1. Key development issues and rationale for Bank involvement

**Country and sector background**
In recent decades, Lesotho has done relatively well, better in fact than the regional average, in raising the standards of living for its people. Nonetheless, it still remains a low income developing country and one of the poorest countries in the region. Lesotho’s per capita income is only $550, with 43% of its population living below the poverty line of one dollar per day.

Over the past decade, Lesotho’s economy experienced three important external shocks, that have had a significant impact on the private sector. The first relates to the slowdown of the activities associated with the Lesotho Highlands Water Project (LHWP). The project has significantly contributed to an overall expansion of the economy and to the composition of the private sector. The construction sub-sector, which benefited substantially from the LHWP, has become unusually large accounting for 23% of GDP, as opposed to less than 10% in most countries and in Lesotho before the LHWP began. With the completion of the LHWP, activities associated with the exports of water and electricity will continue to provide jobs and foreign exchange, but most construction workers will need to look for alternative employment.

The second negative shock is related to retrenchments in the South African gold mines - which had traditionally employed more than half of the male Basotho labor force. It had two negative effects (CEM): (i) a dramatic decline in Basotho miners remittances to 21% of GNP in 2001 from 36% during 1987-98.
and 46% during 1980-88; and (ii) an increasing number of retrenched miners returning to Lesotho looking for jobs (most often not successfully). In addition, male school leavers, who traditionally depended on jobs in the South African mining sector, have now been forced to seek jobs elsewhere, without the necessary skills or attitudes to become entrepreneurs or take advantage of opportunities in other sectors such as the manufacturing or agricultural sector. Both facts further aggravate the unemployment situation in Lesotho, which currently stands at 30%.

The positive development is related to the arrival and rapid expansion of the textile and garments industry firstly, from across the border in RSA and then followed by FDI mostly of Chinese and Taiwanese origins. In addition to offering tax incentives and provision of infrastructure in enclaves, the market opening opportunities provided by agreements such as AGOA and MFA allowed Lesotho’s exports to enter the U.S. market on a preferential basis so that Lesotho’s exports increased by almost 5 fold in 6 years, reaching $321 million in 2002. Compared to regional competitors, Lesotho has successfully built an export-oriented, FDI-driven garment sector.

One of the outcomes of rapid inflow of garment-related FDI is a stunning dichotomy in the private sector. On one hand, there are close to 50 foreign-owned garment factories providing more than 55,000 jobs, well connected to the global supply chains and exporting almost all of their output mostly to the US market. On the other hand, there is a small Basotho-owned private sector comprising mostly of micro and small firms providing goods and services for the domestic market, in competition with imports. They are engaged primarily in trade, services, local construction, sandstone quarrying and, to a limited extent, in manufacturing. Further, they are completely disconnected from the regional supply chains of South Africa and/or other BLNS countries. Also, they are not benefiting from the diffusion of managerial and technical skills or from backward and forward linkages to the FDI manufacturing firms operating in Lesotho despite their presence in the country for nearly two decades. Finally, mushrooming illegal businesses, operating mainly in retail services and operated by illegal immigrants, avoid taxes and regulations, undercut formal competitors, reduce the tax receipts of the government and increase social tensions and distrust towards foreigners in general.

While the LHWP and FDI inflows into the garment sector had a generally positive effect on the economy, this is likely to be transitory. The negative impact of MFA expiration can already be observed in the garment industry as some factories have closed down, while others reduce their employment. Further, AGOA relaxed rules of origin for LDCs are due to expire by the end of 2007, which poses a serious and immediate threat to the sustainability of existing and future FDI and export performance. Therefore, sustaining growth and employment creation will increasingly rely on an active Government role to achieve the following three objectives: (i) retain foreign investors beyond the phasing out of trade privileges and attract larger amounts of FDI; (ii) diversify it away from its heavy reliance on one activity and one market; and (iii) deepen its roots in the economy by better integration of the domestic private sector with that created through FDI and with the RSA.

