FEDERAL PAY DISCRIMINATION IN NON-FOREIGN AREAS
— TWO CASE STUDIES —

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Summary

In Alaska, Hawaii, and the territories[1] of the United States, termed "non-foreign areas" by the Office of Personnel Management, federal employees and federal retirees receive lower pay raises and lower retirement benefits than are received by their grade-level counterparts in the contiguous 48 states and the District of Columbia, even though the costs of living in these remote areas are far higher. This pattern of discrimination, never intended by Congress, is the result of administrative practices that are contrary to civil service laws including the mandate of equal pay for equal work. These practices can be corrected without increasing the overall cost of federal salaries. Ending and remedying this pattern of discrimination will improve recruitment, retention, morale, and productivity of the federal workforce. An effective federal workforce in these unique areas is vital to the interests of the United States.

A. Retirement Annuities

Sally (not her real name) devoted her career to the federal civil service, working in Honolulu, Hawaii. She retired in 2009. Her average salary during her three highest earning years – the primary factor determining the amount of her retirement annuity – was calculated by the Office of Personnel Management from her total earnings history. The amount calculated by OPM (which OPM called the "Actual High-3 Salary") was $58,884. This amount was based on General Schedule pay only. Under rules established by OPM for calculating average salary, Sally's pay did not include the cost-of-living allowance, or COLA, that she had received as a regular part of every paycheck throughout her career for the extremely high costs of living in

[1] The territories with significant populations are Puerto Rico, U.S. Virgin Islands, Guam, Northern Mariana Islands, and American Samoa.

Hawaii. During Sally's high-3 years, her COLA was an additional 25.0% of her GS pay. This COLA rate, also calculated by OPM, was the percentage by which living costs in Hawaii were (and still are) higher than living costs in the Washington DC area. Nor did Sally's earnings history include locality pay, which employees in Washington DC and throughout the contiguous United States have received since 1994 and which OPM counts in calculating their average salaries for retirement purposes. Locality pay was not authorized for Hawaii or any other non-foreign area until 2010. During Sally's high-3 years, the average locality pay rate for Washington DC was 19.9%.

Thus, Sally's gross annuity was based on her GS pay only, and was calculated by OPM as $2,690 per month, beginning in August of 2009. If Sally had been working in Washington DC during her high-3 years, performing exactly the same work, she would have received locality pay instead of COLA, and her original annuity would have been 19.9% higher, or $3,225 per month. An annuity of that amount would have helped Sally manage the costs of living in Hawaii, which are higher than in the Washington DC area (as they are in every non-foreign area[2]). However, Sally worked in a non-foreign area and received COLA instead of locality pay, and so her annuity was only $2,690. Under OPM's rules, not only is this amount lower than that of Sally's contemporaries who retired in Washington DC, but it is also lower than that of any other federal employee who retired in 2009 at Sally's pay grade in any part of the contiguous United States, including the Rest of US locality pay area where costs of living are the lowest of all.

As noted above, living costs in every non-foreign area are higher than in the Washington DC area. How can this fact be taken into account in calculating annuities? The answer is to include COLA in the retirement base, as Congress always intended.[3] If, in calculating Sally's high-3 average salary, OPM had counted the 25% COLA Sally had received during her high-3 years to equalize her salary with the salaries of her counterparts in Washington DC, Sally's annuity would have been not just 19.9% higher, but at least 25.0% higher. In fact, under any reasonable rule, it would have been around 38.5% higher. Long ago, for the convenience of the

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[2] The last COLA rates set by OPM – before the 2009 Act stopped the agency's annual surveys of living cost differentials between the Washington DC area and each of the non-foreign areas – were as follows: Anchorage, Fairbanks, and Juneau, 23%; other Alaska, 25%; Honolulu, Kauai, and Maui, 25%; County of Hawaii, 18%; Puerto Rico, 14%; U.S. Virgin Islands, Guam, and Northern Mariana Islands, 25%. The living cost differentials indicated by these surveys have remained relatively stable through decade after decade of increasingly refined measurements. The differentials are economic facts, and they will remain as facts of life in non-foreign areas for the foreseeable future.

