Modernizing Military Compensation: Providing an Enduring Military Retirement Benefit
WHO WE ARE
Business Executives for National Security (BENS) is a unique nonpartisan, nonprofit organization of senior executives who volunteer time, expertise, and resources to assist defense and homeland security leaders on a variety of national security challenges.

OUR MISSION
Apply best business practices to develop, for government officials, solutions to our nation’s most challenging problems in national security, particularly in defense and homeland security.

ACKNOWLEDGMENTS
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ABOUT THE REPORT

“Providing an Enduring Military Retirement Benefit” is part of Business Executives for National Security’s (BENS) Modernizing Military Compensation Series. Capitalizing on the knowledge and experience of current and former private sector executives, this series examines military compensation programs and offers insights and recommendations for creating a more sustainable and effective compensation system. This report focuses on the military retirement benefit. BENS discusses the benefit’s cost and need for reform, as well as recommends a retirement system that would better suit a 21st century military. BENS shared the substance of this report with the Military Compensation and Retirement Modernization Commission on April 9, 2014.
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EXECUTIVE SUMMARY

The military retirement benefit has come under scrutiny recently due to its rising costs and potentially outdated structure. Payments to military retirees rose by 49 percent between 2002 and 2012, and continue to climb. In 2013, the Military Retirement Fund (MRF) dispersed approximately $54 billion to 2.3 million beneficiaries. By 2023, the Congressional Budget Office (CBO) projects spending will rise to $70 billion despite the number of beneficiaries essentially remaining unchanged.\(^1\)

Additionally, the Military Retirement System (MRS), which generally provides service members with 20 or more years of service with a monthly pension, does not reflect changes to our military and society. Despite a move from conscription to an all-volunteer force, greater parity between military and private sector wages, and increased incidence of post-military careers that supplement retirement income, the military retirement benefit has largely gone unchanged since its implementation in the late-1940s. Many organizations including the Department of Defense (DoD) have called on Congress to reform the system and modernize the benefit to reflect today’s norms.

Reflecting on these issues, BENS convened a group of senior executives to examine the military retirement system. This group used their understanding of compensation and its role in recruiting and retaining top talent to provide insights that would help policymakers determine the need and impact of reform. BENS made three key findings:

First, BENS found that while costs are rising, DoD’s costs are not likely to grow at the rate experienced in the last decade. Because the military retirement system operates under accrual funding, DoD’s annual retirement costs are not tied to monthly payouts to retirees, but rather the Department’s annual contribution to the MRF. DoD’s accrual costs rose dramatically from approximately $14 billion to $22 billion in just six years from 2006 to 2012, but now stand at $20 billion. DoD anticipates their accrual costs will level at $20 billion through 2017 and gradually rise to $23 billion by 2022.\(^2\)

Moreover, while pension payments continue to steadily grow, rising to $70 billion by 2023, these payments are likely to begin to level in the following years. This is because pension payments are tied to a service member’s basic pay, and as basic pay rises or levels, so too does retirement costs. Congress has signaled that the raises in basic pay that were seen in the previous decade are not likely in the near future, and therefore the cost of future payments will also level. The same effect can be attributed to the rise in DoD accrual cost several years ago and the leveling that is seen today. As future payments will cost less, the amount of accrual funds needed to cover those future costs is also less.
Second, the MRS appears to assist in retaining individuals beyond ten years of service. For example, forty-three percent of officers who reach the ten year mark remain until retirement eligible at twenty years of service. However, its assumed effect in the recruitment and retention of younger cohorts is not well validated.

Third, the MRS has not evolved as retirement benefits in the larger public and private sector have. DoD has neither taken advantage of the opportunity to save money through substantial reform, nor establish a benefit for those serving less than 20 years.

