

UNITED STATES OFFICE OF PERSONNEL MANAGEMENT

Nonforeign Area Cost of Living Allowance Report to Congress



**Effect of Locality Pay Adjustments on Salaries and Retirement Benefits
Nonforeign Areas Compared to Contiguous U.S.**

Executive Summary

Section 4 of the Consolidated Appropriations Act of 2020 (Public Law 116-93) and the associated explanatory statement for Division C of the Act and House Report 116-122 directed OPM to submit a report to Congress as follows:

The Committee is interested in a comparison of salary and retirement benefits of Federal employees and retirees living in the states of Alaska and Hawaii and the territories of Puerto Rico, U.S. Virgin Islands, Guam, the Northern Mariana Islands, and American Samoa, with those in the contiguous 48 states and the District of Columbia. Within 120 days of enactment of this Act, OPM is directed to issue a report analyzing the calculation of locality pay (5 USC 5304) in salary and benefit adjustments for employees living in nonforeign areas (5 CFR 591.205). The report must also assess how the calculations compare with those of Federal employees living in the rest of the United States to determine if there are any inequities in such calculations. In addition, the report should include information, where possible, on the differential in pay received by retirees in these locations who did not receive consideration of full locality pay amounts in their high-3 earnings on which annuities are calculated and of survivor annuitants of such Federal employees. The Committee further directs OPM to include policy recommendations for Congress to consider in the report.

Since 1948, Federal employees working in nonforeign areas outside of the contiguous United States (CONUS) have received cost-of-living allowances (COLAs) under 5 U.S.C. § 5941 to compensate for living costs substantially exceeding those in the District of Columbia. While not subject to Federal income tax, such COLA payments are not defined as retirement-creditable “basic pay” under 5 U.S.C. 8331(3) and 8331(4) and therefore cannot be included in the calculation of retirement annuities. Prior to enactment of the Nonforeign Area Retirement Equity Assurance Act of 2009 (NAREAA), employees in nonforeign areas were ineligible for locality payments, which are retirement creditable (unlike nonforeign area COLA payments). NAREAA provided for the gradual transitioning of nonforeign area COLAs to retirement-creditable locality-based pay comparability payments under 5 U.S.C. 5304 while preserving employee take-home pay.

Following the enactment of NAREAA, covered employees in the nonforeign areas began receiving retirement-creditable locality payments. Under the provisions of NAREAA, payable COLA rates are reduced as specified in section 1912(b), and depending on the level of locality payments and the rate at which such payments are increased over time, covered employees in nonforeign areas may receive both locality pay and residual COLA payments for a number of years. (See Attachment 1.) Currently, in addition to receiving retirement-creditable locality pay, covered employees in the nonforeign areas continue to receive residual COLAs that are not subject to Federal income tax.

This report analyzes the calculation of locality pay in salary and benefit adjustments for Federal employees working in nonforeign areas and assesses how those calculations compare to those for Federal employees working in portions of the “Rest of U.S.” locality pay area within the CONUS. We include information on the differential in retirement benefits for nonforeign area retirees and survivor annuitants who did not receive consideration of full locality pay amounts in the “high-3” earnings on which their annuities are calculated. Finally, as the Committee directed, we present policy options for Congress to consider.

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Introduction

Report Requirement

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The Committee is interested in a comparison of salary and retirement benefits of Federal employees and retirees living in the states of Alaska and Hawaii and the territories of Puerto Rico, U.S. Virgin Islands, Guam, the Northern Mariana Islands, and American Samoa, with those in the contiguous 48 states and the District of Columbia. Within 120 days of enactment of this Act, OPM is directed to issue a report analyzing the calculation of locality pay (5 USC 5304) in salary and benefit adjustments for employees living in nonforeign areas (5 CFR 591.205). The report must also assess how the calculations compare with those of Federal employees living in the rest of the United States to determine if there are any inequities in such calculations. In addition, the report should include information, where possible, on the differential in pay received by retirees in these locations who did not receive consideration of full locality pay amounts in their high-3 earnings on which annuities are calculated and of survivor annuitants of such Federal employees. The Committee further directs OPM to include policy recommendations for Congress to consider in the report.

Scope of Report

This report provides a brief history of the cost-of-living allowances paid to Federal employees working outside the CONUS. Also included is information about the locality-based comparability payments authorized for Federal employees working in the CONUS beginning in 1994 and extended in 2010 to employees working in nonforeign areas. Finally, we present policy options for the Committee to consider.

Structure of Report

Part I – Background Information

- The Nonforeign Area Cost-of-Living Allowance Program
- Locality Pay Adjustments under the Federal Employees Pay Comparability Act
- The Nonforeign Area Retirement Equity Assurance Act
- Nonforeign Area Retirees

Part II – Salary Comparisons

Part III – Summary of FERS and CSRS Retirement Benefits

Part IV– Retirement Benefit Comparisons

Part V – Conclusion/Policy Options

Attachment 1 – Estimated Number of Years to Phase out COLA

Attachment 2 – Impact Since 2009 of NAREAA Implementation

Part I - Background Information

The Nonforeign Area Cost-of-Living Allowance Program

In addition to a scheduled annual rate of pay, General Schedule (GS) Federal employees receive supplemental pay or allowances in amounts that depend on the geographic locations in which they work. Federal employees in Hawaii, Alaska, Puerto Rico, the U.S. Virgin Islands, Guam and the Northern Mariana Islands receive cost-of-living allowances (nonforeign COLAs) to supplement their basic pay. See 5 U.S.C. § 5941.

