CHAPTER 5

SUSTAINABLE FINANCING OF THE RISDP

5.1 INTRODUCTION

The RISDP is a long-term development strategy for economic growth and development and requires major commitment of sustainable financial and human resources. This chapter addresses the financing mechanisms available to SADC as well as the policy framework necessary to mobilise funding for the RISDP.

SADC's financing requirements can be divided into financing for SADC's coordination function and financing for development activities.

SADC's coordination function is financed mainly through membership contributions, which from 2003/2004 financial year will be based on the proportional contribution of each Member State to the combined SADC Gross Domestic Product (GDP). International Cooperating Partners also contribute to the SADC operational budget. SADC is also exploring the feasibility of other self-financing mechanisms for its operational budget.

The financing of SADC development activities is relevant to explore for the purpose of financing the implementation of the RISDP. The analysis will focus mainly on the following potential sources of finance and financing mechanisms for development activities:

Financing for Development in SADC:

- Public finance
- Official development assistance (ODA)
- Debt relief
- Domestic savings
- Foreign direct investment (FDI) and portfolio investment (FPI)
- Development Finance and the DFI network

Financing Mechanisms for Financing Development

- Public-private partnerships (PPPs)
- Domestic financial and capital markets
- Private equity and venture capital
- A SADC Development Fund

5.2 FINANCING FOR DEVELOPMENT IN SADC

5.2.1 PUBLIC FINANCE

In order to implement RISDP at a national level it will be imperative for Member States to improve on their public finance mobilisation, expenditure and management systems. While the mobilisation and utilisation of public funds for development occurs at the national level, the development of strategies and policies to improve public finance management and allocation systems across the region and to harmonise approaches, if coordinated at a regional level, will harness greater returns by helping to lower transaction costs across a larger market. This will encourage private savings, investment, exports and growth and will make the region an attractive destination since the private sector will be able to count on relatively constant prices and interest rates in all SADC countries.

STRATEGIES

a) Maintenance of macroeconomic stability

There is need to create and sustain macroeconomic stability by managing the macroeconomic fundamentals as envisaged in the SADC MOU on Macroeconomic convergence.

b) Public Financial Management

There is need to improve public financial management through fiscal prudence and financial discipline, and avoid financial imbalances. Member States would need to implement capacity building programmes in public finance management.

c) Fiscal Management

There is need to develop mechanisms for increasing revenues through strengthening tax administrations to efficiently collect taxes and to broaden the tax net. This will require development and implementation of programmes to strengthen the capacity of Member States.

d) Good Economic Governance

Good governance, including accountable and transparent public resource management, is fundamental in establishing credibility that will attract investment resource flows. NEPAD has identified and prioritised codes and standards for achieving good economic and corporate governance. In this context, harmonisation of best practices in accounting and auditing standards across the region for sound public financial management is an imperative. Member States are encouraged to implement the programme of harmonisation of auditing and accounting standards coordinated by the Eastern, Central and Southern African Federation of Accountants (ECSAFA).

5.2.2 OFFICIAL DEVELOPMENT ASSISTANCE

Although official development assistance has been declining and averages about 0.24% of industrial country GDP it remains one of the important sources of finance for the implementation of the RISDP. NEPAD can play an important role in persuading industrial countries to increase the level of ODA to the recommended 0.7% of their GDP.

The absorptive capacity of SADC in the utilisation of ODA resources will have to be addressed. NEPAD identifies several constraints including good governance (political, economic and corporate).

STRATEGIES

- Development and implementation of capacity building programmes at national level in the debt management, strengthening public budgeting and financial management and effective absorption of donor assistance.

- Work through NEPAD and other fora to mobilise and increase the level of ODA to 0.7% of industrial countries' GDP, reform the aid-delivery system to ensure domestic ownership by recipients and improved coordination with recipients' domestic priorities, and to streamline the fragmented delivery system.

- Work through NEPAD and other fora to reform ODA relationship including the setting up of mechanisms by recipients to engage OECD/DAC and other donor structures.

5.2.3 DEBT RELIEF

Unsustainably high external debt has indeed become a key constraint to development. Debt relief is an important part of a comprehensive strategy to create the basis for sustained growth and poverty reduction. The Heavily Indebted Poor Countries (HIPC) Initiative is the international response to provide comprehensive debt relief to the world's poorest and heavily indebted countries. The Enhanced HIPC Initiative is based on three key elements: deeper and broader debt relief, faster debt relief, link between debt relief and poverty reduction.

