

Sida's Policy for Credit-Financed Development Cooperation

February 2001



SWEDISH INTERNATIONAL DEVELOPMENT
COOPERATION AGENCY

Department for Infrastructure
and Economic Cooperation
Financing and Capital Markets Division

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SUMMARY

The purpose of this policy is to provide guidance for the granting of credits, in the form of guidelines for making assessments and priorities in respect of countries and projects, and for the conditions to be applied in different cases.

Objectives of Sida's contract-financed development cooperation:

As with all development cooperation, the aim of Sida's credits is to improve the living standards of poor people and to fulfil the other objectives of the Swedish policy for international development cooperation. Where Concessionary Credits are concerned there is also a further important purpose: to promote cooperation between Sweden and the recipient countries.

Forms of credits:

- **Concessionary Credits ("U-krediter")** are mainly tied to Swedish exports. The credit component is re-financed on the capital market and Sida issues a guarantee for the credit risk through the Export Credits Guarantee Board (EKN). It is only the grant element, which is settled against Sida's appropriation. Under the OECD's Consensus Agreement, tied concessionary credits may only be granted to countries with GNP per capita which is less than USD 2 995 and may not be used for commercially viable projects. Exceptions are made for the very poorest countries and for credits with a grant element of at least 80%. There are also certain other exceptions, for example for small projects. In accordance with the Credits Ordinance (Kreditförordningen), Sida shall be guided in its decisions by the Swedish Export Credits Guarantee Board's (EKN) assessment of project and country risk. Concessionary Credits may also be granted in untied form.
- **Soft Loans ("Biståndskrediter")** are normally untied, i.e. the support refers to the project and there are no linkages to a specific supplier. However there shall be a Swedish interest in the sector. The entire amount of the credit is settled against Sida's appropriation.

What types of contributions may credits be used for?

Regardless of the form of financing, Sida's assessment of a project is based on an analysis of the development problem and whether it can and should be solved with the aid of a project financed by development cooperation funds. Thereafter consideration should be given to the form of financing which is most suitable: grant, credit or guarantee.

Credits are used primarily to finance investments in tangible assets. Services should be financed with credits only if they are linked to investments in tangible assets and the services component does not constitute a significant proportion of the contribution.

If the problems in the sector are mainly of an institutional or structural character, investments in tangible assets alone, for example with the aid of a credit, rarely offer advisable or adequate solutions.

Sida's role

Where **tied Concessionary Credits** in particular are concerned, Sida's role is mainly limited to contributing finance and evaluation. However Sida is not closely involved in project design or detailed follow-up. Sida's method is therefore mainly **reactive** and assumes that there is capacity in the country and in the sector to administer the project.

Projects financed by **Soft Loans and untied Concessionary Credits** normally differ less from "common" grant-financed projects. Assessments are similar to those of projects financed by grants. Sida's engagement and involvement in the design and implementation phases are often greater than in the case of tied Concessionary Credits - Sida's method is more **proactive**.

However it is important to lay down that Sida always maintains responsibility for the use of Swedish development cooperation funds never varies. Sida therefore must always make its own assessment and monitoring of projects.

Selection of countries

In addition to the rules for granting credits laid down in the **Consensus Agreement** and the **Credits Ordinance**, other aspects should also be taken into consideration prior to approving a certain country for development cooperation on credit terms.

Among other things Sida should make an analysis of the country's **macro-economic situation**. Since the grant element of a credit is often channelled via the recipient country's **national budget**, an analysis of this should be made to ensure that Sida's funds are used in an acceptable way. The country's **debt burden** shall also be given consideration as well as whether it will be possible for the country to repay the credit in the future. Credits should not be granted to countries which, according to the HIPC initiative, have an unsustainable debt burden and which have not yet reached the decision point for debt relief. Countries that have undergone the HIPC process should only be given credits with very high levels of concessionality (80%).

For reasons of capacity there can be grounds for Sida **to limit the number of countries** for which credit financing is considered. In broad outline it is possible to distinguish two groups of countries which should be given special priority:

1. Countries in receipt of extensive Swedish development cooperation and where Sida is often represented and hence good possibilities of working proactively exist.
2. Countries with good capacity to handle Sida's credits and where it is thus possible for Sida to work reactively.

Other countries shall not be given priority but if conditions are suitable, Sida can also offer credits to these countries in certain cases.

