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October 15, 1992

To: Members of the Committee on Administrative Policies

From: The Committee Secretary

Subject: Review of the Tax Allowance System

There is attached for consideration by the Committee a review of the operation of the Fund's tax allowance system and proposals for changes in the system. This matter will be taken up at a meeting of the Committee on a date to be announced.

Mr. J. Kennedy (ext. 34665) is available to answer technical or factual questions relating to this paper.

Att: (1)

Other Distribution:
Members of the Executive Board

INTERNATIONAL MONETARY FUND

Review of the Tax Allowance System

Prepared by the Administration Department

Approved by Graeme Rea

October 15, 1992

I. Introduction

This paper presents the results of a comprehensive review of the tax allowance system used by the Fund and World Bank to compensate staff members who are United States citizens for the taxes paid on their salaries and allowances. It sets forth recommendations for (a) an arrangement to limit the extent to which allowances may fall short of the estimated tax attributed to income from the organizations, and (b) a number of limited technical changes in the present method of calculating allowances. The President of the World Bank has submitted the same proposals to the Executive Board of the Bank.

The paper is organized as follows:

- Section II outlines the origins, objectives, and operations of the tax allowance system.
- Section III summarizes the purpose and main elements and conclusions of the present review; summaries are provided of a technical study of the methodology used in establishing tax allowances and a study of the relative benefits and costs of participation by U.S. staff in the U.S. Social Security System.
- Section IV provides an evaluation of the effectiveness of the tax allowance system and describes the issues involved in modifying the present arrangements.
- Section V discusses possible means of improving the effectiveness of the current system, and presents management's recommendations for changes.
- Section VI sets out the administrative and cost implications of the proposed changes.

II. Current Tax Allowance System

A. Origins and purpose

The tax allowance system dates to 1946 when the Fund and Bank began operations. The two Boards of Governors recognized at that time that measures to eliminate or equalize the burden of taxation on Fund and Bank compensation were essential to achieving equity among members and equality among the personnel of the organizations. To this end, it was decided that salaries would be paid on a net-of-tax basis, and, Article IX, Section 9 of the Fund's Articles of Agreement stipulated that:

> "No tax shall be levied on or in respect of salaries and emoluments paid by the Fund to Executive Directors, Alternates, Officers, or employees of the Fund who are not local citizens, subjects, or other local nationals."

Companion resolutions of the two Boards of Governors recommended to members that they take the necessary action to exempt their nationals from taxation on Fund compensation. Many, but not all, member countries did agree to exempt the organizational pay of staff from taxation. It was accordingly decided that, until such time as exemptions were secured, the Fund and Bank would reimburse the tax payable on organizational income to staff with a continuing liability to taxation. By this means, any staff required to pay taxes on their Fund or Bank income would be left with essentially the same after-tax net income from the organizations as staff members not subject to taxation. This decision was incorporated in the By-Laws of both organizations; Section 14(b) of the Fund's By-Laws provided the following:

> "Pending the necessary action being taken by members to exempt from national taxation salaries and allowances paid out of the budget of the Fund, the Governors and the Executive Directors, and their Alternates, the Managing Director and the staff members shall be reimbursed by the Fund for the taxes which they are required to pay on such salaries and allowances.
>
> In computing the amount of tax adjustment to be made with respect to any individual, it shall be presumed for the purposes of the computation that the income received from the Fund is his total income. All salary scales and expense allowances prescribed by this Section are stated as net on the above basis."

From the beginning, the overwhelming majority of staff members receiving tax reimbursements or allowances have been U.S. nationals.1/ The

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1/ When other staff are subject to taxes on their net salaries, for example French nationals employed in the Paris office, tax allowances are calculated on as consistent a basis as possible with the system for U.S. staff.

original system for reimbursing taxes remained in effect, with a few modifications made to reflect changes in U.S. tax laws, until 1980. Between 1978 and 1980, the Joint Committee of Fund and Bank Executive Directors on Staff Compensation Issues (the Kafka Committee) considered a wide range of possible changes to the system. The impetus for this review was concern about the rising cost of tax reimbursements and certain features of the system which were believed to allow many staff to receive payments substantially larger than the estimated tax due on Fund or Bank income. In January 1980, the Executive Boards of the organizations adopted a new system which provided that in the tax calculations, U.S. staff would be assumed to have the same deductions from income as the average amounts claimed by all U.S. taxpayers at the same income level. 1/ This "average deduction" system remains the basis of the current method of calculating tax allowances in the Fund and Bank.

B. Objectives of the Present System

The present tax allowance system was developed as a compromise among a number of competing objectives. The two principal objectives were (a) internal equity among U.S. staff and between U.S. nationals and expatriate staff, and (b) external equity or comparability between Fund and Bank staff and persons employed outside (i.e., consistency with the process used to establish Fund and Bank net salaries on the basis of gross salaries in the comparator markets). Other objectives included cost, ease of administration, and comprehensibility to staff.

With respect to internal equity, the aim is that, all other things being equal, staff members at the same net salary level should have the same after-tax income. The tax liabilities of staff vary widely, however, depending on their personal circumstances, their outside income, and/or the income of their spouse. To achieve a reasonable degree of equity, the tax allowance system must recognize such differences in a manner that does not unduly under-reimburse or over-reimburse the taxes payable on organizational income.

The criterion of external equity relates to the process used by the Fund and Bank to establish net salaries. Under the compensation system, these are derived from external gross salaries by applying the appropriate tax rates and the average deductions of taxpayers with the indicated gross salary. Prior to January 1980, however, before the present tax allowance system was adopted, allowances were calculated using the standard deduction, which was likely to be smaller than the average deductions. 2/ The result of using different deductions tended to be a much higher gross for U.S. staff in the Fund than U.S. employees outside.

1/ EBM/80/13 dated January 21,1980.

2/ Annex I provides a summary description of the U.S. tax code, including an explanation of the personal exemptions, the available filing statuses, and other terms used in this paper.

The system adopted in 1980 struck a balance between these objectives. On the one hand, the calculation of tax allowances takes into account each staff member's actual circumstances, state of residence, number of dependents for whom a personal exemption can be claimed, and, with an exception noted below, filing status. On the other hand, the calculations assume that each staff member subtracts from income not his or her actual deductions, but rather the average amounts claimed as deductions by all U.S. taxpayers who have the same income. Because these are the same average deductions as those used in calculating the taxes payable on the gross pay of comparators, the tax allowance system maintains a degree of consistency with the compensation process.

The Executive Boards accepted from the outset that the substitution of <u>average</u> deductions for the <u>actual</u> deductions of staff members would result in considerable variation in the extent to which tax allowances would correspond to the actual tax attributable to organizational income. Staff members whose actual deductions are <u>higher</u> than the amounts assumed for their income level would receive a <u>larger</u> allowance than their actual deductions would indicate; and staff members whose actual deductions are <u>lower</u> than the amounts assumed for their income level would receive a <u>smaller</u> allowance than their actual deductions would indicate. It was accepted that the broad principles of internal equity and external comparability could be achieved only with respect to the U.S. staff as a whole, and not for individuals.

Because such variation was expected, Section 14(b) the By-Laws of the Fund (and the corresponding provision of the Bank's By-Laws) was amended to modify the earlier requirement that staff be reimbursed the tax payable on organizational income. As amended, the By-Laws require that staff "shall receive from the Fund a tax allowance that the Executive Board determines to be reasonably related to the taxes paid by them on such salaries and allowances".

C. <u>Methodology</u>

The salaries and allowances of the Fund and Bank are paid on a net, after-tax basis. The basic methodology used to determine tax allowances is to establish the gross, pre-tax pay which corresponds to net pay from the organizations, using the applicable Federal and state tax rates for the current year. Because tax allowances are themselves taxable income, the calculations require an iterative process. The tax due on net pay alone is first calculated and added to net pay; the tax due on this new amount is then calculated and the difference from the earlier amount is added to it, and so on until the differences between two calculations in the series narrow to less than one dollar.

Under the U.S. tax code, a number of expenditures can be subtracted from Adjusted Gross Income (AGI) in arriving at taxable income; such deductions accordingly reduce the amount of an individual's taxes. Expenses which may be deducted include mortgage interest, real estate taxes, state and local income taxes, certain medical and dental expenses, charitable contributions, casualty losses, and business expenses. State tax codes allow similar deductions, with the exception of state and local income tax. Instead of such itemized deductions, taxpayers also have the option of subtracting a "standard deduction", the amount of which is set each year by law. In lieu of the actual deductions claimed by staff, the tax allowance system substitutes in its calculations the average deductions of all U.S. taxpayers at the same level of gross income as the staff.

The amounts of the average deductions at different levels of AGI are obtained each year from the U.S. Internal Revenue Service (IRS). The raw IRS statistics are reviewed for the Fund and Bank by an outside accounting firm, and a number of adjustments are made to them. Some of these adjustments are necessary because the IRS data become available with a three-year delay, and changes in the tax code in this interval may have eliminated some deductions or reduced the extent to which expenses are deductible. Other adjustments remove from the IRS data the amounts of certain deductions, such as business expenses, which cannot be claimed by Fund or Bank staff, against income from the organizations. 1/ Finally, the average amount deducted by U.S. taxpayers for state and local income taxes is removed from the IRS statistics because the tax allowance system directly calculates the state tax payable on each staff member's income.

D. Allocation of tax

A difficult problem in any system of tax allowances or reimbursements is the attribution of tax between the organizational income of the staff member and non-organizational income such as the staff member's own investment income and, for married staff, spouse income. The problem arises because U.S. tax rates are progressive, so the presence of outside or spouse income affects the marginal rates to which organizational income is subject. The present tax allowance system retains the procedures followed by the Fund and Bank since the 1940s: no account is taken of a staff member's own outside income, but, at a married staff member's request, spouse income may partially be taken into account. 2/

1/ These adjustments were approved by the Executive Boards in 1987. See EBAP/87/238, dated November 2, 1987, and EBAP/87/238, Correction 1, dated November 6, 1987.

2/ The specific provisions of the tax allowance system for handling spouse income are described in Annex III. The procedures, adopted in 1948, were deemed to be consistent with the provisions of the By-Laws that Fund and Bank income should be presumed to be the total income of the staff member. The procedures acknowledge the effects of spouse income on the tax rates to which staff income is subject, but offset these in part by calculating the tax attributed to the spouse on the basis of higher "married-filing-separately" tax rates rather than the "married-filing-jointly" tax rates actually used by most married staff.

