

WHEN MARKETS DO NOT WORK, SHOULD GRANTS BE USED?

BY: GRAEME DONOVAN

In rural development today, there is much more reliance on the market than in past decades. In many countries, governments have new roles, and no longer sell outputs and inputs, or deliver credit. Instead, they are supposed to help the private sector develop.

There are still frequent complaints that markets are not developing, or that they are not delivering enough volume or value of goods and services. Questions of what to do to reduce poverty, increase employment and widen consumer choice are still to be answered. To deal with problems of inadequate markets and the persistence of deep poverty, development agency personnel designing projects have increasingly turned to grants to provide solutions.

This note examines the theory of grants, draws lessons from a review of their use in twelve projects that started mostly in the years 1998-2000, discusses findings, and recommends ways to deal with problems faced in grant projects.

THEORY

Grants, in the present context, are government subsidies. They can be used to increase the supply of goods and services, or to increase demand for these. They can be used for investment or for consumption. They can be used to buy assets for the poor, or to supplement their incomes. They are most often used for training, or to promote the development, dissemination, and uptake of new technologies. This note looks at grants mainly as one-time subsidies aimed at helping investment rather than consumption.

The theory of grants starts by defining three types of goods—"private," "pure public," and "impure public." These are defined as follows:

Private Goods: these goods are excludable (those who own them can restrict their use by others, especially by those who do not pay for them) and rival (their use by one consumer reduces their availability to other consumers—they cannot be used over and over again); examples are marmalade and cars. Private sector markets most often provide these goods.

Pure Public Goods: these goods are not excludable, nor rival; examples are market regulations and national defense security. The public sector most often provides these goods.

Impure Public Goods: these goods are less than fully excludable or rival. One example of an impure public good is a road that many users can use at once (thus, not rival), but for which a toll can be charged (thus, excludable). Such goods are sometimes called toll goods. Another example is the fish stock in the ocean. As one user increases its catch, there are fewer fish available for others. Therefore, the ocean fish stock has the characteristic of rivalry. But, it is very hard to restrict users, so there is only a weak characteristic of excludability. Such goods are sometimes called common property resources.

The greatest temptation to use grants occurs in the production of impure public goods, on grounds of market failure or policy failure. Impure public goods are often

ISSUE 9
APRIL
2006





produced by the private sector, but there is always a risk that not enough of them may be produced because the private sector may not be able to capture a sufficient share of the economic benefit to society. Impure public goods are also sometimes produced by the public sector, but there is always a risk that either too much or too little of them may be produced because the public sector does not receive or react to market signals as does the private sector, and thus can be an inefficient producer.

If there is a market failure, the public sector can step in to produce the good itself, or it can take other actions to try to overcome the market failure. Such actions may include:

- Defining, protecting, and enforcing property rights
- Providing infrastructure
- Supporting provision of information

All three of these actions reduce transaction costs for private sector participants in the market. The public sector should give priority to those actions that reduce transaction costs substantially. It should not try to deal with every market failure because governments cannot solve all of them efficiently.

The nature of goods (how they fit into the three-fold classification above) may change over time. Their nature changes as technologies, institutions, and legal systems adapt to new situations. For example, developing new open-pollinated crops used to be done by the public sector because the private sector could not capture the big benefits enjoyed by many people other than those who had paid for the seeds (“spillover” benefits). The private sector could capture more of the “spillover” benefits with institutional developments including stronger property rights, better enforcement, and technological developments such as hybrid crops with securely protected parent lines. The public sector does not need to be so involved in production.

DECIDING WHEN AND HOW TO USE GRANTS

In deciding whether to use grants and how to design them, the following key questions and issues need to be addressed:

1. *Is there a market failure?* Simply because the private sector does not invest in something does not mean there is necessarily a market failure. It may mean merely that profits are low in that line of business or in using that technology. A market failure is when there is a significant difference between social net benefits and private net benefits.

