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United Nations Conference on Trade and Development

Investment Policy Review

Lesotho

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UNITED NATIONS

PREFACE

The UNCTAD Investment Policy Reviews are intended to help countries improve their investment policies and to familiarize Governments and the international private sector with an individual country's investment environment. The reviews are considered at the UNCTAD Commission on Investment, Technology and Related Financial Issues.

The Investment Policy Review for Lesotho was initiated at the request of the Government. The review was carried out through a fact-finding mission in August 2002. In preparing the review, UNCTAD received the full support and cooperation of the Lesotho National Development Corporation, the designated co-operating agency, and other government Ministries and agencies. The mission also had the benefit of the views of the private sector, foreign and domestic, civic society, as well as the resident international community, particularly bilateral donors and development agencies.

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The United Nations Development Programme and the Government of Germany provided funding for the project. The background work for the project was also an input to the Lesotho Integrated Framework Diagnostic Trade Integration Study (World Bank, UNDP, IMF, ITC, UNCTAD and WTO).

The Review was presented at a national workshop on 11 February 2003 and the general assessment and recommendations were endorsed by the Government.

It is hoped that the analysis and recommendations of this review will contribute to an improvement of policies, promote dialogue among stakeholders and catalyse investment in Lesotho**.**

Geneva, March 2003

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ABBREVIATIONS

ACP	Asia, Caribbean Pacific countries
AGOA	Africa Growth and Opportunity Act
BIT	Bilateral investment treaty
CMA	Southern African Common Monetary Area
CMT	Cut, make and trim
DTT	Double tax treaty
EU	European Union
FDI	Foreign direct investment
GDP	Gross domestic product
GFCF	Gross fixed capital formation
GNP	Gross national product
GTZ	German Technical Cooperation
JBCC	Joint Bilateral Commission of Cooperation
LDC	Least developed country
LHDA	Lesotho Highlands Development Authority
LHWP	Lesotho Highlands Water Project
LNDC	Lesotho National Development Corporation
LEC	Lesotho Electricity Corporation
LPRC	Land Policy Reform Commission
MFA	Multi-Fibre Agreement
MIGA	Multilateral Investment Guarantee Agency
MITM	Ministry of Industry Trade and Marketing
NAFTA	North American Free Trade Agreement
OECD	Organization for Economic Cooperation and Development
OPIC	Overseas Private Investment Corporation
PSDC	Penang Skills Development Corporation
PV	Present value
RSA	Republic of South Africa
SACU	South African Customs Union
SADC	Southern Africa Development Community
SMEs	Small-medium enterprises
US	United States of America
VAT	Value added tax

LESOTHO

KEY ECONOMIC AND SOCIAL INDICATORS

Indicator	1990	1995	1999	2000
Population (million)	1.7	1.9	2.0	2.0
GDP at market prices (billion of current dollars)	0.6	0.9	0.9	0.9
Annual GDP growth (per cent)			2.8	3.3
Inflation (per cent)	11.6	9.3	7.3	6.2
GDP per capita (dollars)	366.1	498.4	436.0	445.0
Foreign direct Investment (millions of dollars)	16.1	23.4	32.8	31.4
LHWP[a] (millions of dollars)	81.3	245.7	174.0	113.3
GDP by sector (per cent):				
Agriculture	23.8	17.8	17.3	16.9
Industry	32.8	39.3	41.4	39.9
of which manufacturing	13.9	15.9	16.9	16.0
Services	43.5	42.9	41.3	43.2
Exports of goods and services (per cent of GDP)	16.8	21.3	24.1	27.8
Imports of goods and services (per cent of GDP)	122.4	120.2	96.6	87.0
Gross domestic investment (per cent of GDP)	53.2	60.5	42.5	33.5
National poverty line (percentage) [b]	..	..	49.2	..
Human development index	..	..	0.5	..
Adult illiteracy rate (percentage of people aged 15 and above)	22.1	19.2	17.1	18.0

Sources: UNCTAD, FDITNC database, UNDP *Human Development Report 2001,*
Central Bank of Lesotho *Annual Report 2001,* IMF, *Balance of Payments Yearbook, 2001*

[a] Lesotho Highland Water Project (LHWP) start at 1988
[b] 1984-1999

INTRODUCTION

Lesotho is a small, land-locked, least developed country with a rugged, mountainous terrain and few endowments other than the natural beauty of its environment, water, cheap labour, and some deposits of minerals and diamonds. Yet, Lesotho has been able to attract foreign direct investment, thanks to trade preferences allowed by the development provisions of the WTO Agreements.

Although modest, FDI is important for Lesotho. The economy depends for growth, employment and export revenues on a manufacturing sector that is almost entirely driven by export-oriented FDI in the apparel industry. But such investment is traditionally "foot loose" and could relocate when trade privileges are phased out one day.

Thus, the challenge for Lesotho is to attract greater FDI, diversifying it away from its overwhelming reliance on one activity while trying to retain as much of this activity as possible by deepening its roots in the economy. To do so, Lesotho must develop a competitive base for manufacturing FDI; exploit more fully its complementarities with the economy of its giant neighbour that surrounds it on all sides -- South Africa; improve access to other large markets; and build up its own capabilities in manufacturing, services and agriculture.

This report examines how Lesotho can attract greater FDI, diversify it and benefit more from it.

Chapter I analyses FDI performance. Lesotho has done far better than most other least developed countries in attracting FDI and is unique among African LDCs in attracting predominantly export-oriented investment. Foreign investors in the apparel industry have created new jobs, particularly for female workers, contributing to poverty reduction. FDI has also created new skills and work attitudes. At the same time, the positive spillovers that could be expected from FDI have been limited. Local linkages in Lesotho are negligible: there are practically no spin-offs or subcontracting activity. Backward integration into textile production is starting but it may not be enough to ensure a competitive base for export when inputs can no longer be sourced from the cheapest suppliers. Hence, the capabilities that Lesotho has built up in clothing manufacturing are not yet sufficient to sustain FDI once trade privileges are withdrawn (perhaps as early as two years) and Lesotho faces full competition.

Chapter II reviews the investment framework. Lesotho is largely open to FDI and treats foreign investors well. But the legal framework for investment is weakly developed and requires streamlining to enhance transparency and consistency. The taxation and regulation of business is a mixture of good and poor practice that does not fully address investor needs and in some areas it is already under administrative pressure despite modest levels of FDI and business activity. Improvements are recommended in business taxation, land regulation, work and residence permits, industrial and trade licensing, competition policy and some aspects of foreign exchange control.

Chapter III considers investment strategy. There is unexploited FDI potential in the services and natural resources sectors that should be promoted. FDI in manufacturing should be encouraged to deepen operations and reorganize activity away from reliance on temporary trade privileges in one market; this will also require targeted measures on the part of the host country (and home countries) to create permanent comparative advantage in manufacturing. At the same time, the potential from long-term free access to other markets, notably to that of South Africa, should be fully tapped. Making Lesotho a more attractive location for FDI requires:

- Improving the trade regime and negotiating an extension of trade privileges.
- Closing the large productivity gap with respect to apparel producers in other countries with roughly similar wages, thereby brightening the long-term prospects for export-oriented FDI.
- Strengthening the private-public interface and reinforcing the emerging recognition on the part of firms to commit to local skill development.
- Attention to physical infrastructure, which is improving but significant constraints exist in terms of transport, water, building sites and factory shells; there are also handicaps in power and communications.
- Upgrading FDI promotion efforts to international best practice.

Chapter IV highlights main conclusions and recommendations.

I. FDI IN LESOTHO: TRENDS AND IMPACT

Lesotho, a land-locked least developed country, has a paucity of locational advantages which could attract FDI. Owing, however, to Government efforts combined with trade privileges, Lesotho has been quite successful in attracting, since the mid-1990s, increased inflows of FDI. More importantly, and unusually for an LDC, these inflows have been concentrated in export-oriented manufacturing, producing growth, foreign exchange revenues, new jobs (mainly for female workers) and sources of income, and contributing to poverty reduction. The challenge is that most of its FDI is dependent on temporary trade privileges: Lesotho has little time to prepare itself for full global competition once trade privileges are withdrawn.

A. FDI Trends

1. FDI size and growth

It is not easy to measure the size and growth of FDI in Lesotho. The weakness of available measures (see Box I.1) has historically been exacerbated by the inclusion of foreign inflows relating to the Lesotho Highlands Water Project (Box I.2)

Using the best available data, FDI inflows were relatively stable at low levels through most of the 1980s, rising to a peak of $21 million after the IMF stabilization package of 1988 (Figure I.1). In following years, annual flows were maintained at levels that were higher than the pre-1988 level, although they did not again reach the 1988 peak until 1994, when a surge of investment brought annual inflows to $43 million. This increase was in part due to privatisation sales, but more importantly to investment in garment manufacturing. The remainder of the 1990s saw FDI flows retain similarly high levels, indicating a respectable performance in terms of FDI size and growth over the long term. While the performance could not be called excellent, given that many of its neighbouring countries are doing better in terms of both FDI size and growth, it is creditable, and Lesotho stands out particularly well against other LDCs. On a per capita basis, for example, Lesotho achieved average annual FDI inflows of $15 during the years 1996-2000, compared to $6 for LDCs on average (Table I.2). Moreover, the fact that most of Lesotho's recent FDI has been in export-oriented manufacturing is a particularly good indicator.

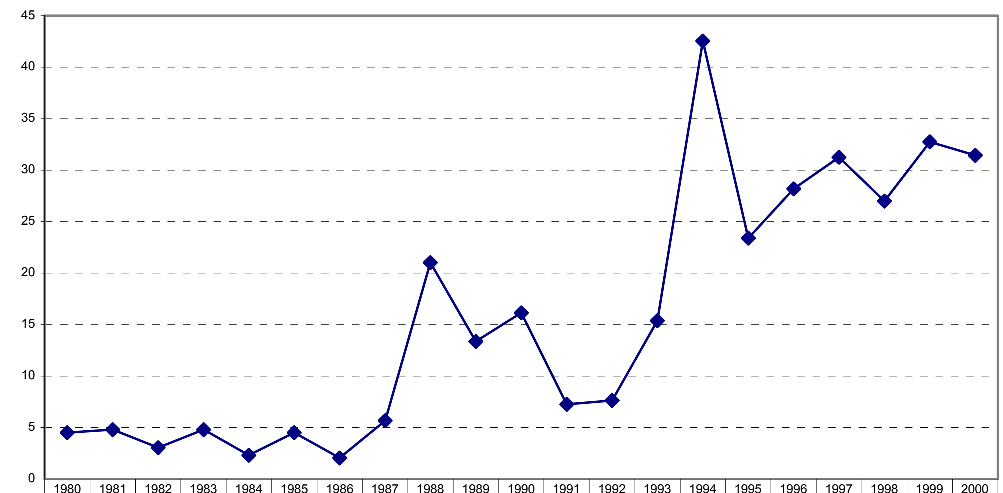
Lesotho's FDI stock by the year 2000 was $417 million (Table I.2), placing it towards the bottom of the range for Sub-Saharan Africa.[1] In per capita terms however, its stock level appears much better, especially in comparison to the other LDCs, whose per capita FDI stock of $55 in 2000 is much lower than Lesotho's $194. Lesotho's FDI stock also appears reasonable when measured relative to the size of the economy: its stock of $464 per $1,000 GDP compares well against LDCs on average ($194), and against other countries in the region (for example, the SADC average was $364 per $1,000 GDP).

[1] UNCTAD, *World Investment Report, 2002*.

FDI inflows as a share of gross fixed capital formation (GFCF) have increased since the mid 1980s, and are on a par with the LDCs average for the years 1996-2000. They are however lower than the average for SADC as a whole, which experienced a much larger increase over the same time period (with the notable exception of Swaziland). The rate of growth of FDI as a proportion of GFCF was much faster for both LDCs and SADC as a whole, compared to Lesotho; however Lesotho's performance in this frequently used ratio is likely to be distorted by the Highlands water project's contribution to national capital formation.

Figure I.1. FDI inflows in Lesotho, 1980-2000

(Millions of dollars)



	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
FDI excluding LHWP into Lesotho (millions of $)	4.49	4.79	3.04	4.80	2.31	4.50	2.06	5.67	21.03	13.37	16.13	7.25	7.64	15.39	42.55	23.39	28.19	31.26	26.99	32.76	31.44

Table I.1. Comparative performance of Lesotho with selected countries of SADC, 1991 - 2000 (Dollars and percentage)

Country	ABSOLUTE PERFORMANCE							RELATIVE PERFORMANCE							
	FDI inflows per year			FDI Stock	FDI inflows per capita			FDI inflows						FDI Stock (Dollars)	
	Millions of dollars			Dollars	Dollars			Per $1000 GDP (Dollars)			As per cent of GFCF			Per capita	Per $1000 GDP
	1986-1990	1991-1995	1996-2000	2000	1986-1990	1991-1995	1996-2000	1986-1990	1991-1995	1996-2000	1986-1990	1991-1995	1996 -1999	2000	2000
LESOTHO	**11.8**	**19.2**	**30.1**	**416.7**	**7.0**	**10.3**	**14.6**	**24.4**	**25.9**	**33.9**	**4.9**	**3.9**	**6.5**	**193.6**	**463.6**
Botswana[a)]	72.4	11.6	72.1	1'919.8	62.2	7.9	48.2	31.1	2.2	14.3	15.5	1.0	6.0	1'198.4	363.0
Mauritius	25.2	17.6	86.0	681.1	24.1	16.1	74.6	11.5	5.3	20.0	4.5	1.9	7.9	574.2	155.0
Nambia	7.3	109.0	110.9	1'807.3	5.5	72.4	65.5	3.2	35.4	31.7	2.0	18.9	15.2	1'028.6	519.0
South Africa	-72.7	376.5	1'517.3	43'462.0	-2.1	9.5	36.2	-0.8	2.6	10.8	-0.4	1.7	6.8	1'015.4	345.0
Swaziland	47.1	69.6	48.0	432.2	65.3	86.3	53.7	76.8	68.7	36.5	39.1	28.2	10.6	413.6	292.0
SADC*	294.5	1'405.1	3'839.3	66'089.0	2.0	8.3	20.2	2.3	7.7	20.3	1.2	4.5	11.7	332.1	364.0
LDC	625.9	1'811.7	3'687.5	36'423.2	1.4	3.3	5.8	4.6	11.4	20.7	2.1	5.9	6.1	55.2	194.0

Source: UNCTAD, FDI/TNC database (WIR02), Central Bank of Lesotho, and IMF (BOP). FDI and Inward stocks and GFCF of Lesotho are excluding LHWP . Other country data were taken from UNCTAD (TNC database)
The series of GDP come from UNCTAD handbook rev.
POP come from ETSBANK(WB).

*) SADC: South African development community (Angola, Botswana, The Democratic Republic of Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia, Zimbabwe)

a) Average of 1991, 1992, 1994, 1995 applied only for Botswana

Box I.1. Need to improve the FDI data in Lesotho

FDI data in Lesotho do not at this time meet the needs of policy making. The inclusion of inflows for the Lesotho Highland Water Project (LHWP) inflates the figures for FDI inflows (see Box I.2). In addition, there are other problems with the data reported in the balance of payments figures. The Bank of Lesotho estimates FDI from information received from the Lesotho National Development Corporation (LNDC). These inflows include *planned,* not *actual,* investment expenditures of the companies that approached LNDC for assistance. This can lead to inflows being overestimated: realised FDI in most countries tends to be well below approved FDI.

At the same time, the data may be subject to significant underestimation. The LNDC data are limited to manufacturing companies, as LNDC is mandated to deal only with such companies. FDI in services (banks, hotels, telecommunications or travel agencies) is not reported; nor is FDI related to privatisation (even in manufacturing), as these transactions are not handled by LNDC. The sale of Lesotho Flour Mills to a US investor, for instance, was not included in the FDI data.

The data in Lesotho do not capture the reinvestment element of FDI inflows. By confining the estimates to initial equity investments, the data ignore the later investments financed by retained earnings by foreign companies already in the country. This adds a further downward bias to FDI figures.

While LNDC believes that its data capture planned investments by 95 per cent of foreign manufacturing companies in Lesotho, it is impossible to gauge how well they reflect total FDI. In the absence of better data, this report uses other available figures on privatisation and on largest affiliates, together with the information from extensive interviews, to calculate the broad trends over time and to compare Lesotho with other countries, especially in manufacturing. This allows a reasonable estimate of the employment and export impact of foreign firms, especially in the garment sector. But for more precise analysis of other aspects of FDI, one has to wait for major improvements of data collection.

UNCTAD could help in this respect within its recently launched programme for FDI data collection, based on a four volume UNCTAD FDI Statistical Manual.

Box I.2. Why is LHWP not an FDI project?

Why should Lesotho Highlands Water Project (LHWP) inflows be treated separately from "true" FDI? Both are inward flows of capital, captured in a country's balance of payments schedule. However FDI is defined to be a special subset of capital flows. It should include only the financing of a foreign affiliate by a parent company, in the form of loans or equity capital; or re-invested earnings. The measure also excludes the financing of a foreign affiliate on either local or international capital markets.

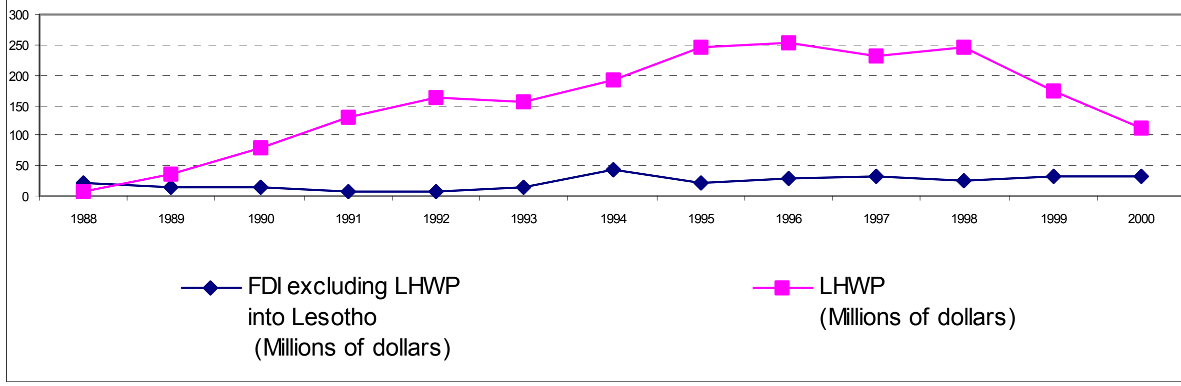
The Lesotho Highlands Water Project clearly does not fit this definition, even though some of its finance was raised on private capital markets. In the first place, it is a development aid project, organized through the auspices of the International Monetary Fund and the World Bank, and financed for the most part through development loans. In the second place, it is questionable to what extent it should be attributed to Lesotho: although the project is located there, responsibility for loan repayment lies with South Africa, for whose benefit the project was primarily directed.

For several years, however, capital flows associated with the LHWP have been included in official estimates of FDI. For example, the International Financial Statistics published by the IMF – sourced from the Central Bank of Lesotho and the Bureau of Statistics - includes flows associated with the water project in the annual FDI estimates. The data is printed in italics, indicating uncertainty about its precision. Further reflecting this uncertainty, the IFS had not published FDI data for the years 1994 to 1999 at all, only beginning from the September 1999 issue. The Central Bank of Lesotho has not helped the confusion by excluding FDI data from its Annual Reports.

The mistaken inclusion of capital flows associated with the LHWP has led to many of the unusual results that can greet one's first glance at the economic profile of Lesotho. Not only does it give the misleading impression that the tiny mountain Kingdom has FDI stocks of the same league as countries that are really giants by comparison, other bizarre results include the finding that FDI stocks far exceed GDP – a pattern that to appears only in countries that are tax havens. For Lesotho to exhibit this indicates some error in the calculation.

The graph below shows starkly the implications of including capital flows associated with LHWP in the measures of FDI. It is clear that the magnitude of flows associated with the water project far exceed FDI.

Figure I. 2. FDI into Lesotho, 1988 - 2000
(Millions of dolars)



The data used in this review therefore represents a best effort at gaining the most accurate picture of true foreign investment in Lesotho – within the constraints described in Box I.1 above.

2. FDI distribution by industry and sector

The most striking feature of FDI in Lesotho is the predominance of export-oriented manufacturing. The great bulk of FDI in Lesotho – 90 percent or more – has gone into export-oriented garment manufacturing, essentially a 'cut-make-trim' (CMT) operation using imported fabrics.[2] This accounts for about 38 out of an estimated 55 foreign affiliates,[3] and the garment sector is currently estimated to be growing at more than 25 per cent per annum.

In the first half of 2001 alone, manufacturing FDI created 10,000 new jobs.[4] The single largest investment, believed to be around $90 million, has come from an existing Taiwanese investor, Nien Hsing, which plans to employ 5,300 workers at its new plant in the Thetsane Industrial Estate. The scale of this investment is second only to the Lesotho Highlands Water Project.[5]

Apart from Mauritius, no other Sub-Saharan African country has such a record of export-oriented manufacturing FDI. In most of Africa, FDI has gone into resource extraction, and FDI in manufacturing has rarely aimed at export-oriented activities. Lesotho's lead in export-oriented FDI gives it an advantage that it should build upon. The other side of this coin is, however, that export activity by foreign firms in Lesotho is highly concentrated in a very narrow range of low technology products.

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[2] A Salm, W.J. Frant, T.J. Green, J.R. Haycock and J. Raimondo, *Lesotho Garment Industry Subsector Study for the Government of Lesotho*, funded by the UK Department for International Development, January 2002. The study remarks on the lack of consistent data on the industry, despite its lead role in attracting FDI and generating exports.
[3] *Lesotho Diagnostic Trade Integration Study*, (August 2002), Chapter 4, pg 105.
[4] 'Sewing Africa into Loop', *International Herald Tribune*, 18 July 2001.
[5] LNDC News, January-March 2002, pg 6.

Foreign affiliates have also invested small amounts in footwear, electrical products, electronics, (a television assembly firm), food-processing and other manufactures such as plastics and umbrellas.

Lesotho has two foreign (South African) owned banks: Nedbank and Standard Bank (which bought a 70per cent share in the state-owned Lesotho Bank). Lesotho is unusual in that industrial and commercial credit to foreign as well as local enterprises is also provided by the state-owned LNDC and its sister organization the Basotho Enterprises Development Corporation. The LNDC is also mandated to promote and facilitate foreign investment (see Chapter III).

FDI has also been attracted to telecommunications, since the 1995 joint-venture between the state-owned Lesotho Telecommunications Corporation and South Africa's Vodacom led to the establishment of a cellular telephone service. Further privatizations saw a 70per cent share in Lesotho Telecommunications Corporation sold to the Mountain Kingdom Communications Consortium, a joint venture between South Africa's power company ESKOM, Zimbabwae's Econet Wireless International and Mauritius Telecom. Lesotho has a relatively high penetration of telephony relative to per capita income, and services have been extensively modernized and expanded in recent years.

FDI in air transportation has not been successful. In 1997 Lesotho Airways was sold to Johannesburg-based charter firm Ross Air. This loss-making operation was liquidated in 1999, and the international consortium South African Airways now handles flights to and from Lesotho.

Foreign investment in tourism, aimed largely at the South African market, may be boosted by activities taken to protect Lesotho's natural environment and ecological attractions. This includes for example, the South African-owned Lesotho and Maseru Sun hotels; and a recent innovative alpine resort financed by Austrian investors (Box I.3).

Another new and promising trend is the renewal of foreign interest in mining, as described in Box I.4. The South African mining corporation De Beers had extracted 289,000 carats from Lesotho mines between 1977 and 1983 before closing the operation because of low world prices and high production costs. Its former site has now attracted interest from other foreign mining firms but it is not clear what the magnitude of FDI is likely to be.

