Addressing the Trade Challenges Facing Landlocked LDCs: The Experience of Lesotho

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Introduction

Given their small domestic markets, expanding international trade is crucial to driving and sustaining growth in Least Developed Countries (LDCs). In turn, attracting foreign direct investment (FDI) often plays a key role in providing the necessary capital for developing export-oriented industries and bringing new technology and techniques. Landlocked LDCs (LLDCs) face a unique set of constraints on their capacity to attract FDI and pursue export-led growth. They confront extra difficulties and costs in accessing global markets and, as with other small LDCs, are also unable to set their terms of trade with the developed countries which constitute their largest trading partners. LLDCs are also often limited in their ability to develop competitive higher value-added activities for export due to weak infrastructure and underdeveloped services sectors, especially in professional services such as accounting and law. These factors combine to raise unique and significant challenges for LLDCs’ ability to pursue strategies for export-led growth.

This note examines these challenges facing LLDCs and discusses policy options for dealing with them. In particular, the note uses the example of Lesotho to show how some of the constraints can be overcome. For example, Lesotho has been successful in building a labor-intensive manufacturing sector based around textiles and clothing production for export by attracting FDI in these activities. However, an investigation of Lesotho also demonstrates the broader challenges, typical to many LLDCs, which remain for export-led growth to be sustained through diversification into a broader range of higher-valued added activities and for the benefits of FDI to spill over beyond a narrow enclave into the broader economy.

The example of Lesotho

Successes

As an LLDC, Lesotho faces a variety of constraints to its economic growth and
development. Lesotho’s macroeconomic policy is circumscribed by virtue of its membership in the Common Monetary Area (CMA), and its trade policy is limited because of its membership in the Southern African Customs Union.¹ The small size of Lesotho’s economy makes it difficult to attract FDI and to diversify both its domestic industries and service sectors. Furthermore, unlike some other African countries, Lesotho cannot fall back on the development of lucrative mining and oil exporting industries since, with the possible exception of diamonds, it does not possess the requisite natural resources.

Despite these factors, Lesotho has been able to implement a successful export-led growth strategy, achieving an average annual export growth rate of 19 percent between 2000 and 2007. Due to its geographical proximity to South Africa, Lesotho has been able to overcome the constraint of being landlocked as it has been able to exploit South Africa’s superior infrastructure to gain access to global markets. Lesotho also has low labor costs that are internationally competitive and the government has, to a large extent, been successful in harnessing this comparative advantage to promote exports in labor-intensive sectors. In these ways, Lesotho’s economy has capitalized on its external access to South African infrastructure and internal low labor costs, particularly for clothing manufacturing. South Africa is Lesotho’s second largest export market, followed by the European Union.

Lesotho has also been able to take advantage of its relationship with the United States, using favorable market access provisions. In particular, Lesotho has benefited from preferential access to this market using the African Growth and Opportunity Act (AGOA), under which Lesotho is the largest exporter. AGOA provides simplified rules of origin for clothing and has, therefore, played an especially positive role in facilitating these labor-intensive exports that use capital-intensive imported inputs. The AGOA program, together with Lesotho’s ability to take advantage of the US market by exploiting South African transport infrastructure, has boosted Lesotho’s exports and has made the United States Lesotho’s primary export market.

Due to its proximity to the large South African market, Lesotho is also well positioned to attract new and higher quality FDI as well as to diversify exports to include higher value added goods such as leather items and furniture. In addition, Lesotho can potentially attract new FDI from South Africa to service opportunities in the South African retail market as well as to integrate Lesotho more closely into South Africa’s supply chains. Under new trade provisions, to Europe for example, there are also significant opportunities to expand exports of existing products. In particular, the relaxation of EU rules of origin for clothing since 2008 (from double transformation to single transformation) under the Economic Partnership Agreement (EPA) suggests that there could now be significant scope for increasing exports of these products.

