOTAL UNFUNDED LIABILITY PAYMENT

TOTAL UNFUNDED LIABILITY PAYMENT OCTOBER 1, 1991 (in billions)	
Initial unfunded liability	$18.2
Experience gains and losses	(4.5)
Changes in assumptions	(2.4)
FY 1986 benefit change	(0.16)
FY 1987 benefit change	0.01
TOTAL (rounded)	$11.2

Source: Valuation of the Military Retirement System, September, 1990

1992 amortization payment for experience gains was $4.5 billion and is subtracted from the initial payment. This $4.5 billion captures the impact of downsizing as well as other factors which reduce the amount of the unfunded liability. The FY 1992 amortization payment, reflecting changes in actuarial assumptions such as smaller basic pay increases and reduced COLAs, is captured by the $2.4 billion payment, and is subtracted from the initial payment as well. The impact of benefit changes in FY 1986 and 1987 is reflected by the last two rows. The net of these changes to the unfunded liability payment, $7.05 billion, subtracted from the initial unfunded liability payment, is $11.2 billion, the amount shown in Figure 5.1 being transferred from the Treasury to the Fund. [Ref. 46: p. O-10]

C. CONCLUSION

The Department of Defense Office of the Actuary supplies the Department of Defense with the necessary dollar figures used by the DoD to budget for military retirement and the payment on the unfunded liability. The computation of these dollar figures is executed through a sophisticated computer model which incorporates the effects of numerous retirement benefits, decrement rates, DoD specific parameters and a broad range of economic assumptions.

VI. THE INVESTMENT PLAN OF THE DEPARTMENT OF DEFENSE MILITARY RETIREMENT FUND

A. INTRODUCTION

This chapter will explain the timetable established for completing the payment on the unfunded liability and will examine the projected cash flows associated with the Fund. The investment strategy chosen and the securities selected for investment will be explained. Concerns over the MRF's current funding arrangement and the limits and problems associated with the Military Retirement Fund from an investment perspective will be discussed.

B. THE INVESTMENT TIMETABLE FOR THE MILITARY RETIREMENT FUND

The Board of Actuaries originally determined that the present value of the original unfunded liability was $528.7 billion. If, on September 30, 1984, $528.7 billion had been deposited into the Fund, then the combination of this sum and the future normal cost payments would have been sufficient to provide all the expected retirement and survivor benefits for those in the system on that date. [Ref. 6: p. 12]

Table 6.1 provides an abbreviated past and projected payment schedule for the unfunded liability as well as normal cost payments, interest income, disbursements and Fund balance [Ref. 6: p. 19]. The Office of the Actuary prepares the

TABLE 6.1 PAST AND PROJECTED "CASH" FLOWS

Military Retirement Fund, Past and Projected "Cash" Flows (in billions)					
Fiscal Year	Normal Cost Payment	Unfunded Liability Payment	Interest Income	Fund Outlays	Fund Balance
1985 (actual)	$17	$9.5	$1.1	$19.0	$10.4
1986 (actual)	$17.4	$10.5	$2.5	$17.6	$24.6
1987 (actual)	$18.3	$10.6	$3.6	$18.1	$38.9
1988 (actual)	$18.4	$10.3	$7.6	$19.0	$93.7
1990 (actual)	$18.5	$9.8	$6.1	$20.2	$50.4
1990 (actual)	$16.3	$10.6	$7.3	$21.5	$80.4
1990 (actual)	$17.2	$10.6	$8.5	$23.1	$93.7
1992	$18.3	$11.2	$7.6	$23.0	$105.0
1995	$16.1	$13.7	$10.0	$28.0	$137.7
2000	$19.5	$17.9	$15.2	$37.1	$208.7
2005	$24.4	$23.3	$21.6	$50.5	$295.8
2010	$31.0	$30.5	$29.5	$66.9	$403.7
2005	$40.5	$39.9	$40.4	$19.0	$556.1
2000	$53.1	$76.4	$63.8	$107.4	$888.6
2026	$73.4	$132.4	$127.5	$141.9	$1,794.2
2031	$95.8	$173.0	$217.2	$182.5	$3070.8
2036	$125.0	$226.1	$357.4	$236.2	$5066.1
2041	$163.4	$295.5	$573.5	$305.8	$8,149.1
2043	PAYMENT ON UNFUNDED LIABILITY COMPLETE, OTHER CASH FLOWS CONTINUE.				

