Overseas Development Institute

ODI Submission to the European Commission Consultation on the Proposed EU Platform for External Cooperation and Development

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* Disclaimer: The views presented in this paper are those of the authors

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ODI has contributed to the debate on the establishment of the EU Platform for External Cooperation and Development through its study on 'EU Blending Facilities: Implications for Future Governance Options'.[1] Beyond the EU structures, ODI has also conducted studies on the trade distortion implications of the use of loans and grants[2], and the use of subsidies by Development Finance Institutions (DFIs).[3] These studies were submitted to the OECD/WTO as a case story on 'Aid for Trade and Blended Finance'. The studies revealed the following:

- Grants and loans do not differ significantly in their trade distortionary effects, though both affect bilateral trade. If anything, grants are more trade distorting than loans;
- Aid grants are likely to leverage in substantial amounts of other finance (official loans as well as private finance) including for regional infrastructure;
- DFI subsidies (ODA grants) can help to mobilise additional capital, including private investment in infrastructure.

A fourth study on the macroeconomic impact of DFIs[4] suggests that investment by multilateral DFIs plays a positive and significant role in fostering economic growth in recipient countries, and that their impact is stronger in lower-income countries than in higher-income countries.

A fifth study on the role of private sector DFIs in tackling global challenges[5] examines the impact of DFIs by estimating their aggregate impact in terms of promoting investment (especially during financial crises, but also post-conflict) and their ability to improve energy efficiency. Regression analysis, based on data from EIB, EBRD, IFC and CDC, shows that DFIs increased total investment and improved energy efficiency in recipient countries compared with the model-based counterfactual. A one percentage point increase in DFI investment as a percentage of GDP would lead to a 0.8 percentage point change in the investment to GDP ratio. Hence, for 26 countries, DFIs have kept investment to GDP ratios more than 1.5 percentage points higher than would otherwise have been the case.

It should be noted that DFIs such as IFC, CDC and EBRD are mostly (or wholly) aiming to leverage in private sector investment. This is in contrast to the EU blending facilities. The European Think Tanks Group study on EU blending facilities, for example, found that none of the beneficiaries of grants for 33 EU-Africa Infrastructure Trust Fund (ITF) projects and only 3 out of 38 Neighbourhood Investment Facility (NIF) projects hitherto were classified as "private". This suggests that the blending facilities are not yet seen as an interface between the Commission and the private sector – for this, further involvement of the EDFIs, the association of European Development Finance Institutions, which aim to support private sector development, seems required.

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[1] European Think Tanks Group (2011), 'EU Blending Facilities: Implications for Future Governance Options', report for UK DFID, led by Mikaela Gavas, Matthew Geddes, Isabella Massa and Dirk Willem te Velde from ODI with inputs from researchers at ECDPM, FRIDE and DIE.

[2] Massa, I. and Te Velde, D. W. (2009) 'The trade distortion implications of loans and grants: an econometric examination.' Report to KfW Entwicklungsbank. Overseas Development Institute, London, Revised draft, July 2009

[3] Te Velde, D.W and Warner, M. (2007) 'The Use of Subsidies by Development Finance Institutions in the Infrastructure Sector.' Working Paper 283, Overseas Development Institute, London.

[4] Massa, I. (2011) 'Impact of Multilateral Development Finance Institutions on Economic Growth.' Overseas Development Institute, London, August 2011

[5] Te Velde, D.W. (2011) 'The role of development finance institutions in tackling global challenges', Overseas Development Institute, London, August 2011

Among other things, the ODI studies analyse the following:

1. What are the benefits of blending;
2. Do loans and grants have differential trade distortionary effects;
3. What are the optimal governance arrangements for the EU blending facilities;

Benefits of blended finance

Compared to pure loans, blending mechanisms allow for:

- Making transfers to heavily indebted countries without exacerbating debt overhang problems;
- Addressing positive externalities to bring the financial rate of return closer to the economic rate of return for projects with a high socio-economic and/or positive environmental impact;
- Improving the quality of funded projects (in practice the grant component also allows projects to be funded which otherwise recipients are unable to finance, in addition to improving the quality of projects compared to a no grant situation);
- Strengthening ownership by funding measures which build on recipient countries' policies; and to which the partner provides their own resources;
- Enhancing EU visibility, and supporting the division of labour by strengthening coordination between EU donors and lenders.

