Occasional

Analytical Note

FEBRUARY **2023**

Financing Infrastructure Deficit: Development and Finance Nexus

Prepared by:
Mr. Rets'elisitsoe Mabote
Head Statistics
Department of Research
Central Bank of Lesotho

Outline

A. Introduction....1
B. Infrastructure Financing....1
C. Financing 2023/24 Capital Expenditure....2
D. Available Financing Options....3
E. Domestic Resource Mobilisation as an aid to Financial Markets Development....3
F. Challenges to Financial Markets....4
G. Recommendations....4

A. Introduction

The African Union (AU) Program on Infrastructure Development for Africa (PIDA) claims that Africa losses billions of dollars annually due to infrastructure inefficiencies. To address that, the African Political leadership resolved to setup PIDA to promote socio-economic development and poverty reduction in Africa through improved access to integrated regional and continental infrastructure networks and services. Infrastructure is one of the key considerations used to attract investment.

The key infrastructure needs may be categorised into ease of movement or accessibility and production facilitation. Those concerned with ease of movement and or logistics are in transport facilities, such as, roads networks, railways, harbours (ports) and airports, whereas, those concerned with production include access to stable power, water reticulation and telecommunication.

Lesotho faces deficit in a wide array of infrastructural provisions, as observed in the National Strategic Development Plan (NSDP). This situation was partially addressed during the construction of Phase I of the Highlands Water Projects as auxiliary components. However, majority of places, especially those in the Highlands, remain inaccessible by road, they lack water and sanitation, and they are excluded from electricity and telecommunication connectivity. The terrain makes it extremely expensive to provide infrastructure, the situation that is worsened by the limited financial resources.

This brief identifies available options government may adopt to ensure separate funding mechanisms for provision of infrastructure and its maintenance. This is in addition to the proposed fiscal rules which aim to contain government expenditure to a sustainable level. The initiative will also serve to catalyse development of domestic financial markets, which will curb illicit financial flows.

B. Infrastructure Financing

Infrastructure financing carries high initial cost, with returns taking much longer to be realised. These investments are classified by stage of development that comes with different levels of risks (World Economic Forum, 2014). For instance,

- *Greenfield* is defined as a new construction which is considered to carry higher risks, while;
- *Brownfield* is maintenance requirements on the existing infrastructure with high demands.

As a result, infrastructure investment is usually not lucrative to private investors because they have to honour their investment obligations. Consequently, governments are obliged to take up the responsibilities of financing creation and ownership of the assets. Therefore, government mostly finances infrastructure through annual budgetary appropriation process in majority of developing countries. This method, though not sufficiently funded, is credited with having a higher level of transparency and public scrutiny through parliamentary oversight committees compared with other government financing vehicles. Annual budget allocations are often faced limited to political commitments plus dire needs for social services.

Governments are faced with social challenges, such as, aging education and health facilities, high unemployment rates, coupled with, diseases. As a result, government resources are overstretched to meet the ever growing socioeconomic needs. To address these phenomenal, governments have instituted fiscal rules to manage within available financial resources. This makes it difficult to accommodate any expansion in government budgetary operations. Consequently, these are constraints on infrastructure investment from budgetary processes, coupled with political pressures to undertake particular investments irrespective of appropriate cost-benefit analysis.

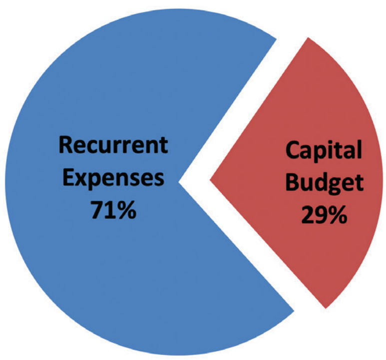
The African Union Agenda 2063 recognised financing as key ingredient to its successful implementation to realise socioeconomic emancipation. This is further corroborate by the UN 2030 Agenda for Sustainable Development that has encouraged Member States to establish funding that will facilitate smooth implementation of national programmes, while realising the global and continental commitments. It is, therefore, imperative to establish funds exclusively for infrastructure financing to ensure that social activities will not be compromised as governments navigates to meet external commitments.

