**IMMEDIATE ATTENTION**



EBAP/87/238
Correction 1

November 6, 1987

To: Members of the Executive Board

From: The Secretary

Subject: Review of the Average Deduction System and Proposed Modifications Resulting From the 1986 Tax Reform Act

The attached correct page 14 should replace the one which was inadvertently included in EBAP/87/238 (11/2/87).

Att: (1)

Other Distribution:
Department Heads

## Report of the Joint Working Group on the Average Deduction System

### I. Introduction

After an extensive review in the context of the Joint Committee on Staff Compensation Issues (the Kafka Committee), the Executive Boards of the Bank and the Fund approved the introduction, beginning in 1980, of a new tax allowance system based on the average deductions claimed by U.S. taxpayers generally. The new system replaced a system based on standard deductions that had been in effect since the early days of the two institutions.

At the time the average deduction system was introduced, it was decided that a comprehensive review of that system would be undertaken at the end of a five-year transitional period. That review was due in 1985, but it was postponed in view of the major revisions of the U.S. tax code, which were then being considered, and which led to the adoption on October 22, 1986 of the far-reaching Tax Reform Act of 1986. The present paper has the twofold objective of (i) undertaking the review of the implementation of the average deduction system that was to have taken place at the end of the five-year transition period, and (ii) considering the implications of the Tax Reform Act on the average deduction system.

This paper is limited to the review of the operation of the tax allowance system and the adjustments to the existing system needed to take account of the 1986 Tax Reform Act. Other issues, such as equity considerations arising outside the tax allowance system, including the appropriateness of the dependency allowance, treatment of spouse income, and the implications of the 1984 Tax Act for G-IV visa holders are not included. These subjects raise more fundamental issues of the impact of the tax allowance system in relation to the equitable treatment of all staff with respect to the income they earn from the Bank and Fund. Furthermore, this paper does not examine the difficult and more fundamental issue of the longer-term feasibility of the average deduction system in the light of the far-reaching implications of the 1986 Tax Reform Act for average deductions generally after the law is fully implemented. Accordingly, these issues of equity and the future feasibility of the average deduction system will be taken up by the Bank and Fund staff as the full implications of the Act become clearer.

### II. Considerations in Establishing the Average Deduction System

1. The previous tax reimbursement system based on standard deductions was considered to be broadly reasonable when it was established in 1946. Over time, however, standard deductions did not keep pace with nominal incomes

and with changes in the tax code. 1/ By the mid-1970s, there was broad agreement among the staff associations, administrations, and managements of the Bank and Fund that the system needed to be changed. There was, however, a wide divergence of views as to what the primary objective of a tax allowance system should be, and the type of system that should be adopted. The average deduction system, as adopted in 1980, is a compromise between competing objectives, and an understanding of the objectives that were weighed at the time the system was adopted is useful in understanding its various features.

2. The two main objectives were

a. Internal equity between U.S. nationals and expatriate staff

The criterion of equal pay for equal work must be applied at the net salary level; thus, all other things being equal, staff members at the same grade should earn the same net income. U.S. staff have tax liabilities that vary depending on their personal circumstances; internal equity requires a tax allowance system which fairly recognizes these liabilities and neither underreimburses nor overreimburses taxes paid, which would have an impact on after-tax income.

b. External equity between Bank/Fund employees and those employed outside (i.e., symmetry with the compensation-setting process)

Bank/Fund net salaries are derived from external gross salaries by application of the appropriate tax rates and deductions to outside gross salaries. Thus, symmetry requires that this netting-down process be as close as possible to the grossing-up process used to develop tax allowances. Otherwise, the gross equivalents of U.S. nationals in the two organizations will deviate substantially from the gross salaries of external comparators.

3. The Kafka Committee considered a range of alternative tax allowance systems in the light of these two objectives, as well as other criteria,

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1/ Under the Internal Revenue Code, taxpayers may either itemize their personal deductions or take the standard deduction (called the "zero bracket amount" from 1978 to 1986), whichever is more advantageous. Personal deductions are those that can be itemized on Schedule A of the U.S. Individual Income Tax Return such as medical/dental expenses, state and local taxes, interest expense, charitable contributions, etc. The Tax Reform Act of 1986 altered substantially the types and amounts of deductions that can be claimed by those who itemize. The standard deduction that can be claimed by those who do not itemize depends upon the filing status, i.e., married filing jointly, head of household, single, or married filing separately. The relationships between the standard deductions for these various categories have changed substantially over time, and certain problems in the implementation of the average deduction system for low-income staff that have arisen as a result of these changes are addressed later in this paper.