

**PREPARED STATEMENT
OF
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CHAIRMAN
DEFENSE ADVISORY COMMITTEE ON MILITARY COMPENSATION
BEFORE THE
SUBCOMMITTEE ON MILITARY PERSONNEL
OF THE
HOUSE ARMED SERVICES COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES**

APRIL 4, 2006

Mr. Chairman, and members of the distinguished subcommittee, thank you for inviting me here today.

The Defense Advisory Committee on Military Compensation was chartered on March 14, 2005. Its purpose is to "... provide the Secretary of Defense, through the Under Secretary of Defense (Personnel and Readiness), with assistance and advice on matters pertaining to military compensation. More specifically, the Committee shall identify approaches to balance military pay and benefits in sustaining recruitment and retention of high-quality people, as well as a cost-effective and ready military force."

I will take this opportunity to summarize the Defense Advisory Committee's findings and recommendations through January, 2006. Our final report should be published later this month. These recommendations are robust in that they provide flexibility to adapt to changing force structure demands and other circumstances that may arise. However, there may be future changes in force structure or other circumstances that can not be anticipated now. At such a time, these recommendations as well as other aspects of the compensation system should be reexamined.

The men and women who serve in the U.S. military are there through voluntary decisions to enter and remain in military service, not through the coercion of conscription. It is the innate ability, training, experience, and motivation of the men and women that staff this force that are the primary reasons for its superb capabilities. The compensation offered to both active and reserve members, coupled with patriotism and the willingness to serve, is, arguably, the single most important factor affecting our ability to staff the forces with qualified people. Most certainly, it is the most important factor that can be affected by policy.

If the military compensation system is not sufficiently competitive to attract new entrants, its other virtues are moot. Beginning in late FY 2004, the active Army, and to a lesser extent the Marine Corps, began experiencing increased difficulties in the active duty recruiting market. This culminated in the Army falling short of its accession goal in February 2005, followed by additional shortfalls through May.

As the Army's recruiting problems grew in the spring of 2005, the Committee undertook a review of the problem. The Army's current recruiting difficulties appear to be the result of a confluence of several factors to include a robust economy and high employment low unemployment. Another contribution was that the Army had reduced its recruiters in the field in the period prior to increasing its end strength and accession goals. This reduction in recruiters has now been reversed. The Army has successfully met its monthly accession goals through December 2005. While the path ahead remains

difficult—the number of recruits in the Army’s delayed entry program remains low—the resources are now in place to allow it to succeed but the market and the resources necessary to succeed in it must continue to be carefully monitored.

Although there are some acute recruiting problems unrelated to compensation, the current compensation system can be improved. With the inception of the modern all-volunteer force in 1973, first term military pay was increased to a level that was competitive with the civilian sector for youth coming out of high school. However, the compensation system inherited in 1973 has elements of lack of choice and relative inflexibility. These aspects of the basic structure of military compensation have remained largely unchanged. Improvements to the system as described below would complete the transition of the compensation system to the volunteer era, and could result in greater flexibility for force managers, providing a yet more effective and efficient force.

Principles for Guiding Change

Changes to the military compensation system should be focused on increasing the effectiveness and efficiency of the system as a force management tool. Proposals that do not improve staffing, force management, motivation of members, performance, or efficiency should be questioned. The following principles or criteria provide a set of guidelines for evaluating proposed changes to both active and reserve compensation in this context:

1. **Force management.** Changes to the compensation system should be linked to force management objectives.
2. **Flexibility.** The compensation system should be able to adjust quickly to changes in circumstances affecting the supply and demand for personnel in general and for specific skills.
3. **Simplification.** A change that simplifies the compensation system, rather than one that makes it more complex, difficult to manage and difficult to understand, is preferred.
4. **Systems approach.** The change in compensation should consider all the implications for incentives and force staffing.
5. **Choice, volunteerism, and market-based compensation.** Where possible, preferences of individual members should be considered in making policy, and compensation should support policies that consider member preferences and provide choice.