Challenges

Recently, however, Lesotho’s exports have performed less well as some of the country’s key advantages have eroded. The end of quotas on international clothing trade in 2005 has led to increased competition from

¹ The Common Monetary Area (CMA) comprises Lesotho, South Africa and Swaziland. All members of the CMA accept the South African rand as legal tender, and their monetary policies reflect the decisions of the South African Reserve Bank. The Southern African Customs Union (SACU), designed to promote free trade within the union, comprises Lesotho, South Africa, Swaziland, Botswana, and Namibia.
large Asian producers and has resulted in a fall in exports, particularly to the United States. Furthermore, despite low unit labor costs, productivity levels in Lesotho are currently half those in East Asia, making it difficult to sustain the level of existing exports as well as develop new export industries. For example, clothing exports from Lesotho fell by 11.5 percent in dollar terms in 2008, and in the first six months of 2009 were 21 percent lower compared with the first six months of the previous year. Lesotho has also encountered problems as price fluctuations in global markets have reduced export income. Since the second quarter of 2009, prices for Lesotho’s high quality diamonds have declined by more than 40 percent.

Beyond these changes in international markets, Lesotho still faces several significant domestic challenges. It is still largely constrained by a burdensome regulatory environment which, in particular, has led to a lack of factory shells to accommodate both new investments and the expansion of existing ones. Inward FDI has also tended to be limited to the manufacturing sector, and there has been a lack of investment in higher value-added activities. As in many other LDCs, there has been little spill over of expertise from the FDI to other sectors of the economy.

Lesotho is also constrained by a shortage of suppliers of professional services such as accounting and legal services which are necessary for a vibrant and growing economy. There are two primary reasons for this: first, Lesotho educates and trains a relatively small number of skilled professionals; and second, professionals who are educated in Lesotho often emigrate to higher paying jobs in South Africa as well as further abroad. In addition to strengthening domestic education systems to facilitate the training of skilled professionals, reforming immigration laws to allow skilled foreign workers to enter the country and implementing mutual recognition agreements with other countries in the region would help suppliers of professional services enter and stay in the country.

Moving forward, Lesotho will have to address these challenges in order to put itself on a path towards greater and more sustainable economic growth. Specifically, reforming regulations to foster a more business-friendly investment environment; ensuring availability of factory shells as well as developing the supporting infrastructure necessary for FDI; and, facilitating trade including through customs reform and cooperation with its neighbor will be important for Lesotho’s future economic development. Lessons for LLDCs from the example of Lesotho can also be taken and are examined in more detail below.

**Lessons for other LLDCs from Lesotho’s experience with trade and investment**

As discussed in the previous section, Lesotho has overcome the challenge of being landlocked by exploiting its geographic location and successfully being able to leverage the market access programs offered to it by more developed countries. In this way, Lesotho has been able to attract FDI and achieve economic growth beyond what a LLDC might otherwise be able to accomplish.

In particular, other LLDCs often do not have the market proximity and infrastructure advantages that Lesotho enjoys, and many do not have equally favorable market access provisions in large developed markets (i.e. Lesotho is also a member of SADC and SACU as well as being eligible for the clothing provisions under AGOA; has access to EBA and is a signatory of an EPA with the EU). Even those LLDCs that do
have similar access provisions to large markets have oftentimes been unable to exploit them fully. For these reasons, LLDCs must focus more strongly on the factors they can influence, namely: policy reforms to attract new and better FDI and to ensure foreign investments provide positive spillovers to the wider economy; implementing reforms to improve their business regulation and investment climates; ensuring that high quality infrastructure is in place to facilitate foreign investment and domestic growth; increasing exports by streamlining customs procedures and upgrading border crossing infrastructure; and, reforming immigration regulations to ease the entry of skilled workers into the market.

**Attracting FDI for export diversification**

An important component of an LLDC’s development strategy is the attraction of high quality foreign resources, such as technology and expertise necessary to develop new exports and exploit new markets. When properly managed, foreign investment can bring technical and financial resources to domestic sectors and can provide jobs and training for large segments of the population. In addition, FDI can strengthen countries’ domestic industries and service sectors, and as a country’s workforce becomes increasingly competent, FDI can also bring higher value added jobs that can further spur economic growth and development. In this way, new FDI can be used to diversify LLDCs’ exports. However, to capture fully the economic benefits derived from foreign investment, governments must ensure that new FDI includes opportunities and training that will enable local workers to perform in skilled and management-level positions.

