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REPORT TO THE CONGRESS

UNITED STATES
GENERAL ACCOUNTING OFFICE

FEB 12 1976

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Policy Of Paying Cost-Of-Living Allowances To Federal Employees In Nonforeign Areas Should Be Changed

Civil Service Commission

The cost-of-living allowance for certain employees in Alaska, Hawaii, and U.S. territories is no longer an appropriate means of compensation since it is in conflict with the Government's pay policies. Special pay rates should be used in lieu of the allowance to overcome any recruitment or retention problems that may exist because of higher private sector pay levels.

As long as the allowance continues to be paid, certain administrative changes are needed to better achieve the intent of the legislation--compensating for interarea cost-of-living differences.

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

This report discusses the need to change the policy of paying a cost-of-living allowance to certain Federal employees serving in nonforeign areas outside the 48 contiguous States.

The nonforeign allowance is inconsistent with the basic pay-setting policy of comparability with the private sector, and it is discriminatory since it does not apply to Federal employees in the continental United States. A more equitable means of compensation is available. Federal pay in nonforeign areas could be adjusted upward when private enterprise salaries for a particular occupation and/or geographical area are so substantially above Federal salaries that they handicap the Government's recruitment or retention of well-qualified personnel. Until the allowance authority is repealed, certain administrative changes are needed to better achieve its legislative intent.

We made our review pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67).

We are sending copies of this report to the Director, Office of Management and Budget, and to the Chairman, Civil Service Commission.

James B. Stacks
Comptroller General
of the United States

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ABBREVIATIONS

BLS	Bureau of Labor Statistics
CSC	Civil Service Commission
GAO	General Accounting Office

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

POLICY OF PAYING COST-OF-
LIVING ALLOWANCES TO FEDERAL
EMPLOYEES IN NONFOREIGN AREAS
SHOULD BE CHANGED
Civil Service Commission

D I G E S T

GAO is recommending elimination of the nontaxable cost-of-living allowance paid to 30,000 Federal employees in Alaska, Hawaii, Guam, Puerto Rico, and the Virgin Islands. A more equitable means of compensation--special pay rates based on private sector pay rates--could be used in lieu of the nonforeign allowance, if warranted, to overcome any recruitment and retention problems caused by higher private sector pay.

The cost-of-living allowance, which was authorized by law in 1948 to reimburse Federal white-collar employees in nonforeign areas outside the continental United States when their living costs were substantially higher than those in the Washington, D.C., area, has outlived its usefulness and is no longer an appropriate means of compensation.

- Nonforeign areas have undergone major social, economic, and political change since the law was enacted authorizing the allowance. (See pp. 3 and 4.)
- A Federal pay-setting policy of comparability with the private sector has been enacted and placed in operation. The cost-of-living allowance is inconsistent with this principle. (See pp. 4 to 7.)
- The allowance is discriminatory because it is not given in other areas of the United States where the cost of living is high. Conversely, pay is not adjusted downward in low cost-of-living areas. (See p. 6.)

Under the pay comparability concept, Federal white-collar pay rates are in force Government-wide and are based on private enterprise average rates which reflect such pay considerations as cost of living and standard of living. (See p. 5.) The Federal pay system has sufficient flexibility to handle any recruitment or retention problems caused by higher private sector pay. (See p. 5.) Special pay rates would conform to the pay comparability principle since they would be based on private sector salaries, not living costs. (See p. 7.)

Until the provision of law authorizing the nonforeign allowance is repealed, the Chairman of the Civil Service Commission should make the following changes to better achieve the legislative intent--compensating for interarea cost-of-living differences:

- Apply the cost-of-living differential percentage to employees' spendable income rather than base pay. This would eliminate the financial gain for such items as Federal income taxes and retirement contributions, which are not included in the interarea comparisons but which cost the same regardless of place of employment. (See pp. 9 to 11.)
- In computing the allowance, consider marital status, family size, income level, and State and local income taxes, which affect employees' living costs. (See pp. 11 to 13.)
- Establish regional rather than flat area-wide allowance rates to recognize any intra-area cost-of-living differences which may exist. (See p. 13.)

The Civil Service Commission agreed to consider the recommended administrative changes but declined to take a position on elimination of the nonforeign cost-of-living allowance, pending the final outcome of two broad studies--the President's Panel on Federal Compensation, whose recommendations were sent to the President in December 1975, and an interagency benefits and allowances study committee. (See pp. 7 and 14.)

CHAPTER 1

INTRODUCTION

Various laws provide that Federal employees' pay rates be comparable with their private sector counterparts. But certain employees in nonforeign areas outside the continental United States are also authorized (5 U.S.C. 5941(a)(1) (1970)) to receive a cost-of-living allowance when living costs are substantially higher than those in Washington, D.C. The allowance, which may not exceed 25 percent of base pay, is not subject to Federal income tax.

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The Civil Service Commission (CSC) is responsible for prescribing regulations governing the payment of the allowance and for reviewing at least once a year the areas' eligibility and the allowance rates. CSC uses living-cost indexes prepared by the Department of State. These indexes are designed to show how living costs for a Federal employee and his family in a city outside the continental United States vary from that for the Washington, D.C., area. Living-cost indexes are intercity comparisons of price levels for a market basket of goods and services. The following major categories are studied.

