

**FOR
AGENDA**

EBAP/11/12
Correction 1

CONFIDENTIAL

February 24, 2011

To: Members of the Executive Board
From: The Secretary
Subject: **Salary Adjustments and the Budget—A Reform Proposal**

The attached corrections to EBAP/11/12 (2/18/11) have been provided by the staff:

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 2, Box 1, first bullet: for “a dollar amount equivalent to the decline in average salaries arising from turnover.”

read “a dollar amount equivalent to the decline in average salaries arising from turnover, to be distributed as merit pay.”

Box 1, third bullet: for “Distribute merit increases to eligible staff on July 1”
read “Distribute merit pay to eligible staff on July 1”

Page 2, footnote 1: for “(FO/DIS/11/21)” read “(FO/DIS/11/21, 1/28/11)”

Page 12, paragraph 30, line 7: for “pay generated by the methodology described in paragraph 28 above”

read “pay generated by the methodology described in paragraph 29 above”

Page 14, Figure 2, sub-title: for “(In millions of U.D. dollars)” read “(In millions of U.S. dollars)”

Figure 2, legend, first line: for “Cumulative savings”
read “Cumulative savings (right axis)”

Page 18, Table A1, footnote added to read: “1/ Computed structure increases are different from the structure increases approved by the Board in 2006 and 2009 due to differences in methodology.”

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: (4)

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INTERNATIONAL MONETARY FUND

Salary Adjustments and the Budget: A Reform Proposal

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and the Office of Budget and Planning

In consultation with the Legal Department

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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, to be distributed as merit pay.*
- *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 pay 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:

¹ The recommendations of the Working Group are set out in *Salary Adjustments and the Budget—A Reform Proposal* (FO/DIS/11/21, 1/28/11), 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).

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	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	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	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	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	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	1.6
Difference (D-C)	-1.2	-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.

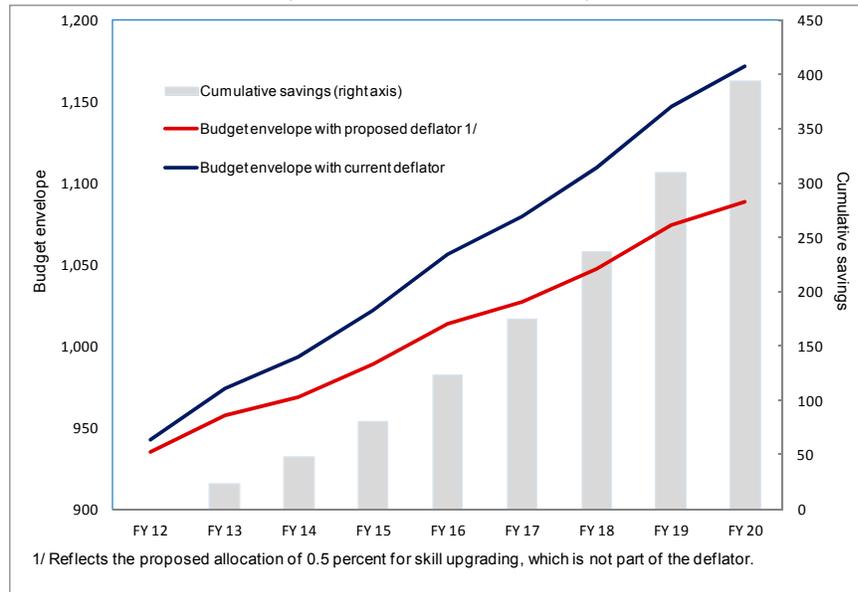
2/ Assumed to equal the historical average over the last decade.

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)



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 29 above. This amount will be distributed to eligible staff effective July 1, 2011.

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

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 C - E
	Structure Adjustment	Comparatio Adjustment	Overall Increase	Comparatio Adjustment	Overall Increase	
	A	B	C = A+B	D	E = A+D	
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

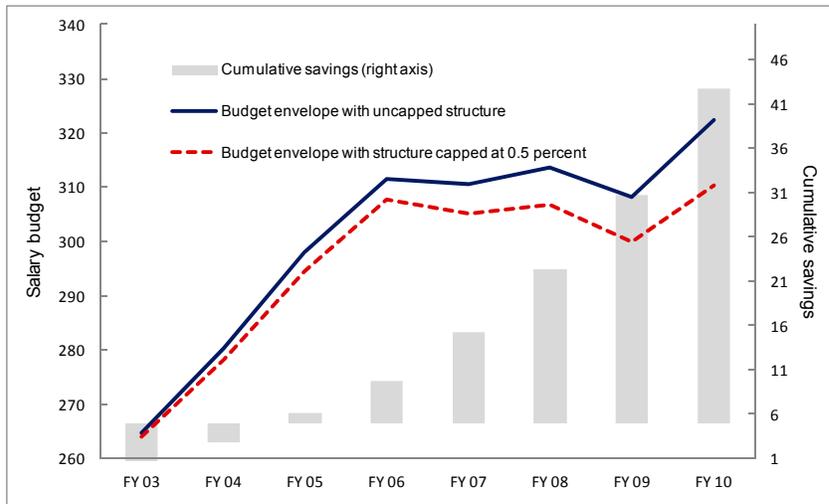
Source: Compensation and Benefits Policy Division.

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 series.

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.S. dollars)



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			Limit on Structural Movements	Computed Structure Increase 1/	Computed Average Midpoint	Number of staff	Salary Budget		Savings	Cumulative Savings
	May 1	April 30	Increase					Current System	Proposed System		
	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.

1/ Computed structure increases are different from the structure increases approved by the Board in 2006 and 2009 due to differences in methodology.