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What practical approaches/frameworks are there for effectively delivering subsidy to private sector entities for development purposes?

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Abbreviations

AfDB	African Development Bank
AMC	Advance Market Commitment
BDS	Business Development Services
CDC	Commonwealth Development Corporation
DEG	*Deutsche Investitions und Entwicklungsgesellschaft* (German Investment and Development Corporation)
EIB	European Investment Bank
DFI	Development Finance Institution
GDP	Gross Domestic Product
IFC	International Finance Corporation
SME	Small or Medium sized Enterprise
TA	Technical Assistance

1 Introduction

The use of subsidies by development finance institutions (DFIs) can often be controversial because of their ability to distort markets. It is vital to ensure that the subsidy is used efficiently, the level of subsidy is appropriate (provides value for money) and market distortion is minimised. It is instructive therefore to examine the practical approaches/frameworks that there are for effectively delivering subsidy to private sector entities for development purposes. The aim of this paper is to contribute to a practical guidance document for DFID on how to effectively deliver subsidies for development purposes.

This short paper will briefly outline the case for donor support for the private sector, with a description of the areas at which interventions can be made and a summary of the major market failures that donors seek to address in delivering such subsidies. It will then identify a typology of approaches to delivering subsidies and finally describe a framework for identifying the appropriate instrument and format of subsidy.

2 Donor support to the private sector

Over the past two decades, a general trend in international development has been away from direct provision by donors and government towards enabling the private sector to deliver the goods and services that can reduce poverty and drive economic growth. For example, putting wealth creation at the heart of development is central to DFID's private sector development strategy[1]. Donors are now looking ahead to an eventual graduation out of aid-dependency and the need for the private sector to create wealth by itself; in supporting the private sectors of developing countries, donors are both sowing the seeds for their own withdrawal and building more able and attractive long term trading partners[2].

DFID is a firm proponent of the idea that supporting enterprises is good for growth[3] – it can foster innovation and deliver the Schumpeterian creative destruction that pushes an economy forward and adds value. It also creates jobs (particularly pertinent with the changing demographics of most poor countries). Size of the SME sector (in terms of contribution to GDP and employment) is positively correlated with a country's wealth (as measured by GDP per capita)[4]. The best support is catalytic – it speeds up the development of the private sector without the need for long term replenishment

Arguments against donor subsidy to private sector entities in a development context tend to focus on two points. Firstly, by making investments on a non-commercial basis, backed by large donor resources and plenty of liquidity, donors may be crowding out private lenders and suppressing the development of a more sustainable commercial lending industry. Secondly, subsidies can create moral hazard. Institutions tend to make different decisions when spending their own money compared to somebody else's. Sometimes this increased risk taking is desirable, but in other cases it can cause harmful market distortion.

[1] DFID, *Private Sector Development Strategy. Prosperity for all: making markets work,* 2008
[2] DFID, *The engine of development: The private sector and prosperity for poor people,* May 2011
[3] ibid
[4] Ayyagari, M., Beck, T. and Demirguc-Kunt, A.; *Small and Medium Enterprises across the Globe* World Bank 2005

3 Market failures

Donors tend to justify subsidies to the private sector by invoking the classical market failure argument – that the free market is failing to allocate goods and services at a level that would be socially optimal[5]. In the context of international development, there are a number of market failures that exist and these must be properly identified before subsidy instruments can be considered. These market failures are well known to any economist and while not dwelling on the specific forms, it is useful to have a refresher on the different justifications for public intervention in private markets.

3.1 Externalities

In the case of externalities, the private sector player is not fully covering the cost of the overall social cost or benefit of their activity. In the context of donor subsidy to the private sector, the externalities are likely to be positive, whereby businesses have a greater impact on society than they are able to realise privately.

3.2 Public goods

Public goods are available to the public on a non-excludable and non-rivalrous basis. Due to the universality of their benefits, they are often (though not always) provided by governments (sometimes with a contribution from donors in developing countries). The private sector might be engaged to provide a public good where the market failure might be address more efficiently by a private operator.