2. *Is a grant the best remedy?* Possible reasons for private sector production to be restricted, or inhibited, indicating whether a grant is likely to help are as follows:

- Lack of public goods such as infrastructure, legislation, or information (e.g., trying to mill grain without electricity): the best solution is to invest in these public goods—it will not help to give grants to reduce the high costs of production caused by their absence.
- Lack of economies of scale (no single enterprise big enough to make the lumpy investments needed): grants do not automatically help, although it may help for governments to support collective action in making lumpy investments.
- High risk (from long gestation periods of investments, political instability, lack of transparency in government policy, natural disasters, etc.): private sector insurance schemes can handle some risks, and governments should first deal with any insufficiencies in their own policies and performance, and only then consider grants.
- High costs of protecting property rights: in general governments should establish and protect property rights and provide subsidies (grants) only where costs of enforcement are too high.
- Lack of commercialization of the economy: this especially slows down development of financial services and grants should not be used in these cases for subsidizing credit, but they may be justified for training, development of management information systems, or helping to expand branch networks and install new technologies.
- Lack of technology, information, or trained staff: grants may be useful to solve these problems.

3. *Grants are generally justified* for training of skills, technology, innovation, information, start-ups of businesses, project preparation, trade fairs, private investment in local infrastructure, networks, lumpy capital, and collective action.

4. *Grants are generally not justified* as subsidies for current inputs or credit, where their use may crowd out private suppliers.

5. *Cost-benefit analysis of grants:* The key issue in analyzing the worth of grants is determining whether the additional benefits of a grant outweigh its costs. The private sector will generally take up investments that are privately profitable, regardless of whether their net economic benefits to society are positive or negative. It will generally not take up investments that are not privately profitable, and some of these (those that have net positive economic benefits to society) may qualify for grants.



6. *How big should grants be?* They should be big enough to turn investments worthwhile to society into profitable investments for private businesses.
7. *What kinds of grant instruments should be used?* There are different ways in which grants can be provided:
 - Vouchers: These are useful to stimulate effective demand and market development because in the hands of demanders they force suppliers to compete. Cost-effective implementation may be difficult, though.
 - Competitive grants: Their advantage is increasing the effectiveness of grants, but the disadvantages may be increasing administrative costs and increasing waiting time for applicants (while they are evaluated).
 - Competitive bidding processes (applicants say how much they are prepared to pay themselves and what level of grant they require): Their advantage is that public budget may be saved and more projects supported, but they require considerable expertise to prepare and evaluate.
 - Matching grants for feasibility studies and technical assistance: These are seldom appropriate in less developed countries where technical or business consulting expertise is limited.
8. *Who are eligible to apply for grants?* It is important to decide in advance whether everyone should have access to grants or only certain specified groups - and for those who are targeted, how much do they need?
9. *Is the capacity adequate to implement a grant scheme?* To answer this question means making judgments about existing capacity and about future capacity that could be built up, if indeed a grant scheme is likely to be sustained well into the future at a large enough scale to justify building capacity to handle it. It is important to make sure the scheme will work without needing to bring in expensive foreign assistance for extended periods.
10. *Is the grant process transparent and accountable?* This is essential for good governance, and requires clear thinking about:
 - Application and decision-making procedures
 - Sources of final authority in decision making
 - Provisions for appeal
 - How to inform the eligible population
 - How to ensure community decisions reflect interests of all groups within communities
 - Possible support for preparation of grant proposals
 - Reporting requirements for recipients
 - Monitoring and evaluation

Grants can be named for:

- The services they support—e.g., research, technology dissemination, export promotion, innovation, community development, business startup, project feasibility assessment, training, market development, business linkage promotion, and capital.
- The procedures used to administer them—e.g., competitive, demand-driven, and matching.



