

Debt Relief for Child Development

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UNICEF Debt Relief for Child Development

The debt crisis and its management has had many negative effects on the heavily indebted developing countries. Clearly one of the most tragic effects are the human ones. UNICEF, as well as other institutions such as the World Bank, the IMF and the regional development banks have documented how vulnerable groups have in many cases borne a very large part of the burden of debt and recession in the 1980s.

In the case of Latin America and the Caribbean (LAC), the region has become a net exporter of financial resources with serious social consequences. As a result of the large negative transfer of resources from LAC, as well as of other factors, poverty increased in LAC between 1980 and 1985 from 35 per cent to 40 per cent of the population in relative terms and from 130 to 163 mn in absolute terms. The poverty which faces children and their families manifests itself in the form of high rates of infant and child mortality, malnutrition, lack of basic services such as safe drinking water and sanitation, low enrolment and high drop-out rates in basic education, illiteracy, etc. After 40 years of steady progress in these areas in LAC, there has been a marked slowdown in recent years. The heaviest burden of the economic crisis is therefore on children, the majority of whom are poor.

In its 1989 *State of the World's Children Report*, UNICEF estimated that in 1988 alone at least half a million young children died in developing countries, (particularly in Africa and Latin America), as a result of economic setbacks precipitated by the debt crisis. Furthermore, the effects of the disinvestment in human capital in the 1980s will extend to the next generation, and its results will be reflected in stunted bodies and the under-education of many adults of the next century.

To help reverse the decline in living standards of vulnerable groups in heavily indebted developing countries, UNICEF has launched an initiative, **Debt Relief for Child Development**, that would combine external debt reduction with assuring that the resources thus freed from debt service will be channelled towards improving the health, nutrition and educational status of poor children and other vulnerable groups.

There is now wide acceptance of the need for debt reduction, at least in principle. The need for debt reduction was first raised by developing countries' governments, was later endorsed by the Japanese and French government, and now has practically unanimous support in the context of the Brady Plan. It is to be hoped that this new consensus for debt/debt service reduction will have favourable influence for **Debt Relief for Child Development**.

The structural stabilisation and adjustment policies adopted in many countries to face the darkening international environment have often resulted in the short run in a worsening of the situation of the poor and vulnerable groups as wages were frozen, food subsidies abolished, and social services benefiting the poor were drastically curtailed. Lately, the concept of 'adjustment with a human face' — first proposed by Richard Jolly at the 1985 SID World Conference in Rome — is being promoted in response to the worsening social and economic crisis. This type of adjustment calls for more expansionary macro-economic policies to secure an efficient use of scarce resources to meet the needs of vulnerable social groups: sectoral policies aimed at raising the productivity of small scale rural and urban producers; and monitoring of the human situation during the adjustment process. The Inter-American Development Bank and UNICEF initiative and other initiatives of Debt for Child Development described below will seek to promote such adjustment policies by supporting investment in human capital formation which is a *sine qua non* for longer-term socioeconomic development, as well as more democratic and stable political development, thus linking the use of these resources to debt reduction.

Different Formulations of Debt Relief for Child Development

The various formulations of **Debt Relief for Child Development** currently being pursued contain the following features:

a) commercial banks may 'swap' *de facto*, donate some of their debts owed by developing countries to UNICEF, and in doing so gain some tax relief (e.g. by deducting losses or by making a charitable donation). As part of this transaction UNICEF would arrange

with the borrower Government to undertake child survival programmes using the proceeds which would be paid to UNICEF by the Government in local currency as a condition of the agreement between UNICEF, the bank and the Government.

b) Debts or just the debt service payments owed by developing countries to Governments or semi-public institutions may be paid in local currency which would be made available to fund UNICEF-assisted child survival and development activities in the borrower country in a programme jointly negotiated by the lender, borrower and UNICEF.

c) Donors may make some funds available to indebted countries to buyback their debt at a discount in the secondary market on condition that the borrower would then set aside some funds — a portion of the difference between the face value of the loan and its discounted value — for social development programmes to be implemented in cooperation with UNICEF.

Donations by banks of developing country debt to charities have received official support by authorities, such as the US Assistant to the Treasury, David Mulford and by the World Bank.

The UNICEF initiative of **Debt for Child Development** proposed that for countries where future prospects for the servicing of external debt are extremely bleak, private creditors consider donating part or all of their outstanding claims on those countries to UNICEF for utilisation in development programmes assisted and monitored by UNICEF. Such resources would be additional to resources already allocated by UNICEF, and would therefore represent a genuine contribution to improving the welfare of the poor (particularly children) and, by investing in human capital, to the country's long-term growth and credit worthiness.