E. The Safeguard and Safety Net arrangements of the Fund and Bank

The present tax allowance system was made effective for U.S. nationals joining the Fund or Bank after December 31, 1979. Because the new system was expected to result in smaller tax allowances than the prior system, arrangements were made to ensure that the principle of the By-Laws in effect before the change would continue to apply to staff hired before that date. Thus, U.S. staff serving in either organization before January 1, 1980 were made eligible for supplementary payments, known in the Fund as the "Safeguard" and in the Bank as the "Safety Net". About 45 percent of U.S. staff in the Fund are now eligible for the Safeguard.

The provisions of the Safeguard and Safety Net are identical; both are intended to ensure that eligible staff receive a total tax allowance that is at least equal to the tax imputed to organizational income given their actual tax deductions. After receiving their tax allowances, eligible staff may apply to have the allowances recalculated using actual data on their tax deductions and outside and spouse income. The base for the calculations is the gross pay of the staff member as established under the regular system, but in estimating the tax payable on that amount, the staff member's actual deductions are substituted for the IRS averages. 1/ Otherwise, the tax calculations are made on the same basis as in the regular system; outside income is excluded, but spouse income is partly taken into account. If the revised allowance is larger than the initial allowance, the difference is paid; however, no reduction in the initial allowance is made if it is found to be the larger amount.

F. Partial payment of the social security self-employment tax

A final element of the tax allowance system for U.S. staff is the partial reimbursement of the U.S. Social Security Self-Employment Tax. Beginning in 1960, U.S. citizens employed within the United States by the Fund and Bank, and by other international organizations, have been required by law to participate in the Social Security System. Normally, both employers and employees are required to contribute to the System, but international organizations are immune from taxation, and they therefore cannot be required to pay the employer's contribution. For this reason, the law provides that U.S. staff members of international organizations shall be treated as self-employed persons rather than as employees. This classification requires the U.S. staff of the Fund and Bank to contribute twice the amount of normally employed persons although benefits are identical; in effect the staff member pays both the employee's and the employer's share. In 1992, each share amounts to up to $5,329, a combined total of $10,658.

1/ The total deductions are reduced on a pro-rata basis in accordance with the ratio of outside income to total income to exclude amounts attributable to outside income; the portion of the remaining deductions to be imputed to spouse income is also established on a pro-rata basis.

In 1961, the Fund and Bank decided that they would reimburse to U.S. staff the difference between the self-employed and employed contributions. This approach was intended to place U.S. staff members on the same footing as other employees in the United States with respect to both their Social Security contributions and benefits. Thus, U.S. staff would not be required to pay more than U.S. employees generally because their employment by the Fund or Bank resulted in their classification as self-employed.

G. Participation and costs of tax allowances

In 1991, about 520 Fund staff received tax allowance payments, which averaged $21,280. 1/ Between 1986, when the system was last reviewed, and 1991, the number of U.S. staff members in the Fund who received payments rose by about 7 percent. In the same period, total tax allowance payments rose by 13 percent; total expenditures in calendar year 1991 amounted to $11.1 million. The FY 1993 budget estimate for tax allowances is $13.19 million. (These figures do not include payments for Social Security.)

As a result of attrition, the number of staff eligible for the Safeguard arrangement is gradually declining. The number of pre-1980 staff has fallen between 1986 and 1991 from 59 to 45 percent of all U.S. staff in the Fund. Of those who are eligible, the proportion making use of the arrangements has also declined substantially, from 29 percent in 1986 to 20 percent in 1990. (The processing of 1991 Safeguards is not yet complete.) In 1990, supplementary payments averaged $2,290; the total additional cost of the arrangement to the Fund was $103,000.

Unlike tax allowances, the cost of the separate partial reimbursements of Social Security has increased substantially in response to the rising level of required contributions. Average payments rose from $1,860 in 1986 to $3,840 in 1991. Total expenditures amounted to $2.0 million in calendar year 1991. The budget estimate for FY 1993 is $2.37 million.

H. Practices of other international organizations

The tax allowance system of the Fund and Bank differs in a number of important respects from the practices of other U.S.-based international organizations which also must address the requirement for U.S. nationals to pay income and Social Security taxes. In brief, the tax reimbursement or allowance programs of the United Nations (U.N.), Inter-American Development Bank (IADB), Organization of American States (OAS), and International Telecommunications Satellite Organization (INTELSAT) are as follows.

-- The U.N. employs a tax reimbursement system based on actual income and deductions; it is designed to treat U.S. staff as if they were, in fact, exempt from taxation on U.N. income.

1/ Additional information on participation and the cost of tax allowances is provided in Annex II.

-- IADB and OAS provide allowances under systems which give staff the option of having their tax allowances calculated on the basis of either (a) the same average deductions used by the Fund and Bank, or (b) the staff member's actual deductions following procedures similar to those of the Fund Safeguard and Bank Safety Net. In addition, the organizations follow different procedures in establishing the applicable level of the average deductions and in allocating taxes among staff, outside, and spouse income.

-- INTELSAT applies a set percentage formula reflecting tax rates from the 1970s to organizational income only.

-- The U.N., IADB and OAS reimburse the difference between employed and self-employed Social Security contributions in the same manner as the Fund and Bank; partial reimbursement of Social Security is built into the INTELSAT formula.

The tax allowance system of the Fund and Bank yields tax allowances that are significantly lower than those of the U.N., and somewhat lower than those of OAS; at net pay levels above $60,000, Fund and Bank allowances are also lower than those of INTELSAT. Allowances are slightly higher than those of IADB, and they are higher than INTELSAT at net pay levels below $60,000.

The most significant difference between the Fund/Bank system and the systems of the U.N., IADB, and OAS is that these three organizations all provide general measures to ensure that tax reimbursements/allowances cannot be less than the estimated actual tax -- given the staff member's actual deductions attributed to income from the organization. By contrast, comparable protection is available under the Fund and Bank system to only the pre-1980 staff eligible for the Safeguard and Safety Net.

III. Review of the Tax Allowance System

A. Purpose and conduct of the review

The Executive Boards last reviewed the tax allowance system in 1987. 1/ That review covered the operation of the system during its initial years and the adjustments necessary to respond to significant changes in the U.S. tax code, which had been enacted in the Tax Reform Act of 1986. It was envisaged at that time that a further review would be conducted once the full effects of the 1986 Act became known. The present review was initiated in late 1990 and was conducted jointly by staff of the Fund and Bank drawn from the personnel, accounting, and legal departments.

1/ EBAP/87/238, dated November 2, 1987, and EBAP/87/238, Correction 1, dated November 6, 1987.

Technical working groups from the Fund and Bank staff associations were consulted throughout the review. The review focussed on three broad issues:

(a) The effectiveness of the system with respect to the requirement of the By-Laws that tax allowances should be "reasonably related" to the tax paid on organizational income.

(b) The reliability and applicability of the average deductions and the IRS statistics from which they are derived, and the continuing appropriateness of the methodology used in calculating tax allowances.

(c) The continuing appropriateness of reimbursing the difference between the self-employed and employed contributions to Social Security.

The review was carried out with assistance from the organizations' tax consultants (Arthur Andersen & Company), and extensive consultations were held with the statistical staff of the Internal Revenue Service. Two special studies were commissioned.

The first study was a survey of U.S. staff members' actual income tax deductions, which was conducted by the accounting firm of Price Waterhouse. The survey provided the data needed to determine how closely the actual deductions and the estimated actual taxes of staff correspond to the assumed average deductions used in the tax allowance system and to the tax allowances themselves. The second was a study of the relative costs and benefits of the participation of U.S. staff in the Social Security System. This analysis was performed by Hewitt Associates, the consultants who carried out the 1989 Quadrennial Benefits Survey for the Fund and Bank.

B. Principal conclusions

The analysis of the elements of the present tax allowance system led to three major conclusions:

(a) The basic framework of the present tax allowance system should be retained, but there is a need to adopt measures to limit the extent to which allowances fall short of the tax estimated to be due on Fund and Bank income.

(b) Within the framework of the present system, there is a need for a number of modest technical changes in the methodology used to derive average deductions and to calculate allowances; these are intended to ensure that the average deductions are determined and applied in a manner consistent with the deductions that staff can realistically claim.

(c) For the time being, present arrangements for partially reimbursing the Social Security Self-Employment Tax should be retained.

Briefly summarized below are the review and recommendations with respect to (a) the methodology used in establishing the average deductions and in calculating tax allowances, and (b) the relative costs and benefits of participation in the Social Security System. The following Sections then address the central question of the relationship between tax allowances and the taxes payable by staff on Fund and Bank income.

C. Methodology and calculation procedures

The extent of the correspondence between the assumed average deductions used in the tax allowance system and the actual deductions of staff can be affected by a number of technical factors and relationships:

(a) the applicability of the underlying IRS statistics on which the average deductions are based;

(b) the effects of the three-year delay in the availability of IRS statistics;

(c) the consistency of the circumstances of Fund and Bank staff and of taxpayers generally, i.e., are they equally able to claim certain deductions; and

(d) the consistency of the relationship of deductions to income in both the IRS statistics and the tax allowance calculations.

The methodology used to derive and apply each year's average deductions and the procedures followed in calculating tax allowances were examined in detail. A report on these analyses is attached as Annex III. A number of technical refinements to the present methods and procedures are proposed. The changes in the average deduction methodology are intended to ensure that the average deductions reflect the current year's provisions of the tax code and that the deductions are as representative as possible of the deductions which may be claimed by staff against organizational income. 1/ The changes in calculation procedures are primarily intended to correct a

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1/ These changes include: (a) remove from the IRS database inappropriate tax returns of persons living overseas and with farm and business income; (b) update to the current year's level the amount of the standard deduction within the IRS statistics; (c) calculate in a consistent manner the overall average of deductions and the itemized deduction for state taxes; and (d) adjust the level of income to which deductions relate so that deductions for Keogh and similar retirement plans, which are unavailable to Fund and Bank staff, are not taken into account.

situation in which a small difference in spouse income can result in a large reduction in tax allowance. 1/

The effect of the changes on the average deductions and tax allowances is limited, partly because some of the changes would raise and others would lower the level of the applicable deductions. Overall, it is estimated (on the basis of 1992 deduction data) that the average deductions, which range from $4,000 to $22,000, would be reduced by $200-$1,600. Thus, these changes would not significantly alter the generally close relationship between the IRS averages and the estimated average deductions of staff described in the following section. Taking into account the changes in deductions and other proposed changes in calculation procedures, tax allowances would be raised by about 1.2 percent as a result of these changes.

As was noted previously, the same average deductions are used for tax allowances and to net down comparator pay under the compensation system. The proposed changes, which increase the amount of tax payable on a given level of gross income, would have the effect of lowering the net pay of U.S. comparator organizations by less than one-quarter of one percent.