In terms of financial additionality, for the EU blending facilities, ODI estimates that 1 unit of grants leverages in between 5-6 units of loans and another 15 units of other finance. Thus aid grants are likely to leverage in substantial amounts of other finance including for regional infrastructure.

However, it is not straightforward to evaluate the effects of blended projects (compared to loan or grant finance only). This is because of methodological reasons (lack of counterfactual) and lack of specific data on the economic and social effects of the blended project, and the exact contribution of the grant component. Whilst a sizeable literature exists about the theoretical use of loans and grants, there is little on how it works in practice, which methodology or procedure works best and whether a certain governance model is more effective in reaching its objectives. There are, however, a large number of project descriptions of grant components of blending mechanisms suggesting they are used to finance essential studies, improve the quality of the project and achieve the required level of concessionality, providing evidence for the importance of blending. There is, however, little quantitative evidence to back this up.

Trade distortionary effects of blended finance

One concern with blending loans and grants has been that ODA loans are more trade distortionary than ODA grants, e.g. when a loan from a country to a recipient leads the recipient to switch imports to the importing country. However, in actual fact, grants and loans do not differ significantly in their trade distortionary effects, though both affect bilateral trade. Surprisingly, if anything, grants are more trade distorting than loans.

Governance arrangements of the EU blending facilities

There are few differences in operational outcomes with the EU blending facilities as a result of a different internal governance arrangement (e.g. ITF vs. NIF). There is, however, a discussion possible on the principles that may help to inform the best possible governance option for EU blending mechanisms, for example:

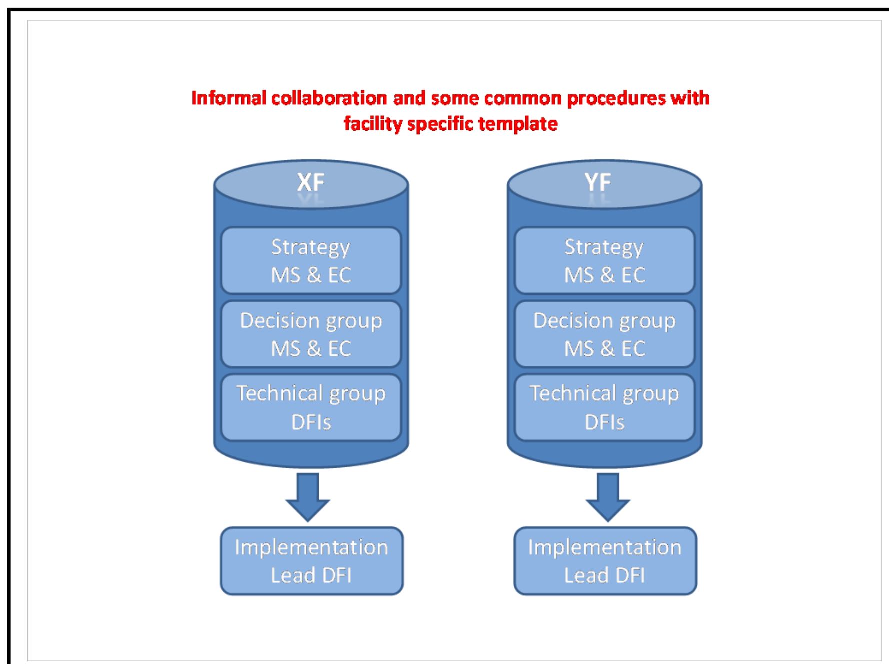
- The need for a fair arbiter in order to avoid potential conflicts of interest between eligible finance Institutions;

- The need to ensure a "policy driven" screening of grant requests based on EU regional policies and strategies and overarching EU development policy as enshrined in the European Consensus on Development;
- The need to keep a separation between the policy and technical aspects of the grant award process (donors vs. DFIs);
- The need for transparent and formal checks and balances on the proposals of project financiers at early stages beyond the checkboxes in the templates;
- The European Commission needs to be ultimately responsible for spending of all EC aid (for auditing purposes).

