



The Director

UNITED STATES OFFICE OF PERSONNEL MANAGEMENT
Washington, DC 20415

May 30, 2007

The Honorable Richard B. Cheney
President of the Senate
United States Senate
Washington, DC 20510

Dear Mr. President:

The Office of Personnel Management (OPM) is submitting the enclosed legislative proposal entitled the "Locality Pay Extension Act of 2007." We request that it be referred to the appropriate committee for prompt and favorable consideration.

Since the enactment of the Federal Employees Pay Comparability Act of 1990, there has been a growing conflict between locality-based comparability payments authorized under that act and nonforeign area cost-of-living allowances (COLA) authorized under section 5941 of title 5, United States Code. The comparability payments, commonly referred to as locality pay, are available only to employees in the 48 contiguous States and the District of Columbia. The COLA program, which pre-dates locality pay, covers white-collar civilian Federal employees in most of the nonforeign areas (i.e., the COLA areas – Alaska, Hawaii, Guam/Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands).

Enacted in 1948, the COLA program was originally designed to address recruitment and retention issues resulting from the relatively higher costs in those areas of providing a standard of living comparable to that on the mainland. Accordingly, COLAs are based on differences in the cost of living, determined by surveying costs in the nonforeign areas and comparing them with costs in Washington, D.C.

Locality pay, on the other hand, is a more market-oriented approach to pay and is determined through surveys of salaries in local areas. It is predicated on differences in the cost of labor – the cornerstone of current Federal compensation policy.

Although a major component of the total pay of the white-collar Federal employees in the COLA areas, COLA payments, like other allowances, are not creditable for retirement purposes. Locality pay does constitute basic pay for computing retirement benefits. However, unlike locality pay, COLA payments are not subject to Federal income tax.

There is a growing perception that total pay and retirement benefits of white-collar civilian Federal employees in nonforeign areas outside the 48 contiguous States and the District of Columbia have eroded gradually in relation to the pay and retirement benefits of similarly situated employees in the 48 States and D.C. These perceived disparities between the pay and retirement benefits of those two groups of employees generate actual and potential staffing problems for Federal agencies in nonforeign areas, especially in retaining

employees near retirement. Over the last 20 years, the COLA program has been fraught with litigation, and has cost the Federal Government hundreds of millions of dollars in settlement payments and attorney fees. One of the outcomes of previous litigation was the *Caraballo* settlement, in which OPM agreed to implement a new methodology including a three-year survey cycle beginning with the Caribbean in 2002. That survey has been completed, and the results confirmed that COLA rates under the revised methodology will decrease for many COLA areas, likely causing further litigation. Additional new litigation, including a constitutional challenge to the non-application of locality pay in nonforeign areas, creates the further possibility of future liabilities.

In an effort to address these issues, we have developed a proposal that will extend locality pay to white-collar Federal employees in the nonforeign areas, while reducing COLA payments gradually to reduce the impact of increased withholding for taxes on the affected employees. Changes would be phased in over a 7-year period, with separate specifications for the handling of special rates, Postal Service, and certain other employees. While implementing the changes made by this proposal would produce modest savings in mandatory expenditures of about \$1 million in the first year, the net cost increase over the first 5 years of the phase-in would be about \$2 million, with a total cost of \$109 million over the next 10 years.

We believe this extension of locality pay to the nonforeign areas will appropriately apply effective and contemporary compensation practices to more Federal employees and eliminate the inefficiencies and conflicts inherent in the outmoded approach taken by the COLA program. Accordingly, we urge the adoption of this proposal.

The Office of Management and Budget advises that the submission of this proposal would be in accord with the program of the President.

Sincerely,

Linda M. Springer
Director

Enclosures



The Director

UNITED STATES OFFICE OF PERSONNEL MANAGEMENT
Washington, DC 20415

May 30, 2007

The Honorable Nancy Pelosi
Speaker of the House
U.S. House of Representatives
Washington, D.C. 20515

Dear Madame Speaker:

The Office of Personnel Management (OPM) is submitting the enclosed legislative proposal entitled the "Locality Pay Extension Act of 2007." We request that it be referred to the appropriate committee for prompt and favorable consideration.

