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AFRICA PRIVATE SECTOR GROUP, WORLD BANK

**LESOTHO:
AN ASSESSMENT OF THE INVESTMENT CLIMATE**

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EXECUTIVE SUMMARY

Lesotho's economy will face important challenges over the next few years. In recent years, garment exports have been one of the drivers of growth for Lesotho. Between 1999 and 2004, garment exports increased from US\$100 million to about US\$350 million. This was largely the result of duty and quota-free access to the United States under the African Growth and Opportunity Act. A strong currency and the phasing-out of the multifiber agreement in 2004 meant that garment exporters faced a more challenging environment in 2005, with garment exports to the United States falling by about 15%. These challenges will only intensify as temporary restrictions on Chinese exports are lifted and Lesotho's ability under AGOA to import inputs from non-members ends at the end of 2007.

The objective of the Lesotho Investment Climate Assessment (ICA) is to evaluate the investment climate in Lesotho in all its operational dimensions and promote policies to strengthen the private sector. By comparing the investment climate in Lesotho to investment climates of other countries, it is possible to observe areas where Lesotho performs relatively well and others where improvement is necessary if Lesotho is to continue to grow. Tackling these investment climates constraints will be vital if Lesotho is to both continue to export garments in an increasingly competitive environment and diversify its economy away from basic garments.

The Investment Climate Survey

The primary source for the assessment is a firm-level survey (investment climate survey or ICS), which was completed towards the end of 2004. About 110 firms in three sectors of the economy—manufacturing, construction and tourism—were interviewed. The information collected during the survey is supplemented with results from a number of other studies conducted by the World Bank, other donor agencies and the Government of Lesotho.

One advantage that the ICA has over other studies using firm-level data is that we are able to benchmark firm performance and the investment climate in Lesotho against other countries around the world. The ICS uses a standard questionnaire, administered using a common approach, and which is targeted at comparable manufacturing firms. With this data, we are able to analyze firm performance, characteristics of labor and financial markets, and the quality of several areas of the

investment climate including infrastructure, regulation, and crime and security. Thus, we can see how firms in Lesotho perform relative to their counterparts in other countries and assess investment climate constraints in a comparative way.

In this study, the investment climate in Lesotho is compared to Mozambique, Tanzania, Kenya, Senegal, South Africa, China and India. The first two countries, Mozambique and Tanzania, are chosen because firm performance in these countries is typical of other countries in Sub-Saharan Africa where investment climate surveys have been completed. The second two countries, Kenya and Senegal, are chosen because firms in these countries tend to perform better than firms in other countries in Sub-Saharan Africa. Although firms in South Africa are far more productive than firms in other countries in Sub-Saharan Africa, this country is chosen because it is an important regional competitor and a potentially important export partner. Finally, China and India are chosen because they are important competitors in Lesotho's main export market—the garment sector.

One concern about the Lesotho ICS is that it covers a relatively small number of firms—only about 75 manufacturing firms compared to about 200-300 in most countries in Sub-Saharan Africa and about 1000 firms in larger countries such as South Africa, China and Lesotho. As a result, it is difficult in Lesotho to break down results by firm type (e.g., for exporters and non-exporters, large and small, and foreign- and domestically-owned firms) and difficult to get precise measures for some areas, such as productivity, where there is missing data.

A related problem is that there is a good deal of overlap between different categories of firms in the Lesotho ICS—the ICS is mostly made up of large, foreign-owned exporters in the garment sector and small, domestically owned non-exporters in other subsectors of manufacturing. Because of the small size of the sample and the overlap between the groups, we mostly present comparative data for foreign and domestic firms. Comparisons for exporters and non-exporters and large and small firms are generally very similar to the comparisons for foreign and domestic firms. We only present other breakdowns when they differ from the breakdowns for foreign and domestic firms.

Macroeconomic Performance

Lesotho is a small country, completely surrounded by the Republic of South Africa (RSA). As a result, its economic performance has traditionally been heavily dependent upon the South Africa economy. Over the past decade, several economic shocks have had a significant impact on Lesotho. First, remittances from Basotho workers employed in South African mines, have declined significantly due to the contraction of employment in this sector in South Africa. Between 1980 and 1987, remittances were equal to about half of Lesotho's GNP. By 2003/04, they were only equal to about 20 percent of GNP. Second, the Lesotho Highlands Water Project resulted in a massive increase in investment in the late 1980s through the late 1990s. As a result of this, GDP growth doubled from an average annual rate of 2.8 percent in the pre-LHWP period (1980/81-1986/87) to 6.0 percent in the high-LHWP period (1987/88-1997/98). Growth contracted to about 3 percent per year in the post-LHWP period (1999/00-2003/04). Finally, due to a large amount of foreign investment from East Asia, garment exports increased rapidly. Since 2001, the U.S. Africa Growth and Opportunities Act (AGOA) has driven this expansion.

As a member of the Common Monetary Area (CMA) and Southern African Customs Union (SACU), interest rates and exchange rates are primarily driven by macroeconomic policy in South Africa. The loti is pegged to Rand, meaning that fiscal policy is the main instrument of demand management in Lesotho. The sharp appreciation of the Rand against the US dollar between 2002 and 2005 has, therefore, been a significant challenge for exporters, especially in the garment industry, that rely upon exports to the United States.

Although garment exports increased rapidly between 2001 and 2004—growing at a rate of 30 percent per year between 2002/03 and 2003/04—the garment industry will face several important challenges over the next decade. The nominal appreciation of the rand (and therefore the loti) from about M12/US\$ at the beginning of 2002 to about M6/US\$ by mid-2005 will pose a serious challenge for garment exporters. In addition, the phasing-out of textile quota under the MFA at the start of 2005 will increase competition in the US market—Chinese and Indian exports to the US increased by 43 percent and 25 percent compared to the previous year. Going forward, the elimination of Lesotho's LDC status under AGOA in 2007 coupled with multilateral tariff reduction of non-agricultural products under the Doha round will further erode Lesotho's preferences.

Labor costs

Per worker labor costs are lower or about the same in Lesotho as they are in most of the comparator countries. In 2002, annual labor costs were about \$1000 per worker in Lesotho—considerably lower than in Kenya, Senegal, or South Africa, but slightly higher than in China, India, Tanzania or Mozambique.

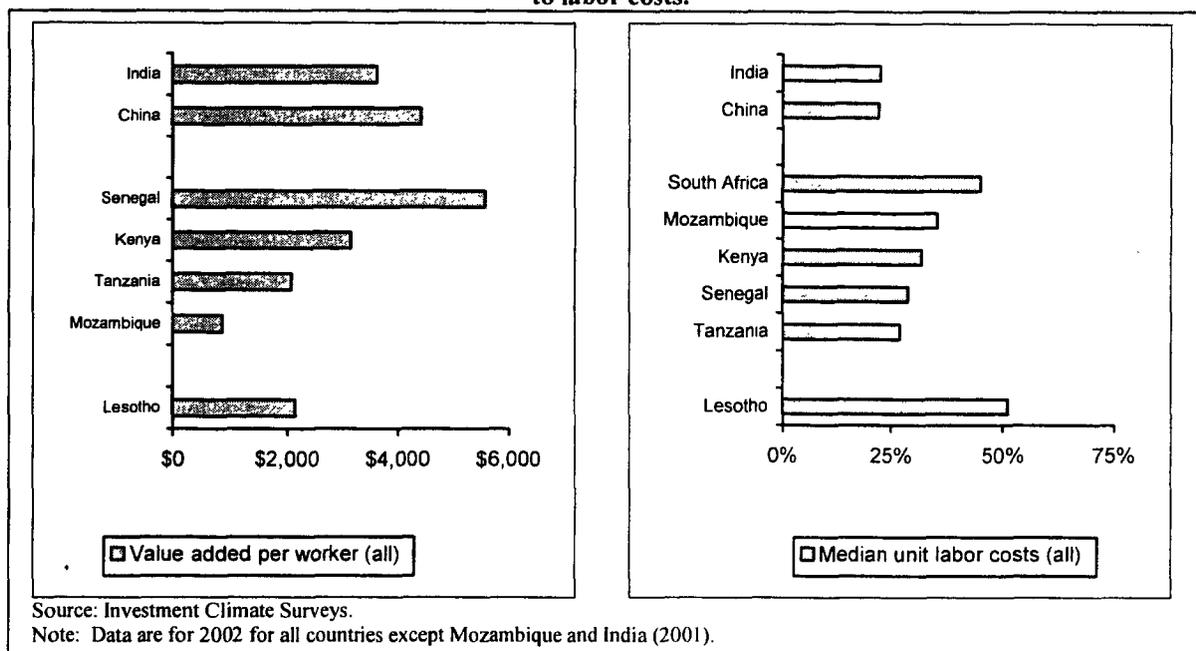
Labor costs typically differ between sectors due to differences in skill requirements, ratios of managers and supervisors to line workers, and many other factors. As a result it is better to compare labor costs for enterprises in a single sub-sector rather comparing costs across all manufacturing enterprises. In the garments sector, labor costs were lower in Lesotho than in all of the comparator countries except Mozambique. Importantly, labor costs were slightly lower than in either China or India.

In general, wage profiles are steeper in Sub-Saharan Africa than they are in China—that is the difference between wages for unskilled workers and professional and managers is greater. This pattern also appears to hold in Lesotho. Whereas the average unskilled worker makes slightly more in China (about \$72 per month) than in Lesotho (about \$62 per month), managers make considerable more in Lesotho (\$237 per month) than in China (\$109 per month). Wage profiles are especially steep in foreign-owned enterprises—whereas unskilled production workers earn about the same in foreign and domestically owned enterprises, managers make close to twice as much. In part, this might be because foreign-owned enterprises are larger than domestic enterprises. However, managers of large foreign-owned firms also appear to make more than managers of large domestic firms.

Firm Productivity

Although labor costs are low in Lesotho, labor productivity is also low. Although slightly higher than in Mozambique or Tanzania, it is considerably lower than in Kenya, Senegal, India, China or South Africa (see Figure 1). Although the samples of garment and agro-processing firms are small in Lesotho, similar patterns also appear in these sectors—productivity appears to be considerably lower than in the better performing economies in Sub-Saharan Africa and than in India and China.

Figure 1: Labor productivity is relatively low in Lesotho whether measured in US dollars or relative to labor costs.



Unit labor cost—labor costs as a percent of value-added—is a useful way of comparing labor costs across countries taking differences in productivity into account. This measure of costs is preferable to value-added per worker because it better controls for differences due to exchange rate fluctuations and labor quality. High unit labor costs means that labor costs are high relative to productivity.

Unit labor costs are generally higher in Lesotho than in most of the comparator countries. Although the small sample means that the data should be treated cautiously, unit labor costs appear consistently higher across years and sectors in Lesotho than in China, India, Kenya and Senegal. These results, which suggest that productivity is relatively low in Lesotho, are consistent with other results from studies that have used different methodologies.

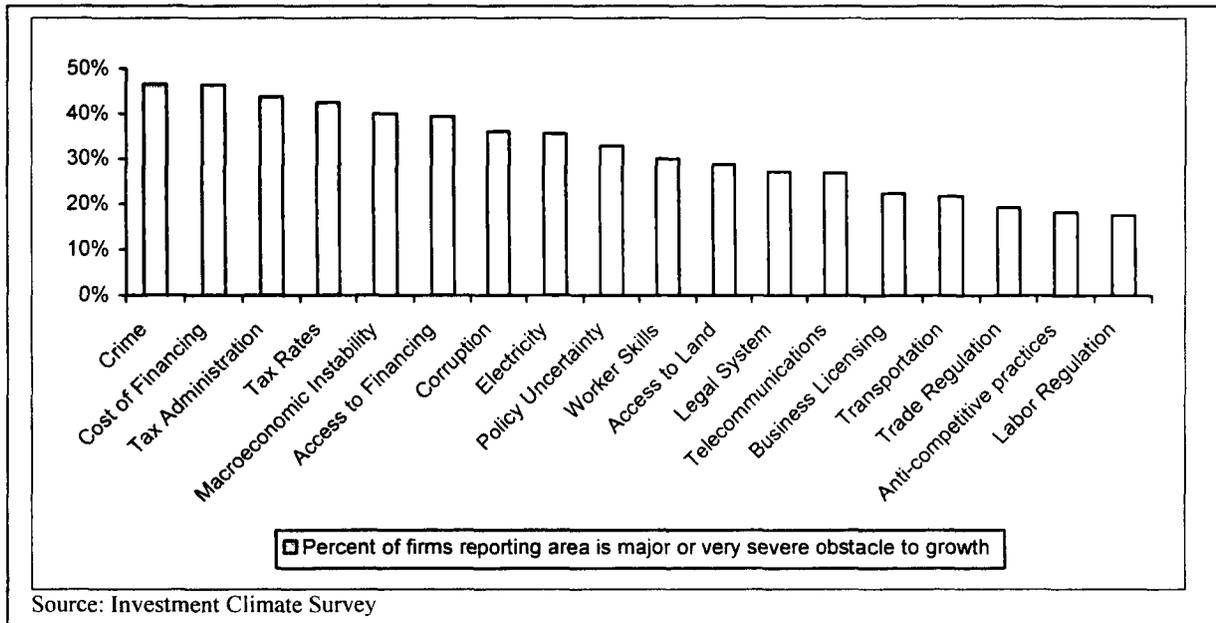
There are several plausible reasons for Lesotho's relatively low labor productivity. First, workers have relatively low levels of educational attainment compared to workers in the comparator countries. Moreover, few firms—especially in the manufacturing sector—have formal training programs. Firms indicated that they would be willing to participate in an industry-led and managed training program and that they would be willing to contribute towards the costs of any such program.

A second reason for Lesotho's low labor productivity might be that firms in Lesotho use less capital per worker than firms in the comparator countries. In general, firms with more capital per worker will produce more output per worker than firms with less capital. Although, total factor productivity would be a better measure of productivity than labor productivity, calculating total factor productivity is more data intensive than calculating labor productivity. Because of the small sample size and the missing data in the productivity survey, we do not attempt to calculate TFP for Lesotho.

Perceptions about the Investment Climate

Managers of manufacturing firms in Lesotho were most concerned about crime, finance, taxation, and macroeconomic instability (see Figure 2). Over 40 percent of managers rated each of these issues as a major or very severe problem. These were not the only issues, however, that they saw as significant problems. Over one-third rated corruption and electricity as major or very severe problems and over one-quarter rated policy uncertainty, workers skills, access to land, legal systems and telecommunications as the same.

Figure 2: Crime, financing, taxes, macroeconomic instability and corruption are firms' biggest concerns.



There were, however, large difference between managers of different types of firms. The only issue that managers of all types of firms saw as a serious concern was crime—over 40 percent of managers said it was a problem in all sectors (manufacturing, construction, and hotels); for both

foreign- and domestic firms, and for exporters and non-exporters. Other issues—labor regulation, anti-competitive practices, and trade regulation--were rated as a minor concern by all types of firm.

For foreign-owned firms, managers were most likely to rate macroeconomic instability, crime, workers skills and education, and electricity as major concerns. Domestically-owned firms, including hotels and construction firms were far more concerned about financing—both access and cost—than foreign-owned firms. Managers of domestically-owned firms were more likely to say that access to finance and the cost of financing were major constraints than any of the other 16 areas. Domestically owned firms were also more concerned about corruption, suggesting that the government has been less successful about protecting these firms against corruption than foreign-owned firms.

Infrastructure

The poor quality of many infrastructure services is a serious problem for enterprises in Lesotho. Although the quality of telecommunications service is relatively poor—outages are more common than in most of the comparator countries, the cost of service, especially international service is high, and it takes a relatively long time to get a connection—and the limited availability of water is placing constraints on the garment industry, the poor performance of the power and transportation sectors appear to be the greater constraints.

Despite price increases at the beginning of 2004, the cost of power does not appear to be high by international standards. Taking into account both fixed and marginal costs, the average cost per kilowatt hour is similar to, or slightly lower than, in most of the comparator countries except South Africa where costs are very low by international standards.

The quality of service, however, is poor. Although outages were less common than in most of the other countries in Sub-Saharan Africa, they were more common than in the best performing countries (e.g., South Africa). Moreover, firms had greater losses due to outages than in several of the comparator countries with more outages. The high losses appear to be because firms are less likely to have generators in Lesotho than in other countries. Only about one-quarter of firms operated a generator, compared to more than half in India, Kenya, Senegal, and Tanzania. Although fewer firms in China or South Africa operated a generator, this reflects that service from the grid appears better in these countries.

Firms did not generally see transportation as a major problem—fewer than 30 percent of the firms surveyed in the Investment Climate Survey saw it as a major obstacle. This probably reflects that existing firms have managed to adapt to poor transportation facilities and that the high cost of transportation impacts their costs only indirectly (e.g., the high cost of transportation will increase the cost of intermediate inputs to the firm but this will often be included in the total price the firm pays rather than separated out as a separate item). Other evidence looking at the entire supply chain (i.e., not just the manufacturing enterprise) has found that transportation infrastructure is a serious problem in Lesotho.

The poor quality of rail service means that intermediate inputs and outputs are transported using trucks rather than rail. Although trucking costs are nearly 75 percent greater than rail costs, trucks can deliver a container from Port Elizabeth in a single day, rather than 9 to 30 days for the same journey by rail.

Finance

Lesotho's financial sector is small and concentrated. The banking sector, which is small and relatively underdeveloped is dominated by three South African-owned banks, while the non-banking financial sector is very small.¹ The commercial banks provide little finance to MSMEs, mostly limiting their services to overdraft facilities to large customers in the service and trade sectors and some industrial clients who have established a banking relationship with them over time. In addition to the commercial banks, Lesotho has two development finance institutions, the Lesotho National Development Corporation (LNDC) and the Basotho Enterprise Development Corporation (BEDCO), which have largely ceased to operate as financial sector intermediaries.

The legal framework is also a deterrent to financial intermediation. The slow execution of due process manifested by slow court proceedings, lender's inadequate access to timely foreclosure procedures, the absence of credit assessment information, and weak enforcement of property rights all undermine financial intermediation. Moreover, the legal system puts married women at a legal disadvantage because matrimonial law in Lesotho treats them as minors.

¹ Although there are four commercial banks (Lesotho Bank, Standard Bank, Nedbank and First National Bank), Stanbic owns 70% of Lesotho Bank and the two are about to merge

Under these circumstances it is not surprising that close to half of enterprises in Lesotho rated the cost of financing (interest rates) as a major or very severe problem and close to forty percent rate access to financing as the same. This is far higher than in China, India and South Africa where between 13 and 22 percent of enterprises saw access to financing and 16 to 23 percent saw the cost of financing as serious problems. Although this suggests that finance is a serious concern, firms in Lesotho were less likely to rate both the cost of financing and access to financing as a major or very severe problem than firms in Kenya, Senegal or Tanzania.

Within Lesotho there are marked differences in the perceptions of firms—foreign-owned enterprises are far less likely to rates financing as a serious problem than domestically owned enterprises. Although this could reflect the fact that the banking sector in Lesotho serves large, foreign-owned enterprises better than it serves domestic enterprises, this does not seem to be the case. Foreign-owned firms were less likely to have bank loans or overdraft facilities than domestically-owned enterprises. Instead, the difference appears to be because foreign-owned enterprises have access to other sources of financing (e.g., from their parent companies). Almost all foreign-owned enterprises without loans reported that they did not want a loan. In contrast, many domestically owned enterprises without loans reported that they did not have adequate collateral or that interest rates were too high.

Crime and Security

In contrast to most other areas of the investment climate, there was broad agreement among the firms covered by the survey that crime and security is a serious problem. About 47 percent of manufacturing enterprises and 53 percent of construction enterprises rated crime, theft and disorder as a major or very severe problem. Moreover, complaints about crime and security were common among foreign and domestic enterprises.

The objective data is broadly consistent with the perception-based data. About 85 percent of firms reported losses due to crime in 2004—higher than in any of the comparator countries including South Africa, where crime is also a serious problem. The economic cost of crime is also high. The manager of the median firm in Lesotho estimated that the cost of security and losses due to crime were equal to about 4 percent of sales. This was higher than in most of the comparator

countries, but is lower than in some countries where investment climate surveys have been completed (e.g., in Central America).

Employee theft appears to be an especially serious problem in Lesotho. In the manufacturing sector, managers attributed close to three-quarters of losses to employee theft. Although questions on the importance of employee theft are not included in all Investment Climate Surveys, employee theft appears to be higher in Lesotho than in other countries for which data are available. In particular, South Africa managers attributed only about 43 percent of direct losses to employee theft—considerably less than in Lesotho. Managers of garment firms were particularly concerned about employee theft—attributing over 90 percent of losses due to crime to employee theft.

Corruption and Regulation

Lesotho ranks relatively well on many corruption indices. In the 2005 edition of Transparency International's Corruption Perceptions Index, Lesotho ranked 70th out of 159 countries—higher than any of the comparator countries except South Africa. Lesotho also scores well on other aggregate indices related to other governance measures (e.g., government effectiveness and the rule of law).

Although corruption remains a concern for many enterprises in Lesotho—about 36 percent said it was a major or very severe obstacle—the objective indicators suggests that it is less of a problem in Lesotho than in many of the comparator countries. About 45 percent of managers said that 'gifts or informal payments' were needed to 'get things done with regards to taxes, licenses, regulations, and services etc.', but the median reported payment was lower than in most of the comparator countries. Further, relatively few firms reported that bribes were needed to secure government contracts, deal with government inspections (e.g., tax inspections or labor and social security inspections) and few reported that they were needed to get utility connections or licenses.

Although corruption is relatively low, the burden of regulation is not. Managers in Lesotho reported spending more time dealing with government regulations, inspections and required meetings than managers in any of the comparator countries except China. The average manager reported spending about 22 percent of their times dealing with regulations, inspections and required

meetings, compared to less than 15 percent in Tanzania, Kenya, Senegal, South Africa, India and Mozambique.

As in most countries, the burden of regulation is greater for large enterprises than it is for SMEs. Whereas the manager of the median large enterprise reported spending 30 percent of their time dealing with government regulations, inspections and meetings, the manager of the median SME reported spending only 14 percent of their time doing so.

Most required meetings and inspections were with tax inspectors. Over 85 percent of enterprises had at least one required meeting with tax inspectors. Although construction firms and hotels were more likely to have required meetings with tax inspectors than manufacturing firms, they typically had fewer meetings—only one or two in a year—when they did. About 77 percent of manufacturing firms also met with labor inspectors, although these were less common in the construction and hotel sectors. Other inspections were less common. Very few firms reported that informal payments were expected or requested during any of these meetings.

Starting a business can also be complicated. In 2005, it took nine procedures and 92 days to start a standard business. This is higher than in most of the comparator countries (India, China, Tanzania, Kenya, South Africa, Senegal, and Tanzania)—only Mozambique has a longer process than Lesotho. The cost is also high in both dollar terms (\$453) and as a percent of per capita income (61.2). This is higher than in three of the seven comparator countries, although it compares favorably to the regional average of 215.3. On all measures, number of procedures, time to complete them and cost, Lesotho falls far short of the OECD average (6 procedures, 19 days, and 6.5 percent of per capita income). By reducing procedures and the time to complete each procedure, the Government could seriously reduce entry costs.

Macroeconomic Instability

Despite Lesotho's relatively impressive macroeconomic performance, about 40 percent of enterprise managers in Lesotho rated macroeconomic instability as a serious concern. Exporters were far more concerned about it (53 percent rated macroeconomic instability as a serious obstacle) than non-exporters (only 29 percent). The reason for the differing opinions about the importance of macroeconomic instability is probably that the main concern in the area is exchange rate instability. Although the peg with the Rand means that there has been little instability with respect to the Rand,

the Rand has varied greatly against the US dollar in recent years. This is extremely problematic for garment exporters because about 93 percent of garment exports from Lesotho are bound for the U.S.

This emphasizes the importance of diversifying exports away from the United States. The heavy reliance of firms on exports to the United States, due in part to AGOA, may worsen concerns about the macroeconomic instability, especially given the dollar's recent instability in currency markets (World Bank, 2003). Diversifying export markets outside of the United States and exports out of the garment sector will reduce concern about the dollar-Rand exchange rate and make the economy less vulnerable to exchange rate fluctuations.

Taxation

About 43 percent rated tax rates as a major or very severe obstacle, making them the fourth largest constraints in Lesotho. Although this might suggest that taxes are too high in Lesotho, it is important to note that taxes are needed to finance public expenditures—including those needed to improve the investment climate—and that tax rates typically rate among the largest constraints, especially in low-income countries. In fact, in all four of the other low-income comparator countries in Sub-Saharan Africa, over 50 percent of enterprises rated tax rates as a serious problem.

Consistent with the perception data that suggests that tax rates are not particularly burdensome in Lesotho, tax rates do not appear to be especially high, especially for manufacturing enterprises. Other evidence is also consistent with this. The World Bank's latest *Doing Business* report calculated the amount of taxes that a manufacturing enterprise would pay under a set of standardized assumptions about profitability, ownership, and other enterprise characteristics. Under these assumptions, the enterprise would pay less in taxes in Lesotho than it would in any of the comparator countries.

Tax administration does appear to be burdensome in Lesotho. In addition to the perception based measures, firms were also asked about the number of tax inspections that they faced during the previous year (see Table 10). The median enterprise in Lesotho reported 7 inspections or required meetings. In comparison, the median enterprise in South Africa and Mozambique reported 1, the median enterprise in Kenya reported 2, and the median enterprise in Tanzania reported 6. Tax administration appears to be particularly burdensome for large, foreign-owned enterprises.

HIV/AIDS

Lesotho has one of the highest HIV infection rates in the world. It is estimated that as many as 33 percent of the adult population (15-49) are living with HIV/AIDS. Prevalence rates are likely to be even higher in many urban areas, with about 42 percent of the population living with AIDS in some urban areas. In addition to being a tragedy in terms of the lost lives, HIV/AIDS also has the potential to undermine economic development—a point stressed in the Government's recent Poverty Reduction Strategy Paper.

Despite the magnitude of the crisis, only about half of manufacturing enterprises said that the epidemic had adversely affected their firm. Foreign-owned manufacturers were more likely to say that it had had an adverse impact than domestic manufacturers and construction firms were far more likely to say that they had been adversely affected than manufacturing firms. The biggest reported impact was on labor turnover and absenteeism. About one-third of firms that reported that HIV/AIDS had affected their firm reported that it had increased labor turnover and absenteeism by more than 5 percent.

Labor Relations

Industrial action was more common for foreign-owned firms and firms in the garment sector than for other firms. Over half of firms in the garments sector reported losing production due to strikes or labor disputes. In contrast, none of the other manufacturing firms (i.e., firms outside of the garments sector) reported losing production due to strikes or labor disputes.

The high level of industrial action in foreign-owned firms might reflect several factors including the high levels of wage inequality in these firms and problems associated with relying heavily on expatriate management. This might result in Basotho workers perceiving that they have few opportunities for advancement.

Policy recommendation

One of the goals of the analysis in an Investment Climate Assessment is to help policymakers craft a strategy to accelerate improvements in the investment climate. Survey results also cast light on the severity of the constraints, enabling Government to prioritize and sequence the reforms to alleviate the binding constraints and provide support and assistance to nurture the private

sector growth. The reforms will aim at building a Minimum Infrastructure Platform (MIP), which is a minimum combination of priority physical infrastructure investments with a specific set of investments in supporting facilities required to ensure sustainable growth and development of Lesotho's key economic industries. The underlining assumption for promoting such an integrated approach is that if these basic building blocks are executed in tandem, they will unleash the growth potential often trapped and untapped in key resources of the Lesotho's economy.

In recent years, the Government has started to implement a number of reforms designed to alleviate some of the constraints identified in the Investment Climate Assessments. Important efforts are ongoing to improve access and affordability of basic physical infrastructure (power, telecommunications, and water). In addition, the Government has recently outlined key reform that will be fast tracked for implementation in the areas of the judiciary and administration of justice, the financial sector, and the land tenure and mortgage regimes. These reforms should improve the availability of finance as firms will be able to pledge land as collateral.

While these reforms are important for private sector development, the Investment Climate Assessment highlights the need for additional reforms to ensure private sector growth, attract foreign direct investment (FDI) and help to diversify the economy away from the garment industry—an important objective in light of the elimination of AGOA benefits in 2007. In this context, the results of this study suggest three areas as top priorities: improving the regulatory environment; improving transportation links to South Africa; and building the capacity of the country's people to improve labor productivity and accelerate diversification.

Improving the regulatory and institutional framework

When governments impose restrictive requirements on businesses, they can unwittingly contribute to increased illegal activities, corruption, and rent-seeking and can discourage foreign direct investment. An important question is how governments can design and implement regulations so that that the promote and encourage legal business activities and investment, serve the public interest, and discourage harassment and corruption. Key reforms that would reduce the high burden of regulation in Lesotho include:

- (i) Reduce the cost and time it takes to start a business by streamline licensing and registration processes.

- (ii) Simplify the procedures to issue foreign workers with visas, work permits and residency permits, and improve immigration services at Lesotho's points of entry.
- (iii) Improve customs procedures and streamline the customs clearance process for import transactions.
- (iv) Lay foundations for a business-friendly legal and regulatory environment by developing and implementing a modern legal framework.

In addition, there would be strong benefits to harmonizing legislation governing private sector development with that in South Africa. Strengthening the institutional capacity of public and private institutions supporting private sector development and improving and institutionalizing the public-private consultative mechanism would also be useful.

Reducing Transportation Bottlenecks.

In the area of infrastructure development, the remaining priority issue is to improve the inefficiencies of the rail systems and to integrate it with the South African rail network. Due to the low reliability of the sector, the garment industry has to rely almost exclusively on trucks for transportation. Because transportation by trucks is almost three times more expensive than transportation by rail, this squeezes profit margins in export-oriented industries such as garments.

The government should take the following steps:

- (i) Finalize the lease agreement between Spoornet and the Government of Lesotho and improve the monitoring of container off-loading activities.
- (ii) Clearly define its policies towards Spoornet particularly with respect to goods that are priorities for imports when adequate rail cars are not available for entry into Lesotho.
- (iii) Support and assist the private sector in expanding affordable warehousing facilities with Maseru.

Improve the Availability of Skilled Labor

The Investment Climate Assessment shows that worker education and skills limit the growth and productivity of the private sector and are a particularly significant constraint for export-oriented

industries such as the garment industry. It is therefore recommended that the Government should take actions to upgrade the level and range of worker skills and develop and expand technical and vocational education and training (TVET). Priority actions include

- (i)* Finalizing and implementing a national TVET strategy and establish legislation for the training levy and supporting institutional arrangements
- (ii)* Enhancing the effectiveness of TVET institutions through public-private partnerships

In addition, the Government should develop programs to support the creation of backward and forward linkages with foreign garment multinationals among local businesses.

INTRODUCTION

The objective of the Lesotho Investment Climate Assessment (ICA) is to evaluate the investment climate in Lesotho in all its operational dimensions and promote policies to strengthen the private sector. The World Bank began carrying out investment climate assessments (ICAs) in 2001. ICAs are based on the results of firm-level surveys (investment climate surveys or ICSs), as well as other available evidence regarding the country's investment climate. The Investment Climate survey in Lesotho was completed in the late fall of 2004. Sebacha Consultants, a private firm from Lesotho, conducted and enumerated the survey, which covered about 110 firms throughout Lesotho. It included firms of all sizes in three sectors of the economy: manufacturing, construction and tourism.

Information from the survey is supplemented with results from a number of other studies conducted by the World Bank within the framework of Economic Sector Work (ESW) conducted in 2003/04 as well as by other donor agencies. The World Bank reports include a Financial Sector Review (2003), Country Framework Report (2004), Integrated Framework Report (2004); a value chain analysis of several strategic sectors including the garments sector, the *Doing Business* report, a skills requirement review, the draft Private Sector Strategy report, and a FIAS review on administrative barriers. Reports from other agencies including the International Monetary Fund, the Central Bank of Lesotho and a garment sector review sponsored by DFID were also used.

I. THE INVESTMENT CLIMATE SURVEY

The ICS gives us a detailed cross-sectional snapshot of Lesotho's private sector. Its main advantage is that it enables benchmarking of firm performance and the investment climate in Lesotho with other countries around the world—the World Bank has now carried out ICSs in over 60 countries. The ICS datasets use a “global core” questionnaire that is administered in a standardized manner across countries, targeted at roughly comparable sub-sectors in manufacturing. The data generated by this questionnaire enables us to analyze several things, including firm performance as measured by firm-level productivity, characteristics of factor markets such as labor and finance, and the impact of the investment climate including infrastructure, regulation, and crime

and security. Thus, we can see how firms in Lesotho perform relative to their counterparts around the world, and what their constraints are in a comparative context.²

Although comparisons between manufacturing and the other sectors within Lesotho are presented, the analysis focuses on manufacturing firms. The main reason for this is that manufacturing is the only sector covered in all countries. To ensure cross-country comparability, we restrict the sample to these firms when making these comparisons.

The comparator countries include four low-income countries in Sub-Saharan Africa: Mozambique, Tanzania, Kenya, and Senegal; one large middle-income country that neighbors Lesotho, South Africa; and two fast-growing countries in Asia: China and India. The low-income countries in Sub-Saharan Africa include two regional competitors, Mozambique and Tanzania. Labor and total factor productivity are similar in these countries to most other countries in Sub-Saharan Africa where Investment Climate Surveys have been completed (e.g., Uganda, Ethiopia and Zambia).³ The other African countries are chosen because firms in these countries are often among the best performers in the continent—firms in Kenya, Senegal and South Africa (especially South Africa) tend to be more productive than firms from elsewhere in Sub-Saharan Africa.⁴

The final two countries, China and India, are chosen because they are important competitors in the garments sector. Competition from these countries will become even more critical in the near future. After the removal of import quotas on Asian exports in the United States in January 2005, garment exports from China and India to the United States—the destination of over 90 percent of Lesotho's garment exports—surged. Exports from China were 43 percent higher in 2005 than they were in 2004, while exports from India were 25 percent higher.⁵ Thus, these countries are likely to become increasingly important competitors for Lesotho in the near future as the garments sector is further liberalized.

² It is worth noting that in countries where multiple rounds of ICS have been conducted (typically once every three years), we are also able to analyze how firms perform over time, and what the impact of policy changes are. Further enumeration in Lesotho will enable this analysis to be carried out for our sample of firms, including an analysis of entry and exit of firms.

³ See Regional Program on Enterprise Development (2002; 2004c)

⁴ See Regional Program on Enterprise Development (2004b; 2005a; 2005b)

⁵ Data from U.S. Census website (<http://www.census.gov/foreign-trade/statistics/>)

One noticeable problem when writing this Investment Climate Assessment was dealing with the data from the Lesotho ICS. The ICS is small—only 75 firms in the manufacturing sector and 35 additional firms. In most countries in Sub-Saharan Africa, the surveys cover between 300 and 400 firms, with between 200 and 300 of them in manufacturing. In larger countries (e.g., India, South Africa and China), the surveys often cover close to 1000 firms.

