



KINGDOM OF LESOTHO

SELECTED ISSUES

June 2022

This Selected Issues paper on Kingdom of Lesotho was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on May 16, 2022.

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Price: \$18.00 per printed copy

International Monetary Fund
Washington, D.C.



KINGDOM OF LESOTHO

SELECTED ISSUES

May 16, 2022

Approved By
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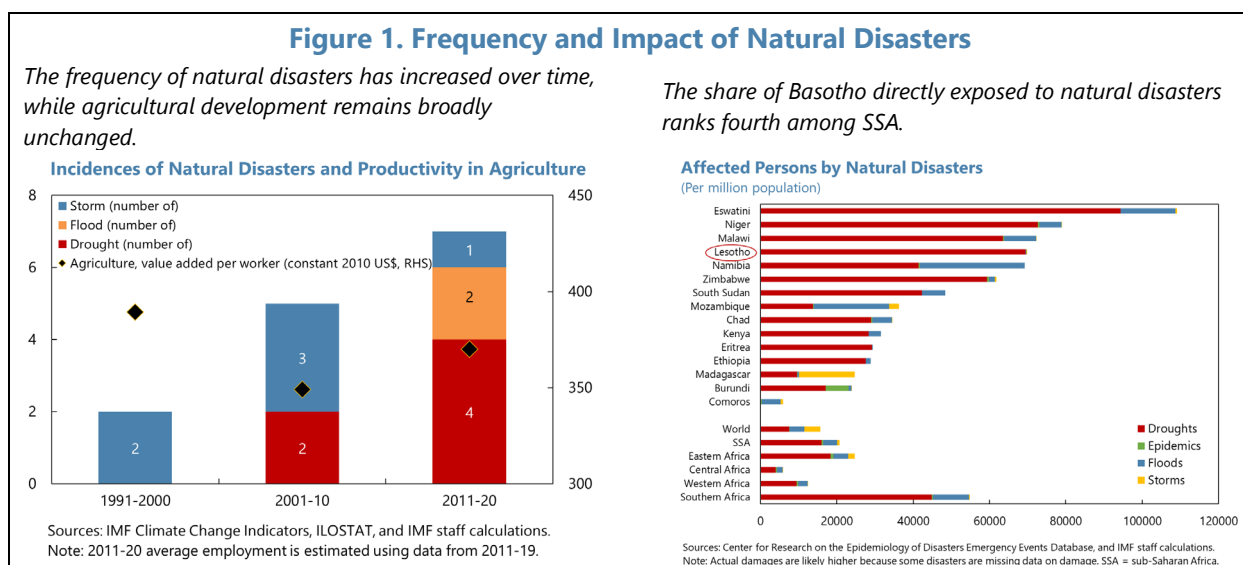
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ADDRESSING LESOTHO’S CLIMATE AND ENVIRONMENTAL CHALLENGES¹

A. Introduction

1. Lesotho is highly exposed to recurrent natural disasters, particularly droughts, floods, and storms. The frequency and severity of these disasters have increased significantly in the past decade. With over two-thirds of the population dependent on rain-fed subsistence agriculture, the share of the population directly exposed to natural disasters ranks fourth among sub-Saharan Africa (SSA) countries, well above the SSA and world average. And in the absence of augmentation measures such as increased bulk water supply, these frequent changes in precipitation exacerbate unmet demand for industrial and household uses.



2. Repeated exposure to natural disasters affects fiscal and macro-financial stability, with severe consequences for food security of low-income households. Natural disasters severely disrupt agriculture and livelihoods, increase net food imports, and ultimately worsen the fiscal stance. Based on data available for the two extreme disasters, the cost of disaster relief for the El Niño–induced drought in FY15/16 and the floods in FY10/11 was estimated at US\$38 million (LSL584 million, 1.7 percent of GDP) and US\$67 million (LSL462.7 million, 3.2 percent of GDP), respectively. The average annual cost of disaster relief is about US\$19.3 million (1 percent of GDP in FY19/20), most of which is borne by the government with limited donor support that was provided only for extreme disasters.²

¹ Prepared by Haiyan Shi.

² This is based on estimates from the World Bank report “Lesotho: Disaster Risk Financing Diagnostic” (December 2019). Data on the cost of disaster relief is not systematically recorded in Lesotho and was available only for two extreme disasters discussed above.

3. In addition to climate challenges, progressive soil degradation is another serious structural consequence of climate variability. Cycles of drought and intense rainfall contribute to massive soil erosion and loss of scarce agricultural land. While only 12 percent of the country's land is arable, it is estimated that 40 million tons of soil (about 2 percent of its topsoil) are lost annually due to erosion and about 66 percent of households live on degraded land. Increasing environmental degradation has also led to loss of critical habitats such as wetlands, forests, and vegetation cover, and has significantly reduced the capacity of catchments to capture and store water. The value of annual depletion of natural resources (soil and related habitats) is estimated at around 4.6 percent of gross national income.

4. Land access and use laws and practices deter long-term investment in irrigation, conservation, and soil improvements. The formal property market in Lesotho is largely undeveloped. This leads to sub-optimal farming practices relating to the selection of crops and seeds. Government interference in commercialization of farm output also locks the rural sector into poverty.

5. The authorities have developed policies and institutions to address climate change and environmental degradation but more is needed. The Disaster Management Authority (DMA) was established under the Disaster Management Act of 1997. In 2007, Lesotho prepared a National Adaptation Programme of Action in compliance with the United Nations Framework Convention on Climate Change guidelines to identify priority activities that respond to their urgent and immediate needs to adapt to climate change. The National Resilience Strategic Framework (NRSF) was approved by the Cabinet in 2019. Interventions include tree planting, land reclamation, protection of wetlands and other biodiversity and conservation programs. Some improvements in the introduction of new technologies and building links from farm to market can be seen in horticulture. However, evidence suggests that considerably greater effort is needed to mitigate the physical and transition risks related to climate and soil degradation challenges.

6. Policy responses should focus on adaptation while transitioning to less carbon-intensive economies. Like other African countries, Lesotho is not a significant source of greenhouse gas emissions but is particularly vulnerable to the expected impact of global warming. At the UN Climate Change Conference in Glasgow (COP26), it was framed as compulsory for developing countries to transition away from fossil fuels and promote the development of less carbon-intensive economies. Therefore, Lesotho could still pursue win-win policies that minimize emissions while tackling urban pollution (with its high health costs) and introducing solar energy and other innovative and cost effective technologies amid the rising price of fuel and gas.

7. Experience from other SSA countries confirms that up-front investment in climate-resilient infrastructure results in long-term savings as measured by reduced spending on disaster relief. Several countries have already developed successful adaptation strategies that could serve as models for Lesotho (Box 2.2, IMF 2020). Investing in resilient infrastructure, though costly, benefits green and inclusive long-term growth by creating jobs and reducing inequality, and reduces the impact of climate shocks on public debt. Successful examples include Mozambique's infrastructure upgrade in the port of Beira and Kenya's investment in renewable solar energy.

8. Non-infrastructure climate adaptation measures are more affordable and could be implemented more quickly. For example, programs supporting farmers in purchasing improved seeds and other crop-protection measures (Ethiopia, Ghana, and Mozambique), improving irrigation and water retention (Chad and Ghana), and those that provide early warning on weather events show relatively high benefit-to-cost ratios. The same applies for swift and targeted social assistance (Ethiopia). Because water resources and subsistence agriculture are key elements of Lesotho's economy, systematic policies and early actions are needed to adequately prepare and manage projected impacts. Any measures require frontloaded investment and financing, which, in turn, entails creating additional fiscal space through revenue mobilization and expenditure restraint.

B. Policies to Address Climate Challenges

9. The government could play a greater role in mitigating the consequences of disasters, most of which are borne by the poorest. The combination of erratic rainfall, fragile soils, and worsening land degradation—exacerbated by poor land-management practices—trigger poor harvests and large livestock losses. While, in the short term, it is important to ensure the availability of funds for disaster relief, it is even more important and less costly over the long term to invest in adaptation techniques. It is essential for the authorities to:

- *Maintain fiscal buffers to provide disaster relief.* The Disaster Management Fund's resources should be prioritized, and its disbursement mechanism strengthened to ensure timely distribution of funds. Participation in regional macroeconomic insurance schemes such as the African Risk Capacity could also help in this regard.
- *Ensure better allocation of social programs.* Better targeting of social assistance could ensure resources are spent most effectively.
- *Implement a climate-smart agriculture policy and improve access to finance.* Investments in adaptation strategies such as drought-tolerant crops, irrigation infrastructure, and sustainable land management strategies would reduce productivity losses from the agricultural sector and help fight poverty. Policies to support penetration of agricultural and disaster insurance in the country could help with the de-risking of the vulnerable communities, as well as helping with their access to finance.

10. International funds should be mobilized for both disaster relief and building climate resilience. The international community can assist the authorities' efforts by expanding financial support and technical assistance beyond disaster relief to target climate resilience and bolster coping mechanisms. Currently, there are several donor-funded climate projects being implemented in Lesotho, for example, some donor-funded projects on adaptation and renewable energy (EU, GEF, MCC, UNDP, and World Bank). Coordination of efforts and the government's cooperation are critical for their effectiveness.

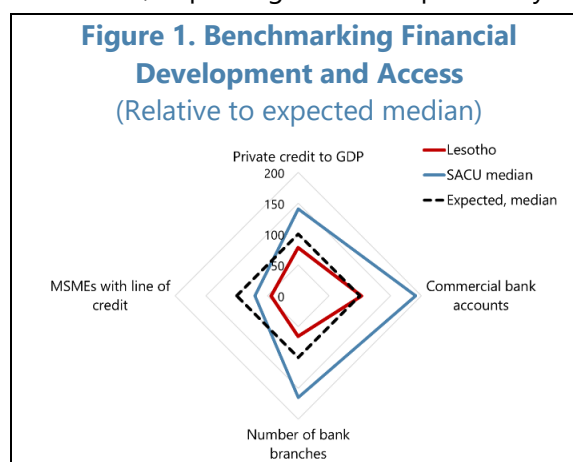
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IMPROVING FINANCIAL INCLUSION¹

A. Progress and Challenges

1. Lesotho is making significant efforts to increase financial inclusion but substantial challenges remain. The rapid growth of mobile money is an important recent success. Active accounts have increased by about four and half times since 2015, improving access for previously excluded parts of the populations, such as the rural poor. By 2021, adults with access to more than one formal financial product increased by 40 percent from 2011. The Central Bank of Lesotho (CBL) recently issued pricing directives to alleviate financial transactions costs. However, Lesotho continues to underperform on key dimensions of financial development and inclusion relative to peers.² Only about 10 percent of households who borrow do so from a financial institution, much lower than in lower-middle income countries (LMICs), while fewer MSMEs have access to credit in Lesotho than in neighbor SACU member states.



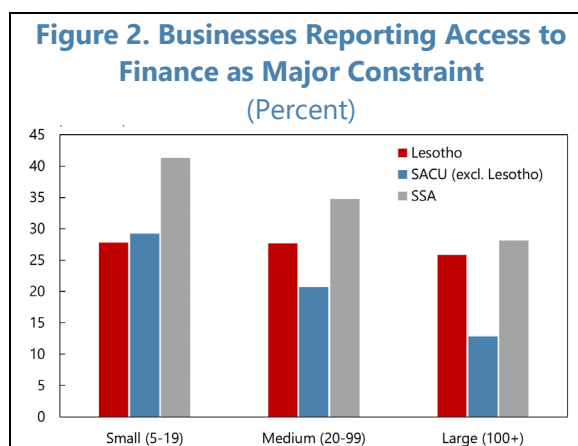
2. The well-capitalized, highly liquid, and largely foreign-owned banking sector's contribution to private sector credit remains limited. The banking sector dominates credit provision with limited competition as suggested by the sector's concentrated asset holdings, high profitability and overhead costs, and large spreads between lending and deposit rates (see Figure 1). While the supply of funds to banks—measured by deposits to GDP—is comparable to Lesotho's peers at 30 percent, only about half goes to the private sector as credit. Banks prefer to invest heavily in South Africa, likely reflecting home bias within the parent banks of the three foreign bank subsidiaries, deeper financial markets and better investment opportunities in South Africa, and a lack of bankable projects in Lesotho. Only about a third of domestic credit goes to businesses, much lower than in peers.

¹ Prepared by Haiyan Shi and Ashique Habib.

² The World Bank's Finstats 2019 tool, used to benchmark Lesotho's performance, attempts to isolate the impact of policy on different dimensions of financial development and inclusion, by using regression analysis to control for structural variables (e.g., population density, per capita income) which may also affect outcomes. The model controls for the level of economic development, population size and density, demographics, the global financial cycle, and special characteristics such as geography and resource endowment, and estimates the expected distribution of outcomes. The underlying data, from various sources, extends up to 2017. The most recent years are used for the analysis.

3. Access to finance for MSMEs is typically a bigger constraint in Lesotho compared to the rest of SACU.

Lenders report that MSMEs often lack adequate financial statements to assess risk and business plans to evaluate prospects. Lenders' ability to use collateral is also limited by the current legal framework. MSMEs borrowers also often face difficulty getting the necessary documentation, such as business registration, licenses, and tax clearance due to the complexity of the processes, and some instead take out more expensive consumer loans. A weak credit infrastructure and information gaps limit access to financial services particularly for rural and non-salaried households.



4. Despite substantial demand, access to financial services remains limited for most households. Lenders prefer to lend to salaried workers, mainly civil servants, using deduction at source from paychecks to manage risk. For example, data from the most recent household budget survey suggest about half of all mortgage loans are to civil servants, who account for only 4 percent of the labor force. Meanwhile, Findex 2017 data suggest the rest of the population has limited access to financial services and use informal methods to meet their needs. They instead tend to rely on family and friends to borrow, and only a minority who save do so through a financial institution. However, lack of documentation, distance to provider, and high costs are particularly important reasons for not being able to open a bank account in Lesotho. Furthermore, agriculture is an important source of income for the majority of Basotho and is subject to high variability due to periodic droughts. Smallholder agricultural insurance has only recently started to be introduced to help mitigate this volatility with surveys suggesting high demand for access.

5. Microfinance institutions (MFIs) and financial cooperatives likely have a limited impact on financial inclusion, while raising consumer protection concerns. The small MFI sector, with only about 5 percent of the assets of the banking sector, lends almost entirely to households, often once again to salaried workers—who are already able to borrow from banks, further raising their indebtedness. Financial cooperatives are growing rapidly, outpacing the supervisory capacity of the central bank. Some of the largest, such as Boliba, remain in regulatory limbo, highlighting critical governance concerns within the sector. Progress on the Financial Cooperatives Bill, which would improve the Ministry of Small Business Development, Cooperatives and Marketing's (MSBDCM) powers to supervise the sector, has stalled. Absent improvements in governance, the sector risks undermining consumer trust and financial inclusion.

6. Mobile money usage has grown rapidly—helping to expand the reach of digital financial services—but less than half of the mobile money accounts are actively used. Lesotho has made greater progress for all groups compared to other LMICs, including for the poor, less educated and rural individuals. Usage has increased rapidly, with mobile money accounts more than

doubling since 2017. 2.2 million mobile money accounts were registered as of year-end 2020, of which 882,000 were 30-days active (40 percent) and 920,000 were 90-days active (42 percent). Active accounts equate to around two-thirds of the adult population of 1.4 million. Therefore, while mobile phone penetration appears high, this reflects the use of multiple SIM cards. Two-thirds of Basotho do not use the internet regularly, because weak competition leads to a high cost to use communication services and low internet usage by both businesses and individuals. Although there are five mobile money issuers, Vodacom dominates the sector with an 87 percent market share. Despite rising interest, digital lending is in its infancy partly due to the lengthy licensing process for Fintech companies.

7. The increasing use of mobile money for domestic remittances has led to a decline in informal services for cross-border remittances. As the growth of mobile money has formalized the majority of domestic transfers, the share of informal remittances (e.g., cash carried across the border) has been declining. FinMark Trust estimates the proportion of informal remittances declined from 54 percent in 2016 to 30 percent in 2018. The decline is due to various partnerships between MNOs, MTOs, retailers (e.g., Shoprite) and exchange bureau that have expanded the availability and reduced the cost of formal remittances.

B. Policies to Increase Financial Inclusion

8. Mobile money and other digital financial services are a promising avenue for increasing financial inclusion for households. The CBL is revising the *National Payments Act* and improving the regulatory framework, which will also increase consumer protection, and is planning upgrades to improve interoperability across service providers. These efforts may need to be complemented by monitoring whether anti-competitive practices may also be hindering interoperability, as suggested by conversations with market participants. Reducing the cost of meeting documentation requirements for individuals, which is currently a major hurdle, while maintaining adequate protections will also be key. Utilizing the national ID for consumer verification, which the authorities are piloting, could substantially reduce costs. The authorities should consider whether there is scope to take a risk-based and tiered approach to banking agent licensing, which has proven essential to expanding financial services in other countries.

9. Fostering digital financial services will broaden financial access and inclusion. Measures include: (i) submit the National Payments Systems Bill to Parliament and implement associated regulations; (ii) implement the Government Payment Gateway; (iii) implement the National Switch- and the associated common data standards and protocols; (iv) implement the National Identification Act; (v) update the Data Protection Act in line with international good practices, and revise and resubmit the draft Computer Crime and Cybersecurity Bill; (vi) adopt simplified customer due diligence requirements; (vii) harmonize Financial Agency requirements; and (viii) adopt Financial Consumer Protection regulations.

10. International coordination is necessary to lower the cost of cross-border remittances. Greater integration of regional payment systems and expanding the usage of existing facilities such as SIRESS to low-value payments, could help further lower costs. Coordinating with South African

and regional authorities to identify areas to streamline regulations could foster use of formal services and increase the number of providers.