Since the enactment of the Federal Employees Pay Comparability Act of 1990, there has been a growing conflict between locality-based comparability payments authorized under that act and nonforeign area cost-of-living allowances (COLA) authorized under section 5941 of title 5, United States Code. The comparability payments, commonly referred to as locality pay, are available only to employees in the 48 contiguous States and the District of Columbia. The COLA program, which pre-dates locality pay, covers white-collar civilian Federal employees in most of the nonforeign areas (i.e., the COLA areas – Alaska, Hawaii, Guam/Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands).

Enacted in 1948, the COLA program was originally designed to address recruitment and retention issues resulting from the relatively higher costs in those areas of providing a standard of living comparable to that on the mainland. Accordingly, COLAs are based on differences in the cost of living, determined by surveying costs in the nonforeign areas and comparing them with costs in Washington, D.C.

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Although a major component of the total pay of the white-collar Federal employees in the COLA areas, COLA payments, like other allowances, are not creditable for retirement purposes. Locality pay does constitute basic pay for computing retirement benefits. However, unlike locality pay, COLA payments are not subject to Federal income tax.

There is a growing perception that total pay and retirement benefits of white-collar civilian Federal employees in nonforeign areas outside the 48 contiguous States and the District of Columbia have eroded gradually in relation to the pay and retirement benefits of similarly situated employees in the 48 States and D.C. These perceived disparities between the pay and retirement benefits of those two groups of employees generate actual and potential staffing problems for Federal agencies in nonforeign areas, especially in retaining

employees near retirement. Over the last 20 years, the COLA program has been fraught with litigation, and has cost the Federal Government hundreds of millions of dollars in settlement payments and attorney fees. One of the outcomes of previous litigation was the *Caraballo* settlement, in which OPM agreed to implement a new methodology including a three-year survey cycle beginning with the Caribbean in 2002. That survey has been completed, and the results confirmed that COLA rates under the revised methodology will decrease for many COLA areas, likely causing further litigation. Additional new litigation, including a constitutional challenge to the non-application of locality pay in nonforeign areas, creates the further possibility of future liabilities.

In an effort to address these issues, we have developed a proposal that will extend locality pay to white-collar Federal employees in the nonforeign areas, while reducing COLA payments gradually to reduce the impact of increased withholding for taxes on the affected employees. Changes would be phased in over a 7-year period, with separate specifications for the handling of special rates, Postal Service, and certain other employees. While implementing the changes made by this proposal would produce modest savings in mandatory expenditures of about \$1 million in the first year, the net cost increase over the first 5 years of the phase-in would be about \$2 million, with a total cost of \$109 million over the next 10 years.

We believe this extension of locality pay to the nonforeign areas will appropriately apply effective and contemporary compensation practices to more Federal employees and eliminate the inefficiencies and conflicts inherent in the outmoded approach taken by the COLA program. Accordingly, we urge the adoption of this proposal.

The Office of Management and Budget advises that the submission of this proposal would be in accord with the program of the President.

Sincerely,

Linda M. Springer
Director

Enclosures

A BILL

To provide for locality pay in nonforeign areas outside the 48 contiguous States and the District of Columbia, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States in Congress assembled, That this Act may be cited as the “Locality Pay Extension Act of 2007.”

Sec. 2. Title 5, United States Code, is amended—

(1) by amending section 5304(f)(1)(A) to read as follows:

“(A) each General Schedule position in the United States, as defined in section 5921(4), and its territories and possessions, including the Commonwealth of Puerto Rico and the Commonwealth of the Northern Mariana Islands, shall be included within a pay locality; and”;

(2) by amending section 5941—

(A) by amending subsection (a)(1) to read as follows:

“(1) the cost-of-living allowance rate established pursuant to this subsection and in effect on December 31, 2007, except as adjusted pursuant to subsection (c);”;

(B) by redesignating subsection (b) as (d); and

(C) by inserting after subsection (a) the following new subsections (b) and

(c):

“(b) The list of locations designated as cost-of-living allowance areas pursuant to this section and in effect on December 31, 2007, shall be frozen on that date.

“(c)(1) The cost-of-living allowance rate payable under this section shall be adjusted on the first day of the first applicable pay period beginning on or after January 1, 2008, and on the effective date of each subsequent change in the applicable locality-based comparability payment under section 6 of the Locality Pay Extension Act of 2007.

“(2) Each adjusted allowance rate under paragraph (1) shall be calculated by subtracting 85 percent of the applicable comparability payment percentage from the allowance percentage rate in effect on December 31, 2007, and then dividing the result by one plus the applicable comparability payment percentage.