Moreover, the Lesotho Survey contained a lot of missing data. This is primarily a problem in the section on firm productivity. Although nearly all firms were willing to answer broad questions on the investment climate, they were often unwilling or unable to answer questions about their income and capital. Whereas all but two firms in the Lesotho ICS answered all questions on perceptions about the investment climate, all but six firms answered a question on the time that senior management spends dealing with regulations, and all but eight answered the question on whether ‘firms like theirs’ typically had to make unofficial payments or gifts to government officials to get things done, only one-third of them provided enough information to calculate value-added per worker. Although it is always difficult to get firms to answer these questions, this is far higher than in most other countries where investment climate surveys have been completed. In the other low-income countries in Sub-Saharan Africa, between 55 and 60 percent of firms answered enough questions to calculate value-added per worker and in South Africa about 80 percent did.

The small sample size also means that it is difficult to break down responses by firm. Most investment climate surveys present information by firm size (micro, small, medium, large and very large), by whether the firm exports or not, by location within the country, by sector, and by foreign or domestic ownership. When the Lesotho data is broken into smaller groups, we are often left with only a small number of observations.

A related problem in Lesotho is that there is good deal of overlap between these different categories in the Lesotho ICS—with the major difference being between the mostly large, foreign-owned exporters in the garment sector and smaller, domestically owned non-exporters in other subsectors of manufacturing. Whereas over 90 percent of firms in the garments sector export, only 15 percent of firms in other sectors do. Because of this, comparisons of exporting versus non-exporting firms usually look like comparisons of garment producers versus non-garment producers. The overlap between ownership and export status is also close—80 percent of foreign-owned firms

but only 30 percent of domestic firms export—as is the overlap between size and export status—85% of large and very large firms but only 15 percent of small and medium-sized firms export.

Although the overlap between the groups is not perfect, breakdowns for large and small enterprises, exporters and non-exporters and foreign and domestic firms are usually similar—and usually similar to the breakdowns for garment versus non-garment producers. Because of the interest in the garments sector—especially due to concerns about its long-term viability—we usually present breakdowns for garment firms separately from other manufacturing firms. In addition, we often present breakdowns for foreign versus domestic enterprises for comparison. In general, we only present other breakdown (e.g., for exporters and non-exporters or large and small) when there is a specific reason to do so (e.g., if the breakdown looks different from the breakdown for foreign and domestic).

II. THE PRIVATE SECTOR IN LESOTHO

In this sub-section we present information on the private sector in Lesotho, based upon a database (the 'private sector mapping') of 4,600 firms in Lesotho compiled as part of the World Bank ESW (see Table 1). We do this to provide basic information on the private sector in Lesotho and to also provide information on how well the small sample for the ICS reflects the broader private sector in the country.

Table 1: Firms in Lesotho (Late 2003)

Activity	No of Companies	Total Employed ⁽¹⁾
Manufacturing		
Meat & poultry	112	611
Food and beverages	100	1,936
Garments and textiles	408	49,233
Footwear & Leather	30	3,167
Other manufacturing	243	1,848
Construction		
Construction	225	8,300
Tourism		
Hotels	44	1,214
Other		
Stone quarrying	8	67
Stone cutting	10	300
Other mining & quarrying	9	8
Agriculture	16	44
Retail & wholesale	2,408	10,884
Bars & restaurants	281	1,339
Other services	743	4,941
Total all	4,640	83,595

⁽¹⁾ Data available for 2,322 companies showing 81,327 employed. For other firms a default size of 1 was assumed.

⁽²⁾ Out of 408 firms in textile and garment, 38 are foreign-owned factories (which provide bulk of employment in the sector), while the remaining firms are usually small-scale Basotho-owned enterprises and dress-makers (tailors).

Although the private sector mapping database remains incomplete with information gaps and partial coverage in some areas, the importance of the clothing and footwear sub-sectors is evident. Firms in these two areas are large and labor intensive, accounting for 62% of the known labor force in the sample. Moreover, they account for just under half of the firms in manufacturing sector. Firms in the meat and poultry and food and beverage sectors account for about 24 percent of manufacturing firms.

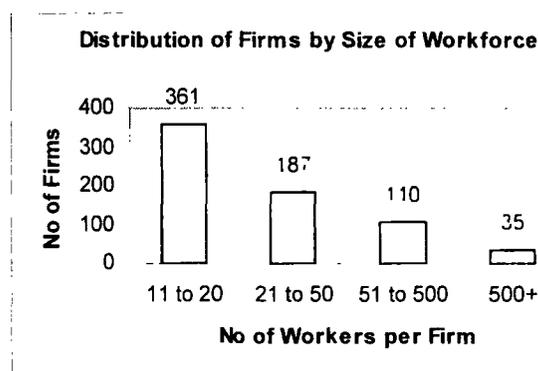
The sample from the ICS matches this fairly well. There are 75 manufacturing firms in the ICS (see Table 2). Close to half the sample was in the garments sector (including footwear and leather) and another quarter were in food and beverages (including meat and poultry). This fairly closely matches the overall distribution of manufacturing firms in the country. The remaining firms were in variety of other manufacturing sub-sectors including construction materials and printing.

Table 2: Sample characteristics.

Total Number of Manufacturing Firms: 75			
Size		Globalization	
Micro (1-9 workers)	15%	Exporters	52%
Small (10-49)	32%	Non-Exporters	48%
Medium (50-99)	3%	Private Domestic	51%
Large (100-499)	25%	Foreign	46%
Very Large (Over 500)	25%	State-Owned	3%
Sector		Ownership	
Garments	47%	African	49%
Food and Drinks (including meat)	25%	Asian	33%
Construction Materials	11%	European/Other	18%
Paper, Printing and Publishing	8%		
Other	9%		

Among the entire sample of 4600 firms in the private sector mapping exercise, about 700 had over 10 workers. Most had between 11 and 50 employees, although about 16 percent had between 50 and 500 workers. About 35 firms—a surprisingly large number—had more than 500 employees. These firms are large even by international standards.

Figure 3: Distribution of Firms (including non-manufacturing firm) by Size of Work Force



To ensure adequate coverage of large and very large firms—and to reflect their importance to the economy in terms of employment—these enterprises are overrepresented in the ICS sample. The sample was divided between small and micro firms and large and very large firms—there were very few medium sized firms with between 50 and 100 employees in the sample. In part, this reflects a divide between garments producers and other firms—the median garment producer in the ICS sample had 550 employees, while the median non-garment producer had 25 employees.

The private sector mapping shows that most of the private sector firms in Lesotho are located in Maseru district, which contains almost 60 percent of companies, followed distantly by Leribe (which includes the important industrial centre of Maputsoe) with 12 percent. Two other districts, Berea and Mafeteng have 6 percent each (Table 2). The ICA sample, which only includes manufacturing firms, matches this distribution relatively closely. About 53 percent of firms in the ICS sample are in Maseru, 14 percent are in Leribe and 14 percent are in Berea. No other regions accounts for over 10 percent of the sample.

Table 3: Lesotho: Distribution of Companies by District

District	No. of Companies	%
Butha-Buthe	219	5
Leribe	558	12
Berea	264	6
Maseru	2638	57
Mafeteng	274	6
Mohale's Hoek	177	4
Quthing	108	2
Qacha's Nek	81	2
Mokhotlong	186	4
Thaba Tseka	94	2
Total	4599	100

Source: Pawłowska (2004).

In summary, the ICS reflects the private sector relatively well in terms of the sectoral and locational distribution of firms in Lesotho. Large and very large firms are oversampled in ICS, reflecting their importance to the economy.

CHAPTER 1: MACROECONOMIC PERFORMANCE

I. BACKGROUND

Lesotho is a small country with a population of about 1.8 million and an area of approximately 30,000 sq km. It is surrounded completely by the Republic of South Africa (RSA). Lesotho is considerably poorer than the other countries in the Southern African Customs Union (SACU)—per capita gross national income was about \$740 in 2004, compared to \$1,650 in Swaziland, \$2,370 in Namibia, \$3,630 in South Africa, and \$4,340 in Botswana. Poverty is also higher than in other countries in the region.

Table 4: Selected economic indicators for Lesotho and other SACU countries.

	Lesotho	South Africa	Botswana	Namibia	Swaziland	SSA ¹
Real GDP Growth, 1994-2004 Ave.	3.3	3.0	5.4	3.8	3.0	3.3
GNI Per Capita, 2004 (Atlas method; US \$)	740	3,630	4,340	2,370	1,650	500
GDP, 2004 (Current US\$, billions)	1.4	212.8	8.4	5.5	2.4	439.3
Annual Inflation, 2004 (% change) ²	5.0	4.3	6.5	5.5	3.5	
Population, 2004 (In millions)	1.8	45.3	1.8	2.0	1.1	704
Poverty headcount (International line \$1 per day; %) ³	36.4	10.7	30.7	34.9	8.0	46.4
Total Investments, 2000-2004 Ave. (% of GDP) ⁴	39.4	15.8	25.8	26.9	6.7	17.6
Public Investment ⁵	9.0	1.4	12.4	10.1	2.1	
Private Investment	30.4	14.4	13.4	16.8	4.6	
Foreign Direct Investment, Ave. 2000-2004 (% of GDP)	3.8	2.1	-0.8	5.7	2.8	

¹ SSA figures are for 2003. ² CPIX (CPI less interest on mortgage bonds) is used for South Africa. Data for Lesotho from IMF *International Finance Statistics*. ³ Poverty headcount is measured at different times: Lesotho (1995); South Africa (2000); Botswana and Namibia (1993); Swaziland (1994) and SSA (2001). ⁴ Gross Fixed Capital Formation. ⁵ Consolidated Public Sector.

Lesotho's economy has traditionally been highly dependent upon South Africa. In the 1980s, remittances from Basotho miners employed in South Africa accounted for close to half of GNP. Lesotho's dependence upon the RSA, however, fell in the 1990s due to a decline in mining sector employment in South Africa and a series of favorable external shocks in Lesotho. Lesotho attracted considerable foreign direct investment (FDI) from East Asia into its rapidly growing garments sector, which exports mostly to the United States. In addition, it experienced a phenomenal increase in external investment to finance the Lesotho Highlands Water Project (LHWP). While these shocks nearly doubled GDP growth and created many new jobs, they did not fully compensate for the negative impact that declining remittances had on GNP.

By the end of the 1990s, the LHWP, the garment industry and the decline in worker remittances had transformed Lesotho's economy (see Table 5). In 2003/04, about 81 percent of Lesotho's GNP was produced domestically, compared to 72 percent a decade earlier. Remittances

from miners and other immigrants were only 20 percent of GNP in 2003/04 compared to 35 percent ten years earlier. Imports fell from 78 percent of GNP in 1993/94 to about 72 percent in 2000/01—although, in recent years, import dependence has increased. Both private investment and exports have increased dramatically.

Table 5: Lesotho: Selected Economic Indicators

	1980/81- 1986-87	1987/88- 1997-98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	1999/00 - 2003/04
Share of GNP (%)	Pre LHWP	High LHWP	Post LHWP	Post LHWP	Post LHWP	Post LHWP	Post LHWP	Post LHWP	Post LHWP
GDP	57	67	78	79	80	82	82	82	81
Net factor income from abroad	43	33	22	21	20	18	18	18	19
GNP	100	100	100	100	100	100	100	100	100
Unrequited transfers	5	13	12	13	12	14	14	13	13
GNI	105	113	112	113	112	114	114	113	113
Consumption	79	98	95	94	94	92	97	93	94
Public	18	18	28	30	28	25	28	26	27
Private	61	80	67	65	65	67	69	67	67
GNS	8	15	18	19	19	22	17	18	19
Public	2	12	5	2	4	8	5	7	5
Private	6	3	12	17	14	14	12	11	14
GDI	8	32	37	37	33	33	31	28	32
Public	10	12	8	7	6	10	8	6	7
Private	-2	6	12	21	19	17	17	17	18
LHWP		16	18	10	9	6	6	4	7
Exports of GNFS	5	13	21	20	26	38	43	39	33
Imports of GNFS	63	77	75	72	73	81	89	78	79
Resource balance	-6	-18	-20	-18	-15	-11	-14	-10	-13
Remittances	48	36	25	24	23	21	21	20	22

II. GROWTH AND INVESTMENT

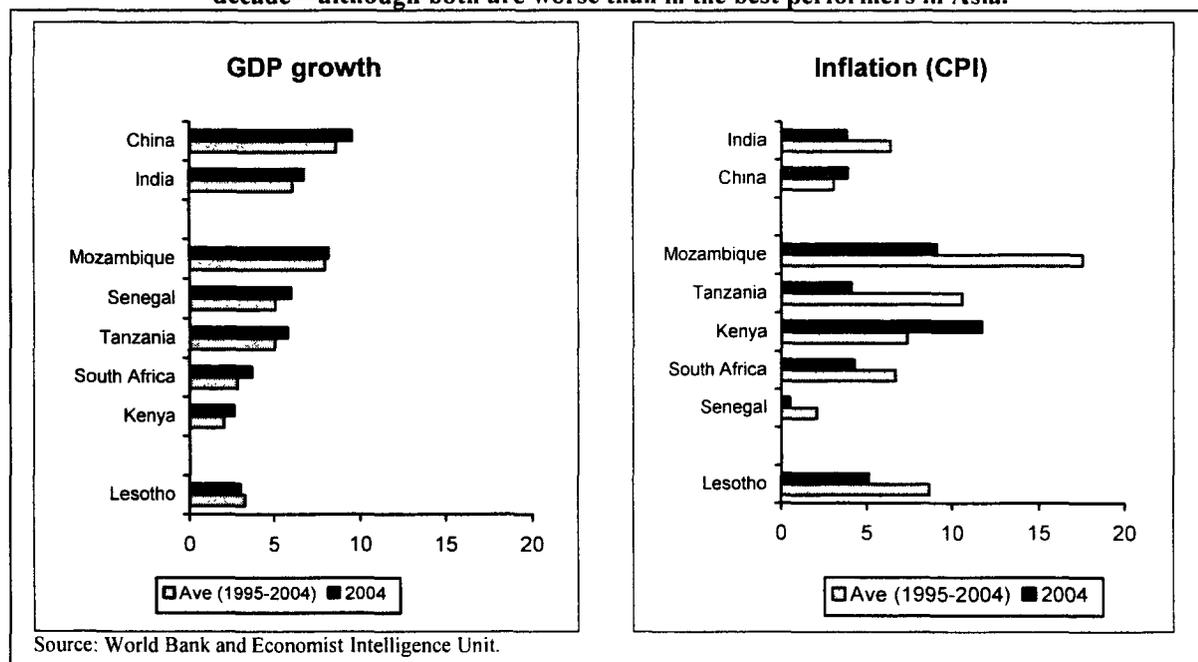
Growth. Lesotho's economy has not expanded at a consistent rate over the past twenty-five years and its development strategies have had only a limited impact on poverty reduction. Three distinct phases—defined with respect to LHWP activity—characterize Lesotho's economy over the past quarter of a century.

- Between 1980/81 and 1986/87, the pre-LHWP period, GDP grew at an average rate of 2.8 percent per year. Only 57 percent of Lesotho's GNP was produced domestically, with households relying upon remittances from RSA for much of their income.
- Between 1987/88 and 1997/98, the high-LHWP period, GDP growth averaged 6 percent per year. The garment industry developed over this period, while employment in mines in the RSA, and hence remittances, declined.
- After 1998/99, the post-LHWP period, GDP growth slowed to about 3 percent per year. The flow of LHWP-related loans and grants slowed significantly and services and manufacturing,

especially garment exports, expanded rapidly. Lesotho has become less reliant upon the RSA over this period.

Despite the positive shocks due to the LHWP and the rapid expansion in garments, growth over the past decade has been similar in Lesotho to most other countries in SACU, except Botswana, and to the average for Sub-Saharan Africa (see Table 4). Growth compares less favorably with countries in the fastest growing regions of the world—for example, it has been far slower than in China and India, Lesotho's competitors in the garments industry.

Figure 4: Lesotho has enjoyed moderate economic growth and modest inflation over the past decade—although both are worse than in the best performers in Asia.



Primary sector. The primary sector's share of GDP declined between 1980/81 and 2003/04. Unlike other sectors, the primary sector was protected from structural shocks. But its performance was vulnerable to cycles of droughts and good weather, resource degradation and institutional factors. Growth has been highly unstable, varying between close to zero in the pre-LHWP era to about 2 percent during the high-LHWP. Since 1999/00, the primary sector has grown at an annual rate of only 0.5 percent.

Secondary sector. The fastest growing sub-sectors in the secondary sector are construction, utilities and manufacturing. Prior to the LHWP, electricity and water accounted for less than 1 percent, while manufacturing and local construction each contributed about 10 percent of GDP. Subsequently, the FDI-financed LHWP-construction sub-sector grew at 116 percent per year and

contributed 6 percent of GDP during the high-LHWP period. Although its inter-sectoral linkages were relatively weak, the LHWP had positive spillovers for utilities and construction. In recent years, with the winding down of the LHWP, construction has contracted sharply; in 2002/03, LHWP-related construction contributed only 2 percent of GDP. But utilities and local non-LHWP construction are performing well. They jointly account for about 20 percent of GDP.

Foreign financed, export-oriented investment in garments resulted in rapid growth in manufacturing (8-10 percent per year) during the 1980s and 1990s. After reaching a critical size, growth in the sector settled at about 5 percent per year. Since 2001, the United States' Africa Growth and Opportunities Act (AGOA) provided further opportunities for expansion. By 2003/04, manufacturing accounted for nearly 17 percent of GDP. Overall, the secondary sector accounted for 38 percent of GDP, up from 22 percent in the pre-LHWP period. Excluding LHWP-construction, the secondary sector accounted for 35 percent of GDP in 2003/04, providing a substantial base for a modern economy.

Tertiary sector. The tertiary, or service, sector's share of GDP declined marginally between the pre- and post-LHWP periods. Except for post and telecommunications, wholesale and retail trade and, to a lesser extent, health and social services, all other service sub-sectors contracted. Significant contraction occurred in education, transportation, financial intermediation and residential real estate. In Lesotho, growth in services has generally moved in line with overall growth and is unlikely to increase unless growth in the rest of the economy does.

Investment. Due to substantial investment in the LHWP, gross domestic investment jumped from an average of 15 percent of GDP in the pre-LHWP period to 47 percent of GDP during the high LHWP period. While this investment started to taper off towards the end of the 1990s, FDI in export-oriented manufacturing and construction picked up. As a result, gross domestic investment has remained at around 40 percent of GDP.

Foreign savings financed much of the domestic investment during the high-LHWP period. As national savings were insufficient and financial intermediation weak, the economy's reliance on foreign savings increased to 17 percent of GNP per year during the high-LHWP era. Since 1999/00, Lesotho's reliance on foreign savings has remained high (see Table 5). This underscores the importance of maintaining a favorable investment climate that can (i) continue to attract foreign

savings to finance growth in Lesotho; and (ii) retain domestic savings in Lesotho, rather than having them flow into private bank accounts in South Africa.

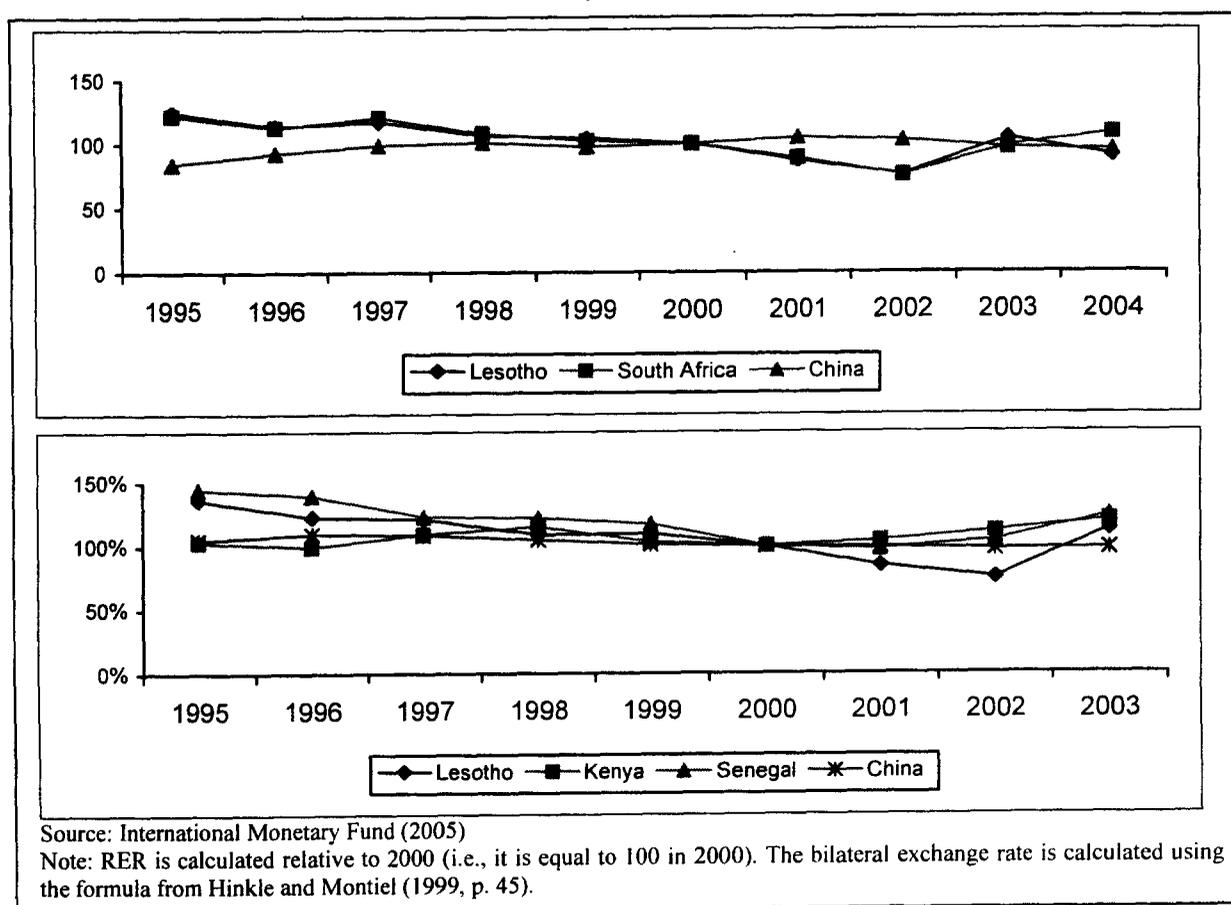
III. ECONOMIC MANAGEMENT

Inflation and exchange rate. As a member of the Common Monetary Area (CMA) and SACU, exchange and interest rates in Lesotho are heavily influenced by South Africa's macroeconomic policy. Lesotho's inflation rate has typically lagged South African inflation. CPI inflation declined from 14 percent per year during the pre-LHWP era to 8 percent in the post-LHWP period. Although inflation has not been especially high in Lesotho over the past decade, it remains slightly higher than in many of the better performing comparator countries (see Figure 4)

The Loti, pegged at par with the South African Rand, has depreciated steadily, averaging 19, 7 and 6 percent per year during the pre-, high- and post-LHWP periods. In 2000, the exchange rate was about 6.9 Rand per dollar. Over the next few years, the Rand weakened against the dollar, with the exchange rate averaging 10.5 Rand per dollar in 2002 and reaching over 12 Rand per dollar at the beginning of the year. The Rand then strengthened, reaching 5.6 Rand per dollar at the end of 2004, rising to around 6.6 Rand per dollar by the end of June 2005.

Although these fluctuations partially reflect the changing value of the U.S. dollar against other major currencies, the bilateral real exchange rate has been far more volatile for Lesotho than for many of the comparator countries (see Figure 5). Although the Rand (and therefore the Loti) has appreciated against most currencies since 2002, the appreciation against the Euro and the British Pound has been far more modest than its appreciation against the US dollar (29 percent against the Euro, 35 percent against the British Pound and 67 percent against the US dollar in real terms). Given Lesotho's heavy reliance on garment exports to the United States, exchange rate instability against the US dollar is problematic.

Figure 5: The real exchange rate, however, has been relatively unstable over the past decade, especially over the past five years.



Fiscal policy. Because of the currency peg, fiscal policy has been the main instrument of demand management in Lesotho. As monetary policy has been anchored to preserve the peg, fiscal restraint has been a key to improving external competitiveness.⁶

Since the late 1980s, Lesotho's fiscal situation has been relatively comfortable. Total revenues were about 47 percent of GDP in the high LHWP period. The largest component was SACU receipts, which accounted for nearly half of total revenues. Due to a decline in construction materials for the LHSP in the post-LHWP period, SACU revenues declined from 27 percent of GDP to about 20 percent of GDP. Total revenues also declined to about 40 percent of GDP. Receipts from the SACU revenue sharing formula have allowed an exceptionally high level of

⁶ World Bank (2003) noted that fiscal deficits had fallen to about 3 percent of GNP by 2003 and that debt service obligations remained manageable (about 10 percent of exports). International Monetary Fund (2004b) notes that the peg to South African Rand has reduced inflationary expectations and has meant that the primary goal of monetary policy is maintaining the peg.

public spending by African and developing country standards. Total expenditures accounted for nearly 50 percent of GDP in the 1990s. Since then it has averaged about 45 percent of GDP.

Nevertheless, Lesotho faces at least three challenges in this area. First, current expenditure growth must be controlled. Second, the efficiency of current spending and the quality of capital projects must be improved. And third, fiscal space from available fiscal surpluses and additional financing must be used to fund fighting HIV/AIDS pandemic, raise the quality and quantity of technical education, and build the physical infrastructure. If these challenges are not met, this will further erode both growth and the existing fiscal headroom.

IV. EXTERNAL SECTOR DEVELOPMENTS

Trade. Lesotho is a highly open economy and trade has been central to its economic fortunes. Partly because of its narrow productive base, imports are equal to close to 79 percent of GNP. Almost everything the Basotho consume, including food, clothing, machinery, and services are imported from South Africa.

As a member of SACU, Lesotho applies common customs tariffs, excise duties, valuation method, origin rules, and contingency trade measures. The simple average common MFN tariff rate is 11.2 percent, but the tariff system remains complex comprising ad valorem, specific, mixed, compound, and formula duties based on reference prices. Ad valorem rates (39 bands) range from zero to 55 percent with more than half of the lines bearing a zero rate. In addition to customs tariffs, imports are subject to excise duties, levies, and VAT. On the IMF's 10-point scale that measures trade restrictiveness, SACU receives a rating of 5 (higher values are more restrictive).

Exports of goods increased significantly during the high-LHWP period. After stagnating in the pre-LHWP period, they grew at an annual rate of 18 percent. In the post-LHWP period, growth accelerated to about 20 percent per year, primarily due to increased exports of garments to the United States. In the past two years (2002/03-2003/04), exports of goods have grown at over 30 percent per year. By 2003/04, exports were equal to about US\$ 505 million or over 40 percent of GDP.

Lesotho's garment exports increased from US\$ 100 million in 1999 to about US\$ 350 million in 2004/05. This has been possible largely because of the duty and quota-free access to the U.S.

market provided by the African Growth and Opportunity Act (AGOA), which will remain in place until 2015. Importantly, Lesotho has been granted less developed country (LDC) status under AGOA, allowing it to import inputs from non-members. This facility, which was set to expire in 2004, was renewed until the end of 2007.

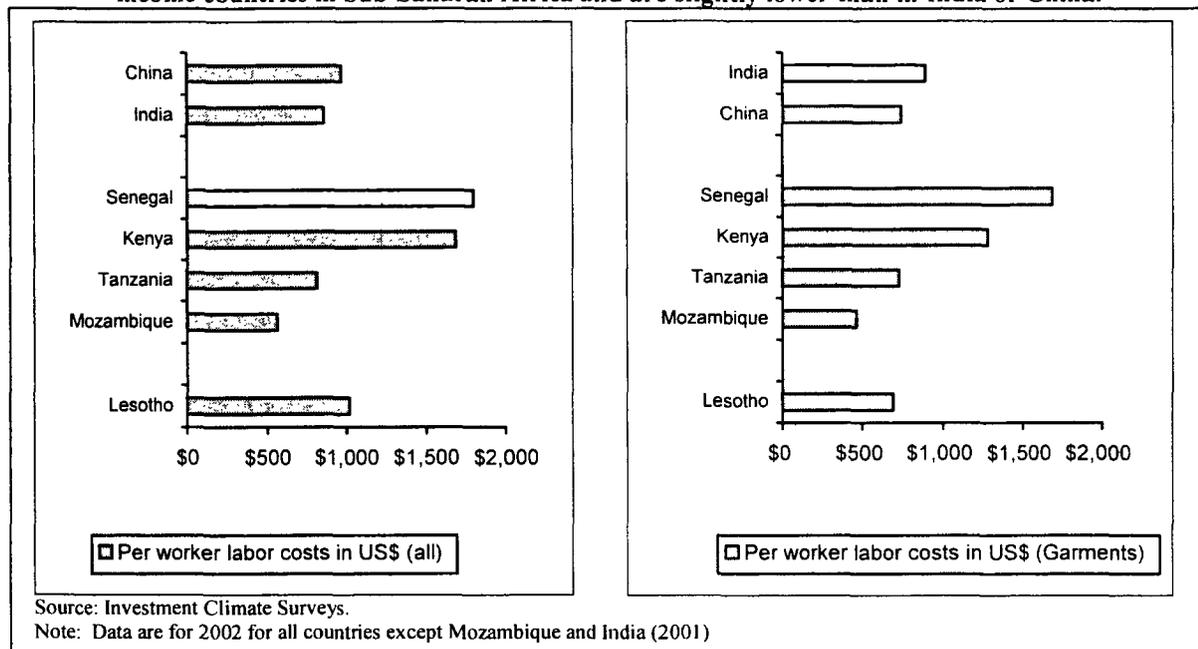
Despite its recent growth, Lesotho's garment industry will face several challenges over the next few years. The nominal appreciation of the rand (and therefore the loti) from about M12/US\$ at the beginning of 2002 to about M6/US\$ by mid-2005 has posed a serious challenge for garment exporters. In addition, the phasing-out of textile quota under the MFA at the start of 2005 has increased competition in the US market—Chinese and Indian exports to the US increased by 43 and 25 percent respectively in the first eight months of 2005 compared to the same period in the previous year. Going forward, the elimination of Lesotho's LDC status under AGOA in 2007 coupled with multilateral tariff reduction of non-agricultural products under the Doha round will further erode Lesotho's preferences.

CHAPTER 2: AN ANALYSIS OF FIRM PERFORMANCE

I. LABOR COSTS

How competitive are firms from Lesotho in international markets? To answer this question we looked at labor costs, labor productivity and capital productivity. On one measure they appear competitive—wage and salary costs are lower, or about the same, in Lesotho as they are in most of the comparator countries (see Figure 6). In 2002, annual per worker labor costs were about \$1000 for the average firm in the manufacturing sector—higher than in Mozambique or Tanzania, but considerably lower than in Kenya or Senegal. Although per worker labor costs were slightly higher in Lesotho than in India or China, the difference was modest. Labor costs were far lower than in South Africa, where annual labor costs were \$7300 per worker.⁷

Figure 6: Labor costs are significantly lower in the garments sector in Lesotho than in the low-income countries in Sub-Saharan Africa and are slightly lower than in India or China.



Because of differences in skill requirements, ratios of managers to workers and many other factors, labor costs typically differ across sectors. Differences between countries might therefore

⁷ Because of the large difference between costs and productivity in South Africa and Lesotho, South Africa is omitted from several figures in this chapter.

reflect sectoral differences in the samples rather than differences in underlying costs. To partially control for this, we also look at labor costs in a single sector—the garments sector.

Wages are lower in the garments sector than they are overall in all seven countries, including Lesotho. There were also some differences in the cross-country comparisons. Most notably, although labor costs were slightly higher in Lesotho than in China, India or Tanzania overall, they were slightly lower in the garments sector.

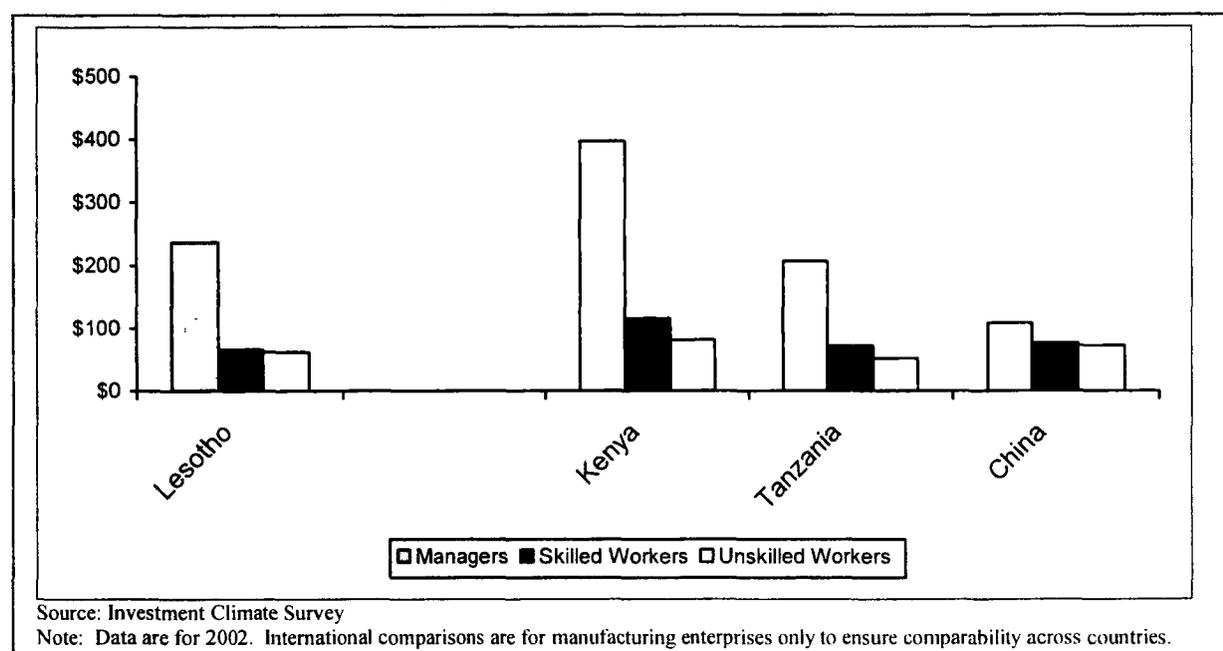
In addition to the aggregate data on wages, firms were also asked to provide information on salaries of various types of workers: management, skilled production workers, unskilled production workers and non-production workers. The distinction between skilled and unskilled workers was partially left to the managers to define themselves—that is, workers would be classified as skilled if they were technicians or supervisors directly involved in the production process and management considered them to be skilled.

