FOR AGENDA

EBAP/11/12

CONFIDENTIAL

February 18, 2011

To: Members of the Executive Board

From: The Secretary

Subject: **Salary Adjustments and the Budget—A Reform Proposal**

Attached for consideration by the Executive Directors is a paper on salary adjustments and the budget—a reform proposal, which is tentatively scheduled for discussion on **Wednesday, March 2, 2011.** A supplement containing a proposed decision will be circulated early next week.

The staff does not propose the publication of this paper after the Executive Board completes its discussion.

Questions may be referred to Mr. Clarke, HRD (ext. 34086) and Ms. Fedelino, OBP (ext. 36053).

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

Att: (1)

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Salary Adjustments and the Budget: A Reform Proposal

Prepared by the Human Resources Department
and the Office of Budget and Planning

In consultation with the Legal Department

Approved by Daniel Citrin and Shirley Siegel

February 18, 2011

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I. Introduction

1. **This paper proposes changes to the Fund's compensation system**. Building on the recommendations of the Working Group on Salary Adjustments and the Budget and the preliminary views of Executive Directors on these recommendations, the paper proposes that the current system for determining and distributing the envelope for merit pay be replaced by a new system.[1] No changes are proposed in the system for determining adjustments in the salary structure based on market comparators. The main proposals are summarized in Box 1.

Box 1. Salary Adjustments and the Budget: Main Reform Proposals

- *Replace the comparatio adjustment with a new system that provides, within a given salary budget, a dollar amount equivalent to the decline in average salaries arising from turnover.*
- *Continue with the current rule-based structure adjustment, to be approved by the Board, and distribute to all staff based on position in the salary range on May 1.*
- *Distribute merit increases to eligible staff on July 1 based solely on performance.*
- *Establish a budget allocation (initially set at 0.5 percent annually for a period of three years) for the cost of changes in the staff grade structure arising from the upgrading of skills.*
- *Eliminate the comparatio adjustment from the global deflator for the Fund's budget.*

2. **Salary adjustments in the Fund include an element based on the comparatio**. The comparatio is a common compensation tool for administering salary adjustments within a defined envelope (see FO/DIS/11/21, Section II). It measures the erosion of salaries relative to the midpoints of the respective salary ranges, which results from turnover and promotions.[2] In the Fund, the comparatio is used to keep the growth in average salaries broadly in line with the salary structure, ensuring that actual salaries remain competitive with those in the Fund's comparator market. The resulting comparatio adjustment also facilitates the progression within salary ranges of good performers. In the absence of this adjustment, average salaries would decline relative to market, and salary progression would be hampered.

3. **The comparatio has long been a source of contention in the Executive Board**. Dissatisfaction with the comparatio has grown in recent years, and has become a key feature of annual discussions on staff compensation in the Executive Board. Four issues relating to salary increases for staff and the application of the comparatio have proved controversial:

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[1] The recommendations of the Working Group are set out in *Salary Adjustments and the Budget—A Reform Proposal* (FO/DIS/11/21), and were presented to Executive Directors at an informal meeting on February 8, 2011.

[2] Newly hired staff receive salaries lower in their salary ranges than those of the staff they replace; and newly promoted staff typically enter the next salary range below the midpoint, as promotion increases (2-5 percent) are smaller than the average distance between midpoints (12 percent).

- ***Headline increase***: the perception that salary increases in the Fund are higher than those awarded in other public and private sector organizations.

- ***Budget deflator***: the inclusion of the comparatio adjustment in the external deflator for the Fund's administrative budget in recent years, which has generated a larger budget envelope than necessary to accommodate increases in the salary structure.

- ***Budget neutrality***: the non-transparent accommodation of changes in the grade structure of staff—resulting from the mix of hiring and promotions—in the salary budget, resulting in salary costs over and above the structure adjustment. While the comparatio does not generate this dynamic, it accommodates it.

- ***Volatility***: the sensitivity of the comparatio to hiring and separations, which results in large comparatio adjustments in sporadic and rare events when turnover is strong, such as during the recent downsizing of the Fund.

4. **In addressing these issues, the paper proposes a system that is more transparent and subject to greater budget discipline**. The proposals address directly the long-standing concerns raised by Executive Directors while remaining faithful to the principles of the Fund's compensation system. Taken as a package, the proposals represent a significant reform of the system governing merit pay.[3]

II. The Proposed System

5. **The proposed system represents a break from past practice**. While adhering to the objectives and principles of the Fund's compensation system (Box 2), the proposed system for determining and distributing merit pay establishes new standards for transparency, pay for performance, and budget discipline. The comparatio system would be replaced with a new system in which the envelope for merit pay is determined within a clearly defined salary budget, including an explicit allocation—a new element compared to past practice—for the cost of changes in the grade structure of staff arising from external hiring, promotions, and separations. New rules would be established to ensure the budget neutrality of the annual merit envelope, and the distribution of merit pay would be separated in time and method from the salary increase that is currently distributed to staff effective May 1. In addition, the comparatio adjustment would be removed from the external deflator for the Fund's administrative budget, a significant change in terms of transparency and potential savings.