Box I.3. An Alpine resort in Lesotho

The Austrian investor HSP Alpine Service is developing Lesotho's snow sports industry, in a joint-venture with government. The project, costing over $12 million, is sited at the Mahlasela ski-slopes on the mountain road towards Mokhotlong. The project seeks to develop alpine-style ski slopes and an accommodation village, and will include snow-making equipment that should extend the skiing season to as long as five months per annum. The first phase of the project was expected to be operational by June 2002, but this deadline has not been met. Further development was mooted for the future, but the timing and extent of these will depend on consumer demand.

The Mahlesela slopes have long been known as a natural skiing destination, but facilities are underdeveloped by international standards. The Austrian investment has the potential to capture regional, and in particular South African, snow-sports enthusiasts, many of whom find international destinations too costly, especially following the depreciation of the Rand. The development could also introduce new enthusiasts to snow-sports, for example South Africa's large number of surfers. The site is well located, with easy access from Johannesburg, and will have very little other competition in the region. The Government has already committed around $1.6 million for infrastructure and services such as electricity, water and service roads.

Source: 'Tourism, Lesotho: the skiing season is to be lengthened', (2001), Africa Research Bulletin, 15024, Basil Blackwell Publishers Ltd.

Box I.4. New FDI in mining

Renewed interest in mining FDI is raising hopes for the revival of Lesotho's diamond mines. Lesotho has a reputation for large, high value diamonds (frequently more than 20 carats), but current production is carried out on a very small scale by artisanal miners (producing about 1,500 carats per year). In a recent geological survey, 33 kimberlite pipes and 140 dikes, of which 24 are diamondiferous, were identified. It is not yet clear what this implies for production or FDI, but two foreign firms have made initial investments.

Lets'eng Diamonds is a new partnership between Johannesburg-based New Diamond Corporation and the Government of Lesotho (which holds 24per cent of the equity). The company is reopening the Lets'eng-la-Terai mines, which lie at 3,200 metres above sea level in the Maluti Mountains. The mine was operated by De Beers from 1977 to 1982, but has since lain dormant. Open-cast mining of Lets'eng-la-Terai's 15.9 hectare and 4.7 hectare kimberlite pipes is expected to produce as much as 2.1 million tonnes of ore and employ 400 people. Commercial production is expected to come on line this year amid expectations that the low frequency of diamonds in these kimberlites will be offset by the high quality of production: about 15per cent of the diamonds to be mined are expected to be larger than 10 carats, and 1.5per cent to be larger than 100 carats. About 14 million Maloti has been spent to date, although projections are for an additional 200 million Maloti to bring the mine into full production this year. The company currently employs 50 people, of whom 90per cent are Lesotho nationals.

The Canadian mining company MineGem (formerly Messina Diamond Corp), the Industrial Development Corporation of South Africa and the Government of Lesotho have formed the Lesotho Diamond Mining Company to develop an open-cast mine on the Liqhobong property. The company has paid $500,000 to the co-operative of 91 diggers who have the licence to mine; they will also receive 10per cent of future profits. It is estimated that a total investment of $7.1 million will be required to bring the mine into production. It is expected to employ around 100 people and to produce 420,000 metric tonnes of ore per year. At full capacity its output will be 300,000 carats per year during a 5-year mine life.

Government incentives

In an attempt to attract these investors and to ensure that their operations begin on a sound footing, the Government has offered a number of concessions. The Lesotho Diamond Mining Company has been exempted from sales tax on inputs used during construction and is also exempt from withholding taxes on dividend and interest payments. In return, the Government is granted 8per cent gross sales royalties, 12.5per cent equity interest in the company and a further 12.5per cent share of dividends.

Sources: Lesotho Review of Commerce, Industry and Tourism (2002), pg 8, Wade Publications, Lesotho; G.J. Coakley (2000), 'The mineral industry of Lesotho', US Geological Survey Minerals Handbook; Central Bank of Lesotho, Economic Review, June 2001; www.MiningWeekly.co.za.

3. The origin of foreign investors

In earlier decades most foreign affiliates in Lesotho originated from South Africa and Taiwan, Province of China, in part attempting to escape international sanctions against the apartheid regime in South Africa. While South Africa is still a significant investor in Lesotho, East Asian investors have played a growing role over the past decade. European manufacturing firms that had invested in the 1980s because of Lesotho's preferential access to EU markets are no longer present.

East Asians own most clothing factories, employing around 38,000 people. Of Lesotho's 42 clothing factories, 31 are from Taiwan, Province of China, 2 from Hong Kong, China, one from Singapore and 8 from RSA. There are now few South African subsidiaries remaining in this sector; earlier entrants having closed down or sold out to Asian firms.

South African FDI is present in Lesotho's three footwear firms (selling entirely to South Africa),four electrical or electronic firms (of which two are large, one in television assembly the other in simple electrical products, again selling to the South African market), two food-processing firms, the Sun Hotel chain, car rental and air travel, insurance and telecommunications, financial services and mining.

FDI from other countries includes mining interests from Canada, food-processing from the United States and China and the planned Austrian ski venture described above.

4. Types of FDI

In recent years, most FDI has taken the form of new start-ups, concentrated in the textiles sector. Acquisitions of existing operations have also been significant, due to the privatisation programme, although the total value of privatisation has been, and is likely to remain, low. (Privatization to foreign companies was worth only around $42 million by 2001, according to official data. The first privatization took place in 1997 with the sale of Lesotho Airways Corporation. While progress has been slow since then, this is attributed to lack of demand from investors rather than to government-created obstacles. Recent developments that may attract FDI include the planned privatization of the Lesotho Electricity Corporation in 2002. Smaller enterprises earmarked for privatization include Loti Brick, Basotho Fruit and Vegetable Cannery, Maluti Highlands Abattoir, the Water and Sewerage Authority and the Maseru Private Hospital.[6] A number of agricultural enterprises are also to be offered for sale, contingent upon Cabinet approval. The Government has set up a special Unit Trust to buy shares for domestic investors, so it is not clear which, or what proportion of, privatised enterprises will be offered to foreign investors.

Table I.2. Privatized Enterprises sold to foreign buyers

Company	Nationality of buyer	Year	Amount
Lesotho Airways	South Africa	1997	$2.4 m.
Avis Rent-A- Car	South Africa	1998	$0.05 m
Lesotho Flour Mills	USA	1998	$10.8 m
Plant Vehicle Pool Services	South Africa	2000	$11.5 m
Minot Kingsway (insurance)	UK & Lesotho (increased shares)	2000	$0.22 m.
Tele-Com Lesotho	South Africa, Mauritius, local consortium	2000	$17.0 m
TOTAL ALL YEARS TILL 2001			$41.97

Source: Diagnostic Trade Integration Study (2002), Volume 2, pg. 122. Calculated from data provided by the Privatization Unit.

Other examples of "brownfield" investment (where foreign affiliates bought interests in existing or previously-existing businesses) include the renewal of mining FDI (Table I.2), and sales to Asian investors of South African-owned garment holdings.

B. IMPACT OF FDI

1. Capital inflows and investment

Although FDI inflows to Lesotho increased significantly in recent years, their share of total foreign capital flows is low (Table I.3), particularly low when compared to remittances by Lesotho nationals working in South African mines.[7] These still account for as much as 18per cent of GNP (23per cent of GDP), despite having fallen from highs of 63per cent of GNP (and 113per cent of GDP) in 1984.[8]

[6] Privatisation Unit (2002), 'Privatisation progress 1995-2000' Lesotho Privatisation and Private Sector Development Project, 23 January 2002.

[7] Miners' remittances were a vital source of income since the discovery of Kimberley diamonds in the 1870s, and have been criticised as one of the reasons for Lesotho's lack of subsequent economic development and diversification. For example, L.V. Ketso (1980), 'Lesotho: the role of agriculture and migration', in Z. Konczacki et al. *Studies in the Economic History of Southern Africa*, Vol II, Frank Cass Publishers.

[8] The distinction between GDP and GNP (which includes factor receipts) is particularly pertinent in the case of Lesotho, given the relative importance of its earnings from water royalties and miners' remittances. Lesotho is different from most countries in that its GDP is typically only about 60 per cent of its GNP.

Table I.3. Selected capital inflows to Lesotho
(Annual averages, current $ US million)

	1981-85	1986-90	1991-95	1996-00
FDI	**4.5**	**11.6**	**18.8**	**29.2**
Miners' remittances	335.4	307.6	358.8	277.7
Water and power royalties	0	0	0	15.4
ODA and official aid	99.7	116.5	128.1	73.2*

Sources: World Bank, including World Development Indicators, CD-Rom 2002.
* Years 1996-99 only.

That FDI flows are small compared to aid flows is not surprising, given Lesotho's status as an LDC, but it is interesting to note how the balance is shifting. In 1991-95, average annual aid per capita was approximately seven times as high as FDI (at $70 per year, compared to FDI per capita inflows of $10). However by the latter half of the decade, aid flows per capita were only twice as large, at $36 per year, compared to FDI inflows per capita of $15.[9] Table 1.4 shows that total aid flows fell from an annual average of $128 million for the first half of the 1990s to $73 million annual average in the second half of the decade.

Lesotho's higher levels of aid may help to attract foreign investors, because much of it has been directed towards developing infrastructure, in addition to poverty reduction. For example, $55 million aid last year included one grant of $ 8.7 million from the Arab Bank for Development of Africa to develop the Maseru peri-urban water supply and a $15.24 million World Bank grant to the Maloti-Drakensberg Transfrontier Conservation and Development Project to help conserve Lesotho's natural resource base. The former could help promote urban investment in the Maseru region, while the latter may boost investment in tourism. It is not clear whether, and to what extent, the trend of decreasing aid flows will affect FDI.

Table I.4. Aid and FDI flows, 1991-2000

	Annual average 1991-1995			Annual average 1996-2000		
	Total Aid US$m	Aid per capita US$	FDI inflows per capita US$	Total Aid US$m	Aid per capita US$	FDI per capita US$
Lesotho	**128.1**	**69.6**	**10.3**	**73.2**	**36.3**	**14.6**
Mauritius	35.2	32.5	16.1	35.6	30.8	74.6
Botswana	109.9	79.6	7.9	90.1	58.9	7.9
Namibia	161.4	110.3	72.4	177.6	108.2	72.4
Swaziland	53.9	63.7	86.3	29.1	29.9	53.7

Source: Derived from UNCTAD FDI/TNC database and World Development Indicators, World Bank, CD-Rom 2001

[9] Derived from World Development Indicators, World Bank, CD Rom 2001.

2. Exports

Foreign affiliates in Lesotho account for over three-quarters of its total export earnings. In 2000, the Central Bank estimated that exports of manufactured goods were worth some $155 million; of this $153 million came from foreign firms (apparel $102 million, footwear $28 million and colour televisions $23 million). Table I.5 shows that manufacturing exports increased by around two and a half times in absolute value since 1990, and maintained a share of total export values of close to 90 percent.

Table I.5. Annual average exports, 1990-2001 (USD million)

Annual average	1990-1993	1994-1997	1998-2001	% change
Manufacturing*	77.2	154.9	187.6	143.0
Food & livestock	8.1	8.7	8.4	3.0
Beverages & tobacco	0.9	0.3	12.6	1281.0
Crude materials, inedible	6.5	8.1	4.7	-26.8
Mineral fuels and related products	0.0	0.1	0.0	0.0
Commodities	0.4	0.1	3.4	814.5
Total Exports	92.6	172.2	216.7	134.0

Note * "Manufacturing" includes manufactured goods, machinery and transport equipment, chemicals and related products, and miscellaneous manufactured goods.

*Source: D*erived from Central bank of Lesotho, Annual Report, 2001 (pg 51) and 2000 (pg 51); converted to USD at annual average rate, IFS; world Bank.

In the 1980s most of Lesotho's exports had been destined for South Africa (footwear) and the European Union (garments). However most of the growth in exports in the last decade has been to the United States, as changes in Lesotho's trade privileges (see Box I.5) have influenced the strategies of foreign investors in the garment industry. Lesotho has virtually no trade with SADC members other than South Africa, reflecting the fact that its narrow productive base does not include the types of goods that other member countries import (such as machinery, capital equipment and natural resource-based manufactures).

Lesotho's exports are thus highly concentrated by both product and market, which makes response to the future phasing out of the AGOA trade privileges its greatest challenge. This is discussed in Chapter III.

Box I.5. FDI and garment exports – access to markets as an engine of investment

The first wave of FDI in garment manufacture started in the 1980s, when investors were attracted from South Africa to Lesotho, as a means of escaping international trade sanctions on South Africa, and to benefit from quotas under the Multi-Fibre Agreement, (MFA) and preferential tariffs. Under the Lomé Convention, Lesotho had duty-free access to the European Union market. Initially there was no local content requirement, and inputs could be sourced from the cheapest and most efficient sources (East Asia). In the late 1980s, however, the EU began to apply 'cumulation' to all ACP countries, requiring at least two stages of production to be carried out locally (i.e. fabric had to be made locally). Lesotho was able to get special dispensation ('derogation') for eight years from the ruling, and a new wave of FDI aimed at the EU market followed.

As EU derogation ended, several foreign investors downsized their factories or closed down completely, but others shifted their exports to North America. Although they now had to pay the 17 per cent duty that applied to all exporters from the developing world, they could still source their raw materials from East Asia. The main benefit they exploited at this stage was unused MFA quotas. However NAFTA and NAFTA-parity countries in the Caribbean have the same privileges, and this privilege is due to end in 2005, when the MFA expires.

A renewed boost to FDI came with the launch of AGOA in 2000. Lesotho can sell all products duty and quota free to the United States, and in the first phase (AGOA 1, 2000-2004) procure inputs freely. (There are nine Sub Saharan LDCs with this privilege). In the second phase (AGOA 2, 2004-2008) it can still sell products to the US market duty and quota free, but it must source its inputs within Sub-Saharan Africa (including South Africa) or from the United States. Its competitive position after 2005 will then depend on the balance between the higher costs of inputs and the duty privilege of 17 per cent over other non-African competitors. The first phase of the agreement is the most beneficial part of the scheme, and Lesotho is trying to get it extended. It is not clear yet to what extent this is likely, or how it will affect FDI.

Source: UNCTAD; Diagnostic Trade Integration Study (2002), volume 2.

3. Employment

Foreign manufacturing affiliates in Lesotho employ around 40,000 people, about one out of four in the private sector. Total employment by affiliates would be higher if services and hotels were included. As shown in Table 1.6, the largest employer is clothing, where over 80 percent of employment is attributed to foreign affiliates. Most of this employment is female, as is common in the garment industry. A further expansion of 12,600 jobs is expected in the near future (Salm et al, 2002), of which 8,500 jobs are attributed to new investors that have expressed interest in investing and are awaiting factory buildings, 600 is from two expansions of existing factories, and 3,500 from firms willing to construct their own factory shells. The footwear industry is also undergoing rapid expansion. The largest foreign affiliates, in terms of employment, are ranked in Table I.7 below.

Table 1.6. Employment by foreign affiliates in manufacturing in Lesotho

Industry	No. of firms	2000	2001
Clothing	38	21,587	33,309
Footwear	3	2,970	5,420
Electrical/electronic	4	963	1,183
Foods	4	600	648
Other (estimated)	6	344	450
Total (estimated)	55	26,464	41,010
All establishments	2,215	51,691	
Affiliates % Total	2.5%	51.2%	

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

There continues to be reliance on expatriates in foreign affiliates, as one might expect given the early stages of the industry. In 2001 there were 1,076 expatriates, mainly from East Asia, in the clothing industry. Because the local skill base is still low, these firms relied heavily on foreign technical, supervisory and managerial staff. By comparison, employment in the financial services sector is much more localised.

Table I.7. Largest foreign affiliates in Lesotho (2002)
(ranked according to number of employees)

Company	Home country	Industry	Employment	Entry year
Lesotho Precious	Taiwan, Province of China	Garments	3,620	1999
Presitex	Taiwan, Province of China	Garments	2,800	2000
CGM	Taiwan, Province of China	Garments	2,000	1987
C& Y	Taiwan, Province of China	Garments	1,900	1990
P&T Garments	Taiwan, Province of China	Garments	1,840	2001
Nien Hsing Textile Co	Taiwan, Province of China	Garments	1,800	2001
United Clothing	Taiwan, Province of China	Garments	1,700	1996
Evergreen Textiles	Taiwan, Province of China	Garments	1,673	1995
Lesotho Fancy	Taiwan, Province of China	Garments	1,540	2001
Springfield Footwear	South Africa	Shoes	1,641	1995
Tzicc	Taiwan, Province of China	Garments	1,210	2000
Teboho Textiles	Taiwan, Province of China	Garments	1,090	1997
Lekim	Singapore	Garments	1,071	1997
Tai Yuan	Taiwan, Province of China	Garments	960	2000
Suntextiles	Taiwan, Province of China	Garments	952	1994
King Ang	Taiwan, Province of China	Garments	920	2001
Lesotho Hinebo	Taiwan, Province of China	Garments	900	1989
Hippo Knitting	Taiwan, Province of China	Garments	850	2000
N-River	Taiwan, Province of China	Garments	850	2001
C-River	Taiwan, Province of China	Garments	768	2001
Vogue Landmark	Taiwan, Province of China	Garments	700	1996
Standard Bank	South Africa	Banking	650	--
Supreme Bright	Hong Kong	Garments	635	2001
Superknit	Taiwan, Province of China	Garments	600	1989
J&S	Taiwan, Province of China	Garments	575	1996
Hong Kong Int.	Taiwan, Province of China	Garments	550	2001
Carca Footwear	South Africa	Shoes	500	1997
TW Garments	South Africa	Garments	500	2000
Mountain Eagle	Fiji	Garments	490	2002
Sun Hotels (Maseru and Lesotho)	South Africa	Tourism	450	1975
E-River	Taiwan, Province of China	Garments	429	2001
San-Yong	Taiwan, Province of China	Garments	350	2002
Lesotho Milling Co.	South Africa	Food	335	1980
Maluti Textiles	Taiwan, Province of China	Garments	392	1998

Maseru Textile	Taiwan, Province of China	Garments	315	2001
Kiota Electronics	South Africa	Manufacturing	256	1990
Maseru Clothing	South Africa	Garments	225	1986
Lesotho Brewing Co.	South Africa	Beverages	222	1980
Nedbank	South Africa	Banking	140	--
OK Bazaars	South Africa	Trade	120	1980
Lesotho Bakery.	South Africa	Food	121	1988

Sources include: LNDC, UNCTAD, World Investment Directory 1996, Africa, pp 206.

4. Technology, skills and productivity

Manufacturing FDI in Lesotho has focused on low technology and low skill activities. Lesotho has a reasonable level of literacy and basic education but it lacks the industrial base, industrial capabilities and industrial entrepreneurship that foreign affiliates would need if they were to set up more advanced facilities. Its tiny economy means that market-seeking investments (that could, in large economies, enter more capital-intensive, complex activities to meet local demand) cannot be attracted on a large scale. And its lack of natural resources means that processing activities, that could deploy advanced technologies, cannot be attracted or promoted.

There is little doubt that export-oriented manufacturing FDI has created new skills in Lesotho. All employees are given some form of training: in the clothing industry, to handle sewing machines, cutting, pressing and the like. However, the full potential for skill transfer and capability building even in these simple activities has not been exploited. Whatever the cause, many supervisory, technical and managerial jobs remain with expatriates, even in firms that have been in Lesotho for a decade or more.[10] This stands out in contrast with the experience in longer established services industries.

A few companies do have in-house training and motivation programmes, and have realised productivity improvements and better labour relations. This does not, however, appear to be the norm and policy efforts may be needed to raise enterprise investments in training (Chapter III). Language, culture, work practices and perhaps a 'footloose' attitude (i.e. a perception by firms that they are only in Lesotho while trade preferences last) may be at fault, raising the cost of adapting to local circumstances and of creating trust and social capital. Part of the fault, however, also lies with the institutional structure in Lesotho. There is no permanent training centre for the garment industry. The Lesotho Garment Centre, funded by the UK aid agency DFID, was being wound up in 2002. Lerotholi Polytechnic provides generic management training and courses on design and bespoke tailoring, and the Institute of Development Management and St Luke's Mission offers similar courses, but these are not geared to the specific needs of the garment industry.

One striking fact is that only two local apparel entrepreneurs, namely, Cee Bee Adonia and Lesotho Manufacturers' Association Ltd., have emerged in Lesotho, some

[10] Apparently, South African firms are more in tune with local culture and practices, and are better at training locals and more willing to devolve responsibility. However, this is based on anecdotal evidence and needs further investigation.

15 years after the first modern garment factory was established.[11] This is unusual in the garment industry, with its low entry barriers and ease of access to world markets via foreign buyers. Other developing countries with apparel exports have done much better. For example, in Bangladesh, also a country with low skill levels, weak infrastructure and minimal industrial tradition, several employees of foreign affiliates left and set up their own export operations within a few years of foreign investors setting up garment export operations.[12] They had, however, been given considerable training by foreign investors; many had been taken to the Republic of Korea, the home country of the earliest entrants. Today Bangladesh exports over $3 billion of garments, with a substantial proportion coming from local companies. Similar growth of local entrepreneurship in garment exports is found in countries like Sri Lanka, Mauritius, Morocco and small economies in Central America.

It is not clear what accounts for Lesotho's poor record in this aspect of skill and technology transfer. Part of the explanation may again lie in the reluctance of foreign firms to train local employees in high-level skills – after all, employees have to serve in managerial and supervisory positions before they can venture out on their own. Part may lie in the local culture and institutions, and part may lie in capital market deficiencies for new entrepreneurs, depriving them of sources of long-term risk finance. However, operations like the South African-owned Metro Cash and Carry have shown the importance of technical support for small local firms (see Box I.6).

The general impression of observers is that foreign affiliates in Lesotho are performing well below international technical 'best practice' in the industry. There is however a growing recognition on the part of some firms of the need to commit themselves more strongly to local skill development, and policy efforts should aim to support and widen this trend. The government, jointly with industry, should mount policies to encourage training and build the institutions needed to support in-house efforts (Chapter III).

Box I.6. Metro- Cash and Carry underpins development of small retailers

Metro Cash and Carry, RSA a South African owned group in wholesale business has been operating in Lesotho and Botswana for 26 years since 1975. It has a paid up capital of $50,000 and employs around 90 people. Its average annual sales turnover in 2001 was about $16.2 million.

The Company is engaged in the wholesale distribution of groceries, food, household products, hardware and electrical goods. It operates 9 branches in the country, and has expansion plans for 3 more branches over the next few years. Local retailers who sell goods from Metro Cash and Carry operate under the banner name of "Lucky 7" and also under "Square Deal". This form of operation is the core marketing strategy of the Company. It essentially combines the strengths of wholesale business and retailing to capture shares in the local market. Metro Cash and Carry of South Africa take advantage of its global purchasing power and marketing know-how to source

[11] Only one firm has been set up by a former Basotho employee to subcontract cut-make-trim operations from larger firms, and this firm appears to be in financial difficulties.

[12] Yung W. Rhee and T. Belot, *Export Catalysts in Low-Income Countries: A Review of Eleven Success Stories*, Washington DC: World Bank, Discussion paper 72.

goods both locally and from abroad at competitive prices, and sell them through the local retailers which carry their banners. Retailers who wish to be part of the banner group pays a one-off fee, for which Metro Cash and Carry Ltd. provides them with the Lucky 7 or Square Deal logo, logistical support where it runs promotions for them twice a month.

