

REPORT DOCUMENTATION PAGE

Form Approved
OMB No. 0704-0188

Public reporting burden for this collection of information is estimated to average 1 hour per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing this collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden to Department of Defense, Washington Headquarters Services, Directorate for Information Operations and Reports (0704-0188), 1215 Jefferson Davis Highway, Suite 1204, Arlington, VA 22202-4302. Respondents should be aware that notwithstanding any other provision of law, no person shall be subject to any penalty for failing to comply with a collection of information if it does not display a currently valid OMB control number. **PLEASE DO NOT RETURN YOUR FORM TO THE ABOVE ADDRESS.**

1. REPORT DATE (DD-MM-YYYY) 6-2012			2. REPORT TYPE Final			3. DATES COVERED (From - To)			
4. TITLE AND SUBTITLE Retirement Choice: 2012						5a. CONTRACT NUMBER N00014-11-D-0323			
						5b. GRANT NUMBER			
						5c. PROGRAM ELEMENT NUMBER 0605154N			
6. AUTHOR(S) Quester, Aline O.; Shuford, Robert W.; L. Gary, Lee; Hattiangadi, Anita U.						5d. PROJECT NUMBER R0148			
						5e. TASK NUMBER X03300			
						5f. WORK UNIT NUMBER			
7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES) Center for Naval Analyses 4825 Mark Center Drive Alexandria, VA 22311-1850						8. PERFORMING ORGANIZATION REPORT NUMBER DRM-2012-U-000276-Final			
9. SPONSORING / MONITORING AGENCY NAME(S) AND ADDRESS(ES) Deputy Commandant Marine Corps Manpower & Reserve Affairs (M&RA) 3280 Russell Road Quantico, VA 22134-5103						10. SPONSOR/MONITOR'S ACRONYM(S)			
						11. SPONSOR/MONITOR'S REPORT NUMBER(S)			
12. DISTRIBUTION / AVAILABILITY STATEMENT Approved for Public Release; Distribution Unlimited.									
13. SUPPLEMENTARY NOTES									
14. ABSTRACT At their 15th year of service, military personnel who are eligible and intend to serve for 20 years must choose either: (1) High-3 retirement plan or (2) A reduced retirement (REDUX) and a \$30,000 bonus paid at the 15th year of service. This paper is designed to help servicemembers make that decision. We describe the REDUX/bonus option as an early, partial cash-out of the servicemember's retirement pension that the member pays back in the form of reduced retirement checks over his or her entire lifetime. We calculate how much the servicemember will "pay back" (the reduction in pension benefits) and we calculate the implied APR or interest rate for this loan. For example, an E-7 who retires at age 38 with 20 years of service is paying an implicit interest rate of 14.8% and would see his or her retired pay reduced by \$381,203 if he or she lived to 79 years. Even if the servicemember received the bonus tax free, the repayment amount is over 12 times the amount of the loan (\$30,000). If this servicemember lives to 85, the repayment amount would be \$504,085. For									
15. SUBJECT TERMS REDUX, CSB, Retirement, Bonus, Pension, Loan									
16. SECURITY CLASSIFICATION OF:						17. LIMITATION OF ABSTRACT	18. NUMBER OF PAGES	19a. NAME OF RESPONSIBLE PERSON	
a. REPORT U		b. ABSTRACT U		c. THIS PAGE U		SAR	38	Knowledge Center/Robert Richard	
						19b. TELEPHONE NUMBER (include area code) 703-824-2110			

Retirement Choice: 2012

Aline Quester • Robert Shuford • Lewis G. Lee • Anita Hattiangadi



DRM-2012-U-000276-Final
June 2012

Photo credit line: MSgt William Carroccia Jr., former S-4 chief with 1st Tank Battalion, receives his retirement flag from LtCol Timothy Barrick, the battalion's commanding officer, during a ceremony marking the unit's history on Oct. 26, 2011. (11/1/2011 By LCpl D. J. Wu)

Approved for distribution:

June 2012



Anita Hattiangadi
Marine Corps Manpower Team
Resource Analysis Division

This document represents the best opinion of CNA at the time of issue.
It does not necessarily represent the opinion of the Department of the Navy.

Approved for Public Release; Distribution Unlimited. Specific authority: N00014-11-D-0323
Copies of this document can be obtained through the Defense Technical Information Center at www.dtic.mil
or contact CNA Document Control and Distribution Section at 703-824-2123.

Copyright © 2012 CNA

This work was created in the performance of Federal Government Contract Number N00014-11-D-0323. Any copyright in this work is subject to the Government's Unlimited Rights license as defined in DFARS 252.227-7013 and/or DFARS 252.227-7014. The reproduction of this work for commercial purposes is strictly prohibited. Nongovernmental users may copy and distribute this document in any medium, either commercially or noncommercially, provided that this copyright notice is reproduced in all copies. Nongovernmental users may not use technical measures to obstruct or control the reading or further copying of the copies they make or distribute. Nongovernmental users may not accept compensation of any manner in exchange for copies. All other rights reserved.

Contents

Introduction	1
How much is retirement income reduced under REDUX/bonus?	3
Get paid now or get paid later?	8
Breaking even: What return would you need for your investment?	10
How much retirement income is forgone?	11
What if you live longer than 79 years?.	12
What if the \$30,000 bonus is tax free?.	13
Why would anyone choose REDUX/bonus?	13
Are the TSP and the \$30,000 bonus related?	15
Take-rates for the REDUX/bonus option	17
Conclusions	21
Appendix A: Another way of looking at figures 2 through 5	23
Appendix B: Officers	27
List of figures	29
List of tables	31

This page intentionally left blank.

Introduction

Military personnel who entered service after July 31, 1986, and who are eligible and intend to serve for 20 years must choose between two retirement plans at their 15th year of service.¹ Once the final selection is made, the choice is irrevocable. The two options are defined below:

1. *High-3 retirement plan*: Retirement pay is based on the highest average basic pay for 36 months of a servicemember's career. These are usually the last 3 years.
2. *REDUX retirement plan plus a \$30,000 bonus paid at the 15th year of service*: In return for accepting the bonus, REDUX provides smaller retirement checks.

How should Marines, Sailors, Airmen, and Soldiers decide which option to take? The Department of Defense (DOD) has a website that provides information and examples to help servicemembers.² We have used a different approach that many have found useful in evaluating these retirement choices.³ Here, we update that work for those making the retirement choice in 2012.