[3] Historical analysis, confirming that Congress has always intended COLA to be counted in the calculation of annuities, is available from the author upon request. This analysis has never been performed by OPM, or at least it has never been made public. Statements by responsible agencies and officials with respect to the rights of non-foreign area employees under the seminal 1948 statutes have been insufficient and misleading, to say the least.

government, the Internal Revenue Service decided to treat non-foreign COLA as tax-exempt. (Without the tax exemption, COLA rates would have to be higher to achieve the same effect, and rates would more often be limited by the 25% statutory cap.) This means that COLA is an especially valuable component of regular pay, and excluding COLA from total pay in calculating the high-3 average is especially harmful.[4] In Sally's case, her COLA rate was equivalent to a locality pay rate of around 38.5%, based on the 0.65 conversion factor utilized in the 2009 Act. Increasing Sally's high-3 average salary by 38.5% would have resulted in a gross annuity of $3,726 per month, not $2,690. The additional amount would allow Sally to afford more of the very high costs of continuing to live in her home state of Hawaii following retirement. The same is true for retirees in Alaska and the territories, where COLA rates differ but living costs are always higher (even as measured by OPM) than in the Washington DC area.

There was no help for Sally in the Non-Foreign AREA Act of 2009, which applies only to post-2009 employees and retirees. Although post-2009 retirees in non-foreign areas have received locality pay that is included as part of their Actual High-3 Salary, such amounts are insufficient for parity during retirement with their counterparts in the contiguous United States. For employees in those remote areas, COLA remains as another essential component of their salaries that OPM continues to exclude, wrongly, from the retirement base. To provide equal pay and benefits for equal work, a combination of locality pay and COLA (or an equivalent supplement) must be included in salaries and in the retirement base. The retirement benefits of post-2009 retirees are still too low to meet the standard of equal pay for equal work. The discrimination against non-foreign area retirees who retired before 2010, like Sally, is simply more extreme. All federal employees take a step down in regular

[4] To suggest (as OPM sometimes does) that COLA should be excluded from the retirement base because it is tax-exempt is, of course, a *non sequitur*. There is no connection between whether a pay component is included in taxable income and whether it is included in the base for calculating retirement annuities. Different policies underlie the two systems. For example, a "post differential" (paid to employees on temporary assignment in American Samoa, Guam, and other small Pacific islands) is excluded from the retirement base even though such payments are taxable as income. It is excluded because, by definition, employees receiving a post differential will not remain in those posts after retirement. If COLA – which is paid to permanent residents of non-foreign areas who intend to remain there after retirement – is excluded because it is <u>not</u> taxable, the Government would be saying, in effect: "Heads we win, tails you lose." Historical analysis confirms the conclusion that COLA's tax exempt status has nothing to do with whether it is included in the retirement base. In 1948, the Civil Service Commission, without notice or explanation, issued a regulation excluding COLA from the base for calculating retirement deductions. See 5 C.F.R. § 350.6 (1949 Edition). On this basis, the agency adopted the practice of excluding COLA from the base for calculating retirement annuities. In the same 1948 regulation, the agency stated its view – incorrectly as it turned out – that COLA is taxable. In 1953, the Internal Revenue Service decided authoritatively that COLA is tax exempt. *See*: Rev. Rul. 237, 1953-2 C.B. 52. Obviously, the tax exemption cannot be a justification for excluding COLA from the retirement base, because the unlawful exclusion began at a time when the agency incorrectly believed that COLA was taxable.

income upon retirement. In non-foreign areas, federal employees retiring before 2010 were required by OPM to jump off a cliff.

It is shocking, but true, that Sally and other pre-2010 retirees in non-foreign areas are living the last years of their lives with far lower annuities than are being paid to comparable federal retirees anywhere in the 48 contiguous states and the District of Columbia. Even in states where living costs are the lowest in the nation – *i.e.* states included in the RUS locality pay area – pre-2010 retirees receive larger annuities (and larger Thrift Savings Plan benefits) than comparable retirees in non-foreign areas, where living costs are the highest in the nation. This is the upside-down result of administrative practices that have always been contrary to the intention of Congress.