The marketing operation contributes towards empowering small retailers through enhancing their knowledge on efficient retailing, and helps them to grow through tapping on the Company's resource network. The major developmental impacts are:

Economies of scale: The Company has the global buying power to buy goods at competitive prices, unlike the individual importer/sole trader who has limited working capital and negotiating power.

Local sourcing and distribution: Most food products are sourced locally, namely, sugar, maize, poultry, eggs, beef, dairy products and beverages while items such as kitchenware, household products and hard ware are imported. Linkages are created with local packaging industries and transportation services. Local suppliers' standards are upgraded, as they are required to conform to packaging goods to the Company's specific requirements.

Transfer of knowledge/expertise: Training programmes for business owners and their employees is an important part of the operations. Metro's retailers are given compulsory basic training course on how to run a retail business, covering basic skills in costing, stocktaking, bookkeeping, merchandising and cost control. In addition they learnt modern food conservation techniques and use of trading tools, like racking, computerized stock pricing and control systems. For those who are keen to improve and expand their businesses, advanced courses in marketing are taught. Guidance is also given on how to draw up business plans, as well as how to make break-even analysis. Some of the more advanced retailers have even installed in-store bakeries, sourced through Metro's contacts at favourable costs.

The Company also runs a seminar for their retailer groups twice a year. An annual convention is held in Swaziland every October over 3 days, and all the "Banner Group" customers in Southern Africa are invited to attend this Convention.

Enable small retailers to grow: This arrangement allows small retailers to grow their business, which would not be likely if they were operating on their own resources. It enables them to get goods at competitive wholesale prices. Small traders on their own have limited access to suppliers nor do they have the muscle to negotiate. Furthermore, small retailers benefit from the Company's elaborate advertising campaign of monthly promotional sales items carrying the Company's brand names.

Source: UNCTAD interview.

5. Backward linkages

There are few backward linkages from manufacturing FDI in Lesotho, apart from essential non-tradable inputs like labour, banking services and utilities. In the clothing industry, all the fabrics and accessories are imported, largely from Asia but also from South Africa. Even the simplest inputs, like packaging, are largely imported. One supplier, a Taiwanese firm, has set up locally to make packaging for exporters, but does not have the capacity to meet more than a small proportion of demand.

The ending of AGOA 1 in 2004 will require garment exporters to source their fabric within Africa or the United States, providing a strong incentive to firms to integrate backwards or for new entrants to set up weaving or knitting mills in Lesotho. A few firms have responded, led by Nein Hsing International, which is setting up a factory in Lesotho to weave denim for its jeans operations. This facility will meet around 70 percent of the current denim needs of all Lesotho-based jeans exporters (which account for 35per cent of total employment in the garment sector). Another Taiwanese exporter has bought a denim weaving facility in South Africa; this has a much larger capacity, which it will use to sell fabric to the region as a whole. However, it is not clear how local denim prices will compare with fabrics from Asia. If they are much higher, the duty-free advantage gained will last only till 2008, when AGOA 2 is supposed to end.

According to Salm *et al.* (2002), it is economically more feasible for Lesotho firms to set up knitting mills than weaving mills (which are far more capital, skill and scale-intensive). The knitted garment segment of the industry (making T-shirts and the like) accounts for nearly 60 percent of employment in the industry, but there are no signs yet of backward integration by firms in Lesotho. Some are threatening to leave if AGOA 1 is not extended, while others have expressed the intention to set up knitting operations.

There is also scope for increasing local content in Lesotho in other inputs, starting with packaging and simple accessories (buttons, trim and the like). However, its real potential needs further analysis in view of skill, technological and entrepreneurial levels in the country.

6. Other effects of FDI

It is difficult to evaluate other effects of FDI without more detailed analysis. Most of the employment created is female, as is common the world over in the garment industry, with concomitant benefits. These benefits have to be set off against the slow progress of training and promotion of local employees. Working conditions in the factories are apparently not bad, but are perceived unfavourably by the workers and the public at large. Conditions have improved in recent years, but earlier harsh practices still "continue to haunt the industry" (Salm, p. 42).

A number of foreign investors are starting to take their social role seriously, especially since the upheavals of 1998. Firms are making donations to schools and other social causes. However, these are not well publicized and the media continues to be critical.

C. Assessment

Lesotho's performance in attracting FDI has been creditable by regional standards, particularly in view of its landlocked and remote location, paucity of natural resources and undeveloped industrial base. It has also been markedly better from that of most other least developed countries. Since 1994 on, FDI inflows have been consistently much higher. Even more impressive is the fact that the bulk of FDI has gone into manufacturing and, within that, overwhelmingly into export activity. Lesotho is (apart from Mauritius) the only country in the region to attract significant FDI in export-oriented manufacturing aimed at OECD markets. As a result, Lesotho now has some 70 percent of its exports coming from manufactures, in contrast to most regional economies that still rely heavily on primary and resource-based exports. This difference is important – Lesotho has a base, which, although fragile, constitutes an opportunity to build upon and capture the benefits of FDI induced growth.

FDI has provided other benefits to Lesotho. The employment benefits, particularly for female workers, have been significant. The income effects have also been beneficial, particularly important in view of the large numbers of Basotho returning from their traditional source of employment, the mines in South Africa. New jobs and sources of income have contributed to poverty reduction. FDI has also created new skills and work attitudes, better trade infrastructure and support services geared to export markets.

On the other hand, the competitive base for apparel, the dominant activity for FDI, remains fragile and narrow, heavily dependent on trade privileges in the US market. The capabilities that Lesotho has built up in clothing manufacturing, while significant in relation to many other African countries, are not yet sufficient to sustain FDI once trade privileges are withdrawn and Lesotho faces full competition. Moreover, the benefits of FDI have not been as large as in other countries (in South and South-East Asia) where export-oriented apparel FDI has also taken root. Local content in Lesotho is negligible. Tax revenues appear to be small. Local employees in manufacturing (but not in services like hotel or banking services) are largely confined to low-skill operations, and there is little investment in training to upgrade skills. There are practically no local spin-offs in export or subcontracting activity. Backward integration into textile production is starting but it may not be enough to ensure a competitive base once the current phase of AGOA ends and inputs cannot be sourced from the cheapest suppliers. Despite the privileges offered by AGOA, so far there has been no foreign investor interest in other labour-intensive activities. The EU is offering duty-free access to most products made in Lesotho under the Cotonou Agreement, again with no FDI response. The other main draw for manufacturing FDI, into labour intensive operations for South Africa (from South Africa and third countries), has not yet led to large amounts of inward investment. And the potential for foreign investment in service (notably tourism) and resource-based activities (mining and agricultural) activities remains largely untapped.

The FDI prospects of Lesotho depend on improving the base for existing foreign operations as well as on raising its attractiveness for new FDI. Export-oriented FDI in the long-term needs considerable upgrading of capabilities.

II. THE INVESTMENT FRAMEWORK

Lesotho is largely open to FDI and treats foreign investors well. But FDI policy and the legal framework are weakly developed and improvements are recommended. Business taxation, land regulation, work and residence permits, industrial and trade licensing, competition policy and aspects of foreign exchange control are singled out for attention.

A. Specific FDI measures

1. Entry and establishment

FDI is able to enter Lesotho freely in most sectors. Lesotho is generally welcoming to FDI especially in export manufacturing, which is currently being actively promoted and supported. In the last 10 years additional sectors have been opened to FDI as steady progress has been made in privatising state-owned enterprises. On the other hand, as detailed below, some services businesses have recently been formally closed to FDI.

Lesotho has no foreign investment law nor, with one exception, foreign ownership restrictions in sectoral licensing laws. There are foreign investment restrictions in licensing of business and consumer services and in a *de facto* form of FDI screening for very small-scale manufacturing.

FDI entry restrictions in business and consumer services were introduced in 1999 into Lesotho's ubiquitous trade licensing system. Trading licences are required for a wide range of services. FDI is not permitted in designated services that require a reserved trading licence. By ministerial regulations issued in 1999 these currently comprise small-scale retail and personal services businesses.[13] No foreign ownership of any level or even board directorship by a non-citizen is permitted in reserved trading licence businesses.

The Minister for Industry, Trade and Marketing may add or remove trading activities from the reserved licence list. The Minister acts on the advice of the Trading Enterprises Board, which consists of heads of relevant government departments, representatives of the police and defence force and a representative of the Lesotho Chamber of Commerce and Industry. The governing act strongly enjoins the Board to promote local business. It does not specifically empower the Minister to prohibit foreign ownership or provide specific criteria for restricting foreign ownership. It is understood that the recommendations of the Lesotho Chamber of Commerce and Industry (which represents only nationally owned businesses, typically small and medium sized businesses) are influential.

All manufacturing businesses employing over 10 people or utilising machinery of more than 25 horsepower require an industry licence. There are no restrictions on FDI under the relevant legislation although it does not preclude the introduction of

[13] Agent of a foreign firm, barber, Basotho beer shop, butcher, snack-bar, domestic fuel dealer, dairy shop, general café, general dealer, greengrocer, hawker, street photographer, broker, mini-supermarket, hair and beauty salon, petrol dealer and tentage dealer.

such restrictions by regulation (as has occurred with trading licences). The Department of Industries appears to operate a *de facto* system under which very small-scale foreign manufacturers (i.e. those under the size thresholds set out above) will be discouraged from establishing. In practice no industry licence has been denied because an applicant was a foreign investor. And, clearly, foreign investment in substantial manufacturing activity is welcomed.

These restrictions on small-scale services and manufacturing business are in fact instruments of immigration control. There is sensitivity in Lesotho to the entry of small business owner-operators from abroad (especially from China and west Africa). If many such businesses were established this would be officially perceived as an unwelcome level of economic migration.

Many trading businesses and all substantial manufacturing businesses are open to FDI. Nevertheless the relevant trading or industry licence is required and must be renewed annually. The licence systems themselves need reform. They are reviewed later, in the section on sectoral regulation. Moreover, the trade and industry licence systems have become administrative instruments of other policies and agencies, including points of reference for the issue of residence visas for foreigners who seek to work in Lesotho. The issue of work and residence permits, which are always key concerns to foreign investors, are reviewed later.

Foreign investors do not have direct access to land title. Under Lesotho's leasehold land title system only Lesotho citizens and commercial entities majority controlled by Lesotho citizens may lease land. Foreign citizens and investors may only sub-lease from Sesotho-owned[14] entities. All transactions in leases and sub-leases, including issue, transfer and mortgages require Ministerial approval. There is a feeling in Lesotho that useable land is scarce and that the land system should prevent a few, who could well include foreigners, from acquiring excessive holdings. These constitute barriers to the entry of FDI in property and infrastructure development. Indeed by 1986 the feeling was such that even naturalised citizens were disqualified from holding land leases, although this is arguably unconstitutional. Hitherto this hindrance to FDI has been relieved by the Lesotho National Development Corporation (LNDC), which develops and lets factory shells and other commercial property. In other sectors, such as tourism and the utilities, parastatals have also perforce been the leading property owners.[15] Heavy state investment in industrial and commercial property to facilitate FDI is unlikely to be practical as FDI expands. Land titling issues are further discussed in Section B below.

2. Treatment and protection of foreign investors

Lesotho's standards of treatment and protection of specific interest to foreign investors are good *in practice*. But the *legal framework* guaranteeing these norms is weakly developed. There is no foreign investment law and a miniscule network of bilateral investment treaties (BITs), which are used by countries to protect foreign

[14] The definition excludes naturalised citizens.

[15] Foreign land ownership restrictions have complicated certain privatisations involving FDI. For example a special act of Parliament was required when the Lesotho Bank was privatised so as to enable the foreign investor to acquire the bank's land holdings in its own right and not as a sub-lessee.

investors and ensure their adequate treatment. BITs have been concluded with only two countries – the United Kingdom (1981) and Germany (1985).

Lesotho thus relies extensively on its track record to assure foreign investors of good treatment and protection. Whilst actions will always speak louder than words two cautions are necessary. First, Lesotho still has a short track record in attracting FDI in any sizeable volume. Secondly such FDI has until relatively recently been small to medium scale investments and from a large and relatively powerful neighbour, South Africa. As Lesotho continues to diversify its sources of FDI (for example from the US and Japan) and to attract larger investors it ought to be able to offer the comfort of a more developed legal framework including a foreign investment law and better investment treaty network.

The track record is not perfect. As mentioned above, in 1999 new trading enterprises' regulations introduced reserved licences that prohibited FDI in 17 business activities, principally retailing. Existing foreign businesses in these activities were given up to end of their remaining licence periods (no more that 12 months) to cease business, although some leeway was granted. A number of foreign businesses closed as a result. This arbitrary treatment of established foreign investors was clumsy to say the least. It would have been possible to exempt established investors from the new regulation or give a much longer period in which to adjust.

This drastic action appears to have arisen because trading businesses were regarded as vehicles for economic migration coupled with a failure of normal immigration controls to keep economic migration to acceptable levels. This action can probably be understood as careless policy making. But at best it is a poor signal to foreign investors and at worst indicates a static view in which FDI has tenure only so long as no national investors are available. Recommendations are made later as to how to improve the FDI regime and the work and residence permits regimes to prevent these lapses re-occuring.

The specific standards of treatment and protection currently afforded to foreign investors are summarised below.

National treatment: In most facets of everyday business, foreign investors are treated equally with national investors. A clear and major exception is the prohibition on ownership of land-lease titles by foreign investors. Quite apart from being a departure from the principle of national treatment it would seem to be an unnecessary and unhelpful measure (see later discussion of "Land"). Lesotho's two BIT's provide for national treatment. The treaty with Germany has in particular a broad view of the business requirements associated with the conduct of an investment that should be accorded national treatment.

Non-discrimination: Are foreign investors from different home countries treated equally in Lesotho? Lesotho has no legal provisions that discriminate among home countries. Naturally it pays close attention to investment relationships with its neighbour South Africa and is a member of the SADC group but neither relationship leads to preferential treatment for investors from these countries. Both BIT's provide for non-discrimination with usual exclusions for international trade and taxation agreements. The UK treaty also excludes national legislation on taxation.

Funds transfer: Lesotho maintains foreign exchange controls and central bank approval is needed for the transfer of profits and the proceeds of disinvestment. There has never been a case of blockage of such transfers. Lesotho's BITs provide for free funds transfer for a wide range of payments associated with an investment. Under both treaties fund's transfer may be delayed in the event of economic difficulties.

Lesotho is a member of the Southern African Common Monetary Area (CMA) and the South African rand is also legal tender exchangeable at par with the local currency, the maloti. In effect Lesotho residents can readily repatriate funds in rand to South Africa. Thus there are no exchange controls to concern South African investors.

Expropriation: The Constitution provides that the acquisition of private property by the State can only occur for specified public purposes and that a law must provide for full and prompt compensation. There is a right of appeal to the High Court as to whether the action is legal and compensation is adequate. The Constitution is silent as to whether compensation may be paid abroad in the case of a non-resident. Such an additional provision would usually be contained in a foreign investment law.

Unfortunately it is not possible to say categorically that Lesotho has never expropriated a foreign investment. It is arguable that the method of application of reserved trading licences in 1999 amounted to expropriation even though the State did not acquire the property.

Dispute settlement: Foreign investors have full and equal recourse to the Lesotho courts to settle commercial and labour disputes. The courts are regarded as fair and impartial in hearing cases involving foreign investors. In complex commercial cases overseas judges may sit. Until recently the Government rarely entered into an investment agreement with a foreign investor. Privatisation has introduced a number of investment agreements and these provide for international arbitration to settle disputes.

Under the relevant BIT's a United Kingdom investor may take a dispute with the Government to international arbitration but the German treaty is silent on this issue.

Lesotho is a member of the Multilateral Investment Guarantee Agency (MIGA) and has acceded to the Convention on the Settlement of Investment Disputes between States and Nationals of other States.

3. Incentives and performance requirements

There are no incentives specifically for foreign investors and no performance requirements are imposed only on foreign investors as a condition of investment.

4. Assessment

Lesotho's legal regime for FDI is weakly developed and its policy is unwritten. Practice on the admission and treatment of foreign investors has been mostly of high standard but in a recent instance (the 1999 introduction of reserved trading licences) in which Lesotho's interests appeared to be threatened and Lesotho had room for manoeuvre there was peremptory treatment of established foreign investors.

Lesotho's investment climate would benefit from a well-articulated foreign investment policy statement by the Government and the introduction of a modern foreign investment law. A policy statement would acknowledge the national benefits of FDI, set out attractive policies on matters of interest to foreign investors and explain how the Government will address potential areas of concern – e.g. the issue of economic migration – which overlap FDI issues.

The introduction of a foreign investment law should be a centrepiece of such a policy. A well-written law would reflect and promote all the good practice features in Lesotho's regime in the entry and treatment of foreign investors. But it would change the approach to restricting FDI. It would:

- Articulate a legal basis for the current good practice in the treatment and protection of foreign investment.

- Permit FDI in all areas of business without the need for prior approval (as at present) unless specifically excluded in sensitive industries as defined in that law and not elsewhere.

- Provide for a body to promote and facilitate foreign investment.

- Provide flexibility in permitting FDI entry to negative list industries in defined circumstances (see below) and a body to screen relevant applications.

- Set out the considerations and procedures required to introduce a "negative list" of business activities in which FDI is restricted. (See below).

An important change recommended is that an FDI law would centralise the approval of sensitive industries to be placed on the "negative list" and remove this power from secondary licensing legislation.[16] This would enable such a step to be taken with due regard for the overall investment climate and other considerations.. The manner of introduction of reserved trading licences shows that wider considerations of the investment climate should be entrenched.

Other considerations involved in drawing up a "negative list" should include the need to promote competition so as to provide consumers and other businesses with more competitive supplies. Further, the proposed law should build in the flexibility to permit FDI in negative list areas where on a case-by-case basis it would be beneficial. A prime example is where an established national investor in a negative list business seeks a joint venture foreign partner to expand or access new markets or technology. A body established under the new law should be able to approve or reject FDI in such cases on their merits.

[16] Of course licences may still be required in regulated sectors by all businesses whether nationally or foreign owned. But the national source of ownership would no longer be one of the considerations involved in the grant of such licences.

Given the close affinity of Lesotho with the SACU countries and the significant common economic arrangements it is worth considering whether to exempt entities from these countries from negative list arrangements for FDI – either as a general rule or on a case-by-case basis. The foreign private sector sees merit in promoting open border arrangements.

A foreign investment law should be supplemented by a more active programme of expanding the BIT network – focussed on key home countries targeted for FDI.

B. General investment measures

1. Taxation

The principal business taxes in Lesotho are income tax, customs and excise duty and sales tax. Sales tax will be replaced by value added tax (VAT) most likely in December 2003.

Corporate income tax heavily favours investment in manufacturing and, to a lesser extent, commercial agriculture. Manufacturing and farming income are taxed at 15per cent and there is no withholding tax on dividends paid to non-residents from manufacturing profits. Income in all other sectors is taxed at 35per cent and there is a further 25 per cent withholding tax on non-resident dividends (absent a double tax treaty of which Lesotho has only two). Moreover, only industrial buildings qualify for depreciation allowances for taxation – thus buildings for services, tourism, farming etc are not depreciable. Also infrastructure such as land improvements and site services does not qualify.

Tax depreciation, where available, is at modest rates.[17]

Withholding tax at an exceptionally high rate of 25 per cent is charged on payments to non-residents of interest,[18] royalties and natural resource payments and management charges.

Tax on services is withheld at 10 per cent, which is more moderate. A non-resident has the (probably unattractive) option to be assessed and pay 40 per cent.

Double tax treaties (DTT's) have been concluded only with South Africa and the United Kingdom (a treaty with Mauritius awaits ratification). These DTT's limit withholding taxes to 10-15 per cent on dividends and to 10 per cent on interest, royalties and services fees. The UK agreement provides for tax sparing on Lesotho's reduced income tax in manufacturing but not for subsequent fiscal incentives.

[17] Tax depreciation rates (on a declining balance basis) range from 5 per cent on industrial buildings to 20 per cent on office equipment and furniture, heavy vehicles and construction equipment to 25 per cent on light vehicles. Other assets, which would include manufacturing plant and equipment, are depreciated at only 10 per cent. Start-up costs are amortisable at 20 per cent.

[18] The Minister of Finance can exempt interest from withholding tax. It is not clear if this has ever been granted and certainly there is no policy on the question.

Individual income taxation is in two bands of 25 per cent and 35 per cent with a personal tax credit, which ensures that minimum wage earnings are not taxed. Highly paid individuals would pay average taxes close to the top marginal rate plus a 40 per cent tax on a wide range of employer-provided fringe benefits. A deduction of up to 20 per cent of salary is allowed for superannuation contributions (including to non-resident funds). Foreign source passive income of resident individuals is also exempt. These are useful provisions for expatriate staff and should be retained. Overall the personal tax regime for the highly paid is not excessive but is definitely not geared to retaining and attracting talented people, including expatriates.

Import duty and excise are set by the common duties' regime of the Southern African Customs Union (SACU). There is no export duty. Manufacturers for export are able to register for duty free import of raw materials. This is a welcome improvement to the drawback system, which suffered from arrears in refunds.

Value-added tax has been legislated but not yet applied. It is welcome because as a tax on consumption it will be more investor friendly than the present sales tax. Unfortunately the VAT law as drafted is deficient precisely in this key area. Credit for input tax is allowed only for manufacturing, construction services and (effectively[19]) for merchandising. Thus other services including business and professional services, transport, tourism and agriculture will bear the incidence of VAT in a manner similar to the current sales tax. This is further example of a bias against non-manufacturing investment.

Elsewhere investors' usual concerns with VAT are that exports will be zero-rated and that excess VAT arising from exports and start-up capital purchases is refunded promptly. It appears that exports will be zero rated in the Lesotho regime. There is a helpful provision to apply for monthly refund where there is consistent excess VAT (the likely case of exporters). Excess VAT during start up can only be applied for quarterly and there should be similar flexibility in this regard to obtain a monthly refund.

The VAT rate will be 10 per cent compared with 14 per cent in South Africa. The lower rate is an effort to encourage consumer purchasing in Lesotho rather than in South Africa. It will do no favours to other businesses. Some investors believe that the rate should be harmonised with that in South Africa because differential rates will slow clearance of imports by the South African authorities, who will be concerned about smuggling.

These are all serious issues in the VAT regime for investors and should be re-considered prior to the implementation of VAT. Fortunately, implementation has been delayed (possibly until December 2003) in order to establish fully the Lesotho Revenue Authority.

Box II.1 presents a comparison Lesotho's taxation of investment with the tax regime in other regional and leading international destinations for FDI. The methodology is explained in Annex 1.

