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Report R40079

*Nonforeign Cost-of-Living Allowances and Possible  
Transition to Locality Pay*

Wendy R. Ginsberg, Analyst in Government Organization and Management

December 1, 2008

**Abstract.** This report provides an overview of the history of the nonforeign COLA and locality pay programs; identifies and describes potential changes to the existing nonforeign COLA system, including the possibility of instituting locality pay; and analyzes the potential effects of keeping the existing system or adopting a nonforeign COLA phase-out plan.

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# Nonforeign Cost-of-Living Allowances and Possible Transition to Locality Pay

**Wendy R. Ginsberg**

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**CRS Report for Congress**

*Prepared for Members and Committees of Congress*

## Summary

More than 41,000 white-collar federal civilian employees, including U.S. Postal Service employees, are stationed in the following “nonforeign” areas outside the contiguous United States: Alaska, Hawaii, Guam, the Commonwealth of Northern Mariana Islands (CNMI), Puerto Rico, and the U.S. Virgin Islands (USVI). These employees receive nonforeign cost-of-living allowances (COLAs) in addition to their regular pay. Nonforeign COLAs, which are authorized by 5 U.S.C. § 5941 and Executive Order 10000 (as amended), were first enacted in 1948 to aid federal white-collar job recruitment in nonforeign areas outside the contiguous United States or in the Alaska territory where “living costs [are] substantially higher than in the District of Columbia.” Nonforeign COLAs have faced legal challenges because they create differences in pay between employees who receive a nonforeign COLA and employees within the contiguous United States who, instead, receive locality-based comparability pay.

Three plans to replace the nonforeign COLA with locality pay have been proposed. On May 30, 2007, the Office of Personnel Management (OPM) released a proposal to phase out the nonforeign COLA system. The Federal Managers Association (FMA) released a plan to eliminate the nonforeign COLA shortly after the OPM plan was unveiled. On May 13, 2008, Senator Daniel K. Akaka and others introduced S. 3013, a bill “[t]o provide for retirement equity for Federal employees in nonforeign areas outside the 48 contiguous States and the District of Columbia, and for other purposes.” All three plans would replace the nonforeign COLA program with locality-based comparability payments—or a combination of locality-based pay and a COLA. The most prominent differences among the three plans are the length of time each allots for the COLA phase out, the length of time COLAs are paid once the transition period is completed, and the percentage of every COLA dollar removed from an employee’s pay for every dollar of locality pay added to it.

Nonforeign COLAs and locality pay are different in several ways. First, nonforeign COLAs are based on OPM surveys that determine cost-of-living differences between nonforeign COLA areas and Washington, DC. In contrast, locality pay is based on Bureau of Labor Statistics research that determines cost-of-labor differences between federal and nonfederal workers in the same geographic area. Second, a nonforeign COLA is not added to an employee’s basic rate of pay when calculating retirement benefits, life insurance, and premium pay. Locality pay is counted toward those benefits. Finally, pursuant to 25 U.S.C. § 912, a nonforeign COLA may not be taxed at the federal level, while locality pay is federally taxed.

This report provides an overview of the history of the nonforeign COLA and locality pay programs; identifies and describes potential changes to the existing nonforeign COLA system, including the possibility of instituting locality pay; and analyzes the potential effects of keeping the existing system or adopting a nonforeign COLA phase-out plan. This report will be updated as events warrant.

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## Introduction

The General Schedule (GS) is the primary pay system for federal white-collar employees. As of June 2008, the GS and GS-related pay systems covered nearly 1.26 million of the 1.93 million employees in the federal workforce.<sup>1</sup> Most GS employees in the contiguous United States receive locality-based comparability payments in addition to their basic pay, with the amount of locality pay based on differences between federal and private sector pay rates for particular sets of jobs within particular pay areas.<sup>2</sup> Locality payments are federally taxed as regular wages, and are considered basic pay when determining an employee's retirement benefits,<sup>3</sup> life insurance, and premium pay.<sup>4</sup>

In contrast, most GS and other white-collar employees in "nonforeign" areas outside of the continental United States do not receive locality pay. Instead, they receive cost-of-living allowances (COLAs), which are based on differences in the cost of living in those areas when compared to the Washington, DC, area.<sup>5</sup> The current nonforeign areas are Alaska, Hawaii, Guam, the Commonwealth of Northern Mariana Islands (CNMI), Puerto Rico, and the U.S. Virgin Islands (USVI). Nonforeign COLAs were initially authorized in 1948 as a way to attract employees to, and retain employees in, remote areas in a consistent manner. As of June 2008, more than 41,000 federal employees in those areas (including employees in the U.S. Postal Service) received nonforeign COLAs of up to 25% of basic pay, with total annual nonforeign COLA program payments estimated to be more than \$544 million.<sup>6</sup> In contrast to locality pay, nonforeign COLAs are not federally taxed and are not considered basic pay in determining an employee's retirement benefits, life insurance, or premium pay. According to media reports, federal employees may choose to leave a nonforeign area and work within the contiguous United States in their final years of federal service in order to receive locality pay and thereby increase retirement benefits.<sup>7</sup> Differences in pay between the nonforeign COLA and locality pay authorities have prompted litigation against the nonforeign COLA program. In addition, some executive branch employees and private organizations claim that continued use of the COLAs may lead to recruitment and retention problems in nonforeign areas.<sup>8</sup>

<sup>1</sup> U.S. Office of Personnel Management, Central Personnel Data File, available at <http://www.fedscope.opm.gov/>. FedScope does not provide detailed location information for certain agencies (e.g., the Federal Bureau of Investigation, the Drug Enforcement Agency, and the U.S. Secret Service).

<sup>2</sup> Section 529 of P.L. 101-509, the Federal Employees Pay Comparability Act of 1990 (FEPCA). For more information on the GS locality pay system, see CRS Report RL34463, *Federal White-Collar Pay: FY2009 Salary Adjustments*, by Barbara L. Schwemle.

<sup>3</sup> For more information see CRS Report 94-971, *Federal Employees: Pay and Pension Increases Since 1969*, by Patrick Purcell.

<sup>4</sup> Premium pay is any pay that is at a higher rate than basic pay. Premium pay can include, but is not limited to, night pay, Sunday pay, holiday pay, and hazardous duty pay.

<sup>5</sup> This report refers only to nonforeign areas as defined in 5 U.S.C. § 5941 and does not include U.S. embassies around the world.

<sup>6</sup> Estimate developed by CRS, based on a salary of \$57,709 per year (a GS-12, step 1) and a 23% nonforeign COLA rate for 41,000 nonforeign COLA recipients.

<sup>7</sup> "Congress Studies Locality Pay Proposal," *Pacific Business News*, May 31, 2007, available at [http://pacific.bizjournals.com/pacific/stories/2007/05/28/daily40.html?jst=s\\_cn\\_hl](http://pacific.bizjournals.com/pacific/stories/2007/05/28/daily40.html?jst=s_cn_hl).

<sup>8</sup> U.S. Congress, Senate Committee on Homeland Security and Governmental Affairs, Subcommittee on Oversight of Government Management, the Federal Workforce and the District of Columbia, *Nonforeign COLA: Finding an Equitable Solution*, hearing on S. 3013, 110<sup>th</sup> Cong., 2<sup>nd</sup> sess., testimony of Charles Grimes III, May 29, 2008, available at [http://hsgac.senate.gov/public/\\_files/GrimesTestimony052908.pdf](http://hsgac.senate.gov/public/_files/GrimesTestimony052908.pdf). See also testimony of Michael FitzGerald, May (continued...)

In the 110<sup>th</sup> Congress, two similar bills—one in the House and one in the Senate—were introduced that would phase out the nonforeign COLA program and convert federal, nonforeign employees to locality pay.<sup>9</sup> The Office of Personnel Management (OPM) and the Federal Managers Association (FMA) also have sent transition proposals to Congress. The three plans primarily differ in three ways: the length of time allotted to the transition, the length of time COLAs are paid once the transition is completed, and the percentage of every COLA dollar removed from an employee’s pay for every dollar of locality pay added to it. In all three transition proposals, COLAs would be removed from a nonforeign employee’s pay at a rate that is lower than the introduction of locality pay. Employees who transitioned to locality pay, therefore, could concurrently receive both a COLA and locality pay. The continued COLA payment is meant to offset federal tax payments for the employee who historically would not have paid federal taxes on his or her COLA. The employee would have to pay taxes on locality pay.

The legislative proposal requires three years to phase in locality pay, would continue a COLA past the transition period, and removes 65% of each COLA dollar for each dollar of locality pay added to an employee’s pay.<sup>10</sup> The OPM proposal would phase in locality pay over seven years, continue a COLA payment once the transition was completed, and remove 85% of each COLA dollar for each added dollar of locality pay.<sup>11</sup> The FMA proposal would switch to locality pay in one year, eliminate COLA payments in the second year, and remove 75% of each COLA dollar for each dollar of locality pay added.

This report explores the history and current status of nonforeign COLAs; identifies and describes proposals to change the COLA system, including the possibility of instituting locality pay; and analyzes the potential effects of keeping the existing system or adopting one of the three nonforeign COLA phase-out plans.

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29, 2008, available at [http://hsgac.senate.gov/public/\\_files/FitzGeraldTestimony052908.pdf](http://hsgac.senate.gov/public/_files/FitzGeraldTestimony052908.pdf); and U.S. Office of Personnel Management, “Cost-of-Living Allowances (Nonforeign Areas); Partnership Pilot Project,” 61 *Federal Register* 59175, Nov. 21, 1996.

<sup>9</sup> S. 3013. H.R. 6516, a similar bill to S. 3013, was introduced in the House, but was not reported from committee. This report focuses on S. 3013, which has passed the Senate and was referred to the House Committee on Oversight and Government Reform.

<sup>10</sup> None of the proposals state the assumed flat tax rate. Instead, each proposal selects a COLA offset rate, which represents the percentage of each COLA dollar that would be removed for each dollar in locality pay that is added to an employee’s pay. The remaining COLA percentage was designed to cover increased tax payments for employees switching from COLAs to locality pay. If the COLA offset rate is 65%—as it is in the legislative proposal—the bill assumes a 35% flat tax rate for federal employees.

<sup>11</sup> In both the OPM proposal and the legislation, COLAs would continue to be paid after the transition is completed to ensure that nonforeign area employees do not have a reduction in their take-home (post federal tax) pay. The continued COLA, in other words, is designed to make certain nonforeign area employees do not experience a reduction in their paychecks because of the transition to locality pay. The COLA that remained after the transition was completed aims to be roughly equal in value to a nonforeign area employee’s estimated reduction in take-home pay caused by federal taxes on his or her locality pay.

# History of Nonforeign COLAs

## Legislation Establishing the Program

The nonforeign COLAs<sup>12</sup> were developed after World War II in response to concerns about inequities in federal pay between employees working in nonforeign areas and those working in the contiguous United States. During the war, various agencies began offering pay differentials in certain areas to aid employee recruitment pursuant to the Brookhart Salary Act of 1930 and the Mead-Ramspeck Act of 1940.<sup>13</sup> In 1977, William L. Camp, then-area manager of the U.S. Civil Service Commission (now the Office of Personnel Management (OPM)), testified about the post-war period, saying that, “[b]ecause agencies acted independently, often with varying degrees of legal authority, employees of the various agencies could and did receive significantly different compensation treatment in the same geographic area.”<sup>14</sup>

In 1946, President Harry S Truman asked the Civil Service Commission (now the Office of Personnel Management) and the Bureau of the Budget to conduct jointly a “study of pay differentials and related compensation problems in the Federal service outside the States.”<sup>15</sup> The study recommended creating a standardized pay scale for all federal employees working in nonforeign areas and basing that structure on two factors: regional costs of living and desirability of living conditions. Both the legislative and executive branches used this study to shape contemporary nonforeign COLA management and operation.

In 1948, Representative Richard Bowditch Wigglesworth introduced an executive office appropriations bill (H.R. 5214, 80<sup>th</sup> Congress), which would have, among other things, given the President authority to establish higher rates of pay in areas outside of the contiguous United States. On February 4, 1948, the House Committee on Appropriations reported the bill, stating its desire to create a “uniform standard ... applicable to all agencies” for payment to all federal employees serving in agencies or companies operating outside the contiguous United States.<sup>16</sup> The committee report noted that a handful of departments—including State, War, and Navy—already paid employees living outside of the continental United States additional compensation, and that the goal of the legislation was to extend the practice to other federal employees living in the same geographic areas. The bill capped the intended pay supplement at 25% of an employee’s salary.<sup>17</sup>

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<sup>12</sup> The term nonforeign area was not used until 1985 (E.O. 12510). This report, however, will adopt the use of the term “nonforeign” throughout.

<sup>13</sup> 46 Stat. 1003; and 44 Stat. 614. Executive Orders 8657 and 8955 also governed federal civilian employee pay prior to the implementation of nonforeign COLAs. The executive orders authorized the War Department and the Department of the Navy to award pay differentials to federal civilian white-collar employees who worked in Alaska or Atlantic naval bases. The pay aimed to increase recruitment in those areas.

<sup>14</sup> U.S. Congress, Committee on Post Office and Civil Service, *Cost of Living Allowance*, hearings, 95<sup>th</sup> Cong., 2<sup>nd</sup> sess., July 8, 1977 (Washington: GPO, 1977) p. 13. This testimony examined the history and contemporary state of nonforeign COLAs.

<sup>15</sup> U.S. Civil Service Commission, *63<sup>rd</sup> Annual Report: The Transition From War to Peace in the Federal Personnel Administration* (Washington: GPO, 1946).

<sup>16</sup> U.S. Congress, House Committee on Appropriations, *Independent Offices Appropriation Bill, 1949*, report to accompany H.R. 5214, 80<sup>th</sup> Cong., 2<sup>nd</sup> sess., H.Rept. 80-1288 (Washington, GPO, 1948), pp. 4-5.

<sup>17</sup> House debate, *Congressional Record*, vol. 94, Part XX (Jan. 30, 1948), p. 782. Locality pay, COLAs, and other types (continued...)



The Committee of the Whole House on the State of the Union considered the bill that same day. Representative Joseph Rider Farrington stated that differentials in pay for areas outside the continental United States originally “came about through the necessity of moving a great many people to those areas for the purpose of prosecuting the war and also because of the high cost of living in those areas.”<sup>18</sup> The pay differential should be extended to all federal employees living in nonforeign territories outside of the continental United States, Farrington said, because it would be unfair to allow certain employees living in an area to receive a 25% increase in pay and prohibit others from receiving the same. The appropriations bill was amended and brought before the House for a vote, where it passed 339 to 10.<sup>19</sup>

The bill then was received by the Senate and referred to the Committee on Appropriations, which held several days of hearings on the legislation—from March 2 through March 5, 1948. During the hearings, some concern over the pay differential was expressed by Harry See, the national legislative representative of the Brotherhood of Railroad Trainmen. In his testimony, See discussed fears that the 25% cap on the pay differential “would operate to the disadvantage of the Federal Government and its employees outside th[e] continental limits.”<sup>20</sup> See asked that federal railroad employees be excluded from the provision:

Most of the comforts and many of what the people in the United States regard as necessities are not available in Alaska.... On the other hand, as the last war amply demonstrated, Alaska is of vital importance to the United States, and our defense program requires that we have large numbers of Federal employees continuously in the Territory. Not only would it be unfair but it would be impossible to induce people to go to Alaska as Federal employees if some provision were not made to adjust wage scales to the higher cost of living, and without some incentive in the form of additional pay.<sup>21</sup>

According to his testimony, See did not disagree with the adoption of a pay supplement. Instead, he wanted Congress to eliminate the 25% ceiling on the pay supplement because he believed Alaska was already operating at an even larger cost-of-living disparity when compared to the continental United States.