6. **Efficiency.** Proposed compensation changes should be “efficient” in that, of alternative ways to meet the objectives associated with the proposed change, the least costly way should be chosen.
7. **Cost transparency and visibility.** The full costs of proposed changes to the compensation system should be clear.
8. **Leverage.** Where possible, compensation improvements should leverage existing benefits in the civilian or other sectors of the economy, rather than crowd them out.
9. **Fairness.** Commitments should be honored and any changes to those commitments freely entered by both the services and the members.

If a particular proposal meets all or most of these criteria, the proposal is likely to be one that moves the compensation system in a coherent direction towards the development of a highly capable, ready, and efficient volunteer force. If a proposed change is inconsistent with most of these criteria, a reasonable observer would conclude that it is unlikely that this change is an improvement to the compensation system. This presumes that observers share the purpose of the compensation system: to attract, retain, and motivate the right numbers of qualified staff; to ensure that they are allocated to where they are needed most; and to do so efficiently.

A Compensation Architecture

The current compensation system has helped to produce an armed force without peer. However, it contains elements that were better suited to an era of conscription and paternalism. These features impede force management, raise costs, and keep a very good force from becoming even better. The compensation architecture presented below addresses the major elements of the compensation system. In particular, the Committee offers specific recommendations in the following areas:

- Substantial changes to the structure of the active component non-disability retirement system.
- Revamping of the Basic Pay table to better reward performance and to support longer career profiles where desirable.
- Changes in the system of housing and other allowances to remove discrepancies in pay unrelated to performance or a member’s value to the service.
- Consolidation, simplification, and enhancement of Special and Incentive Pays.
- Revision of the system of health benefits for retirees to more closely align the benefit’s value to the retiree with its cost to the Department.

- Periodic evaluation of quality of life programs to ensure that they are cost-effective and focused on alleviating the most onerous aspects of military life for members and their families.
- Review of the system of Reserve Component pay and benefits to ensure that Reserve members called to active duty receive the same pay and benefits as Active Component members and that they have an improved opportunity to continue their civilian health benefits while on active duty.

Summary of Recommendations

Active Component Non-Disability Retirement System

The current system provides an immediate lifetime annuity—generous by civilian-sector standards—for those who leave after completing at least 20 years of service. However, those who complete fewer than 20 years of service receive no retirement benefit. The current system provides a powerful incentive to serve for at least 20 years, and a similarly powerful incentive to leave shortly thereafter.

Under the current system, members essentially become locked into a 20-year career after 8-12 years of service. This may happen even if both the member and the service would be better off if the member left prior to completing 20 years. Members are retained until the vesting point because of the powerful incentive provided by the retirement annuity and by the services' reluctance to be seen as acting opportunistically by involuntarily separating members who have invested many years of service.

The current system also makes a diversity of career lengths across occupations difficult. Careers in the health professions, law, languages, cryptology, engineering, information technology, and other technical and scientific occupations might usefully extend beyond 20 or even 30 years. But the compensation system, coupled with high year of tenure policies that require members of certain rank to separate by fixed “years of service” points, makes careers beyond 20 years unusual and careers beyond 30 years rare.

Paradoxically, the current system also results in career lengths in ground forces and combat arms that may be too short. Enlisted members become vested at much lower rates than officers. The services are reluctant to induce many first term enlisted in these “youth and vigor” occupations to stay for additional terms of service, because they may not be able to offer them a 20-year career. The compensation system does not provide a graceful way for large numbers in the combat arms to stay beyond an initial term and exit prior to 20 years of service.

Recommendation

In the near term, the services need ways to improve management flexibility within the current system.

- In the near term, the services should have the authority to “buy-out” members with more than 10 years of service who are not yet vested. The members would presumably be in occupations where changed circumstances have resulted in an excess supply of qualified members.
 - The “buy-outs” would be voluntary. That is, selected members would be offered the opportunity to accept a cash payment and, in exchange, leave active duty prior to vesting in the current retirement system at 20 years of service. However, the member would be free to reject the opportunity.
 - A plan similar to the Voluntary Separation Pay recently proposed by the Navy would be one way to do this.

This near-term solution does not address the underlying problem: management inflexibility resulting from the current retirement system. In the longer term, the military retirement system should be restructured under a vision that increases its overall flexibility and efficiency. This vision would include earlier vesting of retirement and incentives to serve beyond a 20- or even 30-year career, in some occupations. High year tenure policies should be reassessed so that the potential benefits of longer careers can be realized.