D. Relative costs and benefits of Social Security participation

The study of the relative costs and benefits of the participation of U.S. staff in the U.S. Social Security System was intended to address two inter-related issues: (a) do the payments by the organizations constitute a benefit which is not available to non-U.S. staff; and (b) do U.S. staff members' own contributions, after allowing for the amounts reimbursed by the Fund and Bank, constitute a cost for U.S. staff against which no commensurate benefit is received. An earlier study, conducted in 1980, had shown that benefits attributable to staff members' own contributions and the net costs incurred by staff were roughly in balance.

The present study estimated benefit/cost ratios for the current U.S. staff, given their current age, length of service, and pay levels, and assumptions regarding future years of Fund/Bank service, total years of Social Security participation, and retirement age (i.e., whether the payment

1/ The gap in the amount of the tax allowances occurs when spouse income rises above the staff member's income; at that point, a different calculation procedure comes into effect. As a second change, the Fund would adopt the procedures now followed by the Bank in calculating the Social Security reimbursement of staff who separate. A third proposal, which would adjust the income used to establish the applicable amount of the average deductions, is also described in Annex III, but is deferred pending additional analysis for which the necessary data are not available.

of benefits begin at 65 or 62 years of age). 1/ The present value of all benefits estimated to be earned during future years of Social Security participation while employed by the Fund or Bank were compared to the present value of the contributions to be paid by staff in the same period. Calculations were made separately for single staff, married staff whose spouse had no covered Social Security earnings (so that benefits include a separate allowance for the spouse), and married staff whose spouse had covered earnings (in which case benefits do not include those earned by the spouse).

The results of the analysis indicate that on an aggregate basis, benefits are significantly lower than the cost of staff members' contributions (net of Fund/Bank reimbursements). 2/ For single staff, benefits amount to only 48.5 percent of costs, and for married staff, benefits amount to 56.1 or 79.2 percent of costs, depending whether there are or are not spouse earnings. More detailed results show that the estimated benefit/cost ratios vary considerably in accordance with the age, marital status, and level of spouse income; benefits are estimated to exceed costs in only a few circumstances, usually in the case of married staff with relatively low salaries and no covered spouse income.

These results indicate that staff clearly receive no benefit attributable to the portion of the Social Security Self-Employment Tax reimbursed by the organizations. The results rather suggest that U.S. staff members' own contributions now constitute a net cost to them. For this reason, as well as because the out-of-pocket cost of Social Security is substantial, (up to $5,329), particularly for lower-paid staff, the issue arises of a possible change in the present reimbursement arrangements.

Such a change would require a departure from the long-standing principle that the primary purpose of the reimbursements made by the Fund and Bank is to place U.S. staff on the same footing as employees in the U.S. (for whom the cost/benefit ratios would be identical, assuming the same income and demographic characteristics). Such a change would accordingly raise complex issues of comparability. Moreover, because there are many factors which can affect the relative share of the benefit and tax component within an individual's contributions, it would be extremely difficult to devise a method of additional reimbursement that avoids, in all cases, partial payments for benefits.

1/ Additional assumptions regarding rates of salary growth, cost-of-living increases, interest rates, and mortality were generally the same as those employed in the 1989 Quadrennial Benefits Survey. Annex I includes a brief description of the U.S. Social Security System.

2/ Compared to the earlier study, the decline in benefits relative to costs results largely from large increases during the 1980s in both contribution rates and the amount of income on which contributions must be made, and from the introduction of a new surcharge for Medicare.

In light of these considerations, the management of the Fund and Bank are proposing that the present arrangement be continued for the time being, but this issue may be reconsidered at a later date.

IV. Relationship of Estimated Actual Taxes and Tax Allowances

The closeness of the relationship between a staff member's tax payable on organizational income and the tax allowance he or she receives is primarily affected by (a) the relationship between the staff member's actual deductions and the assumed average deductions, and (b) the assumptions made in allocating the individual's total income between organizational and non-organizational sources. This Section examines these two elements of the system.

Analyzing these issues requires information on the actual income and deductions of staff. This was obtained through a survey of U.S. staff, which was conducted with the assistance of Price Waterhouse. The survey provided data on staff members' Adjusted Gross Income (AGI) and deductions for 1989, the most recent year for which comparable IRS statistics on deductions were available. The response rate to the survey was slightly more than 50 percent of Fund and Bank staff. The tax and survey consultants from Price Waterhouse concluded that the results were statistically reliable and representative of U.S. staff members as a whole. 1/

A. Actual and assumed income tax deductions

A key premise of the average deduction system is that the deductions which Fund and Bank staff are able to claim against the organizational income taken into account in the tax allowance system approximate, at least on an overall basis, the deductions claimed U.S. taxpayers generally. 2/ Overall, the deductions claimed by staff in 1989 were found to correspond reasonably closely to the average deductions reported by IRS. Table 1 shows the comparisons on the basis of net deductions (which factor out certain

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1/ To maintain statistical reliability, the analysis in this Section is based on the combined data for Fund and Bank staff. There are few meaningful differences in the reported relationship of income and deductions between the U.S. staff of the two organizations.

2/ This relationship is necessarily imprecise because the level of one's deductions is not determined by current income only; it may, for example, also be influenced by earlier earnings, savings, and tax-free income.

itemized deductions) broadly consistent with those used in the tax allowance system in 1989. 1/

Table 1. Relationship of Staff Member's Actual 1989 Deductions and the Assumed Average Deductions Based on 1989 IRS Statistics

Adjusted Gross Income ($ Thousands)	Percent of Survey Respondents (%)	Average IRS Deduction	Average Staff Deduction	Amount of Difference ($)	Percent Difference (%)
20-40	11.3	4,620	5,000	380	8.2
40-60	16.7	7,010	6,990	-20	-0.3
60-80	13.4	9,570	11,000	1,430	14.9
80-100	17.1	11,830	14,800	2,970	25.1
100-120	13.7	13,720	15,140	1,420	10.3
120-140	10.9	16,430	17,240	810	4.9
140-160	8.6	16,300	15,870	-430	-2.6
160-180	4.8	19,240	20,260	1,020	5.3
180-200	3.7	21,820	21,460	-360	1.6

When weighted by the distribution of Fund and Bank staff, the average net deductions of staff were 9 percent higher than the corresponding IRS averages. The deductions of staff, on average, differed significantly from the IRS averages only in the AGI range of $60,000-$100,000. At both higher and lower income levels, the deductions of staff are very closely related to the IRS averages. About the same number of staff had deductions above (52 percent) and below (48 percent) the IRS averages. Also, about 38 percent of staff were found to have deductions that were within a range of plus or minus 33-1/3 percent of the amounts indicated by the IRS statistics.

The overall closeness of the staff and IRS averages, the evenness of the distribution of staff with higher and lower deductions, and the clustering of a substantial proportion of staff with deductions fairly closely related to the IRS averages indicate that the average deduction system produces results that are consistent with the original intent of the system.

1/ As was noted previously, a number of adjustments are made to the IRS statistics to ensure that they include only the specific deductions which staff are able to claim against organizational income. The basis for these adjustments is discussed in Annex III. The data in Table 1 on net deductions incorporate one of the changes to the average deduction methodology described in Annex III, the mathematical correction to the estimates of state and local income taxes.

On an overall basis, the IRS statistics did in 1989 provide a reasonable proxy for the deductions of the U.S. staff as a group.

For individual staff, however, there was considerable variation. Nearly 30 percent of the staff, and a higher proportion of staff at lower income levels, had deductions that were substantially smaller (i.e., less than 66.7 percent) than the IRS averages. All other things being equal, this group of staff would receive a significantly lower tax allowance than their actual deductions would indicate. On the other hand, about one-third of the staff had deductions that were substantially larger (i.e., more than 133.3 percent) than the IRS averages. All other things being equal, this group of staff would receive a significantly higher tax allowance than their actual deductions would indicate.

B. Estimated actual taxes and tax allowances

In considering the relationship of actual taxes and tax allowances, it is necessary to address the problem of establishing the amount of the tax due on organizational income. The tax allowance system applies one set of rules in making this allocation, but there is really no method of allocating tax between that income, a staff member's own outside income, and spouse income that is universally accepted or can be deemed correct on an *a priori* basis. The assumptions made and the procedures used in the tax calculations determine the allocation; changing the assumptions produces different estimates of the relationship between tax allowances and actual tax and of the extent to which the tax allowance system may overpay or underpay a staff member's actual tax on organizational income. In assessing the tax allowance system, two methods of allocating the tax of staff have greatest relevance. 1/

The first method is based on the rules of the present system, including its Safeguard/Safety Net arrangements. It ignores the staff member's outside income, and reduces, on a pro-rata basis, the actual tax deductions attributable to that income. It then calculates the tax payable by staff using the remainder of the actual deductions and personal exemptions, and state of residence; if the staff member is married spouse income is taken into account. For single staff, the tax arrived at this point is the estimated actual tax on Fund and Bank income. For married staff, the tax of the spouse is calculated and subtracted from the combined tax to arrive at the estimated actual tax on organizational income.

The second method departs from the procedures of the present system by taking actual income and deductions into account in a more comprehensive manner. It is supported by a clear proposition: what additional tax does a staff member have to pay because the United States has not exempted U.S.

1/ These comparisons focus on the basic tax allowances; any supplementary payments which might be paid under the Safeguard and Safety Net arrangements are not taken into account.

nationals from taxation on their organizational income? Under this method a joint tax is first calculated using actual organization, outside and spouse incomes, and actual deductions and personal exemptions. Next, a tax on only outside and spouse incomes, with actual deductions and personal exemptions allowed, is calculated. The estimated actual tax on organizational income is the difference between these two amounts.

Tables 2 and 3 on the following pages compares the present tax allowances and the actual tax on organizational income, estimated in accordance with these two methods.

With reference to the first method, shown in Table 2, tax allowances are, on average, 5.7 percent greater than the estimated actual tax. 1/ Using this methodology, about 38 percent of the 1989 allowances were smaller than the estimated actual tax; on average, these allowances were about $2,075 less than the actual tax imputed to organizational income. The other 62 percent of the allowances were larger than the estimated actual tax, with these differences averaging about $3,085. With respect to variances, shown in Table 2b, 39 percent of the allowances are estimated to be within plus or minus 10 percent of estimated actual taxes. Fifteen percent of the allowances fall short by more than 10 percent, and 46 percent of the allowances are more than 10 percent larger than the actual taxes.

Because this method follows the assumptions and procedures of the present system, both the similarities and differences in taxes correspond broadly to the similarities and differences between staff members' actual deductions and the IRS average deductions described above. Conclusions similar to those reached concerning the average deduction system also apply to the broader tax allowance system: Given the assumptions of the present system regarding the allocation of the tax, the system provides allowances that are reasonably consistent with actual taxes for a substantial proportion of staff. However, a significant number of the allowances do fall short of the actual taxes to a material degree, and a significant number of the allowances do exceed estimated actual taxes to a material degree.