“(3) No allowance rate computed under paragraph (2) may be less than zero.

“(4) Each allowance rate computed under paragraph (2) shall be paid as a percentage of basic pay (including any applicable locality-based comparability payment under section 5304 or similar provision of law and any applicable special rate of pay under section 5305 or similar provision of law).”.

Sec. 3. Section 1005 of title 39, United States Code, is amended—

(1) by redesignating subsection (b) as (b)(1); and

(2) by adding a new paragraph (2) as follows:

“(2) Notwithstanding any other provision of law, each cost-of-living allowance rate made applicable by paragraph (1) to officers and employees of the Postal Service shall be frozen at the percentage rate in effect on December 31, 2007 and shall be deemed to be paid under section 5941 of title 5, except as otherwise provided by the Postal Service with regard to officers and employees covered by sections 1003(b) and 1003(c) and whose duty station is in a nonforeign area for which a cost-of-living allowance is provided under such section 5941.”.

Sec. 4. Except as provided in section 1005(b) of title 39, United States Code, as amended by section 3, when the computations under section 5941(c) of title 5, United States Code, are

sufficient to reduce to zero all cost-of-living allowance rates payable under that section, paragraphs (1) and (3) of subsection (a) and subsections (b) and (c) of such section 5941, as added by this Act, are repealed.

Sec. 5. (a) Each special rate of pay established under section 5305 of title 5, United States Code, and payable in a location designated as a cost-of-living allowance area pursuant to section 5941(a)(1) of such title 5, shall be adjusted, on the dates prescribed by section 6 of this Act, in accordance with regulations prescribed by the Director of the Office of Personnel Management under section 7 of this Act.

(b) Each special rate of pay established under section 7455 of title 38, United States Code, and payable in a location designated as a cost-of-living allowance area pursuant to section 5941(a)(1) of title 5, United States Code, shall be adjusted in accordance with regulations prescribed by the Secretary of Veterans Affairs that are consistent with the regulations issued by the Director of the Office of Personnel Management under subsection (a).

(c) Regulations issued under subsection (a) or subsection (b) may provide that statutory limitations on the amount of such special rates may be temporarily raised to a higher level during the transition period described in section 6 ending on the first day of the first pay period beginning on or after January 1, 2014, at which time any special rate of pay in excess of the applicable limitation shall be converted to a retained rate under section 5363 of title 5, United States Code.

Sec. 6. Notwithstanding any other provision of this Act or section 5304 or 5304a of title 5, United States Code, in implementing the amendments made by this Act, for each non-foreign area determined under section 5941(b) of title 5, United States Code, the applicable rate for the

locality-based comparability adjustment that is used in the computation required under subsection (c) of such section 5941 shall be adjusted effective on the first day of the first pay period beginning on or after January 1—

(1) in calendar year 2008, by taking $1/7$ of the locality pay percentage for the Rest of U.S. locality pay area;

(2) in calendar year 2009, by taking $2/7$ of the otherwise applicable comparability payment approved by the President for each non-foreign area;

(3) in calendar year 2010, by taking $3/7$ of the otherwise applicable comparability payment approved by the President for each non-foreign area;

(4) in calendar year 2011, by taking $4/7$ of the otherwise applicable comparability payment approved by the President for each non-foreign area;

(5) in calendar year 2012, by taking $5/7$ of the otherwise applicable comparability payment approved by the President for each non-foreign area;

(6) in calendar year 2013, by taking $6/7$ of the otherwise applicable comparability payment approved by the President for each non-foreign area; and

(7) in calendar year 2014 and each subsequent year, by using the full amount of the applicable comparability payment approved by the President for each non-foreign area.

Sec. 7. (a) The Director of the Office of Personnel Management may prescribe such regulations as may be necessary to carry out this Act, including—

(1) rules for special rate employees as described in section 5;

(2) rules for adjusting rates of basic pay for employees in pay systems administered by the Office of Personnel Management when such employees are not entitled to locality-based comparability payments under section 5304 of title 5, United States Code, without regard to otherwise applicable statutory pay limitations during the transition period described in section 6 ending on the first day of the first pay period beginning on or after January 1, 2014; and

(3) rules governing establishment and adjustment of saved or retained rates for any employee whose rate of pay exceeds applicable pay limitations on the first day of the first pay period beginning on or after January 1, 2014.