In 1948, President Truman first established a program to provide nonforeign COLAs to Federal employees in Hawaii, Alaska, and certain Federal territories outside the CONUS.¹ In 1966, Congress codified the nonforeign COLA statutory authority in 5 U.S.C. § 5941 as part of the positive law codification of title 5.² Section 5941, which remains in effect, provides that appropriations or funds available to an Executive agency are available for allowances based on living costs for employees who are stationed outside the CONUS or in Alaska and whose rates of basic pay are fixed by statute. Under 5 U.S.C. § 5941(a), the amount of the COLA is based on differences between living costs in the nonforeign area and living costs in the Washington, D.C., area.

In 1948, OPM's predecessor, the Civil Service Commission, first promulgated regulations that reflect the statutory exclusion of COLAs from "basic pay" for purposes of determining retirement benefits.³ In 2002, OPM issued a final rule that again provided that COLAs are not "basic pay" for Federal retirement purposes. The 2002 Rule remains in effect, and it states:

Agencies may not include a COLA or post differential as part of an employee's rate of basic pay for the purpose of computing entitlements to overtime pay, retirement, life insurance, or any other additional pay, COLA, or post differential under title 5, United States Code.

In the 2002 rulemaking, in response to comments regarding the exclusion of COLAs from basic pay, OPM noted that it was aware that COLAs are not included in Federal retirement calculations. OPM explained that under 5 U.S.C. 8331(3) and 8401(4), allowances are excluded from base pay for Federal retirement purposes, and thus it would take changes in the law to include COLAs in base pay. Accordingly, OPM concluded that comments regarding the exclusion of COLAs from basic pay were outside of the scope of the regulations.⁴

COLA benefits are not included in the calculation of an employee's retirement annuity, which is based on the employee's age at retirement, number of years of service, and highest 3-year average rate of basic pay (known as the employee's "high-3")⁵. Congress defined the term "basic pay" as expressly excluding "bonuses, allowances, overtime pay, military pay, pay given in addition to the base pay of the position as fixed by law or regulation except as provided by subparagraphs (B)

¹ See Exec. Order No. 10000, 13 Fed. Reg. 5453, 5455 (Sept. 18, 1948). President Truman acted under a statutory authority (Act of April 20, 1948, ch. 219, §207, 62 Stat. 194; as amended by Act of June 30, 1948, ch. 775, §104, 62 Stat. 1205).

² See Pub. L. 89-554, 80 Stat. 512, 513 (1966).

³ See 13 Fed. Reg. 8725, 8727 § 350.6(f) (Dec. 30, 1948).

⁴ 67 Fed. Reg. 22,339, 22,340 (May 3, 2002)

⁵ See 5 U.S.C. § 8331(4) (Civil Service Retirement System (CSRS)); id. § 8415 (Federal Employees' Retirement System (FERS)).

through (I) of this paragraph.”⁶ While COLA payments are not considered part of an employee’s “basic pay,” they provide an advantage not accorded basic pay in that they are exempt from Federal income tax. See 26 U.S.C. § 912(2) (exclusion from income tax).

Prior to 2009, OPM conducted price surveys that compared cost-of-living rates between designated nonforeign areas and the Washington, D.C., area to determine the nonforeign COLA amounts. To conduct the price surveys, OPM collected information on the prices of more than 300 items in each of the 11 nonforeign COLA areas and used that data to create a nonforeign COLA price index. A nonforeign COLA was established if living costs in the nonforeign area were substantially higher than living costs in the Washington, D.C., area. Once established, the nonforeign COLA was multiplied by the employee’s gross basic pay rate to determine gross take-home pay. By law, the total COLA could not exceed 25 percent of basic pay and could rise or fall. Historically, the amount of the nonforeign COLA ranged from 10 to 25 percent.

Many factors other than price differences can affect the cost of living in a geographic area. Because of the many possible methods of comparing living costs, the nonforeign COLA program was long the subject of litigation. In the early 1990s, attorneys representing employees in the nonforeign COLA litigation developed a proposal, known as the Safe Harbor Process, to resolve the controversies regarding the nonforeign COLA. The resulting settlement agreement provided for employee involvement with OPM in conducting and implementing future nonforeign COLA surveys. The settlement also improved the methodology used to determine the nonforeign COLA rates, such as the weighting of prices, sources of data, collection of prices and the method of measuring housing costs. The settlement provided for an award of back pay and interest in the amount of \$234 million.⁷

In 2009, Congress enacted the Nonforeign Area Retirement Equity Assurance Act of 2009 (NAREAA), which began a transition from the nonforeign COLA program to locality-based comparability payments under 5 U.S.C. § 5304 (locality pay). By specific provision of law, locality pay is part of “basic pay” for purposes of calculating retirement annuities.⁸ Unlike nonforeign COLAs, locality pay is subject to Federal income taxes. As part of the transition, Federal employees in nonforeign areas who retired between 2010-2012 could treat COLAs received during that period as basic pay for calculating their annuity (up to a certain limit), provided that they also made required contributions to the Civil Service Retirement and Disability Fund.⁹ Employees retiring after 2012 can include the locality pay authorized in the NAREAA in their retirement-creditable basic pay but cannot include any past COLA amounts. Congress declined to make any retroactive adjustment to the annuities of existing retirees.¹⁰

⁶ 5 U.S.C. §§ 8331(3), 8401(4)

⁷ See *Caraballo v. United States*, No. 1997-0027 (D.V.I.)