Based on these findings, BENS recommends DoD adopt a hybrid defined benefit-contribution plan that offers portability and, particularly, flexibility. BENS believes a hybrid approach that provides some level of savings, as well as incorporates the appeal of a defined-benefit in addition to the portability of a defined-contribution component would be a more preferable military retirement system. The recommendation of BENS is consistent with other analytical efforts. In March 2014, the DoD proposed a plan that preserves a fixed-income pension for future 20-year retirees that offers a smaller monthly payout and a lump sum transition payment upon retirement. This modified pension plan would be offered alongside a 401(k)-style defined contribution benefit for all service members whereby DoD would provide an annual direct deposit equal to 5 percent of basic pay after two years of service, full individual ownership of these accounts after six years, and a cash retention bonus at 12 years. Similarly, a study by the RAND Corporation in November 2014 concluded that a new model that offers smaller monthly pensions, but provides lump sum “transition pay” immediately upon retirement could be popular. The results suggest that many service members would choose to take an end-of-career payout likely amounting to about two and half years of their annual basic pay in exchange for smaller monthly checks between the time they retire from the military until age 65.
INTRODUCTION

The MRS currently consists of a defined-benefit plan whereby service members with generally 20 or more years of service receive a monthly pension immediately upon retirement, along with non-monetary benefits such as access to installation commissaries and medical care. Service members do not contribute to this system and Cost-of-Living Adjustments (COLA) applied annually protect retiree pensions from inflation.v

This system is continually under review as part of a law requiring the President to comprehensively examine the military compensation system every four years,vi but most recently it has been under scrutiny due to its growing cost in today’s austere budget environment and perceived outdated structure. vii Payments to military retirees and benefit recipients rose by 49 percent between 2002 and 2012 and continue to climb.viii In 2013, the MRF dispersed approximately $54 billion to 2.3 million beneficiaries. By 2023, the CBO estimates that, despite the number of beneficiaries remaining essentially unchanged, spending will rise to $70 billion (See FIGURE 1). ix

Organizations such as the Defense Business Board (DBB), Heritage Foundation, and the Center for American Progress argue that the military retirement system is outdated and suited for the previous generation, not the current one.x The current system has largely gone unaltered since its implementation in 1948 – ignoring such changes as a transition from conscription to an all-volunteer force, greater parity between military and private sector wages, longer life expectancy, and increased incidence of post-military careers capable of substantially supplementing retirement income.xi

These organizations call for a modified system that, in addition to being less costly to the government and recognizing the change to an all-volunteer force, provides greater flexibility for military leaders to shape the force and is more readily available to more service members. Under the current system, 83 percent of men and women who serve do not receive retirement benefits due to its 20-year vesting requirement (although “vested” short of 20 years members do receive a separation benefit).xii Several organizations, DBB and Heritage for example, recommend moving the military system away from the existing defined-benefit to a defined-contribution plan through expansion of the military Thrift Savings Plan.xiii xiv

In consideration of the many concerns that the current retirement system is out-of-step
with the times, BENS convened a group of senior executives to examine the need for change. This group was selected based on their understanding of retirement compensation and its role in recruiting and retaining top talent. The group focused its evaluation on the active component retirement plan due to its substantially larger share of the wider military retirement compensation system. Their goal was to provide insights that would help policymakers determine the need for and impact of reform. And, if reform was determined to be necessary, they would recommend an alternative retirement system better suited for today’s military. The group met with officials familiar with the military retirement system, consultants who have helped private companies and municipalities transition from a pension-style benefit, as well as public and private-sector actuaries. They also modeled the potential savings of a defined contribution plan and compared the military’s retirement benefit to the benefit offered at high performing companies and public agencies that maintain a workforce similar to the military.

Figure 1
DoD Obligations for Military Retired

![Graph showing DoD Obligations for Military Retired]

Data: Department of Defense & Congressional Budget Office
THE MILITARY RETIREMENT SYSTEM

The military retirement system is a cliff vesting 20-year defined-benefit plan that provides a monthly pension payment immediately upon retirement from the active component. The monthly pension is determined by one of three methods based on the date a service member first enters service. For members who entered service before September 8, 1980, the compensation is equivalent to the final base pay (that is, without allowances and subsistence payments) received at the time of retirement multiplied by 2.5 percent for each full year of service and prorated by one-twelfth for each complete month less than a year.\(^\text{xv}\) In effect, retirees with 20 years of service receive a monthly allotment equal to 50 percent of the service member’s base pay while in uniform; 30-year retirees receive the maximum allotment which equals 75 percent of base pay.