(b) With the concurrence of the Director of the Office of Personnel Management, the administrator of a pay system not administered by the Office may prescribe such regulations as may be necessary to carry out this Act with respect to employees in such pay system, consistent with the regulations issued by the Office under subsection (a).

Sec. 8. (a) Except as provided by subsection (b), this Act shall take effect on the date of enactment.

(b) The amendments made by sections (2), and (3) and the provisions of section (5) shall take effect on the first day of the first applicable pay period beginning on or after January 1, 2008.

SECTION-BY-SECTION ANALYSIS

To accompany a draft bill

“To provide for locality pay in nonforeign areas outside the 48 contiguous States and the District of Columbia, and for other purposes.”

The first section of the bill titles the bill as the *Locality Pay Extension Act of 2007*.

Section 2 of the bill would amend various provisions of title 5, United States Code, to provide for the extension of the locality pay system, as defined in section 5304 of that title, to the nonforeign areas, including Puerto Rico, Guam, the Virgin Islands, the Northern Mariana Islands, in addition to Hawaii and Alaska, and for modifications in the determination of the cost-of-living allowance rates for those areas.

Paragraph 1 of that section of the bill amends section 5304(f)(1)(A) of title 5 to authorize the President’s pay agent, as designated under section 5304(d)(1) of that title, to ensure that locality-based comparability payments (locality pay) are paid to all General Schedule employees in both the continental United States and the nonforeign areas.

Paragraph 2(A) of that section of the bill amends section 5941(a)(1) of title 5 to change the nature of cost-of-living allowance rates from being adjustable based on a comparison of living costs in nonforeign areas with living costs in the District of Columbia, to being frozen at the rates in effect on December 31, 2007, as established pursuant to the previous methodology, except as otherwise adjusted under the locality pay phase-in provisions under the new subsection (c) of such section 5941.

Paragraph 2(B) of that section of the bill redesignates subsection (b) of section 5941 of title 5 as subsection (d) of such section 5941 to retain the bar against the payment of a cost-of-living allowance under that section to an employee who is entitled to a cost-of-living allowance under section 5924 of that title.

Paragraph 2(C) of that section of the bill inserts two new subsections into section 5941 of title 5. New subsection (b) freezes the list of locations designated as cost-of-living areas as those areas designated pursuant to that section, as of December 31, 2007. New subsection (c) provides the adjustment process for the cost-of-living allowance rate payable to General Schedule employees working in positions in the nonforeign areas eligible to receive locality pay pursuant to section 5304 of that title, as amended in paragraph (1)(A) of section 2 of the draft bill. Cost-of-living allowance payments are generally not considered taxable income and are not considered basic pay for retirement purposes. Locality pay, however, constitutes taxable income and basic pay for retirement purposes, and it is subject to withholding. Accordingly, new subsection (c) includes an adjustment factor designed to help protect employees’ take-home pay as locality pay is extended to nonforeign areas.

Specifically, new subsection (c)(1) provides that the cost-of-living allowance rate shall be adjusted as provided for in the new subsection (c)(2) on the first day of the first applicable pay period beginning on or after January 1, 2008, and with each effective date of subsequent changes in comparability payments under section 5304 of title 5. New subsection (c)(2) establishes the adjustment rate for cost-of-living allowance payments. Adjusted allowance rates shall be calculated by subtracting 85 percent of the applicable locality pay from the applicable cost-of-living allowance rate in effect on December 31, 2007, and then dividing the resulting adjusted cost-of-living allowance rate by one plus the applicable locality pay percentage.

New subsection (c)(3) provides that no adjusted cost-of-living allowance rate may be less than zero to ensure employees are not significantly disadvantaged by the extension of locality pay. New subsection (c)(4) provides that the adjusted cost-of-living allowance rate shall be paid as a percentage of basic pay, including both applicable locality-based comparability payments paid under section 5304 of title 5 or special rates paid under section 5305 of that title.

Section 3 of the bill would amend section 1005 of title 39, United States Code, to provide a frozen cost-of-living allowance rate for postal employees working in nonforeign areas.

Paragraph (1) of that section of the bill redesignates subsection (b) of section 1005 of title 39 as subsection (b)(1).