The country and regional strategies shall state whether, and if so under what conditions, credit financing of projects is appropriate in each country.

It is important to analyse all projects, regardless of form of financing, from a state-market perspective:

- Credits should only be used for projects, which cannot, or should not, be financed on market terms, and therefore would not take place without concessionary financing.
- Concessionary Credits can also be suitable for financing financially profitable projects in the public sector, particularly infrastructure, which cannot obtain market financing.
- Credits can also play an important role in projects with private sector involvement, for example when a government agency contracts a private company to build and operate a certain item of infrastructure within the framework of a time-limited concession.
- Concessionary Credits should only be given in exceptional cases in connection with industrial investments, i.e. in commercial activities exposed to competition.
- The granting of credits should always be done in a manner which is as neutral as possible in its effects on competition.

Conditions for on-lending and the size of the grant element:

Many recipient countries have national rules for the on-lending of foreign concessionary credits. These rules should naturally be respected. If rules of this type do not exist, on-lending shall take place in accordance with the following guidelines:

The basic principle should be that grant financing and subsidised credit financing of investment projects shall be channelled via central government bodies which absorb the subsidy. It is assumed that the on-lending shall take place from the borrower (e.g. Ministry of Finance) to the organisation implementing the project on terms similar to market terms.

In general poor developing countries should be given support on more advantageous terms than the somewhat richer developing countries. It is also important to give consideration to the effects of the project on the partner country's government finances.

Countries	Level of concessionality¹
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HIPC countries	80%
LLDC countries	50% or 80%
IDA countries which are not LLDC	35%, 50% or 80%
LMIC countries	35% or 50%

Procurement

Sida's guidelines stipulate that all goods, works and services shall be the subject of competitive procurement. The Credits Ordinance specifies that Concessionary Credits shall be procured in international competition.

¹ The higher percentages in each category refer to projects where the level of concessionality is increased due to the low income-generation capacity of the project

1. Purpose and introduction

The purpose of this policy is to provide guidance for the granting of credits. The policy is in the form of guidelines, which shall be used for making assessments and priorities in respect of countries and projects, and for the conditions which shall be applied in different cases. The intention of the policy is to strengthen the predictability of Sida's credit operations and to contribute to consistency in Sida's actions. By establishing a common approach the policy can simplify the work of program officers at Sida's Department for Infrastructure and Economic Cooperation (INEC) and others working at Sida or with other parts of the administration of foreign affairs who are involved in credit activities.

The ideas presented in the document are to a great extent in line with the conclusions of Sida's a study made by Sida in 1996 on the use of credits in international development cooperation ("Bistånd på Kredit", 1996).

The policy mainly concerns Concessionary Credits and Soft Loans, regardless of from which appropriation item they are financed. It also applies to developing countries in Central and Eastern Europe.

Many of the aspects taken up in this document are generally applicable to all international development cooperation, regardless of form of financing, for example the discussion of the types of activities which should receive support, integration of development cooperation funds into recipient countries' budgets, and so on. The reason why these issues are given special emphasis in the policy is that they often come up in discussions on credit-financed projects.

2. Objectives and rules for Sida's credits

As with all other forms of development cooperation, the aim of Sida's credits is to improve the living standards of poor people and to fulfil the other objectives of the Swedish policy for international development cooperation.

Since Sida is a development cooperation agency, development effects constitute the point of departure of assessments of all contributions. Where Concessionary Credits are concerned, there is a further aim in addition to the objectives of the Swedish policy for international development cooperation: to promote cooperation between Sweden and the recipient countries. This cooperation shall take place in sectors in which Swedish goods and services are competitive. In addition to the concrete effects of projects, the contacts established between Swedish trade and industry and their counterparts in the recipient countries can also have positive development effects in the form of transfer of technology, human resource development and the development of a business culture. All these aspects are expected to contribute to economic growth.

All Swedish international development cooperation is governed by the annual letter of appropriation issued by the Swedish government, the country or regional strategies, and Sida's internal directives. The Government's budget bill also

provides guidance. In addition to this the granting of Concessionary Credits is governed by two external documents, the Credits Ordinance (Kreditförordningen, SFS 1984:1132, rev. 1995:870) ² and an agreement between the OECD countries, the so-called Consensus Agreement ³, which states that, with certain exceptions, tied Concessionary Credits may not be used to subsidise commercially viable projects (see further section 5 below).