-
1. Selection of the retirement plan begins at about 14.5 years of service.
 2. The DOD website is <http://militarypay.defense.gov/tools/index.html>.
 3. The original paper was by Aline O. Quester and Lewis G. Lee, *The Retirement Choice: FY 2006*, CNA Research Memorandum D0003713.A6/4REV, Oct. 2005. It benefited from review by several CNA colleagues—Gerald Cox, Donald Cymrot, Michael Hansen, and Ann Parcell—and from critical insights provided by Kathleen Utgoff (former Director of the Pension Benefit Guarantee Corporation), John Warner (Clemson University), Susan Woodward (former Chief Economist at the Security and Exchange Commission), Steve Cylke (Bureau of Naval Personnel), and Neil Singer (former Senior Defense Analyst at the Congressional Budget Office).

We start by describing the \$30,000 bonus as an early, partial cash-out of the servicemember's retirement pension. This \$30,000 cash-out will be "paid back" later in the form of reduced retirement checks. By providing information on how much this cash-out will cost in terms of lower future retirement income, we hope that we can help servicemembers make more informed choices about which plan to select.

First, though, we briefly look at the general provisions of military retirement and then focus more specifically on the two plans. Both pension choices have the following features:

- Both provide retirement income as a percentage of the average of the highest 36 months of basic pay. There is no risk; the retirement payments are specified by law and are guaranteed by the full faith and credit of the U.S. government.
- Both offer deferred compensation for which no taxes are paid until the retired pay is received.⁴ Such plans are called tax-sheltered retirement plans.
- Both are protected against inflation. High-3 has full inflation protection because it changes yearly with the Consumer Price Index (CPI), whereas REDUX/bonus has less protection (CPI minus 1 percentage point). The value of inflation protection for retirement pay cannot be overemphasized. Most military members will be retired for about 40 years. In 40 years, one can expect prices to increase at least four times, meaning that what costs \$1 today will end up costing \$4.⁵

To summarize, military pensions are risk-free, tax-sheltered, inflation-adjusted annuities with options for spousal benefits (such as the Survivor Benefit Plan) on the death of the member. Such private pension provisions are very expensive, and only a few companies offer them.

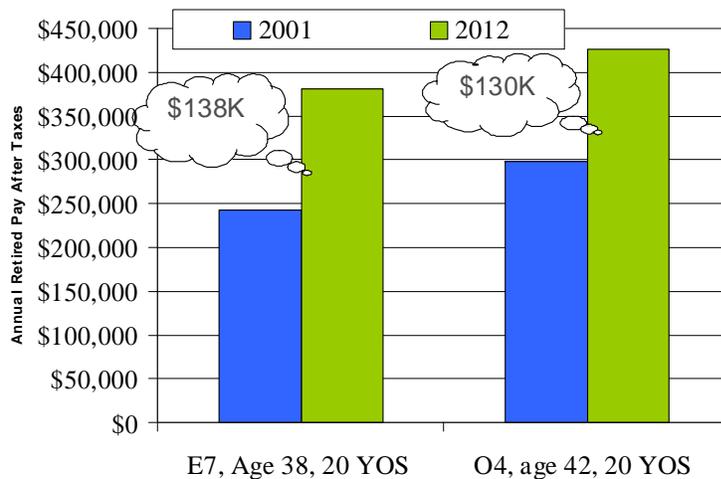
4. The services pay into the retirement fund each year, and the fund grows while the member is in the service. The servicemember has no tax liability for the service's contributions to the retirement fund.

5. The CPI in 2011 was over 7 times the level it was in 1960. This period includes the sharp inflation in 1974 (12.3 percent), 1979 (13.3 percent), and 1980 (12.5 percent). The commonly assumed 3.5-percent inflation rate leads to a fourfold increase in prices over a 40-year period.

How much is retirement income reduced under REDUX/bonus?

We now turn to the retirement choice in the 15th year of service. Choosing REDUX/bonus reduces retirement income. The higher the grade and the lower the years of service at retirement, the greater the reduction. In short, fast-trackers who retire very early are penalized most severely. For *all* military personnel, however, REDUX retirement income is *substantially lower* than retirement income under High-3.⁶ Moreover, as each year passes, the difference between REDUX and High-3 retirement income increases. For example, the *additional* reduction in retirement income under REDUX/bonus for those making the choice in 2012 (compared with 2001) is over \$100,000 for virtually all retirees!⁷ (See figure 1.)

Figure 1. REDUX/bonus choice gets worse each year: Differences since 2001 are over \$100,000!



6. Later in this paper, we discuss the Thrift Savings Plan (TSP) and other bonus investment options. The examples that follow assume that the servicemember pays taxes on, and spends, the bonus.
7. This assumes that the servicemember lives to age 79. The differences are larger if the servicemember lives longer.

Some will find it easier to understand how the two plans differ by comparing plan descriptions (table 1), whereas others will prefer to look at the figures that follow to show the difference in retirement payments under the two plans.

Table 1. Retirement choices for those who entered the service after July 31, 1986—based on highest average monthly basic pay over 36 months

	Retirement plan	
	High-3	REDUX + \$30,000 bonus at 15 years of service
Percentage of basic pay at 20 years of service	50.0%	40.0%
Increase for each year of service past 20	2.5%	3.5%
At 30 years of service	75.0%	75.0%
Yearly cost-of-living adjustments	Full CPI ^a	CPI minus 1 percentage point
Age 62	Retirement payments set equal to each other at age 62 (see figures 2 through 5)	
Age 63 onward	Full CPI adjustments	CPI minus 1 percentage point

a. Consumer Price Index for urban wage earners and clerical workers.

First, we present some examples. To calculate the two retirement pay streams for someone making the decision at 15 years of service in 2012, we need to make some assumptions. We assume the following:

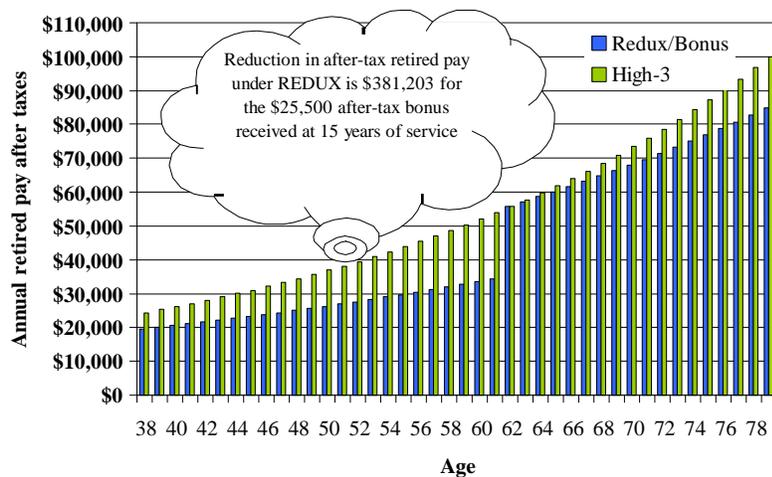
- Military pay will grow at 3.5 percent per year until the servicemember retires.
- The CPI will grow at 3.5 percent per year.
- The servicemember will live to age 79.⁸

8. The National Vital Statistics Reports show an additional 39.9 years for someone age 40, so we use an overall life expectancy of 79 years for military retirees. In a later section, we explore what happens if the servicemember lives past 79 years. See http://www.cdc.gov/nchs/data/nvsr/nvsr59/nvsr59_09.pdf.