1/ In the interest of avoiding excessive repetition, the phrase "actual tax" in the following paragraphs should always be understood to mean "the estimated actual tax attributed to Fund and Bank income".

Table 2a. Changes Needed to Equate Tax Allowances and Estimated Actual Tax on Organizational Income, Calculated on the Basis of Current Methods and Procedures Based on 1989 Survey Data (Amounts in Dollars)

			Average Overall Change For Allowances to Equal Estimated Actual Tax			Average Losses Under the Present System Relative to the Estimated Actual Tax				Average Gains Under the Present System Relative to the Estimated Actual Tax			
Net Pay ($ '000s)	Number of Survey Responses	Basic System Allowance	Added Payment	Revised Allowance	Percent Change	No. of Staff	Percent of Staff	Average Amount	Average Percent	No. of Staff	Percent of Staff	Average Amount	Average Percent
20-30	148	6,061	(666)	5,395	(11.0)	53	35.8	(561)	(10.4)	95	64.2	1,448	26.8
30-40	128	9,858	(654)	9,204	(6.6)	48	37.5	(1,407)	(15.3)	80	62.5	1,891	20.5
40-50	88	14,004	(778)	13,226	(5.6)	37	42.0	(2,068)	(15.6)	51	58.0	2,842	21.5
50-60	84	18,578	(1,709)	16,869	(9.2)	25	29.8	(1,982)	(11.7)	59	70.2	3,274	19.4
60-70	94	23,178	(2,117)	21,061	(9.1)	24	25.5	(2,003)	(9.5)	70	74.5	3,530	16.8
70-80	92	27,570	(1,706)	25,864	(6.2)	36	39.1	(2,209)	(8.5)	56	60.9	4,223	16.3
80-90	86	32,756	(1,260)	31,496	(3.8)	38	44.2	(3,117)	(9.9)	48	55.8	4,724	15.0
90-100	44	37,964	(438)	37,526	(1.2)	22	50.0	(4,294)	(11.4)	22	50.0	5,169	13.8
100-110	34	43,170	(29)	43,141	(0.1)	22	64.7	(3,105)	(7.2)	12	35.3	5,775	13.4
Overall	798	19,344	(1,094)	18,250	(5.7)	305	38.2	(2,073)	(11.4)	493	61.8	3,084	16.9

NOTE: Data exclude 14 staff in the $20,000-30,000 pay range whose allowance equals the estimated actual tax.

Table 2b. Distribution of Gains and Losses Under the Present Tax Allowance System Relative to the Estimated Actual Estimated Actual Tax on Organizational Income, Calculated on the Basis of Current Methods and Procedures Based on 1989 Survey Data

Percent of Survey Respondents in $10,000 Net Pay Ranges

Present Allowances as % of Estimated Actual Tax	Net 20-30	Net 30-40	Net 40-50	Net 50-60	Net 60-70	Net 70-80	Net 80-90	Net 90-100	Net 100-110	Total
Number of Responses	162	128	88	84	94	92	86	44	34	812
Allowance is:										
Less Than Actual Tax	32.7	37.5	42.0	29.8	25.5	39.1	44.2	50.0	64.6	37.6
More than Actual Tax	58.5	62.5	58.0	70.2	74.5	60.9	55.8	50.0	35.3	60.7
Allowance is:										
Less than 70%	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
70-80%	0.0	2.3	8.0	1.2	2.1	0.0	1.2	2.3	0.0	1.8
80-90%	8.0	20.3	18.2	11.9	5.3	9.8	12.8	25.0	17.6	13.2
90-100%	24.7	14.8	15.9	16.7	18.1	29.3	30.3	22.7	47.0	22.5
100%	8.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.7
100-110%	6.1	16.4	7.9	22.6	24.5	16.3	17.4	18.2	11.8	15.0
110-120%	14.2	14.1	12.5	17.9	20.2	22.8	18.6	20.5	11.8	16.7
120-130%	12.3	15.6	20.5	7.1	14.9	13.0	9.3	4.5	5.9	12.6
130% or More of Estimated Actual Tax	25.9	16.4	17.0	22.6	14.9	8.7	10.5	6.8	5.9	16.4

Table 3a. Changes Needed to Equate Tax Allowances and Estimated Actual Tax on Organizational Income, Calculated on the Basis of Assumed Tax Exemption, Including Spouse and Outside Income Based on 1989 Survey Data (Amounts in Dollars)

Net Pay ($ '000s)	Number of Survey Responses	Basic System Allowance	Average Overall Change For Allowances to Equal Estimated Actual Tax: Added Payment	Revised Allowance	Percent Change	Average Losses Under the Present System Relative to the Estimated Actual Tax: No. of Staff	Percent of Staff	Average Amount	Average Percent	Average Gains Under the Present System Relative to the Estimated Actual Tax: No. of Staff	Percent of Staff	Average Amount	Average Percent
20-30	157	6,061	1,650	7,711	27.2	115	73.2	(2,961)	(38.4)	42	26.8	1,743	22.6
30-40	128	9,858	1,876	11,734	19.0	83	64.8	(4,103)	(35.0)	45	35.2	2,233	19.0
40-50	88	14,004	3,452	17,456	24.7	64	72.7	(5,846)	(33.5)	24	27.3	2,932	16.8
50-60	84	18,578	2,692	21,270	14.5	47	56.0	(7,914)	(37.2)	37	44.0	3,941	18.5
60-70	94	23,178	4,320	27,498	18.6	55	58.5	(10,613)	(38.6)	39	41.5	4,555	16.6
70-80	92	27,570	5,494	33,064	19.9	64	69.6	(9,622)	(29.1)	28	30.4	3,940	11.9
80-90	86	32,756	5,355	38,111	16.3	58	67.4	(10,619)	(27.9)	28	32.6	5,549	14.6
90-100	44	37,964	7,167	45,131	18.9	32	72.7	(11,937)	(26.4)	12	27.3	5,552	12.3
100-110	34	43,170	10,051	53,221	23.3	27	79.4	(14,568)	(27.4)	7	20.6	7,370	13.8
Overall	807	19,344	3,776	23,120	19.5	545	67.5	(7,372)	(31.9)	262	32.5	3,631	15.7

NOTE: Data exclude 5 staff in the $20,000-30,000 pay range whose allowance equals the estimated actual tax.

Table 3b. Distribution of Gains and Losses Under the Present Tax Allowance System Relative to the Estimated Actual Tax Due on Organizational Income, Calculated on the Basis of Assumed Tax Exemption Based on 1989 Survey Data

Percent of Survey Respondents in $10,000 Net Pay Ranges

Present Allowances as % of Estimated Actual Tax	Net 20-30	Net 30-40	Net 40-50	Net 50-60	Net 60-70	Net 70-80	Net 80-90	Net 90-100	Net 100-110	Total
Number of Responses	162	128	88	84	94	92	86	44	34	812
Allowance is:										
Less Than Actual Tax	70.9	64.8	72.7	56.0	58.5	69.6	67.4	72.7	79.4	67.1
More than Actual Tax	26.0	35.2	27.3	44.0	41.5	30.4	32.6	27.3	20.6	32.3
Allowance is:										
Less than 70%	30.2	26.6	26.1	25.0	29.8	23.9	20.9	20.5	29.4	26.4
70-80%	11.7	14.8	25.0	13.1	14.9	16.3	19.8	25.0	23.5	16.7
80-90%	11.1	13.3	10.2	9.5	5.3	17.4	10.5	13.6	11.8	11.3
90-100%	17.9	10.1	11.3	8.4	8.6	11.9	16.3	13.6	14.7	12.7
[illegible]%	3.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.6
100-110%	2.5	10.9	3.4	13.1	9.6	6.5	10.5	9.1	5.9	7.6
110-120%	2.5	4.7	6.8	9.5	13.8	14.1	4.7	6.8	2.9	7.1
120-130%	4.3	3.1	6.8	7.1	7.4	6.5	9.3	6.8	2.9	5.9
130% or More of **Estimated Actual Tax**	16.7	16.4	10.2	14.3	10.6	3.3	8.1	4.5	8.8	11.6

Turning now to the second method, which fully takes into account all sources of income and all deductions, the analysis leads to a quite different conclusion. Using this methodology, the results of which are shown in Table 3, the estimated actual taxes are, on average, nearly 20 percent greater than the tax allowances. Two-thirds of the allowances are smaller than the actual tax, and these differences average $7,375. The average amount of the differences for the other one-third where the allowances are larger is $3,630. Referring to variances, which are shown in Table 3b, this method indicates that only 21 percent of the allowances are within plus or minus 10 percent of the actual tax. Significantly, about 55 percent of the allowances fall short by more than 10 percent, and 26 percent fall short by more than 30 percent of the estimated actual tax. Only about 25 percent of the allowances are more than 10 percent larger than the actual tax.

Viewed from the standpoint of this more comprehensive method of allocating total taxes, there is a limited correspondence between allowances and actual taxes on Fund and Bank income, and, for many staff the differences are substantial. This analysis also indicates that tax allowances are generally lower than the estimated actual tax, so that most U.S. staff are in a more adverse position than they would have been if the United States had exempted their Fund and Bank income from taxation.

V. Issues and Proposed Changes

Whichever standard is applied to estimate the amount of the tax payable on organizational income, the foregoing analysis supports two broad conclusions. First, there is considerable variation, both overpayments and underpayments, in the relationship between the tax allowances and the estimated actual tax. Second, there are a substantial number of staff who do not receive a tax allowance sufficient to offset their estimated actual tax on Fund and Bank income. In light of these findings and for the reasons outlined below, it was concluded that there is a need to modify the present tax allowance system.

An important objective of the tax allowance system is to achieve a reasonable degree of internal equity -- equal net pay for equal work -- both among the U.S. staff as a group and between U.S. staff members and non-U.S. staff. Variations in tax allowances arising from differences between the average deductions and staff members' actual deductions were anticipated when the present system was adopted, but at that time the range of these differences was expected to be fairly narrow. This is no longer the case. As was noted above, the 1989 staff survey indicates that about 60 percent of staff now have deductions that differ from the IRS averages by more than plus or minus 33-1/3 percent.