3. Why support on credit terms can sometimes be more suitable than direct grants

The study of credits in development cooperation made by Sida in 1996 ("Bistånd på Kredit") describes a number of potential advantages of credit-financed development cooperation. Among other things it obliges the partner country to make a thorough assessment of projects and their costs, since the credits involve a debt for the country. Decisions to approve projects are most often made at a high political level after a long assessment process. Since the country invests its own resources, includes the costs in the national budget and takes a risk in the financing, the "ownership" of projects is often clearer. Moreover credits are regulated in banking agreements and are treated in the same way as other government debts. However, there is a risk that the decision-makers do not give full consideration to the costs resulting from future repayment commitments.

In addition to this "disciplinary motive", the "leverage motive" is often given as the other important reason for choosing support in the form of a credit rather than a grant, i.e. the use of a market-financed concessionary credit for a certain period of time can result in a larger inflow of capital into the country than a pure grant, given that there are limitations to Sida's budget. This can make it possible to carry out priority projects that would otherwise be difficult to implement.

Moreover credits give a clearer commercial signal to the recipient and can thus contribute to increasing the incentive for running activities efficiently. For example a direct grant for a power station can give the wrong signals since it does not give the energy authorities or the energy corporation the same incentive as a credit to set reasonable tariffs and run operations efficiently. However support can be given to the country in the form of a grant or a very advantageous credit and can then be on-lent on commercial terms to the authority or corporation implementing the project. This can be a suitable solution if the country has serious debt problems and incurring further debts should be minimised.

Credits can also be preferable as a form of cooperation when development cooperation shall be phased out, for example when a country has become richer, or when a project has developed to the stage when it can start generating its own revenues. The transition from grants to financing via concessionary credits can then be seen as a step in a process of transition from traditional development cooperation to purely commercial relations.

² The Credits Ordinance will probably be revised in the year 2001.

³ The agreement on guidelines for government-supported export credits is a gentleman's agreement that came into effect in 1978 within the framework of OECD.

4. Credits and the debt problem

A number of debt rescheduling and debt relief initiatives have been taken since the mid 1980s, but many of the poor countries are still weighed down by unsustainable debt burdens. It is important that the debts are further reduced in order to give these countries a chance to develop.

In 1996 the World Bank and the IMF jointly launched an initiative for the poorest and most heavily indebted countries, the so-called HIPC initiative⁴, which tackles the debt situation of the countries concerned more comprehensively than before. One of the conditions for debt relief is that the country pursues a sound economic policy. Sweden has been one of the most active advocates of far-reaching debt relief since the 1980s. In the HIPC context Sweden has also strongly emphasised that the countries need to establish and to follow sustainable and rational debt strategies.

When a country's debt stock increases, the estimated need of debt relief in the HIPC initiative also increases. In this situation it is not consistent for Sweden to provide credits (i.e. to increase the country's debt burden) while advocating considerable debt relief which is financed by the donor community as a whole. This "free-rider" argument is a reason why Sida should not give credits to HIPC countries that have not yet reached the so-called decision point for debt relief in the HIPC process. Another, perhaps more important, reason is that development cooperation may not contribute to putting a recipient country in an unsustainable debt situation. This naturally applies to the HIPC countries both before and after debt relief and to other countries with serious debt problems. Therefore Sida shall be restrictive in granting credits to HIPC countries even after debt write-off (see further, section 8 below).

5. What types of credits does Sida offer?

Primarily Sida gives two forms of credits: Concessionary Credits and Soft Loans⁵.

Concessionary Credits ("U-krediter")

- Mainly tied to Swedish exports. The financing offered refers to a specific contract, so-called contract-financing.
- Concessionality level (grant element) of 25% - 80%, for tied Concessionary Credits at least 35%.

⁴ HIPC = Heavily Indebted Poor Countries. For more information on HIPC, see www.worldbank.org/hipc/

⁵ Sida's support for micro-credits is usually in the form of a grant that the recipient organisation uses as a basis for credits which it grants. This policy does not therefore specifically refer to micro-credits.

