Economic Review June 2012

1. An increase in the Southern African Customs Union Revenue in 2012/13 - Case for Lesotho

Southern African Customs Union's revenue increased for the second consecutive year in 2012/13, despite uncertainty in the global economic growth…

1.1 Background

Lesotho is a member of Southern African Customs Union (SACU) which was established in 1910. Other member states are Botswana, Namibia, South Africa and Swaziland. The agreement which was signed in 1969 was reviewed in 2002 whereby all member states signed to incorporate more democratic principles in the management of the union. The SACU revenue pool is managed by South Africa and collects revenue from customs and excise duties derived from imports within intra-SACU. The collected revenue is then distributed to the member states according to three components embedded within the revenue sharing formula. In this regard the revenue from the pool has been a significant fiscal support for Lesotho's economy, funding a large portion of government expenditure. This indicates that Lesotho is not immune from other less developed SACU members' states of which their budgetary operations rely heavily on SACU receipts.

As indicated earlier, the amount distributed to the union members is based on revenue sharing formula on total customs, excise and other additional duties collected from member countries during the specified financial year. However, there are some deductions from the total revenue in the pool for administrative costs before applying the following to each member states:

a) *The customs component*

This component takes into account gross value of customs and other duties collected, as a percentage of intra-SACU revenue in a specific period.

b) The excise component

The excise category consists of the gross amount of excise duties collected from each member states. Each member's share calculated from the value of Gross Domestic Product (GDP) as percentage of intra-SACU's GDP in a specified year.

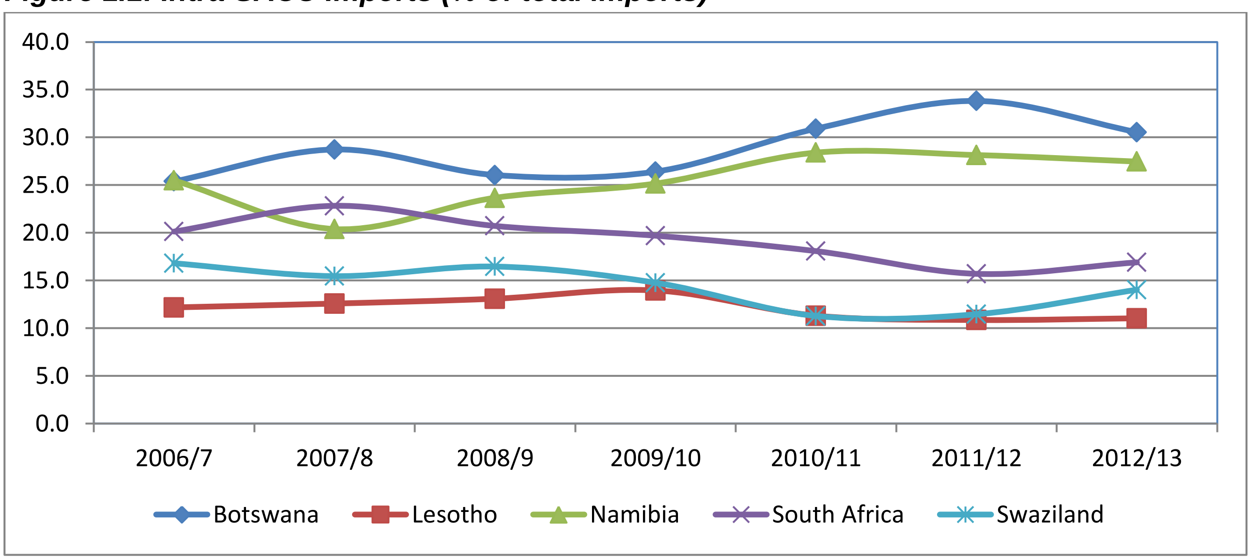
c) The development component

This component is a fixed percentage method of excise component weighted in favour of less developed SACU member states such as Lesotho.

1.2 The Impact of Global Financial Crisis on SACU Receipts

The global financial crisis negatively affected the region, and thus halts the size of the revenue pool. The economic growth in South Africa, as a major driver of trade in the region contracted since 2007/08 and this led to a decline in demand for investment and goods consumption, and therefore led to a lower demand for imports within SACU members. Figure 1 below depicts the trends in imports of each member within intra-SACU from 2006/07 to 2012/13.

