ADDITIONALITY OF GRANTS IN THE FRAMEWORK OF BLENDING MECHANISMS

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Shaping sustainable futures

MAIN OBJECTIVES OF BLENDING

The EU pursues the main following objectives through blending grants and loans:

- Achieve EU policy goals more effectively, i.e. by increasing “aid effectiveness” and "aid coherence";
- Optimize financing packages for beneficiaries by promoting a flexible and efficient allocation of resources and therefore enhancing credibility and leveraging resources;
- Encourage donors to justify the use of budgetary funds and strengthen the supervision on project impacts;
- Promote donors cooperation in particular between European aid actors;
- Enhance the visibility of European aid, vis-à-vis recipients as well as other donors/DFIs

KEY PARAMETERS FOR THE USE OF BLENDING

- **Macroeconomic and sector policy parameters:** loan grant blending mechanism may be required when constraints exist on the financial and budgetary situation of the country, in particular when IMF rules are applicable.

- **Project related (microeconomic) parameters:** the objective is to demonstrate and (whenever possible) to quantify the additionality of the grant element as compared to a situation without grants. Additionality is the development impact deferential between the situation with and without the grant element. Comparison between this deferential and the amount of the grant permits value-for-money measurement from a European taxpayer standpoint.

- **Externalities*:*** Projects may generate positive externalities. Loan grant blending, if designed properly, may help optimizing these externalities in particular in the social sector or the environment and climate change area.

DIFFERENT FORMS OF BLENDING

- **Direct investment grants:** This instrument provides direct finance for specific components of a project. They are the straightforward approach for assistance targeted at meeting redistributive objectives (pro-poor pro-growth development) or in cases where a significant cross-border externality of the investment under consideration justifies grant coverage of part of the costs.

- **Conditionality / performance based grants** (such as Output Based Aid – OBA) are grants whose disbursement is linked to compliance with ex-ante defined conditions or service level performance targets.

- **Interest rate subsidies:** The donor support serves to cover part of the interest payments. The partner country or project promoter thus receives a subsidised loan at below market interest rates rather than a separate loan and grant. Interest rate subsidies – like investment grants - are used to enhance the concessionality of a financing package, e.g. to comply with debt sustainability requirements.

- **Other forms**: some more complex grant instruments could be considered in the method at this stage (risk capital, structured first-loss piece, loan guarantee) for the sake of simplification; they should be taken into account on a later stage once the first steps have proved practical.

POTENTIAL WEAKNESSES OF BLENDING

- **Crowding out other possible financing sources:** Loan grant blending mechanisms improve the terms of the financial package for the beneficiary and should therefore be avoided in case sufficient funds from other sources would be available.

- **Market distortion:** Loan grant blending may give the beneficiary an unfair advantage that prejudices its local and international competitors. Donors must demand adequate documentation to be assured that there is no risk of market distortion.

- **Loss of control or visibility for individual donors**: Depending on the form and setup of loan grant blending, single donors may feel to loose control over the use of funds as they may disagree with certain (aspects of) projects for political and/or economic reasons. In particular in the context of joint financing, the visibility of the donors may be reduced compared with a direct project contribution which may represent a deterring element.

MAIN STRENGTHS OF BLENDING

- **Financial leverage**: Blending loans and grants allow making available more financial resources to support investments that are deemed to be of priority European interest or to have desirable impacts (e.g. environmental, social, or development objectives) and that, without them, would not happen or happen more slowly or at a prohibitive cost to the partner country.

- **Flexibility*:*** The amount of the donor support can be tailored to fit the precise needs of each project on a case by case basis.

- **Project acceleration**: Blending loans and grants may help to get a project off the ground, quicker than would otherwise be the case. LGB allows the necessary loan funding volumes to be provided together with an adequate level of subsidies commensurate to the financial strength of the project.

- **Supply of public goods:** The project may have positive externalities (such as social or environmental). The grant can be designed to “buy” the public goods that are “produced” by the project, and compensate for the additional cost they involve.

MAIN STRENGTHS OF BLENDING

- **Policy leverage**: Blending loans and grants can provide "policy leverage" on the definition of sector policies and projects. It allows focusing the use of resources on the sectors or projects the EU find most important or most in need and which are not fundable on market conditions, thus allowing for higher overall development impact. Via its influence through blending (and an ensuing higher leverage on policy dialogue and accompanying measures), donors may enhance the recipient's policy in priority areas such as protection of the environment or governance.

- **EU Visibility:** Loan grant blending can facilitate joint interventions by the various grant donors and finance institutions within the EU and thereby represents a powerful means to structure and co-ordinate European development assistance.

- **Risk mitigation and borrowing costs**: Blending can help (if designed accordingly) to mitigate risks associated with a country, sector or specific project for the lender which will hence be able to achieve a broader country and project coverage.

- **Donor coordination**: In line with the Paris Declaration on Aid Effectiveness (2005), coordination among (European) bilateral donors and finance institutions avoids duplication of efforts and has the potential to increase efficiency

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