- Granted on the condition that the financing refers to projects which have been given priority by the country applying for the credit, which are assessed by Sida to provide considerable development effects for the country, and where Swedish goods and services are competitive.
- Sida can also offer untied Concessionary Credits, for example when co-financing with multilateral institutions or with Swedish grants.
- Market-financed credits (through the Swedish Export Credit Corporation and Swedish commercial banks). Only the grant element is settled against Sida's appropriation ⁶.
- The project has often already been defined when the supplier or the recipient country applies to Sida for a credit and it is not therefore possible for Sida to exert a significant influence on project design. However Sida can provide information about the conditions which apply to support for the financing of projects in different countries and sectors.
- Sida covers the risk that the borrower fails to fulfil his payment obligations by issuing an export credit guarantee to the Swedish supplier and the bank on receipt of a guarantee premium. The guarantee is administered by the Swedish Export Credits Guarantee Board (EKN) and the transaction shall be drawn up in accordance with the Board's general conditions. Sida shall be guided in its decision by the Board's assessment in respect of project risk and country risk.
- The granting of Concessionary Credits is governed by the OECD's Consensus Agreement. Under this agreement tied Concessionary Credits may only be granted to countries whose GNP/capita is less than USD 2 995 ⁷ and may not be used for projects which would, in normal circumstances, be commercially viable if they were financed by commercial and government-supported export credits ⁸. Exceptions may be made for the least developed countries (LLDC ⁹) and for credits with a high level of concessionality (at least 80% grant element).

⁶ If Sida's premium reserve is insufficient to cover the cost of any losses, the deficit is also settled against Sida's appropriation.

⁷ Is adjusted annually by the OECD. Corresponds to the GNP/capita limit for receipt of 17 years credits from the World Bank. The indicated level came into effect on August 1, 2000.

⁸ According to OECD's definition in the so-called Helsinki protocol to the Consensus Agreement (1993), two criteria shall be present for a project to be regarded as commercially viable and therefore not eligible for financing with tied concessionary credits: 1) that, with the aid of market level prices, the project is expected to generate sufficient cash-flow to cover its costs and financing on conditions corresponding to consensus conditions, i.e. financial viability; 2) access to market financing or public financing for the project and country in question. A certain amount of guidance for the interpretation of these rules is given in the application guidelines (Ex Ante Guidance). According to these guidelines, the following sectors are normally not commercially viable: urban public transport, certain environmental projects, health projects, rural electrification and rural telephony.

⁹ LLDC = Least Developed Countries, according to the UN's definition

There are certain other exceptions, for example for small projects (<2 MSDR¹⁰).

- Sida can offer concessionary financing for small contracts (normally <2 MSDR) between Swedish suppliers and clients in a developing country with the aid of credit lines at development banks or commercial banks. The investments can refer to both traditional governmental and commercial activities that are entirely market-based.

Soft Loans (“Biståndskrediter”)

- Used mainly for revenue-generating projects in the least developed countries, which often do not have access to market-financed loans. Soft Loans can also be appropriate for social projects and environmental projects in somewhat richer countries.
- Normally untied, i.e. the support refers to the project and is not tied in any way to possible suppliers. However, Sida may offer tied Soft Loans subject to approval of the Swedish Government. There shall be a Swedish interest in the sector, i.e. the project shall be in a normal sector for Swedish development cooperation or promote development cooperation in other ways, or be judged to be of interest from the perspective of Swedish exports.
- Level of concessionality 50% - 80% (usually 80%).
- The entire amount of the credit is settled against Sida's appropriation from the outset. Therefore no credit guarantee from the Export Credits Guarantee Board is required. Sida is the lender but the Swedish Export Credit Corporation administers the credits.

6. For what types of contributions may credits be used?

Regardless of the form of financing, Sida's assessment of a project is based on an analysis of the development problem and whether it can and should be solved with the aid of a project financed by development cooperation funds. Thereafter consideration should be given to the form of financing which is most suitable: grant, credit or guarantee.

Where Concessionary Credits are concerned, it is usually the case that Sida first receives a project proposal, i.e. a proposal for a "solution" to a development problem, by the counterpart in the partner country and/or a Swedish company. The analysis must then focus on determining whether the proposed project offers a relevant solution to an urgent problem, i.e. if it provides desirable development effects in an efficient way, and whether a subsidised credit is a suitable form of financing.

¹⁰ SDR = Special Drawing Right. 1 SDR = approximately SEK 11.7 (January 21, 2000)

The contribution of the project to the fulfilment of Sida's overall goal of reducing poverty shall be defined. The project shall be assessed in relation to Sida's action programmes and "Sida at Work". Moreover Sida's sector policies should constitute the basis of priorities in specific sectors. It is therefore important that these sector policies refer to cooperation not only with countries which are among the least developed, but also with countries where perhaps only reactive cooperation is appropriate, for example cooperation financed by credits. As all development projects the project should be in line with and, if possible, contribute to current reform processes in the recipient country. The LFA instrument ¹¹ is used in this analysis.