Depending on the standard used to estimate the tax attributable to organizational income, between 38 and 67 percent of the staff are receiving allowances that are less than the estimated tax payable on organizational income, with shortfalls which average between 11 and 32 percent. Underpayments are a particular problem for younger and lower-salaried staff whose deductions may fall significantly below the IRS averages. Many such staff do not have the resources that would allow them to incur the expenditures -- for example on mortgage interest -- needed to generate the level of tax deductions indicated by the IRS statistics. For many of these staff, the problems of underpayments are also compounded by the cost of meeting their own share of the Social Security Self-Employment Tax. 1/

Underpayments, both real and perceived, are a source of considerable dissatisfaction among the U.S. staff. About 70 percent of the staff who responded to the survey believe that they are not receiving a sufficient allowance. Comments made in the survey criticized most elements of the system: the adequacy of the partial reimbursements of the Social Security; the impact of having lower deductions than assumed in the system (particularly the impact of not owning a home); and the system's partial recognition of the impact of spouse income and no recognition of outside income on the tax payable on Fund and Bank income.

A. Options for change

As was the case when the present system was developed, the basic issues involve a balance of competing objectives. In addition to meeting the basic requirement of the By-Laws that tax allowances be reasonably related to the taxes paid on Fund and Bank income, these issues include both internal and external equity, costs, privacy, and ease of administration.

A number of possible methods of limiting the underpayments and reducing the extent of the variations were examined during the current review. To varying degrees, they all involve the incorporation of information on the actual deductions of staff in the tax allowance system. The inclusion of such information is necessary because any system based on average deductions invariably gives rise to variations, overpayments and underpayments, in its results. Other methods of alleviating the problems of underpayments would be feasible, for example, by reducing the applicable level of the average deductions or the tax attributed to spouse income. However, such measures would not narrow the range of variations, and, for staff with higher than average deductions, they would also increase the amount of overpayments.

Two basic options for changing the tax allowance system in response to the problems of underpayments and variations were considered:

1/ It should be noted that the classification of staff as self-employed for purposes of Social Security does not apply to income taxes as well. Certain deductions and adjustments to income which are generally available to self-employed persons and result in tax savings, are therefore not available to staff.

(a) adoption of modified tax allowance system based fully upon the actual income and deductions of staff; and

(b) retention of the present average deduction system, and the extension of the Safeguard and/or Safety Net to all recipients of tax allowances.

B. Actual income and deduction data

A tax reimbursement system based fully on actual data regarding staff members' income, regardless of source, and tax deductions would be the most effective means of addressing underpayments as well as the variations in allowances, relative to actual taxes. It is also the most effective method, as was recognized by the Kafka Committee in 1980, of achieving internal equity and, specifically, of avoiding overpayments. In its most comprehensive form, such a system would broadly follow the same procedures as those described above in the second method of estimating the tax payable on organizational income. The tax due on income other than that from the Fund and Bank would be calculated with all deductions and personal exemptions attributed to it, and this amount would be subtracted from the total tax due on all income, in order to arrive at the amount of the allowance. Thus, this method would be similar to the approach currently used by the United Nations in its tax reimbursement system for U.S. staff. 1/

A tax reimbursement system based on actual data has several significant drawbacks; the main disadvantages (which ultimately led the Kafka Committee to reject this approach in 1980) are:

(a) Costs. A system which fully takes into account staff members' actual income from all sources and actual deductions would raise costs by an estimated 20 percent.

(b) Intrusiveness. Determining the amount of the tax due on organizational income would require verifiable data, which could only be obtained from copies of the tax returns of all U.S. staff. Although the organizations can require from staff the information needed to calculate allowances, it is questionable whether it is

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1/ There are other potential methods of taking into account staff members' actual income and deductions more completely than the present system but less completely than this comprehensive method. Such "hybrid" approaches might, for example, prorate deductions among income sources or they might use average tax rates. Because such hybrids would depart from the proposition of placing U.S. staff in the same position as if they were exempt from tax, they would introduce judgments that could be debatable, and they could be expected to give rise to considerable dispute in their design and subsequent application. Although they could result in lower costs, they would have the same disadvantages of intrusiveness and burdensome administration as a comprehensive system.

desirable or appropriate for the Fund and Bank as employers to require regular access to this information, given its sensitivity and confidentiality under U.S. law.

(c) Administrative burdens. A system requiring the review of actual tax data from all U.S. staff would substantially increase the staff resources and time required to process such allowances. Moreover, because this system would result in reductions in the present tax allowances of some staff, its introduction would require, at a minimum, an extended transition period, because staff have made long-term financial commitments, such as home mortgages, at least in part on the basis of the provisions of the present system.

B. Proposed extension of the Safeguard and Safety Net

As indicated above, the average deductions employed in the tax allowance system are fairly closely related to the actual deductions of staff, and, given its own assumptions, the present tax allowance system does effectively provide tax allowances reasonably related to the tax on Fund and Bank income of a substantial number of staff. Although the present system is not free from problems, these are not believed to be sufficiently great to require the system to be completely overhauled, particularly when there are significant drawbacks to alternatives. In these circumstances, it was concluded that the basic framework of the present system should be retained, but the system should be modified to address the specific problem of underpayments and the variations in payments which arise from them.

Accordingly, it is proposed to make available the existing Safeguard and Safety Net arrangements to all staff receiving tax allowances, regardless of their date of appointment. Extending these arrangements, which were described in Section II, would partially take into account actual income and deductions, and would limit the extent to which allowances may fall short of the estimated tax due on organizational income. Unlike a system based fully on actuals, it would not, however, subject organizational income to the highest tax rates, on top of outside and spouse income.

This approach has a number of advantages. The foremost, of course, is that it would limit the extent of underpayments, thus narrowing the range of variations in the allowances and the effective net salaries of otherwise similarly situated staff. It would accordingly increase the degree to which internal equity is achieved. It would, in particular, ease the financial burden, arising from the combination of income tax and Social Security payments, on staff with lower salaries.

The extension of the Safeguard and Safety Net would also be more consistent with the practices of other international organizations. Limiting underpayments would place Fund and Bank staff in much the same situation as U.S. staff in the Inter-American Development Bank and Organization of American States. The tax allowance systems of both organizations incorporate broadly similar provisions which permit the allowances of all staff to be based on actual deductions rather than the IRS average deductions. (The Safeguard and Safety Net would, however, still fall short of the more comprehensive system of the United Nations, which does subject organizational income to the highest tax rates.) Although the international organizations are not, strictly speaking, comparators of the Fund and Bank, their practices in this area, which involve the common problem of U.S. taxation, are highly relevant. There is no reason for the remedy provided by the Fund and Bank to be significantly less effective than the remedies provided by the other organizations.

Analysis of the data from the staff survey indicates that an extended Safeguard and Safety Net would potentially affect the allowances of about 20 percent of Fund and Bank staff and around 35 percent of the post-1979 staff. Table 4 presents data on the potential number and amounts of the supplementary payments under these arrangements (based on 1989 tax laws and data from the survey respondents). It is estimated that payments in 1989 would have averaged about $1,750. 1/ Significantly, about 70 percent of the payments would have been made to staff with net pay of $60,000 or less.

Table 4. Impact of Proposed, Extended Safeguard and Safety Net Arrangements, Compared to Basic Allowances (Safeguard/Safety Net Payments for Post-1979 Staff Based on 1989 Staff Survey Data)

Net Pay ($ Thousands)	N	Basic System Allowances (All Staff)	Number of Safeguard Payments	Amount of Safeguard Payments	Payments as % of Allowance	Amount of Overall Allowances (All Staff)	Change in Overall Allowances Amount	Change in Overall Allowances Percent
20-30	162	6,061	40	563	9.3%	6,200	139	2.3%
30-40	128	9,858	19	1,363	13.8%	10,060	202	2.1%
40-50	88	14,004	23	2,179	15.6%	14,574	570	4.1%
50-60	84	18,578	16	2,467	13.3%	19,048	470	2.5%
60-70	94	23,178	13	1,953	8.4%	23,448	270	1.2%
70-80	92	27,570	12	2,147	7.8%	27,850	280	1.0%
80-90	86	32,756	10	2,376	7.3%	33,032	276	0.8%
90-100	44	37,964	4	5,819	15.3%	38,493	529	1.4%
100-110	34	43,170	2	2,829	6.6%	43,336	166	0.4%
Overall	812	19,344	139	1,740	9.0%	19,642	298	1.5%

Note: N = Number of Survey Respondents

1/ Safeguard and Safety Net payments are themselves income on which taxes, and hence additional tax allowances, must be paid. The data in Table 4 incorporate the amounts of the additional allowances. These estimates assume that all staff who would receive supplementary payments, no matter how small, would make use of an extended Safeguard and Safety Net.

Extending the Safeguard and Safety Net would not have a significant impact on the overall cost of the tax allowance system. It is estimated that the supplementary payments would potentially raise the average allowance and total costs by 1.5-2.0 percent (taking into account the payments themselves and their effect on social security reimbursements). In practice, it is likely that the impact would be less, because experience indicates that many staff who would be likely to receive small payments choose not to utilize these arrangements.

A disadvantage of an extended Safeguard and Safety Net is that it would increase the burden of administering the system. The increase is, however, considered manageable, and it would be significantly less than that required for a system fully based on actual income and deductions. Because staff can choose to apply and make available information from their tax returns under the Safeguard and Safety Net, this approach would also be much less intrusive than the more comprehensive system, which would, in all likelihood, make the provision of this information obligatory.

A more substantive concern is that an extended Safeguard and Safety Net would appear to be asymmetrical; it would protect against the possibility of underpayments while continuing to permit overpayments. Strictly within the framework of the present tax allowance system this concern would have some validity; given the assumptions and procedures of the present system for allocating tax to organizational income, the overpayments indicated in Table 2 would continue, and, potentially, there would be no underpayments.

The lack of symmetry appears in a somewhat different light, however, if tax allowances, including the supplementary Safeguard and Safety Net payments, are related to the second and more comprehensive standard -- assuming the tax exemption of U.S. staff -- for establishing the tax attributable to organizational income. Measured, on this basis, about two-thirds of the allowances would still involve underpayments, while only one-third would continue to result in overpayments. Although the Safeguard and Safety Net eliminate underpayments, given the assumptions of the present system, they do not do so if actual income, as well as, actual deductions are fully taken into account in establishing the tax payable on organizational income. 1/

To the extent that potential overpayments are a concern, it should be reiterated that the only system which can prevent tax allowances in excess of the actual tax due on Fund and Bank income is one which takes all actual income and deductions into account. So long as average deductions remain the basis of the system, no changes can eliminate overpayments; there will always be some staff whose financial circumstances are such that they have

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1/ This is because the present system does not fully take the effects of spouse income into account, and it ignores outside income; the effects of these provisions may outweigh the effect of having deductions higher than the assumed average deductions.

tax deductions above the level of average deductions assumed in the system. The U.S. tax system, in fact, incorporates incentives for taxpayers to increase their deductions in order to reduce their taxes. It should, however, also be borne in mind that, as a practical matter, staff with relatively low income and/or limited outside resources have the greatest difficulty in raising their deductions to the level of the assumed averages. As was shown in Table 4, staff at lower salary levels would receive a large majority of the safeguard and safety net payments.