Perhaps due to the slightly ambiguous definitions, the difference in salaries between skilled and unskilled workers was small—median wages for skilled and unskilled workers were about \$66 and \$62 per month in Lesotho. Salaries of skilled and unskilled production workers were lower in Lesotho than in either Kenya or China. In Kenya, they were \$116 and \$81, while they were \$76 and \$72 in China. Wages for unskilled workers were slightly lower in Tanzania, but were slightly higher for skilled workers.

Differences for managers were more pronounced. The median salary for managers was lower in Lesotho than in Kenya, was similar to Tanzania and was considerably higher than in China. As a result, wage inequality at the firm-level is far higher in the three African countries than in China. The relatively low levels of wage inequality for firms in the Investment Climate Survey for China are consistent with evidence from other sources.⁸

⁸ For example, using data from China Labor Statistical Yearbook, Li and Xu (2003) show that workers with college degrees make only about 50 percent more on average than similar workers with junior middle school level education.

Figure 7: Wages for unskilled and skilled workers in Lesotho are slightly lower than in China, while managerial salaries are considerably higher.



Within Lesotho, there were some differences between sectors for skilled and unskilled workers. In the garments sector, the median firm reported salaries of 650 Maloti for skilled workers and 600 Maloti for unskilled workers. Median salaries were slightly higher in other manufacturing firms and the hotel sector—about 700 Maloti for skilled workers and between 600 and 700 Maloti for unskilled workers. Salaries for both skilled and unskilled workers in the construction industry were higher. Median salaries for managers were similar in most sectors—although managers in the hotel sector appear to get slightly less than managers in other sectors.

Table 6: Monthly salaries for different types of worker (in maloti), by firm type.

	Management	Skilled Production Workers	Unskilled Production Workers	Non-Production Workers
Manufacturing	2500	700	650	650
Garments	2900	650	600	621
Construction	2850	2580	900	---
Hotel	2064	699	618	---
Foreign	3400	700	621	650
Domestic	1890	665	650	658

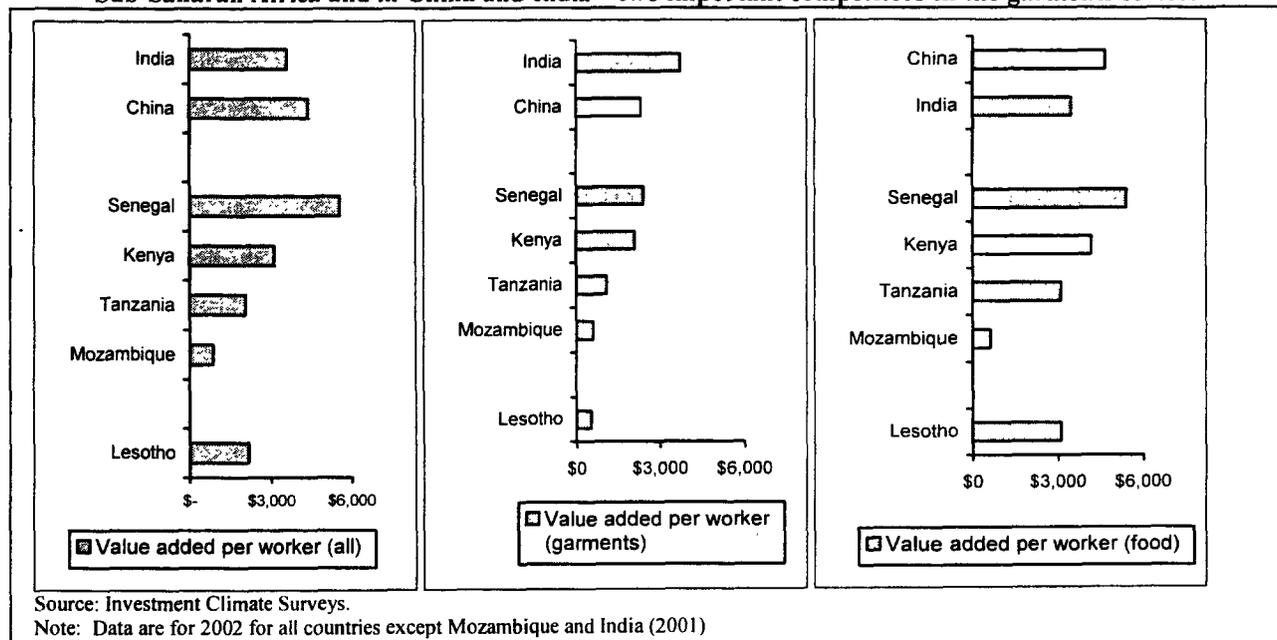
Previous work has noted that the management wages tend to be high in foreign-owned firms in Lesotho—reflecting the high cost of hiring expatriate managers (Pawlowska, 2004). The results from the Investment Climate Survey are consistent with this—managers in foreign-owned firms

earn considerably more than managers of domestically-owned firms (3400 compared to 1900 maloti). In part, this is because foreign-owned firms are larger. But even for large firms, managers in foreign-owned firms earn more. In large foreign-owned firms, the median monthly salary was about 3500 maloti compared to 3150 for large domestic firms. Because salaries for production workers were similar in foreign and domestic firms, this means that the salary gap between management and production workers is greater in foreign-owned firms.

II. LABOR PRODUCTIVITY

Although labor costs are relatively low, labor productivity (value-added per worker) is also low (see Figure 8). Labor productivity is lower in both Mozambique and Tanzania than in Lesotho, but it is about 50 percent higher in Kenya and is over twice as high in Senegal. Labor productivity is also higher in the fast growing Asian economies of China and India—median labor productivity is almost twice as high in China as in Lesotho and is fifty percent higher in India. Labor productivity in South Africa, which is omitted from the figures to make visual comparisons easier, is about \$14,000 per worker.

Figure 8: Labor productivity is lower in Lesotho than in the most productive low-income economies in Sub-Saharan Africa and in China and India—two important competitors in the garments sector.



In the garments and agro-processing industries, results are qualitatively similar—labor productivity in Lesotho is similar to, or higher than, Mozambique or Tanzania but is lower than in

Kenya, Senegal, China and India. In all countries except India, labor productivity is lower in the garment sector than it is overall.

Although labor productivity appears to be especially low in the garments sector in Lesotho relative to the comparator countries, this is based upon a very small number of observations in Lesotho.⁹ Since not all firms provided enough information to calculate value-added, we have enough data to calculate value-added per worker for only about 10 garments producers. Because productivity shocks tend to be large, productivity data tends to vary considerably from year-to-year in small samples. When labor productivity is calculated for garments firms in 2001 rather than 2002, it is higher than in Tanzania or Mozambique, but remains lower than in Senegal, Kenya, China or India. For 2000, it is lower for garment firms in Lesotho than in any of the comparator countries.

So what is the net impact of low productivity and low labor costs on international competitiveness? Unit labor costs—wages and salaries as a percent of value-added—provide one way of comparing labor costs across countries after taking differences in productivity into account. High unit labor costs mean that wages and salaries are high as a share of value-added. This measure is preferably to value-added per worker because it controls for differences due to exchange rate fluctuations and labor quality better than value-added per worker.

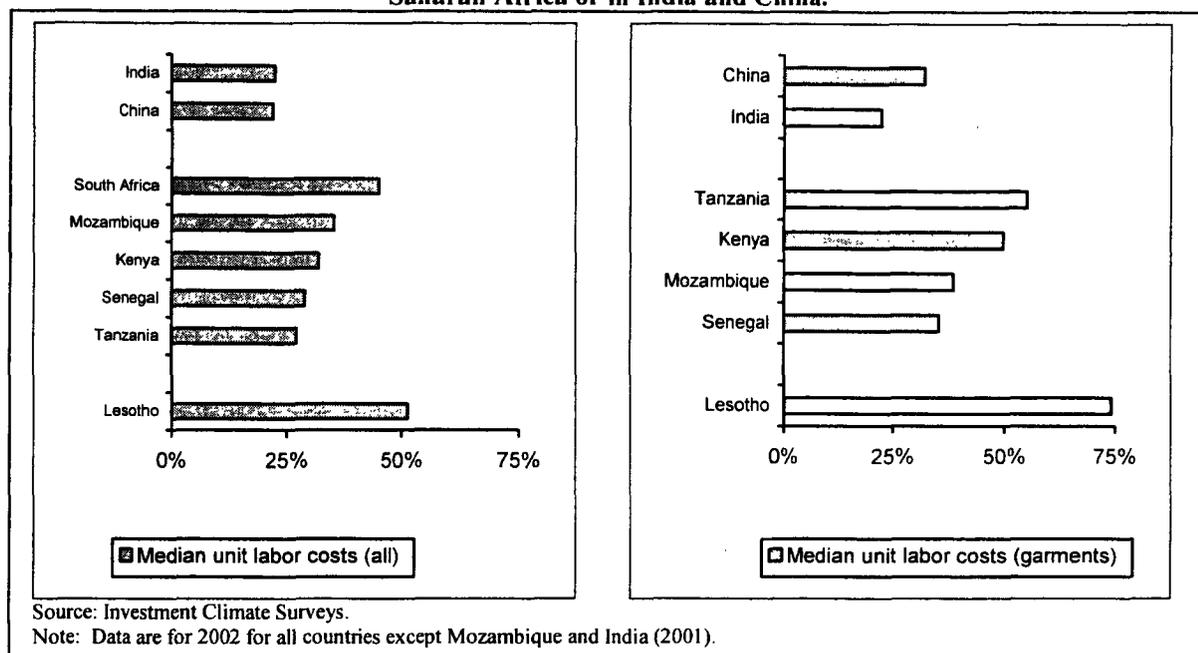
Unit labor costs are relatively high in Lesotho—labor costs were equal to about 50 percent of value-added overall and were equal to about 75 percent of value-added in the garments sector (see Figure 9). Although this might reflect the use of labor-intensive technologies, it is important to note that this is exceptionally high. It is higher than in any of the comparator countries in Sub-Saharan Africa, including South Africa, or in India or China.

As before, it is important to note that the sample for Lesotho is relatively small. As a result, small productivity shocks in a few firms can result in large changes in measured productivity. When unit labor costs are calculated using 2001 data, unit labor costs appear significantly lower—34 percent in 2001 compared to 51 percent in 2002. But this remains higher than in any of the comparator countries except Mozambique and South Africa. For example, unit labor costs in China

⁹ Samples for the comparator countries, especially China and India, tend to be far larger.

and India are only about 22 percent. Median unit labor costs in the garment sector are relatively close in the two years—67 percent in 2001 and 74 percent in 2002. Both are higher than in any of the comparator countries and are considerably higher than in China or India (22 percent and 32 percent respectively).

Figure 9: But labor costs are higher as a percent of value added in Lesotho than elsewhere in sub-Saharan Africa or in India and China.



These findings appear consistent with other studies that have used different methodologies. In particular, a value-chain analysis of a large T-shirt factory in Lesotho found that productivity was lower in that firm than in similar firms in Kenya (Global Development Solutions, 2004). Whereas the average production worker produced about 16 T-shirts per day in Lesotho, the average worker produced between 20 and 25 in Kenya. In addition, the value-chain analysis highlighted other differences that will further reduce productivity in Lesotho. For example, there was one line supervisor for every four workers in Lesotho compared to one for every six workers in Kenya and the in-line defect rate was 2-3 percent in Lesotho compared to only 1 percent in Kenya.

III. WORKER EDUCATION AND TRAINING

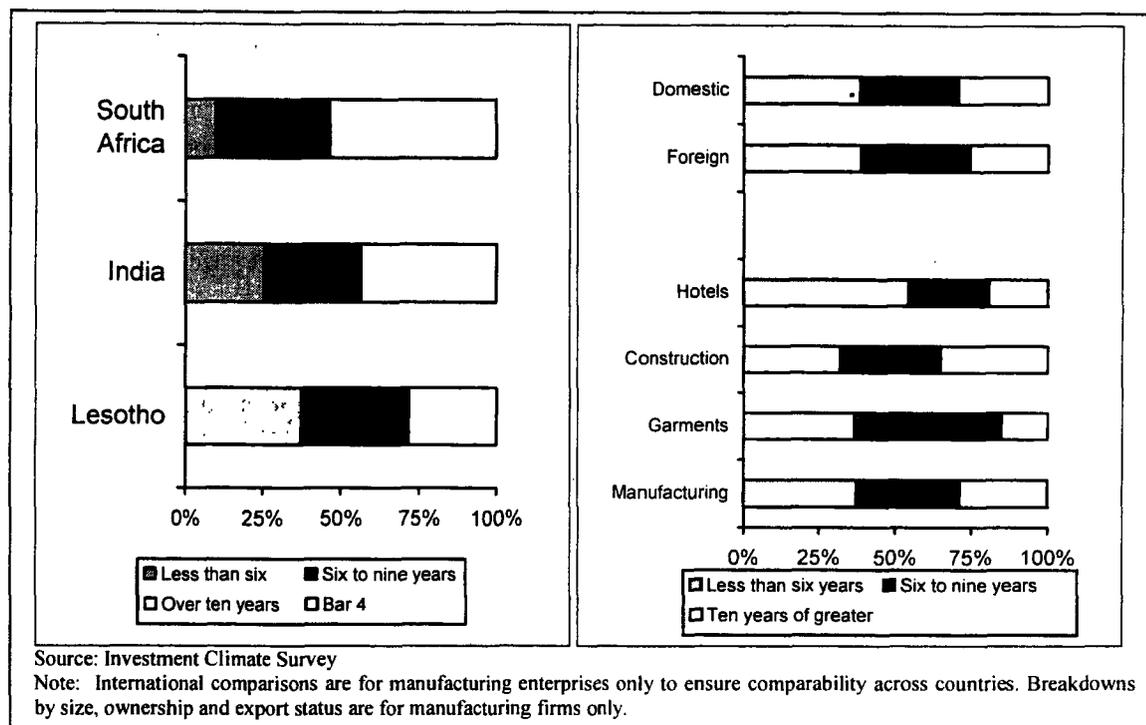
Why is labor productivity lower in Lesotho than in the better performing comparator countries? One possibility is that firms in Lesotho might be inefficient. A firm might produce relatively little because it does not use its employees as efficiently as another firm—for example, it

might not train its workers well or might have too many, or too few, supervisory staff. The rapid growth of the garments sector might also contribute to low productivity—when firms rapidly expand they might not use their inputs (capital and labor) as efficiently immediately as the will in the medium- to long-term. Another possible explanation is that worker skills and training might be low in Lesotho. Since value added per worker does not distinguish between workers with different skills and levels of educational attainment, low productivity could be due to differences in human capital.

Although most Investment Climate Surveys collect data on worker education, it is often difficult to compare data across countries. Unfortunately, the data on worker education collected in the Investment Climate Survey for Lesotho is only easily comparable with data from the South Africa and India Investment Climate Surveys.

Compared to these countries—both of which are richer than Lesotho, worker education appears to be relatively low in Lesotho (see Figure 10). Only about one quarter of workers in Lesotho have ten years or more of education. In comparison, close to half of the workers in India and over half of the workers in South Africa have the same. The low level of educational attainment among worker in Lesotho might partially explain the low labor productivity in the country.

Figure 10: Workers in Lesotho have less education than workers in India or South Africa



This is consistent with previous studies that have noted that although literacy rates are high (about 72 percent for adults over 15), there is a dramatic falloff in enrollment between primary and secondary school—more than 80 percent of primary school students drop out before completing secondary school (World Bank, 2004c). About 75 percent of individuals not attending school indicated that expense was the primary reason (World Bank, 2003).

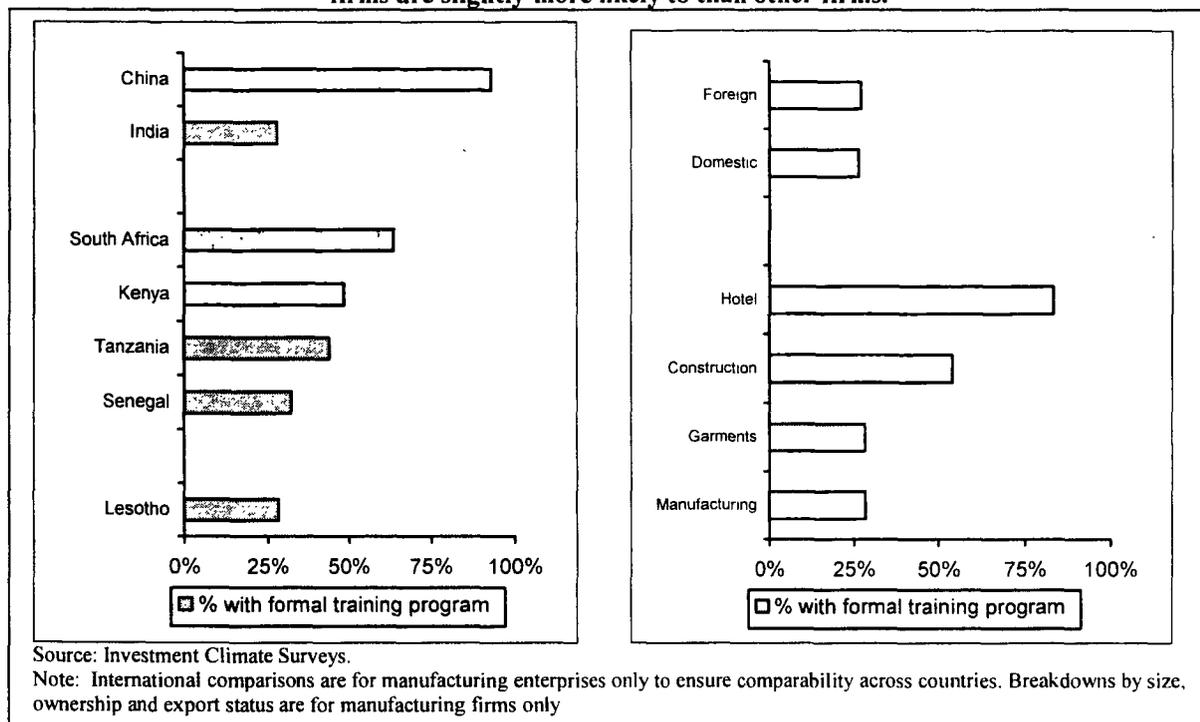
Worker education was considerably lower in the textiles and hotel sectors than in other manufacturing or construction. Only 15 percent of workers in garments firms had over ten years of education compared to about 40 percent of workers in manufacturing firms outside of the garments sector. The low educational attainment of workers in the garments sector might partially explain the low productivity observed in the sector. Despite the large difference between garments and other firms, attainment was only slightly lower in foreign-owned firms than in domestic firms.

The low education levels are worrying for another reason—skilled and educated workers have far better employment opportunities—and earn higher salaries when they are employed—in Lesotho. One study found that whereas about 80 percent of individuals with a diploma/A-level or

higher level of education were employed in the early 2000s, only about 40 percent of those with less education were (World Bank, 2003).¹⁰ Similarly, 75 percent of individuals with technical training were employed (World Bank, 2003). This emphasizes the important of education in boosting employment and wages as well as improving labor productivity and increasing upward labor mobility.

Despite the low level of education attainment, relatively few companies in Lesotho have formal training programs—only about 28 percent (see Figure 11). Although this is similar to India and Senegal, it is far lower than in South Africa or China and is slightly lower than in Tanzania or Kenya.

Figure 11: Few companies in Lesotho have formal training programs – although foreign-owned firms are slightly more likely to than other firms.



Manufacturing firms, including in the garments sector, were less likely to have formal training programs than construction firms or hotels. Over four out of five hotels had formal training programs, as did over half of construction firms. Within the manufacturing sector, differences were generally small. Although firms in the garment sector were less likely to have formal training

¹⁰ However, the high returns to education might also reflect the shortage of workers with these skills.

programs than other firms, foreign-owned firms were slightly more likely to have formal training programs than domestic firms.

Firms without programs were also asked why they did not have one. The most common response—80 percent of firms included it among their reasons for not training—was that there was no need for formal training because informal, on-the-job training was sufficient. Only about one-quarter of firms said that limited government incentives were a constraint and very few firms (only about 10 percent) said that they could not define their training needs or that staff were uninterested in learning new skills.

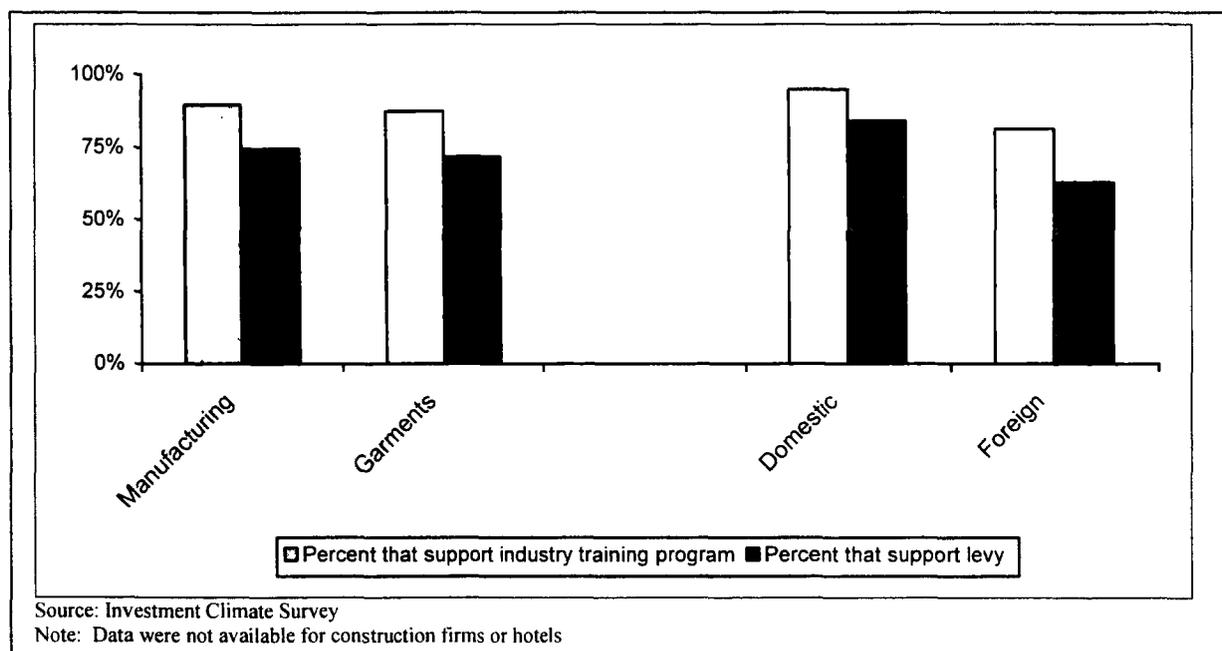
About 50 percent of firms said that it was too risky training staff because of staff turnover. One problem is that skilled workers often seek employment in South Africa, where wages are higher than in Lesotho (World Bank, 2003; 2004c). A second problem, mentioned during field interviews, is that because exports and production were expanding rapidly between 2000 and 2004 in Lesotho, there was very high demand for experienced and skilled workers. Experienced workers who quit their jobs could quickly find another job in the sector. If workers are unsure about whether alternate employment is available, they will generally be less willing to quit and turnover will generally be lower.

About 30 percent of firms said limited external training opportunities played a role in their decision. Even when training programs exist, they often appear to be relatively unsuccessful. For example, a recent World Bank study found that although the School of Commerce and Applied studies provides a two-year program in the areas of tailoring and dressmaking, fewer than 5 percent of its students managed to find employment at any of the Garments producers (World Bank, 2004c). The report attributed this to a mismatch between the skills that were taught and the skills that these firms require.

Although few firms have formal training programs, there is broad support for the idea of an industry-led and managed training program—close to 90 percent of enterprises said that they would be willing to participate (see Figure 12). It is important to note, however, that the private sector should be involved in designing and running any such program. An earlier study found strong opposition to a purely public program, especially among garment firms due to concerns about the effectiveness of these programs (World Bank, 2004c).

Firms were also generally willing to contribute to this program. About three quarters of firms said that they would support a levy to finance training schemes. Support was higher among foreign-owned firms than it was among domestic firms. The introduction of a training levy would provide a sustainable source of financing for technical and vocational training.

Figure 12: Most firms supported industry led and managed training programs and most were willing to accept levies to finance training schemes.

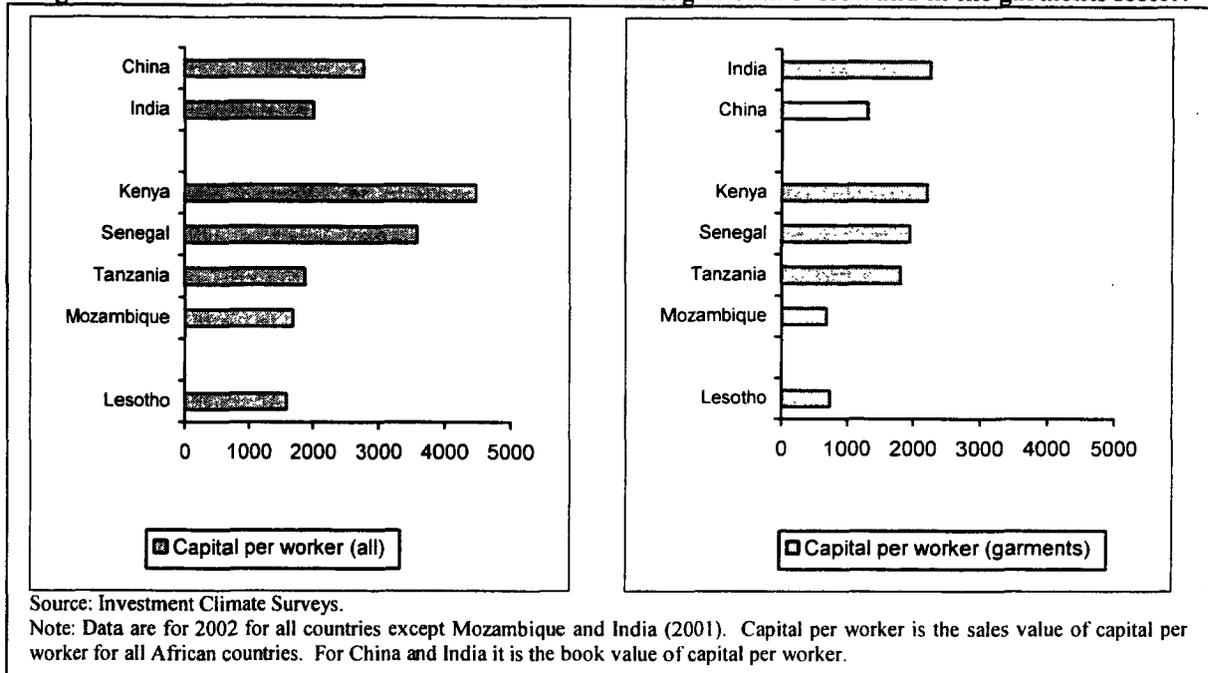


IV. CAPITAL PRODUCTIVITY

Another factor that explains differences between firms is how much capital, or machinery and equipment, the firm has. In general, firms that have more and better equipment will produce more value-added per worker. Firms in Lesotho appear to have relatively low levels of capital per worker—that is, they appear to be highly labor intensive (see Figure 13). The median firm in Lesotho has about \$1600 of capital per worker, lower than in any of the comparator countries. For example, the median firm in India has about \$2000 of capital per worker and the median firm in China has about \$2800 of capital per worker.¹¹

¹¹ Comparable data were not available for firms in South Africa. However, most evidence suggest that they are very capital intensive.

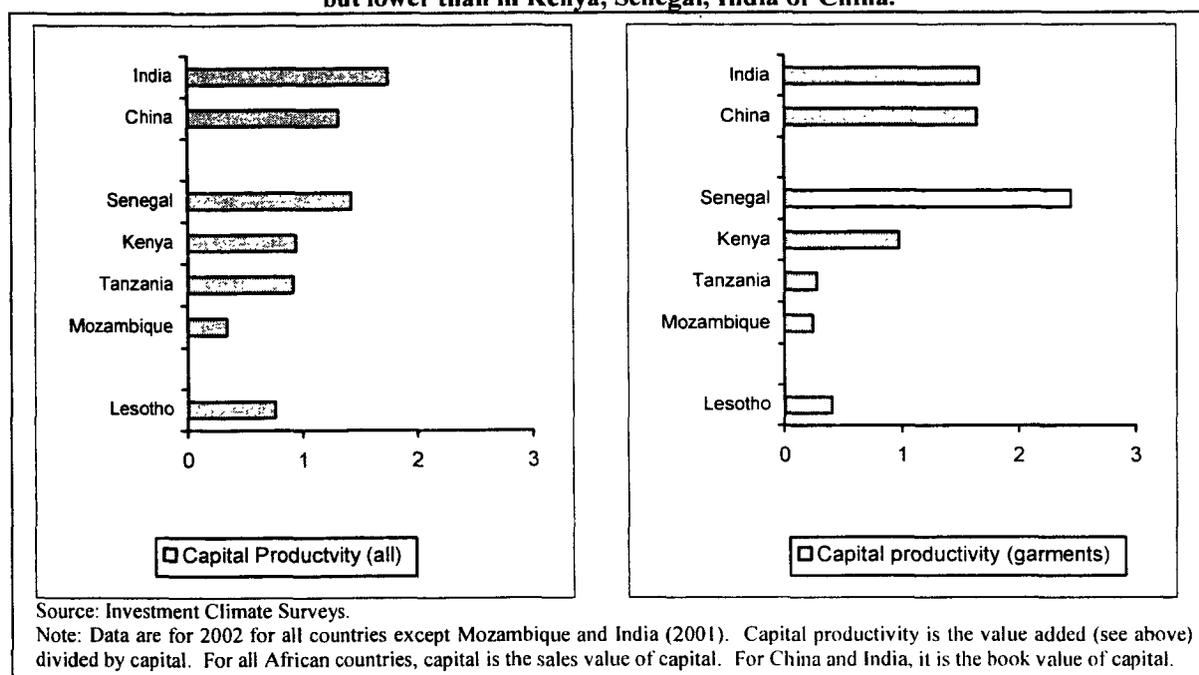
Figure 13: Firms in Lesotho use labor intensive technologies both overall and in the garments sector.



Firms in the garments sector tend to be relatively labor intensive in most countries—they use less capital per worker than firms in many other manufacturing sub-sectors. This is true for the firms in the Investment Climate Surveys—garment manufacturers have less capital per worker than other firms in the same countries. For example, the median garment firm in Lesotho has about \$750 of capital per worker, about one-half the capital of the median manufacturing firm. Garment firms in Lesotho also appear to be more labor intensive than garments firms in the comparator countries.

An analogous measure to unit labor costs for capital is capital productivity (value-added divided by capital). High levels of capital productivity mean that firms produce high levels of output with little machinery. In general, capital productivity is usually higher for labor intensive firms (i.e., they produce more output with less capital) than capital intensive firms. Although capital productivity is higher in Lesotho than in Mozambique—and is similar to capital productivity in Kenya, it is lower than in either India or China. In the garments sector, capital productivity is higher than in Tanzania or Mozambique but remains lower than in the other comparator countries including India and China.

Figure 14: Capital productivity is higher than in Mozambique and Tanzania in the garments sector, but lower than in Kenya, Senegal, India or China.



Total factor productivity is a more general measure of productivity that takes into account use of both capital and labor. It essentially measures how much output the firm produces after taking into account how much labor, capital and intermediate inputs the firm uses. Because it takes into account both capital and labor use, it is more general than either capital or labor productivity. Unfortunately, calculating total factor productivity is more complicated and more data intensive than calculating labor productivity. Because of the very small number of firms that have data for value added, labor, and capital, we do not attempt to do this for Lesotho.

In summary, although wages are relatively low in Lesotho, productivity is also relatively lower. As a result, unit labor costs remain high compared to the best performing economies in Africa and Asia. The high costs reflects both that manufacturing remains highly labor intensive and that labor skills remain low. Despite low worker skills, few firms have training programs.

CHAPTER 4: THE INVESTMENT CLIMATE IN LESOTHO

In addition to collecting information on firm productivity, the Investment Climate Survey also collects information on the quality of the investment climate—including on topics such as infrastructure, access to finance, crime and security, regulation, corruption, and taxation. Two types of information are collected: (i) perception-based measures that ask managers what they see as the major obstacles that their firm faces; and (ii) objective indicators such as production lost due to power outages, whether the firm has a loan or overdraft facility, and amount of time managers spend dealing with government regulations. In this section of the report, we use both types of indicator—and supplementary information from other sources—to assess constraints to enterprise operations and growth in Lesotho and compare these with constraints in the comparator countries.

I. PERCEPTIONS ABOUT PROBLEMS FOR ENTERPRISE OPERATIONS AND GROWTH

The Investment Climate Survey asks firms to rate various areas of the investment climate and to say how serious an obstacle they are to enterprise operations and growth. Perception-based measures provide a good starting place for an analysis of the investment climate. Although they suffer from several problems, an enterprise manager probably has a better grasp of the immediate problems facing his or her business than government officials, academic researchers, or other outside experts.