Credits are used primarily to finance **investments in tangible assets**. **Services** should only be financed by credits if they are linked to investments in tangible assets and the services component does not constitute a significant proportion of the contribution.

If the problems in the sector are mainly of an institutional or structural character, investments in tangible assets alone, for example with the aid of a credit, rarely offer advisable or adequate solutions. In these cases a credit should only be granted within the framework of a donor-supported sector program which has the objective of solving the problems in a credible way. In certain cases support to remedy minor institutional weaknesses can be given within framework of a contract-financed technical cooperation¹² contribution or a similar contribution supported by other donors. Under the Credits Ordinance Concessionary Credits may not be granted for regular supplies.

As opposed to Concessionary Credits, Soft Loans can also be given to partner organisations in the recipient countries without a direct link to investments in tangible assets, provided that the borrowing institution is judged to have good solvency (asset/debt ratio) after using the credit.

7. Sida's role

Where **tied Concessionary Credits** in particular are concerned, Sida's role is mainly limited to contributing finance and evaluation. However Sida is not closely involved in project design or detailed follow-up during the implementation phase.

Where this form of support is concerned, it is essential that the client has the capacity to be a strong counterpart to the supplier. For example, the client must be able to define the assignment, assess tenders, negotiate contracts, fulfil commitments during the construction phase etc. Sida's method is therefore mainly **reactive** and assumes that there is capacity in the country and in the sector to administer the project. The Swedish embassy in the partner country often has an important role in assisting in the administration of the credit instrument.

¹¹ LFA = Logical Framework Analysis

¹² "Kontraktsfinansierat Tekniskt Samarbete (KTS)

Where working reactively is concerned, it is assumed that the client and the supplier perform a large proportion of the work relating to identification and design of the project. In cases where co-financing is used, other donors can also play an important role. Sida's input can therefore often be limited.

However it is important to lay down that Sida's responsibility for the use of Swedish development cooperation funds never varies. Sida must therefore always make its own assessments and follow-ups in a manner which meets the requirements laid down by the Swedish Government in respect of controls of development cooperation funds.

Soft Loans normally differ less from "common" grant-financed projects. Assessments are similar to those of projects financed by grants. Sida's engagement and involvement in the design and implementation phases is often greater than in the case of tied Concessionary Credits - Sida's method is more ***proactive***.

Untied Concessionary Credits make it possible to support important investments, regardless of supplier. Untied credits also give Sida a greater opportunity to exert an influence on project design, which can be desirable, when the project in question is sensitive from the environmental perspective.

There is naturally no specific borderline between reactive and proactive methods. Sida can sometimes act proactively in the case of tied Concessionary Credits. And, even where untied credits are concerned, reactive contract-financing is sometimes used - in cases where the projects have already been clearly defined when they are presented to Sida.

8. Selection of countries

8.1 To which countries can Sida grant credits?

The selection of countries to which Sida can grant credits are governed by international agreements, decisions and ordinances of the Swedish government, including country and regional strategies, and Sida's internal policies.

- Under the OECD's Consensus Agreement tied Concessionary Credits can only be granted to countries whose GNP/capita is ***lower than USD 2 995*** (see section 5 above).
- The Swedish Export Credits Guarantee Board (EKN) issues guarantees for Concessionary Credits on behalf of Sida. Under the Credits Ordinance Sida shall be guided by the ***EKN:s assessment*** of project and country risks when reaching decisions on concessionary credits. Where Soft Loans are concerned, which are financed in their entirety by the development cooperation appropriation, no credit guarantees are necessary.
- The Credits Ordinance states that Concessionary Credits may be granted "for the financing primarily of Swedish goods and services to ***partner countries***

and to **other developing countries with which Sweden wishes to initiate or intensify economic cooperation**". As for all development cooperation it is naturally required that the country pursues acceptable policies in respect of human rights and democracy. In addition the country should pursue a reasonable economic policy (for example in respect of macro-economic stability, structural reform and attitude towards private entrepreneurship). Since the grant element of the credit is most often channelled via the recipient country's government budget, an analysis should be made of this budget. Among other things Sida should analyse whether the budget process is transparent and how allocations are made in the budget.