The recommended architecture for a new retirement system would include the following features:

- A government contribution to a thrift savings plan (TSP) or 401K-like plan that is a percentage of Basic Pay in the range of 5-10%. Government contributions would begin to accumulate immediately upon entrance to active duty and would vest no later than year of service 10 (but not before year of service 5). The member should be provided the flexibility to receive the government contribution in cash, in lieu of the TSP contribution, when vested.

- A retirement annuity that begins at age 60, computed under a formula similar to the current retirement annuity. The annuity would vest at the completion of year of service 10.
- The annuity formula would be extended through 40 years of service, so that a member serving 40 years would receive 100% of the high-three average of Basic Pay.
- The retirement health benefit would continue to vest at the completion of 20 years of service.
- Additional compensation, which could come in various forms. For example, it could include one or more of the following:
 - Transition pay of limited duration for those who leave military service after the vesting point, where the amount and duration of the pay is a function of the pay grade and years of service at separation.
 - Additional pay in the form of a multiple of Basic Pay payable at key years of service such as 10, 15, 20, 25, and 30 years. The member receives this “gate pay” upon completing the relevant year of service, regardless of whether the member separates or remains in service at that point.
 - An increase in Basic Pay or bonuses.

This retirement system change is intended to accomplish three goals. First, it will increase management flexibility and permit a greater diversity of career lengths by providing earlier vesting and continued incentives for longer careers. Second, it will permit those who provide substantial service, but less than 20 years, to leave with some retirement benefits. Third, it will increase the efficiency of the retention incentive by replacing the portion of the annuity members receive from separation to age 60 with an “up front” cash payment. This could come in the form of a “gate pay” at various years of service, or of higher levels of Basic Pay or bonuses.

The current force would be grandfathered under the current retirement system. However, they would have the opportunity to choose to participate in the new system at the time it is introduced.

Basic Pay Table and Pay for Performance

The current Basic Pay table—the centerpiece of the compensation system—is a function of pay grade and years of service. Performance is rewarded almost solely

through the promotion system. The primary financial incentive for promotion is the increase in Basic Pay and allowances that comes with the higher pay grade. Those who have performed extraordinarily well may be promoted early. Those who have had lagging, but ultimately adequate, performance may be promoted later.

Because Basic Pay is a function of longevity, the financial consequences of early or late promotion, compared to an “on time” promotion, are small. Promotion that is a year early, for example, results in compensation higher than it otherwise would be only for a year. After that year, the member’s compensation is the same as it would have been for an “on time” promotion.

Another consequence of the existing pay table is that, because compensation is a function of tenure in the system, it will be difficult to attract lateral entrants into the system should it become important to do so. Similarly, it will also be difficult to be financially attractive to prior service individuals who have been in the civilian sector for more than a short period.

Recommendation

The pay table should become a function of time in grade, rather than years of service.

- Time-in-grade increases in Basic Pay should extend beyond the career lengths currently implied by the time-in-service pay table. High year of tenure (“up or out”) policies should be reassessed. For those occupations where high year of tenure constraints have been relaxed to encourage longer careers, the pay table “time-in-grade” increases should provide a financial incentive consistent with longer service. This change will complement changes in the retirement system that provide incentives to serve beyond 30 years.

The time-in-grade pay table would improve performance both by encouraging greater effort and performance from all, and by being a more attractive system to top performers compared to others. By extending time-in-grade increases to reward service that may extend beyond 30 years, the pay table will provide the financial incentives to encourage longer careers, where appropriate.

Finally, a time-in-grade pay table will be more attractive to prior service individuals considering reentry, as well as to lateral entrants in selected skills.

Differences in Compensation by Dependency Status

The current allowance for housing varies by pay grade and geographic location, as well as whether or not the member has dependents. This variation by dependency status is a remnant of paternalism carried over from an earlier era. Members with dependents receive housing allowances that are about 25% greater (on average) than those who have no dependents at the same grade and year of service.

There is no evidence this differential is related to differences in the productivity or value of the member to the service. Moreover, the differential may encourage, at the margin, members to marry, or to marry earlier than they otherwise might. Further, because members with dependents are paid more than those without dependents, retention rates for members may be relatively higher for those with dependents compared to those without dependents than they might otherwise be.