3.3 Asymmetric information

Information asymmetry refers to a scenario in which once party in a transaction has more information than the other, leading to an outcome which is sub-optimal. Identifying the source of the information asymmetry is key to diagnosing the correct donor response. For example, central credit bureaus can support greater outreach of the financial sector by increasing the available information on a client.

3.4 Availability of support services

Market failures are not limited to the specific markets that are being targeted – often they exist in markets for support services such as the provision of financial services or BDS. In extreme cases, the market for support services might be missing entirely.

[5] For examples see Wiggins, S. and Brooks, J, *The Use of Input Subsidies in Developing Countries*, OECD 2010 and van der Meer, K. and Noordam, M., *The Use of Grants to Address Market Failures: A review of World Bank Rural Development Projects World Bank Agriculture and Rural Development Discussion Paper 27,* 2004

4 Instruments

Based on the above, there exists a rationale for government to assist in the provision of public goods and to address market failures by using rules, information, and finance (tax/subsidy). In developing countries, donors may support governments in their efforts to tackle market failures, with financial assistance and subsidies being important tools. The range of instruments available to donors for delivery of subsidies to the private sector is broad. The major categories of assistance are outlined here.

4.1 Targeted (matching) grants

Matching grants (grants that are made on the proviso that the recipient also invests some of their own resources) are perhaps the simplest approach that a donor could use to deliver subsidy to a private sector entity. They were originally used by donors to boost the supply of public goods, however they have increasingly been used to support investment and innovation where there are significant barriers to entry/growth (such as limited access to finance) or where there are demonstrable associated positive externalities.

It is particularly important to understand the context and the specific market failure that is to be addressed due to the potential distortive effects of a grant. Inasmuch as it is altering a company's behaviour and risk appetite, a matching grant can lead to moral hazard and so the risk profile of the recipient of a grant must be aligned with the wishes of the donor. Matching grants can also promote non-viable or non-sustainable entities or activities (why is the grant needed? If funding cannot be found on a commercial basis, what makes it worthy of subsidy?). In addition, matching grants can crowd out financial institutions or private investment.

The efficiency of grant schemes can be improved by ensuring that payments are tranched (so that cash paid upfront is minimised) and performance-linked (so that poor performance can be penalised)[6].

4.2 Subsidised technical assistance and BDS

Subsidised technical assistance may be to the public or private sector. TA may be used to support government develop a more appropriate business environment or regulatory regime – this could be a correcting of government failure or simply the formation of a more effective response to a market failure. Donors may also provide subsidy to the private sector in the form of BDS. BDS and training, which can be delivered in a variety of ways, helps to develop expertise and skills, the idea being that a one off investment can build capacity within a business or business organisation for the longer term.

4.3 Challenge funds (competitive matching grants)

The major difference between challenge funds and more traditional matching grants schemes (and the source of their appeal for donors) is that they place a greater burden of evidence and innovation on the side of the private sector. Rather than fund enterprises to develop good ideas, they are run as competitions and therefore reward innovation and good ideas. They are used to fund projects and investments that have a demonstrable social gain but would not otherwise take place without the donor support.

[6] For more on matching grants, see International Fund for Agricultural Development (IFAD), *Matching Grants Technical Note* 2012

Examples of challenge funds aimed at supporting the private sector include the Financial Deepening Challenge Fund (FDCF)[7] and the Africa Enterprise Challenge Fund (AECF).

4.4 Partial credit risk guarantees

Donors can use partial credit guarantee schemes to insure the lending of commercial banks and other financial institutions to the private sector. A credit guarantee scheme lowers the risk to the lender by substituting part of the counterparty risk with that of the donor, which guarantees repayment of part of the loan in the event of a default.

They are generally introduced for one of three reasons[8]: i) To correct information asymmetry if the donor has informational advantages over the lender; ii) To direct lending towards a particular sector (such as agriculture, women or SMEs) or to diversify risk across sectoral or geographical specialisations; or iii) To exploit regulatory arbitrage, when the guarantor is subject to different regulations than the lender.