But perception-based measures have several drawbacks. First, it is difficult to quantify and aggregate perception-based data across firms. Consequently, it is difficult to assess exactly what would need to be done to reduce the constraint. Second, although managers may be aware of a problem, they might not be aware of the underlying causes. For example, managers might know that it is difficult use bank loans to finance new investment, but might not know the underlying reasons for this (e.g., lack of competition in the banking sector, government debt issues crowding out private investment or problems with land registration that prevent them from using land as collateral). Third, enterprise managers' interests might not always be consistent with society's. Most managers would like subsidized credit or to be charged less for power or water if they believed that the cost of providing these services would be borne by someone else. Similarly, most managers would be happy to face less competition even if the cost to society outweighed the benefits to their firm. Fourth, the perceptions of managers of existing enterprises might not reflect

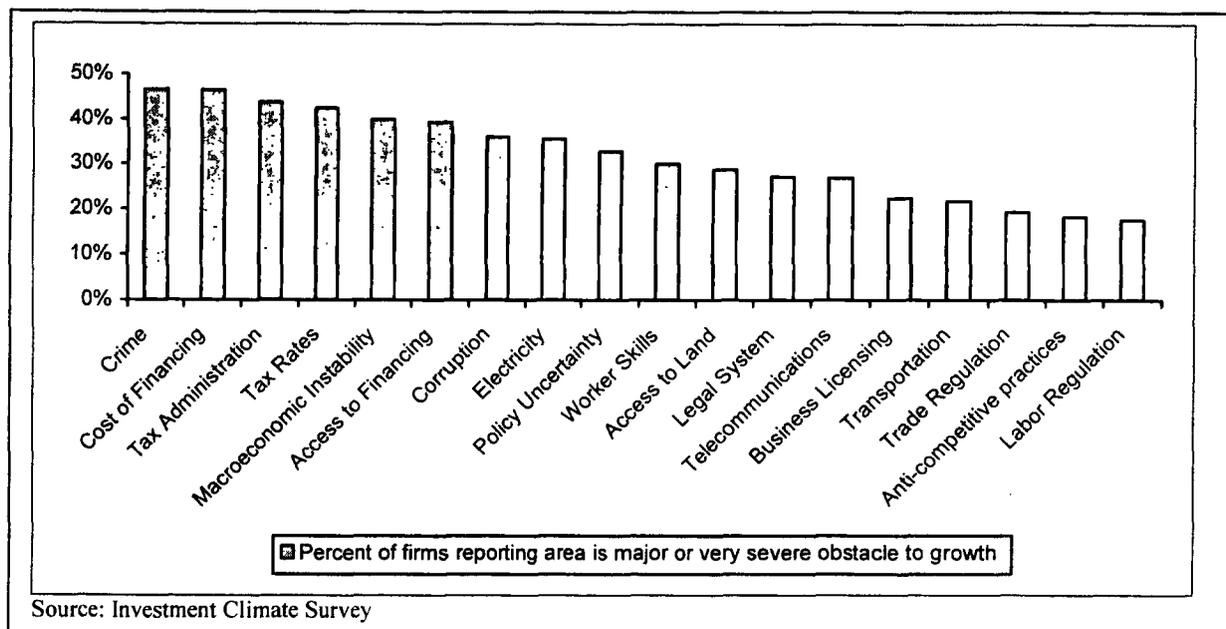
all obstacles to private sector growth. Managers of existing enterprises that have already completed registration procedures might not be concerned about entry costs even if they remain high. Similarly, they might rate some issues as lesser problems because they have structured their businesses in ways to minimize those costs. For example, if transportation costs are especially high in some areas, existing firms might only be located close to transportation facilities. Finally, because firms' experiences and expectations differ significantly between countries, it is difficult to compare perceptions across countries.

Because of these concerns, although we use the perception based data as a starting point, we supplement this information with objective measures of the investment climate taken from the ICS and other sources when appropriate. This section of the paper discusses the perception based measures, while later sections discuss specific issues in greater detail supplementing this information with objective data. The additional objective data allow us to benchmark Lesotho's investment climate against the investment climates of other countries.

I.1 Perceptions about barriers to growth

Managers of manufacturing firms in Lesotho were most concerned about crime, finance, taxation, and macroeconomic instability (see Figure 15). Over 40 percent of managers rated each of these issues as a major or very severe problem. These were not the only issues, however, that they saw as significant problems. Over one-third rated corruption and electricity as major or very problems and over one-quarter rated policy uncertainty, workers skills, access to land, legal systems and telecommunications as the same.

Figure 15: Crime, financing, taxes, macroeconomic instability and corruption are firms' biggest concerns.



I.2 Differences in perceptions across different firms

There were, however, some significant differences across firm type (see Table 7). The only issue that managers of all types of firm rated as a serious problem was crime, theft, and disorder. Over forty percent of firms of all types rated crime as a serious problem. And firms of all types, except non-exporters, rated it among the top five problems.

Although crime was the only issue that firms consistently rated as a serious problem, some additional issues were consistently rated as minor problems—few firms of any type rated trade regulation, anti-competitive practices and labor regulation as serious obstacles. Construction firms were more likely to rate business licensing and transportation as a serious obstacle than other types of firms, but otherwise enterprises were also unlikely to see these as major issues either.

Table 7: Percent of firms that rated issues as serious obstacles, by enterprise type.

	Sector				Ownership		Export Status	
	Manufacturing	Garments	Construction	Hotels	Foreign-Owned	Domestic Owned	Export	Non-Exporters
Crime, theft and disorder	46.6%	45.5%	53.3%	---	53.1%	44.7%	50.0%	46.9%
Cost of Financing	46.4%	32.3%	57.1%	53.3%	25.8%	65.7%	35.5%	61.3%
Tax Administration	43.8%	36.4%	53.3%	18.8%	41.9%	44.7%	32.4%	50.0%
Tax Rates	42.5%	30.3%	40.0%	37.5%	35.5%	50.0%	23.5%	59.4%
Macroeconomic Instability	40.0%	56.3%	42.9%	26.7%	41.9%	36.1%	53.1%	29.0%
Access to Financing	39.4%	34.4%	35.7%	29.4%	19.4%	56.8%	36.4%	38.7%
Corruption	36.1%	21.2%	46.7%	41.2%	25.0%	48.6%	26.5%	48.4%
Electricity	35.6%	39.4%	20.0%	33.3%	40.6%	32.4%	38.2%	25.0%
Policy Uncertainty	32.9%	19.4%	42.9%	---	32.3%	33.3%	21.9%	48.4%
Worker Skills and Education	30.1%	39.4%	13.3%	11.8%	40.6%	21.1%	41.2%	18.8%
Access to Land	28.8%	12.1%	33.3%	5.6%	15.6%	43.2%	11.8%	46.9%
Legal System	27.3%	25.0%	14.3%	11.8%	23.3%	33.3%	30.3%	26.9%
Telecommunications	27.0%	38.2%	33.3%	50.0%	31.3%	21.1%	34.3%	15.6%
Business Licensing	22.5%	18.2%	33.3%	22.2%	28.1%	19.4%	14.7%	26.7%
Transportation	21.9%	24.2%	33.3%	11.1%	19.4%	23.7%	20.6%	25.0%
Trade Regulation	19.4%	18.2%	13.3%	---	20.0%	21.1%	17.6%	22.6%
Anti-competitive practices	18.3%	15.6%	21.4%	11.8%	16.1%	21.6%	12.1%	22.6%
Labor Regulation	17.6%	14.7%	26.7%	22.2%	21.9%	15.8%	17.1%	21.9%

Source: Investment Climate Surveys

Note: The top 5 obstacles for enterprises of that type are in **bold**. Each column shows the percentage of firms of that type who rated each issue as either a 'major' or 'very severe' problem. The survey for hotels omitted some questions or asked about those areas in non-comparable ways. Export status and foreign ownership status refers to manufacturing firms only.

On other issues, there was a noticeable divergence of opinion. First, manufacturing firms that export were more likely to rate macroeconomic instability as a serious obstacle than any of the other obstacles. In contrast, few non-exporters were concerned about macroeconomic instability—over 50 percent of exporters, but only 29 percent of non-exporters rated macroeconomic instability as a serious obstacle. Although garment firms and foreign-owned firms were also likely to rate it as a serious obstacle, this is not surprising given that these firms are heavily involved in exporting.

As discussed in detail in Section V of this chapter, concern about macroeconomic instability appears to be driven by concern about the exchange rate. Although Lesotho is a large exporter of garments by African standards, it remains small by international standards—it does not even rank in the top 25 exporters to the United States. Because of this, exporters will be price-takers on international markets—that is, they receive payments in dollars but need to make payments in Loti. The rapid depreciation and appreciation of the Loti, which is pegged to the Rand, between 2000 and 2004, therefore, has had a large impact on their profitability.

Second, domestically owned firms were far more concerned about the cost of financing and access to finance than foreign-owned firms. Hotels and construction firms were also concerned about the cost of finance. This might not be surprising since most construction firms and hotels are domestically owned.

Third, hotels and, to a lesser extent, exporters and foreign-owned firms are far more likely to be concerned about telecommunications than other firms. About half of the hotels in the sample rated telecommunications as a serious problem, making it the second biggest problem overall.

Fourth, exporters were far less concerned about tax rates than non-exporters. This pattern is similar for domestically and foreign-owned firms. Tax administration is a problem for most firms, although hotels and, to a lesser extent, garments firms and exporters were less concerned about it.

Fifth, exporters, foreign-owned firms and garments firms were far less concerned about corruption than other types of firms. Given the overlap between foreign-owned firms, garment firms and exporters, it is possible that although the government has been more successful at protecting these firms against corruption than firms operating mostly in domestic markets.

Finally, garments firms, exporters and foreign-owned firms were far more concerned about worker skills than other firms. About forty percent of these types of firms rated workers skills as a serious obstacle, compared to less than 20 percent of non-exporting manufacturers, construction firms and hotels.

In summary, different types of firms have very different concerns in Lesotho. Only crime rated among the top five problems for foreign and domestically owned firms and no problem rated among the top five for both exporters and non-exporters. Given the overlap between exporting and foreign-ownership—and given that most of the garments firms in the sample are both foreign-owned and exporters—it is not surprising that the major division is along these lines. Firms involved in international markets are more likely to rate macroeconomic stability and workers skills as serious problems, while firms mostly involved in domestic markets (including construction firms) are more concerned about financing, taxes and corruption. Hotels generally have complaints similar to those of other domestic firms, but are more likely to be concerned about telecommunications.

II. INFRASTRUCTURE

The quality of a country's infrastructure can have a large impact on enterprise performance. In addition to the direct costs of dealing with poor infrastructure – purchasing generators to cope with frequent power outages or drilling wells to cope with disruptions in water supply – poor infrastructure can also impose indirect costs upon enterprises. For example, if enterprises cannot rely upon ports and customs to quickly process imports, they might need to keep higher inventories on hand and will be unable to adopt 'just-in-time' production systems. Similarly, weak communications systems can deter enterprises from entering markets where they would have otherwise been able to operate efficiently or at the very least will increase the costs associated with entering distant markets. Finally, if technologically advanced firms are especially vulnerable to poor infrastructure (e.g., if they rely upon a consistent power supply), enterprises might adopt less advanced production methods when the quality of infrastructure is poor.

II.1 Power

The Lesotho Highlands Water Development has increased Lesotho's generating capacity enough so that the country could potentially meet its domestic needs—although the cost of power remains high due to the financing costs of the project (World Bank, 2005b). In addition, the Government has made a significant progress in increasing private sector participation in the delivery of electricity over the past two years. The transition towards the privatization of Lesotho Electricity Corporation (LEC) is currently being prepared. Thus far, introduction of a management contract as a transitional arrangement has brought about significant improvements regarding new connections, collection rate, arrears reduction and global losses.¹² To continue improving the coverage and the quality of power services, it is essential that the privatization of the LEC through a concession arrangement is finalized as soon as possible.

Although the cost of power is not excessively high, historically electricity tariffs in Lesotho have not been cost-based (Public Private Infrastructure Advisory Facility, 2004). The Lesotho Electricity Corporation, which had a turnover of about M132 million, lost about M26 million in

¹² New connections went from 22,000 in 2001 to 43,730 in 2005. This resulted in more than a doubling of the electrification rate, which went from 5% to 11% in the same period.

2003 (Lesotho Electricity Corporation, 2004). Losses fell to M6.9 million in 2004, due to the price increases and the installation of pre-paid meters for residential customers. Current projections suggest that losses have fallen further in 2005, reaching about M2.4 million, and the Lesotho Electricity Corporation might even become profitable in 2006.

Despite the price increases at the beginning of 2004, power from the grid does not seem to be especially expensive by international standards. Firms in the Investment Climate Survey were asked about the average cost of a Kilowatt-hour from the public grid in 2004. In Lesotho, the cost of power includes both a fixed cost (demand charge based upon maximum demand) and a marginal cost per kWh (see Table 8) and so will vary from firm to firm. Taking both into account, the average cost (i.e., the average cost including both demand charges and the marginal cost per kWh) was about the same in Lesotho as in China, India and Tanzania (see Figure 16).¹³ It was slightly lower than in Kenya or Senegal and was considerably higher than in South Africa, where power is very cheap by international standards.¹⁴

Table 8: Tariffs for industrial users in Lesotho in early 2005.

	Tariff component	Tariff (Maloti)
Commercial (Large volume)	Demand (M/kW)	132.60
	Energy (M/kWh)	0.0740
Commercial	Demand (M/kW)	133.30
	Energy (M/kWh)	0.0819
Industrial(Large Volume)	Demand (M/kW)	132.60
	Energy (M/kWh)	0.0740
Industrial	Demand (M/kW)	133.30
	Energy (M/kWh)	0.0819

Source: Lesotho Electricity Corporation webpage (<http://www.lec.co.ls/business/energy/index.php?id=tariff.htm>).

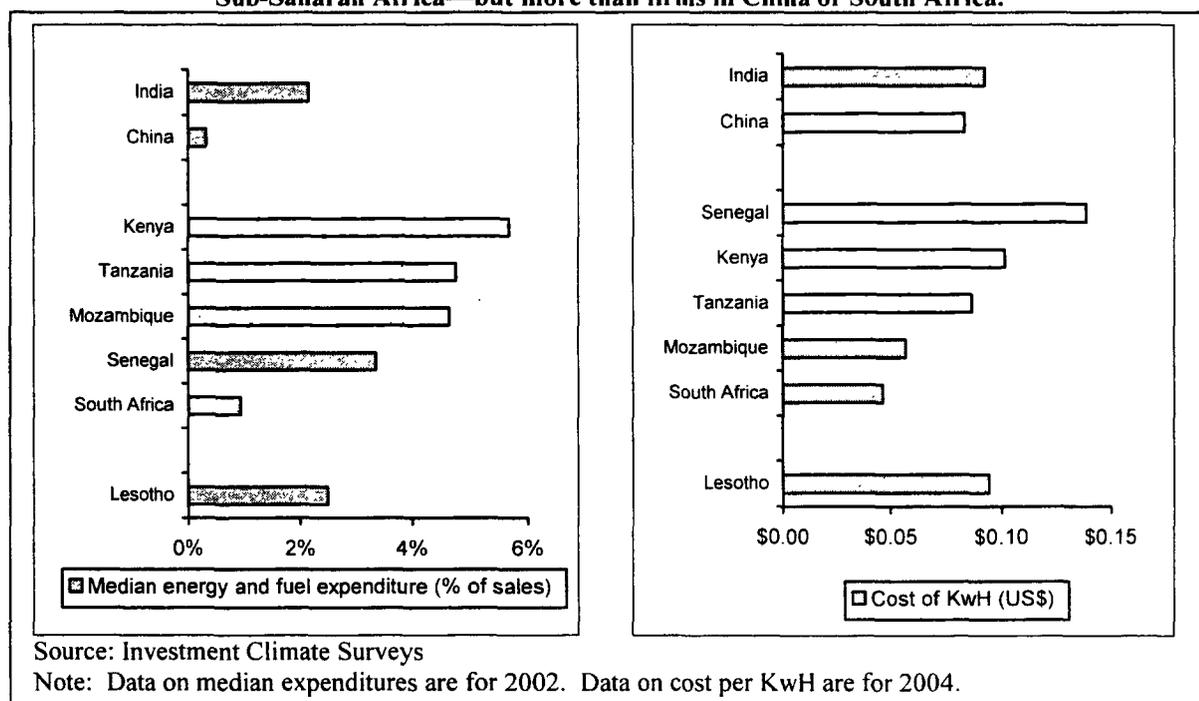
Firms were also asked about their total energy expenditures. The median firm in Lesotho reported that energy and fuel costs were equal to about 2.5 percent of sales in 2002—lower than in any of the comparators in Sub-Saharan Africa except for South Africa. Total costs were fractionally higher than in India and considerably higher than in China, where power supply was more reliable and the average cost of electricity was lower.

¹³ The average cost is calculated by dividing the total bill (demand charge and usage charge) by total kWh.

¹⁴ Due to the appreciation of the Rand in 2003 and 2004, the Rand and Loti were relatively strong in 2004, potentially leading us to overestimate the relative cost of power in Lesotho.

Average cost per kilowatt hour and energy expenditure can give slightly different perspectives on energy costs in Lesotho for at least two reasons. First, the data on expenditures were collected for 2002—the final year that income statement and balance sheet data were collected. Prices were increased by 18 percent on average on January 1, 2004—after being held constant since 1993.¹⁵ The price increase might affect the relative rankings to some degree.

Figure 16: Firms in Lesotho spent less on electricity in 2002 than firms in many other countries in Sub-Saharan Africa—but more than firms in China or South Africa.

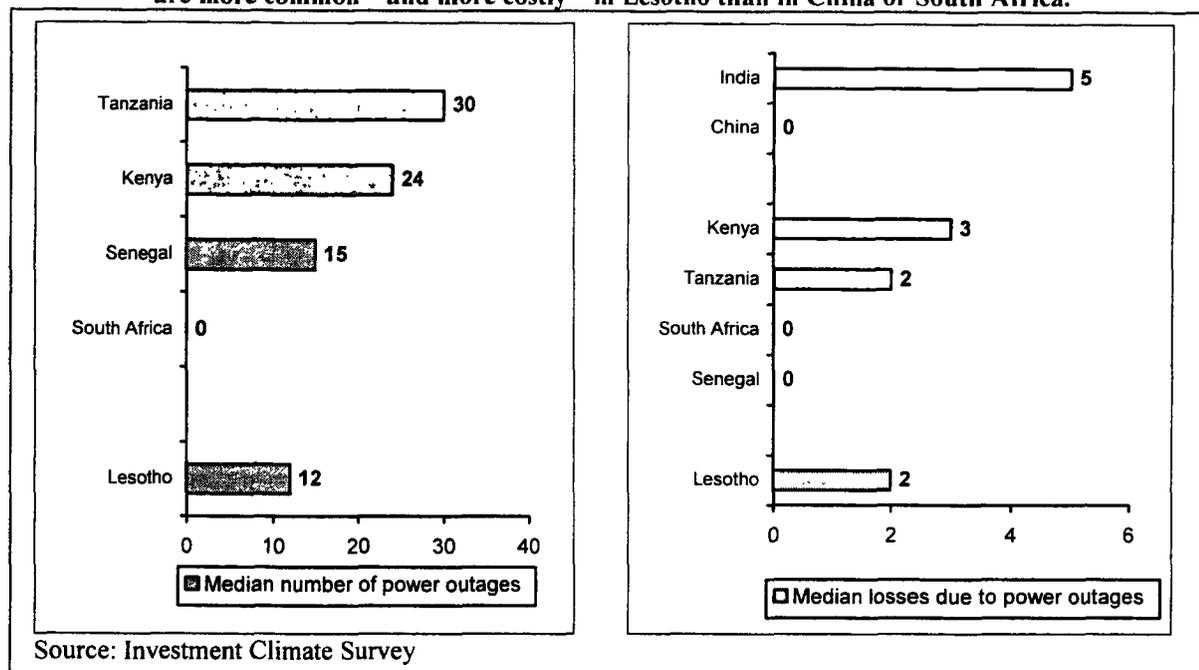


Second, although the cost of electricity from the grid is an important part of the total cost of energy, it is not the only cost. For firms with generators, purchasing and running a generator can be very costly. In a value-chain analysis of a garment producer in Lesotho, the cost of generator fuel was very high. For example, utility costs accounted for 15 percent of total energy costs in finishing/washing, with the remaining 85 percent due to the cost of fuel. Differences in generator usage between countries are discussed in detail below.

¹⁵ Prices were further adjusted in 2005 and 2006, with the maximum demand charge increasing and the usage charge falling in 2005 and commercial and industrial rates being set to the same level. Tariffs for pre-paid domestic use were adjusted upwards both years and general purpose pre-paid tariffs were increased in 2005.

While the cost of power is not high by international standards, service quality is lower than in the best performing countries, imposing a significant burden on many firms. The median enterprise in Lesotho reported 12 power outages in 2004, lasting an average of three hours (see Figure 17). Although this is lower than in Tanzania (30 outages), Kenya (24 outages) and Senegal (15 outages), it is significantly higher than in South Africa where the median firm reported no outages.

Figure 17: Although better than in the worst performing countries in Sub-Saharan Africa, outages are more common—and more costly—in Lesotho than in China or South Africa.

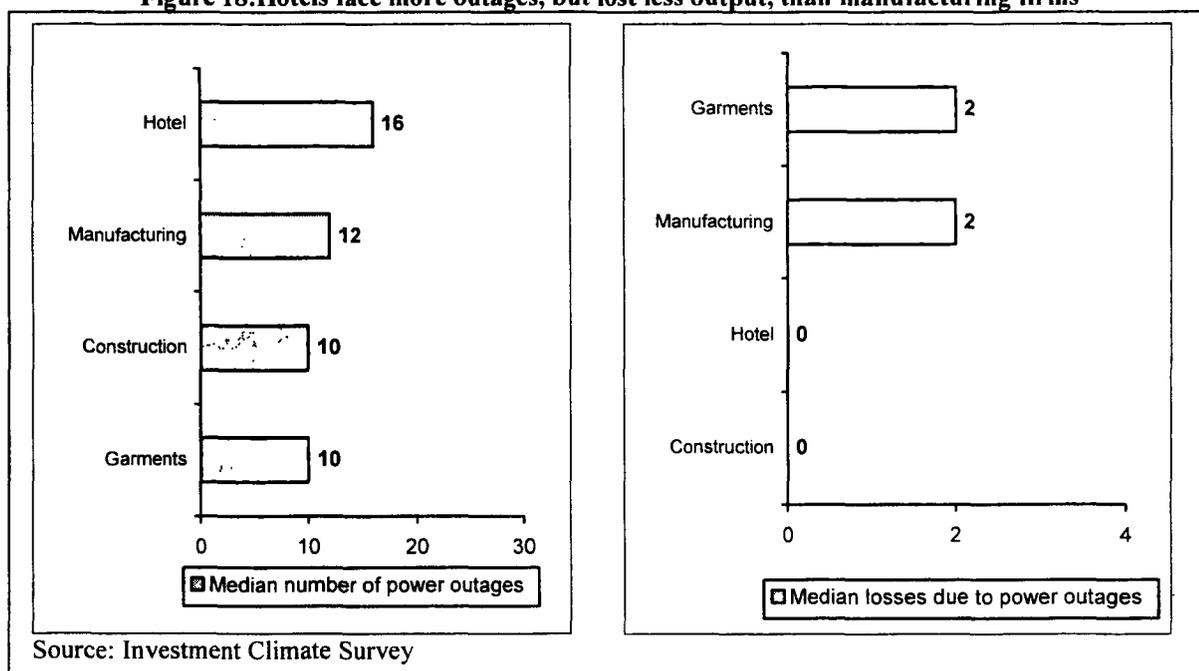


Although outages were less common in Lesotho than in several of the comparator countries, firms reported greater losses from outages than firms in some of these other countries. There are several plausible reasons for this. First, different firms will be affected differently by outages. For example, losses will be greater when outages result in equipment damage or when the enterprise is unable to make up for lost production by running extra shifts. Second, firms with generators are more able to cope with outages than other firms. As discussed below, relatively few firms in Lesotho have generators, potentially increasing the cost of outages to these firms. Third, when outages are more common, firms will be more used to dealing with them.

The number of outages differed only slightly by firm type—the median hotel reported slightly more outages than the median construction or manufacturing firm (see Figure 18). Losses, however, were significantly lower for the median firm. While the median manufacturing firm

reported losses equal to 2 percent of sales, the median hotel reported no losses due to outages. One reason for this might be that many hotels continue operating even when power is interrupted. But hotels were also more likely to have generators than manufacturing firms—more than half the hotels in the sample, but only about one-quarter of the manufacturing firms had a generator.

Figure 18: Hotels face more outages, but lost less output, than manufacturing firms

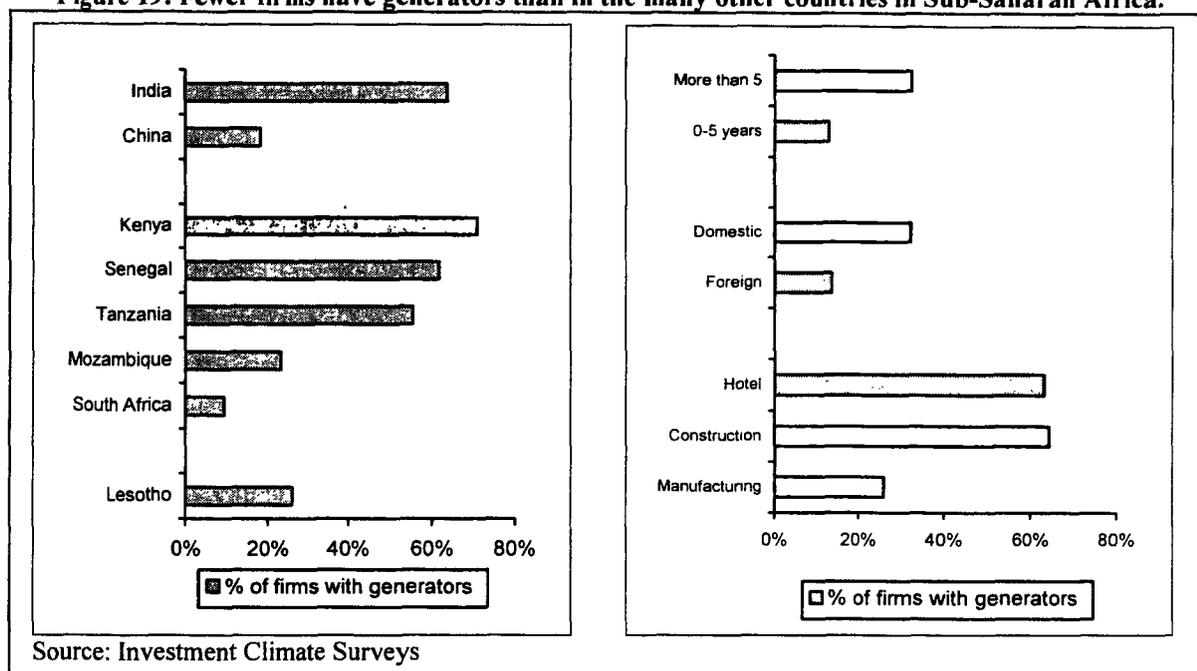


Relatively few firms in Lesotho operate generators. Only about one-quarter of manufacturing firms operated a generator in Lesotho, compared to over half in India, Kenya, Senegal and Tanzania (see Figure 19). Although fewer firms in China and South Africa operated generators, this probably reflects that electricity supply is more consistent in these countries. Despite the low number of generators, few firms reported losses due to power outages in these two countries.

Large firms were more likely to have generators than smaller firms were. Given the high fixed costs of purchasing and running a generator, this is not surprising. More surprisingly, domestically owned enterprises were less likely to have generators than foreign-owned enterprises. This does not appear to be due to differences in reliability of service. Foreign owned enterprises suffered similar numbers of outages to domestically owned enterprises. Given that they suffered similar number of outages, but were less likely to have generators, it is not surprising that they reported greater losses due to outages than domestically owned enterprises. Older firms were more

likely to have generators than younger firms—this could reflect that these firms have greater resources for investment.

Figure 19: Fewer firms have generators than in the many other countries in Sub-Saharan Africa.



II.2 Telecommunications

Due to both technological change in the telecommunications sector and the Government of Lesotho's adoption of the 1999 telecommunication policy, which laid the foundation for enhanced private sector investment, telecommunications coverage has expanded rapidly in recent years. In 2001, Lesotho sold the Lesotho Telecommunications Corporation, the formerly state-owned fixed line telephone operator. A consortium of South African, Zimbabwean, and Mauritian interests purchased a 70% stake in LTC under the consortium Mountain Communications. The Government of Lesotho initially maintained a 30% stake in the firm but later divested this. The new fixed line company, Telecom Lesotho, was granted a 20 year contract with five years of exclusivity for domestic voice and data services and leased line service.

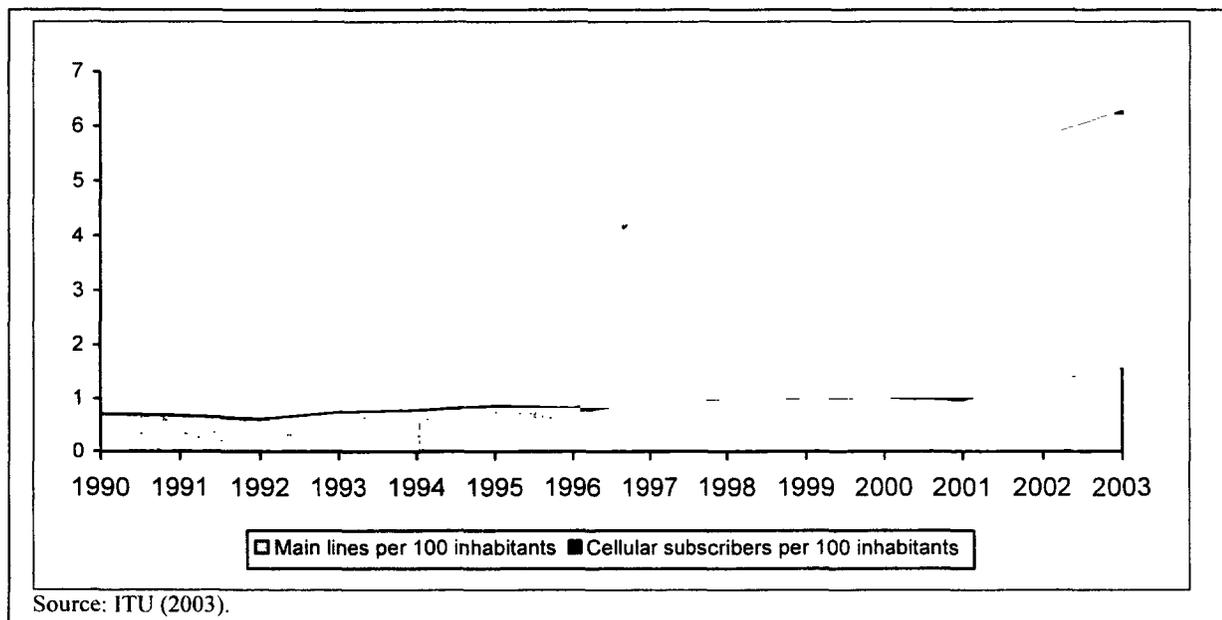
The privatization of the fixed line operator was not the only liberalization in the telecommunications market in recent years. In 1996, Vodacom Lesotho Ltd was granted a license to provide mobile service with a five year exclusivity agreement. In 2001, the five year period expired and a second operator, Ezi-Cell, which is a fully-owned subsidiary of Telecom Lesotho,

entered the market. Various ISPs, broadband providers, and calling card providers have also entered the market to increase competition for telecommunications customers (Public Private Infrastructure Advisory Facility, 2004). The ISPs have to lease capacity from Telecom Lesotho through a line to SAIC in South Africa.

Technological change, the introduction of competition in cellular telephony and the privatization of the fixed-line operator have resulted in a sharp increase in teledensity and a diversification of services to the end users. In 1996, there was less than one telephone per 100 people (see Figure 20). By 2003, this had increased to over 6 telephones per 100 people. Although fixed-line coverage increased modestly—to about 1.6 lines per 100 people, the increase is primarily due to a rapid expansion in cellular coverage. By 2003, there were almost three times as many cellular phones in the country as fixed line phones.

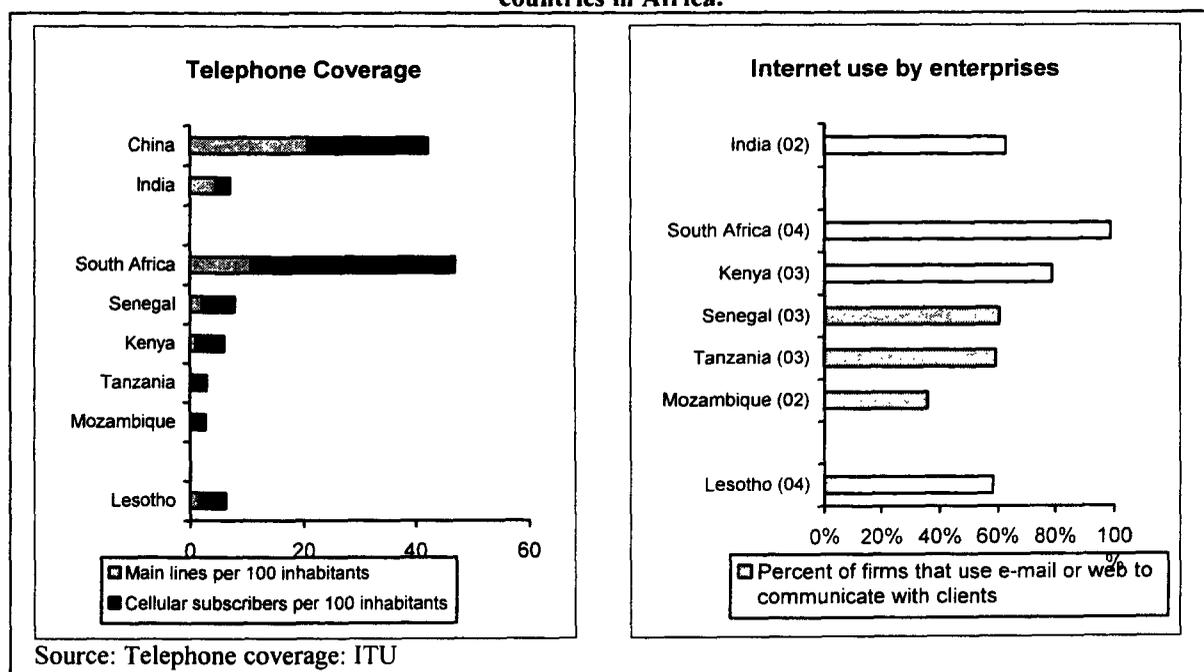
Despite the rapid increase in telephone coverage, coverage remains far lower than in South Africa or China—both countries have more than 40 main lines and cell phones per 100 inhabitants (see Figure 21). Moreover, it is also lower than in other countries in Sub-Saharan Africa such as Senegal and Kenya. When compared to other mountainous, land-locked countries, however, Lesotho appears better. As in most countries in Sub-Saharan Africa, there is considerable disparity in coverage between urban and rural areas.

Figure 20: Telephone coverage has been increasing rapidly in Lesotho since 2000—mainly due to extremely fast growth in cellular coverage.



Internet coverage and access to bandwidth remains low. In 2004, about 58 percent of manufacturing firms reported that they used the Internet to communicate with clients and suppliers. This was significantly lower than in Kenya or South Africa and slightly lower than in India, Senegal or Tanzania. This probably underestimates the extent of the difference, however, since the Lesotho survey was completed after the other surveys. Internet communication has been growing very rapidly in recent years and coverage is likely to have increased in the other countries since their surveys were completed. Part of the problem is that the national telecommunications infrastructure does not support widespread internet usage. The full digitization of the network has been delayed due to financing issues. The lack of an enabling regulatory environment that encourages information and communications technology growth has led to this technology being underused.