To do so, the Government must remove binding constraints to PSD; provide necessary support to private sector; and exploit the economy’s complementarities with that of South Africa and the investment potential in other sectors, including services. Thus, building a conducive, pro-business investment environment, reducing infrastructure bottlenecks, increasing capacity of its people and institutions (including financial sector) will have to be at the top of the development agenda if Lesotho is to succeed.
**Key constraints to PSD**

PSD constraints in Lesotho are generally well documented as a number of analytical studies have been undertaken recently to determine their exact nature and scope.¹ The Government of Lesotho (GOL) has been discussing the ways to address them with the private sector and the donor community in the context of Integrated Framework Study (2002), recently finalized Poverty Reduction Strategy (PRS) and the ongoing CAS preparations. In addition, the Government, with the assistance of the World Bank, has developed a draft PSD Strategy, which identified areas and provided specific recommendations for action to achieve the Government’s objectives to increase the contribution of private sector to GDP growth as measured by private investment in GDP, diversify the economy away from textile and garment industry and increase factor productivity.

In early April 2005 a three-day PSD Strategy Forum was organized jointly by the Government of Lesotho and the World Bank and held in Maseru. The Forum facilitated the discussion between the key partners and led to prioritization of the key binding constraints to the PSD and the development of a strategy to facilitate stronger private sector growth and support economic diversification. The Forum also created an opportunity for increased donor coordination, as there seems to be a strong commitment from the donor community to provide technical and financial support to implement actions in the priority areas specified in the IF Study.

The PSD Forum drew crucial attendance from a wide range of stakeholders including the public and private sectors as well as members of the donor community. Discussions covered wide range of areas, including ways to (i) improve the business climate by reducing legal and administrative impediments to growth; (ii) strengthen logistics, infrastructure, trade and investment facilitation and institutions to support areas with the highest potential for growth and exports; and (iii) strengthen domestic competitiveness through improving skill level and strengthening linkages between training and industrial needs.

In agreement with the Vision 2020 and recently the PRS, all stakeholders endorsed the overarching principle, that a dynamic private sector (both domestic and foreign) is critical for Lesotho to achieve a high economic growth and employment creation. To support the private sector, immediate actions need to be taken in a number of mutually-supportive areas to create a minimum infrastructure platform (MIP) for private sector-led growth. MIP consists of the combination of priority physical infrastructure investments with a specific set of investments in supporting facilities, all aiming at enhancing economic performance and productivity, attracting more private investment and diversifying the economy.² However, while promoting such an integrated approach, it has also been recognized that prioritization and sequencing of the reforms are vital for a successful implementation. The PSD Forum emphasized urgency for support to economic diversification facilitated by retaining and expanding the existing FDI base in the garment industry, attracting new FDI to develop new industrial clusters and supporting the growth of the local private sector in other value-added activities such as agri-business, resource-based sandstone mining and services such as tourism. There is a commitment from the Government to implement reforms necessary to remove main bottlenecks to PSD.

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² MIP includes the following elements: (i) business environment; (ii) trade and investment facilitation regulations and institutions; (iii) human capital; (iv) financial services and (v) physical and support infrastructure.
The PSD Forum and follow-on dialogue with the Government allowed honing in on the most important issues to unleash the potential of the private sector by alleviating binding constraints and increasing its competitiveness. While many of these constraints are structural - such as the high transport and telecom costs, reliability of power, etc. - others relate to policies and institutions (discussed below), such as:

(i) Weak business environment and high costs of doing business.
(ii) Weak enterprise skills and institutional support to PSD negatively affecting labor productivity of the private sector and its ability to compete.
(iii) Lack of economic diversification and weak market linkages putting at risk the sustainability of economic growth.

The private sector has an important role to play in achieving the goals outlined in PRS and the PSD Strategy. For that to happen, however, the Government needs to accelerate the PSD reform agenda and focus on an environment which is conducive to private investment and operations. Attaining high and sustainable level of growth needed to realize the MDGs will also require improving the linkages between urban and rural areas to increase and diversify production of tradable goods, fostering complementarities between public and private investment, facilitating linkages with the regional and global economy, and building the capacity of the private sector to raise the productivity of labor and increase competitiveness of the Lesotho economy.