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[3] The World Bank has also embarked on a reform of its compensation system (Annex I).

Box 2. Objectives and Principles of the Fund's Compensation System

The central objectives of the compensation system derive from Article XII, Section 4(d) of the Articles of Agreement, which requires that the Fund secure the highest standards of efficiency and of technical competence in its staff while paying due regard to the importance of recruiting on a global basis. Accordingly, the Fund's compensation system aims to be:

- highly competitive in the markets in which it competes;
- structured in a way that provides effective incentives for performance;
- internally equitable and consistent; and
- cost-effective in its design and operation.

The compensation system is comparator based, providing for periodic market reviews to ensure the competitiveness of Fund pay, and is grounded in rules that set the parameters of the system.

A. Budgeting for Additional Structural Cost

6. **Changes in the grade profile of staff can add to structural cost**.[4] As discussed below, changes in the structure of an organization's workforce are to be expected. However, in the Fund, there has been little discussion about their underlying causes and the related cost to the salary budget.

7. **Salary budgets in most organizations grow faster than the salary structure**. This is because year-to-year changes in salary budgets reflect not only structure adjustments (price effects) but also changes in the profile of staff (grade composition effects). These changes typically give rise to additional structural cost above the annual increase in the salary structure. For a large sample of firms in the United States, this structural cost averaged about 1 percent a year over the past 10 years (Table 1).[5] As a recent study published by the leading experts on compensation practice put it:

> *…the salary budget increase normally exceeds the salary structure increase because an organization's salary budget increase reflects not just the typical annual increase in wages, but also the acquisition of skills, competencies and experiences as well as employee performance, while the salary structure only reflects one of these: the annual wage increase.*[6]

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[4] Structural cost is the sum product of the salary midpoints of each grade and the number of staff in each grade.

[5] This additional cost, which includes grade composition effects, is not taken into account in the Fund's compensation system, which matches actual jobs and salaries in the market to establish the Fund payline (midpoints of each grade) every three years.

[6] *Salary Structure Change and Compensation Increase Budgets*, WorldatWork White Paper, January 2011.

Table 1. U.S. Increases in Salary Budget and Structure, 2000–10
(In percent of salaries)

Year	Salary Budget Increase	Structure Adjustment	Difference
2000	4.3	3.1	1.2
2001	4.6	3.2	1.4
2002	3.6	2.6	1.0
2003	3.3	2.5	0.8
2004	3.4	2.5	0.9
2005	3.4	2.4	1.0
2006	3.5	2.5	1.0
2007	3.7	2.6	1.1
2008	3.6	2.9	0.7
2009	1.9	1.5	0.4
2010	2.4	1.3	1.1
Average	3.4	2.5	1.0

Source: Hewitt Associates LLC.

Note: Public and private sector data, the composition of which does not correspond to the Fund's comparator market.

8. **In the Fund, these same dynamics are at play**. The key mechanisms through which the Fund acquires talent and acknowledges growth in skills and experience among its staff are hiring and growth promotions.[7] Hiring raises the grade structure when new staff enter the Fund above the average grade, as is the case with mid-career professionals such as financial sector and technical assistance experts. The gradual reduction of lower-graded support functions (e.g., through outsourcing, technology improvements, and restructuring) has a similar effect. The grade structure can also increase as a result of growth promotions, particularly when separations are low (which tend to occur at higher grades). Growth promotions are a central feature of the Fund's business model: within well-defined grade bands, the Fund provides its staff an opportunity for professional growth, reflecting increasing breadth and depth in skills and experience. They help ensure that the Fund maintains the capacity to meet successfully the evolving demands of its membership; and are a critical component of a motivational framework that rewards well-performing staff for professional development.

9. **The resulting cost increases compare favorably to those in other organizations**. On a net basis, structural changes in the workforce (measured by changes in average midpoints) have added an average 0.8 percent in cost over the past 10 years (Table 2), and were thus contained at a level slightly below the experience of U.S. private and public sector

[7] Growth promotions are promotions within a grade band. For example, the economist grade band covers grades A12–A14, with A14 representing a fully performing senior economist. Beyond A14, promotions are governed chiefly by vacancies and grade complements.

organizations (Table 1). That said, the average increase in structural cost was higher during 2007–10 as a reflection of the downsizing and restructuring exercise and the subsequent surge in crisis-related hiring.