Credit guarantees are widely used by governments to subsidise lending to the private sector. In 2003, it was estimated that well over half of all countries were using some form of guarantee scheme, usually targeted at a specific sector of the economy[9].

4.5 Concessional loans

Though mostly used for public sector institutions, offering loans on a sub-commercial basis can also allow donors to support investment by private sector institutions that would struggle to service debt on commercial terms. The EIB is an example of an institution that uses concessional instruments to boost supply of (global and regional) public goods[10].

The actual form of the subsidy may vary – for example if there is a lag time between an investment being made and its results being realised then a concessional loan can offer a long grace period. An alternative approach is to subsidise the interest rate, which means that the cost of servicing the debt for the company is lower than it would be under strictly commercial terms.

4.6 Quasi-equity investments and subordinated debt

Quasi equity investments are an emerging assets class that allow DFIs or other investors to take a stake in a private sector entity that confers some of the benefits of equity without an actual ownership stake. Quasi equity products are increasingly used by DFIs such as IFC, Norfund and EIB[11]. While there is broad range of instruments that could be defined as quasi-equity, a typical investment might be a loan that includes a profit-sharing or revenue-sharing agreement.

For the investor, the major advantage of such an instrument over a more conventional equity stake is that it offers a steady stream of income as opposed to the more lumpy payment schedule associated with dividends and liquidity events. For businesses, which are often unwilling to give up equity, quasi-equity instruments allow most of the benefits of a loan but with a more flexible repayment schedule.

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[7] Arora, S., *Financial Deepening Challenge Fund 2008-08 Project Completion Review* Oxford Policy Management October 2008

[8] Honohan, P., Partial Credit Guarantees: Principles and Practice World Bank 2008

[9] Green, A., *Credit Guarantee Schemes for Small Enterprises: An Effective Instrument to Promote Private Sector-Led Growth?* UNIDO SME Technical Working Paper No. 10. 2003. For more on Partial Credit Guarantees see Honohan, P., *Partial Credit Guarantees: Principles and Practice* World Bank 2008

[10] European Investment Bank *External Mandate 2007-13 Mid-Term Review* February 2010

[11] Practical advice on structuring equity and quasi equity can be found here http://rru.worldbank.org/documents/toolkits/highways/pdf/extract/E14.pdf

4.7 Equity and private equity

Direct equity investments are mostly provided by private sector DFIs and usually take the form of ordinary shares or preference shares. In effect, the shareholders of the DFI guarantee the equity portfolio.

Private equity in frontier markets is a fledgling industry and lack of commercial opportunities means that capital from DFIs is often required to support funds (leading to some concerns about the long term viability of such investments[12]). Donor subsidies into equity stakes can be used to leverage private sector investment, meaning that large amounts of total investment can be realised from a relatively small donor take.

The major appeal of equity stakes for donors is the potential to fund transformative projects in developing countries. It is a higher risk, higher reward proposition than debt.

4.8 Impact investments

Impact investments involve the provision of finance, usually on a commercial or near-commercial basis to businesses that have a demonstrable positive impact on the poor – effectively subsidising a positive externality. Investments can take the form of debt, equity, private equity or venture capital but should be focussed on having some form of positive social impact as well as a commercial return. Impact investments tend to be made by DFIs, such as CDC and Norfund.

4.9 Pull mechanisms

Pull mechanisms provide financial rewards against specific results achieved by innovators. They can be used to correct an information asymmetry or to incentivise innovation where positive externalities are not being fully captured. The World Bank's AgResults is a high profile example of the use of a pull mechanism[13]. Advance market commitments (AMCs) have been widely used in medicine to develop vaccinations and provide a guarantee of a market in which to sell a product or service if it is successfully developed.