Members receive the basic allowance for housing when they do not receive government housing (quarters “in-kind”) at a military installation. When a member and family receive government housing, they forfeit the basic allowance for housing (BAH). In principle, the fair market rental value of the government housing is approximately equal to BAH. In practice, this is more likely to be true for mid-level, senior enlisted, and officers than it is for single junior enlisted who live in barracks.

There are other benefits that distinguish between members with dependents and those without dependents. The Overseas Housing Allowance, for example, provides for a differential based on dependents in a manner similar to BAH. Further, the Family Separation Allowance, by its nature, is not provided to members without dependents.

Recommendation

- The distinction between “with” and “without” dependents in the payment of BAH should be eliminated by paying the allowance to all at the “with dependents” rate. The Overseas Housing Allowance should also eliminate the distinction between those “with” and “without” dependents through a similar change.
- All members should receive BAH. Those in government housing should pay fair market rental rates for the housing they receive. This may mean that some members, particularly junior enlisted living in barracks, would receive BAH that is greater than the amount they must pay for government housing.

- The Family Separation Allowance should be consolidated with other Special and Incentive Pays related to deployment or unaccompanied tours. Appropriate compensation for deployment or the nature of the tour should not differ between those with dependents and those without dependents.

Paying BAH at a rate that does not vary by dependent status eliminates a component of compensation variation that is unrelated to performance. Further, it no longer provides a differential financial incentive to retain those with dependents. In the long run, this more neutral policy with regard to dependents will reduce some types of costs. Raising the “without” dependents rate to the “with” rate will increase compensation of single members and improve retention of these members. Moreover, because single members are disproportionately in the first term enlisted force, the change in BAH should have a positive effect on recruiting.

Special and Incentive Pays

Basic pay and allowances constitute the largest portion of cash compensation—well over 90% on average. These compensation elements, however, vary only by pay grade and years of service. Special and Incentive (S&I) pays are, in principle, the pays that provide the flexibility of the compensation system to respond to differences in supply and demand by occupation, provide compensating differentials for onerous assignments or hazardous duty, or provide incentives to acquire and remain proficient in particular skills. With the flexibility to target these pays to meet specific staffing challenges, S&I pays can be particularly powerful tools for improving staffing and personnel readiness.

While S&I pays are an important part of the compensation package, the current pays have important weaknesses that inhibit their effectiveness and efficiency. The proliferation of pays (there are currently over 60 different S&I pays) makes the system difficult to monitor and manage. Further, payment criteria and payment amounts for many of the S&I pays are rigidly established in law. Some pays have become entitlements that are paid regardless of any underlying force management or staffing issue. In this sense, some of these pays have impeded flexibility, not increased it. Finally, S&I pays constitute only a very small portion of cash compensation—about 5% of cash compensation and about 3% of total compensation. Given that these pays are the primary compensation policy tool to directly target specific staffing and incentive problems, the proportion appears to be inefficiently small.

Recommendation

- Special and Incentive pays should be consolidated into a smaller number of categories. These categories would be descriptive of the broad function of the pay.
- Within each broad category, the budget should be fungible across areas that are included in the broad category. Within broad parameters specified in legislation, the Secretary of Defense and the Secretaries of the military departments should have the authority to determine criteria, payment amounts, and to change payment amounts.
- Of special importance is increased flexibility in responding to wartime conditions to insure that retention and recruiting remain satisfactory. Within the category of hardship/hazardous duty or imminent danger (or the equivalent), the Secretary of Defense should have the authority and discretion to provide monthly payments to deployed members, up to a maximum ceiling amount specified in law.
 - The Secretary would have the discretion to determine if any payments are made; to target those payments by occupation, unit, geography, or other criteria; and to determine the amount of the monthly payment up to the maximum.
 - The legislated maximum should be set reasonably high. This is to provide the Secretary with the flexibility to meet unlikely contingencies.
- Given changes in the structure of S&I pays, the share of S&I pays in the compensation budget should be increased. Once such an increase has been achieved, the effectiveness of S&I pays in achieving force staffing goals should be evaluated to determine if the increase should be sustained.