For those who entered service after September 8, 1980, rather than final base pay, the pension is determined based on the average of the highest three years of service pay—known as ‘High Three.’ Lastly, for service members entering after August 1, 1986, the member can choose either the aforementioned High Three or they can opt for a $30,000 bonus at fifteen years of service and a tiered retirement pension that pays out one percent less for each year of service under thirty years when under age 62 and High Three rates thereafter.\(^\text{xvi}\) Under the latter option known as ‘Redux,’ those with twenty years of service would receive a pension equal to forty percent of their High Three service pay until age 62, and then return to fifty percent at 62. Redux, however, is the least popular retirement plan with less than one percent of current retirees selecting this option.\(^\text{xvii}\)

The Congressional Research Service (CRS) reported that the overall majority of retirees, 86 percent as of 2009\(^\text{xviii}\), qualify for pensions based on final pay. CRS also reported that with the younger cohort of those members still on active duty having reached thirty years in 2010, the number qualifying under final pay will steadily decline.

The retirement system for Reservists is similar to active duty, but uses a point system to calculate ‘qualifying years’\(^\text{xix}\) and generally does not disperse pension payments until age 60.\(^\text{xx}\) Points are awarded based on various Reserve activities.

Disability retirement is also available for those who qualify. A service member retired for disability may choose a retirement plan based on years of service or one based on the severity of the disability.\(^\text{xxi}\)

Service members can also participate in the federal Thrift Savings Plan (TSP), a defined-contribution plan similar to a private-sector 401 (k) plan. Unlike many private sector plans, however, the government does not offer matching contributions.\(^\text{xxii}\) Participation in the program varies depending on Service and pay grade – ranging from 11 percent for enlisted US Army Reserve to 52 percent for enlisted active-duty Navy.\(^\text{xxiii}\)
MILITARY RETIREMENT COST

One of the key arguments to reform the military retirement system is its cost. Some critics have called the costs unaffordable or unsustainable. However, these projections often depart from a baseline starting in FY2000 through FY2010 when military base pay averaged a 4.2 percent yearly increase. These rates translated into a larger contribution the Department had to make to the Military Retirement Fund for future retirees. Since 2011, pay increases have averaged 1.4 percent annually. Should constrained budget realities persist as expected and pay increases remain near the current rates, the MTF contributions are likely to level off at about 30 percent of the annual cost of basic pay. This amount is about 2.5 percent of the DoD budget.

Further, when considering the cost of the military retirement system, it is important to reconcile both the input (the annual cost to support the Military Retirement Fund) and the output (the annual amount paid out to military retirees and beneficiaries). At times, these accounts are conflated or combined to show the total cost of the system. Since 1985, the DoD budget has included accrual payments to the MTF sufficient to finance future payouts to current active duty personnel when they retire. Payments to the MTF for the total future cost of payouts that result from military service prior to the accrual accounting change come from transfers from the General Fund of the Treasury and are categorized as an unfunded liability.

Some concerns have been voiced about the amount of unfunded liability resident within the MRS. However, as the Congressional Research Service points out: “(1) the hundreds of billions of dollars of unfunded liability is a cumulative amount to be paid to retirees over the next 50 years, not all at once; (2) by the time some persons first become eligible for retired pay under the pre-accrual accounting system, many others will have died; and (3) unlike the private sector, there is no way for employees to claim immediate payment of their future benefits. An analogy would be that most homeowners cannot afford to pay cash for a house, so they get a mortgage. If the mortgage had to be paid in full, almost no homeowners could afford to do so. However, spread out over 30 years, the payments are affordable. Similarly, the unfunded liability of federal retirement programs is deemed affordable when federal retirement outlays are spread over many decades.”
RECRUITMENT AND RETENTION

Retirement benefits are designed to recognize and reward those who have served as well as provide an inducement to sustain the all-volunteer force. BENS found little evidence outside of anecdote to support the contention that the current military retirement benefit provides significant influence in the recruitment and retention process for the demographic writ large.