The resources made available as a result of debt relief initiative are a potential source of finance for the implementation of regional development programmes including the RISDP.

STRATEGIES

- Strengthening debt management capacity of Member States, particularly the HIPC countries in the area of coordination between debt and macroeconomic policies, implementation of debt strategies that are consistent with the objective of long-term debt sustainability, legal and institutional frameworks for debt management; and human and other capacity constraints.

- Promoting the development and application of standards in areas such as financial reporting, accounting and auditing, and improving the tracking and effectiveness of budget expenditures, including those associated with HIPC.

- SADC could through NEPAD and other fora lobby for enhanced debt relief and encouragement of creditors outside the HIPC Initiative to participate in this framework.

5.2.4 DOMESTIC SAVINGS AND INVESTMENT

Savings and investment are central determinants of the rate and pattern of economic growth. In increasing domestic savings and using the resources in productive domestic investments SADC economies will strengthen the region's prospects for accelerated economic growth, poverty eradication and sustainable development.

With regard to increasing domestic savings, fundamental conditions include the sound management of macroeconomic and budgetary polices. Furthermore, well developed and functioning financial markets and systems encourages savings. Effective protection and security of deposits for the general public through government regulation increases the tendency to save.

The region is characterised by large informal sectors whose activities and assets are unrecorded and which are also fragmented and/or segmented in terms of financial markets and services. Part of the problem stems from the high transaction costs of the private banking and non-banking institutions to provide financial services to the informal sectors, including emerging entrepreneurs, and poor households.

STRATEGIES

- Governments can through appropriate financial regulatory mechanisms create the conditions for sound financial institutions and thereby improve the public trust in the financial institutions such that the public feels secure to place their savings with domestic financial institutions. For this purpose, further progress in harmonising policy, legal and regulatory frameworks at the regional level should be encouraged.

- Financial institutions should be encouraged to provide a fuller spectrum of financial services to households in both the formal and informal sectors as well as in both urban and rural settings. For this purpose, they could develop and implement programmes to encourage household savings such as through (i) revisiting minimum deposit levels and discretionary administrative fee structures in order to encourage small savers to use the formal financial sector institutions; and (ii) advertising campaigns.

- Government should encourage, directly and indirectly, the development of the microfinance sector to provide sustainable finance for the informal sector and financial services to the poor. On a regional level, Member States should be encouraged to exchange information on best practices on policy and regulatory frameworks for microfinance.

- Harmonisation of policies and regulatory frameworks at the regional level should be encouraged in order to create a larger market for microfinance industry.

- TARGET

- Increase the ratio of gross domestic savings to GDP to 20% and the ratio gross domestic investment to GDP to 25% by 2015.

5.2.5 FOREIGN DIRECT and PORTFOLIO INVESTMENT

Efficiency- and market-seeking foreign direct investment flows into SADC remain small, as the region has not as yet succeeded in attracting these types of investments into the region. Fast tracking market integration to overcome the small size of the national markets and limited effective demand is essential. Similarly, efficiency-seeking investment requires adequate and efficient infrastructure services, a workforce with skill levels that allow for timely and cost-efficient production and delivery of goods to international markets, supported by liberal trade policies and easy access to the export markets.

The most important development in international financial markets has been the increasing integration of world capital markets. Integration into global markets brings potential benefits in terms of increased market efficiency, access to the worldwide allocation of savings, speeding up of the process of financial innovation, the development of ways in which countries can hedge their economies against asset-price instability, and allowing for greater depth and liquidity of financial markets, as well as increased access to foreign capital.

Foreign portfolio investment (FPI) is another potential source of finance in the implementation of the RISDP. FPI complements rather than substitutes FDI. Larger and liquid financial and capital markets attract FPI, which is complementing FDI flows.

STRATEGIES

Attracting foreign investment in a highly competitive environment requires that the region should be able to offer investment opportunities with a relatively higher return given a certain level of risk, or alternatively, a lower risk associated with investments providing a certain rate of return. What do investors expect to see when determining whether SADC has an attractive enabling investment environment?

- Stable and predictable political environment; macroeconomic stability; favourable regulatory environment; quality of economic infrastructure; competitiveness of the regional market; qualified human resources; efficient financial markets; investment protection against expropriation; and transparent legal system.