11. Continued efforts to increase consumer protection and literacy will be necessary to boost inclusion and sustain trust in the financial system. The CBL should continue its efforts to enhance financial literacy and consumer protection. Passage of the *Financial Consumer Protection Bill* and ensuring that the newly-created Consumer Protection Unit is adequately capacitated are key first steps. It will be important to speed passing the *Financial Cooperatives Bill* to ensure adequate coverage for customers of financial cooperatives.

12. The CBL should continue to be vigilant on over indebtedness. The CBL should continue its efforts to expand the coverage of the credit bureau and could also consider integrating information from Treasury's payroll system, which is used by lenders for deduction at source from paychecks, to enhance the monitoring of overindebted individuals. Carefully monitoring lending practices, and issuing warnings and imposing penalties, will also be important.

13. Efforts to increase financial inclusion for MSMEs should focus on creating an enabling environment for lending, complemented with pro-growth and sustainable regulatory and fiscal policies. Improving the credit infrastructure, enhancing the partial credit guarantee scheme, and supporting the development of capital markets will help overcome barriers. In particular, completing the collateral property register, broadening the coverage and scope of the Credit Reporting Act, and implementing the Insolvency Act by developing regulations with detailed provisions for practitioners will facilitate the use of collateral. Including businesses in the credit bureau can help with credit assessments. Creating credit scores for individuals could also facilitate lending to MSMEs, by allowing information on the entrepreneur to serve as a proxy for their business. The required documentation for business loans could be reviewed with a view to facilitating access, while ensuring that risks are appropriately managed. However, the benefits from improving the lending environment will be limited without concurrent efforts to create a pro-growth and stable business environment while eliminating government payment arrears.

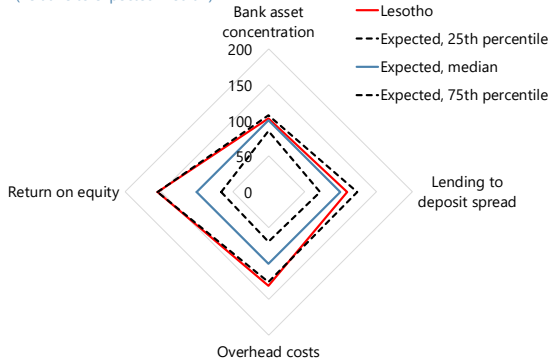
14. Additional interventions should focus on reducing risk and increasing the bankability of projects, while leaving project selection to the private sector. Providing training on business development and preparing financial statements could enhance the bankability of MSMEs. The two existing partial credit guarantee schemes, maintained by LNDC and the MSBDCM, should be reviewed to eliminate overlaps in coverage, and their design should follow international best practices, such as ensuring that the private sector plays the lead role in project selection.

Figure 3. The Banking Sector in Lesotho

Compared to peers, Lesotho's banking sector is less competitive...

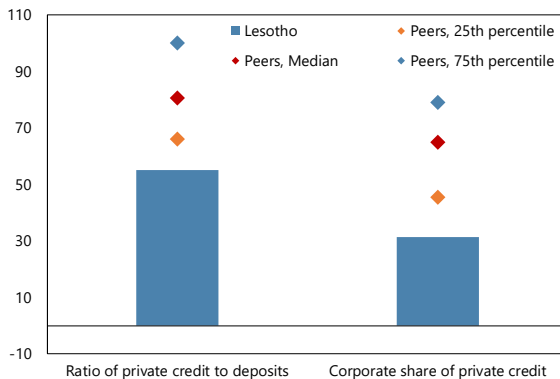
Benchmarking Banking in Lesotho

(Relative to expected median)



...and provides less credit to the private sector, especially businesses.

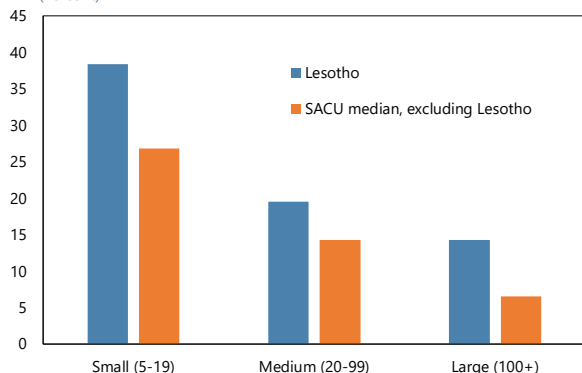
Allocation of Deposits and Credit



Access to credit is lower for SMEs than in other SACU countries.

Share of Firms Identifying Finance as a Major Constraint

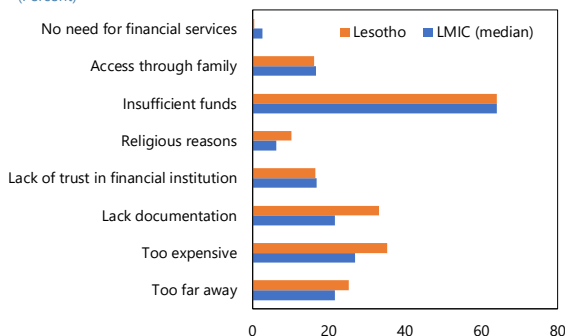
(Percent)



Lack of documentation, high cost, lack of trust, and distance as major barriers to account ownership.

Reasons for Not Having an Account with a Financial Institution

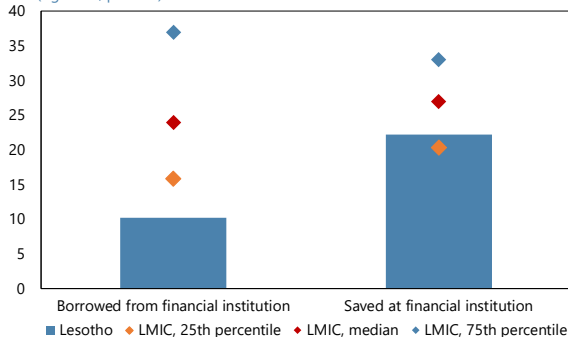
(Percent)



Few households use formal financial institutions to save and borrow...

Share of Borrowers and Savers Using Formal Financial Institutions, 2017

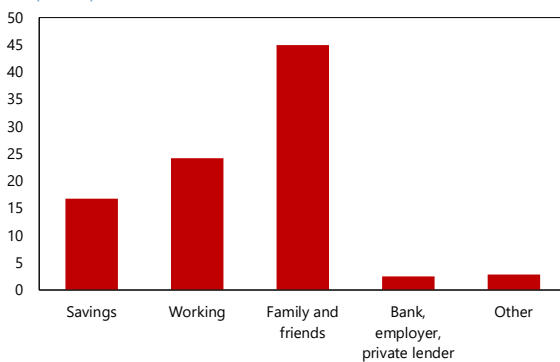
(Age 15+, percent)



... and most rely on family and friends for emergency funds.

Reported Source of Emergency Funds, 2017

(Percent)

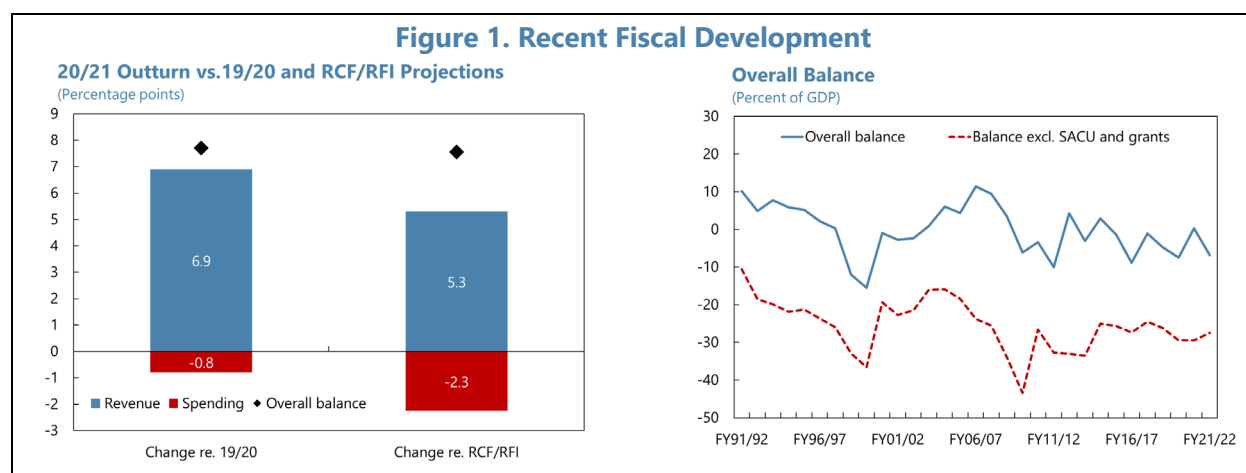


ADDRESSING FISCAL PRESSURES¹

A. Introduction

1. The fiscal outlook remains challenging and absent upfront consolidation the external position will continue to deteriorate. SACU transfers shrunk by a third in FY21/22 and though they are projected to rebound in the short run, the outlook remains subdued and characterized by uncertainty. With the upward drift in spending over time, COVID-induced spending trade-offs are likely to persist if the pandemic lingers. In the absence of consolidation, the government would be forced to either (i) cut spending abruptly or (ii) accumulate sizeable arrears.

2. While fiscal performance in FY20/21 was better than expected, the hard-won savings were not capitalized on in FY21/22. Revenue performance in FY20/21 was 5.3 percentage points of GDP higher than projected under the 2020 RCF/RFI, from direct taxes and royalties and lower nominal GDP effects. Current expenditure fell by 3.6 percentage points of GDP relative to RCF/RFI projections—by limiting spending on goods and services and wage increases—and was redirected to measures to mitigate the pandemic (Figure 1). The result was a small overall balance surplus for FY20/21. However, the FY21/22 budget did not build on these gains, setting out double-digit deficits over the medium term with no concrete adjustment measures. While the March 2022 Budget Speech has provisionally tempered the fiscal outlook, it remains sensitive to revenue collection and the ability to control spending.



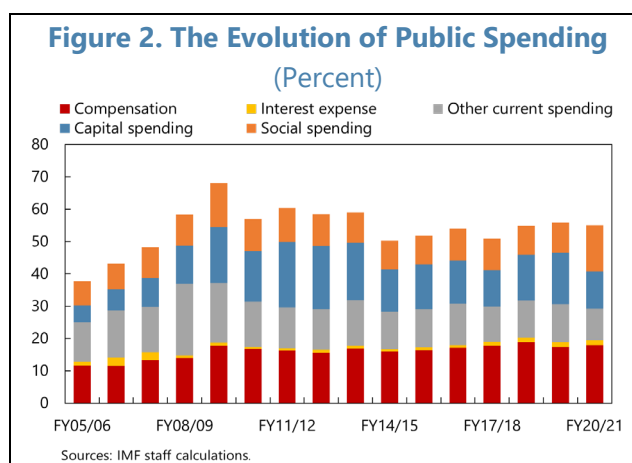
3. Efforts to restrain expenditure throughout 2020 and 2021 were undermined by growing domestic payments arrears. Even though the FY21/22 Mid-Term Budget Review revised down spending, Ministries, Departments, and Agencies (MDAs) continued to spend according to previous budget allocations. As a result, the stock of arrears has increased to LSL1.25 billion (3.4 percent of GDP) as of end-November 2021 from LSL720 million (2.1 percent of GDP) at end-March 2021.

¹ Prepared by Yibin Mu.

4. The traditional approach of containing spending through nonwage cuts to limit nominal spending growth may improve the deficit temporarily but will likely have negative effects on growth and equality. The emphasis on preserving wages over efficient capital spending risks growth in the medium term. At the same time, the use of cash-based warrants can restrict spending but can also lead to arrears in the absence of robust PFM mechanisms and a well-planned depoliticized budget. A shift from a wage-preserving approach to a strategic, growth-friendly, poverty-reducing, and efficiency-oriented spending program—backed by broad-based domestic revenue mobilization efforts that weans the economy of external SACU transfers—would increase the chance of success and the sustainability of fiscal consolidation. By nature, this requires an assessment of not only fiscal costs but also intended results/outcomes, such as the achievement of social and economic objectives, and the provision of high-quality public goods and services.

B. Analyzing Spending

5. Public spending in Lesotho has been outpacing GDP growth (Figure 2). As a result, public spending in percent of GDP increased from below 40 percent to beyond 50 percent over the last 15. The share of compensation of public employees and social spending has been increasing, squeezing capital spending and other nonwage current spending. Since some current spending is incorrectly recorded under the capital budget, the true size and growth of current spending is likely even larger.²



6. Lesotho's public expenditure stands out among peers and is tilted much more towards consumption than investment (Figure 3). Lesotho's public expenditure stands out across the region, across all categories: capital spending, wage spending, and nonwage current spending. Over the past decade, the jump of expenditure in percent of GDP has increased by 4.3 percent on average, compared to 2 percent for sub-Saharan Africa (SSA), and 1.3 percent for LIDCs. Compensation in Lesotho accounts on average for a larger share of total spending in Lesotho compared to SSA, while capital spending for almost 18 percent of total spending, compared to a quarter for SSA.

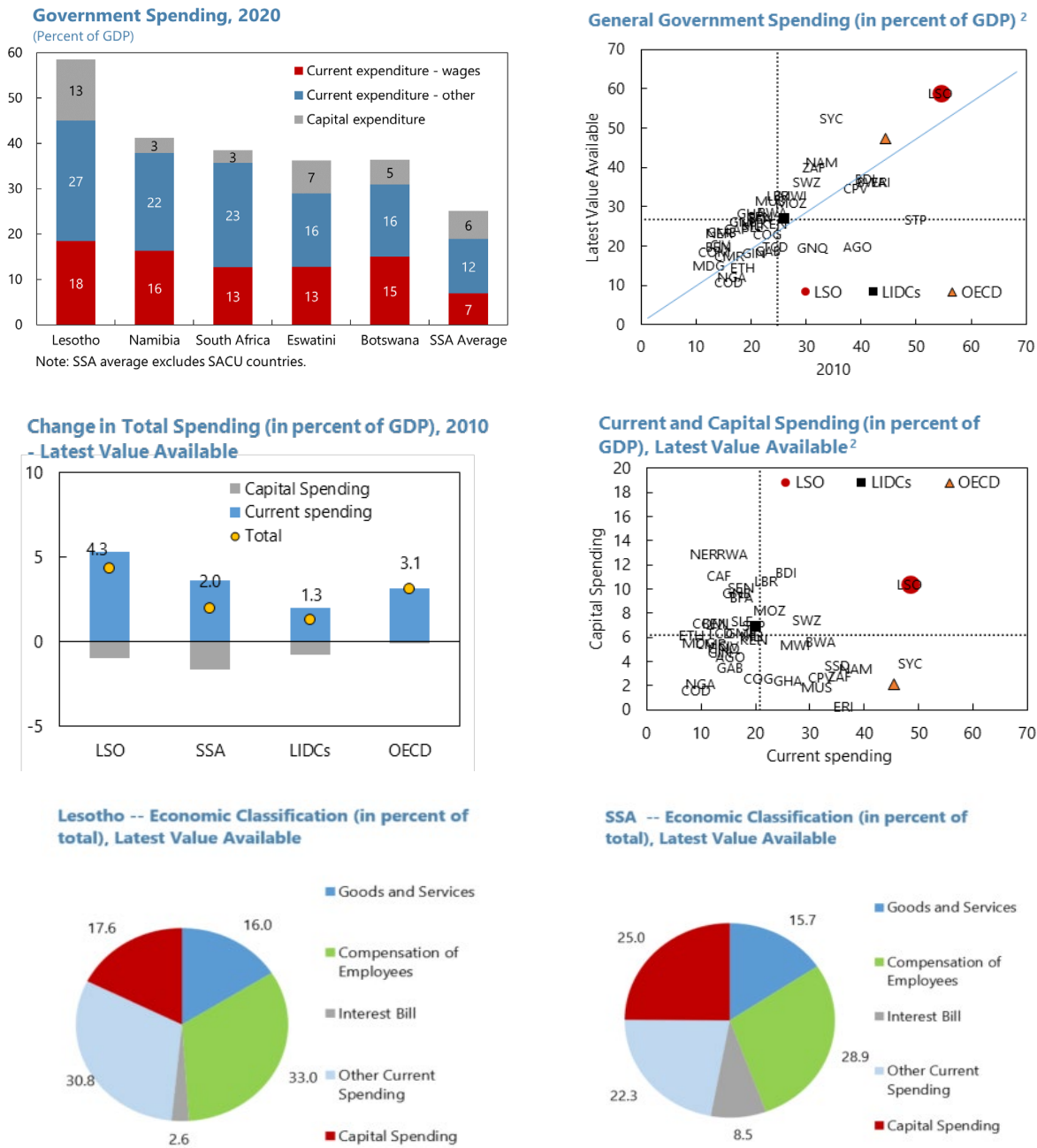
7. The compensation of public employees in Lesotho has been on an increasing trend.³ The wage bill as a percent of GDP has increased from around 11.7 percent in FY05/06 to 18.4 percent in FY20/21, increasing from around 60 percent to 70 percent as a share of domestic revenue. Lesotho's compensation of public employees also stands out among sub-Saharan Africa in percent of GDP in SSA, with the highest public wage premium among SACU countries. Lesotho has

² This reclassification of current spending under the capital budget has begun in the FY22/23 budget.

³ SACU transfers windfall in FY20/21 led to the exceptional low compensation-to-total-revenue ratio.

the highest wage bill as a percent of GDP while the number of public servants per thousand of population are the smallest among SACU countries (Figure 4). This implies the average wage for Basotho public servants would be very high relative to other SACU countries.