- Tax bracket⁹
 - Enlisted: 15 percent; after-tax bonus is \$25,500
 - Warrant officers: 25 percent; after-tax bonus is \$22,500
 - Commissioned officers: 28 percent; after-tax bonus is \$21,600.

Figure 2 shows the two after-tax retirement pay streams, REDUX and High-3, from the first retirement year until age 79 for an E-7 who expects to retire at age 38 with 20 years of service. We see a sharp reduction in retirement pay under REDUX until age 62, then a re-indexing that equates the two retirement pays, followed by a gradual erosion in REDUX retirement pay after age 62 when compared with High-3. For this servicemember, total retirement pay is reduced by \$381,203 if he or she selects REDUX/bonus.

Figure 2. E-7 retiring at age 38 with 20 years of service, 15% tax bracket



9. Later, we discuss what happens if the \$30,000 bonus is tax free.

Figure 3 shows the difference in payments for a servicemember who expects to retire as an E-8 at age 42 with 24 years of service. Here the reduction in retired pay (\$375,950) is just a little less than that for the E-7 who retires at age 38 with 20 years of service (figure 2).

Figure 3. E-8 retiring at age 42 with 24 years of service, 15% tax bracket

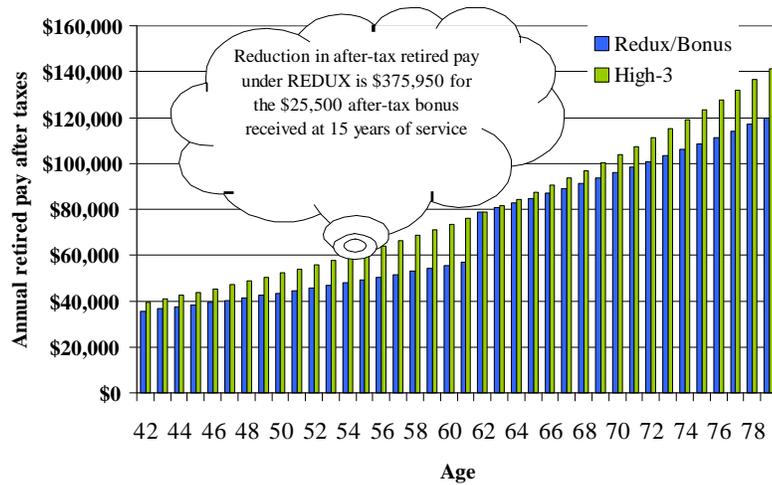


Figure 4 shows the situation for a CWO-3 who expects to retire at age 38 with 20 years of service. Here, the reduction in retirement pay is \$439,328 under REDUX/bonus.

Figure 5 shows the situation for an O-6 who expects to retire at age 50 with 26 years of service. Here the officer's retired after-tax pay is \$376,064 less under REDUX/bonus. (Appendix A illustrates these three situations in a different format.)

Figure 4. CWO-3 retiring at age 38 with 20 years of service, 25% tax bracket

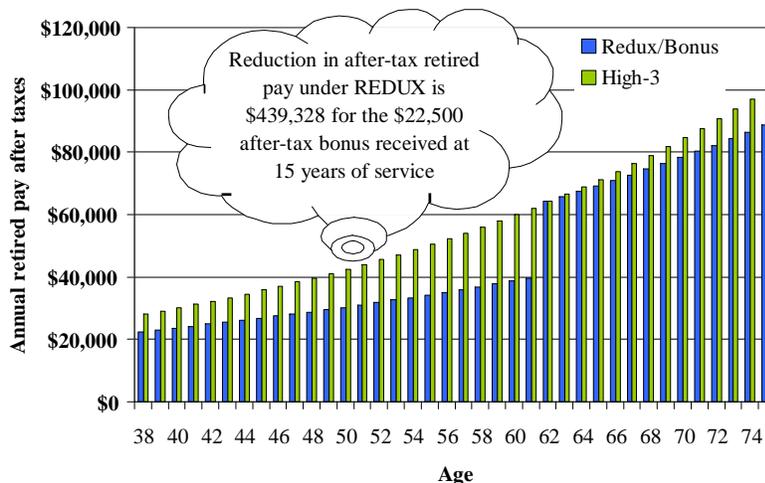
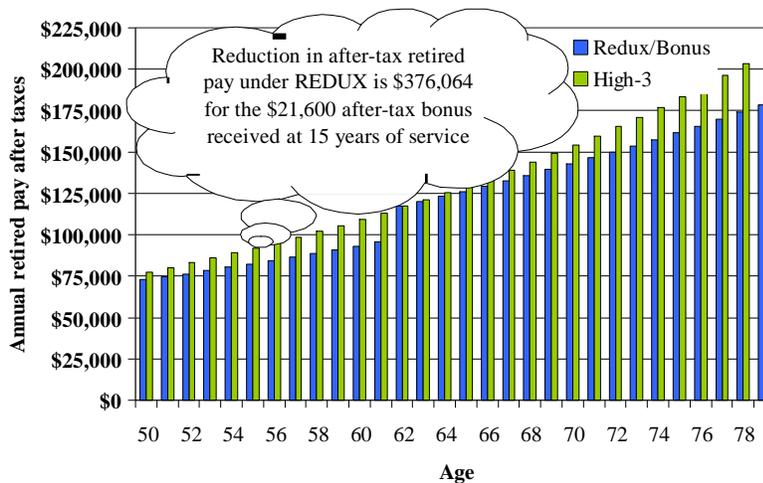


Figure 5. O-6 retiring at age 50 with 26 years of service, 28% tax bracket



Next, we turn to the way in which we propose that servicemembers evaluate the lower retirement pay that they will receive if they select REDUX and the \$30,000 bonus.