Table 2. Sources of Additional Structural Costs in the Fund, 2001–10
(In percent of average midpoints)

Financial Year	Turnover		Growth Promotions	Total	
	Hiring	Separations			
2001	-2.5	0.2	2.0	-0.3	Average = 0.5
2002	-0.7	-0.3	1.5	0.5	
2003	-0.7	-0.2	1.6	0.7	
2004	-0.4	0.0	1.4	1.0	
2005	-0.6	-0.1	1.5	0.8	
2006	-0.8	-0.1	1.4	0.5	
2007	-0.1	-0.3	1.5	1.1	Average = 1.1
2008	-0.1	-0.3	1.3	1.0	
2009	-0.1	-0.3	1.4	1.0	
2010	-0.5	0.6	1.4	1.5	
Period Average	-0.7	-0.1	1.5	0.8	
Memorandum item:					
2011 (May-January)	-0.5	-0.4	1.4	0.5	

Source: Compensation and Benefits Policy Division.
1/ The methodology used here is more precise, and the results therefore differ slightly from those presented in Table 5 of the Working Group report (FO/DIS/11/21).

10. **Changes in structural cost should be interpreted with caution, as the underlying staff movements can result in complex dynamics.** For example, the downsizing and restructuring lowered total salaries but increased average grades and salaries: a large number of A1–A8 staff separated from the Fund in 2010 and were not replaced, raising the average midpoint of the reduced number of staff who remained (by 0.6 percent in Table 2). By contrast, as part of the 2001 exercise to rationalize the categories of employment, the Executive Board approved the conversion to staff of a large number of contractual appointees, most of whom entered the grade structure at lower levels and thus sharply lowered structural cost (by 2.5 percent in Table 2). Excluding such one-off effects, however, the average annual growth in structural cost during the past decade has been around 0.6–0.7 percent (Table 2); this historical perspective tracks with developments in FY 2011, as the increase in structural cost through end-January 2011 has been 0.5 percent.

11. **To enhance transparency, this additional structural cost will now be explicitly recognized and budgeted**. Based on a projection of the expected additional structural cost arising from turnover and promotions in the upcoming financial year, the Executive Board will be asked to decide on a budget allocation for skill upgrading and promotions.

12. **HR policies and practices, grounded in a strategic workforce plan, will provide guidance on the appropriate size of the budget allocation for skill upgrading.** A number of major HR reforms already under way will help support the proposed salary adjustment system and will help to limit uncertainty about future staff movements. In particular, more systematic workforce planning and reformed promotion policies are being designed to align HR policies and practices more closely with core business needs and budget realities. That said, many of these changes break new territory and their implementation will have to be gradual, with somewhat uncertain immediate impact.

13. **For the next three years, while a better staffing framework is being put in place, the allocation would be set at 0.5 percent of budgeted salaries**. This envelope would provide space for the continuous upgrading in skills required to meet the Fund's business needs, which will be used, inter alia, for hiring of mid-career financial sector and technical assistance experts; as well as to help finance growth promotions. It is expected that the new system will exert some downward pressure on growth promotions; new promotion policies that put a stronger emphasis on performance, potential, and readiness will help to ensure that the reduced space is used optimally.

14. **The proposed size of this allocation is conservative.** It assumes (i) a continuation of the gradual upgrading of the Fund's skills mix; (ii) no significant one-off organizational changes that would increase structural costs; and (iii) strengthened HR policies and budget practices (e.g., grade-by-grade budgeting) to ensure departmental hiring and promotion decisions remain consistent with the budget constraint. It also takes into account—and seeks to contain—recent trends in structural costs.

15. **In case of unforeseen sizable structural changes, the size of the proposed annual allocation could prove unduly constraining**. In such cases, a revised allocation for skill upgrading would be proposed to the Board in the context of the annual budget cycle. In any case, the Board would receive an annual report on the evolution of the grade profile of staff and any related structural cost.

B. Determining the Merit Envelope

16. **In the proposed system, the comparatio adjustment will be replaced by a merit envelope equivalent in dollar terms to the actual "salary erosion" in the previous year, ensuring budget neutrality.** The comparatio adjustment relates average salaries to the respective midpoints toward the end of the financial year, including—and accommodating the effects of—any changes in the underlying grade structure. In contrast, the proposed merit envelope will be defined using the budget as a benchmark. In other words, the system will no longer accommodate automatically the effects of changes in the grade structure through salary adjustments over and above the budget allocation for skill upgrading.