In spite of See’s testimony, the Senate reported the bill on March 15, 1948, with several requested amendments, but none that exempted railroad workers from the new pay differential.<sup>22</sup> The Senate and House passed the bill on April 12, 1948, and President Truman signed it on April 20, 1948.<sup>23</sup>

On June 8, 1948, Representative Wigglesworth introduced H.R. 6829 (80<sup>th</sup> Congress), a supplemental Executive Office appropriations bill. The Committee on Appropriations reported the

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of federal pay increases that can be added to basic pay may be referred to in the aggregate as pay supplements throughout this report.

<sup>18</sup> House debate, *Congressional Record*, vol. 94, (Feb. 4, 1948), p. 1088.

<sup>19</sup> Eighty-one members did not vote. The amendments made to the bill did not affect the pay differential.

<sup>20</sup> U.S. Congress, Senate Committee on Appropriations, Subcommittee of the Committee on Appropriations, *Independent Offices Appropriation Bill, 1949*, hearing on H.R. 5214, 80<sup>th</sup> Cong., 2<sup>nd</sup> sess., S.Rept 80-984 (Washington: GPO, 1948), p. 289.

<sup>21</sup> *Ibid.*, pp. 289-290.

<sup>22</sup> *Ibid.*

<sup>23</sup> P.L. 80-491.

bill, which amended the previous legislation by adding more detail.<sup>24</sup> As reported, the bill would have granted the President power to establish pay differential rates and prohibited federal employees from receiving other pay differentials if they received this cost-of-living allowance. On June 19, 1948, the House and Senate agreed to the final conference version of H.R. 6829. The President signed the bill into law on June 30, 1948.<sup>25</sup>

The second law applied “to all persons stationed outside the continental United States or in Alaska whose rates of basic compensation are fixed by statute.” Pursuant to the law, these qualifying federal employees could receive “additional compensation as a recruitment incentive” if their living costs were “substantially higher than in the District of Columbia.”<sup>26</sup> The President was still charged with establishing the additional compensation rates, defining the areas to be considered for the additional pay, and determining which classes and groups of employees would be eligible for the pay. The public law maintained the 25% of compensation cap on the pay differential rate.

## Executive Order 10000

Pursuant to P.L. 80-862, on September 16, 1948, President Truman issued Executive Order 10000.<sup>27</sup> The order defined the non-continental U.S. territories and states that were eligible to receive the new pay differentials as including “Alaska, Hawaii, other territories and possessions of the United States, the Trust Territory of the Pacific Islands, and such additional Areas located outside the continental United States as the Secretary of State shall designate as being within the scope of the new provisions.”<sup>28</sup> The executive order charged the U.S. Civil Service Commission (now OPM) with determining the nonforeign areas to receive cost-of-living compensation.<sup>29</sup> According to E.O. 10000, the Civil Service Commission was also to determine cost-of-living compensation rates and any necessary accompanying policies and procedures to ensure federal employees received additional pay. The rates were to be re-examined “periodically, but at least annually.”<sup>30</sup>

Subsequent executive orders have modified E.O. 10000. Executive Order 12107, issued in 1978, granted OPM much of the authority formerly held by the Civil Service Commission. Executive Order 12510, issued in 1985, replaced the term “territory” with “nonforeign area,” and made other changes. Executive Order 13207, issued in 2001, modified OPM’s procedures to reduce nonforeign COLA rates where cuts were warranted.<sup>31</sup>

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<sup>24</sup> U.S. Congress, House Committee on Appropriations, *Supplemental Independent Offices Appropriation Bill, 1949*, report to accompany H.R. 6829, 80<sup>th</sup> Cong., 2<sup>nd</sup> sess., H.Rept. 80-2245, (Washington: GPO, 1948).

<sup>25</sup> P.L. 80-862.

<sup>26</sup> *Ibid.* Later codified at 5 U.S.C. § 5941(a). Additional justifications for creating nonforeign COLAs are available in 5 C.F.R. §§ 591.202-591.203.

<sup>27</sup> U.S. President Harry S Truman, “Regulations Governing Additional Compensation And Credit Granted Certain Employees of the Federal Government Service Outside the United States,” 13 *Federal Register* 5453, Sept. 18, 1948.

<sup>28</sup> *Ibid.*

<sup>29</sup> *Ibid.*, sec. 205.

<sup>30</sup> *Ibid.*, sec. 210. The language “at least annually” was removed from the executive order by Executive Order 13207, 66 *Federal Register* 18399, which was signed Apr. 5, 2001.

<sup>31</sup> Executive Order 12107, “Relating to the Civil Service Commission and Labor-Management in the Federal Service,” 44 *Federal Register* 1055, Dec. 28, 1978; Executive Order 12510, “Non-Foreign Area Cost-Of-Living Allowances,” 50 *Federal Register* 15535, Apr. 17, 1985; Executive Order 13207, “Further Amendment to Executive Order 10000, (continued...) ”

## Subsequent Efforts to Modify the Nonforeign COLA Program

Numerous efforts have been made during the past 60 years to change or eliminate the nonforeign COLA program. For example, legislation was introduced in 1965 (H.R. 7401, 88<sup>th</sup> Congress) and 1966 (H.R. 8390, 89<sup>th</sup> Congress) that would have eliminated the nonforeign COLA program. Neither bill was enacted. In 1973, Representative Spark M. Matsunaga introduced a bill (H.R. 2062, 93<sup>rd</sup> Congress) that would have permitted qualifying employees in nonforeign areas to receive both a full post differential<sup>32</sup> and a full nonforeign COLA concurrently. Under current statutes, an employee who is eligible for both a nonforeign COLA and a post differential may receive both, provided the supplements—when added together—are capped at 25% of the employee’s basic pay.<sup>33</sup> Representative Matsunaga’s bill was never reported from the House Committee on Post Office and Civil Service. An identical bill was reintroduced in the 94<sup>th</sup> Congress (H.R. 1916) and also was not reported from the committee.

In 1976, the General Accounting Office (GAO, now the Government Accountability Office) recommended eliminating the nonforeign COLA program in favor of a “more equitable means of compensation.”<sup>34</sup> According to the GAO report, the designated nonforeign areas had witnessed rapid population growth and steady increases in both employment and per capita income. As a result, GAO said the nonforeign COLA program “had outlived its usefulness and [was] no longer an appropriate means of compensation.”<sup>35</sup> GAO also recommended modifying the calculation of nonforeign COLAs in a variety of ways, including incorporating an employee’s family size, income level, and state and federal taxes into the computation. Another recommendation called for the creation of more specific nonforeign COLA areas to be carved out within existing ones to recognize cost differences across larger nonforeign areas.<sup>36</sup> The Civil Service Commission (now OPM) took no position on GAO’s recommendations, concluding that reform of the nonforeign COLA program should be part of a larger reform of the federal pay system.<sup>37</sup>

In 1992, Congress required OPM to report on the practices of nonforeign area employers other than the federal government, as well as analyze the options and alternatives to the nonforeign COLA program that would “take into account all costs of living.”<sup>38</sup> OPM was also instructed to examine possible effects of implementing any alternative system on recruiting and retaining federal employees in nonforeign areas. Congress then froze nonforeign COLAs through

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Regulations Governing Additional Compensation and Credit Granted Certain Employees of the Federal Government Serving Outside the United States,” 66 *Federal Register* 18399, Apr. 9, 2001.

<sup>32</sup> Post differentials are granted to employees working in “extraordinarily difficult working conditions,” “excessive physical hardship,” or “notably unhealthful conditions.” 5 U.S.C. § 5925. See also U.S. Office of Personnel Management, “Nonforeign Area Cost-of-Living Allowances: Post Differentials,” available at <http://www.opm.gov/oca/cola/postdifferential.asp>.

<sup>33</sup> If the nonforeign COLA and post differential together are greater than 25% of the employee’s basic pay, the employee will receive the full nonforeign COLA and as much of the pay differential possible up to the 25% cap.

<sup>34</sup> U.S. Government Accountability Office, *Policy of Paying Cost-Of-Living Allowances To Federal Employees In Nonforeign Areas Should Be Changed*, GAO Report FPCD-75-161, Feb. 12, 1976, p. i.

<sup>35</sup> *Ibid.*, p. i.

<sup>36</sup> *Ibid.*, p. ii.

<sup>37</sup> *Ibid.*, p. 19. OPM later substantively complied with one of GAO’s recommendations, carving out Anchorage, Juneau, and Fairbanks, AK, as separate nonforeign COLA areas from the rest of the state, and providing separate rates for Honolulu, the County of Hawaii, the County of Kauai, and the counties of Maui and Kalawao in Hawaii.

<sup>38</sup> P.L. 102-141.

December 31, 2000, and required submission of the report by March 1, 2000.<sup>39</sup> The *Nonforeign Area Cost-of-Living Allowance Final Report*<sup>40</sup> was released July 26, 1999. A Technical Advisory Group, a panel of economic advisers hired as advisers by OPM on the nonforeign COLA issue,<sup>41</sup> published an analysis of the final report on July 17, 2000, which concluded that locality pay should not replace COLAs.

[The research] concludes that locality pay is not a sufficient alternative to a COLA supplemented by a direct adjustment for non-price factors, and that the current methodology under-compensates COLA area employees to the extent that it ignores the locality pay received by employees in the [contiguous United States].<sup>42</sup>

## Current Nonforeign COLA Program

The statutory, executive order, and regulatory requirements governing the nonforeign COLA program are codified in 5 U.S.C. § 5941 or included in 5 C.F.R. § 591. The following description of the program is drawn from those sources as well as from OPM, the *Federal Register*, and the *U.S. Code Annotated*.

### Covered Geographic Areas and Pay Systems

As of July 2008, the nonforeign COLA program includes white-collar federal employees who work in Alaska, Hawaii, Guam, the Commonwealth of the Northern Mariana Islands (CNMI), Puerto Rico or the U.S. Virgin Islands.<sup>43</sup> As shown in **Table 1**, there are 11 total pay areas with varying nonforeign COLA rates.

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<sup>39</sup> Ibid. From 1991 through Dec. 31, 2000, Congress barred COLA rate reductions.

<sup>40</sup> *The Nonforeign Area Cost-of-Living Allowance Final Report* is available as an appendix at [http://www.opm.gov/oca/Cola/Rsrch\\_ap.pdf](http://www.opm.gov/oca/Cola/Rsrch_ap.pdf), pg. 14.

<sup>41</sup> The Technical Advisory group is a panel of three economic experts selected to help a committee of OPM employees and nonforeign COLA recipients determine ways to modify nonforeign COLAs to better reflect costs of living. See “Special Research Relating to the Nonforeign COLA Area Cost-of-Living Allowance (COLA) Program,” available at [https://www.opm.gov/oca/cola/Rsrch\\_ap.pdf](https://www.opm.gov/oca/cola/Rsrch_ap.pdf).

<sup>42</sup> Appendix B. *Report of the Technical Advisory Group*, July 17, 2000, available at <http://www.opm.gov/oca/cola/App-b.pdf>.

<sup>43</sup> U.S. Office of Personnel Management, “Nonforeign Area Cost-of-Living Allowances,” available at <http://www.opm.gov/oca/Cola/INDEX.asp>.

**Table 1. Nonforeign Area COLA Rates, July 2008**

Geographic Area	Nonforeign COLA Rate Percentage (to be multiplied by basic rate of pay to determine nonforeign COLA pay)	
<b>Alaska</b>	Anchorage (within 50-mile road radius)	24%
	Fairbanks (within 50-mile road radius)	24%
	Juneau (within 50-mile road radius)	24%
	Rest of Alaska	25%
<b>Hawaii</b>	Honolulu (city and county)	25%
	County of Hawaii	18%
	County of Kauai	25%
	County of Maui and County of Kalawao	25%
Territory of Guam and Commonwealth of the Northern Mariana Islands	25%	
Commonwealth of Puerto Rico	13%	
U.S. Virgin Islands	25%	

**Source:** U.S. Office of Personnel Management, "Nonforeign Area Cost-Of-Living Allowances," available at <https://www.opm.gov/oca/cola/rates.asp>.

**Notes:** Nonforeign COLA rates suggest that living cost differences between the designated areas and the Washington, DC, area range between 13% and 25%. Other private-sector methods for comparing costs of living, however, suggest that living cost differences are not as high as are reflected in existing nonforeign COLA rates. In fact, some cost-of-living calculators find that living costs are higher in Washington, DC than in some nonforeign COLA areas. For example, Salary.com's "Cost of Living Wizard Tool" calculates that living costs in San Juan, Puerto Rico are 39% lower than in Washington, DC. The website also calculates that Anchorage, Alaska's living costs are 22.9% lower. Honolulu, Hawaii's living costs are 1.9% higher than in Washington, DC, according to Salary.com. For more information, including the website's methodology, see Salary.com, "Cost of Living Wizard," available at [http://swz.salary.com/costoflivingwizard/layouts/scripts/coll\\_start.asp](http://swz.salary.com/costoflivingwizard/layouts/scripts/coll_start.asp). For another cost-of-living calculator, see CNNMoney.com, "How far will my salary go in another city?" available at <http://cgi.money.cnn.com/tools/costofliving/costofliving.html>. Some nonforeign COLA areas, like Guam, are not included as comparison cities on the cost-of-living calculators.

Within those areas, nonforeign COLAs apply to white-collar employees who are paid under the following schedules:

- the General Schedule;
- the Veterans Health Administration Schedule;
- the Foreign Service Schedule; or
- the Postal Service Schedule.

Other federal workers are also eligible for COLAs, including the following employees:

- administrative law judges paid under 5 U.S.C. § 5372
- employees in the Senior Executive Service (including the Federal Bureau of Investigation and Drug Enforcement Administration Senior Executive Service);

- employees in senior-level scientific or professional positions paid under 5 U.S.C. § 5376; or
- administrative appeals judges paid under 5 U.S.C. § 5941.<sup>44</sup>

An agency may also extend a nonforeign COLA to other employees if authorized “by specific law” to do so.<sup>45</sup>

## Recent Nonforeign COLA Rate Changes and Proposals

On May 29, 2008, OPM published a final rule in the *Federal Register* to change the nonforeign COLA rates in Puerto Rico and Hawaii County, HI. Effective June 30, 2008, Puerto Rico’s nonforeign COLA rate rose to 13% from 10.5% and Hawaii County’s rate rose to 18% from 17%. The changes are the “result of interim adjustments OPM calculated based on relative Consumer Price Index differences between the cost-of-living allowance areas and the Washington, DC, area.”<sup>46</sup>

Further changes in nonforeign COLA rates may be forthcoming. On January 3, 2008, OPM published a proposed rule in the *Federal Register* to reduce the nonforeign COLA rates in Fairbanks, Anchorage, and Juneau, AK.<sup>47</sup> The change would reduce the nonforeign COLA in those areas by one percent—from 24% to 23%.<sup>48</sup> The change would also limit the Alaska nonforeign COLA area boundaries to a “50-mile radius ... by the shortest route using paved roads.”<sup>49</sup> Comments on the proposed change were accepted until March 3, 2008.