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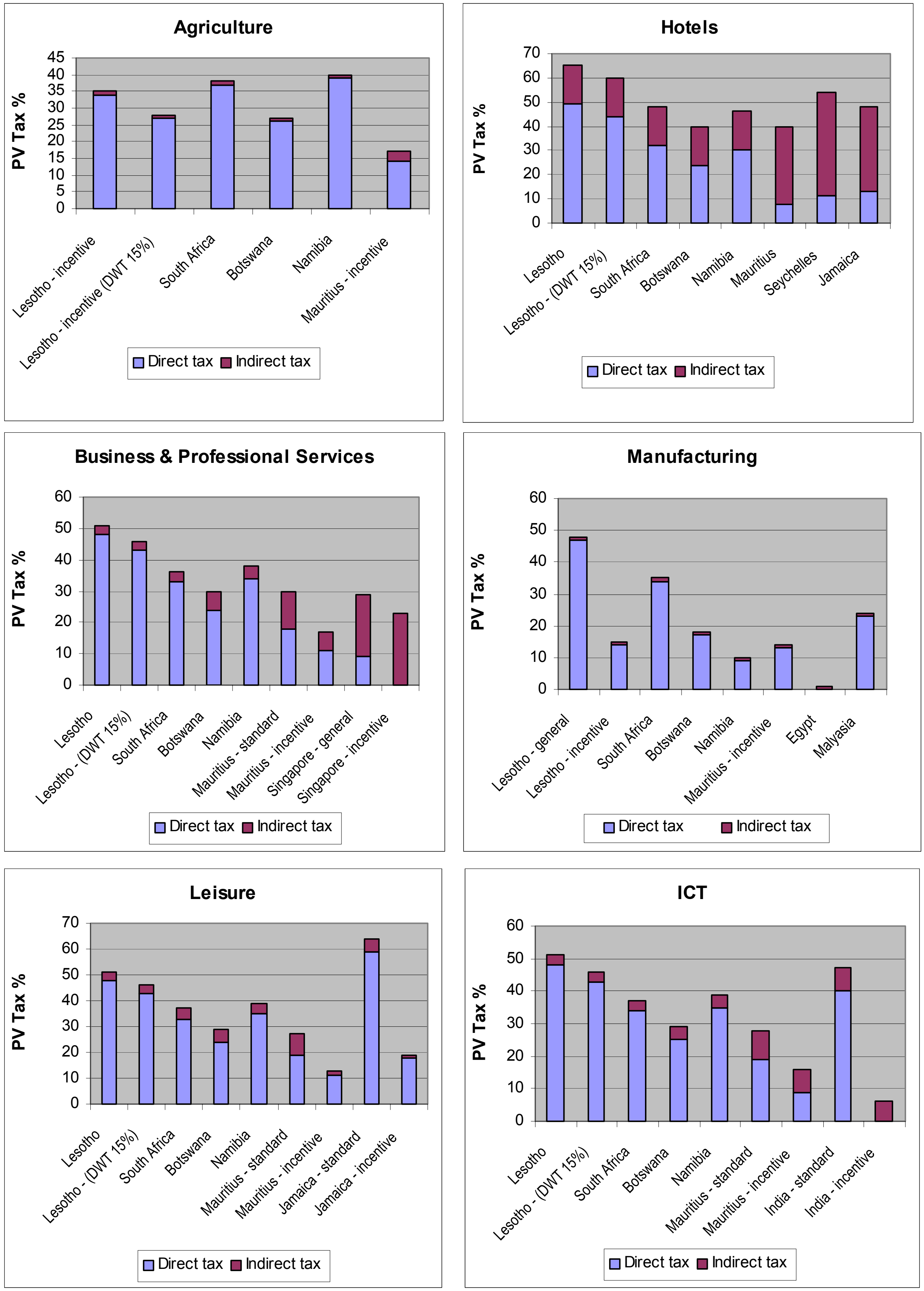
[19] This is implied by the limitation of input credit only to goods and services that are re-sold in substantially the same form.

Box II.1 Comparative taxation of FDI in Lesotho



In respect to the competitiveness of Lesotho taxation it is concluded:

- The special corporate tax regime for manufacturing makes taxation of this sector competitive with the rest of SACU and especially with South Africa. It also compares reasonably with other countries' incentives schemes with the exception of Egypt, which grants extended tax holidays to export manufacturing. (Note however that these international comparisons exclude Lesotho's high withholding taxes on interest and management charges.)

- The reduced rate of profits tax for agriculture also enables this sector to be tax competitive with other SACU countries. However, Lesotho's regime is not as attractive for investment as that of, say, Mauritius because of the relatively high rate of dividend withholding tax levied in Lesotho.

- In all other sectors the general tax regime applies in Lesotho. This regime is clearly not competitive with that in other SACU countries and most definitely uncompetitive with other countries that have developed special tax regimes to attract FDI on a sector-by-sector basis.

- Mining taxation as designed is not competitive. [20] Some aspects are negotiable on a project-by project basis and the state may take equity. (See the box on mining in Chapter 1). This conflicts with usual international practice of providing a known and stable fiscal regime. Admittedly, in diamonds *ad hoc* negotiation is more usual because of the highly varied nature of kimberlite deposits.

The conclusion from these comparisons is that the general taxation regime (outside the special regimes for manufacturing and agriculture) is quite unattractive for investors. Moreover, these comparisons exclude other unattractive features of Lesotho taxation – in particular its high withholding taxes on interest and management fees. *If* Lesotho wishes to mount a serious campaign to attract FDI in other sectors, including tourism, business and professional services, property development, information and communications technology (ICT) it will need to provide more competitive regimes for corporate income taxation.

The Ministry of Trade, Industry and Marketing is proposing a plethora of additional incentives in manufacturing – with lower rates of corporate income tax for investment that locates outside Maseru or creates significant employment. Since corporate income tax rates in manufacturing are already low these are unlikely to be efficacious. Moreover they should not be a priority for attention either within the manufacturing sector or more generally.

[20] In mining the conclusion stands because mine development works and buildings are not tax depreciable; plant and equipment depreciation is low by international standards; pre-development exploration is amortisable at only 20 per cent per annum; and income tax and withholding tax rates are high.

Further tax reform should focus on strategic priorities – *sustainability* in manufacturing and *diversification* to encourage investment into other sectors:

Manufacturing:

i. An immediate priority is to ensure that VAT is implemented correctly so as to minimise its impact on working capital of exporters. This apparently obscure administrative area is more important to business than is usually realised in government;

ii. The next priority is to revise the fiscal regime so as to maximise the sustainability of the textiles and other industries as trade preferences tighten. These should focus on special measures to promote upstream manufacturing. Such investment is likely to be much more capital intensive than garment assembly. The tax changes to consider are accelerated depreciation for upstream investment – as much as 100 per cent immediate depreciation for new investment whether by new or established investors. A full rebate of duty on imported plant should also be considered. Finally, withholding tax on interest should be reduced as large-scale investments are more likely to entail some international debt financing. For reasons set out in Chapter 3 an increase in the 125 per cent training expense deduction is not recommended. A refundable training levy scheme would be a more effective.

Other sectors:

iii. Currently the fiscal regime does not encourage investment into the non-manufacturing sectors – in particular in tourism, property development and mining that require more competitive arrangements to attract investment, especially FDI. The reforms should include lower profits' tax rates, lower withholding taxes, universal tax depreciation coverage and faster tax depreciation. A full VAT system should apply. Where it can be established that SACU-level tariffs on capital assets are non-competitive there should be a facility to grant a rebate.

Related issue:

iv. Lesotho should retain the present practice that case-by-case application for incentives is avoided in favour of general tax rules that apply competitive tax treatment. Case-by-case application (as is still practised in Mauritius for example) is often merely a procedure to remove disincentives prevailing in the general fiscal regime. It sets up another level of approvals required by investors and is a potent source of red tape to be avoided where possible.

2. Foreign exchange regulation

Lesotho has traditional foreign exchange controls, with the additional feature that it is part of the Southern African Common Monetary Area. The CMA comprises Lesotho, Namibia, South Africa and Swaziland. Under the CMA the South African rand is legal tender in Lesotho - possibly up to 30per cent of Lesotho transactions are made in rand. According to the CMA rules, including an ancillary bilateral agreement concluded in 1986 with South Africa, the maloti must be exchanged at par with the rand and the issue of maloti must be backed with reserves in rand and other foreign exchange. There are no exchange controls between Lesotho and South Africa but CMA members including Lesotho agree to have exchange controls with third parties no less stringent than those of South Africa.

The commercial banks have delegated authority to undertake current account transactions and Lesotho has acceded to Article VIII of the International Monetary Fund. Dividend payments still require central bank approval however. The central bank maintains direct powers of approval over foreign exchange requirements for all capital account transactions including FDI, capital disinvestment, and contracting and servicing of offshore debt.

In practice the maloti is readily convertible and does not present an issue for investors. The procedures for approving dividend remittance are somewhat bureaucratic but no more so than for other countries that have foreign exchange control regimes. Copies of audited company accounts are needed for final dividend payments; interim dividends require "only" management accounts. Tax clearance certificates are required for both interim and final dividend payments. Policy on approval of foreign loans is not strongly developed. The central bank says that there is little foreign borrowing by resident businesses.

The central bank is very cautious about liberalising foreign exchange controls. It is considering requests from investors to enable them to hold foreign currency accounts (FCA's) in the domestic banks. It has rebuffed requests from exporters to maintain offshore accounts on the grounds that it does not want to introduce piecemeal measures and is concerned at loss of control. The much bolder step of complete abolition of exchange controls is far away in official thinking. There is a concern about capital flight and the experience of reversals in other countries of this step is pointed to.

Lesotho's foreign exchange arrangements are functional but could be more investor friendly. Exporters should be granted their requests to hold FCA's under appropriate conditions. This would reduce their foreign currency conversion costs and provide a hedge against weakening of the rand. Secondly, the central bank should be more flexible in granting the right to operate offshore accounts where these are important in obtaining project debt finance from international lenders. Until exchange controls are abolished there will occasionally be valid ad hoc requests for such arrangements. It is "catch 22" to say that such requests cannot be entertained because they represent piecemeal reform.

Whilst Lesotho is a member of the CMA its scope for liberalising foreign exchange control depends on relaxation of South Africa's controls. The primary benefit of the current regime for Lesotho is that foreign investment from South Africa into Lesotho is free of domestic foreign exchange control. Also Lesotho residents can borrow and raise equity in the South Africa capital market, which is by far the most developed in sub-Saharan Africa.

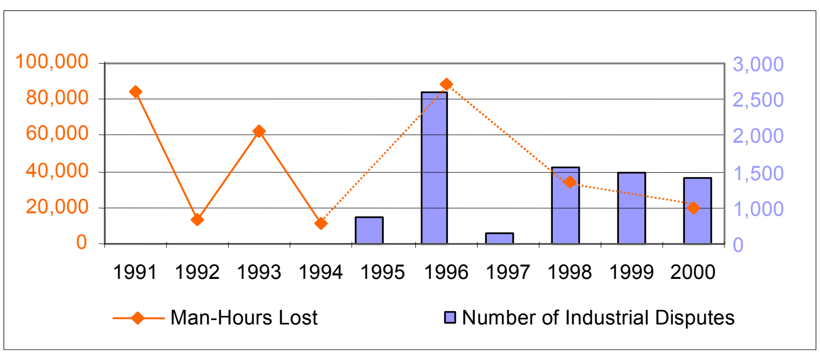
The benefits to Lesotho of free capital movement with South Africa outweigh the costs of accepting tight foreign exchange controls. This will remain true so long as South Africa has financial stability and the rand is convertible. The exchange rate of the maloti against major currencies is entirely dependent on the external value of the rand and thus of South African monetary policies. However, it is important for Lesotho to put a convincing case for FCA's and offshore accounts as required.

3. Labour

Lesotho has a modern labour code, introduced in 1992, providing for light regulation of employment terms and conditions and for worker health, safety and welfare. Union organisation is permitted. A tripartite Industrial Relations Advisory Council was established in 2000 to handle conciliation and arbitration of industrial disputes and generally to advise the government on good practice in industrial relations. Importantly, this innovation includes a full time and independent Directorate of Industrial Dispute Prevention and Resolution. This approach replaces the older resort to the government labour officer to settle disputes. The Government thus takes a neutral role but provides dispute resolution mechanisms. This appears to be very useful and is appreciated by the unions.

Industrial disputation is currently low and is generally on an improving trend although the data are incomplete. Figure II.11 shows that the number of industrial disputes has risen. Nevertheless the number of days lost through strikes appears to be falling which suggests an improving trend in resolving disputes. In both cases the 1996 spike-up was due to political disturbances. Industrial relations compare favourably with those in South Africa.

Figure II.1 Industrial disputes



Source: Labour Market Information Bulletin, 2000. Data on man-hours lost in 1995, 1997 and 1999 are not available.

Statutory minimum wages are fixed annually by the minister responsible for labour, who acts upon recommendations from a tripartite Wages Advisory Board. Minimum wages are set for a reasonably wide range of semi-skilled and unskilled occupations in manufacturing, transport, commerce and hospitality industries. Minimum wage setting is sensitive to the textile and garment industry's need to maintain competitiveness.

In future minimum wages might cover only unskilled occupations but be differentiated and calibrated by industry so as to maintain competitiveness. Since 1995 the minimum wage (as earned by a trained machine operator) has increased about 7per cent in real terms and is currently about $50 per month. Thus moderation in wages has been achieved which is appropriate given existing high levels of unemployment.

There is some concern at compliance by investors in the textiles and garments industry with Lesotho's norms for treatment of workers, especially working conditions. Unions, including moderate unions, believe that factory inspections should be improved and that *some* investors are loath to be fully compliant. They also believe that there is inadequate training of personnel officers in some companies.

Labour policy and administration is a commendable feature of the Lesotho investment framework – it has developed pro-actively and has focussed on sustaining a competitive advantage for Lesotho over alternative nearby locations for FDI. In these respects it is a model for other countries.

4. Employment of non-citizens

Obtaining work permits and residence permits is frequently cited by investors as an irritating and time consuming feature of doing business in Lesotho. On the other hand the Government has become increasingly concerned about the entry of foreigners (both legally and illegally) to Lesotho to be self-employed in small-scale businesses. These entrants are principally from China and west Africa. A crackdown is underway but it also seems to be affecting the normal permitting requirements of well-established businesses. On occasion, residence permits are granted for 3 months only and with no explanation. Investors believe that there are unreasonable delays.[21] Work permits appear to be less problematical. Current requirements and procedures are summarised in Box II.2.

[21] The immigration authorities were not interviewed.

Box II.2. Residence and work permit procedures

Residence visas: Under the Aliens Control Act a non-citizen employee or self-employed person (and dependents) can obtain an indefinite permit to reside in Lesotho. The Act sets out conventional conditions under which an application will be considered. Current procedure is that both types of applicant are required to submit a work permit, tax clearance certificate and a medical clearance. In addition a self-employed applicant must submit company registration documents, bank statements, and a trading or manufacturing licence if applicable. A recent rule also requires every applicant to have a sponsor or guarantor, which may be a government ministry or a resident individual. An employee must additionally supply evidence of educational attainment. Current practice is to issue indefinite permits for 1 year only and to consider renewal on the basis of re-submission of all the above-listed documentation.

A committee comprising various ministries meets weekly to consider applications. This has been recently augmented by a Security Committee, which tries to identify nefarious applicants. The Minister signs residence permit approvals although there is power to delegate under the Act.

Work permits: the Labour Code Order requires every non-citizen employee or self-employed person to have a certificate of employment (work permit). A work permit is issued by the Labour Commissioner who must be satisfied that no qualified Lesotho citizen is available for the position. The statutory maximum duration of a work permit is 2 years. A work permit may be cancelled before term or renewed. Applicants must submit details of qualifications and a lifetime employment and salary history. No substantive distinction is made between an employee and a self-employed businessman.

Current procedure is that a Work Permit Committee of various ministries meets weekly to consider applications, which are approved by the Minister. Work permits are commonly issued for one year, keyed to the duration of trading and manufacturing licences. Certain unwritten policies apply – usually permits for the chief executive and chief financial officer are given for 2 years; also in the garment industry a company is permitted to employ 1 non-citizen for every 20 citizens.

The workload in administering work permits for business is still small but increasing fast as seen in the table below. Comparable data was not available for residence visas but would obviously show a similar picture:

Work permits issued or renewed for business

	1994	1995	1996	1997	1998	1999	2000
Total	1,026	1,288	1,024	1,570	1,253	1,530	2,470
Of which:							
Manufacturing	262	332	169	489	523	339	947
Trading*	154	283	259	311	105	749	1061

Source: Labour Market Information Bulletin 2000. * Includes wholesale and retail trade and other minor services but not tourism, financial or property services.

The residence and work permit systems need to be rethought with three principles in mind. *First*, genuine investors should be facilitated in their requirements for non-citizen staff. Indeed this should be developed and portrayed as an incentive feature of the Lesotho FDI regime. *Secondly*, unwanted economic migration should be controlled as required but without jeopardising the first principle. *Thirdly*, investors should institute appropriate training and localisation plans.

At present there are single-track procedures for considering all requests for residence visas and work permits. This presents the danger that preoccupation with economic migration will lead to delays and frustration for genuine investors.

A redesign should include the following elements:

- Work and residence permit applications should be considered jointly and possibly issued as a single permit (other than for dependents).

- Work permits should be the primary control instrument. New measures are needed to ensure that the employment or self-employment is *bona fide* and not a vehicle for unwanted economic migration although this will never be completely controlled in areas restricted for foreign entry.[22]

    - In businesses on the negative list for FDI, there should be pre-investment screening as now. By definition there should be no work permits for *self-employed* persons (i.e. owner-managers) unless a negative list business has specific FDI approval. And work permits for *employees* need to be carefully screened in these activities. This approach should enable the Government to control economic migration to levels and economic activities that it deems appropriate.

    - In businesses open to FDI, permits should be given in accordance with a well-developed and positive policy (see immediately below). Applications within policy guidelines need not be elaborately screened prior to the investment. A post-investment audit of investor financial statements by a recognised accounting firm after say 18 months of establishment would establish whether or not the investment has taken place as promised. This approach would fast track permits for genuine investors but provide a mechanism to revoke work and residence permits where the promise of investment was bogus.

- A *written* policy on work permits (and associated rights for residence permits) that is attractive to investors should be developed. It would contain many of the unwritten features of current policy such as key worker schemes – in which a number of positions are allocated for non-citizen employment without the need to establish if Lesotho citizens are available or suitable. In due course this should be allied to a more formal training and localisation scheme for citizens. These should be written statements of policy. The current impression is that policy is ad hoc and unpredictable from case to case.

- Work and residence permits should be for longer periods for employees and indefinitely for the self-employed once it is clear that a promised investment in an activity open for FDI has indeed taken place. This is more sensible for investors and eases the administrative burden of frequent renewals.

5. Land

The Lesotho land system is problematical for business in general and foreign investors in particular.

The Constitution vests all land in the nation. The 1979 Land Act abolished the chiefs rights of land allocation and introduced a leasehold title system for land in designated urban, agricultural and "development" areas and thus available for

[22] Even in areas restricted for FDI (and by definition not open to self-employed non-citizens) citizens can be found to "front" for foreign economic migrants.

commercial use. The remaining "rural" land is held in a less formal system of "allocation" but can be acquired by the Government for designation as one of the above areas and allocated in titled form. Maximum lease tenure is up to 90 years for residential use and either 60 years or 30 year for business use.

Foreigners may only sub-lease land. Every such transaction requires ministerial approval and it is understood that the maximum duration granted is 30 years.

This land system presents four main issues for the investment climate:

(i) The long-term provision of land for formal commercial use is under threat. Government interviews indicate significant fraud in the claims of users of rural land for rights that pre-date the 1979 Act. This hampers acquisition of land for formal use and proper land use planning.

(ii) Sub-lease title presents risks to a foreign investor wishing to develop commercial or industrial property for its own use of lease. The foreign investor is not in control of the primary relationship between the lessee and the Government. Default by the lessee will impact the sub-lessee's security of title - there is no certainty of novation to the sub-lessee under the law. Borrowing against the security of a sub-lease is also problematical. Technically a foreign-owned bank cannot take ownership of land resumed under mortgage but must arrange for a qualified back-to-back buyer. All banks currently operating in Lesotho are foreign-owned as such is defined in land law.

(iii) The Lesotho National Development Corporation provides a stopgap solution by obtaining leases and developing industrial and commercial property for rental to foreign investors. But this is not a competitive or sustainable solution (see also Chapter III).

(iv) The need for government approval for sub-leases introduces factors that may impede normal business requirements. For example the minister could decline to allow a company sufficient land on which to expand on the grounds that the applicant has acquired land for "speculative purposes". Any such system of case-by-case government approval of straightforward business transactions will introduce imponderables.

(v) The procedures for transfer of titles and registration of mortgages are cumbersome. It commonly takes over 6 months to complete these routine transactions. It is understood that deeds from three sources need to be consolidated prior to the approval of the transfer or mortgage. Further, ministerial approval is required for all land transactions involving foreign interests. This power has been delegated only in respect of mortgages under the equivalent of about $100,000.

In short the land system has not permitted a sensible land market to develop in which investors and others requiring land are able freely to purchase and encumber titles from others and put the land to improved commercial use.

Many of these issues are recognised by a Land Policy Reform Commission (LPRC) reported in September 2000. It recognised that the present system is not conducive to foreign investment and recommended limited use of freehold title for commercial and industrial purposes and an open market in such titles.

The following short-term reforms are urgently needed to materially improve this important aspect of the investment climate:

(i) Enable foreign investors to lease land. Some commentators have argued that freehold title is necessary for business purposes. This is a misunderstanding. Leasehold title of sufficient duration can provide perfectly bankable title and can be retained if more appropriate in a Lesotho setting. A uniform term of at least 60 years should be provided. There is no justification for differing lengths of tenure on the basis of the type of business.

(ii) Retain ministerial powers to allocate *new* lease titles to land whether on market or non-market terms (new leases are often allocated on social grounds). But remove the requirement for the minister or officials to approve lease title *transfers* and *encumbrances* (except where land has not been improved in accordance with a condition of issue of new title). This would promote a market in land and remove a key uncertainty in attracting private investment in developing land for business use. Thus title transfers and encumbrances would simply be registered in conventional fashion by the deeds' registry.

(iii) Deal with public interest issues in land allocation by alternative instruments. First, land use issues should be dealt with primarily by zoning and planning regulations and not by *ad hoc* conditions on individual land titles. Secondly, consider introducing a property tax based on unimproved value as a more efficient means of curbing land speculation (the Commission makes related proposals).[23]

These reforms would facilitate those foreign investors wishing to build their own premises or which have special needs for premises which third party developers would be unlikely to supply. They would also open up property development to foreign investment and improve the competitive supply of property for lease. There would be implications for the future role of the LNDC, which is the principal provider of factory shells but is financially constrained from keeping pace with demand. The LNDC could consider entering into joint ventures with private, including foreign,

[23] The proposals of the Commission to limit the number of commercial holdings of any one person would artificially limit business expansion and would create fresh problems of implementation in an already overburdened land administration system. It is asking too much of the present administration to control a regime which, for example, could easily be circumvented by the creation of multiple holding companies.

investors for new property development and divesting its more mature properties to national investors and institutions. (See also Chapter III on the role of the LNDC.)

The current land system is based on genuine sensitivities but is archaic and cumbersome and not suited to a modern business environment. The above proposals introduce adequate title for all investors and a freer market that encourages land use more in tune with commercial needs. The removal of case-by-case approval would speed up title conveyancing and mortgaging. Further efficiencies would come from better procedures and computerisation of the land system once the fundamental policy has been redesigned.

Land is always a sensitive issue. The Government is carefully considering the Commission's report and is likely to produce a White Paper on land law reform this year. But it must act soon and decisively on both the short and long term issues. The present land regime is dysfunctional and its performance is bound to deteriorate.

6. Commercial freedoms and rule of law

Business generally enjoys normal commercial freedoms without undue interference from government.

The judicial system is fair and competent in commercial matters and the Government is willing to supplement the bench with foreign judges in specialised cases. There is a backlog of cases (of all kinds). Recently the Commercial Court has been established with special procedural rules in order to expedite commercial cases.

There is a greater problem in enforcement of judgements although this is more a question of resources than of bad faith.

Generally, there is adequate regard for contract and equal treatment of foreign investors before the courts in disputes with national parties or the Government.

Corruption is not a significant factor for foreign investors. Anti-corruption legislation was passed in 1999. It is now being implemented through the creation of an autonomous anti-corruption unit.

7. Corporate and commercial laws and standards

Company law is based on the Companies Act of 1967, which provides reasonable standards for most purposes but is believed to be incomplete and needlessly complex.

Technical improvements were incorporated in a 1998 draft of a new company law and were circulated to stakeholders but a new law has not been introduced.

Lesotho has adopted international accounting standards.