Paragraph (2) of that section of the bill adds a new subsection (b)(2) in section 1005 of title 39. New subsection (b)(2) provides that, with some exceptions, Postal Service officers and employees paid a cost-of-living allowance based on 5941(a) of title 5, United States Code, shall be paid an allowance based on a rate frozen at the percentage rate in effect on December 31, 2007. The exceptions are limited to Postal employees working in the Office of the Inspector General of the United States Postal Service and Postal employees working as Postal Inspectors who are compensated based on a standard of comparability to the compensation and benefits paid for comparable levels of work in the executive branch of the Government outside of the Postal Service under sections 1003(b) and 1003(c) of title 39, respectively.

Section 4 of the bill repeals subsections (a)(1), (a)(3), (b) and (c) of section 5941 of title 5, United States Code, except as otherwise provided in section 1005(b) of title 39, United States Code, as amended by section 3 of the bill, when the cost-of-living payments adjusted by the new section 5941(c) of title 5 are reduced to zero based on the schedule prescribed in section 6 of the bill. Section 5941(a)(2) of title 5, concerning the post differential, is maintained regardless of the repeal of the other provisions of section 5941.

Section 5 of the bill addresses the payment and adjustment of special rates of pay established under section 5305 of title 5, United States Code, or section 7455 of title 38, United States Code, during the process of extending locality pay to positions in the nonforeign areas. Employees who are working in the nonforeign areas and entitled to special rates will receive special rates that are adjusted in accordance with regulations provided by the Director of the Office of Personnel Management.

Subsection (a) of that section of the bill provides that each special rate of pay established under section 5305 of title 5, United States Code, shall be adjusted in accordance with the dates prescribed by section 6 of this Act and regulations provided by the Director of the Office of Personnel Management.

Subsection (b) of that section of the bill provides that each special rate of pay established under section 7455 of title 38, United States Code, must be adjusted in accordance with regulations provided by the Secretary of Veterans Affairs consistent with regulations issued by the Director of the Office of Personnel Management under section 5(a) of the bill.

Subsection (c) of that section of the bill provides that statutory limitations on the amount of special rates under either section 5305 of title 5, United States Code, or 7455 of title 38, United States Code, may be temporarily raised to a higher level during the transition period described in section 6 ending on the first day of the first pay period beginning on or after January 1, 2014, at which time any special rate of pay in excess of the applicable limitation shall be converted to a retained rate under section 5363 of title 5, United States Code.

Section 6 of the bill provides a schedule outlining the seven-year locality pay phase-in of the newly applicable locality pay authorized under sections 5304(f)(1)(A) and section 5941(c) of title 5, United States Code, as amended by section 2 of the bill. The applicable rate will be computed:

- (1) in calendar year 2008, by taking 1/7 of the locality pay percentage for the Rest of U.S. locality pay area;
- (2) in calendar year 2009, by taking 2/7 of the otherwise applicable comparability payment approved by the President for each non-foreign area;
- (3) in calendar year 2010, by taking 3/7 of the otherwise applicable comparability payment approved by the President for each non-foreign area;
- (4) in calendar year 2011, by taking 4/7 of the otherwise applicable comparability payment approved by the President for each non-foreign area;
- (5) in calendar year 2012, by taking 5/7 of the otherwise applicable comparability payment approved by the President for each non-foreign area;
- (6) in calendar year 2013, by taking 6/7 of the otherwise applicable comparability payment approved by the President for each non-foreign area; and
- (7) in calendar year 2014 and each subsequent year, by using the full amount of the applicable comparability payment approved by the President for each non-foreign area.

Section 7 of the bill authorizes the Director of the Office of Personnel Management to prescribe regulations necessary to carry out the provisions of the Locality Pay Extension Act. That section specifically authorizes the Director to provide regulations to adjust special rates paid under section 5305 of title 5 and retained rates of employees who, but for the entitlement to a retained rate, would have received a special rate of pay. The section further authorizes the Director to provide regulations for Senior Level Positions paid under section 5376 of title 5, United States

Code, Senior Executives paid under section 5383 of that title, and other positions to which a cost-of-living allowance or the equivalent would otherwise be paid, but for the enactment of this Act.

The final section of the bill sets the effective date of this bill as the date of enactment, and the effective date of the amendments in sections 2, and 3, and the provisions of section 5 of the bill as the first day of the first applicable pay period on or after January 1, 2008.