There are several key factors that tend to influence foreign firms’ decision about whether or not to invest in a country. One of the most important is the strength and quality of the country’s investment environment. A strong investment climate is important since FDI tends to be attracted to those countries with the least burdensome regulations and the lowest costs of doing business. Consequently, LLDCs are often at risk from losing FDI to regional competitors with marginally higher levels of development; better infrastructure; and, higher quality investment climates. In order to attract FDI, LLDCs must therefore strive to increase their attractiveness as an investment destination and ideally provide an as good, or better investment climate than any of their neighbors (for Lesotho particularly South Africa) in order to succeed.

In the past many countries in Africa have sought to attract investment through the use of tax incentives for preferred investors and sector. However, this approach has had mixed success and global experience now indicates that pursuing uniformly low rates across all sectors in order to encourage both foreign and domestic investments in competitive sectors is a first-best policy option.

**Improving the investment climate and the regulatory environment**

Another factor for LLDCs is the strength of their investment climates and regulatory environments. Regulation that is conducive to forming new business enterprises and strengthening existing ones is vital for economic development. Regulatory relief from excessive administrative procedures can sway foreign firms that are considering investment decisions on where to locate. For these reasons, LLDCs must take steps to reduce bureaucratic red tape and similar regulatory burdens that can also strengthen the competitiveness and efficiency of
domestic businesses. Similarly, inefficient systems for granting business licenses and permits can raise transaction costs for domestic and international investors alike, and should therefore be streamlined. More efficient systems of registration, as opposed to licensing, could benefit domestic businesses while also attracting FDI. The common feature to African countries that have been successful in attracting FDI and developing vibrant domestic service sectors, such as Mauritius and South Africa, is a streamlined investment environment that reduces bureaucratic red tape and lowers the costs of doing business in the country.

**Strengthening infrastructure including through greater private sector participation**

Improving the quality of supporting infrastructure, including airports (and ports for littoral countries), roads, and the efficiency of essential backbone services such as power, water and transport, are crucial. Besides the importance of infrastructure for facilitating cross-border trade, LLDCs with poor infrastructure are more likely to lose foreign investment opportunities to countries with more developed infrastructure. Some middle income countries have overcome this problem by establishing specialized facilities dedicated to attracting FDI, such as high-tech industrial estates in Malaysia, Taiwan, and Singapore, as well as software industry parks in India, Jamaica, the Dominican Republic, and Mauritius. These specialized facilities can also offer higher quality infrastructure on site with a greater range of business support services.

Experience from elsewhere in the world suggests that the success of building facilities and supporting infrastructure for FDI can be linked to the ways in which these are located, developed, and managed. In particular, the management of factories and industrial parks is enhanced when they are operated on a cost-recovery rather than a subsidized basis, and are market-oriented as well as customer focused. Indeed, privately owned business parks tend to perform better in attracting FDI than publicly operated ones. For example, industrial zones in Mauritius, Madagascar, and Kenya have performed extremely well. Private sector participation in the provision and management of industrial sites can therefore help alleviate infrastructure concerns. The entry of the private sector into industrial park development has also changed the range of facilities and services available within them, particularly when the private sector is allowed to play a role in their provision. Private parks are less expensive for the host country to develop since governments are required only to provide offsite infrastructure which is usually a fraction of the total development cost (typically no more than 25 percent). From the perspective of the host country, private industrial parks can yield better economic results and greater development gains. A greater role for the private sector in the provision and management of industrial parks should there be considered and encouraged if LLDCs are to attract and maintain higher levels of FDI.

**Improving trade facilitation and streamlining customs procedures**

The inherent challenges that LLDCs face in accessing global markets typically restrict their ability to engage in international trade. In addition to these built-in challenges, outdated and ineffective customs procedures and systems in many countries oftentimes result in high transaction costs; delays in the clearance of imports and exports; and, opportunities for administrative inefficiencies. For these reasons, inefficient customs processes can augment existing infrastructural difficulties, and so the reform
and implementation of customs and border crossing procedures are important components as part of a broader trade facilitation strategy.

