VOLUME 1

Integration into the World Trading Environment

Lesotho

INTEGRATED FRAMEWORK
DIAGNOSTIC TRADE INTEGRATION STUDY

FOR CONSULTATION AND DISCUSSION

November 20, 2003

LIST OF ABBREVIATIONS

ACP	African, Caribbean, Pacific
AGOA	African Growth and Opportunity Act
ASYCUDA	Automated Systems for Customs Documentation
BEDCO	Basotho Enterprises Development Corporation
BLNS	Botswana, Lesotho, Namibia, Swaziland
BOS	Bureau of Statistics
CBL	Central Bank of Lesotho
CET	Common External Tariff
CMA	Common Monetary Area
CMT	Cut-Make-Trim
COMESA	Common Market for Eastern and Southern Africa
CPI	Consumer Price Index
DFID	Department for International Development (UK)
DTIS	Diagnostic Trade Integration Study
EC	European Commission
EPA	Environment Protection Agency
EPA	Economic Partnership Arrangement
EU	European Union
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Service
FTA	Free Trade Area
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GNI	Gross National Income
GSP	Generalized System of Preferences
GSP	Generalized Systems of Preference
HF	Heritage Foundation
HIV	Human Immunodeficiency Virus
HS	Harmonized System
IF	Integrated Framework
IMF	International Monetary Fund
IPR	Intellectual Property Rights
IPR	Investment Policy Review
IT	Information Technology
ITA	Information Technology Agreement
ITC	International Trade Center
LCCI	Lesotho Chamber of Commerce and Industry
LDC	Least Developed Country
LHWP	Lesotho Highlands Water Project
LNDC	Lesotho National Development Corporation
MDP	Ministry of Development Planning
MFA	Multi Fiber Agreement
MFN	Most Favored Nation

MITM	Ministry of Industry, Trade and Marketing
MNCs	Multinational Corporations
MOF	Ministry of Finance
PPP	Purchasing Power Parity
PRSP	Poverty Reduction Strategy Paper
PSIRP	Public Sector Improvement and Reform Project
QUAD	Japan, European Union, Canada, and United States of America
REPAs	Regional Economic Partnership Agreements
RETOSA	Regional Tourism Organization for Southern Africa
RSA	Republic of South Africa
SACU	South African Customs Union
SADC	Southern African Development Community
SITC	Standard Industrial Trade Classification
SMMEs	Small, Medium and Micro Enterprises
SPS	Sanitary and Phytosanitary Standards
SQAM	Standards, Quality, Assurance, and Metrology
TBT	Technical Barriers to Trade
TDCA	Trade, Development and Cooperation Agreement
TPR	Trade Policy Review
TRIPS	Trade Related Intellectual Property Rights
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program
USTR	United States Trade Representative
VANS	Value Added Network Services
VAT	Value Added Tax
WDI	World Development Indicator
WIPO	World Intellectual Property Organization
WSJ	Wall Street Journal
WTO	World Trade Organization

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PREFACE

A High-Level WTO Meeting established the Integrated Framework (IF) in October 1997 to facilitate coordination of trade-related technical assistance and promote an integrated approach to assist the least developed countries (LDCs) enhance their trade opportunities. Following the meeting of the Heads of Agencies in the summer of 2000, the IF was redefined to ensure better integration of trade with national development strategies and complemented by a trust fund for IF activities. The government of Lesotho has requested to become part of the redefined IF process. Its initial component is the Diagnostic Trade Integration Study (DTIS). The Lesotho DTIS began in November 2001 with consultations with core participating agencies in Geneva (ITC, UNDP, UNCTAD) and government and non-government organizations in Maseru, Lesotho. The World Bank, with the assistance of the UNDP Mission to Lesotho, coordinated the study.

The study was officially launched by the government on March 26, 2002 at the National Integrated Framework Conference in Maseru, Lesotho. Representatives of the government, Lesotho's civil society, donor community and six core agencies attended the conference. The conference was preceded by a special empowerment workshop organized by the UNDP to familiarize national participants with the ideas underlying the IF process. The discussions during the Conference were crucial to the development of terms-of-reference for the study and designing its organizational framework to assure active participation of all stakeholder in all stages of the IF process.

The team participating in the IF study consisted of Bart Kaminski (consultant, mission leader), Ihsan Ajwad (World Bank, poverty), Willy Alfaro (WTO, trade regime), Vandana Chandra (World Bank, country economist for Lesotho), Antero Hyvärinen (ITC, international competitiveness of the garment sector), Sanjaya Lall (UNCTAD, foreign direct investment), Kellelo Lerotholi (consultant, business environment), David Luke (UNDP, trade capacity building), Mandisa Mashologu (UNDP, economic development), Francis Ng (World Bank, trade statistics), Umesh Kumar (National University of Lesotho, legal issues), Maika Oshikawa (WTO, trade policy), Andrew Salm (consultant, garment sector), Phil Schuler (consultant, market access), Joshua Setipa (Lesotho Mission to the WTO), Ashish Shah (ITC, trade promotion), Yvonne M. Tsikata (World Bank, trade policy and institutions) and Alexander Yeats (consultant, trade performance). Khiba Nteso and Melanie Faltas provided excellent research and technical assistance.

The diagnostic study is composed of two volumes. Volume 1 is the main report, which provides the assessment and technical analysis of major issues faced by Lesotho as it attempts to take advantage of opportunities offered by the international environment. Volume 2 contains background papers prepared for the Diagnostic Study. The studies in Volume 2 are readily available upon request.

The IF study was carried out in close consultation with and benefited from with several ongoing projects. In particular, it has drawn on the work done for Lesotho's Poverty Reduction Strategic Paper (PRSP) and the National Vision, UNCTAD's Investment Policy Review, the WTO's Trade Policy Review for SACU, DFID's Africa Trade Policy and Poverty Project (ATPP), the World Bank's Growth Options Study (GOS)—as well as other projects carried out by the Government of Lesotho (GoL) and other core agencies and donors such as a report on the garment sector funded

by the UK Department for International Development. The IMF, ITC, UNCTAD and WTO prepared background papers for the Lesotho IF study.

The study benefited from the collaboration with the National Steering Committee, other government officials, representatives of civil society in Lesotho, and the staff of the DFID regional office in Pretoria. The authors had the opportunity to discuss main findings of the different missions at the Ministry of Industry, Trade and Marketing; Ministry of Finance; Ministry of Development Planning; Ministry of Foreign Affairs; Ministry of Agriculture; Lesotho National Development Corporation; and the Basotho Enterprises Development Corporation among others. The process also benefited from the guidance and support of Ms. Mandisa Mashologu (UNDP) and Ms. Helena McLeod (DFID, Pretoria).

The authors would like to express their gratitude to all our counterparts in the government, non-government organizations and business community, for the time they spent with us in open and friendly discussions. Their collaboration and cooperation made this study possible. In particular, special thanks are due to Mr. R.M. Rantekoa (PS, MITM) and ‘Me Qoane (DPS, MITM) for their leadership, oversight and support to the entire IF process as well as members of the National Steering Committee for their effective support and organization of the multiple agendas.

Executive Summary

Lesotho is small and landlocked. Lesotho's macroeconomic policy is circumscribed because of its membership in the Common Monetary Area (CMA) while its foreign trade policy is limited because of its membership in the Southern Africa Customs Union (SACU). These features are not necessarily liabilities. 'Land-lockedness' is not a liability considering Lesotho's access to South Africa's infrastructure offering low cost exit for its goods into world markets. Smallness can be a political asset as the government is closer to its people. For a small country to be a viable economic entity, however, it has to be part of a larger open market. Hence, maintaining a liberal economic environment domestically, ensuring macroeconomic stability and encouraging integrated markets are key to Lesotho's economic success.

Economic Features and Performance

Lesotho, with PPP GNI per capita of US$2,980 in 2001 and ranked 139th among 207 economies (WDI 2003), stands out in four important respects from other LDCs. First, although land-locked, Lesotho borders only one country—South Africa—that happens to have a developed economy with modern transport infrastructure. Second, because of its large external sector, gross national income (GNI) is a better indicator of welfare than is GDP. Thus while real annualized per capita GDP grew slightly in the 1990s, real annualized per capita GNI fell by 1.6 percent over the same period. Not surprisingly, poverty rose over the period. Third, Lesotho has had a relatively liberal foreign trade regime through its membership of the Southern Africa Customs Union (SACU). Finally, yet importantly, it has been evolving towards the rule of law and democracy as demonstrated by recent elections. The process of consolidation of democratic institutions augurs well for political stability and the quality of economic policies.

Among countries with similar developmental characteristics, Lesotho's foreign trade and investment performance stands out. Openness of its economy as measured by foreign trade in goods as a percentage of goods GDP was 198 percent in 1999, the third highest among African countries (WDI 2002). Only SACU partners—Botswana (200 percent) and Namibia (208 percent) were more open. Lesotho also compares favorably to a group of countries that are similar in terms of resource endowments, land-locked status, and level of economic development. A second measure is exports per capita. Lesotho's were US $81 in 1999, putting it at the top of this group of similarly endowed countries. Third, the country's share of exports in GDP (18 percent) was significantly above average. Over 1989-99, the growth in real trade was higher than the growth in real GDP. Export-led growth has driven Lesotho's economy with an average annual growth rate of export volume at 11 percent over 1990-98. Imports grew at 1.4 percent over the same period.

Lesotho has done very well in attracting FDI, with its per capita FDI stock well above the average for LDCs. FDI inflows into export-oriented manufacturing accounted for the bulk of total investments amounting to approximately 90 percent of the total. Thanks to FDI, Lesotho has been able to take advantage of trade privileges in US markets under the Multi Fiber Agreement (MFA) and since April 2001, AGOA. In 2002, it emerged as a major exporter of apparel to the U.S., the largest market for apparel in the world, and the largest supplier from Sub-Saharan Africa. With exports of US$260 million in April 2001-April 2002 (or US$129 per capita), it surpassed South Africa (US$167 million) and Mauritius (US$244 million). It accounted for 25 percent of total apparel exports to the U.S. originating in Sub-Saharan Africa over April 2001-April 2002. It currently accounts for 0.5 percent of US imports of apparel and is ranked the 33rd supplier in terms of value of exports. The value of exports increased over the entire AGOA-covered period, i.e., between April 2001 and April 2002, from US$155 million to US$261 million, or 68 percent.

Challenges Ahead

Yet, in spite of the impressive trade performance, the overall socio-economic picture is not bright and Lesotho faces tremendous challenges. First, poverty remains pervasive in Lesotho. Unemployment continues to be high at almost 30 percent; about half of the population is considered poor; and income inequality is among the highest in the world (World Bank 2001). Poverty is concentrated heavily in rural areas, with more than 80 percent of poor residing in rural areas. It also appears that the increase in domestic employment (primarily female) mainly thanks to foreign firms has not fully compensated the losses in employment due to the fall in government production and reduced opportunities for Basotho workers in South African mines. Without a large increase in employment opportunities in non-agricultural sectors of the economy, the prospects for making significant strides in alleviating poverty appear grim.

Second, the HIV/AIDS pandemic has emerged as a major health concern with potentially devastating consequences for Lesotho's economy. Already life expectancy has declined from 53 years in 1989 to 45 years in 1999. The level of population is expected to be 20 percent lower by 2015 than in a no-HIV baseline, and life expectancy is expected to be 31 years lower (World Bank 2000). Since AIDS hits disproportionately the economically active, mainly urban population, it affects more the country's educated population thus reducing the pool of skilled human capital. It has already affected the universal primary education program, as a shortage of teachers has been exacerbated by the HIV/AIDS epidemic.

Third, while foreign owned firms have significantly contributed to the country's welfare, their overall positive effects appear to fall well short of effects observed in other developing countries on two counts. To begin with, despite the sustained presence of foreign owned firms in garments, there have been no significant positive spillovers. Domestically owned businesses that would provide simple sub-contracting services or inputs to this sector are yet to emerge. In addition, foreign owned firms, especially those in the successful garment sector, appear to make a very limited direct contribution to tax revenues. Explosion in garment exports to the U.S. has so far failed to produce similar surge in corporate tax revenues from this sector. Unless remedied, both issues will unnecessarily create social tensions and continue to depress government revenues.

Fourth, further development of the textiles and apparel industry may hit the barrier of mounting infrastructure and environmental pressures. While the availability of utilities and infrastructure was not a serious problem in the 1990s, it has now become apparent that the quality of physical infrastructure necessary to support business activity is a binding constraint to further industrial development. The main constraints include electricity, telecommunications, adequate and reliable supply of water to the industrial estates, the limited availability of serviced industrial land and pre-built factory shells and the limited handling capacity of the Maseru Railhead. Capacity problems emerging in infrastructure will constrain the further expansion of textiles unless urgently addressed.

Fifth, external conditions that have helped drive Lesotho's recent trade and investment boom may disappear. Almost all Lesotho's exports enter respective markets on a preferential basis. Many products may be competitive only insofar as artificially created comparative advantages by international preferential trading rules remain in place. Among these, the AGOA (together with MFA quotas) is regarded as the most pressing. The question is how sustainable this trade will be in the future, given that favorable tariff treatment under AGOA is a temporary policy expiring in 2008. The most favorable aspect of it—the relaxed rules of origin for LDCs—expires sooner, at the end of 2004. In addition, the MFA quotas limiting access of the world's largest garment exporters to the U.S. market (as well as to markets of other highly developed countries) are due to be removed in 2005.

Hence, the international trade environment within which Lesotho's firms now operate will significantly change in the mid-2000s. Policies implemented within the next 2-3 years will determine how a new environment will affect Lesotho's economy in the late 2000s. The major task facing the country is leveraging the temporary tariff preferences offered under MFA / AGOA to develop a permanent comparative advantage. (In addition, the government should lobby both the European Commission and U.S. government to receive waiver from a 'double transformation' requirement on the grounds of Lesotho's small size and environmental concerns).

Lesotho's industrial base is still very narrow, turning out only a few products that are competitive in international markets. These are clothing, footwear and assembled color TV sets. Trade is highly concentrated not only in terms of products but also markets. This indicates a high level of potential vulnerability to adverse developments in two markets—in South Africa and the U.S. There are some signs indicating an increase in exports to the EU. The task remains to introduce measures that would diversify the economy and its export basket.

Need for an 'Integrated' Strategy

Lesotho's economic well being is not only dependent on foreign trade, but its welfare is ultimately linked to that of South Africa, as it cannot bypass South Africa as it attempts to take advantage of opportunities offered by global markets. Tapping these benefits requires two kinds of action. First, it calls for the active pursuit of measures that would simultaneously realize gains from participation in regional arrangements (SACU and SADC) and the WTO. Second, it requires efforts to improve the country's investment climate for foreign and domestic investors alike.

Lesotho should take advantage of its sovereign status to pursue two parallel strategies: one to lower the "costs of trading" with South Africa and other SACU partners, and another aimed at establishing a competitive business environment vis-à-vis other countries in the region. The former calls for the removal of various remaining barriers to trade and movement of capital and labor within SACU and thereby transforming it into a full-fledged single market. The latter calls not only for the removal of various administrative barriers that impede the conduct of business activity, but also the effective provision of public services including public order and good governance. These two strategies complement and reinforce each other.

External commitments affect domestic policy formation, but many options are available. Lesotho's freedom of action is already constrained by virtue of its small size and weak capacity. Policy integration should be seen instead as a step towards greater control over its fate by increasing Lesotho's participation in the development and implementation regional economic policies. Areas where Lesotho can exercise its sovereign powers to its economic advantage are "behind the border" measures.

Maximization of gains from participation in regional arrangements: Lesotho has several special assets. Leaving aside its status as a LDC, which confers preferential trade treatment and access to foreign assistance, SACU membership and proximity to South Africa are assets. The challenge is how to exploit them, i.e., to 'negotiate a better, growth conducive regional environment.'

Lesotho can use regional integration—and most importantly integration with South Africa (and SACU)—as a springboard to greater integration into the world economy. This can be achieved through supporting measures that increase the contestability of SACU markets and regional regulatory coordination. The former calls for liberalization of SACU's common external tariff where it is beneficial for Lesotho and limitations on the use of non-tariff barriers, whereas the latter calls for regional cooperation in the introduction of trade facilitating measures.

While the SACU common external tariff rates declined in the post-Uruguay Round environment, they remain dispersed and high especially in products (e.g., textiles) where Lesotho has shown a competitive edge in international markets. Moreover, RSA has been resorting extensively to anti-dumping as a tool of protecting its domestic industries. The results are higher prices also for Lesotho's consumers of these products. The new SACU Treaty opens the decision process to its smaller members, and Lesotho should take advantage of it. It should focus its negotiating resources on lowering SACU common external tariffs on these items that are critical to Lesotho's export competitiveness as well as influencing South Africa's proclivity to use anti-dumping actions as its preferred tool of protectionism.

Another area in which SACU offers an opportunity worth exploring is regional regulatory cooperation transforming SACU market into a genuine single market with as little impediment to border flows as possible. Approaching regulatory reform from a regional perspective makes sense only insofar as it is a stepping-stone towards greater integration into the world economy and offers opportunity to realize economies of scale in policy implementation and/or reducing the costs of policies on international trade. Examples include meeting WTO-rules concerning customs clearance and valuation, standards and technical regulations, sanitary and phytosanitary measures, intellectual property rights. These would be more effectively dealt with at a regional level. In these areas, the SACU framework may provide a useful arena in which to harmonize, provided that the outcomes are WTO compatible. This would not only minimize trading costs across borders but also lower the cost of their implementation and compliance. While not related to WTO commitments, a similar argument applies to harmonization of VAT/sales tax rates: different tax structures encourage smuggling and distort trade flows.

A free trade area among SADC countries (as currently proposed) is in the economic interest of Lesotho, not because Lesotho trades much with non-SACU SADC members (currently less than one percent), but because of the potential for developing a regional supply chain in garment manufacturing. As long as transportation infrastructure remains weak, the potential is limited. Another barrier relates to protectionist-bias present in the SADC Trade Protocol reflecting an inward regionalism rather than an open regionalism, where the regional entity is used as a springboard to help members participate more fully in the world economy. For these reasons, SACU offers a much more effective venue to Lesotho's economic development.

Bilateral free trade agreements (FTAs): Lesotho has little to gain in terms of market access from bilateral FTAs with highly developed countries as long as it has LDC status. As the AGOA experience illustrates, preferential access to large, rich country markets can yield significant benefits to Lesotho's economy, in terms of export revenue, employment, and links to foreign investors. Moreover, membership in SACU further limits the use of bilateral FTAs signed outside the SACU framework.

But it may gain from FTAs between SACU and highly developed countries. For instance, although the EU–South Africa TDCA (Trade Development and Cooperation Agreement signed outside the SACU framework) may result in the fiscal pressures arising from declining SACU customs revenue, it is likely to increase FDI inflows into South Africa with potentially positive spillovers for Lesotho. Furthermore, as the intensity of competition in SACU markets will increase, Lesotho's users of imports will benefit. For instance, as a net importer of agricultural products, Lesotho will undoubtedly benefit from the elimination of tariffs on 46 percent of South African imports of these products from the EU by 2005. One would expect that US-SACU FTA would have similar positive impacts, though this will need to be confirmed in the pre-negotiations analysis.

Actions to improve business climate: Lesotho should exercise its sovereign powers to its economic advantage in shaping the 'behind-the-border' measures and other determinants of business climate, i.e., political stability, governance, physical infrastructure, and human capital.

The establishment of a friendlier business environment than South Africa's should be the objective of the government. Lesotho's challenge is to adopt a strategy of selective harmonization with South Africa: integrating its policies and regulations with South Africa's in areas where this reduces the costs of conducting international trade, while charting its own course in creating a better business climate.

However, their positive impact will be limited if not accompanied by simultaneous improvement in other areas. While the government has made significant strides towards establishing rule-based public-private interface and acted upon the 1997 FIAS recommendations, administrative barriers persist. These among others include the licensing system for new business entrants and foreign trade operations, land management. In addition, the existing system governing entry of foreigners into Lesotho constitutes a serious impediment to private business activity as well as to the development of tourism (see below).

The government and donors should resist the temptation of addressing administrative barriers merely through computerization without their simplification and careful assessment. The task is first to redesign and simplify procedures and then address the issue of administrative constraints. Bad procedures more efficiently implemented may become an even more effective barrier to conducting business in Lesotho.

Other impediments relate to Lesotho's landlocked location and the quality of physical infrastructure and the availability of human capital. While both of them can be addressed successfully over the medium term given political commitment and resources, the first is more resource intensive and time-consuming than the second is. However, even as far as physical infrastructure is concerned, much could be done in a short time without spending huge resources (e.g., the Maseru Railhead). Removing other impediments related to poor infrastructure may take time and should become part of the government's poverty reduction strategy. Measures to be exploited may include tax incentive schemes for investors investing in infrastructure-related projects as well as developing various variants combining public and private resources to invest in transportation and telecommunication infrastructure.

Lesotho's landlocked location and small market can be addressed not only by building a better transportation network but also, as mentioned above, by policy measures facilitating trade with Lesotho's only neighboring country—South Africa. This is clearly cheaper and can significantly lower transaction costs.

Investing in human capital is both a long-term as well as a short-term challenge. The long-term challenge is about education, whereas the short-term challenge is about the development of human capital especially in the garment sector—the largest employer in Lesotho with the greatest potential for positive spillovers of knowledge and skills. Steps should be taken to overcome foreign firms' resistance to have programs geared toward training and promoting local employees to managerial and supervisory positions.

Administrative barriers are a combination of constraints on policy-making capacity exacerbated by weak statistical reporting and administrative procedures whose design pays lip service to restraints related to existing bureaucratic structures. Without data, neither government nor business can make rational decisions especially including foreign investments. High costs of due diligence often discourage potential investors from considering a country as a location.

Foreign Direct Investment (FDI): While regulations should not discriminate against domestic investors, potential foreign investors have in many areas an advantage vis-à-vis local investors, especially in access to Lesotho and relevant information. All facilities established for foreign investors should be also available for domestic investors.

Given the importance of FDI to Lesotho's economic development, the existing FDI regime deserves separate consideration. Although Lesotho has been successful in attracting FDI, the regime has several weaknesses. First, the investment promotion agency within MITM does not proactively "market" the country. The quality of provided information, its availability leaves much to be desired, and there is no regularly updated web site. Second, requirements for granting visas, especially multiple-entry visas, and procedures for obtaining work and residence permits are complex and time consuming. Third, it has failed to provide incentives to firms to establish vocational training centers and promote locals to managerial and technical positions.

Poverty reduction as an integrating theme of a strategy: The links with poverty reduction are complex, yet the discussed measures, through their impact on production, trade and investment could help addressing the problem of high unemployment. Their common theme is facilitating economic expansion. The key is to maintain a business friendly environment; reduce the 'hassle cost' of doing business including entry that is particularly onerous for small firms (lower cost of regulatory compliance); strengthen linkages between larger export firms and SMMES through sub-contracting and the like; and to work with the private sector to expand business and vocational training, while reorienting key agencies to focus on policy development.

Quick Wins (stroke of a pen measures)

Some areas can be corrected quickly without external assistance (for all areas covered, see the Action Matrix). These include:

- Overhaul of visa regulations, making it easier for potential investors to obtain multiple entry visas.
- Signing a consular protocol with South Africa (or other country) to issue entry visas in countries where Lesotho does not have a consular representation.
- Implementing fully the 2001 Environment Act based on a principle that a polluter should pay for the damage done to natural environment;
- Extending land leases to 99 years.
- Improving the Lesotho Electricity Corporation's billing practices.
- Transforming the Maseru Railhead into a modern transportation facility through clarifying property rights issues and leasing it.
- Organizing an information center that would collect information relevant to conducting business activity in Lesotho.

One might also include in this list the launching of lobbying efforts to obtain a waiver on a double transformation requirement in EU and the extension after 2004 in the US. This may, however, call for some assistance in developing the campaign.

Other issues are more time and resource consuming. Their implementation requires strong cooperation between donors and government as well as private businesses and civil society organizations. The most pressing priorities in technical assistance are highlighted below.

Enhanced Institutional Capacity and Aid Coordination: Conditions for Success

Government institutional capacity and coordinated activities of donors are critical to successfully implement the integrated strategy addressing both external and domestic business environments. For reasons discussed earlier, the capacity to evaluate the impact of external developments is even more important in Lesotho than in most other countries, simply because the government can directly influence some components relevant to Lesotho's economic performance and poverty reduction strategy. In order to pursue the 'integrated' strategy, the government's capacity must be considerably enhanced in respect to its ability to assess tradeoffs and links between international environment and domestic business activities.

Without external assistance, it would be very difficult, if not impossible for the government to establish the 'right' institutional setting to cope with the challenges of globalization and regionalism and develop the capacity to carry out all the stages involved in the trade policy cycle. A starting point is **the strengthening of the key Ministries and institutions involved in trade policy development and implementation**. Support for the Strategic Plan of the Ministry of Industry, Trade and Marketing, as well as the Ministries of Foreign Affairs, Ministry of Law and Constitutional Affairs, Ministry of Agriculture and Ministry of Finance & Development Planning, a well-defined Investment Promotion Agency, the Lesotho Chamber of Commerce and Industry, the Employers Association and other stakeholders is discussed in the study. Equally important is **the need to improve mechanisms to facilitate dialogue and consultation on trade issues amongst stakeholders**.

An important part of enhancing institutional capacity is **improving data collection** (ideally setting up a modern statistical system), analysis as well as the overall institutional setting. The quality of foreign trade data is low, and capacity is weak in other areas relevant to the "new trade agenda"-- policy formulation, analysis and evaluation. Improving statistical data should become a heightened priority for the government. Without it, changes in the institutional setting would be weakened. Without good data and analysis, negotiating capacity is bound to remain weak.

Another important identified need **is a unit capable of processing data and assessing the impact of alternative policy and negotiating scenarios**. While organizational details would ultimately be worked out between donors providing technical assistance and the government, the major underpinnings of such an arrangement can be summarized as follows. First, there a need to establish organizational unit (s), which would be (a) capable of evaluating policy impacts of various scenarios; (b) in charge of coordinating all activities across ministries and government agencies related to Lesotho's economic interaction with the external world; and (c) in charge of tracking information about conducting business in Lesotho and conditions in market access (abroad and in Lesotho) for both exporters and importers. All regulations relevant to business in Lesotho and Lesotho's external economic relations should be available in a single focal point linked to the investment promotion agency (see Foreign Direct Investment).

Coordination problems exist in managing external assistance on both donor and recipient sides, though the problem is less acute in trade. The idea of a 'lead donor' or 'donor facilitator' introduced under the IF process in Lesotho goes a long way to address this problem, though much work lies ahead to make this a programmatic and dynamic concept. Two remaining loose ends—recipient coordination and the plan of action—need to be closed. The Lesotho IF National Steering Committee should play a lead role in implementing the IF program and coordinating external assistance to achieve its goals. The remaining key recommendations and technical assistance implications are presented in the Action Matrix below. These can be summarized as follows:

- Scaling up of infrastructure necessary to support the growing garments industry (recognizing the limits to growth in this industry).
- Liberalization and cooperation at the regional level;
- Making domestic business environment friendlier to domestic and foreign firms alike.