17. **In practical terms, the merit envelope will be determined based on a measure of salary erosion within a given budget envelope.** This measure will be given by the

difference between budgeted average salaries at the start of the financial year and actual average salaries at the end of the year, based on the following elements:

- **Salary budget at the beginning of the financial year.** Salaries of staff (including vacancies) will be valued at the midpoints of their respective grades (adjusted by the structure adjustment and the budget allocation for skill upgrading).

- **Budgeted average salaries at the beginning of the financial year**, given by the salary budget divided by the number of staff and vacancies.

- **Actual average salaries at the end of the financial year,** computed on the basis of total actual salaries.[8]

- **Dollar merit envelope for the next financial year,** determined by multiplying the difference in average salaries by the number of staff eligible for a merit increase.

18. **The proposed merit envelope rests on a simpler and stronger budget foundation than the comparatio adjustment**. It aims at ensuring budget neutrality, while preserving competitiveness as required under the Fund's rules-based compensation system. The annualized dollar amount equivalent to the salary erosion in any given financial year would be distributed on July 1 of the following financial year.

19. **The proposed merit envelope also reinforces the point that merit pay is not an addition to the budget.** This misperception about the comparatio adjustment has proved difficult to dispel. Distributing merit pay at a different time than the structure adjustment will underscore its different nature relative to the structure adjustment (see Section II.C.).

C. Separating the Structure Adjustment and the Merit Increase

20. **Combining salary adjustments at the beginning of the year has contributed to the perception that Fund salary increases are "too large."** This perception may stem from a false comparison between the overall increase awarded to Fund staff at the beginning of the financial year (comprising both a structure adjustment and a comparatio adjustment) and the announced increases of private and public sector organizations, which do not take into account the range of salary adjustments awarded to individual employees. For example, *step increases* in many public sector organizations work in the background, are administered and distributed in a more or less automatic way, and are not related to or assessed together with annual structure adjustments.

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[8] Average salaries will be computed so that any under spend arising from unfilled vacancies does not translate into a higher merit pay envelope.

21. **Placing Fund salary adjustments on an equal footing with those of other organizations is thus key to enhancing understanding of Fund compensation**. The proposed approach is intended to more clearly isolate the structure adjustment as the appropriate basis for comparison with other organizations. The new system would decompose the overall salary increase (currently awarded as one increase on May 1) into its constituent parts:

- ***a structure adjustment*** would continue to be determined on the basis of the current system and approved by the Executive Board, for distribution to staff on May 1; and

- ***a merit increase*** would be determined on the basis of the approach described in Section II.B., for distribution to eligible staff on July 1. The timing of the increase would coincide with the conclusion of the Annual Performance Review, in which the relative performance rankings of staff are established.

22. **An additional change in the method of allocating salary increases would reinforce differences between the structure adjustment and the merit increase**. Under the current approach, the overall salary increase is distributed based on two factors: position in the salary range, consistent with the compensation principle that individual salaries should converge to the midpoint of the salary range over time (midpoint control), and performance. Under the proposed system, the structure adjustment would be distributed on the basis of position in the salary range (excluding staff whose performance was deemed unsatisfactory) and the merit increase would be distributed on the basis of performance. This system (with a stand-alone merit envelope) would engender a heightened awareness among staff of the incentives for strong performance.[9] As in the past, the distribution of merit pay will be administered by management, based on the assessment of performance in the Annual Performance Review. Table 3 summarizes the process changes.

Table 3. Proposed Distribution of Salary Adjustments

	Current system		**Proposed system**	
Structure adjustment	May 1	Based on position in salary range and performance	May 1	Based on position in salary range
Comparatio adjustment	May 1		n.a.	
Merit Increase			July 1	Based on performance

[9] Under the Fund's performance assessment system, only three rating categories are eligible for merit pay, and about 30 percent of staff typically falls in the top two categories. With a smaller merit pay envelope, meaningful merit increases for top performers will require that the size of merit increases be limited for others.

D. Removing the Comparatio Adjustment from the Budget Deflator

23. **The deflator is a price index used to translate the budget envelope, formulated in real terms, into nominal terms**. Its current construction is based on the concept of an external deflator introduced in 2006, to establish an anchor for measuring and constraining spending growth. [10] The basic building blocks of the external deflator, broadly reflecting the composition of the Fund's administrative budget, are as follows:

- ***A personnel component*** (70 percent weight), based on an external salary index derived on the basis of the Board-endorsed methodology for comparing Fund salaries to the national markets and sectors that comprise its comparator market. As the structure adjustment is determined by salary movements in the comparator market and ensures that the salary structure is competitive, it was chosen to measure personnel costs at the Fund.