The first country chosen by UNICEF for a debt development swap programme was Sudan, with the Sudanese government cooperating fully with UNICEF in the establishment of the programme. Other governments of debtor developing countries have also expressed interest in participating in such a scheme. UNICEF welcomes offers or suggestions about bankers willing to make debt donations for child development.

In December 1988, the Midland Group donated all its loan exposure to Sudan (amounting to US\$ 800,000) for exclusive use by UNICEF in a health, water sanitation and reforestation programme now being implemented by UNICEF. The Sudanese government will redeem the debt in local currency, which will then be used solely for water sanitation, reforestation and health education programmes in the Kordofan region of Sudan, benefiting principally children and women.

The programme will benefit at least 5,000 villagers in 10 villages. It will provide them with clean water and

sanitation, made possible by the building of handpumps; it will also improve the natural environment, as the additional water run-off will allow the planting of ten village seedling nurseries and ten village woodlots.

Midland Bank was the first bank to make a donation to the UNICEF scheme. It was also the first British or European bank to participate in a debt-for-development swap. Senior Midland officials have said that one of the main reasons why Midland was willing to make the donation was because the UNICEF scheme was related to such a specific well-designed and cost-effective project, which came with the clear support of the Sudanese government.

A few debt donations for charitable purposes have been made by US banks, following a 1987 Internal Revenue Service (IRS) ruling that allows donations of Third World debts and other obligations in exchange for tax breaks. For example, in February 1988 Fleet Norstar in Providence, Rhode Island, donated \$250,000 in Costa Rican debt to a conservation effort in that country. In August 1988, American Express Bank donated \$1 mn Nigerian obligations to the International Foundation for Education and Self-Help, which will use the funds as a part of a programme for nutrition, health and other social expenditure in Nigeria.

It seems likely that further debt donations to charities will be made, as these have important advantages not only for the debtor countries (and particularly the poorest sections of their populations) but also for the creditor banks. Amongst the main advantages for the banks are the following: firstly, the bank can *save* on costs, administrative expenses and, above all, on senior management time, relating to debt re-scheduling and processing of arrears linked to fairly small amounts of debt, whose repayment prospects are in any case very doubtful. This gain is particularly clear if *all* of a bank's exposure to a particular country is donated together. Secondly, the bank will benefit from a large amount of goodwill generated by such a donation. Indeed, the donations made so far have attracted a great deal of interest in the media. Thirdly, the bank's management will know that the debt donation will be used for purposes that benefit long-term development in the debtor economy. Last, but certainly not least, the bank may in most cases obtain important reductions in its tax obligations. We discuss these in some detail in the next section.

Tax Treatment of Debt Donations

In the case of British, American and Dutch banks we have verified that important tax advantages to debt donations can occur.

For example, a UK bank gives as a charitable

donation a certain amount of debt to a charitable institution, such as UNICEF, this would have tax advantages for that bank; the magnitude of the tax advantage basically depends on the level of provisioning already made previously by the bank against that particular country's debt and the value of the debt accepted previously by the Inland Revenue as the appropriate one for tax purposes. As normally the latter is a lower amount, and as a donation implies that the Inland Revenue *will* accept the full loss, a donation will imply a potential tax gain in the UK. (For calculations see Appendix 1).

In the US case, similar principles apply for tax treatment of charitable donations of debt. The tax advantage to the bank lies in the fact that the US Internal Revenue Service will accept tax allowances for the *total* of the debt donated, whereas if the same debt was totally written off but not donated, the Internal Revenue could and probably would question at least part of the write-off, as not being tax deductible.

Furthermore, in the US, disclosure requirements (on details of banks' financial results) are the most extensive of the major creditor countries. This is one important reason why US banks are especially reluctant to accept losses, because they must report the details of their performance so thoroughly and frequently. In this context, a senior US private bank official pointed out that donation of debt that is unlikely to be serviced or paid, implies a clear advantage for the donating bank; the amount given will be registered as a charitable donation taken from after-tax profits, whereas a write-off of the debt would be registered as a loss from pre-tax income. Though this distinction may seem somewhat formal, it is important to US banks and their shareholders, given the disclosure requirements and the emphasis on analysing short-term financial performance by the markets.

In the case of the continent of Europe, similar tax relief principles seem to apply as in the United States and the United Kingdom. For example, in the Netherlands, a donation of debt would also be tax-deductible: the bank would benefit if the debt had not already been totally written off. (The tax benefit may possibly be somewhat smaller than for the US and the UK, as on the continent of Europe a higher percentage of provisions against losses tend to be accepted by the tax authorities as tax-deductible).

To summarise, in the case of the three countries examined — the United Kingdom, the United States and the Netherlands — tax advantages can be obtained from debt donations by banks to charities.