ACTION MATRIX

INSTITUTIONAL CAPACITY: NATIONAL POLICY MAKING AND TRADE ENHANCEMENT				
	Barrier or Opportunity	**Policy Action**	**Technical Assistance**	**Time Frame**
1.	Insufficient trade data for policy analysis by government and non-government actors	Computerize customs as a first step to establish a reliable statistical accounting system Integrate data reporting with SACU	IT equipment and software purchases Train staff in data collection and statistical analysis	Medium term
2.	Weak analytical capacity in support of trade and investment agreements negotiators	Create trade policy analysis unit in MITM. Expand and train analytical staff. Create coordinating body as recommended below.	Train and equip staff of MITM and other related units in the Ministry of Foreign Affairs, Ministry of Development Planning the Ministry of Law and Constitutional Affairs, and other public and private institutions to conduct economic analysis	Short term
3.	Fragmented trade policy process	Create coordinating body	Advice on administrative reorganization and help with setting up IT support.	Short term
4.	Opportunities to affect Lesotho's external economic environment Weak industrial base	As above. Organize lobbying effort in the EU and US (see above "the small size domestic market" barrier). Address Address supply side constraints	As above As above in "the small size domestic market" barrier.	Medium term Medium term

REGIONAL INTEGRATION (HOW TO INCREASE DOMESTIC MARKET)				
	Barrier or Opportunity	**Policy Action**	**Technical Assistance**	**Time Frame**
5.	Excessive economic borders and inconsistent regulatory frameworks within SACU	Harmonize tax systems, licensing and customs procedures, and regulatory frameworks	Train and equip staff for economic analysis; Legal analysis to rewrite laws; Train staff on SACU-wide procedures	Medium term
6.	Tariff peaks in SACU tariff and excessive anti-dumping actions create anti-export bias	Assert Lesotho's position in SACU Tariff Board Lobby SACU to reduce tariff peaks in CET Seek to restrain South Africa's anti-dumping actions through SACU	Technical and financial support for data collection systems (including computerization) Training to develop analytical expertise to assess the welfare cost of trade restraining actions	Medium term
7.	Onerous rules of origin in SADC Trade Protocol prevent development of regional supply chains	Conduct analysis of harmful impact of restrictive rules of origin Lobby other SACU members for relaxed rules of origin	Train and equip staff to conduct economic analysis	Medium term
8.	Compliance with TRIPS attracts FDI	Integrate with South Africa's intellectual property rights regime	Training Legal expertise	Medium term

		Support for administrative reorganization	
9. Compliance with TBT allows to integrate into external production networks	Use South Africa's conformity assessment, certification, but review carefully its mandatory domestic technical regulations	Legal support to adopt South Africa's standards Train personnel in TBT-related issues	Medium term
10. Compliance with SPS	Use South Africa's testing, quarantine, etc.	Legal support to harmonize with South Africa and develop local expertise	Medium term
11. Reducing transaction costs through improved customs procedures	Computerize customs	Training, software and hardware needs	Short term
MULTILATERAL ISSUES			
Barrier or Opportunity	**Policy Action**	**Technical Assistance**	**Time Frame**
12. Cutting costs through regional regulatory cooperation	See above	See above	Long term
13. GATS Negotiations—improving business climate and competition	Liberalize at least as much as South Africa Liberalize more than South Africa in key areas (e.g., tourism)		Short term
14. WTO Government Procurement Agreement	Study costs and benefits of implementing agreement Lobby other SACU members to sign and implement agreement as a group	Training to develop analytical expertise Support for administrative reforms	Medium term
BILATERAL ISSUES			
Barrier or Opportunity	**Policy Action**	**Technical Assistance**	**Time Frame**
15. FTA with United States	Study options, including whether to sign alone or with other SACU members Lobby SACU members	Train and equip staff for economic analysis	Short term
16. Cotonou Agreement	Study options, lobby SACU members	Train and equip staff for economic analysis	Short term
17. Double transformation requirement in EU and the prospect of the waiver termination in US.	Launch lobbying effort to obtain a waiver on a double transformation requirement in EU and the extension after 2004 in the US	Technical advice on designing the lobbying strategy	Short term
BUSINESS ENVIRONMENT			
Barrier or Opportunity	**Policy Action**	**Technical Assistance**	**Time Frame**
18. Dispersed and unreliable information about	Set up a unit that would gather (and provide) relevant information.	Equipment and training	Short term

business regulations in Lesotho 19. Difficulties experienced by (potential) foreign investors in conducting due diligence about opportunities in Lesotho	Set up a web site and keep it updated Either separate the LNDC into an autonomous investment promotion agency or strengthen the existing capacity. Establish a One-Stop-Shop		
20. Complex business licensing procedures 21. Absence of an Investment Code	Shifting to a registration system with areas identified as outside of private business activity Develop an Investment Code	Computerization of <u>revised</u> procedures Technical support in designing and supporting such a code	Short term
22. Land leases for too short time	Shifting to leases granting the right of use of 99 years	Assessment of impact on land prices	Short term
23. Environmental degradation	Cost impact analysis and implementation of provisions of the 2001 Environment Act based on a principle that a polluter should pay for the damage done to natural environment	Technical assistance needed	Short term
24. Unpredictable Lesotho Electricity Corporation's billing practices	Improve Lesotho Electricity Corporation's billing procedures	No technical assistance needed	Short term
25. Telecommunications: insufficient roaming arrangements in Lesotho	Make mobile phone services fully compatible with South Africa's	No technical assistance needed	Short term
26. Tax laws discriminate against services	Equalize tax rates across all sectors except for public 'bads'	No technical assistance needed	Short term
27. Foreign investors have difficulties obtaining visas because of lack of Lesotho's consular services	Accept visas granted by RSA as valid for Lesotho for short-term business trips Sign a consular agreement with South Africa (or other country) to provide consular services across the world Revise visa regulations, making it easier for potential investors to obtain multiple entry visas	No technical assistance needed	Short term
28. Complex procedures to obtain land leases, site development, and land survey	Overhauling administrative procedures and establishing a land registry Create interagency coordinating process Simplify procedures Computerize and reduce the number of fees required	Training of surveyors and strengthening of cadastre	Medium term
29. Weak entrepreneurial skills. No Basotho managers	Work with industry groups to promote Basotho to higher-level positions and establish business-training programs	Support for the development and implementation of a comprehensive, multi-faceted program.	Medium term

	Cooperate with the Chamber of Commerce and banks to establish workshops to train in writing business plans Review technical courses offered in schools to include business training		
30. No linkages between SMMEs and large-scale industry No backward linkages.	Work with industry groups to improve small business training Work with banks to improve SMME access to credit	As above.	Medium term
31. No diversification of exports, especially in the agro industry sector	Improve the policy and regulatory environment for exports Establishment of export oriented agro industries utilizing locally available raw materials	Financial and technical assistance needed for production, processing and marketing	Short to medium term
32. Insufficient customs facilities	Provide full-service customs services at more border posts	Support for training of new staff	Medium term
33. Low tax compliance among foreign owned firms.	Introduce basic accounting procedures compatible with international and South Africa's standards and improve Tax Authorities Simplify tax code (equalize tax rates across various sectors, see above on discrimination against services)	Support for training for both accountants and Lesotho Revenue Authority in consultations with South African experts	Long term
34. Worker discontent and tensions with foreign investors.	Provide incentives to expatriates in foreign owned companies to have a command of English. Institutionalization of a dialogue involving foreign investors, government and non-government organization on industrial relations and conditions needed to promote Basotho to managerial positions	Providing information on experience of other developing countries	Long term
35. Small size of domestic market—single SACU marker as an opportunity	See actions under multilateral and regional headings Launch lobbying effort to obtain a waiver on a double transformation requirement in EU and the extension after 2004 in the US	See assistance needed under respective multilateral and regional headings Technical advise on designing the lobbying strategy	Long term

PHYSICAL INFRASTRUCTURE

Barrier or Opportunity	Policy Action	Technical Assistance	Time Frame
36. Deficient rail facilities	Work with Maseru railhead stakeholders to facilitate improvements	No assistance needed	Short term
37. Insufficient supplies of water to industrial estates	Find ways to reduce consumption and link the development of factory shells to the availability of water Explore possibilities of recycling water for industrial use	Survey of water availability as a constraint to industrial and agricultural development	Medium term

38. Lack of industrial sites.	Survey possible sites taking into account environmental constraints including availability of water	Financial and technical assistance needed to assess possible environmental impacts of various locational variants of industrial development	Medium term
39. Insufficient all-weather roads, especially in rural areas	Prioritize with a special emphasis of the impact on agricultural sector Expand private contracting for road construction and maintenance in multi-year contracts	Financial and technical assistance needed. It should be linked to commitment to future maintenance as well as take into account Lesotho's potential to attract tourism.	Long term
40. Lack of access to utilities throughout rural areas and potential industrial sites.		Financial and technical assistance needed.	Long term
OTHER CROSS CUTTING ISSUES			
Barrier or Opportunity	**Policy Action**	**Technical Assistance**	**Time Frame**
41. FDI data are internally inconsistent	Create better systems for gathering information Computerization	Technical advice on designing tax reporting systems Support equipment purchases Train staff in data collection and statistical analysis	
42. Trade liberalization reduces government revenue	Introduce broad-based tax system to reduce reliance on border taxes Assess impact of tax reform	Train and equip staff Expertise for legal and organizational reforms	

CHAPTER 1
ECONOMIC AND POLICY SETTING

1.1 INTRODUCTION

This Diagnostic Trade and Integration Study (DTIS) asks how Lesotho can integrate into the world economy in ways that enhance economic development and poverty reduction. The study first assesses the country's present trade and investment regime, and then derives implications for policy reform and technical assistance. This represents the first step in the Integrated Framework (IF) process: the DTIS will enable the Lesotho IF National Steering Committee to carry forward the IF program and coordinate technical assistance.

This study argues that Lesotho's size, internal policies, and economic relationships with regional and global partners demand a two-track policy towards greater integration. The first component is to pursue policy integration at the regional level with the aim of creating a single integrated market within Southern Africa Customs Union (SACU). Complementing this diplomatic strategy is a second component, consisting of unilateral steps to improve the domestic investment climate in Lesotho. Significant technical assistance will be needed to strengthen the government's capacity to pursue these policies more effectively, and the IF provides one mean of prioritizing and coordinating the needed assistance. Many policy reforms do not require external aid, but are rather "quick wins" that can be carried out with the stroke of a pen.

This chapter outlines the country's economic and policy setting. It begins by reviewing Lesotho's economic structure and policy environment—both the trade regime and internal regulatory policies. This is followed by an evaluation of external competitiveness. The last section outlines major issues related to Lesotho's integration into the region and the world economy and gives a road map for the report.

Before we proceed, an important and recurring caveat has to be made. The quality of statistical data in Lesotho is extremely low—not only for foreign trade (as extensively discussed in Volume 2, Chapter 1), but in other areas as well. Hence, conclusions derived from empirical data compiled by Lesotho authorities have to be treated with caution.

1.2 CONTEXT AND STRUCTURE

1.2.1 Geographic Context

Lesotho is a unique country, but this uniqueness does not stem from being landlocked, poor and small. Instead this derives from its geographic position. Lesotho is not the only landlocked country facing long land transit to the nearest accessible seaport. In fact, the 720-kilometer distance from Maseru to Durban's port compares rather favorably with the 2,050 kilometers land transit facing exporters from Chad. Furthermore, Lesotho's exports transit only the territory of a single country on their way to the nearest port. Nor is Lesotho the poorest. With GNI per capita of

US $530 in 2001, it was ranked 156th among 207 economies (WDI 2003). Even its alpine location with no lowlands below 1,400 meters in altitude, albeit rather atypical and earning Lesotho the name ‘Mountain Kingdom,’ is not completely unique, as other countries have similar characteristics (e.g., Nepal). Its population of 2.1 million people does not make Lesotho unique either, as there are at least 14 other countries in the world with similar or smaller populations, although most of them are not land-locked.

Integration with South Africa

Lesotho borders only one country—South Africa—which has the most developed economy in Africa. One cannot discuss Lesotho’s economic structure and performance without mentioning its close economic integration with South Africa. The level of economic interaction with South Africa is high for three main reasons: size differential, proximity and the customs union. Because of its size and relatively high level of economic development, South Africa supplies more than 90 percent of Lesotho’s imports and, until recently, purchased the bulk of its exports. In addition to the monetary and trade linkages already mentioned their capital and labor markets are closely linked as well. Capital can move freely across borders and South African banks operate in Lesotho. Although East Asian investors have probably invested more in Lesotho’s economy, South African owned firms play an important role in services and manufactures. Finally, yet importantly, South Africa provides markets for many services including water royalties and power.

In addition to trade and investment links, there is also substantial labor market integration. The South African economy has traditionally created employment opportunities for the Basotho. This peaked in the late 1980s when around one-third of Lesotho’s male force worked there mainly in gold mines. With the restructuring of the South African mining sector, the demand for Lesotho labor dramatically declined. As noted earlier, remittances from miners’ wages have steadily declined and while employment is growing in other sectors of the South African economy, it has not filled the gap.

South Africa’s GDP per capita is almost six times higher than that of Lesotho. Consequently, Lesotho is not as geographically isolated as many least developed countries are but is well-positioned to take advantage of South Africa’s modern transport infrastructure as well as other opportunities offered by its markets. Furthermore, since both are members of SACU, the oldest customs union in the world, Lesotho has preferential access to South Africa’s markets. This arrangement, falling into the “North-South” type, is a source of not only trade, but other benefits as well.

1.2.2 Economic Structure

The structure of Lesotho’s economy is simple. Lacking many natural resources and manufacturing, the majority of the population is engaged in subsistence agriculture. Historically, the main sources of wage income were the mining industry in South Africa, the public sector, and retail activities. With the recent expansion of the garment industry, which in 2000 surpassed the government as the major employer, this is beginning to change.

TABLE 1.1 STRUCTURE OF LESOTHO'S ECONOMY, 1996-2001
(SHARE OF MAJOR SECTORS IN GDP IN PERCENT)

	1996/97	1997/98	1998/99	1999/00	2000/01	Index, 2001, 1996=100
Primary Sector	18	17	18	17	17	94
Crops	12	11	11	10	11	91
Livestock	5	5	6	6	5	103
Secondary Sector	40	42	39	42	44	108
Manufacturing	16	17	17	16	16	98
Construction	9	10	10	15	17	183
Tertiary Sector	42	42	43	41	39	95
Wholesale and retail	9	9	9	9	9	98
Public Admin.	8	8	9	9	8	105
Education	9	9	10	9	8	95

Source: Derived from data in IMF: Statistical Annex 2002, Table 8.

Poverty Profile

Lesotho ranks among the world's fifty poorest countries, with a GNI per capita of US $530 (WDI 2003). With a Gini coefficient of 0.57, Lesotho's income inequality ranks among the highest in the world (Ministry of Development Planning, 2000). Like most other Southern African countries, Lesotho is projected to lose over one-quarter of its adult population aged 15 to 49 to HIV/AIDS-related illnesses in the next decade (World Bank 2000). Already life expectancy has declined from 53 years in 1989 to 45 years in 1999.

Approximately 58 percent of Lesotho's population was classified as poor in 1986, and this proportion has remained virtually unchanged through the 1990s.[1, 2] Poverty in Lesotho is mostly rural, and over three quarters of the rural households are classified as poor. Moreover, poverty in Lesotho worsens with altitude and is clearly demarcated by geographic location. In the mid- to late 1990s, the proportion of poor households in the rural mountains was three times that in the urban lowlands such as Maseru. In recent years, however, Lesotho has experienced a rapid rise in urban poverty.

The primary income source for most of the poor rural households is agricultural activity. For the urban poor, the primary sources of income are the public sector and the garment industry. Using a consumption aggregate, we find that between 1993 and 1999, the percentage of both the poor and the destitute increased. Half the population (49 percent in 1993 and 51 percent in 1999) is below the poverty line, defined as 50 percent of the national mean of monthly expenditures.[3] Twenty-six percent of the population in 1993 and 33 percent in 1999 were characterized as being destitute (see Table 1.2).

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[1] There is considerable debate about the actual incidence of poverty in Lesotho. For instance, Gay and Hall (2000) report a poverty incidence of 68 percent using income data, while the World Bank (1995) reports a rate of 51 percent.
[2] Here the poverty line is defined as the half the average consumption per capita.
[3] A better measure of the poverty line would be the minimum expenditures necessary for a household to purchase the minimum basic needs.

TABLE 1.2 POVERTY MEASURES IN LESOTHO

	Rural		Maseru		Other Urban		All	
	1993	1999	1993	1999	1993	1999	1993	1999
Incidence								
Poverty	54	56	28	22	27	29	49	51
Extreme Poverty	29	37	14	10	11	15	26	33
Intensity								
Poverty	27	30	13	22	12	27	24	30
Extreme Poverty	10	14	4	11	5	14	9	14
Population Share	82	80	14	15	4	5	100	100
Gini Coefficient	0.55	n.a.	0.58	n.a.	n.a.	n.a.	0.57	0.6

Notes: Incidence is the proportion of people falling below the poverty or extreme poverty lines across the entire population. The intensity is the poverty gap. It measures the household expenditure shortfall relative to the poverty line.
Source: Reproduced from World Bank (2001). The summaries for 1993 are taken from Sechaba Consultants (1994) while the summaries for 1999 are taken from Sechaba Consultants (2000).

Box 1.1 Gender

Another facet of the poverty profile is that female-headed households tend to be poorer, though this is less problematic for those families in which the male household head is sending remittances from abroad. Some progress has been made to change the status of women from minors to citizens lawfully able to own property. However, there are fewer economic opportunities for women as they are still prohibited from owning and transferring property.[1]

Allegations persist that women encounter problems entering into the formal labor market and gaining access to credit markets. As such, women are often restricted to the informal sector and to household chores. Gender issues are particularly important in Lesotho, where one in six labor force participants is employed in South Africa leaving the woman as the *de facto* household head.

If in fact, spouses of migrant workers have limited opportunities to generate income, then the incentive to migrate falls, which, in turn affects the domestic labor market and family welfare. The outlook for female employment in the formal sector is greatly dependent on the outlook for sectors such as textiles and garments, in which a significant proportion of women work in unskilled jobs.

The gender and poverty issue is ultimately one of property rights. The ability to own and transfer an asset is a key factor that will allow women to expand their opportunities and generate wealth. Granting females asset ownership rights will reduce poverty. Although property laws promised to include women as early as 1967, implementation of these laws has been slow (see Chapter 4). Because of these legal restrictions, methods of circumventing them are frequently employed.

Box 1.2 The Lesotho PRSP

The Interim Poverty Reduction Strategy Paper (I-PRSP) for Lesotho was presented to the Executive Boards of the IDA and the IMF in March 2001. The full PRSP completion date was originally set for June 2002 but is now set for November 2003. A PRSP preparation status report was conducted in order to determine progress since the I-PRSP was issued. Although additional time was required at each stage of the process, the I-PRSP indicates that the Technical Working Group has generally kept to the proposed schedule. [The primary reason for the delay is due to the fact that this is the first attempt to prepare a community-driven and country-owned poverty reduction strategy in Lesotho.] Further delays are expected during the process beginning with the broad-based consultations that were concluded in March of 2002. In addition, more time may be required to complete the data analysis and final drafting of the PRSP.

The I-PRSP identifies export led economic growth as an important objective for Lesotho. The recommendations presented include targeting non-traditional activities, such as tourism as the main engine of growth. The I-PRSP identifies the following trade related objectives and targets:

- Promote free trade by simplifying the license acquisition process, reducing quantitative trade restrictions, and establishing a competition policy along WTO guidelines.
- Review the Export Finance Project to further export diversification.
- Advance Lesotho's competitiveness by reforming public utilities and reviewing the incentives for investment.
- Promote private sector development by increasing the capacity of the Lesotho Chamber of Commerce and Industry (LCCI) and the Lesotho Manufacturers Association (LMA), establishing micro-finance credit schemes, and providing training to small, micro and medium enterprises (SMME) and greater market access for SMMEs.
- Improve assistance to businesses through the Basotho Enterprise Development Corporation (BEDCO), LMA and others.

An important aspect of the Integrated Framework (IF) process is to strengthen the links between trade policy and poverty reduction strategies. Towards that end, the IF national steering committee includes participants from the Ministry of Development Planning, which manages the PRSP. In addition, a key PRSP Technical Working Group is the Sector Working Group on Trade, Industry and Tourism chaired by the Permanent Secretary of the Ministry of Industry, Trade and Finance.

1.3 POLICY ENVIRONMENT

1.3.1 Macroeconomic Policy

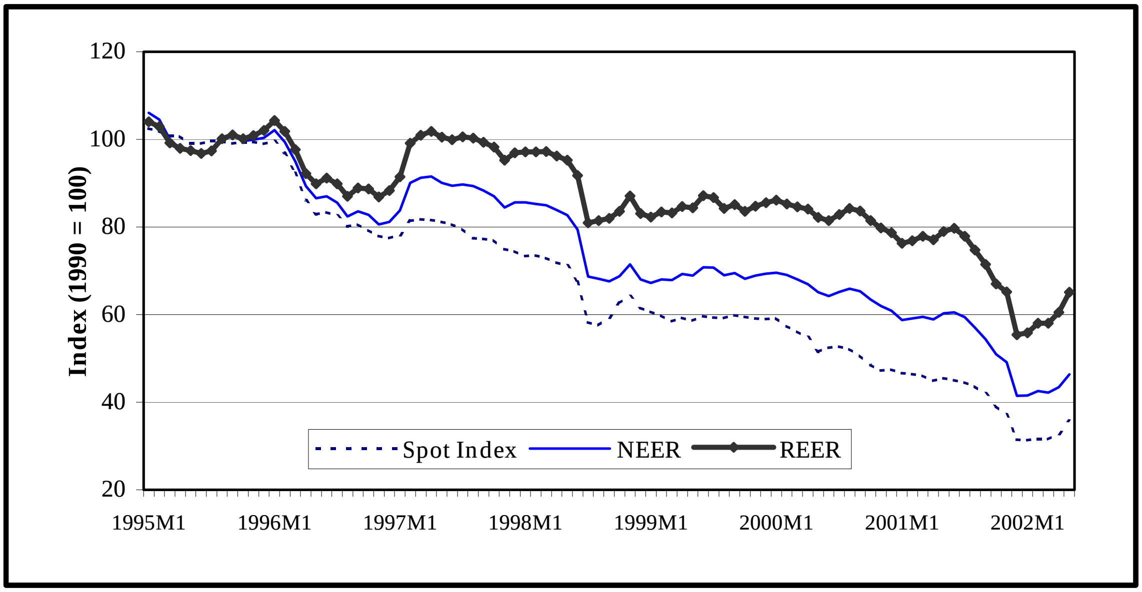
Lesotho's macroeconomic policy is circumscribed because of its membership in the Common Monetary Area (CMA).[4] Under the CMA, currencies are pegged at parity with the South African Rand. This eliminates monetary policy autonomy and it implies that Lesotho's external competitiveness will be reflected in movements in the real effective exchange rate (REER) of the Rand.[5] Following initial appreciation in the early 1990s, the Loti has depreciated almost

[4] Other members are Namibia, South Africa and Swaziland.

[5] The real exchange rate is the nominal exchange rate (measured as foreign currency per unit of domestic currency) multiplied by the ratio of domestic to foreign price indices. A decrease in the real

continuously in real terms since then, as seen by the evolution of the Rand from 1995 to the present, shown in Figure 1.1.

FIGURE 1.1 REAL VS NOMINAL EXCHANGE RATE INDEXES (SOUTH AFRICAN RAND), 1995–2002



Note: The spot index reflects changes in currency exchange quotations. The nominal and real exchange effective exchange rate indexes (NEER and REER) take into account trade flows. Decreases in the value of the index number reflect depreciation of the rand.
Source: IMF, *International Financial Statistics*

What effect has Rand (and therefore Loti) depreciation had on Lesotho's competitiveness? While hard to assess given Lesotho's poor trade statistics, this appears to have been beneficial overall. First, the depreciation lowers the cost of local labor and utilities (in terms of foreign currency), benefiting export-oriented foreign investors, especially those with U.S. dollar export earnings. Second, while depreciation also raises the price of imported inputs, the impact on Lesotho's import bill has been somewhat weakened: imports used in Lesotho's production of garments for U.S. markets come mainly from East Asia, and East Asian currencies were appreciating less vis-à-vis the Loti than the Loti was depreciating against the dollar. The net effect was an increase in competitiveness of Lesotho's exports to U.S. markets when measured in real terms.

1.3.2 Fiscal Policy

Since membership in the CMA, with its attendant fixed exchange rate regime, all but eliminates independent monetary policy, fiscal policy is the main macroeconomic policy instrument at Lesotho's disposal. The government's fiscal position rises and falls with macroeconomic growth.

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exchange rate indicates real depreciation and an improvement in competitiveness. For a detailed discussion of issues involved, see IMF 1998.

The World Bank Growth Options Study reports that during 1980–87, the government of Lesotho incurred fiscal deficits of close to 27 percent of GDP and, at the same time, government revenue was less than 20 percent. With the onset of the economic boom in the late 1980s, customs revenues more than doubled and the deficits rapidly disappeared. But when economic growth dropped off in 1999, Lesotho's overall fiscal balance after grants slipped into a deficit of 6 percent, which doubled to 12 percent in 2000.[6] Fiscal problems were exacerbated by the deteriorating economic situation resulting from the winding down of the LHWP and continued layoffs in the South African mines. Moreover, spillovers from the 1998 currency crisis in South Africa resulted in significant exchange rate depreciation with its attendant effects on inflation and interest rates.

TABLE 1.3 CENTRAL GOVERNMENT BALANCE, 1996–2001
(MILLIONS OF MALOTI AT CURRENT PRICES AND IN PERCENT)

	1996/97	1997/98	1998/99	1999/00	2000/01
Revenue	2,035	2,247	2,174.6	2,313	2,627
Customs Revenue	49%	52%	48%	51%	43%
Non-customs Tax Revenue	27%	28%	30%	31%	31%
Non-Tax Revenue	24%	20%	22%	18%	26%
Expenditures	2,053	2,342	2,438	3,373	2,898
Current Expenditures	57%	63%	80%	69%	82%
Capital Expenditures	43%	37%	20%	14%	18%
Balance before Grants	-18	-95	-265	-1,061	-271
Grants from Abroad	203	179	120	130	126
Overall Balance after Grants	185	84	-145	-931	-146
Memorandum					
Customs/Total revenue	49%	52%	48%	51%	43%
GNP at market prices	4,216	4,770	5,082	5,733	6,377
Customs revenue/GNP	24%	25%	20%	21%	18%

Source: IMF, *Lesotho: Statistical Annex 2002.*

In late December 1999, the government began implementing an IMF staff-monitored program (SMP) that was followed by a PRGF by the end of 2000. The 2001 Article IV Consultations and the second review of the PRGF in March 2002 concluded that the government's fiscal stabilization program remained on track with the fiscal deficit down to 2.9 percent.

Table 1.3 shows information on the government's fiscal position since 1996. As is evident, the majority of government revenue comes from customs revenue. Duties are collected by SACU and redistributed to the customs union members according to a set formula. In recent years, this has represented between 43 and 52 percent of total central government revenue and significantly contributed to reducing the fiscal deficits described above. Since South Africa exercised exclusive oversight over the level of the SACU common external tariff in the past, a large part of the government revenue had been out of the control of fiscal authorities in Maseru. We turn next to a discussion of SACU tariffs and Lesotho's trade policy.

[6] IMF data generate slightly different figures for the fiscal deficit after grants as a share of GDP: 2.8 percent in 1998/1999 and 16.2 percent in 1999/2000 (IMF Statistical Annex 2002, Table 7).

1.3.3 Tariff Policy

Lesotho is a member of the Southern African Customs Union (SACU), the world's oldest union formed in 1910 whose other members are Botswana, Namibia, South Africa and Swaziland (the "BNLS" countries). The SACU agreement calls for all members to apply the same customs and excise duties (as well as related trade laws) to goods imported into the common customs area from outside. Goods imported from outside the common customs area are subject to a Common External Tariff (CET). Under the old SACU agreement, South Africa primarily determined tariff rates.[7] Under the new agreement that was initialed on October 21, 2002, tariff rates will be determined by a separate Tariff Setting Board.

Due to tariff liberalization and simplification conducted in the 1990s, SACU has a relatively open trade regime. The simple average applied MFN tariff rate was 10.4 percent in 2001, down from 15.1 percent in 1997. There are significant tariff peaks on garments in the CET, however, which creates an anti-export bias for Lesotho. Additionally, the CET is plagued by a number of specific, compound, mixed and formula duties, which are less transparent than simple *ad valorem* tariffs and therefore facilitate protectionist lobbying. We discuss the CET and opportunities for Lesotho to influence its future shape below in Chapter 3.

1.3.4 Regulatory and Business Climate

A country's domestic regulatory and business climate critically shapes its integration with the external environment. It affects the level of investment as well as its productivity. Government regulations that are unnecessarily complicated tend to facilitate corruption and rent seeking behavior, thereby discouraging foreign investment. Like tariffs, they add to the costs paid by exporters and imports and therefore distort trade flows, but they additionally divert real resources to complying with regulations or to rent seeking behavior that could be used more productively elsewhere in the economy. A hostile business climate acts as a barrier to poverty reduction and economic development.

After independence from the UK, regulatory policies supported the aim of reducing dependence on South Africa through import substitution industrialization, extensive wage and price controls, government provision of credit, and state monopolies. This statist approach was abandoned in the 1990s. Privatization and deregulation have contributed to an improved environment for investment and private economic activity. How does Lesotho's domestic business climate compare with other countries?

Two major cross-national reviews of investment climates include Lesotho in their rankings: the Wall Street Journal and Heritage Foundation survey (WSJ/HF 2002) of 'economic freedoms' and the Africa Competitiveness Report (Schwab 2000). Lesotho's overall WSJ/HF index of 3.4 places it

[7] Article 5 of the SACU agreement requires South Africa to afford the other SACU members adequate opportunities for consultations before imposing, amending or abrogating customs duties, except in specific cases. Under the current agreement, the South African Department of Trade and Industry sets the CET for all of SACU, upon the recommendation of South Africa's Board on Tariffs and Trade (BTT). When the tariff is amended, all SACU members implement the new tariff (WTO 2002).

in the “relatively restricted” country group (between 3 and under 4) indicating an unfavorable commercial environment, South Africa’s value of this index of 2.9 places it low in the “relatively free” country group (over 2 and below 3).[8] The picture emerging from the Competitiveness Report is fully consistent with that of the WSJ/HF: it places Lesotho at about the mid-point (13) of the 24 African countries whose international competitiveness is assessed. The business environment is regarded as restrictive because of the lack of established investment code and restrictions on hiring of expatriates, as well as lingering price controls.

This presentation, which is developed further in Chapter 5, supports two conclusions. First, Lesotho must take the lead in implementing significant structural reforms that would substantially improve the local investment environment. Second, while not much can be done immediately about such factors as those related to Lesotho’s ‘land-lockedness’ or poor infrastructure, progress can be made rather quickly in other areas identified in the discussed cross-country studies.

1.3.5 Consolidation of Democracy?

Democracy has ‘economic value’—it contributes to political stability and predictability of policies. Both are crucial to a business-friendly environment.