Source: Valuation of the Military Retirement System, FY 1991 projected amortization schedule and "cash" flows associated ith the Fund by using a variation of the "GORGO" computer model called "open group" projection [Ref. 6: p. 3]. The current amortization schedule provides for the unfunded liability through 60 annual payments which will be completed in the year 2043. In 2043, the unfunded liability will be paid off and, in this sense, the Fund can be referred to as fully funded. However, this should not be interpreted to mean that the Fund is now self-supported by its interest payments. The DoD accrual charge will still be required to keep the retirement system financially sound from an actuarial perspective [Ref. 47: p. 31].

Figure 6.1 is provided to give a long term perspective of the "cash" flows associated with the Fund. While the projected cash flows will certainly be modified by changing economic assumptions, endstrengths, benefits and more, it does provide an illustration of the temporary role of the unfunded liability payment (which drops to zero in 2043) and the increasing role of the interest received from the Fund's assets. The projections provided by the valuation report also show that as a percent of basic pay, the normal cost payment stabilizes at approximately 30 percent, while outlays to retirees remain relatively constant at between 50 to 60 percent of basic pay [Ref. 6: p. 19].

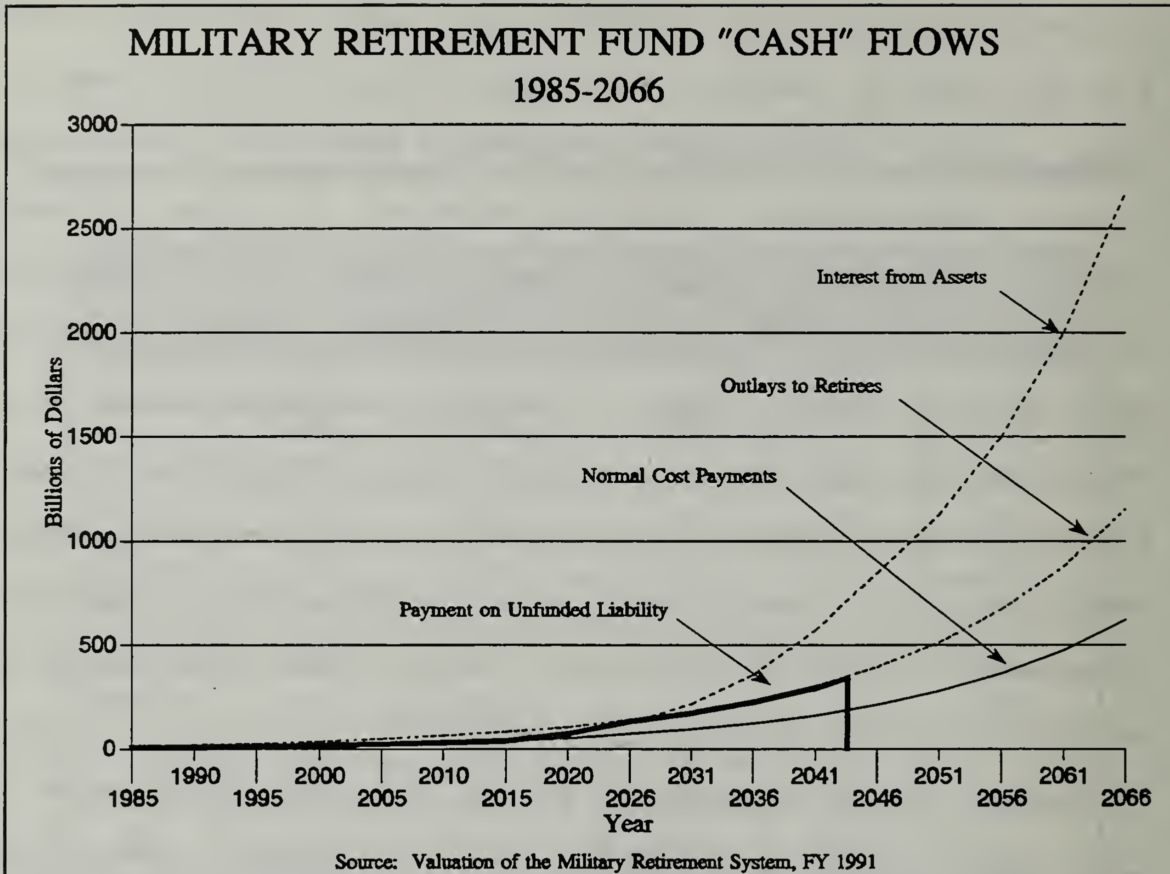

Figure 6.1 "Cash" Flow Projections

C. CONCERNS OVER THE MRF'S FUNDING ARRANGEMENT

One problem with the current funding method is that the Treasury's involvement in making payments will not really end in the year 2043. To explain this, Table 6.2, which shows the 1991 total unfunded liability payment, is provided. As stated above, the unfunded liability payment, $18.2 billion in 1991, will end in 2043. However, the adjustments to the initial unfunded liability payment--the next four lines in Table 6.2 which reflect gains and losses, assumption changes, and benefit changes--will not stop in the year 2043. This is