On August 25, 2008, OPM again published a proposed rule in the *Federal Register* that would reduce the COLA rate for employees in Anchorage, Fairbanks, and Juneau an additional 1% (from 23% to 22%).<sup>50</sup> The reduction proposals cannot be implemented within the same 12-month period because COLA rates can only be reduced by up to 1% per year. Also, in the August 25 notice, OPM proposed raising Puerto Rico’s COLA rate by 1% (from 13% to 14%). Puerto Rico’s proposed increase is not contingent on Alaska’s rate reduction. Comments on Alaska’s most recent rate decrease proposal and Puerto Rico’s proposed increase were accepted until October 24, 2008.

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<sup>44</sup> 5 C.F.R. § 591.204(a).

<sup>45</sup> 5 C.F.R. § 591.204(b).

<sup>46</sup> U.S. Office of Personnel Management, “NonForeign Area Cost-of-Living-Allowance Rates; Puerto Rico and Hawaii County, HI,” 75 *Federal Register* 30727, May 29, 2008.

<sup>47</sup> U.S. Office of Personnel Management, “Nonforeign Area Cost-of-Living Allowance Rates; Alaska,” 73 *Federal Register* 772, Jan. 3, 2008.

<sup>48</sup> According to 5 C.F.R. § 591.228(c), “OPM may reduce the COLA rate in any area by no more than 1 percentage point in any 12-month period. Any reduction in the COLA rate for any COLA area cannot be effective until the effective date of the first survey conducted in Hawaii and Guam and CNMI under these regulations.”

<sup>49</sup> *Ibid.*, p. 772.

<sup>50</sup> Office of Personnel Management, “Nonforeign Area Cost-of-Living Allowances; 2007 Interim Adjustments,” 73 *Federal Register* 50177, Aug. 25, 2008.

## Nonforeign Area Employees

More than 41,000 federal employees on the General Schedule—or on a similar pay schedule—work in nonforeign areas and receive a COLA. **Table 2** shows the departments and agencies in which these nonforeign COLA worked as of June 2008. As the table shows, more than 90% of the nonforeign COLA recipients worked in Alaska, Hawaii, or Puerto Rico, and nearly 25% of all recipients worked in the Department of Defense.

**Table 2. Federal Civilian Nonforeign COLA Recipients by Agency, June 2008**

Department/ Agency	Alaska	Hawaii	Guam	Northern Mariana Islands	US VI	Puerto Rico	Total
Air Force	635	903	193	0	0	166	1,897
Army	1,469	1,647	2	1	87	629	3,835
Navy	1	3,180	473	0	0	72	3,726
Other Defense	168	535	133	0	0	157	993
<b>Total Defense</b>	<b>2,273</b>	<b>6,265</b>	<b>801</b>	<b>1</b>	<b>87</b>	<b>1,024</b>	<b>10,451</b>
Agriculture	1,155	774	32	6	11	586	2,564
Commerce	561	341	23	0	0	86	1,011
Education	0	0	0	0	1	8	9
Energy	1	1	0	0	0	0	2
Health and Human Services	357	149	1	0	4	120	631
Homeland Security	414	562	114	99	159	1,334	2,682
Housing and Urban Development	39	29	1	0	0	73	142
Interior	2,670	478	10	9	79	120	3,366
Justice	52	245	27	4	39	324	691
Labor	22	26	2	1	0	32	83
State	2	20	0	0	0	1	23
Transportation	158	80	0	0	0	40	278
Treasury	80	137	0	0	6	534	757
Veteran's Affairs	445	563	0	13	8	2,284	3,313
Other Agencies	177	266	19	12	24	541	1,039
<b>Total Non- Defense</b>	<b>6,133</b>	<b>3,671</b>	<b>229</b>	<b>144</b>	<b>331</b>	<b>6,083</b>	<b>16,591</b>
U.S. Postal Service	8,116	2,611	119	12	229	2,949	14,036
<b>Grand Total</b>	<b>16,522</b>	<b>12,547</b>	<b>1,149</b>	<b>157</b>	<b>647</b>	<b>10,056</b>	<b>41,078</b>

**Source:** U.S. Office of Personnel Management, Central Personnel Data File, available at <http://www.fedscope.opm.gov/>. The U.S. Postal Service employee count was supplied by USPS as of January 2008.

**Note:** The Central Personnel Data File does not include employee counts from several federal agencies, including the Central Intelligence Agency, the Defense Intelligence Agency, the National Geospatial-Intelligence

Agency, the Postal Rate Commission, and USPS. The employee count does not include Senior Executive Service employees, administrative judges, or other federal employees who are not paid on the General Schedule.

## American Samoa

Federal personnel in American Samoa who do not receive a nonforeign COLA are also not included in the employee count. On March 29, 2007, Representative Eni F.H. Faleomavaega introduced a bill (H.R. 1786) that would provide nonforeign COLAs to federal white-collar employees living in American Samoa. OPM does not classify American Samoa as a nonforeign COLA area.<sup>51</sup> Federal employees who move to American Samoa for their job receive a pay differential, which is distinct from a COLA and is provided in areas considered “unhealthful” or “extraordinarily difficult” when compared to the U.S. mainland. Native American Samoans who are federal employees do not receive any pay supplement. On April 16, 2007, H.R. 1786 was referred to the House Oversight and Government Reform Committee’s Subcommittee on Federal Workforce, Post Office and the District of Columbia. It was not reported from committee. As of June 2008, 50 white-collar federal employees work in American Samoa.

Although S. 3013 does not explicitly state whether American Samoa’s federal employees would receive locality pay if enacted, the Senate report that accompanied the bill (S.Rept. 110-456) stated, “[t]he legislation would apply to federal employees in all of the non-foreign areas, including Alaska, Hawaii, the Virgin Islands, Puerto Rico, Guam, CNMI, American Samoa, and Johnston, Wake, and Midway Atolls.” OPM has stated that American Samoa would receive locality pay under its transition proposal. The FMA proposal does not state whether American Samoa would be eligible for locality pay.

## Methodology for Determining Nonforeign COLA Rates

Nonforeign COLAs are based on OPM price surveys that compare cost-of-living rates between designated nonforeign COLA areas and the Washington, DC, area. In contrast, locality pay is based on Bureau of Labor Statistics (BLS) data that compare federal and nonfederal salaries for similar occupations within a single geographic area. Nonforeign COLAs are also distinct from post differentials, which are provided in areas considered “unhealthful” or “extraordinarily difficult” when compared to the U.S. mainland.<sup>52</sup>

To conduct the nonforeign COLA price surveys, OPM collects information on the prices of more than 300 items in each of the 11 nonforeign COLA areas and uses the information to create a nonforeign COLA area price index.<sup>53</sup> To gather the necessary information, OPM employees visit stores; call retail outlets; and use catalogs, the Internet, or similar sources.<sup>54</sup> When creating the index, OPM gives greater weight to essential consumer goods like food and housing.<sup>55</sup> OPM is

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<sup>51</sup> The decision not to include American Samoa as a nonforeign COLA area is not found in statute. OPM determines which areas qualify for nonforeign COLAs. OPM did not state why American Samoa or other American territories were not included as COLA areas when asked on September 16, 2008. OPM provided the information to the author by telephone on September 16, 2008.

<sup>52</sup> 5 C.F.R. § 591.203 and 5 C.F.R. § 591.232.

<sup>53</sup> U.S. Office of Personnel Management, “2006 Nonforeign Area Cost-of-Living Allowance Survey Report: Alaska and Washington, DC, Areas,” *73 Federal Register* 775.

<sup>54</sup> 5 C.F.R. § 591.214.

<sup>55</sup> U.S. Executive Office of the President, Office of Management and Budget, *Nonforeign Area Cost-of-living* (continued...)



also required to consider the availability of goods and services, the concentration of federal employees, and the “existence of a well-defined economic community” in determining whether an area should receive a nonforeign COLA.<sup>56</sup> OPM conducts the price surveys in each nonforeign COLA area once every three years on a staggered schedule. For example, in the first year, Puerto Rico and the U.S. Virgin Islands are surveyed. In the following year, all areas in the state of Alaska are surveyed. In the third year, the nonforeign COLA areas of Hawaii, Guam, and CNMI were surveyed.<sup>57</sup> A department or agency head or a designee may request an OPM review to determine if employees in an organization meet nonforeign COLA area requirements.<sup>58</sup>

A nonforeign COLA may be established if living costs in the area are “substantially higher” than in the Washington, DC, area.<sup>59</sup> Once established, the nonforeign COLA rate is then multiplied by the employee’s basic pay rate (not including overtime pay, night differentials, extra holiday pay, or other allowance differentials) to determine the precise dollar amount of the employee’s total paycheck, including the nonforeign COLA.<sup>60</sup> Nonforeign COLA rates may not exceed 25% of basic pay. If surveys warrant, the nonforeign COLA rates may rise any number of percentage points per year, but they may be lowered only up to one percentage point per year.<sup>61</sup>

## Estimated Locality Pay Rates

OPM has conducted surveys to estimate what locality pay rates would be in some nonforeign areas if COLAs were eliminated. OPM’s estimated locality pay rates for the current nonforeign COLA areas in 2008 are shown in **Table 3**. In some areas, the estimated locality pay rate is higher than the current COLA rate. In other areas, the estimated locality pay rate is lower than the current COLA rate.

OPM estimated, for example, that Anchorage’s 2008 locality pay rate would have been 27.74%—2.75% higher than its 24% nonforeign COLA rate in 2008. This locality pay rate is comparable to the Houston, TX, locality pay rate (27.39%). The differences in federal and non-federal pay rates in Anchorage, therefore, are estimated to be similar to the pay differences in Houston. OPM estimates that Anchorage employees would receive pay that would be similar to that of employees in Houston if a transition were enacted.

Honolulu’s OPM-estimated locality percentage of 20.38% is 4.12% lower than the current COLA rate (25%). The estimated locality pay rate is similar to the locality pay percentage in the Washington, DC, area (20.89%). Honolulu employees, according to OPM’s estimates, would

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(...continued)

*Allowances*, available at <http://www.opm.gov/oca/cola/index.asp>.

<sup>56</sup> 5 C.F.R. § 591.206(a).

<sup>57</sup> 5 C.F.R. § 591.223. The “rest of the state of Alaska” nonforeign COLA area is excluded from this three-year survey schedule unless it appears that the nonforeign COLA rate might need to be reduced. In this case, OPM conducts on-site surveys in “one or more” locations in Alaska to determine if a rate reduction is warranted (5 C.F.R. § 591.215(b)).

<sup>58</sup> 5 C.F.R. § 591.206(b).

<sup>59</sup> 5 U.S.C. § 5941(a).

<sup>60</sup> 5 C.F.R. § 591.201. Overtime pay of firefighters is included in the calculation of basic pay.

<sup>61</sup> 5 U.S.C. § 5941(a). The one percentage point cap on nonforeign COLA reduction is written in the lawsuit settlement for Roberto Caraballo, et al. v. United States of America No. 1997-0027 (D. V.I. 1997), an electronic copy of the settlement as issued from the District Court of the Virgin Islands is available at <http://www.colasettlement.com/images/notice.pdf>, p. 3.

receive pay checks comparable to federal employees in the Washington, DC, area if they received locality pay instead of a COLA.

OPM estimates that the labor cost comparisons in the other nonforeign COLA areas would yield a percentage that is lower than the existing Rest of United States (RUS) locality pay percentage of 13.18%. Areas with labor comparison costs lower than the RUS rate automatically receive the RUS rate. Therefore, employees in Puerto Rico, U.S. Virgin Islands, the Northern Mariana Islands, and Guam would, most likely, receive the RUS locality pay rate (13.18% for 2008). OPM estimates that locality pay rates will climb, on average, 1% per year until the pay disparity between federal and non-federal employees is 5% or less in each individual locality pay area.

**Table 3. OPM Projected Locality Payments in the Nonforeign Areas and Comparative Areas in the Contiguous United States**

Nonforeign Area	2008 Estimated Locality Payment (%)
Anchorage	27.74%
Honolulu	20.38%
Puerto Rico	13.18% <sup>a</sup>
Guam	13.18% <sup>a</sup>
Commonwealth of the Northern Mariana Islands	13.18% <sup>a</sup>
U.S. Virgin Islands	13.18% <sup>a</sup>
Locality Pay Area	2008 Actual Locality Payment (%) <sup>b</sup>
Houston-Baytown-Huntsville, TX,	27.39%
San Jose-San Francisco, CA	32.53%
Washington, DC	20.89%
Rest of U.S. (RUS)	13.18%

**Source:** U.S. Office of Personnel Management, Center for Performance and Pay Systems, 2006 report of Locality-based Comparability Payments for the General Schedule, at <http://www.opm.gov/oca/payagent/2007/2007PayAgentReport.pdf>. 2007 recommendations of the Federal Salary Council are available at <http://www.opm.gov/oca/fsc/recommendation07.pdf>, attachments 1 and 3.

- a. Rest of U.S. locality pay rate is shown for locations not surveyed by BLS. According to OPM, locality pay estimates for these areas, which are provided by OPM, should not be considered robust estimates.
- b. Because a 12-month "reference period" is used to establish rate increases, locality rates in effect in 2008 are based on pay gaps as of 2006 (extra time is needed to calculate increases once the 12-month period has expired). Estimated locality rates for nonforeign areas are based on 2007 pay disparity calculations. See the U.S. Office of Personnel Management, Report on Locality-based Comparability Payments for the General Schedule, available at <http://www.opm.gov/oca/payagent/2007/2007PayAgentReport.pdf>.