Get paid now or get paid later?

Bonus-takers will get some of their retirement income early, at the 15-year-of-service point. The best way to think about this is to consider REDUX's \$30,000 bonus as an early cash-out of part of a servicemember's retirement pension. We can calculate how much this cash-out costs the member by thinking of it as a "loan" to be paid back later in the form of lower retirement checks.

This so-called loan, given at 15 years of service, is paid back over the servicemember's entire retired lifetime. Most people are familiar with car loans, mortgages, and credit card debt. Car loans and mortgages have fixed loan periods, often 5 years for cars and 30 years for mortgages. Credit card debt is a little different, requiring only a minimum payment per month. We characterize all these loans by the interest rates and interest payments attached to them.

The \$30,000 bonus has a rather peculiar payback scheme. The servicemember pays nothing until retirement, pays quite a bit from the beginning of retirement until age 62, and then continues to pay back smaller amounts over the rest of his or her life. The "payments" are the differences in the height of the High-3 and REDUX/bonus bars in figures 2 through 5. Although this payment scheme is peculiar, we can calculate the implied interest rate, or annual percentage rate (APR). We do this for a variety of situations and show the results in table 2 for enlisted personnel. (Results for chief warrant officers and commissioned officers are in appendix B.)

Looking at table 2, if an E-6 expects to retire at age 38 with 20 years of service and lives to age 79, our calculations show that, by selecting REDUX/bonus at 15 years of service, the servicemember

- pays an implicit interest rate of 13.6 percent for the cash-out (this is after tax);
- loses \$326,653 in after-tax retirement income; and
- would be required to earn at least 15.9 percent before tax *each year* until age 79 on the invested bonus to make up the difference between the REDUX pension and the High-3 pension.

Table 2. REDUX/bonus choice for enlisted personnel (15% tax rate)^a

Characteristics at retirement	Implicit interest rate for bonus (after tax)	Break-even interest rate ^b	Total reduction in after-tax retirement pay	"Interest" ^c
E-6 at 20 years of service				
Age 38	13.6%	15.9%	\$326,653	\$301,153
Age 40	13.3%	15.7%	\$287,538	\$262,038
Age 42	13.0%	15.3%	\$252,092	\$226,592
E-7 at 20 years of service				
Age 38	14.8%	17.4%	\$381,203	\$255,703
Age 40	14.5%	17.1%	\$335,557	\$310,057
Age 42	14.3%	16.8%	\$294,192	\$268,692
E-7 at 22 years of service				
Age 40	12.4%	14.6%	\$356,026	\$330,526
Age 42	12.2%	14.3%	\$311,755	\$286,255
Age 44	11.8%	13.9%	\$271,946	\$246,446
E-8 at 20 years of service				
Age 38	15.5%	18.2%	\$416,954	\$391,454
Age 40	15.3%	18.0%	\$367,027	\$341,527
Age 42	15.0%	17.7%	\$321,782	\$296,282
E-8 at 22 years of service				
Age 40	13.1%	15.5%	\$396,790	\$371,290
Age 42	12.9%	15.1%	\$347,450	\$321,950
Age 44	12.5%	14.8%	\$303,083	\$277,583
E-8 at 24 years of service				
Age 42	11.3%	13.3%	\$375,950	\$350,450
Age 44	11.0%	12.9%	\$327,757	\$302,257
Age 46	10.6%	12.4%	\$284,829	\$259,329
E-8 at 26 years of service				
Age 44	9.7%	11.4%	\$351,105	\$325,605
Age 46	9.3%	11.0%	\$305,254	\$279,754
Age 48	8.9%	10.5%	\$264,895	\$239,395
E-9 at 20 years of service				
Age 38	16.6%	19.5%	\$476,827	\$451,327
Age 40	16.4%	19.3%	\$419,730	\$394,230
Age 42	16.2%	19.0%	\$367,989	\$342,489
E-9 at 22 years of service				
Age 40	14.1%	16.6%	\$456,828	\$431,328
Age 42	13.8%	16.3%	\$400,022	\$374,522
Age 44	13.5%	15.9%	\$348,942	\$323,442

Table 2. REDUX/bonus choice for enlisted personnel (15% tax rate)^a

Characteristics at retirement	Implicit interest rate for bonus (after tax)	Break-even interest rate ^b	Total reduction in after-tax retirement pay	“Interest” ^c
E-9 at 26 years of service				
Age 44	10.4%	12.3%	\$408,969	\$383,469
Age 46	10.1%	11.8%	\$355,561	\$330,061
Age 48	9.6%	11.3%	\$308,551	\$283,051
E-9 at 30 years of service				
Age 48	7.7%	9.1%	\$358,205	\$332,705
Age 50	7.4%	8.7%	\$312,904	\$287,404
Age 52	7.0%	8.3%	\$274,515	\$249,015

a. We use information provided at DOD’s website, <http://militarypay.defense.gov/retirement>.

b. This is the rate of return for investing the bonus that the servicemember would need to obtain to break even between REDUX/bonus and High-3. This rate of return would provide after-tax amounts that exactly equal the differences in pension payments between High-3 and REDUX.

c. Reduction in retirement pay after excluding the after-tax bonus of \$25,500.

Breaking even: What return would you need for your investment?

The break-even interest rate is the before-tax interest rate that the servicemember would have to earn to equalize compensation under the High-3 vice REDUX/bonus retirement packages. For example, if the servicemember put the after-tax bonus into an investment account, that investment account would have to earn the break-even interest rate *every* year to generate an income equal to the yearly difference in retirement pensions. And, at age 79, the account would be exhausted. If, for only one year, the member earned less than the break-even interest rate, the account would be exhausted before the member’s

death.¹⁰ The break-even interest rates are high enough that it will be virtually impossible for anyone to break even.

How much retirement income is forgone?

For the 40-year-old E-6 retiring with 20 years of service, table 2 shows an “interest” payment of \$262,038—the difference between the total after-tax reduction in retired pay (\$287,538) and the after-tax amount of the loan (\$25,500). Although all the interest rates are high, it is probably the cumulative amount of forgone retirement income that is most surprising. How do these amounts compare with those for a 30-year home mortgage? Table 3 shows this information.

Table 3. Payments on a 30-year \$30,000 mortgage^a

Interest rate	Total amount paid	Total interest payments
4.0%	\$51,562	\$21,562
5.0%	\$57,975	\$27,975
6.0%	\$64,748	\$34,748
7.0%	\$71,853	\$41,853
8.0%	\$79,246	\$49,246
9.0%	\$86,894	\$56,894
10.0%	\$94,781	\$64,781

a. Information is from <https://www.eloan.com/s/amortcalc?context=purch>.