Fewer than twenty percent of enlisted members stay beyond the ten year point; for officers, the rate is about forty percent. For officers who reach the ten year mark, forty-three percent then go on to receive retired pay. Historically, only thirteen percent of enlisted personnel stay in service long enough to receive a pension. It is hard then to make the connection that the promise of retirement benefits correlates strongly with recruitment and retention.

Veterans Services Organizations claim retirement reform will hurt recruitment and retention. The Military Officers Association of America believes that retirement plan changes “would do grave damage to long-term retention and readiness. By dramatically reducing its financial commitments to service members without any reduction in the enormous sacrifices demanded of career troops and families, it would destroy the sense of reciprocal commitment between member and service.”

Nevertheless, if retirement benefits remain a valued tool (and for those who choose a career it has influence), the standard twenty-year vesting provides little flexibility in recruiting and retention. The current system incentivized a force profile for today but it may not be appropriate for tomorrow’s. As stated, the Services may not necessarily want more traditional 20 plus consecutive year career troops. Rather, it may prefer highly specialized members, e.g., cyber, to move between civilian and military careers in order to stay relevant in the latest technologies and information. The current 20-year vesting provides little flexibility for rewarding those sought after individuals. Moreover, it does not reward other in-demand fields like special operations.

BENS noted that much of the debate tends to focus on those already serving or those who have already served and believes the focus of retirement reform should solely be on the future force. It is largely agreed by most in the debate, to include the BENS executives participating in this study, that any reform should and will grandfather all those currently in uniform and those who have already retired. A commitment was made and precedent should be followed to not change the benefit ex post facto. The contention of this report, on the other hand, is that the current defined-benefit program seems to have been an appropriate benefit for the past and current force, but it may not be appropriate for the future force. We live in a time where priorities and resources have shifted, and we should be open to discussing changes that would adapt and serve our military force and service members better going forward.
Having discussed the need to keep faith with those currently in uniform, BENS believes it is fair to question the value of the retirement system vis-à-vis retention in the future. The impact on retention must be a key consideration for any reform. Upon discussions with several subject-matter experts who worked with private and public entities transitioning from traditional pension-style retirement benefits to alternative plans, BENS was surprised to learn that there has been little study of the effects retirement plans had on retention. In fact, a paper released in November 2014 may be the first report that provides empirical evidence on the retention effects of removing the cliff-vesting component of a public sector retirement system.\textsuperscript{xxvii}

That report, which evaluated the attrition rates of the Australian Defense Force following their transition from a defined-benefit pension with 20-year vesting to a new system with both defined-benefit and defined-contribution components, found attrition rates were lower under the 20-year, cliff-vested defined-benefit plan than compared to the new plan.\textsuperscript{xxviii} The study concluded that the removal of the traditional cliff-vested benefit had important consequences on retention and that further research is needed, particularly to determine retention based on employee quality.\textsuperscript{xxix} This study and its results make clear that further analysis is appropriate before substantive reform decisions are made.
One method to assess the validity and worth of the MRS today is to compare it to retirement packages of private companies, as well as comparable public sector professions. The private companies used for this assessment represent the top companies within their respective industries as determined by their rank in the Fortune 500 portfolio of companies. These companies attract the “best and brightest,” and do well at retaining them. The public service organizations selected for this assessment represent a variety of comparable professions in populous cities throughout the United States. The main observations from this comparative examination are below. The key difference between both the private sector company plans and the public service organization plans versus the MRS is the ability for almost all employees to receive some level of retirement benefit regardless of their years of employment in the organization. The greatest benefit of the MRS is that unlike the other two types of organizations examined, it does not require any contribution on the part of the service member, and the payout is significant and lifelong after retiring.