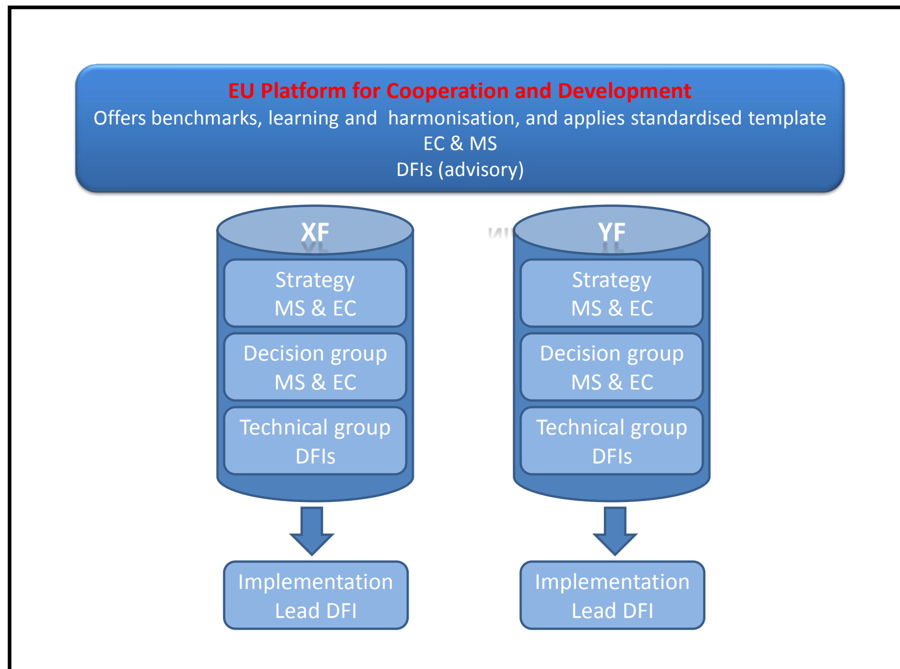
On the one hand, the principles or the evidence do not favour one approach over another (e.g. should DG DEVCO in the European Commission or the EIB chair the project financiers group). On the other hand, there is a clear perception that the chair of the group matters for which projects were being considered for blending. There are two ways to resolve this. Either the chair uses a transparent and objectively measured way to decide which projects will be considered for blending (e.g. the minutes of the meeting could be made public), or a third party would be brought in to chair the project financiers group. A third party might be DG ECFIN which has oversight of the EIB in general.

Five possible governance options of a future platform might include:

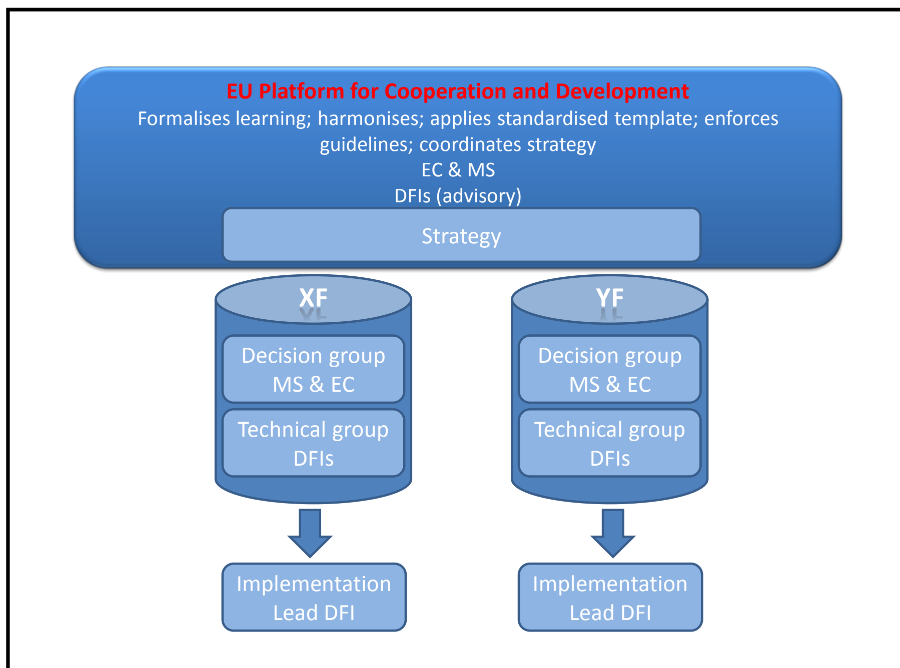
1. Option 1 – 'business as usual' – the current situation where there is some informal collaboration and common procedures. Project applications currently use facility specific templates, but they do not determine the grant share of blending.