TABLE 6.2 TOTAL UNFUNDED LIABILITY PAYMENT

TOTAL UNFUNDED LIABILITY PAYMENT OCTOBER 1, 1991 (in billions)	
Unfunded liability payment	$18.2
Experience gains and losses	(4.5)
Changes in assumptions	(2.4)
FY 1986 benefit change	(0.16)
FY 1987 benefit change	0.01
TOTAL (rounded)	$11.2

Source: Valuation of the Military Retirement System, September, 1990

because the original legislation stated that the Treasury is responsible for the amortization of the unfunded liability **and** amortization of changes in the **Fund**[3] resulting from cumulative actuarial gains,losses and benefit changes [Refs. 18: § 1466].

The current downsizing provides an excellent example of how the Fund experiences a gain or loss. Because fewer people are staying in the military, the accrual charge is smaller. Furthermore, the Fund will have more assets in it than it needs, in relation to the payment plan, because payments in previous years were based upon a greater number of retired personnel. This is a gain to the Fund which, according to legislation, must be amortized and deducted (or added to if a

[3]"Fund," in this instance, means both the assets currently held in the Fund and the amount of the unfunded liability.

loss) from the Treasury's payment on the unfunded liability.

Changes to the Fund will continue to occur, even after the unfunded liability has been paid off, because projected interest rates, benefits, etc., will not exactly match with reality. [Refs. 18,48: § 1466, p. 10]. To put this in a current perspective, the Treasury captures the benefits of changes in the Fund as a result of downsizing, lower COLAs, benefits etc. Certainly the DoD accrual charge is smaller than projected because of downsizing and lower COLAs because of fewer people and lower future benefits, but it would be even smaller if it could capture part of the gains to the Fund that the Treasury experiences. While being able to capture gains to the Fund would be to the DoD's benefit now, the reverse would happen if inflation picks up, or a manpower build up occurs, or benefits were increased. It is also debatable whether gains in the Military Personnel Account, as a result of lower accrual charges, could be reprogrammed to other areas in the DoD budget.

1. Proposals to Change the Current Funding Arrangement

In December, 1992, the Retirement Board of Actuaries proposed, in the quadrennial report to the President and Congress, an alternative arrangement for incorporating gains and losses to the Fund into annual payments. The following quote provides the substance of the proposal.

> (1) define the Treasury's responsibility to be only the liability for benefits attributable to service before

> October 1, 1984 (i.e., "the pre-October 1, 1984 accrued liability"), including subsequent adjustments for experience, assumption changes, and benefit changes and (2) define DoD's responsibility to be the liability for benefits attributable to service since October 1, 1984, including subsequent adjustments. [Ref. 48: p. 9]

The result would be that the DoD would be able to capture some of the gains (or future losses) being experienced by the Fund. In addition, the Treasury's involvement with making payments into the Fund would end when the unfunded liability was paid off and adjustments associated with pre-1984 service are no longer applicable. Five year projections supporting this proposal show that the 1997 DoD accrual charge would be 15 percent lower and the Treasury payment would be 12.6 percent higher than they would have been otherwise. [Ref. 48: p.9]

Another significant aspect to the proposal is that it claims to make a stronger link between endstrength and the retirement accrual charge [Ref. 48: p. 10]. Higher endstrength would create a higher accrual charge (as compared to before) and lower endstrength would create a lower accrual charge. If this proposal was accepted, it would have an immediate benefit for the DoD and could also serve to strengthen the DoD incentives to economize on manpower and consider retirement costs now rather than in the future. It would have the added benefit of dissolving the Treasury's responsibility for cumulative gains and losses to the Fund once the unfunded liability was paid off. To this end, the proposal appears to be a positive and constructive change.