Housing	Recreation
Food at home	Food away from home
Clothing	Auto purchase
Transportation	Personal care
Furnishings and household operations	Tobacco and alcohol
Medical care	Domestic service

A cost-of-living allowance rate established for the nonforeign area is applied to the base pay of all eligible employees. The nonforeign allowance rates--expressed as a percentage of base pay--effective in June 1975 were:

<u>Area</u>	<u>Percent</u>
Alaska:	
Anchorage	22.5
Other locations	25.0
Hawaii	12.5
Virgin Islands	10.0
Puerto Rico	7.5
Guam	7.5

As of March 31, 1974, about 48,000 Federal civilian and United States Postal Service employees were in the above areas.

General schedule	25,892
Wage system (blue-collar)	18,243
Postal Service	2,414
Other (note a)	<u>1,450</u>
Total	<u>47,999</u>

a/ Includes employees under all other statutory pay systems and those whose salary rates are determined administratively.

Cost-of-living allowances are authorized for employees of executive departments, Government-owned corporations, and independent establishments whose rates of base pay are fixed by statute. Allowances are not authorized for blue-collar employees since their pay is based on prevailing local rates.

We estimate that the eligible employees in nonforeign areas (approximately 30,000) received cost-of-living allowances of about \$60 million in 1974. The base pay rates for these employees are uniform throughout the service and are based on the national average rate in the private sector.

SCOPE OF REVIEW

We reviewed selected aspects of the process for determining the cost-of-living allowance in nonforeign areas. We evaluated the adequacy of the process and explored other means of compensating civilian employees stationed in nonforeign areas. Our review included an examination of pertinent concepts and methodologies and discussions with Washington, D.C., headquarters officials of CSC and the Allowances Staff of the Department of State.

CHAPTER 2

MORE EQUITABLE MEANS OF

COMPENSATION AVAILABLE

The cost-of-living allowance for nonforeign areas may have been a practical approach during earlier years, but the allowance has outlived its usefulness and is no longer appropriate. It is a serious departure from the fundamental concepts underlying compensation programs for Federal civilian employees within the United States. Allowances introduce a concept of pay related to need which conflicts with the basic pay-setting policy of comparability with the private sector.

The regular pay system has sufficient flexibility to handle any recruitment or retention problems that may occur in nonforeign areas. CSC can authorize special pay rates for any area and/or occupation where such problems are caused by higher private sector pay.

PAY RELATED TO NEED

Before 1948 additional compensation in the form of differentials or higher grades was paid to employees in U.S. territories. In some instances the additional pay applied to all employees, while in others it applied only to employees recruited in the 48 contiguous States. There was no systematic basis for or uniformity in determining and applying the differentials. In 1948 the Congress passed the existing law authorizing cost-of-living allowances in the territories. Such compensation was considered necessary to attract employees to these areas because of high living costs.

Since 1948 the areas have undergone major economic, political, and social change. For example:

- Alaska and Hawaii became States in 1959.
- Between 1950 and 1970 the total population more than doubled in Alaska and the Virgin Islands and increased by 54 percent in Hawaii.
- In 1970, 48 percent of Alaska's population and 58 percent of Puerto Rico's population were in urban areas compared with 27 percent and 40 percent, respectively, in 1950.
- The total labor force increased by 98 percent in Alaska and 59 percent in Hawaii between 1950 and 1970.

- Manufacturing employment increased 126 percent in Alaska between 1954 and 1972. During that same period the number of manufacturing establishments in Hawaii increased by 47 percent. Between 1958 and 1967 the number of manufacturing firms increased by 155 percent in Guam and 171 percent in the Virgin Islands.
- The total business and industry payroll in Puerto Rico increased by 1,400 percent between 1949 and 1967. The total payroll increased by 75 percent in Guam and 413 percent in the Virgin Islands between 1958 and 1967.
- From 1950 to 1974 per capita income in Alaska and Hawaii increased 195 percent and 324 percent, respectively. Alaska was ranked 2d behind the Washington, D.C., metropolitan area in per capita income in 1974, and Hawaii was ranked 11th.
- Median urban family income in 1970 was \$12,035 in Honolulu, \$8,933 in Guam, and \$5,461 in the Virgin Islands compared with \$10,474 for all standard metropolitan statistical areas in the United States and \$12,933 for Washington, D.C., area.
- Average weekly production earnings in Alaska are among the highest in the United States--\$270.29 in May 1975.

The improved and expanded local employment resulting from these changes should lessen the need to attract employees from the 48 contiguous States.

The concept of pay related to need brings into focus employees' marital status, number of children, income level, geographic location, housing preference, etc. As discussed in the following chapter these factors create problems. The work force and areas have to be stratified a number of ways to obtain a reasonable allowance which compensates for cost-of-living differences.

CONFLICT WITH FEDERAL PAY POLICY

Before 1962 there was no established framework in which the Federal white-collar salary determination could be considered. Pay adjustments were based on many factors, such as the changing purchasing power of the dollar, rates paid and wage trends elsewhere in the economy, special concern for lower grade employees, rising standards of living,

increases in productivity, and budgetary and economic effects of Federal pay raises. Many studies recognized the need for reform in methods of determining pay.