Figure 3. Benchmarking Government Spending¹



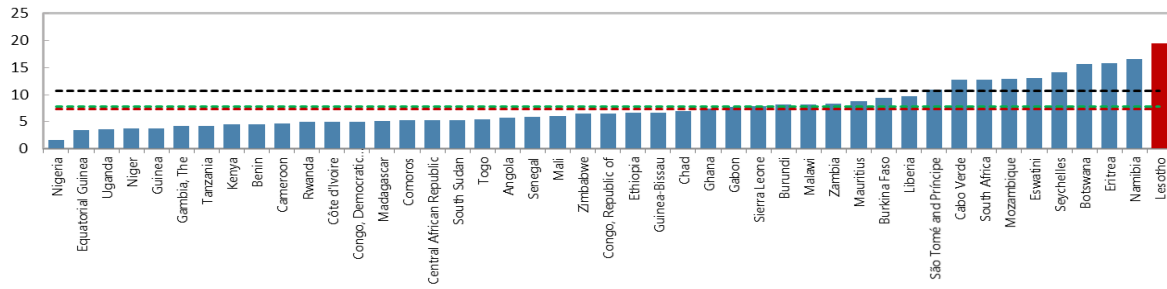
Sources: IMF FAD Expenditure Assessment Tool (EAT), World Economic Outlook.

¹ Coverage refers to general government as per World Economic Outlook metadata.

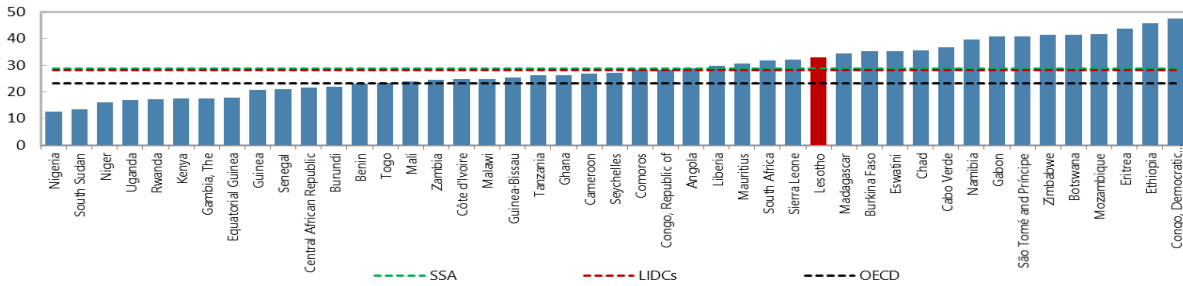
² Sashines are the average of SSA.

Figure 4. Public Wages

Latest Value Available (in percent of GDP)

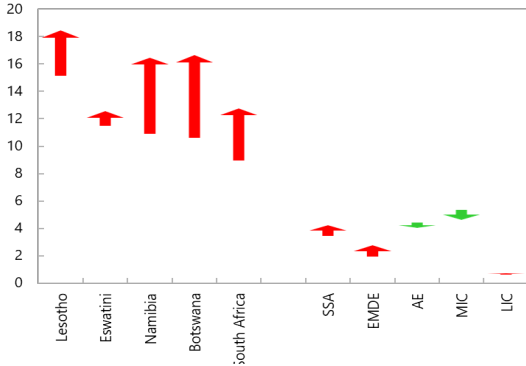


Latest Value Available (in percent of total spending)



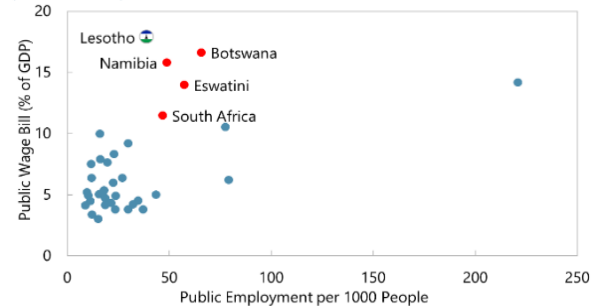
Wage Bill

(Percent of GDP; 2007-2020)



Public Employment and Wage Bill

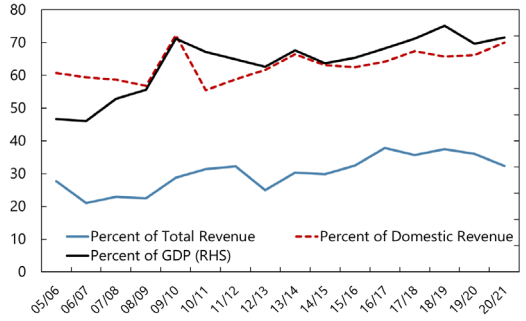
(Latest available)



Note: Public sector employment covers employment in the government sector plus employment in publicly-owned resident enterprises and companies, operating at central, state (or regional) and local levels of government. It covers all persons employed directly by those institutions, regardless of the particular type of employment contract. Sources: IMF World Economic Outlook, ILOSTAT, and staff calculations.

Public Employee Compensation

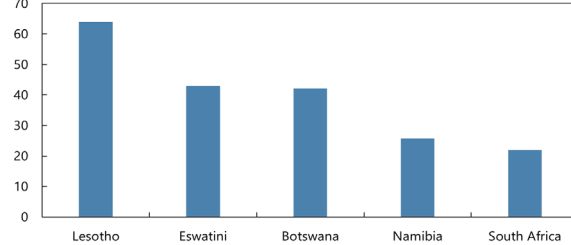
(Percent)



Source: IMF staff calculations.

Public Wage Premium

(Percent)



Note: The public wage premium is estimated using Mincer equations. The log incomes of individuals/households are regressed on a public employment dummy, education, age, and disability status (as a proxy for experience and skills), gender, household size, marital status, and regional dummies. Propensity score matching is used to ensure robustness. Estimates for Botswana are based on 2020 Quarterly Multi-Topic Survey, for Namibia, based on 2018 Labor Force Survey, and for South Africa, FAD CD report. Estimates for Eswatini and Lesotho are from the SACU 2018 Spring Meeting workshop. Total spending in percent of GDP is calculated using 2020 data.

Sources: IMF FAD Expenditure Assessment Tool (EAT), IMF FAD Government Wage Bill and Employment Dataset, IMF FAD Public-Private Wage Premium Dataset, World Bank.

Note: Dash lines are the average for countries in the regional benchmark group.

8. Social spending has been increasing over the past five years, from 6.4 percent of GDP in FY16/17 to around 8.2 percent of GDP in FY20/21, or around 15 percent of total spending. Budget transfers to Tertiary Bursary Program and Old Age Pension (OAP) account for the largest, 2.64 and 2.39 percent of GDP, respectively, or 4.81 and 4.35 percent of total spending, respectively. (Figure 5, Table 1).

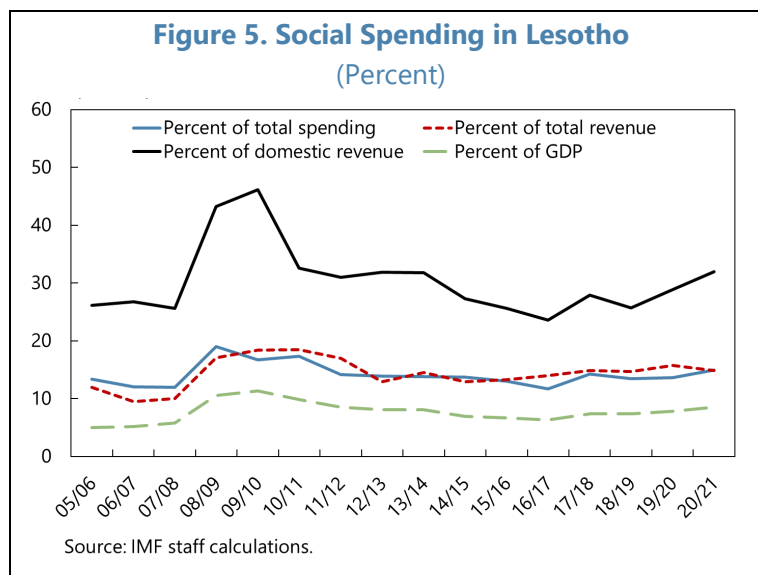


Table 1. Lesotho: Social Protection Spending in Lesotho (FY20/21)

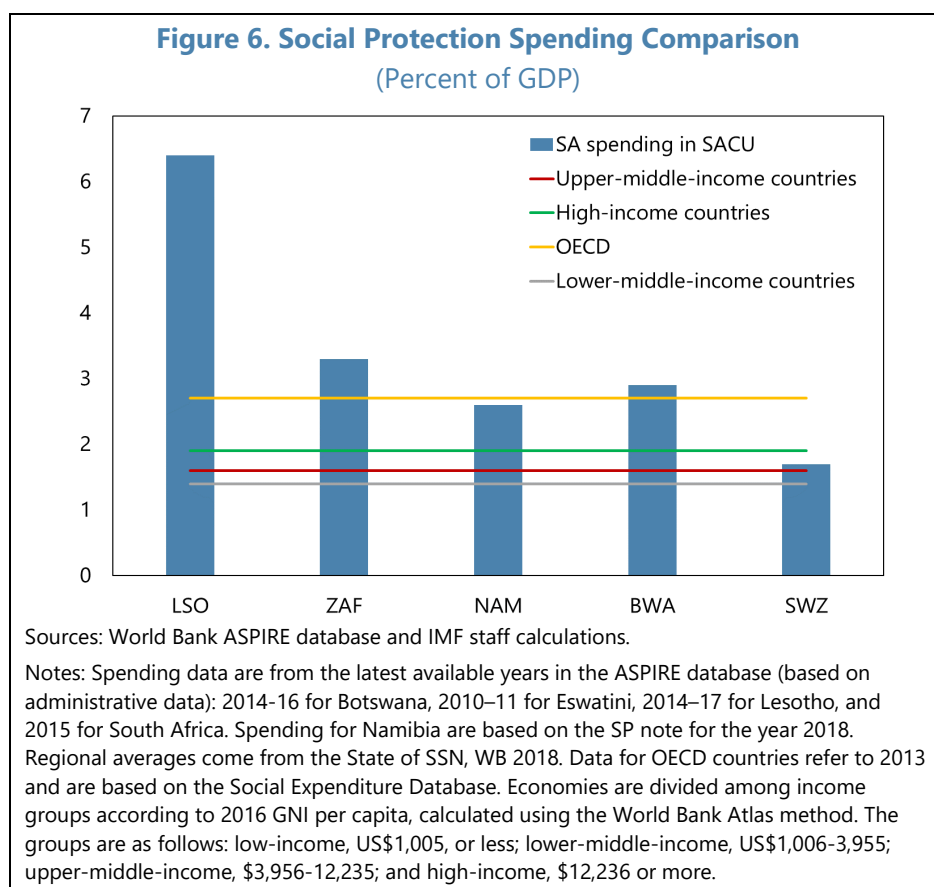
	Amount	Percent of GDP	Percent of Total Spending	Percent of Total Social Spending	Coverage
CGP	57.6	0.17	0.31	2.08	22
School feeding	187.2	0.56	1.01	6.75	100
Cash-for-work assistance	98.22	0.29	0.53	3.54	20
Public assistance	28.8	0.09	0.16	1.04	6
OVC bursary	73.5	0.22	0.40	2.65	11
Tertiary bursary	891.4	2.64	4.81	32.12	4
OAP	806.9	2.39	4.35	29.08	>100
Other social spending*	631.4	1.87	3.40	22.75	
Total social spending	2775.0	8.23	14.96	100.00	

Units: LSL Million

Note: *Mainly employer social benefits.

Sources: Author's calculation based on the data from the authorities.

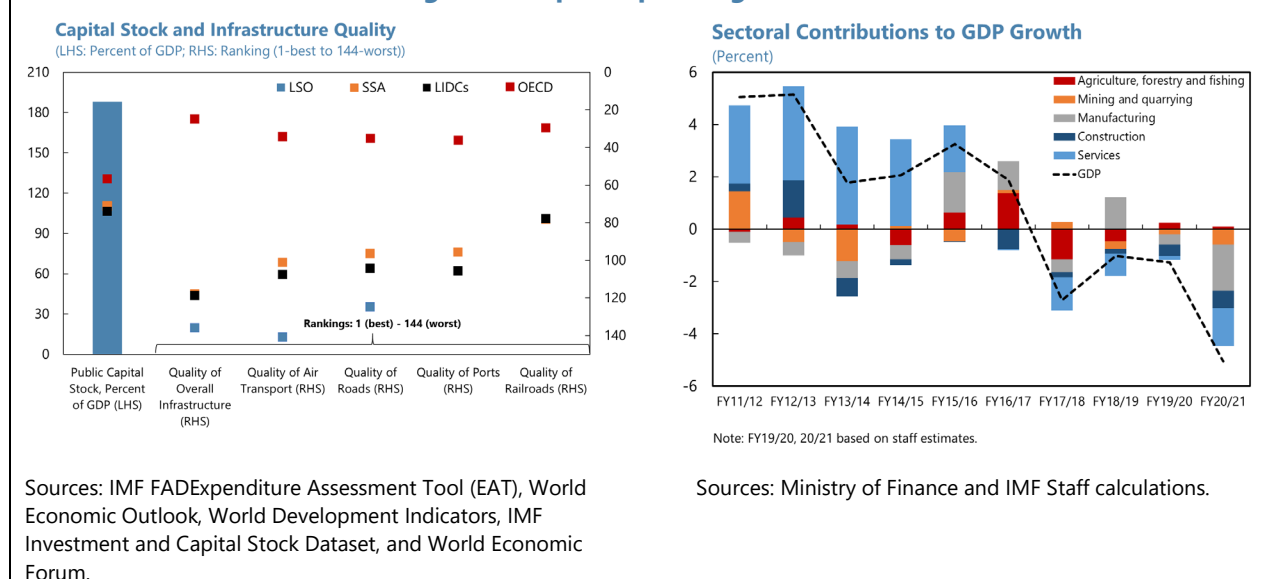
9. Lesotho social spending ranks among the highest within the region. Social spending is also twice that of its neighbors on social protection spending as a share of GDP (World Bank 2021, Figure 6).



10. Capital expenditure has been on a declining path for much of the past decade—both as a share of GDP and as a share of total expenditure. From a recent peak in FY11/12 of 20.2 percent of GDP and around a third of expenditure, by FY20/21 it had fallen to 12.0 percent of GDP and around a fifth of expenditure. Capital expenditure has been squeezed as overall revenues have declined in the context of rigid current expenditures. There are also capacity issues in line ministries that slow the development of ‘bankable’ projects consistent with national priorities and that result in uneven quality of project appraisal. Concerns were also raised about the legacy of current expenditure costs associated with some donor-financed capital projects.

11. Public investment should finance areas where it will have the maximum growth impact, crowding in private sector investment, and reducing poverty. The capital budget has so far produced a capital stock that is relatively high as a share of GDP but of lower quality compared to peers (Figure 7). Streamlining the budget by identifying and minimizing stalled projects and misclassified current spending—as well as improving investment appraisal and execution—will help ensure that capital spending is more efficient and better targeted to achieve development priorities and maximize growth.

Figure 7. Capital Spending in Lesotho



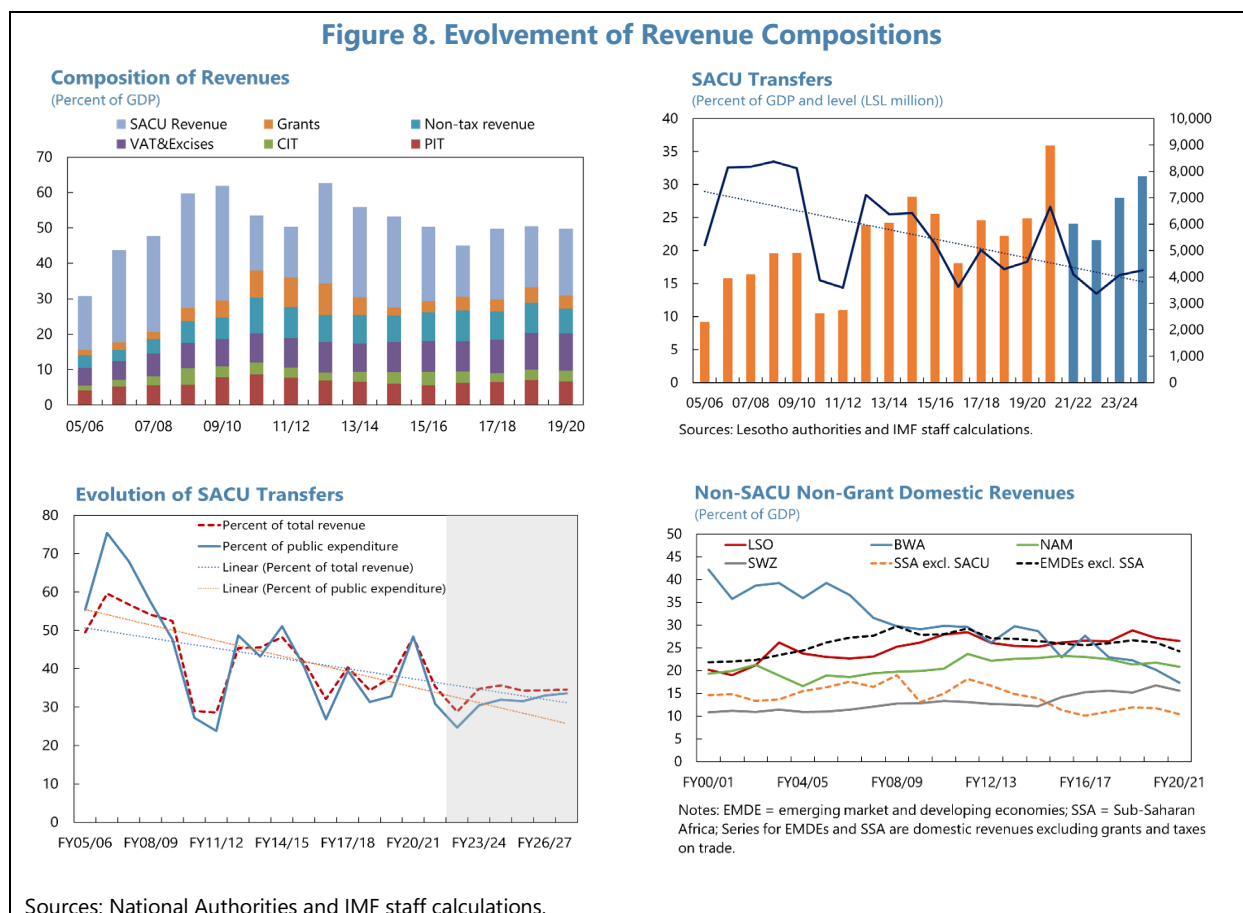
C. Analyzing Revenues

12. Lesotho has become reliant on external SACU transfers. Total revenue comprises external transfers (grants and SACU transfers) and domestic revenues. The latter includes tax revenues—including personal income tax (PIT), corporate income tax (CIT), VAT and excises—and non-tax revenues, for example, water and mining royalties. Overall, the share of external transfers has been declined from 60 percent in late 2010s to around 50 percent in recent years (Figure 8).