Even for a 9.0-percent 30-year home mortgage loan—a *very high* interest rate by current standards—one pays back a little under 3 times the amount borrowed. For today’s 4.0-percent mortgages, one pays back less than 2 times the loan amount. In contrast, for the after-tax portion of the \$30,000 bonus, table 2 shows that the servicemember is paying back from 9 to over 18 times the bonus (i.e. the amount “bor-

10. The break-even interest rate is higher than the after-tax interest rate because taxes must be paid on investment income. The break-even interest rate times the tax rate is equal to the after-tax implicit interest rate.

rowed”)!¹¹ **Why are the repayment amounts so large for this \$30,000 “loan”?**

Consider someone who dies very early in retirement. Indeed, if the servicemember dies at the retirement point, there is no repayment. The servicemember got the \$30,000 at the 15-year point but died before collecting any retirement monies.¹² So one reason why repayment amounts are so large is because the average life expectancy is 79 years. The terms of this financial arrangement are *reduced retirement checks over the entire lifetime*.

The second reason the repayment amounts are so large is that one cannot pay off this “loan” early. If the servicemember chooses REDUX/bonus, the servicemember who lives the normal lifespan loses tremendous amounts of retirement income. The servicemember who lives *longer* than the normal lifespan loses even more.

What if you live longer than 79 years?

The longer the servicemember lives, the greater the loss in retirement income for those who chose the REDUX retirement and the \$30,000 bonus. Table 4 shows some examples for enlisted and officers if the servicemember lives until age 85, rather than age 79.

The E-7 who retires at age 38 with 20 years of service will pay back \$504,085 in reduced retirement income for the \$30,000 bonus received at 15 years of service if he or she lives to age 85. Living to age 90 (not shown), this servicemember will lose \$656,674 in retirement income.

11. All calculations are after taxes. An E-6 who retires at age 42 with 20 years of service pays back \$252,092 for the \$25,500 ($(\$252,092/\$25,500) = 9.9$); an E-9 who retires at age 38 with 20 years of service pays back 18.7 times the amount borrowed ($(\$476,827/\$25,500) = 18.7$).

12. We have not addressed survivor benefits in this analysis, but we are concerned that the reduced retirement income will make the Survivor Benefit Plan (SBP) unaffordable for some REDUX retirees.

Table 4. Examples of reduction in retirement pay if REDUX/bonus is chosen: by length of life

Status at retirement			Reduction in retirement pay by length of life		Difference (\$)
Grade	Age	Years of service	Age 79	Age 85	
E-6	38	20	\$326,653	\$431,949	\$105,296
E-7	38	20	\$381,203	\$504,085	\$122,882
CWO-3	38	20	\$439,328	\$580,946	\$141,618
O-4	44	20	\$372,271	\$517,205	\$144,934
O-5	44	22	\$441,556	\$636,048	\$194,492

What if the \$30,000 bonus is tax free?

If the servicemember chooses REDUX/bonus while in a combat zone, the \$30,000 bonus is tax free. Should this make a difference in the decision? We believe it should not. Consider the E-7 who retires at 38 with 20 years of service or the O-5 who retires at 44 with 22 years of service. If the bonus is tax free, the E-7 will get the full \$30,000 (rather than the \$25,500 we assumed when the bonus was taxed) and the O-5 will get the full \$30,000 (rather than the \$21,600 we assumed when the bonus was taxed). Both, though, will still pay back (through reduced retirement income) the full amounts in the age 79 column of table 4: \$381,203 for the E-7 and \$441,556 for the O-5. And, that's only the reduction in retirement pay if they live to age 79. As shown in the age 85 column of table 4, if they live longer, the reductions will be larger.

Why would anyone choose REDUX/bonus?

Why would anyone reject the more generous High-3 retirement plan and select the bonus and associated reduced retirement payments under REDUX? There are two main reasons:

1. Servicemembers want or need the money now.
2. Servicemembers think that they can do better by investing the \$30,000. Many believe that the federal government's Thrift Sav-

ings Plan (TSP) provides especially good investment opportunities.

Neither of these reasons should justify the REDUX/bonus choice. Servicemembers who want or need the money now should look into other ways to obtain the required funds. Are there alternatives for borrowing \$30,000 that do not involve several hundred thousand dollars of interest payments?

There also are some misconceptions about the TSP. Many private-sector employees, as well as civilian federal government employees, have long had the option of putting some of their pre-tax earnings into various types of savings plans designed for retirement. TSPs either supplement or, more likely, replace private-sector pensions. Retirees then supplement their Social Security in their retirement years by drawing down their TSPs.

Servicemembers now can contribute pre-tax dollars to a TSP. By contributing to the TSP, uniformed personnel can save additional monies for the years in which they are truly retired. Because TSPs were designed to provide savings for the older years, however, there are tax penalties for withdrawals made before age 59.5.¹³ In short, servicemembers should not put savings in a TSP if they anticipate needing those funds before they are in their sixties.

Retirement savings plans such as the TSP share one feature with conventional military retirement plans—namely, the tax sheltering of pre-retirement income. Many servicemembers, in fact, do not seem to realize that military pensions are tax sheltered. Retirement tax sheltering means that *no taxes are paid until the money is received in retirement*. With military pensions, the member pays no taxes on the accrued benefits until the pensions are paid in retirement. With TSP, the contributions to the TSP are pre-tax dollars, and taxes are not paid until the money is withdrawn. TSPs, however, *lack* the two other important features of the High-3 retirement plan:

- Risk-free, guaranteed payments or returns

13. Under exceptional circumstances, the tax penalties for withdrawals before age 59.5 can be waived.

- Full inflation protection

The TSP offered to military members allows the member to choose the fund, or funds, in which to invest the savings. These funds differ by the level of risk or variability of the investment returns. Funds that have higher risk will have higher average returns for long-term investors, but those returns will be more variable. *None* of the funds, however, have *inflation protection* or *guaranteed returns*.

Are the TSP and the \$30,000 bonus related?

It is merely a coincidence that the introduction of both TSP and the choice between REDUX/bonus and High-3 occurred at the same time. Because of the timing, however, many commentators linked the two ideas, suggesting that servicemembers might elect REDUX/bonus and put the maximum amount of the bonus that can be tax sheltered in a TSP account.