Compared to many other countries on the continent, Lesotho’s political system is relatively stable and open. A constitutional monarchy with a significant role for traditional chieftains, Lesotho has held four democratic elections since independence in 1966. Military rule preceded the election in 1993, which was followed by political unrest and instability. The election in 1998 was also characterized by violence in which loss of life and considerable damage to property occurred. By contrast, the last election in May 2002 was peaceful. The incumbent party was re-elected with a massive mandate to continue its economic reform program. While Lesotho is yet to meet the final test of consolidation of democracy, i.e., a peaceful transfer of power to a non-incumbent party, the last election augurs well for future political stability. Solidifying a system that takes broader public interests into account is necessary for fostering a good investment climate. It also contributes to Lesotho’s ability to promote its interests in regional and global settings. In Chapter 4 we recommend ways to improve public-private dialog in trade policy formation.

Yet, a nagging external perception of Lesotho as a politically unstable country persists. The violence in 1998 fostered widespread insecurity among Asian investors, many of whom temporarily closed their factories. Moreover, East Asian investors have felt particularly insecure because the Lesotho media and the public at large perceive them negatively. In terms of public perceptions, it is possible for the government to improve the image of the foreign investment community in Lesotho. In turn, foreign investors can themselves do a great deal to improve their image, integrate better with the host community and publicize their contributions to the Lesotho economy.

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[8] Other groups are classified as follows: free with the values of overall indices of 2 or less, and restricted with the values between 4 and 5. As for other Lesotho’s SACU partners, Botswana and Namibia are ranked above South Africa in a ‘relatively free’ group, and Swaziland is above Lesotho in the ‘relatively’ restricted group.

1.3.6 Summary

The salient characteristics of Lesotho's economic setting are the following: First, Lesotho's integration into the regional economy is an inescapable fact. Lesotho's economy is inextricably linked with its regional partners'—particularly South Africa's—through flows of goods, services, labor and capital. Trade, exchange rate and monetary policies are similarly integrated, as is appropriate when economies are so intertwined. From Adam Smith onwards, economists have pointed out that the benefits of the division of labor are limited by the extent of the market. Lesotho's integration into the larger regional market yield economic benefits it could not hope to enjoy, given its location, resources, and small size. There remain important barriers that prevent the customs union from attaining the level of a single market, however.

But Lesotho has not ignored the broader world outside of the region—it has cultivated foreign direct investment to build an entirely new and dynamic industry, which in turn has gained a foothold in the world's largest economies. Although one might dismiss the emergence of the garment industry as opportunistic behavior by footloose foreign investors (who will leave Lesotho as swiftly as they arrived), Lesotho took advantage of this opportunity while other countries did not. Clearly the country's investment climate offers some unique features, such as some favorable regulations, relatively stable democracy, and the like. But more can be done to improve the internal business climate, as well as to reduce the costs of trading within the region. It is to these challenges and opportunities that we now turn our attention.

1.4 ECONOMIC PERFORMANCE

1.4.1 Macroeconomic Growth and Stability

Lesotho's long-term growth performance has been better than that of other low-income countries despite similar population trends and flat growth performance of South Africa. As shown in Table 1.1. at the beginning of this chapter, construction grew faster than other sectors during the past five years. Manufacturing's contribution to GDP increased from 12.5 percent between 1991–95 to 16 percent in 1996–2000, with 31 percent of its total value added originating in textiles and clothing (Basu and Srinivasan 2002). In contrast to South Africa, agricultural output contracted over this period.

Gross National Income (GNI), relative to GDP, is a much better indicator of welfare for a country like Lesotho because of the large external sector. For example, in 1990, GNI which measures 4.6 trillion Maloti, was 66 percent greater than GDP. Figure 1.2a indicates real GDP rose at an annualized rate of over 3.7percent between 1990 and 2001, while real GNI actually fell by 0.4 percent. At the per capita level, as shown in Figure 1.2b, the story is even more ominous because real GDP only grew at an annualized rate of over 1.8 percent during the same period, while real GNI actually fell at an annualized rate of over 2.2 percent.[9] The decline in per capita GNI is thus consistent with the rise in poverty reported at the outset, while the rise per capita GDP is not.

[9] These growth rates are calculated from GNI, GDP and population data in World Development Indicators 2003, using the formula $Y_t(1 + r)^n = Y_{t+n}$ to determine the annual growth rate, r.

FIGURE 1.2A GNI AND GDP COMPARISON

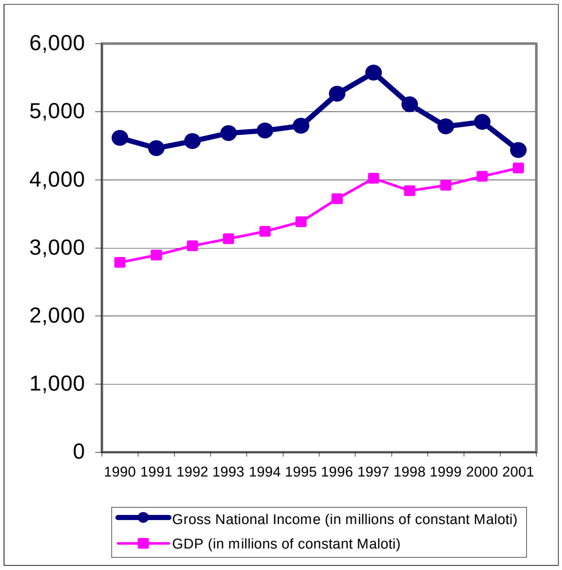
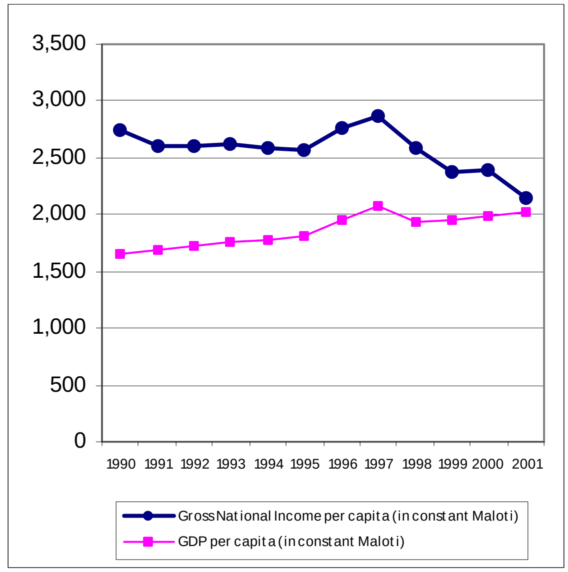


FIGURE 1.2B GNI PER CAPITA AND GDP PER CAPITA COMPARISON



Source: World Development Indicators

There have been four dynamic shifts in income sources in the last decade. On the negative side, remittance income has fallen dramatically, and several droughts have adversely affected rural subsistence farmers, including the drought in 1998. On the positive side, the Lesotho Highlands Water Project (LHWP) has generated both revenues and temporary employment benefits to the economy, while the small but growing garment industry has provided jobs to the growing urban poor.

Remittance Income

In Lesotho, the remittance income from abroad has been very large relative to domestic production. According to the 1999/2000 agricultural census about 20 percent of Basotho household heads worked away from home—most out of the country—for an extended period of time, (Bureau of Statistics 2001a).

The fall in demand for Basotho mining labor between 1994 and 2001 is the primary explanation for the decline in remittance income (see Figure 1.3). The number of miners employed in South Africa has declined by nearly one half, from almost 127,000 in 1990 to 65,000 in 2000. Some of the slack in demand has been taken up by other sectors (such as agriculture) in South Africa, although mining wages are generally four or five times higher than wages in other sectors for workers with similar skills. The current proportion of Basotho miners and non-mining laborers now stands at 45 and 55 percent, respectively.[10] The proportion of miners is likely to continue falling, which will have a negative effect on total remittances. It should also be noted that the high incomes received in South African mines allows most Basotho families to move out of

[10] **These figures are preliminary results from the 1999 Lesotho Labor Force Survey [CITE].**

poverty, but the prospects for these miners in Lesotho is limited and the families often fall into poverty when the source of income is seizes.

Despite the continuing decline in the number of migrant workers being hired in South African mines, miners still make up 15 percent of Lesotho's total labor force, and represent one quarter of South Africa's miners.

FIGURE 1.3A NUMBER OF MINERS EMPLOYED IN SOUTH AFRICA

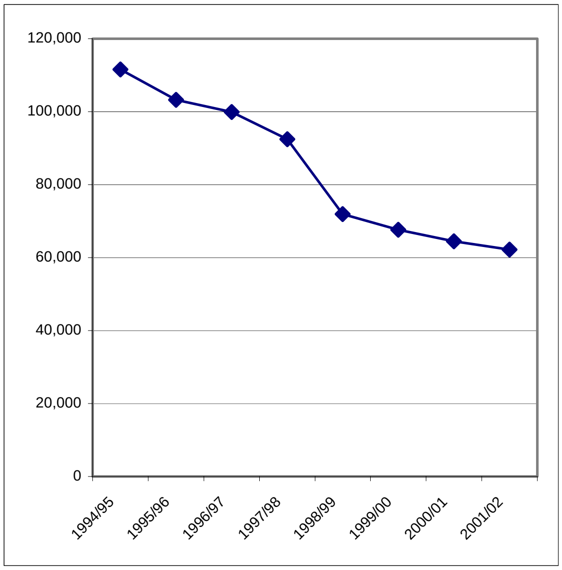


FIGURE 1.3B RATIO OF MINERS REMITTANCES TO GNI

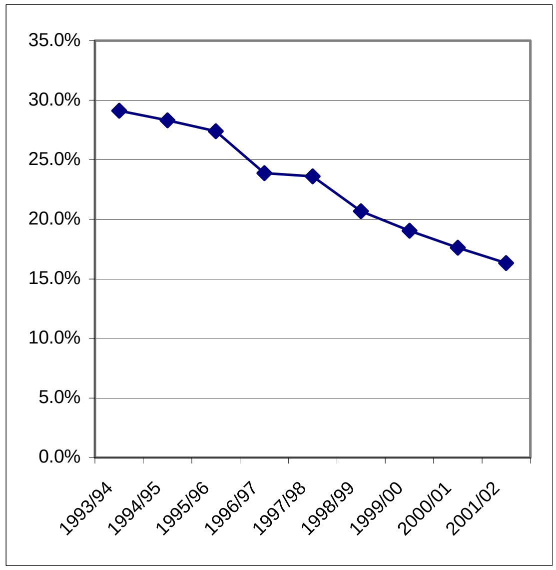


Table 1.4 shows the effects of a 25 percent decline in remittance income using a Social Accounting Matrix (SAM) – based model developed for the World Bank Growth Options Study. The impact of the decline has a significant distributional impact. High income households in rural areas and low income households in urban areas are particularly hard hit. Reductions in income of this magnitude have the obvious impact of severely reducing the welfare of households and increasing poverty rates.

TABLE 1.4 SIMULATION OF A 25 PERCENT DECLINE IN REMITTANCES ON HOUSEHOLD INCOME

	Household Income Before Shock	Impact on Household Income	Percentage Change After Shock
Urban – High income	3414.7	-358.2	-10.5%
Urban - Low income	34.5	-4.6	-13.3%
Rural lowlands - High income	517.5	-56.4	-10.9%
Rural lowlands - Low income	275.8	-19.8	-7.2%
Rural foothills - High income	296.7	-31.9	-10.7%
Rural foothills - Low income	158.0	-11.5	-7.3%
Rural mountains – High income	230.9	-30.1	-13.0%
Rural mountains - Low income	117.4	-8.7	-7.4%
Rural Senqu River Valley - High income	133.8	-17.4	-13.0%
Rural Senqu River Valley - Low income	77.7	-5.8	-7.5%

Source: Growth Options Study

Table 1.5 details some of the changes in employment across various domestic industries as a result of the 25 percent decline in remittance income. Those most affected by the remittance income shock are agricultural workers, with nearly sixty percent of the reduction in employment arising in crop and horticultural industries.

TABLE 1.5 SIMULATION OF A 25 PERCENT DECLINE IN REMITTANCES ON EMPLOYMENT

	Change in Employment	Percentage of Total Job Loss
Vegetable production	-8,284	25.9%
Field crops (traditional)	-5,260	16.5%
Fruit production	-4,355	13.6%
Cattle production	-2,418	7.6%
Goats	-2,181	6.8%
Sheep	-2,037	6.4%
Field crops (improved)	-1,134	3.5%
Reduction in Total Employment	-31,976	
Total Initial Employment	**464,055**	

Source: Growth Options Study

Subsistence Agriculture

Agriculture prospects in Lesotho are not encouraging. Only 10 percent of land is arable, soil quality is low, there is a lack of access to modern farming equipment, yields have been declining and there is a high prevalence of HIV/AIDS among the economically active population. Furthermore, population density, at 65 people per square kilometer, is high for a predominantly subsistence economy. In addition to the above constraints, the periodic droughts that afflicted the Southern African region during the 1990s hit Basotho farmers especially hard.

According to the 1999 Labor Force Survey, about 80 percent of the economically active rural population listed "subsistence agriculture" as the household's main occupation (Bureau of Statistics 2001b). In fact, the poor derive more than twice as much income from subsistence farming than do the non-poor. As a result, negative shocks such as draughts have a particularly adverse impact on the poor.

Given the general poor land quality in Lesotho, the issue for people engaged in agricultural production is not simply to change from subsistence to cash crop production.[11] To see this, consider a second simple counterfactual exercise of a 25 percent increase in commercial agricultural production conducted within the SAM framework. Table 1.6 shows that total income across regional household types would be affected only minimally by improvements in commercial agriculture. The biggest impacts are felt by urban high-income households and high income households in rural lowlands.

TABLE 1.6 SIMULATION OF A 25 PERCENT INCREASE IN COMMERCIAL AGRICULTURAL PRODUCTION ON HOUSEHOLD INCOME

	Household Income Before Shock	Impact on Household Income	Percentage Change After Shock
Urban - High income	3414.7	7.7	0.2%
Urban - Low income	34.5	0.1	0.3%
Rural lowlands - High income	517.5	7.4	1.4%
Rural lowlands - Low income	275.8	1.4	0.5%
Rural foothills - High income	296.7	4.3	1.5%
Rural foothills - Low income	158.0	0.8	0.5%
Rural mountains - High income	230.9	2.5	1.1%
Rural mountains - Low income	117.4	0.6	0.5%
Rural Senqu River Valley - High income	133.8	1.4	1.1%
Rural Senqu River Valley - Low income	77.7	0.4	0.5%

Source: Growth Options Study

Table 1.7 details employment effects, which are almost entirely confined to the agriculture sector. The biggest increase in employment would likely be in vegetable production.

[11] Using data from CIESIN and Landscan, Chapter 4 of the 2003 World Development Report reports Lesotho falls in the bracket of countries with between 30 and 50 percent of the people live on so-called fragile land, which cannot support intensive agricultural production. See: http://econ.worldbank.org/files/17954_WDR_2003_chp_4_web.pdf

TABLE 1.7 SIMULATION OF A 25 PERCENT INCREASE IN COMMERCIAL AGRICULTURAL PRODUCTION ON EMPLOYMENT

	Change in Employment	Percentage of Total Job Gain
Vegetable production	3,504	50.7%
Field crops (improved)	677	9.8%
Fruit production	612	8.9%
Cattle production	592	8.6%
Goats	332	4.8%
Sheep	310	4.5%
Total impact on employment	**6,905**	

Source: Growth Options Study

While there may be no reason to advocate any particular agricultural strategies, that should not stop individuals from engaging in specialized agricultural activities that are deemed to be viable. For instance, certain fruit and vegetable producers can take advantage of niches in the domestic market resulting from consumer preferences or micro-climactic advantages to expand production. These include:

- *Fruit*: Peaches, apples, grapes and berries grow in many parts of the country (peaches are the most widespread).
- *Dairy products*: milk producers report that they face little domestic competition; scarce land (for fodder) holds back commercial production.
- *Vegetables*: growers suggest there is substantial unmet demand for traditional vegetables such as cabbage, carrots, and beets in the domestic market.
- *Eggs and poultry*: egg producers face competition from South African producers during part of the year; meat producers report they could serve more of the local market if they had access to better packaging and processing facilities.

Other potentially promising agricultural income generating activities include highly specialized products (i.e., honey, garlic and paprika) that flourish in the climate of this small mountainous country. Additional possibilities exist in rural areas for non-agricultural products and services. Tourism is frequently identified as an industry that could produce employment opportunities in rural areas. Lesotho appears to enjoy a comparative advantage in sandstone blocks for construction purposes. It presently exports sandstone to Botswana and South Africa, in addition to supplying the domestic market.

The Lesotho Highlands Water Project

The LHWP had little impact on household incomes because a large share of the construction force was labor from South Africa.

To see this, a similar pair of experiments looks at the distribution of a simulated 50 percent decline in investment related to the Lesotho Highlands Water Project. Table 1.8 documents that even a shock twice as large as the one hitting remittance income has relatively small effects across the entire spectrum of households. High income households in rural foothills and rural lowlands are hardest hit.

TABLE 1.8 SIMULATION OF A 50 PERCENT DECLINE IN INVESTMENT RELATED TO THE LESOTHO HIGHLANDS WATER PROJECT ON HOUSEHOLD INCOME

	Household Income Before Shock	Impact on Household Income	Percentage Change After Shock
Urban - High income	3,414.7	-109.2	-3.2%
Urban - Low income	34.5	-0.7	-2.0%
Rural lowlands - High income	517.5	-25.8	-5.0%
Rural lowlands - Low income	275.8	-6.4	-2.3%
Rural foothills - High income	296.7	-15.0	-5.1%
Rural foothills - Low income	158.0	-3.7	-2.3%
Rural mountains – High income	230.9	-9.3	-4.0%
Rural mountains – Low income	117.4	-2.8	-2.4%
Rural Senqu River Valley - High income	133.8	-5.4	-4.0%
Rural Senqu River Valley - Low income	77.7	-1.8	-2.4%

Source: Growth Options Study

Finally, for the employment story, the results listed in Table 1.9 suggest that nearly one third of all persons losing jobs as a result of the fall in LHWP investment are in that industry. Another third of all job losses occur in crop and horticultural production.

TABLE 1.9 SIMULATION OF A 50 PERCENT DECLINE IN INVESTMENT RELATED TO THE LESOTHO HIGHLANDS WATER PROJECT ON EMPLOYMENT

	Change in Employment	Percentage of Total Job Loss
Civil engineering	-4,552	24.3%
Vegetable production	-2,936	15.7%
Field crops (traditional)	-1,861	9.9%
Building construction	-1,557	8.3%
Fruit production	-1,455	7.8%
Total impact on employment	-18,734	

Source: Growth Options Study

The Garment Industry

Garment production for exports has increased dramatically over the last decade. However, much of this expansion is due to a very small value added in Lesotho, with much of the inputs being imported. As a result, the linkages between the garment sector and SMMEs or other large-scale industries are limited.

The expansion in the sector has led to tremendous job creation, with the primary beneficiaries being the urban poor and mostly women. However, due to the large disparity in total income earned by Basotho working abroad and domestic garment industry workers, growth in the garment industry has not offset the decline in remittance incomes. In 1998, the average garment sector worker earned just over a fifth of the salary earned by a miner in South Africa.[12] Furthermore, despite the fact that the number of miners fell from 127,386 to 64,907 between 1990 and 2000, the entire garment sector employed only about 20,000 people in 2000.

As Salm (2002) suggests, prospects for the garment sector could improve if duty drawback rules are redrawn so that small amounts of wasted fabric can be used in small-scale production for domestic consumption, instead of being destroyed, as is currently mandated. An expanded SMME presence in activities linked to the garment industry would help Lesotho derive greater economic benefits from existing FDI. Finally, the garment industry could offer opportunities for sub-contracting, but a more concerted effort needs to be made by LCCI and exporters to identify these opportunities (see Chapter 3).

What can be said about economic growth in the future? Will the recent decline continue or will the economy rebound? There are two reasons for optimism. First, the rapid expansion in garment exports to the United States is already contributing to economic growth, even if this is presently outweighed by other factors, and Lesotho has good prospects for expanding the garment business. Second, the recovery of the South African economy, which was stagnant throughout most of the 1990s, may provide a powerful trigger to Lesotho's exports and growth.

1.4.2 Inflation

As a result of monetary union with South Africa, inflation rates in Lesotho has been low and stable, especially compared to many other LDCs. Year on year growth rates in the consumer price index during 1997–2001 ranged from 6 to 9 percent (IMF 2002). This stability has contributed to Lesotho's success at attracting investment and maintaining export competitiveness.

1.4.3 Trade and Investment Flows

The main features of Lesotho's trade include: unexplored opportunities from its trade in services, high geographical and commodity concentration, dramatic expansion of exports of garments to the US, and the absence of any meaningful participation in global networks of production and distribution. Moreover, there has been a persistent trade deficit, financed from remittances by those employed in South Africa, among other sources.

Among countries with similar developmental characteristics, Lesotho's foreign trade and investment performance stands out. First, its economy is more open to trade: foreign trade in goods as a percent of goods GDP was 198 percent in 1999, the third highest among African countries (WDI 2002). Lesotho also compares very favorably to a group of countries that are similar in terms of resource endowments, land-locked status, and level of economic

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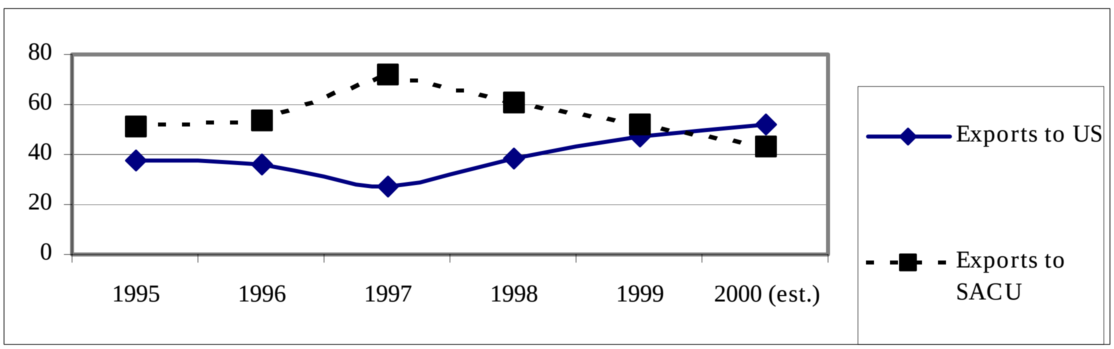
[12] Miners earned about M 25000 per year while garment sector workers earned about M 5741 per year in 1998.

development.[13] A second measure is exports per capita: Lesotho's were US$81 in 1999 putting it at the top of this group of similarly endowed countries. Third, the country's share of exports in GDP (18 percent) was significantly above average. Over 1989–99, Lesotho's growth in real trade was higher than real GDP growth, albeit by a small margin of 0.3 percentage points. Export-led growth has driven Lesotho's economy with an average annual export volume growth of 11 percent over 1990–98. Imports grew at 1.4 percent in the same period.

Lesotho's Rise as a Garment Powerhouse

The past decade has witnessed a fundamental shift in the Lesotho's trade and investment flows, which is part and parcel of the rise of garment manufacturing in Lesotho. In 2000 the United States replaced SACU as the number one destination of Lesotho's exports. According to a very rough estimate, exports to the U.S. exceeded exports to South Africa in 2000. This is reflected in Figure 1.3. In contrast, SACU, or more precisely South Africa, accounts for around 90 percent of total imports, and this has remained steady during recent years. South Africa's position as a dominant supplier is easily explained by it proximity and economic size.

FIGURE 1.4 DIRECTION OF TRADE, 1995–2000



Note: for 2000, predicted values based on the estimates of total exports/imports (estimates of the Central Bank of Lesotho and IMF staff), corrected by the increase in the value of exports to the US (as reported by the U.S) above the projected level and value of Asian imports derived from their ratio to US-oriented exports.
Source: Based on statistics from Table 5.1 (Direction of Exports by Regions and SACU) on page 11 in Bureau of Statistics (BOS), *1999 Foreign Trade Statistics*, and Table A13 (Direction of Trade-Imports C.I.F.) on page 53 of the Central Bank of Lesotho's (CBL), *Annual Report for 2000*. Because of significant differences, we used the average of two estimates (Volume 2, Chapter 1).

Lesotho's exports to the U.S., almost exclusively clothing, can be attributed to Taiwanese firms that have invested in the country to serve the U.S. market. Lesotho's garment exports have received preferential treatment in the U.S. market as a consequence of the Multi Fibre Agreement (MFA)—a system of import quotas imposed by industrial countries on the world's largest garment exporters. This will end in 2005.[14] Preferential treatment was further expanded for

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[13] This group of comparators includes Armenia, Bhutan, Burkina Faso, Burundi, Central African Republic, Chad, Kyrgyz Republic, Lao PDR, Malawi, Mali, Moldova, Mongolia, Niger, Rwanda, Tajikistan, and Zambia (for details, see Volume 2, Chapter 2). The average value of exports per capita in this group was $41. Only Mongolia and Moldova had higher exports per capita.

[14] In 1995, the WTO Agreement on Textiles and Clothing (ATC) replaced the MFA. The ATC was established as an interim management providing for the gradual integration of the textiles and clothing sector in WTO disciplines and phase-out of former MFA quotas. The schedule of

African countries under the U.S. African Growth and Opportunity Act (AGOA), which was enacted in 2000. As an LDC, Lesotho is exempted from the standard rules of origin until 2004, enabling producers to buy fabric from the most efficient suppliers. After 2004 they must source inputs either from another AGOA country or from the U.S.

The development of Lesotho's garment industry therefore results in part from temporary, non-reciprocal trade preferences. One must point out, however, that many other Sub-Saharan African countries enjoy the same treatment, but Lesotho stands out in its ability to take advantage of this opportunity. Clearly Lesotho has something that the other countries lack. Chapter 2 and several of the background studies contributed to Volume 2 of this study address the extent to which Lesotho's comparative advantage in garments is artificial or natural.

Here we want to point out that this distinction has important ramifications for poverty reduction. The basic question is: How can Lesotho take advantage of temporary preferential treatment to build an industrial sector that has a permanent comparative advantage? If business leaders and policy makes can answer this question, manufacturing employment can continue to expand in Lesotho and thereby fill the gaps created by falling remittances and contraction in agriculture. If not, Lesotho may experience a decline in manufacturing employment in 2005 as dramatic as its recent expansion.

Services: Unexplored Opportunities

Services value-added accounted for 45 percent of GDP in 2000 and for 11 percent of total trade in goods and services (BOP basis) in 2000 (WDI 2002). Despite Lesotho's location requiring significant expenditures related to transport of goods, trade in services was balanced with exports—including water royalties and power sales—amounting to around 97 percent of the value of imports in 1999. Transportation expenditures were by far the largest item on the import side illustrating high transportation costs faced by land-locked economies. Assuming that these expenditures were mainly related to imports of goods, transportation alone added on average six percent of the value of imports to their cost.

TABLE 1.10 TRADE IN SERVICES, 1990 AND 1999
(MILLIONS OF US DOLLARS AND PERCENT)

	Exports		Imports	
	1990	1999	1990	1999
Total commercial services (in $ millions)	34	45.6	48	47.1
Transport	15%	2%	69%	74%
Travel	50%	52%	25%	26%
Other	35%	46%	8%	2%

Source: Derived from data in IMF (2001) and WDI (2001).

On the export side, almost half of the receipts relate to travel ($24 million). In 1999 they accounted for almost 10 percent of the value of exports of goods and services. Payments for water supplied

liberalization is back-end loaded: most of the quotas will be eliminated only at the end of 2004—the final year of the 10-year transition period.

under the LHWP and energy were another important service exported in 1999 totalling $12 million. These receipts significantly offset payments for transportation services that accounted for three-fourths of total imports of commercial services.

Yet, given Lesotho's enormous potential for tourism (UNDP 2000), this is rather a low level. For instance, the share of travel in Namibia's exports of goods and services was 15 percent in 1999. Considering tourism's usually significant contribution to poverty reduction (one mechanism is employment of unskilled labor), it is an important candidate for development.

1.5 IMPLICATIONS: CHALLENGES AND OPPORTUNITIES FOR INTEGRATION

LDCs can often benefit substantially from policy-induced deeper integration with a more developed country. The benefits usually include incentives for the government to: a) launch sound macroeconomic policies; b) encourage openness and integration into international markets; and c) implement efficiency enhancing institutional and policy reforms (World Bank 2000a). Lesotho's current level of integration into South Africa takes care of the first two benefits (macroeconomic stability and foreign trade), but fails to generate pressures in the third area. Should the Government of Lesotho pursue a policy of full institutional and regulatory convergence with South Africa? Alternatively, should it reverse course, and strive to develop a regulatory regime that is fully independent of its larger neighbor's institutions? We argue that neither is the best policy option.

Lesotho should take advantage of its sovereign status to pursue ***two parallel strategies***: one designed to lower the "costs of trading" with South Africa, other SACU partners and rest of the world, and another aimed at establishing a competitive business environment relative to other countries in the region. The former calls for the removal of various remaining barriers to trade (customs, technical regulations and standards, etc.) and movement of capital and labor within SACU, thereby transforming it into a full-fledged single market, as well as lowering CETs. The latter calls not only for the removal of various administrative barriers impeding the conduct of business activity (discussed in Chapter 5) but also the effective provision of public services including public order and good governance.