## Litigation

According to OPM, since 1981, the nonforeign COLA program has been "fraught with litigation."<sup>62</sup> Many lawsuits emerged from both real and perceived pay differences between

<sup>62</sup> Letter from Linda M. Springer, Director of the Office of Personnel Management, to Richard B. Cheney, President of the U.S. Senate, May 30, 2007, available at [http://www.opm.gov/news\\_events/congress/proposals/Locality\\_Pay\\_Extension\\_Act.pdf](http://www.opm.gov/news_events/congress/proposals/Locality_Pay_Extension_Act.pdf).

nonforeign COLA area employees and other federal employees who receive locality pay.<sup>63</sup> One of the more significant nonforeign COLA lawsuits, *Roberto Caraballo, et al., v. United States of America*, culminated in a class action settlement that required the federal government to award \$234 million in back pay to all nonforeign COLA employees of a qualifying class and modified the methodology for determining the nonforeign COLA rate. According to the settlement's "Safe Harbor Process," the federal government must now ensure that nonforeign COLA rates better reflect regional costs of living by including "non-price factors" in the calculations.<sup>64</sup> Under the settlement, nonforeign COLA survey schedules were changed from one survey per year to one every three years, and rate settings were required to be rounded to the nearest whole percentage point.<sup>65</sup>

On January 30, 2008, the U.S. District Court in Hawaii dismissed another nonforeign COLA lawsuit, *Matsuo v. United States of America*.<sup>66</sup> The suit, filed on June 22, 2005 by 10 current and former nonforeign federal employees from Alaska and Hawaii, claimed that locality pay unconstitutionally granted non-COLA area federal employees a larger retirement annuity than those who received a nonforeign COLA.<sup>67</sup> The employees argued that because locality pay and nonforeign COLAs "serve different purposes," federal employees should "be entitled to locality pay regardless of the fact that they receive COLA."<sup>68</sup> The plaintiffs have appealed the court's dismissal, and the case currently is pending.

## Transition Proposals

Currently, three proposals to transition nonforeign areas from COLAs to locality pay have been offered. A legislative proposal (S. 3013) calls for a three year phase-in.<sup>69</sup> OPM's proposal suggests a seven-year phase-in. The Federal Managers Association's proposal posits a one-year replacement.

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<sup>63</sup> See, for example, *Alaniz v. Office of Pers. Mgmt.*, 728 F.2d 1460 (Fed. Cir. 1984); *Roberto Caraballo, et al. v. United States of America* No. 1997-0027 (D. V.I. 1997); *Matsuo v. United States of America* 532 F. Supp. 2d 1238 (D. Haw. 2008); *Alaniz v. OPM*, 728 F.2d 1460 (Fed.Cir. 1984); *Angelet v. United States of America* No. 97-1378RU (Fed. Cir. 1994); *Cruz v. United States* No. 98-00021 (D. Guam 1998).

<sup>64</sup> *Roberto Caraballo, et al. v. United States of America* No. 1997-0027 (D. V.I. 1997). See also "Exhibit A: Safe Harbor Principles," D.C. Civil No. 1997/27 [http://colasettlement.com/images/exhibit\\_a.pdf](http://colasettlement.com/images/exhibit_a.pdf), pg. 5. According to the notice of proposed settlement, non-price factors include "differences in need, availability of and access to goods and services, and quality of life." These factors are calculated together and incorporated into COLA rates as an adjustment factor. Each nonforeign COLA area is assigned its own adjustment factor rate.

<sup>65</sup> *Ibid.*, p. 3.

<sup>66</sup> *Matsuo v. United States of America* 532 F. Supp. 2d 1238 (D. Haw. 2008).

<sup>67</sup> *Ibid.* As noted previously, locality pay is considered part of basic pay and included when calculating retirement and pension benefits, nonforeign COLAs are not.

<sup>68</sup> *Ibid.* See also *Locality Pay Disparity (Hawaii and Alaska)*, p. 1, at <http://www.wmlaborlaw.com/assets/cases/cola/>.

<sup>69</sup> A similar bill was introduced in the House (H.R. 6516) by Representative Neil Abercrombie of Hawaii and others on July 16, 2008. This analysis, however, will focus on S. 3103, which was passed in the Senate and was introduced and referred to multiple committees in the House.

## The Legislative Proposal

The Senate Committee on Homeland Security and Governmental Affairs's Subcommittee on Oversight and Government Management, the Federal Workforce, and the District of Columbia held a series of town hall, fact-finding meetings with constituents in Oahu and Maui, HI, throughout 2007.<sup>70</sup> At those meetings, the subcommittee reported that federal employees expressed concerns that their pay and benefits were not keeping pace with those of employees working within the contiguous United States.<sup>71</sup> "Alaska's federal employees have been telling me that they want to switch from a federal tax-free COLA to locality pay that counts toward their future retirement benefits. The high cost of living in Alaska makes this legislation essential to ensuring that federal retirement benefits are fair," said Senator Lisa Murkowski, a co-sponsor of the bill, in a joint press release with Senator Akaka.<sup>72</sup> According to news reports, some federal workers in nonforeign COLA areas have sought transfers "to the Mainland in the years immediately before retirement because it gets them better retirement pay."<sup>73</sup>

To respond to these constituent concerns, on May 13, 2008, Senator Akaka and others introduced legislation (S. 3013) that would transition federal employees who currently receive a nonforeign COLA<sup>74</sup> to locality pay.<sup>75</sup> The locality pay phase-in would occur over a three-year period starting January 2009. When introducing the legislation, Senator Akaka called it "the latest step forward toward determining the best way to ensure retirement equity for federal workers in the non-foreign areas."<sup>76</sup>

The bill seeks to phase in locality pay over three years. In each of those three years, one-third of the locality pay rate would be added to a federal employee's pay. Concurrently with the introduction of locality pay, the nonforeign area employee would have his or her COLA reduced. Pursuant to S. 3013, for every dollar an employee received in locality pay, 65 cents in nonforeign COLA pay would be removed from his or her pay. After the three year phase in, the nonforeign employee would receive full locality pay in addition to a COLA. The COLA would continue to be

<sup>70</sup> According to a committee report issued after the meetings, the "[s]ubcommittee staff met with close to 1,000 federal employees in over 20 agencies." See U.S. Congress, Senate Committee on Homeland Security and Governmental Affairs, *Non-foreign Area Retirement Equity Assurance Act of 2008*, report to accompany S. 3013, 110<sup>th</sup> Cong., 2<sup>nd</sup> sess., S.Rept. 110-456 (Washington: GPO, 2008), p. 5.

<sup>71</sup> *Ibid.*, p. 6. According to the committee report, nonforeign federal employees expressed a variety of concerns about the transition. Among the concerns were a possible reduction in take home (post-federal tax) pay if taxable locality pay replaced nontaxable COLAs. Another concern was the possibility of having to postpone retirement if the phase-in process took several years to complete. Still other employees were uncertain whether employees in unique, non-GS pay scales would be included in the possible transition.

<sup>72</sup> Senator Daniel K. Akaka, "Senators Introduce Legislation to Ensure Fair Retirement Benefits for Federal Workers in Hawaii, Alaska and U.S. Territories," press release, May 13, 2008, available at [http://akaka.senate.gov/public/index.cfm?FuseAction=PressReleases.Home&month=5&year=2008&release\\_id=2193](http://akaka.senate.gov/public/index.cfm?FuseAction=PressReleases.Home&month=5&year=2008&release_id=2193).

<sup>73</sup> "Congress studies locality pay proposal," *Pacific Business News* (Honolulu), May 31, 2007, available at <http://www.bizjournals.com/pacific/stories/2007/05/28/daily40.html>.

<sup>74</sup> While most employees affected by the legislation are granted nonforeign COLAs under 5 U.S.C. § 5941, defense intelligence employees covered by 10 U.S.C. § 1603(b) are also eligible to transition to locality pay pursuant to S. 3013 Sec. 6(B).

<sup>75</sup> When the bill was introduced by Senator Akaka, it contained language that would have permitted nonforeign area employees to choose whether to transition to locality pay. The option was removed from the bill when it was reported by the Senate Homeland Security and Governmental Affairs Committee.

<sup>76</sup> Daniel K. Akaka, "Statements and Speeches: Nonforeign Area Retirement Equity Assurance Act of 2008," available at [http://akaka.senate.gov/public/index.cfm?FuseAction=Speeches.Home&month=5&year=2008&release\\_id=2194](http://akaka.senate.gov/public/index.cfm?FuseAction=Speeches.Home&month=5&year=2008&release_id=2194).

paid until the employee's post-tax pay is equal to or higher than what the employee's take home pay would have been if the transition had never occurred.

S. 3013 was favorably reported by the Senate Homeland Security and Governmental Affairs committee on September 11, 2008.<sup>77</sup> The Senate passed the bill by unanimous consent on October 1, 2008. On October 2, the bill was referred to the House Committee on Oversight and Government Reform and the House Committee on Veterans Affairs.

### Calculating the Legislative Proposal Phase-in

S. 3013 would affect the pay of a federal employee living in a nonforeign area who is on a GS or similar pay scale. Each employee would be affected differently, according to a variety of variables that include the employee's location, grade, and step. This section uses a hypothetical GS-9, step 5 federal employee living in Anchorage, AK to demonstrate the possible effects of S. 3013.

A GS-9, step 5 in Anchorage, with 2008 basic pay of \$45,103 currently receives a 24% nonforeign COLA rate, which calculates to an \$10,825 annual nonforeign COLA ( $\$45,103 \times 0.24$ ). Total pay in 2008 for this employee, therefore, equals \$55,928 ( $\$45,103 + \$10,825$ ).

Pursuant to S. 3013, the changes in pay for that same employee living in Fairbanks, AK (a GS-9, step 5)—with basic pay in 2008 of \$45,103—would occur as shown in **Table 4**.

In Column A, the General Schedule rate of pay is the pay any federal employee on the GS schedule at the GS-9 level, would receive annually. That rate of pay is scheduled to increase 2.9% in January 2009 (pursuant to P.L. 110-329). OPM estimates that the GS rate of basic pay climbs, on average, 2.5% per year.<sup>78</sup> The GS basic pay rate for 2009, therefore is 2.9% higher than in 2008. Each additional basic pay increase is estimated at 2.5%.

Column B shows the percentage of the locality pay rate that would be added to the hypothetical employee's salary each year. In 2008, nonforeign employees do not receive locality pay, so the percentage is 0%. In 2009, 1/3, or 33.3% of the locality pay rate is added to the employee's pay. By 2011, 100% of the locality pay rate would be added to a federal employee's salary. Column C shows the estimated dollar amount of locality pay that would be added to the employee's salary each year.

Column D shows the employee's depleting nonforeign COLA pay. For every dollar in locality pay added to the employee's salary, 65 cents of the COLA is removed. At the end of the three year phase in, when 100% of the locality pay rate is being added to the employee's salary, COLAs will continue to be paid. According to the estimates, COLAs would continue to be paid to this hypothetical employee until 2018. Pursuant to the legislation, after completion of the three-year phase-in, the nonforeign employee would continue to receive both a nonforeign COLA and locality pay until post-federal tax take home pay eclipsed the post-tax take home pay if the

<sup>77</sup> U.S. Congress, Senate Committee on Homeland Security and Governmental Affairs, *Non-foreign Area Retirement Equity Assurance Act of 2008*, report to accompany S. 3013, 110<sup>th</sup> Cong. 2<sup>nd</sup> sess., S.Rept. 110-456 (Washington: GPO, 2008).

<sup>78</sup> All federal employees working in the contiguous United States receive locality pay. The lowest locality pay rate is the Rest of U.S. rate, which as of January 2008 was 13.18%. The lowest total pay in 2008 for a GS-9, step 5, living in the contiguous United States, therefore, is \$51,048.

transition had not occurred. As a result, in 2011, the employee would receive \$2,131 more in basic pay than a GS-9, step 5, in other locality pay areas with similar costs of labor (e.g., a Houston employee would be estimated to receive \$63,578 in 2015.<sup>79</sup>

Column E shows the employee's total pay, which includes the GS annual rate of pay, locality pay, and the nonforeign COLA. In contrast, Column F shows the pay that would be both taxable on the federal level and would count when the employee's retirement benefits were calculated—the GS annual rate of pay and locality pay. This column demonstrates the rapid increase in retirement creditable income a nonforeign employee would experience if S. 3013 would pass. As this column's value increases over time, federal taxes also grow. For the nonforeign employee, therefore, the transition to S 3013 would increase retirement benefits and concurrently increase federal taxes.

Column G estimates the hypothetical employee's federal taxes as they increase with the phase in and beyond. Although S. 3013 does not directly state that it assumes a 35% flat tax rate, it does stipulate a 65% COLA offset factor. Because only 65 cents of every COLA dollar is removed for every locality pay dollar added to the employee's pay, 35 cents of the COLA continues to be included in the employee's paycheck. This 35 cents is meant to offset the federal tax payments for the transitioning nonforeign area employee who historically has not paid federal taxes on his or her pay supplement. Locality pay can be taxed on the federal level, and, under S. 3013, locality pay will increase throughout the transition. An employee who goes through the transition, therefore, would be paying more in federal taxes than if the transition had not occurred. The remaining COLA pay is what S. 3013 assumes the employee will have to pay in federal taxes. The 65% COLA offset factor, therefore, assumes a 35% flat tax rate for all nonforeign area federal employees. Column H shows what the employee's take home pay would be after the 35% assumed tax rate is removed from his or her total pay. This column is the difference if Column G is subtracted from Column D.

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<sup>79</sup> According to OPM's assumption (a 1% increase in locality pay rate per year), Anchorage would have a 30.74% estimated locality pay rate in 2011, while Houston would have a 30.39% locality pay rate that same year.

**Table 4. Estimated Salary for a Hypothetical GS-9, Step 5, Working in Anchorage, AK, if S. 3013 Were Enacted**

Year	Column A General Schedule Annual Rate of Pay	Column B Percentage of Locality Pay Phased In	Column C Locality Pay	Column D Nonforeign COLA	Column E Total Pay	Column F Federally Taxable/ Retirement Creditable Pay	Column G Annual Federal Taxes (35% Flat Rate)	Column H After Federal Tax, Take Home Pay
2008	\$45,103	0%	\$0	\$10,825	\$55,928	\$45,103	\$15,786	\$40,141
2009	\$46,411	33.3%	\$2,191	\$9,715	\$58,317	\$48,602	\$17,011	\$41,306
2010	\$47,571	66.6%	\$9,264	\$5,396	\$62,231	\$56,835	\$19,892	\$42,338
2011	\$48,761	100%	\$14,989	\$1,960	\$65,709	\$63,750	\$22,312	\$43,397
2012	\$49,980	100%	\$15,864	\$1,684	\$67,527	\$65,843	\$23,045	\$44,482
2013	\$51,229	100%	\$16,772	\$1,393	\$69,934	\$68,001	\$23,801	\$45,594
2014	\$52,520	100%	\$17,717	\$1,086	\$71,313	\$70,227	\$24,579	\$46,734
2015	\$53,833	100%	\$18,698	\$764	\$73,284	\$72,520	\$25,382	\$47,902
2016	\$55,168	100%	\$19,717	\$424	\$75,309	\$74,885	\$26,210	\$49,100
2017	\$56,547	100%	\$20,775	\$67	\$77,390	\$77,323	\$27,063	\$50,327
2018	\$57,961	100%	\$21,874	\$0	\$79,528	\$79,835	\$27,942	\$51,585

**Source:** CRS calculations using S. 3013.

**Notes:** These calculations are estimates, and not the actual benefits an employee would receive if the S. 3013 were enacted. The estimates are rounded to the nearest dollar. The calculations do not account for maximum limitations on pay, promotions, or step increases. In 2009, pursuant to S. 3013, locality pay is calculated by using the Rest of US locality pay rate, which is currently estimated at 13.18%. In the second and subsequent years, the OPM estimated locality rate for the Anchorage, AK nonforeign COLA area of 27.74% is used to calculate pay. The calculations adopt OPM's assumption that locality pay will increase 1% per year, so the estimated locality pay rate for 2009, for example, is 14.18%.

