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Loans or grants in development cooperation? Mainly a question of efficiency

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The question whether grants or (concessional) loans are "better" suited for development cooperation runs like a golden thread through the development policy debate of the last 50 years. The debate has recently gained momentum because of two opposing trends: Several important donor countries have significantly scaled back their development lending over the past years (USA) or have never allocated any loans at all (UK), while others are considering a massive expansion of loan financing (such as the European Commission, Spain or Korea). What arguments support grants, and what arguments favour loans¹?

Arguments of the advocates of grants

- Development assistance is a moral obligation and should be given without expecting anything in return.
- The industrialised countries are (partly) responsible for the plight of the developing countries and should therefore pay for the "repairs" themselves.
- Developing countries are too poor to repay loans, which would throw them into a debt crisis.
- Instead of repaying loans, the developing countries had better use the funds for urgently needed investments in their own countries.
- Development assistance is often provided in areas that are important to ensure sustainable development (emergency relief, meeting basic needs, global public goods) but do not generate sufficient revenues - at least not in the short term - from which loans could be repaid.
- As long as the developing countries are not

internationally creditworthy, the financial gap must be bridged by grants.

Arguments of the advocates of loans

- Grants are "sweet poison". They reduce the incentives for partner governments to finance their own development through tax revenues, so in the long term they make them more dependent on donors.
- The obligation to repay loans, on the other hand, creates particular incentives to use the borrowed money carefully and efficiently.
- Loans ensure more "distributive justice" because their benefit is spread among many people (for example in the financing of irrigation systems for smallholders) through their revolving nature instead of reaching just a few "lucky ones", as a one-time grant does.
- Loans strengthen the partners' sense of ownership and accountability because they have to take responsibility for the efficient use of the funds and their repayment (avoidance of moral hazard).
- Loans can mobilise substantially higher amounts and, accordingly, achieve much greater development impacts. For example, when budget funds are not given as grants but instead are used to reduce the interest rate on capital market funds, the financing volume can easily be multiplied - depending on the intensity of the interest rate reduction (leverage).
- Loans take the strain off budgets of donor countries because of their revolving nature and their leverage of capital market funds, thus making it easier for donors to meet their ODA quotas.
- Concessional development loans are a very flexible instrument for gradually moving partner countries closer to international

capital markets which must replace development assistance as a funding source in the long term.

The solution: an intelligent mix!

For all arguments listed above, practical cases can be found that either support or refute the argument. Leaving moral philosophical aspects aside, establishing the financing conditions in development cooperation is primarily a question of financial efficiency. Thus, pure grants or market-conforming loans are merely two opposite poles of a continuum from mildly to highly concessional financing instruments. A measure of the degree of concessionality of financing is the "grant equivalent"², which can adopt values between 0 (pure capital market funds) and 1 (pure grants).

The lower the grant equivalent, the more activities can be supported and the more impact can be generated. From the aspects of financial efficiency and fairness (and, not least, also in light of the budget constraints of donor countries), the grant equivalent should always be as low as possible - not higher (because this would mean a waste of concessional funds) but not lower either (because otherwise the development objective would no longer be achieved). The higher the financial capacity of the partner or the rate of return on the financed project, the lower the grant equivalent can be (see table). ■

		Financial capacity of the partners	
		Low	High
Rate of return of the individual measure	Low	Pure grants (GE = 1)	Intelligent mix (0 < GE < 1)
	High	Intelligent mix (0 < GE < 1)	Pure capital market (GE = 0)

¹ Some of the arguments relate to the conditions of transfers between countries and some refer to the conditions at which funds are "channelled" to the final beneficiaries/target groups.

² In simplified terms, the grant equivalent (GE) is the discounted monetary advantage over pure capital market financing expressed in percent of the allocated capital.