There is no doubt that OPM's rules and practices have the ongoing effect of lowering Sally's standard of living during retirement, compared to the standard provided to all other retired employees who performed comparable work anywhere in the contiguous United States. The same discrimination impacts every retiree in Hawaii, Alaska, and the territories. Non-foreign area employees remain the only class of federal employees in the United States whose regular salaries are discounted – not fully included – in the calculation of "average pay" for purposes of retirement annuities and other benefits.[5]

B. Regular Salaries

To make matters worse, Sally's salary during the 1990's and 2000's was allowed (by default of OPM) to fall behind the salaries of her counterparts at the same pay grade in the contiguous United States, even though living costs in Hawaii were rising just as fast or faster. For example, in 2009, the year Sally retired, her monthly salary increased by 2.9%, as did the salaries of all other non-foreign area employees, due to an increase of 2.9% in GS rates. However, the salaries of employees in the contiguous United States increased by 3.9%, due to a separate increase of 1.0 points in average rates of locality pay, which non-foreign area employees did not receive. They did not begin receiving locality pay until 2010.

A similar disparity between the amount of Sally's annual raise and the amount received by her grade level counterparts in the contiguous United States occurred in every previous year of Sally's career going back to the inception of the locality pay

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[5] No policy justification has ever been offered for the exclusion of COLA from the retirement base, and of course there is no justification. Likewise, no evidence of Congressional intent to exclude COLA from the retirement base has ever been presented, again because there is no such evidence. All of the historical evidence (beyond the scope of this report) points inescapably to the conclusion that Congress and the President have always intended the "additional compensation" paid to federal employees in non-foreign areas (as it was called in the seminal 1948 act, or the "salary differential" as it was called in the accompanying committee report) to be included in the retirement base.

program in 1994. (These years included, of course, the high-3 used to calculate the amount of Sally's retirement annuity.) During this period, although salaries in non-foreign areas were lagging farther and farther behind salaries in the 48 contiguous states and the District of Columbia, OPM did not establish special rates under 5 U.S.C. § 5305 or otherwise act to reduce pay inequality.

The same discrimination is continuing today, and the equal pay gap is still widening with each increase in locality pay. This is because, even after the locality pay program was extended to non-foreign areas beginning in 2010, locality pay raises in non-foreign areas are being cancelled out by commensurate decreases in COLA.

Ramona (not her real name) was a federal career employee in San Juan, Puerto Rico, who retired at the end of 2016. Her bi-weekly paycheck always included COLA pay for 80 hours. For the last pay period of 2009, immediately before the 2009 Act took effect, Ramona's paycheck included $372.00 of COLA. For the first pay period of 2010, her COLA was reduced to $294.40 in accordance with the formula specified in the Act. One year later, for the first pay period of 2011, it was again reduced to $212.00. The next year, for the first pay period of 2012, it was reduced a third time to $132.80. These reductions corresponded with the amounts of locality pay added to her paychecks in three annual steps, as locality pay was phased into the composition of non-foreign area pay. On her pay stubs, the reductions in COLA cancelled out the net (after tax) amounts of locality pay. The effect of the Act, instead of protecting Ramona's take home pay as the sponsors had promised, was to begin actually docking her paychecks by the exact amounts needed to offset locality pay as it was being added or increased. The effect, in other words, was to continue widening the equal pay gap that had started accumulating in 1994.[6]