- Integration of the national financial and capital markets to create larger regional financial and capital markets with higher liquidity level. The development of the SADC Protocol on Finance and Investment will provide a legal and policy framework for the integrated regional financial and capital markets.

- Harmonised investment regime and business environment.

5.2.6 DEVELOPMENT FINANCE AND SADC DFIs

Development finance can play an important role in the implementation of the RISDP and eradication of poverty in the region. Development finance usually pertains to financing for investments in revenue-generating activities. It also makes a distinction between capital and recurrent expenditure with the application of development finance largely being confined to the initial capital outlay and the first cycle of working capital requirements, with future recurrent costs being covered through internal cash generation from the project or enterprise or through commercial working capital arrangements.

SADC Development Finance Institutions (DFIs) can offer a range of financial services in the implementation of the RISDP including long-term capital for development projects to stimulate industrial development, promote entrepreneurship and private sector development, capital market development and trade finance.

SADC DFIs through their Network have agreed to collaborate to:

a) Mobilise financial and human resources for sustainable development and investment and trade finance projects in SADC, and where their establishment agreements and national legislation permit, to consider issuing bonds for balance sheet lending and cross-share holding;

b) Harmonise and apply international best practice credit risk management policies, procedures and methodologies in the appraisal and approval of cross-border and other sustainable and commercially viable investment and development projects;

c) Cooperate in financing investment projects in SADC, and where their establishment agreements and national legislation permit, to explore, *inter alia*, the use of co-financing, syndication, subordination, or other structured finance arrangements.

The proposed measures or strategies will encourage risk-taking and sharing by DFIs in cross-border lending and hence facilitate greater flow of funds into the regional development activities.

STRATEGIES

- The creation of an enabling regulatory environment for purposes of developing vibrant financial and capital markets in the SADC;

- The granting of preferred creditor status to DFIs that are engaged in cross-border lending;

- In the event of unsecured lending to a Member State government or public entity, to rank the obligations towards a DFI Network member under a rescheduling agreement or in the event of insolvency of that entity, *pari passu* with all its other unsecured external debt;

- The acquisition of an international credit rating for each SADC country and for DFI Network members should be encouraged.

TARGETS

- Implementation of the MOU of SADC Development Finance Institutions and the programme of the DFI Network.

- Capacity building in Member States and in DFIs to acquire international credit rating status.

5.3 FINANCIAL STRUCTURES AND MECHANISMS FOR FINANCING DEVELOPMENT IN SADC

5.3.1 PUBLIC-PRIVATE PARTNERSHIPS

Public-private partnerships (PPPs) are effective financing mechanisms for both national and regional development activities, especially infrastructure projects. In this respect, the availability of development finance over the medium-term is considered an important ingredient in ensuring:

- Materialisation of such PPP initiatives,
- Developing PPP projects;
- Undertaking financial structuring and packaging of projects;
- Mitigating the risks confronting PPP activities and projects.

STRATEGIES

a) PPP Policies, Strategies and Regulatory Frameworks

Member States need to develop and implement policies and strategies on PPPs and market these to key stakeholders including potential investors. Member States need to create legislative frameworks conducive for the development of PPPs. A transparent regulatory framework on PPPs is essential including the pricing of services and exit regulations for the private sector. Harmonisation of such regulatory frameworks, policies and strategies at the regional level will create a larger PPP market space and attract PPP oriented investments.

b) Re-balancing public-private sector production and ownership

Private sector development and restructuring of State Owned Enterprises would stimulate capital market development and increase liquidity in the market. It also stimulates participation of the private sector in the economy, especially in productive areas.

c) Promotion of Public-Private Partnerships in the provision of infrastructure and other services

Improve the provision of infrastructure services (telecom, energy, transportation, water and sanitation) either through better public provision of services or through effective PPPs.

d) Capacity Building for PPP Development

PPP units or agencies are essential to implement PPP policies and programmes. Development of PPP skills is a key ingredient in the capacity building programme for PPPs promotion.

e) PPP Options

PPP policies and strategies should allow consideration of a full range of PPP options in order to ensure optimal choices depending on the situation at hand, including:

- **Lease Contracts**: A private company rents facilities from a municipality and assumes responsibility for operation and maintenance. The lessee finances working capital and replacement of capital components with limited economic life and fixed assets remain the responsibility of the public partner.

