

EB/CB/08/6
Supplement 1

CONFIDENTIAL

January 21, 2009

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Consolidated Medium-Term Income and Budget Framework—
Information on the Fund's Deflator and Internal Costs—
Supplementary Material**

The attached supplement to the paper on the medium-term income and budget framework (EB/CB/08/6, 12/29/08) provides information on the use of the external deflator and internal costs in setting the Fund's administrative budget envelopes, which was requested at an informal technical briefing for Executive Directors on budget matters held on January 15, 2009. This supplement will be discussed, together with the related staff paper, at a meeting of the Committee on the Budget, to be held tomorrow, **Thursday, January 22, 2009.**

Questions may be referred to Mr. Green (ext. 34797) and Mr. Henderson (ext. 34745) in OBP.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

**Consolidated Medium-Term Income and Budget Framework—
Information on the Fund’s Deflator and Internal Costs:
Supplementary Material**

Prepared by the Office of Budget and Planning

Approved by Siddharth Tiwari

January 21, 2009

1. At the informal technical briefing for Executive Directors on budget matters held on January 15, 2009, staff were asked for more information on the use of the external deflator and internal costs in setting the Fund’s administrative budget envelopes. This paper responds to that request.

Background

2. Beginning in FY 01, the Fund—like many other international financial institutions—operated under a policy of zero real growth in its annual administrative budget. Initially, *real growth* was measured with reference to the projected or actual rise in the Fund’s internal costs. While the World Bank has continued to follow this approach,¹ in FY 07 the Fund moved to an “external deflator” for setting the Fund’s nominal budget envelopes, as an indirect way to seek efficiency gains by constraining the size of the budget and the number of staff. The current deflator (see Annex I) consists of:

- a personnel component (70 percent), constructed as the weighted average of changes in three published series: U.S. public sector salaries (50 percent), financial sector total compensation (40 percent), and private industrial sector total compensation (10 percent); and
- a non-personnel component (30 percent), set equal to the latest changes in the Washington-Baltimore CPI index.

¹ Specifically, the World Bank’s deflator is constructed as a weighted average of the structural salary adjustment for headquarters-based staff, as approved by the Bank’s Executive Board (53 percent) and the WEO forecast of the U.S. CPI (47 percent). The Bank’s deflator may be revised in the near future as a weighted average of this headquarters-based deflator and similarly calculated deflators for locations where the Bank has overseas offices.

3. Although the external deflator so-constructed has moved in line with the Fund's internal costs in some years, there have been significant deviations in others. The deviation in FY 10 could also be large, depending on the upcoming merit exercise and salary adjustment. Directors will recall that staff compensation follows a three-year cycle. In the first year, comparator-based reviews take into account compensation levels in comparator markets, while in intervening years, index formulae are applied. In both cases, salaries which account for about 70 percent of the budget are largely independent of the external deflator, but this is especially the case for comparator based reviews (as in FY 10).

4. Table 1 presents historical data on the external deflator and internal costs. For illustrative purposes, for FY 10 it assumes a wage bill increase of 6.7 percent, 1 percentage point higher than FY09. (The FY 10 merit exercise will be concluded in March 2010.)

Table 1. Internal vs. External Costs, FY 06–FY 10			
Financial Year	Internal Costs ¹	External Deflator	Difference (internal–external)
2006	3.7	3.5	0.3
2007	6.2	3.4	2.8
2008	3.8	2.7	1.0
2009	3.9	4.0	-0.1
2010 proj.	5.0	3.0	2.0

¹ Calculated as a weighted average of the percent change in the average staff standard cost estimated for the forthcoming financial year (70 percent) and the most recent annual percent change in the Washington-Baltimore CPI (30 percent).

Assessment of a Divergence Between the External Deflator and Internal Costs

5. In the present circumstances where nominal envelopes are constructed on the basis of the external deflator, to the extent that the Fund's internal costs rise faster than the external deflator, any given policy stance implies an even larger reduction in the real resources available to the Fund. In particular, even with a zero-real-growth policy stance, adhering to the budget constraint would require some reduction in staffing (possibly through the maintenance of higher vacancy rates) and/or non-personnel expenditures in each year. Alternatively, when internal costs are lower than the external deflator, unintended financing is provided to the budget.

6. In the context of the current downsizing, the FY 09–11 MTB incorporated up-front steady state efficiency gains—eliminating 380 staff positions and committing to \$100 million in real savings by FY 11—and thus additional reductions through the use of an external deflator should not be sought as it will lead to staffing levels below the steady state FTE target.

7. Calculations shown in the budget framework paper and reproduced in Table 2 assume a 5 percent increase in internal costs in FY 10 and 4 percent thereafter.