[12] African Development Bank (AfDB), *Private Equity Investment in Africa in Support of Inclusive and Green Growth* 2012

[13] For more information on when to use pull mechanisms see http://siteresources.worldbank.org/CFPEXT/Resources/WEB_AGPM_When__to_use.doc.pdf

5 Identifying the appropriate instrument

In assessing the effectiveness and the efficiency of donor subsidy to the private sector, there are a number of factors that must be taken into consideration. These include:

- Value for money – is the level of subsidy appropriate and proportionate to the anticipated impact?
- Targeting – is the subsidy focussed on addressing a specific failure of the market?
- Spillovers – the subsidy should aim to maximise its impact on its desired target while minimising market distortion elsewhere

There is certainly no 'best way' to channel public funds into the private sector and it is vital that thorough contextual analysis leads to appropriate diagnosis and then response. In evaluating the appropriateness of a response, we suggest it is important that impact is assessed against a number of criteria including the following

5.1 Commercial basis

The first assessment that a donor must make in assessing approaches to deliver subsidy to the private sector is the commercial basis of the subsidy – that is, will the subsidy be written off or will there be repayment, and if there is to be repayment what will be the terms?

The least commercial subsidy that a donor can provide is a pure grant, that will require no repayment. Such grants are often made for investments, such as research or BDS, with no direct cash flow returns. Obviously, such subsidies have significant implications for accountability and moral hazard and so matching grants, in which the recipient is required to make some parallel investment in order to align incentives, are more attractive to donors where possible. Competitive matching grants, such as those disbursed by challenge funds, are usually required to prove some commercial viability for the project before award.

Donors can adjust the conditionality of loans that they provide in order to increase or decrease the commercial basis on which they are made. Non-recourse loans and concessional loans, with subsidised interest rates or long grace periods, essentially offer some protection for borrowers from full commercial forces.

More commercial is the debt or quasi equity finance provided by institutions such as IFC, EIB and DEG, which is generally invested in projects with demonstrable commercial returns against which repayments can be made. The investment may be made on purely commercial terms but the subsidy (whether it be direct, like a concessional loan, or indirect, like a guarantee by shareholders) may be in the form of funding for a project with development gains greater than the private cost (because of positive externalities).

Moving away from debt into equity investments and even private equity means that the donor shares in some of the risk of a development venture (though it can also potentially share in the gains) and such investments consequently are the most commercial that donors could make.

5.2 Scope of support

This refers to the support of an individual business versus the support for services that are available for use for all businesses in a market (for example by subsidising the provision of public goods (such as infrastructure) or support services (such as financial services)). Support may be provided by subsidising inputs (such as interest rate

subsidies) or rewarding outputs (output based aid[14]); the former is usually easier to administer and popular with beneficiaries, but is also more likely to lead to negative market distortions.

The most direct form of support in this sense would be to provide funding directly to a business. Direct funding to an enterprise can range from a pure grant to an equity stake, therefore this axis runs entirely perpendicular to the commercial axis. Supporting a firm directly carries a higher risk of market distortion as the subsidy creates a significant imbalance from the market equilibrium.

Rather than support a business, the subsidy can instead go to a business organisation, association or cooperative. Particularly in industries characterised by a large number of small players, businesses often group together and economies of scale can be achieved by, for example, subsidising supply side BDS for all members of an business membership organisation. This is likely to have less of a skewing effect on the market as more players are receiving the subsidy.

More general support for businesses can be provided by offering support to or through support services, such as finance or business development. Taking the example of financial services, a donor might use an innovation challenge fund to stimulate the development of new lending products, or it could offer credit guarantees to a certain sector by insuring some of the bank's loan portfolio, or it could provide technical assistance to the bank to allow it to better understand small business lending; the ultimate beneficiary of each of these subsidies would be the SMEs that receive credit that they would not receive in its absence.

Finally, the form, of subsidy that is most likely to benefit the entire market is support for a public good. By definition, public goods are non-excludable and so useable by all; pure public goods, such as clean air, development of standards, and publicly available research are examples of support that will benefit the entire market.