⁸ Pub. L. No. 111-84, title XIX, subtitle B, §§ 1911-1919, 123 Stat. 2190, 2203-04 (2009); see 5 U.S.C. § 5304(c)(2)(A)

⁹ NAREAA, § 1917(c), (d)(1).

¹⁰ See *id.* at §§ 1911-1919.

Locality Pay Adjustments under the Federal Employees Pay Comparability Act

On November 5, 1990, Congress enacted the Federal Employees Pay Comparability Act of 1990 (FEPCA) (Public Law 101-509) to address the need for pay reform in the Executive branch.

Beginning in the late 1970s, a significant gap between Federal and private sector pay for comparable jobs developed and continued to widen each year. The uniform GS pay system relied on a national average pay, which failed to reflect the rates paid in different localities. As a result, Federal civil service salaries lagged behind those in the private sector, making it difficult for Federal agencies to recruit and retain qualified employees. FEPCA replaced the nationwide annual pay adjustment for GS employees with a method that uses a combination of across-the-board increases based on the Employment Cost Index (ECI) and locality pay adjustments.¹¹ The pay changes authorized by FEPCA went into effect beginning in January 1994.

The salary adjustments under FEPCA consist of two components: (1) a general increase linked to the ECI; and (2) a GS locality adjustment that applies only to specific areas of the United States where non-Federal pay exceeds Federal pay by more than 5 percent. The locality component of the pay adjustment under FEPCA was to be phased in over a 9-year period. However, the schedule for locality pay adjustments under FEPCA has not been followed.

Unlike the nonforeign COLA, locality pay authorized under FEPCA is subject to Federal income and Social Security/Medicare taxes and is considered part of an employee's basic pay for retirement purposes. Locality pay also is part of basic pay for the purposes of determining employee and matching agency contributions to the Thrift Savings Plan (TSP).

FEPCA specifically excluded Federal employees working in nonforeign areas from receiving locality pay.¹² These employees continued to receive the nonforeign COLA, which continued to be exempted from Federal income taxes. Thus, a comparison of the treatment of employees in nonforeign areas relative to the treatment of CONUS employees showed that, on one hand, employees in nonforeign areas had an advantage in that their supplemental pay in the form of COLA was tax-free; however, on the other hand, they did not have access to locality pay that would increase their retirement benefits.

In 2020, there are 53 locality pay areas as defined in 5 CFR 531.603(b). The locations comprising each locality pay area are listed on the OPM website at <https://www.opm.gov/policy-data-oversight/pay-leave/salaries-wages/2020/locality-pay-area-definitions/>.

¹¹ The ECI measures changes in private-sector wages and salaries.

¹² 5 U.S.C. §5304(f)(1)(A), prior to amendment by §1912(a)(1) of Pub. L. 111-84.

The Nonforeign Area Retirement Equity Assurance Act (NAREAA)

NAREAA was enacted on October 28, 2009, to address the retirement inequities affecting employees in nonforeign areas compared to employees in the CONUS. NAREAA transitioned recipients from nonforeign COLAs to locality pay in nonforeign areas, thus permitting the use of base salary plus locality pay in the calculation of retirement benefits for those individuals.

Under NAREAA's provisions, locality pay was phased in over a 3-year period beginning in January 2010. In 2010, the locality rate for all nonforeign areas receiving the COLA was one-third of the locality rate applicable in the Rest of the United States (RUS) locality pay area. Beginning in January 2011, OPM issued locality pay tables applicable to all nonforeign areas at the same time locality pay tables for the CONUS were issued. For January 2011, the locality rate for each nonforeign geographic area was set at two-thirds of the full applicable locality rate, and in January 2012, the full applicable locality rate was used. The payments were phased in because locality pay is part of basic pay, meaning that agency payroll costs increased due to higher retirement contributions, Social Security and Medicare payments, and matching Thrift Savings Plan contributions. The 3-year phase-in was designed to spread the impact over several years and give agencies time to absorb and budget the increased costs.

The nonforeign COLA rates payable prior to enactment of NAREAA were frozen as of the date of the enactment of the NAREAA, October 2009. As locality pay percentages increased, nonforeign COLA rates were adjusted each year using a methodology prescribed in law.¹³ This adjustment protected employee take-home pay, since the COLA is not taxable income and locality payments are subject to Federal taxes and retirement deductions. Locality pay will have to increase significantly before the nonforeign COLA is completely eliminated; this is illustrated in Attachment 1.

NAREAA also contained a provision that permitted Federal employees who retired during the 3-year phase-in period the opportunity to elect to have a portion of their nonforeign COLA treated as locality pay for retirement calculation purposes. To exercise this option, the Federal employee was required to deposit the retirement deduction amounts that would have been withheld had they received the full locality pay rate, plus interest. If the employee made the deposit and retired by December 31, 2012, salary rates based on the unreduced locality pay rate were used to compute the high-3 average salary under FERS or CSRS.