- **SACU transfers have been volatile over time and appear to be declining over time.** SACU transfers to Lesotho has been on declining trend in percent of GDP, total revenue, or total expenditures. The outlook of SACU transfers is also very challenging. SACU transfers are forecasted to shrink by a third in FY21/22 and remain subdued thereafter.
- **Lesotho's domestic revenue mobilization has performed well over time.**⁴ Lesotho's domestic revenue in percent of GDP is among the highest in the region.

⁴ See SIP: *An Overview of Taxation in Lesotho*.

Figure 8. Evolution of Revenue Compositions

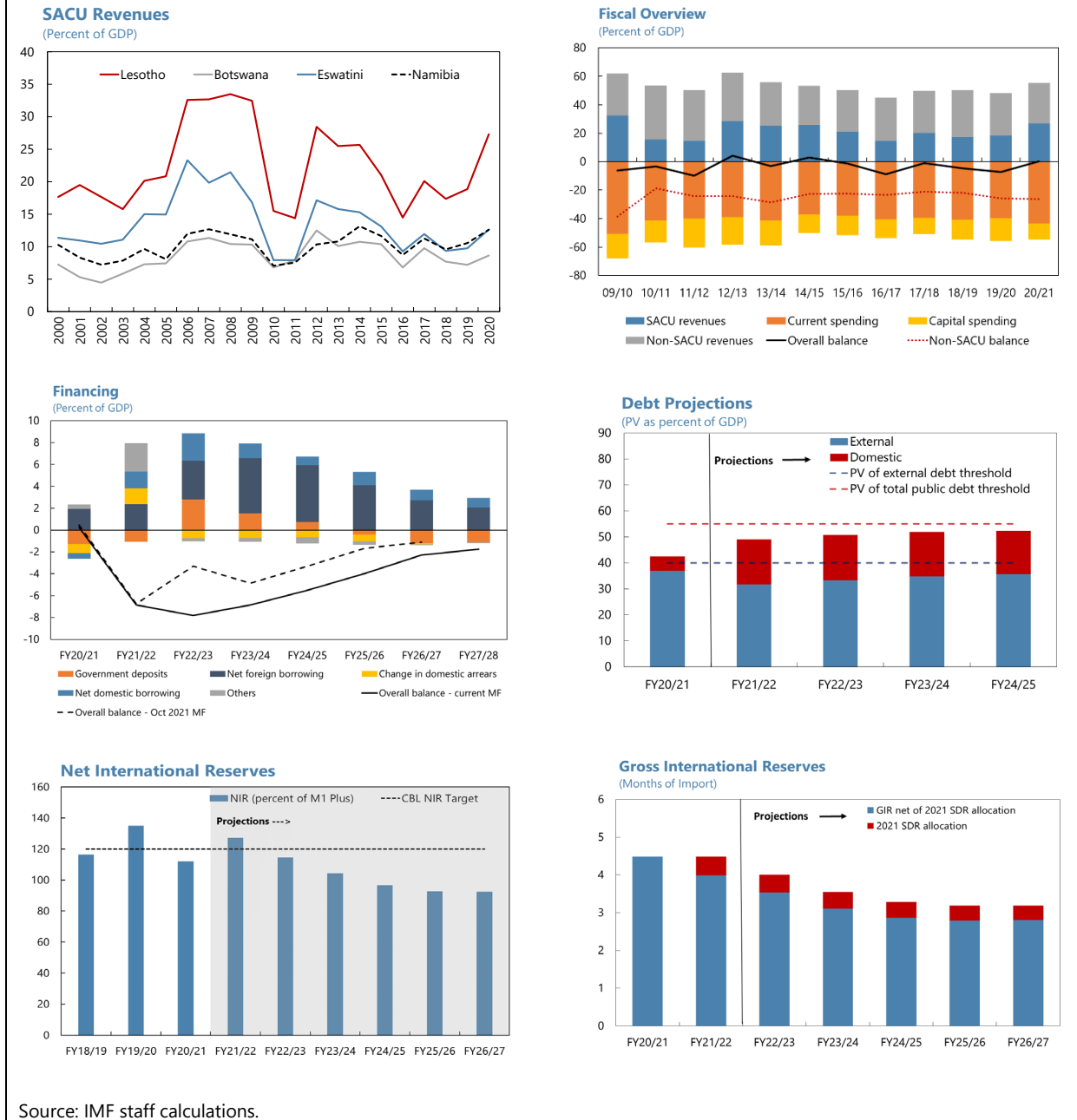


D. Analyzing the Overall Fiscal Balance

13. Lesotho faces increasing fiscal challenges. Benefited from generous SACU transfers, Lesotho has maintained very high expenditure levels. However, SACU transfers are very volatile while the spending seems much rigid in downward adjustment, as a result, the total spending in percent of GDP has been increasing and the deficit (excluding SACU transfers) has been deteriorating.

14. Fiscal pressures under the current policy scenario are causing financing constraints to bind, risking debt sustainability and the peg (Figure 9). Lesotho experienced chronically large fiscal deficit and a growing debt burden, beyond 60 percent of GDP. The high levels of government spending and debt are limiting room for maneuver. Under current policies, the IMF, and World Bank Joint Debt Sustainability Analysis (DSA) showed that the present value of public debt would rapidly approach threshold after which the country is at high risk of debt stress. Net international reserves would decline to below 100 percent, and gross international reserves will go below 3.5 months of imports coverage.

Figure 9. Fiscal Pressures Drive Financing Needs and Debt



E. Policy Recommendations

15. Fiscal consolidation is crucial to reduce imbalances and rebuild much-needed fiscal space to protect the vulnerable, finance the recovery, and mitigate external shocks. Given the already high revenue ratio, the highest among SACU countries, expenditure must bear the brunt of adjustment. The authorities must find ways to contain current spending, scale back unproductive capital spending, and improve efficiency to ensure fiscal sustainability and preserve macroeconomic

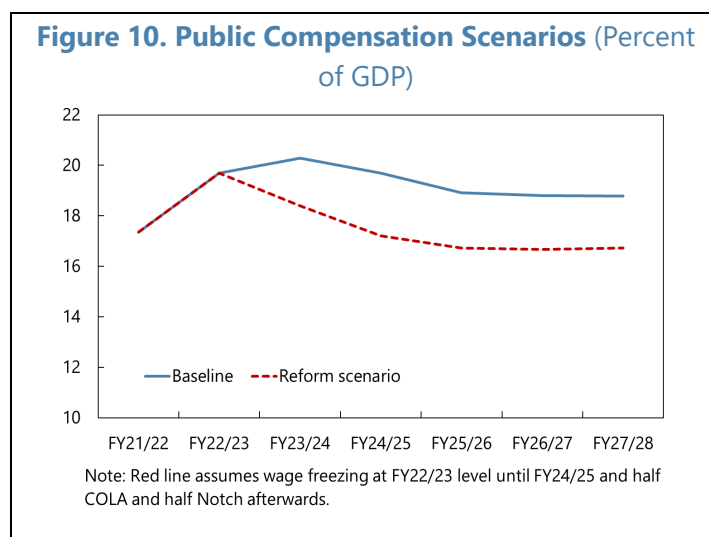
stability. The risk of overly ambitious revenue projections and high expenditure jeopardize not only fiscal sustainability, but also resources needed to sustain the exchange rate peg.

16. Lesotho's public expenditure in percent of GDP is among the highest in the world, which poses significant challenges to fiscal and debt sustainability; instead of cross-board cutting, it is advisable to take targeted cutting on specific items to support growth, specifically:

- *Contain the wage bill.* Spending of public employee compensation accounts for around 20 percent of GDP or over 70 percent of domestic revenues. If the country can freeze the public wage and size the of public employee for 2–3 years, this can reduce wage bills by 3–5 percentage points of GDP or to below 60 percent of domestic revenues (See Para. 18).
- *Rationalize the social spending.* Eliminating the ghost OAG beneficiaries, significantly cutting the budget transfers to tertiary bursary program while enhancing poverty-reducing social programs could reduce social spending in percent of GDP by about 2–3 percentage points while increasing poverty-reducing by 0.5–1 percentage point of GDP (See Para 19).
- *Improve capital spending efficiency.* Lesotho's capital spending accounts for 12–15 percent of GDP, much higher than neighboring countries. However, the outcome is poor. It is advisable to enhance the selection of capital projects while there is some room for cutting in capital spending (See Para. 20).

In nutshell, the above measures could save spending by 5–8 percentage points of GDP, which should improve Lesotho's fiscal situation dramatically and get on sustainable path.

17. Compensation of public employees is surely an area for savings. It is advisable to adopt the following structural reforms to contain wages. Over 4 to 5 years, public wage bill in percent of GDP could be lowered by 3–5 percentage points (Figure 10) and from 70 percent to below 60 percent of domestic revenues.



- a. *Implement a wage freeze* with no cost-of-living-adjustments ("COLA") and no structural wage increases ("notches") for 2 to 3 years and then half "notch" and half "COLA" for 1 to 2 years;
- b. *Freeze the number of public services.* Close established positions that have been vacant for 12 months or more and freeze the hiring of non-essential public servants, and fill existing posts by re-deploying the existing work force as needed. The definition of essential positions will be determined by the Establishment Committee. This definition and the requirement to close long-vacant positions will be recorded in the Civil Service Establishment Policy and published online. If the Establishment Committee deems that those temporarily hired under the Apprentice Program are nonessential, the Apprenticeship Program should be wound up. While apprenticeships have provided valuable training and transferable skills to those looking to enter the job market, it should be noted that absorption of young people into the public sector has undermined the recruitment in the private sector.
- c. After two to three years of freezing period, *add steps within job grades and reduce associated pay increases to slow remuneration growth.* Explore the introduction of performance-based compensation.
- d. Alongside measures to curb the high wage-to-GDP ratio, efforts should *review and adopt a new Civil Service Employment Policy* that aims to maintain a sufficiently lean, professional, and highly efficient civil service.

18. Prioritizing poverty-reducing social spending is essential to protect the vulnerable.

However, the size of Lesotho's social spending stands out within the region as being relatively high as a share of GDP and so it is advisable to eliminate/minimize inefficient spending and better re-allocate across existing social programs. In addition, it is advisable to use new technologies to help reduce both leakage and the cost of operations.

- *Continue to eliminate false payments to "ghost" pensioners under the Old Age Pension Program (OAP).* According to the same World Bank study (World Bank 2021), there are around 38 percent of ineligible OAP beneficiaries. Assume cleaning up these ineligible beneficiaries (removing 34 percent with 4 percent as cushion) during year T=1 and then 6 percent of natural growth of the program to capture the natural increasing of beneficiaries. To do so, it is necessary to link the new OAP management information system—Government of Lesotho Social Assistance Benefits System (GOLSABS)—with the National Identity and Civil Registry (NICR) via a secure exchange of data to ensure program integrity and help eliminate "ghost" pensioners.
- *Reduce the cost of the tertiary bursary scheme over time,* which is currently financing many students who do not need support. These cuts will start in T+1 (e.g., FY22/23) by reducing the intake of new students and further reducing costs by enhancing collection of

outstanding student loans and improving the targeting of the scheme through means-testing approach.

- *Increase spending on key poverty-reducing social assistance programs.* Specifically, spending on the cash-for-assistance, child grants, orphans and vulnerable children, public assistance, and school feeding programs will be increased to expand coverage and adequacy of benefit levels and help alleviate poverty and inequality. Increased social spending on these specific programs can also help offset the regressive impact of any tax policy changes. Specifically, double school feeding program and jump public assistance, OVC bursary and cash-for-work programs by fifty percent.

Figure 11 and Table 2 show the combined considerable results of these reforms. Total social spending could be reduced by 2–3 percentages of GDP over three to four years while poverty-reducing spending could be improved from 1.4 to 1.6 percent of GDP.

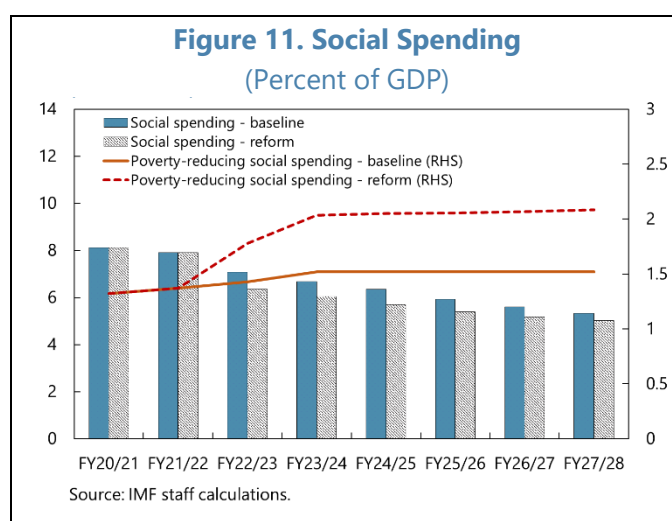


Table 2. Lesotho: Simulation of Social Program Reforms

	Base*	growth rate	T+1	T+2	T+3
<i>Poverty-related social programs to be enhanced</i>					
CGP	0.16	0.3	0.19	0.23	0.28
School feeding	0.51	0.3	0.61	0.74	0.91
Cash-for-work assistance	0.27	0.15	0.28	0.31	0.33
Public assistance	0.08	0.15	0.08	0.09	0.10
OVC bursaries	0.20	0.15	0.21	0.23	0.25
Total (floor)	1.21		1.38	1.60	1.86
<i>Programs to be contained</i>					
Tertiary bursary	2.71		1.75	1.15	0.75
OAP	2.19	0.08	1.34	1.36	1.37
<i>Programs to be maintained</i>					
Other social spending	1.72		1.66	1.65	1.64
Total social spending	7.84		6.13	5.76	5.62

Note: in LSL millions

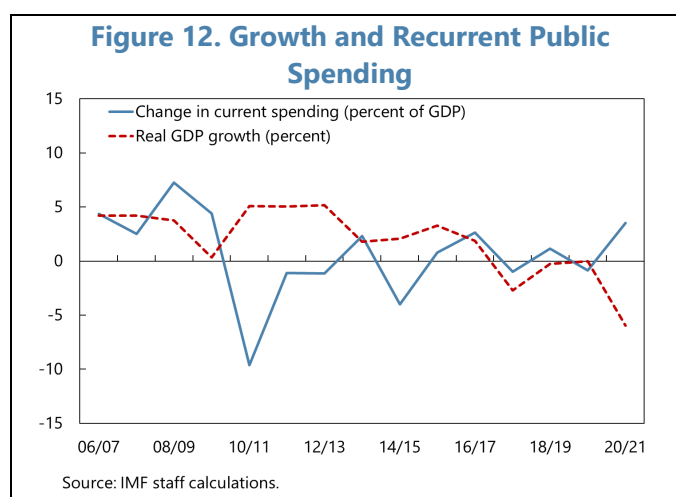
* data are from the authorities.

** Cleaning up inellible beneficareis druing t+1, and then assuming natrual growth of 8 percent.

19. Alongside current spending, the capital budget needs urgent attention to strip out misallocated and unproductive capital spending. The capital budget will be rationalized by identifying and eliminating unproductive projects and temporarily halting stalled projects. Improving investment planning and execution—including project appraisal and prioritization—will also help ensure that capital spending will be better targeted to achieving both the objectives under the NSDP-II and the SDGs. The capital budget can be streamlined further by eliminating inefficiencies, including items of current expenditure misallocated as capital spending. Potential savings can also be deployed to build climate-resilient infrastructure. Particularly, the government funded capital investment projects should be cleaned up and then enhanced to support growth.

20. Cost-cutting measures will also benefit from the compilation of a registry of government assets. This registry will help with the identification and disposal of unnecessary public nonfinancial assets, which can help raise funds and reduce costs. Such savings, for example, would include the reduction of the government vehicle fleet.

21. Fiscal consolidation along the above lines would be growth friendly. Rising expenditure in recent years has not led to higher growth, perhaps owing to inefficiencies. Fiscal consolidation through scaling back less-productive expenditure while focusing on more efficient, well-targeted spending, growth-friendly investment, and revenue administration could, therefore, mitigate risks to growth (Figure 12). Nonetheless, strong social safety nets remain important to protect the vulnerable.



22. Domestic revenue mobilization can still help support the adjustment. While (non-SACU non-grants) domestic revenue performance—driven by stable personal income tax revenues, VAT, and water royalties—stands out relative to peers, the authorities are encouraged to use all available opportunities to broaden the tax base, improve tax administration, and increase compliance so as to help maximize resources as external transfers decline. These include (i) introducing excises on alcohol and tobacco; (ii) improving the efficiency of tax administration by introducing cashless tax collection systems, and (iii) improving compliance by enhancing transparency and audit. It is also vital to maintain the integrity of existing taxes, notably the VAT.