There are also potential negatives to the proposal. The benefit to the DoD, which appears in the form of lower DoD accrual charges, may have questionable utility. It is debatable whether lower accrual "savings" could be reprogrammed to other areas of the DoD budget or count against spending caps and future spending baselines[4] [Ref. 49: pp. 4,6]. Another potential problem with the proposal is that the incentives inherent in the accrual charge might be masked or distorted by large gains or losses in the Fund. Furthermore, as stated earlier, while the benefits of this proposal would be positive for the DoD now, they would be negative in the future if inflation or other factors caused the Fund to experience a net loss. If this occurred, the Fund would require more resources from the DoD in the form of upward adjustments in the normal cost payment.

Whether or not this specific proposal is accepted, an arrangement which phases out the Treasury's involvement with

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[4]For the interested reader, this topic is covered in the 5 June, 1992 GAO report titled *DOD BUDGET, Budget Impact of Proposed Reduced Retirement Fund Payments*. This report discusses the budgetary impact of a proposed change in the method for calculating the annual DoD accrual charge. This proposal was never fully pursued. The report also details the potential impact of changing actuarial assumptions which occurred later in 1992. The report highlighted the fact that "savings" from the proposed accrual charge would not count toward discretionary DoD savings. It also emphasized that "savings" produced by changing actuarial assumptions do not represent reductions in defense programs or long-term federal retirement obligations.

payments on cumulative gains and losses would be positive. It would make the funding system more comparable to private pension systems which have only one entity providing for payments [Ref. 48: p. 9]. Furthermore, the DoD would eventually bear the full responsibly of funding future retirement costs. Any proposal modifying procedures for adjusting cumulative gains and loss to the Fund would require federal legislation since it seeks to modify the original Military Retirement Fund legislation.

D. FUND ASSETS

The assets of the MRF are invested in U.S. Treasury obligations and are administered by the Secretary of the Treasury [Refs. 6, 18: p. 5, § 1461]. The Fund's managers invest in so-called market-based special issues known as the government account series. Although these securities "mirror" securities that have been issued to the public and have identical maturity dates and coupon rates, they cannot be marketed publicly. [Refs. 6,47: p. 5., pp. 32, 33]

The Fund's managers can select particular issues and maturities to help achieve their investment goals. They also incur the risk associated with market/price fluctuations [Ref. 47: p. 33]. Because of this, the book value of the Fund's assets fluctuate and must be taken into account when preparing the Fund's financial statements. The Treasury handles the investment by a book-entry system which simply credits purchases without physically issuing securities [Ref. 47: p. 32]. The Fund managers are free to sell the special issue securities as needed to pay benefits or other authorized spending. From the Treasury's perspective, the redemption drains cash balances, which must then be replenished by tax inflows or sale of marketable securities (borrowing) [Ref. 47: p. 32].

It is also significant to note that the Treasury securities (government account series) held by the Fund do not increase the national debt held by the public. They serve mainly as an internal federal bookkeeping function and are considered internal federal debt. As such, these Treasury obligations add to the gross national debt through an increase in internal federal debt but do not contribute to the national debt held by the public. [Ref. 47: p. 4,5]

To gain perspective on the size of the debt created by the MRF in relation to the total or gross national debt, a breakdown of the national debt, shown in Figure 6.2, is provided. At the end of FY 1992, the gross national debt amounted to approximately four trillion dollars [Ref. 47: p. 92]. The gross national debt can be broken down into two categories, public debt and debt held by government accounts, primarily federal trust funds [Ref. 47: p. 27]. In FY 1992, debt held by federal trust funds accounted for one trillion dollars or 25 percent of the gross national debt [Ref. 47: p. 27]. According to the Congressional Budget Office (CBO), the