Figure 1.1: Intra-SACU Imports (% of total imports)



Source: SACU Annual Report 2012

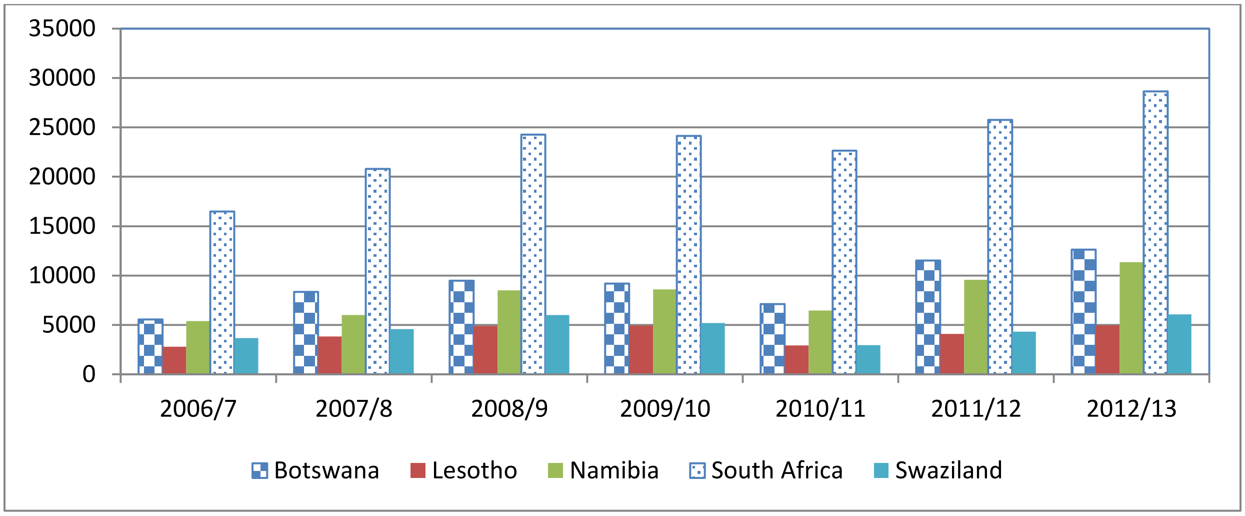
South Africa's imports from SACU members decelerated from 2008/9 to 2011/12 and picked-up thereafter. The impact has also been realized in Lesotho in 2010/11 and 2011/12, whereas it improved in 2012/13. Swaziland imports declined from 2009/10 to 2011/12, and rebounded in

2012/13. Botswana recorded a decline in 2008/09 and 2009/10 and recovered thereafter until 2011/12, while in 2012/13 there was deterioration. Namibia's imports dropped in 2007/08 and recovered from 2008/09 to 2010/11, while the decline was observed in 2011/12 and 2012/13.

1.3 SACU Revenue Shares

As already indicated, the sharing of the revenue is based on three components of the formula relative to each member contribution. Figure 1.2 illustrates the revenue shared by members over a period of seven years.

Figure 1.2: Trends in SACU Members Revenue Shares (R.billion)