The donor community is assisting in achieving these objectives through a number of sector-specific as well as cross-sectoral operations (see Annex 1). The proposed project complements initiatives that are already under implementation and aims to further the Government’s effort in removing the key obstacles to PSD and support a faster private-sector led economic growth.

Weak Business Environment and High Costs of Doing Business

The legal and administrative framework is a key element of the investment climate. The FIAS report of 1997 on “Administrative Barriers to Business” highlighted the deficiencies that exist in Lesotho, which taken together constitute a significant barrier to doing business by domestic and foreign, small and large investors alike. A follow-up work in 2004 under the ESW and the results of the ICA survey confirmed these findings and identified several specific aspects of the existing legal and regulatory framework that contribute to high costs of doing business and high “hassle” element for the investors. Among the binding constraints are:

(i) Obstacles to firms’ entry into the market, i.e., cumbersome, timely and costly companies registration and licensing regimes;
(ii) Impediments to firms’ day-to-day operations, i.e., procedures to issue basic documents, such as visas, work, residents and import permits;

Although GOL has made certain improvements over the past few months, administrative impediments still prevail. The Government is fully committed to implement the reforms to remove costly and time-

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3 It takes 92 days and at an average cost of $497 to open a business in Lesotho. The annual industrial license fee is $153 for medium and large-scale enterprises and it takes 3-5 weeks to obtain it. It takes 2-5 weeks to obtain the trade license and fees range from $12 to $153.
4 Approval or denial of these routine applications often exceeds 24 months.
consuming requirements to entry and doing business by reforming the company registration and industrial and trade licensing regimes as well as a comprehensive reform of the immigration services. Further, in order to implement these reforms, the Government needs to introduce necessary legislative changes without any further delays.

Weak Enterprise Skills and Institutional Support to PSD

The results of the Investment Climate Assessment show that productivity and competitiveness of SMEs are among the key constraints to their growth and development. While average labor productivity in Lesotho is similar to other countries in sub-Saharan Africa (i.e., Tanzania, Mozambique), it is lower than in the most productive countries in Africa such as Kenya, Senegal and South Africa, and most importantly, considerably lower than in China and India – the two important competitors in textiles and garments. While reasons for this are numerous, workers education and availability of training seems to be an important aspect. Indeed, ICA shows that only about 28% of the companies in Lesotho have formal training programs, which is lower than in other African countries (i.e., Uganda, Senegal, Zambia, Tanzania, Kenya), and far lower than in South Africa or China. Further, compared to India and South Africa, worker education appears to be relatively low in Lesotho; over half of workers in SA and close to half in India had a secondary education or greater – compared to about 15% in Lesotho.

In addition, the institutional support for PSD in Lesotho is weak, inefficient and the agencies are often unable to fulfill their basic functions. The network of chambers of commerce, headed by the Lesotho Chamber of Commerce and Industry (LCCI), is the main channel by which the domestic private sector interests (mostly MSMEs) are represented, both in the formulation of new GOL policies and in dealing with problems in the implementation of policies. The chamber movement still lacks the capacity to fully represent its members in the dialog with GOL. Industry-specific, informal organizations and professional associations are starting to emerge. The few that are active are new, inexperienced, lacking sufficient membership fee income, and unclear about their role. The exception to this are the Association of Employers (representing mostly larger firms as well as several South Africa-based firms) and the Association of Exporters (comprising firms from South-East Asia), which are the strongest private sector organizations. They, however, tend to rely on their own networks for trade information and do not appear to perceive a gap in these information channels. Finally, although the public-private consultative mechanism has been initiated under the framework of the PRS, it appears as it has lost its momentum and has yet to reach its potential for channeling dialog.