- As discussed in section 4 above, programmes of development cooperation may not contribute to putting the recipient country in an unsustainable debt situation. Consideration should therefore be given to the country's **debt burden** when making assessments of credit financing. In addition the granting of credits must be consistent with Sweden's actions in other international contexts, for example where international programmes for the re-negotiation of debts are concerned. Credits should therefore not be given to those countries which, according to the HIPC initiative, have an unsustainable debt burden but have not yet reached the decision point for debt relief. Countries that have undergone the HIPC process should only be granted credits with a high level of concessionality (80%). In these cases careful consideration should be given to the advantages, i.e. that countries can start a process towards credit-worthiness and normal business transactions, and the disadvantages, i.e. that they rapidly acquire a further debt burden.¹³

8.2 Countries which shall be given priority

In addition to the restrictions described above, there are grounds for Sida to limit the number of countries for which credit-financing is considered, for example for reasons of capacity. In broad outline it is possible to distinguish two groups of countries which should be given special priority:

- **Countries in receipt of extensive Swedish development cooperation**, where Sida is often represented. In these countries it is possible for Sida to be more involved in the design and follow-up of projects. Thus there are good possibilities of **working proactively**. Sida can also work reactively in these countries if the counterpart is considered to have appropriate capacity or other donors are involved.
- Countries with the capacity to handle Sida's credits and where it is thus possible to work **reactively**. These are most often lower middle income countries or other countries in which Swedish suppliers have shown considerable interest.

¹³ Transitional rules shall apply to projects that are under assessment when the policy comes into effect.

Other countries shall not be given priority but, if conditions are suitable, Sida can on a case by case basis also consider offering credits to these countries.

The **country and regional strategies** shall state whether, and if so under what conditions, credit-financing of projects is appropriate in each country. The country analysis shall include a section on infrastructure sectors and other areas that can be suitable for credit-financed support as well as an analysis of the country's macro-economic situation and government budget. Linkages shall be made to the overall strategy for cooperation. It should be made clear - in cooperation agreements and contacts with the partner country - that the forms of Swedish financing can vary depending on the situation, and that credit-financing is one possible form of financing. Geographical priorities in respect of credit activities are further specified in the **annual decisions of direction of Swedish development cooperation**.

9. Credit-financed support in an increasingly market-oriented environment¹⁴

It is important to analyse all projects, regardless of their form of financing, from a **state- market perspective**, i.e. to consider what commitments and interventions it is reasonable for a government to undertake in a market economy and what should be the tasks of the market.

As is the case for all development cooperation, credits should be given for projects which are **economically viable**. Other important criteria, which should be used in assessments of projects proposed for credit-financing, are presented below:

a) **Credits should only be used for projects that cannot, or should not, be financed on market terms and therefore would not take place without concessionary financing¹⁵**. This is in conformity with the above-mentioned Consensus Agreement (see section 5). The most common reason why projects important for a country's development cannot be implemented on market terms is that the project's financial return is low or non-existent. This is often the case in the social and environmental sectors, and in certain parts of the infrastructure sector ¹⁶. In these sectors there is thus often good reason for public

¹⁴ In this chapter, the term "concessionary credits" refers to all types of concessionary credit financing, i.e. both what Sida has named Concessionary Credits ("U-krediter") and Soft Loans ("Biståndskrediter").

¹⁵ In the export credit context it can sometimes be the case that a company is granted support for an export credit on terms which have been adapted to the terms competing companies have been offered in other countries. The aim is to neutralise the effects of terms of financing in a competitive procurement - the expression used in this connection is "matching". Sida does not grant credits for matching purposes.

¹⁶ In the infrastructure sector so-called "market failures" are common. These are caused by the economic character of infrastructure (for example "natural monopolies" and "public good") and the existence of so-called "external effects". In the social sectors the reason for a government intervention normally originates from the "equality perspective", for example the right of all citizens to basic education, health care etc.

involvement, which is the reason why both credits and other forms of support for investments are directed towards these sectors.

The investments which are most suitable for credit-financing are those which have the potential to generate revenues and thus reduce the burden on government finances when the credit is repaid. Concessionary credits therefore have an important role to play in the financing of **projects that may generate revenues but are not fully financially viable**. This applies for example to areas such as railways, electrification of rural areas or poor urban areas, water supplies and solid waste management.