These two strategies are complementary and self-reinforcing. An improved investment climate stimulates savings, increases the willingness to make productive investment for the longer term, and attracts foreign and domestic investors. Unimpeded access to larger markets offers economies of scale and the possibilities for taking advantage of production fragmentation. Larger markets combined with a liberal, business-friendly environment are more likely to attract multinational corporations (including those operating in South Africa)—the major agent of integration into global markets.[15] Consequently, the dual strategy will result in dynamic gains thanks to the decrease of the "costs of trading" and generation of foreign direct investment and technology spillovers. While some economists (Schiff and Winters 1998) caution that neither theoretical

[15] As the authors of the World Investment Report (WIR 2001, p. XVII) succinctly note, "While the main traditional factors driving FDI location—large markets, the possession of natural resources and access to low-cost unskilled or semi-skilled labor—remain relevant, they are diminishing in importance (…). The location (…) increasingly reflects three developments: policy liberalization, technical progress and evolving corporate strategy."

analysis nor empirical evidence offer conclusive evidence as to growth effects of integration, the crux of the matter is that gains are more likely to transpire in the case of "deeper" integration, as it contributes to lower transaction costs.

1.5.1 Policy Integration: Where Does it Yield Benefits?

Institutional harmonization is advantageous when a regulatory regime's construction requires high initial fixed costs and when the existence of independent national policies creates large transaction costs for intra-regional trade. What types of regulatory policies do we have in mind? First, there are many of the trade-related regulatory reforms that Lesotho must eventually implement to comply with its WTO obligations. As is discussed in greater detail in Chapter 3, LDCs such as Lesotho typically lack the administrative capacity to develop well-functioning regimes governing technical regulations and standards, intellectual property rights protection, plant and animal sanitary standards, and the like. In addition to the direct costs to the Government of Lesotho to establish these institutions, the existence of separate national regimes within the region creates extra transaction costs for traders who have to meet different requirements to trade with each country.

Similar transaction costs exist when members of a customs union such as SACU maintain independent national procedures directly related to the movement of goods across borders inside the union. Examples include customs administration and import licensing requirements. Harmonizing such policies at the customs union level is a logical continuation of a common external tariff, and it helps to create a single integrated regional market, thus providing Lesotho (or other SACU countries) with a more solid steppingstone to greater integration into the world economy. To meet these challenges, Lesotho needs to develop its capacity to conduct commercial diplomacy and push SACU towards more liberal policies. Chapter 4 assesses Lesotho's trade policy institutions and makes recommendations for reform and technical assistance.

1.5.2 Policy Differentiation: When Should Lesotho "Go It Alone?"

Not all regulations can or should be harmonized at the regional level. One of the more interesting consequences of globalization during the past several decades is the coexistence of pressures pushing some governance task downward to the local level with pressures pushing others upward to supra-national levels. Lesotho's small size is a distinct advantage in areas where government responsiveness to demands from the economy is important, such as in creating a business climate conducive to trade and investment. Lesotho should distinguish itself from South Africa in this area.

In Chapter 2 we evaluate the recent changes in trade and investment flows, as well as the factors led to the creation of a substantial number of private sector jobs in the garment industry, thereby contributing materially to macroeconomic growth and poverty reduction. Chapter 5 continues by reviewing Lesotho's business climate. The clear lessons that emerge from this review are, first, that Lesotho must take the lead in implementing significant structural reforms to improve the local investment environment. In other words, it has to converge to that of more developed economies. Second, while not much can be done immediately about such factors as those related to Lesotho's 'land-lockedness,' poor infrastructure or effects of the HIV/AIDS pandemic, progress can be made rather quickly in some areas identified in various cross-country studies. Third, Lesotho's investment climate can be improved relatively quickly in several areas.

Finally, yet importantly, Lesotho's regulatory gap vis-à-vis South Africa is not as high as one might expect given the gap in GDP per capita. Closing the 'investment climate' gap (leaving aside physical infrastructure) vis-à-vis a developed partner in SACU could be achieved relatively quickly. Furthermore, despite significant progress achieved over the 1990s, South Africa is not among world leaders in terms of having institutions and policies in place assuring competitiveness and expansion in world markets. As the reviewed studies show, South Africa still lags behind a number of emerging markets. This has significant implications for Lesotho's strategy.

Assessments of Lesotho typically start and end with the observation that Lesotho is small, poor and landlocked, leaving the reader to infer that these characteristics naturally impose severe constraints on the country's options. However, we argue that Lesotho has been able to rise above these constraints. In part, it has done so by using its proximity to South Africa as a stepping-stone to the world economy. In addition, Lesotho has succeeded in part in overcoming its physical constraints by integrating directly into the world economy, independent of its regional neighbors, through foreign investment and garment exports. The task that now lies before Lesotho is to transform the temporary preferential access into a permanent source of comparative advantage.

CHAPTER 2
INTEGRATION INTO GLOBAL MARKETS AND CHALLENGES AHEAD: INVESTMENT AND TRADE[16]

2.1 INTRODUCTION

Lesotho's scope and pace of integration into external markets defies predictions. While one would expect Lesotho to have strong economic ties with other countries in the region, given its size, resource base, and level of development, Lesotho has strong links with the world economy that are independent of its regional partners. The most important in recent years have been the inflow of foreign direct investment from East Asia and the expansion of export of garments to the United States. One would also expect Lesotho to be in a group of mediocre performers among these countries, given its weak resource base and relatively unfavorable perception among international analysts of Lesotho's business / investment climate.

The reality, however, has been different. Lesotho stands out among Sub-Saharan African countries in two respects: It has attracted FDI into manufacturing sector, and it has emerged as the largest exporter of garments to the U.S. in the region. The link between FDI and foreign trade has been particularly strong and foreign-owned firms have transformed the geographical pattern of Lesotho's trade. Foreign owned firms have been responsible for the impressive export performance in US markets.

Since Lesotho's exports benefit from preferential treatment because of its LDC status, this raises the question whether its revealed comparative advantage is 'natural' or 'artificial.' In other words, a critical question is: *How well is Lesotho positioned to face the challenges posed by more competitive and changing global markets once preferential margins enjoyed in these markets disappear?* Other related questions discussed here include among others: To what extent preferential margins have been responsible for Lesotho's success in exports of garments? Will foreign firms turn out to be 'foot-loose' and leave Lesotho once preferences expire? Is it worth an effort to keep them in Lesotho?

This chapter addresses these questions by first providing background information on FDI inflows and trade patterns.[17] It then discusses the extent to which preferences explain Lesotho's performance in international markets. The twin challenge of the loss of preferential treatment as result of phasing-off MFA and AGOA as well as entry in force of the EU-South Africa trade agreement and of sustaining FDI inflows is then addressed.

[16] The sections of this chapter and other chapters that cover FDI benefited from the mission participation and inputs from UNCTAD prepared as background for the Investment Policy Review.
[17] A major difficulty is the absence of reliable data on both investment and trade. Foreign trade data as reported by Lesotho's foreign trade partners, whenever these are available, are used.

2.2 FDI AND TRADE

As noted above, FDI firms have shaped foreign trade of Lesotho. The expansion in FDI inflows began in the 1990s. In 1990 the total stock of FDI was the lowest among SACU member-countries. By 1995, with a nine-fold increase, it moved ahead of neighboring resource-rich Botswana and Swaziland.[18] In 2000, the value of FDI stock in Lesotho was higher than in resource-rich Namibia, despite the fact that its share in total SACU FDI stock fell from 6.8 percent in 1995 to 4.3 percent in 2000 due to the surge of FDI flows into South Africa. Lesotho experienced the highest increase between 1999 and 2000 among SACU members and its stock on a per capita basis is higher than in South Africa despite huge disparity in GDP per capita.

Even excluding South African public investment outlays on the LHWP—which technically are not FDI, because they are not private direct investments, albeit they are not much different than investments in other projects tapping a natural resource—Lesotho still stands out among African countries in terms of its ability to attract FDI into non-natural resource sectors. On the basis of an estimate of LHWP outlays one arrives at the total of US $233 million invested over 1990-2000 in non-LHWP sectors of the economy. Although the FDI stock per capita of around US $120 and the share of this stock in the 2000 GDP of 23 percent places it at the very bottom of SACU members including Swaziland, the FDI stock for other countries includes investment in natural resources, Lesotho still stands out in terms of its success in attracting FDI to manufacturing activity where most other African countries including small members of SACU have failed.

A small proportion of FDI (around 10 percent) went to the services sector. Over the 1990s, there was FDI in tourism (the main hotels are operated by the Sun chain from South Africa), car rental, air travel, insurance and telecommunications (privatized to a consortium of South African, Mauritian and local interests).

However, the bulk of FDI (around 90 percent or more) in Lesotho has gone into export-oriented manufacturing sector, mostly clothing (38 out of estimated 55 companies), which is essentially a 'cut-make-trim' (CMT) operation using imported fabrics.[19] East Asians own most clothing factories, employing around 32,000 people. Of the 38 clothing factories, 25 are from Taiwan, Province of China, and another four have headquarters in Hong Kong, China, or Singapore. Most sell their output to and procure their inputs from East Asian ‘full package’ suppliers to the U.S. market.[20] There are two South African subsidiaries; there were more firms earlier but they were unable to compete with the Taiwanese entrants and have either closed down or sold their factories to the Asian firms. (As we shall see, this may provide an explanation of the shift in patterns of garment exports away from the EU to US markets even before special preferential treatment in the EU expired).

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[18] Data on FDI are drawn from UNCTAD’s *World Investment Report* and from backround information prepared for its Investment Policy Review of Lesotho.
[19] See Salm et al. (2002). The authors point to the lack of consistent data on the industry, despite its lead role in attracting FDI and generating exports.
[20] Full package suppliers are intermediaries that undertake the buying function for retailers and wholesalers in developed countries. They obtain large orders and place them with factories throughout Asia and (to a much lesser extent) elsewhere, in North Africa, Sub-Saharan Africa and the Caribbean basin. They provide or help source the inputs. See Gereffi (1999).

Apart from the garment industry, there are three foreign companies in footwear; all South African (and selling entirely to South Africa). There are four electrical or electronic firms, all South African owned, of which two are large (one in television assembly, the other in simple electrical products; both destined for the South African market). There are four food-processing firms, two South African, one US, and one Chinese-owned. Finally, there is an assortment of some six firms with foreign equity producing umbrellas, plastics and other manufactured goods firms.

Export Orientation: These firms appear to account for the bulk of exports to South Africa. Consider the following: Footwear accounted in 1989 for 35 percent of total exports to South Africa, another big export item—color television receivers--accounted for 12 percent of Lesotho's South African exports. Thus, at least half of Lesotho's exports to South Africa, which now absorbs around 50 percent of Lesotho's total exports, are attributable to South African subsidiaries in Lesotho. On the other hand, clothing and apparel—the sector dominated by Taiwanese-owned firms—were conspicuously absent in Lesotho's exports to South Africa.

They dominated, however, in another major market for Lesotho's products in the United States. Garments manufactured almost exclusively by East Asian-owned firms accounted for almost 100 percent of its exports there. Recent CBL data suggest that the share of the US in Lesotho's exports has now exceeded that of South Africa. This sector has been behind spectacular expansion in exports to the United States in 2000-01 and emerged as an engine of growth of Lesotho's economy.

FDI and Trade Balance: FDI firms have made a significant contribution to foreign exchange earnings. This holds true even after taking into account the fact that most of their inputs are imported. As noted earlier, clothing, footwear and color TV sets account for most (around 75 percent) of exports originating in Lesotho. They account for virtually all exports of manufactures.[21] Exports of all these product groups come exclusively from foreign-owned firms.

While it is clear that foreign firms generate more than three-fourths of earnings from exports of goods, an interesting question is whether imports of inputs for these products do not consume fully their export earnings. Unfortunately, because of the absence of good quality detailed statistics on composition of imports, it is impossible to come up with reliable estimates. We know nevertheless with some degree of certainty, based on recent CBL data, the value of Lesotho's imports from Asia in 1999, which amounted to $61 million. Assuming all imported materials used came from Asia,[22] the ratio of imports to exports in this sector was 60 percent. While this ratio may be different in other sectors, garments dominate the picture. Their share in total exports was 52 percent in 1999, according to the official data. One may thus conclude that overall foreign firms export more than they import using Lesotho mainly as an export platform.

[21] **In 2000, according to Central Bank data, the total value of exports of manufactures was $155 million—of this textiles were $102 million, and footwear were $28 million. Adding the estimated value of around $23 million worth of exports of color TV sets yields the total of $153, or 99 percent of manufactured exports in 2000.**

[22] **This seems to be a reasonable assumption given ownership structure in this sector (mostly East Asians) and East Asia competitiveness in these products.**

2.3 PREFERENTIAL MARKET ACCESS AND FDI/TRADE PATTERNS

Lesotho's ability to attract FDI has depended heavily on the international trade regime for clothing for developing countries. Quotas (under the MFA) and preferential tariffs in the EU provided a magnet to foreign investments. According to a widely held view, Lesotho had been attractive to foreign investors only as long as *no local content was required* to obtain preferential treatment. Data, however, do not provide support to this view. In a nutshell, the contraction in exports to the EU took place well before the EU derogation on local content expired, while export expansion to the US took place even before the local content was allowed under the AGOA. This suggests that Lesotho's performance could hardly be attributable to special preferences setting it aside from a large number of developing countries. Furthermore, this suggests that attractiveness of Lesotho to foreign investors goes beyond special preferences, albeit—as far as textiles are concerned—preferences have mattered.

2.3.1 "Local/Regional Content Requirement" for Preferential Treatment and Exports of Garments

In the 1980s, under the Lomé Convention, Lesotho had duty-free access to the European Union market, initially with no local content requirement, and to other highly developed countries under quotas under the MFA. The latter usually required local sourcing. Most inputs to foreign-owned firms established in Lesotho came from East Asia, the cheapest and most efficient source. In the late 1980s, the EU started to apply 'cumulation' to all ACP countries, meaning that at least two stages of production had to be carried out locally (i.e. the fabric had to be made locally). [23] Lesotho was able to get this postponed ('derogated') for eight years until 1996. This was not, however, the reason for attracting a wave of new clothing FDI in the late 1980s. Although some still aimed at the EU market, many were unable to compete with the Taiwanese entrants and have either closed down or sold their factories to the Asian firms. By 1990, most of the foreign exporters present today had already set up factories in Lesotho and their eye was mainly on U.S. rather than EU markets.

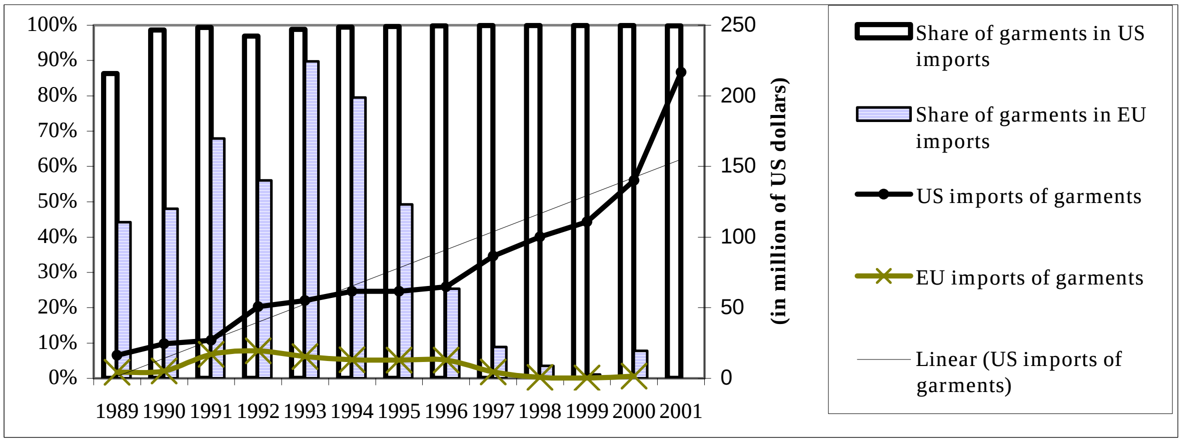
EU's "double transformation" derogation was not behind the development of garment sector

The US market rather than the EU was behind FDI in the garment sector in Lesotho. Data in Figure 2.1 collaborate this view. Exemption from the EU 'local double transformation' was not the driver of Lesotho's exports of garments. Note first that already in 1989 the value of US-oriented exports of garments was four times higher than that to the EU. This difference—except over 1991-93—expanded rapidly over 1994-01. Second, the 'double-transformation' derogation did little to energize exports to the EU. Their value peaked in 1992 (still 72 percent below the value of these exports to the US), contracted 20 percent in 1993, and were stagnant over 1994-96 ($13 billion each year). Although indeed their value fell almost 75 percent in 1997, following the termination of derogation in 1996, even before the contraction they amounted to 20 percent of the US-oriented

[23] Until 1996 Lesotho could export into the European Union due to the derogation from the cumulation clause under the Lomé Convention. According to this clause the local content of 30% was enough to qualify for exports of garments from a Lomé Convention signatory country to the EU. This clause was, however, discontinued in 1996, which practically finished the garment exports from Lesotho to the EU because of the double transformation that is now needed for the preferential market access (Hyvärinen 2002). Their value fell by more than half in 1997 over 1996.

exports. Thirdly and most importantly, the value of US-oriented exports consistently exceeded that of exports to the EU over 1989-2001. This would suggest that there was no massive redirection; instead foreign-owned firms targeted U.S. markets from the very beginning.

FIGURE 2.1 VALUE OF EU AND U.S. TOTAL AND GARMENTS IMPORTS FROM LESOTHO, 1989-2001 (IN MILLION OF US DOLLARS AND PERCENT)



Note: Right-hand axis: total imports from Lesotho in million of US dollars.
Left-hand axis: share of garments in respective imports from Lesotho.
Source: derived from USITC and Comext databases.

Since US markets had been targeted at the outset, MFA quotas rather than extra preferences under the EU 'double transformation' exemption had driven Lesotho's exports and attracted FDIs. In the US markets—except for a 17 percent duty—there were no 'local content' restrictions to take advantage of unused MFA quotas. But exporters from Lesotho had to compete with potential suppliers from a number of developing countries under the MFA quotas. In order to sell, they had to outperform a large number of firms from other countries.

AGOA is not fully responsible for impressive export performance in the U.S.

US data on imports from Lesotho do not support the view that special preferences under the African Growth and Opportunity Act (AGOA) have been solely responsible for the emergence of Lesotho as the largest exporter of garments among Sub-Saharan countries.[24] In fact, they paint a different picture of competitive edge obtained under more demanding conditions prior to AGOA.

The expansion in garment exports occurred well before the enhanced preferential access provisions of the AGOA kicked in. Consider first that not all exports were eligible for enhanced preferential treatment, i.e., zero tariffs within quotas and no local/regional content requirement. The AGOA, signed in May 2000 as Title 1 of the USA Trade and Development Act of 2000, has the Special Apparel Provision that allows unrestricted sourcing of materials (both yarns and fabrics—

[24] Under AGOA-1, which runs from 2000 to 2004, exporters from the least developed countries of Sub-Saharan Africa have duty and quota free access to the US market.

mainly of cotton) for garment producers.[25] The Special Provision does not come automatically. A country must have a “visa” system—certified by the USTR—or the articles to prevent fraud. As Lesotho was certified to qualify for AGOA special treatment only in April 2001, [26] exports that entered the U.S. in January-May were not eligible. AGOA duty-free exports represented 60 percent of Lesotho’s exports into the United States in 2001 (USTR 2002a, p. 104).

Second, the average rate of growth over 1996-2000 of US imports from Lesotho in terms of value was an impressive 22 percent per year. The value of these imports would have been $170 million in 2001 assuming the average rate of growth for 1996-2000. The value of non-AGOA exports during the first six moths was $86 million, which extrapolated would amount to $172 million. The actual value was $217 million or 26 percent more. AGOA explains this surge, with established and new Taiwanese firms taking advantage of the tariff and quota free regime to rapidly expand production and employment.

Last but not least, the enhanced AGOA preferential access has not been granted exclusively to Lesotho but to other countries (Table 2.1). Many countries have it and also have abundant supplies of cheap labor. But clearly preferential access alone is not sufficient, as only few have been successful. In addition to the disciplined and skilled labor, two other factors worked in Lesotho’s favor—government policies and sanctions against South Africa. As noted earlier, the latter generated positive external effects for Lesotho that have survived the end of sanctions. The former included the government’s strong investment program that created a friendly environment for foreign investors as well as build a factory shell.

2.3.2 Concluding Observation

External conditions have helped drive Lesotho’s recent trade and investment boom. Expansion in exports of garments to US markets was the result of a decision made by foreign investors to focus on these markets rather than those of the EU in spite of a ‘double-transformation’ still in force until 1996. It suggests that foreign firms producing apparel have had well-established commercial contacts in the US well before the AGOA was enacted. Though the main question, addressed in the next section, is whether the anticipated change in preferential market access conditions will negatively affect Lesotho’s economy.

Will the anticipated change in these conditions negatively affect Lesotho’s economy? We address this question in the next section.

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[25] The Special Apparel Provision for these countries (12 out 17 AGOA eligible countries) allows sourcing of materials (both yarns and fabrics—mainly of cotton) for garment producers in Lesotho anywhere in the world. This special allowance is valid for four years till the end of September 2004.
[26] The USTR certified that Lesotho qualified for this special rule in April 2001. Imports received (or moved out of warehouse) before April 23, 2001, were subject to the same tariff treatment as other AGOA members.

TABLE 2.1 AGOA ELIGIBILITY STATUS OF SUB-SAHARAN AFRICAN COUNTRIES

Eligibility for AGOA Status (as of May 2002)		
Elegible		
Cameroon [a]	Guinea	Nigeria
Cape Verde	Guinea-Bissau	Rwanda [c]
Chad	Kenya [a]	Sao Tome and Principe
CAR	Lesotho [a]	Senegal [a]
Republic of Congo	Madagascar [a]	Seychelles
Djibouti	Malawi [a]	Sierra Leone [d]
Eritrea [b]	Mauritania	South Africa [a]
Ethopia [a]	Mozambique [a]	Swaziland [a]
Gabon	Namibia [a]	Tanzania [a]
Ghana [a]	Niger	Uganda [a]
Not Eligible		
Burkina Faso [e]	Equatorial Guinea [g]	Togo [I]
Burundi [f]	The Gambia [h]	Zimbabwe [I]
DRC [f]	Liberia [i]	
Under Review		
Cote d'Ivoire		

Note: [a] including textile and apparel benefits. [b] has applied for textile and apparel benefits. [c] textile visa certification system not yet in place. [d] but with delayed implementation. [e] foreign policy and participation in the conflict diamond trade. [f] economic reform, rule of law and human rights. [g] economic reform, rule of law, political pluralism and human rights. [h] political pluralism, human rights and participation in the conflict diamond trade. [i] economic reform, political pluralism, human rights and corruption.
Source: Derived from USTR 2002a.

2.4 FUTURE EXTERNAL CHALLENGE: THE LOSS OF PREFERENTIAL TREATMENT

External conditions that have helped drive Lesotho's recent trade and investment boom may disappear. Almost all of Lesotho's exports enter respective markets on a preferential basis. Many products may be competitive only insofar as artificially created comparative advantages by international preferential trading rules remain in place. From this perspective, two issues loom on the horizon: the loss of preferential access to US markets with the end of AGOA and relations with the EU, especially the increased competition in SACU markets from imports from the EU due to a free trade agreement.

Hence, the international trade environment within which Lesotho's firms now operate will significantly change in the mid-2000s. Policies implemented within the next 2-3 years will determine how a new environment will affect Lesotho's economy in the late 2000s. The major task facing the country is leveraging the temporary tariff preferences offered under MFA / AGOA to develop a permanent comparative advantage.

2.4.1 United States: the End of AGOA and MFA

Among these two, the AGOA (together with MFA quotas) is regarded as the most pressing. The question is how sustainable this trade will be in the future, given that favorable tariff treatment under AGOA is a temporary policy expiring fully in 2008. The most favorable aspect of it—the relaxed rules of origin for LDCs—expire sooner, at the end of 2004. In addition, the MFA quotas, limiting access of the world's largest garment exporters to the U.S. market (as well as to markets of other highly developed countries), are due to be removed in 2005.

The past performance in U.S. markets indicates that Lesotho's exporters of garments were competitive also under MFA arrangements. This truly remarkable performance augurs well for the country's competitiveness once these special preferences expire. Yet, considering that Lesotho's industrial base is still very narrow, turning out only a few products that are competitive in international markets, concerns abound as to the prospects of survival in a post-AGOA and MFA environment. This is clearly a challenge for the government, which has to prepare to respond to the future overseas competition, i.e., to shift toward higher-value-added manufacturing and more diversified export basket.[27] It needs to be prepared for that transition by ensuring that wages are consistent with productivity and supporting worker education and training programs. It needs also to recognize weaknesses in Lesotho's business/investment environment and address physical barriers to the development of garment sector.

In addition, the government should make the case for a waiver from a 'double transformation' requirement. The case is strong, as Lesotho is small and its ecosystem is fragile. The development of local supply capacity might lead to huge environmental costs and undermine government's effort to develop eco-tourism as part of its strategy to alleviate poverty.

2.4.2 European Union: Cotonou and EU-South Africa Trade Cooperation and Development Agreement (TCDA)

The ACP-EU Partnership Agreement, which was signed in Cotonou in June 2000, provides for negotiating "Economic Partnership Agreements" (EPA) between ACP countries and the EU. These will comply with WTO rules on regional agreements and replace the non-reciprocal preferences that grew out of the Lomé Convention. The EU will begin negotiations in September 2002 and conclude them at the end of 2007.

Even though Lesotho's trade with the European Union is relatively low, the Cotonou Agreement has important ramifications. The first important issue relates to rules of origin. Lesotho—and developing countries generally—have not benefited as much as they could have from past and present EU trade preferences because of restrictive rules of origins and bureaucratic

[27] There are some encouraging signs. First, apparel was not the most rapidly expanding group of exports into the U.S. An often-overlooked statistic is that other goods recorded much faster growth in both 2000 and 2001, albeit from a more modest base. The value of these exports increased from $99,000 in 2000 to $474,000 in 2001. Second, the value of exports to the EU increased 53 percent in 2000 (from EU 15 million to EU 23 million) with the share of garments growing from one percent to eight percent of Lesotho's total EU-oriented exports. (Data taken from EU Comext database.) These facts suggest that: (a) Lesotho's garment exports to the EU have begun to pick up despite a double transformation requirement; and (b) Lesotho's export competitiveness has increased in both EU and US markets.

requirements. Lesotho is potentially losing preferential access in some products. Documenting this loss would be a useful exercise and lay the foundation (in lobbying with other LDCs) for a reconsideration of the rules of origin (either an outright derogation for the current rules or alternatively simpler cumulation rules or proof of origin as argued in Brenton and Mianchin (2002)). Moreover, it should not be forgotten that firms spend real resources complying with rules of origin and documenting their compliance.

A second issue is the nature of the EPAs and how Lesotho can benefit from it, given that the EU-South Africa FTA/TDCA is already determined. The EU has proposed Regional Economic Partnership Agreements (REPAs) that can be signed with different ACP regions or countries as a replacement for existing non-reciprocal trade preferences. In the case of Lesotho, given its LDC status (Lomé-equivalent access under the Generalized System of Preferences (GSP)), it has little to gain from membership in a REPA in the short-term. In the longer-term, to the extent that the REPA helps lock SACU into its free trade path, it is likely that increased investment into the region would support its development and benefit lower cost producers.

A third issue is the EU-South Africa Trade Cooperation and Development Agreement (TCDA), which was negotiated without the participation of the BNLS. It gives rise to two fears: it will undermine competitiveness of Lesotho's producers and reduce customs collection. As for the latter, although South Africa's tariff cuts are back-end loaded, SACU will experience a decline in customs collections once these cuts take place, with a significant impact on Lesotho's treasury. The EU has set up a fund to compensate the BNLS countries for potential adverse effects of the EU-South Africa TCDA. [28] As for the latter, the key question is whether the TCDA will result in EU exports displacing some of Lesotho's exports to SACU and the magnitude of any such displacement.[29]

Given a long 'phase-in' period, one can only make some inferences based on 1999 EU and Lesotho exports to SACU and the existing SACU tariff protection.[30] Both are only rough indicators, as high

[28] The TCDA may have significant revenue implications for Lesotho. Chapter 2 of Volume 2 reports that several empirical analyses employing available CGE models, like GTAP, show the revenue losses will be of major importance. According to a joint study by the Botswana Institute for Development Policy Analysis and the UK Institute for Development Studies (BIDP-IDS), estimated total SACU tariff revenue collections would decline by about one-third after the implementation of the agreement (BIDP-IDS 1998). This analysis assumed that products currently excluded from the liberalization process (the status of these items is to be reviewed not later than five years after the agreement's entry into force), would continue to face tariffs indefinitely. If import duties on these items are also eliminated the decline in SACU customs revenues is projected to be about 50 percent below current levels.

[29] Lesotho will also lose its preferential edge in EU markets over exporters from South Africa. Under the terms of the European Union's Generalized System of Preference (GSP), program most of Lesotho's exports to Europe already face zero preferential tariffs. While this situation seemingly is favorable, there are constraints that limit the benefits Lesotho experiences. Having a limited natural resource base Lesotho imports most of the raw materials used in manufacturing. Because of stringent rules of origin, Lesotho's exporters had difficulties in taking advantage of preferences in EU markets. Hence, we assume that this is unlikely to affect competitiveness of Lesotho's exports in the EU.