**Table 5** estimates the salary of an employee who would transition to locality pay. Similar to **Table 4**, this table shows the same hypothetical employee’s GS rate of pay (Column A), locality pay (Column B), nonforeign COLA (Column C), and total pay (Column D). Column E shows the pay that is both taxable on the federal level and included when calculating retirement and other benefits. If a transition to locality pay were not enacted, the federally taxable pay would be equal to the GS rate of pay because COLAs are not federally taxable, which would be the only pay supplement received by the employee. The employee’s taxes, as shown in column F, therefore, would be lower than if the transition were enacted. After-tax, take-home pay (Column G), however, would be equal whether or not S. 3013 were enacted.

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**Table 5. Estimated Salary for a Hypothetical GS-9, Step 5, Working in Anchorage, AK, if S. 3013 Were Not Enacted**

Year	Column A General Schedule Annual Rate of Pay	Column B Locality Pay	Column C Nonforeign COLA	Column D Total Pay	Column E Federally Taxable/ Retirement Creditable Pay	Column F Annual Federal Taxes (35% Rate)	Column G After Federal Tax, Take Home Pay
2008	\$45,103	\$0	\$10,825	\$55,928	\$45,103	\$15,786	\$40,141
2009	\$46,411	\$0	\$11,139	\$58,316	\$46,411	\$16,244	\$41,306
2010	\$47,571	\$0	\$11,417	\$62,231	\$47,571	\$16,650	\$42,338
2011	\$48,761	\$0	\$11,703	\$65,709	\$48,761	\$17,066	\$43,397
2012	\$49,980	\$0	\$11,995	\$61,975	\$49,980	\$17,493	\$44,482
2013	\$51,229	\$0	\$12,295	\$63,524	\$51,229	\$17,930	\$45,594
2014	\$52,520	\$0	\$12,605	\$65,125	\$52,520	\$18,378	\$46,734
2015	\$53,833	\$0	\$12,929	\$66,753	\$53,833	\$18,838	\$47,902
2016	\$55,168	\$0	\$13,240	\$68,408	\$55,168	\$19,309	\$49,100
2017	\$56,547	\$0	\$13,547	\$70,118	\$56,547	\$19,792	\$50,327
2018	\$57,961	\$0	\$13,911	\$71,872	\$57,961	\$20,286	\$51,585

**Source:** CRS calculations using the current OPM nonforeign COLA rate for Anchorage, AK.

**Notes:** These calculations are estimates, and not the actual benefits an employee would receive if S. 3013 were enacted. The estimates are rounded to the nearest dollar. The calculations do not account for maximum limitations on pay, promotions, or step increases. The COLA rate remains 24% throughout the calculations.

## The COLA Offset

The COLA offset rate of 65% under S. 3013 may overestimate the pay needed to ensure that nonforeign employees who transition to locality pay do not have their take-home (post-federal tax) pay affected. Senator Akaka stated that the COLA offset would “help protect employees’ take home pay as locality pay is extended to non-foreign areas.”<sup>80</sup> As stated earlier, the 85% COLA offset leaves 35% of the allowance to pay federal taxes. According to the Internal Revenue Service, an individual would have to have earned at least \$357,700 in 2008 to qualify for a 35% federal tax rate.<sup>81</sup> The General Schedule pay scale for 2008 does not go above \$149,000 (the pay for a GS-15, step 10, in Houston, TX—the locality pay area with the highest rate). The 35% federal tax rate estimate may be higher than the actual federal tax rate in the nonforeign areas. If the estimated federal tax rate is higher than the actual federal tax rate, the nonforeign area employees may receive COLAs that are in excess of what would be needed to ensure their take home pay is not affected.

## Pay Comparisons

In 2009, an employee who transitioned to locality pay would receive \$2,191 more in federally taxable/retirement creditable pay than an employee who did not. Moreover, an employee who transitioned would receive \$767 more in take home (post-federal tax) pay than an employee who did not transition. The \$767 is 35% of \$2,191—the estimated difference in federal taxes for an employee depending on whether S. 3013 were enacted (\$17,011 - \$16,244 = \$767). By 2010, the employee who elected to transition to locality pay is estimated to receive \$9,264 more in federally taxable/retirement creditable pay and \$3,243 more in total pay than and employee who did not opt to transition.

Under S. 3013, an Anchorage employee would continue to receive a COLA in addition to locality pay at the end of the three-year transition. The COLA would continue to be paid until after-tax locality pay was worth more than the COLA. According to CRS calculations, COLAs in Anchorage could be paid through 2017 under this proposal.

S. 3013 concurrently attempts to ensure that a nonforeign area employee’s take home pay is unaffected by a transition, and that the employee’s retirement and other benefits are calculated identically to those of federal employees who work within the contiguous United States. By maintaining the COLA even after the transition is completed, however, employees in the contiguous United States may receive less in take home pay than a similar employee living in a nonforeign area. This discrepancy in take home pay between nonforeign and contiguous federal employees could lead to future claims of unfair pay differences among federal employees with similar work profiles.

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<sup>80</sup> Daniel K. Akaka, “Statements and Speeches: Section-by-Section Analysis of The Non-Foreign Area Retirement Equality Assurance Act of 2008,” press release, May 14, 2008, available at [http://www.senate.gov/~akaka/public/index.cfm?FuseAction=Speeches.Home&month=5&year=2008&release\\_id=2195](http://www.senate.gov/~akaka/public/index.cfm?FuseAction=Speeches.Home&month=5&year=2008&release_id=2195).

<sup>81</sup> Internal Revenue Service, “Part III: Administrative, Procedural, and Miscellaneous,” Revenue Procedure, available at <http://www.irs.gov/pub/irs-drop/rp-07-66.pdf>.

## Retirement Effects

If a transition to locality pay occurred, nonforeign area employees' retirement annuities would be affected. As noted previously, nonforeign COLAs are not considered part of basic pay when calculating retirement benefits, life insurance, and premium pay. Locality pay is considered basic pay for the purpose of calculating such benefits. The transition from nonforeign COLAs to locality pay, therefore, could increase future retirement benefits for nonforeign employees.

A federal employee's retirement pay is calculated by first determining the employee's "highest average annual pay produced by the employee's basic pay rates during any three consecutive years of service."<sup>82</sup> For most federal employees, the previous three years of service will produce his or her "high-3" average. Within-grade pay increases, quality-step increases, and locality pay are included when calculating an employee's "high-3."<sup>83</sup> A nonforeign COLA is not included when calculating a "high-3." An employee who lives in a nonforeign area, therefore, may seek to transition to locality pay at least three years prior to retirement to ensure he or she generates a "high-3" average that includes a pay supplement in addition to the GS basic rate of pay.<sup>84</sup>

Each employee's retirement benefits are dependent on a number of factors, which include his or her age, years of federal service, and retirement system (Civil Service Retirement System (CSRS) or Federal Employees Retirement System (FERS)). **Table 6** shows a pension benefit comparison between hypothetical GS-9, step 5, employees working in Puerto Rico. The employees are both at least 55 years old, retired in 2013, were employed by the federal government for 30 years, and are covered by CSRS. One employee demonstrates the retirement annuity if S. 3013 were not enacted. The other employee demonstrates the retirement annuity if it were enacted.

**Table 6. Estimated CSRS Retirement Annuity Comparison Between Hypothetical GS-9, Step 5, Employees in Puerto Rico Who Retired in 2013**

	If S. 3013 Were Not Enacted	If S. 3013 Were Enacted
"High 3"	\$49,990	\$58,593
Retirement Annuity	\$28,119	\$32,959
Retirement Benefit Over 20 Years	\$562,380	\$659,180

**Source:** CRS calculations pursuant to CSRS (P.L. 66-215; 5 U.S.C. § 8348). For details on calculating CSRS retirement benefits see CRS Report 98-810, *Federal Employees' Retirement System: Benefits and Financing*, by Patrick Purcell. CSRS employees must have been hired prior to January 1, 1984.

<sup>82</sup> See CRS Report 98-810, *Federal Employees' Retirement System: Benefits and Financing*, by Patrick Purcell, pp. 7-8. These three consecutive years are often referred to as an employee's "high-3."

<sup>83</sup> Employees on the GS scale performing at a satisfactory or better level receive within-grade step increases and may receive a quality-step increase. Federal employees receive within-grade increases (WGIs) if they serve a specified amount of time and have acceptable job performance ratings. These increases are provided for by Chapter 53 of Title 5 of the U.S. Code. Regulations for within-grade increase distribution are at 5 C.F.R. § 531, Subpart D. Federal Employees receive quality-step increases (QSIs) if they receive the highest rating available and meet other agency criteria. A QSI allows the employee to progress through GS scale pay steps more rapidly than under regular circumstances. QSIs are provided for under 5 C.F.R. § 531, Subpart E.

<sup>84</sup> Federal Employees hired after 1983 are automatically enrolled in the Federal Employees Retirement System (FERS), which calculates retirement benefits differently than the Civil Service Retirement System (CSRS). CSRS serves most employees hired prior to 1983.

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If S. 3013 were enacted, a GS-9, step 5, in Puerto Rico could receive an estimated \$4,840 more per year in retirement annuity than if S. 3013 were not enacted. Over a 20 year retirement period, the GS-9, step 5, would receive \$96,800 more in nominal retirement benefits under S. 3013 than if it was not enacted.

For two similar employees in Puerto Rico who are 60 years old,<sup>85</sup> employed by the federal government for 30 years, and covered by FERS, pension benefits are estimated in **Table 7**

**Table 7. Estimated FERS Retirement Annuity Comparison Between Two Hypothetical GS-9, Step 5, Employees in Puerto Rico Who Retired in 2014**

	If S. 3013 Was Not Enacted	If S. 3013 Were Enacted
“High 3”*	\$51,240	\$60,563
Retirement Annuity	\$15,372	\$18,169
Retirement Benefit Over 20 Years	\$307,440	\$363,380

**Source:** CRS calculations pursuant to FERS (P.L. 99-335; 5 U.S.C. (Part III, Subsection G, Chapter 84)). For details on calculating FERS retirement benefits see CRS Report 98-810, *Federal Employees’ Retirement System: Benefits and Financing*, by Patrick Purcell. All full-time white-collar federal employees hired on or after January 1, 1984 are FERS employees.

Under FERS, the GS-9, step 5, would be estimated to receive \$2,797 more in annual pension benefits if S. 3013 was enacted than if it was not. Over 20 years, the federal employee would receive an estimated \$55,940 more in pension benefits if S. 3013 were enacted.

### Retirement Projections

The number of employees nearing retirement age in nonforeign areas is rising. In general, the average age of civilian employees across federal government has risen to 46.9 in 2005, up from 44.2 in 1995.<sup>86</sup> Retirement rates are expected to climb by 0.3% per year in average across all areas of federal government through 2010, according to the OPM’s retirement statistics.<sup>87</sup> Recent retirement trends, however, have been less than expected. In nonforeign areas specifically, 3,916 employees are older than 60 years of age, and 1,096 of those employees are older than 65.<sup>88</sup> **Table 8** shows cumulative retirement projections in the nonforeign areas from 2008 through 2016.

**Table 8. Cumulative Retirement Projections for Nonforeign Areas, 2008 Through 2016**

	2008	2010	2012	2014	2016
Alaska	386	1,171	1,956	2,714	3,439

<sup>85</sup> Benefits for employees who retire at age 62 or older will be slightly larger than those who retire prior to age 62 because of statutes governing the FERS retirement system. For more information see CRS Report 98-810, *Federal Employees’ Retirement System: Benefits and Financing*, by Patrick Purcell.

<sup>86</sup> U.S. Congressional Budget Office, “Characteristics of Pay and Civilian Employees,” March 2007, p. 23, available at [http://www.cbo.gov/ftpdocs/78xx/doc7874/03-15-Federal\\_Personnel.pdf](http://www.cbo.gov/ftpdocs/78xx/doc7874/03-15-Federal_Personnel.pdf). According to the same study, the average age of private sector employees is 40 (p. 5).

<sup>87</sup> The Office of Personnel Management, “Retirement Statistics,” <http://www.opm.gov/feddata/retire/rs2004.pdf>.

<sup>88</sup> Information provided electronically to the author by OPM on Aug. 5, 2008.

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	2008	2010	2012	2014	2016
Guam	62	181	293	405	516
Hawaii	857	2,523	4,136	5,618	6,969
Northern Mariana Islands	1	5	8	11	14
Puerto Rico	241	741	1,249	1,750	2,238
U.S. Virgin Islands	15	47	78	108	137
<b>TOTAL</b>	<b>1,562</b>	<b>4,669</b>	<b>7,719</b>	<b>10,607</b>	<b>13,312</b>

**Source:** OPM.

**Notes:** Projections are based on employee counts as of October 1, 2007 (40,973). As of March 2008, 54,815 federal employees worked in nonforeign areas. The projections do not include U.S. Postal Service employees. The retirement projections are cumulative, and, therefore, the number of projected retirees in 2008 is included within the total projections for 2010. Projections for 2016 include retirement projections for all previous years shown.

S. 3013 states that employees planning to retire during the transition could “pay into the Civil Service Retirement and Disability Retirement Fund” and increase his or her benefits before the transition were complete. By paying into the fund, the employee may be able to retire during the transition and still have accrued the same retirement benefits as a similar employee who had been receiving locality pay throughout their federal career.<sup>89</sup>

According to S. 3013, employees who retire between January 1, 2009 and December 31, 2011, would be permitted to include some of their COLA pay when calculating retirement benefits. The Senate Homeland Security and Governmental Affairs Committee reported that “[t]he limit on the amount of the COLA an employee may count as locality pay is the amount of locality pay that would be in effect for that area if not for the phase in provisions” in the bill.<sup>90</sup> A federal employee in Anchorage who retired in March 2011, therefore, may be allowed to count his or her entire COLA as locality pay because the COLA rate is lower than the estimated locality pay rate. The employee’s COLA would be subject to federal taxes, but could also be included when calculating the employee’s retirement benefits.

### Estimated Cost of S. 3013

The Congressional Budget Office (CBO) estimated that S. 3103 would increase federal discretionary spending by \$2.2 billion from 2009 through 2018.<sup>91</sup> The cost increases would be a combination of increased salaries (\$1.5 billion over 10 years), federal government contributions toward creditable retirement (\$741 million over 10 years), and payment of benefits to retiring

<sup>89</sup> S. 3013, Sec. 7, see also Daniel K. Akaka, “Statements and Speeches: Section-by-Section Analysis of The Non-Foreign Area Retirement Equity Assurance Act of 2008,” available at

[http://akaka.senate.gov/public/index.cfm?FuseAction=Speeches.Home&month=5&year=2008&release\\_id=2195](http://akaka.senate.gov/public/index.cfm?FuseAction=Speeches.Home&month=5&year=2008&release_id=2195).