For countries which are not among the very poorest and which have sound government finances, concessionary credits can be appropriate for the financing of **investments which do not generate any revenues at all**, which is often the case in the social sectors and certain parts of the infrastructure sector, for example roads.

This underlines the importance of financial analyses which give special consideration to the **effects of projects on government finances** in the partner countries and on the possibilities available to governments to bear future costs generated by the investments. This is also an important factor to take into consideration when determining the size of grant elements (see further section 11).

b) Concessionary credits can also be suitable for financing **financially profitable projects in the public sector, particularly infrastructure, which cannot obtain market financing**. For example a credit of this type could facilitate an investment in power transmission lines in a situation in which a publicly-owned power company has problems in mobilising finance from both private and public sources¹⁷.

c) Traditionally public undertakings have often been understood as public ownership and public production. However during recent years private companies have become increasingly involved, not merely in public sector operations but also in **investments in infrastructure with the use of private capital**. In certain infrastructure sectors important steps have been taken towards market competition in combination with public regulation and occasionally also with public subsidies. **Concessionary credits can play an important role also in projects with private sector involvement**, for example when a government agency contracts a private company to build and operate a certain item of infrastructure under a time-limited concession. Great emphasis must be given to arranging the financing so that it is coordinated with, and does not crowd out, private investments in infrastructure.

¹⁷ The reason why publicly-owned companies can have difficulties in borrowing on the private capital market is often due to a combination of certain factors: a) that the owner (the government) has exhausted its possibilities of guaranteeing borrowing activities, b) that, despite reforms, many companies have still not achieved the status necessary to be able to borrow without government guarantees, and c) that the domestic capital market is still under-developed and cannot thus offer the financing required.

d) Today few concessionary credits are granted in connection with **industrial investments**, i.e. for commercial activities that are exposed to competition. In general the granting of public credits is not an effective solution of problems concerning deficiencies in the capital market. Therefore concessionary financing should only be granted in exceptional cases to activities of this kind.¹⁸ (See also reference to the Consensus Agreement above.)

The granting of credits should always be done in a manner which is as neutral as possible in its effects on competition. This applies both to competition in respect of entry to a market (concessions etc. see point c) and to competition in respect of customers on the market (point d), and can be achieved in different ways. For example a subsidy can be offered to all tenderers participating in a procurement process relating to a concession (mainly applicable to point c). The risk of distorting competition is also reduced if the credit is channelled via financial institutions, for example a development bank, which can offer financing to several parties on the market. By on-lending on terms similar to market terms, as recommended in section 10 below, the subsidy in question that is provided directly through the credit to the project, can be reduced. However it is worth pointing out that, in a situation where it would not otherwise be possible to borrow funds for a project, the granting of credits on terms similar to market terms also has certain subsidy effects which should be taken into consideration.

10. Who benefits from the grant element? Conditions for on-lending.

When stipulating the conditions for the on-lending of Sida's subsidised credits, the goal should be to ensure a ***rational allocation of resources and sound financing***.

Many recipient countries have ***national rules*** for the on-lending of foreign concessionary credits. These rules should naturally be respected. If rules of this type do not exist, on-lending shall take place in accordance with the following guidelines.

The basic principle should be that grant financing and subsidised credit financing of investment projects should be channelled via central government bodies to which the subsidy accrues. It is assumed that the on-lending shall take place from the borrower (e.g. Ministry of Finance) to the organisation implementing the project on terms similar to market terms. The purpose of this is that the real cost of capital shall be made clear and shall be born by the organisation implementing the project.

¹⁸ If Sida finances investments in commercial activities in exceptional cases, the assessment of projects should be made in accordance with the principles for project selection laid down in Sida's "Policy for financial sector development" as well as the principles which apply to Sida's programmes of private sector cooperation. OECD/DAC's guidelines for "Support to Private Sector Development" are also relevant.

As mentioned above, financing with the use of development cooperation funds is mainly given to projects where public contributions are required and justified. Also in cases such as these, the aim should be that on-lending takes place on terms similar to market terms while the recipient country itself is responsible for channelling the subsidy to the project in question via the government budget. There are different ways of achieving this: for example a commercial credit combined with a government subsidy, direct budget financing of the investment which the company then takes over, etc. This also has the effect that the recipient country's use of government resources can be made more transparent.

