

FROM THE GHANA COUNTRY PROGRAMME EVALUATION

## Matching grants: a smarter way to subsidize rural finance?

**A**ccess to rural financial services is a key element of rural development and poverty reduction. IFAD and the World Bank have been developing the use of matching grants, as an alternative to subsidized credit. These grants provide a lump sum for a specific development initiative, provided that the applicant provides a matching contribution, in money or in kind. Evaluation of the first experiences of matched grants found performance to be mixed, with implementation problems such as low disbursement levels. Several questions need to be resolved, such as whether loans and grants should be managed by the same entity. However matching grants were judged to have significant potential for poverty reduction and may prove a valuable alternative to subsidized interest rates.

### Smart subsidies in rural finance

Providing credit to the rural poor can be challenging for both the lender and the borrower. This is because: (i) the poor often have no collateral to guarantee loans; (ii) market rates may be very high, either because of inefficient rural financial institutions, or limited competition; (iii) reaching a dispersed rural population leads to high operating costs.

These shortcomings have been used to justify the introduction of subsidies. However, when subsidies have been directed to reduce interest rates below market levels, the results have been poor in terms of effectiveness, efficiency, sustainability and equity. In particular, they undermine the financial sustainability of private credit schemes.

Recently, IFAD and the World Bank have been developing “smart” subsidies. To be economically viable and equitable a smart subsidy should meet the following requirements:

- The approval process should be transparent,
- Approval should be based on the personal characteristics of the applicant (e.g. income, gender, household assets), rather than on repayment capacity (as for a loan),
- Investments should be cost effective (the return of the investment should be higher than the amount to be repaid),
- Distortions to market prices should be minimized: the subsidy should be used to purchase goods and assets rather than to artificially reduce interest rates,

- The subsidy should be administratively efficient, with low administrative costs and straightforward implementation.

A matching grant is a form of smart subsidy that provides a lump sum to an applicant to a credit (an individual, a household or a community) in order to implement a specific development initiative (e.g. digging a well, building a health clinic, establishing a tree nursery) under the expectation that the applicant will also contribute in money or in kind. In Ghana, IFAD and its partners have used matching grants to support the financing of investments by smallholder farmers and poor rural entrepreneurs.



A garden near the river bank in the Upper West region.

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## First experiences in Ghana

IFAD and the World Bank first introduced matching grants in the context of a pre-existing cofinanced intervention, the Village Infrastructure Programme. Despite pressure to subsidize interest rates, it was opted to use matching grants. Smallholder investments were financed by three sources: (i) an individual contribution of equity by the applicant, (ii) a loan from a financial institution at market interest rate; (iii) a matching grant provided by the project to help purchase assets or goods (for example machinery for food processing). The role of the matching grant was to reduce the proportion of the investment to be financed through a loan. This was expected to reduce the risk for both the borrower and the lender and encourage lending to rural poor clients without artificially lowering interest rates. This model was later extended to other projects supported by IFAD in the areas of rural enterprises, roots and tubers, cereals, and vegetables.

The Ghana country programme evaluation, conducted by IFAD's Independent Office of Evaluation, validated the rationale for matching grants but found that their performance had been mixed. Disbursement rates were low and this was partly because rural financial institutions remained conservative in their lending to agriculture and to poor clients. These institutions also suffered from liquidity constraints, a problem which had received limited attention during the project's design.

## Questions and challenges

Several questions and challenges merit further analysis and reflection:

**Should loans and grants be managed by a single institution or by two separate entities?** Some practitioners argue that, if the same rural financial institution is in charge of channelling both the loan and the matching grant, borrowers may be confused and erroneously assume that the entire amount is a grant and that the loan component does not need to be repaid. Although this principle has some justification, experience in Ghana has shown that a dual approval process can create administrative inefficiency, and be prone to political interference. It also creates a risk for the borrower: during evaluation, cases were found where the loan was approved by a financial institution but the matching grant was delayed or failed to get approval by a separate institution. The borrower was unable to complete the investment but still had to pay for his/her debt, leading to a financial loss. This suggests that management of both the loan and the matching grant by a single institution is a more practical solution.

**What should matching grants be financing?** Matching grants seem more suitable for financing fixed capital

Note:

The contribution of William Steel, Adjunct Professor, University of Ghana, in reconstructing the "history" and rationale of matching grants in Ghana, is acknowledged.

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### Further information:

Republic of Ghana Country Programme Evaluation, Report No. 2433-GH, May 2012, ISBN 978-92-9072-313-4, Independent Office of Evaluation of IFAD, Via Paolo di Dono, 44, 00142, Rome, Italy. The full report, Profile and Insights are available online at [www.ifad.org/evaluation](http://www.ifad.org/evaluation); email: [evaluation@ifad.org](mailto:evaluation@ifad.org).

(e.g. equipment), rather than working capital (e.g. salaries, fertilizers), the amount of which can be more easily financed by ordinary bank loans. Grants for working capital may be justified if there are public goods considerations (e.g. purchase of improved seeds) and an exit plan.

**Rural financial institutions may still be reluctant to finance medium-term investments.** Typically, their savings deposits are short-term. For this reason, rural banks may still need some dedicated credit line support.

**Are matching grants facilitating access by very poor clients?** This is one of the expectations of a matching grant subsidy but more evidence is required from impact studies to show whether this is the case.

## Are matching grants a smarter way to subsidize

In spite of the operational limitations encountered so far, the country programme evaluation found that matching grants have significant potential for poverty reduction. If implementation shortcomings are addressed, they may prove to be an effective instrument for persuading policy makers that financial subsidies do not need to take the form of subsidized interest rates. IFAD and the World Bank have been active in promoting the negative consequences of subsidized interest rates. They have held workshops and sensitization campaigns on this subject. Through the Rural Financial Services Project, they have also supported the preparation of a national microfinance policy which discourages this practice. Yet subsidized credit programmes still persist. If proved viable, the matching grant model may help move subsidies away from such artificial reduction of interest rates, by providing a better alternative.



**A farmers' group specializing in horticulture in Northern Ghana.**

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