<sup>90</sup> U.S. Congress, Senate Committee on Homeland Security and Governmental Affairs, *Non-foreign Area Retirement Equity Assurance Act of 2008*, report to accompany S. 3103, 110<sup>th</sup> Cong., 2<sup>nd</sup> sess., S.Rept. 110-456 (Washington: GPO, 2008), p. 7.

<sup>91</sup> U.S. Congressional Budget Office, *Congressional Budget Office Cost Estimate*, S. 3013, Non-Foreign AREA Act of 2008, July 29, 2008, p.1. The CBO’s federal employee estimates use Central Personnel Data File counts from December 2007. The counts do not include USPS employees.

employees (\$302 million over 10 years).<sup>92</sup> CBO estimated that 13,000 nonforeign employees would retire between 2009 and 2018, leading to \$295 million in “additional retirement benefits and \$7 million for higher Social Security benefits.”

## Unique Pay Scales

Some white-collar federal employees are not paid under the General Schedule. Employees in non-GS pay systems who receive a nonforeign COLA would be included in the transition to locality pay—including employees at the Transportation and Security Administration (TSA), the Department of Defense (DOD), and the Federal Aviation Administration (FAA) who are in performance-based pay systems. Employees in some performance-based pay scales are required to receive satisfactory performance ratings to be eligible to receive locality pay. S. 3013, however, includes language prohibiting a reduction in locality pay that is prompted by a poor performance rating.<sup>93</sup>

In addition, some federal employees receive a “special rate,” which is additional pay used to attract qualified employees to areas facing recruitment difficulties.<sup>94</sup> According to OPM, employees in nonforeign area who receive a special rate would be able to keep that pay differential under S. 3013 unless the locality pay rate was larger than their special rate. Employees automatically receive the pay differential that gives them the highest pay rate.<sup>95</sup>

## U.S. Postal Service

More than 14,000 of the 54,815 total nonforeign COLA recipients are employees of the United States Postal Service (USPS).<sup>96</sup> USPS employees living in the continental United States are not eligible to receive locality pay. Under S. 3013, USPS employees would not be permitted to transition to locality pay.<sup>97</sup> Instead, USPS employees would continue to receive a COLA. The COLA, however, would be tied to the locality pay rate.

If the locality pay rate climbs higher than the COLA rate, USPS employees would then receive the locality pay rate—although the pay supplement would still be considered a COLA for tax and other purposes. The USPS nonforeign area COLA would not be federal taxable on the federal level, and would not count when calculating retirement and other benefits—even if the rate was linked to the locality pay rate. Unlike current statutes that govern COLAs, however, S. 3013 would allow the USPS nonforeign COLA rate to climb above 25% if Bureau of Labor Statistics data warranted the increase.

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<sup>92</sup> \$295 million in “additional retirement benefits and \$7 million for higher Social Security benefits.” *Ibid.*, p. 3.

<sup>93</sup> S. 3013, Sec. 6(2)(C).

<sup>94</sup> U.S. Office of Personnel Management, “Special Salary Rates,” at <http://apps.opm.gov/ssr/tables/index.cfm>.

<sup>95</sup> See Sen. Daniel K. Akaka, “Non-Foreign COLA Update: Frequently Asked Questions,” question number three, available at [[http://akaka.senate.gov/public/index.cfm?FuseAction=Issues.Home&issue=Non-Foreign%20COLA%20Update&content\\_id=33#Non-Foreign%20COLA%20Update](http://akaka.senate.gov/public/index.cfm?FuseAction=Issues.Home&issue=Non-Foreign%20COLA%20Update&content_id=33#Non-Foreign%20COLA%20Update)].

<sup>96</sup> USPS employees sometimes refer to their nonforeign COLAs as territorial COLAs or T-COLAs.

<sup>97</sup> When S. 3013 was introduced by Senator Akaka, it included language that would have permitted USPS employees to decide individually whether to transition to locality pay. That language was amended when the bill was reported by the Senate Committee on Homeland Security and Governmental Affairs.

## OPM's Recommendation

In May 2007, OPM proposed that employees in nonforeign areas transition from nonforeign COLAs to locality pay.<sup>98</sup> The phase-in would occur over a seven-year period, and COLAs would continue to be paid when the transition was complete.

OPM director Linda M. Springer stated that the proposal aimed to stem the “growing perception that total pay and retirement benefits of the white-collar civilian Federal employees in nonforeign areas ... have eroded gradually in relation to the pay and retirement benefits of similarly situated employees in the 48 States and D.C.”<sup>99</sup> Springer also said that the perception of a disparity in pay between the nonforeign COLA areas and the contiguous United States has made staffing for nonforeign federal agencies more difficult—especially retention of federal employees who are nearing retirement.

## Calculating the OPM Proposal Phase-in

Under the OPM proposal, pay changes for a hypothetical GS-9, step 5, living in Honolulu, HI—with a 2008 basic pay of \$45,103 and a COLA rate of 25%—may trend as shown in **Table 9**.<sup>100</sup>

Similar to **Table 4**, **Table 9** has nine columns of information. In column A, the GS rate of pay is the pay any federal employee on the GS schedule at the GS-9 level, would receive annually. That rate of pay is scheduled to increase 2.9% in January 2009 (pursuant to P.L. 110-329). OPM estimates that the GS rate of basic pay climbs, on average, 2.5% per year.<sup>101</sup> The GS basic pay rate for 2009, therefore, is 2.9% higher than in 2008. Each additional basic pay increase is estimated at 2.5%.

Column B shows the percentage of the locality pay rate that would be added to the hypothetical employee's salary each year. In 2008, nonforeign employees did not receive locality pay, so the percentage is 0%. In 2009, 1/7, or 14.29% of the locality pay rate is added to the employee's pay. By 2015, 100% of the locality pay rate would be added to a federal employee's salary. Column C shows the estimated dollar amount of locality pay that would be added to the employee's salary each year.

Column D shows the employee's depleting nonforeign COLA pay. For every dollar in locality pay added to the employee's salary, 85 cents of the COLA is removed. At the end of the three year phase in, when 100% of the locality pay rate is being added to the employee's salary, COLAs will continue to be paid. According to the estimates, COLAs would continue to be paid to this hypothetical employee until 2018—the first year that the employee's after-tax pay under the transition would be greater than the after-tax pay if the transition had not occurred. As a result of

<sup>98</sup> Letter from Linda M. Springer, Director of the Office of Personnel Management, to Richard B. Cheney, President of the U.S. Senate, May 30, 2007, available at [http://www.opm.gov/news\\_events/congress/proposals/Locality\\_Pay\\_Extension\\_Act.pdf](http://www.opm.gov/news_events/congress/proposals/Locality_Pay_Extension_Act.pdf).

<sup>99</sup> Ibid.

<sup>100</sup> The table includes a number of assumptions that demonstrate what may occur in a transition, but are not to be used as definitive estimates.

<sup>101</sup> All federal employees working in the contiguous United States receive locality pay. The lowest locality pay rate is the Rest of U.S. rate, which as of January 2008 was 13.18%. The lowest total pay in 2008 for a GS-9, step 5 living in the contiguous United States, therefore, is \$51,048.

the continued COLA, the employee would receive roughly \$655 more in basic pay in 2015 than a GS-9, step 5, in other locality pay areas with nearly identical labor costs (e.g., a Washington, DC employee who would be estimated to receive \$68,834 in 2015.<sup>102</sup>

Column E shows the employee's total pay, which includes the GS annual rate of pay, locality pay, and the nonforeign COLA. In contrast, Column F shows the pay that would be both taxable on the federal level and would count when the employee's retirement benefits were calculated. This column includes the GS annual rate of pay and the locality pay. As this column's value increased over time, the employee's federal taxes would also increase. For a nonforeign employee, therefore, OPM's proposal would concurrently increase federal taxes and retirement benefits.

Column G estimates the hypothetical employee's federal taxes as they increase with the phase in and beyond. While the OPM proposal does not directly state that it assumes a 15% flat tax rate, it does stipulate an 85% COLA offset factor. Because only 85 cents of every COLA dollar is removed for every locality pay dollar added to the employee's pay, 15 cents of the COLA continues to be included in the employee's paycheck. This 15 cents is meant to offset the federal tax payments for the transitioning nonforeign area employee who historically has not paid federal taxes on his or her pay supplement. Locality pay can be taxed on the federal level, and, under OPM's proposal, locality pay will increase throughout the transition. An employee who goes through the transition, therefore, would be paying more in federal taxes than if the transition had not occurred. The remaining COLA pay is what the OPM proposal assumes the employee will have to pay in federal taxes each year. The 85% COLA offset factor, therefore, assumes a 15% flat tax rate for all nonforeign area federal employees. Column H shows what the employee's take home pay would be after the 15% assumed tax rate is removed from his or her total pay. This column is the difference if Column G is subtracted from Column D.

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<sup>102</sup> In 2015, using OPM's assumption (1% increase in locality pay rate per year) Honolulu is estimated to have a locality pay rate of 27.38% while Washington, DC is estimated to have a locality pay rate of 27.39%.



**Table 9. Estimated Salary for a GS-9, Step 9, Working in Honolulu, HI, if Locality Pay Transition Were Implemented**

Year	Column A Percentage of Locality Pay Phased In	Column B General Schedule Annual Rate of Pay	Column C Locality Pay	Column D Nonforeign COLA	Column E Total Pay	Column F Federally Taxable/ Retirement Creditable Pay	Column G Annual Federal Taxes (15% Rate)	Column H After Federal Tax Take Home Pay
2008	0%	\$45,103	\$0	\$11,275	\$56,378	\$45,103	\$6,765	\$49,613
2009	14.28%	\$46,411	\$940	\$10,803	\$58,155	\$47,351	\$7,103	\$51,052
2010	28.57%	\$47,571	\$3,042	\$9,307	\$59,920	\$50,613	\$7,592	\$52,328
2011	42.86%	\$48,761	\$4,886	\$8,037	\$61,684	\$53,647	\$8,047	\$53,637
2012	57.14%	\$49,980	\$6,963	\$6,577	\$63,519	\$56,942	\$8,541	\$54,978
2013	71.43%	\$51,229	\$9,287	\$4,913	\$65,429	\$60,516	\$9,077	\$56,352
2014	85.71%	\$52,520	\$11,873	\$3,036	\$67,418	\$64,382	\$9,657	\$57,761
2015	100%	\$53,833	\$14,736	\$930	\$69,489	\$68,559	\$10,284	\$59,205
2016	100%	\$55,168	\$15,657	\$483	\$71,309	\$70,825	\$10,624	\$60,685
2017	100%	\$56,547	\$16,614	\$15	\$73,176	\$73,161	\$10,974	\$62,202
2018	100%	\$57,961	\$17,609	\$0	\$75,092	\$75,570	\$11,335	\$63,757

**Source:** CRS calculation using information provided by OPM on May 23, 2008.

**Notes:** These calculations are estimates, and not the actual benefits an employee would receive if the OPM proposal were enacted. The calculations do not account for maximum limitations on pay, promotions, or step increases. In the first year of the transition, pursuant to its proposal, OPM would use the Rest of US locality pay rate (13.18% in 2008) to calculate actual locality pay amounts. In the second and subsequent years of the phase-in, a Honolulu employee's locality pay rate would be calculated by BLS. OPM hosts a website that includes an online calculator to help federal employees determine potential effects a transition to locality pay would have on their salaries [https://www.opm.gov/news\\_events/congress/proposals/COLA-TransitionEstimator.asp](https://www.opm.gov/news_events/congress/proposals/COLA-TransitionEstimator.asp).

**Table 10** shows the pay rate of a hypothetical employee if a transition to locality pay were not enacted. Similar to **Table 9**, this table shows the same hypothetical employee's GS rate of pay (Column A), locality pay (Column B), nonforeign COLA (Column C), and total pay (Column D). Column E shows the pay that is both taxable on the federal level and counted toward retirement and other benefits. If a transition to locality pay were not enacted, the federally taxable pay would be equal to the GS rate of pay because COLAs are not federally taxable. If a transition were not enacted, a COLA would be the only pay supplement received by the employee. The employee's taxes, as shown in column F, therefore, would be lower than if the transition were enacted. After-tax, take-home pay (Column G), however, would be equal whether or not the OPM proposal were enacted.

**Table 10. Estimated Salary for a GS-9, Step 5, Working in Honolulu, HI,  
if Locality Pay Transition Were Not Implemented**

Year	Column A General Schedule Annual Rate of Pay	Column B Locality Pay	Column C Nonforeign COLA	Column D Total Pay	Column E Federally Taxable/Retirement Creditable Pay	Column F Annual Federal Taxes (15%)	Column G After Federal Tax Take Home Pay
2008	\$45,103	\$0	\$11,276	\$56,379	\$45,103	\$6,765	\$49,614
2009	\$46,411	\$0	\$11,603	\$58,014	\$46,411	\$6,962	\$51,052
2010	\$47,571	\$0	\$11,893	\$59,464	\$47,571	\$7,136	\$52,328
2011	\$48,761	\$0	\$12,190	\$60,951	\$48,761	\$7,314	\$53,637
2012	\$49,980	\$0	\$12,495	\$62,474	\$49,980	\$7,496	\$54,978
2013	\$51,229	\$0	\$12,807	\$63,036	\$51,229	\$7,684	\$56,352
2014	\$52,520	\$0	\$13,128	\$65,637	\$52,510	\$7,876	\$57,761
2015	\$53,833	\$0	\$13,456	\$67,278	\$53,823	\$8,073	\$59,205
2016	\$55,168	\$0	\$13,792	\$68,960	\$55,168	\$8,275	\$60,685
2017	\$56,547	\$0	\$14,137	\$70,684	\$56,547	\$8,482	\$62,202
2018	\$57,961	\$0	\$14,490	\$72,451	\$57,961	\$8,694	\$63,757

**Source:** CRS calculations using U.S. Office of Personnel Management data.

**Notes:** These calculations are estimates, and not the actual benefits an employee would receive if the OPM proposal were enacted. The calculations do not account for maximum limitations on pay, promotions, or step increases.

## The COLA Offset

If an employee had not been converted to locality pay, his or her basic salary plus his or her nonforeign COLA would have equaled \$58,014 in 2009. In the first year of the OPM transition, therefore, a Honolulu employee may receive \$141 more in total pay than if the transition did not occur—for a total pay of \$58,155. The \$141 in additional take home pay for the employee in the transition is equal to the estimated difference in take-home (post-federal-tax) pay if the transition had not occurred. The COLA offset is included to ensure an employee's take home pay is not affected by the transition. As noted earlier the 85% COLA offset assumes a 15% flat federal tax rate for employees. According to the Internal Revenue Service, an employee earning between \$11,450 and \$43,650 would qualify for a 15% federal tax rate.<sup>103</sup> This estimated federal tax rate, therefore, may not accurately estimate the federal taxes for many nonforeign area federal employees. Nonforeign area federal employees who earn more than \$43,650 would not receive a COLA that would be large enough to ensure their take home pay would not be reduced.