8. Intellectual property protection

Lesotho respects international intellectual property laws, and is a member of the World Intellectual Property Organization as well as the African Intellectual Property Organization. Patents are rarely issued in Lesotho but trademark protection is often sought, and is granted.

In 1989 Lesotho updated its intellectual property protection law through passage of the Industrial Property Order and the Copyright Act. The legislation is comprehensive in its coverage of patents, industrial designs, trademarks and grant of copyright. The latter predates the information technology boom and there is no specific reference to computer software. The Ministry of Tourism, Sports and Culture is responsible for enforcement of copyright (reflecting the law's focus on protection of artistic works). The Deeds Registry carries out registration.

Investors believe that enforcement is given little attention and is only reactive to complaints. However, the authorities will act on complaints and this is probably sufficient protection for a foreign investor seeking to safeguard industrial know-how. There is no visible evidence of widespread music or software piracy and certainly no apparent local commercial production of pirated software and music or fake designer clothing.

9. Competition law

Lesotho has no competition law or overall competition regulator. In fact it has the opposite – under the industrial and trading licences system a business can apply for protection from competition for up to 10 years. The installation of a competition policy will be one of the most important and delicate tasks in promoting greater competitiveness in the economy. Lesotho suppliers have a tiny customer base and in businesses that depend on scale it will always be difficult to ensure that there is adequate competition among suppliers to businesses and consumers. Vigorous competition will always be the best means of ensuring competitive supply. But regulatory oversight is needed to ensure that market concentration does not lead to restrictive practices.

The Government is keen now to introduce a competition policy and associated law and regulator.

FDI can play a vital role by providing sources of new competition to incumbents. This factor should always be considered before reserving an industry solely for national investors. As discussed earlier this dimension should be explicitly reflected in a foreign investment law.

Conversely the Lesotho market for non-tradable services is tiny and one or two investors – often foreign investors - are likely to be dominant. Cases in point are the utilities, financial services, large-scale merchandising and possibly air services. Many of these sectors provide important inputs to business and are thus important in the competitive fabric of the investment climate. It is important to have the authority to regulate commercial behaviour in conditions where market dominance is unavoidable.

These issues have been grappled with in the privatisation of Telecom Lesotho and in the projected privatisation of the Lesotho Electricity Corporation. Indeed their terms of privatisation have or will contain competitive exclusions – no new fixed line or international voice operations until 2006 in the case of telecommunications and an exclusive service area in the case of electricity. This been mandated in order to achieve satisfactory sale of these companies to competent operators and to achieve other development objectives such as network expansion. In both cases a regulated user charge regime has been established as a part of the sale conditions and an independent industry regulator provided by law.

In these cases it has been clear that competitive conditions will not prevail for some time. By extension, there are likely to be other sectors of business where it is difficult to create genuine competition and there is a need for a general competition authority with the power to regulate monopolistic market behaviour.

9. Environmental protection

Modern and comprehensive environmental management legislation was introduced in 2001. All significant investment projects may be required to submit an environmental impact assessment to the Environment Authority established under the Act. Prior to this step an intending investor submits a project brief to the Authority, which may determine that a full environmental impact assessment is not required. This is a helpful procedure to expedite smaller investments. Full consideration of the environmental impact assessment is an elaborate procedure that includes public hearings.

The Environment Authority is charged with setting and enforcing environmental standards. Once well established the Authority should be able to provide investors with clear information on their environmental responsibilities and machinery to ensure that their obligations are dealt with promptly and professionally.

10. Sectoral regulation

To what extent does sectoral regulation present an enabling environment for private investment whilst efficiently safeguarding the public interest?

The status of sectoral regulation in Lesotho is the opposite of most developing countries. The regulatory framework for utilities is modern (with the exception of water and sanitation) whilst mining is outdated. Financial services regulation is also up to date but the industrial and trading licensing system is anachronistic.

Table II.1. Status of sectoral regulation

Sector	Last revised	Comment
Mining	1967	Outdated law, being revised.
Tourism	1997/2002	Licensing law not reviewed.
Manufacturing	1969	Outdated licensing law.
Trading	1993	Licensing law with FDI restrictions.
Banking	1999	Sound framework.
Telecommunications	2000	Sound framework with regulator established.
Electricity	2002	Recently modernised; no regulator established.
Water	1991	Parastatal.

Source: UNCTAD

Trade and industry*:* All sizeable manufacturers and a wide range of services' businesses require licences to operate.

Industrial (manufacturing) licensing has long ago lost its original purpose of protecting start up firms from competition. This is acknowledged by MITM although the law remains in force and industrial licences continue to be required. In fact a more modern approach would emphasise the benefits of encouraging competition among firms rather than protection from competition. This is particularly important among firms that supply non-tradable business inputs to exporters as access to competitive supplies and services are essential to their ability to sell internationally.

Trading licences are required for 44 types of business. Some enterprises can require up to 4 licences for one premises. The relevant law is cast as if the right to do business is a privilege conferred by the State. This does not represent the thinking of the present Government on private sector development. Insofar as one of its aims is to reserve certain trading activities for national investors this is better covered in a new foreign investment law. The scope of licences should be confined to regulating matters of specific public interest – environmental protection, public health and safety and consumer protection – and only where they do not duplicate regulatory procedures in the governing legislation. For example, environmental protection is now covered comprehensively in a new law.

Both types of licence are issued and renewed one year at a time. This introduces an unnecessary element of risk for investors when first investing or expanding. This approach is simply not appropriate when typical investments require several years to recover the cost of capital and earn a return.

Industrial licences should be abolished forthwith as they amount to unnecessary red tape for investors. Trading licences should refocused and confined as suggested above.

Certain consequential changes are recommended:

- The transfer of reserved activities regulation now contained in the sectoral licensing laws to a foreign investment law with appropriate policy safeguards (as recommended in section A of this chapter).

- Other channels by which work and residence permit agencies gauge whether businesses are *bona fide* (as recommended in the section dealing with the employment of non-citizens).

***Mining**:* Lesotho's mining legislation is unusual in that the authority to grant title rests in the King and Chiefs, upon the recommendations of a Mining Board, rather than with a minister. The legislation does not distinguish between large-scale and artisanal mining. As a consequence it provides inadequately for the commercial rights sought by large-scale mining investors. These include the right to grant of a mining lease subject to proper development conditions after completing exploration (which is expensive and risky) and the right to sell minerals on a free commercial basis. Negative licence recommendations of the Mining Board or of the King and Chiefs are subject to appeal only on narrow grounds.

It *is* possible for a prospecting lease to contain conditions, including fiscal terms, under which a mining lease may be granted and this could be a vehicle for clarifying an investor's rights. But the veto rights of Mining Board and of the King and Chiefs remains and there is the risk that additional unacceptable terms could be imposed. The law foreshadows for example that the State may require a share of profits at a level to be negotiated *ad hoc*, in addition to taxation.

A draft law to modernise the regulation of mining is under consideration by the Government. This has not been available for review.

Electricity**:** Recent legislation opens the sector to private investment as a precursor to privatisation of the Lesotho Electricity Corporation (LEC), which is expected in 2002. The LEC is currently a distribution/supply entity and will also take over the transmission assets of the national grid. Lesotho’s power generation needs are 85per cent supplied by the Muela hydroelectric station, which is owned by the Lesotho Highlands Development Authority (LHDA). The LHDA is a parastatal and is not slated for privatisation.

The new framework will permit private investment in generation, transmission or distribution separately under the control of an independent licensing authority. It will also permit direct supply to major users. However, upon privatisation LEC will be granted an indefinite and exclusive right to supply all customers in its current service areas. It will also be obliged to enter a take or pay power purchase agreement for all the power that Muela wishes to supply. *Prima facie* this will cramp the prospects for additional private investment in both generation and distribution. But the market is so small that there are few realistic prospects in any event.

Lesotho’s additional power needs are supplied at low cost from the Southern African Power System – in effect by Eskom the South African power company. There is overcapacity in South Africa and further private investment in Lesotho generation is not regarded as a commercial prospect in the short-term.

The independent electricity regulatory authority has yet to be established.

Banking and other financial services: Banking regulation was updated in 1999 and is a straightforward framework for prudential regulation. There appear to be no powers for the central bank to give directions as to interest rates, exchange rate margins or the spread of services offered and the branch network. This creates a low political risk environment for banking investment. However, the small market is a major handicap to attracting more FDI in the sector, which has effectively shrunk to two South African owned banks. Regulations for the nascent fund management industry were introduced in 2001.

Telecommunications: A modern regulatory regime was established in 2000 in which industry regulation was split from the commercial operations of the then state-owned telecommunications company. A Telecommunications Authority was established as an independent regulator. This foreshadowed the privatisation of Telecom Lesotho (as it is now called). The new Authority should provide the conditions for the entry of competitive operators although it is bound for some time – at least in fixed line and international services - by the exclusivity conditions of that privatisation.

12. Administrative issues

So far, Lesotho is not beset by serious "red tape" on the whole. In most administrative areas the Government is coping with the workload involved in permitting. But pressures are already showing and often systems are coping because the absolute numbers of approvals is small and of personal contacts that are helpful in resolving issues in a small community. These informal methods cannot be relied on when the volume of FDI expands and sources diversify.

Administrative areas under actual or near-term pressure are listed below. In several cases the departments concerned believe that computerisation of their management systems will resolve administrative delays. Computerisation would help but the sheer volume of transactions is rarely the issue. Business volumes are still small in Lesotho. Typically the problem is unnecessary or poorly designed regulation. Policy reforms as discussed above should be implemented first, followed by computerisation of systems as appropriate. Adiministrative issues requiring attention are:

i. land titling, transfers and encumbrances: transfers and mortgage registration can take 6 months even though the number of approvals is small. The policy regime needs reform as discussed above.

ii. border immigration controls: there are reports of serious delays at the main border crossing from South Africa These appear to be a management problem.[24]

iii. residence and work permits: separate committees meet weekly to consider applications and there appear to be increasingly elaborate background

[24] The Immigration Department was not interviewed.

checks especially for residence permits. Policy and administrative reforms are needed.

iv. Trading and manufacturing licences: in themselves these licences appear to have little public interest merit. Nevertheless they must be renewed annually and they have become networked with other compliance functions – tax clearance, immigration and work permits. Policy reforms are needed.

v. Sales tax: delays in refunds in part because of lack of clarity as to legal entitlements. These must be overcome in the new VAT regime and tackled as a priority by the new Revenue Authority.

vi. Corporate tax compliance: interviews in Government suggest that very little corporate tax is paid by the apparel industry. Without detailed research it is not possible to say whether this indicates a tax compliance problem or exceptionally tough international pressure on profit margins. It must of course be tempting for apparel investors to regard Lesotho as a cost centre rather than a profit centre and thus to arrange their affairs so that little or no taxable income is reported in Lesotho.

Certainly Lesotho's corporate taxation regime in <u>manufacturing</u> is moderate and there is no justification for tax evasion. The proposed new Revenue Authority should ensure that the tax authorities have the assistance needed to be satisfied that there is adequate compliance. This must be done professionally and carefully. The apparel industry in particular is a large and visible source of FDI.

In other sectors the taxation regime is considerably less attractive and may motivate some non-compliance. Reform of tax policy in these sectors is a necessary step towards improving the climate for tax compliance.

13. Assessment

Regulatory conditions for business in Lesotho are reasonable on the whole but variable – modern and flexible in some areas and outdated and retrogressive in others. This means that attention to improving the investment climate has been *ad hoc* rather than systematic. For example, an advanced telecommunications regulatory system lies alongside a manufacturing licensing system from a bygone era.

Table II.2 summarises the findings and indicates priorities for improvement. Regulatory areas denoted by a single "*" present dangers to the investment climate and need immediate attention. Regulatory areas denoted by "**" have policy gaps or flaws and/or emerging administrative bottlenecks.

Table II.2. Summary of assessment of operating conditions

	Policy	Administration	Comment
Taxation	**	**	Uncompetitive for non-manufacturing, emerging administrative problems.
Foreign exchange	**	***	Inflexible controls.
Labour	***	***	Updated law and focussed administration.
Employment of non-citizens	**	**	Unwritten policy, disjointed administration.
Land	*	*	Inadequate title system, serious delays.
Commercial freedoms and rule of law	**	***	Controls remain but practice reliable.
Commercial law & accounting	**	**	Functional.
Intellectual property protection	***	°	Regime in place, reactive enforcement.
Competition law	°	°	No general law or agency.
Environmental protection	***	°	Modern law with flexibility. Agency not fully established.
Sectoral regulation			See Table II.1.

Source: UNCTAD Assessment

Code:
* serious deficiencies likely to inhibit investment
** functional but improvable policy regime/ under foreseeable administrative pressure
*** high standard policy regime or administration
° does not exist or was unavailable/not visited.

C. Investment framework – summary of findings and recommendations

Lesotho is open to FDI. Foreign investors are treated fairly albeit in circumstances in which Lesotho has had little choice. Regulatory conditions for business are workable in a small community but are a patchwork of good and bad practice. Pressures are emerging which could turn unnecessary red tape from a nuisance to burden for investors.

A **seven point agenda** of improvements to the investment framework is recommended. These are entirely practicable steps to fill gaps in, and anticipate pressures on, Lesotho's investment framework. They are presented in broad order of urgency as seen by this review. Note that they are summaries of findings and recommendations and the relevant sections of this review should be consulted for the details.

1. Permit foreign investors to hold leasehold land title and to freely transfer and encumber these titles. Allied to this change, encourage FDI in property development. A shortage of developed industrial sites constrains investment in export manufacturing.

2. Reform taxation of investment to improve sustainability of the manufacturing base and to help diversify FDI into new sectors, including tourism, property development and mining. These reforms should remove the bias in corporate taxation and VAT against non-manufacturing.

3. Redesign the work and residence permits schemes to present a more predictable, reliable and timely system for genuine applicants whilst preserving controls against unwanted economic migration. Publish statements of policy and procedure so that investors know what to expect.

4. Introduce a modern foreign investment law that offers high standards of treatment and protection to foreign investors. (Such a law should enable future restrictions on FDI entry to be removed from sectoral licensing law and considered in the light of broader national interests. The FDI entry restrictions should then be implemented flexibly and with due care for the interests of established investors.) Consider special provisions to welcome capital and skills from neighbouring countries.

5. In individual sectors: abolish industrial licences and reform trading licences to ensure that they do not duplicate other regulations; carry through reform of the legal regime for mining.

6. Introduce a competition policy and authority.

7. Introduce foreign currency accounts for exporters.

It is also highly appropriate for the Government to acknowledge and reinforce the many pockets of good practice within the administration – including the current openness to FDI in key job creating sectors, the good management of industrial relations, the steady progress in privatisation, the low levels of corruption and the excellent job which the LNDC has done in facilitating FDI in manufacturing.

III. STRATEGIC PERSPECTIVES

A. Introduction

Lesotho is at a critical juncture in its development. With declining incomes from agriculture and workers' remittances, the economy is increasingly dependent for growth, employment and export revenues on a manufacturing sector that is almost entirely foreign owned and directed at export markets. Earnings from the Lesotho Highland Water Project provide a welcome addition to revenues but cannot be expected to drive future growth. FDI will have to provide much of the impetus, in part in manufacturing but also, increasingly, in service activities like tourism and perhaps in resource-based activities.

Lesotho has been fortunate in having built a base of export-oriented manufacturing FDI in the recent past. It must now use this base to launch a clear strategy to retain foreign investors beyond phasing out of trade privileges and attract larger amounts of FDI, diversify it away from its overwhelming reliance on one activity and deepen its roots in the economy. To do so, it must develop a competitive base for manufacturing FDI, exploit more fully its structural complementarities with the South Africa economy and exploit investment potential in services and resource-based activities.

B. Investment potential

Lesotho does not have the endowments to attract significant amounts of market-seeking FDI, because its internal market is small (Table III.1). But it has several advantages. As a member of Southern Africa Customs Union (SACU), Lesotho has free access to the RSA market and can attract labour-intensive operations from its more industrialized neighbour or from other countries aimed at exporting to RSA. It has also privileged access to more distant markets of the United States (although this access is time-bound) and the European Union. Its base of industrial operations, set up by foreign investors in response to sanctions on the apartheid regime in South Africa had lasted after sanctions ended, proving that Lesotho can also compete in more distant markets on the basis of low wages, trainable and reasonably educated labour and privileged market access. Its geographical handicaps can be offset by its access to the (well-developed) transport system of RSA. And its resource base has not been fully explored or exploited.

1. Growth and stability

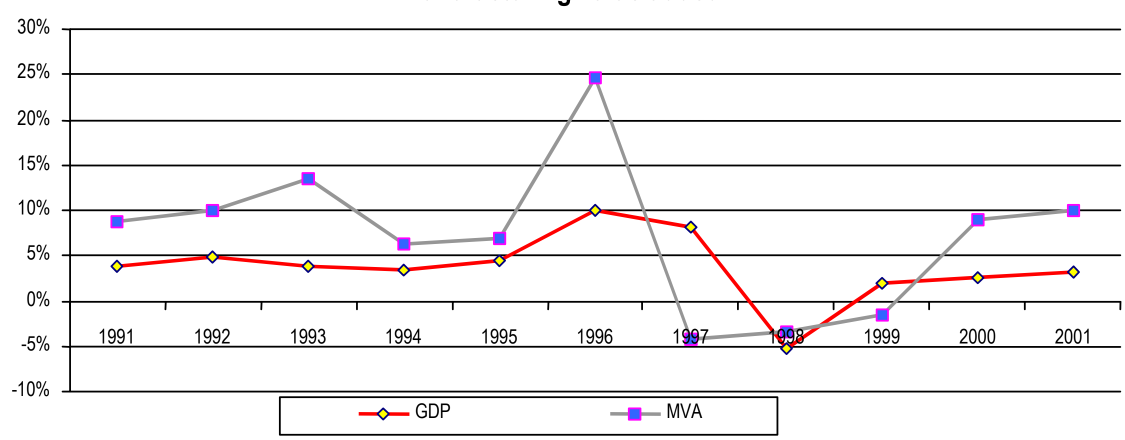
In recent years Lesotho's growth performance has been quite good. Table III.1 and figure III.1 show Lesotho's performance relative to comparators in Sub-Saharan Africa. Average long-term growth record, during 1990-99, was impressive, only second to Mozambique and much better than in other countries of the region. However there was a sharp dip in GDP and manufacturing in 1997-98 due to political disturbances. There was a revival in 1999 followed by manufacturing-led growth. In 2001, manufacturing expanded by a robust 10 per cent due to export expansion by foreign affiliates. This trend is likely to continue in the near future due to further expansion of the textile and clothing industry.

Table III.1. Market size and growth rates of Lesotho and comparators (1990-99)

	GDP					
	Total (current US$ million and per cent)			Per capita ($ and per cent)		
	1990	1999	Growth rates	1990	1999	Growth rates
Lesotho	622	874	3.9%	365.9	416.2	1.4%
Malawi	1,803	1,810	0.0%	193.9	164.5	-1.8%
Mozambique	2,512	3,979	5.2%	179.4	234.1	3.0%
South Africa	111,997	131,127	1.8%	3,294.0	3,122.1	-0.6%
Zambia	3,288	3,150	-0.5%	456.7	315.0	-4.0%
Zimbabwe	8,784	5,608	-4.9%	896.3	467.3	-7.0%
Subtotal above	129,006	146,548	1.4%	1,736.3	1,592.9	-1.0%
Subtotal exc. S. Africa	17,009	15,421	-1.1%	422.1	308.4	-3.4%
	Manufacturing value added					
	Current US$ million and per cent			**Per capita ($ and per cent)**		
	1990	1999	Growth rates	1990	1999	Growth rates
Lesotho	65.7	117.6	6.7%	38.65	56.00	4.2%
Malawi	313	253	-2.3%	33.66	23.04	-4.1%
Mozambique	235	517	9.2%	16.79	30.43	6.8%
South Africa	24,040	24,914	0.4%	707.06	593.19	-1.9%
Zambia	408	378	-0.8%	56.67	37.80	-4.4%
Zimbabwe	1,799	953	-6.8%	183.57	79.45	-8.9 %
Subtotal above	26,861	27,134	0.1%	361.52	294.93	-2.2%
Subtotal exc. S. Africa	2,821	2,220	-2.6%	69.99	44.39	-4.9%

Source: World Bank, *WDI 2001*

Figure III.1. Annual changes in Lesotho's GDP and manufacturing value added



In terms of the potential for FDI attraction, Lesotho's growth experience holds promise. While the economy is too small to attract significant market-seeking FDI in manufacturing, its sustained expansion opens up potential for FDI in services (below). Moreover, it sends a positive signal to the investment community in terms of stability and economic management.

Lesotho's image in the international investment community has suffered from political and social instability in the past. Elections in 1993 and 1998 were followed by disturbances, the latter with loss of life, damage to property and temporary closure of operations. The peaceful elections of May 2002 were regarded as an important test of stability.

2. Potential by sectors

(a) Resource-based activities

While Lesotho's resource base is small in comparison with that of neighbours that offer gold, diamonds and other minerals, it does have unexploited investment potential, including some FDI potential, in minerals and agro-based products.

Minerals. Lesotho has exploitable potential in sandstone, diamonds and basalt, where there has been some activity and investor interest in the past. Sandstone is plentiful and easily accessible near the border with South Africa; it holds export promise. The Government is encouraging local enterprises to quarry sandstone but there is a need for larger-scale, capital-intensive operations that can be handled by foreign firms. The prospects for developing the industry, tapping export markets and attracting appropriate foreign investors need to be explored in greater detail. Diamond and basalt mining has been stopped recently and, again, its prospects need to be explored.

Wool and mohair. Lesotho is well known for its wool and mohair. However, poor extension services and breeding practices appear to have led to a deterioration in the quality of the wool and in productivity levels (World Bank, 2002). Virtually all wool and mohair are exported in raw form due to inadequate local processing facilities. The genetic stock and management techniques used by many producers are poor. It is necessary to restock herds with quality stock and to raise the awareness of herders of good breeding practice. Tapping export markets may also require better downstream processes, designs and marketing. It should be possible to attract FDI into some of these downstream activities. The attraction of FDI into tourism should also stimulate demand for products based on wool and mohair.

Agriculture. The main domestic economic activity in Lesotho, could provide an avenue to promote local investments for exports and perhaps some FDI. While production is likely to remain mainly in local hands (there are few prospects for large-scale plantation crops in Lesotho), foreign investors may be interested in downstream processing and marketing agricultural products. The possibility of using high value crops like *mushrooms* and *asparagus* for export is under active examination by the Government. The EU supported asparagus production for some time but withdrew in face of drought and falling yields; there was also an asparagus canning plant in the public sector but it closed down. There may be a case for reviving the activity. Mushrooms, a new crop for Lesotho, also have good export prospects (Auetragul, 2002). As noted, however, agricultural production in general has suffered from drought and from inadequate irrigation and extension, and a concerted effort is needed to improve the productive base and infrastructure.

(b) Services

FDI potential in services is in tourism, planned privatisation of water and electricity utilities as well as expansionary investment of existing foreign investors, in particular in banking, hotel and telecommunication services, undertaken in response to the growing needs of the expanding economy.

Tourism is already high on the government agenda, and a new Tourism Board is being set up to invest in infrastructure, set up facilities and seek foreign investors. It will cooperate with South Africa and develop a 'tourism route' through Lesotho's highlands and exploit tourism potential related to artificial lakes created by the construction of Katse Dam and Mohale Dam, both part of the Lesotho Highland Water Project . There are prospects for developing tourism on a regional basis, that is, in cooperation with SADC members. However, at this time Lesotho's tourism earnings are low, around $16 million (under the heading "travel services", net of "personal expenditures by expatriates") in 2001, around 5 per cent of the value of exports of goods and services. In dollar terms these earnings have not changed since 1990. Tourist arrivals after reaching a peak of 416,882 visitors in 1992 fell to 307,341 in 1999. 96 per cent of visitors were from South Africa.[25]

The highlands are an enormously valuable natural resource, but considerable physical infrastructure is needed to bring out its potential. Foreign investors are showing some interest: an Austrian firm is exploring the setting up of a ski resort (Box 7.3).

