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 loans? 1

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 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, 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 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.
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Note: This paper reflects the views of the authors and does not necessarily represent the position of KfW.