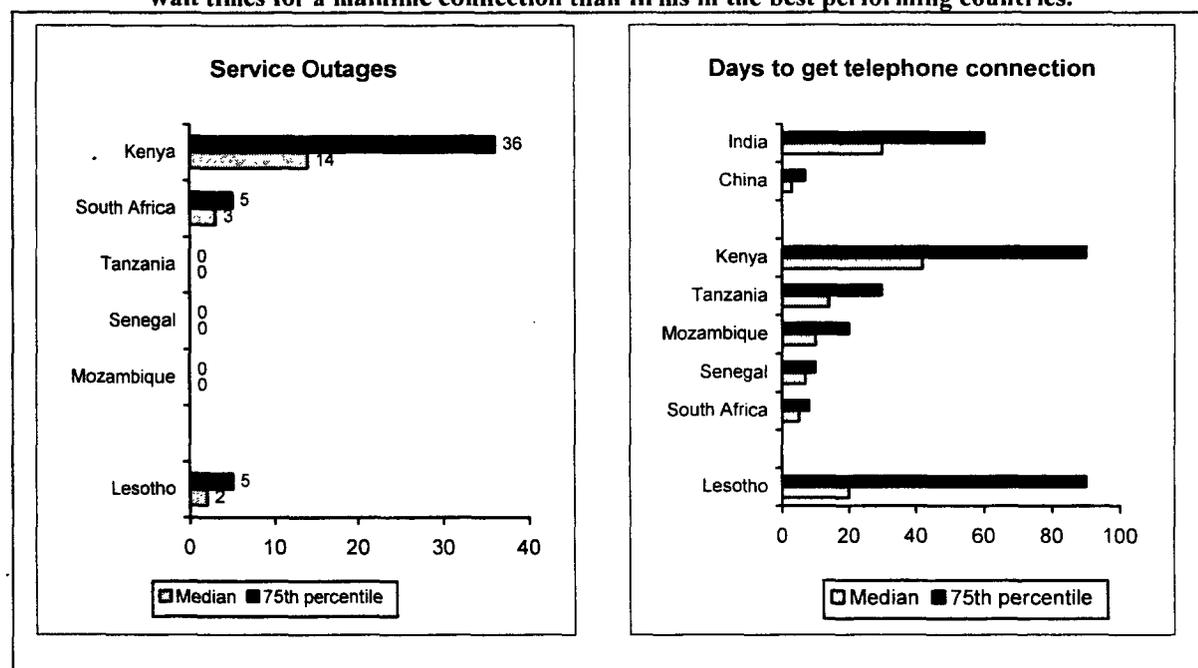
Figure 21: Coverage for telephones and the Internet is similar in Lesotho to other low-income countries in Africa.



The quality of Internet service is also low. Many firms, including hotels and the garment industry, have a demand for broadband Internet service that is not currently being met (Public Private Infrastructure Advisory Facility, 2004). This unmet demand might explain why hotels and garment producers rank telecommunications as a serious problem even though quality of fixed-line service does not appear any worse for hotels than for other firms (see below).

Moreover, the quality of fixed line service remains poor. Firms were asked how common service outages were in 2004. The median firm in Lesotho reported about three service outages during the year—significantly lower than in Kenya, but higher than in other comparator countries where fewer than a quarter of firms suffered outages. It also takes a relatively long time to get fixed line service. The median firm that got fixed line service between 2003 and 2004 reported that it takes about 20 days to do so. This was longer than in most of the comparator countries other than Kenya and India. But a significant number of firms faced even longer delays. At the 75th percentile, it took about three months to get a phone (i.e., one-quarter of firms reported delays of three months or greater). This was higher than in any country other than Kenya.

Figure 22: Although service is better than in some countries, firms report more outages and greater wait times for a mainline connection than firms in the best performing countries.

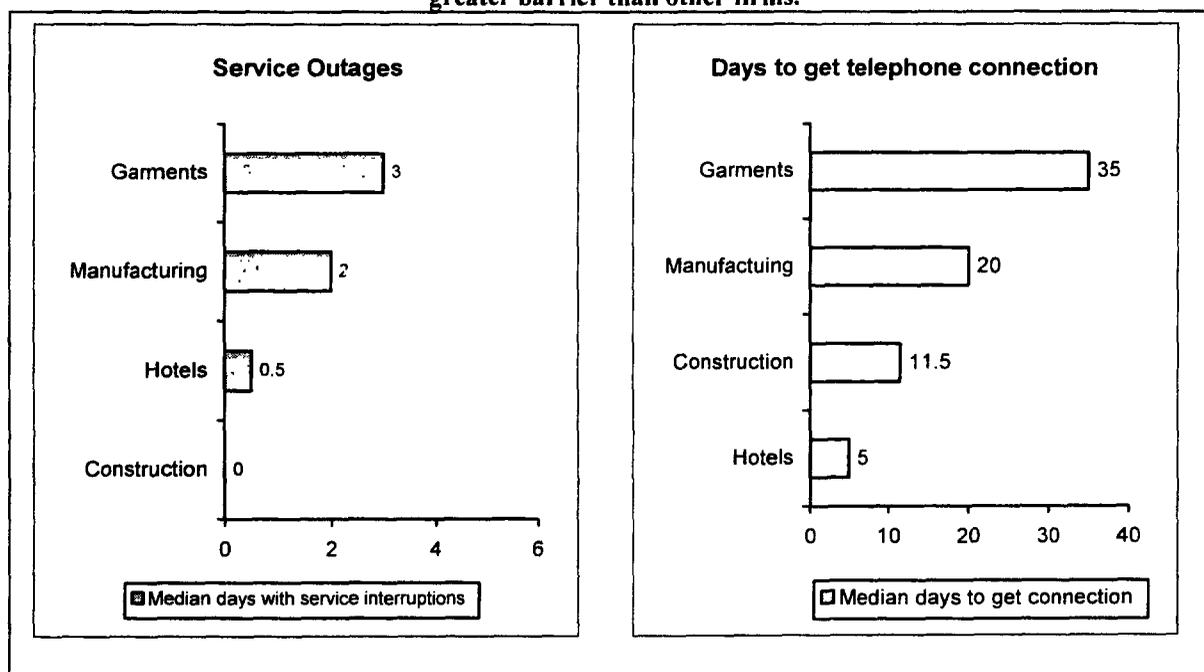


Aside from the relatively lower quality of service and lack of access to telecommunications technology, the high cost of services to consumers also hinders the expansion. The price of international calls remains high by both regional and global standards. Increasing competition in this segment of the market could contribute to lower prices and higher quality services.

As noted previously, hotels and garment producers are more concerned about telephone service than other enterprises. Hotels did not generally report worse service than other firms—although garment producers did report slightly worse service. The greater concern therefore probably reflects greater vulnerability to poor service rather than worse service. Because hotels rely

heavily on international service—and many top-end hotels earn significant revenue from in-room telephone calls—it might not be surprising that they are more concerned about telecommunications service than manufacturing firms, especially those operating primarily in domestic markets. Poor telecommunications will have a negative impact of sector development unless it is adequately addressed.

Figure 23: Hotels do not report worse service—although they see telecommunications service as a greater barrier than other firms.



II.3 Water Supply

Although water and sanitation is not included in the list of constraints that the Investment Climate Survey asks about, other evidence from the survey suggests that it is a problem for existing enterprises. The median manufacturing enterprise reported that they had insufficient water supply for about 10 days in 2004. Moreover, enterprises that got new connections reported that it took about 30 days to get a connection. Service was no better for garments firms than for other firms—the median garments firm also reported 10 outages and a wait period of about 30 days.

Other studies have noted that the limited availability of water is placing constraints on the garment industry, since it uses a significant amount of water in their manufacturing process and relies upon an efficient water and water treatment infrastructure. These constraints will prevent garment manufacturers from expanding current operations and diversifying their product lines and discourages potential entry by firms that might produce textiles locally. This is important because

after 2007, AGOA's rules of origin clause will prevent firms in Lesotho from sourcing their inputs from Asia while still benefiting from tariff-free access to the United States.

As the economy grows, the problems with water supply will likely get worse without significant investment in water infrastructure. Hence, room for improvement exists in the operations and maintenance of the network (Public Private Infrastructure Advisory Facility, 2004). First, as in the power sector, the tariff/fee structure is not high enough to adequately maintain the infrastructure. Though improvements have occurred in the last several years in this area, the current model does not cover costs.

A second concern is the efficiency of delivery to the garment industry. Though garment producers without laundry facilities were mostly satisfied with service, the wet industries were "almost universally dissatisfied." (Salm and others, 2002) Water supply is inconsistent and poorly managed. It is estimated that 30-40% of water is lost due to leakage, indicating poor maintenance (Global Development Solutions, 2004).

Beyond operations and maintenance, a simple capacity issue exists for water treatment. The lack of adequate wastewater collection and treatment capacity is resulting in discharge of untreated or partially treated wastewater into the environment. The Thetsane water treatment facility is unable to handle the 5 mega liters of wastewater produced currently. This creates environmental problems as this waste water is dumped into Mosenyathe stream which flows into the Mohokare river (World Bank, 2003). It has been suggested that some effort could be made to enable the effluent from the water treatment plants to be leveraged by industries requiring non-potable water, which would allow more targeted use of potable water to those in need (Public Private Infrastructure Advisory Facility, 2004).

Solid waste disposal is also problematic. Two formal refuse landfill sites exist in Tsosoane and Maputsoe; however, neither has been developed to any recognized engineering standard that would accommodate for adequate environmental protection (Public Private Infrastructure Advisory Facility, 2004). Similar to the capacity limitations with water treatment, the lack of standards for waste disposal will have negative ramifications for the environment in Lesotho. As most foreign investors are required to meet some level of environmental standards based on their home countries

regulations, or the regulations of the trade agreements, the inability of Lesotho to provide these services is a serious issue (World Bank, 2005b).

II.4 Transportation

Fewer than 30% of the firms surveyed in the Investment Climate Survey saw transportation as a major or very severe obstacle to growth. However, other evidence strongly suggests that transportation is a serious problem in Lesotho. Although existing firms may not view it as a bottleneck for their firm, at its current capacity or relative to other obstacles, this could be because they have managed to adapt—for example by locating their facilities near transportation hubs. For new firms entering the market, the transportation network might therefore be a greater problem.

As a land locked country, Lesotho has three transportation options for enterprises operating within its borders: rail, truck and air. As air transportation is expensive, most businesses opt for rail or truck service, or some combination of the two.

The rail network in Lesotho is limited to a 2 km spur connecting to a single station in Maseru. Track maintenance and the container facility in Maseru (Mascon) are managed by Spoornet, the South Africa rail service. Spoornet and the government are currently negotiating a deal for a long term lease. Until that deal is finalized, it is unlikely that any significant investment will be made to the Mascon facility.

The Mascon facility, which is the only rail facility in Lesotho, creates a bottleneck. A 2002 study of the garment industry indicates that the station at Maseru is already operating at full capacity, with some enterprises already experiencing delays on the delivery of containers (Salm and others, 2002). Nearly all garment factories complained of delays in the receipt of their raw materials (Salm and others, 2002). Some of the issues at Mascon are the result of insufficient infrastructure. The facility only has a single side of the track that is suitable for loading and unloading containers; the storage area is not paved, making wet weather issues dangerous; and there is no weighing capacity at the location (Salm and others, 2002).

A separate issue, identified in a value chain analysis of the garment industry that exacerbates the bottleneck issues is the importers' lack of adequate warehouse space (Global Development Solutions, 2004). As the Mascon facility does not have adequate storage facilities, containers bound

for Lesotho remain in Bloemfontein until the importers request them. Importers only request containers as they have space for them. As a result 80-90% of rail cars allocated to Lesotho traffic sit idle at the inland port. Though fines exist for containers that are not claimed within 3 days, Spoornet has not consistently enforced this fine, reducing the incentive for firms to change their behavior or develop storage facilities. The conclusions reached by the sector study, value chain analysis, and country framework report on the infrastructure are similar—for further growth, upgrade of the rail terminal in Maseru is essential.

Because rail service is inefficient, many firms use trucks instead of rail. While trucking costs are nearly 75% higher than rail costs, trucks can deliver a container from Port Elizabeth to Maseru in one day. In contrast, transporting the same goods by rail can take between 9 – 30 days for the same journey. If the performance of the Mascon facility could be improved, it would improve the cost competitiveness of the Lesotho garment sector and, in so doing, might ensure the long-term viability of the sector (Global Development Solutions, 2004).

The trucking industry in Lesotho is dominated by several carriers, which are South African affiliates. RSA customs regulations stipulate that cross border traffic requires third party insurance coverage, which is affordable by only a few carriers. This increases the cost of truck transport in Lesotho (Public Private Infrastructure Advisory Facility, 2004). However, the infrastructure study notes that other obstacles increase prices further. These are route circuitry, low levels of asset utilization, high percentage of empty back flows and lack of effective MIS to manage scheduling and coordination. If the performance of the rail freight sector could be improved enough to make it a viable competitor, competition between rail freight and truck freight might encourage cost reductions. If the capacity of the rail line is not upgraded, one would expect prices for trucking to continue to escalate.

Poor transportation imposes additional costs on garment firms. Due to delivery delays for raw materials, firms often have to outsource work to meet deadlines. This can substantially increase production and administrative costs—approximately 2% of the cost of manufacturing a T-shirt arises from subcontracting due to late delivery of essential inputs (Global Development Solutions, 2004).

A final issue that affects both road and rail infrastructure is the cost recovery capability of the government. The Road Fund, set aside to enable maintenance and construction for the road network is not capable of handling the ongoing maintenance and current growth of the road network (Public Private Infrastructure Advisory Facility, 2004). The tax/fee collections could be reevaluated to cover the current expansion strategy, or the expansion strategy could be restricted to ensure maintenance of the current network. Similarly, the cost recovery on the Maseru spur falls below the established threshold of Spoornet, which has led them to consider a concession for this line (Public Private Infrastructure Advisory Facility, 2004). Without an appropriate cost recovery mechanism for the transportation infrastructure, it will be difficult to establish a marketable capability to encourage foreign investors.

III. FINANCE

In many countries, enterprises see access to finance and the cost of financing as serious obstacle to enterprise operations and growth. In 17 of 49 low- and middle-income countries where Investment Climate Surveys had been completed, over 40 percent of enterprises reported that finance was a major or very severe problem.¹⁶ It has been an especially great problem in low-income countries in Sub-Saharan Africa, with access and cost of finance often rating among the top investment climate related problems.¹⁷

Lesotho is no different from other countries in Sub-Saharan Africa in this respect. Close to half of enterprises in Lesotho rated the cost of financing (interest rates) as a major or very severe problem, the second greatest problem, and close to forty percent rated access to financing as the same, the sixth greatest problem (see Figure 24). This was far higher than in China, India and South Africa where between 13 and 22 percent of enterprises saw access to financing and 16 to 23 percent saw the cost of financing as serious problems. Although this suggests that finance is a serious concern, firms in Lesotho were less likely to rate both the cost of financing and access to financing as a major or very severe problem than firms in Kenya, Senegal or Tanzania.

¹⁶ World Bank (2004d)

¹⁷ For example, cost of and access to financing ranked first and fourth in Uganda (Regional Program on Enterprise Development, 2004a); second and eleventh in Kenya (Regional Program on Enterprise Development, 2004b); and third and sixth in Tanzania (Regional Program on Enterprise Development, 2004c).

III.1 The Financial Sector in Lesotho

Lesotho's financial sector is very small and concentrated. At the beginning of 2004, there were three private commercial banks operating in Lesotho, Standard Bank Lesotho, Lesotho Bank (1999) Limited, and Nedbank Lesotho. Because Standard Bank Lesotho owned 70 percent of Lesotho Bank (1999) Limited the sector operated as a virtual duopoly (Lesotho Financial Sector Review 2004). In October 2004, a third bank, First National Bank, entered Lesotho, reducing concentration somewhat. All three banks are majority South African owned.

The non-banking financial sector is underdeveloped, accounting for only 11 percent of total assets in the financial system (excluding the Central Bank of Lesotho (CBL). It consists of four insurance companies, two development finance institutions (Lesotho National Development Corporation and Basotho Enterprise Development Corporation), which no longer make loans, the recently established Standard Bank Lesotho (SBL) Unit Trust and a Corporate Bodies Pension Scheme (administered by the Lesotho National Insurance Corporation). There are no leasing companies, finance companies, or other financial institutions that could provide competition for the banks and provide a meaningful choice of financing alternatives. Although the main reason for this is the small domestic market, the lack of a coherent body of law to govern leasing transactions also retards sector development. Problems include: (i) the absence of a leasing law; (ii) the absence of a pension fund enabling act; and (iii) that the Financial Institutions Act that does not differentiate between banks and non-banks. As a consequence, any NBFIs other than an insurance company must have M10 million in initial capital and must comply with all other conditions of the Act that are set for commercial banks. This poses a substantial if not insurmountable barrier to entry of potential new competitors in a situation where new competition is badly needed.

According to the Financial Sector Review (2004) as a result of inadequate competition among the banks and the absence of NBFIs lending institutions and other deposit taking institutions the banks engage in what appears to be de facto cartel-like pricing with key deposit interest rates at a negative 3 percent in real terms (2001 data), all deposit rates consistently well below those immediately across the border in South Africa, high service charges, and lending rates consistently (but justifiably) higher than in South Africa despite operating within the same common money market.

The legal framework, which fails to guarantee property rights or support property rights enforcement, restricting the use of collateral, also constrains financial intermediation and restricts access to credit in Lesotho. Enforcement of legislation is also constrained by slow execution of due process manifested by slow court proceedings and lenders' inadequate access to timely foreclosure procedures. The execution of court orders, even after considerable delays, is rarely undertaken in a timely manner. The Commercial Court, which has been established at CBL's initiative in 2000, has had little or no impact at all on the adjudication of commercial cases. This is largely attributable to resistance shown by legal practitioners to the new procedures and ignorance on the part of stakeholders such as business community, judges and legal practitioners.

The absence of adequate credit assessment information tools has also been a contributing factor. There is no credit bureau in Lesotho. CBL is considering setting up a credit bureau in collaboration with the commercial banks. However, the absence of a unique personal identification system represents an important constraint. The Central, with finding and TA form the First initiative and the IMI is setting up a credit registry, within the Central Bank.

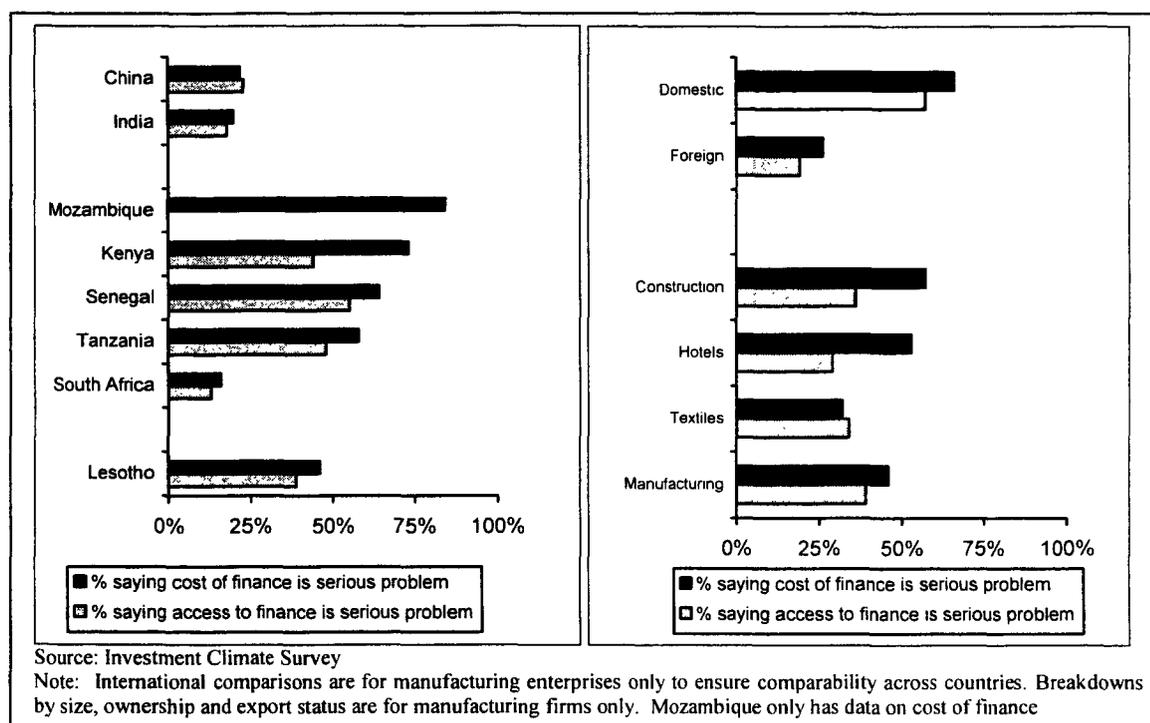
Access to finance is especially difficult for married women, since Lesotho matrimonial law treats women as minors. Unable to be sued in a court of law (as a legal minor), women cannot undertake many financial activities without the consent of their husbands—including opening a new account, taking out a loan, registering immovable property in their name, acting as a company director or binding themselves as surety.¹⁸ Although the application of this discriminatory practice is seemingly not uniform, it nonetheless places impediments on the development of an important group of entrepreneurs in Lesotho's society.

III.2 Differences between foreign and domestic firms

Although fewer firms in Lesotho rating finance as a serious problem than in other countries in Sub-Saharan Africa, there were marked difference between different types of firms. The most noticeable difference was between foreign and domestic firms. Domestic firms were nearly three times more likely to say that access and cost of financing were serious problems.

¹⁸ The "Married Persons Equality Rights" written by the Law Reform Commission in 2002 is still under review

Figure 24: Access to finance is less of a problem in Lesotho than in other low-income countries in Sub-Saharan Africa—but only for foreign-owned enterprises.



Because there are a relatively high number of foreign-owned firms in Lesotho, this partially explains the difference between Lesotho and other low-income countries in Sub-Saharan Africa. Although fewer firms in Lesotho rated access and cost of financing as serious problems than in Tanzania, domestic firms in Lesotho were more likely to rate them as serious problems than domestic firms in Tanzania. Similarly, domestic firms in Lesotho were no less likely to rate access to finance as a serious problem than domestic firms in Senegal or Kenya.

Why are foreign-owned firms less likely to see access and cost of financing as serious problems? One possibility is that the domestic financial system might serve foreign-owned firms better than it serves domestically owned firms. Under this hypothesis, the South African owned banks that dominate the local banking sector in Lesotho might be more willing to lend to foreign-owned companies than they are to lend to domestic companies.

But this is not the only possible reason for the difference. A second possibility is that foreign-owned firms might not rely upon the domestic financial system at all. If foreign-owned firms can either rely upon banks in their home country or their parent companies for financing, then

they might be less concerned about access and cost of financing than domestically owned firms even when the financial system of the host country is performing poorly.

Evidence from the Investment Climate Survey favors the second explanation. Although foreign-owned firms did not generally see financing as a problem, they were less likely to have loans or overdraft facilities and financed less working capital through banks than domestic firms (see Table 9). Only one of the more than 30 foreign-owned firms in Lesotho had a bank loan, compared to about one-quarter of domestic firms.

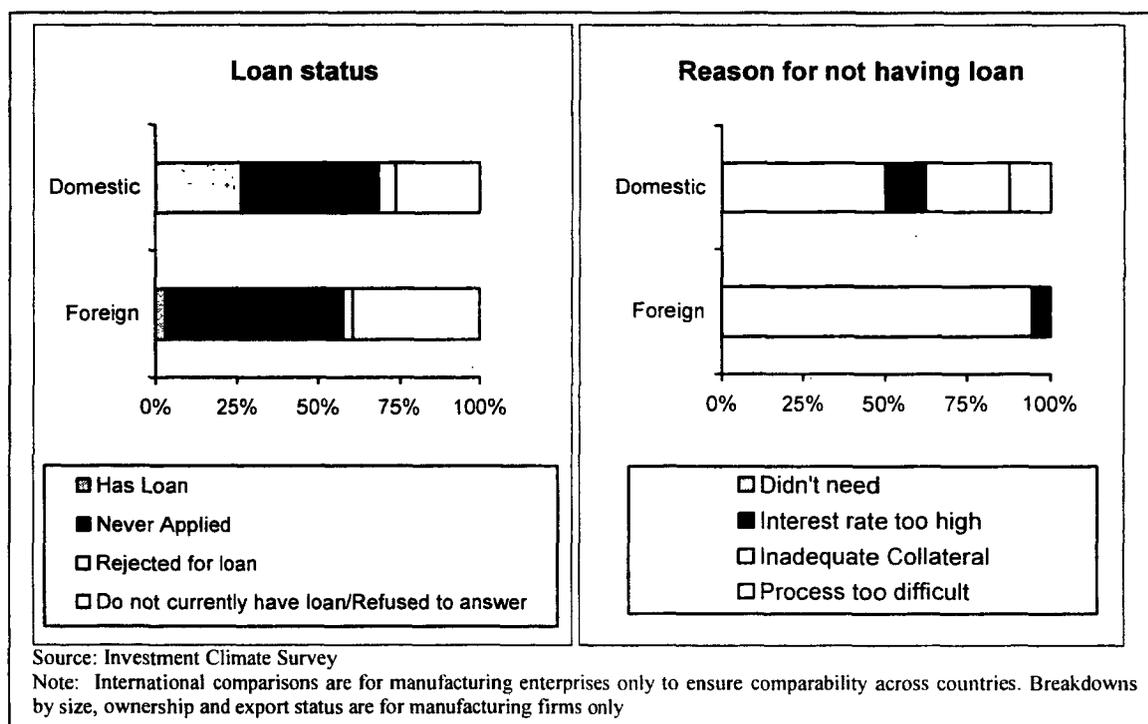
Table 9: Financial system indicators by firm type.

	% with Loan	% with Overdraft	% never applied for a loan	% ever rejected for loan	% of working capital financed through banks
Manufacturing	15%	30%	48%	8%	10%
Garments	9%	10%	51%	8%	4%
Construction	67%	77%	20%	0%	12%
Hotel	0%	18%	---	---	7%
Foreign	3%	23%	55%	5%	8%
Domestic	26%	36%	42%	11%	11%

Other evidence also supports this view. Most of the foreign-owned firms either did not have currently have a loan or had never applied for a loan (see Figure 25). Only 5 percent of foreign-owned firms reported that they had ever had a loan application rejected, compared to about 11 percent of domestically owned firms.

Firms without loans were also asked why they did not have one. Nearly 95 percent of foreign-owned firms said that they did not need or want a loan. In contrast, only about half of domestic firms said the same. About one-quarter of domestic firms said that they had inadequate collateral (compared to no foreign firms), about one-eighth said that interest rates were too high (compared to 5 percent of foreign-owned firms) and one-eighth said that the application process was too difficult (compared to no foreign firms).

Figure 25: Few foreign-owned firms in Lesotho have loans—although of those that did not reported that they did not want one.

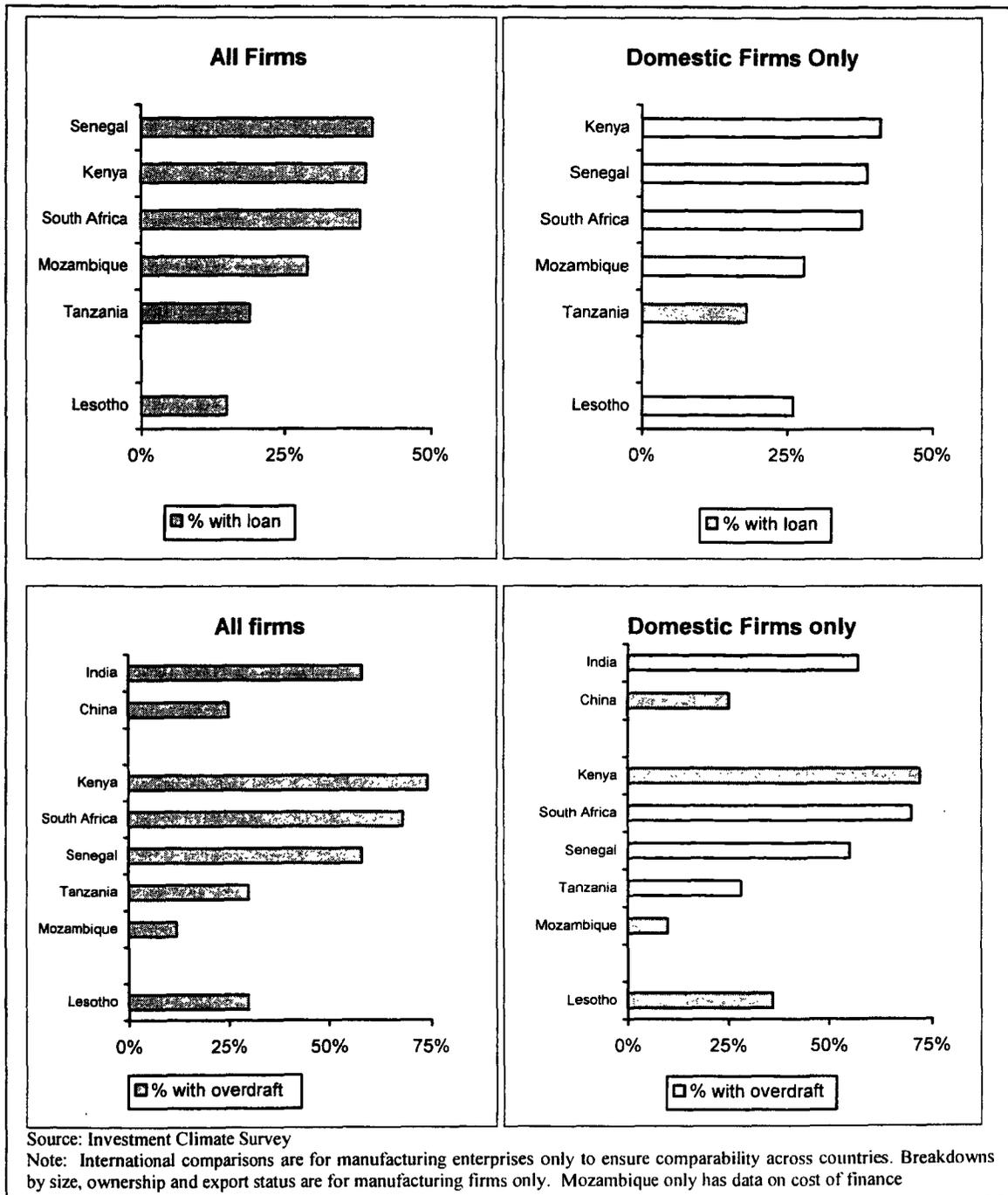


In summary, although foreign-owned firms do not rate access to finance or the cost of financing as serious constraints, this does not seem to be because they are favored by domestic banks. Rather, because they have access to financing from their parent companies and other sources, they do not generally need to turn to domestic banks for their financing needs.

III.3 Access to finance for domestic firms.

Firms in Lesotho were less likely to have loans than firms in any of the comparator countries. Whereas only about 15 percent of firms in Lesotho had loans, 19 percent of firms in Tanzania and 29 percent of firms in Mozambique did. Firms from South Africa, Kenya and Senegal were even more likely to have loans. Firms in Lesotho were more likely to have overdraft facilities than firms in Mozambique or Tanzania, but less likely than in the better performing countries in Sub-Saharan Africa.

Figure 26:

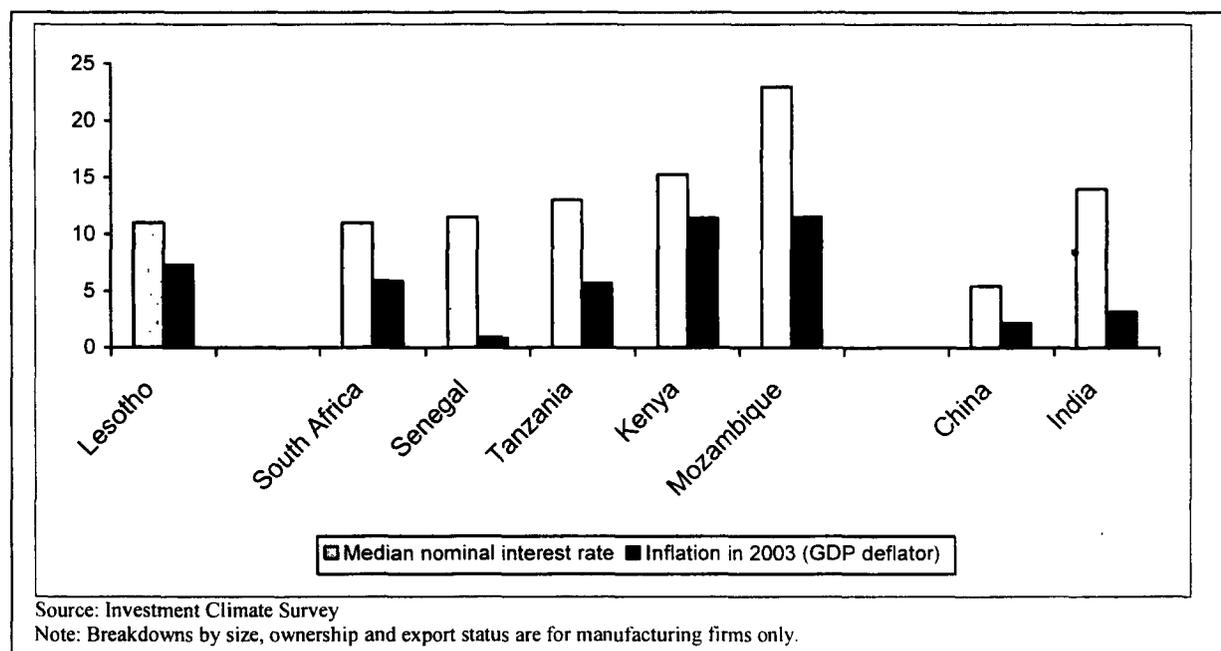


In part, this is because few foreign-owned firms have either loans or overdraft facilities in Lesotho. Because there are so many foreign-owned firms in Lesotho, this makes cross-country comparisons difficult. When comparing only domestic firms, the difference between Lesotho and the best performers (Kenya, Senegal and South Africa) is smaller. Further, domestic firms in

Lesotho were more likely to have loans than domestic firms in Tanzania and only slightly less likely than firms in Mozambique.