There is a modest amount of FDI in hotels serving tourists and business visitors in Maseru, dominated by the Sun Hotel chain from South Africa. There is potential for further hotel expansion as the economy continues to grow and the promotion of tourism bears fruit.

(c) Challenges in manufacturing

Lesotho has a tiny manufacturing base geared to domestic markets, but it has attracted a relatively large amount of FDI into export-oriented activities. The domestic-oriented industrial sector has a few foreign investors, dominated by an RSA-owned brewing plant (an affiliate of the giant South African Breweries, the world's second largest brewer). There is also is a milling mill, privatized to a US firm in 1998. Given the small size of the local market and its openness to imports from SACU, future prospects for substantial market-seeking manufacturing FDI are not very bright. They should not, however, be discounted. Smaller foreign investors may be able to set up operations if incomes grow and if agriculture or mining related activities take off and create the demand for parts and components.

Export-oriented manufacturing linked to privileged access to international markets has been the dynamo of FDI in Lesotho and remains the best hope for further FDI expansion. It faces, however, two key challenges. One is related to the fact that the competitive base for apparel exports, the dominant activity for FDI, and Lesotho's greatest success in attracting FDI, is heavily dependent on *temporary trade privileges* in the US market, granted to Lesotho and other countries under AGOA scheme. Once trade privileges are limited (after AGOA 1 ends in 2004) and then phased out (when AGOA 2 ends in 2008), this may result in the loss of existing investors. The other challenge is that Lesotho has not yet been able to capitalize satisfactorily on *long-term trade privileges* in the European Union (under Cotonou Agreement and Everything But Arms initiative). Even more notably *permanent* free access to large South

[25] Data on earnings are from The Central Bank of Lesotho. Data on visitors from World Tourism Organization and UNDP, "The Kingdom of Lesotho. Background to the National Tourism Policy. Final Report", Vol. II, Madrid 2000, pp. 13-14.

Africa's market (under SACU) has hardly been exploited. These two challenges – AGOA challenge and South African challenge -- are considered in turn.

(i) AGOA-related challenges

Most FDI in Lesotho has been in *apparel aimed at industrial countries*, and recently mostly at the US market. Chapter I described FDI in this industry, driven by trade privileges given by the EU and later the USA under AGOA (box III.1).

Box III.1. Trade privileges and apparel FDI in Lesotho

The development of the clothing industry in Lesotho (as in many other developing countries) was driven by trade rules rather than by a natural evolution of competitive advantages. The first wave of foreign investors in Lesotho came from South Africa in the 1980s to escape sanctions and to take advantage of quotas (under the Multi-Fibre Arrangement, MFA) and preferential tariffs. Under the Lomé Convention, Lesotho and other members of the ACP group had duty-free access to the European Union market, initially with no local content requirement. Most inputs came from East Asia, the cheapest and most efficient source.

In the late 1980s, the EU started to apply 'cumulation' to all ACP countries, meaning that at least two stages of production had to be performed locally (i.e. the fabric had to be made locally). Lesotho was able to get this postponed ('derogated') till 1996, thus attracting some new clothing FDI in the late 1980s and early 1990s, still aimed at the EU market. By 1990 most of the foreign exporters present today had already set up factories in Lesotho. As EU derogation ended, a number of Taiwanese clothing factories downsized or closed down, but others shifted to exporting to the US. They had to pay the 17.5 percent duty that applied to all other exporters from the developing world. There was no restriction on their sourcing of raw materials, which continued to come from East Asia.

The main benefit under the trading system at this stage was unused MFA quotas. This was also the advantage of other exporters from Southeast Asia, South Asia, North Africa and Central America. However, Mexico and Caribbean producers had additional privileges in the US market under NAFTA and the Caribbean Basin Initiative. Most producers in Asia and elsewhere were part of global sourcing systems coordinated by 'full service' providers based in East Asia, which allocated production across the globe according to quotas and costs (the exceptions were affiliates of US firms in its neighbourhood). They generally assigned (this is still the case) low-value items to Lesotho, where skill needs were minimal and long lead times between order and delivery were not as critical to retaining competitiveness. Specialisation in the 'commodity' end of apparel production provided a good starting point for Lesotho. However, upgrading will become necessary as wages rise and other low wage competitors enter the market.

The MFA quota system will end by 2005 and quotas will no longer provide Lesotho (and many other countries) with protection against more competitive Asian producers. In the meantime, however, the launching of AGOA in 2000 has given a fresh trade policy stimulus to Lesotho garment exports to the US. As a least-developed country, Lesotho can sell duty and quota free and, in the first phase (AGOA 1, 2000-2004), procure inputs freely from the cheapest sources in the world. In the second phase (AGOA 2, 2004-2008), it can sell duty and quota free (but the quota privilege will cease to 'bite' as the MFA ends) but it would have to procure inputs within Sub-Saharan Africa from other AGOA countries (including South Africa) or from the US (World Bank, 2002). Its competitive position after 2005 would then depend on the balance between the higher cost of inputs and the duty privilege of 17 per cent over other non-African competitors. AGOA 1 is the most beneficial phase of the scheme and Lesotho is trying to get it extended.

AGOA 1 has greatly stimulated clothing production in Lesotho, which has emerged as the largest exporter to the US under this scheme (Hyvarinen, 2002). AGOA 2 will lead to some backward integration into fabric weaving and knitting. However, by 2008 Lesotho will face full competition against all comers in global markets, but firms will once more be able to source inputs freely. Its competitive position will then depend on the relative efficiency of the processes performed within the country: labour costs, skills and productivity, logistics and organizational efficiency. Its wages are lower than much of Asia (below), but its location is a handicap. Skills and technological capabilities are on balance lower than countries with long industrial traditions, higher investments in education and training and more direct access to raw materials. Major producers like China and India also have considerable backward integration into textiles and are building design capabilities, giving them much greater flexibility and economies of scale and scope.

Source: UNCTAD

Challenge number one is to retain the existing investors after AGOA will move from phase 1 to phase 2 in 2004 and the rules of origin of products eligible for AGOA privileges will change: exporters will be required to source fabrics from the US or other AGOA countries (including South Africa). This change in the rules of origin is intended to help Lesotho and/or other AGOA-eligible countries to upgrade FDI by encouraging investors to expand from simple CMT (cut, make and trim) operations to fabric production, a much more capital and skill-intensive process. But the fear is that foreign firms would pull out in substantial numbers by 2004 instead of undertaking capital-intensive investment. This is what happened when, in 1996, the European Union changed for Lesotho the rules of origin applying to other ACP countries since the late 1980s: Lesotho's total exports to the EU fell from an annual average of almost $20 million during 1992-1996 to below $1 million during 1997-2001, thus practically ceasing to exist.[26] Towards the end of 2002 indications are that the AGOA plan is working, at least partly, for both, the region and Lesotho, although it is too early to make the final judgement. Within the region, the main potential supplier is RSA, and capacity there is being expanded. In fact, some Taiwanese investors in Lesotho are setting up or acquiring textile plants in RSA. Most promising is the fact that foreign affiliates in Lesotho are showing serious interest in setting up weaving and knitting plants locally. One firm is already building a denim factory for around $100 million and others are planning to set up knitting facilities. As however revealed during interviews conducted by the UNCTAD team, these firms encounter several obstacles to their investment related to land availability, factory shells, transportation, water and electricity supplies as well as various bureaucratic hurdles. The Government should assist these investors overcome obstacles. The speed and effectiveness of this assistance may decide which of these firms will put deeper roots in Lesotho and which of them will become candidates for re-location.

The second challenge is whether the (emerging) more integrated textile and apparel industry in Lesotho can survive open world competition after 2008. Productivity in Lesotho's apparel manufacturing still lags well behind that in Asia (see below) and the production structure remains confined to the simplest commodity end of the product range. Unless productivity rises and the product range diversifies, it will be difficult to sustain garment exports from Lesotho, and so to retain a substantial part of its FDI in the long term. AGOA offers a window of opportunity to reduce the competitive weaknesses, but the period is not very long when the requirements of capability building are taken into account. Some firms are know to be gearing up to the challenge in expanding investments into fabric weaving and putting in place training programmes to raise productivity and improve firms' competitiveness (Box.III.2).

[26] Central Bank of Lesotho, "Annual Report for 2001", Maseru, March 2002, p. 52.

Box III.2. A strategy for long-term commitment: the case of Lesotho Fancy Garments

Lesotho Fancy Garments Group, a wholly-owned foreign company from Taiwan, Province of China, is an example of a foreign affiliate with long-term commitment to Lesotho. The Group has 5 subsidiaries in Lesotho, which were set up between 1995 and 2001. Its capital is $6 million and a workforce around 3,300 persons. Its annual sales, all exports, of about $ 30 million make it one of the biggest garment exporters in Lesotho. Almost all its exports are to the United States where its customers include Gap, Sears Walmart and K.Mart. But orders come from agents based in Taiwan, Province of China and Singapore.

The company's strategy for a long-term commitment consists of two components. First, in anticipation of the new rules of origin on fabrics when the first phase of AGOA ends, Fancy Garments plans to expand its present CMT operations to integrated operations. Plans are afoot to invest in textile weaving in Lesotho.

The second component includes an elaborate training and incentives system aimed at increasing productivity and quality, and permitting to move to higher value-added operations. The training system, started in August 2002, spans over 18 months, up to February 2004. During this period the target is to raise the share of workers at the higher skill and productivity levels (Level III) and decrease the share of workers at the lowest skill and productivity levels (Level I) in the total workforce. Specifically, the targets and timing are as follows:

	August 2002	May 2003	February 2004
Level I worker	35 per cent	30 per cent	20 per cent
Level II worker	55 per cent	50 per cent	50 per cent
Level III worker	10 per cent	20 per cent	30 per cent

By February 2004, only 20 per cent of the Groups' work force should be at Level I productivity (this will include the new intakes) and 30 per cent of the workforce at Level III productivity. The move into the higher category involves increase in wages.

The improvement programme includes 6 sub-programmes addressing various workers' needs and productivity problems. A Basic Training System aims at new workers and the Retraining System addresses the needs of workers with poor performance. An Upgrade Training System – a sub-programme aimed at localizing managerial positions -- is open to workers who want to upgrade themselves to higher levels, like supervisors, trainers and line managers. Within a Pre-Production Training System workers are trained on the introduction of new styles and products. And finally, there is a Non-Production Training System, including courses on issues relating, among others, to safety, health, HIV or labour codes, aiming at increasing the awareness of these issues by employees.

The scheme is voluntary. It aims at helping motivated workers who wish to improve themselves, move up on a wage scale and contribute to a better performance of the company. Workers, who show good potential and have achieved consistent high performance after going through the training would be promoted to the higher levels. This would be based on objective evaluation of performance, which is monitored and recorded. Their productivity will be benchmarked against that in the Asian countries. Important is that there is no cap on promotions, as workers with potential can move to managerial positions. Through the Upgrade Training system the Company hopes to achieve a target of localizing at least 70 per cent of the line managers at the end of 18 months training. Presently, all the Company's supervisors are locals but most of the line managers are Chinese. It remains to be seen how effective the upgrading programme will be.

Source: UNCTAD.

And finally the third challenge is to exploit other than garment-export related opportunities. AGOA applies to all manufacturing activities, and it is surprising that investors in other labour intensive export-oriented industries have not set up in Lesotho to take advantage of it. In East Asia, the growth of apparel exports went hand in hand with expansion of exports of products like sports goods, footwear, toys, travel goods and assembly of light consumer electronics. The skill, scale and technological needs here is similar to that of apparel; the only important difference is that trade in these products is not governed by a quota system (like the Multi-Fibre Arrangement for apparel). It is important to investigate why foreign investors in these other industries have not been attracted to Lesotho and to address the factors constraining them.

(ii) South African challenge

The second category of export-oriented FDI in Lesotho consists of *investments from South Africa.* These are mainly labour intensive operations aimed at RSA markets, though a few RSA firms also aim at global markets. Smaller apparel and footwear firms, in particular, are relocating to Lesotho to cope with Asian competition in the home market. One TV and radio assembler has been present for many years, initially drawn by tax incentives (these incentives have now been abolished in favour of a low uniform tax rate for manufacturing).

But in general, in spite of Lesotho's free access to South Africa's market and other attractions such as the absence of foreign exchange risk and low transportation costs because of RSA's proximity and good road connections, integration with South Africa through export-oriented FDI by RSA represents an unexploited potential for Lesotho. Moreover, there are no third country investors in Lesotho who would target RSA's market. As a result, Lesotho's exports to the United States exceeded exports to South Africa in 2000. In addition, although South Africa accounts for around 90 per cent of Lesotho's total imports, it only receives some 50 per cent of Lesotho's exports of goods.[27]

The attraction of Lesotho for RSA firms and firms from third countries selling to RSA is mainly low wages. There are pockets of cheaper labour within RSA (in the homelands) but Lesotho's physical infrastructure is better developed and basic skills are more readily available. Its labour supply is also better located than in the homelands - it is concentrated in areas bordering South Africa - allowing investors to live in RSA and commute daily to plants in Lesotho. Lesotho is also better regarded as a manufacturing location than Swaziland, Botswana or Namibia for similar reasons. A growing attraction of Lesotho is better labour market conditions than in RSA: workers are less unionised and unions are less aggressive. In addition, some investors claim that the lower crime rate is an inducement.

South African FDI has great potential in view of the structural complementarities between the two economies – one highly industrialised and with relatively high wages and the other without an industrial base but with low wages – with similar legal systems, strong historic ties and a customs union. There are other

[27] The World Bank, "Lesotho. Diagnostic trade integration study", vol. 1, draft of 9 September 2002, p. 61.

recent cases where such structural complementarities have been successfully exploited. Perhaps the most noteworthy is Mexico within the North American Free Trade Area (NAFTA), but there are also others in Asia (like the Singapore, Indonesia and Malaysia 'growth triangle') and in East Europe (in particular, Poland, Hungary and the Czech Republic in relation to the EU).

Labour-intensive activities, processes and functions that can be potentially relocated from RSA to Lesotho (or located in Lesotho by third country investors for exports to RSA) include the following (though some call for more and better technical skills than are currently available in Lesotho):

- Assembly and packaging in a variety of engineering industries: the most likely candidates are consumer electronics;
- Final operations in labour intensive industries like leather goods, toys, plastic products, travel and sports goods;
- Simple machining activities and simple metal products and shapes;
- IT activities at the entry level like call centres and data entry.

The main constraints to relocation in Lesotho are shortages of skills (at all levels, but particularly supervisory and technical), border transaction costs and the threat of VAT advance deposits. Infrastructure costs, particularly telecommunications, also tend to be higher than in RSA (below). Once the 'hassle factor' is taken care of, FDI inflows, South African and other, will depend entirely on the cost and quality of the productive factors in Lesotho. These are considered in the discussion of policy.

3. Conclusions

Lesotho's prospects for retaining FDI in the country and for attracting new FDI lie in exploiting better its inherited endowments and in creating new competitive capabilities. FDI till now has been based mainly on location and trade privileges: cheap labour has helped, but this is not what distinguishes Lesotho from other, less successful, developing countries. Such inflows have some way to go: AGOA is likely to attract more FDI in the textile sector and the relocation of labour-intensive activities by RSA firms is likely to continue (if they continue to be competitive in the global arena).

It would, however, be unwise to rely passively on these factors. Trade privileges have a limited life and it is imperative to improve the productivity of apparel manufacture before the privileges end. However, they may still have unexploited potential: they have not attracted other labour-intensive export activities apart from clothing and it may be possible to target and induce them to invest in the time left. As with apparel, the AGOA 'window' should also be used to enhance the competitiveness of new activities so that they survive after the privileges end.

Realising the potential of South African relocation will depend in the first instance on reducing transaction and hassle costs in trade with Lesotho (below). In the longer term, however, it will depend on Lesotho's ability to provide a skilled work force and strong infrastructure. As RSA opens up its industrial sector to international competition, the viability of its FDI in Lesotho will depend on the availability of its ability to furnish the kinds of factors that industry requires to compete globally.

At the same time, Lesotho's inherited endowments have not yet been fully exploited. Its natural resource base in mining and agriculture seems to have greater investment potential than has been realised by foreign (or local) enterprises. The service sector can also draw more FDI, into tourism and other local market oriented services and perhaps into export-oriented IT activities. Privatisation can attract some more FDI, though the amounts will not be very large.

FDI promotion and retention calls for carefully crafted policies. The next section discusses these policies.

C. Policy challenges for Lesotho

1. Trade regime

Two aspects of the international and local trade regime are particularly relevant to FDI:

- ***External*** *(status accorded to Lesotho by the OECD importers)*. As a least developed country in Sub-Saharan Africa, Lesotho has privileged access to major markets. In the past, the main privilege was that given by the Lomé Convention – now replaced by the Cotonou agreement,[28] which allowed it free access to European markets. This provided a spur to apparel exports until 'derogation' ended and it became necessary to provide local fabric inputs. (More recently, AGOA allows it duty and quota free access to the US market, and is, as discussed above, the most important driver of FDI.) While this regime is not under the control of Lesotho, it can participate in international negotiations and lobby bilateral trading partners to influence the outcome. Measures to be taken by the home countries of foreign investors are discussed below.

- ***Internal*** *(Lesotho's import and export regime)*. Lesotho's trade regime is given by its membership of SACU (the South African Customs Union), with free trade between the members and a common external tariff and duties. In practice, tariffs and anti-dumping, countervailing and safeguard duties have till now been set by RSA, the dominant partner. This is, however, changing as a separate Tariff Setting Board comes into effect in 2002. It remains to be seen how much leeway it provides to countries like Lesotho to influence SACU trade policies, by reducing its proclivity to protect its own industries.

On the ***external*** front, the regions with which Lesotho has significant trade agreements affecting FDI are the USA and EU. At present, the most significant one is AGOA. It may be worthwhile for Lesotho to try and negotiate its extension, in terms both of delaying the second phase (so that it can continue to source inputs from the

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

cheapest sources after 2004) and of extending its duty free access to the US market after 2008.

AGOA is, at least in intent, more than a trade agreement. It also calls for expanded US FDI in Sub-Saharan Africa and directs the US President to negotiate "reciprocal and mutually beneficial agreements, including the possibility of establishing free trade areas" with those countries (World Bank, 2002). While there has not been much progress so far on FDI promotion or establishing free trade areas, there are two hopeful preliminary steps. First, in October 2001, the United States Government established a $200 million facility to be run by the Overseas Private Investment Corporation(OPIC)[29] to facilitate US FDI in Sub-Saharan Africa. Second, in February 2002, the US Trade Representative held discussions with SA on establishing a Free Trade Agreement.

Both may have implications for FDI in Lesotho. OPIC can encourage US investors to view the region more favourably and explore new investment opportunities. A US-SA free trade agreement should stimulate export activity in South Africa and lead producers there to search for more efficient locations (below). Lesotho is one of the best placed countries to benefit, given its long experience of export-oriented activity. However, it needs to analyse in greater depth the implications of such an agreement so that it can draw the greatest benefit from it (World Bank, 2002).

The EU also offers market access to countries under the Cotonou agreement, though without the free access to inputs currently given in AGOA. With growing concern over African development and the evidence of beneficial results from AGOA it may be possible to negotiate more generous terms from the EU.

On the ***internal*** trade policy front, membership of SACU has both benefits and costs for Lesotho. The main benefit is free access to the regional – particularly the RSA – market. Since there are significant structural differences between Lesotho and RSA, this offers, as discussed earlier, potential for FDI to locate activities in Lesotho to exploit these differences.

However, this potential is being diluted by border formalities in Lesotho, which Lesotho retains for two reasons. First, its tax rates differ from those of RSA. Second, its LDC status obliges Lesotho to trace the origin of inputs to enjoy preferential access to external markets. The border controls imposed by Lesotho raise transaction costs to traders and investors, and in interviews several investors, particularly from RSA, remarked on the 'hassle factor'. The difference between South Africa's VAT (value added tax) and Lesotho sales tax rates creates its own 'economic border'. When goods leave South Africa for Lesotho, the shipper applies for a VAT refund from South African authorities and pays sales tax to Lesotho. The need to file paperwork in two countries and the time taken to obtain a refund from RSA increases the costs of trade.

[29] OPIC is a U.S. government agency that provides political risk insurance, project financing and other investment services to U.S. firms investing in developing countries. OPIC's current exposure in Sub-Saharan Africa was $1.1 billion in 2001, comprising $815 in project financing and $278 million in risk insurance (World Bank, 2002).

In addition, there are differences between Lesotho and RSA on WTO rules concerning customs clearance and valuation, technical standards regulations, sanitary and phytosanitary measures and intellectual property rights (World Bank, 2002). These differences raise transaction costs and also the cost of implementation and compliance in Lesotho.

There is an additional cost to Lesotho-RSA trade looming on the horizon: Lesotho plans to introduce VAT, under which producers, even those aiming at export markets, will have to deposit VAT on the value of imported inputs with government and reclaim it later. This will not only tie up a large amount of working capital, it will, if repayments are delayed (and investors claim this is likely), impose large additional financing costs. In export-oriented activities that operate on very fine cost margins, this may make location in Lesotho uneconomical. The benefits of SACU can be realised only if transactions between members are truly low cost and hassle free.

The costs of SACU to Lesotho have to do with the common external tariff and duties. While SACU tariff rates and their dispersion have fallen over time (World Bank, 2002), they remain high on some products (like textiles and apparel). In addition, RSA uses anti-dumping safeguards extensively. High levels of protection for RSA industries may adversely affect Lesotho's competitiveness. At present, the SACU tariffs do not affect apparel exporters based in Lesotho: they can import inputs at world prices, with no SACU tariffs payable as long as the imports are used for export-oriented operations. However, in the second stage of AGOA fabrics will have to be obtained locally, within the region or from the USA, and a major source of supply is likely to be RSA. High protection on textiles may hold back the competitiveness of RSA producers and so affect adversely the exporters based in Lesotho that have to source from them. There is also a welfare loss inherent in the protection offered to RSA industry: domestic consumers have to pay higher prices than they would otherwise.

Policy recommendations are:

- Lesotho should negotiate with the US to extend AGOA privileges.
- It should analyse carefully the implications of the US-RSA free trade agreement and mount strategies that maximise its benefits from such an agreement.
- It should use AGOA privileges to attract non-apparel FDI in export-oriented activities (specific recommendations on FDI promotion are given below).
- It should negotiate for more generous trade privileges with the EU which could bring visible effects in terms of helping attract FDI.
- The governments of Lesotho and South Africa need to explore better tracking systems for exporters aimed at lowering trade and compliance costs.
- Lesotho should consider harmonizing its tax rates with RSA and working out a system for transferring revenues between the two countries to minimize trade costs and delays.

- The new VAT system should be introduced in a way that does not penalise exporters (in line with the previous point).

2. Human capital

Wages in Lesotho are about the same as in Tanzania or Vietnam and somewhat lower than Bangladesh, India or China.