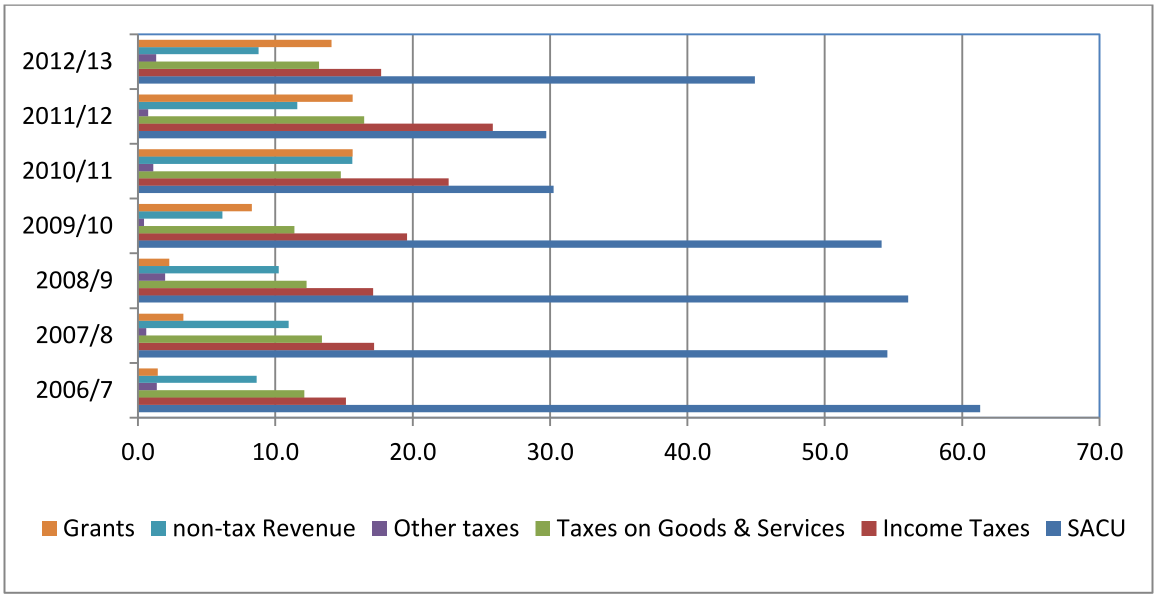
Source: SACU Annual Report 2012

The total revenue share continued to increase for the second consecutive year to 2012/13, reflecting improvements in all SACU members' revenue. The SACU revenue pool grew by 15.2 per cent in 2012/13, following an increase of 31.2 per cent registered in 2011/12. The growth in revenue was realized in all member states, however with different percentage shares of the total revenue. The highest earner of SACU revenue was South Africa with 45.0 per cent of the total in 2012/13 compared with 46.6 per cent in the previous period. The second largest recipient was Botswana with 19.8 per cent in 2012/13, lower than 20.8 per cent in 2011/2012. Namibia was the third collector of SACU revenue with 17.8 per cent in 2012/13, higher than 17.3 per cent in the previous year. Swaziland was fourth receiver with 9.5 per cent in 2012/13 compared with 7.8 per cent of total share in 2011/2012. Lesotho continued to be the least recipient of SACU revenue with 7.8 per cent in 2012/13, higher than 7.4 per cent realized in the previous period. It received M5 966.3 million in 2012/13 compared with M2 752.6 million registered in 2011/2012.

1.4 Is Lesotho Benefiting from SACU Revenue

SACU revenue to the Lesotho Government cannot be underrated since it takes noticeable share in total government revenue. Figure 1.3 below presents the shares of SACU revenue and other government revenue, to total revenue (including grants) during the period 2006/07 to 2012/2013.

Figure 1.3: Government Revenue (% of total revenue)



Source: CBL 2011 Annual Report and Ministry of Finance

It is evident that a large portion of government revenue is derived from SACU receipts which contributed 44.9 per cent in total government revenue in 2012/13 compared with 29.7 per cent realised in the previous period. This indicates that SACU receipts contribute a sizable share of government budget. As a result, an increase in SACU revenue has a positive impact on government activity in Lesotho, because it is largely used to finance investment and infrastructure. However, domestic taxes decelerated in 2012/13, indicating that government expenditure heavily relies on SACU receipts. Therefore, it would be difficult for the country to substitute SACU receipts with domestic tax without external assistance such as foreign grants and external debts.

1.5 Conclusion

Lesotho Government budgetary operations depend largely on SACU receipts. Therefore, an improvement in SACU revenue is likely to result in positive economic development for Lesotho. However, there are downside risks in relation such as; a possible to SACU revenue pool change in the SACU revenue-sharing formula, a reduction in the common tariff rate because of trade liberalization and the creation of Southern African Development Community (SADC) customs union.

2. Lesotho Government Signs Memorandum of Understanding with Commercial Banks: Possible Spill-over Effects on the Economy

The Government of Lesotho signs the memorandum of understanding with commercial banks on the establishment of a Partial Credit Guarantee Fund…

2.1 Introduction

The Government of Lesotho (GoL) signed the Memorandum of Understanding (MoU) with commercial banks on the establishment of a M50 million Partial Credit Guarantee Fund (PCGF) in May 2012.A PCGF is a fund that is meant to facilitate access to finance for Micro, Small and Medium Enterprises (MSMEs) by providing a guarantee to enterprises that do not have access to credit. Typically a credit guarantee is designed in such a way that it does not cover a full value of the loan in order to avoid information failures such as moral hazard and adverse selection problems. It is meant to cover a share of the default risk of the loan in cases where a borrower fails to repay the loan.

The number of MSMEs operating in Lesotho is 100,000 with employment of over 300,000 people, including those in informal sector and subsistence agriculture (Draft National Strategic Development Plan, 2012).This indicates that MSMEs have a potential to contribute to a country's economic growth, employment creation and poverty reduction. However, one of the findings of the 2008 study on "The State of Small Enterprises in Lesotho" is that micro-enterprises have a huge predominance within the MSMEs with eighty per cent employing not more than three (3) people. This reflects the fact that there are still a number of structural rigidities that have to be tackled in order to realize the potential benefits of the sector. The large majority of MSMEs is in the retail and service sector followed by manufacturing sector and agro-processing.