In February 1962 the President sent the Congress a special message, accompanied by draft legislation, on pay reform for white-collar employees which recommended the principle that Federal pay should be comparable with private sector pay. The President enunciated the purposes and logic of the comparability principle, as follows:

"Adoption of the principle of comparability will assure equity for the Federal employee with his equals throughout the national economy--enable the Government to compete fairly with private firms for qualified personnel--and provide at last a logical and factual standard for setting Federal salaries. Reflected in this single standard are such legitimate private enterprise pay considerations as cost of living, standard of living, and productivity, to the same extent that those factors are resolved into the 'going rate' over bargaining tables and other salary determining processes in private enterprise throughout the country."

The resultant legislation declared that the white-collar pay rates would be based on the principle that such rates would be comparable with private enterprise rates. The law, as amended, prescribes a method for an annual review and adjustment of Federal pay by the President.

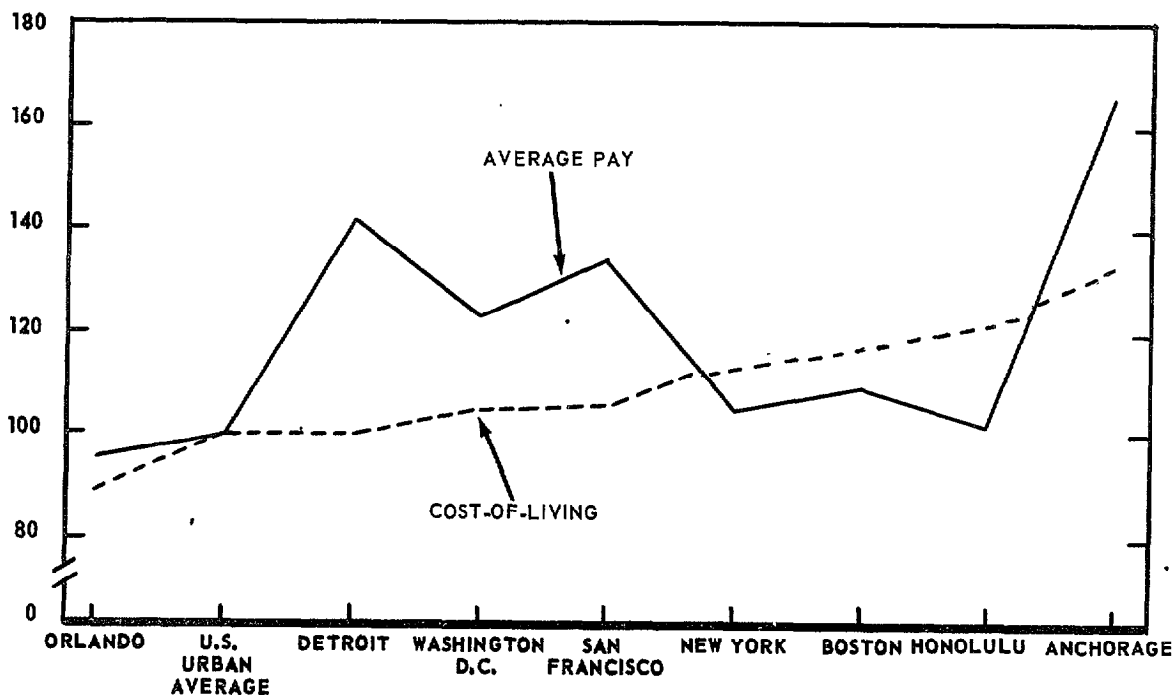
The 1962 legislation also introduced an element of greater flexibility in Federal pay setting. It authorized the establishment of higher Federal pay rates when private enterprise pay for an occupation or location is substantially higher than Federal pay and significantly handicaps the Government's recruitment or retention of well-qualified personnel.

The pay comparability system has generally advanced the evolution of Federal white-collar pay determination. Cost-of-living allowances in nonforeign areas conflict directly with the pay principles and concepts and preclude achievement of the pay policy objectives.

Federal white-collar pay rates are Government-wide and are based on private enterprise average rates. Under the comparability concept, as the President said in 1962, all factors affecting pay (including cost of living and standard of living) influence pay determinations in the private sector

and are resolved into the going rate. In adopting the going rate, the Government accepts the private sector's resolution of the various forces which affect pay.

Providing additional compensation based on cost-of-living differences distorts pay equity since there is no direct relationship between geographic wage rates and geographic cost-of-living data. BLS studies show that private sector pay levels and living costs in metropolitan areas vary considerably. But there is no consistent pattern between area living costs and pay levels. The following chart shows BLS's 1974 cost-of-living and pay indexes for selected locations.



Living costs in Detroit were the same as the average for all metropolitan areas, but pay levels in Detroit were among the highest in the Nation. Conversely, living costs in Honolulu were 19 percent higher than the metropolitan area average, but wages were only slightly higher.

Basing the allowance on comparative living costs can result in pay inequities between the Federal employee and his private sector counterpart and unfair competition in the various labor markets for qualified personnel between the Federal and non-Federal sectors.