- ***A non-personnel component*** (30 percent weight), based on an index that reflects most closely the Fund's non-staff related costs (travel, facilities, and IT). This has been measured by the projected U.S. CPI.

24. **The deflator was modified in 2009 to include the total salary increase (structure adjustment and comparatio adjustment) in the personnel component**.[11] While the comparatio adjustment should be budget neutral, this change was considered appropriate to deal with the uncertainty associated with the restructuring and the increased work pressures created by the financial crisis. In particular, the restructuring and downsizing exercise was expected to result in an upgrade, on average, of the staff profile. The change in the deflator works to accommodate this shift, as well as some benefits that were not growing in line with the structural salary increase.

25. **With the restructuring largely completed, the design of the deflator should be re-aligned to its primary purpose—measuring the cost drivers in the Fund's budget for a given level of real activity and business**. Therefore, it is proposed that the deflator exclude the comparatio adjustment, while retaining the two components for personnel and non-personnel costs. [12] Any real growth in personnel costs would be budgeted for explicitly (see Section II.B).

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[10] *The FY2007–FY2009 Medium-Term Administrative and Capital Budgets* (EBAP/06/39, 3/31/06).

[11] See *The Global External Deflator: Setting Nominal Budget Envelopes in the Fund's Medium-Term Budget* (EB/CB/08/6, Sup. 1, 1/21/09).

[12] The proposed changes in the deflator were discussed by the Committee of the Budget on January 28, 2011 on the basis of *Initial Contours of the FY 12–14 Medium-Term Budget and Consolidated Income and Expenses Framework,* (EB/CB/11, 1/13/11); and at the February 8, 2011 informal session of the Executive Board on *Salary Adjustments and the Budget—A Reform Proposal* (FO/DIS/11/21, 1/28/11).

26. **The proposed change in the deflator will reduce its size significantly**. If the deflator continued to include the comparatio adjustment in the personnel component, other things being equal, the deflator would be larger by 1.2 percentage points of salary each year over the medium term (Table 4).

Table 4. Projected Global External Deflator (with and without Comparatio Adjustment)

		Financial Years								
		2012	2013	2014	2015	2016	2017	2018	2019	2020
A.	Personnel component (70 percent)	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2
A.1	Structure Adjustment 1/	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
A.2	Comparatio Adjustment 2/	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7
B.	Non-personnel component (30 percent)									
	U.S. CPI (WEO projections)	1.1	1.4	1.6	1.8	1.8	1.8	1.8	1.8	1.8
	Global External Deflator									
C.	Current (A×0.7 + B×0.3)	2.6	2.7	2.7	2.8	2.8	2.8	2.8	2.8	2.8
D.	Proposed (A.1×0.7 + B×0.3)	1.4	1.5	1.5	1.6	1.6	1.6	1.6	1.6	1.6
	Difference (D-C)	-1.2	-1.2	-1.2	-1.2	-1.2	-1.2	-1.2	-1.2	-1.2

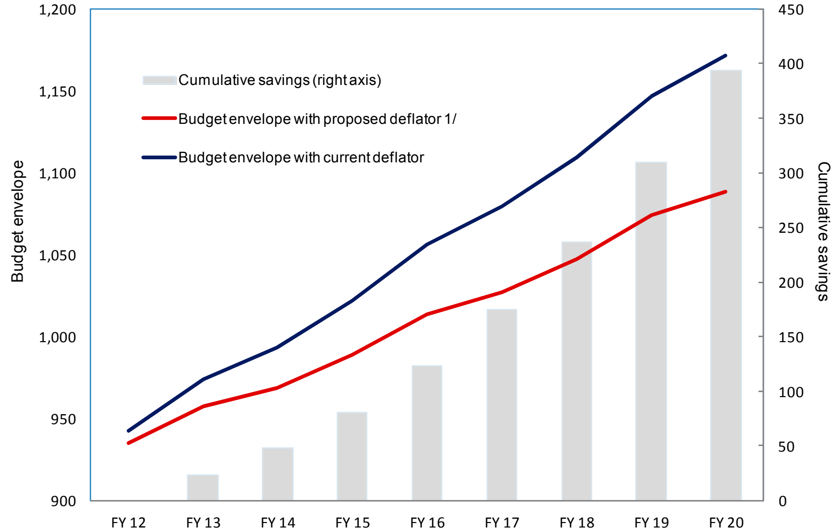
Source: Office of Budget and Planning.
1/ Assumed to remain constant at the 2012 level.
2/ Assumed to equal the historical average over the last decade.