Nonforeign Area Retirees

Since enactment and implementation of NAREAA, several groups have expressed concern over the exclusion of retired Federal employees from the benefit of including locality pay in the calculation of retirement benefits. Critics argue that the retirement inequity began in 1994, with the enactment of the locality pay provisions under FEPCA and the exclusion of nonforeign areas from locality-based pay increases. Nonforeign Federal employees who remained in service through 2009 and the enactment of NAREAA received the benefit of having a portion of their nonforeign COLA treated as locality pay for retirement calculation purposes following the payment of a deposit. However, those who separated for retirement before 2009 continue to receive retirement benefits calculated without the benefit of locality pay.

¹³ See 5 U.S.C. 5941(c)(2), as amended by section 1912(b)(3).

Part II – Salary Comparisons

Pay Comparisons between the Nonforeign Areas and the CONUS

As explained previously, locality payments are retirement-creditable and subject to Federal tax, while COLA payments are not. Therefore, prior to implementation of NAREAA the amount of retirement-creditable, Federally taxable pay for GS employees in nonforeign areas was lower than that for employees in the CONUS to the extent that locality payments in the CONUS exceeded base GS pay rates. For example, prior to implementation of NAREAA, an employee in Honolulu received a 25-percent COLA payment, none of which was retirement-creditable or subject to Federal tax. In contrast, a CONUS employee receiving Washington-Baltimore locality pay received no such “tax-free” allowance but did receive a 23.10-percent locality payment in 2009, all of which was retirement-creditable and subject to Federal tax.

Because locality payments are subject to Federal tax while COLA payments are not, NAREAA took into consideration that dollar-for-dollar replacement of COLA payments with locality payments could result in a loss of take-home pay for affected employees. With that in mind, Congress included a methodology in NAREAA intended to prevent losses in take-home pay for affected employees. Under that methodology, for each dollar by which locality pay is increased the applicable COLA payment is reduced by approximately 65 cents.¹⁴ As a result, an employee in Honolulu who was receiving the 25-percent COLA in 2009 could expect to continue receiving some residual COLA until the applicable locality rate increased to 25 percent divided by 65 percent, which is 38.46 percent. (See Attachment 1, which shows that replacing COLA payments with locality payments under NAREAA could take many years in some nonforeign areas.) The two tables provide examples of NAREAA implementation since 2009.

Results of NAREAA Implementation in Honolulu/Kauai/Maui/Kalawao, HI Since 2009					
Year	Locality Pay Percentage (Applied to Base GS Rates)	COLA (Applied to Base GS Rate Plus Locality Pay)	Locality Pay Plus COLA (Total Amount Paid above Base GS Rates) †	Pay above Base GS that is Retirement-Creditable (Same as Locality Pay Percentage)	Amount above Base GS that is Not Federally Taxable
2009	0.00%	25.00%	25.00%	0.00%	25.00%
2010	4.72%	20.94%	26.65%	4.72%	21.93%
2011	11.01%	16.07%	28.85%	11.01%	17.84%
2012	16.51%	12.25%	30.78%	16.51%	14.27%
2013	16.51%	12.25%	30.78%	16.51%	14.27%
2014	16.51%	12.25%	30.78%	16.51%	14.27%
2015	16.51%	12.25%	30.78%	16.51%	14.27%
2016	16.81%	12.05%	30.89%	16.81%	14.08%
2017	17.92%	11.32%	31.27%	17.92%	13.35%
2018	18.43%	10.99%	31.45%	18.43%	13.02%
2019	18.98%	10.64%	31.64%	18.98%	12.66%
2020	19.56%	10.28%	31.85%	19.56%	12.29%

† Note: Because NAREAA provides that COLA is paid on top of locality pay, (1) the value of locality pay plus COLA is equal to [(1 + Locality Pay Percentage) * (1 + COLA Percentage)] - 1, and (2) the amount above base GS rates that is not Federally taxable is higher than the COLA rate for all years locality pay is in effect in the nonforeign areas (i.e., 2010 and after).

¹⁴ More precisely, when a locality pay percentage increases in a nonforeign area, the COLA rate is reduced as follows: First subtract 65 percent of the applicable locality rate from the frozen COLA rate (the COLA rate in effect in 2009), then divide the result by one plus the applicable locality pay percentage and round the result to four decimal places.

Results of NAREAA Implementation in Anchorage/Fairbanks/Juneau, AK Since 2009					
Year	Locality Pay Percentage (Applied to Base GS Rates)	COLA (Applied to Base GS Rate Plus Locality Pay)	Locality Pay Plus COLA (Total Amount Paid above Base GS Rates) †	Pay above Base GS that is Retirement-Creditable (Same as Locality Pay Percentage)	Amount above Base GS that is Not Federally Taxable
2009	0.00%	23.00%	23.00%	0.00%	23.00%
2010	4.72%	19.03%	24.65%	4.72%	19.93%
2011	16.46%	10.56%	28.76%	16.46%	12.30%
2012	24.69%	5.57%	31.64%	24.69%	6.95%
2013	24.69%	5.57%	31.64%	24.69%	6.95%
2014	24.69%	5.57%	31.64%	24.69%	6.95%
2015	24.69%	5.57%	31.64%	24.69%	6.95%
2016	25.16%	5.31%	31.81%	25.16%	6.65%
2017	27.13%	4.22%	32.49%	27.13%	5.36%
2018	28.02%	3.74%	32.81%	28.02%	4.79%
2019	28.89%	3.27%	33.10%	28.89%	4.21%
2020	29.67%	2.86%	33.38%	29.67%	3.71%

† Note: Because NAREAA provides that COLA is paid on top of locality pay, (1) the value of locality pay plus COLA is equal to [(1 + Locality Pay Percentage) * (1 + COLA Percentage)] - 1, and (2) the amount above base GS rates that is not Federally taxable is higher than the COLA rate for all years locality pay is in effect in the nonforeign areas (i.e., 2010 and after).

