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Proposed changes in tax treatment of banks, so as to encourage debt/debt service reduction

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An important potential problem with the Brady Plan is that banks are expected to participate voluntarily in debt reduction or new money arrangements. Ultimately, it may prove difficult or even impossible to persuade a sufficient number of banks voluntarily to reduce their aggregate claims enough on particular debtor countries to levels that are sustainable - that is, fully serviceable without compromising growth objectives. Regulatory and tax measures can play an important role in encouraging banks to participate in Brady-type debt arrangements.

The US Treasury Secretary, Mr Nicholas Brady, stressed when launching his plan that "creditor governments should consider how to reduce regulatory, accounting or tax impediments to debt reduction where these exist."

The main common regulatory feature in Europe and Canada (as opposed to the US) has been the far more favourable attitude of the authorities on encouraging banks to make loan loss provisions, particularly through the tax deductibility of such provisions.

This has had the desired effect of strengthening all the banks in those countries, against particular or real losses on Third World debt, and has also provided the potential cushion for those banks to agree debt or debt service reduction, without their solvency being threatened.

However, the fact that full tax incentives are already provided at the time of provisioning implies there is no tax incentive to accept debt or debt service reduction. Thus, existing tax provisions in Western Europe and Canada encourage provisioning, but discourage debt or debt service reduction.

It would therefore seem desirable that Britain takes the lead in designing a tax policy so as to ensure that sufficient (but not excessive) levels of provisioning are maintained. This would imply that tax incentives would continue to be given, at the time of provisioning, in the context of criteria defined by the Bank of England matrix.

However, there tax concessions would only be maintained if within a limited time period (eg, 3 years) the commercial bank accepted debt or debt service reduction at least equivalent to the amount of provisioning being accepted for tax concessions. If a deal was agreed within the context of the Brady Plan for a particular country within the period of 3 years, the bank would maintain tax relief only if it participates in the debt or debt service reduction exercise (or makes equivalent contributions), and the tax relief would only be maintained for the proportion of the effective debt/debt service reduction granted.

Such an approach to taxation of banks would be more consistent than current practice with the basic general taxation principle that to be accepted for tax purposes a loan loss premium must relate to the expected irrecoverability, or past irrecoverability of the debt. In fact, for most business debt in the UK, tax concessions on bad debt are only obtained once the debt has gone bad, and the company is in liquidation or receivership. Given the magnitude of Third World debts, and the need to safeguard banks' solvency, it seems advisable to continue allowing special treatment to banks in that they may initially obtain tax relief against provisioning, but only maintain it if after a period equivalent debt service or debt reduction effectively occurs.

It should be stressed that this policy would imply no additional cost to the taxpayers; on the contrary, it could imply a higher tax income, for the Inland Revenue if the banks did not agree as high a debt/debt service reduction as they has provisioned against.

If such a line were to be taken by British tax authorities, it would be particularly valuable if the position was made clear and public, to provide signals to the banks. Lack of knowledge and clarity about future reactions of tax authorities to changes in debt management policies often inhibits the search for innovative solutions.

The suggested course of action on tax policy for Britain would clearly be consistent with both the letter and the spirit of the Brady Plan, which seeks to encourage by the actions of governments and international financial institutions sufficient debt reduction so as to encourage growth and accessary structural reforms in highly indebted countries. Such a tax policy would be consistent also with the clear efforts which both US regulatory and tax authorities are making (in the context of their own framework) to provide incentives for implementing the Brady initiative. It would also be consistent with the Japanese taxation and regulatory framework Britain could take a leadership role within Europe (in ways similar to what it did on official debt) to encourage other European countries to similarly adapt their tax practice to provide the desired incentives; it would seem likely that other European countries would be sympathetic to such an approach.

sgjpcctb/tkg/21.2.90