

SPECIAL RESEARCH RELATING TO THE NONFOREIGN AREA COST-OF-LIVING ALLOWANCE (COLA) PROGRAM

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ABBREVIATIONS

AK:	Alaska
APA:	Administrative Procedure Act
BLS:	U.S. Bureau of Labor Statistics
COLA:	Cost-of-living allowance
CMSA:	Consolidated Metropolitan Statistical Area
CNMI:	Commonwealth of the Northern Mariana Islands
CSC:	Civil Service Commission (predecessor of the Office of Personnel Management)
DC:	District of Columbia
FEPCA:	Federal Employees Pay Comparability Act of 1990
JPC:	Joel Popkin and Company
HI:	Hawaii
MOU:	Memorandum of Understanding
MSA:	Metropolitan Statistical Area
OPM:	Office of Personnel Management
PR:	Puerto Rico
SHP:	Safe Harbor Principle
SHWG:	Safe Harbor Working Group
SIC:	Survey Implementation Committee
TAG:	Technical Advisory Group
VI:	U.S. Virgin Islands

SUMMARY

This announcement provides background information on the nonforeign area cost-of-living allowance (COLA) program and on recent COLA research. The research was requested by Congress and was conducted under a memorandum of understanding (MOU) between the Government and the plaintiffs in certain litigation related to the COLA program. The purpose of the MOU is to resolve long-contested issues in the COLA program and to assist OPM as it prepares a report to Congress on the COLA program and the compensation of Federal employees in the COLA areas.

The Government pays nonforeign area COLAs to approximately 44,000 Federal white-collar and U.S. Postal Service employees in Alaska, Hawaii, Guam, the Commonwealth of the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands. COLA rates reflect differences in living costs between the allowance areas and the Washington, DC, area. OPM conducts surveys in the COLA areas and in the Washington, DC, area to determine COLA rates. The law limits COLAs to no more than 25 percent of basic pay; the current range is from 10 to 25 percent.

Since 1991, OPM's surveys conducted using the existing methodology have indicated that, using this methodology, COLA rates would have been reduced in several allowance areas. This has raised concerns relating to the COLA methodology. Since 1991, Congress has barred COLA rate reductions. The bar is in effect through December 31, 2000. Congress also required OPM to study and submit a report on the COLA program and the compensation of Federal employees in the COLA areas.

Since 1996, the Government and the plaintiffs have engaged in a cooperative effort under the MOU. This cooperative effort led to a proposed settlement of *Caraballo, et al. v. United States*, No. 1997-0027 (D.V.I), a case brought in the District Court of the Virgin Islands. If approved, the settlement will form the basis for new OPM regulations on the COLA program.

I. BRIEF HISTORY OF THE NONFOREIGN AREA COLA AND POST DIFFERENTIAL PROGRAMS

A. What is the COLA Program?

The Federal Government pays cost-of-living allowances (COLAs) to approximately 44,000 Federal white-collar and U.S. Postal Service employees in nonforeign areas--Alaska, Hawaii, Guam, the Commonwealth of the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands. COLAs reflect differences in living costs between each of the allowance areas and the Washington, DC, area. To determine COLA rates, the Office of Personnel Management (OPM) conducts annual living-cost surveys of the prices of over 200 items in about 3,500 outlets in the nonforeign areas and in the Washington, DC, area. OPM publishes the results of these surveys in the *Federal Register* for comment.

B. What Pay Practices Preceded the COLA Program?

The Mead-Ramspeck Act of 1940, as implemented by Executive Orders 8657 and 8955, authorized the War and Navy Departments to pay differentials to U.S. citizens recruited for white-collar civilian positions in Alaska and in the Atlantic naval bases leased from the British government. The purpose was to help speed up the recruitment of personnel for the war effort. Within a short time, the military departments extended the differentials to all areas outside the continental United States. Other agencies soon began to pay differentials as recruitment incentives under the authority of the Brookhart Salary Act of 1930.