[30] At the time this report was written some SACU preferential tariffs for the EU had started to be phased in. The rates reported in this analysis are the average tariffs before any preferential

SACU tariff rates may effectively suppress imports from the EU and the export mix will change over time reflecting change in the competitiveness of various products. Lesotho has 34 six-digit HS items directly competing with the EU in SACU markets (Volume 2, Chapter 2). Altogether, these 34 products account for about 96 percent of Lesotho's exports to SACU. They benefit from varying preferential tariff margins over non-preferential suppliers. One assumes that the most vulnerable to displacement by EU exports are Lesotho's suppliers of products enjoying high levels of tariff protection and the least affected will be products subject to zero or very low tariff rates.

The overall conclusion that one can draw from Table 2.2, which offers a breakdown of EU and Lesotho's exports at corresponding levels of MFN tariff rates, is the potential for EU displacement of Lesotho's exports is likely to be low. Consider the following. First, the potential for EU displacement of 20 percent of Lesotho's SACU-oriented exports is nonexistent, as they already compete with EU products at zero applied MFN tariffs.

Second, although 13 percent of Lesotho's exports enjoy tariff protection of 40 percent *ad valorem* or more, these are garments in which Lesotho is likely to remain competitive even without extra protection. Lesotho's garment producers already compete successfully against domestic producers in both the EU and U.S. markets. They are unlikely to be displaced by EU suppliers, especially when 'protected' by transportation costs. One could also include denim (subject to protective tariffs with rates of 22 percent and higher) in this group, which accounts for three percent of Lesotho's exports. Thus, around 40 percent of Lesotho's exports to SACU are unlikely to be affected by improved EU-access to SACU markets.

TABLE 2.2 VULNERABILITY OF LESOTHO'S EXPORTS TO SOUTH AFRICA TO IMPORTS FROM THE EU IN THE 'POST-TDCA' ENVIRONMENT

MFN rate	EU exports to SACU (million of US dollars)	Lesotho exports to SACU (millions of US dollars)	Share in Lesotho's exports to SACU (percent)	Cumulative share (percent)
40(*)	1.4	10.1	12.7%	-
40	0.0	0.3	0.4%	13.1%
30(*)	0.3	7.8	9.8%	22.9%
30	3.8	17.2	22.1%	45.0%
22(*)	0.4	2.3	2.9%	47.9%
20	0.1	2.4	3.0%	50.9%
18.3	0.8	2.4	1.2%	52.1%
17.5	0.9	1.0	4.5%	56.6%
12.5	4	9.8	12.3%	68.9%
5.3*	0	1.2	1.5%	70.4%
(**)	0	3.8	4.7%	75.1%
0	0	16.3	20.5%	95.6%

reductions occurred. In cases where different SACU tariffs were applied at the eight-digit HS level these duties were averaged to get the six-digit rates. For details, see Yeats (2002)..

Notes: (*) - The tariff on this item includes an additional fixed charge per unit whose nominal equivalent could not be estimated: (**) - The tariff on this item consists solely of a fixed charge per unit whose nominal equivalent could not be estimated.
Source: Derived from data in Volume 2, Chapter 1.

As for the remaining 60 percent of Lesotho's exports, one can only speculate. Products protected by 30 percent tariff rates are unskilled-labor intensive products in which the EU is unlikely to have a competitive edge. Despite the relatively large trade base the EU has been able to establish in the presence of the existing high MFN tariffs for footwear, exporters from these two countries probably operate in different market niches. Thus, one would expect that footwear (accounting for 35 percent of total exports to SACU) would survive. Similarly, color television receivers, accounting for 12 percent of Lesotho's SACU-oriented exports, involve labor-intensive assembly operation and are unlikely to be displaced. In all, at least three-quarters of Lesotho's exports do not appear to face the prospect of extinction by imports from the EU.

In all, leaving aside the fiscal pressures arising from declining SACU customs revenue, TDCA should also bring several benefits to Lesotho. It is likely to increase FDI inflows into South Africa with potentially positive spillovers for Lesotho as well as directly to Lesotho. The intensity of competition will increase with benefits to Lesotho's users of imports. For instance, as a net importer of agricultural products, Lesotho will undoubtedly benefit from the elimination of tariffs on 46 percent of South African imports of these products from the EU by 2005.

2.5 Internal Challenge: Keeping Foreign firms and Attracting New FDI

Will foreign firms turn out to be 'foot-loose' and move out once preferential access expires? While foreign owned firms have created large employment opportunities and contributed to economic growth, their other contributions are less clear. Backward and forward linkages appear to be weak, if they exist at all. Available statistics strongly indicate that the foreign owned sector is an enclave or an export platform sourcing and selling abroad. This low level of integration with the domestic economy limited to taking advantage of abundant cheap unskilled labor raises concerns about foot-loose character of this sector. The danger is that once Lesotho looses its competitive edge due to cheap and disciplined labor, foreign firms will leave.

2.5.1 Employment and Poverty Reduction: Are FDI Worth Retaining?.

Although data are not entirely reliable there are a number of information sources indicating that foreign-owned firms are making a substantial contribution to job creation in Lesotho. Foreign firms created almost 15,000 new jobs in 2001 with the clothing sector contributing 80 percent to this increase and footwear 17 percent (Table 2.1). These two sectors accounted for 84 percent of the total employment in foreign owned firms. The clothing sector surpassed the government as the largest employer in Lesotho and foreign-owned firms created almost 15,000 new jobs.

Furthermore, the Bureau of Statistics Manufacturing Establishments Survey's estimates that wage employment in the private sector in 1999 was 112,000. Given total employment in foreign firms, this could indicate that one in four employees in the private sector is employed in FDI-related manufacturing firms. The impact may be even larger considering that foreign owned or franchised hotels and other service activities have also created additional employment. However, no reliable recent data for these sectors are available.

TABLE 2.3 EMPLOYMENT BY FOREIGN AFFILIATES, COMPOSITION AND CHANGE, 2000, 2001

Industry	2000	2001	Percent change in 2001	Share, 2000	Share, 2001
Clothing	21,587	33,309	54	82%	81%
Footwear	2,970	5,420	82	11%	13%
Electrical/electronic	963	1,183	23	4%	3%
Foods	600	648	8	2%	2%
Other (estimated)	344	450	31	1%	1%
Total (estimated)	26,464	41,010	55	100%	100%
In percent of total employed in 1999	5.1%	8.0%			

Note: Clothing employment data are for March 2001 and November 2001. Other data are for year-end.
Source: Clothing data from Salm et al, 2002; figures include 1,000 expatriate staff in 2000 and 1,076 in 2001. Other data are from LNDC and Bureau of Statistics, Labor Force Statistics, 2001, and 1999 Labor Force Survey.

What impact has FDI had on poverty reduction? As noted earlier, all available evidence suggests that poverty is largely concentrated in rural areas. Foreign firms, on the other hand, are concentrated in manufacturing, not in the agricultural sector. A pessimist would argue that the FDI-led expansion of exports and employment contributes nothing to poverty reduction in Lesotho.

But this pessimistic view does not tell the whole story. Urban areas offer better employment prospects and have been absorbing a growing share of Lesotho's population. Hence, jobs created there contribute indirectly to poverty reduction in rural areas through labor migration. Moreover, manufacturing activities appear also to have offered special opportunities to women, who are disproportionately affected by poverty. With 83 percent of total employment in 2000, female workers have dominated in manufacturing sector. Moreover, their presence in the fastest growing foreign owned sectors—garments and footwear—was even more impressive. In 2000 over 91 percent of the employees in these sectors were female. Finally there is evidence indicating a significant transfer of wages earned by urban workers to the poor in rural areas. These remittances are not negligible.[31]

The size of the garment sector in Lesotho and the scale of its growth must therefore be seen as an integral link in the development of the country's poverty reduction strategy and should be given due consideration in the Poverty Reduction Strategy Paper currently being prepared. No other sector currently offers the same opportunities for stimulating growth, increasing employment and promoting technological transfers.

[31] The Sechaba survey finds factory workers are spending an average of M139 per month on remittances. See Sechaba Study, Table 10 in Annex 3, as quoted in Salm et al. 2002.

2.5.2 How Potentially 'Foot-Loose' are Foreign Firms? Backward Linkages and Wage Competitiveness.

Backward linkages: There have been few backward linkages from manufacturing FDI in Lesotho, apart from non-tradable like labor and utilities. The lack of natural resources may be one explanation as downstream processing activities that could deploy advanced technologies, cannot be attracted or promoted. Assembly operations have not triggered the kinds of local business activity that could service them. For instance in the clothing industry all the fabrics and accessories are imported, largely from Asia. Even the simplest inputs, such as packaging, are largely imported, though there are plans to develop them locally and regionally.

While the expiration of AGOA-1 in 2004, which-as noted above-will require garment exporters to source their fabric within Africa or from the U.S., provides strong incentive to firms to integrate backwards.[32] However, there has been little serious response to this challenge so far.[33] New entrants are not setting up weaving or knitting mills in Lesotho and some firms are threatening to leave unless AGOA-1 is extended. According to Salm *et al.* (2002), it is economically more feasible for Lesotho firms to set up knitting mills than weaving mills (which are far more capital, skill and scale-intensive). The knitted garment segment of the industry (making T-shirts and the like) accounts for nearly 60 percent of employment in the industry, but there are no signs of backward integration by firms in Lesotho.

However, there does appear to be scope for increasing local content in other inputs, such as packaging and simple accessories (buttons, trim, etc.). However, further analysis with respect to the available skill, technological and entrepreneurial levels in the country is first needed.

Wage Competitiveness: The inflow of FDI clearly demonstrates that Lesotho is competitive in terms of labor costs despite productivity levels below (around 50 percent) those in East Asia's garment sector. The critical question is whether this competitive edge can be maintained. The answer depends on what happens to exchange rates and the relationship between labor productivity and wage rates. In 2001, garment wages increased by 10 percent while the dollar cost fell by 39 percent. In other words, the real wage costs to firms exporting to the U.S. decreased by 29 percent. In addition, utilities, another major cost in garment production have also become relatively cheaper in terms of their dollar selling prices. The depreciation has helped maintain Lesotho's cost competitiveness and will provide some room to address the wage demands within the industry in 2002. A continued depreciation of the Loti would maintain competitiveness even in the absence of increases in labor productivity, but this would also undermine macroeconomic stability with negative impacts on investment activity and standards of living.

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[32] South African fabric suppliers are apparently unreliable in terms of quality and delivery, and cannot compete on price despite their proximity to Lesotho.

[33] One firm is setting up a factory in Lesotho to weave denim for its jeans operations. This facility will meet around 70 percent of the current denim needs of all Lesotho-based jeans exporters (which account for 35% of total employment in the garment sector). Another Taiwanese exporter has a denim weaving facility in South Africa, with a much larger capacity (which it will use to sell to the region as a whole). However, it is not clear how their denim prices will compare with imported fabrics from Asia. If they are much higher, the duty-free advantage gained will last only until 2008, when AGOA-2 is supposed to end.

At present average wages in the garment industry in Lesotho are US $80–100 per month (Hyvärinen 2002), or approximately US $0.42–0.53 per hour. This compares favorably with a number of developing countries (Figure 3.4). The rates are similar to those in Tanzania and Vietnam, and somewhat lower than rates in Bangladesh and the less industrialized parts of India or China (Volume 2, Chapter 4). Wages for technical and engineering employees are difficult to gauge since the minimum wage legislation does not include these categories, and there are few local personnel in these grades in the export-oriented foreign companies.

However, the expansion of the garment sector has already led to pressures for higher wages. These pressures are unlikely to abate, as garment wages are lower than other manufacturing wages. The average wage in clothing was more than 20 percent below the average for manufacturing in 1997–2000, albeit well above the government mandated minimum rates. Since 1998, however, clothing wages have risen faster then in other sectors, and the gap, while still significant, has narrowed substantially (IMF 2002)..

While Lesotho appears reasonably competitive on wage grounds, low wages *per se* are now declining in importance as a source of competitive advantage for FDI in all but the very simplest activities. To attract export-oriented activities countries must also provide a minimum level of productivity and technical, supervisory and management skills. Labor productivity is a factor of formal education, industrial experience, on-the-job technical training, work organization and quality of equipment deployed. These factors are interconnected. For instance, a shortage of labor lacking the skills required to maintain sophisticated technical equipment has restricted investment in labor saving machinery in Lesotho. This in turn limits a company's ability to increase production efficiency through modern technology.

Hence, there are two prerequisites crucial to sustaining Lesotho's performance: encouragement of the development of skills and techniques necessary to raise productivity and keeping wages in line with productivity. The GoL and donor agencies should assist private industry in establishing and operating a training facility with the objective of increasing labor productivity.

2.5.3 Conclusion

Manufacturing FDI has created enclaves with little or no links to domestic economy. The virtual absence of local entrepreneurs in the sector some 15 years after the establishment of the first modern factory is rather unusual.[34] The absence of significant positive spillovers indicates, as many case studies convincingly demonstrate (Lall 1992), unavailability of local skills and technological prowess to adapt techniques used elsewhere. Whatever the cause, this is clearly a major problem indicating. We shall return to this issue in Chapter 5.

2.6 POLICY IMPLICATIONS

Two policy tracks should be pursued independently. First, the GoL should launch a campaign to lobby Washington to retain the 'double-transformation' waiver while simultaneously seek to

[34] Only one firm has been set up by a former Basotho employee to subcontract cut-make-trim operations from larger firms.

obtain this treatment from the EU. Lesotho is a small country with fragile environment. Expansion in production of inputs to its garment sector might have serious negative ecological consequences. Consolidation of democracy in Lesotho and positive climate around the New Partnership for Africa's Development, this is not a hopeless task.

Second, the GoL should pursue domestic policies on the assumption that the first track will not yield success. The route to achieve it is through improvement in domestic business climate and pro-economic growth policies (see Chapter 5) The country needs to increase its linkages with the world economy and ensure that the domestic economy realizes the full potential from these international linkages. The country exports little more than garments, labor, and water. Greater diversification in geographic patterns as well as in export offer would make Lesotho less vulnerable to adverse external development.. The success the country enjoys in garment exports is not only vulnerable to changes in other countries' trade policies but also to rising labor costs and other domestic factors; the garment industry in Lesotho urgently needs better physical infrastructure, stronger backward linkages, and enhanced local human capital.

CHAPTER 3
CHALLENGES, CONSTRAINTS AND OPPORTUNITIES AT THE REGIONAL AND GLOBAL LEVELS[35]

This report calls for Lesotho to follow a two-pronged strategy towards greater international integration: Regional regulatory cooperation to foster a single integrated regional market on the one hand, and creating a better domestic business environment on the other. Chapter 3 develops the first of these two. In this chapter, we explore how Lesotho can take advantage of existing regional and multilateral agreements. Lesotho faces opportunities and constraints at each level. Membership in the World Trade Organization (WTO) helps lock in liberalization and brings benefits of MFN treatment negotiated by larger WTO members. Membership in SACU integrates Lesotho into a larger regional market, but the structure of SACU's common external tariff introduces an anti-export bias in some products important to Lesotho. Although there are substantial barriers to trade within SADC, there is some scope for regional regulatory cooperation in that forum. While most of these conditions are beyond Lesotho's control, it can shape some of them or utilize policies to take greater advantage of existing arrangements. This chapter addresses these issues and is organized as follows.

3.1 PARTICIPATION IN SACU

Lesotho is a member of a number of regional arrangements, the most important of which is the South African Customs Union (SACU) in terms of the scope and depth of economic integration. How do these arrangements help or hurt Lesotho's ability to integrate into the world economy?

The first thing to note is that SACU is a rather unusual regional arrangement, involving LDCs as well as South Africa, a wealthier and larger country (near-industrial country conditions prevail in some sectors). It therefore makes sense for Lesotho to use regional integration—particularly integration with South Africa—as a springboard to greater integration into the world economy. Given South Africa's underdevelopment in certain areas, however, Lesotho may wish to pursue a more active integration strategy.[36] This section addresses SACU market access provisions, the persistence of economic borders within the customs union, and prospects for regional regulatory cooperation to reduce the costs of trade within the region.

Structure of the Common External Tariff: Mismatch between RSA and Lesotho?
SACU has a relatively open trade regime due to reductions in tariffs rates and dispersion during the 1990s, but the CET remains complex and a significant amount of discretion persists in tariff setting. According to 2001 data, the simple average applied MFN tariff was 10.4 percent, down from the 1997 rate of 15.1 percent. Mean tariff rates often conceal tariff peaks and escalation, however. Particular product groups face average tariff rates of 30 percent and above. These include apparel (HS 61), clothing accessories (HS 62), tobacco (HS 24) and carpets (HS 57). About sixteen of the HS chapters contained average tariff rates above 20 percent and these were mainly

[35] This chapter will be revised in light of the outcome of the Trade Policy Review to be held around April 24th, 2003.
[36] That strategy is developed in chapters 3 and 5.

on clothing products (60, 61, 62, 63), footwear (64), umbrellas (65), tobacco (24), beverages (22), preparations of cereals (19), fish and crustaceans (03) and meat and edible meat offal. Several of these tariff peaks represent important obstacles to future expansion of Lesotho's exports, and thus provide one focus for Lesotho's commercial diplomacy at the regional level.

TABLE 3.1 MAIN FEATURES OF THE SACU TARIFF, 2001

		Tariff dispersion		
	Simple average MFN tariff (%)	**Range (%)**	**Standard deviation[a] (%)**	**Coefficient of variation[a]**
All tariff lines	10.4	0–60	11.6	1.11
By Sector[b]:				
Agriculture and fisheries	5.4	0–35	8.6	1.59
Mining	0.7	0–10	2.3	3.29
Industry	10.8	0–60	11.7	1.08
By Degree of Processing				
Primary products	4.7	0–60	8.7	1.85
Semi-processed products	11.6	0–27	10.0	0.86
Finished goods	10.5	0–55	13.0	1.23

[a] The coefficient of variation is a measure of relative dispersion, defined as the standard deviation divided by the average.

[b] Based on ISIC classification.

Source: Data provided by the South African authorities; calculations by the WTO Secretariat.

Significant tariff escalation persists in the SACU tariff structure when measured by the degree of processing: 4.7 percent on primary goods versus 11.6 and 10.5 on semi-processed and finished goods respectively (WTO 2002).[37] However, this is an improvement over corresponding rates in 1997, which were 4.4 percent for raw materials, 5.7 percent for primary goods, 18.6 percent for semi-processed goods and 13.8 percent for fully processed goods (WTO 1998).

The present CET remains complex despite progress in reducing overall tariffs and their escalation since the 1980s. Table 3.2 below illustrates that progress in reducing complexity in the CET stalled in the latter part of the nineties. The CET contains 7,819 lines (defined at the eight-digit level of the Harmonized System) and has different types of customs duties, which can be *ad valorem*, specific, mixed, compound or formula duties. About 75.4 percent of all tariff lines have *ad valorem* rates. Mixed duties apply to 1,773 eight-digit lines on products such as fish, sugar, wool and apparel products. Furthermore, specific duties on 186 tariff lines apply to agricultural and petroleum products, further complicating the schedule. Less complexity would increase transparency, reduce the scope for protectionist lobbying, and therefore facilitate trade.

[37] Tariff escalation refers to the practice of levying increasingly higher duties as the degree of processing rises. It captures the extent to which effective protection exceeds nominal protection.

TABLE 3.2 COMPLEXITY OF SACU TARIFF STRUCTURE, 1997 VS. 2001

	1997	2001
Share of tariff lines that are compound, formula, mixed, specific	24.6%	25.6%
Number of bands	45	40
Maximum ad valorem rate	57.5%	55%
Share of tariff lines with zero rates	44%	45%

Source: WTO 1998a, 2002.

The South African government historically set SACU's common external tariff unilaterally. The views of the smaller countries in the Union (Botswana, Namibia, Lesotho, and Swaziland, usually referred to simply as the BNLS) were not considered. This raises an important question: given this asymmetry, has membership in SACU resulted in an acceptable trade regime?

With respect to Lesotho's integration into the world economy, SACU's relatively high tariffs on textiles, clothing and inputs, has perhaps the greatest consequence. The high import tariff creates an anti-export bias for Lesotho as a garment exporter, raising the costs of garments in domestic markets.[38] Even though South Africa has accelerated tariff liberalization on clothing and textiles,[39] duties on most finished garments remain at 24 to 47 percent, which is extremely high (more than double U.S. rates, for example). The 2002 CET lists duties of 18 percent on yarns, 24 percent on many types of fabrics, labels, elastic, badges, lace, and so on. Moreover, many South African anti-dumping actions focus on clothing and textiles (see below).

Rebates or duty drawback provisions for inputs used to make garments for export rarely fully offset the export-bias inherent in the tariff schedule.[40] The existing tariffs work against Lesotho's competitiveness by raising domestic and regional prices for these items.[41] Furthermore, a system of first setting a high tariff rate but then rebating or exempting exporters using a duty drawback system is far less transparent than simply setting a low tariff rate on imported garment inputs. After 2004, when AGOA will require Lesotho to use either U.S. or regional inputs, this protectionism will adversely affect Lesotho's competitiveness. In general, such high import tariffs on inputs and finished products undermine the goal of increasing garment exports.

The most recent revision in the SACU treaty, signed on October 21, 2002, introducing clearer rules and cooperation in setting tariffs provides a new opening to make CET more predictable and business-friendly.

[38] This point is noted in the 1998 Trade Policy Review (WTO 1998).

[39] Although in the Uruguay Round, South Africa agreed to a 12-year phase out in duties on clothing and textiles, it has since then unilaterally moved to a seven-year phase out of tariffs.

[40] The Lesotho law has provisions allowing for the use of export drawback. However, exporters appear to prefer duty rebates.

[41] Tariffs and anti-dumping duties raise the price not only of the imported articles on which they are applied, but also of domestically made articles that compete with those imports. They therefore increase production costs paid by exporters, and reduce their competitiveness in international markets.

Recommendation 1: *Within SACU, Lesotho should focus on reducing the common external tariff on items that are critical to Lesotho's export competitiveness.*[42]

Anti-dumping

South Africa has been one of the WTO's leading initiators of anti-dumping actions since the WTO's inception;[43] some of these measures are currently imposed on garment imports. For example, South Africa has imposed 43 percent duties on over 80 types of cotton fabric defined at the 8-digit level of the Harmonized System. Officials at the Lesotho Department of Customs report that SACU membership requires all members to apply these anti-dumping duties.

As noted above, this is particularly problematic for Lesotho as imposing duties raises production costs. Even if Lesotho does not apply these duties (either because it does not import the relevant goods or because of duty rebates or drawback), their existence raises prices on all competing garment inputs within the broader SACU market. This reduces incentives to seek greater efficiencies. It is difficult to argue that fabric production requires infant industry protection. And one must keep in mind that AGOA rules change in 2004: garment makers in Lesotho will have to rely on inputs produced either in another AGOA country or in the U.S. to qualify for duty-free access into the U.S. market.

Anti-dumping actions are a particularly pernicious form of protectionism. They are discriminatory, distinguishing between firms as well as countries of origin, and label as illegal, actions that would be perfectly legitimate in a domestic context. Procedures are biased in favor of finding dumping even when it is absent and they are far from transparent.

Recommendation 2: *Lesotho needs to take the initiative in lobbying South Africa to scale back its anti-dumping actions. To succeed in this task, the GoL must be able to present compelling economic analysis documenting how anti-dumping hurts the South African economy. It also needs to show how alternative policies are in its own interest. Technical assistance to MITM can help it develop the capacity to conduct such analysis.*

Internal Economic Borders

A principle advantage of a customs union is that it eliminates internal economic borders, creating a larger integrated market at least in terms of the movement of goods. Borders generate transaction costs that fragment markets. One needs to make sure that economic policies do not create unnecessary economic borders.

The customs border is the most obvious economic border between Lesotho and South Africa. SACU rules require that imports be cleared at their first point of entry into the SACU region, even if just in transit to another SACU country. This is logical as the customs union should have a common external economic border and as few internal economic borders as possible. Officials with the Lesotho Department of Customs report that Lesotho received a waiver. This makes far

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[42] Looking for alternative ways of offsetting anti-export bias would be counterproductive. Duty-free schemes for exporters usually entail significant costs. They penalize suppliers of importable inputs, absorb administrative resources, and create opportunities for corruption.

[43] South Africa reported initiating 155 anti-dumping investigations and applying 92 anti-dumping measures during the period from January 1, 1995 through December 31, 2001, making it the fourth largest user of anti-dumping actions (after the U.S., EU, and India). See WTO report at http://www.wto.org/english/tratop_e/adp_e/adp_stattab2_e.htm and stattab7 ehtm.

less sense: at a minimum, this duplicates administrative structures and redistributes the burden onto Lesotho. If there are important economies of scale in customs clearance, this also raises aggregate cost for SACU as a whole. Casual observation suggests that Lesotho and South African customs bureaus are not perfect substitutes. Lesotho has weaker administrative capacity (most obviously in the area of data collection and reporting). Based on this fact, the costs of clearing goods in Lesotho are much higher than clearing them as they first enter SACU.

One obvious solution would be to abolish Lesotho customs administration (except at international airports), relying entirely on staff of other SACU members to process goods bound for Lesotho. However, as long as Lesotho's LDC status offers preferential market access this would be counterproductive. Meeting rules of origin requirements under AGOA or any other preferential arrangements that distinguish between Lesotho and other SACU members requires the GoL to track the origin and movement of goods across its borders. More specifically, since AGOA distinguishes between goods made in Lesotho from those made in RSA, it may be necessary to retain some sort of customs clearance at the Lesotho/South Africa border to document more fully a garment's country of origin. At least in the case of AGOA there is no evidence that exporters in Lesotho experience difficulty meeting rules of origin reporting requirements when their products actually qualify for duty-free treatment.[44]

Recommendation 3: *The governments of Lesotho and South Africa need to explore better tracking systems that help exporters comply with other countries' rules of origin requirements, without simultaneously creating additional economic borders.*

The difference between South Africa's value added tax (VAT) and Lesotho sales tax rates creates a second economic border. The RSA imposes a 14 percent VAT; Lesotho a 10 percent sales tax. When goods exit South Africa and enter Lesotho, the shipper applies for a VAT refund from South African authorities and then pays a sales tax to the Government of Lesotho. The need to file paperwork with two different countries and the time to obtain a refund from South African authorities unnecessarily increases the costs of conducting international trade.

Recommendation 4: *From a competitiveness point of view, harmonizing the tax rates and working out a system for transferring revenues administratively between the RSA and Lesotho would be more trade-friendly*.

The presence of different tax rates and customs procedures across customs union members, when combined with porous physical borders between the countries, creates incentives for smuggling, even as it hinders the flow of legitimate trade and investment. In a March 2000 speech to parliament, Deputy Prime Minister Kelebone Maope attributed the longstanding problem of beer smuggling to differences between Lesotho and South Africa liquor tax rates.[45] The 1998 WTO review of the SACU trade regime repeatedly mentions that Lesotho faces problems with

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[44] Officials from Lesotho's Department of Customs state that no AGOA "visas" submitted to U.S. Customs have been rejected. Recent statistics from the U.S. International Trade Commission support this: more than 99 percent of garment shipments from Lesotho to the U.S. are currently entering duty-free under AGOA.

[45] The text of the deputy prime minister's speech is reproduced at http://www.lesotho.gov.ls/speeches/spfin30mar2000.htm. He expressed the hope that reducing the liquor tax rate from 20 percent to 15 percent would alleviate the smuggling problem.

smuggling and tax evasion, a point echoed in the Heritage Foundation's 2002 survey of economic freedom (WSJ/HF 2001).

In conclusion, the persistence of economic borders within SACU to some extent reduces the benefits of the regional agreement in the limited areas highlighted above.[46] One priority facing Lesotho's trade negotiators is to seek ways of resolving these problems at the SACU level.

3.2 PARTICIPATION IN THE WTO

Lesotho is a charter member of the WTO, which provides, through multilateral trade negotiations, one obvious route to greater integration into the world economy. This section addresses Lesotho's WTO membership and the way in which it will affect the country's ability to integrate into the world economy. It also analyses strategies to maximize the benefits from effective participation in the WTO.

As mentioned above, WTO membership gives Lesotho a chance to lock in trade liberalization. An important way in which it does this is by offering the opportunity to bind tariffs on goods and services at levels that suit Lesotho's trade and development needs. The new and more democratic structure of SACU offers the BNLS countries an opportunity to reshape the SACU tariff structure with their economic structures in mind, not just South Africa's. The binding of commitments would be important for the smaller members of SACU to lock South Africa into the structure. This will of course involve difficult negotiations at both the SACU and WTO levels for which technical assistance would be helpful for the smaller countries.

Like all WTO members, Lesotho benefits from guaranteed MFN access to the markets of other WTO members and from the minimization of capricious protectionist policies, which are curbed by WTO rules. This discipline works both ways, of course: WTO rules constrain Basotho policymakers from adopting protectionist policies. And like other WTO members, Lesotho enjoys access to the WTO's dispute settlement process. Lesotho receives better than MFN access to the markets of its principal trade partners by virtue of either regional agreements (SACU) or special preferences offered by industrial countries (AGOA, GSP). Lesotho has been particularly successful in taking advantage of special preferences under AGOA, as is discussed throughout this report. This enhanced market access is granted independently of Lesotho's WTO membership.