C. Financing 2023/24 Capital Expenditure

Government budget has and remains biased towards recurrent activities, as depicted in figure 1 below. The recurrent budget, including its projections for the three years to 2019/20, averaged 70 per cent of total budget. This means there was only 30 per cent available to put up infrastructure, including that associated with social needs, such as education and primary healthcare. For that reason, there is little or no provision for infrastructure provision and maintenance. It is either provision of priority infrastructure, while the existing deteriorates to a level where replacement becomes absolutely cheaper than maintenance.

Government of Lesotho has and continues to finance about 63 per cent of capital budget from tax revenue (own resources); the remaining 37 per cent is split between capital grants and loans from international financiers. This situation is projected to obtain for the remainder of the Medium Term Budget period to 2023/25.

Figure 1: Distribution of Government Budget



Source: Budget Speech 2017/18

The 2017/18 capital budget prioritised maintenance of health facilities and other government assets built through the Millennium Challenge Account (MCA). Similarly, it proposed construction of water supply and sanitation facilities in the urban and rural areas to address the chronic shortage of portable water. This was in addition to construction of roads and aviation infrastructure, which is regarded as the backbone for connectivity and mobility of people from both remote and urban areas of the country. Specifically, this proposed rehabilitation of Moshoeshoe I International Airport by rehabilitating the terminal building, and improving the aeronautical ground and apron lighting. However, very little was achieved against those set targets. The subsequent budget had to deal with combating the scourge of COVID-19 and its effects on the livelihoods. This took all government resources, safe for the essential services. The current budget, therefore, is seen as the need catalyst to reconstruction and recovery from both COVID-19, and the consequences of the Russian invasion of Ukraine.

D. Available Financing Options

The current budget has earmarked development component from SACU revenue to finance infrastructure projects. However, this may likely be absorbed in annual activities due to higher fiscal deficits. Available options to finance development projects have always been:

a) Concessional loans from the Multilateral Organisation: this is one option that has since evaded Lesotho as the country has official been classified as a low middle income country. As a result, external debt will be relatively more expensive, with repayments amounts unpredictable since both interest rates and foreign exchange rates are market determined.

b) Foreign Direct Investment and foreign aid: these are tied to the objectives of foreign investors and in some cases, foreign policies of donor countries. They also create donor dependence as they involve significantly large amount of recurrent activities including human resources that lives on the associated cash receipt.

c) Public-Private-Partnership Arrangements, (Design-Build-Operate): the operator maybe paid a lump sum for completed stages of construction and then receives an operating fee. The other common option is “the project financing”, also known as “limited recourse” or “non-recourse” financing (World Bank, 2016). The operator finances construction and retains the right to operate the facility for a specified duration, through which government repays construction and operating costs.

E. Domestic Resource Mobilisation as an aid to Financial Markets Development

The above options may not be desirable for Lesotho given that they mostly subject governments to some kind of ransom. Infrastructure financing is about mobilising a stable and predictable base of financial resources that can largely be achieved through domestic financial resources. Domestic Resource Mobilisation offers the advantages of greater domestic policy ownership and greater coherence with domestic needs.

It must, however, be noted that the problem of infrastructure financing is not only about mobilising domestically-generated financial resources, but also about leveraging and intermediating those resources for productive investments, as well as social, inclusive and sustainable development. Lesotho needs not remain behind in terms of financial development, but more effective superstructures for mobilising and channelling those funds. This includes financial institutions and markets, financial instruments, as well as, financial services.

The country has recently established a stock market. However, reception has been minimal, probably because majority of financial players already enjoy their placements with institutions based in South Africa. It is, therefore, imperative to emphasise on domestic resource mobilisation, cautiously not to crowd out the private sector, and at the same time, not to overburden government with expensive domestic debt, but to leverage potential instruments through appropriate legislation that the private sector can tap into to finance their expansion desires. This is premised on the observable high liquidity in the local banking sector.