C. How Did the Current COLA and Post Differential Programs Evolve?

In 1946, in response to widespread reports of a lack of uniformity in the payment of these differentials, President Truman directed the Civil Service Commission (CSC) and the Bureau of the Budget to prepare a report on pay differentials outside the United States. CSC prepared a draft report that recommended standardizing pay practices and establishing two types of adjustments--one based on relative living costs and a second based on undesirable living conditions. These recommendations became the basis for the current COLA and post differential programs.

In 1949, Congress enacted legislation that authorized a pay differential for employees outside the continental United States or in Alaska. The differential was to be based on living costs, conditions of environment, or both. The law directed the President to regulate the program. President Truman, in Executive Order 10000, established two separate programs--one based on living-costs (i.e., the nonforeign area COLA program) and another based on conditions of environment (i.e., the post differential program). The President delegated the authority to administer these programs to the CSC.

D. What's the Difference between COLAs and Post Differentials?

Section 5941 of title 5, United States Code, provides for the payment of an allowance based on differences in living costs or on differences in conditions of environment, or both. The total payment, however, may not exceed 25 percent of basic pay.

COLAs, established under section 205 of the Executive Order, are payments designed to recognize substantially higher living costs in the nonforeign areas relative to those in the Washington, DC, area. The Government pays COLAs to both local and non-local hires.

Post differentials, established under section 203 of the Executive Order, are recruitment incentives designed to encourage people from other areas to go to work for the Federal Government in a nonforeign area that has "(a) extraordinarily difficult living conditions, (b) excessive physical hardships, or (c) notably unhealthful conditions" compared with the continental United States. Since a post differential is a recruitment incentive to get people to move to a nonforeign area, the Government does not pay post differentials to people who are local hires.

E. What Litigation Has Been Filed Since 1980 Concerning the COLA Program?

Early in the 1980s, two lawsuits challenged OPM's administration of the COLA program. These were *Alaniz v. OPM*, No. A81-072 (D. Alaska), filed by employees in the Anchorage allowance area, and *Karamatsu v. United States*, No. 224-85C (Cl. Ct.), which had the effect of expanding the *Alaniz* class to include employees in all other COLA areas. In the late 1980s, the plaintiffs filed additional litigation in *Arana v. United States*, No. 389-86C (Cl. Ct). The Government and plaintiffs agreed to a joint stipulation for settlement of the litigation in September 1988. The settlement provided for a 2-year period during which OPM would develop and implement a new COLA methodology and set new COLA rates.

OPM proposed new regulations in 1989. After analyzing and taking the public comments into account, OPM implemented final regulations in early 1990. The results of the surveys under the new regulations indicated that OPM should consider making COLA rate reductions in many areas. Subsequently, Congress temporarily prohibited COLA rate reductions and asked OPM to conduct research and prepare a report on the COLA program and the compensation of Federal employees in the COLA areas. In addition, the plaintiffs in *Alaniz* and *Karamatsu* proposed to join with the Government in a cooperative effort to find solutions to the long-contested COLA methodology issues and to assist OPM as it prepares its report to Congress.

The Government and the plaintiffs entered into a memorandum of understanding that established a "Safe Harbor Process" in which the parties could work together to resolve issues concerning the COLA program. In the interim, the plaintiffs filed four additional lawsuits that were stayed pending the conclusion of the Safe Harbor Process and court approval of a settlement agreement. Those cases are *Angelet v. United States*, No. 97-1378RU (D.P.R.), *Caraballo v. United States*, No. 1997-0027 (D.V.I.), *Cruz v. United States*, No. 98-00021 (D. Guam), and *Matsuo v. United States*, No. 97-01418 (D. Hawaii).

On June 20, 2000, the parties in *Caraballo* filed a joint stipulation for settlement of the litigation with the District Court for the Virgin Islands. The court has preliminarily approved the settlement and authorized notice to the class.

II. SAFE HARBOR PROCESS

A. What Is the Memorandum of Understanding?

The memorandum of understanding (MOU) is a court-approved agreement between the Government and the plaintiffs in past and current COLA litigation.¹ The purpose of the MOU is to engage the parties in a cooperative effort to resolve long-contested COLA issues and to assist the Office of Personnel Management (OPM) in preparing its report to Congress.