Government Procurement Agreement—a New Opportunity Worth Tapping?

The WTO Government Procurement Agreement (plurilateral)[47] requires signatories to make procurement laws and regulations as transparent as possible and to ensure that these neither protect domestic suppliers nor discriminate between different foreign suppliers. Signatories commit to accepting certain procedures on documentation, tender announcements, deadlines, and so on. Developing countries have more latitude on writing procurement rules, as they may

[46] Some aspects of these intra-SACU economic borders persist because LDC members of SACU are treated differently in many international agreements than other members, especially South Africa.

[47] Since only a subset of WTO signatories agreed to the codes, they were termed "plurilateral" to distinguish them from the multilateral commitments of the WTO itself, which are binding on all WTO signatories.

consider development objectives. Allowances are made for technical assistance for developing countries.[48] There are 22 members, including the Quad,[49] South Korea, Hong Kong China, and Singapore.

Lesotho can derive economic benefits from greater transparency in government procurement. As a first step, the GoL should accelerate its current efforts to revamp the procurement law and to establish a coherent legal framework. The current arrangements have the following weaknesses. First, the tender threshold of M 10,000 (or $1,000) appears to be too low as it unnecessarily overburdens the administrative capacity of the Central Tender Board and results in massive delays. Second, the use of different forms further exacerbates complex administrative procedures. The Foreign Investment Advisory Services recommended their standardization (FIAS 1997). Third, although the process is open to foreign companies, respective Ministries determine whether they are allowed to bid.[50] Fourth, there is no effort to actively involve small, micro and medium-sized enterprises (SMMEs).

Implementation of Trade-related Regulatory Reforms

The implementation costs of WTO disciplines with respect to domestic regulatory regimes could be costly for LDCs for two reasons. First, LDCs often start from a position of weak administrative capacity and therefore must create many administrative structures from scratch. Second, in some cases the relevant WTO agreements (e.g., TRIPS) tend to treat the practices that already exist in industrial countries as the model to which developing countries must conform (Finger and Schuler 2000). If handled carefully, however, the reforms undertaken to meet these new requirements can improve the domestic business climate, making it more attractive for trade and investment.

Lesotho's LDC status entitles it to certain benefits not available to either industrial countries or developing countries such as South Africa. To the extent that implementation is costly and the mandated reforms are not critical to Lesotho's progress, the longer transition period is beneficial.[51] Significant economies of scale could also be realized in some cases by pursuing regional cooperation.

3.3 Participation in SADC

The South African Development Community (SADC) is the second major regional arrangement that Lesotho belongs to. Unlike SACU, SADC is not solely (or perhaps not even principally) an exercise in regional economic integration. SADC was originally created to serve regional security

[48] See http://www.wto.org/english/docs_e/legal_e/gpr-94.pdf for details.

[49] The "Quad" refers to the quadrilateral activities of the United States, Japan, Canada and the European Union.

[50] The Central Tender Board now plans to involve South African firms in bidding for procurement orders.

[51] These include, *inter alia*, laws governing intellectual property rights protection, food and plant sanitation, import licenses, and industrial product standards. These trade-related domestic regulations are often referred to as "behind-the-border" policies in the trade policy literature.

and solidarity objectives.[52] Since the end of apartheid in South Africa, SADC has expanded its scope to address other political issues, coordinate regional policies, as well as to facilitate regional trade and investment. Of particular interest to Lesotho's trade policy is the SADC Trade Protocol, which went into effect in 2000.

Lesotho's Trade with SADC

It seems unlikely that the SADC free trade agreement, once finally implemented, will have much impact on Lesotho's gross trade flows. As Table 3.3 indicates, Lesotho trades very little with the non-SACU SADC members (less than one percent of Lesotho's trade). A similar story holds generally for other SACU members.

TABLE 3.3 LESOTHO'S TRADE WITH SADC, 1998
(PERCENT)

Direction of Trade	Imports	Exports
With SACU	89.6	64.4
With Rest of SADC	0.05	0.04
With Rest of World	10.2	35.6f

Source: Central Bank of Lesotho (personal communication).

But while the eventual FTA might not dramatically alter gross trade flows, it could potentially help Lesotho integrate its garment industry into a regional supply chain. Consultants commissioned by SADC report that there is capacity to develop regional supply chains for cotton-based fiber/finished garments and artificial fiber-based yarn/finished garments (Coughlin *et al.* 2001). The existence of regional suppliers will enable Lesotho to continue receiving preferential treatment in the U.S. market after 2004. At this time, Lesotho's garment producers will need to source inputs from either the U.S. or from another regional AGOA participant.[53]

Are there obstacles to an emerging regional supply chain? If so, what strategy should Lesotho adopt to overcome these constraints? In part, the emergence of a regional supply chain is constrained by the kinds of regional problems—non-transparent business and investment climate, inadequate infrastructure, poor training facilities—that also plague Lesotho.[54] Additional impediments can be found, however, in the restrictive trade practices among SADC members (including SACU CET and anti-dumping policies, which were discussed above). The following sections focus on recent moves towards trade liberalization at the SADC level.

Trade Liberalization under the SADC Protocol

The SADC Free Trade Area Protocol was signed in 1996, entered into force January 25, 2000 and officially launched September 1, 2000. Trade liberalization in the protocol focuses on the elimination of customs duties and various non-tariff barriers to trade among SADC members. The protocol also envisions regional regulatory cooperation, promotion of trade in services, cross-

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[52] Current SADC members are Angola, Botswana, Democratic Republic of Congo (DRC), Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe.

[53] Note however that the region's largest source of cotton fiber is Zimbabwe, which is excluded from AGOA for political reasons.

[54] See Chapters 2 and 5 below.

border investment, and trade facilitation (including customs cooperation and facilitation of transit trade). However, in most cases it does not spell out modalities for moving forward.

The SADC member countries have agreed on modalities for tariff reduction. By 2012, trade barriers should be largely eliminated, though liberalization is back-end loaded (duties that are low already will be reduced to zero immediately, tariffs on sensitive goods will be eliminated after 12 years, others will be eliminated in 8 years).[55] In addition, SACU has been particularly intransigent on relaxing rules of origin, insisting on higher local content to qualify for preferential treatment than other SADC members would like to accept. This debate over rules of origin has proven to be the most contentious part of implementing the protocol.

Special rules of origin have been applied to certain sectors (e.g., motor vehicles and sugar), and negotiations for other sectors are still ongoing—most notably textiles and garments, and wheat and flour. In the case of textiles and garments, imported raw materials will have to undergo a minimum of two stages of production ("double transformation") before they can be considered to have originated in a SADC country. This is done ostensibly to promote the development of backward linkages. However, in practice this represents a particularly expensive method of protecting domestic producer interests at the expense of consumers. Unlike a protective tariff, for example, overly restrictive rules of origin force producers to incur additional costs of complying with local content requirements.

Furthermore, restrictive rules of origin also introduce an incentive against exporting within the SADC region. This is particularly the case in industries where successful competition in international markets requires participating in global supply chains. This in turn *reduces* the scope for creating backward and forward linkages across countries within the SADC region. These are precisely the sort of linkages that Lesotho's garment industry must create by 2004, after which time AGOA rules will require garment producers to use inputs sourced either from within Sub-Saharan Africa or from the U.S.

The danger at present is that the SADC Trade Protocol tends to reflect an inward regionalism. It introduces a number of protectionist measures (most notably the restrictive rules of origin in a few key sectors) rather than advocate an open regionalism that could be used as a springboard to help members participate more fully in the world economy. One should recognize that the region's weak transportation infrastructure must be improved before SADC can become an effective route for increasing Lesotho's global integration. Inward looking regional agreements are not the only barrier that must be overcome.

Other SADC Economic Activities

SADC members also envision closer harmonization of government and economic policies. SADC members established the Regional Tourism Organization for Southern Africa (RETOSA) in 1996, and they drew up a protocol on tourism in 1998, which so only Botswana, Mauritius, and Zimbabwe have signed. RETOSA has conducted economic studies of tourism and engaged in some promotional activities. The goals of the tourism protocol are to exploit tourism for purposes of sustainable development, promote the region as a single tourist destination by coordinating and facilitating intra-regional travel. SADC members have accepted in principle to establish a

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[55] In addition, countries can exclude some goods from the liberalization exercise entirely. The value of these excluded goods may not exceed 15 percent of total SADC imports in any country.

common region-wide visa for international tourists, called UNIVISA. If implemented, this could yield benefits for Lesotho, given its limited consular operations abroad. A number of working groups have been formed and strategy documents published. There is no evidence of results so far. Poor regional transportation infrastructure limits the potential for developing a regional tourism industry.

Standards are one area where SADC has helped to establish a structure for regional cooperation. The SADC Protocol on Standards, Quality Assurance, and Metrology went into effect in 2000, although some elements had previously been established. The protocol's goal is to eliminate technical barriers to trade both within SADC and between the region and the outside world. Mechanisms for cooperation among governments in the development of standards and product accreditation were established. It also coordinates metrology training for government officials at the National Metrology Laboratory in Pretoria.

In the areas of finance, investment, monetary, and tax policy, individual SADC members pursue independent courses. There is no attempt to integrate, coordinate, or harmonize policies across countries. The SADC subcommittee formed to work on tax issues has been concentrating on gathering information about regional tax policies (including establishing a database of national tax policies) and exploring areas for capacity building. SADC members are pursuing independent strategies to attract FDI; they are not trying to coordinate them.

The SADC Trade Protocol requires members to adopt customs valuation methods that are WTO-compliant and, in general, to adopt customs laws that accord with international conventions (e.g., World Customs Organization recommendations) and best practices. In addition, member countries are expected to develop common clearance procedures and a common customs document that would be used for both FTA member trade and with third parties. The protocol also calls on member countries to computerize their customs operations. Finally, the protocol requires members to appoint a subcommittee on customs issues, which would work with member country governments to coordinate customs operations. Once implemented, these measures should prove important in reducing transaction costs of trading with SADC countries.

Implications for Lesotho

How can SADC help Lesotho increase its integration into the world economy? Creating a free trade area offers the best avenue, not because Lesotho trades that much with SADC members (apart from trade within SACU) at present, but because of the potential for developing a regional supply chain in garment manufacturing at some time in the future.

Recommendation 1: *Lesotho should push for looser rules of origin and accelerated access into SACU markets. Its goal should be to facilitate backward linkages with other countries in the region. To the extent that regulatory differences within the region deter investment from countries outside the region, Lesotho should push for harmonization of regulations. Harmonization of customs procedures is one area.*

3.4 Regional Regulatory Cooperation -- A Means of Integrating into the Multilateral System

The Uruguay Round introduced disciplines on a number of trade-related domestic regulations (e.g., technical standards, intellectual property rights). Most, if not all, enhance microeconomic efficiency and improve the business climate. Developing countries generally face considerable costs in implementing these reforms, and Lesotho is no exception. Lesotho does have one advantage, however—its proximity to South Africa, which has already implemented these new WTO agreements. The "revamped" SACU structure, which allows for greater voice by all SACU members, might in the future offer a framework for harmonization of regulations.

Lesotho may wish to consider adopting regulations congruent to those adopted by South Africa, with an eye towards integrating the two countries' regulatory apparatuses. In order to ensure success it would be preferable for Lesotho and its SADC partners to adopt regulations simultaneously in order to avoid criticism of ceding sovereignty to the RSA. More importantly, the inclusion of Lesotho into future RSA decision-making would be beneficial. The establishment of technical facilities branch offices in Lesotho in an effort to build local capacity would also be advantageous. This may ultimately require some formal agreement whereby RSA recognizes educational and professional credentials issued in Lesotho.

Technical Regulations and Standards

The Agreement on Technical Barriers to Trade (TBT) requires that a WTO member's regime of technical regulations and standards be transparent and non-discriminatory, offer national treatment to foreign firms, and in general not impose excessive burdens on traders. Where possible members should adopt international standards and recognize results of certification tests conducted in other member countries.

Technical regulations and standards issues are important for a number of reasons. Differences in national standards and regulations create extra transaction costs for firms serving multiple markets (consider the costs of different mobile phone standards on business people operating across different areas of the world). Adopting commonly used international standards in place of unique national standards is a prerequisite to integration into "fragmented production", such as supply chains spread throughout over several countries. Harmonization is essential in assembly operations (e.g., TV assembly) as common standards reinforce linkages between component manufacturers, assembly operations, and distributors in the final product markets.

Maintaining an independent national standards regime is costly as well, especially for small developing countries. Direct outlays for staff, training, equipment and facilities can be quite substantial. The high fixed costs suggest there are significant economies of scale. The more important expense, however, is the opportunity cost of the highly sophisticated equipment and technical expertise.

This is one area where regional cooperation can facilitate greater global integration. Lesotho, at present, lacks a functioning standards regime. Rather than going it alone, an option would be to harmonize its standards working closely with the South African Standards Board.

Sanitary and Phytosanitary Measures

The WTO Agreement on Sanitary and Phytosanitary Measures (SPS) introduces disciplines in a second area of standards regulations—those affecting safety or sanitation of food, animals, and plants. Many of the arguments enumerated above for complying with the TBT Agreement apply equally to SPS. In principle, the SPS Agreement protects food exporters by blocking capricious or discriminatory import practices: importers' regulations must be transparent, non-discriminatory, offer national treatment, and based on "sound science." Implementation costs include: plant and animal disease eradication campaigns; quarantine provisions and testing regimes to document that food exports originate in disease-free areas; and introducing new post-harvest sanitation systems (e.g., to prevent fungus growth or to remove pesticide residues).

Lesotho's small size renders it impossible to consider imposing SPS measures on imports that diverge from international standards. Foreign producers would simply ignore the Lesotho market altogether. The real issue is rather how Lesotho can meet foreign countries' standards. Although agriculture continues to contribute a large share of economic activity, this is currently primarily subsistence agriculture rather than production for foreign markets. In light of Lesotho's fragile mountain ecosystems, one doubts that Lesotho has much potential to become a major agricultural exporter in the future. Investing in meeting rich country standards may not yield much in the way of a commercial payoff, though of course valuable for health and other reasons.

One strategy for Lesotho would be to integrate its SPS measures into South Africa's regime rather than to attempt implementing the SPS Agreement on its own. First, most of Lesotho's food exports are destined for South Africa and must meet South Africa's import standards. With respect to third parties, the fact that South Africa surrounds Lesotho indicates that it already benefits from existing disease eradication and prevention measures are undertaken in South Africa. (Exporters in Lesotho would still need to prove to importers that this is true however.)

Intellectual Property Rights Protection

The WTO Agreement on Trade-Related Intellectual Property Rights (TRIPS) requires that WTO members provide certain minimum levels of intellectual property rights (IPRs) protection, such as 20-year patent terms, patents on medicines, plant variety protection, protection of geographical indications, and the like. For Lesotho, as for most WTO developing country members, implementing TRIPS means introducing greater protections and stronger enforcement.

TRIPS has proven to be one of the most controversial products of the Uruguay Round. Even many of its critics, however, will acknowledge that some protection of IPRs is crucial for investment in creative industries and industries intensive in research and development. Some connect stronger IPRs to increased foreign direct investment. Certainly foreign firms employing easily imitated technologies think twice before establishing production in countries where IPRs are not protected. As with other trade-related regulations discussed here, the administrative costs of implementing TRIPS can be quite substantial, when one takes into account the need to write new laws, train judges, empower customs officials to interdict shipments of counterfeit goods, establish and staff IPR-related agencies, and so on. These are properly thought of as investments in institutions and government capacity.

Lesotho's government should consider implementing the TRIPS agreement through regulatory integration at the regional level, rather than attempting to implement it independently. Regional cooperation spreads the costs of administrative investments, allowing partners to take advantage of economies of scale in administering IPR protection. It also reduces the costs of IPR regulation compliance to firms. The job of interdicting shipments of counterfeit goods would more logically take place at the SACU level— through common IPR enforcement procedures, otherwise pirates will exploit the customs union member with the weakest enforcement regime.

Finally, regional integration of IPR regulations will help countries to standardize their approach to invoking the provisions in TRIPS on national emergencies (should it be necessary). This is particularly relevant with respect to compulsory licenses on AIDS drugs.[56] Every country in the region faces the same public health crisis and all stand to benefit from coordinated waivers of patent enforcement. This is especially true for smaller countries lacking a domestic pharmaceutical industry. They must, therefore, find foreign firms willing to ship generic drugs under compulsory import licenses.[57]

Customs Valuation and Administration

The WTO Customs Valuation Agreement requires members to levy customs duties on an imported good's transaction value rather than on a reference price constructed by the government. By defining a good's value in terms of its market price, the agreement promotes predictability and transparency of customs clearance procedures, while also reducing the scope for protectionism. Lesotho was party to the Tokyo Round's plurilateral agreement (i.e., only applying to its signatories) on customs valuation. Although it has not yet completed implementing the customs valuation agreement from the Uruguay Round,[58] Lesotho does indeed follow this agreement, according to customs officials interviewed in 2002 in Maseru. Some argue that the benefits of implementing the WTO Agreement on customs valuation are more likely to be fully attained if customs officials maintain accurate and up-to-date computer databases of prices which they can use to detect fraudulent invoicing (Rege 2002).

Transparency in valuation practices is one component of a customs regime that facilitates trade. Another is computerization of customs clearance. In its submissions to the WTO, Lesotho noted that it needed technical assistance in the area of computerization. Many developing countries have adopted ASYCUDA, the customs software developed by UNCTAD, as part of broader development projects devoted to customs reform.[59] ASYCUDA and similar customs software packages are designed to simplify clearance procedures by reducing paperwork requirements, thereby cutting down on the time that goods are delayed at the border. Another advantage of sensible computerization is increased revenue collection (by reducing human error in addition to identifying fraudulent invoices) and improved data dissemination.

The importance of this goes beyond the mundane matter of improving administrative efficiency; implementing the package of reforms implied by adopting WTO valuation is important to Lesotho's integration into the world economy. The type of trade that benefits most from electronic clearance and transaction valuation is high volume, time-sensitive trade. It is difficult for a country to participate in "fragmented production" (where supply chains are spread over many countries) if its customs procedures are time-consuming and costly because they involve complex paperwork, non-transparent valuation methods, and routine physical inspection of all shipments. By contrast, infrequent trade in unique items or trade in simple commodities whose prices are widely known does not benefit as much from modern customs practices.

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[56] Zimbabwe has already announced that it will lift legal restraints on generic AIDS drugs, invoking the national emergency provisions of TRIPS.

[57] Lesotho has only one establishment manufacturing drugs and medicines, according to 1998 UNIDO data.

[58] See WTO submissions G/VAL/M/9, dated 28 January 1999, and G/VAL2.24/Rev.1, dated 12 March 1999.

[59] In addition to buying computers and software, countries often need to upgrade the physical facilities where goods are cleared and complement these measures with improved incentives and performance management for staff from customs authorities.

In Lesotho's case, there is an additional dimension to consider: the extent of differences in customs procedures across SACU members. The customs union's common external tariff is undone to some extent if individual countries use different procedures. It would make sense, therefore, to vest all customs administration in a regional authority. This would ensure common procedures, reducing transaction costs for shippers. It would take advantage of economies of scale in data processing. If SACU cannot actually unify customs clearance, Lesotho may wish to consider whether there is benefit to harmonizing at least its procedures with those of its major trading partner, South Africa.

Trade in Services

Trade in services is regulation-intensive and liberalization is frequently a matter of streamlining government regulations or eliminating state-sanctioned monopoly providers. Expanding trade in services represents an important avenue for increasing Lesotho's global integration. Imported services are often critical for improving domestic production (and exports) in manufacturing and agriculture. Importing services can serve as one channel for technology transfer, particularly if locals can imitate foreign providers of services. Lesotho has much to gain from providing the freest possible market access to providers of professional services (e.g., law, architecture, technical) and financial services.

Developing export-oriented service industries is also one way to overcome the natural resource constraints that Lesotho faces. An example is tourism. Opening markets to foreign providers of services, along with investments in physical infrastructure, hospitality industries and marketing can contribute to a thriving domestic tourism industry.

Lesotho's strategy in services trade liberalization should be to treat South African regulations and WTO commitments as the starting point for its own liberalization. In other words, the GoL should ensure that its services trade regime is no less open (and certainly no less discriminatory) than South Africa's.[60]

3.5 SUMMARY: IS REGIONAL INTEGRATION A STEPPING STONE OR STUMBLING BLOCK?

International trade economists often question whether regional trade agreements are "stepping stones or stumbling blocks" to greater integration into the world economy. And they answer their question by either estimating the static welfare effects of preferential tariff liberalization—does the agreement create new trade or merely divert existing trade—or by evaluating the dynamic effect of negotiating a regional agreement on the feasibility of a multilateral agreement. The analysis in this diagnostic study suggests that there are other important dimensions to this question. In addition to expanding regional trade, regional integration has benefited Lesotho through greater macroeconomic stability. Its proximity to South Africa allows it to take advantage of high quality physical infrastructure, which to some extent mitigates Lesotho's disadvantages as a land-locked country.

[60] For example, South Africa bound its market access commitments in the Uruguay Round but Lesotho did not. Other things being equal, making a bound commitment facilitates trade by providing traders with greater certainty

Balanced against these points are the persistence of economic borders and present inconsistencies between the common external tariff and Lesotho's industrial structure. Both suggest the need to increase Lesotho's participation in SACU decision-making. The new SACU Treaty should help facilitate that. However, to take full advantage of regional arrangements as a stepping-stone towards greater integration into the world economy, Lesotho in some instances may wish to approach regulatory reform from a regional perspective — harmonizing as appropriate and desirable. Nevertheless, in other areas, such as regulations affecting services trade, Lesotho can integrate directly into the world economy by going one step beyond its regional partners. The same is true for other regulations that affect the investment climate in Lesotho. Before addressing unilateral steps to improve the domestic business climate, we first take up the issue of strengthening the country's institutional capacity to conduct commercial diplomacy.

CHAPTER 4
BUILDING INSTITUTIONAL CAPACITY

The previous chapters identified several constraints and opportunities facing Lesotho as it integrates into the world economy. Some are generated by multilateral trade liberalization and others relate to its membership in SACU. To take advantage of new economic opportunities, Lesotho must increase its ability to implement all stages of the trade policy cycle (analysis, policy formulation and strategy, negotiations, implementation, and monitoring and evaluation). This chapter analyses Lesotho's institutional capacity for trade policy development; describes the overall institutional setting; assesses its capacity to carry out the stages of the trade policy cycle; and offers a set of options and recommendations to help Lesotho strengthen its trade capacity.

4.1 Institutional Setting

The current institutional framework falls well short of effectively addressing complex trade policy issues. It is characterized by weak institutions, a fragmented policy process and poor public-private dialogue.

4.1.1 Weak Institutions

In the public sector, the Ministry of Industry, Trade and Marketing (MITM) is the most important institution in trade policy formulation. The Ministry carried out a strategic planning exercise in 1998 (see Volume 2, Chapter 3). The strategic plan, which was updated in 2001, recommends restructuring the Ministry as part of component one of the Government of Lesotho Civil Service Reform Programme (CSRP), and was originally submitted to the Ministry of Public Service for approval in 2000. The Strategic Plan so far offers the clearest indication of the direction that MITM intends to go. Any interventions in MITM should therefore strive to build on this existing effort, with adjustments as necessary.

The Strategic Plan makes several good innovations in bridging the gap between the current organizational structure and the Ministry's emerging needs. However, certain areas of the Strategic Plan may benefit from additional refinement and acceleration. These include consistency between the organizational set-up and TA needs identified in the DTIS, the relation between MITM and other Ministries and complementary issues such as career development, job descriptions, staff appraisals and a holistic training approach.

A number of other agencies also play critical roles, including the Ministry of Finance (MOF), the Ministry of Development Planning (MoDP), the Ministry of Foreign Affairs (MFA), and the Ministry of Agriculture (MoA). Given the growing importance of behind-the-border regulatory measures that affect international trade, the Ministry of Law and Constitutional Affairs is also an important player. Finally, the investment promotion agencies—the Lesotho National Development Corporation (LNDC) and the Basotho Enterprises Development Corporation (BEDCO)—provide support to firms in trade and industrial development.

A plethora of private sector organizations exist but their formal role in trade and industrial policy formulation is limited. The main organizations are:

a) Lesotho Chamber of Commerce and Industry (LCCI)

b) Employers Association

c) South East Asian Exporters Association

d) Taiwanese Chamber of Commerce

Knowledge and capacity with respect to trade-related issues is weak within the private sector and especially in LCCI. While the Employers' Association and the various exporters associations are familiar with key issues that directly affect them, their broader understanding of the implications of various negotiations is limited. The capacity of civil society (Lesotho Consumers Association and Lesotho Council of NGOs) is even more limited.

Recommendation 1: *Accelerate implementation of the MITM strategic plan.*

Recommendation 2: *Include the private sector and civil society in relevant training program on trade issues.*

4.1.2 Fragmented Policy Process

Responsibilities for developing and implementing trade policies are dispersed throughout the government. For example, MITM and MoDP share the lead in negotiations with SADC. Given the revenue concerns, MOF leads negotiations with SACU partners while the WTO is the domain of the MFA. The Ministry of Law and Constitutional Affairs is responsible for drafting the implementing legislation for any trade agreements negotiated (see Volume 2, Chapter 3).

The fragmented responsibilities are compounded by the weak consultative mechanisms for trade policy formulation and co-ordination within the Government. An informal Inter Ministerial Committee on Industry was initiated by MITM in 2001. Its membership includes the Ministry of Labor (Immigration Department), Ministry of Health, Police and Customs. Meetings were to be held monthly but in practice have been held infrequently on an ad hoc basis.

Recommendation 1: *Establish a Cabinet Sub-Committee to oversee Lesotho's preparation for the next Ministerial in Mexico in 2003 and the negotiations thereafter. It would also help coordinate policy development across the various agencies and monitor implementation. The Sub-Committee would be similar to the Cabinet Committee on Reconstruction that was set up after the 1996 election. The Sub-Committee would be supported by a team of principals drawn from the various agencies currently involved in trade policy and a small staff independent of these ministries.*

4.1.3 Public-Private Dialogue

Also missing in the present institutional setting are mechanisms for effective policy dialogue between the Government and private sector, and within the private sector itself. Trade policy design and evaluation call for active participation of the private sector (labor and management, and both exporters and importers) as well as organizations representing civil society.

Existing consultation mechanisms are sporadic and do not cover the full spectrum of firms. Elements of the private sector consult with the Government on specific issues. For example, the Association of Employers, Exporters Association, the Ministry of Labor, and the LECAWU have a tri-partite arrangement to discuss labor issues. A national network on WTO issues chaired by MITM includes participants from the private and public sectors and academia. Its objective is to disseminate information related to the WTO trade agreements and their implications nationally and regionally. Technical sub-committees have been established for agriculture, trade in services, trading rules, TRIPS, SPS and TBT. The network was scheduled to meet on a monthly basis, but meetings have been sporadic due in part to lack of interest by participants and the complex and esoteric nature of the subjects discussed. Some participants indicated a lack of clarity on how the subjects under discussion affected them.

There is no mechanism within the private sector for internal dialogue and assessment of government policies. The private sector is extremely polarized at present. Due in part to the difficulties currently faced by the national Lesotho Chamber of Commerce and Industry (LCCI) no single private sector forum effectively represents the private sector's interests or speaks to the Government with one voice. This gap is especially critical for smaller firms. The Association of Employers and the Association of Exporters (comprised mainly of larger firms) collaborate on labor-related issues. The former includes mostly larger firms as well as several South Africa-based firms while the latter includes firms from South-East Asia for the most part. The members of these organizations tend to rely on their own networks for trade information and do not appear to perceive a gap in these information channels. By contrast, the smaller firms represented by the LCCI, Maseru Chamber and members of the Lesotho Manufacturers' Association appear quite unaware of the required standards and potential market opportunities. Through the Lesotho Council of NGOs (LCN), civil society has a viable mechanism for consulting with each other. However, as indicated above, their weak capacity on trade issues limits their effective participation in the dialogue.

Recommendation 1: *The Government should consider establishing a system of trade policy advisory committees to facilitate public-private dialogue and ensure that the Government's trade policy and negotiating strategies accurately reflect the country's economic and social interests. The committees would each have a different sectoral (agriculture, mining, garments, etc.) or functional focus (such as customs/licensing, environment, or SMMEs). Membership would be drawn from the private sector and civil society. Representatives from MITM would chair these committees, or serve as co-chairs with representatives from another relevant ministry (for example a representative from the Ministry of Agriculture would co-chair the agricultural trade advisory committee).*

This sort of committee system would facilitate a *two-way flow* of information. It should not be simply another mechanism for the Government to disseminate information to the outside world. The trade policy advisory committee system needs to be designed from the ground up as a channel for stakeholders to advise policy-makers. Committee chairs should be tasked with actively soliciting input from committee members and the constituencies they represent.

Recommendation 2: *Strengthen the national Lesotho Chamber of Commerce and Industry. This is predicated on LCCI resolving current internal differences and resolution of pending legal case.*

Recommendation 3: *Consider whether establishing a high-level National Business Council or Private Sector Foundation to provide an overarching mechanism for dialogue would be useful. Identify 1-3 issues of common interest that they could work on together.*

4.2 THE TRADE POLICY PROCESS: AN ASSESSMENT

Regardless of the specific trade challenges different countries face, an effective and sustainable trade policy framework and process underpins trade capacity building. The framework introduced here draws closely on the Development Assistance Committee Guidelines *Strengthening Trade Capacity for Development* (OECD 2001) (see Volume 2, Chapter 3).