- **Differences between Private Companies’ Retirement Plans and the MRS.** The primary distinction between private companies and the MRS is the provision of a 401(k) benefit within the former but not the latter. Currently, of the nine companies considered, 100 percent of them offer a 401(k) defined-contribution plan with a company match, ranging from 4.5 to 6 percent of the employee's salary based on what the individual contributes. Almost all of the private companies maintained a vesting period of 3 years with all personal contributions refundable any time one leaves the company. Those funds, along with the company match contributions would then be able to be rolled over into a future 401(k) plan or used at the employee's discretion if he/she attained the required number of years to be fully vested. Only two of the nine private companies examined also provide a defined benefit retirement plan for employees. (See ENCLOSURE)

- **Differences between Public Service Organizations’ Retirement Plans and the MRS.** Two primary distinctions exist between the MRS and the retirement packages of other public service organizations. First, 100 percent of the plans are defined-contribution and are mandatory for employees. All of them deduct the contribution directly from employee's salary before taxes but match their employees' contributions. Second, 100 percent of the public service organizations considered offer an optional deferred compensation plan, either a 401(k) or 457 (a type of non-qualified tax advantaged deferred-compensation retirement plan that is available for governmental and certain non-governmental employers.) Few match these plans but offer them as an additional way for employees to invest.
Mandatory employee contributions to their retirement fund are refundable any time the employee leaves the service, and the contributions of the organization can also be withdrawn by the individual if the specified vesting period is attained prior to departure. Employees that leave early usually have the option to defer the payment of the fund until their normal retirement time or receive the refund immediately. The MRS offers only a defined-benefit plan that, while it does not require service member contribution, cannot be redeemed by anyone who departs military service prior to 20 years in uniform. Additionally, the MRS does not contain provisions for a deferred compensation plan, which must be done through the individual's personal initiative. (see ENCLOSURE)

- **Similarities between Private, Public, and the MRS.** The majority of both the private sector and public service organizations require employee contributions to their own retirement accounts. While most of the private sector companies do not require employee contributions into their 401(k) plans, they incentivize them to contribute by offering a match. Their plans also offer the benefit of “options” with not only their personal contributions but also their companies’ contributions available to them should they leave prior to reaching retirement age. While the public service organizations do not generally match their employees’ deferred compensation plan contributions, they do mandate contributions to their personal pension plans, which the organizations either match or increase through a competitive interest rate. Those contributions also give employees the benefit of “options” should they leave prior to their minimum service requirement because the funds are refunded or can be rolled over into a pension plan if they achieve vesting mandates. The MRS lacks major similarities to the other two sector plans. However, while the contribution method is different, it does offer a pension plan similar to the public service organizations and a small number of the private sector companies, but at no cost to employees other than through years of service.

While the MRS was a typical retirement plan in the past, it is largely atypical today. Private companies and public service organizations moved toward their present models as a cost saving measure and have benefitted accordingly. Defined contribution plans not only save the employer money, but also allow the individual who departs before vesting to do so with money in their pocket.
CONCLUSION & RECOMMENDATION

In summary, BENS concludes that:

- The costs of the MRS are not as prohibitive as they may be perceived.
- The current MRS appears to assist in retaining individuals in years 10-20 of service, however its assumed effect in the recruitment and retention of younger cohorts is not well demonstrated.
- The MRS has not evolved as have retirement benefits in the larger public and private sector.
- DoD has not taken advantage of the opportunity to save money and provide an enhanced benefit to those serving less than 20 years.

Based on our conclusions and findings, BENS recommends DoD adopt a hybrid defined benefit-contribution plan that offers portability and, particularly, flexibility.
## Comparison of Private Sector Retirement Plans

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<th>BrightScope Rating*</th>
<th>Defined Contribution on Behalf of Employee</th>
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<th>Company Match Offered</th>
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* BrightScope is an independent provider of retirement plan ratings and investment analytics to participants, plan sponsors, asset managers, and advisors in all 50 states. The company maintains a comprehensive database of information on the retirement plan market and adds additional value and insight by quantitatively rating 401k and 403b plans across critical metrics.

## Comparison of Public Sector Retirement Plans

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