For these reasons, capacity building (CB) is of critical importance for Lesotho to meet its growth and poverty reduction objectives. Currently, CB for the individual firm consists mainly of open training courses and limited assistance with business planning. Most of this is supplied by public-sector entities at highly subsidized rates. As a result, private supply of business development services (BDS’s) has barely started to develop.

Lack of Economic Diversification and Weak Market Linkages

While acknowledging the exceptional growth of the garment industry and its key positive role as the engine of economic growth in Lesotho, the Government and the private sector also acknowledged the downside of this phenomenon, namely high dependence on one-industry, one-market and vulnerability of the economy to the external shocks (such as elimination of AGOA benefits or opening the markets to Asian competitors due to MFA expiration). The PSD Forum called for action in three areas to allow Lesotho to successfully develop a diversified, pro-export economy integrated with the regional markets:

(i) Retaining and expanding the existing FDI base in the garment industry
(ii) Attracting new foreign investors to develop new industrial clusters.
(iii) Supporting the growth of the local private sector in other value-added activities (including agri-
business, resource-based sandstone mining and services such as tourism), by ensuring that it is
effectively integrated with the Lesotho-based FDI sector as well as with the private sector in the
RSA and in the region.

Recognizing the urgency of the reforms and a great need for actions on the Government side, as the
extension of AGOA will only provide a short three-year “window of opportunity” for the Government to
take appropriate measures addressing current weaknesses and improving environment for a faster and
more diversified economic growth, the Government asked for World Bank assistance in developing
targeted industry-specific programs aiming at facilitation of forward and backward market linkages and
industry-relevant skills development programs.

2. Proposed project development objective(s)

The key objective of the project is to increase private sector participation in the economy by increasing its
productivity and competitiveness, and hence its ability to compete. This goal will be achieved by
improving the business environment and reducing the costs of doing business; strengthening the linkages
with the regional economy, especially with South Africa; strengthening institutional support for
employable skills and business management; and improving productivity at the firm level. The project
measures will also support poverty reduction strategy dialogue and implementation of agreed policy
measures.

3. Preliminary project description

The PSD Project will comprise of the following three key components: (i) Improving the Business
Environment through Reducing Costs of Doing Business and Strengthening Legal Framework; (ii)
Strengthening the Competitiveness of the Private Sector and the Capacities of its Representative
Organizations; and (iii) Supporting Economic Diversification through Development of Skills and Market
Linkages. The scope and coverage of each of the components will be further refined and determined in
details based on: (i) results of the PHRD-funded studies; (ii) discussions with the donors so that the
overlapping and duplication is minimized; and (iii) discussions with the Government and the private
sector to ensure their ownership and buy-in.

Component 1: Improving the Business Environment through Reducing Costs of Doing Business and
Strengthening Legal Framework

The objective of this component would be to streamline licensing and registration process and improve
immigration services. The salient features discussed and agreed with the MTIMC are as follows. In the
area of the company registration and industrial and trade licensing regimes, the reforms would include (i)
consolidating and streamlining of the business registration procedure, by revising and reducing the
requirements and procedures; (ii) significantly streamlining and simplifying the industrial licensing
procedures (including tourism businesses currently mandated to be licensed by MTEC), and for trade
licensing (iii) by replacing licensing by a registration process.

In the area of immigration, the reforms would include (i) streamlining and simplifying the procedures to
issue basic documents, such as visas, work and residents permits; (ii) computerizing immigration services
offered at Lesotho’s ports of entry with the objective of creating an intra-government communication
channel; and (iii) streamlining the customs clearance process for import transactions. Finally, in order to

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5 The PHRD Application is currently under consideration by the Japanese Government.
implement these reforms, specific legal and regulatory legislation would need to be reviewed and modernized to bring it into line with best international practice (e.g., the Industrial Licensing Act (1969); Pioneer Industries Encouragement Act (1969); Aliens Control Act (1969)).