The parties settled *Alaniz* and *Karamatsu* in the mid-1980s except for the disposition of unclaimed judgments. Both the plaintiffs and the Government reserved rights to the amounts of unclaimed judgments. In late 1993, the MOU process began when the plaintiffs approached the Government with a plan to use a portion of the unclaimed amounts in these cases to fund comprehensive research of the COLA issues Congress and others had identified. Over the next 2 years, the parties jointly expanded and developed the plan into an MOU, and the courts approved

¹ A copy of the MOU is available on this website at www.opm.gov/oca/cola/index.htm.

the MOU in April 1996. The MOU allows the use of undistributed judgment funds from *Alaniz* and *Karamatsu* to pay for research relating to issues in the COLA program. The MOU established a Safe Harbor Process in which the parties could freely discuss the issues without concern that individual statements would be used in any future litigation. It contemplated that the parties would develop a set of Safe Harbor Principles that would become part of a settlement agreement and form the basis for future regulatory changes in the COLA program. The MOU also identified numerous specific topics that the parties agreed they needed to address during the research.

B. Who Is Involved in the Safe Harbor Process?

To plan, budget, monitor, and review the research, the plaintiffs and the Government formed a working committee called the Safe Harbor Working Group. The Working Group has seven members--five representatives from the COLA Defense Corporations and two representatives from OPM. Each of the COLA areas has representatives, although some of the smaller COLA areas share representation. The Safe Harbor Working Group members represent a broad range of interests, including employees, unions, and management.

Because of the many complex issues involved in living-cost comparisons, the Safe Harbor Working Group was advised and assisted by a panel of economic experts, called the Technical Advisory Group (TAG). The TAG members are Eva Jacobs, former Chief of Consumer Expenditure Surveys at BLS; Dr. Alan Heston, Ph.D., University of Pennsylvania and President of the Center for International and Interarea Comparisons; and Dr. Harold Watts, Ph.D., Columbia University. These economists helped the Working Group to understand the basic economic and statistical principles involved in complex living-cost issues. The TAG also worked with, monitored, and reviewed research conducted by Joel Popkin and Company and others. The TAG also conducted some of its own research on selected issues.

Joel Popkin and Company (JPC) conducted the majority of the research for the Working Group and TAG. JPC is a private consulting firm in Washington, DC, that specializes in economic forecasting, analysis, and measurement, including place-to-place price measurement projects. Dr. Joel Popkin, Ph.D., President of JPC and former Assistant Commissioner of the Bureau of Labor Statistics, Office of Prices and Living Conditions, managed the economic research. Dr. Rakesh Kochhar, Ph.D., Senior Economist, JPC, was the Project Director who conducted or supervised most of the research.

C. What Were the MOU Research Issues?

The Safe Harbor Working Group reviewed the COLA methodology issues identified in the MOU and consolidated them into six areas:

1. *Level of Living Issues.* Whether and how the COLA program should take into consideration differences in the need for, availability of, and access to goods and services in the COLA areas relative to the Washington, DC, area. How to account for the different ways that people spend their money (e.g., local versus base area expenditure weights).

2. *Housing Issues.* How to compare shelter costs in the COLA areas with shelter costs in the Washington, DC, area for comparable housing in light of the many environmental differences and conditions that affect home construction, maintenance, insurance, etc.
3. *Transportation Issues.* How to measure transportation costs, particularly air transportation and the relative availability and use of public transportation in the COLA areas.
4. *Miscellaneous Issues.* Other things to include in the COLA methodology and how to measure their relative costs. Examples of research topics include medical services, insurance and out-of-pocket expenses; K-12 and college/university education expenses; retirement; life insurance; income taxes; and job-classification grade-level issues.
5. *Locality Pay Issues.* Whether to replace COLA with General Schedule locality pay; whether to pay Washington, DC, locality pay in the COLA areas; and the effect of job classification and grading differences between the COLA areas and the Washington, DC, area.
6. *Environmental Issues.* Whether and how to compensate for hard-to-quantify issues, such as remoteness, isolation, winter darkness, etc.