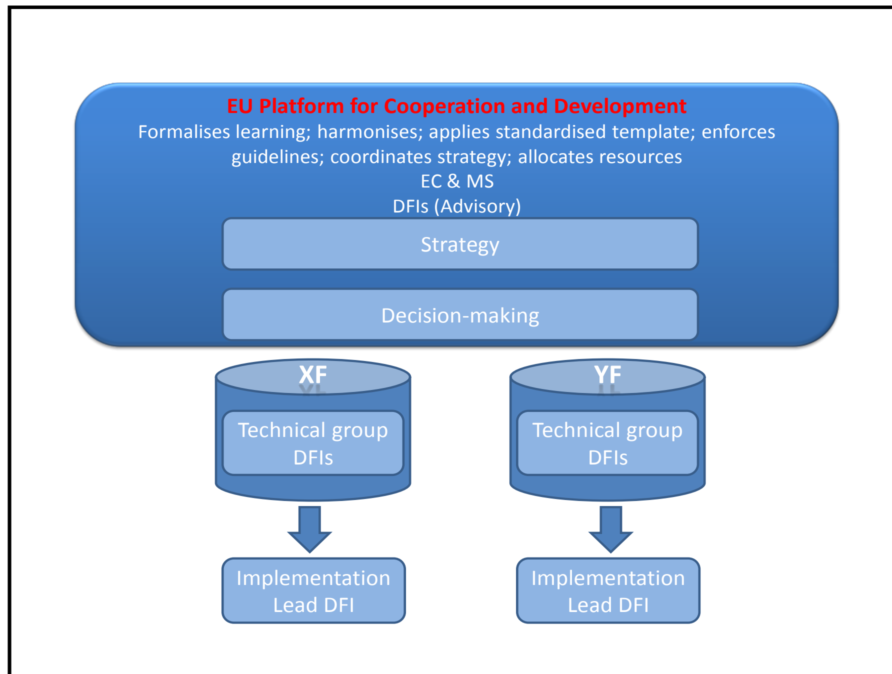
2. Option 2 – 'governance light' – where the platform applies a standardised template for grant applications; offers benchmarks for assessing and comparing grant values across facilities and brings out differences in blending according to these criteria; offers learning possibilities; and promotes harmonisation more systematically than is currently the case (e.g. in environmental projects).



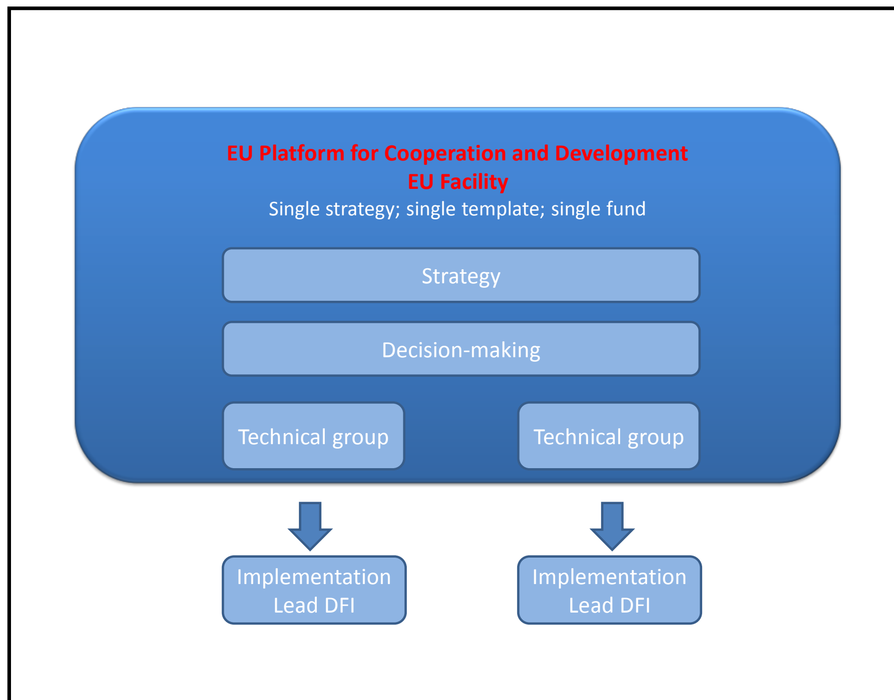
3. Option 3 – 'governance medium' – where learning and harmonisation is formalised, and a standardised template is applied for grant applications according to which grants are assessed. It provides a globally coordinated strategy, taking over this role from the individual facilities, and enforces guidelines on the facilities which determine project areas eligible for grant funding.