Table III.2. Basic minimum monthly wages in Lesotho, 2001 (US$)

Sewing machine operator or weaver (six months training)	53.5
Sewing machine operator or weaver (trained)	56.0
Weaver (six months training)	53.5
Machine operator	73.2
Telephone operator	63.1
Unskilled labourer	53.5 to 58.9
Domestic servant	18.1
Watchman	74.4
Driver	73.2 to 102.6
Source: Government of Lesotho, *Legal Notice no. 169 of 2001*	

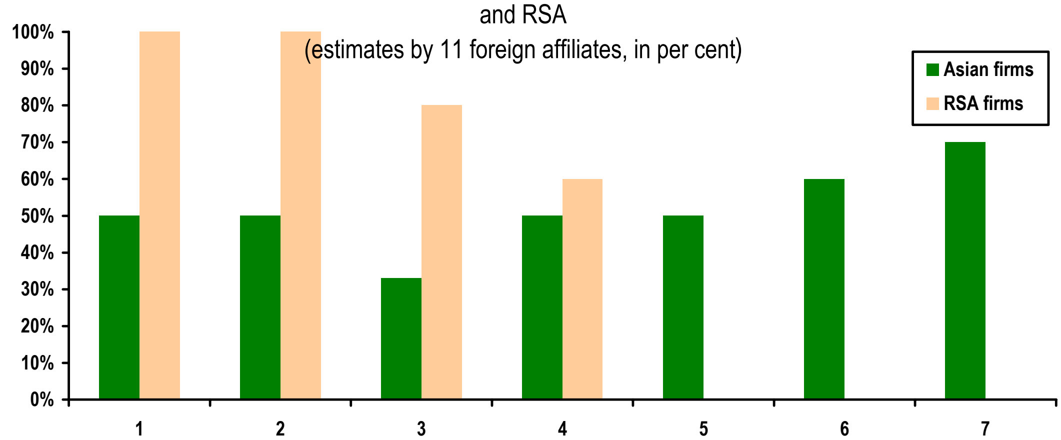
Average wages, including benefits, are somewhat higher than minimum wages Table III.2. The apparel firms interviewed pay shop-floor workers around $60-75 per month, but skilled and experienced workers can get around $250 per month. Wages for fresh engineering graduates start at around $500 per month

While Lesotho is competitive in terms of wages, there are two issues. First, low cost labour *per se* is declining in importance as a source of competitive advantage. Even in the simplest activities, export-oriented TNCs increasingly demand a minimum level of productivity and the availability of a spread of technical, supervisory and management skills. Second, despite low wages Lesotho does not have an ample supply of workers with technical and managerial skills in industry. Practically all the enterprises interviewed noted the severe shortage of such skills and the desirability of raising their supply.

Industry in Lesotho has overcome skill shortages by relying on expatriates and, in apparel, by specializing in the low end, undertaking basic cut, make and trim operations for ‘commodity’ products. Trade privileges have also sheltered firms with skill inadequacies. However, as wages rise, more complex operations are undertaken and trade privileges end, it will be imperative to raise skill levels. It will also be necessary to continue using expatriate technical and managerial staff (even an economy as advanced as Singapore has to rely heavily on specialised expatriates). In fact, if Lesotho is able to attract more and higher quality FDI, it will need to facilitate easy access to foreign skills.

Another aspect of skill deficiencies is more worrying: worker productivity is low in Lesotho even in simple CMT operations. Figure III.2 shows labour productivity comparisons by 7 Asian and 4 South African investors; the former is entirely in the apparel industry while the latter covers both apparel and footwear. The comparison with East Asia (where the main comparator is China) is particularly striking. The highest estimate for Lesotho productivity is 70 percent and the lowest 33 percent relative to levels in similar operations elsewhere.[30] This is despite the fact that workers in Lesotho are given less demanding tasks than counterparts in Asia, undertaking only one function rather than two or more different functions. The comparison with RSA is more favourable, with two firms rating Lesotho on a level with RSA workers. However this is not relevant to apparel, where the main competition industry will come from Asia.

Figure III.2. Relative labour productivity in Lesotho's foreign affiliates compared to Asia and RSA
(estimates by 11 foreign affiliates, in per cent)



It was not possible to measure the educational levels of workers in foreign affiliates in Lesotho. However, relative educational enrolment rates can serve as a broad indicator of national skill levels. Figure III.3 shows enrolments at the secondary and tertiary levels as percentages of the relevant age groups for Lesotho and comparators. Lesotho does well in comparison to Zambia and Mozambique but it lags behind most others, including Botswana, Namibia, Swaziland and Zimbabwe. It does better than Malawi in tertiary but not secondary enrolments, and vice versa for Zambia. Looking further afield, Lesotho lags behind Asia and China.

[30] These estimates are, of course, impressionistic but in the absence of detailed productivity analysis they can denote broad orders of magnitude. However, the impression of low productivity is confirmed by the more detailed study of the apparel industry by Salm *et al.*2002).

Figure III.3. Secondary and tertiary enrolment as % of relevant age group (late 1990s)

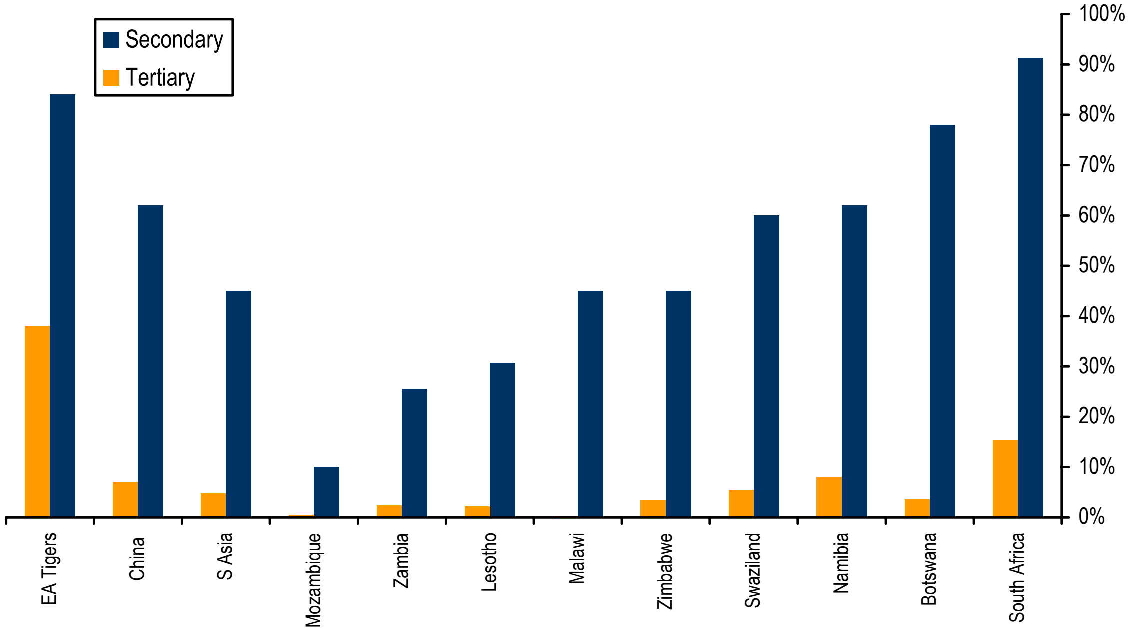


Table III.3 shows a narrower measure of high-level technical education: numbers enrolled at the tertiary level in science and technology. The rankings among Lesotho's neighbours remain similar, but the gap with Asia widens.

Table III.3. Tertiary technical enrolment

	Thousands			per cent of population	
	1987	1995	Growth rates (87-95)	1987	1995
Lesotho	0.2	0.6	10.4%	0.02%	0.03%
Malawi	0.5	0.8	6.1%	0.01%	0.01%
Mozambique	0.8	2.1	12.8%	0.01%	0.01%
South Africa	68.9	68.1	-0.1%	0.21%	0.16%
Zambia	1.1	2.7	11.9%	0.02%	0.03%
Zimbabwe	0.9	9.5	34.3%	0.01%	0.08%
Sub-total of above	72.4	83.8	1.8%	0.05%	0.09%
Sub-total exc. S. Africa	3.549	15.65	20.4%	0.01%	0.03%

Source: UNESCO, *Statistical Yearbook*, 1994 and 1997. Notes: Technical subjects include pure science, engineering and mathematics and computing.

These data suggest that Lesotho is rather poorly endowed with skills at the international and even the regional level. Enrolment data do not capture several aspects of skill creation relevant to FDI attraction or industrial competitiveness. They do not, for instance, capture differences in dropout rates, quality of education, the relevance of the curriculum and so on. Nor do they capture the skill creation based on industrial experience and employee training, which are probably of greater relevance to foreign investors than the numbers enrolled in schools.[31]

[31] For instance, though Bangladesh has lower overall levels of secondary enrolments than Lesotho, it has over the years built up a substantial technical and managerial skill base in the apparel industry. As a result, apparel companies in several other countries use technicians, supervisors and managers from Bangladesh.

There are major deficiencies in Lesotho in the area of employee training for manufacturing (banks and hotels have more extensive training programmes). There are no institutions for skill formation in the main industrial activity, clothing, or in other activities of interest to foreign investors like footwear or metal working. There is therefore a widespread dearth of such skills like machining, supervision, maintenance or marketing. There was a British aid-funded training institute for the clothing industry but it closed down early in 2002. Enterprises do train workers, but mainly in the basic skills needed to launch CMT operations. Most training is on-the-job (without external or course-based inputs). In general, investment in skill formation by firms is very low. Asian investors seem particularly reluctant to participate in or support the provision of more formal or advanced training by the government.

However, there are signs that this is changing as investors become more aware of the need to upgrade skills. Most Asian firms now have locals in supervisory positions, and the share of expatriates in total employment is going down. Most personnel managers in Asian affiliates are Basotho. A few firms have also introduced modern personnel practices linking promotion to in-house training and performance. RSA firms seem to invest more in training workers and some send high-level employees to their headquarters in South Africa. They also seem more willing to promote them to responsible positions. Most RSA firms commented favourably on the trainability of local workers. At the same time, they note the pressing need for policy support of worker training. Firms cannot on their own meet all the skill needs of industry and private enterprises tend to under-invest in training workers who may leave for other firms once they have acquired skills.

It should be reiterated that skill needs in Lesotho are rising apace. The deepening of the apparel industry into textiles, a more capital-intensive and complex activity, will call for more advanced skills in the next year or two. The loss of trade privileges in 2008 will accentuate this need. The relocation of labour-intensive activities from RSA will be sustainable only if skill levels rise. There is little use of industrial engineering (time and motion studies of task level productivity) in enterprises, without which it is very difficult to achieve sustained productivity increase. There are practically no local industrial engineering skills available in the country. Management skills are weak and there is little or no local design or marketing capability. Yet all such skills are necessary if the industry is to narrow its productivity gap and build a genuine competitive edge as it diversifies its industrial base and moves up the technology and quality ladder.

Policy support for industrial training need not entail the direct government provision of training. In fact, there is considerable scepticism on the part of business enterprises of the ability of the government to manage industrial training efficiently. This means that government training agencies have to improve their capabilities and make their services more relevant to the needs of industrial firms. It also means that the government should support industry-operated training centres, providing institutional seed-money and fiscal incentives or subsidies for training. Salm *et al* (2002) make a convincing case for the setting up an industry-managed training centre for the clothing industry. Such centres have worked well in other countries; a well-known example of industry-led training is the Penang Skills Development Corporation in Malaysia (Box III.3).

Box III.3. The Penang Skills Development Corporation (PSDC)

The PSDC, in the heart of the high-technology export based state of Penang in Malaysia, was launched in 1989 in response to the growing skill shortages in the fast growing region. The initiative and land were provided by the state government, which also gave some seed money (only about US$ 24,000) and induced three leading electronics affiliates operating in Penang to participate. These companies formed a steering committee, raised funds and gave full access to their own training programmes and methods. Other foreign and local firms then joined the PSDC, and over time private industry has continued to play the leading role in the centre, with a strong sense of 'ownership' and commitment.

PSDC borrowed trainers from the companies, and devised a range of training programmes that industry needed for its operations and for which full costs were charged. The programmes were changed constantly to meet evolving needs, and the PSDC has a very pro-active approach to its curricula. It is entirely autonomous in its operations and decision-making.

The government gave double (i.e. 200 per cent) tax exemption to firms that sent their personnel to the PSDC
for training and allowed the centre to bring in without work permits, high level foreign trainers (however, 90 per cent of the training is done by local staff). Sophisticated machinery was obtained from equipment suppliers for free, and some firms have even moved their own training facilities to PSDC. From providing employee training the PSDC has moved to pre-employment training, also paid for by companies that were experiencing shortages of trained recruits. PSDC has started to give scholarships to school leavers and is preparing its own teaching materials.

PSDC now has 58 member companies, 80 per cent foreign owned. Its annual budget is $385,000, of which only $48,000 comes from the government. As of late 1995, it had conducted some 6300 courses attended by over 9500 participants. Salaries paid to trainers are on a par with industry, but they are hired on contract basis and there is no tenure offered. The Board of the PSDC consists mostly of private industrialists, with some representation by technology institutes but *not* from the central government. Industry continues to give grants, as do the state government of Penang and aid donors.

The Malaysian government is now emulating the PSDC model in every state; most have started up, some with greater success than others, depending on the level of participation of local enterprises and the personality of the director.

Since the main industrial and foreign affiliate activity in Lesotho is in the clothing industry, and in the near future in fabric manufacturing, it is vital for government to pay attention to the specific skill needs of this industry.

There are four other issues related to human capital in Lesotho:

- The ***wage payment system.*** The Lesotho Labour Code forbids the use of piece-rate payments, and the organised labour movement is opposed to such a system. However, piece rates are widely used in the apparel industry in export-oriented developing countries, and have been found to provide strong incentives to raise productivity. There is an overwhelming case for the government to consider permitting piece rates in the export-oriented sector, combining it with safeguards to ensure that worker rights and working conditions are not compromised.

- ***Working conditions.*** There has been some adverse publicity in the United States regarding this in Lesotho. While the mission could not investigate the issue at any length, it gained the impression that while there may earlier have been legitimate grievances conditions have improved considerably. Employers in export-oriented apparel factories are subject to intense scrutiny from foreign buyers, which undertake regular inspections of working conditions. The widespread use of locals as personnel managers has also improved relations with workers.

- ***Labour unions.*** Most firms claim to have excellent relations with their workers but some express concern at union problems, particularly at the large number of unions recruiting members in factories and at the militancy of some unions. Most managers were willing to negotiate with one union but not to deal with several on an uncoordinated basis. There may be a case for the government to look carefully at the union situation and to win their support for making the Labour Code more flexible and up-to-date.

- ***Impact of HIV/Aids.*** The high rate of HIV infection rates (around 30 percent for the total population, 42 percent for Maseru) threatens the workforce in the clothing industry. The effects are just starting to be felt in the older factories, but over time such high infection rates are likely to affect productivity. There may be a large loss of trained workers and greater absence from work. It is beyond the scope of this report to analyse this, and the problem affects several other countries in the region, but it is clearly a potential deterrent to FDI.

It is not necessary to this report, having established the case for improvement, to go into details of how to strengthen the skill and education base in general or to reduce the incidence of HIV/aids. More specific recommendations are:

- Create or catalyse the setting up of institutions to meet specific industrial skill needs, involving enterprise managers in all stages of the process, including the operation of the institutions, the choice of curricula, and selection of teachers and equipment and the establishment of continuous linkages with industry.

- The primary need is for a training institution geared to the needs of the apparel and textile industry, not just immediate needs for machining and supervisory skills but also for more advanced design, marketing, pattern making and managerial skills.

- Establish a refundable levy system for training linked to skill formation actually undertaken by firms. The incentive may be financed by a training levy (in most countries this is 1 per cent of the payroll), with training expenses refunded to enterprises that undertake approved forms of training (internally or externally).

- Allow the use of piece-wages in the apparel industry, linked to regulations to ensure good working conditions. The minimum wage could serve as a 'floor' for remuneration for retained employees.

3. Local entrepreneurship

There is a paucity of industrial entrepreneurship in Lesotho. Though there are many micro-enterprises (with one to three employees), there are few in organised modern industry.[32] For this reason, there has been practically no spillover to the local economy from the foreign firms, unlike other developing countries where, say, local employees of apparel firms have left within a short period to set up their own operations (as in Bangladesh). There is only one case in Lesotho of a local entrepreneur setting up as a clothing subcontractor. There are no local input suppliers to foreign affiliates and none have appeared over time; the one maker of cartons in Lesotho is also Asian owned.

These entrepreneurial weaknesses limit the ability of Lesotho to 'root' FDI strongly in the local economy, to raise the local content of industrial activity, to attract higher quality FDI (in more complex activities and functions) and to reap spillover benefits from foreign presence. In a globalising world, capable local firms and efficient local industrial clusters are important magnets to FDI, since local suppliers lower the cost of operations and add greater flexibility to production (UNCTAD, *WIR2001*).

The Ministry of Industry, Trade and Marketing in Lesotho is charged with promoting SMEs and is launching initiatives. A GTZ funded project was launched in 2000 to strengthen business development service providers; there is a Garment Centre, a micro finance scheme and a skills training programme. The results to date have, however, been meagre. The limitations on local entrepreneurial, technical and marketing skills, in addition to inadequate financial resources and institutional support, are proving very difficult to overcome. Support institutions also suffer from managerial and technical limitations, lack of coordination and weak motivation to reach out to their constituency.

Recommendations on entrepreneurship strengthening related to FDI promotion are:

- Strengthen entrepreneurship training schemes, drawing upon the experience of Asian countries that have promoted broad based SME activity in manufacturing and modern services. Target such schemes at activities that can support foreign affiliates by supplying services, parts and components, and by subcontracting. Encourage industry associations and banks to offer training. Seek external assistance from donors for training schemes, not just in Lesotho but also abroad.

[32] Estimates indicate that about 60 percent of micro enterprises are in retail trade, 22 percent in traditional manufacturing and 11 percent in services (World Bank, 2002).

- Provide incentives to foreign affiliates to use local suppliers and to provide training to local firms in quality, technology, financial and other skills (*WIR2001*).

- Set up technology information and support facilities able to reach out to small scale entrepreneurs and provide a package of useful assistance.

4. Physical infrastructure

There are several infrastructure deficiencies that affect FDI in Lesotho:

- ***Land and factory shells.*** LNDC is responsible for providing industrial land and for building most factory shells (the land is sub-leased to investors by LNDC to comply with land ownership laws in Lesotho). There are now four major industrial estates and one smaller one in operation and two others are planned or under development. All available factory shells are occupied and all serviced industrial land is taken in Maseru and Thetsane. There is unsatisfied demand for factory shells, but LNDC is unable to meet this demand because of financial constraints in developing new estates and constructing buildings.

  There is a recent trend for foreign investors to buy factory buildings from LNDC and add factory shells or to build new factories at their own expense. LNDC has started to divest itself of estate management activities, subcontracting it to JHI Real Estate Limited (a South African multinational). This is an encouraging trend.

- ***Transport and logistics.*** Road connections to the industrial estates are good. All the estates are located near the border and the Maputsoe and Maseru crossings are open 24 hours. Rail transport is much cheaper for bulk transport than road, but there are serious problems at the railhead (of which there is only one located in Maseru). The area is not paved, and container handling facilities are inadequate and outdated. While the handling facilities are owned and operated by a South African company (Spoornet), the firm has no lease or tenure on the government-owned site. This deters Spoornet from investing in improving the facilities, while the Lesotho government is not prepared to operate the site itself. "The result is a completely inadequate facility operated under dangerous and unsecured conditions" (Salm *et al*, 2002). Unsuitable storage and inadequate handling facilities mean that containers cannot be stored in Lesotho and have to be kept waiting in South Africa, at a cost to the companies.

  Goods often have to be sent by road rather than train, with empty containers sent back by rail. Empty road transport containers are brought into Lesotho, packed at the factories and sent to ports. Obtaining truck space in RSA is sometimes a problem. The bottleneck at the railhead raises costs for exporters and affects timely shipments. In addition, there are problems with delays in customs and excise because of manual procedures, both in importing and exporting products. As noted earlier, there are serious incipient problems once

VAT is introduced in Lesotho and importers have to deposit the value of imports with the central bank.

- ***Utilities*****.** There have been problems in the past with electricity supplies (erratic cuts and inefficient billing); while the situation has improved recently, investors still complain about the unreliability of power supply. Electricity charges are considerably higher than in South Africa (the World Bank, 2002, estimates them to be 40 per cent higher).

  Water is a more important problem, and will get worse as clothing production expands and textile mills appear. Maseru has a critical shortage of water for residents; the apparel sector will use up to one-third of the available water (Salm, 2002). The Highlands Water Project does not help because all the water is piped directly to South Africa (the pipeline heads north while Maseru lies to the west).

  Telephone lines were inadequate earlier but may improve with the privatization of the telecom company. However, South African firms complain that telecom costs are considerably higher than in RSA. It is not possible for visitors from Europe, USA or Asia to use their mobile telephones (as it is in RSA), and local mobile charges are also relatively high. Internet connections in Lesotho are poor, with few service providers and regular interruptions in connections.

- ***Environment.*** There are problems with the treatment of effluent from the garment factories, and recycling of water is not practised (or anticipated). Water taken from the Caledon River reduces flow rates and the availability of water to residents of Maseru. Discharge of untreated effluents in the watercourse creates pollution (this is about to be banned in Lesotho, and is illegal internationally). The burning of solid waste creates air pollution. The Lesotho Government has not imposed any penalties for pollution, but the clothing industry may face future pressures from buyers. The South African government (which shares the Caledon River) has already complained about water pollution.

Recommendations concerning physical infrastructure are as follows:

- As a matter of top priority, increase the supply of factory shells to foreign investors. This may involve separating the industrial estate and factory provision and management activity of LNDC from its FDI promotion activity and placing the former in private hands. A significant part of new industrial estate construction and management in Asia is now privately managed. The financial implications of removing the infrastructure activity from LNDC are addressed below.

- Another priority matter is to improve the railhead facilities at Maseru, giving the private operator the incentives needed to invest in upgrading the facilities and bringing them to international standards of efficiency and security.

- Analyse inefficiencies in power supplies, telecommunications and water supplies and launch long-term measures to deal with them. The most urgent problem here is water supply for the incipient textile industry. In the medium term, it is imperative to improve Lesotho's Internet 'connectivity' with the outside world, particularly if it is to make any headway in the area of new services.

- Improve environmental management and institute appropriate incentives and penalties to ensure that industrial enterprises minimise toxic effluence.

5. Private-public interface

The present institutional set-up does not provide for effective dialogue between government and the private sector or within the private sector (World Bank, 2002). Existing consultation mechanisms are sporadic and do not cover the spectrum of firms. It is important to improve the mechanisms to ensure that the government is fully aware of the needs of foreign investors and able to respond to them, and that foreign enterprises understand the policy objectives of government and feed into the design of new policies. One of the hallmarks of a business-friendly government today is to have an efficient interface and to involve the private sector in the policy process. This also means that the private sector should be able to analyse and articulate its own needs adequately.

This gap is especially critical for smaller firms. The Association of Employers and the Association of Exporters (comprised mainly of larger firms) collaborate on labour-related issues. The former includes mostly larger firms as well as several South Africa-based firms, while the latter is largely comprised of Asian firms. Members of these organisations tend to rely on their own networks for trade information. By contrast, the smaller firms, represented by the Lesotho Chamber of Commerce and Industry, the Maseru Chamber and members of the Lesotho Manufacturers' Association, appear unaware of international standards and potential market opportunities.

The strengthening on the public-private interface can be a major step forward in improving the FDI climate in Lesotho. The recommendations here are:

- The government should establish an effective forum for continuous interactions with the main constituents of the private sector, including small local firms, ensuring that there is adequate exchange of information and views and that legitimate concerns are promptly taken care of.

- The private sector itself should establish a more cohesive consultative and analysis mechanism, able to present a coherent view to the government of its policy needs.