As the above table “Results of NAREAA Implementation in Honolulu/Kauai/Maui/Kalawao, HI Since 2009” shows, an employee in Honolulu who received a 25-percent COLA payment and no locality pay in 2009 receives a 19.56-percent locality payment in 2020, all of which is retirement-creditable, while still receiving a 10.28-percent COLA allowance that is not Federally taxable. (Because it is applied to base GS pay plus the applicable 19.56-percent locality payment, the 10.28-percent residual COLA is 12.29 percent of the applicable base GS pay rate.) In contrast, CONUS employees who receive locality payments do not receive COLA payments. (Note that amounts still paid in residual COLA vary by location. See Attachment 2, which in addition to the two tables above also contains tables showing the results of NAREAA implementation since 2009 for the other locations in Alaska and Hawaii.¹⁵)

On the question of equity, NAREAA ensures GS employees working in nonforeign areas are covered by the same locality-based pay system as GS employees in the CONUS. Under the Act, the salaries on which retirement benefits are based include locality payments both in nonforeign areas and in the CONUS, and locality payments in nonforeign areas are based on the same salary survey/pay comparison methodology as in the CONUS. While the method by which nonforeign COLA payments are reduced during the transition to locality pay provides a “tax-free” portion of pay not provided for CONUS employees, to the extent residual COLA rates continue to be reduced under the NAREAA formula, that difference in pay will continue to diminish.

¹⁵ The Committee directed OPM to include American Samoa in these pay comparisons. American Samoa does not receive a COLA under 5 U.S.C. 5941; however, NAREAA did extend locality pay to American Samoa, which is now part of the RUS locality pay area and as such receives a 15.95-percent locality payment in 2020.

Retirement Comparisons between the Nonforeign Areas and the CONUS

The Committee expressed interest in a comparison of the retirement benefits of Federal employees and retirees living in the nonforeign areas and American Samoa. Because of the changing rules affecting Federal employees in the nonforeign areas, the calculation of retirement benefits must consider the laws in effect during the relevant time periods.

Since January 2012, employees in the nonforeign areas receive the full applicable locality rate. That is, the locality pay is part of basic pay and is credited for retirement, Social Security, Medicare, and Thrift Savings Plan contributions. Thus, starting in 2012, all Federal employees in the CONUS and nonforeign areas receive retirement benefits based on their full applicable locality rate.

NAREAA provided that Federal employees who retired between 2010-2012 could opt to treat a portion of the COLAs received during that period as basic pay for retirement purposes. Therefore, employees who retired between 2010-2012 can receive a retirement benefit that is like the retirement benefit of CONUS Federal employees in that a portion of the nonforeign COLA was treated as locality pay for retirement purposes.

Federal employees who separated for retirement before 2010 receive retirement benefits calculated without the inclusion of any portion of the nonforeign COLA as Congress declined to make any retroactive adjustment to the annuities of employees who retired before 2010. It is the Federal employees who retired between 1994 and 2009 who receive a retirement benefit that is not based on any locality pay nor any portion of the nonforeign COLA. It is a fact that Federal employees working in nonforeign areas who retired before 2010 would have had higher retirement benefits if they had received retirement-creditable locality pay. Given the unique history of the pay issues surrounding the nonforeign areas, it is difficult to provide equity in retirement benefits to this group of former employees. Also, any retroactive retirement benefits would create significant unfunded liabilities for the retirement fund.

Part III – Summary of FERS and CSRS Retirement Benefits

The Federal Employees' Retirement System (FERS) and the Civil Service Retirement System (CSRS)

FERS and CSRS are the two principal retirement plans for Federal employees. FERS is a three-tiered system consisting of Social Security benefits, basic FERS (a defined benefits plan), and the Thrift Savings Plan (a defined contribution plan). CSRS is a defined benefit plan that pre-dates Social Security and was originally established as a stand-alone staff retirement plan. Beginning in 1984, certain employees subject to CSRS coverage also became covered by Social Security. Coverage under both CSRS and Social Security is referred to as CSRS Offset. Employees covered under either CSRS (without Social Security) or CSRS Offset (with Social Security) may also participate in the TSP.

Both plans provide for immediate, disability, and deferred retirement, as well as survivor benefits. Eligibility is determined by age at separation and the number of years of creditable service. Under FERS, immediate voluntary retirement benefits may be paid as early as the employee's Minimum Retirement Age with 30 years of service. CSRS employees may retire at age 55 with 30 years of service. Under both plans, immediate voluntary retirement is available at age 60 with 20 years of service and age 62 with five years of service.