The current Selective Reenlistment Bonus (SRB) program is an example of how the consolidated S&I pay program may operate. There would be authority to raise or lower payments over broad ranges, with force managers making tough tradeoff decisions across competing uses within overall budget authority. The consolidation of S&I pays and the increased flexibility in the authority to pay them should result in a more efficient program and in improved staffing and readiness.

Military Health Benefit

TRICARE, the military health benefit, is a valuable component of the military compensation package. The health benefit offered to the active member and the member's family competes favorably with the benefits offered by civilian employers. It serves to increase the attractiveness of military service. Moreover, its comprehensive

nature is particularly valuable to the family when the member is deployed, mitigating stress on the family from that source. The health benefit offered to military retirees, however, has shortcomings. The provision of a retiree health benefit, both to pre-65 retirees and under TRICARE for Life for the post-65 retirees, is a deferred, “in-kind” benefit that is not likely to be valued highly by junior and mid-career active duty members, but is costly to the Department.

Moreover, in the case of the pre-age 65 benefit, it tends to “crowd-out” civilian health benefits for the pre-65 retirees. Most pre-age 65 retirees are employed in the civilian sector and are offered a health benefit by their employer. The employee is typically asked to pay a share of the total premium. Because TRICARE premiums for pre-age 65 retirees have not been adjusted since 1995, pre-65 retirees are increasingly switching to TRICARE. There is evidence that some employers provide cash bonuses to employees who are eligible for TRICARE and are willing to shift to TRICARE. The pre-65 retiree who switches to TRICARE from a civilian employer program gains the difference in the premiums (and any bonus from the employer). However, the Department pays for the full cost of the insurance, less the nominal premium. The civilian employer’s plan saves the difference in premium cost to the employer. The result is a large cost to the Department of Defense for a relatively modest benefit to pre-65 retirees and a subsidy to civilian employers. This migration from civilian health programs to TRICARE should be discouraged.

Recommendation

- The premium and cost-sharing provisions for TRICARE retiree pre-65 Prime beneficiaries should be restored to more competitive levels commensurate with premiums and cost sharing in civilian employer plans.
- The premium and cost-sharing provisions (i.e., deductibles and copays) once adjusted should grow at the same rate as the annual cost-of-living adjustment to the military retirement annuity.
- The retiree pre-age 65 TRICARE plan should be funded on an accrual basis, similar to retirement pay and the TRICARE for Life programs.

Funding the entire retiree health program on an accrual basis should result in decisions regarding active duty personnel strengths that more fully reflect the cost, potentially resulting in more efficient choices. Further, greater visibility to the costs of the health care program in the budget will help to focus attention on managing those costs. However, because the change to an accrual basis for the pre-age 65 TRICARE benefit from a system of budgeting for actual outlays is an accounting change, a one-time

accounting adjustment should be made to the Defense budget “top line” to offset the difference between the accrual charge and what the outlay costs would have been in the year that the change is made. The incentives provided by the budget structure should also be examined to ensure that those who are likely to be most effective in controlling health care costs have the appropriate budgetary incentives to do so.

Quality of Life Programs

Quality of life programs are an integral part of the total compensation package. They provide members and families with recreational and shopping opportunities in remote areas where they otherwise would be unavailable. They help members and their families adjust to the rigors of military life, including frequent permanent change-of-station moves and deployment. They are particularly important to military families in helping prepare for deployment and adjust to the absence of the deployed military member.

Two particularly difficult areas associated with the quality of life for members and families are spouse employment and dependent schools. Because of frequent moves and assignments to remote areas or areas with underdeveloped community services, spouses may face reduced employment opportunities, and educational opportunities for spouses and children may be less than desired. One way to attempt to reduce hardships on military members and their families in these areas is by providing greater choice in assignments, subject to the needs of the service.

Quality of life programs can be a valuable way to offset some of the hardships that military life imposes on the member and the family. However, it is important to consider that “in-kind” compensation, which includes most quality of life programs, is generally less efficient than cash compensation. Moreover, it is also important to leverage programs and services that are available in the civilian sector where possible, rather than “crowding out” civilian sector services and opportunities through direct government provision.