4. Option 4 – 'governance heavy' – where decision-making on individual projects moves into the platform. This allows the platform to have an overview of all projects submitted across the facilities and to assess their comparative strengths and weaknesses. The platform can be responsible for allocating resources to specific projects on the basis of project, region and theme-specific yardsticks.



5. Option 5 – 'governance super heavy' – where all the facilities have been amalgamated together into a single facility under the platform, covering all themes and regions. This single entity comprises a single strategy, a single grant application template and a single fund.



These options are examined on the basis of the following criteria:

- **Flexibility**: can the level and nature of blending be discussed on a case-by-case basis (high) or are the same guidelines applied to each project and enforced (low)?
- **Eligibility**: does clarity exist on the nature of projects eligible for blending?
- **Sustainability**: is the project likely to be financially viable (high) or is it likely to be

unsustainable and hence market distorting (low)?

- **Transparency**: is the project assessed according to a set of fixed criteria?
- **Harmonisation**: do the blending facilities operate independently (by regional area and by theme) with different criteria (low) or do they operate as one with common criteria?
- **Visibility**: is a bundled approach more visible than a fragmented approach leading to greater policy influence?
- **Donor policy influence in areas beyond loans**: to what extent does the allocation of grants reflect donor and recipient priorities? Projects presented by the Finance Institutions ("demand driven", i.e. identified and negotiated with the beneficiary country) shall not be contradictory to or inconsistent with the EU country strategy or regional strategy (e.g. EU Delegations are systematically consulted in the decision-making process). However, they can complement the EU country strategy by supporting investments not specifically covered by this strategy.

The results are as follows:

	Business as usual	Governance light	Governance medium	Governance heavy	Governance super heavy
Flexibility	High	High	Medium	Low	Low
Eligibility	Low	Low	High	High	Low
Sustainability	High	High	Medium	Low	Low
Transparency	Low	Medium	Medium	High	Low
Harmonisation	Medium	Medium	High	High	High
Visibility	Medium	Medium	High	High	High
Donor policy influence	Low	Low	Medium	High	High

'Governance medium' and 'governance heavy' come out the best, if all principles are treated equally.

Given the lack of transparency about blending decisions and the importance of strengthening transparency (e.g. to clear up misgivings on the importance of the chair of the groups), the 'governance heavy' option is the most preferred option. This option might help to promote more upstream discussions between the project financiers and the grant providers. In all cases however, transparency could be improved by publishing the interaction between the DFIs and the platform.

Along with transparency, harmonisation of practices and visibility are principles that have few negative effects. The 'medium' and 'heavy' governance models are suggested as being the most likely to optimise both harmonisation and visibility potential.

The remaining concepts are highly intertwined and maximising one generally involves trading off the potential to maximise another. Flexibility for DFIs and the sustainability of projects are thought to go hand-in-hand. Donor policy influence and clear (strict) eligibility criteria also were viewed as moving together. Together these two pairs of principles frame the debate on the potential and pitfalls of grants leading loans.