STATEMENT OF

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before the

SUBCOMMITTEE ON OVERSIGHT OF GOVERNMENT
MANAGEMENT, THE FEDERAL WORKFORCE, AND THE
DISTRICT OF COLUMBIA
COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

on

NON-FOREIGN COLA: FINDING AN EQUITABLE SOLUTION

May 29, 2008

Mr. Chairman and Members of the Subcommittee:

I am here today on behalf of Linda M. Springer, Director of the Office of Personnel Management (OPM), to discuss the proposals to extend locality pay in lieu of cost-of-living allowances (COLA) to Federal employees working in Hawaii, Alaska, Guam, Puerto Rico, U.S. Virgin Islands, and other U.S. territories and possessions.

Background

Over the years, the focus of Federal pay policy has evolved from simply keeping pace with the overall labor market to effectively competing within the labor market. The enactment of the Federal Employees Pay Comparability Act (FEPCA) of 1990 is a tangible manifestation of that change in focus. Under this market-based policy, the Federal Government, as an employer, has achieved greater comparability and competitiveness with the private sector by paying a locality-based pay adjustment based on non-Federal pay data collected by the Bureau of Labor Statistics (BLS). However, FEPCA applies only in the 48 contiguous states. In the nonforeign areas noted above, we have a conflicting compensation policy that provides for a cost-of-living allowance (COLA). The conflicting policies create real differences in employee take-home pay and in retirement benefits.

Market-based Pay

Implemented in 1994, FEPCA provides for an annual pay adjustment, called locality pay, to narrow the pay gap between Federal and non-Federal salaries. Under FEPCA, locality pay is paid within each locality pay area determined to have a Federal – non-Federal pay gap greater than 5%. The Federal Salary Council recommends establishment of particular locality pay areas, and the President's Pay Agent approves the areas. There currently are 32 locality pay areas, including a catch-all area called Rest of the U.S. (RUS).

The COLA Program

The COLA program, which pre-dates locality pay by nearly 50 years, covers white-collar civilian Federal employees in the nonforeign areas noted above. Enacted in 1948, the COLA program was originally designed to address recruitment and retention issues resulting from higher costs of living in the nonforeign areas. Accordingly, COLA rates are based on OPM surveys measuring the differences in the cost of living between each nonforeign area and the Washington, D.C., area.

Beyond being philosophically different from locality pay, COLA has tangible effects on an employee's take-home pay and retirement annuity. Employees view some of these effects positively and some negatively. For instance, some employees like the fact that COLA payments are not subject to Federal income tax because they are not intended to increase income, but to stabilize buying power.

On the negative side, given that COLA payments are non-taxable allowances, they are not considered base pay for retirement purposes. Therefore, when an employee retires, his or her retirement benefit, under either the Federal Employees' Retirement System (FERS) or the Civil Service Retirement System (CSRS), does not reflect COLA payments. In addition, COLA is capped at 25% of base pay by law. As locality pay continues to increase, particularly as it approaches or even exceeds existing COLA payments, agency recruitment and retention efforts in the nonforeign COLA areas could suffer.

Given these negative effects, there is a growing perception that total pay and retirement benefits of white-collar civilian Federal employees in the nonforeign areas are gradually eroding in relation to the pay and retirement benefits of similarly situated employees in the continental United States. The disparities between the pay and retirement benefits of the two groups of employees create staffing problems for Federal agencies in nonforeign areas, especially with regard to retaining experienced employees who are near retirement. As employees in the COLA areas near retirement, many consider and seek short term employment in the continental United States, where their “high 3” salaries are boosted by locality pay.

The Administration, FMA, and Senate Proposals

For several reasons, the Administration believes that these disparities are best addressed by extending locality pay in lieu of COLA to the nonforeign areas. First, locality pay is retirement creditable. Although it is taxable, locality pay increases an employee’s “high-3” average salary used in retirement calculations. For employees covered under CSRS, locality pay increases the monthly annuity payments significantly. For employees covered under FERS, locality pay increases base pay for the defined benefit aspect of the FERS package as well as the matching contribution paid by the Government into employees’ Thrift Savings Plan accounts.

Second, locality pay is not capped at 25%. In high cost-of-labor areas like San Francisco, locality pay has risen to more than 32% and will likely continue to rise. Over the past few years, locality pay has increased about 1% per year on average, although the increase amounts have been higher in the higher cost of labor locality pay areas. We expect locality pay to make similar gains going forward.