While no single "ideal" trade policy framework exists, there are certain common inter-related elements that all countries face in the trade policy cycle: trade analysis, policy and strategy formulation, negotiations, implementation, and monitoring and evaluation. Chapter 3 of Volume 2 expands in detail on each element and assesses how well equipped Lesotho is to manage them. A summary is presented below.

4.2.1 Data Limitations

Successful policy making and economic diplomacy depend first on having accurate information and then on being able to process that information. Without good data and analysis, negotiating capacity is bound to remain weak. There is no doubt that negotiating in the national interest is impossible without adequate information about what will enhance national economic welfare. Similarly, even in the presence of strong analytical capacity, the absence of reliable statistical data would only result in a "garbage in-garbage out" outcome.

The first obstacle one encounters when trying to conduct economic analysis in Lesotho is that the necessary information is often not available. Trade data are incomplete, inconsistent and, in many cases, simply unavailable. When they are available, several inconsistencies between trade data reported by the Bureau of Statistics (BOS) and the Central Bank of Lesotho (CBL) make them of little use for economic analysis (Volume 2, Chapter 1). These inconsistencies are not trivial. They yield conflicting information about the commodity structure of trade, the direction of trade and the growth of trade volumes (see Chapter 1). Infrastructure constraints (lack of computerization of customs) and lack of demand for analysis explain the poor data.

As mentioned earlier, over 80 developing and transition countries use UNCTAD's ASYCUDA computerized customs clearance software, including two SACU members—Botswana and Namibia. Other computerized systems are also available. The SADC Trade Protocol urges members to adopt any one of the standard computer packages.

Recommendation 1: *Lesotho should adopt a system that is fully interoperable with those used by its partners in the customs union such as ASYCUDA, and that easily transmits trade data to the UN Statistical Office.*

This is not purely an information technology issue, however. Simply computerizing inefficient procedures does not increase efficiency. On the contrary, it may actually compound problems with customs clearance. The lesson from customs and tax computerization projects around the world is that the real productivity increases come when new information technology is used to reform customs institutions and organizations.[61] In addition, the various agencies responsible for

[61] **This is a theme stressed in *PREM Notes* Number 44 (October 2000).**

compiling and processing economic statistics must also address issues of data quality. The EU is presently working with the Bureau of Statistics to improve the accuracy of national accounts. The focus of this exercise could potentially be re-engineered to increase the priority accorded to the international trade and investment data, and MITM should consider championing such a proposal.

Problems of weak data analysis capacity extend beyond trade or foreign investment statistics. Lesotho needs a modern statistical system for both government and private business generally. Without it, the quality of policy making will remain poor, the noted earlier misperception of Lesotho's performance among foreign analysts will persevere, and high cost of due diligence will keep many high quality investors out of Lesotho.

Recommendation 2: *The Government should consider initiating a regular census of business enterprises (including SMMEs). Data collected would be invaluable to poverty-focused economic policy making in addition to mitigating misperceptions held by foreign businesses.*

4.2.2 Analytical Expertise

Once the data are available, the country needs to have the capacity to process the information and generate useful economic analysis. As in many LDCs, analytical expertise is spread very thin within the government of Lesotho as well as in the non-profit sector (for example, in private consulting firms and the National University). This talent remains thin in spite of receiving considerable amounts of technical assistance over the years. Some suggest that this reflects the form that technical assistance too often takes. They cite a history of relying on foreign consultants to conduct the analysis instead of training local analysts to conduct it on their own.

MITM has primary responsibility for trade policy analysis and within MITM; the Department of Trade is expected to take the lead. MITM relies on the Ministry of Development Planning (primarily through the Bureau of Statistics) and (indirectly) the Central Bank to provide it with basic statistics on trade, industry and the national economy. For two main reasons, however, MITM has been unable to carry out this role: data weaknesses as well as weak analytical capacity. Firstly, Lesotho has a fundamental problem in carrying out basic trade analysis because it does not have timely or accurate trade data as described elsewhere in the DTIS (see Chapters 1 and 3). Thus, the ability to collect relevant information and skills in preparing and presenting data as well as in identifying inconsistencies in available data series are important requirements.

Second, the country suffers from a dearth of analytical capacity. There are only a handful of trade analysts between MITM, the National University of Lesotho and in private consulting firms. The situation is compounded by the fact that under the current organizational structure responsibility for policy analysis in MITM is dispersed across units.

A wide variety of policy issues urgently demand better economic analysis. Advice and technical support would be particularly useful in:

- *Regional:* Analysis of laws and regulations that can be harmonized at the regional level and thereby facilitate Lesotho's integration into the world economy.

- *Market access:* Implications of the phasing out of the MFA and the shift to AGOA-2; how to structure trade liberalization with Europe under the Cotonou Agreement and whether Lesotho would benefit from an FTA with the United States.
- *SADC:* SADC related issues (rules of origin and free trade arrangements) and the potential for building regional supply chains through regional agreements.
- *Non-Tariff-Barriers:* Impact of non-tariff barriers frequently employed or advocated by South Africa, such as restrictive rules of origin and anti-dumping actions that have a damaging impact on Lesotho. Compiling and quantification of technical barriers to trade as well as identifying new markets and potential barriers to entering those markets, including both foreign trade barriers and domestic supply constraints.
- *Fiscal:* Assessing the fiscal impact of trade agreements and, more importantly, finding effective ways of moving away from trade taxes as the source of government revenue.
- *Legal:* Compatibility of the existing legal and trade policy framework to assess its compatibility with Lesotho's obligations in bilateral and multilateral fora; Market and legal analysis to support liberalization of critical services imports.

Enhancing the capacity to conduct economic analysis will generate more demand for data, putting pressure on the various statistical offices within the government to collect higher quality data. However, the real payoff, of course, will be improving the ability to identify areas where policy interventions are needed and where they are not.

Within MITM, the institutional framework as well as preparatory mechanisms for negotiations does not currently support planned and strategic analysis as a foundation.[62] MITM is characterized by a plethora of job titles and designations, yet some essential skills (such as economists, statisticians, IT) are not distinguished and appear to be in short supply. There is no explicit unit for capacity building, nor is there an overall training planning that links individual staff development with departmental mandates. The basic inputs required to carry out analysis (computers, software, printers, Internet access and adequate and up-to-date reference materials) do not exist in sufficient numbers.[63]

Recommendation 1: *Establish a policy analysis unit in the MITMwith a clearly identified work program and skills assessment to underpin training/recruitment needs. One option is to redefine the functions of the external trade division to include the functions of a policy analysis unit and upgrade existing skills. Without a drastic improvement in data collection and staff training, merely reshuffling the organization chart to create a policy analysis unit will fail to create high quality outcomes.*

Recommendation 2: *Establish a Government-wide training program to build capacity of the proposed policy unit as well as that of staff in other related units in the Ministry of Foreign Affairs, Ministry of Development Planning and the Ministry of Law and Constitutional Affairs.*

Finally, the government should not overlook the advantages of forging closer ties with public policy schools, think tanks and academics throughout the region. In the short run, this shares the

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[62] See Volume 2, Chapter 3 for details on issues related to the MITM.
[63] This is not a problem limited to the MITM, of course.

burden of analysis with institutions outside of government. In the end, these organizations represent pools of talent from which government agencies can recruit staff in the future.

4.2.3 Negotiating Capacity

Improvements to organizational structure, data collection, and economic analysis are three ways of improving Lesotho's trade policy process. A fourth is to enhance the capacity to participate in trade negotiations. These ingredients complement each other and are mutually reinforcing—for example, better data, a rationalized organizational structure, and economic analysis should help negotiators work more effectively. However, more needs to be done to address the issue of negotiating capacity more directly.

One necessary step is to draw up a calendar of upcoming negotiations. As noted throughout this study, Lesotho is a party to multiple, overlapping trade agreements, which serves to increase the workload imposed on trade negotiators. The agencies involved in trade policy need to compile a comprehensive calendar of upcoming negotiations with lead individuals, teams and short briefing notes on key issues arising that need to be analyzed. By communicating a sense of when each set of negotiations is to be concluded and who is participating in each forum, this shared calendar can help the Government assign priorities and responsibilities to different negotiating tasks.

After delineating responsibilities across ministries and departments, the next task is to establish a training program for staff participating in trade negotiations (see **Recommendation 2** immediately above). The Government should work with major donor agencies to develop the structure and budget for such a training program, drawing on domestic and regional expertise, to the extent possible. It would also be useful for Lesotho's negotiators to network with their counterparts in the region.

4.3 IMPROVING INSTITUTIONAL CAPACITY

Many observers feel that developing countries were shortchanged in the Uruguay Round because they lacked both analytical capacities and the staff needed to participate fully in the negotiations. Certainly, their delegations in Geneva were tiny compared to those sent by the U.S. and the EU. Enhancing the government of Lesotho's capacity to participate in international trade negotiations is clearly one important ingredient to increasing the country's integration into world trade and investment. In the regional multilateral negotiations, the government has often relied on South Africa to undertake the analytical work related to negotiations. However, national interests do not always overlap—hence the need for the development of local institutional capacity. The expansion of the trade agenda to "second generation," i.e., behind-the-border issues renders the task of establishing strong institutional capacity urgent.

In fact, developing strong institutional capacity for dealing with international policy issues is an investment with a huge rate of return. Improvements in this area combined with other measures ameliorating business/investment climate contribute directly to economic growth and poverty reduction. Lesotho is small and highly vulnerable to external developments. It can ill-afford to be short changed in international negotiations. On the other hand, it can gain a lot from well-designed policies and a favorable international environment.

The key to enhancing institutional capacity is improving data collection (ideally setting up a modern statistical system), strengthening policy analysis and creating an institutional setting that supports the implementation of trade and industrial policies. This is an important task for three reasons. First, Lesotho has been involved in the process of policy-induced regional integration encompassing regulatory issues going beyond organization of flows of goods and services across the border. Moreover, as we argued earlier, Lesotho can influence its regional policy environment to make it more attractive for business activity. Second, the multilateral trade agenda has become increasingly filled with issues that were once considered the province of domestic politics, such as intellectual property rights, government procurement, food safety regulations, and the like. Third, because of the increasing domestic impact of trade-related issues, the institutional setting has to be more inclusive. Non-government actors (e.g., Lesotho Chamber of Commerce) as well as line ministries should become an integral part of the process. 'Behind-the-border' issues are increasingly unfamiliar trade negotiators (and the ministries from which they are drawn). To succeed in international negotiations on these "behind-the-border" trade-related issues, negotiating positions must be formed with participation of line ministries (e.g., Agriculture, Health) as well as representatives of consumers and producers.[64]

The assignment of priorities to international policy issues should take into consideration Lesotho's expected biggest payoffs. One needs to identify which issues have the highest priority—bilateral, regional or multilateral. For instance, our discussion of the bias against Lesotho's exports inherent in the SACU tariff schedule would appear to suggest that increasing Lesotho's participation in the regional (South African) tariff-setting process, including trade remedies, is a good place to start. This naturally leads to the question of how Lesotho can best participate at the world level. Lesotho's stake in world markets is so small that it has little to gain from playing a large role in multilateral negotiations. It can afford to free ride on the MFN treatment it receives as a by-product of other countries' negotiations.

Instead, Lesotho has much more to gain from leveraging its membership in SACU—and perhaps more importantly, its proximity to South Africa. For example, it makes more sense for SACU members to pool their representation to specialized standards setting bodies (e.g., Codex Alimentations, ISONET, IPPC, WIPO, etc.). Coordinating negotiating strategies at the regional level also goes hand in hand with coordinating domestic policies in these areas. Note that this is *not* the same as arguing that Lesotho should ignore markets outside the region.

Another priority might involve preferential arrangements offered by key bilateral partners, most notably under AGOA. While it would be naive to think that Lesotho can determine whether the U.S. or EU grants such preferences in the first place, it might be able to affect such programs at

[64] The best illustration of the importance of involvement of experts and those directly affected by various measures comes from the Uruguay Round negotiations. It is commonly argued that developing countries were disadvantaged in the Uruguay Round by the expense of maintaining delegations in Geneva. Indeed, one wonders whether trade negotiators would have agreed to expensive agreements such as TRIPS or SPS if there had been communication between them and the officials in the line ministries back home who knew something about filing patents or quarantine procedures, and who now bear the burden of implementing these agreements.

the margins as alluded to earlier in this chapter. Lesotho is often held up in the U.S. media as one of the great success stories of AGOA. By exploiting this *wunderkind* image, Lesotho could potentially convince U.S. lawmakers to improve the generosity of AGOA provisions that are particularly important to Lesotho.

4.4 SUMMARY AND CONCLUSIONS

We argue in the preceding chapters that Lesotho should followed a dual strategy of regional cooperation to foster a single integrated market on the one hand, while simultaneously "going it alone" by creating a better business environment at home. Together these will help Lesotho build on its success in attracting foreign investment and supplying foreign markets. One crucial requirement is improved commercial diplomacy: Lesotho needs to be able to make its case with its fellow SACU members as well as in Geneva, Washington and Brussels. To achieve this goal, the Government of Lesotho needs to enhance and assure best use of available local institutional/policy analysis capacities. Moreover, it needs to integrate trade policy analysis into the PRSP process. Local institutional and analytical capacities are not only weak but are also spread among several ministries engaged in managing Lesotho's external economic relations. Local participation should contribute to the development of institutional capacity to formulate and deal with 'second generation' trade policy issues. In this chapter, we recommended ways of developing these capacities. We turn now to measures Lesotho can take on its own develop a better business environment.

CHAPTER 5
BARRIERS TO SUSTAINING FDI INFLOWS

5.1 INTRODUCTION

Lesotho has been quite successful in shifting from import-substitution to export-driven growth led by FDI-exporting firms. As discussed in Chapter 2, the impressive export growth performance since 1999 is due in part to the government's success in attracting FDI to the garment sector. Lesotho's low production costs combined with preferential access to U.S. markets under MFA and AGOA have been the engines of this growth. While this type of lopsided integration into world markets is probably not viable in the long term, particularly since preferential treatment will be phased out, continuing impressive export-led growth may be sustainable.

There are a number of important factors critical to sustaining the inflow of FDI. Issues such as macroeconomic and political stability and harmonization of trade-related regulations were discussed in Chapters 1 and 3 respectively. This Chapter examines the barriers to FDI sustainability--physical barriers to continued development of the garment sector, human capital, HIV/AIDS and business climate.

5.2 THE GARMENT SECTOR: BARRIERS TO EXPANSION

Continued export expansion hinges critically on new industrial capacities in the garment sector. What are the major barriers to the expansion in supply? The major physical constraints to the consolidation and further growth of the industry may be listed as follows (Volume 2, Chapter 8):

Insufficient or erratic supplies of water to all major industrial estates. Fabric mills and many garment production industries require significant volumes of water for the post-production processing of their produce. Water supply throughout the Lesotho industrial estates is erratic and inadequate now. Investment in the maintenance of Maseru's existing reticulation system where approximately 40 percent of water is lost would provide additional water capacity for the establishment of new factories.

Lack of available factory shells and serviced industrial sites: The pressures of expansion of the industry have resulted in a shortage of serviced industrial sites. In the past the Lesotho National Development Corporation (LNDC) provided factory shells to attract entrepreneurs moving into the country as it shortened start-up times. With the success of the program, the LNDC now has very limited facilities for its expansion. While a number of entrepreneurs have agreed to finance the building of their factories themselves, thus dispelling fears of 'foot-loose' syndrome, no industrial land is readily available.

Inadequate conditions and handling facilities at the Maseru railhead: The facilities at the Maseru railhead are completely inadequate to handle 40 containers a day that are brought into the station on two trains. No part of the station is paved and containers are lifted off the rail trucks by crane or forklift trucks. Given that the working surface is uneven and in wet weather turns into a quagmire, the entire operation of the station is dangerous and insufficient to handle Lesotho's development requirements. Full containers cannot be stored on an uneven surface as it is virtually impossible to lift them again with a forklift. Because of the lack of storage capacity, a large number of containers consigned to Lesotho are stored on a regular basis in Bloemfontein. A demurrage charge of M295 per container per day is revenue lost to Lesotho. If the Maseru railhead was given a reasonable portion of the revenue for its incoming containers and was able to earn the demurrage on containers in storage, it is likely that it would be profitable and self-sustaining. To achieve this it needs to be completely upgraded with suitable container handling facilities—increased siding length and paved storage and handling areas. It is worrisome that despite the fact that the denim mill alone will increase container traffic by 10 percent, there do not appear to be any plans to increase capacity of the railhead.

Customs Facilities: The majority of raw materials for the garment industry are imported into Lesotho by rail. All raw materials imported under rebate have to be inspected by Customs during unloading of the containers. In addition, Customs must verify all exports to the U.S. and Europe during the loading process. The garment industry is currently concentrated near Maseru and Maputo. While inspection facilities are available at Maputo, final document clearances and verification must be done in Maseru, some 100 kilometers away. While it is possible to import containers through Ficksburg, which is the South African border town with Maputsoe, the document clearances must still take place in Maseru. Investors claim that this requires a senior employee to travel to Maseru where a whole day may be wasted every time a consignment arrives or leaves. Currently, a customs official must accompany containers consigned to Mafeteng and cleared through the Maseru railhead to the factory where they are inspected. This is a round trip of some three hours. Hence, the establishment of full clearance and export facilities in Maputsoe would be of enormous benefit to the garment industry in Maputsoe and could be a pilot scheme for the development of similar facilities in the future expansion areas of Mafeteng, Mohale's Hoek and Butha Buthe.

Recommendation 1*: Implement quick fixes*. *A number of bottlenecks could be removed without encountering technical obstacles. These include: reviewing Lesotho Electricity Corporation's billing practices; maintaining roads; making mobile phone service compatible with and acceptable to other international providers; and implementing the 2001 Environment Act,[65] which encapsulates the principle that a polluter should pay for the damage done to the natural environment.[66]*

Recommendation 2: *Decentralize Custom**s: Establish full clearance facilities in Maputsoe.*

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[65] During implementation one should ensure that costs from new administrative procedures do not undermine benefits from a cleaner environment.

[66] The Act is not yet operational. Section 4 of the Act grants every person in Lesotho a right to a clean and healthy environment and places a duty on individuals to safeguard and enhance the environment. Individuals are entitled to take legal action, or other action, against any enterprise, which threatens the right to a clean and healthy environment. The Act enshrines such basic principles of environment management as the polluter pays principle, the precautionary principle, the principle of ecosystem integrity, the principle of public participation in development policies, plans and processes and the principle of inter-generational or intra-generational equity. A Lesotho Environment Authority has been set up with its own Board of Directors as the principal agency to manage the environment (Volume 2, Chapter 6).

5.3 HUMAN CAPITAL AS A BARRIER

The quality of human capital in Lesotho is high relative to its level of GDP per capita. The literacy rate in Lesotho is among the highest in Sub-Saharan Africa,[67] although the government's program for universal free primary education has not been fully implemented.[68] Levels of secondary school enrollments are also impressive, relative to other low-income African countries. For instance, the secondary school enrollment rate in Lesotho (in the mid 1990s) was 28 percent of the relevant age group, compared to 5 percent in Tanzania, 28 percent in Kenya, 6 percent in Malawi, or 21 percent in Zambia. It did not, however, match the 56 percent reached in Botswana or 47 percent in Zimbabwe—not to mention South Africa with 98 percent (WDI 2001). Despite the relatively high level of human capital foreign firms continue to hire expatriates for managerial and technical jobs.[69] Moreover, local-owned larger firms are virtually non-existent and low productivity characterizes the clothing sector.

5.3.1.Shortage of Local Entrepreneurship

Although statistics on the size, distribution and location of Lesotho's private sector are incomplete, they indicate that the private sector is characterized by a dual structure with entrepreneurial skills in short supply. First, there are a small number of foreign-owned, large manufacturing firms mainly producing garments for exports. They are clustered in four designated industrial estates: Maputsoe, Thetsane, Maseru, and Ha Nyenye. They form an enclave with limited links to the rest of the economy; there are no domestic firms providing inputs or technical and maintenance services to the foreign sector (Volume 2, Chapters 4 and 8). There are a few foreign-owned firms in other sectors, but their numbers have not increased in recent years.

Then there are the Small, Micro, and Medium-sized Enterprises (SMMEs) owned mostly by local Basotho entrepreneurs and engaged mostly in service activities catering to local markets. SMMEs, employing 1-3 employees each, operate throughout the country, although they are located primarily in urban and peri-urban areas. While local-owned SMMEs are still in the majority, foreign-owned ones are increasingly rapidly.[70]

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[67] Lesotho's adult literacy rate was 16.6 percent in 2000, the fourth lowest in Sub-Saharan Africa, after Mauritius (15.5 percent), South Africa (14.7 percent), and Zimbabwe (11.3 percent) (WDI 2002).
[68] While the program has been successful, and more children have enrolled in school during the past few years, a shortage of teachers, exacerbated by the HIV/AIDS epidemic, may slow down progress towards universal primary education (IMF 2002).
[69] In rare cases where Basotho supervisors have been appointed they are not necessarily chosen on their ability or suitability and invariably receive inadequate training to equip them for the job on hand (Salm et al. 2002).
[70] This local predominance may not last long. Despite the law banning foreigners from owning SMMEs, Asian-owned SMMEs—mostly though not exclusively in retail—have recently mushroomed. Many Basotho believe that Basotho businesses have been compromised by the Government's inability or unwillingness to control the proliferation of South East Asian trading businesses with which they cannot compete (Volume 2, Chapter 5).

TABLE 5.1 LARGE FIRMS REGISTERED BY LNDC BY SECTOR, 1996-2001

	1996	1997	1998	1999	2000	2001
Clothing and Textiles	19	22	23	22	24	33
Agro-industry	5	5	5	4	4	4
Wholesale and retail	6	6	6	6	6	6
Others	6	8	8	4	5	6
TOTAL	36	41	42	36	39	49

Source: See Volume 2, Chapter 5.

SMMEs are found in a wide range of sectors: construction, mining and quarrying, retailing, repair shops, restaurants, and transport. Estimates indicate that about 60 percent are in retail trade, 22 percent in manufacturing and 11 percent in services. While there are no reliable statistics and the majority of SMMEs are informal,[71] i.e., without legal status, it is obvious that the SMME sector is rather small compared with that in East and West Africa (World Bank, Growth Options Study, forthcoming). SMMEs are notably absent from the garment-related industries, a rather unusual absence given that low entry barriers characterize this industry. This is considered another indicator of the lack of an entrepreneurial culture in Lesotho.

A good illustration of this barrier is the garment sector--the largest employer in Lesotho with the greatest potential for positive spillovers of knowledge and skills. Most positions in this sector do not require tertiary technical education, which is in short supply, but basic and often transferable skills. In many countries with similar features as Lesotho (i.e., low skill levels, weak infrastructure and minimal industrial tradition) employees of foreign owned firms have succeeded in setting up either supply or even garment export operations. Growth of local entrepreneurship in garment exports can be found in countries like Bangladesh (see Box 5.1), Sri Lanka, Mauritius, Morocco and small economies in Central America.

Box 5.1 Lessons from the Bangladesh Experience

Garment industries in both Lesotho and Bangladesh have experienced remarkable growth in a relatively short period. In Lesotho, employment in this sector tripled from 11,000 in 1996 to 33,000 in 2001, while its exports to the U.S. rose more than three-folds from US$ 65 million to US$ 215 million over the same period. In Bangladesh, the garment industry employs close to 1.5 million people. Its garment exports increased from US$ 2 million in the early 1980s to about US$ 4 billion in 2000. In spite of these similarities, the Bangladesh garment industry has initiated some major steps in its industry that distinguish it from other garment exporting countries.

The Bangladesh garment industry received a boost in the early 1980s when Korean firms started programs recruiting workers from Bangladesh to go to Korea for intensive training for periods ranging between three and six months. The workers were trained in various skills, ranging from machine and production line experts to administrative personnel. The training not only equipped the locals with the necessary skills to make garments, but also to run and manage their own garment firms. This consequently led to the transfer of knowledge from the trained workers to Bangladesh's entire garment industry. By 1985, there were more than 700 locally managed and owned garment-exporting factories in Bangladesh (Rhee and Belot, 1990).

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[71] **Informal SMMEs are primarily in rural areas, and are mostly run by women.**

The government of Bangladesh also played a pivotal role in making this sector a success story. The back-to back 'letter of credit' (L/C) arrangement allowing the exporters to open an L/C for fabric imports based on the L/C issued to them by the foreign buyer is a good example (Hyvärinen 2002).

5.3.2 Explaining the Entrepreneurial Gap

Various explanations are offered as to why the Basotho-owned private sector is so small and has failed to integrate into a buoyant foreign sector. First, some argue that the absence of an entrepreneurial culture is attributable to the availability of employment opportunities in South African mines and industries. Until these opportunities diminished in the 1990s, there were no incentives to look for local earning opportunities. Indeed, the emergence of SMMEs is only a recent phenomenon.

A second explanation focuses on the risk-averse and conservative nature of Lesotho's banking system and "shallowness" of its financial sector. Lack of capital is thus held responsible for an ill-developed local private sector. As the CBL (2001) notes, it is difficult for new businesses to emerge or existing ones to expand in such an environment. However, while access to credit is clearly very important, one should note that in many developing countries small business flourish despite huge deficiencies in capital markets. Moreover, South African banks are excellent and they operate in Lesotho.

Finally, another explanation focuses on the absence of training facilities, particularly the failure of foreign firms to transfer higher-level skills to local employees through various formal and informal training mechanisms. While entrepreneurial skills are not easy to teach —they are largely a product of a cultural and business environment accepting failure and rewarding innovative approaches — technical skills can be improved. One explanation for the reluctance of foreign firms to train locals is believed to be an entrenched 'footloose' attitude held by many foreign firms in Lesotho.

These explanations taken together suggest that lack of capacity is the key reason why entrepreneurial skills are weak and SMMEs have failed to integrate with industries where FDI is clustered. Lack of capacity is not caused by the inherent inability to learn, but rather by deficiencies in training and possibly in the cultural and business environment. Such an explanation implies the need for changes in the policies of government as well as foreign firms.

Recommendation 1: ***Develop better vocational and business training***. *Drawing on the experience from other countries, there is clearly scope for the development of better vocational and elementary business training.*[72] *With respect to vocational training, the government and donor agencies, working together with industry, could help establish a network of relevant industry-owned training facilities. Cooperation with industry will be the key to success. For example, the Lesotho Garment Center, a UK funded initiative established to teach industry specific skills, recently ceased operations, perhaps due to a lack of industry cooperation. Getting industry involvement will require the government to breakdown foreign firms' reluctance to train local employees in higher-level skills. Without commitment by foreign firms to promote*

[72] **While many secondary and high schools do teach commercial subjects, the current curriculum reportedly does not sufficiently address entrepreneurship.**

local workers to higher positions, the establishment of specific sector-oriented training centers will serve little purpose.
With respect to general training, banks in cooperation with the Lesotho Chamber of Commerce might be persuaded to offer short business workshops in business plan preparation, financial planning, bank relationship management, basic accounting principles, etc. In addition, secondary level educational programs should be reviewed to make sure that they provide requisite mathematics and technical skills.

There is a strong resentment and distrust among the population towards foreign investors from South East Asia. While perceptions cannot be changed overnight, the government must persuade the public of the advantages of having foreign firms in Lesotho. In part, public resentment is reportedly a response to the perceived contempt of foreign investors for local culture and customs and is exacerbated further by the fact that many expatriates do not speak English. [73]

Recommendation 2: *Promote mutual trust and understanding*. *The Lesotho Chamber of Commerce (LCCI) or another government agency may consider organizing regular events to bring together representatives of government and local and foreign businesses. This combined with moral inducements to foreign investors to integrate into local communities would help to distill the 'footloose' mentality and to establish relationships based on mutual trust and understanding.*

5.3.3 HIV/AIDS as a Barrier to Development

HIV/AIDS has emerged as a major health and development concern in Lesotho. Lesotho suffers from a very high incidence of HIV/AIDS. The World Bank estimates 24 percent of the adult population is infected with the virus and 16,000 Basotho are believed to have died of AIDS. Lesotho had very few reported cases until the mid-1990s, but the virus has spread rapidly. Already life expectancy has declined from 53 years in 1989 to 45 years in 1999. The population level is expected to be 20 percent lower by 2015 than in a no-HIV baseline, and life expectancy is estimated to be 31 years lower (World Bank 2000b).

The channels through which HIV/AIDS affects Lesotho's economy are multiple and the implications are huge, affecting all sectors of the economy. AIDS disproportionately affects the economically active, mainly urban population[74] as it is clustered primarily in the 20–39 year age groups. It also is more prevalent among the country's more highly educated population thus reducing the pool of skilled human capital. This together with increased morbidity and absenteeism will negatively affect productivity. Moreover, training costs will rise due to shorter tenure in positions, as well as a lack of training and trained staff.

The deleterious effect can already be felt in some areas. For instance, it appears that Lesotho's emerging program for universal free primary education has already been a victim of HIV/AIDS. While the program has been quite successful, and more children have enrolled in school during the past few years, a shortage of teachers, exacerbated by the HIV/AIDS epidemic, may slow down progress towards universal primary education (IMF 2002). If the level of education is not raised, the shift towards higher value added production that requires higher-level skills would be jeopardized.