Moreover, the cost-of-living allowance discriminates against employees located in those areas of the continental United States where the cost-of-living also exceeds that of

Washington, D.C. BLS's urban family budget for the fall of 1974 shows that living costs in metropolitan areas within the 48 contiguous States varied by as much as 36 percent. Boston and New York intermediate family income budgets were 11 and 10 percent, respectively, above that for Washington. Honolulu was 13 percent higher than Washington. Conversely, Federal employees in those areas of the country where the cost-of-living was lower than that of Washington received the same rates of pay as Washington area employees. For example, living costs in Orlando were 18 percent lower than in Washington, but Federal white-collar employees in both cities received the same rates of pay.

SPECIAL PAY RATES WOULD BE MORE EQUITABLE

Instead of a cost-of-living allowance, special pay rates authorized by 5 U.S.C. 5303 would be a more equitable means to handle any recruitment or retention problems. Special pay rates conform to the pay principle since they would be based on private sector rates, not living costs. Also, special rates enable the Government to focus on a specific area and/or occupation in which there is a recruitment or retention problem rather than blanketing the total work force of an area.

Special rates are also more desirable from a retirement standpoint. Unlike the cost-of-living allowance, special rates are considered part of employees' pay for civil service retirement benefits. These benefits, which are based on pay and length of service, include an annuity at retirement and an annuity for the family if the employee dies in service. The employee and his family get accustomed to a certain standard of living while he is working. At annuity time, the level of benefits compared to preretirement earnings would be higher under special rates than under the cost-of-living allowance.

CSC COMMENTS

CSC said that it used the same rationale to support legislative proposals in 1964 and 1965 to eliminate the non-foreign cost-of-living allowance but the proposals failed. CSC was not taking a position on our recommendation to repeal the allowance authority, pending the results of two broad compensation studies. This course of action would enable the issue to be considered within a framework of a comprehensive compensation plan.

The President's Panel on Federal Compensation made a comprehensive review of compensation practices and recommended, in December 1975, geographic or locality pay for lower grade white-collar employees. If the Panel's

recommendation is adopted, these white-collar employees would probably be treated the same as blue-collar employees and would not receive the cost-of-living allowance.

An interagency committee, of which CSC is a member, is reviewing all nonforeign and foreign area benefit and allowance programs to determine, among other things, their appropriateness and value to the Government. The committee's study could result in a proposal to modify the allowance process.

CHAPTER 3

ALLOWANCES NOT REPRESENTATIVE OF INTERAREA COST-OF-LIVING DIFFERENCES

Until such time as the nonforeign allowance is eliminated, certain administrative changes are needed to better achieve the legislative intent--compensating for interarea cost-of-living differences.

The purpose of the cost-of-living allowance is to enable Federal employees in nonforeign areas to purchase goods and services generally comparable to those which employees purchase in Washington, D.C., with their base pay alone. The allowance should result in neither financial gain nor loss for an employee but should provide reimbursement for extra costs of maintaining a standard of living equivalent to that which the employee could maintain in the Washington, D.C., area. However, the allowance process, as presently administered, is not achieving the purpose because:

--The allowance rate is applied to base pay, but the rate is based on cost comparisons of only selected consumption items.

1. Employees receive financial gain because some items which cost the same regardless of place of employment (e.g., 7 percent retirement contribution and Federal income taxes) are not considered in the interarea comparisons.
2. Although some local taxes (e.g., real estate and sales) are considered, State and local income taxes are not considered.

--One allowance rate is used for all employees in a given area although consumption patterns differ, depending upon employee marital status, family size, and income level.

--With one exception a single allowance rate is used for each nonforeign area although living costs may vary within the area.

EXCESS ALLOWANCE FROM APPLYING RATE TO BASE PAY

The cost-of-living allowance rate is based on interarea comparisons of certain consumption items. The percentage is applied to base pay to determine the dollar amount of the allowance.

Interarea comparisons do not include income taxes, retirement contributions, life insurance premiums, gifts and contributions, and savings. By applying the allowance rate to base pay, CSC is, in effect, presuming that Federal income taxes, retirement contributions, and employee group life and health insurance, which all employees pay, are higher in Alaska, Hawaii, the Virgin Islands, Guam, and Puerto Rico. In fact, Federal employees receiving the same base pay incur essentially the same costs for these items, regardless of their place of employment. Consequently, the tax-free allowance is greater than justified by the interarea comparative cost data. The higher paid employees' excess allowance is proportionately greater as shown below.

GS grade/step	Base pay (note a)	Payroll Deductions				Total	Excess allowance for these items (note f)
		Federal income taxes (note b)	Civil service retirement (note c)	Life (note d)	Group Insurance Health (note e)		
15/4	\$34,441	\$7,438	\$2,411	323	335	\$10,507	\$2,626
14/4	29,546	5,671	2,068	277	335	8,351	2,088
13/4	25,198	4,270	1,764	258	335	6,627	1,657
12/4	21,324	3,187	1,493	222	335	5,237	1,309
11/4	17,881	2,319	1,252	185	335	4,091	1,022
9/4	14,829	1,708	1,038	151	335	3,232	809
7/4	12,150	1,252	851	120	335	2,558	640
5/4	9,819	790	687	111	335	1,923	481

^aOctober 1975 general salary schedule rate for step 4.

^b1975 withholding amount for a married employee with 4 exemptions.

^c7 percent of base pay.

^dRegular insurance coverage.

^eBlue Cross-Blue Shield, high-option plan.