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[6] From 1948, when Congress standardized what it called the "salary differential" being paid to federal employees in the territories and possessions of the United States, until 1994, when locality pay took effect in the contiguous United States, the salary differential (now called COLA) served to maintain a fair equivalence between the purchasing power of federal salaries in non-foreign areas – where living costs were (and still are) different in kind and higher in degree than anywhere else in the nation – and the purchasing power of federal salaries in the contiguous United States. In 1994, when locality pay was implemented in the contiguous United States, employees there received a 3.95% pay raise while employees in non-foreign areas received no raise at all, because the first locality pay rates averaged 3.95% and Congress decided not to increase General Schedule rates. This first "equal pay gap" of 3.95 percent was equivalent to 10.3 days of unpaid work, based on a 40-hour work week. The equal pay gap widened to 4.55 percent the following year, when employees in the contiguous U.S. received a 2.00% increase in GS pay together with an average increase of 0.6 points in locality pay rates, while employees in non-foreign areas received only the GS increase. Therefore, non-foreign area employees worked 11.8 days without pay in 1995. And so on down to the present day. By 2018, the equal pay gap had widened to 18.95 percent, and non-foreign employees worked 49.3 days during 2018 without pay, not counting their additional work during the government shutdown. Now, in 2019, the gap has increased again, to an astounding 19.45 percent. In other words, the standard of living afforded by federal salaries is now 19.45% higher in the contiguous United States than in non-foreign areas, compared to the parity which had existed for decades prior to 1994. Rising costs of living, which have been covered by locality pay increases in the contiguous U.S., have cut deeper and deeper into the living standards of federal employees in non-foreign areas.

Thus, the 2010 general pay raise of 1.5%, including an increase in average locality pay rates of 0.5 points, was reduced in Ramona's take home pay to 1.0 %. Stated another way, the dollar amount of the 2010 pay raise was 33% larger for employees in the contiguous United States than for Ramona and every other non-foreign area employee. The next increase in locality pay rates occurred in 2016, with the same discriminatory result in non-foreign areas. The 2016 general pay raise of 1.3% consisted of a 1.0% increase in GS pay and an increase of 0.3 points in average locality pay rates. The locality pay increase in non-foreign areas was cancelled out by an equivalent reduction in COLA, so that the pay increase in 2016 was 30% larger for employees in the contiguous United States than for comparable employees in non-foreign areas. In Ramona's case, her last pay period in 2015 included $139.20 of COLA, but her first pay period in 2016 included only $136.80 of COLA despite an increase in the base on which COLA is calculated.

After Ramona retired at the end of 2016, the equal pay gap has continued to widen. The 2017 general pay raise of 2.1% was reduced (by more than half) to 1.0% in non-foreign areas; the 2018 pay raise of 1.9% was reduced to 1.4%; and the 2019 pay raise of another 1.9% is (again) being reduced to 1.4%. These annual reductions have accumulated, each adding to the one before. Perhaps this is why Ramona, like many other highly skilled employees in non-foreign areas, decided to retire at the end of 2016.

Another factor in Ramona's decision may have been the particular unfairness of the 2016 raise. Locality pay rates have been raised five times after the 2009 Act – for calendar years 2010, 2016, 2017, 2018, and 2019 – along with concurrent raises in GS or other scheduled pay. In all five years, the percentage and dollar amounts of the overall raise for employees in the 48 contiguous states and the District of Columbia greatly exceeded the percentage and dollar amounts of the raise for employees of the same pay grade in non-foreign areas. However, in some of those years, subsets of federal employees in the contiguous United States received raises that were very much larger than the raises of anyone else, as a result of decisions by the President's Pay Agent to create new locality pay areas. (In fact, the number of locality pay areas increased from 34 in 2010 to 53 in 2019.) The most notable example is the general pay raise for 2016. In a notice published by OPM in the Federal Register on June 1, 2015, the administration announced its intention to provide an extraordinary pay raise for an estimated 102,000 federal employees by creating 13 new locality pay areas where living costs were becoming higher than in adjacent areas. The agency explained that this change would have no effect on overall federal salary costs because it would result in "relatively lower pay increases for employees in existing locality pay areas than they would otherwise receive." Thus, in 2016, employees in non-foreign areas (approximately 50,000 in number) not only had their paychecks docked by the entire amount of their locality pay increase, despite rising living costs, but they were forced to stand on the sidelines while the administration

awarded extraordinarily high pay raises to their counterparts in 13 new areas who were just beginning to experience the discomfort of uncompensated higher living costs. Non-foreign area employees have been experiencing such costs since 1994, not merely with discomfort but with real pain. No extraordinary pay raise has ever been proposed for them. In 2016 the equal pay gap between non-foreign areas and the contiguous United States had accumulated to 17.35%. In 2019 it stands at 19.45%. These gaps represent more than uncompensated living costs. They represent a steady decline in the standard of living afforded by federal salaries in non-foreign areas, compared with the standard of living afforded by federal salaries in all other parts of the United States.

