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Financial Aid to Ukrainian Reconstruction: Loans versus Grants

This brief provides an overview of the discussion on the relative merits of grants and loans in the literature on foreign aid, including a short section on debt relief initiatives. These claims are then tested against the context of Ukrainian post-war reconstruction, and it is argued that the case for providing grants is very strong. This argument is based on the magnitude of the investments needed, the need to create a long-run sustainable economy, the road towards a future EU membership, and the global value of a democratic and prosperous Ukraine as a bulwark against autocratic forces.

Introduction

One topic in the discussion on the post-war reconstruction of Ukraine is to what extent foreign support should come as loans or grants. The case at hand regards reconstruction in the aftermath of a military invasion by an aggressive neighbor. Therefore, Ukrainian reconstruction is sometimes compared to the Marshall Plan, the US package to help rebuild Europe after World War II. But this choice is also part of the more general discussion on foreign aid, comparing concessional loans (loans with lower interest rates than the market rate) with grants (financial transfers with no expectation of repayment), not least since many aid receiving countries have been highly indebted. What are then the arguments in favor of one or the other in the foreign aid literature? And how should we think about this in the context of the Ukraine crisis?

The Case for Loans

From a donor perspective, loans could be preferred from a purely financial viewpoint, as long as they are repaid. This must be put into the perspective of the purpose of foreign aid, though. If the purpose is to increase the welfare of the poor, and if loans cause macroeconomic imbalances that eventually lead to a debt crisis, using loans for aid will defeat its purpose. It is thus important, even from a donor perspective, to differentiate between the pure financial costs and the effectiveness and efficiency of foreign aid in relation to the stated goals. Yet, the paradigm on which development banks such as the World Bank motivate their strategy is that, even from an effectiveness perspective, loans may outperform grants. In their model, the bank has a broad portfolio of investments across multiple countries prioritized in order of the social rate of return. By lending out money, the bank can invest the returns from the most prioritized project into the second-most prioritized project, most likely *in a different country*. If the money instead had been given as a grant, the best possible outcome is that the receiving country can now invest the returns in the next best project *within that country*. This argument thus relies on the assumption that development banks can continually identify the most promising recipients among their wide portfolio of alternatives.

It has also been argued that grants may reduce incentives to raise tax revenues, and encourage government consumption over investments, as there is no need to generate net revenues to repay the debt (e.g., Clements et al. 2004; Djankov et al. 2004). From a donor perspective, it can also be argued that the monitoring of grants may be weaker because donors have no direct financial interest in the success of a project if it is financed by a grant. The disciplining effect of loans, though, relies on the absence of moral hazard problems. If receiving governments expect debt to be forgiven anyway when it is perceived as unsustainable and counterproductive to the country's development, loans may be no better.

Based on arguments such as those above, part of the literature suggests that concessional loans are more likely than grants to promote growth in recipient countries, at least in good institutional environments. Cordella and Ulku (2007) look into this in detail and develop a model linking the degree of concessionality, for a given level of foreign aid (i.e. the extent to which finances are on preferential terms compared to market rates), to the receiving country's economic growth rate, in a world where default is possible. Concessionality varies from 100 percent grants to 100 percent loans on market terms. The model suggests that a country with better policies and stronger institutions has a higher absorptive capacity for investments, meaning it can handle a lower level of concessionality (i.e., more loans, fewer grants) without going into default. They also argue that the immediate incentives for default on a loan are higher for a poorer and more indebted country as the cost of servicing the loan is higher. This would motivate relatively more grants and fewer loans to countries that are poor and highly indebted. Taking this to the data, they find in consistence with their theory that for any given level of total assistance, the impact on growth is increasing with the degree of concessionality for poor countries with weak policy and institutional environments, whereas this matters less for richer countries with better policies and stronger institutions. Looking at the level of indebtedness, the results are inconclusive.