^fBased on a 25-percent allowance rate applied to the amount of payroll deductions which are part of employees' base pay.

In contrast to CSC's method, the Departments of State and Defense use "spendable income" as the base for computing foreign area and military cost-of-living allowances. Spendable income is base pay less income taxes, retirement contributions, life insurance premiums, gifts and contributions, and savings which are not computed in interarea cost-of-living data. The Department of State said that the spendable income approach was reasonable and proper and that the soundness of the concept was evidenced by having been widely adopted by business firms with employees in foreign areas.

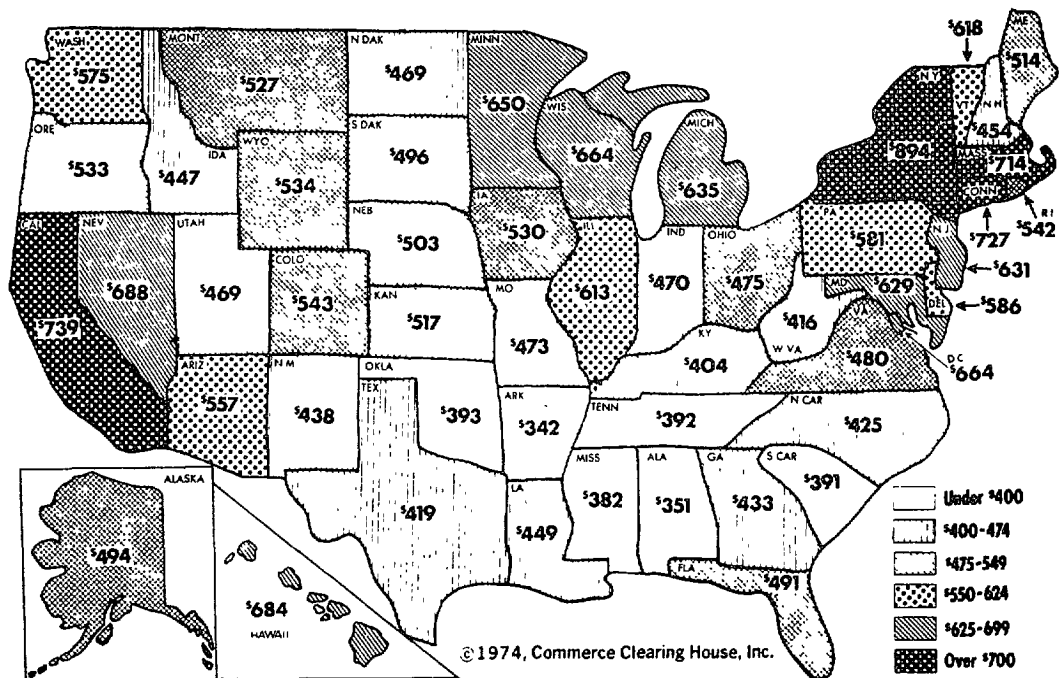
We believe that the statutory limitation of 25 percent of pay prescribes the maximum amount of allowance that can be granted and does not pertain to the methodology for determining the allowance. CSC's practice is inconsistent with

the purpose of the law since it overcompensates employees for interarea cost-of-living differences.

STATE AND LOCAL INCOME TAX DIFFERENCES NOT CONSIDERED

Cost-of-living indexes used by CSC to determine the non-foreign allowance rates include some taxes, such as sales and real estate, but do not include State or local income taxes. The nature and extent of State and local taxes varies from area to area. Data compiled by the Commerce Clearing House for 1972 and 1973 shows that differences existed in per capita State and local taxation--within the Washington, D.C., metropolitan area; between Washington and Alaska; and between Washington and Hawaii. This data, shown below, illustrates the tax differences between geographical areas and the need to consider such differences in cost-of-living comparisons.

State and Local Per Capita Tax Burden in Fiscal 1972-73



Federal employees in Alaska and Hawaii, as well as the Washington, D.C., area, must pay State and/or local income taxes on their earnings; but employees serving in Guam, Puerto Rico, and the Virgin Islands receive partial or full local tax credit for Federal income taxes paid. We did not inquire about the nature or amount of other taxes paid by Federal employees in nonforeign areas, but we noted that State and local income tax rates varied substantially. For example, the following table shows the comparative amounts of taxes

payable for a married Federal employee with two children, a \$13,000 gross income in 1974, and a 15-percent tax deduction leaving a taxable income of \$8,000.

<u>Geographical area</u>	<u>State and/or local income taxes payable</u>	
	<u>Amount</u>	<u>Index</u>
District of Columbia	\$370	100
Maryland	510	138
Virginia	270	73
Alaska	269	73
Hawaii	430	116

As indicated, there are geographical tax differences which affect living costs, but such differences are not reflected in the interarea cost-of-living percentages.

MARITAL STATUS, FAMILY SIZE, AND
INCOME LEVEL NOT ADEQUATELY RECOGNIZED

Consumption patterns vary and are responsive to a host of factors including marital status, size of family, and income level. For example, the BLS 1974 family budget studies at three income levels--lower, intermediate, and higher--show substantial differences in consumption at each income level for families of different size and composition.