The conclusion, discussed in Section III above, that the current practice regarding the partial reimbursement of Social Security Self-Employment Tax should be continued is also relevant to the question of symmetry. Although there is wide variation among staff, the cost/benefit analysis indicates that participation in Social Security constitutes a net cost to U.S. staff, and this cost could, to some extent, be considered as an offset against any overpayments under the tax allowance system.

VI. Costs and Administration

The proposed technical changes presented in Annex III are expected to increase the cost of tax allowances by about 1.2 percent (about $160,000 in the Fund on the basis of 1992 staffing levels and tax laws). It is proposed the technical changes be implemented in the average deductions for tax allowances payable on 1993 income; accordingly, their main budgetary impact will begin in FY 1994.

The effect of extending eligibility for the Safeguard to post-1979 staff cannot be projected with certainty. Data required to estimate payments are available for only 1989 (from the staff survey), and both tax laws and salary levels have changed since then; the proportion of staff who will, in practice, utilize the extended Safeguard is also uncertain, although, at least in the first year, the proportion is likely to be higher than the 20 percent of pre-1980 staff who received Safeguard payments in 1990. Allowing for these uncertainties, and some growth in both the level of basic allowances and number of U.S. staff, the added cost of this arrangement is estimated at 1.5-2.0 percent of the basic allowances ($200,000-260,000 in the Fund on the basis of 1992 staffing). It is proposed that the extended Safeguard be made available beginning with tax allowances paid with respect to 1992 income. Because most Safeguard payments are processed after April 15, when U.S. Federal income tax returns are due, most payments will be made in mid-1993, so the budgetary impact of this arrangement will first arise in FY 1994.

Processing additional Safeguard payments will, as was noted above, have some impact on the staff resources required to administer the tax allowance system. Apart from the first year, when staff will lack familiarity with the arrangement, the requirements are expected to be fairly modest. Implementation of a new, integrated payroll/personnel computer system, which is now being developed, is expected to ease the current burden of processing Safeguard payments to some extent.

Consistent with past practices, the average deductions and tax allowance calculations will continue to be reviewed annually and adjusted as necessary to ensure that they reflect the current year's provisions of the U.S. tax code. If the extended Safeguard is approved, arrangements that are consistent with it will be applied for non-U.S. staff who are eligible for tax allowances.

VII. Draft Decision

The Committee on Administrative Policies recommends that the following decision be adopted by the Executive Board:

(a) The current Safeguard shall be extended to all staff receiving tax allowances, beginning with the allowances paid with respect to 1992 income.

(b) The six technical changes set forth in EB/CAP/92/11, Annex III, shall be implemented beginning with the average deductions and calculation of tax allowances for 1993.

The U.S. Income Tax and Social Security Systems

U.S. Income Tax System

The U.S. Federal income tax system operates under a complex code of law and regulations. It requires persons subject to the U.S. income tax system to report and pay tax on their worldwide income for each calendar year regardless of where they are located in the world. The premise of the tax system is that all income, whether earned (such as wages) or unearned (such as interest or dividends), is taxable, unless provided to the contrary in the law or regulations. The tax system imposes high penalties (including imprisonment) for failure to disclose all income or to pay the tax on it. The U.S. Internal Revenue Service (IRS) administers the tax system and collects the tax imposed.

The tax system requires the reporting of total income, including wages, interest income, dividends, capital gains, net business income, net rental income, and royalties. The system allows the taxpayer to take certain adjustments that reduce the total income attributable to an individual. Examples of such adjustments include contributions to individual retirement accounts (IRAs), alimony paid, and one-half of the cost of self-employment tax (social security). 1/ Once reduced by these adjustments, total income is referred to as Adjusted Gross Income (AGI). It is AGI against which deductions data are reported by IRS in the data used in the tax allowance systems of the Fund and Bank.

From AGI, a further reduction is allowed. This reduction, known as a personal exemption, is an amount prescribed by law for each individual covered by the return, including dependents supported by the taxpayer. Each personal exemption is worth $2,300 in 1992.

AGI is also reduced by allowable deductions to income. Deductions may be taken either as a "standard deduction," which is an amount prescribed by law and determined by filing status, or as "itemized deductions" which cover certain expenses incurred by taxpayers during the tax year. 2/ Generally, a taxpayer will claim itemized deductions when they are higher than the standard deduction, because this results in larger tax savings. Itemized deductions may be claimed for such expenses as medical and dental expenses in excess of those covered by medical insurance and above 7.5 percent of AGI, state and local income taxes, real estate taxes, mortgage interest,

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1/ The adjustment for IRAs is not available to middle and upper income employees who participate in employer-sponsored retirement plans.

2/ In 1992, the standard deduction for the four principal filing statuses are: $3,600 for single; $5,250 for head of household status; $6,000 for married filing jointly; and $3,000 for married filing separately.

investment interest, charitable contributions, casualty and theft losses, moving expenses, and, if they exceed 2 percent of AGI, unreimbursed employee business expenses.

Total income after reduction by all adjustments to income, the personal exemption, and by all allowable deductions to income, equals taxable income. The amount of tax owed is calculated by applying to taxable income tax rates prescribed by law. The tax rates, expressed as a percentage of taxable income, are graduated and based on ranges of income. They also vary according to filing status. The main 1992 Federal tax rates are as follows: 1/

Married Taxpayers Filing Joint Returns

Up to $35,800	15 percent of taxable income
$35,800-$86,500	$5,370 plus 28 percent of income over $35,800
Over $86,500	$19,566 plus 31 percent of income over $86,500

Married Taxpayers Filing Separate Returns

Up to $17,900	15 percent of taxable income
$17,900-$43,250	$2,685 plus 28 percent of income over $17,900
Over $43,250	$9,783 plus 31 percent of income over $43,250

Single Taxpayers

Up to $21,450	15 percent of taxable income
$21,450-$51,900	$3,217.50 plus 28 percent of income over $21,450
Over $51,900	$11,743.50 plus 31 percent of income over $51,900

Heads of Households

Up to $28,750	15 percent of taxable income
$28,750-$74,150	$4,312.50 plus 28 percent of income over $28,750
Over $74,150	$17,024.50 plus 31 percent of income over $74,150

In addition to federal income taxes, most of the individual states and some municipalities impose a tax on personal income. All three of the local jurisdictions, the District of Columbia, Maryland and Virginia impose tax on personal income. These jurisdictions set their own values for personal exemptions, deductions and tax rates and base their taxes on the income reported for federal tax purposes.

1/ For upper income taxpayers, effective marginal tax rates for 1992 are somewhat higher because the amount which can be claimed for personal exemptions and part of the amount which can be claimed as itemized deductions are both phased out.

U.S. Social Security System

The U.S. Social Security System provides several types of benefits to participants:

- -- retirement pensions normally beginning at age 65;
- -- disability benefits;
- -- survivor benefits; and
- -- the hospital insurance component of Medicare.

The level of benefits is generally based on average career earnings which are indexed for cost-of-living increases. Retirement benefits are fully vested after 10 years of participation, and Medicare benefits are fully vested after 5 years of participation.

Assuming maximum covered earnings (see below) throughout employment, the annual pension of an individual retiring at age 65 in 1992 would amount to $13,056. A supplementary benefit of 50 percent is provided for a spouse who had no covered earnings in his or her own right; the combined annual pension if the couple both retired at age 65 in 1992 would amount to $19,584. When both husbands and wives have covered earnings, benefits are related to the earnings of each, but they are subject to a maximum family benefit. Retirement benefits are partially subject to Federal income tax if the sum of one-half of the benefit plus AGI exceeds $25,000 for an individual and $32,000 for a married couple.

Under the System, employees contribute a percentage of their earnings up to a certain ceiling, and employers contribute the same amount. However, self-employed persons are required to make the contributions of both employees and employers; thus, they contribute twice the amount of employed persons.

For 1992, the employee contributions are 7.65 percent of gross pay up to $55,500 plus a Medicare surcharge of 1.45 percent of pay between $55,500 and $130,200. Self-employed contributions for Fund and Bank staff amount to 15.3 percent of pay up to $55,500 plus 2.9 percent of pay between $55,500 and $130,200. (Each of the maximum amounts of covered earnings is adjusted annually in accordance with cost-of-living increases.) Illustrative amounts of contributions in 1992 are as follows:

Gross Pay	Employee Contributions	Employer Contributions	Total Self-Employed Contribution
$ 20,000	$1,530	$1,530	$ 3,060
$ 55,500	$4,246	$4,246	$ 8,492
$100,000	$4,891	$4,891	$ 9,782
$130,200	$5,329	$5,329	$10,658

Tax Allowance System: Participation and Operating Costs 1986-91

This Annex provides information on the participation of U.S. staff and the operating costs of the tax allowance system in the Fund between calendar years 1986, the last year preceding the implementation of the extensive provisions of the Tax Reform Act of 1986 (TRA86) and 1991, the last year for which data are available.

Tax Allowance Payments: 1986-1991

The number of participants and the cost of tax allowance payments for the years 1986 to 1991 are summarized in Table 1 below. In 1991, 521 U.S. staff received payments and expenditures amounted to $11.1 million. The average tax allowances in 1991 was $21,279. Between 1986 and 1991, total payments rose by 13.1 percent, but, allowing for the effects of a 7.4 percent increase in the number of U.S. staff, the average payment rose only 5.3 percent. 1/

Several factors have influenced the level of tax allowance payments over the period; some tended to increase, and others tended to decrease the amount of the allowances. Factors which have tended to raise average tax allowances include:

-- Average salaries have risen by about 17 percent over the period; this has increased both the amount of taxable income and the proportion of it subject to higher marginal tax rates.

-- An key feature of TRA86 was to reduce the overall level of deductions by immediately eliminating some and phasing out other previously allowed deductions. These changes reduced the average deductions used in calculating tax allowance system, which, in turn, increased taxable income and tax allowance payments.

The increases over the period were offset by a number of factors which have tended to reduce tax allowances. These include:

-- TRA86 reduced the number of marginal tax rates from over ten different rates to only three, and it lowered the highest marginal rate from 50 to 33 percent.

-- The amounts subtracted from income for personal exemptions have risen over the period from a base of $1,900 in 1987 to $2,300 in 1992. These changes reduce taxable income and tax allowances.

1/ The estimates in part A of Table 1, with the exception of 1991 for which processing is incomplete, include supplementary payments made under the Safeguard. They do not include payments for Social Security. The average tax allowance in the Bank was $21,152 in 1991.