D. How Did the Safe Harbor Process Work?

Early in 1997, the Working Group held public briefings in each of the COLA areas to inform Federal employees about the MOU process, present the research plan, and obtain comments. The Working Group held multiple briefings in several of the larger COLA areas and also videotaped some of the briefings to reach a broader audience. Working Group members also remained at the briefings for extended periods to exchange information and comments.

After the public briefings, the Working Group communicated frequently to modify and refine the research plan and to develop a statement of work for the conduct of the living-cost research. Section III contains a summary of this research. Although the bulk of the research results were not available until the summer of 1999, the Bureau of Labor Statistics (BLS), JPC, the TAG, and OPM provided the Working Group with several draft reports and many working papers as they became available.² The combined JPC, BLS, and OPM research covers well over 1,000 pages of text, charts, and tables. To review and discuss the research materials, consider other MOU issues, and develop Safe Harbor Principles, the Working Group has had to date 44 telephone conference calls and 18 face-to-face meetings. At these times, BLS, TAG, JPC, and other experts, such as Dr. Charles Levin, a consultant to JPC on quality-of-life issues, presented and discussed complex economic, statistical, and compensation issues.

E. What Are the Results of the Safe Harbor Process?

Based on the research and discussions, the Working Group developed a series of Safe Harbor Principles and adopted 26 of them as part of the proposed *Caraballo* settlement.³ If the

²JPC presented several papers and all of the research findings to the Working Group by the summer of 1999. JPC followed this with additional written reports on each of the remaining research topics.

³ See *Stipulation for Settlement*, Exhibit A, at www.colasettlement.com.

settlement is approved, the Safe Harbor Principles will form the basis for proposed changes in the COLA program, including amendments to Executive Order 10000 and regulatory changes in the COLA program. As part of the settlement agreement, OPM anticipates developing these regulations in consultation with the Survey Implementation Committee, which will consist of the members of the Safe Harbor Working Group.

III. SUMMARY OF RESEARCH

A. What Did Congress Ask OPM to Study?

Congress asked OPM to study and submit a report on the COLA program and the compensation of Federal employees in the COLA areas. The law requires:

- 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;
- An evaluation of the likely impact of the different approaches on the Government's ability to recruit and retain a well-qualified workforce; and
- An examination of the pay practices of non-Federal employers in the COLA areas.

This section provides a short discussion of each of these topics. The appendix contains summary reports that provide additional information.

B. What Was the Research on Alternative Approaches for Calculating COLA?

Congress asked OPM to study alternative approaches in dealing with the unusual and unique circumstances of the COLA areas, including modifications of the current methodology for calculating allowances that take into account all costs of living. The Senate Committee on Appropriations identified several specific issues it wanted OPM to address. As noted earlier, these are:

1. Air transportation;
2. Education;
3. Extraordinary medical expenses;
4. Special housing maintenance costs;
5. Goods and services needed in the COLA areas but not in the Washington, DC, area;
6. Remoteness and isolation; and
7. Assumptions and calculations used under the Miscellaneous Component in the COLA methodology.

In developing the MOU, the Government and the plaintiffs prepared a list of 14 research areas that incorporated these issues. With the assistance of the Technical Advisory Group, the Safe Harbor Working Group consolidated these and various other issues into a research outline. The outline consisted of the following research topics:

1. Level of Living
2. Housing
3. Transportation
4. Miscellaneous
5. BLS Locality Pay
6. Environmental Issues

The Working Group then developed a research plan and budget and presented its plans in public briefings in each of the COLA areas in early 1997. After these briefings, the Working Group modified the research plan to take employee comments and suggestions into account in consultation with the TAG and JPC. The final research plan covered nine tasks. Although the TAG conducted some of the research, JPC performed most of the work during 1998 and early 1999. An important part of the research required a survey of a sample of Federal employees in both the COLA areas and Washington, DC, during the summer of 1998.