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EVALUATING FISCAL RULES FOR LESOTHO¹

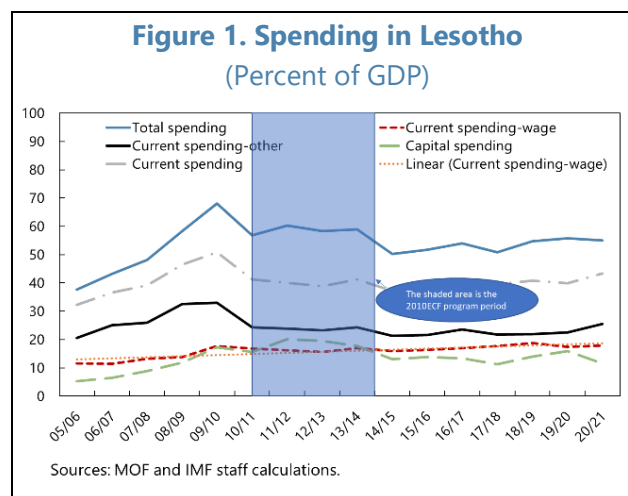
A. Introduction

1. Fiscal rules help set permanent constraints on fiscal policy and—with the appropriate institutions—reduce uncertainty about future fiscal policy developments. While recognizing that history, tradition, and preferences—in addition to economic factors—may cause the optimal size of government and public debt to vary, the political economy literature has shown how the political and institutional environment can lead to distortions in the conduct of fiscal policy, resulting in outcomes that may be undesirable from society’s point of view. For this reason, fiscal rules have developed to help impose durable constraints on fiscal policy through numerical limits on key budgetary aggregates or debt indicators (Schaechter and others 2012, Basdevant 1993).

2. A key challenge for Lesotho is the downward rigidity in public expenditure—which increases when SACU transfers are buoyant but fails to be pared back when they fall. These outcomes are largely due to the difficult political context in Lesotho (Honda and others 2017). Fiscal rules would be of value in Lesotho to help provide constraints on spending and resist political pressure to overspend, while embedding fiscal responsibility within the country’s macro-fiscal framework and ensuring debt sustainability.

3. Fiscal restraint has been exercised in the past, helping to halt the upward trend in overall spending and restoring fiscal sustainability, albeit only temporarily.

Following agreement over an IMF-supported medium-term arrangement in 2010, overall spending gradually declined up until FY14/15. However, following exit from the program and in the absence of durable institutions to provide strong check and balances, past bad behaviors—as well as political tensions in 2014—reemerged to erode fiscal restraint (Figure 1).



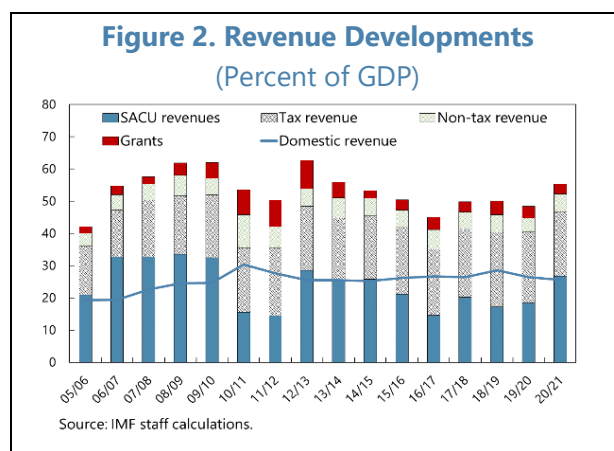
4. This paper evaluates options for fiscal rules for Lesotho. Section 2 provides some background on the fiscal situation in Lesotho and motivation for the importance of fiscal rules; Section 3 reviews the types of fiscal rules and their pros and cons. Section 4 discusses the institutional framework required to help underpin a sound fiscal-rule framework. Section 5 posits a possible fiscal-rule framework for Lesotho and offers a roadmap to introduce the framework.

¹ Prepared by Yibin Mu.

B. Revenue and Spending in Lesotho

The Macro-Fiscal Context in Lesotho²

5. **Total revenues have been on a declining trend since their peak of 66.5 percent of GDP in FY06/07.** SACU transfers contributed 44 percent of total revenues on average over the past 15 years and have accounted for 85 percent of the decline over the past 15 years. Domestic revenues have been relatively stable at just under 25 percent of GDP but fell as a share of GDP in FY20/21 during the pandemic (Figure 2).



6. **SACU transfers are the main driver of overall revenue volatility.** Grants are also a significant contributor to overall revenue volatility. Table 1 shows two measures of variability by source of revenue over the past 15 years (King 2021):

- **The average absolute contribution to total revenue year-over-year (y/y) change.** SACU transfers contribute to growth four times more than the next largest revenue source (taxes on income, profits, and capital gains). With SACU transfers contributing 10.0 percentage points to revenue growth on average, all else equal, expenditure would have to rise or fall by 10 percent from the previous year to avoid any impact on the fiscal balance due to SACU transfers' volatility alone.
- **The standard deviation of the absolute contribution to total revenue y/y changes** (i.e., the volatility of those contributions which reflects the combined effects of the volatility of the underlying revenue stream and its size relative to total revenue). The variability (standard deviation) of the contribution of SACU transfers to overall revenue volatility is again over four times greater than the revenue item with the second largest variability (grants).

² Please see SIP: *Addressing Fiscal Pressures*.

Table 1. Lesotho: Summary of Revenue Changes Contributions and Volatility

15 years from 2007/08 to 2021/22 (July 2021 forecast)	Level	Growth	
	Average share of total revenue (%)	Average absolute contribution (ppts)	Standard deviation of growth contribution (ppts)
	Total revenues	100.0	10.6
<i>of which</i>			
SACU receipts	43.6	10.0	13.9
Non-SACU receipts	56.4	5.9	6.8
<i>of which</i>			
Taxes on income, profits, and capital gains	21.1	2.4	2.2
General Taxes on Goods and Services	13.9	1.5	1.4
Grants: From international organisations	7.2	2.3	2.9
Water Royalties - LHDA	5.0	0.8	1.2
Rent	2.3	0.9	1.4
Dividends	2.2	1.7	2.4
Excise taxes	1.9	0.6	0.7
Grants: From foreign governments	1.1	0.6	0.8
Electricity 'Muela	0.5	0.2	0.4
Other revenues	1.2	n/a	n/a

Source: King 2021.

7. On expenditure, certain key components have proven downwardly rigid over time.

Wage spending is the largest component of both current spending (45 percent) and overall spending (30 percent) and has been on an increasing trend over time (Figure 3). Given the politicization of civil service employment, wages tend to be a protected spending item, with unsuccessful efforts to rein them in over time. As a result, when revenue constraints bind—for example, due to a dip in SACU revenues—other items of spending, typically capital spending, are cut to make room. As a result, the share of capital spending in the total spending has been on a declining trend since FY12/13.

8. With little adjustment in spending, the pattern of the overall fiscal balance is heavily impacted by volatile SACU transfers, with debt drifting upwards over time. However, the overall balance does not recover as quickly as SACU transfers on account of the rigidity in spending. For example, the overall balance in FY19/20 was still deteriorating while SACU transfers recovered (Figure 4). As a result, total public and external debt have been increasing over the past decade, reaching close to 60 percent and 50 percent of GDP, and projected to go beyond them in the next few years, respectively (Figure 5).

Figure 3. SACU Transfers, Capital Spending, and Wages

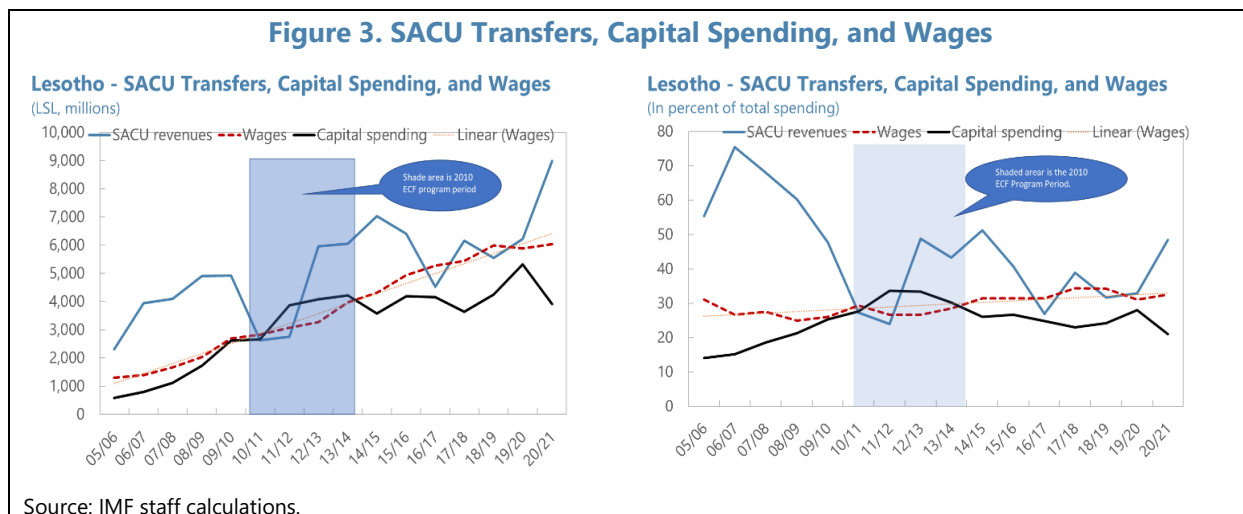


Figure 4. Fiscal Balance and SACU Transfers (Percent of GDP)

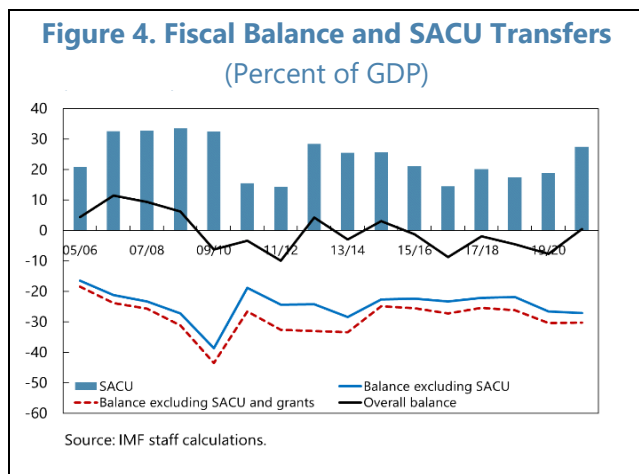
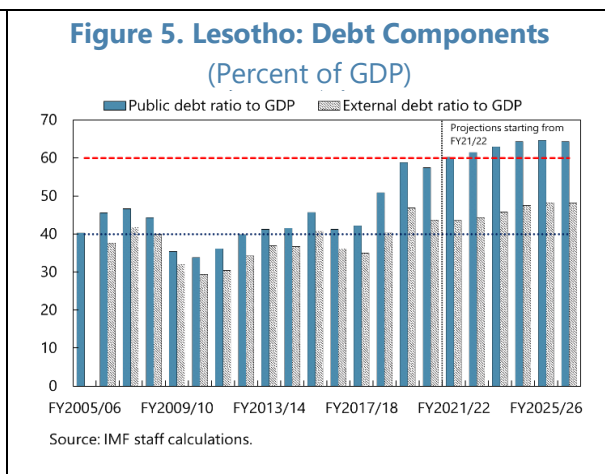


Figure 5. Lesotho: Debt Components (Percent of GDP)



Existing Fiscal Principles and Targets in Lesotho

9. Lesotho has established several fiscal objectives and complementary fiscal targets, which are set out in the Budget Strategy Paper (BSP) (Table 2). The principles are a mix of the *quantitative* (ii.a, ii.b, and ii.c)—setting bounds or specific targets—and *qualitative* (i, iii, iv, v, vi)—setting out key priorities. Since FY09/10, only one of these principles have been met each year (Table 3). Under the authorities’ current forward-looking medium-term fiscal framework, it would be very challenging to meet any of these principles in the coming three years.

10. Given current trends and the already high wage bill, ensuring wages do not grow as a share of GDP (principle ii.b) would be ambitious without specific targeted measures. More generally, the key drawback of expressing this rule in terms of GDP is that in practice it could be pro-cyclical and undermine fiscal sustainability as the wage bill could rise in years of strong GDP growth, but would then be difficult to reduce in absolute terms in years of weak GDP growth or economic contraction. This could therefore result in the wage bill actually rising as a share of GDP. Between FY09/10 to FY20/21, the rule would have been met five times and missed seven times (Table 3). In the FY22/23 Budget, it will be met once and missed twice over FY21/22-FY24/25.

Table 2. Lesotho: Existing Fiscal Principles and Targets in Lesotho

Principles	Target categories	Specifications	Where specified
(i)	Overall budget	Adopt a Budget that is affordable, sustainable, and yet responsive to the needs of the country over the medium-term.”	BSP
(ii.a)	Overall fiscal balance	Over the medium-term, bring the overall fiscal deficit to below 3 percent of GDP consistent with long-term GDP growth	BSP
(ii.b)	Wage bill	The Government’s expenditure on wage bill should not be seen growing as a percentage of Gross Domestic Product (GDP) and must be reduced over the medium term alongside measures to streamline the civil service.	BSP
(ii.c)	Ratio of recurrent to capital spending	Consistently constraining the Government’s recurrent expenditure not to grow more than development expenditure.	BSP
(iii)	Public financial management	Improve monitoring, transparency, and accountability mechanisms to ensure expenditure efficiency.	BSP
(iv)	Arrears	Prioritize the elimination and curtailment of accumulation of arrears.	BSP
(v)	Domestic revenue mobilization	Expand domestic revenue mobilization to reduce reliance on volatile and shrinking transfers from SACU.	BSP
(vi)	Golden rule	Over the medium term, the Government’s borrowings shall be used only for the purpose of financing development expenditure and not for recurrent expenditure.	BSP
	Safeguard the peg	Adopt a Budget that is affordable, sustainable, and yet responsive to the needs of the country over the medium-term.	BSP
	Debt limit	The ceilings on total public debt, including guarantees, will be 60 percent of GDP and public external debt will be limited to 40 percent of GDP. Government guarantees will be subjected to an overall limit of 5 percent of GDP.	Debt Management Policy Framework

Sources: Budget Strategy Paper 2021 (Ministry of Finance) and Debt Management Policy Framework (Ministry of Finance).

Table 3. Lesotho: Performance of Existing Fiscal Principles and Targets

	08/09	09/10	10/11	11/12	12/13	13/14	14/15	15/16	16/17	17/18	18/19	19/20	20/21
Current expenditure to grow more slowly than development expenditure													
Current expenditure growth		13%	-10%	10%	7%	20%	4%	13%	10%	-4%	8%	3%	8%
Capital expenditure growth		51%	2%	46%	6%	3%	-15%	17%	-1%	-17%	22%	26%	-26%
Principle met?		Yes	Yes	Yes	No	No	No	Yes	No	No	Yes	Yes	No
Wage bill should not grow as a percentage of GDP													
Wage bill as % of GDP	13.8%	17.8%	16.6%	16.1%	15.6%	16.8%	15.8%	16.2%	16.9%	17.3%	17.9%	17.7%	19.1%
Year-on-year change		3.9%	-1.1%	-0.6%	-0.5%	1.2%	-1.0%	0.5%	0.7%	0.4%	0.5%	-0.2%	1.4%
Principle met?		No	Yes	Yes	Yes	No	Yes	No	No	No	No	Yes	No
Borrowing should only finance development expenditure (over the medium term)													
Net lending	575	-873	-499	-1,876	909	-697	856	-388	-2,729	-652	-1,385	-2,429	153
Capital expenditure	1,733	2,613	2,654	3,863	4,086	4,217	3,574	4,195	4,158	3,453	4,208	5,321	3,914
Principle met?		Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Deficit of less than X per cent of GDP													
Net lending	3.9%	-5.8%	-2.9%	-9.8%	4.3%	-2.9%	3.1%	-1.3%	-8.7%	-2.1%	-4.1%	-7.3%	0.5%
Principle met at 5% of GDP?	Yes	No	Yes	No	Yes	Yes	Yes	Yes	No	Yes	Yes	No	Yes
Principle met at 3% of GDP?	Yes	No	Yes	No	Yes	Yes	Yes	Yes	No	Yes	No	No	Yes

Sources: Ministry of Finance and IMF staff calculations.

11. Ensuring current expenditure does not outpace capital spending (principle ii.c) would require that the composition of total expenditure shifts towards development over time. This principle was introduced to help shift spending towards growth-enhancing investment. In theory, it should be straightforward to operationalize within overall budget ceilings and at the level of Ministries, Departments, and Agencies (MDAs). However, meeting it would not play a direct role in ensuring fiscal sustainability, since the composition of public expenditure does not determine the overall fiscal balance or the path of debt—although it does influence them indirectly to the extent that investment affects GDP growth and domestic revenues. Furthermore, while the BSP implicitly aims for public investment to rise as a share of total public expenditure (via the target for recurrent expenditure to grow more slowly than development expenditure), it does not set an explicit target or floor for public investment. Between FY09/10 and FY20/21, this principle has only been adhered to six times and missed six times. Over FY21/22–FY24/25, this principle will be met twice and missed once. As discussed in the next section, the extent of the misses in years where recurrent expenditure has grown faster than capital expenditure has been on such a scale that capital expenditure has fallen sharply as a share of total expenditure.

12. Principle vi is a classical structural “golden rule” that requires recurrent expenditure to be financed by revenues over the economic cycle. Very simply, the government aims to run (cyclically-adjusted) recurrent budget surpluses such that all public consumption benefiting the current generation should be paid for by that generation. The main drawback of this rule in Lesotho’s fiscal context is that it has typically been very far from binding, so would rarely constrain budget decisions, although that is not the case at present with the deficit historically high and capital expenditure relatively low. This principle has been met comfortably in every year between FY09/10 and FY20/21, given the large SACU transfers. But it is projected to be met over the period FY21/22–FY24/25.