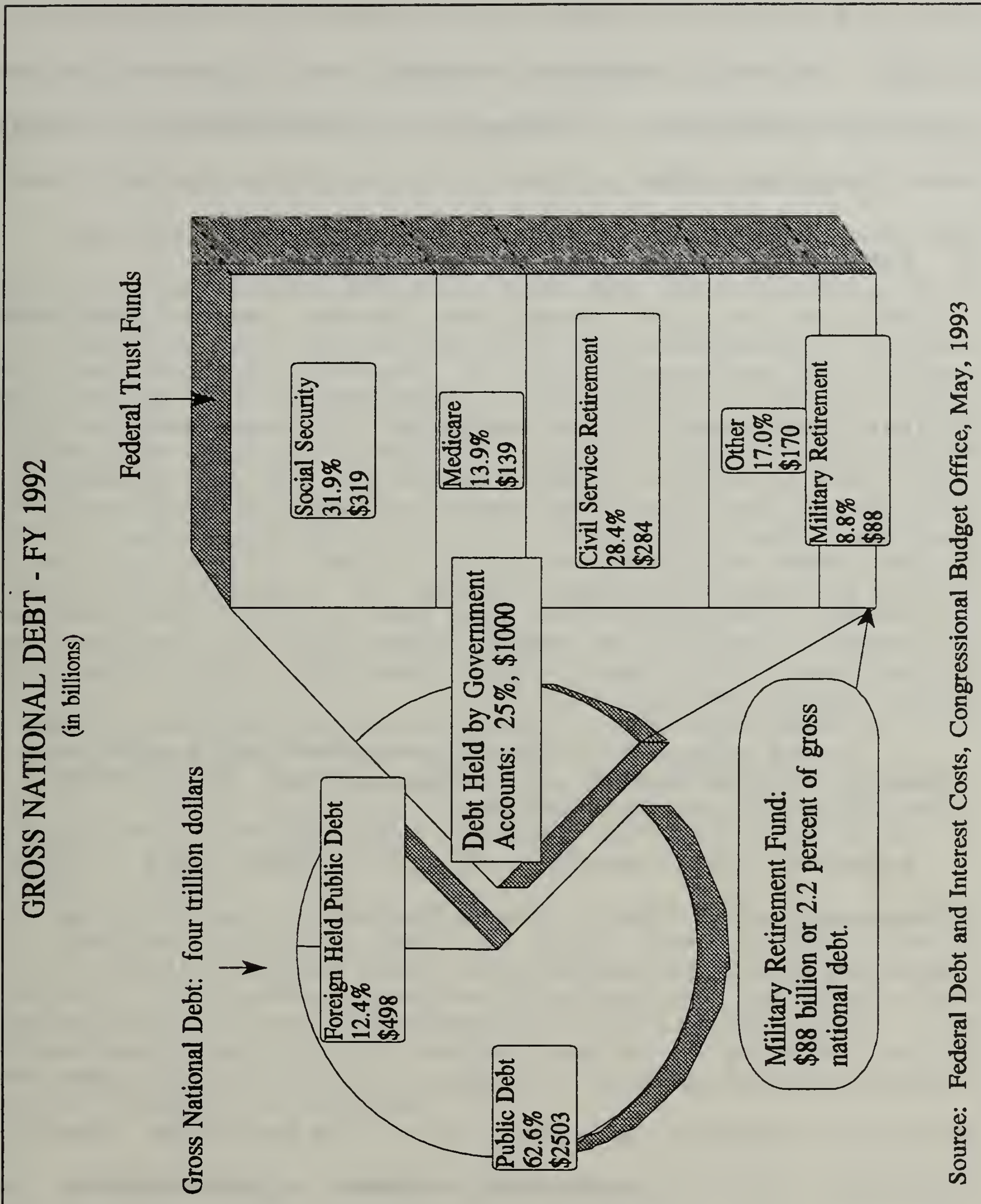

Figure 6.2 Gross National Debt

FY 1992 balance in the MRF was $88 billion dollars [Ref. 47: p. 28]. The Fund therefore accounted for 2.2 percent of the gross national debt or 8.8 percent of debt held by federal trust funds in 1992.

E. LIMITS ASSOCIATED WITH THE MRF'S ASSETS

Because the Fund's assets are internal federal debt used mainly for bookkeeping, it is erroneous to consider the Military Retirement Fund as analogous to private pension funds which have a pool of assets managed for the sole benefit of recipients [Ref. 47: p. 28]. In fact, during hearings in 1983 on the Military Retirement System, an actuarial consultant referred to federal retirement funds (such as the MRF) as mirror games [Ref. 12: p. 155].

> ...in the case of the Federal Government and funding its pension system under the mechanism that is currently available, it is a mirror game.

Because the assets of the Fund are simply intragovernmental IOUs, those affected by the Fund may be concerned about the security of their benefits [Ref. 47: p. 27]. The reality is that the government has not really saved money to pay for military retirement, but has simply earmarked future tax receipts [Ref: 48: p. 11]. The Retirement Board of Actuaries has classified the current funding system as "accrual accounting without advance funding" [Ref 48: p.3]. The interest (which from Figure 6.1 climbs rapidly in the outyears) that is "earned" by the Fund's assets may be the most disconcerting aspect of the MRF. It is, in fact, not earned at all but simply created (from a Federal Government/unified budget perspective) and must be paid at some time in the future with taxes or additional borrowing.