**Component 2: Strengthening the Competitiveness of the Private Sector and the Capacities of its Representative Organizations**

This component will address weaknesses in the human and institutional capacity of the private sector. It is a combination of three complementary and mutually reinforcing activities to support an enterprise-level development and improving firm-level competitiveness; building capacity of key private and public sector institutions supporting PSD and finally developing an institutional environment for the public-private sector consultative mechanism to catalyze policy dialogue and implementation.

*Sub-Component A - Capacity Building of private firms and its representative organizations*

The objective of this sub-component would be to provide matching grant support to private firms (including MSMEs, BDS providers, private banks, MFIs), associations and chambers aimed at building international competitiveness within MSMEs, building the capacity of institutions providing financial services and capacities of business and professional associations and of chambers to better serve their members. The Matching Grant Scheme (MGS) will provide cost-sharing grant support to enable the purchase of any skills development services aimed at improving their competitiveness and effectiveness. The firms would decide on their own service requirements, and make their own selection of service suppliers. MGS will be managed by a single Management Unit that would also undertake pro-active promotion of the scheme, which would reflect the government’s priorities, in terms of sub-sectors, cities and/or regions. It would also provide free hand-holding assistance to private firms applying for help, advising them on “process” issues, such as how to develop plans, find and select specialist service suppliers, etc.

*Sub-Component B - Capacity building of the public institutions supporting PSD*

The objective of this sub-component would be to provide support to sector-specific as well as economy-wide public institutions supporting PSD in their capacity to serve the private sector (e.g., Investment Promotion Center, Lesotho Tourism Development Cooperation, field support services, etc.). In addition, consideration will be given to strengthen capacity of selected legal and judicial institutions supporting PSD (e.g., commercial and labor courts, commercial dispute resolution, the anti-corruption commission, etc.). In spite of various ongoing and planned initiatives by other donors, it is clear that CB gaps still remain. It is, therefore, recommended that a more detailed “gap analysis” of selected institutions be conducted under the PHRD to determine the exact nature of this support. This assessment should also include preparation of CB plans, training and consultancy services required for their implementation.

*Sub-Component C - Improving the public-private consultative mechanism*

The objective of this sub-component would be to strengthen the policy dialogue between the public and the private sectors concerning economy-wide as well as sector-specific issues. The PSD Forum clearly indicated a strong need for increased and formalized dialogue between the key stakeholders. To support the development of this sub-component, external experts, funded by the PHRD grant, will carry out detailed analysis and development of options and implementation plans to support the public-private sector consultative mechanism to catalyze policy dialogue and implementation.

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6 Most other Bank-supported MGF schemes in other countries have used 50/50 cost-sharing. A high contribution from the firm tends to achieve more sense of “ownership,” and more effort by the firm to obtain value for money. The exact cost-sharing formula for Lesotho will be determined through the PHRD-funded studies and further dialogue with the Government and the private sector.
consultative mechanism. Work shall include a clear timeframe to institutionalize arrangements agreed upon with the GOL and the private sector, along with designing a follow-up, monitoring and evaluation mechanism of actions agreed upon.

**Component 3: Supporting Economic Diversification and Ensuring Sustainability of Growth through Development of Skills and Market Linkages**

This component will support economic diversification through development of skills and market linkages in the following priority industries: garment, horticulture, tourism and sandstone mining. While a preliminary description of the component is provided below, the Government will undertake, as part of project preparation, a series of background studies funded under the PHRD grant to assist the GOL in designing and implementation of the programs, identify the project outcomes and outputs and the linkages with the inputs provided under the project.

**Sub-Component A – Industry-Specific Support Programs.**

(i) **Garment Support Scheme.** The principal objective of this program is to help GOL and the private sector to diversify the garment sector’s input sourcing patterns, to improve throughput time by working with major buyers to explore possible avenues for establishing certified quality agents in Africa, and to design production flow, and time and motion analysis program to help garment manufacturers improve their throughput time and labor productivity. A study will be undertaken under the PHRD grant to help develop a detailed program framework.