13. The deficit rule (principle ii. a) in combination with the outlook for nominal GDP growth, would determine that profile of the debt-to-GDP ratio and fiscal sustainability. As a member of the SADC, Lesotho is committed to a public debt convergence criterion of 60 percent of GDP. The latest IMF WEO forecast for the next five years points to nominal growth recovering to around 5 percent a year, which is consistent with 3 percent of deficit. On this basis, a deficit limit of 3 percent of GDP is consistent with stabilizing public debt at 60 percent of GDP over the medium term (since $3/60=0.05$). However, the size and volatility of SACU transfers presents problems for a simple overall balance-based fiscal rule (see Section E).

14. Public debt limits and capital expenditure are not covered in the BSP and are set within the *Debt Management Policy Framework (DMPF)*. This document states that “the ceilings on total public debt, including guarantees, will be 60 percent of GDP and public external debt will be limited to 40 percent of GDP. Government guarantees will be subjected to an overall limit of 5 percent of GDP. The government will not be able to borrow in the form of additional net borrowings or issue additional net guarantees beyond these ceilings”. It also states that “[t]o provide adequate fiscal flexibility with respect to debt ceilings, a trigger level of debt limit is being established for public debt, excluding guarantees, at 50 percent of GDP, for public external debt at

35 percent of GDP, and for government guarantees at 3 percent of GDP. When outstanding debt breaches this threshold, the government will be required to initiate a fiscal adjustment mechanism that will steer the debt below the threshold levels". There are also older legislated limits still in force on external and domestic debt stemming from *the 1967 Loans & Guarantees Act and subsequent Amendments* (which place a very high limit on debt by stating that it must not exceed the past three years' recurrent revenues).

15. The BSP does not set out 'escape clauses' or stipulate how quickly or by what means deviations from targets should be addressed. This may be reasonable for targets that can be revisited in each BSP and adjusted to reflect current economic conditions, but it would be problematic for fiscal rules that are established in legislation. This has been recognized in the draft PFM Bill, which incorporates a section on deviations from targets.

C. Fiscal Rules—Types and Practice Experience

Types of Fiscal Rule

16. Countries committed to a medium-term fiscal framework typically anchor fiscal policy on a numerical rule relating to the budget balance, public expenditure, and public debt (Davoodi and others 2022). The chosen rule needs to support, but need not be identical with, the ultimate objective of the policymaker. The literature on fiscal rules sets out 5 types (Table 4).

- **Expenditure rules set limits on total, primary, or current spending.** Expenditure ceilings directly define a limit on public resources that can be used by the government and are, in general, relatively easy to communicate and monitor. Such limits are typically set in absolute terms or growth rates, and occasionally in percent of GDP with a time horizon ranging from between three to five years. These rules are not linked directly to the debt sustainability objective since they do not constrain the revenue side. They can, however, provide an operational tool to trigger the required fiscal consolidation consistent with sustainability when they are accompanied by debt or budget balance rules. Furthermore, they can constrain spending during temporary booms, when windfall revenue receipts are temporarily high and headline deficit limits easy to comply with. Moreover, expenditure rules do not restrict the economic stabilization function of fiscal policy in times of adverse shocks as they do not require adjustments to cyclical or discretionary reductions in tax revenues. Even greater counter-cyclicality can be achieved by excluding cyclically-sensitive expenditure items, such as unemployment support, however, at the expense of creating a bigger distance to the sustainability target. Also, expenditure rules are not consistent with discretionary fiscal stimulus.
- **Revenue rules set ceilings or floors on revenues and are aimed at boosting revenue collection and/or preventing an excessive tax burden.** However, setting ceilings or floors on revenues can be challenging as revenues may have large cyclical components, that fluctuate with the business cycle. Exceptions are those rules that restrict the use of "windfall" revenue for additional spending. Revenue rules also could result in procyclical fiscal policy,

Table 4. Lesotho: Types of Fiscal Rules

Rules	Definition	Examples	Pros	Cons
Expenditure Rules	Limit total / primary / current spending, either by putting a ceiling on its growth, or on the relevant ratio to GDP.	<i>Namibia</i> : public expenditure levels below 33 percent of GDP. <i>Peru</i> : real growth of current expenditure ceiling of 4 percent.	<ul style="list-style-type: none"> • Clear operational guidance; • Steer the size of government; • Allows for economic stabilization; • Relatively easy to communicate and monitor. 	<ul style="list-style-type: none"> • Not directly linked to debt sustainability as no constraints on revenue side; • could lead to unintended changes in the distribution of spending, e.g., shifting to expenditure categories that are not covered by the rule.
Revenue Rules	Set ceilings or floors on revenues or determine use of windfall revenues.	<i>Kenya</i> : maintain revenues at 21-22 percent of GDP. <i>France</i> : determine ex ante the allocation of higher-than-expected tax revenues.	<ul style="list-style-type: none"> • Can improve revenue performance; • Steers government size; • clear operational guidance; • easy to communicate and monitor. 	<ul style="list-style-type: none"> • Not directly linked to debt sustainability as no constraints on expenditure side; • No economic stabilization feature (can be procyclical).
Overall Balance Rules	Constrain the size of the deficit and thereby control the evolution of the debt ratio.	<i>Indonesia, Israel</i> : overall deficit ceiling of 3 percent of GDP.	<ul style="list-style-type: none"> • Clear operational guidance; allow for economic stabilization; easy to communicate and monitor; closely linked to debt sustainability. 	<ul style="list-style-type: none"> • Could be procyclical; • headline balance could be affected by development outside the control of the government (e.g., a major economic downturn).
Structural balance rule	Account for the business cycle and set up structural budget balance target.	<i>Sweden</i> : surplus of 1 percent of GDP over the cycle.	<ul style="list-style-type: none"> • Countercyclical; linked to debt sustainability. 	<ul style="list-style-type: none"> • Need to estimate the structural balance.
Debt Rules	Set an explicit limit on the stock of public debt.	<i>Liberia, Poland</i> : debt ceiling of 60 percent of GDP. <i>Kosovo</i> : debt ceiling of 40 percent of GDP.	<ul style="list-style-type: none"> • Directly linked to debt sustainability; easy to communicate and monitor. 	<ul style="list-style-type: none"> • No clear operational guidance as policy impact on debt limit is not immediate; • rules could be met via temporary measures (e.g., below-the-line transactions). • Can be procyclical. • Debt could be affected by developments outside the government control.

- as floors do not generally account for the operation of automatic revenue stabilizers in a downturn nor ceilings in an upturn. However, like expenditure rules, they can directly target the government size. Most of these rules are also not directly linked to the control of public debt, as they do not constrain spending.
- **Budget balance rules constrain the key budget aggregate that drives the public debt ratio and are largely under the control of policy makers.**
 - **Overall balance or primary balance rules provide clear operational guidance by targeting well-specific quantities and can help ensure debt sustainability.** The main drawback of these rules is that they are less sensitive to the business cycle—leaving little room for maneuver in a period of significant economic upheaval—and difficult to adhere to in the face of spending rigidities. The inclusion of well-defined escape clauses in these rules can help enhance the reaction of fiscal policy to unexpected shocks by allowing for temporary deviations from targets (see below).
 - **Structural or cyclically-adjusted balance rules and balanced “over the cycle” rules explicitly account for economic shocks and are counter-cyclical.** By adjusting for cyclical fluctuations, these rules are more suitable for countries subject to large external shocks, such as unexpected changes in SACU transfers in Lesotho. The drawback is that these rules require significant data and knowhow to estimate the “structural” balance and can be difficult to communicate and monitor. There are several varieties in addition to the common structural balance rules:
 - a. An **“over-the-cycle”** balance rule requires the attainment of a given nominal budget balance ceiling on average over the cycle (IMF 2009). What distinguishes this rule from other budget balance rules is not the budgetary aggregate it constrains but rather how the limit constraining the budgetary aggregate is assessed. Instead of being defined and assessed annually, the limit is typically set and assessed as an average over the years encompassing all stages of the business cycle, including both expansionary and contractionary stages. Such rules tend to have stronger stabilization properties than cyclically-adjusted or structural balance rules (Caceres and Ruiz-Arranz 2010). Indeed, over-the-cycle rules can accommodate not only automatic stabilizers but also discretionary fiscal measures (stimulus or contraction). However, greater flexibility might come at the expense of credibility: these rules can lead to excessively loose or tight fiscal policy at various times during the cycle; that is, they might allow fiscal relaxation or tightening that is not warranted by cyclical conditions or that could be difficult to reverse later. More fundamentally, assessing compliance with the rule requires precise dating of the cycle, which hinges on the methodology used to identify business cycle turning points (peaks and troughs) and the stability of national accounts data (IMF 2018).
 - b. An investment-based **“golden rule,”** which targets the overall balance net of capital expenditure, is less linked to debt. With a zero ceiling, borrowing is permitted to

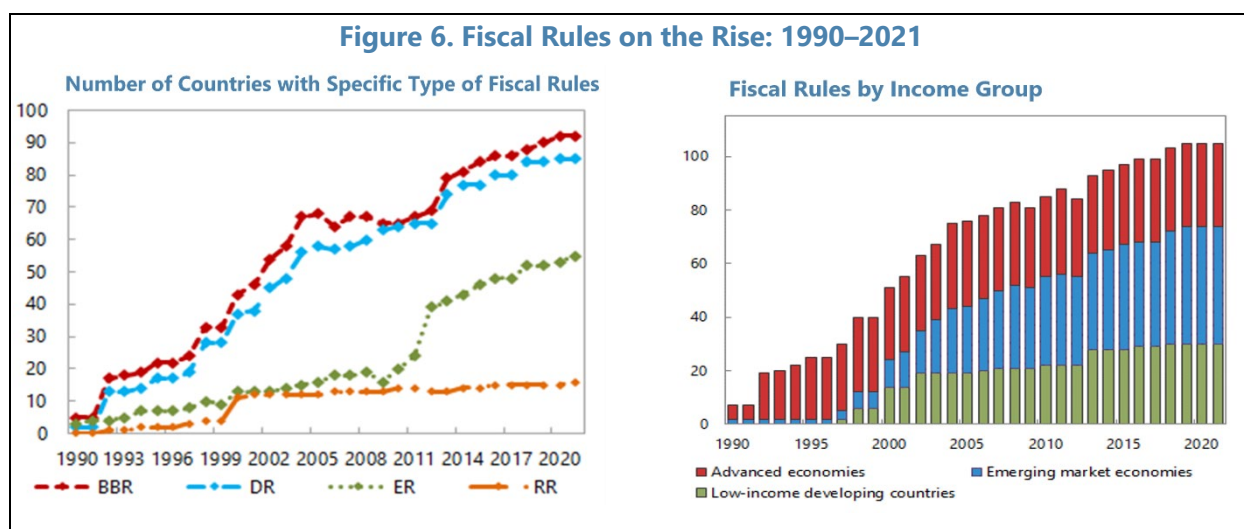
finance investment only; current spending must be covered by revenues. Golden rules are designed to promote and protect capital expenditure, which is seen as more pro-growth and politically easier to cut than other types of spending (IMF 2009). These rules are also more consistent with intergenerational equity than other budget balance rules, since they shift the burden of financing public investment projects from current to future generations, which will be the main beneficiaries of such project. The potential shortcomings without a proper public investment management framework, the possibility of borrowing for investment without restriction can lower incentives for proper cost-benefit analysis, resulting in the selection of projects with low social returns and revenues (Balassone and Franco 2000). In addition, monitoring and enforcement of golden rules is particularly challenging, because the exclusion of capital expenditure favors creative accounting and the reclassification of unproductive expenditures as investment to circumvent the rule (Servén 2007). A particular concern is that, by excluding capital expenditure, the golden rule can allow excessive borrowing and weaken the link between the aggregate targeted by the rule and debt dynamics, creating possible risks to debt sustainability. There are some precedents. In Mexico, for instance, the government excluded capital expenditures made by the national oil company and the state-owned electricity company from the nominal budget balance in 2009; this impeded an appropriate assessment of the fiscal stance and contributed to adverse public debt dynamics (Valencia 2015).

- c. **“Pay-as-you-go”** rules stipulate that any additional deficit-raising expenditure or revenue measures must be offset in a deficit-neutral way. Since they do not set numerical limits on large budgetary aggregates, they are typically considered procedural rules and thus not counted as numerical fiscal rules in the IMF fiscal rule dataset (Schaechter and others (2012)).
- **Debt rules set an explicit limit or target for public debt in percent of GDP.** This type of rule is, by definition, the most effective in terms of ensuring convergence to a debt target and is relatively easy to communicate. However, debt levels take time to be impacted by budgetary measures and therefore do not provide clear short-term guidance for policy makers. Debt could also be affected by developments outside the control of the government, such as changes in interest rates and the exchange rate, as well as “below-the-line” financing operations (such as financial sector support measures of the calling of guarantees), which could imply the need for unrealistically large fiscal adjustments. Moreover, fiscal policy may become procyclical when the economy is hit by shocks and the debt target, defined as a ratio to GDP, is binding. On the other hand, when debt is well below its ceiling such a rule would not provide any binding guidance.

Fiscal Rules in Practice

17. During the past two decades, a growing number of countries across the world have adopted rules-based fiscal frameworks. As of end-2021, about 105 economies have adopted at least one fiscal rule, 11 countries more than the last update in 2015 and 96 countries more than 1985, the beginning of the database period (Davoodi and others 2022).¹ Advanced countries were frontrunners on the adoption of fiscal rules, but they are increasingly common in emerging market and developing economies especially since the late 2000s. As of end 2021, the number of EMDEs with fiscal rules were more than double the number of advanced economies.

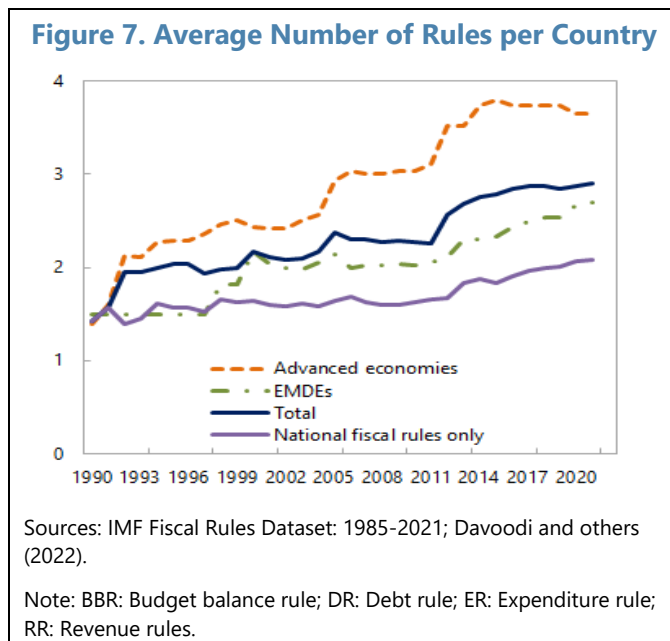
18. The expansion in rules came in waves, driven largely by the adoption of rules in the aftermath of large shocks and the inclusion of supranational rules (Figure 6). For example, in the early 2000s, the increase was driven by the adoption of national rules in emerging markets as well as supranational rules in low-income developing countries. National rules in emerging markets have often been adopted to commit to fiscal adjustments in the wake of a crisis (e.g., Colombia, Brazil, India), lock in gains from reforms (e.g., Chile, Mexico, Poland), or avoid procyclical spending owing to volatile natural resource prices (Mongolia, Russia).



19. The average number of fiscal rules per country has also increased steadily during the last two decades (Figure 7). Countries had an average of about three fiscal rules in 2021 up from about 2 in the early 2000s. Some have considerably more. The increase has been more pronounced in Europe, where many countries have adopted own national rules along with the supranational

¹ The fiscal rule dataset contains 106 economies (Canada was included as historically it had adopted fiscal rules) comprising four main types of fiscal rules: expenditure rules, revenue rules, budget balance rules, and debt rules. The fiscal council dataset covers more than 50 fiscal councils on a de-jure basis and describes their mandates, structure, and operational independence.

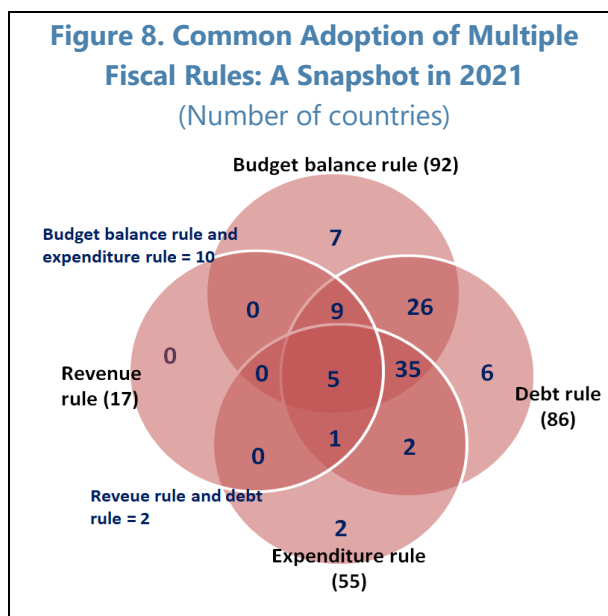
rules in European Union. The use of multiple rules in many countries was motivated by the need to achieve multiple fiscal objectives and constrain different budget aggregates. But multiple fiscal rules contribute to the complexity of the fiscal framework and can make compliance more difficult to explain and monitor. In some cases, the large number of rules was related to political difficulties in eliminating existing rules when introducing new rules (Caselli and others 2018).