## Pay Comparisons

The continued COLA pay may also create pay differences between the nonforeign area and an area in the contiguous United States with similar labor costs. The estimated locality pay rate for Honolulu is nearly identical to the locality pay rate for Washington, DC (22.38% for Honolulu and 22.29% for Washington, DC in 2008). The 2011 estimated total pay for a GS-9, step 5, working in Honolulu, however, is \$1,362 more than the estimated total pay for a similar employee if he or she were working in Washington, DC.<sup>104</sup> In 2012, the pay difference between the two employees is \$1,071. Federal employees working in the contiguous United States may have concerns about the pay differences prompted by the COLA offset.

## Retirement Rates

OPM stated that its locality pay proposal stretches the transition to locality pay over seven years to ease effects on the employee retirement fund.<sup>105</sup> At a May 29, 2008 congressional hearing Charles D. Grimes III, the deputy associate director for performance and pay systems, stated that the extended phase-in period was intended to mitigate the economic affects of retirees on OPM's budget.

We believe it is not advisable to exacerbate staffing problems by creating an incentive to retire, as might be the case if there were a shorter phase-in period. The phase-in period also reduces the financial impact on agency budgets caused by higher employer retirement contributions.<sup>106</sup>

<sup>103</sup> Internal Revenue Service, "Part III: Administrative, Procedural, and Miscellaneous," Revenue Procedure, available at [<http://www.irs.gov/pub/irs-drop/rp-07-66.pdf>].

<sup>104</sup> The employee working in Honolulu is estimated to receive \$64,941. If the employee lived in Washington, DC, he or she is estimated to receive \$63,579.

<sup>105</sup> U.S. Congress, Senate Committee on Homeland Security and Governmental Affairs, Subcommittee on Oversight of Government Management, the Federal Workforce and the District of Columbia, *Nonforeign COLA: Finding an Equitable Solution*, hearing on S. 3013, 110<sup>th</sup> Cong, 2<sup>nd</sup> sess., testimony of Charles D. Grimes III, May 29, 2008, available at [http://www.opm.gov/news\\_events/congress/testimony/110<sup>th</sup>Congress/05\\_29\\_2008.asp](http://www.opm.gov/news_events/congress/testimony/110<sup>th</sup>Congress/05_29_2008.asp).

<sup>106</sup> *Ibid.*

## Estimated Cost of the OPM Proposal

OPM estimates first-year costs for the transition proposal at \$15.7 million and second year costs at \$31.4 million.<sup>107</sup> The President's FY2008 executive budget included funding "for a legislative proposal to transition from non-foreign COLAs to locality pay for employees working in non-foreign areas," but does not provide any details about the proposal.<sup>108</sup> The President's FY2008 budget estimates that the COLA transition will cost \$50 million from FY2008 through FY2017.<sup>109</sup> Therefore, less than \$3 million would be available in the remaining five years of the transition. According to OPM, the seven-year phase-in period would allow transition costs to be more easily absorbed by agency budgets.<sup>110</sup> CBO's budget estimate for S. 3013, which involves a three-year transition period, estimates a cost of \$2.2 billion. In comparison, OPM's cost estimates may be low.

## The U.S. Postal Service

OPM's proposal does not mention USPS employees. According to both OPM and the American Postal Workers Union, however, USPS employees would not be included in OPM's nonforeign COLA phase out.<sup>111</sup> USPS employees, instead, would continue to receive nonforeign COLAs with the rate frozen at its December 31, 2008 level.

## The Federal Managers Association Proposal

At a May 29, 2008, congressional hearing, Michael FitzGerald, representing the Federal Managers Association (FMA), introduced a third transition proposal, which would fully implement the switch to locality pay the first year it is authorized.<sup>112</sup> The FMA proposal would convert nonforeign area employees to locality pay in one year, and would eliminate nonforeign COLAs in the second year. **Table 11** estimates employee pay for a hypothetical GS-9, step 5, living in Puerto Rico if the FMA proposal were enacted.

## Calculating the Federal Managers Association Proposal

Similar to both the OPM proposal and S. 3013, the FMA proposal would remove only a portion (75%) of every dollar of a nonforeign COLA for every full dollar added to an employee's salary in locality pay. In the first year of implementation, an employee's locality pay would be

<sup>107</sup> Information provided electronically to the author by OPM on Feb. 1, 2008.

<sup>108</sup> U.S. Executive Office of the President, Office of Management and Budget, *Budget of the United States Government Fiscal Year 2008*; Appendix (Washington: GPO, 2007), p. 1007.

<sup>109</sup> *Ibid.*, Table S-6 Effect of Proposals on Receipts, available at <http://www.whitehouse.gov/omb/budget/fy2008/summarytables.html>.

<sup>110</sup> See Daniel K. Akaka, "Non-Foreign COLA Update: Frequently Asked Questions," question number three, available at [http://akaka.senate.gov/public/index.cfm?FuseAction=Issues.Home&issue=Non-Foreign%20COLA%20Update&content\\_id=33#Non-Foreign%20COLA%20Update](http://akaka.senate.gov/public/index.cfm?FuseAction=Issues.Home&issue=Non-Foreign%20COLA%20Update&content_id=33#Non-Foreign%20COLA%20Update).

<sup>111</sup> Information provided to the author by telephone from the American Postal Workers Union and OPM on Feb. 8, 2008.

<sup>112</sup> U.S. Congress, Senate Committee on Homeland Security and Governmental Affairs, Subcommittee on Oversight of Government Management, the Federal Workforce and the District of Columbia, *Nonforeign COLA: Finding an Equitable Solution*, hearing on S. 3013, 110<sup>th</sup> Cong, 2<sup>nd</sup> sess., testimony of Michael FitzGerald, May 29, 2008, available at [http://hsgac.senate.gov/public/\\_files/FitzGeraldTestimony052908.pdf](http://hsgac.senate.gov/public/_files/FitzGeraldTestimony052908.pdf).

calculated using the Rest of US (RUS) percentage (currently 13.18%). In the second and final year of implementation, OPM would use BLS locality pay rates to determine an employee's locality pay. If BLS determined the locality pay rate in Puerto Rico were below the RUS rate, federal employees in Puerto Rico would automatically receive the RUS rate. Under the FMA proposal, nonforeign COLA pay would be completely eliminated in the second year of implementation. FMA favors the rapid transition to allow employees "to retire on their own terms, in their own homes and in their own communities."<sup>113</sup>

As in the previous tables, Column A shows the annual GS rate of pay for any federal employee on the GS schedule at the GS-9 level. That rate of pay is scheduled to increase 2.9% in January 2009 (pursuant to P.L. 110-329). OPM estimates that the GS rate of basic pay climbs, on average, 2.5% per year. The GS basic pay rate for 2009, therefore is 2.9% higher than in 2008. Each additional basic pay increase is estimated at 2.5%.

Column B shows the total locality pay that could be added to a hypothetical employee's salary each year under the FMA proposal. Unlike S. 3013 and OPM's proposal, the FMA proposal does not phase in locality pay. Instead, locality pay would be instated in full in 2009.

Column D shows the employee's depleting nonforeign COLA pay. For every dollar in locality pay added to the employee's salary, 75 cents of the COLA is removed. In 2009, when 100% of the locality pay rate would be added to the employee's salary, COLAs would continue to be paid. According to the FMA proposal, however, COLAs could be eliminated in 2010.

Column E shows the employee's total pay, which includes the GS annual rate of pay, locality pay, and the nonforeign COLA. In contrast, Column F shows the pay that would be both taxable on the federal level and would count when the employee's retirement benefits were calculated. This column includes only the GS annual rate of pay and locality pay. As this column's value increased over time, the employee's federal taxes would also increase. Like the previous proposals, FMA's proposal could concurrently increase federal taxes and retirement benefits.

Column G estimates the hypothetical employee's federal taxes as they increase with the phase in and beyond. While the OPM proposal does not directly state that it assumes a 25% flat tax rate, it does stipulate an 75% COLA offset factor. Because only 75 cents of every COLA dollar is removed for every locality pay dollar added to the employee's pay, 25 cents of the COLA continues to be included in the employee's paycheck. This 25 cents is meant to offset the federal tax payments for the transitioning nonforeign area employee who historically has not paid federal taxes on his or her pay supplement. Locality pay can be taxed on the federal level, and, under OPM's proposal, locality pay will increase throughout the transition. An employee who goes through the transition, therefore, would pay more in federal taxes than if the transition had not occurred. The remaining COLA pay is what the OPM proposal assumes the employee will have to pay in federal taxes each year. The 75% COLA offset factor, therefore, assumes a 25% flat tax rate for all nonforeign area federal employees. Column H shows what the employee's take home pay would be after the 25% assumed tax rate is removed from his or her total pay. This column is the difference if Column G is subtracted from Column D.

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<sup>113</sup> U.S. Congress, Senate Committee on Homeland Security and Governmental Oversight, Subcommittee on Oversight of Government Management, the Federal Workforce and the District of Columbia, *Nonforeign COLA: Finding an Equitable Solution*, hearing on S. 3013, 110<sup>th</sup> Cong., 2<sup>nd</sup> sess., testimony of Michael FitzGerald, May 29, 2008, available at [http://hsgac.senate.gov/public/\\_files/FitzGeraldTestimony052908.pdf](http://hsgac.senate.gov/public/_files/FitzGeraldTestimony052908.pdf).

**Table 11. Estimated Salary for a Hypothetical GS-9, Step 5, Working in Puerto Rico if the Federal Managers Association Plan Were Enacted**

Year	Column A General Schedule Annual Rate of Pay	Column B Locality Pay	Column C Nonforeign COLA	Column D Total Pay	Column E Federally Taxable/ Retirement Creditable Pay	Column F Annual Federal Tax (25% Flat Tax Rate)	Column G After Tax Take Home Pay
2008	\$45,103	\$0	\$5,863	\$50,966	\$45,103	\$11,275	\$39,691
2009	\$46,411	\$6,117	\$1,446	\$53,974	\$52,527	\$13,132	\$40,842
2010	\$47,571	\$6,746	\$0	\$54,317	\$54,317	\$13,579	\$40,738

**Source:** CRS estimates using information from congressional testimony. U.S. Congress, Senate Committee on Homeland Security and Governmental Oversight, Subcommittee on Oversight of Government Management, the Federal Workforce and the District of Columbia, *Nonforeign COLA: Finding an Equitable Solution*, hearing on S. 3013, 110<sup>th</sup> Cong., 2<sup>nd</sup> sess., testimony of Michael FitzGerald, May 29, 2008, available at [http://hsgac.senate.gov/public/\\_files/FitzGeraldTestimony052908.pdf](http://hsgac.senate.gov/public/_files/FitzGeraldTestimony052908.pdf).

**Notes:** These calculations are estimates, and not the actual benefits an employee would receive if the OPM proposal were enacted. The calculations do not account for maximum limitations on pay, promotions, or step increases. Estimates are rounded to the nearest dollar. The COLA rate is estimated at 13% for all three years. Also for all three years, locality pay is calculated by using the Rest of US locality pay rate, which is currently estimated at 13.18%.

**Table 12** shows the pay rate of a hypothetical employee the FMA proposal were not enacted. Similar to **Table 11** this table shows the same hypothetical employee’s GS rate of pay (Column A), locality pay (Column B), nonforeign COLA (Column C), and total pay (Column D). Column E shows the pay that is both taxable on the federal level and counted toward retirement and other benefits. If a transition to locality pay were not enacted, the federally taxable pay would be equal to the GS rate of pay because COLAs are not federally taxable. If a transition were not enacted, a COLA would be the only pay supplement received by the employee. The employee’s taxes, as shown in Column F, therefore, would be lower than if the transition were enacted.

http://wikileaks.org/wiki/CRS-R40079

**Table 12. Estimated Salary for a GS-9, Step 5, Working in Puerto Rico if the Federal Managers Association Proposal Were Not Enacted**

	Column A	Column B	Column C	Column D	Column E	Column F	Column G
Year	General Schedule Annual Rate of Pay	Locality Pay Amount	Nonforeign COLA	Total Pay	Federally Taxable/ Retirement Creditable	Annual Federal Tax (25%)	After Tax Take Home Pay
2008	\$45,103	\$0	\$5,863	\$50,966	\$45,103	\$11,276	\$39,691
2009	\$46,411	\$0	\$6,033	\$52,444	\$46,411	\$11,603	\$40,841
2010	\$47,571	\$0	\$6,184	\$53,756	\$47,571	\$11,893	\$41,863

**Source:** CRS estimates using OPM COLA rates.

**Notes:** These calculations are estimates, and not the actual benefits an employee would receive if the OPM proposal were enacted. Estimates are rounded to the nearest dollar. The calculations do not account for maximum limitations on pay, promotions, or step increases.

http://wikileaks.org/wiki/CRS-2010-079



## The COLA Offset

According to **Table 11**, an employee living in Puerto Rico would receive a \$1,446 COLA in 2009 in addition to \$6,117 in locality pay. When compared to any other employee working in an area in the contiguous United States that receives the RUS locality pay rate, a Puerto Rico employee would receive an additional \$1,446 in pay. According to the FMA, the additional pay is meant to offset the loss in take home pay for a transitioning employee who historically had not paid taxes on his or her pay supplement. An GS-9, step 5, working in the contiguous United States in a market with similar labor costs, however, would not receive the COLA and would pay the same federal taxes.

The employee would receive pay and retirement benefits comparable to a similar employee living in any of the areas designated as RUS. As noted earlier, the FMA proposal includes a 75% COLA offset rate, which assumes a 25% federal tax rate. According to the IRS, an employee who earns between \$32,550 and \$78,850 would have a federal tax rate of 25%.<sup>114</sup> This federal tax rate estimate would cover most federal employees, but would not cover the federal tax increase costs for a federal employee who is a GS-13, step 6, or higher.

## Pay Comparisons

As **Table 12** demonstrates, a GS-9, step 5 living in Puerto Rico would receive nearly \$1,125 less in after federal tax pay in 2010 than he or she would have if the switch to locality pay had not occurred (\$40,738 take home if the transition occurred, \$41,863 if it did not). Unlike the other transition proposals, the FMA proposal would not ensure that nonforeign area employees do not experience a reduction in post-tax, take-home pay. In 2009, however, the Puerto Rico employee would receive \$1,446 in COLA offset pay. No federal employee working in the contiguous United States in a locality pay area with the RUS rate would receive the additional COLA. The Puerto Rico employee, therefore, would receive \$1,446 more in total pay than counterparts in the contiguous United States. The additional COLA may prompt concern about pay differences for employees working the contiguous United States.

## Retirement Effects

As stated earlier in this report, a federal employee's retirement benefits are calculated using his or her highest salary (plus other eligible pay) for three consecutive years. An employee living in a nonforeign area may choose to wait until locality pay is fully implemented before he or she retires because it will increase his or her retirement benefits. A more rapid transition to locality pay under the FMA proposal may encourage employees to retire earlier. The earlier retirements may increase federal pension costs. In addition, the federal government may have difficulty finding new hires or moving current employees into positions formerly held by retirees.

