Grants or Loans?

Development Finance and Incentive Effects

Some people think the best way to give aid is through grants. Others advocate aid embedded in subsidized loans. Mostly, incentive effects on donors and recipients are ignored in this debate. But grants and loans carry different incentives and in some settings can be complementary. Donors should offer a wider menu of options, including ongoing forgiveness of loans, unbundled subsidies, and loans combined with output-based grants. Donor agency staff should be rewarded for outcomes, not volume of funds out the door.

How is US$100 million of donor funding best delivered—through US$100 million of grants or through a larger volume of concessional loans with a “grant equivalence” of US$100 million? In a world of perfect capital markets there is no difference (box 1).

But capital markets are not perfect. That brings us to a hypothetical world that might be called the development bank paradigm. In this world poor countries cannot tap private capital markets. But they do have a stock of good-quality development investments, the best of which also offer the highest returns. There are no incentive considerations: the money is always spent as promised, and always repaid. There is no uncertainty, and the donor agency can perfectly identify the best prospects.

In this world loans outperform grants. Both a grant and a loan of US$100 million would immediately be invested in a high-return project. The returns to the recipient from the loan would be reduced because the loan must be repaid, but the donor agency would immediately lend the repayments to the worthiest recipient awaiting a loan. By assumption, the relending of the money (reflows) has a higher rate of return than leaving it with the original recipient because the donor agency has a broader choice.

Clearly, these assumptions are not realized in the real world. But in an approximate form they add up to the main justification for development banks lending to sovereign countries:

- Because there are good projects lacking capital, loans (subsidized or not) are useful.
- Because poor countries cannot tap private capital markets very well, development agencies provide those loans.
- Because the development banks believe that they can continually identify the most promising recipients, they ask for some repayment so they can relend the money.
Development finance in the real world

What’s misleading about the development bank paradigm? The strongest advocates of grants typically take one or more of these positions:1

■ Many projects will fail and even good projects do not generate high financial returns, so the loans won’t be repaid without great hardship.

■ Most countries are either capital constrained for good reasons or not badly capital constrained, so development bank loans do not correct any market failure.

■ Reflows of aid money are neither large nor especially well allocated by development banks, so making a grant in the first place may be better.

In other words, critics of subsidized loans believe that grants are appropriate because the development bank paradigm is a bad description of the world. A more moderate view is that grants are sometimes appropriate because the paradigm is not always a good description of the world—because capital constraints are not the problem or because past projects have failed, leaving an inability to pay off debt. A symposium reflecting a broad spectrum of views arrived at consensus on at least one point: grants are more appropriate in some circumstances, and loans in others.2 This Note aims to say more about those circumstances.

Incentive effects for recipients

Little can sensibly be said about grants and loans without considering incentive effects. For example, advocates of grants argue that debt-financed projects have not earned sufficient returns and countries therefore could not repay the loans. But the real problem was not loans but that the projects performed poorly. The burning question is whether grants or loans will be well spent in future. To answer it requires asking what incentives grants and loans produce for recipients and for donors. Let’s start with the incentive effects for recipients.

Do grants reduce debt?

To argue that grants are appropriate for countries with severe debt problems seems sensible enough. The implicit assumption is that the grants will be used to pay down debt or for some legitimate development purpose. But is that true?

Clements and others (2004) show that an increase in grants tends to suppress domestic tax revenue. The effect is particularly stark for the most corrupt quartile of countries, in which 95 percent of grant money seems to be immediately dispersed as tax giveaways. By contrast, loans encourage revenue raising.

Odedokun (2004) finds a similar effect: grants reduce tax effort or encourage deficit finance. Moreover, grants, more than loans, promote government consumption spending and retard government investment spending. Djankov, Montalvo, and Reynal-Querol (2004) also find that grants tend to raise government consumption, and loans to raise investment.

But Odedokun also finds problems with subsidized loans: recipient countries will demand an excessive supply of them. Unless subsidized loans are carefully rationed—here the donors need the right incentives—they may also encourage indebtedness.

This research is not conclusive. But it does provide some empirical backing for the theoretical insight that the cheaper money is, the less efficiently it may be used. Still, there are good reasons to provide cheap money to the poor. The important thing is that spending is disciplined. The right kind of grants or loans might produce the right disciplines.

### Box

**How loans can be equivalent to grants**

Assume a world of perfect capital markets, where all borrowers and lenders can borrow without limit at the same interest rate, 10 percent in real terms. If a country takes a concessional loan of US$100 million at 5 percent, repayable after one year, this creates a cash inflow of US$100 million this year and a cash outflow of US$105 million next year.

The country could convert the loan into a grant of about US$4.55 million by banking US$95.45 million and spending the rest. Next year the US$95.45 million will have earned enough at the 10 percent commercial rate to repay the US$105 million.

The country could also convert a grant into a loan. A grant of US$4.55 million can become a one-year concessional loan at a rate of 5 percent. The country simply borrows US$95.45 million commercially, for a total cash inflow of US$100 million. Next year the loan must be repaid with interest, a cash outflow of US$105 million.

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Do grants promote growth?