We find the linkage in the press between TSP and the \$30,000 partial cash-out of the High-3 pension to be puzzling. Why would servicemembers want to give up the inflation protection provided by military retirement and invest that money in non-inflation-protected TSPs? Why would they even consider a cash-out of part of their pensions when the implicit interest rates they will pay for this are greater than the long-run returns in the stock market? Why give up a riskless investment for a risky one if you can expect to earn a lower return on the risky investment? Although we see the TSP as an opportunity for servicemembers to put additional money away for their old age, we cannot understand why members would want to *cash out* some of their tax-sheltered, inflation-protected, guaranteed military retirement income for a TSP.¹⁴

14. Saving money in a TSP is an excellent idea as long as one does not have to reduce future retirement income in order to do so. For example, saving some reenlistment bonus money or special pay in a TSP is an excellent way to ensure greater income in one's older years. The maximum amount that can be tax sheltered in a TSP is \$17,000 in 2012.

This page intentionally left blank.

Take-rates for the REDUX/bonus option

Despite the significant downsides of the REDUX/bonus choice, many servicemembers still choose this option every year. As of September 2011, more than 23,000 Marines had made their choices. Of those who had decided:

- 33 percent of enlisted Marines chose the \$30,000 bonus and the reduced REDUX retirement.
- 26 percent of warrant officers chose the \$30,000 bonus and the reduced REDUX retirement.
- 7 percent of officers chose the \$30,000 bonus and the reduced REDUX retirement. Of those:
 - Officers who were in grades O-1E through O-3E were much more likely to select the bonus than were other commissioned officers.

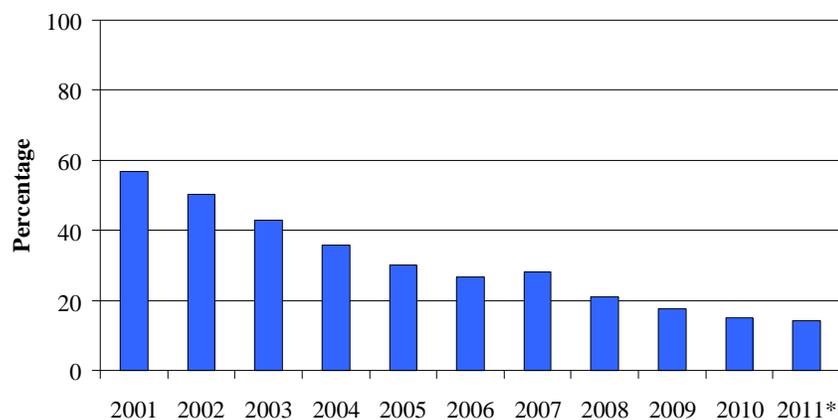
Although these take-rates seem high, they have fallen sharply. Overall, the percentage of Marines selecting the bonus declined from 57 percent in 2001 to 14 percent in September 2011 (see figure 6). Thus, by 2011, fully 86 percent of Marines selected High-3 as their retirement plan.

In 2011 (through September), the take-rates were

- 18 percent for enlisted Marines (26 percent for staff sergeants);
- 2 percent for commissioned officers (6 percent for those who held O-1E–O-3E grades at 15 years of service); and
- 11 percent for warrant officers.

Gunnery sergeants make up the largest group to face the retirement choice; their take-rate for REDUX/bonus dropped from 54 to 16 percent in the period.

Figure 6. Marine Corps take-rates for REDUX/bonus: 2001 to 2011^a



a. *Through September 2011.

CNA has been conducting an extensive education campaign about retirement choice since 2002. Each year, in addition to this paper, we provide CDs with a retirement choice calculator to Marines attending the General Officer Symposium, the Executive Offsite, the Commander's Course, the Sergeant Major of the Marine Corps' Symposium, and various senior enlisted symposiums and conferences. The retirement choice calculator also is available on CNA's website. (Go to www.cna.org and search for retirement choice.)

Since 2007, in an attempt to further educate, the Marine Corps has issued MARADMINs annually that reinforce the Commander's responsibility to

- ensure that all affected Marines receive appropriate counseling about this choice;
- certify that Marines electing REDUX/bonus are recommended and qualified to continue to 20 years of service; and
- verify that a CO, XO, or sergeant major witness the election in block 13 of the DD form 2839.¹⁵

15. The latest one to date is MARADMIN 427-11.

We believe that these efforts, combined with those of the manpower management, separations, and retirement branch (MMSR) have been important in ensuring that Marines understand this choice and make decisions that reflect that understanding. We attribute the continuing decline in the REDUX/bonus take-rate to CNA's education campaign. The sharp drop between 2007 and 2008 (from 27 percent to 21 percent) can be attributed to the first MARADMIN in 2007 that energized Marine Corps leaders.

This page intentionally left blank.

Conclusions

We find that, for almost all servicemembers, the REDUX retirement plan plus a \$30,000 bonus paid at the 15th year of service is a bad choice that significantly reduces their retirement income. The higher the grade, the lower the years of service at retirement, and the longer the servicemember lives, the greater the reduction. Moreover, as each year passes, the difference between REDUX and High-3 retirement income increases.

Thinking of the \$30,000 bonus as a “loan,” it is one that is paid back (through lower retirement income) at extremely high interest rates. Even if servicemembers invest the bonus, the required interest rates make it virtually impossible for them to break even.

Despite the significant downsides of the REDUX/bonus choice, many servicemembers still choose this option every year. Although the share taking REDUX/bonus has fallen over time, 14 percent of eligible Marines are still choosing this option. We continue to work with the Marine Corps leadership to help inform Marines about the consequences of this choice.

This page intentionally left blank.

Appendix A: Another way of looking at figures 2 through 5

In this appendix, we show the information in figures 2 through 5 somewhat differently. Instead of looking at the retirement pay streams directly, we look at the differences in retirement pay for the two plans. Specifically, we look at the payments under REDUX/bonus minus the payments under High-3. Figures 7 through 10 show the amount of the bonus payment and the subsequent yearly reduction in retired pay (shown as negative amounts) to the servicemember from the point at which the member retires (for figure 7, this is age 38). Because REDUX/bonus is set equal to High-3 at age 62, the difference between the two plans is zero at that point. The reductions in retired pay from age 63 to age 79 reflect the less than full indexing for inflation under REDUX/bonus.