Under both plans, the high-3 average salary is one of two variables that drive the calculation of annuity benefits, with the other variable being the amount of service. The high-3 average salary is the highest average basic pay earned by the employee during any three consecutive years of service, usually the final three years of service.¹⁶ Basic pay is the basic salary earned and includes increases to salary for which retirement deductions are withheld, such as shift rates and locality pay. It does not include bonuses, allowances, overtime pay, military pay, or pay given in addition to the base pay of the position (such as the nonforeign COLA), except as otherwise expressly provided by law.¹⁷

Under FERS, the basic annuity is generally calculated as one percent of high-3 average salary for each year of service.¹⁸ For CSRS retirees, the basic annuity is calculated using a tiered formula that provides: 1.5 percent of high-3 average salary for the first five years of service, plus 1.75 percent of high-3 average salary for the next 5 years of service, plus 2 percent of high-3 average salary for all additional years of service.¹⁹

Both plans allow the retiree to provide a survivor annuity for a spouse. If elected, the annuity benefit is reduced to provide the survivor benefit. Upon death of the retiree, the unmarried surviving spouse may be paid the survivor benefit during his or her lifetime. The amount paid to a surviving spouse is approximately half the retirement benefit paid to the retiree, however, the retiree and spouse may elect a smaller survivor benefit.

¹⁶ See 5 U.S.C. §§ 8331(4) and 8401 (3).

¹⁷ See 5 U.S.C. §§ 8331(3) and 8401(4).

¹⁸ See 5 U.S.C. § 8412(a).

¹⁹ See 5 U.S.C. § 8339(a).

Part IV– Retirement Benefit Comparisons

The Committee asked OPM to compare retirement benefits for retirees in the nonforeign areas with retirees in the CONUS. As stated above, the relevant comparisons are for the Federal employees who retired between 1994 and 2010. Unfortunately, OPM has no means available to accurately identify the retirees who worked in a nonforeign area before retirement. OPM retains no identifying data within the annuity roll and paper retirement records that would enable us to identify which, among our over 2.5 million living retirees and survivors, earned their high-3 average salary while working in a nonforeign area. Our annuity roll captures the retiree's last employing agency and the retiree or survivor's current mailing address. As individuals often relocate at retirement, the current mailing address is not a reliable indication of where the employee might have worked. OPM has no means to identify the Federal employees who moved into or out of the nonforeign areas after retirement.

Even if an extremely labor-intensive review of each physical retirement file were conducted, the results would yield little information of value regarding a retiree's or survivor's nonforeign employment history. Nearly every Federal employee is serviced by a consolidated payroll office. The retirement records OPM receives from the consolidated payroll office do not provide us with the employee's duty station, which is necessary to determine eligibility for the nonforeign COLA.²⁰ The employee's application for retirement does ask the employee to provide us with the name and address of his or her employing agency; however, applicants often provide incomplete information or only the address of the servicing human resources office, which often differs from the employee's duty station. Therefore, even if OPM were to undertake a manual review of every retirement file, we would not be able to reliably identify the annuitants and their survivors who worked in nonforeign areas.

²⁰ Data regarding an employee's duty station is captured on the employee's Notification of Personnel Action, Standard Form 50, which is not a required part of the retirement package sent to OPM.

Part V – Conclusion

Conclusion

OPM has implemented the pay and retirement laws as enacted by Congress. Beginning in 1948, Congress provided authority for special cost-of-living allowances for Federal employees working in nonforeign areas and provided that such allowances would not be subject to Federal income tax. Congress did not make nonforeign COLAs part of retirement-creditable basic pay, which avoided dramatic differences in the retirement benefits of Federal employees working in nonforeign areas compared to employees working in all other locations. (We note that most Federal employees were paid on the unitary worldwide General Schedule.) Beginning in 1994, Congress provided authority for retirement-creditable locality pay for Federal employees in the contiguous 48 States but specifically excluded nonforeign areas within the United States and foreign areas, since employees in those areas were receiving special allowances. Beginning in 2010, Congress provided authority to provide retirement-creditable locality pay to employees in nonforeign areas, while requiring corresponding reductions in tax-free COLAs. All of these changes were made on a prospective basis.

However, the Committee directed OPM to include policy recommendations in this report for Congress to consider. Accordingly, below are OPM's thoughts regarding policy options Congress could consider.

Policy Options

Over the years, the focus of Federal pay policy has evolved from keeping pace with the overall labor market in a very generalized manner to competing effectively and responsibly within local labor markets. The implementation of NAREAA reflects that shift. COLAs were initially designed to address recruitment and retention issues resulting from higher living costs in the nonforeign areas compared to Washington, DC. As those living cost differences declined because of the modernization of supply chains and the rapid growth of the Washington, DC, region, however, Congress opted for a different pay philosophy in the nonforeign areas so that agencies could effectively compete for talent on a labor-cost basis. By providing locality pay based on local labor costs, Congress has given agencies with employees stationed in the nonforeign areas a tool to better compete for talent with other employers in a local area economy. In addition, the methodology by which COLAs are being replaced with locality pay under NAREAA ensures employees' take-home pay is protected during that transition.

For agencies with staffing difficulties that persist despite the progress so far under NAREAA, it is imperative to consider the strategic use of such pay flexibilities as recruitment, relocation and retention incentives; special rates; student loan repayments; and post differentials. Such flexibilities can help agencies attract desirable applicants and retain effective employees.