While the nature of the Fund's assets may produce some concern, the current MRS still provides its intended purpose of enhancing decision making about force levels and the cost of benefits for new entrants [Refs. 47,48: p. 29, pp.3,11]. It may also provides a sense of security to military personnel to know that the Fund has earmarked future tax receipts for their retirement. While it is doubtful that many service members know this, it does make the DoD's job of justifying its outlays for retirees easier since the resources are already earmarked. In this sense, it provides greater security to the MRS as a whole and the government has formally recognized its obligation to military retirees [Refs 47,48: p. 29,30 p.3,11].

Despite concerns over the Funds assets, what really matters to the Federal Government and military retirees is the government's ability to tax and borrow to provide for the actual outlays to retirees.

F. ALTERNATIVES TO TREASURY SECURITIES

While numerous proposals to invest federal trust funds in private investments such as corporate stocks and bonds have been made (mostly in regard to social security), the difficulties arising from such a decision could be even more disconcerting than the present system. [Ref. 47. p.33,34]. The risk associated with the stock and bond market fluctuations would not go well with a public whose retirement pay would then depend on fluctuating assets. Furthermore, the Federal Government would be entangled in disputes and conflicts associated with where to invest in the private sector. The detrimental effects and instability created by these decisions would probably offset any gains created through higher return on assets which might be achieved in the private sector. [Ref. 47: p. 33,34]

G. CONCLUSION

The Military Retirement Board of Actuaries and the Office of the Actuary have established a specific timetable for completing the payment on the unfunded liability and created an actuarial plan for future normal cost payments. An alternative to the current arrangement for handling gains and losses to the Fund has been proposed by the Military Retirement Board of Actuaries which would enhance the incentive for the DoD to achieve saving through economizing on manpower. It would also eliminate the responsibility of the Treasury for the annual payment into the Fund once the unfunded liability was paid off. Regardless of whether or not the proposal is accepted, an alternative to the current plan for adjusting gains and losses to the Fund should be developed. The goal of such a proposal should be to phase out the Treasury's responsibility for making amortized payments for gains and losses to the Fund and give the DoD sole responsibility for providing for the Fund.

The Fund invests in internal federal debt which is used as a bookkeeping function. As long as the Federal Government can continue to tax and borrow to provide for the projected cash outlays, then the fact that Fund is investing in internal federal debt is not significant. What is relevant, from the designer's perspective, is that the Fund operates on a sound actuarial basis and that it provides the incentives to DoD that were originally intended. By earmarking future tax receipts for military retirement, the creation of the Fund has enhanced the security and funding for military retirees.

VII. PROBLEMS AND CONCERNS OF THE DEPARTMENT OF DEFENSE MILITARY RETIREMENT FUND

A. INTRODUCTION

While some of the problems associated with the Military Retirement Fund have been outlined in Chapter VI, other problems associated with diversions of the Fund's assets exist. This chapter will outline a recent diversion of Fund assets and potential future diversions. In addition, the consequences of such diversions will be discussed.

B. UNITED STATES COURT OF MILITARY APPEALS

The National Defense Authorization Act of fiscal year 1989 (Public Law 100-456) awarded United States Court of Military Appeals (COMA) judges a significant increase in their retirement benefits [Ref. 48: p. 11]. Judges who successfully completed their term of service, for which they were appointed, would receive an annuity equivalent to 80 percent of the rate of pay for a COMA judge in active service [Ref. 50: Section 722]. In addition, the judge would receive cost-of-living adjustments equivalent to those provided under the federal civilian retirement program [Ref. 50: Section 722]. The law established the Military Retirement Fund as the source of funding for retired COMA judges and removed the Civil

Service Retirement and Disability Fund from any responsibility [Ref. 48,50: p. 11, Section 722].

The impact of this law on the Military Retirement Fund is negligible due to the small number of COMA judges [Ref. 48: p. 11]. And while providing retirement funding for COMA judges from DoD funds is not an objectionable act, the precedent set by this law is of concern to the DoD. This concern stems from the practice of awarding benefits without arranging for adjustments to the normal cost or Treasury payment. This arrangement could threaten the actuarial integrity of the Fund, especially if it occurred on a larger scale. In fact, this precedent is being followed in a proposal for another diversion of MRF resources, this time to assist the Armed Forces Retirement Home Trust Funds [Ref. 48: p. 11].