Although the objective indicators suggest that access to financing is more difficult in Lesotho than it is in other countries in the region, the cost of financing does not appear to be exceptionally high in Lesotho. Firms in the investment climate surveys were asked to report the nominal interest rates that they paid for loans. The median firm in Lesotho reported a nominal interest rate of about 11 percent—similar to South Africa and Senegal, but lower than in Tanzania, Kenya and Mozambique. Moreover since inflation has been relatively high in Lesotho, this suggests that real interest rates have been lower than in most of the comparator countries. Because few firms had loans, we do not try to breakdown interest rates by firms—the samples become very small when we do this, making comparisons difficult.

Figure 27: Firms in Lesotho report that they pay lower real interest rates than firms elsewhere in Sub-Saharan Africa.



The results from the Investment Climate Survey primarily reflect the experience of formal enterprises—many of which are relatively large. Previous work, however, suggests that access to financial services is poor for informal microenterprises. Because these firms can often not attain minimum deposit requirements, they often have very weak access to financial services. These problems are amplified by the unorganized microfinance sector (Pawlowska, 2004)

IV. CRIME AND SECURITY

In contrast to most other areas of the investment climate, there was broad agreement that crime and security is a serious problem in Lesotho. About 47 percent of manufacturing enterprises and 53 percent of construction enterprises rated crime, theft and disorder as a major or very severe problem. Moreover, complaints about crime and security were common among foreign and domestic enterprises. In addition to the perception-based measures, the Investment Climate Survey includes additional questions on crime and security. In this subsection, we look at these objective measures, benchmarking Lesotho's performance against other countries in the Sub-Saharan Africa and other major garments producers.

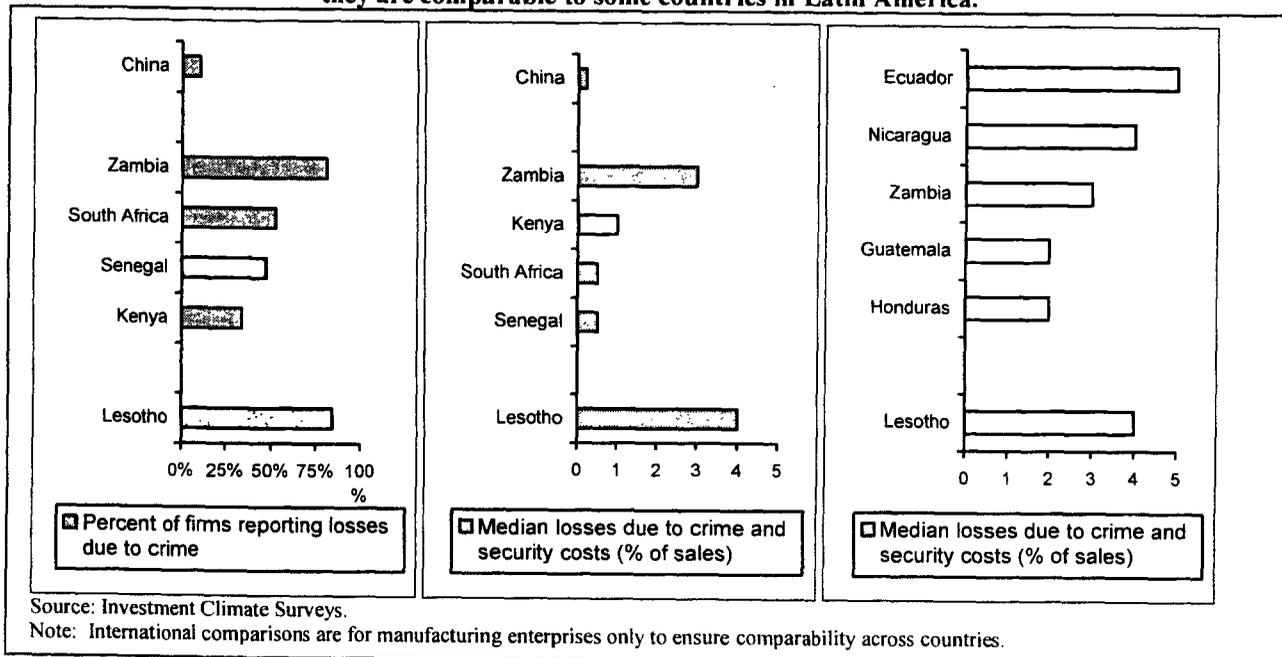
IV.1 Losses due to Crime

About 85 percent of manufacturing firms reported losses due to crime in 2004 (see Figure 28). This is higher than in most of the comparator countries for which comparable data were available. For example, only 11 percent of firms in China reported losses due to crime or theft. Even in South Africa, a country where crime is often thought to be a major problem, only about 50 percent of firms reported losses.¹⁹ This is also high compared to other countries in Africa where Investment Climate Surveys have been completed—fewer than half of firms reported losses in Ethiopia, Kenya, Mali, Mozambique, Tanzania, and Senegal. Only Zambia, where about 81 percent of firms reported losses due to crime, came close to Lesotho in this respect.

In addition to being relatively common, the economic cost of crime was also high. The median firm manager in Lesotho estimated that the cost of security and losses due to crime resulted in total costs equal to about 4 percent of sales. This was also higher than in most of the comparator countries and other countries in Sub-Saharan Africa—although Zambia was also close on this measure.

¹⁹ World Bank (2005c)

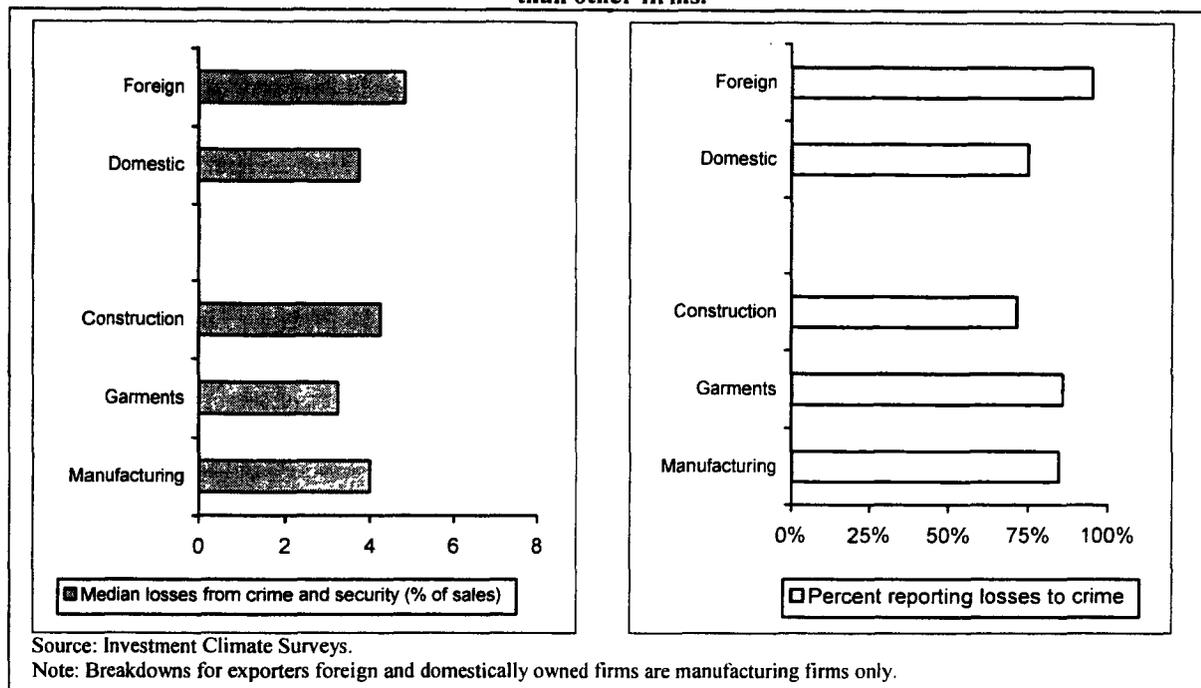
Figure 28: Crime and security costs are higher in Lesotho than elsewhere in Africa and in China, although they are comparable to some countries in Latin America.



Although the cost of crime and security is higher in Lesotho than in the comparator countries and elsewhere in Sub-Saharan Africa, it is not completely out of line with numbers reported in other developing countries. In particular, many countries in Latin America—especially in Central America—also report high costs. The median firm in Ecuador reported total costs equal to 5 percent of sales, while the median firm in Nicaragua reported costs equal to about 4 percent of sales.

The relatively high cost of crime and security does not appear to be confined to only some sectors or sub-sectors. Crime appears to be a serious problem for all types of firms in Lesotho (see Figure 29). For all groups of firms, over 70 percent reported direct losses due to crime and the median cost of crime and security exceeded 3 percent of sales.

Figure 29: Foreign-owned manufacturers have greater losses and are more likely to be crime victims than other firms.



Although all firms reported high costs by international standards, the cost was higher for some groups of firms than others. Foreign-owned firms reported slightly higher losses than domestically owned firms—close to five percent of sales for foreign-owned firms compared to less than 4 percent of sales for domestically owned firms. Despite this, garments firms reported slightly lower losses than other manufacturing firms—only about 3.25 percent of sales. Perhaps because of the lower losses in the garments sector, losses were lower for exporters than for non-exporters.

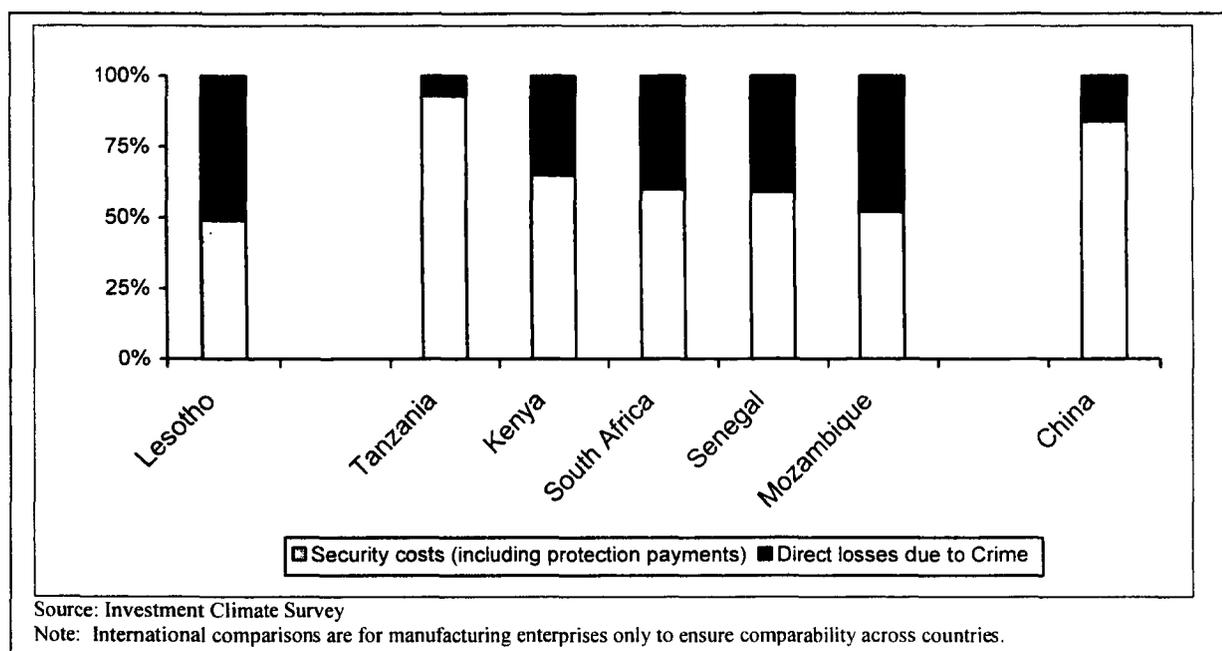
It might seem surprising that construction firms reported similar losses to manufacturing firms, given that it would seem to be more difficult to secure a construction site than a closed manufacturing plant, making construction firms more vulnerable. In other countries, such as South Africa, this appears to be the case—construction firms have greater losses due to crime than manufacturing firms do.²⁰ As discussed below, the high share of crime attributed to employee theft might partially explain this discrepancy in Lesotho.

²⁰ World Bank (2005c)

IV.2 Breakdown of costs

About 52 percent of the cost of crime is direct losses due to crime, while the remainder, 48 percent, is for security. This is considerably higher than in most of the comparator countries where security costs, not losses due to crime, account for most of the cost of crime and security. Security costs accounted for more than two-thirds of the total cost of crime in Kenya, China, and Tanzania and more than half in Senegal, South Africa and Mozambique.

Figure 30: Direct losses to crime make up a greater share of costs in Lesotho than in most other countries.



Employee theft appears to be an especially serious problem in Lesotho. In the manufacturing sector, managers attributed close to three-quarters of losses to employee theft, while in the construction sector they attributed less than half to employees. This might be because manufacturing firms are better at preventing crime by outsiders—as noted above, it is easier to prevent crime by outsiders in a closed factory than in a construction site.

Although questions on the importance of employee theft are not included in all Investment Climate Surveys, employee theft appears to be higher in Lesotho than in other countries for which data are available. In particular, South Africa managers attributed only about 43 percent of direct losses to employee theft—considerably less than in Lesotho.

Employee theft appears to be a more serious problem for foreign-owned enterprises—managers of foreign-owned enterprises attributed about 78 percent of direct losses from crime to employee theft. But it is also a problem for domestically owned enterprises—managers of domestically owned enterprises attributed close to two-thirds of direct losses due to crime to employee theft. Managers of garments firms were especially worried about employee theft, attributing over 90 percent of direct losses due to crime attributed to employee theft in both foreign and domestically owned garment firms.

So why does employee theft appear to be a serious problem in Lesotho? Although it is difficult to diagnose the complex societal problems that can lead to crime, it seems plausible that the high level of inequality in Lesotho might play a role.²¹ At the firm level, the high degree of wage inequality in Lesotho (see previous chapter) might exacerbate tensions between workers and management and contribute to the relatively high level of employee theft. The especially high wage inequality observed in foreign-owned enterprises might worsen tensions in these enterprises. Moreover, previous work has noted that foreign staff hold many of the supervisory and management positions in foreign-owned firms, potentially adding to concerns about inequality and increasing social tension within these firms.²²

IV.3 Courts and Police

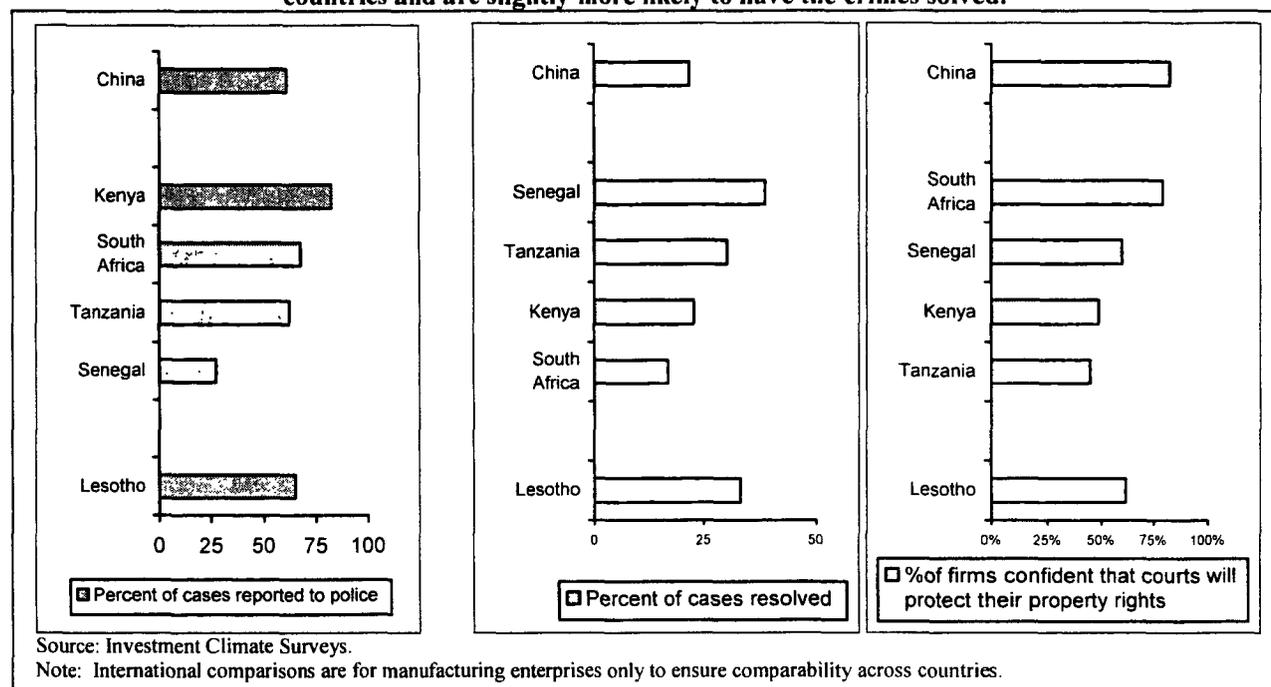
Although the previous evidence suggests that crime is a more serious problem in Lesotho than in most of the comparator countries, some objective indicators are more positive. One positive indicator is that firms are more likely to report crimes to the police in Lesotho than they are in most of the comparator countries (see Figure 31). Firms report about two-thirds of crimes to the police—higher than in China, Senegal or Tanzania and similar to South Africa. If the police force is thought to be particularly corrupt or incompetent, firms will be unwilling to take the time to report crimes to

²¹ World Bank (2003) notes that inequality is higher in Lesotho than in most countries in Sub-Saharan Africa. In 1994, the highest decile accounted for over half of all expenditures, while the bottom decile accounted for only 0.27 percent (World Bank, 2005b).

²² For example, Global Development Solutions (2004, p. 22) notes “there are clear indications that as the garment sector continues to grow, it is also brewing animosity among Basotho workers who feel that it is their right to hold supervisory and administrative positions... This is further compounded by social-cultural and language barriers.” Similarly, World Bank (2003, p. 12) notes “considerable ill will exists between the management and the low-skilled Basotho workers and between expatriate industrialists and the Basotho businessmen who feel that the [Government of Lesotho] favors foreign-owned businesses over them...”

the authorities. This appears consistent with other evidence—as noted in the Section on Corruption, very few firms reported that the police requested bribes during inspections.

Figure 31: Enterprises in Lesotho are as likely to report crimes to the police as in most of the comparator countries and are slightly more likely to have the crimes solved.

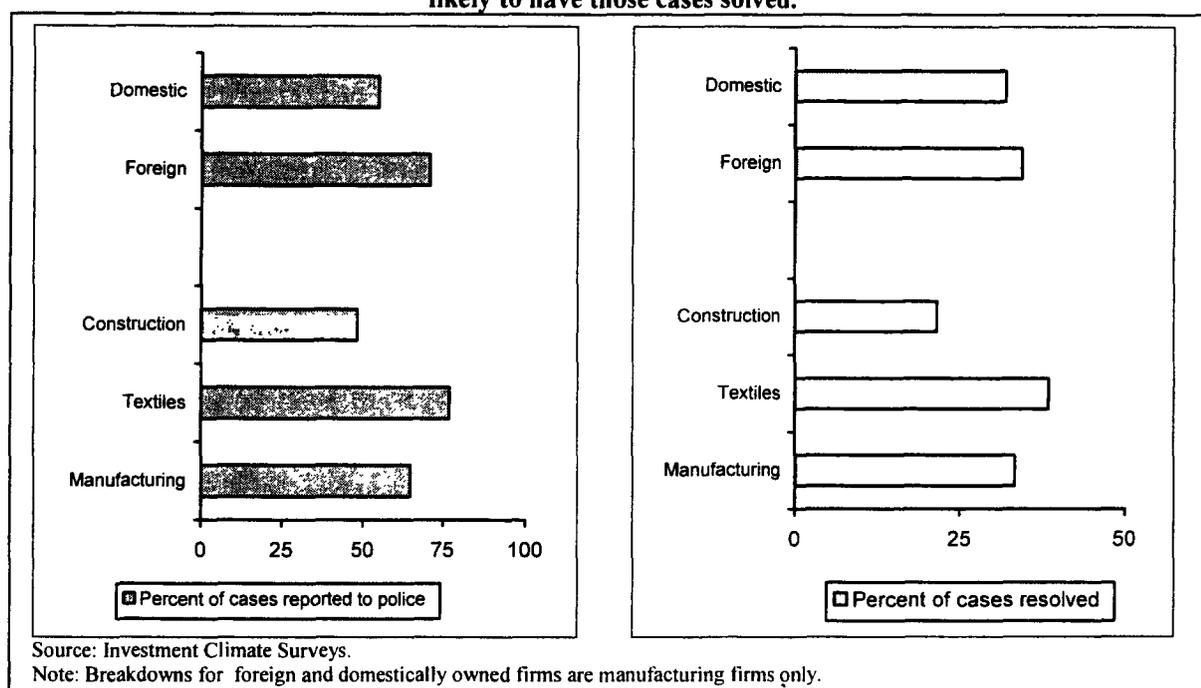


Another positive sign is that firms also reported that many of the reported crimes were resolved after being reported to the police. Close to one-third of reported crimes were resolved in Lesotho—higher than in China, Kenya, South Africa or Tanzania. Since firms are probably be more likely to report crimes when they believe that they might be solved, this seems consistent with the previous evidence regarding reporting. Consistent with this, firms also expressed confidence in the court system. About 60 percent of firms said that they were confident that the courts would protect their property rights—more than in Kenya, Tanzania or Senegal.

Although better performing than in many other low-income countries in Sub-Saharan Africa, some concern remains. Confidence in the court system is lower than in China, South Africa and other middle income countries such as India, Malaysia and Peru. Moreover, there is concern that both the judiciary and the police force are understaffed, leading to a substantial backlog in cases (Pawlowska, 2004). For firms that had disputes over payments that had to be resolved by court action, it took about 32 weeks to resolve a case. Understaffing, and the associated delays in resolving cases, could potentially undermine confidence in the court system in the medium term.

Foreign-owned firms and garment firms were more likely to report crimes to the police than other firms were (see Figure 32). These same firms were also more likely to report that their cases were resolved. One possible explanation for this might be that the police try especially hard to resolve cases for these firms, which might be seen as particularly important for the domestic economy. If the cost of crime is too high, foreign-owned firms might be especially likely to have this affect their investment and location decisions. Another potential explanation might be that these firms were also more likely to report that employee theft was a particular problem. If it is easier to catch the perpetrator when the perpetrator is an employee, this could also explain the observed pattern.

Figure 32: Foreign-owned manufacturers are more likely to report cases to the police and are more likely to have those cases solved.



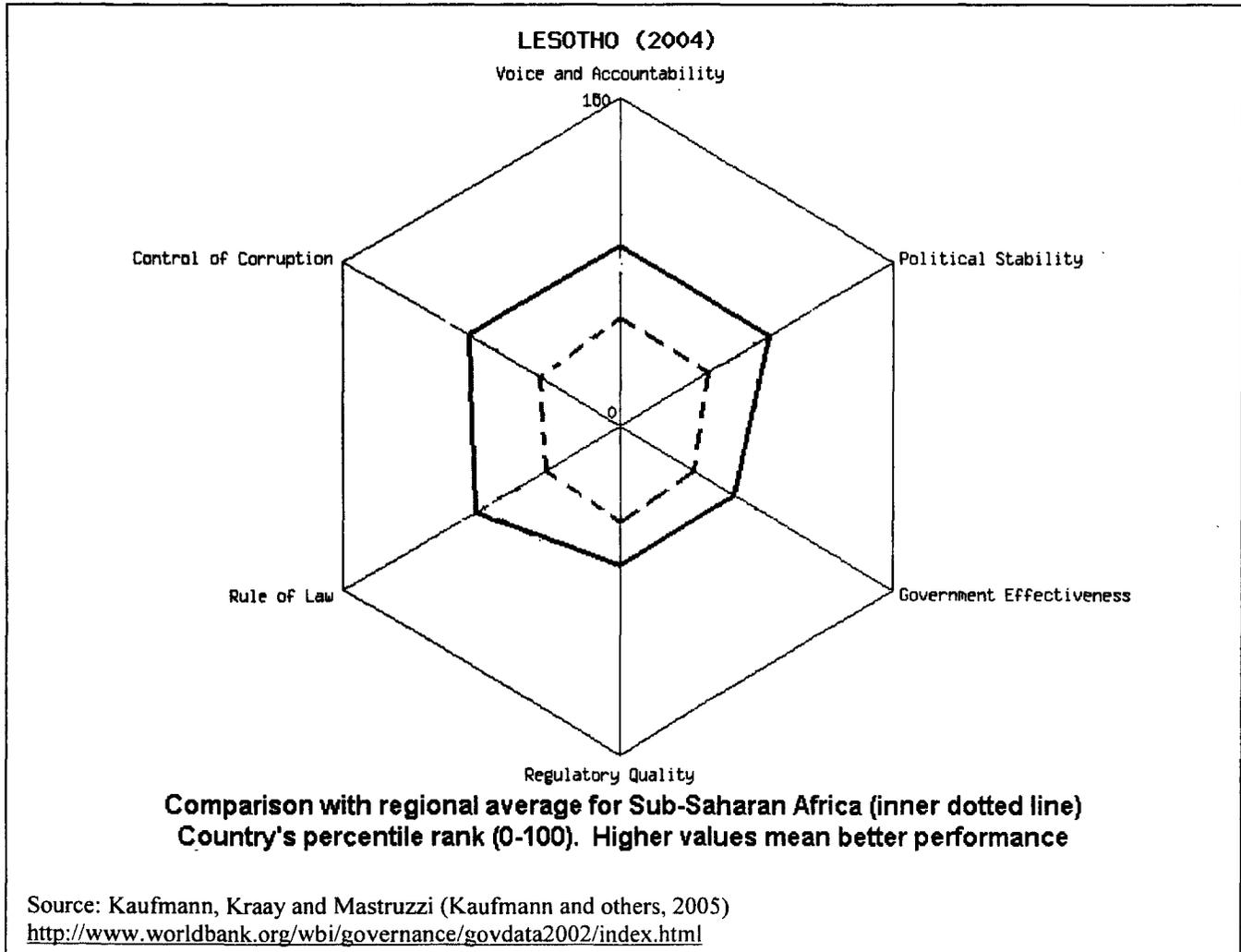
V. CORRUPTION AND REGULATION

V.1 Corruption

In the 2005 edition of Transparency International's Corruption Perceptions Index, Lesotho ranked 70th out of 159 countries, above most of the comparator countries except South Africa (46th). Other evidence also suggests that corruption is less of a concern in Lesotho than it is many other countries in Sub-Saharan Africa. Kauffman, Kraay and Mastruzzi (2003) ranked Lesotho at about the 50th percentile for corruption in 2004 (see Figure 33). This is better than the regional average

(the average country in Sub-Saharan Africa ranks in the 30th percentile) and better than the average for low-income countries (24th percentile).

Figure 33: Lesotho ranked better than average for Sub-Saharan Africa on all measures of governance.



Lesotho also ranks relatively well on most of the other governance indicators in the Kaufmann, Kraay and Mastruzzi (2005). On all indicators, voice and accountability, control of corruption, government effectiveness, regulatory quality, rule of law and political stability, Lesotho performed better than average for Sub-Saharan Africa. These measures are described in detail in Box 3.1.

Box 3.1: Different Aspects of Governance

In recent years, many researchers and practitioners have tried to produce aggregate statistics that can be used to compare the quality of governance across countries and for single countries over time. Few of these studies cover the entire world or all topics. Further, although the studies often cover similar topics, responses and questions are usually not comparable across surveys. In order to increase country coverage, Kaufmann, Kraay, and Mastruzzi (2003) combined information from as many as 60 mostly subjective indices from other sources to produce six measures that capture different aspects on regulation, corruption and governance. The six measures are:

Voice and Accountability: the extent to which citizens of the country are able to participate in the selection of government.

Political Stability: the likelihood that the government will be destabilized or overthrown by possibly unconstitutional and/or violent means, including terrorism.

Government Effectiveness: the quality of public service provision and the government bureaucracy, the competence and independence of the civil service, and the credibility of the government's commitment to adhering to announced policies. This measure primarily focuses on 'inputs' that government's need to implement good policies and deliver public goods.

Regulatory Quality: the quality of government policies. This measure is 'output' rather than 'input' based, in that it focuses on the prevalence of market-unfriendly policies such as price controls or inadequate bank supervision, as well as perceptions about the burden imposed on businesses by regulation.

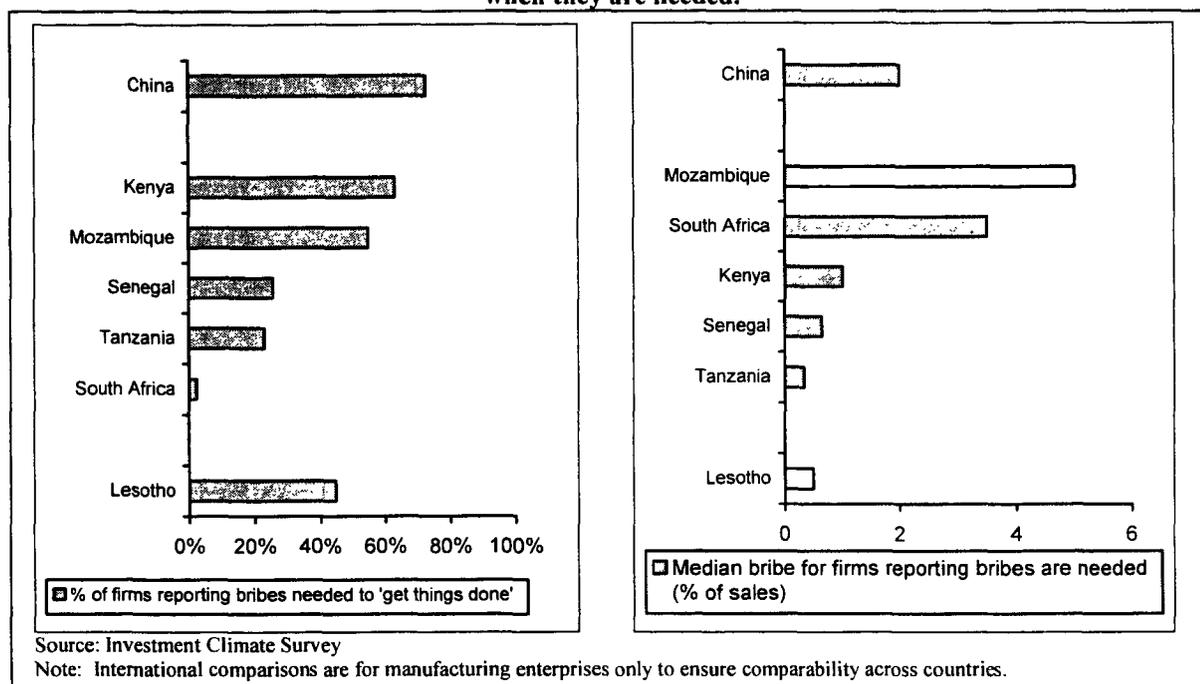
Rule of Law: the extent to which individuals have confidence in and abide by the rules of society. This includes perceptions about the incidence of crime (both violent and non-violent), the effectiveness and predictability of the judiciary, and the enforceability of contracts.

Control of Corruption: the extent of corruption (i.e., the illegal use of public power for private gain).

Although corruption remain a concern for many enterprises in Lesotho—about 36 percent of enterprises said that corruption is a serious issue for their business—the objective indicators of corruption are consistent with the earlier results. Compared with other countries in Sub-Saharan Africa and China, corruption appears to be relatively low in Lesotho.

When asked whether 'gifts or informal payments' are needed for a 'typical firm like yours' to 'get things done with regards to customs, taxes, licenses, and regulations, services etc.', about 45 percent of managers in Lesotho said that they were needed. This was considerably higher than in South Africa, where only 2 percent of enterprises said that they were needed. But, it was lower than in Mozambique, Kenya, or China.

Figure 34: Firms are less likely to report that bribes are needed and report that bribes are lower when they are needed.



Moreover, the median reported amount for enterprises reporting that bribes were needed was low—only 0.4 percent of sales. For firms that reported bribes were needed, payments exceeded 0.5 percent of sales in Senegal, 1 percent of sales in Kenya, and were over 2 percent of sales in South Africa, China and Mozambique.

Other indicators of corruption also suggest that corruption remains a relatively modest problem in Lesotho. Only 16 percent of manufacturing firms and 23 percent of construction firms said that gifts or informal payments were needed to secure government contracts. Moreover, the reported amounts were quite low—only 1 and 2 percent of the contract value for the median manufacturing and construction enterprise.

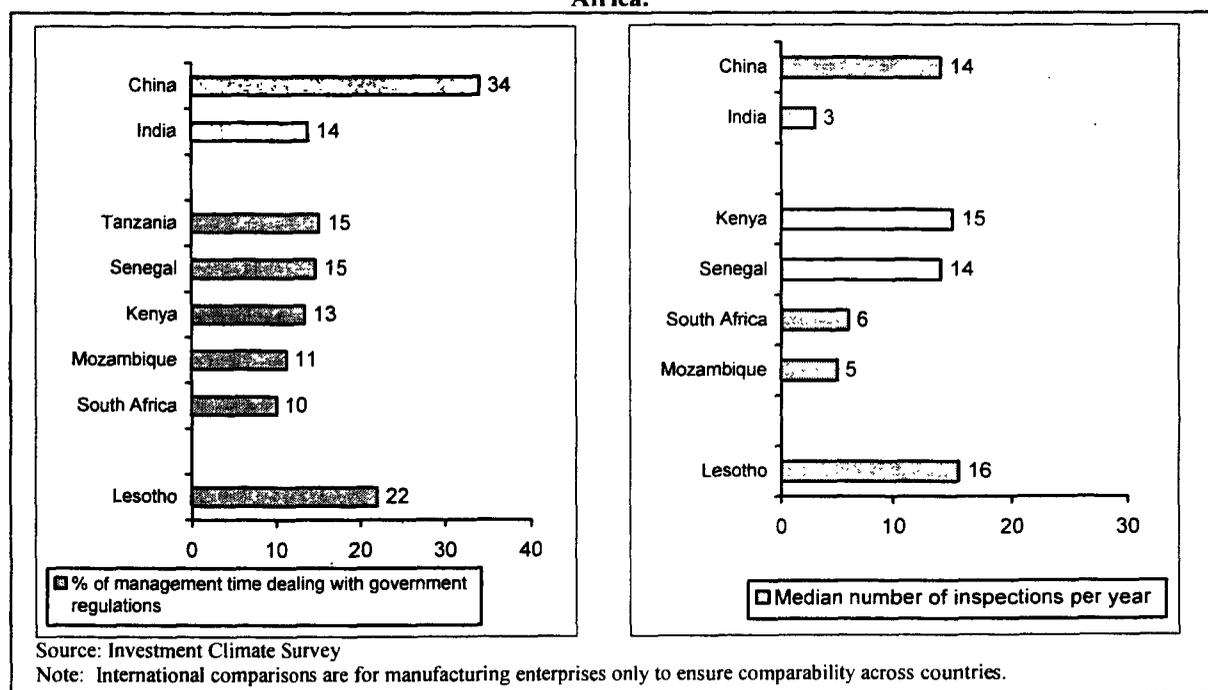
Firms were also unlikely to report that bribes were needed in many government interactions. For example, no firms reported that bribes were needed to deal with government inspections in the areas of fire and building safety, municipal police, sanitation or the environment (see Table 10). Only 3 percent of firms reported that bribes were needed to deal with tax inspectors and only 2 percent for labor and social security inspections. Similarly, few firms reported that bribes were needed for utility connections or licenses. No firms that had recently obtained them reported that bribes were needed for construction permits, import licenses or mainland telephone connections.