-- Tax brackets have been indexed to inflation and have risen since 1987. The increase in the tax brackets slows the rise in the marginal tax rates to which increasing staff income is subject.

The effects of the reduced tax rates is most clearly seen in the large decline in average tax allowances between 1986 and 1988. 1/ On the other hand, the impact of the declining level of deductions is seen in the rising level of tax allowance payments between 1988 and 1991.

Safeguard Payments: 1986-1991

Part B of Table 1 provides information on the supplementary payments made under the Safeguard arrangement for which U.S. staff employed by the Fund before January 1, 1980 are eligible. Given normal attrition, the number of such staff and the proportion they constitute of all staff have been gradually falling. The proportion of eligible staff who actually make use of the arrangement has also declined; total costs have accordingly fallen, although average payments have changed little.

Social Security Reimbursements: 1986-1991

The cost of the partial reimbursement of the Social Security Self-Employment Tax has increased significantly, particularly during the 1989-1991 period. The increases, which are shown in Part C of Table 1, reflect a combination of three factors: (a) rising contribution rates; (b) increases in the amount of "covered wages" on which contributions must be paid; and (c) the 1991 introduction of a new surcharge for the Medicare component of Social Security.

1/ Payments in 1987 were uncharacteristic, because they reflect a large number of separations following the implementation of the job grading system.

Table 1. Annual Payments for Tax Allowances and Social Security for U.S. Staff of the Fund: 1986-1991

	Year						% Change
	1986	1987	1988	1989	1990	1991	1986-1991
A. Total Tax Allowances:							
No. of Staff	485	500	508	496	500	521	7.4%
Total Payments ($ m)	9.8	10.3	8.3	9.4	9.8	11.1	13.3%
Average Payment	20,206	20,600	16,339	18,952	19,600	21,279	5.3%
Payments as a % of Net Salaries	43.9%	42.6%	35.5%	37.5%	35.6%	36.0%	-18.0%
B. Safeguard Payments for Pre-1980 Staff:							
No. of Eligible Staff	285	278	258	235	226	NA	-20.7%
% of all Staff	58.8%	55.6%	50.8%	47.4%	45.2%	NA	-23.1%
No. of Payments	82	78	63	55	45	NA	-45.1%
% of Eligible Staff	28.8%	28.1%	24.4%	23.4%	19.9%	NA	-30.8%
Total Payments ($,000)	207	186	147	127	103	NA	-50.2%
Average Payments	2,524	2,385	2,333	2,309	2,289	NA	-9.3%
C. Social Security Payments:							
Total Payments ($ m)	0.9	1.0	1.0	1.2	1.7	2.0	122.2%
Average Payments ($)	1,856	2,000	1,969	2,419	3,400	3,839	106.8%

Analysis of the Average Deduction Methodology and Calculation Procedures

This Annex provides a summary report on the recommendations of the Joint Fund and Bank Working Group on changes in the methodology for deriving average deductions from the Internal Revenue Service (IRS) statistics, and in the procedures applied in calculating tax allowances.

A. Derivation of average deductions

The average deductions used in the tax allowance system are calculated on the basis of the most recent IRS statistics estimating the amount of the deductions claimed by all United States taxpayers at given levels of Adjusted Gross Income (AGI). Applying the IRS statistics in the system involves issues of the timeliness of the IRS data; the composition of the underlying statistical base; and the consistency of first, the specific deductions included in the IRS averages and the deductions for which staff are eligible, and, second, the way in which the deductions are related to income in the IRS statistics and the tax allowance calculations. The principal reasons that require adjustments to the raw IRS statistics are the following.

-- The IRS data used to establish average deductions become available after a delay of three years. Because of this time lag, the tax code reflected in the data reported by IRS may not be identical to the tax code governing current deductions.

-- The compensation and administrative policies of the Fund and Bank result in conditions that limit or preclude the ability of staff to claim some deductions generally available to U.S. taxpayers. In other cases, generally available deductions have been considered inapplicable to staff because they are directly related to types of income which are not taken into account in the tax allowance system.

-- The IRS statistics used in the tax allowance system have generally been based on the returns of all U.S. taxpayers, regardless of their filing status or types of income. 1/ These deduction data can differ from the deductions which can be claimed by Fund and Bank staff because of differences in the financial situations of particular classes of taxpayers included in the IRS data.

-- In determining tax allowances, certain deductions, such as state and local income taxes, are directly calculated on the basis of the staff member's state of residence or payments made by the Fund

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1/ Since 1987, data for single taxpayers have also been obtained from IRS and used for single staff with AGI of less than $45,000-55,000.

or Bank, so the amounts claimed by U.S. taxpayers for such taxes must be subtracted from the IRS data in order to avoid double-counting.

-- The income to which the average deductions are related in the IRS statistics and in the tax allowance calculations are established in different ways, which may not be entirely consistent.

Initially, the only adjustment made to the IRS statistics was the subtraction of the deduction for state and local income taxes. The need for most other adjustments arose as a consequence of the Tax Reform Act of 1986 (TRA86), which significantly changed the qualifying rules and treatment of certain deductible expenses, including the immediate or phased elimination of some deductions. These adjustments, which are noted below, were approved by the Executive Boards in 1987. 1/

As part of the review of the tax allowance system, a detailed examination was made of current tax law and the adjustments made in recent years; this examination identified a number of changes that would be more effective in (a) accounting for changes in tax laws, (b) matching the deductions included in the IRS statistics with the deductions actually available or applicable to staff, and (c) relating deductions to a level of staff income in the tax allowance calculations that is consistent with the income to which deductions are related in the IRS data.

1. Applicability of the underlying IRS statistics

Single staff. The deductions used in the tax allowance system are primarily based on IRS "all returns" statistics, which incorporate the estimated income and deduction data for all U.S. taxpayers, regardless of filing status (e.g., single, married filing jointly, etc.). In 1987, the Executive Boards authorized the substitution of IRS data on the deductions of single taxpayers for the all-returns data in the tax calculations for single staff with organizational income below $45,000; in subsequent years, the level at which this substitution was made increased to $55,000. Analysis of the IRS statistics and information obtained through the staff survey indicate that this procedure remains appropriate; at relatively low income levels, the deductions of staff are more closely related to the single IRS data than to the IRS all-returns data, but the reverse situation applies at upper income levels.

Exclusion of information from overseas filers and taxpayers with farm and business income. To the extent possible, it is desirable for the types of income and deductions incorporated in the IRS statistics to be representative of and broadly consistent with the types of income and deductions of staff. In consultations with the statistical staff of IRS, it was found

1/ EBAP/87/238, dated November 2, 1987, and EBAP/87/238, Correction 1, dated November 6, 1987.

that about 15 percent of the IRS data are for returns reporting overseas income and foreign tax credits and returns reporting farm and business income and losses. Persons working overseas and those engaged in farm and business employment are subject to special rules on the reporting of income (and losses), and the types of deductions they may claim are uncharacteristic of those available to Fund and Bank staff. Thus, it is appropriate for such data to be removed from the statistics on which the average deductions are based. The effects of this change (based on 1989 data) are to reduce the average deductions used in the tax allowance calculations by $150-500, depending on income levels, and marginally to raise tax allowances.

2. The effects of the three-year delay

The average deductions used in the tax allowance system are published with a three-year delay; for example, the 1992 average deductions are based on statistics from 1989. When there have been changes in the tax code in the intervening three-year period, using the lagged data could result in current deductions being significantly overstated or understated. This issue was considered by the Executive Boards in 1987, and it was decided that the organizations' tax consultants should make adjustments to the IRS statistics when it is necessary to bring them line with the current year's law. Analysis of the tax consultant's projections and actual IRS data for the 1984-1989 period indicate that these projections can be made with considerable, but not complete, accuracy.

Adjustment to the standard deduction. The major differences between the projected and actual, current year deduction data relate to the standard deduction, which taxpayers may claim in lieu of itemized deductions. Each year, the amount of the standard deduction is increased by IRS in accordance with cost-of-living increases. Heretofore, these increases have not been reflected in the average deductions used for tax allowances, with the result that the deductions for the current year have been understated. To strengthen the accuracy of the projections, it is proposed that the amounts of the standard deduction incorporated in the IRS statistics be adjusted to reflect the increases over the intervening three years. It is estimated that this adjustment would, on average, raise the average deductions by $125-500, with the larger increases occurring at lower income levels; tax allowances would be reduced slightly. 1/

3. Consistency in the composition and treatment of deductions

A number of the changes TRA86 made to the tax code, when combined with the administrative practices of the Fund and Bank, make it impossible or unlikely for staff members to claim some expenses as itemized deductions. The amounts of such deductions, however, generally remain in the IRS

1/ The effects of this change are limited because the calculations already apply the current year's standard deductions if it is higher than the average deductions.

statistics because the circumstances of other taxpayers differ from those of staff.

To avoid overstating the deductions that staff members could actually claim, the Executive Boards decided in 1987 that four itemized deductions would be subtracted from the IRS statistics. These deductions were for:

(a) Medical and dental expenses, which were limited to amounts in excess of 7.5 percent of pay, a level of expense that the "stop-loss" provisions of the Fund and Bank medical insurance programs makes unlikely.

(b) Moving expenses, which are generally reimbursed by the organizations, and the amounts reimbursed are directly entered into the calculation of tax allowances.

(c) The miscellaneous itemized deductions, primarily unreimbursed employee business travel expenses, which, under the organizations' travel policies are generally not applicable to staff.

(d) Interest paid on investments, which can only be claimed to offset investment income (which is not taken into account in the tax allowance system), so it is inappropriate to attribute the deduction to income from the Fund and Bank.

Upon review, it was concluded that it remains appropriate to subtract these amounts in establishing the average deductions. The staff survey confirmed that the overwhelming majority of staff do not claim significant amounts, if any, for the first three purposes.

State and local taxes. A change is proposed to the procedure followed in removing the amount of the deduction for state and local income tax from the IRS data. These amounts are removed from the IRS statistics because staff members' state taxes are directly calculated in the system. Since 1980, the amount removed has been increased (by calculating the average amount to be removed by dividing the total deduction by the smaller number of taxpayers who itemize deductions rather than the total number of taxpayers), which has had the effect of reducing the level of the remaining deductions used in calculating tax allowances. This adjustment was made to maintain consistency between the both the total deductions and the net average deductions for staff members and within the IRS statistics. This adjustment is no longer required, and its elimination is proposed. The effect of this change is to increase the average deductions by $250-600, and to reduce tax allowances slightly.