Figure 7. Differences in after-tax retirement payments if REDUX/bonus is selected: E-7 retiring at age 38 with 20 years of service, 15% tax bracket

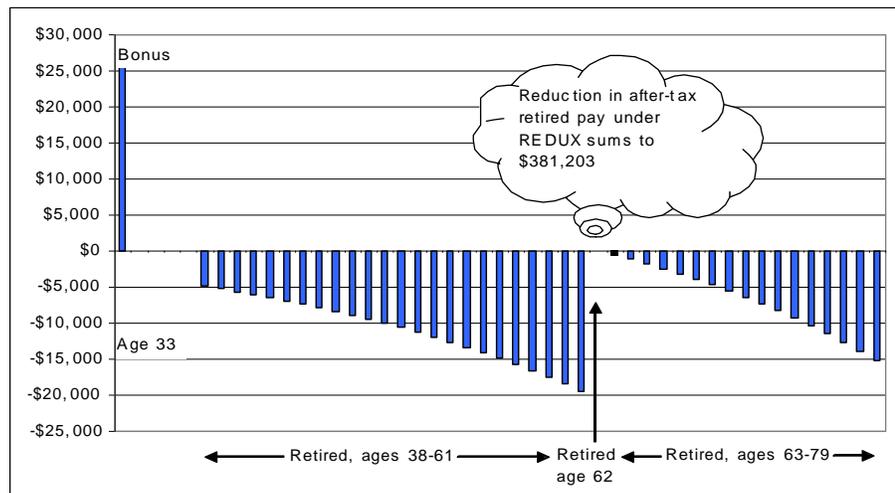


Figure 8. Differences in after-tax retirement payments if REDUX/bonus is selected: E-8 retiring at age 42 with 24 years of service, 15% tax bracket

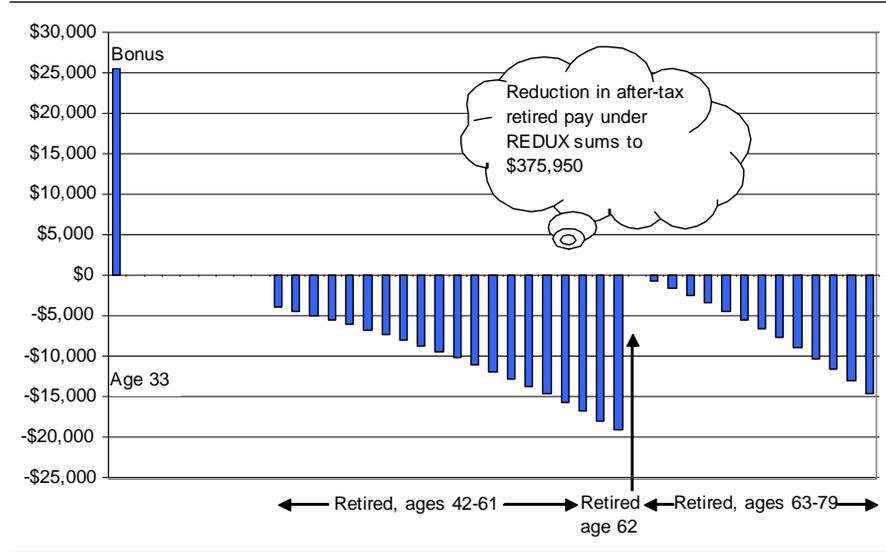


Figure 9. Differences in after-tax retirement payments if REDUX/bonus is selected: CWO-3 retiring at age 38 with 20 years of service, 25% tax bracket

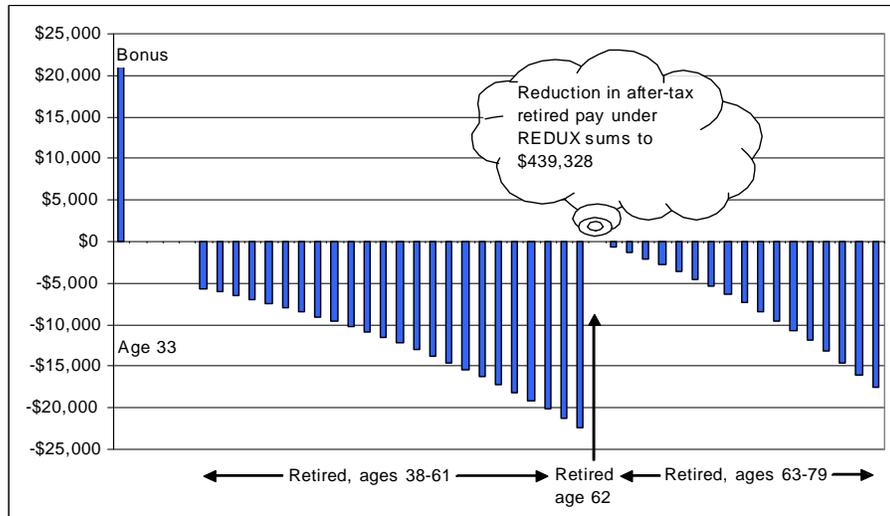
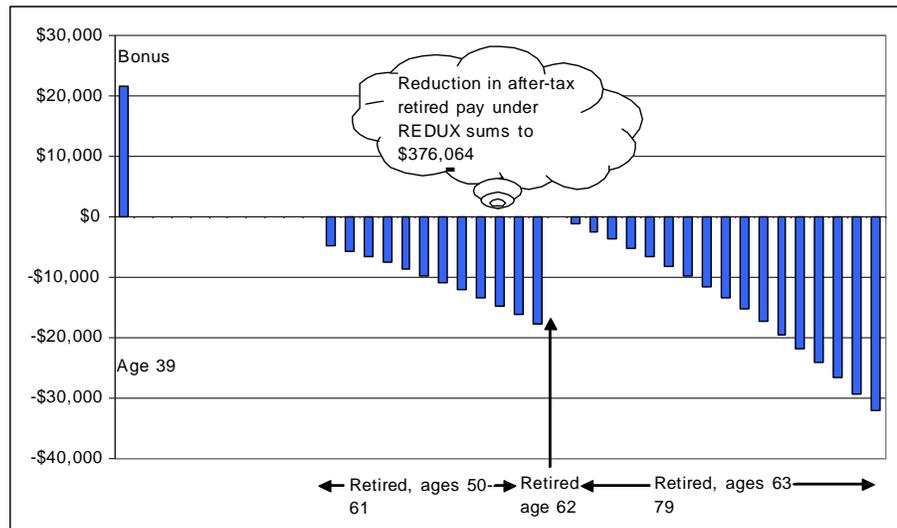


Figure 10. Differences in after-tax retirement payments if REDUX/bonus is selected: O-6 at age 50 retiring with 26 years of service, 28% tax bracket



This page intentionally left blank.