Another possible policy option to consider is the post differential authorized under 5 U.S.C. 5377. Extending locality pay to nonforeign areas may require OPM to address the treatment and calculation of post differential payments at some point in the future. A post differential can be paid to employees who are not locally recruited in areas where the conditions of environment differ substantially from conditions in the CONUS and where major Federal employers within the area believe the differential is warranted as a recruitment incentive to attract candidates from

outside the area to work there.²¹ Currently, a 20-percent post differential is authorized for Guam, and a 25-percent differential is authorized for American Samoa, Johnston Atoll, Midway Atoll, and Wake Atoll. An employee can receive both a nonforeign COLA and post differential up to a combined total of 25 percent.²² In such cases agencies pay the authorized COLA first, then pay the post differential up to the 25 percent limit. Agencies considering increasing post differential rates in Guam or a new post differential in an area like Puerto Rico or the U.S. Virgin Islands should contact OPM for more information.

²¹ 5 CFR 591.230(a).

²² The Committee mentioned American Samoa in directing OPM to produce this report. American Samoa does not receive a COLA under 5 U.S.C. 5941; however, NAREAA did extend locality pay to American Samoa, which is now part of the RUS locality pay area and as such receives a 15.95-percent locality payment in 2020.

Attachments

Attachment 1 – Estimated Number of Years to Phase out COLA

2019 and 2020 Locality Pay Rates and Residual COLA Rates in Nonforeign Areas Estimated Number of Years to Phase out COLA Based on 2019-2020 Change to Locality Pay Percentage							
Nonforeign COLA Areas	COLA Rate at Time of NAREAA Enactment (%)	Locality Rate Required to Reduce COLA to Zero	2019 COLA Rates (%)	2019 Locality Rates (%)	2020 COLA Rates (%)	2020 Locality Rates (%)	Estimated Number of Years to Phase out COLA Based on 2019-2020 Change to Locality Pay Percentage
Anchorage, Alaska	23.00	35.38	3.27	28.89	2.86	29.67	7
Fairbanks, Alaska	23.00	35.38	3.27	28.89	2.86	29.67	7
Juneau, Alaska	23.00	35.38	3.27	28.89	2.86	29.67	7
Other Alaska	25.00	38.46	4.83	28.89	4.40	29.67	11
City and County of Honolulu, Hawaii	25.00	38.46	10.64	18.98	10.28	19.56	33
County of Hawaii, Hawaii	18.00	27.69	4.76	18.98	4.42	19.56	14
County of Kauai, Hawaii	25.00	38.46	10.64	18.98	10.28	19.56	33
County of Maui (including Kalawao County), Hawaii	25.00	38.46	10.64	18.98	10.28	19.56	33
Puerto Rico	14.00	21.54	3.29	15.67	3.13	15.95	20
U.S. Virgin Islands	25.00	38.46	12.80	15.67	12.62	15.95	80
Guam & Commonwealth of the Northern Mariana Islands	25.00	38.46	12.80	15.67	12.62	15.95	80

Notes: When the applicable locality pay percentage in a nonforeign area is increased, the residual COLA rate is decreased. To calculate the adjusted COLA rate, first subtract 65 percent of the applicable locality rate from the frozen COLA rate, then divide the result by 1 plus the applicable locality pay percentage and round the result to 4 decimal places. For example, in Anchorage, AK, the 2020 residual COLA rate is calculated as follows:

$$[.23 - \text{round}((.2967 \times .65), 4)] / 1.2967 = .0286 = 2.86 \text{ percent.}$$

The locality pay percentage required to reduce COLA to zero in a nonforeign area is the frozen COLA rate (the COLA rate in effect at the time of NAREAA enactment) divided by 65 percent. Future locality pay percentages are unknown. The above estimates of the number of years required to reduce COLA to zero in each nonforeign area are based on percentage point changes in applicable locality pay percentages being the same in future years as they were between 2019 and 2020.

Attachment 2 – Impact Since 2009 of NAREAA Implementation

Results of NAREAA Implementation in Anchorage/Fairbanks/Juneau, AK Since 2009					
Year	Locality Pay Percentage (Applied to Base GS Rates)	COLA (Applied to Base GS Rate Plus Locality Pay)	Locality Pay Plus COLA (Total Amount Paid above Base GS Rates) †	Pay above Base GS that is Retirement-Creditable (Same as Locality Pay Percentage)	Amount above Base GS that is Not Federally Taxable
2009	0.00%	23.00%	23.00%	0.00%	23.00%
2010	4.72%	19.03%	24.65%	4.72%	19.93%
2011	16.46%	10.56%	28.76%	16.46%	12.30%
2012	24.69%	5.57%	31.64%	24.69%	6.95%
2013	24.69%	5.57%	31.64%	24.69%	6.95%
2014	24.69%	5.57%	31.64%	24.69%	6.95%
2015	24.69%	5.57%	31.64%	24.69%	6.95%
2016	25.16%	5.31%	31.81%	25.16%	6.65%
2017	27.13%	4.22%	32.49%	27.13%	5.36%
2018	28.02%	3.74%	32.81%	28.02%	4.79%
2019	28.89%	3.27%	33.10%	28.89%	4.21%
2020	29.67%	2.86%	33.38%	29.67%	3.71%

† Note: Because NAREAA provides that COLA is paid on top of locality pay, (1) the value of locality pay plus COLA is equal to [(1 + Locality Pay Percentage) * (1 + COLA Percentage)] - 1, and (2) the amount above base GS rates that is not Federally taxable is higher than the COLA rate for all years locality pay is in effect in the nonforeign areas (i.e., 2010 and after).