C. DIVERSION OF MRF ASSETS TO THE ARMED FORCES RETIREMENT HOME TRUST FUND

In 1992, a recommendation came from within the Office of Management and Budget to fund shortfalls in Armed Forces Retirement Home Trust Funds with assets from the Military Retirement Fund [Ref. 48, 51: p. 11]. Unlike the diversion of funds for COMA judges, this proposal would involve the diversion of substantial sums [Ref. 48: p. 11].

The Armed Forces Retirement Home Trust Funds provide medical and domiciliary care and other authorized benefits for approximately 2000 selected retired solders and sailors. There are actually two trust funds, one for the U.S. Soldier's and Airmen's Home and one for the United States Naval Home. Normally theses funds are sourced from fines, forfeitures, and withheld pay and contributions from active members of the services. The U.S. Naval Home trust fund appears to be adequately funded through its receipts and interest [Ref. 19: Appendix pp. 526-527]. However, the U.S Soldier's and Airmen's trust fund is projected to lose money. For example, in 1992 the balance in the fund was $127 million. In 1994 the balance is projected to be $93 million. This is a loss of $34 million at a time when the fund should be growing. [Ref. 19: Appendix pp.526-527]

The Office of Management and Budget proposed to make up the shortfall in the U.S. Soldier's and Airmen's Trust Fund using the MRF [Ref. 48: p. 11]. Again, while it is not objectionable to ask DoD to fund retirement homes for sailors and soldiers, these additional costs should be incorporated into the normal cost payments and unfunded liability payments of the MRF.

If the Military Retirement Fund was required to make up the shortfall, legislation should be extended that would allow the DoD to make adjustments to the normal cost payments and Treasury payments to include the cost of the diversion of MRF funds. If this is not allowed, the actuarial integrity of the Fund could be in question.

An alternative solution would be to seek supplemental funding from the three military services on a direct cost basis. This would make the services proportionately responsible for funding shortfalls based upon the number of their service members in that retirement home.

The reason why the MRF has been the object of diversions and potential diversions is probably because of its size. With $106.1 billion in assets at the end of FY 1992, the Fund is an attractive source of resources [Ref. 48: pp. 4, 11]. In addition, underfunded activities, such as COMA judges and the Armed Forces Retirement Homes, closely connected to military retirement can more easily justify supplemental funding from the MRF than they could otherwise. The DoD must be especially diligent to keep the Fund operating on a sound actuarial basis in light of the current fiscal constraints being experienced by numerous government agencies.

D. CONCLUSION

The Military Retirement Fund has been subject to diversions and potential diversions which could threaten the actuarial integrity of the Fund. If the Military Retirement Fund becomes responsible for outlays to individuals for whom the Fund's assets weren't originally intended, then legislation should be extended which will allow for the normal cost payment and Treasury payment to compensate for the additional outlays.

VIII. SUMMARY AND RECOMMENDATIONS

A. SUMMARY

The Military Retirement Fund was created in FY 1985 through legislation which reformed the accounting and funding system for military retirees. The Fund serves to pay for the costs of military retirement through a specific investment plan created by the Department of Defense Office of the Actuary and is designed to function similar to private pension plans. The original purposes for the Military Retirement Fund were: (1) to reduce costs; (2) to create incentives in the DoD and Congress to consider future retirement expenses in today's dollars and manpower numbers; (3) to implement accrual accounting; and (4) to comply with ERISA.

The Military Retirement Fund invests in interest bearing U.S. Treasury obligations and is funded through two separate sources. The DoD is the first funding source, and pays for the normal cost of future retirements through an annual accrual payment identified as a percent of the basic pay account in the annual Military Personnel Appropriation. The second funding source, the U.S. Treasury, pays for the original unfunded liability through annual amortization payments. The Treasury's annual amortization payment is adjusted by any cumulative gains and losses to the Fund and then deposited into the Military Retirement Fund. In addition to these two funding sources, the Fund also receives as income the interest on the Treasury securities contained in its account. Since all three of the above sources of income are intragovernmental transfers, offsetting receipts are created in other accounts to prevent double counting in the unified budget. The only outlays that count against the defense function are the annual accrual charges, and the only outlays that count against the Federal Government in the unified budget are the actual outlays to military retirees. The net result of the creation of the Military Retirement Fund has been to decrease defense outlays, increase outlays from the Treasury's General Fund, and increase federal debt. There has been no direct impact on federal outlays.