<u>Family size, type, and age</u>	<u>Lower level</u>	<u>Intermediate level</u>	<u>Higher level</u>
Single person, under 35	\$2,560	\$3,810	\$5,240
Husband and wife, under 35:			
no children	3,590	5,330	7,340
1 child under 6	4,590	6,750	9,290
2 children, under 6	5,270	7,830	10,780
Husband and wife, 35 to 54 years:			
1 child, 6 to 15 years	6,000	8,920	12,280
2 children, the elder 6 to 15 years	7,318	10,880	14,976
3 children, the eldest 6 to 15 years	8,490	12,620	17,370

Cost-of-living indexes used by CSC to determine non-foreign area allowance rates are based on living costs of married Federal employees, and the rate is used for all eligible employees regardless of marital status, family size, or income level. In contrast, both the State and Defense Departments recognize that these variables affect employees' expenditures and have designed their foreign area and military

cost-of-living allowances accordingly. The State Department computes separate "with family" and "without family" spendable income levels for application of the allowance percentage and supplements the "with family" allowance for each child living with the employee. Similarly, the Defense Department uses six separate tables showing the spendable incomes at each gross income level for a single member and for members with one, two, three, four, and five or more dependents.

Since the purpose of the cost-of-living allowance is to compensate employees for higher living costs, we believe that the nonforeign area allowance should be restructured so as to better recognize individual circumstances and needs.

INTRA-AREA LIVING COSTS NOT
SUFFICIENTLY RECOGNIZED

CSC bases nonforeign allowance rates on surveys of Federal employee living costs. A single allowance rate is paid in each area except Alaska, where a separate rate was recently established for the City of Anchorage. Living cost surveys are made in three cities in Alaska, two areas in the Virgin Islands, and one city each in Hawaii, Guam, and Puerto Rico. Most Federal civilian employment is concentrated in these particular areas, but a substantial number of employees are stationed outside these areas.

The cost of living varies by geographic location. For example, BLS's 1974 family intermediate budget study shows that (1) costs ranged from 86 percent to 133 percent of the average for the 40 metropolitan areas studied and (2) the average cost for the metropolitan areas was 14 percent higher than for the 4 nonmetropolitan areas studied.

CSC's living cost surveys in Alaska show similar variance patterns. Based on a Washington area index of 100, the 1974 cost-of-living indexes were 121.3 for Anchorage, 123.5 for Juneau, and 129.3 for Fairbanks.

In April 1974, CSC said it would reexamine its approach. Effective June 8, 1975, CSC established a separate allowance rate of 22.5 percent for Anchorage and determined that a rate of 25 percent would still apply in all other areas of Alaska. We believe similar expanded survey coverage in other nonforeign areas would enable CSC to establish regional allowance rates to more properly reflect actual living cost differentials.

CSC COMMENTS

CSC said that justification and precedent were ample for its practice of applying the interarea living cost differential percentage to employees' base pay and using the same allowance for all eligible employees in a given area. CSC said such practices were followed before enactment of the 1948 law and it had merely continued these practices. CSC, however, recognizes the need to explore for nonforeign areas the use of the spendable income concept being used by the Departments of State and Defense. Accordingly, its staff will study the concept and prepare a report for consideration by the Commissioners.

CSC agreed that State and local income taxes affect employees' living costs and should be considered in inter-area cost comparisons. CSC plans to study the entire issue of State and local taxes and to make appropriate administrative changes in its practices. CSC also agreed that its living cost surveys should be expanded to include additional locations within nonforeign areas. Starting with the 1976 surveys, data will be collected on living costs in additional locations in Alaska, Hawaii, and Puerto Rico and, if warranted, separate allowances rates will be established.

CHAPTER 4

CONCLUSIONS AND RECOMMENDATIONS

CONCLUSIONS

The cost-of-living allowance is no longer an appropriate means of compensating Federal employees in nonforeign areas. Since authorization of allowances in 1948, the eligible areas have undergone substantial economic, political, and social changes. Also, a definitive statutory Federal pay policy of comparability with the private sector has been established. Federal pay is based on private sector pay, which is affected by many factors including cost of living. But there is no direct relationship in the private sector between geographic pay rates and geographic costs of living. The allowance is discriminatory since it does not apply to Federal employees in many high-cost areas of the continental United States.

A more equitable means of compensation is available. Special rates of pay could be established in nonforeign areas when private enterprise salaries for a particular occupation and/or geographical area are so much above Federal salaries that they handicap the Government's recruitment or retention of well-qualified personnel.

~~Special~~ Special rates would be a more viable means of handling any recruiting or retention problems since (1) the pay rates established would be based on non-Federal rates and (2) the method has sufficient flexibility to focus on the specific areas and/or segments of the work force requiring special pay consideration.

As administered by CSC, the allowance overcompensates nonforeign area employees for interarea cost-of-living differences. Although CSC agreed that administrative changes may be needed, it declined to take a final position on repeal of the nonforeign allowance authority, pending the outcome of the recommendations of the President's Panel on Federal Compensation and the results of the work of the interagency study committee.

RECOMMENDATIONS TO THE CHAIRMAN, CSC

If the President does not recommend geographic pay rates for white-collar employees and such rates are not enacted, the Chairman, CSC, should develop and propose to the Congress legislation for (1) repealing the cost-of-living allowance authority for nonforeign areas and (2) phasing out in an equitable manner the cost-of-living allowance being received by present employees to lessen any financial

impact where there would be a significant reduction. We recommend, also, that the special pay rate authority be used in nonforeign areas, if warranted, to overcome any recruitment and retention problems caused by higher private sector pay.