Recent work on aid effectiveness asks in which countries aid produces economic growth. Few papers have tackled the question of what kind of aid produces growth. One that does is Sawada, Kohama, and Kono (2004). Decomposing aid flows into grants and concessional loans, the authors find that aid on average has no effect on growth (regardless of recipient policies), nor do grants. But loans to a country with good policies are associated with faster growth. Djankov, Montalvo, and Reynal-Querol (2004) find similar results: loans can promote growth in a good institutional environment, but grants do not.

That does not mean that grants are ineffective. Grants may support projects, such as providing primary school textbooks, that are not aimed at boosting medium-term growth. But more evaluation of this question would be valuable. Given Odedokun’s finding that grants are spent on consumption rather than investment, the failure of grants to produce growth seems a cause for concern.

Incentive effects for donors

The incentives of donors are even less well explored than those of recipients. There are several issues of concern. First, that donors will provide less money (in gross terms) if they supply grants rather than loans. Second, that development banks that rely on loans have an incentive to push them even when inappropriate. And third, that aid agencies may be less assiduous in monitoring grants than loans, since they have no direct financial interest in the success of a project once a grant is made. Little evidence seems to exist on any of these questions.

Do grants reduce the volume of aid?

Since grants are more generous than loans, increasing the share of grants will necessarily reduce gross disbursements if donors refuse to increase funding levels. (Some aid agencies also fear that switching from loans to grants will place them at the mercy of unpredictable appropriation processes in donor governments.) Will they? Only up to a point.

Odedokun (2004), looking at official flows from 22 donor countries in 1970–99, finds that the larger the share of grants a donor makes, the lower the gross disbursements. The choice is indeed between a large volume of loans and a smaller volume of grants. But Odedokun finds no evidence that reflows are being used to fund current grants or loans: large shares of loans several years previously are not correlated with high disbursements today.

Do loans encourage “loan pushing”?

Critics of loans argue that development banks have a strong incentive to lend even when such lending is inappropriate. Reasons cited include a culture that values gross flows, and “defensive lending,” in which official lenders provide loans to enable borrowers to repay existing debt.

Birdsall, Claessens, and Diwan (2003) found evidence of substantial defensive lending: donors to African countries in 1978–98 lent more to those with bad policies if they also had large existing debt.

Yet agencies given grants to disburse also face pressure to spend money, sometimes so quickly that it is impossible to find the best projects. The problem seems to be not whether funds are disbursed as loans or grants but what kind of behavior is rewarded. Both “loan pushing” and “grant pushing” need to be discouraged with appropriate incentives. A good place to start would be for donors to insist on accountability for development results rather than volumes disbursed.

Smarter development finance

The debate over grants and loans has been useful but too polarized. There are plausible objections to the use of grants:

- Grants increase government consumption and reduce investment spending.
- In corrupt governments grants are used to finance tax reductions.
- Grants do not seem to promote growth.
- Even heavily indebted countries are happy to secure subsidized loans, thus getting deeper into debt.
- Compounding this problem, development banks may push loans when they are inappropriate.
- Reflows from loans do not necessarily finance further aid.
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These objections are really protests against sloppy development finance. Both grants and loans should be better monitored and evaluated. Development agency staff should be rewarded for producing good outcomes, not for handing out cash. And donors should explore more sophisticated approaches to development finance. Several proposals exist:

- **Ongoing forgiveness.** Loans could be made with predetermined conditions, to be independently audited. Every year in which the conditions are met, that year’s loan payment would be forgiven. The loan would thus be converted into a grant, gradually and according to transparent conditions. (Alternatively repayment could be deferred until a predetermined condition is met, such as high commodity prices or high GDP growth.)

- **Unbundled subsidies.** A US$150 million subsidized loan can be regarded as, say, a US$50 million grant and a US$100 million market-rate loan. The funds could instead be offered as a US$50 million grant with an option to borrow up to US$100 million at market rates. That would leave the recipient free to take the loan only if appropriate; it would have no need to borrow to get the subsidy.

- **Loans combined with output-based grants.** Output-based grant schemes pay grants only on delivery of the desired output. But finance is also needed. The ideal is private finance, but output-based schemes, being generally experimental, may be slow to attract such finance. And loans with a sovereign guarantee undermine the disciplines behind output-based aid. That leaves development banks that lend to the private sector, such as the International Finance Corporation. Output-based aid is an attractive piece of financial engineering: the promise of the grant shifts purchasing power to the poor, performance risk is shifted to the private investor, and political risk is transparently priced because attracting investors to risky projects will be expensive.

Providing a menu of financing options is likely to produce better results than offering each borrower a particular type of aid, even if supposedly tailored to the borrower’s needs. Lending without a sovereign guarantee should be part of this menu; it may help to address (but will not eliminate) the “moral hazard” problems of lending to countries that expect eventual debt forgiveness.

Better evaluation of the incentive effects of both loans and grants is urgently needed. The results should help design more effective aid, no matter how that aid is financed.

Notes

1. Ken Rogoff (2004) and the Meltzer report (IFIAC 2000) argue that development bank loans no longer correct a market failure. François Bourguignon and John Taylor, at a recent symposium, both drew attention to the fact that unsustainable debt is an argument against the use of loans (the transcript from the symposium, held October 1, 2004, at the Center for Global Development, is at http://www.cgdev.org/docs/grants%20and%20loans%20transcript.pdf). Taylor also argued for grants on the basis that social projects do not necessarily generate financial returns and that reflows are relatively trivial.

2. For details on the symposium, see note 1.

References


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