In this chapter, we describe the compensation scheme we evaluated. This scheme consists of a retirement system which we call MFERS, a pay raise, and a system of retention bonuses. MFERS consists of three main parts that are identical to the three main parts of FERS: (1) a defined benefit plan called the “basic benefit plan” where the member’s benefit is predetermined by a formula, (2) a defined contribution plan called the “thrift savings plan” where the member’s benefit is determined by market forces and where workers have several withdrawal options should they separate from federal service, and (3) Social Security benefits.

We describe below these three parts of MFERS in greater detail, highlighting the vesting provisions, benefit determination methods, and other key provisions, as well as the ways in which MFERS would differ from FERS. We also describe two methods that could be adopted to transition the current system to MFERS. One is simply to grandfather current members under the new system, as was done for prior retirement system changes. The second would allow current members to convert to MFERS.

**BASIC BENEFIT PLAN**

Just as with FERS, the basic benefit plan under MFERS would vest members at five years of service. That is, a member must have at least five years of service to be eligible to receive benefits under the plan. Under the basic benefit plan, members would be required to contribute a small percentage of their basic pay—7 percent minus the tax rate under Social Security’s OASDI (Old-Age, Survivors, and
Disability Insurance) program. In 1994, this percentage was .8 percent. However, the member would have the option of getting a refund of these contributions with interest instead of the retirement annuity when he or she left federal service.

The benefit formula under the basic plan equals 1 percent of an individual’s highest three-year average pay times the years of service (YOS). If the member retires at or beyond age 62 with 20 or more years of service, the formula is 1.1 percent of highest three-year average pay times YOS. The normal age of retirement (i.e., the age when an individual can leave the service and begin collecting this benefit) depends on the member’s years of service. The schedule is shown in Table 1. For those with five years of service, the normal retirement age is 62. For those with 20 YOS, the normal age is 60. For those with 30 YOS, the normal age is between 55 and 57, depending on one’s date of birth.

The basic benefit plan also allows for early retirement. Those who have 10 years of service could retire as early as age 55 or age 57, depending on their date of birth. The basic benefit plan also would give a cost-of-living-adjustment (COLA) to those age 62 and older. This adjustment would equal the change in the Consumer Price Index (CPI) if the change in the CPI is less than or equal to 2 percent. It would equal 2 percent if the change in the CPI is between 2 and 3 percent and would equal the percentage change in the CPI minus 1 percent if the change in the CPI exceeds 3 percent.

Table 1
Normal Age of Retirement Under Basic Benefit Plan

<table>
<thead>
<tr>
<th>Age</th>
<th>Years of Service</th>
</tr>
</thead>
<tbody>
<tr>
<td>62</td>
<td>5</td>
</tr>
<tr>
<td>60</td>
<td>20</td>
</tr>
<tr>
<td>55-57a</td>
<td>30</td>
</tr>
</tbody>
</table>

aThe allowed normal retirement age depends on date of birth.
THRIFT SAVINGS PLAN

The thrift savings plan is a defined contribution plan that shares many features with the 401(k) pension plans found in the private sector. Under the plan, the government makes automatic and matching contributions to a fund and the employee has several options for investing the fund, including investing it in a government securities fund, a common stock fund, or a fixed-income index fund (or some combination of the three). The government’s automatic contribution for each member is 1 percent of the member’s basic pay, in which the employee is vested after three years. The government will also match contributions made by the employee up to 5 percent of basic pay. \(^1\) Individuals are immediately vested in their own contributions, and their contributions (and earnings from the contributions) are tax deferred.

The thrift savings plan has several provisions for withdrawing funds. Members can withdraw the balance of their account only if they leave federal service. The withdrawal options depend on whether the member is eligible for retirement benefits under the basic benefits plan, as determined by his or her age and completed years of service. If the member is ineligible and separates from federal service, he or she must transfer the vested account balance of the thrift savings plan to an Individual Retirement Account (IRA) or other eligible retirement plan. \(^2\)

If the member is eligible for retirement benefits, he or she has three withdrawal options. First, the member can transfer the account balance to an IRA. Second, he or she can receive a cash lump sum or a series of equal payments. Finally, he or she can purchase a life annuity that can begin at the date of separation or later. If the member chooses the first option, he or she faces a 10 percent penalty for withdrawing from the IRA before age 59.5. Under option 2, if the

\(^{1}\)Specifically, the government matches 100 percent of the employee’s contribution for the first 3 percent; 50 percent of the employee’s contributions for the next 2 percent; 0 percent of the employee’s contributions above 5 percent. An individual can contribute a maximum of 10 percent of basic pay each period subject to Internal Revenue Service restrictions.

\(^{2}\)This is true if the account balance exceeds $3500. If the balance is $3500 or less, the member receives an immediate lump-sum cash payment.
member receives any proceeds before age 55, there is a penalty equal to 10 percent of the amount received before age 59.5.

**SOCIAL SECURITY BENEFITS**

Both the current military compensation system and MFERS include Social Security benefits, and members’ earnings under both plans are subject to Social Security taxes. Thus, with regard to Social Security benefits, there is no difference between MFERS and the current military system. The only difference that can arise is if MFERS is coupled with an active duty pay increase. In this case, the members’ Social Security tax liability is greater (since the tax is figured as a percent of earnings) and the members’ future Social Security benefit is greater under MFERS since active duty pay would be greater. The net effect would depend on the rate of return on Social Security taxes. In the analysis in Chapters Four and Five, we ignore the differences in Social Security benefits and liabilities between MFERS and the current military retirement system.

**COUPLING MFERS WITH A PAY RAISE**

Under MFERS, military members would be required to contribute to their basic benefit plan and could voluntarily contribute to the thrift saving plan, as discussed earlier. Under REDUX, the current system, members make no contributions to retirement. To reimburse members for their mandatory contributions under MFERS’s basic plan and the tax consequences of those contributions, MFERS would be coupled with a 7 percent pay increase. Any retention problems that occurred under this system would be addressed through retention bonuses that could be targeted to distinct populations.

**DIFFERENCES BETWEEN MFERS AND FERS**

MFERS differs from FERS in several respects. First, MFERS would allow medical, Commissary, and Exchange benefits for those military personnel who reach 20 years of service, just as under the current military retirement system. Second, the thrift savings plan under FERS features a loan program. Individuals can borrow from their contributions to the plan for the purchase of a home, educational
expenses, medical expenses, or because of financial hardship. The ability to cash out contributions based on financial hardship when leaving military service would be made explicit under MFERS. We ignore these features of MFERS in our analysis in this report and focus solely on the basic plan and the thrift savings plan features.

TRANSITIONING TO MFERS

One transition option is to grandfather current members under Redux; another is to allow current members to voluntarily convert to MFERS or remain under Redux. Obviously, those who convert would forgo the expected benefits they would have earned from the current military retirement system. Furthermore, their previous years of service under the current system would not be included in the calculation of benefits under MFERS. Thus, for example, members who convert to MFERS at 10 years of service would have only one year of service under MFERS when their YOS was 11.

To compensate members who convert to MFERS for the loss in expected retirement benefits that would occur by moving away from the current system, those who convert would earn double the government’s thrift savings plan contributions for a period of time equal to years of prior service. For example, a member with six years of service who converts to MFERS and contributes 5 percent of basic pay into the thrift savings plan would earn DoD contributions equal to 10 percent of basic pay for the next six years. This would allow converting members to gain some credit for their prior years of service. Nonconverting members would also have an opportunity to contribute to the thrift savings plan, but none of their contributions would be matched by DoD.