The benefits of quality of life programs are often difficult to discern clearly. Because resources are scarce and quality of life programs compete directly with other uses of compensation resources, such as cash compensation, it is important that the benefits and costs of quality of life programs be better understood. Finally, commanders of military units should ensure that members understand and know how to take advantage of these quality of life programs.

Recommendation

Quality of life programs should be subject to periodic, rigorous evaluation to ensure that they represent the best use of resources, meeting the demands of members and families, and the readiness demands of the services.

- Recognizing that the quantitative assessment of the benefits of such programs is difficult, the Office of the Under Secretary of Defense (Personnel and Readiness), should develop a framework and guidelines for determining the efficacy of potential investment in quality of life programs.
- Further, programs that are implemented should be periodically and systematically evaluated, using these guidelines, to insure that the programs continue to represent the best expenditure of resources.

Reserve Compensation

During the Cold War, the role of the reserve components was that of a strategic reserve. Reserve members were expected to remain ready through weekend drill and summer training. They were likely to be called only rarely and within the context of a larger, national mobilization scenario. In the post Cold War period, the role of the Selected Reserves has changed from one of a strategic reserve to one of an “operational reserve” with reserve units more highly integrated into deployment operations. Despite the smaller size of today’s reserve, annual mobilization days for reserve members have increased significantly relative to the Cold War, with peaks for Desert Shield/Desert Storm and Operation Enduring Freedom/Operation Iraqi Freedom (OEF/OIF).

One would anticipate that some reserve members who entered under the older concept of reserve use might find it difficult to continue under the anticipation of more frequent mobilization. In particular, deployment to OEF/OIF operations might be expected to reduce retention. However, despite this significant change in the expected use of the reserve, retention has remained acceptable, in the aggregate. Recruiting in the Army National Guard and Army Reserve has fallen short of goals.

Reserve members who are mobilized are frequently faced with the choice of maintaining their civilian employer-provided health insurance for their family or changing to TRICARE. In many instances, changes in health insurance also imply changes in health care providers. Because continuity of care is important, particularly when family members are undergoing treatment, many members attempt to keep their civilian employer’s health insurance during periods of mobilization.

Recommendation

- Mobilized reserve members and any reserve member on active duty should receive the same pay and benefits as otherwise equivalent active duty members.
- Reserve members who are called to active duty but who choose not to participate in TRICARE should be offered a stipend or payment to help defer the cost of their alternative insurance.
- The reserve components must have the flexibility to solve recruiting and retention problems as they arise. A “systems” approach is critical to recruiting in that active and reserve components recruit from the same non-prior service market and prior service reserve accessions are active duty losses. Further, because reserve units rely on a local population for staffing, reserve components need the flexibility to target incentives by unit or geographic location.

In addressing actual staffing problems or anticipating future problems, it may be tempting to increase the attractiveness of reserve service by (for example) increasing retirement benefits or health benefits offered to reserve members. It is important, however, that any changes in the compensation and benefit system for reserve or active duty members be structured to achieve force management and staffing goals efficiently, and be considered in the context of a comprehensive “system” where both active and reserve staffing are considered.

We have today a force without peer. However, it operates, in part, under a compensation system that was best suited for an earlier era. The recommendations suggested here would modernize the compensation system. The recommended retirement system architecture increases force management flexibility, provides for a greater diversity in career lengths, and enfranchises members who serve less than 20 years. Changes to the pay table and housing allowance will make the compensation more responsive to performance, motivating and encouraging the top performers, while eliminating distinctions in compensation that are not relevant in a volunteer force. Consolidation of special and incentive pays will simplify a complex system and improve its efficiency. Adjustments to the health benefit will better align benefits and costs, and insure that costs are visible to those making force management decisions. Finally, with greater operational integration of the active and reserve component, it is important to firmly establish the principle that the reserve member enjoys the same compensation as his or her active duty counterpart when called to active duty.

Thank you for the opportunity to present these recommendations.

Members of the Committee

Chairman

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- Retired as Vice Chief of Naval Operations, U.S. Navy, November 2000

Members

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- Keith & Jan Hurlbut Senior Fellow, Hoover Institution, Stanford University
- Member, Defense Policy Board, 2001
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Mr. Frederic W. Cook

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