F. Challenges to Financial Markets

Lesotho's financial sector is dominated by companies that are headquartered in South Africa. They mainly place their excess liquidity with their parent companies and retain little for operational purposes. As a result, their motive of operating in Lesotho may be interpreted to be profit maximisation at the expense of market development. This largely explains the low level of development of the sector with limited product range compared to what obtains elsewhere. They offer minimum product mix to hedge against any potential growth of expenses, and lack project development capacity to sponsor local economic activities.

The locally owned firms have limited financial capacity and access to international capital market due to poor infrastructure, and to some extent, large amount of capital required to finance infrastructure projects.

G. Recommendations

In order to manage the volatility of the SACU revenue and keep recurrent expenditures at sustainable levels, GoL has been advised to adopt fiscal policy rules. This was meant to insulate government revenue from the SACU revenues volatility in order to deliver government commitments as provided for in the National Strategic Development Plan.

For that reason, and in support of Government intentions to explicitly use development component of SACU revenue for infrastructure financing, this brief proposes establishment of the **Infrastructure Development Fund,** which can be built from the following sources:

a) Tax Revenue: section 3 above has established that 19 per cent (63 per cent of Capital Budget) total budget allocated to development projects is sourced from tax revenue. This could be maintained to build and smoothen infrastructure investment fund.

b) Pension Assets: Pension fund is one of the lubricants to investment. Given the relative level of financial development in the country, the funds could be used for development of domestic capital markets which could also build this fund, with competitive remuneration.

c) Mineral Earnings: Diamond mining continues to grow, with exploration for other minerals on pipeline. Earnings from exportation of these minerals could form part of the fund, mainly to facilitate construction of infrastructure to facilitate accessibility.

d) Diaspora Remittances: Economic integration is inevitable, as people move to other parts of the world in search of livelihoods. Some of Basotho now reside in Americas, Europe, Asia, Oceania and of course the mother continent, with South Africa hosting majority. Therefore, efforts could be made to utilise diaspora remittances as one of the sources of build the proposed fund, using the experienced garnered during management of remittances from migrant mineworkers.

e) Private Equity Market: Lesotho's equity market is underdeveloped. Deliberate policies could be in place to facilitate development of the market, with technical assistance from international financiers.

f) Illicit Financial Flows: Due to low level of market development, coupled with the CMA arrangements, Basotho have limited options to keep their surplus savings. As a result, there is potential for high illicit financial flows which could easily self-rectify with appetising options domestically.

H. References

1. Adeoye, B. 2014. Maximising the 'Beyond Aid' approach: Mobilising domestic financial resources for Africa's transformation. GREAT insights Magazine, Volume 3, Issue 8. September 2014.
2. African Union Commission, "Programme for Infrastructure Development in Africa (PIDA)", https://au.int/ie
3. Central Bank of Lesotho, (2015), Fiscal Policy Rules in Lesotho: A Case of Volatile SACU Revenue, Policy Brief to the Honourable Minister of Finance, Unpublished.
4. Hon. Moeketsi Majoro, (2017) 2017/18 Budget Speech to Parliament, www.gov.ls
5. NEPAD, (2014), Mobilising Domestic Financial Resources for Implementing NEPAD National and Regional Programmes and Projects – Africa Looks Within, NEPAD/UNECA Report.
6. Office of the Special Advisor on Africa (2015), Financing Africa's Infrastructure Development, Policy Brief, www.un.org/.../osaa/pdf/policybriefs/2015_financing_infrastructure.pdf
7. World Bank Group, (2016), "Main Financing Mechanisms for Infrastructure Projects" https://ppp.worldbank.org/public-private-partnership/financing/mechanisms
8. World Economic Forum, (2014) Infrastructure Investment Policy Blueprint, www3.weforum.org/ docs/WEF-II/Infrastructure-Investment-Policy-Blueprint.pdf

Central Bank of Lesotho, Corner Moshoeshoe
and Airport Roads, Maseru 100