The Case for Grants

The arguments above generally favor loans over grants, but it is of course crucial to also consider the risks and consequences of excessive debt burdens and sovereign default. Perhaps the most dramatic example of the potential consequences of shouldering a country with an excessive debt burden comes from Germany after the end of World War I. The economic struggles and sense of humiliation that followed have been argued to have contributed to German grievances leading up to World War II. Less dramatic but still with significant implications is the "lost decade" affecting Latin American middle-income countries in the 1980s. The combination of cheap credit from oil-exporting countries and the sudden dramatic increase of international interest rates following US policies in the early 1980s resulted in unsustainable levels of commercial loans. This crisis led to a US initiative, the Brady Plan, by which bank loans were consolidated and partially backed by the US government.

Excessive lending is often the result of distorted incentives. Within development banks, there are widely recognized internal incentives to get projects "through the door" (e.g., Briggs 2021). This "aid pushing" happens for both grants and loans, but the consequences can be more detrimental for loans if this leads to unsustainable debt levels. Similarly, there is evidence of defensive lending, where countries receive loans simply to be able to repay previous loans. Birdsall et al. (2003) find that donors lent more to African countries with bad policies if they had a large existing debt. On the other side, recipient country governments with short-term horizons and in environments with weak institutional checks and balances do not necessarily internalize the full costs of excessive lending. Due to these incentives on both sides, loans too often reach unsustainable levels, with debt to GDP ratios and debt to net export revenues becoming increasingly alarming.

With increased recognition of the costs of development of unsustainable levels of official lending, debt negotiations targeting highly indebted low-income countries have become common. These negotiations have often taken place through the Paris Club (a group of 22 high or upper-middle income creditor nations, including Russia) or through the HIPC (Highly Indebted Poor Countries) initiative (e.g. Birdsall et al. 2002). These debt reduction agreements have been continuously renegotiated, offering more and more generous conditions including debt forgiveness, rescheduling of existing loan terms, and more focus on grants in the portfolios of official financing.

Of particular relevance for this note, though, are the discussions around these initiatives that illustrate the different arguments made in favor of, or against, debt relief. As brought up in Birdsall et al. (2002), critique against the HIPC initiatives came from both sides. On the one hand, some argued that debt forgiveness was just more aid "down the rathole", encouraging irresponsible policies by receiving governments (e.g. Easterly 2001), and fuelled by commercially motivated bilateral donors and multilateral institutions with misguided bureaucratic incentives. In order for aid to be effective, much more stringent conditionality was needed, and if that didn't work, stricter selectivity in terms of which governments to partner with. On the other hand, others argued that the initiatives did not go far enough (e.g. Sachs, 2002). The economic arguments largely relied on concepts of a poverty trap, impossible to escape under conditions of a heavy debt burden requiring scarce foreign exchange to be used for debt service and discouraging investments. These countries were perceived as particularly vulnerable to adverse economic shocks, and as such, in need of insurance mechanisms that wouldn't burden them with claims hampering their ability to prosper looking forward. But there was also a moral dimension, with blame focused on the creditor side, arguing that citizens of poor nations could not be burdened by debt issued for political reasons by creditors looking the other way when receiving rulers used proceeds for personal purposes.

Financing Post-war Recovery

The discussion above relates to foreign aid in general. The situation of financing post-war recovery is more specific, but past examples may give some points of reference. It should be noted, however, that every situation is unique in terms of the level of destruction, preconditions for a quick recovery, the political ramifications, and the risk of a resurgence of violence. And all these factors matter for the ability and willingness of foreign actors to step in and help.