Moreover, only 5 percent of firms reported that bribes were needed for an operating license, 4 percent for water connections and 7 percent for electricity connections.

V.2 Inspections and Regulation

Corruption is often thought to be a response to overly restrictive regulation. Rather than complying with restrictive regulations, it can sometimes be easier and less expensive to try to use bribes or side payments to avoid them. Overly restrictive regulation gives firm managers a strong incentive to offer bribes to government officials, while government officials will have a strong incentive to try to adopt and enforce restrictive regulations in environments where bribery and corruption are common. As a result, restrictive regulations and bribes often go hand-in-hand.

Figure 35: The burden of regulation is high in Lesotho compared to other countries in Sub-Saharan Africa.



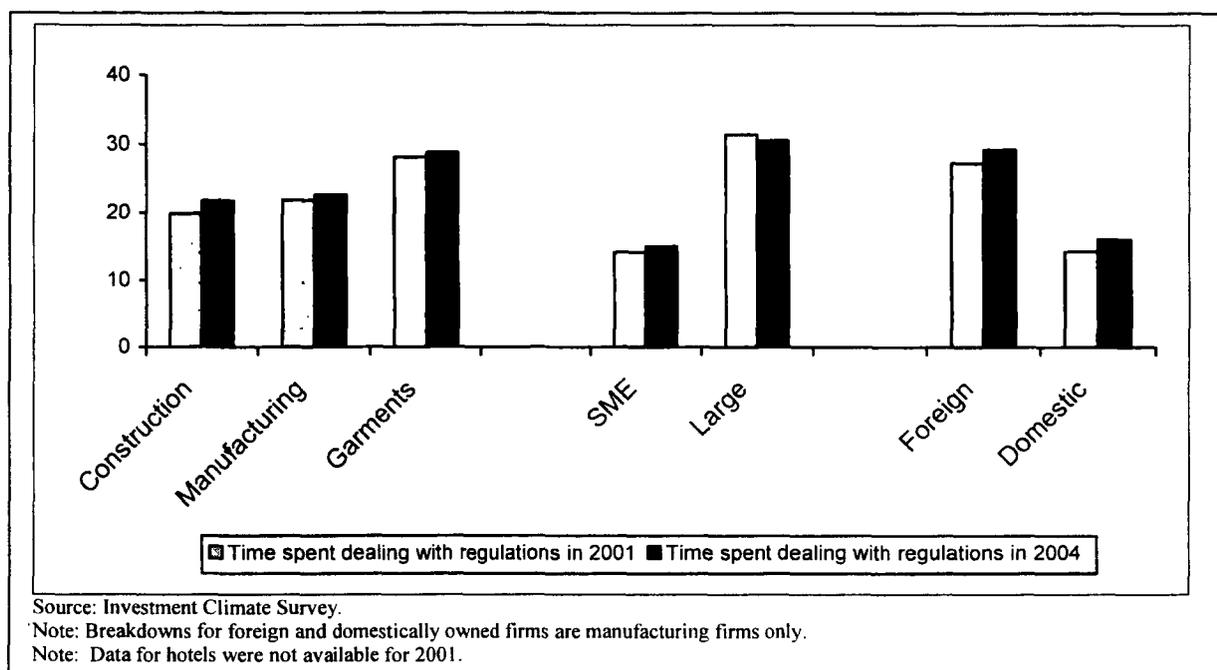
Given that corruption appears to be a relatively modest problem in Lesotho, it seems possible that the burden of regulation would also be modest in Lesotho. This does not appear to be the case. Enterprise managers reported spending more time dealing with government regulations and inspections in Lesotho than in any of the comparator countries except for China (see Figure 35). The average enterprise manager reported spending about 22 percent of their time dealing with regulations and inspections, compared to less than 15 percent in Tanzania, Kenya, Senegal, South Africa, India, or Mozambique. A similar pattern can be observed with respect to inspections.

Enterprise managers in Lesotho reported more inspections than managers in any of the comparator countries including China.

In addition to asking about the burden of regulation in 2004, the survey also asked about the burden in 2001. Although retrospective questions should be treated cautiously, there was little evidence that the burden of regulation has fallen in recent years. Enterprise managers reported that they spent about 20 percent of their time dealing with government inspections and regulations in 2001, compared to about 22 percent in 2004. This appears true for most types of enterprise (see Figure 36), although the differences are usually small and statistically insignificant.

Although actual estimates might be difficult to make retrospectively, these two questions were asked at the same place on the survey. Thus, managers should have been able to remember their answer to the question about the burden three years ago when they answered the questions about the current version. The evidence from comparing these numbers paints a similar picture. About half of the enterprises in survey said they spent about the same amount of time in the two years dealing with government regulations and inspections, about 20 percent said they spent less and 30 percent said they spent more time. This suggests that the burden of regulation has stayed about the same—or increased—in recent years.

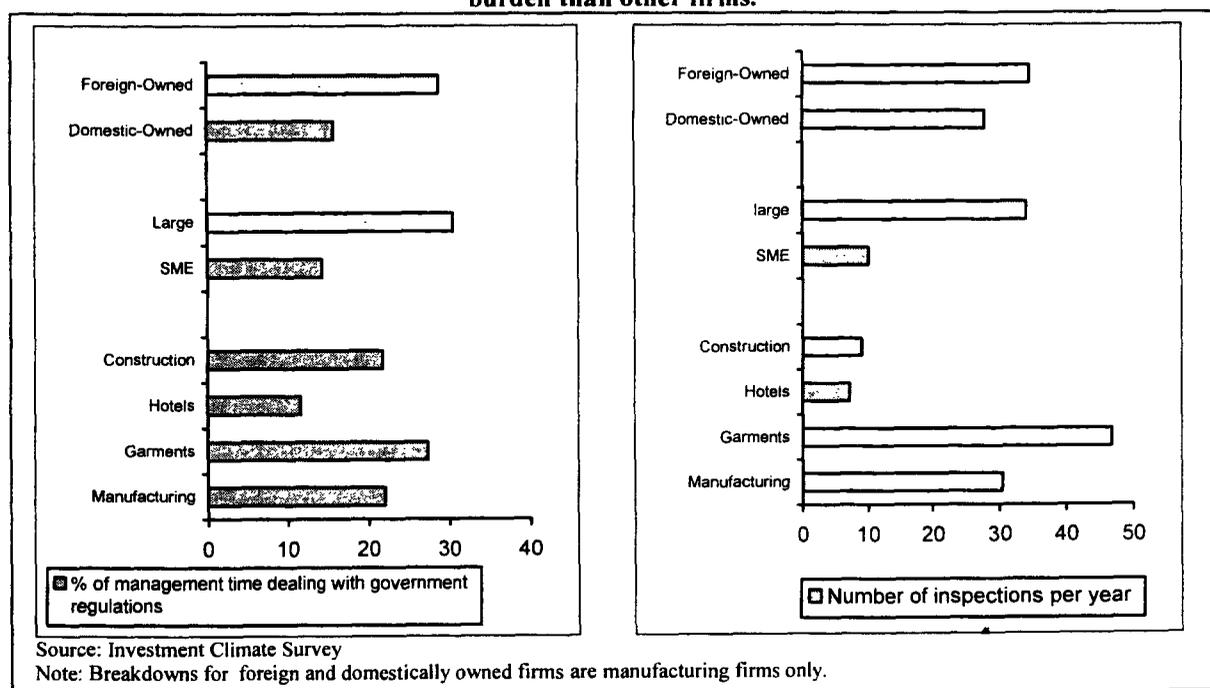
Figure 36: The regulatory burden is as high, or even higher, in 2004 than it was in 2001.



The burden of regulation varies considerably across different types of firms (see Figure 37). The patterns, however, for the questions about inspections and the total burden of regulation provide similar evidence. First, as in most countries, the burden of regulation is greater for large firms. Whereas the manager of the median large firm spend about 30 percent of their time dealing with government regulations and faced 34 required meetings and inspections in a year, the median manager for a small firm spent only 14 percent of their time and had 10 required meetings or inspections.

The burden is also heavier on manufacturing firms, and garment producers in particular, than on hotels or construction firms. Manager of hotels spend less time dealing with government regulations and faced fewer required meeting and inspections than managers of other firms. Consistent with the evidence that garment producers face more inspections and a greater regulatory burden, foreign-owned enterprises (many of which are in the garments sector) also faced a greater burden.

Figure 37: Manufacturing firms—and garments firms in particular—face a greater regulatory burden than other firms.



Most required meetings and inspections were with tax inspectors (see Table 10). Over 85 percent of enterprises had at least one required meeting with tax inspectors for all types of enterprise. Although construction firms and hotels were more likely to have required meetings with tax inspectors than manufacturing firms, they typically had fewer meetings—only one or two in a

year—when they did. About 77 percent of manufacturing firms also met with labor inspectors, although this was less common in the construction and hotel sectors. Other inspections were less common—especially for construction firms and hotels. As discussed above, very few firms reported that informal payments were expected or requested during any of these meetings.

Table 10: Inspections and bribe requests by type of inspector.

	Percent of firms reporting inspections			Median number of inspections for firms that were inspected			% of firms reporting bribes requested
	Manufacturing	Construction	Hotels	Manufacturing	Construction	Hotels	Total
Tax Inspectorate	85%	93%	92%	7	2	1	3%
Labor and Social Security	77%	21%	58%	2.5	4		2%
Fire and Building Safety	47%	14%	0%	2			0%
Sanitation/Epidemiology	32%	14%	8%	3.5			0%
Municipal Police	29%	14%	8%	2.5			0%
Environmental	27%	14%	33%	2			0%

Note: Median number of inspections omitted when fewer than 5 firms reported inspections.

V.3 Entry Restrictions

Some level of entry regulations are necessary—for example, registering with the tax authorities. But entry regulations, if too burdensome or expensive, can discourage firms from becoming formal or even from starting to operate. Although fewer than thirty percent of firms rated business licensing as a major or very serious obstacle to their own operations and growth, since these firms had already completed these procedures, this might not reflect the burden that entry restrictions put on new (rather than existing) enterprises. Further, existing firms might even view restrictions positively if they believe they reduce new entry and limit their competition. Because existing firms are not always the firms that you want to ask about entry restrictions, we will supplement the evidence from the Investment Climate Survey with information from the World Bank's Doing Business database (World Bank, 2004a).

In 2005, entrepreneurs had to complete nine procedures to start a business in Lesotho. These procedures took on average 92 days. This is higher than in most of the comparator countries (India, China, Tanzania, Kenya, South Africa, Senegal, and Tanzania)—among the comparators only Mozambique has a longer process than Lesotho. The cost is also high in both dollar terms (\$453) and as a percent of per capita income (61.2 percent). This is higher than in three of the seven comparator countries, although it compares favorably to the regional average of 215.3 percent. On all measures, number of procedures, time to complete them and cost, Lesotho falls far short of the

OECD average (6 procedures, 19 days, and 6.5 percent of per capita income). By reducing procedures and the time to complete each procedure, the Government could seriously reduce entry costs.

The most expensive procedure of the registration process is the hiring of an attorney, as can be seen in the table below. This regulation is not supported by legislation, but it is a rule that was created by the registry. This rule came about due to the number of errors that had been present in previous applications; however, the presence of errors may be attributed to lack of guidance within the application material or perhaps unsatisfactory documentation (World Bank, 2004b). Were the documents structured in a simple manner, an attorney should not be necessary for application submission which would reduce by more than 50% the cost of the overall process.

Nature of Procedure (2004)	Proc #	Duration (days)	US\$ Cost
Hire a registered attorney	1	30	267.62
Open a bank account	2	12	0
Submit Forms for Tax Registration	3	1*	0
Register for Sales Tax	4	60*	0
Have land lease stamped and pay the stamp duty	5	1*	3.04
Request for a Post Office Box or Private Box	6	1*	0
File for Workman's Compensation	7	1*	0
Apply for Manufacturing or Trading License	8	30*	225.90
Receive an inspection by the Public Health Inspector	9	14*	0
Totals:	9	92	\$496.56

* This procedure runs simultaneously with previous procedures.
Source: World Bank (2004a).

Several other processes should be mentioned that influence the cost of setting up a business in Lesotho. The first process is the selection of a company name. This supposedly simple task is a conspicuously time consuming process. To ensure that companies do not have names that duplicate existing companies or societies, a clerk must manually check all company names that have been registered, as well as society names. Complicating this process, the companies are ordered by registration date, rather than alphabetically (World Bank, 2004b). This process can take several days, and remains error prone. The process would be greatly simplified by the implementation of a database to store this material.

In addition to procedures directly related to setting up a business, other processes also increase the time and cost of starting a business and the cost of expansion. One is the issuance of visas and work permits for foreign staff (Pawlowska, 2004). As most foreign investors bring some of their own staff into the country to start the business and manage the business once it is operational, the procedures for obtaining a visa and work permit can create delays if not executed

efficiently. Obtaining a visa to enter Lesotho can be difficult. As Lesotho does not have extensive diplomatic missions, foreign investors may need to travel to a separate country to obtain a visa prior to entry, as visas are not granted at ports of entry in Lesotho. Also, as consular officers have little training in visa issuance, the process can take longer than necessary, or the officers could admit people who should be denied entrance. The inability to issue a visa at ports of entry creates added burden for investors entering the country.

The issuance of work permits also creates burdens for investors in Lesotho. The Labor Code requires all non-citizens, planning to work in Lesotho, to have a certificate of employment. Such a certificate can be obtained from the Labor Commissioner. They must be satisfied that the position could not be filled by a citizen of Lesotho. The Labor Review Board, composed of several ministries, meets weekly to prepare the certificates which must be approved by the Minister of Labor and Employment (World Bank, 2004b). This process would seem to require three separate approvals for a regulation whose requirements are clearly specified in the Labor Code. It is not surprising that this process confuses new immigrants and employers. These certificates have a maximum duration of two years but are commonly issued for a single year.

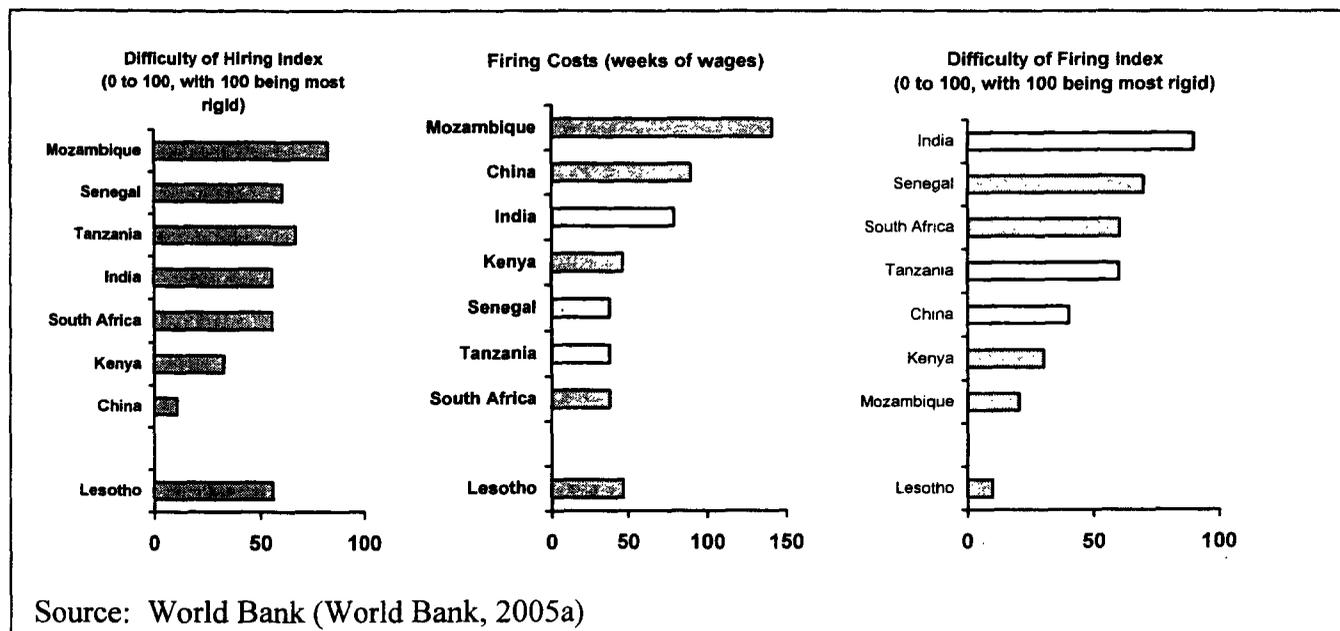
A final factor that affects ease of entry and expansion is restrictions on land ownership. The Land Act of 1979 restricts the foreign ownership of land. In lieu of ownership, foreign investors may lease land for a period of 30 years from the Lesotho National Development Corporation (LNDC). As the return on investment may require a longer time period than 30 years, the regulation discourages investment in Lesotho (Public Private Infrastructure Advisory Facility, 2004).

V.4 Labor Regulation.

Another process that increases the cost of entry and the ease of expansion is hiring and firing employees. In this area, Lesotho compares favorably to both Sub-Saharan Africa and the OECD, having less rigid procedures than the average countries in both regions. When analyzing these indices against specific comparator countries, Lesotho's hiring index of 60 is better than or the same as most of the comparator countries. For the firing index, Lesotho has the least rigid environment with a score of 10. Mozambique comes in second for this measure at 20. On the cost of firing a worker in weeks of wages, Lesotho also performs better than, or close to, most of the comparator

countries. The positive regulatory environment for labor is echoed by UNCTAD's Investment Policy Review of Lesotho. They note that the labor policy and administration is a strong feature of Lesotho's investment environment, allowing Lesotho to hold a competitive advantage over regional competitors.

Figure 38: Labor Market Regulations



VI. MACROECONOMIC INSTABILITY

As discussed in Chapter 1, Lesotho has enjoyed modest GDP growth and relatively subdued levels of inflation over the past decade. Despite Lesotho's relatively impressive macroeconomic performance, about 40 percent of enterprise managers in Lesotho rated macroeconomic instability as a serious concern. But there were differing opinions on macroeconomic instability across groups of enterprises. About 53 percent of exporters and 56 percent of garment firms saw macroeconomic instability as a major or very severe obstacle to their operations and growth. For these groups, enterprise managers were more likely to rate macroeconomic instability as a serious problem than any other issue that the survey asked about. In contrast, only 29 percent of non-exporters saw it as a serious obstacle, meaning that it did not even rank in the top five problems.

The reason why exporters and non-exporters have differing opinions of the importance of macroeconomic instability is that the main concern in the area is exchange rate instability (see Figure 5). Although the peg with the Rand means that there has been little instability with respect

to the Rand, the Rand has varied greatly against the US dollar in recent years. This is extremely problematic for garment exporters because about 93 percent of garment exports from Lesotho are bound for the U.S. market (Global Development Solutions, 2004). Although these firms import many of the raw materials from Asia, labor costs, which are equal to about two-third of value-added in Lesotho (see Figure 9) are denominated in local currency. Consequently, the rapid changes in the bilateral real exchange rate with the US dollar in a commodity-type good can have a serious impact on firm profitability and probably explains why exporters, and garment producers in particular, see macroeconomic instability as a major issue despite the relatively favorable inflation and growth rates.

This emphasizes the importance of diversifying exports away from the United States. The heavy reliance of firms on exports to the United States, due in part to AGOA, may worsen concerns about the macroeconomic instability, especially given the dollar's recent instability in currency markets (World Bank, 2003). Diversifying export markets outside of the United States and exports out of the garment sector will reduce concern about the dollar-Rand exchange rate and make the economy less vulnerable to exchange rate fluctuations.

VII. TAXATION

About 44 percent of enterprises in Lesotho rated tax administration as a major or very severe obstacle to enterprise operations and growth and 43 percent rated tax rates as a major or very severe obstacle. Overall, this means that enterprises managers saw tax administration and tax rates rated as the third and fourth largest constraints in Lesotho.

VII.1 Tax Rates

About 43 percent of manufacturing enterprises, 40 percent of construction firms and 38 percent of hotels said that tax rates were a major or very severe constraint on their operations and growth. Domestically owned enterprises were more likely to say that tax rates were a serious problem than foreign-owned enterprises.

Although this might suggest that taxes are a serious problem, it is important to keep in mind two important points. First, although taxes represent a cost to firms and reduce their incentives to invest and create jobs, governments need revenue to cover the cost of providing public services—

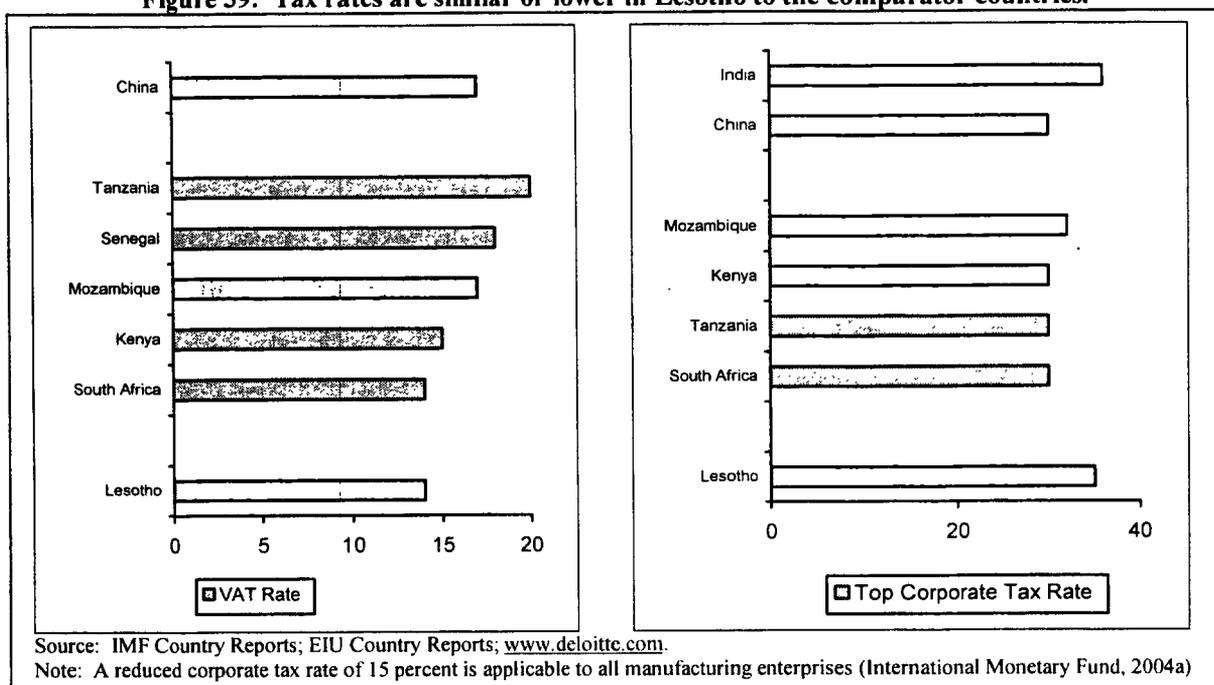
including those that improve the functioning of the investment climate. All countries struggle with how to strike a balance between these priorities in an efficient and equitable way. Second, tax rates typically rank among enterprises' greatest concerns. According the 2005 World Development Report, enterprise managers ranked tax rates among the top five obstacles in over 4 out of 5 low income countries where Investment Climate Surveys had been completed. Further, in all four low-income comparator countries in Sub-Saharan Africa, firms were more likely to say that taxes were a serious concern than they were in Lesotho.²³

Consistent with the idea that tax rates are not an especially great problem in Lesotho, they do not appear to be higher in Lesotho than in most of the comparator countries (see Figure 39). At the time of the survey, the top corporate tax rate is 35 percent in Lesotho.²⁴ This is similar to India and is slightly higher than in Kenya, Tanzania, South Africa and China (30 percent). However, a reduced corporate tax rate of 15 percent was applicable for manufacturers at this time (International Monetary Fund, 2004a), favoring these enterprises over service firms. The value-added tax (VAT) is low by international standards. The standard rate is 14 percent, lower than in Tanzania, Senegal, Mozambique, Kenya or China, and the same as in South Africa.

²³ 51 percent of enterprises in Senegal, 54 percent in Mozambique, 68 percent in Kenya, and 73 percent in Tanzania said taxes were a major or very severe problem.

²⁴ Since the survey was completed, the tax was reduced to 25 percent for non-manufacturers and 10 percent for manufacturers and most income from foreign sources of income outside of SACU was exempted from corporate income taxes (interview with Commissioner General of Lesotho Revenue Authority, March 29, 2006).

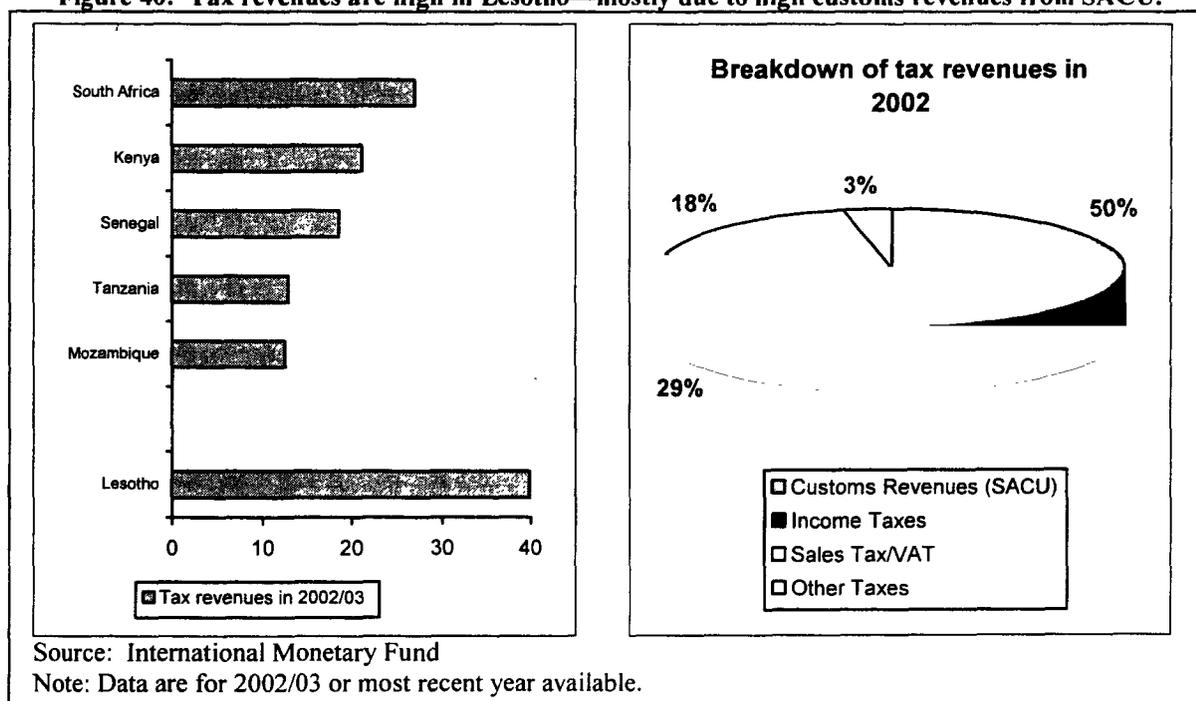
Figure 39: Tax rates are similar or lower in Lesotho to the comparator countries.



Results from the World Bank's recent Doing Business report are consistent with the idea that taxes are not especially high for manufacturers in Lesotho (World Bank, 2005a). This report calculated how much a business that produces ceramic flowerpots and sells them in the domestic market would pay in taxes under a standard set of assumptions about profits, ownership, and other enterprise characteristics. Under these assumptions, the representative firm would pay about 38 percent of profits in local and national taxes in Lesotho. This was lower than in any of the comparator countries (average of 48 percent).

Although rates on income taxes and value-added taxes are similar, or lower, in Lesotho than they are in other low and middle income countries, tax revenues are relatively high. According to data from the International Monetary Fund, tax revenues were equal to about 40 percent of GDP in 2003/04. This is far higher than in most low-income countries in Sub-Saharan Africa (see Figure 40). For example, tax revenues were equal to about 12-13 percent of GDP in Tanzania and Mozambique and about 19-21 percent of GDP in Kenya and Senegal. Although tax revenues generally increase with country income, tax revenues are also higher as a percent of GDP in Lesotho, than in South Africa.

Figure 40: Tax revenues are high in Lesotho—mostly due to high customs revenues from SACU.



Although this might suggest that taxes are high in Lesotho, as noted in Chapter 1 most tax revenues—close to 50 percent—are customs revenues from SACU. Revenues from other taxes are more similar to revenues in other countries. For example, income taxes (including corporate income taxes) are equal to about 7.5 percent of GDP in Lesotho in 2003/04. Although this is higher than in Tanzania or Mozambique (about 3 percent of GDP), it is fairly close to Kenya (between 6 and 7 percent of GDP). Similarly, revenue from the value-added tax is equal to about 4.5 percent of GDP in Lesotho, compared to 3.5 percent of GDP in Kenya. The higher revenue in Lesotho might be due to the importance of trade in the country—value-added taxes are usually easier to collect on imported goods than domestically produced goods (Ebrill and others, 2001). In summary, although

tax revenues are high in Lesotho, taxes on businesses do not appear to be out of line with other countries.

VII.2 Tax Administration

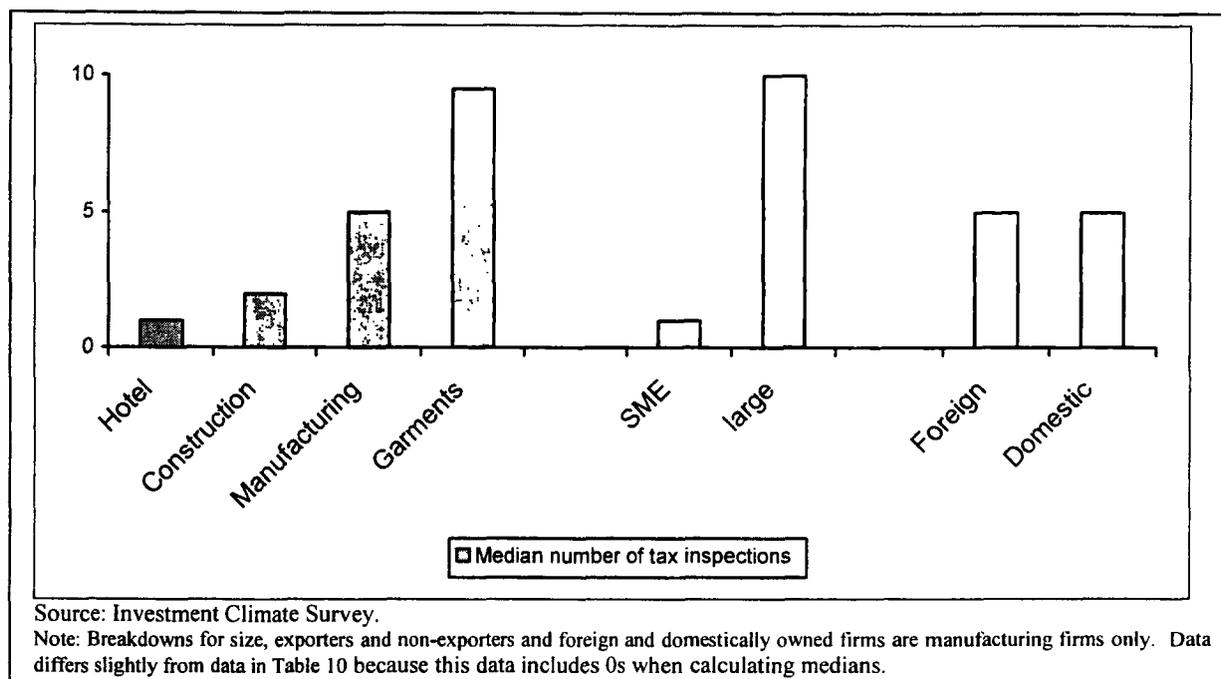
About 43 percent of enterprise managers said that tax administration was a serious obstacle to enterprise operations and growth. In contrast to tax rates, both foreign and domestic enterprises rated tax administration as a serious concern—about 42 percent of foreign-owned and about 45 percent of domestic enterprises. Garment manufacturers were slightly less concerned about tax administration than other enterprises (32 percent rated it a serious obstacle), but it remained a concern even for these enterprises.

Objective indicators support the idea that tax administration is relatively burdensome in Lesotho. In addition to the perception based measures, firms were also asked about the number of tax inspections that they faced during the previous year (see Table 10). The median enterprise in Lesotho reported 7 inspections or required meetings. In comparison, the median enterprise in South Africa and Mozambique reported 1, the median enterprise in Kenya reported 2, and the median enterprise in Tanzania reported 6.

As with the total number of inspections, large enterprises and garment firms faced more inspections and required meetings than other enterprises (see Figure 41). For example, the median manufacturing enterprise outside of the garments sector had about four inspections or required meetings while the median garment producer had about ten. Hotels and construction firms had fewer still.

Within the manufacturing sector, the burden tends to fall heavily on large enterprises. Whereas the median SME had only one inspection or required meeting, the median large enterprise had 10. Similar patterns can be observed in other countries, although the increase does not usually appear as steep. For example, the median small enterprise in Kenya had about two inspections or required meetings, while the median very large enterprise had five. Concentrating administrative effort on large and profitable firms generally makes sense from a revenue-maximizing approach, but can end up imposing a large burden on a few enterprises.

Figure 41: Large firms and firms in the garment sector have more required meetings with tax inspectors than other firms.