27. **The resulting nominal budget envelope would be significantly lower**. Even taking into account the allocation for the additional structural cost (0.5 percent), the resulting savings are large and compound over time (Figure 1).

28. **The proposed system would therefore significantly enhance transparency**. This would be achieved by:

- excluding the comparatio adjustment from the global external deflator;
- explicitly budgeting for skill upgrading; and
- establishing precise rules for calculating the dollar budget for merit increases.

Figure 1. Removing the Comparatio Adjustment from the Deflator: Projected Savings
(In millions of U.S. dollars)



1/ Reflects the proposed allocation of 0.5 percent for skill upgrading, which is not part of the deflator.

E. Implementation in FY 2012

29. **It is proposed that the new system be put into effect starting with the 2011 compensation round**. The methodology described in Section II will be applied. In order to do so, a method must be established on a notional basis for generating a merit pay envelope for FY 2012, since the FY 2011 budget formulation for personnel costs did not provide an explicit allocation for skill upgrading. Therefore, it is proposed to apply the system as if such an allocation had been in place, minus the dollar amount equivalent to 0.2 percent of salary in accordance with last year's decision to phase in the impact of the downsizing on the comparatio over three years.[13]

30. **Other elements of the proposed system will be introduced with immediate effect**. In particular, following Board approval of a proposed structure adjustment as part of the 2011 staff compensation round, the resulting increase will be distributed to staff effective May 1, 2011. The subsequent paper on the administrative budget for FY 2012 will include the proposed 0.5 percent allocation for skill upgrading, while the outturn paper on the administrative budget for FY 2011 will provide information on the dollar amount for merit pay generated by the methodology described in paragraph 28 above. This amount will be distributed to eligible staff effective July 1, 2011.

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[13] See *2010 Review of Staff Compensation* (EBAP/10/24, 03/30/2010).

III. Simulating the Impact of the New System

31. **The proposed system alters the way salary adjustments are computed**. The impact of this change can be assessed using either:

- *backward-looking simulations*—these assess how salary adjustments would have evolved had the proposed system been in place in the past; or

- *forward-looking simulations*—these gauge the future evolution of salary adjustments over time. This approach does not provide much insight into the dynamics of the proposed system, as it inevitably relies on projections of constant values of key parameters (either at their historical average level or at their latest observation), and was therefore not pursued.

32. **Backward-looking simulations also pose a number of challenges**. Computing the dollar-based merit increase (as described in Section III.B) requires information on the budget baselines that is not available: in the past, personnel budgets were not established with a granular definition of grades, a practice that was introduced only recently;[14] similarly, existing vacancies were not assigned a specific grade. To overcome this hurdle, the analysis presented in this paper relies on the intuition that salary adjustments under the proposed system would be equivalent to the comparatio adjustments in cases when the increase in structural cost above the structure adjustment had been contained to 0.5 percent a year.

33. **The results suggest that salary increases would have been lower under the proposed system.** Assuming that the proposed system had been introduced in FY 2000, annual salary increases since then would have been lower by 0.4 percentage points on average (Table 5). The difference between salary increases under the comparatio system and the proposed system would have fluctuated over the years: initially, the proposed system would not have changed the outcome; in later years, it would have imparted significant downward pressure on salary increases, most notably in 2010. These results are suggestive but they do not take into account possible changes in staff movements in response to the tighter constraint.

34. **The proposed system preserves the basic framework for determining salary adjustments but, because greater discipline will be exercised over structural cost increases, would lower overall salary costs relative to what they would have been otherwise**. In line with the findings in Table 5, savings would have started to accrue in FY 2003, and would have accelerated in recent years (Annex II). On a cumulative basis, savings would have amounted to some $43 million by 2010 (Figure 2). While only illustrative, these

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[14] *Changing the Personnel Standard Cost (*EB/CB/08/5).

results strongly suggest that the proposed salary adjustment system, combined with stronger workforce planning, will impart discipline over salary costs at the Fund.

