Smart Subsidies and Financing with the Private Sector

Private Sector Engagement Toolkit - Tip Sheet #13:

There are circumstances when Mercy Corps provides funding or financial support – *subsidies* - to a business or other private sector partner with the goal of spurring investment and activity. *Smart Subsidies* are funding that encourages private businesses or lead firms to do something they otherwise would not do at this time because the activity is too risky, but also ensures we do not provide any more support than is necessary.[1]

Why do we fund a firm?

- Demonstrate viability of a new product or service, often part of a pilot or incubation phase.
- Buy-down risk for the private sector to introduce a new product or expand to a new geography. Smart subsidies can also encourage behavior change on the part of a private sector partner.
- Absorb program costs the private sector would not support that are essential for program success.
- Encourage uptake of a product by a targeted population and thereby increase demand.

How do we provide funding?

- Investments in private business that enable Mercy Corps to take an ownership stake in that entity, typically done when we want to hold a share in the business, when adequate private financing is unavailable, or when the private sector is unwilling to invest due to perceived risk.
- Grants made directly to the private sector, either directly to private businesses or to MFIs to encourage their lending to MSMEs and program participants.

Where do the funds come from?

- Grantor funds provided by institutional or foundation donors or other individuals that pass through us directly to private sector partners. Sometimes these are part of general funding for a specific program; other times they are targeted solely to a designated private business.
- Investment funds from angel or impact investors who partner with Mercy Corps to put funds into firms. These funds may go directly from the investor to the firm or pass through Mercy Corps.

What are the development challenges with directing funds to a private sector partner?

- Market distortion can result if the subsidy favors one market actor or sector beyond what is necessary to encourage a private business (or lead firm) to act in way they otherwise would not. All subsidies will help those participants over firms that do not get the subsidy but this can be justified if the positive impact on the market/target group will be greater than the negative impact on competing firms.
- Aid dependency can result if subsidies are not used sparingly and thoughtfully, such that a program can be ultimately scalable and sustainable without the subsidy.

Market distortion and aid dependency are closely linked and poorly designed subsidies often impact both issues simultaneously.

What are other important considerations?

- Implicit subsidies such as technical support or use of Mercy Corps resources can also build unsustainable dependency among partners. They should be included as part of the subsidy calculation.
- Funder restrictions may limit what and how we support private businesses through sub-grants and investments.
- Understand compliance and talk to your legal team! Whenever considering an equity investment or exploring a joint venture with a private business, it is essential to review the investment arrangements with your Legal Services Team and the Finance and Compliance Support Unit.

CONTACT

Mercy Corps Global Headquarters
45 S.W. Ankeny Street
Portland, OR 97204
503.896.5000
800.292.3355

Ted Volchok
Senior Advisor, Economic and Market Development
tvolchok@mercycorps.org

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[1] Adapted from AFE, Field Facilitation Working Group, cycle 3 report