- **Concessions**: A private company handles operations and maintenance and finances investments in addition to working capital of a public partner. The public partner exercises a regulatory and oversight role and receives a concession fee for this arrangement.

- **Build-Operate-Transfer or Build-Own-Transfer (BOT)**: A form of concession with an emphasis on construction of new, stand-alone systems and comes in several variations.

- **Corporatisation**: A government entity forms a separate legal corporate entity to manage service provision. These corporate entities often referred to as "utilities," involve partnerships in the sense that government creates a separate, contractual "partner".

TARGETS

- Creation of Public-Private Partnership Units and capacity building thereof in Member States by 2005.

- Development of PPP policies, strategies and guidelines in Member States and harmonisation of PPP regulatory framework at the regional level by 2007.

- SADC countries will need to shift from 100% reliance on public finance for physical infrastructure to a 70:30 ratio of public-to-private finance by 2010 and a 50:50 ratio by the year 2015.

5.3.2 SADC FINANCIAL AND CAPITAL MARKETS

The presence of well-developed and robust financial systems will increase flows of foreign investment into the region. However, the SADC region has a narrow range of intermediaries and limited financial instruments. The lack of liquidity, due to the limited number of market participants and the low market capitalization also poses a barrier to investment in securities, as it is difficult to determine a market price for an investment in an illiquid market and the investment risk increases owing to the additional risk that the investor may not be able to dispose of the investment at the expected price.

The SADC Committee of Stock Exchanges is an initiative to fast tract the development of capital markets in the region by improving the liquidity of trade in equities, bonds, derivatives and other financial instruments in Southern Africa, so as to raise capital for regional economic development and to make the SADC securities markets more attractive to local and international investors. The Committee's strategy is to keep national markets autonomous and to find ways of using technology, skills-sharing, dual-listing and cross-border investment within the SADC to accelerate development of a regional capital market. The vision is to have established an integrated real-time network of the region's national exchanges by the year 2006. This initiative should improve the liquidity and attractiveness of small national stock exchanges.

STRATEGIES

a) Harmonising and achieving best practice in the Policy, Legal and Regulatory Environment.

Harmonising the policy, legal and regulatory framework for managing financial and capital markets is critical. Implementing best practice in adopting the policies and laws for dealing with financial regulation.

b) Promote broader participation by the population in equity markets through the restructuring of State Own Enterprises and other empowerment mechanisms.

Governments can encourage the participation of the population in equity markets through the restructuring of State Owned Enterprises by offering part of the equity to the broader section of the population at a discount. Governments can also encourage private sector to spread the participation in shareholding to a broader section of the population whenever there is an initial public offering (IPO).

TARGETS

- Full implementation of the MOUs and programmes of CCBG, DFIs, CISNA, Stock Exchanges, Banking Association.

- Development and implementation of programmes and strategies to increase the participation of the broader population in the equity markets by 2008.

5.3.3 PRIVATE EQUITY AND VENTURE CAPITAL FUNDS

Private equity provides equity investment (risk capital) to enterprises not quoted on a stock market. It is used in developing new products and technologies, to expand working capital, to make acquisitions, or strengthen a company's balance sheet. Private equity also resolves ownership and management issues: a succession in family-owned businesses, or management buy-out or buy-in (MBO/MBI). Venture capital, which is a subset of private equity, provides equity investment (risk capital) for early stage of business development including seed or launch, start-up, and early expansion.

The recent direction in private equity and venture capital is the development of transnational private equity funds where institutional investors to the fund come from various countries and the fund's mandate is to invest in different countries or regions. The infrastructure funds provide one example of transnational private equity funds with a mandate to invest in infrastructure in developing countries or emerging market economies.

a) Private Equity and Venture Capital Funds

The main forms of venture capital finance are business angels, entrepreneurs' own sources, friends and relatives, corporate venture finance and government sources.

Business angels: Business angel capital is equity investment in new and unquoted businesses by individuals acting on their own or as part of informal syndicates. Business angel capital complements the venture capital industry by providing smaller amounts of finance capital at the earlier stages than most venture capital are able to invest. This form of capital takes the investee business to the point at which it is attractive to a venture capital firm. Creation and strengthening of business angel networks is an important step in the development of a venture capital industry.