An often-made reference in conjunction with Ukrainian recovery plans is the Marshall Plan, also known as the European Recovery Plan following World War II. Through this plan, financed by the US, initially 16 countries in Europe were getting "help to self-help" at an amount corresponding to roughly 10,5 percent of the countries' GDP at the time (roughly about $13 billion, or $138 billion in 2019 dollars). The resources were spent differently across receiving countries, depending on the level of physical destruction. Importantly, grants accounted for as much as 90% of the total resources (Becker et al. 2022). More generally, grants usually account for a more significant share of aid flows when it comes to post-war reconstruction. This is natural, as a large share of the funding typically goes to humanitarian relief, and war-torn countries tend to be saddled with debt and a low capacity to raise domestic revenues in the short to medium term given the destruction of the war.

The common reference to the Marshall Plan in the context of Ukraine is probably partly geographically motivated: it is another war in Europe. But there are also other reasons, such as the direct unprovoked aggression by one of the world's leading military powers, and the potential ramifications for world peace and the existing world order. The Marshall plan was motivated by the desire to avoid the mistakes from the peace agreements after WWI, and to help create a unified western Europe as a bulwark against further communist expansion from the Soviet Union. There are similar arguments to be made for the case of Russia's war on Ukraine.

Implications for Ukraine Reconstruction

According to World Bank statistics, the total external debt stock of Ukraine in 2020 was $130 billion in current values, or 81,4 % of Gross National Income (GNI). This is already quite high, but the war has of course completely upended the situation and the IMF argued that Ukraine was facing debt sustainability issues already by the beginning of March 2022. Public finances are in the short run facing double pressure from a steep fall in revenues as economic activity drops and the ability to raise taxes is eroded, and an increase in expenditures on defence and humanitarian relief. Looking ahead, estimates of the Ukrainian costs of the war range between $440 and $1 000 billion by end of March 2022, but there is of course high uncertainty, and the bill is increasing for each day that the war goes on (Becker et al. 2022). This could be compared to the 2021 estimate of Ukraine's GDP at around $165 billion. Even in the most optimistic scenarios, the rebuilding effort will be very costly, and will require massive amounts of foreign capital.

The sheer amount of effort needed in itself speaks to the need for grant financing. Rebuilding will require both public and private capital, and attracting new investments will necessitate an economic environment that is perceived as stable, dynamic, and conducive to long-term growth. As in the discussion on debt forgiveness for low-income countries above, such new investments are unlikely to materialize if the debt situation is deemed unsustainable. Furthermore, arguments in favor of loans over grants on grounds of fostering domestic macroeconomic responsibility and reducing moral hazard problems, fall flat when a country is invaded by an aggressive neighbor. Ukraine has had its share of bad politics, but the current situation is not caused by poor policies, lack of reform, or irresponsible lending under the assumption of future bailouts.

It should also be noted that both the Ukrainian government and representatives of the European Union (EU) have emphasized the long-term ambition that Ukraine should join the EU. This will not be possible, however, unless the country's economy is in order, including a sustainable debt level, according to EU requirements for all joining members. Were Ukraine to shoulder excessive levels of debt at this moment it would thus jeopardize this ambition. And not least, Ukraine is fighting for its survival, but the war is also part of a wider emerging struggle between democratic and authoritarian forces over the future world order. The result of the war is of great significance for all democratic countries, though it's the people of Ukraine that are facing the immediate horrific consequences. It is thus in our common interest to rebuild a prosperous and democratic Ukraine also as a bulwark against further authoritarian ambitions to change the existing world order. A Ukraine saddled with an unsustainable debt burden runs completely counter to the interests of the democratic world.

The Marshall Plan was successful in its goal "to permit the emergence of political and social conditions in which free institutions can exist". This allowed for economic and political cooperation to take roots in western Europe, also contributing to political stability and prosperity. This cooperation expanded further east after 1989 with the inclusion of new member states into the European Union, largely solidifying a move towards market-based democracy in the region (despite some recent setbacks, primarily in Hungary). Let us build on these successful examples. The current situation offers an opportunity to bring an additional 44 million people into the European umbrella of peaceful cooperation in the near future. This ambition would become much more difficult, though, if Ukraine was saddled with an excessive debt burden.

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