As many members of Congress have pointed out, locality pay is designed for the contiguous United States and does not reflect what Congress has called "the unusual and unique circumstances" of non-foreign areas. To provide equal pay and benefits for equal work, a combination of locality pay and COLA (or an equivalent supplement) is required. Otherwise, the equal pay gap will eventually stop growing and become simply a large and static discount in the pay of federal employees in non-foreign areas. Such a discount is unacceptable as a matter of federal pay policy, and it may be found unacceptable as a matter of constitutional law as well.

Conclusion

The Non-Foreign AREA Act of 2009 has not had the effect that Congress intended. The Act changed the composition of federal salaries in non-foreign areas beginning January 1, 2010, but it failed to protect take home pay. The salary lag has continued, and the equal pay gap has widened. Moreover, although the name of the 2009 Act is derived from the phrase "Retirement Equity Assurance," discrimination in retirement benefits still persists, most extremely against the oldest (pre-2010) retirees.

This pattern of discrimination, never intended by Congress, is the result of administrative practices maintained by the Office of Personnel Management. Ending and remedying this discrimination in both of its platforms – salaries and annuities – will improve recruitment, retention, morale, and productivity of the federal workforce in non-foreign areas. In these areas, virtually all citizens are directly and adversely affected by federal pay discrimination, which handicaps agencies as they try to carry out the missions authorized and funded by Congress. Removing this handicap will be of great benefit not only to employees and agencies, but also to citizens in these areas who depend on the services that federal agencies provide. It is important to remember, also, that these unique areas are on the front lines of our nation's defenses against foreign threats of all kinds. An effective federal workforce in non-foreign areas is vital to national security and other interests of the United States.

The changes needed to end pay discrimination against federal employees in non-foreign areas can be implemented without increasing the overall cost of federal salaries.[7] They will simply require the cost to be allocated in a non-discriminatory manner. Agencies must include COLA in the retirement base, as Congress always intended. Special rates and other tools should be utilized to end the salary lag described above. The President will take these changes, and the costs of restitution, into account in determining the amounts of annual raises pursuant to 5 U.S.C. §§ 5303(b) and 5304a and in other decisions affecting personnel costs.

It is time to end, once and for all, federal pay discrimination in non-foreign areas. Legislation has been proposed that will provide a framework for negotiating a final settlement of these longstanding inequities. Within this framework there is a great deal of flexibility, and the Government can ensure that the settlement will be consistent with any subsequent nation-wide federal pay reform. The legislation will do no more, and no less, than create a level playing field going forward. Otherwise, legal experts believe, the 2009 Act will not survive the constitutional challenge which is sure to come.

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[7] The exchange of COLA for locality pay pursuant to the Non-Foreign AREA Act of 2009 has been essentially cost-free to the government. Most of the costs projected by the Congressional Budget Office have not occurred. In its July 29, 2008, report, the CBO stated: "The conversion to locality pay for approximately 38,000 eligible federal employees [not counting employees of the U.S. Postal Service] would increase salaries by $1.5 billion over the next 10 years." However, this money was never spent, as the example of Ramona makes clear. The Act changed the composition of federal salaries in non-foreign areas beginning January 1, 2010, by adding locality pay (previously denied to employees in non-foreign areas) to the salary mix and subtracting an equivalent amount of COLA. The cost of locality pay is completely offset by reductions in COLA payments and taxes on locality pay. In fact, the effect of the Act has been to reduce salary costs by withholding substantial parts of general pay raises from employees in non-foreign areas. The only real "cost" of the Act – a slight increase in retirement benefits for post-2009 retirees, attributable to the pre-existing rule including locality pay in the retirement base – is not enough to meet minimum standards of fairness, and it is offset by the "savings" resulting from lower annual raises for the entire non-foreign area workforce, a disparity which is accumulating year after year without any end in sight. In this way, the small gains in retirement benefits realized by older employees who have retired after 2009 are coming out of the pockets of their job successors and all other employees in non-foreign areas.