The role of grants versus loans in development cooperation - lessons for climate finance and REDD+

Key message

The appropriateness of using grants or concessional loans to support REDD+ activities will vary depending on the economic and institutional strength of the country and the types of activities being supported.

1 **International financial support for development projects and programmes in developing countries can be provided in the form of grants or concessional loans[1].** A grant is a transfer made in cash, goods, or services for which no repayment is required, while a loan is a transfer for which repayment is required. In practice, loans can include a grant element.

2 **The appropriateness of grants or loans for financing climate change mitigation activities in developing countries depends on (1) the macroeconomic and institutional strength of the recipient country and (2) financial variables of the recipient project.** This helps to establish general conditions under which grants and loans might be appropriate for investments at country and project levels (Table 1).

Table 1: Conditions under which grants and loans might be appropriate for supporting climate change mitigation activities at national and project levels.

Investment level	Conditions under which grants or loans are appropriate
Investments borne by government	Grants should be preferred over loans for government support in countries with low level of income, high level of inherited debt, and high risk of economic volatility. Grants should be preferred over loans for government support in countries with low capacity to manage loans or with low capacity to achieve fiscal sustainability (although loans can encourage fiscal discipline in countries, which have initiated such policies).
Project-level financial considerations: (for any investment)*	Loans should be preferred over grants when funding revenue-generating projects, with large upfront capital needs. Grants should be preferred to fund pilot projects with high technical risk, and for capacity building projects for which there is no direct revenue stream. Projects that are likely to generate sufficiently high and immediate financial returns could be financed through loans on commercial terms to avoid over-subsidising projects (thereby wasting limited aid funding) and creating market distortions.

Notes

* Note that, while both macro-level and project-level variables need to be considered when making an investment to a government recipient, the macro-level variables should be considered first. For example, if an investment is being made to a government that has weak capacity and high levels of debt but the project is likely to generate a return on investment, a grant would still be recommended.

Disclaimer

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Table 2: General guidelines for the use of grants and concessional loans for REDD+ investments[3]

Conditions	Revenue generating activities	Non-revenue generating (e.g. capacity building, policy planning and reform)	Revenue generating activities with high technical risks (e.g. untested technologies)
Sovereign funding to country with strong macroeconomic and institutional conditions	CONCESSIONAL LOANS	GRANTS	GRANTS
Sovereign funding to country with weak macroeconomic and institutional conditions	GRANTS	GRANTS	GRANTS
Project-based funding to non-government entity	CONCESSIONAL LOANS	GRANTS	GRANTS

3 **The use of grants and loans for supporting REDD+ activities will vary depending on similar country and project-level criteria outlined above.** Table 2 summarises the conditions under which grant/loan finance could be appropriate.

4 **Grant finance for REDD+ will be necessary for non-revenue generating activities.** These include:

- Capacity building, i.e. 'readiness' activities (those that determine and fill the gaps between existing social, technical and institutional capacities and those that are required for participation in an eventual REDD+ mechanism)[4].
- Policy reform and planning processes.
- Information dissemination.
- Ongoing activities that do not generate any financial return (such as certain types of forest conservation).

5 **For grant financing and loans with high levels of concessionality, distribution and allocation of funds among countries should be considered.** There may be a risk that using grant resources for mitigation activities in countries with high financial capacity will divert financial resources from low income countries. The global allocation of funds among and across countries, especially given limited grant resources, should be considered.

6 **Loans will not be appropriate in certain countries.** If the recipient country has high levels of debt and weak institutions, and the REDD+ investment is to be made through the government, in such circumstances it is generally not advisable to offer loans[5]. This may apply to a number of the rainforest countries currently prominent in the REDD+ debate.

7 **The use of concessional loans can catalyse further lending and can help to mitigate investment risk.** If a concessional loan is provided, it offers a 'stamp of approval' to other investors. Financial participation of a donor can make other investors more confident about the overall level of risk of a project. However, the decision whether to provide a loan or not will still be based on financial criteria of the initiative itself (e.g. enough revenue to cover the debt service). If the financial criteria are not met, external investors will not support the project even in the context of donor funding.

8 **Forests are often not acceptable collateral for loans.** The administrative costs for small vs. large loans tend to be similar; this tends to discourage lending to small enterprises[6].

Key publications on this issue

Baudienville, Brown, Clay, te Velde (2009) 'Assessing the Comparative Suitability of Loans and Grants for Climate Finance in Developing Countries' Report for the DFID and DECC, prepared by the Overseas Development Institute.

Cohen, D., P. Jacquet and H. Reisen (2007) 'Loans or Grants?' Discussion Paper 2007/06. Helsinki: WIDER.

FAO (2008) 'Financing Sustainable Forest Management', FAO Forest Policy Brief. FAO: Rome.

Forum for the Future (2009) 'Forest Investment Review'. Forum for the Future: London.

Odedokun, M. (2004) 'Multilateral and Bilateral Loans versus Grants: Issues and Evidence'. The World Economy 27(2): 239-263.

Radelet, S. (2005) 'Grants for the World's Poorest: How the World Bank Should Distribute Its Funds'. Notes (June). Washington, DC: CGD.

Rajan, R. and A. Subramanian (2005) 'Aid and Growth: What Does the Evidence Really Show?' Working Paper 05/127. Washington, DC: IMF.

Reinhart, C. and K. Rogoff (2003) 'Serial Default and the "Paradox" of Rich to Poor Capital Flow'. American Economic Review 94(2): 52-58.

1 We use the standard OECD definitions for loans and grants. Broadly speaking, official development assistance includes grants (including for technical co-operation) or loans undertaken by the official sector which promote economic development and welfare at concessional financial terms (a loan, having a grant element of at least 25 per cent).

2 Note that, while both macro-level and project-level variables need to be considered when making an investment to a government recipient, the macro-level variables should be considered first. For example, if an investment is being made to a government that has weak capacity and high levels of debt but the project is likely to generate a return on investment, a grant would still be recommended.

3 This is a general guidance taken from Baudienville et al 2009. For more details, see full report

4 Definition taken from Johns et al (2009), 'An Overview of Readiness for REDD'

5 Baudienville et al., 2009

6 FAO, 2008