Until such time as the allowance is eliminated, we recommend, that the Chairman, CSC, bring it more in line with the intent of existing legislation by requiring that:

- The allowance percentage be applied to employees' spendable income instead of base pay.
- Employees' marital status, family size, income level, and State and local income taxes be considered in determining the amount of allowance.
- Regional allowance rates within nonforeign areas be established where appropriate.

RECOMMENDATION TO THE CONGRESS

The Congress should enact legislation repealing the authority for paying a cost-of-living allowance to Federal employees in nonforeign areas and thereby place Federal employees in these areas on the same footing as similar employees in the continental United States with respect to their pay.



UNITED STATES CIVIL SERVICE COMMISSION

IN REPLY PLEASE REFER TO

WASHINGTON, D.C. 20415

YOUR REFERENCE

Mr. H. L. Krieger, Director
Federal Personnel and
Compensation Division
U. S. General Accounting Office
Washington, D.C. 20548

SEP 22, 1975

Dear Mr. Krieger:

This responds to your letter of June 9, 1975, requesting the Commission's views on a draft report titled, "Change the Policy of Paying Cost-of-Living Allowances to Federal Employees in Non-Foreign areas."

The draft report contains recommendations on five aspects of the cost of living allowance program administered by the Commission and our views on each follow.

1. Legislation to repeal statute authorizing cost of living allowance in nonforeign areas.

The rationale offered in your draft in support of this recommendation is identical to that which was used in 1964 and 1965 by the Commission to justify legislative proposals to repeal the statute. H.R. 7401, 88th Congress (1964) and H.R. 8390, 89th Congress (1965) were Administration-sponsored bills that would have repealed the cost of living allowance statute.

Representing the Administration, the Commission made a forceful logical case for repeal citing all the factors outlined in your draft as justification. Neither bill was ever reported out by the Subcommittee on Compensation. As might be expected, there was intense opposition to repeal by most interested parties.

Circumstances have not changed materially in the ten years since that earlier attempt. Living costs in the nonforeign areas are still substantially higher than Washington, D. C. costs. Accordingly, it is our view that a legislative proposal to repeal the statute, standing alone, would meet the same fate as the previous proposals.

THE MERIT SYSTEM—A GOOD INVESTMENT IN GOOD GOVERNMENT

The President's Panel on Federal Compensation is in the process of conducting a comprehensive review of Federal pay. One cannot predict at this time the recommendations that may result from the Panel's work or the action that may be taken by the President. One subject under consideration by the Panel, for example, is the desirability of setting pay rates for groups of employees on a limited geographic basis as opposed to the current system of worldwide rates for all occupations. If this approach to pay setting is adopted, it certainly would have an influence on the issue of cost of living factors as a basis for employee compensation.

For this reason, we are not taking a position on your recommendation for repeal of the statute pending the results of the work of the President's Panel. In our judgment, the issue must be dealt with within the framework of a comprehensive plan for Federal compensation rather than as an isolated proposal.

From a somewhat different perspective, we believe that the draft takes too narrow a view of this issue by confining it to the situation in nonforeign areas. Through a linkage arrangement among the statutory pay systems, i.e., General Schedule, Department of Medicine and Surgery, and Foreign Service, the comparability principle is applied on a Federal service-wide basis. This means, of course, also on a worldwide basis. Therefore, any consideration of living cost factors in determining Federal pay should be on a service-wide, i.e., worldwide, basis.

Substituting the special salary rate authority for the cost of living allowance program (COLA) may not be an appropriate answer in many overseas areas. Special salary rates may only be used in a limited sense, i.e., when pay competition is causing staffing problems. In many overseas areas, if COLA is repealed, staffing problems may emerge because of living cost factors but in isolated or non-industrial areas there may not be a local employment base that would produce salary competition factors which must, under current law, serve as a basis for authorizing special salary rates.

Accordingly, in this kind of situation, the Government could well find itself in the position of having significant staffing problems in high cost areas but with no flexibility to resolve those problems. If COLA is not the answer (and it may well be the most feasible, if not completely satisfactory, solution) then either the special rate authority should be modified to permit raising pay based on factors other than salary competition or some other pay flexibility should be developed.

In September 1974, GAO released a report titled, "Fundamental Changes Needed to Achieve a Uniform Government-Wide Overseas Benefits and Allowances System for U. S. Employees" (B-180403). This report points out that there is significantly different treatment of employees in nonforeign areas as compared to employees in foreign areas. In each instance, these employees are serving "overseas", that is, outside the 48 States. There are a number of reasons for the differences in treatment and some are not explainable on any logical basis. The report recommends that there be greater consistency of treatment and more equitable application of allowances and benefits to all employees.

A cost of living allowance is paid to employees in foreign areas but under a different statute than the one covering nonforeign areas. Both are intended to compensate employees for living costs substantially higher than Washington, D. C. costs. [Your proposed recommendation to repeal the allowance only for nonforeign areas must be considered within the context of the published report that there should be equal treatment for all employees in overseas areas.] [See GAO note on p. 23.]

