

»»» Additionality of mobilized private capital: Crowding-in or crowding-out?

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Facing a worldwide infrastructure funding gap of USD 6 trillion a year and tremendous financing requirements for reaching the Sustainable Development Goals (SDGs) an increased private sector participation in development finance is key. Recently, the level of private capital in development finance has increased substantially, reaching a ratio of concessional financing by multilateral development banks to private capital of less than 1:1. But according to the 'Blended Finance Taskforce' the ratio would have to double on the private side to close the funding gap for the attainment of the SDGs. In this light, private capital mobilization in developing countries in general has gained attention once again. One possibility is blended finance, which is the strategic use of public development finance to mobilize additional private sector investment. To increase the efficiency and effectiveness of blended finance the OECD defined five principles for its operationalization. Additionality is one of them, which is currently being debated.

Definition of additionality

In the international discussion many different definitions are used. According to the OECD additionality is threefold:

Financial additionality refers to a project that would not be funded by commercial sources alone and may among others consist of better terms or prices or reduced risks for the private sector.

Value additionality means the offering or mobilization of non-financial value that the private sector is not offering before the intervention, by incorporating social equity considerations or social and environmental standards.

Developmental additionality refers to the developmental impacts that arise and would not have occurred without the joint intervention or any actor alone.

Crowding-in and crowding-out

Looking at financial additionality, ideally, private capital is mobilized to address local market failures by minimizing risks for private investments and also by setting incentives or sending certain signals to crowd-in commercial investors. The challenge is to ensure that interventions by development agencies towards the private sector do not crowd-out certain investors through "over-subsidizing". In this case the benefitting private companies would gain unfair competitive advantages over others that are not taken into account, which in turn might then no longer be able to compete and could consequently be pushed out of the market. Over-subsidizing thus generates new market distortions instead of eliminating them. Therefore, the paradigm of minimal concessionality requires that public lenders use only the absolute minimum of concessional finance, offering conditions close to the market or the lowest subsidy level needed to reach the intended outcome.

Challenges

Yet, minimal concessionality is hard to achieve since the actual level of subsidy can often be calculated only after the end of an intervention. Due to the lack of financial data the risk levels are hard to calculate upfront and therefore the right level of subsidy is difficult to determine. Furthermore, local markets are not static but highly dynamic, which is why the design of projects involving the private sector or aiming at catalyzing additional flows needs to be well monitored and adapted to changes in the environment.

The risk of over-subsidizing and crowding-out, at least temporarily, is large. Therefore, a huge challenge is to really understand the incentive structures relevant for any given intervention.

Possible distortive incentives concern companies searching maximum subsi-

dies, hence best financing conditions, and competing development agencies accepting these deals for the sake of meeting their targets, especially towards end of the year.

A positive example of a dynamic private sector approach is the GET FiT scheme in Uganda funded by multiple donors, focusing on small scale renewable energy projects. The approach allowed leveraging USD 453 million of private capital. The support consisted of risk mitigation measures and technical assistance as well as smart subsidies topping up the feed-in tariffs. These are granted for early movers only and gradually being phased out, forcing the project to become viable in the long run. A study using financial modelling with detailed project-level data (benchmark approach based on internal rate of return) confirmed that 8 out of 14 small hydropower plants under the GET FiT fulfilled the criteria of additionality. In retrospect, feed-in tariff top-up could have been even lower for some of the investments. A reversed bidding process, in which the private sector company with the lowest needed subsidy would win an auction, would have been more efficient.

Outlook

Despite positive examples, additionality and minimal concessionality in general are very difficult to operationalize. Rather, further scientific research on how to overcome market failures and on possible market distortions by development finance is needed for an in-depth discussion on the role of blended finance in reaching the SDGs. ■