

January 18, 2001

Honorable C.W. Bill Young
Chairman
Committee on Appropriations
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

I am pleased to provide you with this report on the nonforeign area cost-of-living allowance (COLA) program. Congress requested this report in the Treasury, Postal Service, and General Government Appropriations Act, 1992 (Public Law 102-141), as amended.

Agencies pay nonforeign area COLAs to white-collar civilian Federal and United States Postal Service employees in Alaska, Hawaii, Guam, Puerto Rico, and the U.S. Virgin Islands. COLA recipients have long contested the methodology used to determine COLA rates and other issues affecting their compensation. To help resolve the issues, Congress asked the Office of Personnel Management (OPM) to study and submit a report on the COLA program and the compensation of Federal employees in the COLA areas. Congress also barred COLA rate reductions through December 31, 2000, and required our report to be submitted by March 1, 2000.

On February 7, 2000, I wrote to inform you and Senate Committee on Appropriations Chairman Ted Stevens that we did not believe it was in the Government's best interest for OPM to submit a report by March 1. At that time, the Government was involved in sensitive settlement discussions regarding matters relating to pending litigation on the COLA program.

I am pleased to report that these settlement discussions were successful. The Government and the plaintiffs reached an agreement in *Caraballo, et al. v. United States*, No. 1997-0027 (D.V.I). The District Court for the U.S. Virgin Islands approved this agreement on August 17, 2000. Under the agreement, COLA rates in some locations increased on October 1, 2000, and no COLA rates will be reduced for at least the next 3 years.

Public Law 102-141, as amended, asked OPM to research and report on the following matters:

1. An examination of the pay practices of other employers in the COLA areas;
2. Consideration of alternative approaches in dealing with the unusual and unique circumstances of the COLA areas, including modifications to the current

- methodology for calculating allowances that take into account all costs of living;
and
3. An evaluation of the likely impact of the different approaches on the Government's ability to recruit and retain a well-qualified workforce.

Representatives of the Government and of the plaintiffs in all COLA areas in two previous COLA lawsuits engaged in a cooperative effort under a memorandum of understanding (MOU) to research these issues. The MOU provided funding for this research through the use of contested, undistributed judgment funds remaining in the two previous lawsuits. Under the MOU, we engaged in two major research efforts. The Bureau of Labor Statistics researched non-Federal pay practices in Alaska, Hawaii, and the San Juan metropolitan area, and Joel Popkin and Company (JPC) examined a wide range of economic issues relating to living-cost and compensation comparisons between the COLA areas and the Washington, DC, area. JPC's research included a survey of Federal employees in each of the COLA areas.

To plan, monitor, and review this research, the Government and the plaintiffs established a joint Working Group. The Working Group was composed of seven employee representatives from the COLA areas and two OPM representatives. The Government and the plaintiffs also established a Technical Advisory Group (TAG), composed of three well-known economists, to conduct and monitor some of the research and to advise the Working Group on complex research issues. The combined BLS, JPC, and TAG research includes well over 1,000 pages of text, charts, and tables. In July 2000, OPM posted summaries of this research on its web site at www.opm.gov/oca/cola/html/cola-n.htm. I am enclosing copies of these summaries.

The research and collaborative efforts described above led to the development of 26 principles, which the parties incorporated in the *Caraballo* settlement. These principles will be the cornerstone for OPM's future administration of the COLA program. Due to statutory constraints on OPM's authority, the parties agreed only to principles that could be adopted consistent with OPM's authority. One of these principles calls for the involvement of employee representatives in future COLA program administration, and the settlement establishes a special committee composed of OPM representatives and employee representatives from the COLA areas to guide the development of regulations necessary to implement the settlement agreement. That committee is already hard at work.

The Senate Appropriations Committee, in a report that accompanied Public Law 102-141, asked OPM to recommend any appropriate legislative changes. Although the COLA program has been and will continue to be a difficult and challenging program to administer, we do not have legislative recommendations at this time. We are aware, however, that a number of concerns about the compensation of COLA area employees arose during the course of discussions between representatives of the Government and the plaintiffs that could prompt the development of future legislative proposals. These concerns relate chiefly to the fact that COLA area employees do not receive locality-based comparability payments under the locality pay system established by Congress in 1990 for

General Schedule (GS) employees in the 48 contiguous States and Washington, DC. Since GS locality payments (which are subject to Federal income taxes) are considered basic pay for retirement and certain other purposes, while COLA payments (which are not subject to Federal income taxes) are not considered basic pay, many employees and some agency officials have expressed concerns about the different compensation of employees in the continental United States and the District of Columbia and those in the COLA areas.

During the course of the Safe Harbor research, the parties carefully examined the statutory constraints on the COLA program. Although the research provides useful analysis regarding these subjects, the parties focused on issues that could be adopted within OPM's statutory authority. Broader questions about the compensation of employees in the COLA areas raise complex issues that deserve careful consideration. In reviewing these issues, it will be important to consider several factors, including the following. For example, we believe we need to consider the extent to which specific proposals to address these matters might affect the take-home pay of COLA employees. In addition, we need to consider the effect of any such proposals on U.S. Postal Service employees, who do not receive GS locality payments in the COLA areas, in the Washington, DC, area, or anywhere else. Further, some proposals likely will raise issues common to COLA area employees and Federal employees working in foreign areas. Different proposals also will have varying cost implications for agencies' budgets and for the unfunded liability of Federal retirement systems. Finally, we must consider the overall relationship between the pay entitlements of employees in the COLA areas and those in the contiguous 48 States.

In keeping with the principles established under *Caraballo*, we plan to discuss these issues with COLA employee representatives and hope to arrive at a consensus position. We will also seek the views of employing agencies and other relevant parties. As we work with all interested parties, we look forward to a mutual sharing of perspectives on possible legislative proposals affecting the COLA program.

Thank you for providing us with an opportunity to report on the nonforeign area COLA program.

Sincerely,

[signed]
Janice R. Lachance
Director

Enclosures

cc: Honorable David Obey
Ranking Member
Committee on Appropriations
U.S. House of Representatives
Washington, DC 20515