The published report, however, also recommends that each allowance and benefit be reviewed to determine its appropriateness, value to the Government, and the like. To this end, the Department of State has organized an inter-agency Committee to review the entire allowance and benefit structure for both nonforeign and foreign areas. The Commission is a member of that inter-agency Committee.

Considerable attention is being given to the cost of living allowance program as well as to other programs like housing. As with the President's Panel, we cannot predict the recommendations or courses of action that might emerge from the Committee's deliberations. The point is that living costs as a factor in compensating Federal employees in overseas areas are being considered by this inter-agency group.

Our conclusion on your proposal to repeal the cost of living statute is that any consideration of this course of action should be based on the results of the work of the President's Panel and the inter-agency Committee. In this way, the issue can be considered within the framework of a comprehensive plan for Federal employee's compensation as well as the considered judgments of agencies regarding the treatment of employees serving overseas in both nonforeign and foreign areas.

2. Allowance payments should be based on spendable income instead of base pay.

3. Allowance payments should consider marital and dependency status.

The percentage of base pay payment method followed by the Commission was established when the law was enacted in 1948 and has continued up to the present time. Prior to enactment of the current law, various

agencies had special authority to make allowance payments outside the 48 States and the amount of payment differed; however, all agencies paid the allowance (whatever it was) as a percentage of base pay. Thus, this payment method precedes the current law and the CSC, in effect, merely continued past practice.

As the following two examples illustrate, adopting the spendable income concept and considering marital and dependency status in computing allowance payments would have a considerable impact on employees now receiving allowances.

COMPENSATION FROM BASE PAY vs. SPENDABLE INCOME

<u>EMPLOYEE STATUS</u>	<u>GRADE/STEP</u>	<u>BASE PAY</u>	<u>25% OF BASE PAY</u>	<u>25% OF SPENDABLE INCOME</u>	<u>DOLLAR DIFFERENCE</u>	<u>PERCENT DIFFERENCE</u>
Single	GS-9/4	\$14,125	\$3,531	\$1,420	\$-2,111	-59.8
Man & Wife & Two Children	GS-9/4	14,125	3,531	2,685	-846	-24.0

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<u>EMPLOYEE STATUS</u>	<u>GRADE/STEP</u>	<u>BASE PAY</u>	<u>12.5% OF BASE PAY</u>	<u>12.5% OF SPENDABLE INCOME</u>	<u>DOLLAR DIFFERENCE</u>	<u>PERCENT DIFFERENCE</u>
Single	GS-9/4	\$14,125	\$1,766	\$1,010	\$-756	-42.8
Man & Wife & Two Children	GS-9/4	14,125	1,766	1,397	-369	-20.9

The first example shows the impact on those employees in Alaska receiving a 25 percent allowance and the second example shows the impact in Hawaii where a 12.5 percent allowance is in effect. For both examples, the amounts received under the spendable income column are based on Department of State payment tables.

In our judgment, the applicability of the spendable income concept to nonforeign areas must be thoroughly explored to assure that it is an appropriate method of payment for that type of employment environment. The issues involved are quite complex and highly technical and time has not permitted us to conduct the kind of indepth study that we believe the issue deserves.

We do not believe it appropriate to simply abandon almost 28 years of practice in paying the allowance without first considering the alternatives and our obligations under the statute. Accordingly, I have directed the staff to study the concept and to prepare a report for consideration by the Commissioners. I will write to you again on this issue when we have reached our conclusions on the staff report.

4. State and/or local income taxes should be included in determining living cost differences.

We agree that taxes represent an expenditure from gross income and that tax liability differences could have an influence on interarea living costs. It is our view, however, that the tax issue goes beyond state or local income tax obligations. Local governments derive their revenue from a variety of sources and the mix of revenue from income vs. other taxes is subject to local political, social, and economic considerations and judgments. For example, a high income tax in one jurisdiction may be offset by real estate taxes in another location.

Accordingly, we intend to explore the issue from the standpoint of total tax liability in the Washington, D. C. area and in each location covered by an allowance. How taxes should be treated in the COLA process would be conditioned by the results of our study.

5. Expand geographic scope of survey.

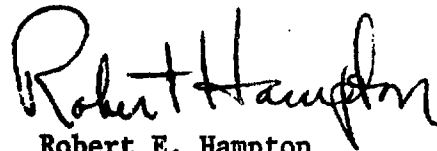
Surveys in the past have been limited to those cities where the majority of Federal employees have duty stations. It is possible that other locations within Alaska, Hawaii, and Puerto Rico may have living costs that differ enough to warrant separate allowance treatment.

Accordingly, starting with the 1976 surveys we plan to collect data in additional locations in Alaska, Hawaii, and Puerto Rico and will establish COLA rates on the basis of local indexes. We are already surveying all appropriate locations in the Virgin Islands and on Guam. The number of additional locations to be surveyed in each place will depend on employment distribution patterns and on the extent to which a surveyable economic base exists.

We have already moved in this direction in Alaska. As a result of the last annual review, a separate allowance rate was set for Anchorage based on the index for that city.

We appreciate the opportunity to comment on the draft report and hope our comments are helpful.

Sincerely yours,



Robert E. Hampton
Chairman

GAO note: Original sentence was changed by CSC to sentence in brackets.

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