

Chapter 8

Overcoming Challenges to Long-Term Financing: A Behavioral Perspective

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ABSTRACT

A concern that has emerged repeatedly in the support for long-term sustainable development is the insufficient availability of long-term finance for projects such as infrastructure. This paper considers some of the possible strategies to overcome obstacles (cognitive or otherwise) to ensure the provision of long-term financing. The author discusses several behavioral interventions to surmount hurdles both from the demand and supply sides as well as creating enabling environments for better access to finance. This effectively requires challenging the rationale underlying private financial flows that are driven by short-term profits and rents, and strengthening mechanisms for mobilizing and allocating both domestic and external finance for value creation and development over a longer time horizon. It also involves properly designed projects that contractually distributes risks and shares returns within economically rational financing structures and create the right incentives for the various partners.

1. INTRODUCTION

Private financial markets cannot be relied upon to fully fund long-term investment projects because such investments typically involve longer tenures and entail greater risk and uncertainty about eventual outcomes, even while they create significant positive externalities for the rest of the economy (UNCTAD, 2015). These factors produce differences between private profitability and social returns on such investment. Also, private financial markets seldom finance directly such classes of borrowers like start-ups or small and medium-sized enterprises (SMEs), or activities whose returns are not immediately evident and at times cannot be readily calculated. This negatively affects activities that could be crucial for future growth and which could produce considerable social benefits, such as innovation, technological progress and environmental protection.

DOI: 10.4018/978-1-7998-2448-0.ch008

Financing for purely public goods necessarily requires appropriate public domestic revenues, and in the context of external financing this is most likely to be supported by official development assistance (ODA) or other forms of development cooperation. In the case of warrant goods and services, as well as other activities with large positive externalities, a mix of public and private arrangements is involved, usually some degree of explicit or implicit government subsidies, which in turn would require either internal or external resources, usually channelled through the public coffers. Finally, there are some activities that generate changes in productive structures and are potentially profitable (such as some kinds of infrastructure investment), which are nevertheless avoided by private investors because of uncertainties associated with lumpy investment requirements with large initial costs, long gestation periods and perceived risks.

This article considers some of the possible strategies to overcome obstacles (both cognitive and otherwise) to ensure the provision of long-term financing. Also, greater financial integration has not delivered on expectations of easier access to the kind of long-term financing needed to boost growth and development. In section 2, we suggest ways on how to facilitate long-term financing activities, both in public as well as private sector using variable forms of funds, including those from sovereign wealth funds and multi-lateral development banks. In our scope of discussion, we argue for necessary change in traditional practices of financial risk-assessment and enriching them with a behavioural orientation, as well as the specification of possible useful tools, and a reassessment in investment focus and horizon. In section 3, we discuss several interventions from behavioral perspectives to surmount hurdles both from the demand and supply sides as well as creating enabling environments for better access to finance via suitable long-term capital market instruments as well as regulatory improvements.

1.1 Challenges to Long-Term Financing

In providing for long-term financing, the challenge lies in promoting a financial system that incentivizes sustainable development. Both domestic and international private sources (banks, institutional investors, direct investors) and public resources will be necessary. Public and private resources should, however, not be necessarily seen as substitutes, as they have different investment objectives. Despite small (but growing) pockets of socially conscious investors, most private capital remains driven by the profit motive. As a result, the private sector will under-invest in public goals when the expected return underperforms other investment opportunities on a risk adjusted basis. Hence it is important to recognize plainly that public financing and public sector policies are instrumental to a long-term financing strategy.

Another challenge in channelling investor funds into long-term projects like infrastructure, is the apparent mismatch between investment demand and the supply of finance — there is a lack of properly structured projects. For instance, infrastructure investments entail complex legal and financial arrangements, requiring a lot of expertise (BIS, 2014). Building up the necessary expertise is costly, and investors will only be willing to incur these fixed costs if there is a sufficient and predictable pipeline of infrastructure investment opportunities. Otherwise, the costs can easily outweigh the potential benefits of investing into infrastructure over other less complex asset classes.

A few common economic characteristics differentiate long-term project assets like infrastructure from other asset classes. These characteristics also make it more difficult to match investment demand and financing supply:

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