20. The most common combination is the use of a debt rule together with operational limits on expenditures and/or balanced budgets. About 60 percent of countries with fiscal rules

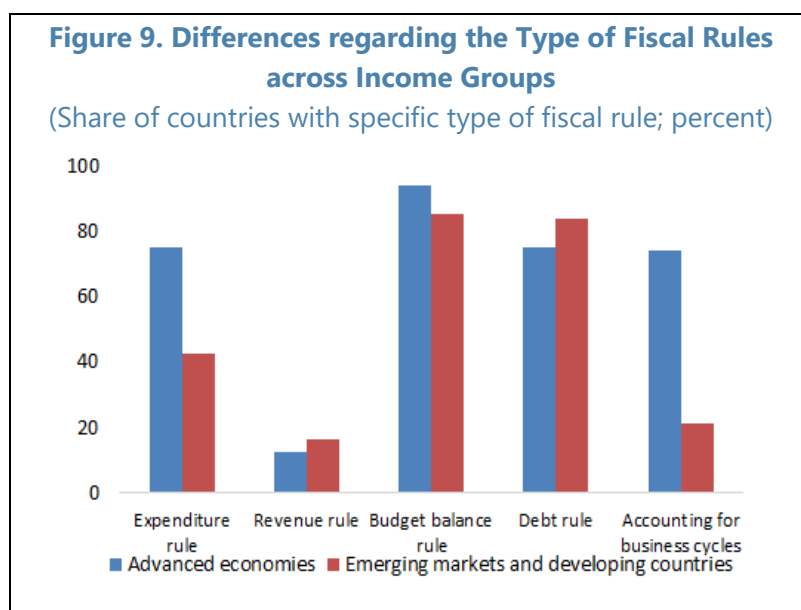
have a debt rule combined with operational limits on annual budget aggregates. Specifically, out of the 105 economies with fiscal rules in 2021, one-third had a debt rule together with a deficit limit and an expenditure ceiling, while another quarter of economies had a debt rule combined with a budget balance rule.

Expenditure rules are increasingly common, often set as a ceiling on annual expenditure growth. Revenue rules have been less used, partly reflecting the fact that revenues are more volatile over business cycles and revenue rules are less well suited for fiscal sustainability. Revenue rules are often set a ceiling on revenue-to-GDP ratio in advanced countries (Belgium, Denmark) to avoid further tax hikes, while the rules are often set as a floor in low-income countries (such as the WAEMU) to encourage greater revenue mobilization (Figure 8).



21. Differences regarding the type of rules tend to persist across income groups.

- Expenditure rules are prevalent, but largely among advanced economies** (Figure 9). About three-quarters of advanced economies have expenditure rules, partly reflecting that several European countries (Austria, Croatia, Greece, Italy, Spain) adopted expenditure rules as part of their national fiscal framework, which aligned to the “expenditure benchmark” that set a ceiling on annual growth of primary spending in the European supranational framework in 2011. However, only less than a third of emerging markets and developing economies adopted expenditure rules (Brazil, Mongolia, Paraguay), possibly reflecting less developed institutional capacity in expenditure controls and the expected rise in spending financed by revenue mobilization efforts.



- Debt rules are particularly common in EMDEs**, with over 80 percent of EMDEs having adopted them. The majority of debt rules is set as a debt limit or ceiling, while about 10 percent of national debt rules uses an *anchor* concept rather than a hard ceiling (Finland, Australia, United Kingdom). Countries could deviate from the anchor levels in an adverse shock and aim to return to the anchor levels over the medium-term. Most countries have the debt rule expressed in percent of GDP, and sometimes the debt rule is set in net present value terms for low income developing countries, as they receive a significant share of concessionary financing.
- Budget balance rules accounting for business cycles are more predominant in advanced economies (Czech Republic, Estonia) than emerging markets (Chile, Colombia)**. Even for the former group, assessing the output gap in real time for budget purposes is challenging. For those EMDEs that have deficit limits accounting for economic cycles, they often rely on thresholds on actual economic activity rather than an output gap concept.

Lessons Learned from International Experience

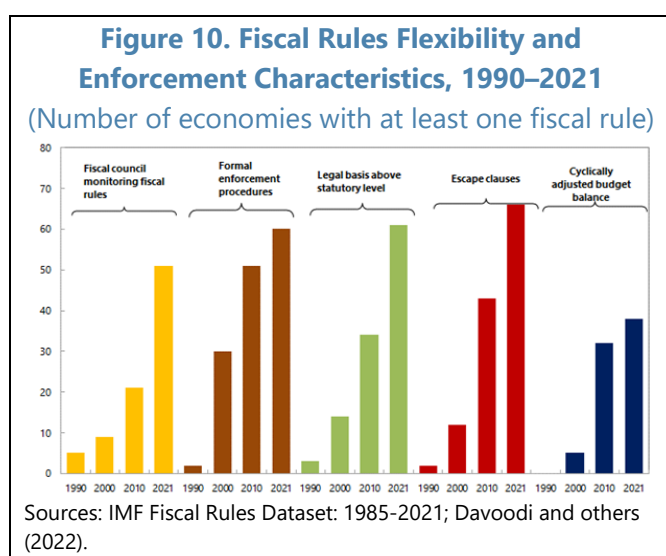
22. Some of the key lessons include on the use of fiscal rules include:

- An adequate public finance management (PFM) framework and political buy-in matter.
- A good fiscal rule needs to strike an appropriate balance between simplicity, flexibility, and enforceability (Caselli and others 2018).
- It is critical to cover a broad range of government fiscal activities to reduce the scope for (i) allocating spending to arrears that are not covered, or (ii) playing accounting tricks.
- It is important to incentivize building fiscal buffers during upturns and allowing for adequate fiscal support during downturns, i.e., ensuring rules are counter-cyclical.
- A good fiscal rule needs to be calibrated in line with sustainability and stabilization objectives, for example, deficits are consistent with stable or falling debt/GDP ratio.
- Given the trade-offs, many countries combine two or more fiscal rules. Not all types of fiscal rules are equally apt to support the sustainability, economic stabilization, and possibly the size of government objectives, even when its design features are fine-tuned. Using a combination of fiscal rules can help address the gaps. For example, a debt rule combined with an expenditure rule would provide a link to debt sustainability while also assisting policymakers with short to medium-term operational decisions, allowing for some countercyclicality and explicitly targeting the size of government. This could similarly be achieved through a combination of a debt and cyclically adjusted budget balance rule.

D. The Institutional Framework for Fiscal Rules

23. **An institutional framework has been developed over time to enhance flexibility, enforcement, and monitoring of the fiscal rules** (Figure 10). The global financial crisis in the late 2000s and the commodity price collapse in 2014–15 prompted countries to revise their fiscal rule frameworks. There were a range of reforms to improve flexibility and operational relevance of fiscal rules, as well as to enhance the monitoring and enforcement of the rules outside the government.

24. **Effective implementation and monitoring of fiscal rules often require a number of supporting arrangements and good institutional framework.** Fiscal rules should be



underpinned by a set of institutional arrangements to convert the intent of the fiscal rule into the reality of budget policy and execution. Fiscal rules can be supported by fiscal responsibility laws (FRLs) which typically set out procedural and transparency requirements, and in some cases also numerical rules. An increasing number of advanced and some emerging economies are using independent bodies (e.g., fiscal councils) to further enhance the credibility of their fiscal rules.

25. A key component of the institutional framework is a strong legal basis for fiscal rules.

An increasing share of countries have legal basis of their national fiscal rules above the statutory level.² In 2000, only 30 percent of countries established fiscal rules in the legislation. The share has more than doubled by 2021, currently more than 60 countries have fiscal rules featured at or above statutory levels such as in the Fiscal Responsibility Law (Armenia, Jamaica, Paraguay) or in constitutions (Brazil, Denmark). As of 2021, over 40 percent of fiscal rules were supported by fiscal responsibility laws (typically specify the numerical rules and set out procedural and transparency requirement), doubled from a decade ago and particularly in EMDEs. Governments could have adopted stronger legal basis as an attempt to make fiscal rules more durable and credible.

26. The desirable legislative support depends on country-specific circumstances. Rules enshrined in higher-level legislation are more difficult to reverse and therefore tend to be longer lasting since they are more difficult to modify even with a change of government. While higher-level legislation thus tends to confer more stability to the framework, this may not necessarily enhance the effectiveness of the fiscal rules if enforcement mechanisms and accountability procedures are weak. For some countries, with weak institutions, the simplicity of adoption and rapid implementation may also be key factors in deciding which legislative framework to use.

27. Escape clauses can provide flexibility to rules in dealing with rare events. They should include (i) a very limited range of factors that allow such escape clauses to be triggered in legislation, (ii) clear guidelines on the interpretation and determination of events (including voting rules), and (iii) specification on the path back to the rule and treatment of accumulated deviations. Formal escape clause provisions exist for budget balance (and debt rules) in Brazil, Colombia, Germany, Mauritius, Mexico, Jamaica, Panama, Peru, Romania, Slovakia, Spain, and Switzerland (Table 5). In all cases, the escape clause provisions allow for temporary deviations from the rules in the event of a recession or a significant growth slowdown. Other triggers include, for example, natural disaster (Brazil, Germany, Jamaica, Mauritius, Panama, Peru, Slovakia, Switzerland), and banking system bailout (Slovakia).

28. Formal enforcement (e.g., automatic corrections of ex post deviations from the rule) can raise the rule's credibility and is increasingly built into fiscal rules. Like with other elements of rules, specifying the mechanism clearly and anchoring it legislation, can help adherence but it is ultimately the political will that matters. Below some examples are summarized (Box 1).

² Most of the fiscal rules are implemented through a mix of political commitments, coalition agreements, and statutory norms (legislative directives or constitutions). For supranational rules established by international treaties.

Box 1. Some Examples of Correction Mechanisms

- The Swiss and German structural budget balance rules contain automatic correction mechanisms (“debt brakes”). In both countries, deviations from the structural budget balance rule (positive or negative) are stored in a notional account. When the accumulated deviation exceeds a threshold improvement in the structural balance are required within a pre-defined timeframe to undo these deviations. The main differences in both countries are the thresholds (1.0 percent of GDP in Germany per ordinary law and 1.5 percent per constitution; and 6 percent of expenditure in Switzerland), and the type of deviations that need to be corrected. In Germany, only those deviations that did not result from errors in real GDP growth projections enter the notional account, while in Switzerland all misses are tallied up. The latter is more transparent but provides less flexibility to accommodate errors outside the control of the government. In Switzerland the excess amount must be eliminated within the next three annual budgets. In Germany, overruns only need to be reduced during an economic recovery to avoid a procyclical tightening and can be corrected via expenditure and revenue measures.
- Poland’s and Slovakia’s debt rules, which set a 60 percent debt of GDP ceiling, include thresholds that trigger actions to avoid that the rule is missed. In the case of Slovakia, when debt-to-GDP ratio reaches 50 percent, the Minister of Finance is obliged to clarify the increase to parliament and suggest measures to reverse the growth. At 53 percent of GDP, the cabinet shall pass a package of measures to trim the debt and freeze wages. At 55 percent, expenditures would be cut automatically by 3 percent and next year’s budgetary expenditures would be frozen, except for co-financing of EU funds. At 57 percent of GDP, the cabinet shall submit a balanced budget. Ideally, the later trigger points would not be needed if effective action is taken earlier on. A caveat is that triggers do not account for the cyclical position of the economy.
- So-called sequesters are another form of automatic correction. In the United States, due to the failure of the Joint Select Committee on Debt Reduction to reach agreement on deficit-reduction proposals, automatic spending cuts (sequesters) are scheduled to take effect from January 2013. In this case, this would be a one-time adjustment to the expenditure path rather than a recurrent mechanism embedded in a fiscal rule framework. Also, sequesters tend to have the disadvantage of creating a bias against capital spending which is the easiest to cut quickly. This was the experience of the United States in the 1990s.
- Kenya’s correction mechanism is a bit light. Under the Fiscal Management Act of Kenya, the Minister of Finance needs to submit a compliance report to the National Assembly, which shall state (a) the reasons why fiscal objectives and targets were not met; (b) the remedial measures being undertaken to ensure that objectives and targets not met will be made good in the next quarter; and (c) any proposed Government policy decisions that may materially affect the objectives and targets in the budget statement of intent or the country’s overall fiscal and economic performance.

Source: Schaechter and others 2012.

E. A Fiscal Rule Framework for Lesotho

Designing a Fiscal Rule Framework for Lesotho

29. The following key characteristics of Lesotho’s fiscal situation should be considered when deciding what rules are suitable for the country (see Section 2):

- (i) The importance of safeguarding the exchange rate peg;

- (ii) The volatility of SACU transfers;
- (iii) The downward rigidity of spending: current spending is driven by a large public sector wage bill;
- (iv) Insufficient room for capital spending, which is nonetheless very large and inefficient relative to SACU peers;
- (v) Weak institutional capacity, and
- (vi) Political instability.

These factors suggest a rule that is (i) countercyclical, and (ii) easy to operate, (iii) easy to enforce.

30. The authorities are considering including requirements to set fiscal principles, objectives, and numerical targets in primary legislation. These are to be included in the pending Public Financial Management and Accountability (PFMA) Bill,³ with the definition of those principles, objectives, and targets left to either underlying regulations or the BSP. In a difficult political environment characterized by upward drift in spending and a reliance on large, uncertain external transfers, it is advisable not to define objectives and targets in primary legislation, since the deviations would risk undermining the credibility of such laws and/or incentivize off-budget activities or other creative accounting techniques/tricks to meet the words but not the spirit of the law.

31. Given the importance of political buy-in to successful fiscal rules, a rule can build on existing targets that have already approved by the Cabinet with some modest changes. Specially, this SIP considers:

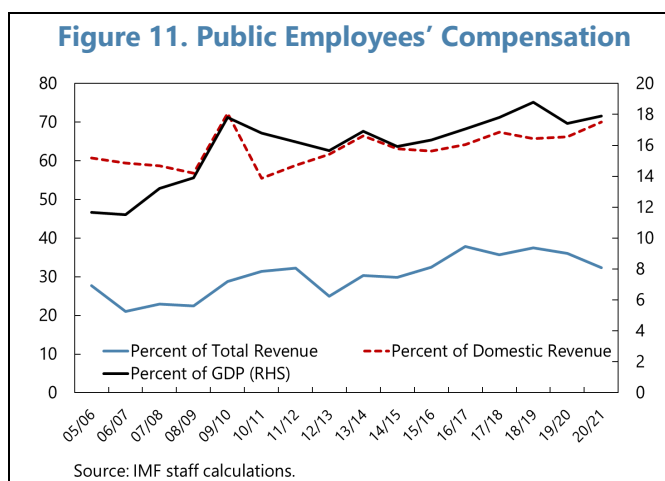
- **Some type of debt rule is necessary to safeguard the exchange rate peg.** The peg arrangement is an important nominal anchor and source of macroeconomic stability. Without debt sustainability, confidence in the peg will likely fade. To this end, the debt ceilings currently under the debt management framework can be converted into a fiscal rule, whereby the ceilings on total public debt, including guarantees, will be set at 60 percent of GDP and public external debt will be limited to 40 percent of GDP. Government guarantees will be subject to an overall limit of 5 percent of GDP. The above should be set out in PFM regulations.
- **Some type of budget balance rule is also needed given that a solitary debt rule will be insufficient to guarantee fiscal discipline.** Debt levels take time to be impacted by budgetary measures and therefore do not provide clear short-term guidance for policy makers (Section 3). Here, we examine two options:

³ The PMFA Bill is currently with the Law Office for reviewing.

- **Option A. Implement a structural balance rule.** Structural balance rules can be countercyclical and overcome the procyclicality of overall balance rules (Section 3). However, given the difficulty of estimating the structural balance for Lesotho, the overall balance excluding SACU transfers and external grants—the most cyclical components—could be a possible alternative to proxy for the structural balance. Assuming (i) SACU transfers and grants are expected to remain at around 14–16 and 2–3 percent of GDP, respectively, and (ii) a 3 percent overall balance is consistent with trend growth, a target overall balance excluding SACU and grants of around negative 20 percent of GDP could be a possible target. This target would have to be revisited at certain intervals as more information is available on the path of SACU transfers—which could change as SACU is integrated further into the African Continental Free Trade Area.
- **Option B. Implement an overall balance rule together with an expenditure rule.** SACU transfers are very volatile. When combined with rigid and steadily increasing spending, the overall balance will be both volatile and growing over time. To address the upward momentum (increasing) deficit over time, it will be necessary to include an expenditure rule that limits expenditure growth to less than nominal GDP growth or (current) expenditure to a certain percentage of GDP.
- **In addition, it is important to introduce a formal target for limiting domestic arrears to make the overall balance rule effective.** Arrears can be treated as an adjustor in calculating the budget balance. The budget balance should be adjusted upward (downward) by the amount of increase (decrease) of arrears.
- **Additional analysis should be undertaken to determine the most useful budget balance rule,** as well as to calibrate the appropriate numerical targets consistent with trend growth.

32. The above two rules could be complemented by two numerical targets to improve the quality of the spending. These targets could be set at the cabinet level such as in the BSP.

- **Switch the wage bill target to a share of domestic revenue from a share of GDP.** The benefits of setting the principle in this way are to avoid some of possible procyclicality of a GDP-based target and to allow the target to be addressed via domestic revenue mobilization as well as by wage restraint. Over the past the decade, wage bill in domestic revenue has been increasing (Figure 11). The goal is to gradually reduce to and then not to exceed 60 percent of domestic revenue.



- Make the existing capital expenditure target explicit once fiscal position has been restored.

33. In a nutshell, given the nature of Lesotho’s fiscal situation and characteristics of various fiscal rules, this SIP recommends two fiscal rules supplemented by two numerical targets to rationalize the composition of expenditures (Table 5). Once the fiscal position has been restored, the authorities could look again at the case for using a stabilization fund to manage volatility in SACU revenues.