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[73] The Ministry of Employment and Labour has been working with the Employers Association to address tensions with foreign investors.
[74] The adult prevalence rate in Maseru is around 50 percent (World Bank 2000, p. 46).

The financial sector is also likely to be affected by rising death rates among the economically active population, for a number of reasons. First, the cost of borrowing will increase, as financial institutions factor in the higher incidence of default. Financial institutions may themselves encounter difficulties as the number of default rises. The higher cost of borrowing will erect an extra barrier to private sector development, consumer credit, and so on. Second, the fall in savings as expenditure for treatment and funerals draws down savings, will reduce the amount of domestic funds available for investment. This can be expected to exacerbate both Lesotho's current low rate of capital formation as well as its large current account deficit (IMF 2002).

Finally, public finances are also likely to be negatively affected. On the revenue side, it will depress tax revenue. On the expenditure side, it will increase expenditures because of extra costs of health care services and care for orphans.

In all, the World Bank (2000b) estimates that the cumulative impact of reduced productivity and capital formation will reduce average GDP growth over the 1986–2015 period from 4.4 percent to 3.6 percent. In consequence, the economy will be 20 percent smaller in 2015 than without HIV/AIDS. Due to population decline, these estimates imply a less dramatic difference in per capita income levels. However, the World Bank cautions that these forecasts are highly speculative and conservative.

The government has a limited number of programs to deal with the spread of HIV/AIDS. An institutional framework was established in the mid-1980s, but program development and execution have not been uniformly successful. There is little information about the extent of the epidemic or on the success of education programs, particularly in rural areas, where most of the population lives. The government maintains sentinel surveillance centers at locations across the country providing information and treatment for mothers and patients with sexually transmitted diseases. Each government ministry is expected to apportion two percent of its funds for HIV programs, much of which has gone towards education. The spread of the virus, however, implies that even maintenance of current levels of care will become much more expensive in the future.

5.4 BUSINESS CLIMATE AND ADMINISTRATIVE BARRIERS

Business climate broadly encompasses institutions, governance, and policies that affect not just the level of capital investments but also the productivity of existing firms and their willingness to engage in business activity for the longer term (Stern 2001). Reforming the business climate requires leadership and powerful government advocacy. Two aspects determine the quality of governance and conditions for conducting business: the mode of organizing public-private interface and restraints on starting and conducting business, i.e., on exercising property rights. Lesotho's economic regime scores relatively highly on these two counts. This stands in stark contrast to external perceptions of business environment, probably influenced among others, by administrative barriers still in place.

5.4.1 Toward a Rule-Based Public-Private Interface

Lesotho has made significant strides towards establishing rule-based public-private interface, which is a necessary condition for a viable market economy. Given its institutional complexity, the establishment of a rule-based public-private interface is time consuming. This task involves at least three critical steps—most of which, it appears, have been largely accomplished. These are macroeconomic stability, privatization of state assets, and an effective regulatory framework for property rights enforcement. First, as discussed in Chapter 2, Lesotho already has a framework for sustainable macroeconomic stability, although some work remains with respect to putting in place transparent, financially sound revenue and expenditure mechanisms in public finance (IMF 2002).

Second, impressive progress has been made in privatizing state-owned assets, which resulted in a significant improvement of an overall investment climate, as privatization included many services crucial to the conduct of business (e.g., financial services, transportation, and telecommunications). Between 1997 and 2000, sales of state-owned assets to foreign investors generated revenue of $42 million with a single largest transaction of $17 million involving privatization of Lesotho TeleCom (Volume 2, Chapter 4). By the end of 2001, over thirty companies were privatized including the national airline, the Lesotho Bank, and the government's Plant and Vehicle Pool Service. The government, however, remains involved as sole owner of a number of enterprises including, among others, Loti Brick, Lesotho Pharmaceutical Corporation, and Basotho Fruit and Vegetable Canners.[75] The government is in the process of privatizing over 20 additional companies, such as the Lesotho Electricity Company, Lesotho National Insurance Holdings, and Maluti Oil. Some successful enterprises set up by the LNDC (Lesotho National Development Corporation), which provides seed financing for businesses investing in Lesotho, have been taken out of the privatization program. This is justified in terms of cross subsidizing, i.e., LNDC's need capital to cover losses on less successful companies.

Third, as for creating the framework for guiding private sector behavior and enforcing property rights, Lesotho appears to have been making significant progress towards a market-based economy that protects and enforces private property rights. Corporate taxes were reformed in 1996 to a flat 15 percent of profits in manufacturing, improving transparency of the tax system as well as tax collection.[76] There is a consensus among international observers that existing laws in Lesotho do provide a framework for a due process with authorities respecting court decisions (USTR 2002a). Moreover, business surveys in Lesotho assess tax and customs administration positively. These are linchpins for minimizing corruption and encouraging respect for property rights. This would suggest that laws protecting private property are not only enshrined in books but that they are also enforced and respected in practice. This is an encouraging sign for future development.

As an UNCTAD report (Volume 2, Chapter 4) for this study notes: "…Lesotho has now a fairly liberal and welcoming regime. Tax rates are low and discretionary incentives are no longer used. Entry procedures are non-discriminatory. Rent seeking behavior is uncommon." These

[75] The World Bank supported a privatization project from 1995 to 2000, and has started a new project in 2001, dealing with the privatization of electricity and water. The African Development Bank will finance the privatization of more than 20 enterprises not covered by the project.

[76] The government has undertaken numerous reforms and plans to undertake more to diversify revenue sources and improve tax administration. The sales tax, introduced in 1982, is to be replaced in 2003 by a VAT, which will be administered by the Lesotho Revenue Authority (LRA), separate from the Ministry of Finance, and is due to be launched at the end of 2002.

assessments notwithstanding some larger and smaller irritants are still in place. Policy-making capacity, ill-defined level of integration in SACU and discrimination against foreigners belong to the former group, whereas various administrative procedures belong to the latter.

5.4.2 Restrictions in Property Rights: The Case of Land

Land ownership is a contentious issue in many countries. Lesotho is no exception. It has a dual land tenure system: customary laws are applied in rural areas while statutory land tenure is valid mainly in urban areas. The common defining principle of both sets of laws enshrined in the Constitution is that land belongs to the Basotho Nation and cannot be owned by an individual. The law entitles only Basotho to acquire a registered certificate or a title to occupy or use the land, but it rules out private ownership even for Masotho.[77]

This has important legal implications for both foreign and domestic investors. Foreign investors or citizens who are not Basotho can only hold land as a sub-lessee for a limited duration. In order to lease, a foreign company would have to establish a joint venture with the Basotho equity of at least 51 percent. Under these circumstances, the most attractive option is to sublease factory shells arranged by LNDC (Lesotho National Development Corporation).

Land Management problems

The problems with land management in Lesotho are threefold. First, securing a sublease or lease is a complicated and costly process with an uncertain outcome.[78] While technical assistance may be required to ascertain reasons for the cumbersome processes and delays, it seems pretty clear that this is caused by the involvement of nine ministries in land administration,[79] limited surveying and valuation facilities, and weakly functioning cadastre. Second, the duration of a sublease, once obtained, is limited.[80] Taken together, these problems explain why land issues have emerged as a major constraint to industrial development and constitute a disincentive to foreign investments. Third, as discussed earlier, the availability of LNDC-run factory shells has become increasingly limited. How can these barriers to investment be removed?

Recommendation 1: ***Reduce processing time***. *This can be accomplished by simplifying procedures, establishing an inter-agency committee with coordinating responsibilities of various ministries, training surveyors, and establishing a cadastre to trace/ lease property rights.*

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[77] Under the 1997 Land Act, land in rural areas is held in the form of an allocation, which can be neither registered nor transferred, and in urban areas, land is held in the form of a lease, which can be registered and transferred. Village Development Councils have the power to grant title to land in the form of an allocation. They also have been given power to revoke allocations. In urban areas, the relevant Urban Land Committee issues title to land (Volume 2, Chapter 6).

[78] Due to limited human, technical and financial resources, land administration is chaotic and registration of a lease sometimes takes upward to six years to complete. See Report of the Land Policy Review Commission, Government of Lesotho, September 2000 (p. 59).

79 These include Ministries of Agriculture, Local Government, Justice, Trade and Industry, Public Works, Natural Resources, Tourism, Environment, and Ministry of Education and Finance.

[80] Although these usually ten-year subleases can be renewed indefinitely, it introduces an element of uncertainty.

Recommendation 2: *Extend Lease duration*. *Extending the duration of a lease (or a sublease) to 99 years, as is the case in the UK and several countries in English-speaking Africa. Cross-country experience clearly demonstrates that leasing per se does not have to be an impediment to urban and industrial development. Similarly, allowing foreigners to own land, although usually useful is not critical to attracting foreign investments.*

Recommendation 3: *Increase the availability of factory shells*. *The LNDC in cooperation with other relevant government agencies could identify potential sites for industrial parks. (These would of course be chosen with due considerations for the government's other priorities such as tourism and environmental concerns). Site development would be tied to a committed major investor, or investors.*

Addressing these three issues along the lines suggested above would dramatically improve land management in Lesotho, although it would still confine development to industrial parks. These recommendations appear to be less radical than the 2001 Land Policy Review Commission which recommended: (a) that foreigners be allowed to own freehold land in the form of a freehold in designated areas for industrial development and for approved industrial purposes, high rise buildings for residential and commercial use and for special projects; and (b) that the customary land tenure system be abolished. Without an assessment how the removal of the customary land tenure would affect poverty in rural areas, it would be difficult to fully endorse these recommendations.

Recommendation 4: *Cease discrimination. The termination of discrimination against women in customary law should be immediately implemented, as recommended by the 2001 Land Policy Review Commission.*[81]

5.4.3 Administrative Barriers: 'Hassle' Cost of Doing Business

Administrative barriers stem from excessive regulations and weak administrative capacities. The former compounds the latter, as do the administrative procedures favoring centralized decision-making. The GoL has yet to address weaknesses identified in the 1997 FIAS Report on administrative barriers to foreign investments (for summary see Box 5.2).

Business licensing regulations

Regulations setting up the licensing system for all new entrants involve a slow and cumbersome process. The current system imposes a significant administrative burden as it compels the relevant government agencies to review each application separately and requires consequently a huge amount of information from an applicant. To make it even more complicated, manufacturing and service enterprises need a host of different licenses. Different rules applied to "large" and "small" firms are further compounded by the absence of well-defined criteria for classifying enterprises as 'large' and 'small.' Last, all applications have to be filed in Maseru, regardless of the ultimate location of the firm.

[81] Under Section 14 of the Land Act, the Registrar of Deeds can refuse, except under an order of the court, attesting, executing, registering all deeds and documents in respect of immovable property in favor of a married woman, whose rights are governed by Basotho law and custom where such registration would be in conflict with customary law.

In all, procedures guiding entry into the business sector are a classic illustration of excessive centralization and economic micromanagement by the state. These are detrimental to the development of competitive markets not only because of delays triggered by them but also because applications for business establishment that would compete with existing firms can be (and are often) rejected. While it would be tempting to call for computerization of the process, this would be a wrong remedy, as the main problem is with its design and procedures.

Box 5.2 Status of Implementation of "FIAS 1997" Recommendations as of March 2002

Measures recommended by FIAS that have not been implemented:

General Approvals, Permits and Licenses; Immigration and Passport Services: A joint committee between Ministry of Employment and Ministry of Local Government to simultaneously grant work permits valid for a period of at least two years to foreign investors and foreign employees has not been formed. The resident permit is still valid for only one year, and the number of documents required for a Resident Permit (as well as the time period required for processing visas) has not been cut.

Site Development; Land Survey and Physical Planning: The role of the Minister has not been curtailed in the following activities; land allocation, land management, lease transfer, subleases and mortgages. The only exception is a sublease for less than 20 years where Commissioner of Land is authorized to decide. LSPP has not computerized information systems management and reduced the number of fees required for its services.

Specialized Approval; Ministry of Industry, Trade and Marketing (MTIM): The GoL has not replaced a system of licensing with registration and reduced the amount of information needed in application forms. The recommended "negative list" of trading activities, which are closed to foreign investors, has not been established.

Ministry of Tourism, Sports and Culture: Ministry still issues business licensing of hotels and lodges.

Operational Requirements, Ministry of Employment and Labor: There has been no change in regulations governing processing of Work Permits.

Central Tender Board: The Tender Board has not replaced different forms in use with a standard form issued with each tender. Board members are not remunerated and no special preferences for SMMEs have been introduced.

Selected Measures recommended by FIAS 1997 that have been implemented:

Site Development; Lesotho Electricity Corporation (LEC): Recommendations to change the current tariff structure, to reduce in the cost of electricity to levels comparable with other parts of Southern Africa, to improve the reliability of electrical supplies, to eliminate LEC's monopoly position are being addressed in the context of the ongoing privatization exercise. The organization is currently under a private management consortium that has been appointed to make it attractive to investors as part of the government's privatization program.

Site Development; Lesotho Telecommunications Corporation (LTC): LTC was advised to give priority to service delivery over production and to expand the network in regions outside of Maseru. In addition, the report called for an improvement in the management of line installations, repairs and an improvement in staff skills. In addition, FIAS recommended improvements in the corporations' management information system and an overall restructuring of LTC's tariff structure. Since 1997, LTC has been privatized and is now known as Telkom Lesotho (TCL). The new company is actively involved in ways of addressing their service delivery and has a specific strategy of addressing the concerns of large industry. Telkom Lesotho's parent company, Telkom South Africa, is undergoing restructuring due to its position as a monopoly in long distance, telex, fax and privately leased circuits services. Telkoms monopoly has affected Internet Service Providers (ISP's) and Value Added Networks (VANS). As a member of the WTO, South Africa has indicated it will improve the competitive atmosphere in telecommunications by adding another network in the near future to compete with Telkom.

Sources: Kelly Lerotholi, Conditions in Conducting Business Activities in Lesotho, July 2002, Mission Conference interviews, July 2002, United States Trade Representative (USTR), www.ustr.gov.us

Recommendation 1: *Implement simple registration system. The existing system should be overhauled, as already suggested in the 1998 draft of a Company Law. The shift from licensing to a simple registration system—with appropriate safeguards—would considerably ease administrative burden and accelerate the time needed to register a new business. In fact, one could introduce a rule that registration of firms for activities that are restricted or banned should be granted in a pre-determined amount of time. Once a new system is in place, then the forms used for registration should be simplified, computerization introduced, and the staff appropriately trained. The same comment applies to such other projects as investment advisory services or one-stop shops. These projects are tempting as they are often regarded as substitutes for a badly needed reform of a system.*

Barriers to entry for foreign residents

Obtaining work permits, residence permits and visas is one of the most cumbersome aspects of doing business for prospective and actual foreign investors in Lesotho (Volume 2, Chapter 6). These procedures are complex, duplicative, expensive and time consuming. Their design fails to take into account limited administrative resources and is a barrier to foreign investment. The current regime urgently needs an overhaul.

The current system has two major impediments. First, Lesotho's diplomatic missions abroad are not allowed to issue multiple entry visas, and the cost of obtaining the initial visa and its conversion to a multiple entry visa (M 1,000) is the highest in the region. Moreover, investors residing in countries without diplomatic missions have an additional burden in obtaining visas.[82] Second, work and residence permits are subject to separate procedures involving the submission of numerous, unnecessary documents to separate ministries - Home Affairs for a residence permit, and Employment and Labor for work permits.[83] The time required to obtain relevant visas also varies by ministry and one can end up obtaining a work permit but no residency permit. As a rule, permits are valid for no more than a year, although the existing regulations allow for a two-year maximum period.

The existing system governing entry of foreigners into Lesotho constitutes a serious impediment to private business activity as well as to the development of tourism. The extent of its negative impact is difficult to measure, yet it seems to be very significant. Surveys examining preferences among investors stress the importance of created assets (rather than natural or related to the cost of factor production) as the determinant of locational preferences (Dunning 1995). Both

[82] For visitors and investors from countries without a Lesotho mission, for example, Japan, the only alternative is to pass by the Lesotho Embassy in Pretoria *en route* (Volume 2, Chapter 5).

[83] Granting of a work permit is contingent upon certification by the National Employment Service that no Lesotho citizen is at that time qualified and available for the employment in question. Meetings to clear the work permits are now held weekly, but it still takes an average of four to six weeks to issue a work permit.

impediments are relatively easy to redress and necessitate significant streamlining of procedures and required information, as recommended by the 1997 FIAS study. [84]

Recommendation 1: *Visa issuance. Lesotho diplomatic missions should be authorized to issue multiple-entry visas. To further expedite entry Lesotho could unilaterally accept short-term visas authorizing entry into South Africa.*[85] *Finally, the GOL could consider processing applications for multiple-entry visas electronically or by mail. If granted the visa would then be stamped into a passport upon entry into Lesotho.*

Tax and Customs

The corporate income tax rate of 15 percent for manufacturing activity appears to be the lowest in the region. For non-manufacturing activities the tax rate is 35 percent. Firms do not regard tax compliance as a constraint to doing business in Lesotho and the investor community in Lesotho has not been critical of tax administration. In fact, it would appear that many firms have been successful at evading taxes. According to data from the Department of Income, Ministry of Finance, foreign-owned firms operating in the garment sector fail to declare profits. In fact, almost all of them have been reporting losses (or zero profits) since tax holidays were eliminated. The surge of exports to the U.S. has yet to produce a similar surge in corporate income tax revenue.

Recommendation 1: *Improve auditing capability.*[86] *Given that it would appear to be blatant tax evasion, in most cases, there is a need to dramatically improve the auditing capability of Lesotho's tax authorities and to enforce international accounting practices. External technical assistance could clearly help in analysing how to widen the tax base and lower tax rates on non-manufacturing activity, currently at 35 percent.*

Similarly, there are no complaints about customs administration, albeit with a caveat concerning its organization. The centralization of customs clearance in Maseru forces, for instance, firms with headquarters in Maputsoe to send a senior employee to Maseru to clear imports coming in containers through Ficksburg—the South African border town.

5.4.4 External Perception of Business Environment: Lesotho vs. South Africa

This section looks at foreign perceptions of Lesotho's current policy environment in comparison with South Africa and other countries with which Lesotho competes for investment and trade. Two studies—the Wall Street Journal and Heritage Foundation survey (WSJ/HF 2002) of 'economic freedoms' and the Africa Competitiveness Report (Schwab 2000) prepared for the World Economic Forum— assess external perceptions of the investment climate of Lesotho. The international scope of the latter is narrower than that of the former and the criteria used differ. Both, however, rank Lesotho at about the mid-point of the 24 African countries whose

[84] A review of immigration procedures is now underway. Recommendations to improve these procedures have been raised in PRSP and Vision document drafts.
[85] An alternative might be a special agreement that would authorize South African consular missions in countries where Lesotho is not represented to issue visas for entry into Lesotho. But this would be clearly an inferior solution.
[86] Note that the recently established Lesotho Revenue Authority is expected to implement a significant improvement in tax audit capacity.

competitiveness is assessed. Both rank South Africa higher than Lesotho. Both underrate Lesotho's business climate indicating the lack of updated information. This in turn suggests that the need for providing comprehensive information and overall greater attention that Government should pay to the external image of Lesotho's economic regime.

Lesotho vs. South Africa

According to the WSJ/HF scorecard for Lesotho and South Africa, the differences are much smaller than one might expect from the difference in the two countries levels of economic development. South Africa scores higher on three criteria: fiscal burden of government, capital flows and foreign investment, and wages and prices. Government interventions into wage setting, hiring practices of expatriates, debt investment, controls over several agricultural commodities seem to be responsible for 'worse grades' in the latter two respective areas. Not surprisingly, given the level of policy integration between two countries, scores in trade and monetary policy are the same for Lesotho and South Africa. Similarly, Lesotho's overall WSJ/HF index of 3.4 places it in the "relatively restricted" country group (between 3 and under 4) indicating an unfavorable commercial environment, South Africa's value of this index of 2.9 places it low in the "relatively free" country group (over 2 and below 3).[87]

Four policy areas account for the difference in the value of the overall WSJ/HF index for Lesotho vis-à-vis its more prosperous neighbor—South Africa.

Business environment: It is regarded as restrictive because of the lack of an established investment code and restrictions on hiring expatriates. Enacting an investment code should not encounter any political opposition. Changing the labor code may be more difficult because of public misperception—widely shared in many other countries—that foreigners take jobs from locals. In fact, as noted earlier, they do not.

Wage and price controls: Central controls over wages and prices have been declining. Export licenses on cereals, legumes, and sunflower preparations have not been invoked in recent years. However, import licenses remain in effect for beer, eggs, raw meat, milk and sugar (WTO 1998). Based on the most recent information therefore, Lesotho's score should be more favorable; in fact, it should be above South Africa in terms of liberalization.

Excessive regulation and the black market: Another area where Lesotho scores below South Africa concerns excessive regulation of the industrial sector which is still governed by the Industrial Licensing Act of 1969, whose underlying philosophy is that of state interventionism and import substitution. However, even later regulations such as the 1984 Export and Import Control Act or the 1993 Trading Enterprises Order are the products of a similar philosophy—nothing is allowed unless explicitly permitted. These complex acts only serve to maximize bureaucratic power and seem to be abused.

Public administration: The low quality of public administration impedes private sector development and raises the cost of conducting business in Lesotho. Removing redundant

[87] Other groups are classified as follows: free with the values of overall indices of 2 or less, and restricted with the values between 4 and 5. As for other Lesotho's SACU partners, Botswana and Namibia are ranked above South Africa in a 'relatively free' group, and Swaziland is above Lesotho in the 'relatively' restricted group.

bureaucratic procedures and simplifying others would reduce the scope for government interventions and raise the quality of public administration. This should become an integral component of the government's anti-corruption program.

In sum the studies showed that while the regulatory gap vis-à-vis South Africa is not as high as one might expect given the size of the GDP per capita gap, Lesotho needs to significantly improve its business climate. While not much can be done immediately about physical infrastructure, many reforms could have immediate impact. For instance, the existence of a black market and smuggling of consumer goods such as televisions, radios, clothing and food could be addressed by harmonizing Lesotho's sales tax rate and VAT in South Africa. Harmonization would remove the incentive to smuggle consumer goods. It would also remove one of the minor obstacles to having a genuinely common market in the region provided that other SACU members follow. Furthermore, despite significant progress achieved over the 1990s, South Africa is not among world leaders in terms of having institutions and policies in place assuring competitiveness and expansion in world markets. As the reviewed studies show, there is still a large gap in relation to most competitive economies in the world. This has significant implications for Lesotho's strategy.

5.5 CONCLUSIONS

The success the country enjoys in garment exports is vulnerable to changes in other countries' trade policies as well as rising labor costs and other domestic factors; the garment industry in Lesotho urgently needs better physical infrastructure, stronger backward linkages, and enhanced local human capital. If it is to diversify its industrial base, it will also need a better business climate.

It also concluded, however, that FDI has created enclaves with few if any linkages to the domestic economy. Thus far, there have been no significant positive spillovers indicating, as many case studies convincingly demonstrate (Lall 1992), unavailability of local skills and technological prowess to adapt techniques used elsewhere. This may also indicate that investments are 'foot-loose' with no commitment to stay in Lesotho. Whatever the cause, this is clearly a major problem indicating not only a market failure but also a government policy failure.

This chapter examined the barriers to sustaining FDI – physical, human, cost and policy – and suggested recommendations for dealing with structural and policy impediments. It also examined Lesotho's business environment. While it is difficult to give a numerical estimate, the existing regulations impose significant compliance costs that together add to the 'hassle' cost of doing business in Lesotho. If not remedied, it may be difficult to sustain FDI inflows. Finally, this section also compares the business climates of Lesotho and South Africa respectively by drawing on Wall Street Journal and Heritage Foundation surveys. It concludes that Lesotho's business climate was more restrictive and provided additional recommendations.

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CHAPTER 6
WAY AHEAD: SUPPORT FOR TRADE DEVELOPMENT

6.1 INTRODUCTION

This chapter identifies components of the proposed two-pronged strategy designed to tap opportunities offered by the global economy. As argued throughout this report, Lesotho will need assistance in implementing a number of ingredients of this strategy, albeit not all of them especially those that we referred to as 'quick-wins'. Moreover, the success depends on coordination of aid. Thus, this Chapter takes inventory of existing support and goes hand in hand with the action matrix at the beginning of the volume.

6.2 EXISTING SUPPORT

The main donors to Lesotho (in terms of size) are the European Commission (EC), the Department for International Development (DFID), Ireland Aid and GTZ. On the agency side, FAO, UNCTAD, ITC and UNDP have ongoing projects. The interest of the main donors and agencies in trade-related areas is summarized in Table 6.1.

Ireland Aid has provided a range of support to MITM. In addition to providing computer equipment to MITM, it is also supporting the preparation of a Government White paper on SME Policy. It has also provided support to BEDCO towards a strategic review and on an ad hoc basis.

Germany's GTZ is supporting SMME promotion in Lesotho. The project aims to increase the supply, quality and use of Business Development Services (BDS) for SMMEs by strengthening service providers and facilitating the establishment of a Network. The main activities include identifying training needs, developing training for BDS providers, establishing quality standards, and designing and implementing appropriate organizational structure and implementation guidelines for the Network.

The **European Union** is currently providing support to the Bureau of Statistics to strengthen Lesotho's statistics. Initial efforts have focused on improving the accuracy of the national accounts.

UK's DFID is currently supporting a review of rural marketing constraints in Lesotho and a major trade project is under development. The IF and DFID design team have collaborated closely to ensure synergies.

UNCTAD, UNDP and the ITC are supporting a project on export development villages.

TABLE 6.1 MAIN DONOR TRADE RELATED CAPACITY BUILDING ACTIVITIES IN LESOTHO/

Area	Donor	Project	US$	Year	Implementing Agency
National Policy Making					
Trade Analysis					
Policy formulation & implementation: Trade Policy SMME policy Rural marketing policy	 DFID NZ Ireland Aid DFID	 Trade Policy Project STTA Trade Policy Training Development of SMME White Paper Long term marketing policy		 2002- 2002 2002 2002	 MITM MITM MITM
Trade Enhancement					
Trade-related infrastructure					
Entrepreneurial capacity SMME Promotion	GTZ	Support to SME	0.1 mln Euro	2001-2003	MITM Ministry of Education and Labor
Human and institutional capacities Statistics	EU	Assistance to Bureau of Statistics	1.1 mln Euro	2000-2003	Statistics Sweden
Trade Finance					
Export Development					
Multilateral Framework					
WTO-related Agreements Customs TC Customs Val. Competition Pol Services	 Japan Canada WTO WTO	 Workshop Training on Module 1 of WTO Customs Valuation Agreement (w/ WCO) National seminar National seminar	 7,000 6,000	 2001 2002 2002 2002	
Environmental Requirements					
Food safety and health requirements Food laboratory	FAO				Ministry of Agriculture MITM
Regional Cooperation and Integration					

A/ In addition, Lesotho participated in several regional workshops carried out by the WTO, USAID and Switzerland.

6.3 TOWARDS BROADER COORDINATION

At present, the ongoing programs outlined above tend to support specific projects rather than address some of the more fundamental capacity building gaps in terms of policy and strategy formulation in a broad sense.

However, this gap will likely be largely filled with the advent of the DFID Africa Trade and Poverty Project (ATPP) in 2002, a major project designed in July 2002 and currently under development). Support for competitiveness is another area that has yet to be championed. Finally, a huge gap remains in strengthening private sector organizations and helping them to increase their overall capacity to participate in a dialogue on trade.

Currently, the Ministry does not maintain a centralized inventory control of ongoing support received by the Ministry. Limited project and financial management capabilities further exacerbate the problem. Donor capacity on trade-related matters is mixed. Some donors have resident experts but even for those who do not, there appears to be significant support as necessary from headquarters or other field offices.

In addition to organizing periodic UNDP Roundtables (the last one was held in Geneva in 1997), the UNDP in its role as Resident Coordinator of the UN agencies currently plays a leadership role in donor coordination. Donors also convene and work together around specific issues such as civil service reform and the PRSP. The lesson from these exercises (as well as the IF process itself) suggest greater coordination of donors would be desirable in those areas given the complexities of issues and multi-sectoral nature of donor support. Ideally, the Government should carry this out. Thus, continued strengthening of the Department of International Co-operation in the Ministry of Development Planning is an important aspect of increasing the effectiveness of overall development assistance.

With respect to trade, given the narrow range of issues being covered and the existing good donor relationships, it appears that more systematic consultation and more structured mechanisms for dialogue between the private sector, public sector and donors is what is needed rather than heavier coordination. It would also be helpful for these donors to encourage their trade and industry experts to frequently participate in the dialogue. Together with the Government, they can monitor implemented trade projects. It is imperative that external development partners (donors, multilateral agencies, etc.) squarely address Lesotho's limited absorptive capacity by working together to avoid duplication and ease the burden on the Government's administrative resources. The Government may wish to engage the major donors in a joint programming exercise following discussion of its trade capacity building needs.

A third area of institutional capacity building is increasing the government's capacity to absorb foreign aid. By virtue of its LDC status, Lesotho receives foreign assistance. In principle, this advantage should facilitate the integration of its economy into world markets. However, many feel the country has little to show for the foreign aid. The IF offers unique tools to identify and address weaknesses in the current framework.

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