LIVING-COST RESEARCH TASKS

- Task 1. Critique of COLA model now used by OPM.
- Task 2. Level-of-living issues, including a review of COLA programs in use by other agencies and organizations, special needs in the COLA areas and in the Washington, DC, area, local versus base-area weights, and single- versus multiple-income level approach.
- Task 3. Housing issues, including alternative approaches such as rental-equivalency and user-costs, hedonic methods for comparing costs, and empirical tests of an alternative model.
- Task 4. Specific expenditure categories other than housing, including transportation, medical expenses and services, and education.
- Task 5. Income-related costs, including income taxes, government services, and retirement issues.
- Task 6. Locality pay, including a review of BLS survey results, OPM's analyses, and issues relating to classification of positions in the COLA areas compared with those in the Washington, DC, area.
- Task 7. Other issues, including environmental issues, non-quantifiable price factors, and quality-of-life issues.
- Task 8. The base area, specifically whether it should be changed to the U.S. average or some other city with living costs close to the U.S. average.

Task 9. Time-to-time analysis of housing data, through a comparison of the results of the 1998 employee survey with those of OPM's 1992/93 Federal Employee Housing and Living Patterns Survey.

JPC prepared a series of detailed reports on each of the tasks above and a Summary Report. To assist the Working Group, the TAG produced an assessment of JPC's research. JPC and the TAG made recommendations to the Working Group on potential changes in the COLA program. The Working Group used these recommendations as the basis for the development of the Safe Harbor Principles. The detailed task reports, charts, and tables that JPC and the TAG produced fill more than 800 pages. Many of these materials are highly technical, reflecting the very complicated issues involved in comparing living costs across geographic areas. The JPC Summary Report and TAG assessment are available in Appendices A and B to this announcement.

As stated earlier in this announcement, the Safe Harbor Working Group developed a series of Safe Harbor Principles based on the research and discussions and adopted 26 of them as part of the proposed *Caraballo* settlement. If the settlement is approved, these principles will be the basis for several changes in the COLA program that OPM will implement in the coming years.

C. How Will These Changes Affect Recruitment and Retention in the COLA Areas?

OPM believes the actions the Government will take to implement the Stipulation for Settlement, if it is approved, will enhance the Government's ability to recruit and retain a well-qualified workforce in the COLA areas. The stipulation also provides for employee involvement in the future administration of the COLA program. OPM believes this will be invaluable because it will improve OPM's administration of the program and help employees better understand how COLA is calculated.

D. What Are the Pay Practices of Non-Federal Employers in the COLA Areas?

The MOU provided funding for the Bureau of Labor Statistics (BLS) to conduct surveys of non-Federal pay in the COLA areas. In 1996, BLS conducted Occupational Compensation Surveys in Alaska, Hawaii, and in the San Juan-Caguas-Arecibo Consolidated Metropolitan Statistical Area (CMSA) in the Commonwealth of Puerto Rico. BLS tabulated and published the results of these surveys as well as special tabulations for the Anchorage, AK, and Honolulu, HI, Metropolitan Statistical Areas (MSAs).

Using the BLS data, OPM compared average non-Federal salaries with average Federal salaries in the same locations. OPM applied the same process it uses to calculate the locality payments for employees in the 48 contiguous States under the Federal Employees Pay Comparability Act

of 1990 (FEPCA).⁴ In March 1997, BLS briefed the Safe Harbor Working Group on the results of the surveys. At that same meeting and again in July 1999, OPM briefed the Working Group on locality pay and the comparison of Federal and non-Federal pay in the COLA areas that BLS surveyed. (See Appendix C for a detailed discussion of the research and results. The BLS/OPM research is also addressed in the Joel Popkin and Company Summary Report in Appendix A and in the Technical Advisory Group Assessment of JPC Research in Appendix B.)

⁴ Federal Employees Pay Comparability Act of 1990, 5 U.S.C. chapter 53, subchapter I. Under FEPCA, most Federal white-collar employees in the 48 contiguous States and Washington, DC, receive a rate of pay under the worldwide General Schedule plus an additional locality-based comparability payment for their geographic locality. Federal white-collar employees at duty stations outside the 48 contiguous States (i.e., in the COLA areas, in other U.S. territories and possessions, and in foreign countries) do not receive FEPCA's locality-based comparability payments.