The IDB-UNICEF Human Capital Development Initiative

The Inter-American Development Bank (IDB) and the United Nations Children's Fund (UNICEF) are about to launch an initiative for human capital development in the 1990s. It is proposed that the initiative would be financed through a special Trust Fund called the 'Social Investment Trust Fund' which will be initially financed through contributions to IDB by interested donors. The IDB in turn would lend the funds to its member states in Latin America and the Caribbean (LAC) to finance the buy back of their external debt in the secondary market, thereby gaining the benefit of a considerable discount. As a condition of this borrowing, the LAC countries would agree to contribute an amount (a portion of the difference between the face value of the debt purchased and the new loan from IDB) in local currency to finance social development programmes, in their own countries. The new loan from the IDB Trust Fund would feature several concessionary terms including reduced interest rates and extended grace and amortisation periods. The programming of the social projects to be supported as part of the arrangement would be a joint exercise involving the borrower Government, IDB and UNICEF.

The details of the IDB-UNICEF initiative are being worked out. Furthermore donor government support is being negotiated. A helpful precedent is a trust fund that the IDB has recently established with support from the Government of Spain for a programme of economic, social and cultural progress in Latin America in commemoration of the quinqucentennial of Spain's links with the New World.

Considering the potential scope for social project financing and the needs associated with a multi-year set of projects identified by the IDB and UNICEF, an order of magnitude equivalent to US\$500 mn in resources available to the Fund would be viewed as highly desirable.

IDB-UNICEF initiative hopes to transform the current crisis of investment in human capital into an opportunity for reviewing how to promote human development in the 1990s. In terms of human capital formation, investment in children must be given a high priority since they constitute an age group with very high rate of return in social investment. Accordingly, the present IDB-UNICEF initiative is conceived as an investment in the present generation of children so as to avoid the reproduction of poverty in the generations to come.

Social needs vary from country to country. Like in other areas of development, a *country focus* is irreplaceable and a continuous dialogue with the national authorities is the cornerstone for the planning

of technical cooperation and financial assistance in the social areas. While leaving the selection of projects to country specific programming, the board priority areas for the IDB-UNICEF programme have been identified as follows:

a) basic health, including primary health care with particular emphasis on immunisation and control of transmissible diseases. Priority will be given to programmes well designed to reach timely targets in terms of the reduction of infant mortality, under-five mortality, maternal mortality and eradication of major diseases.

b) Nutrition programmes, especially those to eliminate severe child malnutrition and to reduce moderate malnutrition in the younger population, plus maternal malnutrition.

c) Basic education including virtual elimination of illiteracy, particularly among women, development of services for the young child including pre-school attention, universal primary education, training on life skills and civic values.

d) Universal access to environmental sanitation, particularly safe drinking water in urban slums and poor rural communities.

e) Social communication and mobilisation to help communities to organise and to train for the development of self-management capabilities to cope with their own problems.

f) Last but not least, cooperation to create and improve systems of social indicators required to target and monitor cost-effective social programmes, and to strengthen the administrative capacity of social sectors and local communities.

The initiative is timely in that it offers the possibility of

mobilising *additional* resources for children, while making a positive, though modest, contribution to debt relief in a region where disinvestment in human capital formation threatens to perpetuate the cycle of poverty and deprivation.

Appendix 1.

Tax effects of a charitable debt donation by a British Bank

The effect is best explained by a hypothetical numerical example. Bank X has exposure in country A of £1 mn (face value), and has made a provision of 40 per cent against its exposure in Country A due to difficulties in getting the debt serviced and/or perceived risk that the principal may not be paid back.

The Inland Revenue however has only accepted (for tax purposes) provisioning of 15 per cent, as the Inland Revenue accepted the provision for risk of loss of principal but not for the future *reduced or delayed payment of interest*. In the initial situation, therefore, the bank's shareholders have accepted loan-loss provisioning of £400,000 while the Inland Revenue had for tax purposes only accepted £150,000.

Bank X decides to donate 10 per cent of its exposure in country A to UNICEF within the scheme of Debt for Child Development. The face value of the debt being donated is thus £100,000, and its balance sheet value is £60,000. The bank would thus incur an additional loss of £60,000.

Because the bank would *as a result of the transaction have no further right* to principal or interest, the Inland Revenue would *give relief for the whole face value to the extent this had not already been allowed*. The Inland Revenue had previously already accepted a loss of 15 per cent for Country A (equivalent to £15,000 given the amount to be donated). The arithmetic difference between the total loss (£100,000) and the previously accepted loss (£15,000), which would be equal to £85,000, could be set against profits in the rest of the bank's operations. Assuming that the bank is paying corporation tax at a rate of 35 per cent, and that it is overall registering a profit, the tax savings would be £29,750.