(ii) **Horticulture Outgrower Scheme.** The principal objective of this program is to create forward and backward market linkages in the horticulture sector. This program will built on the ongoing discussions between the Ministry of Agriculture and Food Security (MAFS) and two South African companies (i.e., Alpha Farms, located across the river outside Ladybrand and Denmar Estates, located in Slabberts), regarding the possibility of developing a partnership to establish a commercial horticulture farming and commercial apple operation in Lesotho. Currently, Alpha Farms successfully grows and markets a number of horticultural crops, which are sold to Woolworth in South Africa and to a number of supermarket chains in Europe. Denmar successfully grows and markets a number of apple varieties, which are sold not only in South Africa, but also across the region. The preparation of the World Bank Private Sector Competitiveness project and its focus on market diversification and market linkages have created an opportunity to accelerate the current dialogue between Alpha Farms, Dennmar and MAFS. The PHRD funding will be utilized to define a detailed framework required to launch a commercial horticultural farming operation in Lesotho.

(iii) **Tourism industry support.** The principal objective of this program is to provide support to develop a strategy for growing tourism industry in Lesotho. A process of defining a tourism strategy for Lesotho is ongoing under the World Bank/GEF-financed Maloti Drakensburg Transfrontier Conservation Project (MDTCP). In addition, an AfDB-financed Highlands Natural Resources Project and Rural Income Enhancement Project (HNRIIEP) are ongoing with important tourism content. It is expected that the PSC project will add value to the tourism activities already covered under these projects. In order to scale up tourism activities in Lesotho it will be necessary to define both products and distribution hubs and corridors to link them. The PHRD funding will be utilized to conduct necessary background studies to inform the strategy on the core tourism product lines.

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7 This work will build on the options/solution proposed in the IF report including creation of coordinating/advisory bodies (a Cabinet Sub-Committee) with a sectoral or functional focus with membership from the private and public sectors and establishing a rule-based public-private consultative mechanism.
in core strategic areas where the growth opportunities are highest and linked to tourism corridors that will build on existing and potential cottage industries and tourism attractions.

*Sub-Component B - An industry-led, demand-driven skills development program for two priority sectors: textile and garments and sandstone mining.*

The objective of this sub-component is to enhance the productivity and competitiveness of the textile and garment industry in Lesotho. In case of the garment industry, the program will draw upon the lessons learned from the current ComMark co-financing scheme (which is expected to end in 2007) and will consist of an industry-led, demand-driven skills development program based on proven models in Malaysia and Mauritius. The proposed scheme will consist of a network of trainers and service providers utilizing a combination of workplace and centralized skills programs. The training needs, curriculum and management will come from the private sector while government will provide the enabling policy and regulatory environment, access to under-utilized public facilities and financial support through innovative financing mechanisms that will provide incentives for firms to train. It is proposed that the scheme be managed by a private contractor in partnership with the Lesotho Textile Exporters Association under the oversight of the Inter-ministerial Cabinet Task Force.

The objective of the skills development program for the sandstone mining industry is to strengthen current initiatives to enhance the level of skills in the industry to enhance the competitiveness and growth prospects of the sector. The program will strengthen the technical skills of workers through a combination of workplace and institutional training in partnership with a group of firms in the industry (coming together to form an industry association), the Mineworkers Development Agency (which is already working with the industry on skills development) and possibly the Lesotho Development Center. The scheme will also be industry-led and demand-driven, managed by a private contractor in partnership with the MDA. The PHRD funding will be used for detailed analysis and design of the programs in partnership with all key stakeholders.

2. Safeguard policies that might apply

   *(Guideline: Refer to section 5 of the PCN. Which safeguard policies might apply to the project and in what ways? What actions might be needed during project preparation to assess safeguard issues and prepare to mitigate them?)*

3. Tentative financing

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4. Contact point

   Contact: Agata E. Pawlowska
   Title: Economist
   Tel: (202) 473-4727
   Fax: (202) 522-1198
   Email: apawlowska@worldbank.org