Corporate venturing: Corporate venturing is a new but increasingly important phenomenon in venture capital where public or private firms provide equity investment in new businesses outside their activities and spinout independent firms. It is one of the useful growth tools for growth oriented companies and has a potential to invigorate economic growth. Private corporate venturing responds to market forces, while public corporate venturing may require government direction and support.

- Corporate venture capital may involve passive investment in technologies and business activities outside the venturing firm to monitor growth ahead of acquisition.

- The second option of corporate venturing entails investing in ideas that spring from within the venturing firm. Such investments are active and aimed at building new, independent businesses that relate back to the core business of the venturing firm.

Government venturing: The traditional role of government in promoting venture capital has been indirect through creating the fiscal and legal framework to assist the market channel resources to new and innovative enterprises, that is establishment of an environment conducive for venture capital development. In the new role government is a venture capitalist itself by providing direct supply of risk capital in the form of:

- Government equity investment (matching funds)
- Government loans (low interest facilities)
- Loan guarantee facilities (guarantee of institutional loans)
- Equity guarantee facilities (guarantee of institutional equity)
- Tax incentives (tax credit)
- Investor regulations (institutional investors)

b) Infrastructure Funds

There are various infrastructure funds sponsored by international development agencies and regional institutions that are a potential source of finance for the implementation of the RISDP. These funds make equity or debt investments particularly in infrastructure projects. Examples include:

- Comafin Fund

The Comafin Fund is an initiative by Commonwealth Heads of Government to create a new source of risk capital for commercial and infrastructure investment in Africa. This investment was designed to improve capital market development in the region; give practical support to regional integration; and facilitate new direct foreign investment flows into the region.

- AIG Africa Infrastructure Fund (AAIF)

This fund involves the setting up of a Pan-African equity fund for infrastructure investment, with a strong SADC focus. It will invest in equity and quasi-equity and convertible debt instruments in private sector infrastructure projects. The Fund has a mandate to invest in continental Africa, however its focus at present is on those countries where economic reforms have been implemented, or are being implemented and where there is a high level of political stability, good economic growth prospects, and where the necessary mechanisms exist to facilitate the Fund's exit strategy.

- Emerging Africa Infrastructure Fund (EAIF)

Emerging Africa is a recently established facility originally proposed by the UK's Department for International Development (DFID). Emerging Africa will make long-term debt financing available for private sector infrastructure companies in Sub-Saharan Africa. It is managed by Standard Infrastructure Fund Managers (Africa) Limited, a Standard Bank Group, Netherlands Development Finance Company and Emerging Market Partnership joint venture.

STRATEGIES

- Development and maintenance of a private equity and venture capital infrastructure including legal and regulatory framework, and government support to venture entrepreneurs.
- Promote development of venture capital industry associations at regional and national levels to lead the creation of a conducive environment for development of a venture capital culture.
- Promote business angel networks at the regional level to facilitate investment by individuals in the region.
- Encourage development and implementation of pro-venture capital legal framework and taxation policies to facilitate structuring of venture capital funds.
- Development and maintenance of a comprehensive database on regional and international funding mechanisms which can be accessed by Member States on a bilateral basis or through a regional window for the implementation of RISDP projects.

TARGETS

- Establishment of a venture capital infrastructure in Member States including venture capital business associations, business angel networks and legal and regulatory frameworks by 2008.
- Development and implementation of programmes to promote venture capital including business angels, corporate and government venturing by 2008.
- Publication of a compendium of regional and international funding mechanisms with a potential to support RISDP activities by 2005.

5.3.4 A SADC DEVELOPMENT FUND

A feasibility study is underway to advise Member States of the desirability and viability of establishing a SADC Development Fund in support of its regional development objectives. The important issues for regional integration are potential asymmetrical benefits and costs of regional integration in terms of resource flows, the need to provide sustainable finance for SADC Programme of Action, and bottlenecks and constraints in the mobilisation and utilisation of existing sources of finance for regional development. The need therefore arises for the re-allocation of resources in favour of less endowed countries to avoid polarisation.

The study will take into account and address the following issues:

- Existing funding arrangements (i.e. investment funds) both in SADC and continent-wide;
- The effectiveness of such funding sources and their suitability in addressing the development agenda of the region;
- The need for a development funding mechanism for regional cooperation and integration projects;
- The need for and advisability of enabling elements for intra-regional resource transfers to avoid polarisation (i.e. structural funds);

The first phase of the study is expected to be complete by June 2003.