REVIEW OF WORLD BANK PROJECTS THAT USE GRANTS

A wider review in 2002 for the World Bank by the TDI Group¹ concluded that the use of grants tended to evolve with the level of economic development, providing expertise mainly in low-income countries and in more mature economies to support a wider range of policy objectives. Grants had been used for export promotion, project preparation, research, technology adoption, training, welfare-oriented community development, and income-generating schemes. Research funds had focused on applied and adaptive research, and evolved towards putting funds in the hands of users of technology who could contract appropriate research providers (Reifschneider et al 2000).

The twelve World Bank-financed projects overviewed (Van der Meer and Noordam 2004) were selected as three groups of four from grants for agricultural research and development, private enterprise development, and community development. Following are the main findings of this review:

- Too much decision making is left to implementers (as shown by lack of information in Project Appraisal Documents).
- Economic justification for productive projects for which grants are to be used is largely absent and generally weak. Given the scale at which the World Bank operates, this is unacceptable.
- Many staff involved in community driven development (CDD) projects believe, incorrectly, that selection by communities will guarantee that grants will be put to uses that provide net economic benefits.
- Projects justify grants by describing various obstacles to development. It is often not clear whether or not these obstacles are market failures. In many cases, the argument made for grants is merely that the target population is poor and lacks assets.
- Information provided in project documents is insufficient to make the case either that grants can be effective or that they are the best intervention under the circumstances.
- Little attention is given to the possible distortion of markets by using grants.
- The case for cost effectiveness of grants is often insufficiently made.
- It is hard to design and manage grant schemes. In addition, projects often provide for international consultants to help, a solution that is generally too expensive.
- Project documents are often not clear on the eligibility criteria for obtaining grants.
- Detailed cost-benefit analyses of all grant-financed investments, to the extent that such investments are of an economic nature for which such analyses are possible. In some cases, this may be possible only at the aggregate level.
- Broader analyses of other investments such as community-driven development (CDD) projects and cash or food-for-work schemes, to ensure that the interventions proposed are the most cost-effective way to help the poor without distorting markets and private sector activity.
- Analysis of pilot interventions or stylized model investments should be attempted and, wherever feasible, ex post evaluation of samples of sub-projects should be carried out when economic analysis is too difficult.
- Project Appraisal Documents should include more details of implementation, and give more guidance to the implementers.
- The World Bank's Independent Evaluation Group (IEG) should evaluate grant schemes with special attention to justification, economic evaluation, and implementation details.

The review recommends the following actions in the World Bank for addressing these deficiencies:

- Guidance notes, standard guidelines and manuals, and training for task managers, emphasizing the need to explicitly identify market failures and justify the use of grants to address them, as well as providing frameworks for detailed design of grant schemes. Such guidelines should draw on the large experience with grant schemes in development agencies outside the World Bank. The guidelines should be drawn up by the Agriculture and Rural Development Department (ARD) and promoted by training through Thematic Groups within the department.

CONCLUSION

Economic theory suggests grants can be good instruments to compensate for market failure, but their improper use is risky. It can waste public resources, distort or destroy markets, crowd out the private sector, provide unfair competition, and give rise to political favoritism and corruption. Careful preparation, assessment, monitoring, and evaluation of grant projects are essential.

SELECTED READING:

Kees van der Meer and Marijn Noordam. 2004. "The Use of Grants to Address Market Failures: A Review of WorldBank Rural Development Projects." Agriculture and Rural Development Discussion Paper 27, World Bank, Washington, DC.

F. Reifschneider, D. Byerlee, and F. Basilio da Souza. 2000. "Competitive Grants in the New Millenium." Proceedings of "A Global Workshop for Designers and Practitioners," Brasilia, Brazil May 16-18.

¹ TDI Group is an international consultancy, training, and project management organization. For more information about this group: <http://www.tdigroup.ie/>

This note is based on the larger report entitled *The Use of Grants to Address Market Failures: A Review of World Bank Rural Development Projects* by Kees van der Meer and Marijn Noordam. Editorial input for this note was provided by Derek Byerlee, Jock Anderson, and Kees van der Meer. You can download a full copy of the report at www.worldbank.org/rural or email ard@worldbank.org.