6. FDI promotion

The Investment Promotion Centre is the marketing arm of the LNDC and is charged with attracting and facilitating FDI, though it shares with other units of LNDC other FDI support functions. The IPC was set up in 1992/93, with financial support by the World Bank till 1997. Thereafter it became dependent entirely on the LNDC for its budget, and over time its resources were severely reduced (MIGA, 1999). LNDC itself was established in 1967, with many objectives apart from investment promotion: *viz.* to “initiate, promote and facilitate the development of manufacturing and processing industries, mining and commerce in a manner calculated to raise the level of income and employment in Lesotho”. LNDC receives no budgetary support from the government and, as a result, has to generate its own earnings, mainly from industrial estates and factory shells and from companies in which it holds shares.

LNDC essentially plays a facilitating role for foreign investors, providing information to prospective investors, arranging for site visits, and helping with permits and licences as well as with operational problems as they arise. LNDC also provides land sub-leases and factory shells, and this is a major source of income for the corporation. By all accounts LNDC does a good facilitating job: foreign investors interviewed were overwhelmingly complimentary about the assistance given by LNDC and by its continued support over time. Its infrastructure functions are more problematic. As noted, current delays over factory shells, due to LNDC’s financial difficulties, are becoming a significant constraint on FDI, and it is not clear (apart from financial reasons) why an agency like the LNDC should be involved in infrastructure provision. Its investment promotion and general development functions would be better served if this function were located elsewhere and, to the extent feasible, privatized.

As far as FDI promotion in the narrow sense is concerned, the diverse objectives of LNDC and its need to earn a living constrain the effectiveness of IPC in its investment promotion efforts. There is confusion over the role of IPC in dealing with foreign investors, since other units of LNDC also participate in this. Moreover, IPC has the mandate to promote FDI only in the manufacturing sector: FDI in tourism or agriculture are not covered. This can dilute the effectiveness of national image building in the investment community and lead to slower development of investment promotion capabilities in Lesotho.

The IPC has a staff of five: the director, a promotion manager, two investment officers (dealing exclusively with investment promotion), one research manager and one public relations officer. Its annual budget (including salaries, travel and advertising) is now Maloti 1 million (around $100,000), and this is a significant improvement over the previous year. The budget and human resources of the investment promotion unit are miniscule by international standards. IPAs in other countries have considerably larger budgets and staff. The average IPA in LDCs has an annual budget of US$285,000 and 29 staff, of which 20 are professionals.[33]

The activities of the IPC tend to be constrained by its budgetary resources and more often it reacts mainly to initiatives from investors and it lacks a coherent marketing strategy of its own in terms of regions or investors. It does not utilize ‘best practice’ investment promotion techniques used by IPAs in advanced countries (table III.4). It does not have a database on prospective investors or on the activities of investors in the country (apart from employment generated). Its main function is to

[33] UNCTAD, "The World of Investment Promotion at a Glance: A Survey of Investment Promotion Practices", Advisory Studies number 17 (2002).

help prospective investors with site visits; its promotion activities are relatively weak or minimal. Its promotion activities till 2001 are shown in table III.5. The number of solicited and walk-in site visits increased dramatically after Lesotho became AGOA eligible.

Table III.4. Investment Promotion Agency (IPA) functions

Function	Objective	Activity/Result
Strategy and organisation.	Set investment objectives.	Government commitment to FDI attraction Attracting FDI to promote technology transfer, skill development, exports, industrial deepening, R&D and so on. Structure of IPA, relations with government departments, network of regional/international offices, collaborators. Priority setting by activity, upgrading existing activities over time.
Image building.	Create or change image of location as investment site	Public relations, general advertising, Website and other IT tools. Information seminars, general trade missions, participation in trade shows and conferences.
Investment prospecting.	Directly attract new investment in areas of most economic interest.	Direct mail campaigns, telemarketing, firm-specific direct selling, targeted advertising, participation in trade shows/conferences Focus on selected sectors and investors, use of business networks Provision of accurate, up-to-date and useful comparative information, effective response to enquiries.
Lead generation and investment facilitation.	Facilitate and realize new investment.	Lead generation, handling 'major enquiries', pre-investment site visit. Negotiation of investment package, license and permit facilitation, land and factory acquisition, infrastructure provision.
Competitive advantage creation.	Ensure that local factors and institutions meet needs of targeted investors.	Improve specific skills and institutions needed by targeted investors. Create industry specific infrastructure and reduce business transaction costs. Show willingness to listen, adapt and improve to please customer.
Investor services and after-care.	Follow up services for existing investors, customer satisfaction surveys, linkage promotion, upgrading of activities.	Identifying local business partners, sites for expansion, training opportunities Contact, monitoring and assistance. Improve local support institutions. Helping to develop 'quality of life' for foreign investors. Ability to provide incentives and institutional assistance for R&D, skill development and linkage creation with suppliers, universities and technology institutions.
Evaluation of IPA activities.	Monitor, evaluate and improve functioning of IPA.	Assessment of leads generated, investors attracted, advertising, tours and so on. Jobs and exports created. Linkages created. Benchmarking of IPA performance against competitors and best practice.

The MIGA (1999) evaluation of the different aspects of IPC's work assigns particularly low scores to its promotion and lead generation. Most of the focus of investment promotion has been on RSA, though some efforts have been made in Mauritius. Promotion in East Asia has been largely by participating in government trade missions, without a clear strategic thrust or targeted message. Its advertising is unfocused. It does not have a functioning website, able to provide prospective investors with comprehensive information on Lesotho.

Table III.5. Investment promotion activities by LNDC

	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01
Presentations	100	178	165	148	236	208	76	100	70
Site visits	20	19	12	20	22	15	22	32	40
New projects	1	3	6	11	7	6	6	9	9

Source: LNDC.

To its credit, as noted, LNDC has been very efficient in *facilitating* foreign investment. It has excellent relations with investors in Lesotho, has won their trust and is regarded highly by practically all firms. Lesotho has an advantage over much of Africa in that it has an established base of export-oriented investors with no need to change a negative image in the investment community. Its FDI regime, while it can be improved, is better than that of many competitors. This gives it a base on which it can build.

However, given its location and structural handicaps, Lesotho now has to strenghten its FDI promotion capabilities and to build new competitive assets. There is thus a *strong case for upgrading the capabilities of the investment promotion unit*. This can best be done if the unit is *given greater autonomy* and *a separate budget with adequate financial and human resources for promotion and targeting.*

The recommendations are:

- FDI promotion, facilitation and after-care functions should be strengthened and provided with considerably larger resources by the government.

- The investment promotion agency should not be encumbered with extraneous functions such as the provision of industrial land or buildings.

- It should be able to act as a genuine 'one-stop shop' for investors, providing all the necessary permits in a short period (see Chapter II).

- It should be mandated to cover FDI promotion in all activities, not just manufacturing.

- The IPA should build capabilities in modern tools of investment promotion, marketing, targeting and after-care. This would involve, among other things, the building of a database on prospective investors in activities identified with potential, and the launching of targeted, carefully formulated campaigns and internal evaluation of the costs and benefits of different techniques.

- It should seek to diversify manufacturing FDI into new labour-intensive activities like footwear, toys, sports goods and simple metal and plastic products by establishing contact with leading companies in these areas and assessing their factor needs.

- It should focus promotion efforts on foreign investors already in the country, using them as ‘ambassadors’ for Lesotho by improving business conditions and responding to their needs.

- It should involve the private sector in developing the FDI promotion campaign.

- It should develop an attractive website that contains basic information on investment conditions, costs and facilities relevant to prospective investors.

- The use of investment incentives should be considered as part of the promotion campaign, but with limited scope and clear objectives (Chapter II).

D. Support by development partners.[34]

Efforts of host developing countries, especially LDCs, to attract and benefit from FDI are being increasingly supplemented by measures undertaken by development partners, including also home country measures (HCMs) undertaken to influence the magnitude and quality of FDI flows to developing countries. These measures, overwhelmingly unilateral in design and application, can range from support to investment and trade promotion efforts through investment insurance guarantees to preferential market access

In Lesotho, they have helped to improve its locational attractions and attract most of the FDI Lesotho has received. Earlier on, factors such as sanctions on the South African apartheid regime, combined with unused quotas under the Multi-Fibre Agreement had induced FDI flows into Lesotho. They triggered the first wave of garment investors in the 1980s. Later, the most important impact was preferential access to EU markets under the Lomé Convention and, most recently, to the US market under AGOA I. Other examples of enhancing locational advantages are the effective use by Lesotho of ODA from the EU (recently 15-20 million Euros annually) to improve infrastructure, especially roads and water supply.

Other key measures are:

- Financial assistance to remove the bottleneck at the rail depot in Maseru by upgrading and expanding its facilities. This is vital for the competitiveness of garment exporters, which are forced to use more expensive and slower road transportation. While all major donors can participate, the commitment of RSA is necessary because of ownership issues and of the fact that Lesotho does not have its own railway company.

- Financial and other assistance to mount a concerted skill development campaign in Lesotho, aimed primarily at the apparel industry but broadening to cover other activities, both in manufacturing and in services.

- Removing hassles at the border with South Africa by helping introduce free movement of goods, services and business people and limiting controls to

[34] UNCTAD, 2001, *Home Country Measures* (United Nations: New York and Geneva).

indispensable checks related to illegal immigration and contraband. This is important for Lesotho's competitiveness and tourism development. Much depends on the Lesotho government, but the full cooperation of the South African government is also necessary. The recently established Joint Bilateral Commission of Co-operation (JBCC) between Lesotho and RSA provides the appropriate forum for such co-operation as well as well as for a review of other investment stimulating measures by South Africa (box III.4)

- Helping Lesotho to exploit the FDI potential related to trade privileges in the EU market, RSA market and the US market for non-garment products (several thousands items can benefit from AGOA). This can involve feasibility studies, market research, trade missions and investment fora for investors on trade and investment opportunities.

Box III.4. Joint Bilateral Commission of Cooperation between RSA and Lesotho (JBCC)

The JBCC between Lesotho and South Africa was established in the aftermath of the UN LDC conference held in Brussels in May 2001. The purpose of the JBCC Agreement, signed in 2001, is to "uplift Lesotho from its current status as a Least Developed Country within a period of five years". Although the timeframe for achieving this objective may be umbitious, the objective itself is praiseworthy and RSA clearly has a role to play in fulfilling it. One important way would be by helping promote FDI in Lesotho through HCMs.

The Commission first met in May 2002 launching a programme of work aimed initially at the implementation of 6 projects: (1) The Maloti/Drakensberg Trans-Frontier Conservation and Development area; (2) Geo-Chemical Mapping Project; (3) Stone-Cutting Project; (4) A Road Construction Project involving the upgrading of the Mokhotlong/Sani Pass/Underberg road infrastructure and the establishment of a permanent board post; (5) Technical Assistance in Commercial Production of Livestock; (6) Tikoe Industrial Estate Project. Some of these projects, if successful, may be relevant, directly (sandstone project) or indirectly (improved roads and border crossing), for future FDI. The programme of work of the Commission is open-ended and is only shaping up. Other initiatives by the South African side include, among others, the identification of SA investors interested in projects in Lesotho. So far 14 investors have been identified.

Source: UNCTAD

E. Summary of findings and recommendations

Lesotho is at a critical juncture in its development and FDI has played a central role in sustaining it by providing indispensable resources and ingredients including capital and foreign exchange, managerial and industrial skills, demand for export products and their design, access to marketing channels as well as technology. In the absence of immediate local alternatives, FDI will have to provide much of the impetus for future growth, not only in export-oriented manufacturing, but also, increasingly, in service activities like tourism and perhaps in resource-based activities. Lesotho has been successful in having built a base of export-oriented manufacturing FDI in the recent past, but this base is facing serious challenges, as it is largely dependent on time-bound trade privileges in one market. At the same time Lesotho has not yet been able to exploit fully free long-term access to other major markets.

To fully exploit existing FDI potential in non-manufacturing sectors, to face challenges related to existing FDI in manufacturing and to benefit more from free access to major markets, Lesotho needs a well-developed, coherent FDI strategy. There are many components to this strategy.

The most pressing task should be to deal with challenges arising out of the transition from AGOA 1 to AGOA 2, including removing obstacles to upstream investment in the garment industry faced by the existing foreign affiliates. Another priority should be to minimize constraints to closer integration with RSA (by reducing unnecessary border transaction costs and hassles) and introduce VAT in a way that does not penalize export-oriented firms. In addition, the government should negotiate with RSA ways of harmonizing standards and taxes, and analyse ways of using the SACU trade regime to enhance its competitiveness and attractiveness to FDI.

Lesotho should also seek to extend (and improve where needed) its privileged access to major markets, by negotiating for an extension to AGOA and for obtaining similar access to EU markets.

Lesotho must enhance its competitive base in manufacturing and services. The most pressing task it to raise productivity in the apparel sector. The critical variable here is skills and worker motivation; improving these involves policies for training inside and outside firms and linking remuneration to performance. There are also urgent issues related to the provision of infrastructure (factory shells, better railroad facilities and water suppliers) and its cost and quality.

Lesotho must strengthen the local enterprise sector, both to attract more and better FDI and to root existing investors more firmly in the economy. Lesotho also must also try to attract other labour-intensive activities apart from apparel that benefit from AGOA.

In resource-based activities and services, Lesotho must better exploit existing competitive advantages and create new advantages. The most urgent need is to improve the tourism infrastructure and to analyse the potential for attracting FDI into agro-based and mining activities. Over the long term it should strengthen Internet facilities and develop the skill and institutional base to attract FDI into IT services.

Sustaining higher inflows of FDI entails the building of better interface mechanisms between the government and the private sector, with initiatives required on both sides.

Lesotho needs improvements to and modernisation of the FDI attraction and promotion system. The IPC needs to be enlarged and strengthened, and provided secure government funding. It also needs a structure and higher levels of professional skill. It should be mandated to attract FDI in all activities, not only manufacturing, and should develop a coherent strategy of targeting investors in areas of strength in Lesotho.

Finally, there is a significant role for development partners, including home country governments in assisting Lesotho in its FDI attraction and retention efforts. The most important is probably the extension of trade privileges that have provided a magnet of foreign investors and a new industrial base. Given the newness of this base and the time needed to raise productivity to competitive levels, home countries should consider giving a longer 'learning' period. But simply extending trade privileges will not be sufficient – assistance is needed in improving the skill base and physical infrastructure and reducing further remaining impediments to business activity.

IV. CONCLUSIONS AND RECOMMENTATIONS

Lesotho has done far better than most other LDCs in attracting FDI, and is unique among African LDCs in attracting predominantly export-oriented FDI. Apparel TNCs have generated significant employment and foreign exchange; they have also created industrial and exporting skills that, though narrow in scope, could provide a base for longer-term FDI and industrial development. There is also a trickle of South African FDI relocating labour-intensive processes, and this offers good prospects for long-term growth. There is little resource-based FDI, but it should be able to attract investors in the foreseeable future.

However, Lesotho may not be able to attract FDI at rates seen recently. While the investment climate is reasonably good and political uncertainties have been allayed, policy impediments remain. The macroeconomic climate, largely determined by SACU, is stable but the trade regime can be improved. The physical infrastructure is improving but significant constraints exist in terms of transport, water and building sites; there are also minor handicaps in power and communications. The financial system is lagging in its ability to service export-oriented investors. FDI promotion is also well behind international best practice.

The most important constraints, however, lie in the economic attractiveness of Lesotho as a location for FDI. Export-oriented FDI has been driven largely by trade privileges for apparel exports and, to a much smaller extent, by low wages and proximity to the RSA market. Trade privileges will continue to attract investors for the next 2-3 years, but once AGOA ends it is not clear whether significant new investments will come or, indeed, if many existing investors will stay. There is a large productivity gap with respect to apparel producers in East Asia, with roughly similar wages, and unless this gap is reduced the long-term prospects remain shadowy. The other important driver of export-oriented FDI, low wages, will remain intact, but much depends on the competitiveness of RSA investors even with lower wages and on the ability of Lesotho to provide higher quality labour.

Objective 1: Strengthen the investment framework

A seven point agenda of improvements is recommended to fill gaps in, and anticipate pressures on, Lesotho's investment framework. These are practical steps, presented in broad order of urgency:

- Permit foreign investors to hold leasehold land titles and freely transfer and encumber these titles. Allied to this, encourage FDI in property development. A shortage of developed industrial sites constrains investment in export manufacturing.
- Reform taxation of investment aimed at manufacturing and to help diversify FDI into new sectors, including tourism, property development and mining. These reforms should remove the bias in corporate taxation and VAT against non-manufacturing.
- Redesign the work and residence permit schemes to provide a more predictable, reliable and timely system for genuine applicants whilst

preserving controls against unwanted economic migration. Publish statements of policy and procedure so that investors know what to expect.

- Introduce a modern foreign investment law that offers high standards of treatment and protection to foreign investors. Consider special provisions to welcome capital and skills from neighbouring countries.
- In sectors: abolish industrial licences and reform trading licences to ensure that they do not duplicate other regulations; carry through reform of the legal regime for mining.
- Introduce a competition policy and authority.
- Introduce foreign currency accounts for exporters.

The Government should also acknowledge and reinforce the many pockets of good practice within the administration – including the current openness to FDI in key job creating sectors, the good management of industrial relations, the steady progress in privatisation, the low levels of corruption and the excellent job which the LNDC has done in facilitating FDI in manufacturing.

Objective 2: Improve the trade regime and negotiating an extension of trade privileges

As a least developed country in sub-Saharan Africa, Lesotho has privileged access to major markets. While this privilege is not under the control of Lesotho, the Government can participate actively in international negotiations and lobby bilateral trading partners to influence the outcome. In addition, while the trade regime in Lesotho is largely governed by membership of SACU, there are areas in which the Government can act to take better advantage of its integration with RSA. Actions include:

- Negotiate with the USA to extend AGOA privileges.
- Negotiate for AGOA-like trade privileges with the EU.
- Explore, together with RSA, better tracking systems for exporters to comply with rules-of-origin requirements without creating additional economic borders

Objective 3: Human resource development

Prospects for export-oriented FDI hinge on the ability to close the productivity gap with respect to producers in other countries with roughly similar wages. Actions include:

- Establish a refundable levy system for training linked to skill formation undertaken by firms.
- Draw on the levy to create or catalyse the setting up of industry-funded and run institutions to meet specific skill needs, involving enterprise managers in all stages of the process (including the operation of institutions), choice of curricula and selection of teachers and equipment, and establishment of close linkages with industry.
- Set up, as a priority matter, such a training institution for the apparel and textile industry.

Objective 4: Strengthen local entrepreneurship

A paucity of entrepreneurship in Lesotho limits the extent to which FDI can 'root' strongly in the local economy, and the country can attract higher quality FDI (in more complex activities and functions) and reap spillover benefits from foreign presence. Actions include:

- Strengthen entrepreneurship-training schemes, and target them at activities that can supply services, parts and components and subcontracting to foreign affiliates.

Objective 5: Improve physical infrastructure

Physical infrastructure is improving but significant constraints exist in terms of transport, water, building sites and factory shells; there are also handicaps in power and communications. Actions include:

- Change policy to give foreign investors and private developers a bigger role in improving physical infrastructure. The policy considerations relate to land, the role of LNDC and privatisation.
- As a matter of top priority, reform land law so that foreign private developers can increase the supply of factory shells to foreign investors and the owner of the Maseru railhead can invest in expanded facilities.

Objective 6: Improve public-private interface

The emerging recognition on the part of foreign firms to commit to local skill development should be reinforced. Actions include:

- Establish an effective forum for government interactions with private sector, ensuring adequate exchange of information and views.
- Encourage the private sector to establish a cohesive consultative and analysis mechanism, able to present a coherent view to the government of its policy needs.

Objective 7: Strengthen FDI promotion and facilitation

There is need to upgrade FDI promotion efforts to international best practice. Actions include:

- Assign FDI promotion, facilitation and after-care functions to an autonomous and adequately funded investment promotion agency (IPA).
- The IPA should act as a genuine 'one-stop shop' for investors, facilitating all necessary permits in a short period. Its mandate should be extended to cover FDI promotion in all activities.

- The IPA should be adequately funded, at least at the average level of IPAs in other LDCs, namely $285,000.

Objective 8: Reshape role of LNDC

The above recommendations have significant implications for the role of LNDC:

- The valuable work done by the Investment Policy Unit should be strengthened and it should be adequately funded.
- Reform of land laws would enable foreign developers to invest in factory shells, currently a preserve of LNDC. In the short-term, under a new land title system, LNDC could respond by entering into joint ventures with private developers. In the long-term, LNDC may be a candidate for privatisation but this step should not be contemplated until the property market is functioning effectively with private capital.

Objective 9: Avail of development partners

Measures by development partners, including also home country measures will be an indispensable complement to Lesotho's efforts to cope with the challenges of upgrading and benefiting from FDI and attracting FDI into new activities. Actions by development partners include:

- Consider the case for extending trade privileges to Lesotho and, also, help Lesotho exploit the FDI potential in trade privileges in the EU, RSA and US markets for non-garment products. This can involve feasibility studies, market research, trade missions and investment forums.
- Provide assistance to raise skills in Lesotho, aimed primarily at the apparel industry but also covering other activities in manufacturing and services.
- Help Lesotho remove hassles at the RSA border by aiding it to introduce free movement of goods, services and business people and limiting controls to indispensable checks related to illegal immigration and contraband. The new Joint Bilateral Commission of Co-operation (JBCC) between Lesotho and RSA provides the appropriate forum for such co-operation.

Annex 1. Methodology of international tax comparisons

The Comparative Taxation Survey compares taxation on investment in several sectors in Lesotho with taxation in selected other countries – neighbours and countries elsewhere that have succeeded in attracting FDI to the sectors concerned. These comparisons enable Lesotho to assess the competitiveness of its taxation.

Taxation affects the cost of investment and its profitability and thus the return on investment. This impact is not just a question of looking at the headline rate of tax on profits. The tax burden on the investor depends on a number of factors and their interaction including expenses allowed, rates of capital allowances (tax depreciation), the availability of tax credits, investment allowances and tax holidays, the loss-carry-forward provisions and the taxation of dividends among other things. Moreover, customs and excise duties affect the cost of investment and operating margins. Together these make up the overall fiscal regime that affects the cost of and return on investment.

Comparative tax modelling is a method of taking into account the most important of these variables in the fiscal regime in a manner facilitates comparison between countries. The tax variables included in the analysis are:

- Corporate income tax
  - Rate of tax including tax holidays, if any
  - Loss-carry-forward provisions
  - Capital allowances, investment allowances and investment credits
  - Tax on dividends
- Customs import duties and excise duties on business inputs

Sales tax is not considered in the analysis because it is to be replaced by VAT. In any event a correctly administered VAT falls on the consumer and is not a tax burden on business.

Financial models of project investment and financing, revenues and expenses are utilised for a hypothetical business in each sector. These are based on typical costs and revenues experienced in such businesses in a developing economy. The business models cover a selected business within each sector.

The fiscal regime in Lesotho and the chosen comparator countries for each sector is applied to the standard business model for each sector over 10 years beginning with the initial investment. The financial models calculate net cash flow to the investor assuming that the company pays out all residual profits after tax (100per cent dividend pay out) and that the investor gains the residual value of the company which is sold after 10 years for an amount equal to its balance sheet value.

The impact of the fiscal regime is presented as the *Present value of tax (PV Tax).* PV Tax is the total of taxes and duties collected by government over the 10 years as a percentage of the project cash flow pre-tax and post-finance where both cash flows are discounted to a present value at a rate of 10per cent per annum. PV Tax thus measures how much of investor's potential project return is taken by the government in taxes and duties. The higher the PV Tax the more than the fiscal regime burdens investors and reduces the incentive to invest.

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