S. 3013 and the OPM proposal phase in COLAs over a number of years. In contrast, FMA institutes full locality pay in one year and eliminates the COLA in the following year. FMA's one-

<sup>114</sup> Internal Revenue Service, "Part III: Administrative, Procedural, and Miscellaneous," Revenue Procedure, available at [<http://www.irs.gov/pub/irs-drop/rp-07-66.pdf>].

year replacement proposal may encourage employees to retire sooner because their retirement-creditable pay will reach its maximum level in a shorter amount of time.

## **The U.S. Postal Service**

The FMA proposal intentionally does not address whether USPS employees would be included in the transition because postal workers are not members of the organization.<sup>115</sup>

# **Analysis of Legislative Options**

## **Transition Proposals**

The three transition proposals differ most drastically from one another in the timing of the phase-in, the length of time the nonforeign COLA continues to be paid once the transition period is completed, and the percentage of every COLA dollar removed from an employee's pay for every dollar of locality pay added to it. While S. 3013 would phase-in locality pay over three years, the OPM proposal would do so over seven. The Federal Managers Association plan switches to locality pay in one year and eliminates the nonforeign COLAs in the second year of implementation. For both S. 3013 and the OPM proposal, the percentage of nonforeign COLA pay that remains and the length of time it would continue to be paid after the phase-in is complete would vary by location. As stated earlier, OPM estimates that nonforeign COLAs could continue to be paid between 10 and 30 years after enactment of the seven-year transition—depending on the location. All three proposals could increase federal personal income tax collections.

## **Timing of Phase-in**

Phasing in locality pay over several years may prompt certain employees to postpone retirement. As noted earlier, Charles D. Grimes III, deputy associate director for performance and pay systems at OPM, said that the longer phase-in periods may reduce an older employee's incentive to retire quickly so he or she could ensure they receive the largest retirement benefits possible. The postponed retirement could save the federal government large retirement benefit costs. Shorter phase-in times, like the three-year proposal of S. 3013 or the one-year proposal from FMA could precipitate earlier retirements.

We believe it is not advisable to exacerbate staffing problems by creating an incentive to retire, as might be the case if there were a shorter phase-in period. The phase-in period also reduces the financial impact on agency budgets caused by higher employer retirement contributions.... S. 3013, though welcomed as a step forward in resolving these issues, would cost significantly more due to the shorter phase-in period and reduced offset.<sup>116</sup>

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<sup>115</sup> Information provided to the author by FMA on Oct. 22, 2008.

<sup>116</sup> U.S. Congress, Senate Committee on Homeland Security and Governmental Oversight, Subcommittee on Oversight of Government Management, the Federal Workforce and the District of Columbia, *Nonforeign COLA: Finding an Equitable Solution*, hearing on S. 3013, 110<sup>th</sup> Cong., 2<sup>nd</sup> sess., testimony of Charles Grimes III, May 29, 2008, available at [[http://hsgac.senate.gov/public/\\_files/GrimesTestimony052908.pdf](http://hsgac.senate.gov/public/_files/GrimesTestimony052908.pdf)].

A longer transition period, however, could cost the federal government more money in pay for employees still in the workforce, because the three- and seven-year transition plans give employees both a COLA and locality pay for an unspecified number of years. If locality pay rates never become high enough to exceed COLA pay, eligible employees could receive both forms of pay in perpetuity.

## The Continued COLA

Paying a nonforeign employee both locality pay and a nonforeign COLA may lead to considerable inequities in pay and retirement benefits between nonforeign employees and those who work in the contiguous United States. In 2013, under S. 3013, a GS-9, step 5 in Anchorage, AK, would receive \$179 more per year in retirement creditable pay than an identical employee with similar labor costs living in Houston, TX, (\$68,001 for the employee in Anchorage, \$67,822 for the employee in Houston).<sup>117</sup> **Table 13** shows the estimated annual difference in total pay (annual rate of pay + locality pay + COLA) between two hypothetical employees who are hired at the same grade and step if S. 3013 were enacted. One employee lives in Houston and the other in Anchorage.

**Table 13. Total Pay for Hypothetical GS 9, Step 5, Employees Working in Anchorage, AK, and Houston, TX**

Year	GS Schedule Annual Rate of Pay	Total Pay for the Employee in Houston	Total Pay for the Employee in Anchorage
2008	\$45,103	\$57,457	\$55,927
2009	\$46,411	\$59,587	\$58,317
2010	\$47,571	\$61,552	\$62,231
2011	\$48,761	\$63,579	\$65,709
2012	\$49,980	\$65,688	\$67,527
2013	\$51,229	\$67,882	\$69,394

**Source:** CRS calculations using S. 3013.

**Notes:** These calculations are estimates, and not the actual benefits an employee would receive if S. 3103 were enacted. The calculations do not account for maximum limitations on pay, promotions, or step increases. The annual base pay adjustment in 2009 is 2.9%, pursuant to P.L. 110-329. In subsequent years of the phase in, annual basic pay adjustments are estimated at 2.5%. In the first year of the phase-in, locality pay is calculated by using the RUS locality pay rate, which is currently estimated at 13.18%—the 2008 RUS rate. In the second and subsequent years, the OPM estimated 2008 locality pay rate for the Anchorage, AK COLA area of 27.74% is used to calculate pay. In the final year of the phase-in, nonforeign COLAs are still allotted because the ratio between reduction in nonforeign COLAs and increasing locality pay is not one to one. The nonforeign COLA offset factor is 65%—for every dollar added in locality pay, 65% of each nonforeign COLA dollar is removed—to help defray the impact of the transition to federally taxable income.

According to **Table 13**, the employee in Anchorage, who has an OPM-estimated locality pay rate that is 0.35% higher than the rate for the Houston employee (27.74% in Anchorage and 27.39% in Houston), is estimated to receive \$1,512 additional dollars in total pay in 2013. The additional pay for the Anchorage employee largely consists of continued COLA pay.

<sup>117</sup> OPM estimates that the locality pay rate will increase 1% per year. Houston, TX, has a locality pay rate in 2008 (27.39%) similar to OPM's estimated 2008 locality pay rate for Anchorage (27.74%).

Both S. 3013 and the OPM proposal continue to pay nonforeign federal workers a COLA after the transition is completed. The continued COLA is meant to offset the federal tax payments for nonforeign area employees who historically have not paid federal taxes on their COLAs, but must now pay federal taxes on their locality pay. These ongoing COLA payments, however, may prompt concerns of pay equity between employees living in nonforeign areas and those living in areas of the contiguous United States with similar labor costs. Employees within the contiguous United States who have similar labor costs would not receive COLA offsets, but could face similar federal tax bills.

## **Federal Tax Rates**

The COLA offsets provided in the transition proposals aim to ensure that nonforeign-area employees do not take home less pay than they would have if the proposal had not been enacted. The continued COLA attempts to cover the federal taxes a nonforeign employee would pay on his or her locality pay that he or she had not paid on a COLA. A 65% COLA offset, like the one proposed in S. 3013, therefore, assumes that a nonforeign employee will pay the remaining 35% of his or her COLA in federal taxes. The COLA offset, therefore, assumes a 35% flat tax rate for all nonforeign employees.

If the federal tax rate estimate is too high, nonforeign area employees may receive more federal pay than needed to maintain their take-home pay. Too low of an assumed federal tax rate may force some federal employees to owe more in federal taxes than they received in their COLA offset, leaving nonforeign employees with less take-home pay than they would have had if the transition had not occurred. S. 3013 assumes a 35% federal tax rate, which is a federal tax bracket for workers who earn more than \$357,000 per year. No federal white-collar employee on the GS scale earned more than \$149,000 in 2008.<sup>118</sup> The OPM proposal assumes a 15% federal tax rate, which includes federal employees who earn between \$8,025 and \$32,550. Federal employees above GS-7 pay federal taxes at a rate higher than 15%. Under this proposal, many nonforeign area federal employees would pay more in federal taxes than provided by the COLA offset to ensure the transition did not affect their take-home pay. The FMA proposal assumes a 25% federal tax rate. Employees who earn between \$32,550 and \$78,850 are in a 25% federal tax bracket. Under this proposal, some employees in the lowest grades may receive more money than necessary to ensure their take home pay is not reduced as a result of the transition. Federal employees above the GS-13, step 6 level, however, may not receive a COLA large enough to ensure the transition would not reduce their take home pay.

At a May 29, 2008, congressional hearing, Sharon Warren, president of the COLA Defense Committee of Anchorage, Inc., said OPM's plan was "not acceptable." Moreover, she said that the 85% COLA offset factor in the OPM proposal "assumes an unrealistically low federal income federal tax of 15 percent, and does not account for other mandatory deductions (e.g., Social Security and Medicare federal taxes)."<sup>119</sup> Warren continued her testimony by expressing the

<sup>118</sup> A GS-15, step 10 living in Houston, TX, earned \$149,000 in 2008. Houston had the largest locality pay rate in 2008 at 27.39%. The pay cap does not include one-time lump sum pay bonuses that may have been awarded to an employee.

<sup>119</sup> U.S. Congress, Senate Committee on Homeland Security and Governmental Oversight, Subcommittee on Oversight of Government Management, the Federal Workforce and the District of Columbia, Nonforeign COLA: Finding an Equitable Solution, hearing on S. 3013, 110<sup>th</sup> Cong., 2<sup>nd</sup> sess., testimony of Sharon Warren, May 29, 2008, available at [[http://hsgac.senate.gov/public/\\_files/WarrenTestimony052908.pdf](http://hsgac.senate.gov/public/_files/WarrenTestimony052908.pdf)].

Defense Committee's support of S. 3013, saying the legislation was a positive step, but not "perfect for everyone."<sup>120</sup>

## **Personal Income Federal Tax**

Switching to locality pay would likely result in an increase in federal personal income federal tax collections. This increase in personal income federal tax collections is the result of several factors. First, the shift from excluded nonforeign COLA payments to federal taxable locality pay would increase federal taxable income, and, in turn, increase federal tax collections directly. Secondly, the inclusion of locality pay, that is creditable for retirement purposes, would likely result in an increase in federal taxable retirement benefits. In turn, this would also result in a direct increase in federal tax collections. Finally, both of these increases in federal taxable forms of income may interact with the alternative minimum federal tax (AMT) and other federal tax provisions, resulting in an indirect increase in federal tax collections.<sup>121</sup>

## **Concluding Observations**

Congress created both the nonforeign COLA and the locality pay authorities to help attract and retain federal workers to specific locations. Nonforeign COLAs attempt to compensate for high living costs. Locality pay, on the other hand, attempts to narrow the pay gap between federal and nonfederal workers who live in separate, designated areas. Three proposals have been introduced that would replace nonforeign COLAs with locality pay. The proposals would place federal employees who work in nonforeign areas in the same pay system as federal employees in the contiguous United States. Congress may choose to adopt any of the proposed transition plans or it may maintain the current COLA system.

If none of the proposals were enacted and the nonforeign COLA program were maintained, federal employees in nonforeign areas may continue to be concerned with the differences in how their supplemental pay is calculated in comparison to federal employees in the contiguous United States. Regardless of fluctuations in nonforeign COLA rates, nonforeign area employees may believe their pay and benefits are not equal to pay and benefits of federal employees in other areas.

If locality pay were phased in, some nonforeign areas may see a reduction in the rate percentage of their supplemental pay. In Honolulu, for example, the nonforeign COLA rate is currently 25%. OPM's estimated locality pay rate for Honolulu is 20.38%—4.6% lower than the current COLA rate. The rate reduction, however, would be supplemented by continued use of COLA pay to attempt to ensure that the take-home pay of nonforeign employees is not affected by a transition. According to OPM's estimates on annual locality pay increases, Honolulu's locality pay rate could reach 25% by 2013 if a transition were implemented. Under S. 3013, a Honolulu resident may receive more total pay and greater retirement benefits than if the transition did not occur because he or she would receive both locality pay and a COLA concurrently. If the locality pay rate in Honolulu did not increase at the OPM-estimated 1% per year, however, the employee may

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<sup>120</sup> Ibid.

<sup>121</sup> CRS Report RS21817, *The Alternative Minimum Tax (AMT): Income Entry Points and "Take Back" Effects*, by Steven Maguire.

receive a pay supplement at a lower rate of pay than if he or she had continued to receive the nonforeign COLA.<sup>122</sup> In 2011 and 2012, for example, OPM estimates that a Honolulu employee could have a 23.38% and 24.38% locality pay rate, respectively—both rates are lower than the current COLA rate (25%). In Anchorage, however, the OPM-estimated locality pay rate in 2011 (30.24%) is 6.24% higher than the current nonforeign COLA rate (24%).

The cost of each of the three transition plans may also be a concern to lawmakers. In 2014, nonforeign area employees in Honolulu, HI, would be receiving both a nonforeign COLA and locality pay. If the locality pay rates increase one percentage point per year, the federal government could pay a nonforeign COLA to Honolulu employees until 2017 or longer.<sup>123</sup> The total transition time to phase in locality pay under S. 3103, therefore, could last nine or more years.<sup>124</sup> If locality pay did not continue to increase, the federal government could pay employees nonforeign COLAs in perpetuity.

Under OPM's transition proposal, a nonforeign area employee in Honolulu, Hawaii would continue to receive a nonforeign COLA rate until 2017.<sup>125</sup> This transition to locality pay could last nine or more years. Like under S. 3013, the federal government could pay employees a nonforeign COLA in perpetuity under the OPM proposal if the locality pay did not continue to increase. As noted earlier, OPM estimates first year phase-in costs for its transition plan at \$15.7 million. Second year costs are estimated at \$31.4 million.<sup>126</sup> According to CBO's \$2.2 billion cost estimate for the transition, OPM's estimate may be low.

If locality pay were instituted in full in one year—like in the FMA proposal—some agencies may struggle to pay benefits to retirees. The pace of any locality pay phase-in may affect federal retirement rates in nonforeign COLA areas. Employees who plan to retire may do so soon after acquiring a “high 3” average basic salary that includes locality pay—and, in some cases, both locality pay and a COLA. A more rapid transition to locality pay, therefore, may encourage employees to retire as soon as three years after locality pay is fully implemented. Agency budgets may need to be increased, or programs streamlined, to ensure that a retiring employee receives his or her earned benefits. A longer transition period may spread retirements out over the phase-in period, but may also cause challenges for federal employees who served government and planned to retire before the longer phase-in were completed.

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<sup>122</sup> If locality pay increased 1% per year, as estimated by OPM, Honolulu employees would receive a continued COLA through 2017 under the OPM transition proposal.

<sup>123</sup> CRS estimate using S. 3013.

<sup>124</sup> Three years of transition and six years to eliminate the COLA.

<sup>125</sup> CRS estimate using OPM's transition provisions. The estimate assumes locality pay will increase OPM's estimated annual increase of 1% per year.

<sup>126</sup> U.S. Executive Office of the President, Office of Management and Budget, Budget of the United States Government Fiscal Year 2008; Appendix (Washington: GPO, 2007), p. 1007.

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