Finally, because of subjective elements in measuring relative living costs, the COLA program has been the subject of litigation numerous times since its inception. The most recent settlement, reached in the *Caraballo* case, topped $230 million. We expect the bill, once finalized, to reduce the ongoing litigation risk associated with the COLA program.

In May 2007, the Administration transmitted a legislative proposal to Congress to address these issues. We are pleased that Senator Akaka, and Senators Inouye, Stevens, and Murkowski, have recently introduced S. 3013, the "Non-foreign Area Retirement Equity Assurance Act of 2008," to stimulate discussion on how best to transition from pay based on the relative differences in cost of living to pay based on the labor market. Also, the Federal Managers Association (FMA) has put forth a proposal. The Administration's proposal, the FMA's proposal, and S. 3013 would extend locality pay to white-collar Federal employees in the nonforeign areas over time, while reducing COLA payments gradually. However, the Administration's proposal differs significantly from the FMA's proposal and S. 3013 regarding the phase-in period, the offset, and employee coverage.

The Administration's proposal would phase in locality pay over a 7-year period. One purpose of the phase-in period is to limit the impact of locality pay on retirement behavior. 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. During the phase-in period, decreases to COLA would be limited to 85% of the increase in locality pay in order to reduce the impact on take-home pay of increased deductions for retirement contributions and tax liability. S.

3013 would reduce the phase in of locality pay to three years, and would set the offset to COLA at 65% of the increase in locality pay. The FMA proposal would phase in locality pay over two years, with an offset of 75%.

In both the Administration's proposal and S. 3013, the RUS rate, subject to their differing phase-in rates, would apply in all areas in the first year of phase in while data are being collected, pay gaps are determined, and recommendations for pay rates are being made. That is, under the Administration's proposal, the first year locality payment would be one seventh of the RUS rate, and under the Senate bill, one third of the RUS rate. The FMA's proposal would implement the full RUS locality pay rate in the first year, and the full locality pay rate for Hawaii and Alaska in the second year. We believe that Hawaii and Alaska would likely be established as separate locality pay areas by the Federal Salary Council and the President's Pay Agent, with locality rates based on BLS data from Honolulu and Anchorage, respectively. Puerto Rico, Guam and the Virgin Islands would likely be covered by the RUS locality pay area rather than become separate locality pay areas. Based on existing data, we estimate the locality pay rates for Hawaii and Alaska would be 20.38% and 27.68%, respectively. The current rate for RUS is 13.18%.

The Administration's proposal would permit OPM to promulgate regulations for various categories of employees such as those on special rates. With the concurrence of OPM, certain other agencies like the Transportation Security Administration and the Federal Aviation Administration would promulgate their own regulations to comply with the proposal and OPM regulations. Finally, Postal Service employees would receive a frozen

COLA rate, set at the COLA rate effective at the time of the draft bill's passage, since Postal Service employees are not eligible to be paid GS locality pay. S. 3013 specifies in statutory language what employees are covered, and further gives employees a chance to opt out of coverage and keep a frozen COLA rate. One result of this specificity is that Senior Executive Service (SES) members in the non-foreign areas would be granted locality pay, which SES members currently do not receive, regardless of location.

We believe the Administration's proposal addresses the issues in a responsible fashion, particularly with regard to cost and reduced litigation risk. 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. The FMA's proposal would cost even more, since it would establish the RUS locality pay rate for all areas immediately, followed in year two by full locality pay for Hawaii and Alaska. In addition, we believe the opt-out provision S. 3013 could lead to further litigation, rather than reducing litigation risk.

Mr. Chairman, we appreciate your website which contains much information on this issue. As you know, we provided your office with a list of Frequently Asked Questions, as well as a calculator to help individuals determine the effect of phasing in locality pay. In addition to meetings with employees this week and earlier this year in Hawaii, we also joined Representative Luis Fortuno for a townhall meeting with his constituents in Puerto Rico last August, and we joined Senator Ted Stevens this past March for similar meetings with his constituents in Alaska.

We believe the time is upon us to extend locality pay to the nonforeign areas. Locality pay provides employees in the nonforeign areas a retirement benefit comparable to employees in the continental United States. Additionally, locality pay is uncapped and traditionally has increased about one percentage point a year over the last few years, unlike COLA, which has a history of fluctuations with most areas currently trending downward.

Conclusion

Mr. Chairman, thank you for the opportunity to discuss this important issue with you today and for your support as we work towards a more market-based pay system in our nonforeign areas which will benefit both employees and agencies. We will continue to work closely with your subcommittee and the cosponsors on S. 3013. I would be happy to address any questions you may have.