4. Adjustments to income

All itemized deductions are subtracted from AGI to establish taxable income. Under U.S. tax laws, there are six types of expenses which can be subtracted from total income before arriving at AGI: contributions to

Individual Retirement Accounts (IRAs); contributions to Keogh and certain other retirement plans for self-employed persons; payments for medical insurance by self-employed persons; penalties paid in connection with early withdrawals of funds from time-restricted savings accounts; one-half of amounts paid for the Social Security Self-Employment Tax; and alimony payments.

In 1987, the Board approved an adjustment to the IRS statistics for contributions to IRAs. This adjustment was made because IRA contributions only defer the tax due on the contributions. Subtracting IRA contributions from income inappropriately reduces tax allowances by understating the total tax--both current and deferred--payable on a given level of AGI. For this reason, it was decided that the deduction for IRAs should not be taken into account in tax allowances. 1/ Upon review, it was concluded that excluding the IRA deductions from the tax allowance system remains appropriate.

Keogh plans. To date, no adjustments to the IRS statistics have been made for any of the amounts other than IRAs. Although current procedures were found to be appropriate for most of these items, a change is proposed with respect to Keogh Plans and similar self-employed retirement plans. As was noted above, the principal reason for making the current adjustment to IRA contributions is that these amounts defer rather than reduce the tax payable by an individual. This is equally true of Keogh and other self-employed retirement plans, which, for all essential purposes are equivalent to IRAs. It is therefore equally inappropriate to take these amounts into account in the tax allowance system, and it is proposed that the IRS statistics be adjusted to factor out the effects of this adjustment to income. It is estimated that the adjustment for Keogh and other retirement plans would reduce the average deductions by about $400-1,000 depending on income levels.

B. Procedures for calculating tax allowances

The procedures used by the Fund and Bank in calculating tax allowances were reviewed in detail; in most cases, they remain appropriate, but a small number of changes are proposed. Some of these are inconsequential technical changes that would eliminate minor differences in the procedures followed by the two organizations; these are not described here, but information on them can be provided. The others include revised procedures for (a) calculating tax allowances when spouse income is higher than staff income, and (b) calculating the amount of Social Security Self-Employment Tax to be

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1/ Because the IRA amounts are subtracted from income before, rather than after, AGI is established, excluding their effect on taxes requires a different procedure than the adjustments to itemized deductions. The adjustment has been made by raising, by the average amount of the IRAs, the income to which a given level of itemized deductions applies; this has the effect of slightly reducing the amount of itemized deductions for a given level of AGI.

reimbursed when staff separate, and (c) establishing the income used to determine the applicable level of deductions. Of these, only items (a) and (b) are proposed for adoption at this time.

1. Treatment of spouse income

At present, when the income of the spouse is lower than the income of a married staff member, spouse income may be taken into account in the tax allowance calculations. A two-step process is followed. First, staff and spouse income are combined to calculate a combined, joint tax. Second, the separate tax of the spouse alone is calculated (using married-filing-separately rates) and then subtracted from the joint tax to arrive at the staff member's allowance. However, when the spouse's income is higher than that of the staff member, spouse income is not taken into account; the staff member's tax allowance is rather calculated on the basis of married-filing-separately tax rates, which are higher than the normally used married-filing-jointly tax rates.

There are two reasons for this procedure. The first dates to 1948 when the married-filing-jointly tax rates were initially introduced in the United States, and the Fund and Bank decided to assume their use in the tax allowance calculations. The new rates reduced the tax of married taxpayers by permitting income to be split between the couple. Assuming married-filing-jointly status (rather then single status, which was later replaced by married-filing-separately status) reduced the cost of tax allowances. In making this assumption, the organizations implicitly recognized the effects of spouse income on the tax of the staff member, and they accordingly decided that spouse income should be taken into account in the tax allowances calculations. Spouse income was included while it was lower than staff income, because it would then be advantageous for staff to shift income to their spouse. However, it was reasoned that there was no advantage to the staff member to shift income to his or her spouse if the spouse's income was already higher, so in these circumstances there would be no savings from married-filing-jointly tax rates to the staff member or organization. Thus the use of single (later married-filing-separately) tax rates continued to be used when spouse income was higher (even though the staff member actually filed a joint return).

The second reason for this procedure is that when spouse income greatly exceeds staff income, the use of married-filing-separately rates can raise the calculated amount of the spouse's tax above the amount of the joint tax on the combined incomes. In such cases, the staff member could receive no tax allowance.

The dual treatment of spouse income now results in large discontinuities in the allowances payable at the cross-over point where spouse income rises above staff income. At middle and upper level of staff income, the switch in calculation procedures can reduce the amount of tax allowances by amounts ranging up to $7,000. Analysis indicates that these discontinuities result in part from the collapsing of the marginal tax brackets under the

Tax Reform Act of 1986, and from the relationship of the married-filing jointly and married-filing-separately tax rates. While the original rationale for switching procedures when spouse income rises above staff income may remain valid in the abstract, discontinuities of the present magnitude are disproportionate and undesirable.

It is accordingly proposed that current procedures be changed so that, when spouse income is higher than staff income, the allowance would be determined as the larger of the allowances calculated under the two methods. Extending the use of the married-filing-jointly tax rates, with spouse income taken into account, eliminates the gap in allowances, and retaining the married-filing-separately procedure for extreme cases avoids the possibility of the staff member receiving no allowance. This change will increase the cost of tax allowances by less than 1 percent.

2. Reimbursement of social security upon separation

When a staff member is employed by the Fund for only part of a calendar year, the following procedures are applied in determining the amount of the Social Security Self-Employment Tax to be reimbursed. If the staff member has paid Social Security taxes for the portion of the year preceding or following Fund employment, the reimbursement is determined on the difference between his or her total income (organizational income plus previous or subsequent income) and the amount of the previous or subsequent income subject to the Social Security tax. In effect, Fund income is always treated as if it were the last income, and the Social Security tax paid by a staff member (and partly reimbursed) while employed by the organization is always regarded as additional to the amounts paid while the staff member is employed elsewhere. Because the amount of annual earnings subject to the Social Security tax is capped, this treatment results in some savings to the Fund.

This approach is appropriate when staff join the Fund, but it results in problems when staff separate. Many of these problems are administrative. Because the amount of Social Security tax on subsequent earnings is not known at the time of separation, staff are required to file a report after the end of the year, and the amounts previously paid are then adjusted retroactively. This procedure is cumbersome, and it is difficult to explain to staff or to enforce. An inordinate amount of staff time is devoted to frequently unsuccessful efforts to obtain the necessary information.

When former staff members are employed by an organization subject to Social Security, they contribute no more to Social Security than they would had they been employed by the Fund throughout the calendar year. However, when former staff members become self-employed, the effect of the current procedure is to shift to them the additional cost of the employer's normal share of the contributions (up to $5,329 in 1992). Former staff in this situation question the fairness of this procedure.

For these reasons, revised procedures based on the sequence of earnings from the Fund and outside earnings are proposed. (Such procedures are already followed by the Bank.) When staff members join the Fund, their income from the organizations subject to Social Security tax would, as at present, be treated as last income, and reimbursement would be made only with respect to the additional tax over and above that previously paid. However, when staff members separate, their income from the organizations subject to Social Security tax would be treated as the first income, and no adjustments would be made, regardless of subsequent earnings.

3. Consistency of the relationship between income and deductions

A number of the adjustments to deductions, which were discussed above, are intended to ensure that the average deductions used in calculating tax allowances match as closely as possible the deductions that staff are actually able to claim. It is equally necessary to ensure that the income that determines the level of deductions in the tax allowance calculations is consistent with the income to which deductions are related in the IRS statistics. If these relationships are not the same, the deductions imputed to staff at a given level of income will be too high or too low. To the extent possible, the income should on both sides be that which is available to taxpayers for expenditures which give rise to tax deductions and thereby reduce the amount of the taxes due.

In the tax allowance system, the applicable level of deductions is established against total income from the organizations, less certain non-salary, lump-sum payments (such as the cost of separation allowances and spouse travel on points) which cannot be used for deductible expenditures. Except for these amounts the total earnings of staff are treated as if they were equal to AGI and, after taxes are paid, available for expenses that can result in tax deductions.

This income differs from the income base in the IRS statistics in two respects. First, the Fund and Bank income to which deductions are related in the calculations includes the full amounts of staff members' own contributions to such benefit programs as the Staff Retirement Plans (SRP), medical benefits programs, and life insurance plans. After these contributions are paid to the organizations, the gross income actually available to staff for deductible expenses is 8-12 percent lower than the income that determines the level of deductions in the tax allowance system. The AGI to which the deductions of taxpayers are related in the IRS statistics is not, however, subject to comparable reductions. This is primarily because defined-benefit retirement plans similar to the SRP are provided at no cost to employees by more than 90 percent of major private sector employers.

Second, the income reported to IRS and reflected in the IRS statistics is not, in many cases, the total income of taxpayers; the reported salaries and wages have been reduced by certain payments for benefits which many employees can exclude from their pre-tax earnings through what are known as "salary reduction plans". Such plans include 401(k) and other retirement savings plans and flexible benefits plans, many of which encompass medical and life insurance plans, as well as retirement components. 1/ Contributions which employees make to such plans do not constitute taxable income to them. To the extent that employees make contributions on this basis, they retain a larger proportion of their AGI. The Fund and Bank offer no equivalent plans, so that all contributions made by staff for comparable purposes are reported to IRS as fully taxable income; and all contributions by staff for these purposes must be subtracted from the income on which deductions are based in the tax allowance system.

As a consequence of these differences, the proportion of the income reflected in the IRS deduction statistics that is available to taxpayers for deductible expenses is larger than the proportion of the gross income used in the tax allowance system to establish the applicable level of deductions that is actually available to staff. All other things being equal, treating the gross income of staff as if it were identical to AGI in the IRS statistics has tended to overstate the deductions attributed to staff in the tax calculations.

An additional consideration is that, like IRAs and Keogh plans, salary reductions for 401(k) and similar salary-reduction retirement plans only defer the tax payable on the amounts contributed. As in the case of the IRAs and Keogh plans, these salary reductions should not be taken into account in the tax allowance system, as doing so would understate the total tax attributed to a given level of income.

Adjustments that would more closely align the income base in the tax allowance calculations and the IRS statistics are feasible. They are not proposed at this time, however, because the all the data necessary to ensure that the size of the adjustment accurately reflects the differences between current tax allowance calculations and the IRS statistics are not now available. The intention is to obtain the required additional data from the IRS and in the course of the 1993 Quadrennial Benefits Survey and then to revisit this matter.

1/ Surveys indicate that up to 90 percent of major employers offer 401(k) or similar retirement plans, and over 60 percent offer flexible benefits programs.