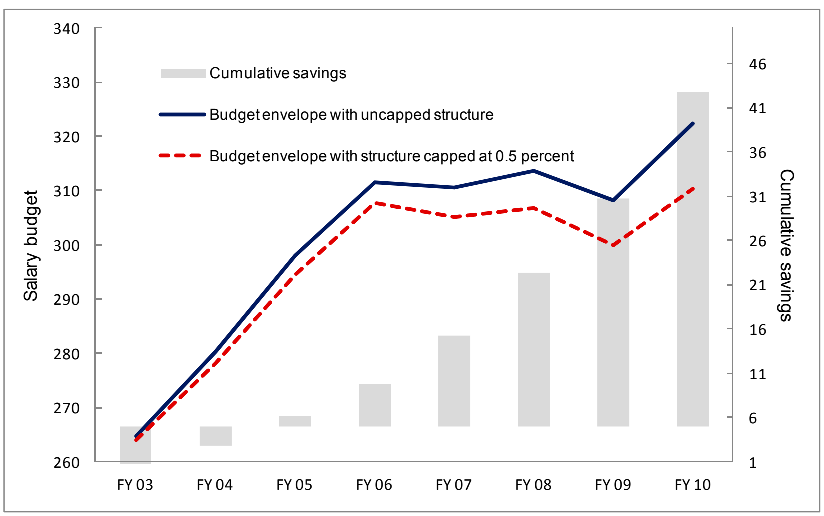
Table 5. Simulation of Proposed Salary Adjustment System, FY 2000–10

Year	Actual			Proposed System 1/		Difference
	Structure Adjustment	Comparatio Adjustment	Overall Increase	Comparatio Adjustment	Overall Increase	
	A	B	C = A+B	D	E = A+D	C - E
2000	4.5	1.9	6.4	1.9	6.4	0.0
2001	4.8	1.9	6.7	1.9	6.7	0.0
2002	4.0	1.9	5.9	1.9	5.9	0.0
2003	4.0	1.9	5.9	1.7	5.7	0.2
2004	5.6	1.5	7.1	1.0	6.6	0.5
2005	3.6	1.7	5.3	1.4	5	0.3
2006 2/	*-0.4*	*3.6*	*3.6*	*3.6*	*3.6*	*0.0*
2007	3.3	0.7	4.0	0.1	3.4	0.6
2008	4.2	1.5	5.7	1.0	5.2	0.5
2009	3.3	1.7	5.0	1.2	4.5	0.5
2010	2.6	2.3	4.9	1.3	3.9	1.0
Average 3/	4.0	1.7	5.7	1.3	5.3	0.4

Source: Compensation and Benefits Policy Division.

1/ Merit increases resulting from limiting the cost of staff structure changes to 0.5 percent.
2/ In 2006, a supplemental increase was awarded beyond the comparatio adjustment. For this reason, 2006 data are not comparable to the rest of the seris.
3/ Excludes 2006 data as they are outliers (see footnote 2).

Figure 2. Simulated Savings Under the Proposed System, FY 2003–10
(In millions of U.D. dollars)



ANNEX I: RECENT CHANGES IN THE WORLD BANK COMPENSATION

The World Bank Group adopted revisions to elements of its compensation system on February 8, 2011. The new approach for determining the overall pay increase (OPI) will consist of three elements:[15]

- a *structure adjustment*, to align salary scales with comparator markets (no change);
- a *salary progression adjustment (0.6 percent for Washington-based staff)* to allow some progression of staff salaries within their respective ranges and to address partially the erosion of aggregate salaries during the year;[16] and
- a *supplemental merit increase adjustment (up to a maximum of 1.1 percent for Washington-based staff)* to be distributed only to the high performing staff and/or to staff in critical grades that lag behind the market. Simulations suggest that over the last five years this increase would have been 0.5 percent. The supplemental merit increase adjustment will be calculated annually based on a 5-year rolling average of the difference between aggregate salaries of top performers in relation to their respective midpoints, subject to the maximum of 1.1 percent.

The second and third components are in lieu of a comparatio adjustment, which are, taken together, smaller in size. Under the new approach, the payroll will not be raised to market levels, and the overall comparatio will not equal 100. However, to assess competitiveness, the gap between salaries and market levels will be tracked, and adjustments will be made up to a certain limit/cap for distribution to top performers. The new approach places greater emphasis on performance differentiation, with highest performing staff having the opportunity to receive a higher annual salary increase.

The World Bank Group Overall Pay Increase: All Distributed Based on Performance

Prior Approach	**New Approach**
Overall Pay Increase (OPI) Envelope:	Performance-Based Salary Increase (PBSI) Envelope:
Structure Adjustment	Structure Adjustment
Comparatio Adjustment (1.7 percent on average)	Salary Progression Adjustment (0.6 percent)
	Supplemental Merit Increase (SMI) Envelope:
	0.5 percent based on last 5-year average, up to a cap of 1.1 percent

[15] The same compensation framework, principles and approach will apply to WBG country offices.

[16] The 0.6 percent is calculated based on the average salary erosion of staff with more than one year in the same grade, over the last 5 years. The actual average salary erosion of all staff over this period was 1.7 percent a year.