5.3 Market or government failure?

Interventions to support the private sector are not necessarily caused by failures in private markets. Donors may subsidise the private sector because of failures in government systems.

The notion of government failure goes back to Coase and his work on the impact of regulation on the private sector. It refers to a state of affairs where government action leads to a less efficient allocation of resources than the market would determine.

Subsidised BDS is often used to support businesses where there is a lack of basic training and skills, which stems from a government failure (weakness in education) even if this failure is compounded by under investment from the private sector.

Matching grants and challenge funds can also be used to overcome failures that originate in government rather than the markets. The idea behind challenge funds is that innovation is currently undersupplied by the market but this can be a failure of innovation systems which is a matter for government.

It is likely that most issues that donors seek to tackle involve some combination of government and market failures. In many cases, addressing government failures will have a wider impact as the business environment sets the rules of the game for all businesses operating in a market.

[14] Much more on output based aid to found at www.gpoba.org

5.4 Sustainability of investment and sustainability of outcomes

A fourth issue to consider when subsidising the private sector is the sustainability of the investment. Some investments will have a long lag time between investment and impact, and therefore the investment might need to be supported for a longer period of time.

The shortest repayment time for donor subsidies is likely to come from private equity investments as these involve direct involvement with the private sector and are generally used to turnaround a project or company before withdrawal. Though grants are not expected to be repaid, they can also be used to have a quick and decisive development impact.

Other instruments however can have far longer lag times. Concessional loans for infrastructure development, for example, will require significant up front subsidies for very long term public and private gain. Investments in research and development will also be characterised by a long lag between investment and impact.

6 Frameworks for delivering subsidies to the private sector

Having developed a typology of approaches to identifying market failures and selecting the appropriate intervention instrument, it is important for practical purposes to build these into a framework for intervention. Because a subsidy is designed to address a market distortion, and therefore by definition will alter market incentives, it is vital that the subsidy is properly designed – a bad subsidy can have significant negative social implications (an example of government failure).

The design of a subsidy and selection of the appropriate instrument should be a three stage process: define the purpose, isolate the market failures, and identify the appropriate instruments[15]. In order to ensure value for money, a thorough analysis taking into account the full discounted value of all projected costs and benefits should be utilised.

What is the donor trying to do, and what is the ultimate goal of the intervention? This might be to support a particular sector (such as agriculture) or group (such as women).

What is causing the inefficiencies in these industries and sectors? Where are the rigidities? What is the economic theory behind it and where is action needed?

For each of the market failures, how can the private sector be supported (if at all)? How can we maximise positive externalities but minimise negative ones?

The example below provides shows how the framework can be used to determine appropriate subsidies.

Purpose	Market or Government Failures	Instruments
To support the SME sector to drive growth, boosting output and increasing employment	1.Weakly developed rules and regulations environment	Direct TA to support policy making Grants to civil society organisation to lobby
	2. Missing middle in financial sector lending	Competitive matching grants to support new financial products Partial credit guarantees to support riskier borrowers
	3. Undersupply of BDS	Supply side BDS and embedded services

[15] This approach is similar to that developed for the IFC in the following paper: Boorstin, L. C., *Delivering Social Value via the Private Sector: A Framework for Market-Based Interventions* prepared for Workshop on Private Investment for Social Goals IFC September 2004

7 Conclusion

There exists a strong and well-established case for donors to intervene in private markets to deliver subsidies for development purposes. Though the theoretical reasons for intervention are well established by the economics literature, the practical approaches and frameworks for delivering subsidies to private sector entities are more complex and less understood.

The approaches that do exist vary widely and not just in one dimension. We have identified some key criteria that can be used to evaluate different approaches and instruments and, where possible, given examples of their usage by different donor institutions. In practical terms, thoroughly-researched cost benefit analyses should be used to assess project impact and it is vital that donors recognise that by actively distorting a market outcome, there may be significant consequences that must be fully understood and analysed.

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