Allowing the recipient country to channel the subsidy via the government budget in this way naturally requires confidence in the recipient government's policies, and a close dialogue between Sida and the recipient country. ***In exceptional cases***, if there is reason to believe that the government budget is being used for undesirable purposes, Sida may prefer to channel the grant element directly to the implementing organisation.

If Sida does not want the grant aid element to accrue to the government budget, one alternative, which can be used in exceptional cases, is to create a trust fund with clear rules for its use. However, this involves more responsibilities and additional work for Sida and it is important to consider how long-term Sida's undertaking should be - among other things regarding the follow up of the use of resources.

Sometimes there may be other reasons to make an exception from the principle that the grant element shall be administered at central government level, for example if central government does not have an efficient system for on-lending on market terms. Another case is when activities that would be legitimate to subsidise, for example health care or rural electricity, do not receive funds via the government budget, but the hospitals or electricity company are obliged to finance these types of investments themselves instead. As mentioned above, this is usually the case in countries where the reform process has not made sufficient progress. Sida can sometimes make an assessment that, from the development perspective, the project is very important and that its positive effects outweigh the negative, distorting effects on the allocation of resources. The reasons for making this type of exception should be evident from the documentation supporting Sida's decision.

11. The size of the grant element

In general, ***poor developing countries*** should be given support on more advantageous terms than the somewhat richer developing countries, which can afford to finance more of their investments, themselves. As a country moves towards the stage where development cooperation shall be phased out, it is normally possible for the form of financing to go from grants, via credits with gradually lower levels of concessionality and guarantees, to commercial financing.

Heavily indebted countries should be given very advantageous credit terms. If credits are at all given to the countries that are included in the HIPC initiative, these shall be given, as mentioned above, at a concessionality level of 80%. It is also important to give consideration to the **effects of the project on the partner country's public finances**. If the project in question has little potential to generate its own revenues, Sida should be able to offer a higher grant element than to projects which can cover their costs to a higher degree. In such situations it can be justified, particularly in the case of poor countries, to adjust the terms of a credit so that the grant element corresponds approximately to that part which cannot be covered by revenues. Otherwise there is a risk that the project will involve a direct or indirect burden on the recipient country's government budget which is usually already extremely stretched.

To simplify administration, only three levels of concessionality should be used: 35%¹⁹, 50% and 80%. Soft Loans are often offered with a level of concessionality of 80%, but can also be given at 50%.

In accordance with this and given the limitations described above in respect of tied concessionary credits to countries which are not among the least developed, the table below can be used to provide rough guidance for levels of concessionality of credits to different groups of countries.

Countries	Level of concessionality²⁰
HIPCs ²¹	80%
LLDCs	50% or 80% ²²
IDA countries ²³ which are not LLDC	35% ²⁴ , 50% or 80%
LMIC ²⁵	35% ²⁴ or 50%

¹⁹ Also 25% for untied concessionary credits

²⁰ The higher figures in each category refer to projects where the level of concessionality is increased due to the low income generation capacity of the project

²¹ If credits are at all granted to these countries - see section 8.

²² Under the OECD agreement tied concessionary credits for LLDC countries shall have a level of concessionality of at least 50%.

²³ The World Bank's International Development Association (IDA). A country must fulfil three criteria to receive IDA resources: 1) GNP/capita max. USD 885 (Feb 6, 2001), 2) credit-worthiness which makes it impossible to borrow on market terms and thus a need of subsidised credits to finance the country's development, 3) sound economic and social policy.

²⁴ Does not apply to Soft Loans.

²⁵ The World Bank definition of Lower Middle Income Countries (LMIC): GNP/capita = USD 756–2995 (Feb 6, 2001).

12. Procurement

Sida's guidelines stipulate that the procurement of all goods, works and services shall be the subject of a competitive bidding process. When making assessments of contributions, it is important that we always examine the procurement process. The Credits Ordinance specifies that Concessionary Credits shall be procured in international competition. Procurements based on competition in Sweden or single source procurement can be approved in exceptional cases and only if the recipient country has special reasons which are acceptable to Sida, and provided that competitive prices can be obtained. An evaluation of the tender (price and quality) shall then be made. However this can only be done in the case of projects which consist of standard solutions where prices can be compared to similar projects in the country or in other countries. Prices should be compared with international prices and not merely with price levels in Sweden. Competitive procurements are not necessary in cases of repeat orders to companies which have previously supplied a certain component to a project as a result of orders which they have obtained in an international procurement.



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ISBN 91-586-8931-1