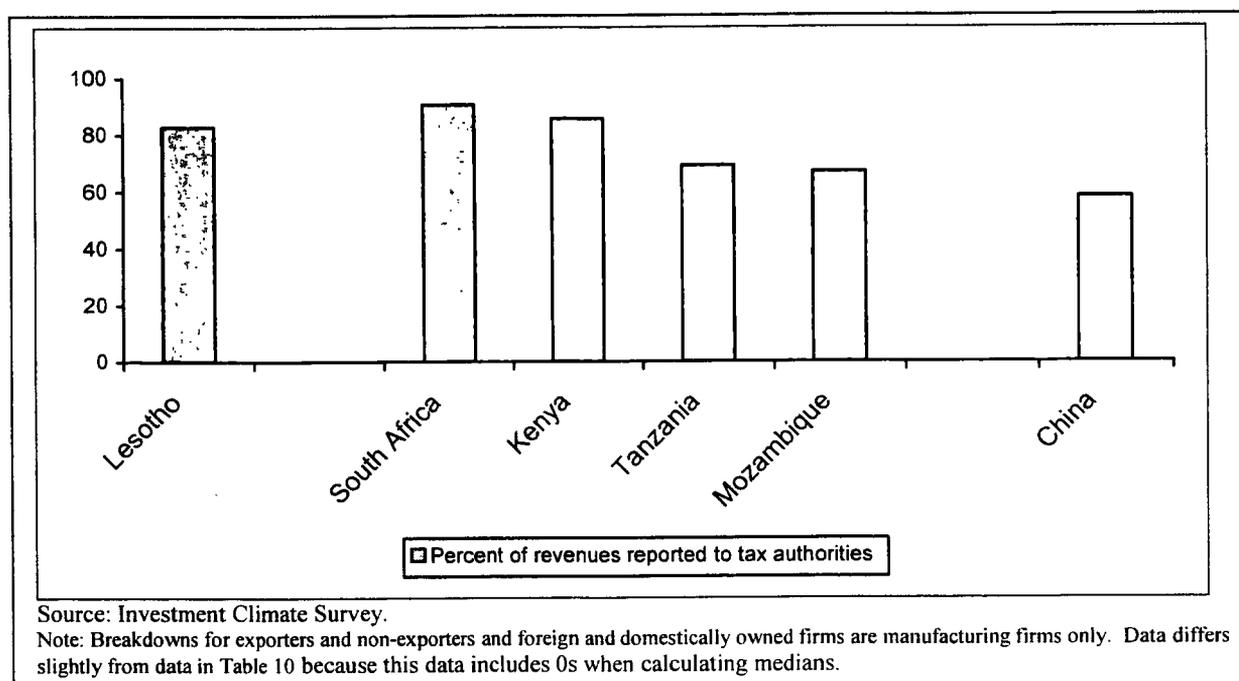


Tax administration appears to be relatively successful on some dimensions. First, as noted above, tax revenues are relatively high as a percent of GDP compared to other low-income countries in Africa. Given that tax rates do not appear out-of-line with rates in other countries, this suggests that tax effort (i.e., actual revenue collected compared to the theoretical level under full compliance) is relatively good.

Also consistent with this, firms reported that they believed that ‘firms like theirs’ generally reported most of their revenues to the tax authorities.²⁵ On average, enterprise managers said that firms like theirs reported about 83 percent of revenues to the tax authorities. Although lower than in South Africa (about 90 percent), this was considerably higher than in Tanzania or Mozambique (less than 70 percent in both cases).

²⁵ The question on the survey was phrased in this way (i.e., about other firms like theirs rather than the firm itself), so that enterprise managers could answer without implicitly admitting to tax evasion.

Figure 42: Firms report a greater share of revenues to the tax authorities in Lesotho than in many low income countries in Sub-Saharan Africa.



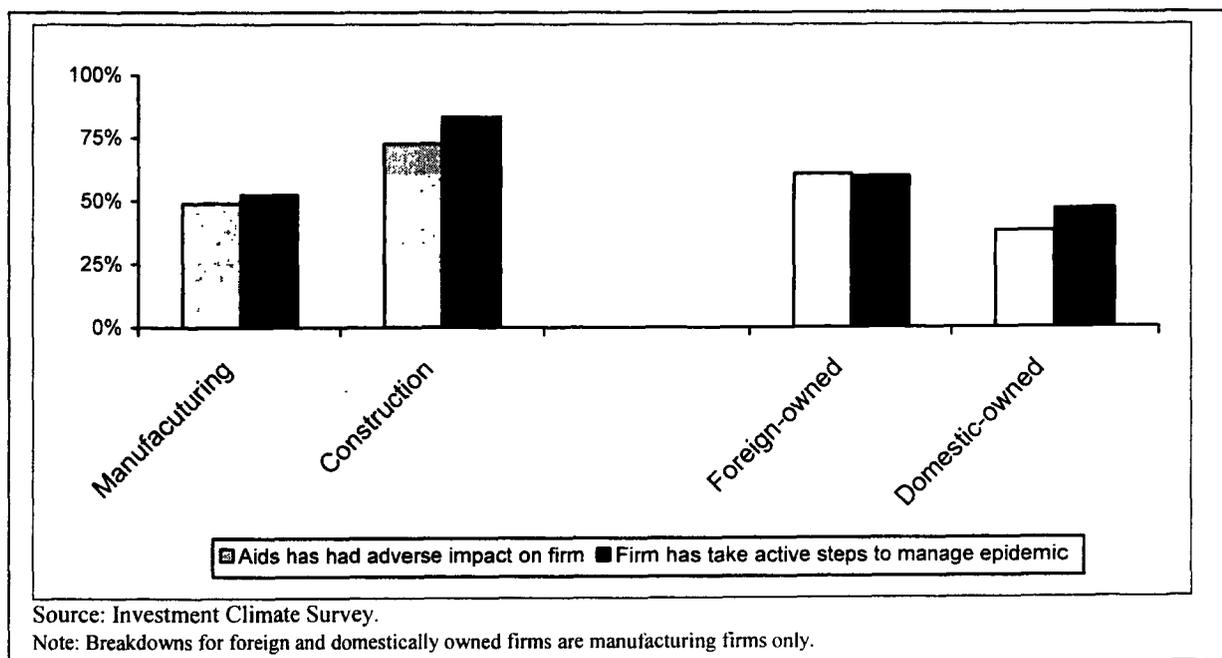
Although the results from this section suggest enterprises believe that the burden of tax administration is high, the survey results do not provide specific guidance on how to fix it and how to balance these concerns with other social goals. Taxes are needed to pay for vital services, including those related to the investment climate. To move forward, the impact of tax rates and administration on business competitiveness in different sectors deserves more attention. A more detailed analysis would make it possible to evaluate how to balance the government's need for revenue with firms' concerns about rates and administration.

VIII. AIDS

Lesotho has one of the highest HIV infection rates in the world. The first case of AIDS was reported in 1986 (Kingdom of Lesotho, 2005) and it is now estimated that as many as 33 percent of the adult population (15-49) are living with HIV/AIDS. Prevalence rates are likely to be even higher in many urban areas, with about 42 percent of the population living with AIDS in some urban areas (World Bank, 2005b).

In addition to the lost lives associated with the epidemic, HIV/AIDS also has the potential to undermine economic development—a point stressed in the Government's recent Poverty Reduction Strategy Paper (Kingdom of Lesotho, 2005). Estimates by the World Bank suggests that the GDP of Lesotho might be one-third lower in 2015 than it would have been in the absence of the epidemic (World Bank, 2000).

Figure 43: Firms in the construction industry and foreign-owned manufacturers were more likely to report that AIDS had had a negative impact on their firm and were more likely to have taken steps to manage the crisis.



Despite the magnitude of the crisis, only about half of manufacturing enterprises said that the epidemic had adversely affected their firm (see Figure 43). Foreign-owned manufacturers were more likely to say that it had had an adverse impact than domestic manufacturers and construction firms were far more likely to say that they had been adversely affected than manufacturing firms

One reason for the relatively modest level of concern appears to be that even among the firms that report that they have been adversely affected, most believed that it had had only a relatively minor impact. Managers that reported an impact were also asked to estimate how great the impact had been on various aspects of their business. The greatest affect appears to have been on labor turnover and absenteeism. About one-third of managers that believed that HIV/AIDS had adversely affected their firm estimated that it had increased labor turnover by more than five percent and a little more than one-third said that it had increased absenteeism by more than five percent. Fewer firms reported a large impact on labor productivity (only about one-fifth) and very few firms said that the epidemic had affected their medical costs significantly—no firm reported an increase greater than 5 percent and only one-fifth reported that it had increased medical costs by between 0-5 percent.

Table 11: About one-third of firms reported that HIV/AIDS had increased labor turnover and absenteeism by more than 5 percent.

Impact as a %	Percent of manufacturing firms that reported an impact of AIDS, that reported impact in several areas.			
	Decreased Labor Productivity	Increased Labor Turnover	Increased Absenteeism	Increased Medical Costs
0%	29%	42%	20%	83%
0-5%	54%	27%	44%	17%
Over 5%	18%	31%	36%	0%

Note: Questions asked firms to indicate the impact of AIDS/HIV on various measures of firm impact, expressed as a percentage. Question was not asked for construction firms or hotels

Given the low level of concern, it is not surprising that relatively few managers reported that their firm had take active steps to manage the effect of the epidemic. Consistent with the previous results suggesting that foreign-owned firms were more concerned about the business impact of the epidemic, they were also likely to report that they had taken any steps to manage the epidemic. Similarly, construction firms were more likely to report that they had any steps than manufacturing firms were. Few of these firms, however, believed that their actions had been very successful—only 35% described the results as good or excellent, while 22% said that their program had had very little success.

IX. LABOR RELATIONS

Enterprise managers estimated that about one-quarter of their employees in the manufacturing sector belonged to a union in the manufacturing sector (see Table 12). Employees of large enterprises were more likely to belong to unions than employees in small enterprises (24

percent for SMEs compared to 37 percent for large enterprises). Employees at export-oriented were no more likely to belong to unions than employees at non-exporters—29 percent compared to 30 percent for non-exporters. But employees at foreign-owned firms were slightly more likely to belong to unions—34 percent of employees in foreign-owned firms compared to 26 percent in domestic firms.

Industrial action was more common for foreign-owned firms and firms in the garment sector than for other firms. Over half of firms in the garments sector reported losing production due to strikes or labor disputes. In contrast, none of the other manufacturing firms (i.e., firms outside of the garments sector) reported losing production due to strikes or labor disputes. The number of garments firms losing production due to strikes is higher than in South Africa, where only about 13 percent of garment firms and 14 percent of other manufacturing firms reported losing production due to strikes or labor disputes. For firms that did suffer lost production, the losses appear relatively modest—the median firm that faced industrial action lost only two days of production due to strikes.

The high level of industrial action in foreign-owned firms might partially reflect either poor communication between management and employees in these firms or the high levels of wages inequality in these firms. As noted in the previous chapter, wages inequality is greater in foreign-owned firms than it is in domestically owned firms. In addition, it might also partially reflect tensions associated with having predominantly expatriate management and predominantly Basotho workers. Previous studies have noted that relying heavily on expatriate management can result in Basotho workers perceiving that they have few opportunities for upward mobility (Pawlowska, 2004). This, in turn, might contribute to the ill will that previous studies have noted exists between the foreign management and Basotho workers in some foreign-owned firms (Global Development Solutions, 2004; World Bank, 2003). As well as leading to industrial action, poor labor relations might also partly explain why managers in garment firms are particularly concerned about employee theft.

Table 12: Garment producers and hotels were more likely to lose production due to industrial action than other firms

	Percent of workforce in union	% of companies losing production due to strikes	Median number of days lost to strikes for firms with strikes
Garments	27	52%	2
Other Manufacturing	32	0%	---
Construction	21	15%	---
Hotels	9	50%	---
Foreign	34	38%	1.25
Domestic	26	11%	---

Source: Investment Climate Surveys

Note: Median days are not calculated for construction firms, hotels and domestic firms due to the small number of observations with any days lost.

Employees in the hotel and construction industries were less likely to report that they belonged to unions than employees in the manufacturing sector—only about 20 percent of the workforce in the construction sector and only 10 percent in the hotel sector. Only 15 percent of construction firms lost production due to strikes. Despite the low level of unionization, about half of the hotels in the sample reported losing production due to strikes or labor disputes in 2004.

CHAPTER 5: POLICY RECOMMENDATIONS

In this chapter we will attempt to provide key policy recommendations to assist the Government in addressing current weaknesses and improving environment for a faster and more diversified economic growth. We will start with a brief summary of the main conclusions reached in the previous chapters that analyzed the investment climate in Lesotho from the international and regional perspective.

I. SUMMARY OF KEY ICA SURVEY FINDINGS

One of the key objectives of the ICA is to assess the role of the investment climate in a particular country and that of the main constraints to doing business, increasing productivity and competitiveness of the economy. Analysis of labor productivity in Lesotho clearly indicates that Lesotho lags behind better performing economies in Sub-Saharan Africa (e.g., Kenya and Senegal) and the fast growing Asian economies of China and India.²⁶ This significant gap erodes and undermines the competitiveness of Lesotho economy and jeopardizes future development. Therefore, understanding of the underlying factors is of critical importance for the policy makers.

To identify the components of investment climate in Lesotho where policy actions are likely to have the most beneficial effect on private sector growth, the World Bank conducted an Investment Climate Survey of close to a hundred of businesses operating in manufacturing and service sectors sampled from across the country. Analysis of the constraints to business performance and growth will help policymakers crafting an industrial policy and a strategy for accelerating improvement of the investment climate. Survey results will also cast some light on severity of the constraints, which would enable the Government to prioritize and, subsequently, structure and sequence the reforms to alleviate the binding constraints and provide support and assistance to nurture the private sector growth.

These reforms will aim at building a Minimum Infrastructure Platform (MIP), which is a minimum combination of priority physical infrastructure investments with a specific set of

²⁶ Median labor productivity is almost twice as high in China as in Lesotho and is fifty percent higher in India.

investments in supporting facilities required to ensure sustainable growth and development of Lesotho's key economic industries.²⁷ The underlying assumption for promoting such an integrated approach is that if these basic building blocks are executed in tandem, they will unleash the growth potential often trapped and untapped in key resources of the Lesotho's economy. Further, from an economic development standpoint, there is empirical evidence to show that for foreign and domestic investments operating in productive sectors (e.g., agriculture, agro-business, tourism, mining, manufacturing) to meet their productive and economic objectives there needs to be a complement of preceding investments in supporting physical infrastructure as well as in facilitating institutions.

Based on the interviews with firms across Lesotho, top business climate constraints to day-to-day business operations identified by the investment climate survey can be clustered into five groups:

- (i) Crime, theft and disorder – 46.6% of respondents identified this area as a serious obstacle to their operation.
- (ii) Problems of cost of and access to external finance – 46.4% and 39.4%.
- (iii) Issues relating to tax administration and rates – 43.8% and 42.5% respectively.
- (iv) Access to basic physical infrastructure – electricity 35.6%, telecommunication 27%, and transport 21.9%.
- (v) Cumbersome public administrative and business regulatory requirements imposed on firms (such as license, registration, customs, etc.) – between 20% and 30%.²⁸
- (vi) Lack of skilled labor – 30.1%.

The Government is committed to remove these binding constraints and over the past years has undertaken a number of wide spread reforms in many areas. Important efforts are ongoing to improve access to basic physical infrastructure (i.e., power, telecom and water) as described in Chapter IV, Section II. In addition, the Government has recently outlined the key reforms to be fast tracked for implementation in three important areas (see Annex 1 for details): (i) the judiciary sector

²⁷ Including: (i) business environment; (ii) trade and investment facilitation regulations and institutions; (iii) human capital; and (iv) financial services.

²⁸ Experience shows that there is a close relationship between excessive business regulations and increased corruption. This is because firms try to avoid payments and circumvent the legal system.

and administration of justice; (ii) financial sector, and (iii) land tenure and mortgage regime, which should also contribute to increasing the availability of finance as the firms will be able to pledge land as collateral. These efforts are to be supported by the technical and financial assistance from the Millennium Challenge Corporation (MCC).

While these reforms are important for the private sector development in general, they will not be sufficient to accelerate the much needed diversification of the Lesotho economy away from the garment industry – the objective especially important in light of the potential end of third-party sourcing under AGOA in 2007. It is therefore, of utmost importance that diversification facilitated by attracting new FDI and growth of domestic private sector should be a priority for the Government of Lesotho. In this context, the following three areas emerge as top priority: (i) improving the regulatory and institutional framework for PSD; (ii) integrating Lesotho's transport with that of South Africa to reduce the costs of transport; and (iii) building the capacity of its people to improve the productivity of its workforce and accelerate economic diversification outside the garment industry.

II. IMPROVING THE BUSINESS ENVIRONMENT (REGULATORY AND INSTITUTIONAL FRAMEWORK)

Business regulations cover a wide range of cross-sectoral and sector-specific rules and laws governing business activities in a country, including administrative barriers to entry/exit (i.e., business registration and licensing requirements), labor relations and flexibility in labor use, efficiency and transparency of financing and taxation, regulations concerning the environment, safety, health, and other legitimate public interests, and trade/investment facilitation (i.e., customs rules and administration, technical standards and quality specifications for domestic market and export, tariffs/duty rebate regime, bonded warehouse system, etc.). Experience shows that by imposing more and increasingly restrictive requirements on the businesses, the governments may unwillingly contribute to increased illegal activities, corruption and rent-seeking behavior, as well as negatively affect FDI. The question, therefore, is not whether to regulate or not, but whether regulations are designed and implemented in a way that promotes and encourages legal business and investment, serves public interest and discourages harassment, corruption as well as adverse selection and moral hazard problems.

All these problems lead to increased cost and “hassle factor” for investors and increased corruption and thus, negatively affect the entrepreneur’s decision to invest, constrain implementation and in effect, increase transaction costs. The Government is committed to improve the business environment through reducing costs of doing business and strengthening legal framework. During the PSD Strategy Forum organized in Maseru (6-9 April, 2005), the Government, jointly with the key development partners (including the World Bank), has 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 and confirmed its support for fast-track implementation. The key reforms aiming at improving the business environment include:

- (v) Remove costly and time-consuming requirements to entry and doing business by streamline licensing and registration processes. 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.
- (vi) Remove obstacles to conduct business by improving immigration services. The reforms should 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.
- (vii) Improve customs procedures by decentralizing customs services and providing full customs clearance services in two large industrial estates in Maputsoe and Ha Nyenye and streamline the customs clearance process for import transactions.
- (viii) Lay foundations for a business-friendly legal and regulatory environment by developing and implementing a modern legal framework. Development of the *Investment Code* and adoption of the *Company Law* (currently in a draft form) would be a first step in the right direction. These laws would regulate and promote investments and to provide assurance to foreign investors against expropriation, nationalization, non-discriminatory treatment, international arbitration and freedom of investment in permissible areas. Other legal and regulatory legislation that would need to be reviewed and modernized to bring it into line with best

international practice includes: the Industrial Licensing Act (1969); Pioneer Industries Encouragement Act (1969); Aliens Control Act (1969).

It is important to notice that there is a strong need and benefits stemming from harmonizing the legislation governing PSD with that of South Africa. By doing so, Lesotho could benefit from the best practice approaches adopted there and economize on the scarce financial and human resources it has.

Institutional Support. In addition, as clearly indicated in the Integrated Framework Report, 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 so far 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 PRSP, it appears as it has lost its momentum and has yet to reach its potential for channeling dialog.

It is, therefore, recommended that immediate action should be undertaken to strengthen the institutional capacity of the economy-wide public and private institutions supporting PSD (including financial sector and institutions supplying information on market opportunities) in their capacity to serve the private sector, coordinate the dialogue with the Government and exchange information between them. The public-private consultative mechanism should also be improved and institutionalized.

III. REDUCING TRANSPORTATION BOTTLENECKS

It seems that, from the PSD perspective, the priority issue in the transport sector is to address the inefficiencies of the rail system and integrate it with the South African railway network, as it negatively impacts the biggest employer in Lesotho – the garment sector. Due to low reliability of the rail service and lack of capacity, the garment industry is almost exclusively relying on truck transport, which is approximately three times more expensive than rail. This places a high costs and squeezes profit margins of the investors, especially during the times of appreciation of Maloti/Rand against the dollar.

Taking into account that the rail sector is virtually dysfunctional in providing timely service to the manufacturing sector in Lesotho, the trucking sector lacks a competitive environment that would help reduce the cost of transporting inputs and finished products. The solution is not necessarily to regulate the trucking sector, but to help accelerate improvements in the rail sector to provide a choice for exporters. Namely, the Government needs to take the following steps:

- (i) Finalize the long-term lease agreement between Spoornet and the Government of Lesotho which is expected to open a path for Spoornet's investments in the rail yard in Maseru. Upon conclusion of the lease arrangements with Spoornet, improvements in the monitoring of container off-loading activities to reduce rent seeking activities should be undertaken.
- (ii) Clearly define its policies towards Spoornet particularly with respect to goods which have priority for imports when adequate number of rail cars is not available for entry into Lesotho.
- (iii) Support and assist the private sector in expanding access to affordable warehousing facilities within Maseru to limit importers from using container rail cars parked idle in Bloemfontein as a temporary warehousing solution.²⁹ This practice is contributing to the limited number of rail cars available in the system to effectively move goods in and out of Lesotho. Similarly, the Lesotho Textile Exporters Association must formulate a code of conduct that helps regulate this type of practice amongst its members.

²⁹ As one of the options the Government could consider the public-private partnership.

IV. IMPROVE AVAILABILITY OF SKILLED LABOR

If the Government of Lesotho is to successfully achieve its export diversification objectives, it should more actively seek technical assistance to build skilled labor force able to adapt to changing environment and fulfill the needs of growing private sector, foreign or domestic. Promoting investment by foreign and domestic companies in their staff is one way of helping meet the export potential untapped in the private sector. Increased availability of highly-trained Basotho will reduce production costs, improve product quality and allow for expansion of the range of products being exported including higher value added products. Also, public and private sector institutions supporting the private sector (such as sectoral and professional associations, chambers of commerce, investment, export promotion, quality and standards agencies, etc.) have an important role to play in improving the capacity of the workforce (see section above).

The ICA results show that productivity and competitiveness of SMEs are among the key constraints to their growth and development. While reasons for this are numerous, workers education and availability of training is one of them. For these reasons, capacity building (CB) is of critical importance for Lesotho to meet its growth and poverty reduction objectives.

It is, therefore, recommended that actions should be implemented to upgrade the level and range of skills to increase labor productivity through development and expansion of industry-driven technical and vocational education and training (TVET). In this context two priority actions include: (i) finalization and implementation of a national TVET strategy through a process of stakeholder consultation and establish legislation for the Training Levy and supporting institutional arrangements; and (ii) enhancing the effectiveness of TVET institutions through private-public partnerships. Linkages between training providers and employers should be established for the key institutions while the role and functions of others need to be refocused. A possible model (borrowed from the Penang Skills Development Center in Malaysia and presented in Box 1) could be employed to convert the Lerotholi Polytechnic into the proposed Clothing and Textiles Training Center.

Further, programs should be developed, with the assistance of the donor community, to support creation of backward and forward industrial linkages with the foreign garment multinationals, among local businesses and, if possible, regionally with the South African firms.

These programs would aim to improve the availability and quality of BDS services, including training through TVET institutions and extension services.

Box 1: A possible model for private-public partnership for the textile and garment industry

Interviews with the garments firms suggest broad demand for basic CMT skills as well as the following categories of skills: supervisory and middle management skills including line leaders; equipment maintenance and repair technicians, laundry and washing supervisors and quality management supervisors. Borrowing from the Penang Skills Development Center model, the School of Commerce and Applied Studies (SOCAS) of the Lerotholi Polytechnic could become a dedicated training facility for the garments industry, such as the proposed Clothing and Textiles Training Center. One possible mode of collaboration is for Lerotholi Polytechnic to provide the land and building at nominal rental to the Lesotho Textile Exporters Association or any legal and credible association of garment firms and support the center through the training levy scheme. This would mean that the training programs at the Center are approved programs and the participating firms will be eligible for reimbursement of training expenditure. The management of the Center could be through a private contract with the LTEA (based on a performance contract) and the initial operational expenditure could be through a combination of donor funds, training fees and membership fees. The overall operations of the Center could be overseen by a Management Council with representatives from industry, Government and academia (if required), which will also supervise the management of the Center. The industry will be responsible to support curriculum design, identify trainers and training resources and provide leadership and direction for the operation of the Center. The Center could also function as a resource center to train trainers from other public training institutions.

A similar model could be developed for other sectors as well such as the sandstone industries with government providing the policy and institutional support and physical infrastructure and the private sector providing training content, knowledge and direction. The donor community can provide support through funding, technical expertise and facilitating knowledge sharing and collaboration arrangements with institutions in other countries that are recognized global leaders in skills development for various industries.

ANNEX 1

**ACTIVITIES IN THE AREA OF THE FINANCIAL AND JUDICIAL SECTORS TO BE SUPPORTED BY THE MILLENNIUM
CHALLENGE CORPORATION (AS OF JUNE 2005)**

AREA FOR REFORMS	OBJECTIVE
JUDICIAL SECTOR	
<p>Improve the efficiency of the justice system by improving case management system by strengthening the following institutions: prosecution, police, service of process (subpoena, summons), judiciary (local and central courts, Magistrate courts, High court), court of Appeal (transcription of court records)</p> <p>Setting up a Commercial Court along the lines defined by the High Court of Justice, as an autonomous entity, under the oversight of the Lesotho High Court of Justice. Special judges and magistrates should be assigned to treat commercial cases. The procedure for registering "bonds" or claims against collateral should be streamlined procedures and technical assistance in the form of equipment and training to the commercial Judges/Magistrates and practitioners on financial sector operations should be provided.</p>	<p>Accelerate speedy settlement of trade and commercial disputes; increase confidence in the justice systems.</p>
<p>Increase safety and security by developing a national crime strategy (including developing/strengthening the Community Policing and Crime Prevention Committees throughout the country); improving skills training for Police Officers, especially in crime investigation and statement taking skills; and developing a well managed data and information for dissemination to all stakeholders.</p>	<p>Reduce the level of crime and increase the level of crimes detected.</p>
<p>Promote and protect human rights of all people in Lesotho by developing a holistic approach to human rights protection, promotion and awareness</p>	<p>Increase public awareness about human rights</p>
<p>Reform Lesotho's Penal System by, <i>inter alia</i>, rationalizing sentencing, increase use of early release schemes to reduce overcrowding, an increase development and rehabilitation programs for offenders.</p>	<p>Improve the state of conditions in Lesotho prisons and the conditions under which prisoners are detained leading bringing back rehabilitated citizens to the society.</p>
<p>Improve the efficiency in the delivery of justice by improving court administrative systems, case management, capacity of the sector to tackle corruption and the execution of judgments. These reforms would include</p>	<p>Improvements in the delivery of service by all agencies (i.e., reduce the backlog of cases, increase the level of accountability of the justice sector, etc.), particularly the High Court, will increase the level public confidence</p>

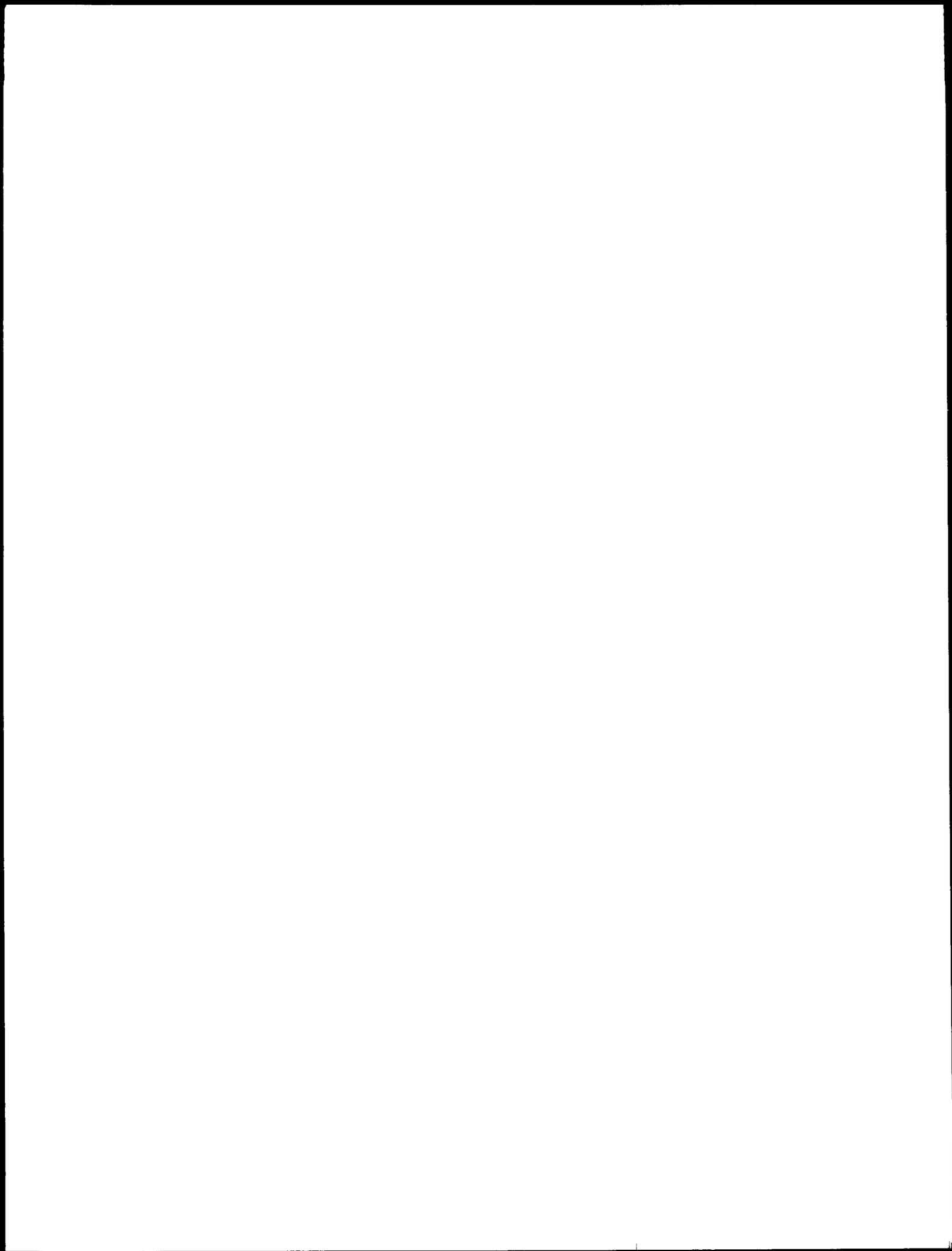
AREA FOR REFORMS	OBJECTIVE
improvements in the law, staff training as well as investments in equipment (e.g., proper case and personnel management; file system; records computerization)	and that of the international investor community.
Design and implement the legal and judiciary sector reforms to improve credit discipline by, <i>inter alia</i> , improving the functioning of the Commercial courts and establishing of a Small Claims Court	Improved access to credit.
FINANCIAL SECTOR	
<p>Restructure the financial sector to allow for more competition in the banking system:</p> <ul style="list-style-type: none"> • Develop an appropriate legal and regulatory framework for Rural and Micro Finance Institutions; • Review, amend and tier Financial Institutions Act • Lower Minimum Capital requirements for new financial institutions and introduce provision for segregation of financial institutions in the legislation • Review and overhaul the Insolvency Proclamation and introduce insolvency provisions in the Financial Sector Legislation • Review and enact matrimonial Act to eliminate credit restrictions 	<p>Enable different institutions to participate in the banking sector.</p> <p>Promote bank lending to the agriculture, tourism and industrial sectors and MSMEs</p> <p>Create a balanced access to credit across both sexes and increase women participation in the economy and MSME sector in particular</p>
<p>Diversify sources of finance by :</p> <ul style="list-style-type: none"> • Establishing and developing a leasing industry by (i) the promulgation of a Leasing Act consistent with if not identical to the corresponding Act in South Africa, which will indicate the rights, duties and obligations of participants including those related to the adjudication of cases; and (ii) attempt to attract investors with experience in leasing to set up operations in Lesotho and diversification of the sources of leasing finance by tapping insurance firms and pension funds (iii) the provision of technical assistance (TA) to SME's on the potential benefits of leasing, through workshops, seminars and other enlightenment mechanisms, in coordination with the commercial banks (Ned Bank and Standard Bank) that already provide some training to potential clients. • Developing a Rural and Microfinance Policy and Development Action Strategy which will include, <i>inter alia</i>, (i) a careful assessment of the different kinds of existing microfinance institutions (MFIs) and the nature of their activities, scale and funding sources as the basis for (ii) the definition of a regulatory and supervisory framework for MFIs guided by whether and how to supervise and regulate them; and (iii) the creation of a rural and microfinance forum or association to serve as a 	<p>Reduce financial risk of investing in activities linked to the project.</p> <p>Introduce a financial product mostly suited to fulfill the needs of MSMEs and risk mitigating instruments to improve MSME access to finance.</p>

AREA FOR REFORMS	OBJECTIVE
<p>body that will set standards for rural and microfinance services and provide a platform for discussion and information dissemination. The Government has already sought assistance from the GTZ and IFAD.</p> <ul style="list-style-type: none"> • Develop a risk mitigation facility by which LNDC will utilize its strong balance sheet to provide partial guarantees for a few carefully selected, carefully appraised projects in cases where commercial banks are willing to make loans. LNDC would take small equity stakes to improve selected borrowers' management and gearing in payment for such guarantees 	
<p>Review and amend the Cooperatives Act to ensure that it is not in conflict with Financial Institutions Act</p>	<p>Provide a conducive environment and guidance to cooperatives and encourage nationals to establish business enterprises</p>
<p>Modernize the payment system in Lesotho by:</p> <ul style="list-style-type: none"> • Introducing a robust Legal and Regulatory framework that supports a modern payment system (e.g., Evidence Law, Bills of Exchange, National Payment System Act, Electronic Communication Transactions Act, Consumer Protection Act, Checks Act, etc.) • Introducing new electronic payment instruments and reduce cash usage and paper-based instruments • Automating the Clearing House • Implementing a Real Time Gross Settlement System 	<p>Improve the efficiency, security and reliability of funds transfers between transaction agents, thus attracting investors since they will be assured that their economic transactions will be settled on time</p>
LAND TENURE AND MORTGAGE REGIME	
<p>establishing and maintaining a system of land relations in Lesotho and creating efficient land markets, including enactment of Land Bill and complementary legislation (e.g., Land Acquisition and Compensation Act, Land Transaction Act and Land Use Planning Act);</p>	<p>Improve land tenure and mortgage regime, which should also contribute to increasing the availability of finance as the firms will be able to pledge land as collateral.</p>
<p>Establishing an efficient mortgage regime including enactment of the Mortgage Legislation and reviewing Deeds Registrar Act and Stamp Duties Act.</p>	

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