The costs imposed by these deficiencies can be illustrated by Lesotho’s underdeveloped border crossings with South Africa. At Maputsoe Bridge, for example, trucks carrying cargo into South Africa must be left on the Lesotho side of the border while the driver walks the border to process the consignment. On both sides of the border there is little space to park or inspect trucks, often leading to gridlock. Completing the transaction itself is a lengthy process, as the customs officials in Lesotho lack a computerized system for customs clearance. In both the quality of border infrastructure and customs processes, Lesotho’s archaic international trade logistics systems hamper the country’s ability to facilitate trade for the benefit of the economy.

Due to their unique constraints, even more so than other developing countries, LLDCs must therefore work to implement effective policies for overcoming constraints on cross-border transportation and trade. One of the most effective policies that can be implemented to overcome outdated infrastructure is to upgrade border control facilities and streamline customs procedures. In particular, many developing countries have multiple inspection and revenue collection agencies in operation, and these agencies can oftentimes be consolidated into fewer, more efficient agencies. Simplifying procedures, as well as computerizing many of the most common tasks and functions, would help to streamline customs and ease the flow of goods across landlocked countries’ borders.

Using immigration to access skills

A final area for reform that can assist in attracting FDI is the streamlining of immigration systems, particularly for the processing of foreign work permits and residence visas. Procedures for obtaining residency visas and work permits in many LLDCs, including Lesotho, are complex and burdensome, discouraging skilled expatriate workers and foreign investors alike. They also limit the movement of highly trained foreign labor, expatriate expertise, and managerial staff that are needed for LLDCs to diversify into the production of higher value-added products. In order to attract FDI, LLDCs must therefore make a concerted effort to facilitate and ease the entry of foreign investors and their families through the reform of their residence visa and work permit systems. To this end, applications from investors for foreign staff should be expedited, applications for work permits and residency visas should be considered jointly, and work permits and residence visas should be granted for longer periods to employers once the investment has been established in the country.

Concluding remarks and policy recommendations

The success of Lesotho in attracting FDI for export-led growth, largely based on clothing exports to the United States under AGOA, shows that while facing many challenges typical of a small landlocked developing country, these constraints can be overcome, albeit with some assistance from neighboring countries. In Lesotho, exports have been the main engine of growth, based on the country’s availability of low cost labor; access to tariff preferences under relatively liberal rules of origin; and, its relatively easy access to global markets through reliance on South Africa’s superior infrastructure. However, many other LLDCs in Africa do not have such economically advanced or willing neighbors, and for them the challenge of accessing global markets is much greater.
The lack of easy access to global markets facing LLDCs emphasizes the importance of coastal countries’ ability and willingness to provide efficient transportation and logistics services to their landlocked neighbors. In some cases, such as between Lesotho and South Africa, the transit country is amenable to facilitating the LLDC’s trade. Where this is not the case, more effort must be made to formulate effective corridor management arrangements that bring gains to both countries. Besides bilateral talks, the negotiation of corridor management arrangements is an area where regional integration can play an important role. Regional integration can create harmonized transit and customs regimes, leading to major gains. For example, a single customs form that is applicable across national borders would go a long way towards reducing the inefficiencies currently present in many countries’ customs procedures. Working with neighboring countries at the regional level in reforming trade facilitation and customs are therefore important to facilitate access to global markets and, potentially, benefit the region as a whole.

What does Lesotho’s experience imply for other LLDCs? A key message is that when moving forward in designing and implementing effective policies for export-led growth and development based on attracting FDI, governments of LLDCs should place particular emphasis on improving their business regulation and investment climates. LLDCs that do not have Lesotho’s proximity advantage will have to focus even more on these policy issues if they are to succeed. Within this process, the role of the private sector is crucial. Reaching out to private sector partners, both domestic and foreign, can help attract FDI (in the form of capital, technology and know-how) and develop industrial parks to manufacture higher value-added goods for export. Similarly, private sector partners are oftentimes best able to assist with the construction and development of the vital infrastructure that is needed to support foreign investments in new productive sectors.

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