Table 2. Net Administrative Budget, FY 08—FY 12				
	FY 09	FY 10	FY 11	FY 12
		(in millions of FY 08 U.S. dollars)		
Approved FY 09–11 MTB (rolled forward)	835	813	796	796
Proposed FY 10–12 MTB		813	796	796
		(in millions of U.S. dollars)		
FY 09–11 MTB				
As approved	868	880	895	
Using FY 10–12 internal costs	868	888	904	
FY 10–12 MTB				
Using external deflator		871	878	904
Using internal costs		888	904	940

Moving Forward

8. In the current circumstances, the Fund could return to defining its deflator on the basis of internal costs. This approach would be consistent with best practices in many central governments that use a multi-year budget framework (Annex II). If members of the Committee agree, staff would seek their endorsement of setting the nominal envelope on the basis of a deflator that reflects internal costs and is calculated as a weighted average of changes in the personnel costs (70 percent) and non-personnel costs (30 percent). Based on this methodology, the staff would seek endorsement of nominal envelopes for FY 10–12 calculated on the basis of internal costs and described in Table 2. Once the salary award is known with certainty this figure would be revised accordingly.

9. A key issue with making such a change would be validating that the \$100 million in real savings has been achieved. The most straightforward approach would be to maintain the real targets set out in the FY 09–11 MTB, and simply revalue them in nominal terms using the new deflator.

**ANNEX I:
CALCULATION OF THE EXTERNAL DEFLATOR**

The External Deflator, FY 06–FY 10

(in percent per annum)

	FY06	FY07	FY08	FY09	Provisional FY10
External Deflator 1/	3.5	3.4	2.7	4.0	3.0
Washington-Baltimore CPI 2/	3.6	4.1	2.9	4.5	2.5
Compensation Index 3/	3.4	3.1	2.7	3.7	3.3
Public Sector Compensation 4/	3.7	3.4	2.6	4.5	4.5
Private Financial Sector Compensation 5/	2.8	2.2	2.9	3.1	1.8
Private Industrial Sector Compensation 6/	4.3	4.6	2.0	2.4	2.3

Sources: U.S. Bureau of Labor Statistics, U.S. Office of Personnel Management.

1/ Calculated as: $0.7 \times \text{compensation index percent change} + 0.3 \times \text{Washington-Baltimore CPI percent change}$.

2/ Washington-Baltimore Consumer Price Index, as published by the U.S. Bureau of Labor Statistics. January observations were used for FY04-FY08; since FY09, November observations have been used. For example, the FY10 figure is calculated as CPI(Nov2008) over CPI(Nov2007).

3/ Calculated as: $0.5 \times \text{public sector percent change} + 0.4 \times \text{financial sector percent change} + 0.1 \times \text{private industrial sector percent change}$.

4/ Federal government scheduled salary increase for the locality pay area of Washington-Baltimore-Northern Virginia, as published by the U.S. Office of Personnel Management. For FY(X), the percent increase effective January 1 CY(X-1) is used; pending release of 2009 data, the FY 10 figure is held constant at the FY 09 percentage change.

5/ Employment Cost Index for Total Compensation: Private Industry Workers: Service-providing industries: Finance and Insurance; as published by the U.S. Bureau of Labor Statistics. For FY(X), the percent increase in the index, Q4 CY(X-2) over Q4 CY(X-3), is used. Pending release of Q4 data for 2008, the FY10 observation is estimated as 2008:Q3 over 2007:Q3.

6/ Employment Cost Index for Total Compensation: Private Industry Workers: Goods-producing industries: Management, Professional, and Related Occupations; as published by the U.S. Bureau of Labor Statistics. For FY(X), the percent increase in the index, Q4 CY(X-2) over Q4 CY(X-3), is used. Pending release of Q4 data for 2008, the FY10 observation is estimated as 2008:Q3 over 2007:Q3.

ANNEX II:
REAL EXPENDITURE FRAMEWORKS—CROSS COUNTRY EXPERIENCE¹

1. **Multi-year real expenditure frameworks are only used by a handful of OECD countries**, but where they are used (Norway, Netherlands, Finland, and a number of transition countries), they are appreciated for the clarity they provide to decision makers in identifying real expenditure growth and cutbacks. Some countries (Australia) nominally have a nominal framework, but these in fact function very much like real frameworks. Budget offices have two ways to maintain and update a real expenditure framework:

(i) **Use of a multitude of bottom-up, line item inflators.** This practice implies that the framework is adjusted during the annual budget preparation process to reflect expected nominal expenditure on a line item basis for the next fiscal year. The framework is only "inflated" for the next year. Nevertheless, using this approach requires price estimates for all line items or for their constituent parts. To do this accurately requires multitude of data and careful screening by the budget office;

(ii) **Use of top-down macro-economic inflators has become the standard in some countries that use real frameworks.** The advantages of this approach include simplicity, accuracy, and the calculation of nominal outlays just before the budget submission. The choice of deflator is important: For central governments, rough deflators such as the GDP deflator have worked well. Wage expenditures are usually not guided by the macro-deflator, but by actual wage agreements for the next year.

2. **Inflation adjustments can also used as a cutback tool**, i.e. by awarding ministries only partial inflation compensation, thus enforcing real cutbacks. FAD advises countries against this practice; rather such cutbacks should be made explicit, for example as efficiency targets.

3. OBP's proposal to use a single price estimate for staff (salaries and benefits) and one price for all other line items is an acceptable simplification of the bottom up approach. Staff costs would be forward looking projections, with the largest component (salaries) set by the Board in the merit exercise. The WEO US inflation projection could be used for all other costs (as is done by the World Bank). The path of real spending—the 13½ percent reduction in staff size and the \$100 million in real savings by FY 11—could be easily identified within this framework.

¹ Prepared by OBP based on input from FAD.