Although a number of problems hindering growth of the MSMEs have been identified by various studies, access to finance has been found to be a major factor inhibiting growth in this sector. The commercial banks' reluctance to provide loans to MSMEs emanates from the fact that MSMEs are deemed not to possess enough assets to cover collateral requirements and lack appropriate accounting records. Furthermore, according to the commercial banks, it is too costly to establish the credit worthiness of smaller firms. In Lesotho, there are only four commercial banks, three of which are South African-owned subsidiaries (accounting for about 90 percent of total assets of the banking sector in the country) and only one is local and state-owned. The sector has been fairly stable over the years, though it remains relatively small and underdeveloped. Among these four banks, only one has a countrywide outreach with 16 branches. Lesotho's terrain and weak infrastructure have also been a limiting factor for outreach branches, especially for the rural population. This has left a large number of Basotho population unbanked and without access to financial services. The graph below shows how credit to the private sector has evolved from 2000 to 2012.

Figure 2.1: Private Sector Credit (Million Maloti: End of Period)

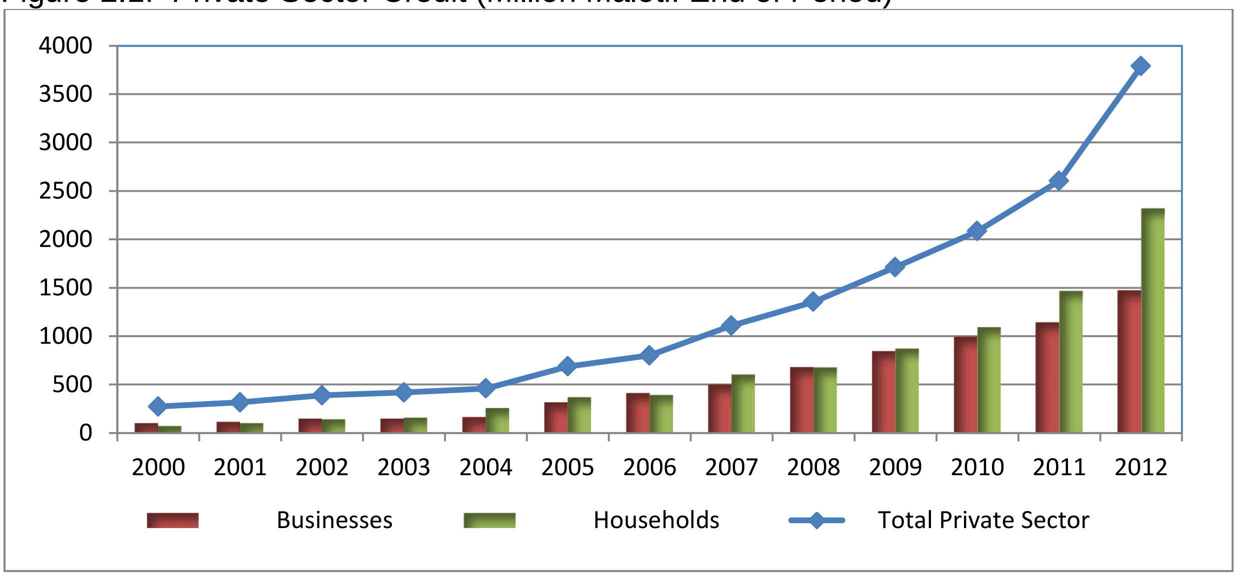


Figure 2.1 shows that credit to the private sector has been increasing gradually over the years. Credit extended to the households constitutes the largest share of domestic credit at an average of 54 per cent of the total credit while the businesses accounted for an average of 46 per cent of the growth between 2007 and 2012. The graph also confirms the fact that though commercial banks in Lesotho remain highly liquid, credit extended to MSMEs has been relatively sluggish.

2.2 Signing of the MoU between the Government and Banks in Lesotho

The main objective of the fund is to create a sustainable structure for the development and growth of Basotho-owned businesses in Lesotho. The fund seeks to provide part of the collateral that most banks require before issuing a loan. This will assist the MSMEs to access loans from the banks in order to expand their businesses and participate in the economic growth of the country. Eligible projects that are approved by the bank will qualify for a 50 per cent guarantee on the final loss while the remaining 50 per cent of the loss will be covered by the participating bank. Therefore, the guarantee from the Fund will be called upon when the guaranteed business fails. The inherent risk for such a fund is that huge fiscal cost could be borne by the government if majority of the guaranteed projects default on their loans. It is therefore critical that projects are adequately screened before they are approved.