All elements of the overall pay increase envelope will be distributed based on performance (and position in range under the PBSI) and there will be no automatic increase or cost of living increase.

As has been the practice since 2006, the structure adjustment will continue to be the only input for the Price Adjustment Factor for Headquarters and country offices (direct budget impact). The salary progression adjustment and the supplemental merit increase components will be absorbed within the real budget envelope.

The new compensation approach adopted by the World Bank is thus fundamentally different from the one it replaces. A key change is the departure from the compensation principle typically followed among international financial institutions that determines the organization's competitiveness by aligning average salaries with payline midpoints (or ensuring a comparatio broadly equal to 100). The new approach will be implemented in the Bank Group's FY12 annual compensation review (July 1, 2011). It will be monitored over time to ensure competitiveness.

ANNEX II: SIMULATING THE SAVINGS UNDER THE PROPOSED SYSTEM

What would have been the implications of the proposed 0.5 percent allocation on the cost of changes in the grade structure had this been applied in the past? In other words, what would have been the size of the salary budget if structural costs had been contained to 0.5 percent? An illustrative analysis is provided in Table A1.

The historical baseline (left block) shows the actual cost of changes in the grade profile of staff (that is, the growth in average salaries above the increase given by the structure adjustment). This cost amounted on average to 0.8 percent over FY 2001–10. It is computed by comparing staff-weighted average actual midpoints at the end of the financial year (April 30) to the staff-weighted average actual midpoints at the beginning of the same financial year (May 1)—combining the impact on the salary structure (average midpoints) from all personnel actions that affect the grade structure of staff (separations, hiring, and promotions).

The "scenario with constrained structure costs" (central block) shows what would have been the effect of limiting the structural cost to 0.5 percent for each financial year. With this illustrative scenario, end of year average midpoints are computed as if their growth were limited to 0.5 percent. As shown in Table A1, starting in FY 03, the end of year midpoint would have changed, impacting in turn the starting and ending midpoints for the following financial years (where the 0.5 percent limit would also have been binding). For this simulation, midpoints were rebased by applying the allocation of 0.5 percent.

Based on this approach, applying the proposed new system to the midpoints with constrained structure costs would have delivered a lower salary budget (right block). The annual savings would have amounted to some $11 million in FY10—or a cumulative $43 million over the period.

While only illustrative, the analysis shows that the savings are significant.

Table A1. Illustrative Savings from the Proposed System, FY 2001–10

FY	Historical Baseline			Scenario with Constrained Structure Costs				Illustrative Savings			
	Average Midpoints							Salary Budget			
	May 1	April 30	Increase	Limit on Structural Movements	Computed Structural Increase	Computed Average Midpoint	Number of staff	Current System	Proposed System	Savings	Cumulative Savings
	A	B	C = B / A	D = max(C,0.5%)	E = (A(t+1) / B(t))-1	F = min(B/F(t-1)× (1+D(t-1)+E(t-1)))	G	H = B×G	I = F×G	J = H - I	K
FY 01	89,332	89,040	-0.3%	0.0%	4.8%	89,040	2,552	227,230,080	227,230,080	0	0
FY 02	93,311	93,786	0.5%	0.5%	4.0%	93,786	2,665	249,939,690	249,939,690	0	0
FY 03	97,540	98,249	0.7%	0.5%	4.0%	98,009	2,694	264,682,806	264,036,057	646,749	646,749
FY 04	102,179	103,238	1.0%	0.5%	5.6%	102,419	2,715	280,291,170	278,068,594	2,222,576	2,869,324
FY 05	109,019	109,888	0.8%	0.5%	3.6%	108,667	2,711	297,906,368	294,595,229	3,311,139	6,180,464
FY 06	113,844	114,459	0.5%	0.5%	0.3%	113,122	2,721	311,442,939	307,804,939	3,638,000	9,818,464
FY 07	114,785	116,051	1.1%	0.5%	3.3%	114,010	2,676	310,552,476	305,090,207	5,462,269	15,280,733
FY 08	119,880	121,036	1.0%	0.5%	4.2%	118,341	2,592	313,725,312	306,741,154	6,984,158	22,264,891
FY 09	126,120	127,385	1.0%	0.5%	4.1%	123,904	2,420	308,271,700	299,847,733	8,423,967	30,688,858
FY 10	132,563	134,571	1.5%	0.5%	2.6%	129,560	2,395	322,297,545	310,296,309	12,001,236	42,690,094
		Average	0.8%	0.5%							

Source: Compensation and Benefits Policy Division.