The assets which flow to the Military Retirement Fund come from permanent appropriations and annual appropriations. The annual accrual charge is largely an annual appropriation, while the Treasury payment and interest on the Fund's assets are largely permanent appropriations. The Military Retirement Reform Act of 1986, which reduced future retiree benefits, provides an example of how the annual appropriation flow can be used to produce defense savings, while the 1993 budget reconciliation act demonstrates how the permanent appropriation flow can be reduced as part of a deficit reduction effort. The creation of the Military Retirement Fund has increased the fiscal flexibility available to

Congress as large and persistent deficits put pressure on all federal programs.

The Department of Defense Office of the Actuary supplies the Department of Defense with the necessary dollar figures used by the DoD to budget for military retirement and the payment on the unfunded liability. The computation of these dollar figures is executed through a sophisticated computer model which incorporates the effects of numerous retirement benefits, decrement rates, DoD specific parameters and a broad range of economic assumptions.

The assets of the Fund are a source of concern since the Treasury obligations purchased by the Fund are considered internally held federal debt used mainly for bookkeeping and earmarking of future tax receipts. However, as long as the Federal Government can continue to tax and borrow to provide for the projected cash outlays, then the fact that Fund is investing in internal federal debt is not significant. What should be relevant, from the designer's perspective, is that the Fund operates on a sound actuarial basis and that it provides the incentives to DoD that were originally intended. By earmarking future tax receipts for military retirement, the creation of the Fund has enhanced the security and funding for military retirees.

B. RECOMMENDATIONS

As stated earlier, the Treasury department captures all the gains and losses to the Fund in its annual payment. Furthermore, the Treasury will conceivably be involved in making payments (positive or negative) to the Fund past the point at which the unfunded liability has been paid off. These two facts have not gone unnoticed and have resulted in several recommendations to modify the current design of the accrual charge and the allocation of cumulative gains and losses to the Fund.

It is the opinion of the author that the design of the system would best be served if the Treasury's involvement in making payments to the Fund is phased out at the same time the payment on the unfunded liability is completed. This should produce a funding system similar to private funds where a single entity is responsible for funding pension plans. Furthermore, the original intent of Congress to have a DoD accrual charge that reflects incentives to economize on manpower would be left intact and possibly enhanced. If it becomes apparent that the DoD incentive inherent in the accrual charge is masked or distorted by large adjustments for gains and losses, a modified schedule for amortizing gains and losses should be considered.

The Military Retirement Fund has been subject to diversions and potential diversions which could threaten the actuarial integrity of the Fund. If the Military Retirement

Fund becomes responsible for outlays to individuals for whom the Fund's assets weren't originally intended, then legislation should be extended which will allow for the normal cost payment and Treasury payment to compensate for the additional outlays.

C. FURTHER RESEARCH OPPORTUNITIES

An analysis of other federal retirement funds such as the Civil Service Retirement Fund and the Railroad Retirement Fund compared with the MRF could produce significant insight into the legislation and budgeting for federal retirement funds. Of special interest would be a comparison of the Military Retirement Fund's arrangement for handling unfunded liabilities and gains and losses with the arrangement of other federal retirement funds.

In September 1993, the Senate Appropriations Committee recommended that the FY 1994 accrual charge be reduced by $600 million to account for gains in the Fund [Ref. 52: p. 10]. As an alternative, the Committee stated it would be amenable toward reprogramming $600 million out of other DoD funds to produce the same "savings". The report did not specifically endorse the proposal in the December 1992 report from the DoD Board of Actuaries. It is interesting to note that the Committee did not extend legislation which would allow the DoD to modify the accrual charge or its ability to capture gains or losses. An examination of DoD's response to this recommendation and the eventual outcome could provide further insight into the politics and mechanics of budgeting for the MRF.

D. CONCLUDING REMARKS

The establishment of the MRF has been a remarkable change in the manner by which the DoD and Congress budget for military retirement. The MRF has enhanced the security of the Military Retirement System through the earmarking of future revenues. Furthermore, the MRF not only creates cost awareness, but increases the avenues by which military retirement outlays can be curtailed. The funding arrangement for the Military Retirement System is based upon actuarial assumptions and schedules which must be carefully observed in order to maintain the fidelity of the funding plan. As the Federal Government continues to experience large and persistent deficits, which are applying pressure throughout federal programs, the pressure to reduce DoD costs through modifying benefits and personnel costs will increase. Furthermore, the pressure to produce savings through diversions and modification of the current funding arrangement and Fund gains and losses will also continue. While some of the proposals to modify the current funding arrangement may be favorable to the DoD, other proposals to modify the current MRF arrangement may be unfavorable to the DoD and the integrity of the Fund itself.

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