The MoU have been signed by all the commercial banks in the country, being: the First National Bank, Lesotho Post Bank, Ned Bank Lesotho and Standard Lesotho Bank. The GoL was represented by four Ministers, namely; the Minister of Finance, and Minister of Gender and Youth, Sports and Recreation, Minister of Tourism, Environment and Culture and Minister of Trade and Industry, Cooperatives and Marketing who also signed on behalf of the government. The establishment of a PCGF is one of the numerous efforts of the GoL to promote private sector-led growth.

2.3 International Experience of PCGF

Even though there is a lack of scientific studies on the effects of intervening in the market to reduce liquidity constraints, MSMEs have come to be seen as playing an important role in stimulating economic growth, by increasing productivity, providing jobs for low-skilled workers and reducing poverty (OECD, 2004).

For instance Arráiz *et al*.(2012) studied the effects of government-backed Partial Credit Guarantee (PCG) on firm's performance using firm-level datasets for Columbia. The study found that firms that accessed the funds were able to grow both in terms of employment and output while their sales in foreign markets also improved. The paper also found that the national guarantee fund does not affect the bank's incentives to conduct an accurate credit appraisal since banks have partially assumed the default risk.

For India, the scheme was slow to take off in the initial years but picked up considerably on the sixth year in operation (Hussain, 2012). This was due to the operational mechanism whereby the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) has powers to reject any application without assigning any reasons. The private sector banks are eligible for guarantee cover but have to enter into an agreement with CGTMSE for becoming member lending institutions for the trust. The settlement of the claims has been criticized as a serious drawback as it takes too long. The CGTMSE is however looking at ways of improving its operations so as to ensure speedy filing of guarantee applications.

A study by Lelarge *et al.* (2008) evaluated the effects of a French loan guarantee program (targeting new ventures) using firm level data. They used firms eligible before 1995 (only manufacturing and business services industries) as control group, while examining the behavior of firms that became eligible before and after 1995. The finding of the study is that the French loan guarantee program had a significant impact on the development of newly created firms. Furthermore, these firms also experienced a higher growth rate than other similar firms. However, the study also discovered that a loan guarantee significantly increase the firms probability of default, suggesting risk-shifting to be a serious problem for such loan guarantee programs.

2.4 Potential Benefit for Lesotho

Based on studies discussed above (and many other different studies), it is generally a consensus that PCGF has a great potential to stimulate economic growth by increasing productivity of previously disadvantaged MSMEs. For Lesotho, PCGF has been explained as the starting point of Lesotho's largest business development strategies. The GoL hopes this will help Basotho start or maintain their own businesses and eventually contribute positively to the economy.

However, given experiences from other regions of the world, it is evident that PCGF has advantages and disadvantages, depending on how they are structured. Hence PCGF should not be viewed as a panacea as MSMEs face a number of structural weaknesses that would still need to be addressed. Through implementation of the National Strategic Development Plan, other structural weaknesses within the MSMEs will be tackled. This includes amongst others;

- Improving entrepreneurship capacity.
- Improving competitiveness and productivity.
- Developing MSMEs-related infrastructure and access to technology

The signing of the MoU is an important milestone in the history of Lesotho. The growing unemployment challenge, in particular, youth unemployment makes the development of the MSMEs sector even more urgent (Draft MSMEs Policy for Lesotho, 2011). The establishment of the fund will play a pivotal to the successful development of the MSMEs. The Fund is the first of its kind as the GoL has previously established other schemes which were more inclined towards fully subsidizing production by entrepreneurs. This initiative is different in that it would be more secure and transparent due to the involvement of the Banks, which improves operational efficiency by undertaking risk assessment measures.

This article benefitted from:

1. Arráiz I, Meléndes M, and Stucchi, R. (2012). *Partial Credit Guarantees and Firm Performance: Evidence from the Colombian National Guarantee Fund.* Office of Evaluation and Oversight. Working Paper WP-02-12.
2. Hussain, M. (2012). *Effectiveness of Credit Guarantee Scheme*. Wadhwani Centre for Entrepreneurship Development.
3. *Micro, Small and Medium Enterprises Policy for Lesotho-Draft*. Ministry of Trade and Industry, Cooperatives and Marketing. (June, 2011).
4. Lelarge, C., Sraer, D., and Thesman, D., (May, 2008). *Entrepreneurship and Credit Constraints: Evidence from a French Loan Guarantee Programme.* World Bank Conference on Small Business Finance.