Results of NAREAA Implementation in Alaska Locations <u>Other than</u> Anchorage/Fairbanks/Juneau Since 2009					
Year	Locality Pay Percentage (Applied to Base GS Rates)	COLA (Applied to Base GS Rate Plus Locality Pay)	Locality Pay Plus COLA (Total Amount Paid above Base GS Rates) †	Pay above Base GS that is Retirement-Creditable (Same as Locality Pay Percentage)	Amount above Base GS that is Not Federally Taxable
2009	0.00%	25.00%	25.00%	0.00%	25.00%
2010	4.72%	20.94%	26.65%	4.72%	21.93%
2011	16.46%	12.28%	30.76%	16.46%	14.30%
2012	24.69%	7.18%	33.64%	24.69%	8.95%
2013	24.69%	7.18%	33.64%	24.69%	8.95%
2014	24.69%	7.18%	33.64%	24.69%	8.95%
2015	24.69%	7.18%	33.64%	24.69%	8.95%
2016	25.16%	6.91%	33.81%	25.16%	8.65%
2017	27.13%	5.80%	34.50%	27.13%	7.37%
2018	28.02%	5.30%	34.81%	28.02%	6.79%
2019	28.89%	4.83%	35.12%	28.89%	6.23%
2020	29.67%	4.40%	35.38%	29.67%	5.71%

† Note: Because NAREAA provides that COLA is paid on top of locality pay, (1) the value of locality pay plus COLA is equal to [(1 + Locality Pay Percentage) * (1 + COLA Percentage)] - 1, and (2) the amount above base GS rates that is not Federally taxable is higher than the COLA rate for all years locality pay is in effect in the nonforeign areas (i.e., 2010 and after).

Results of NAREAA Implementation in Honolulu/Kauai/Maui/Kalawao, HI Since 2009					
Year	Locality Pay Percentage (Applied to Base GS Rates)	COLA (Applied to Base GS Rate Plus Locality Pay)	Locality Pay Plus COLA (Total Amount Paid above Base GS Rates) †	Pay above Base GS that is Retirement-Creditable (Same as Locality Pay Percentage)	Amount above Base GS that is Not Federally Taxable
2009	0.00%	25.00%	25.00%	0.00%	25.00%
2010	4.72%	20.94%	26.65%	4.72%	21.93%
2011	11.01%	16.07%	28.85%	11.01%	17.84%
2012	16.51%	12.25%	30.78%	16.51%	14.27%
2013	16.51%	12.25%	30.78%	16.51%	14.27%
2014	16.51%	12.25%	30.78%	16.51%	14.27%
2015	16.51%	12.25%	30.78%	16.51%	14.27%
2016	16.81%	12.05%	30.89%	16.81%	14.08%
2017	17.92%	11.32%	31.27%	17.92%	13.35%
2018	18.43%	10.99%	31.45%	18.43%	13.02%
2019	18.98%	10.64%	31.64%	18.98%	12.66%
2020	19.56%	10.28%	31.85%	19.56%	12.29%

† Note: Because NAREAA provides that COLA is paid on top of locality pay, (1) the value of locality pay plus COLA is equal to [(1 + Locality Pay Percentage) * (1 + COLA Percentage)] - 1, and (2) the amount above base GS rates that is not Federally taxable is higher than the COLA rate for all years locality pay is in effect in the nonforeign areas (i.e., 2010 and after).

Results of NAREAA Implementation in Hawaii County, HI Since 2009					
Year	Locality Pay Percentage (Applied to Base GS Rates)	COLA (Applied to Base GS Rate Plus Locality Pay)	Locality Pay Plus COLA (Total Amount Paid above Base GS Rates) †	Pay above Base GS that is Retirement-Creditable (Same as Locality Pay Percentage)	Amount above Base GS that is Not Federally Taxable
2009	0.00%	18.00%	18.00%	0.00%	18.00%
2010	4.72%	14.26%	19.65%	4.72%	14.93%
2011	11.01%	9.76%	21.84%	11.01%	10.83%
2012	16.51%	6.24%	23.78%	16.51%	7.27%
2013	16.51%	6.24%	23.78%	16.51%	7.27%
2014	16.51%	6.24%	23.78%	16.51%	7.27%
2015	16.51%	6.24%	23.78%	16.51%	7.27%
2016	16.81%	6.05%	23.88%	16.81%	7.07%
2017	17.92%	5.39%	24.28%	17.92%	6.36%
2018	18.43%	5.08%	24.45%	18.43%	6.02%
2019	18.98%	4.76%	24.64%	18.98%	5.66%
2020	19.56%	4.42%	24.84%	19.56%	5.28%

† Note: Because NAREAA provides that COLA is paid on top of locality pay, (1) the value of locality pay plus COLA is equal to [(1 + Locality Pay Percentage) * (1 + COLA Percentage)] - 1, and (2) the amount above base GS rates that is not Federally taxable is higher than the COLA rate for all years locality pay is in effect in the nonforeign areas (i.e., 2010 and after).



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