Appendix B: Officers

Table 5. REDUX/bonus choice for chief warrant officers (25% tax rate)^a

Characteristics at retirement	Implicit interest rate for bonus (after tax)	Break-even interest rate ^b	Total reduction in after-tax retirement pay	“Interest” ^c
CWO-2 at 20 years of service				
Age 38	16.0%	21.3%	\$392,289	\$369,789
Age 40	15.8%	21.1%	\$345,315	\$322,815
Age 42	15.6%	20.8%	\$302,747	\$280,247
CWO-3 at 20 years of service				
Age 38	17.0%	22.6%	\$439,328	\$416,828
Age 40	16.8%	22.4%	\$386,721	\$364,221
Age 42	16.6%	22.1%	\$339,049	\$316,549
CWO-3 at 22 years of service				
Age 40	14.4%	19.2%	\$422,537	\$400,037
Age 42	14.2%	18.9%	\$369,996	\$347,496
Age 44	13.9%	18.5%	\$322,750	\$300,250
CWO-4 at 24 years of service				
Age 42	12.9%	17.2%	\$438,501	\$416,001
Age 44	12.6%	16.6%	\$382,290	\$359,790
Age 46	12.2%	16.3%	\$332,219	\$309,719
CWO-4 at 26 years of service				
Age 44	11.1%	14.8%	\$413,665	\$391,165
Age 46	10.7%	14.3%	\$359,644	\$337,144
Age 48	10.3%	13.8%	\$312,094	\$289,594
CWO-5 at 30 years of service				
Age 48	8.4%	11.3%	\$392,038	\$369,538
Age 50	8.1%	10.8%	\$342,458	\$319,958
Age 52	7.8%	10.4%	\$300,443	\$277,943

a. We use the information provided at DOD’s website, <http://militarypay.defense.gov/retirement>.

b. This is the rate of return for investing the bonus that the servicemember would need to obtain to break even between REDUX/bonus and High-3. This rate of return would provide after-tax amounts that exactly equal the differences in pension payments between High-3 and REDUX.

c. Reduction in retirement pay after excluding the after-tax bonus of \$22,500.

Table 6. REDUX/bonus choice for commissioned officers (28% tax rate)^a

Characteristics at retirement	Implicit interest rate for bonus (after tax)	Break-even interest rate ^b	Total reduction in after-tax retirement pay	"Interest" ^c
O-4 at 20 years of service				
Age 42	19.1%	26.5%	\$426,537	\$404,937
Age 44	18.8%	26.2%	\$372,271	\$350,671
Age 46	18.5%	25.7%	\$323,250	\$301,650
O-5 at 20 years of service				
Age 42	20.1%	27.9%	\$472,746	\$451,146
Age 44	19.9%	27.6%	\$412,601	\$391,001
Age 46	19.5%	27.1%	\$358,270	\$336,670
O-5 at 22 years of service				
Age 44	16.5%	22.9%	\$441,556	\$419,956
Age 46	16.1%	22.4%	\$383,563	\$361,963
Age 48	15.7%	21.8%	\$331,659	\$310,059
O-5 at 24 years of service				
Age 46	13.8%	19.1%	\$410,991	\$389,391
Age 48	13.3%	18.5%	\$355,996	\$334,396
Age 50	12.8%	17.8%	\$307,350	\$285,750
O-5 at 26 years of service				
Age 48	11.4%	15.9%	\$374,531	\$352,931
Age 50	11.0%	15.3%	\$324,552	\$302,952
Age 52	10.5%	14.5%	\$281,028	\$259,428
O-6 at 24 years of service				
Age 46	14.6%	20.3%	\$468,515	\$446,915
Age 48	14.2%	19.7%	\$405,822	\$384,222
Age 50	13.7%	19.0%	\$350,368	\$328,768
O-6 at 26 years of service				
Age 48	12.2%	17.0%	\$433,975	\$412,375
Age 50	11.8%	16.3%	\$376,064	\$354,464
Age 52	11.2%	15.6%	\$325,632	\$304,032
O-6 at 28 years of service				
Age 50	10.3%	14.4%	\$409,562	\$387,962
Age 52	9.9%	13.8%	\$356,918	\$335,318
Age 54	9.5%	13.2%	\$312,071	\$290,471
O-6 at 30 years of service				
Age 52	8.8%	12.2%	\$381,143	\$359,543
Age 54	8.5%	11.8%	\$336,540	\$314,940
Age 56	8.3%	11.5%	\$299,807	\$278,207

a. We use the information provided at DOD's website, <http://militarypay.defense.gov/retirement>.

b. This is the rate of return for investing the bonus that the servicemember would need to obtain to break even between REDUX/bonus and High-3. This rate of return would provide after-tax amounts that exactly equal the differences in pension payments between High-3 and REDUX.

c. Reduction in retirement pay after excluding the after-tax bonus of \$21,600.

List of figures

Figure 1. REDUX/bonus choice gets worse each year: Differences since 2001 are over \$100,000!	3
Figure 2. E-7 retiring at age 38 with 20 years of service, 15% tax bracket	5
Figure 3. E-8 retiring at age 42 with 24 years of service, 15% tax bracket	6
Figure 4. CWO-3 retiring at age 38 with 20 years of service, 25% tax bracket	7
Figure 5. O-6 retiring at age 50 with 26 years of service, 28% tax bracket	7
Figure 6. Marine Corps take-rates for REDUX/bonus: 2001 to 2011	18
Figure 7. Differences in after-tax retirement payments if REDUX/bonus is selected: E-7 retiring at age 38 with 20 years of service, 15% tax bracket	23
Figure 8. Differences in after-tax retirement payments if REDUX/bonus is selected: E-8 retiring at age 42 with 24 years of service, 15% tax bracket	24
Figure 9. Differences in after-tax retirement payments if REDUX/bonus is selected: CWO-3 retiring at age 38 with 20 years of service, 25% tax bracket	24
Figure 10. Differences in after-tax retirement payments if REDUX/bonus is selected: O-6 at age 50 retiring with 26 years of service, 28% tax bracket	25

This page intentionally left blank.

List of tables

Table 1.	Retirement choices for those who entered the service after July 31, 1986—based on highest average monthly basic pay over 36 months	4
Table 2.	REDUX/bonus choice for enlisted personnel (15% tax rate)	9
Table 3.	Payments on a 30-year \$30,000 mortgage	11
Table 4.	Examples of reduction in retirement pay if REDUX/bonus is chosen: by length of life	13
Table 5.	REDUX/bonus choice for chief warrant officers (25% tax rate)	27
Table 6.	REDUX/bonus choice for commissioned officers (28% tax rate)	28

This page intentionally left blank.