Table 5. Lesotho: Suggested Fiscal Rule Framework

Rules/targets	Contents	Setting body
Introduce fiscal rule requirement	Establish requirements to set fiscal principles, objectives, and numerical targets	Parliament, primary legislation (PFMA)
Two fiscal rules		
Debt rule	The ceilings on total public debt, including guarantees, will be 60 percent of GDP and public external debt will be limited to 40 percent of GDP. Government guarantees will be subjected to an overall limit of [5] percent of GDP.	Parliament, e.g., PFM regulations
Option A: Structural balance rule (overall balance excluding SACU transfers and grants)	Reduce the structural fiscal balance (overall fiscal deficit excluding SACU revenue and grants) until it has increased above [-20] percent of GDP consistent with long-term growth trend. This target would have to be revisited at certain intervals as more information is available on the path of SACU transfers. Arrears should be treated as an adjustor to the efficacy of this rule.	Parliament, e.g., PFM regulations
Option B: Overall balance rule	Overall deficit below 3 percent of GDP plus total spending below a certain percent of GDP (to be calibrated).	Parliament, e.g., PFM regulations
Fiscal Targets		
Government deposits with the central bank	Ensure the level of government deposits with the central bank target for NIR.	Cabinet, e.g., BSP
Wage bill	Reduce the wage bill progressively until it has fallen to 60 percent of domestic revenues.	Cabinet, e.g., BSP
Capital expenditure	Once the fiscal position has been restored, consider setting an explicit target for capital or development expenditure (e.g., not to fall below “core” SACU transfers.).	Cabinet, e.g., BSP

A Roadmap to Introduce Fiscal Rules in Lesotho

34. Once the above fiscal rule framework has been agreed, next steps should include the following:

- a. **Develop and enact PFM fiscal rule regulations that characterize the fiscal rules.**
 - **Include requirements to set fiscal principles, objectives, and numerical targets in primary legislation (notably, the new PFMA Bill) but leave the specification of those principles, objectives, and targets to PFM regulations.** In an unstable political environment, missing targets that are specified in laws risk undermining the credibility of the legislation, incentivize off-budget activities, and encourage creative accounting to meet the letter but not the spirit of the law.
 - **Calibrate the precise numerical fiscal targets** which are consistent with preserving debt sustainability and to safeguard the peg.
- b. **Establish mechanisms to ensure fiscal policies are set consistent with fiscal rules.** Set up monitoring, transparency, and reporting arrangements to ensure fiscal outcomes are in line with fiscal rules.
- c. **Define what should happen when rules are missed.**
- d. **Ensure political buy-in.**

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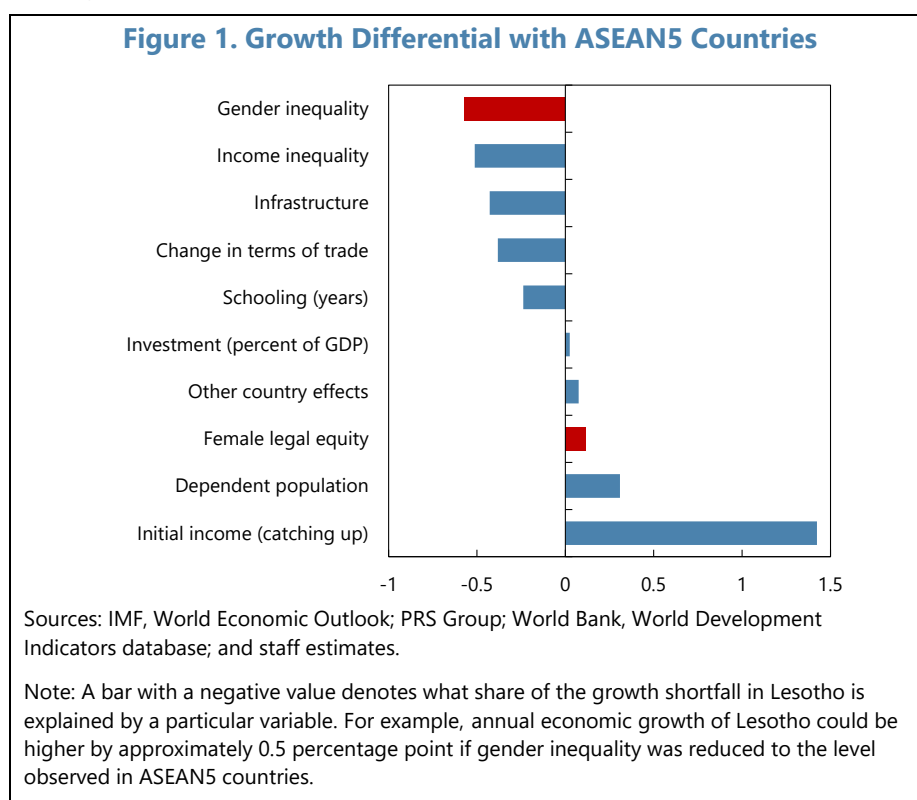
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THE IMPACT OF COVID-19 ON GENDER INEQUALITY¹

1. Gender inequalities in opportunities and outcomes persist in Lesotho and the growth potential from closing the gender gaps is sizable. Gender-based legal restrictions, as well as barriers in access to education, healthcare, financial services, assets, the labor market, and formal-sector employment prevent women from fully and equally participating in the economy. This in turn lowers aggregate productivity and hampers the efficient allocation of talent and resources, thereby weighing down on economic growth. Eliminating gender inequality is thus macro-critical — it can boost productivity and help countries fulfill their growth potential, while enhancing economic stability and resilience.² A 2015 study suggests that closing the gender gap of Lesotho with the ASEAN-5 countries could boost economic growth by 0.5 percentage point, which is comparable to cutting income inequality, and greater than the impact of improving infrastructure. To quantify, we selected a subgroup of ASEAN-5 countries with a strong track record of growth as the benchmark and decomposed the differences in average real GDP per capita growth between Lesotho and these fast-growing countries to determine the role that different factors play in explaining Lesotho’s growth shortfall (Figure 1).³



¹ Prepared by Romina Kazandjian and Zhangrui Wang.

² IMF, *How to Operationalize Gender Issues in Country Work*, IMF Policy Paper (2018).

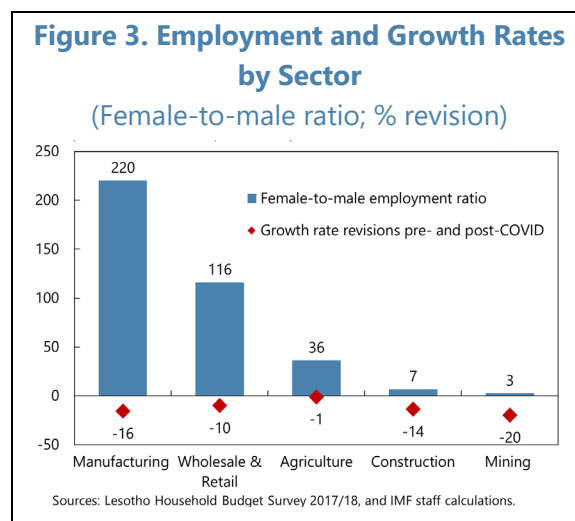
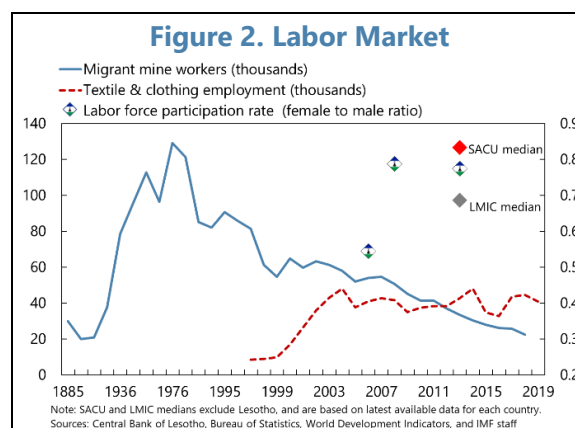
³ ASEAN-5 includes Indonesia, Malaysia, the Philippines, Thailand, and Vietnam. For details of the model, see IMF, 2015, "Inequality and Economic Outcomes in Sub-Saharan Africa," *Sub-Saharan Africa Regional Economic Outlook (October)*.

2. The COVID-19 pandemic is disproportionately impacting women of all ages in Lesotho.

Key drivers include occupational gender segregation in affected sectors, heavier unpaid care work burdens, increased gender-based violence (GBV), and possibly permanent loss of human capital.⁴ To ensure a timely, equitable, and sustainable post-pandemic recovery, both the underlying macro-critical structural gender inequalities, as well as the COVID-related gender-specific setbacks, should be addressed in policies and practice.

3. While female labor force participation has risen in recent years, it is typically concentrated in low-skilled jobs and those sectors badly impacted by the pandemic (a “she-cession”).⁵

Historically, a large number of Basotho men migrated to South Africa to work in the mining sector, which had a direct positive effect on the female-to-male labor force participation ratio. Yet, in the past two decades, while the South African mining industry retrenched Basotho workers, the textile and apparel industries in Lesotho took off, which further improved job opportunities for female job seekers (Figure 2). As a result, female labor force participation significantly improved, but the gender gap is still wider than in other members of the Southern African Customs Union. At the same time, while Basotho men migrate to South Africa to work in the mining sector, women have tended to migrate for work in the domestic help sector. In general, women are more likely to be employed in low-skilled jobs and dominate the labor- and service-intensive industries such as manufacturing, domestic services, wholesale and retail trade, and education—all of which have been among the sectors hardest hit by the pandemic. (Figure 3).

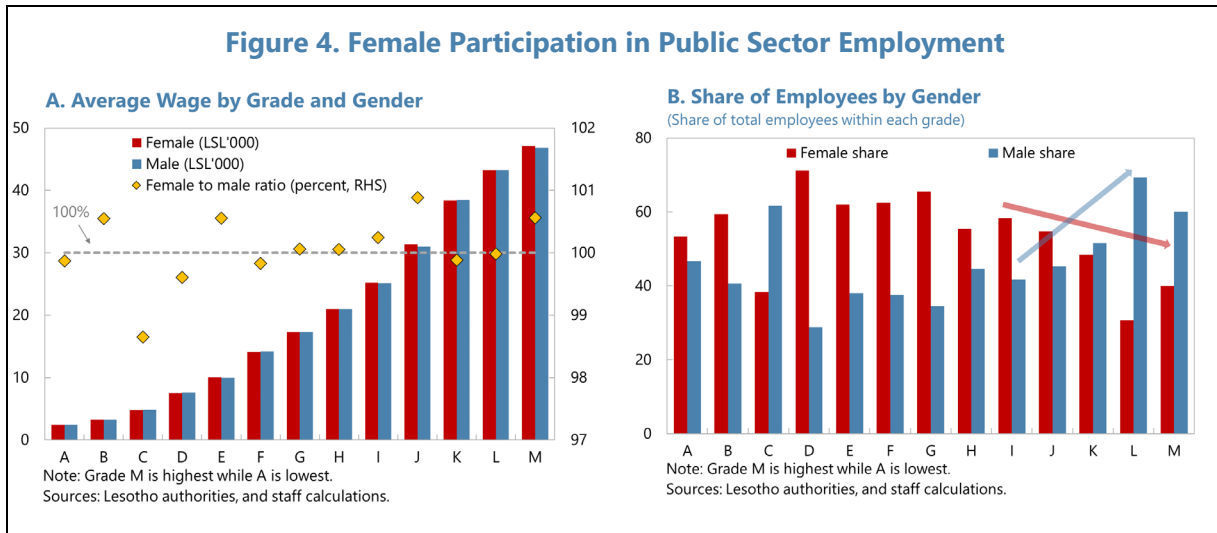


4. Findings suggest an encouraging trend of narrowing gender disparity in public sector employment, but this may be due to women’s self-selection into more female-friendly environments. The small relative gender wage parity within each grade (Figure 4.A.), along with more accommodative compensation and benefit policy, including a 90-day paid maternity leave (including weekends), may have encouraged highly-educated women to seek employment as public

⁴ UNDP-Lesotho, *Socio-economic Assessment of the COVID-19 on Gender Equality and Women’s Empowerment in Lesotho*, Draft Report (2020).

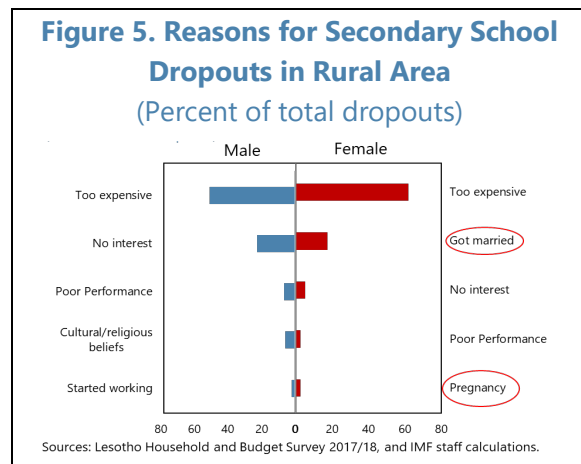
⁵ Ibid.

servants. As a result, women prevail in most lower salary grades (Figure 4.B.). However, the prevalence gradually dilutes into senior positions, and a glass ceiling is forming at the highest levels.

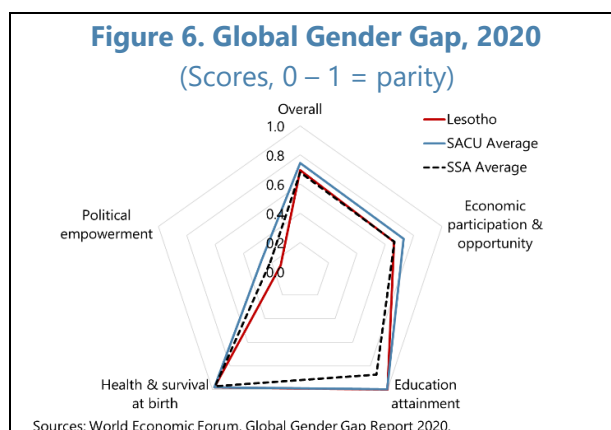


5. COVID-19 has also severely impacted the informal economy, which has a disproportionately large concentration of female workers. Women account for over half of informal workers and employees in health, tourism, and small businesses. Informal vendors who depend on cross-border trade and migrant domestic and industrial workers have also been negatively affected by the South African border closures, while workers in services and manufacturing have suffered losses of income due to the lockdowns and firm and factory closures. In the textiles industry, COVID-19 has disrupted supply chains and made employment, in normal times characterized by low wages and benefits, even more precarious.

6. Female access to education is impressive compared to regional peers, but the pandemic is likely to reinforce the remaining gender-specific barriers to school enrollment. Although women outperform men in terms of literacy and educational attainment, even before the pandemic they had a greater likelihood of dropping out of school primarily for family reasons. Besides costs, marriage and pregnancy are two of the top reasons for the high drop-out rates from secondary schools, particularly in the rural areas (Figure 5). COVID-related school closures are likely to compound this trend as schoolgirls are expected to attend to household chores and care for ailing family members or younger siblings, which may force them to permanently drop out. Socio-economic inequalities may further exacerbate educational opportunities since schoolchildren from poorer households are unable to access education through digital platforms.

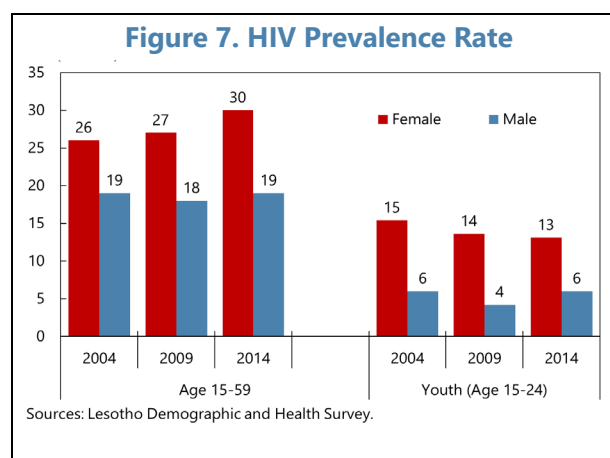


7. Providing better healthcare and support for women can help further boost female labor force participation. Lesotho has a slightly larger female population than male, and it has reduced the gender disparity in sex ratio at birth and healthy life expectancy, so that the global gender gap in these two dimensions has been closed (Figure 6). However, according to the latest data, the maternal mortality rate remains high compared to regional peers with 544 deaths per 100,000 live births, relative to 391 for the East and Southern Africa region. The adolescent birth rate is 94 per 1,000 girls, the fertility rate is 3.1 children per woman, only 60.9 percent of women make their own informed reproductive health decisions, and women's healthy life expectancy at birth is 48 years, compared to 45 for men.⁶



Additionally, health statistics show that in 2018, two of the top three causes of female adult admissions to hospitals were incomplete and threatened abortions, totaling 42.6 percent of female inpatients.⁷ These alarming health outcomes can have a significant impact on the quality of the labor force and on female labor force participation.

8. Disproportionately high HIV prevalence continues to threaten female labor force participation and it may also complicate the COVID-19 response. HIV prevalence rate among women remains notably higher than that among men, and it has been increasing in recent years (Figure 7). This is partly due to GBV, particularly child marriage. The civil law and customary law coexist under the dual legal system, and provide a legal loophole for child marriage.⁸ The negative impacts of child marriage cascade to lower education and health outcomes for girls, with significant setbacks to economic growth: eliminating child marriage would increase long-term annual per capita real GDP growth in emerging and developing countries by 1.05 percentage points (Mitra and others 2020). Also, key legislation on protecting females from GBV, the Domestic Violence Bill, had been under consideration in Parliament since 2000, hampering women's ability to take precautions against HIV infection. The bill is currently under consideration by the National Assembly.



⁶ UNFPA, *World Population Dashboard and Demographic Dividend Dashboard*, Lesotho, 2017.

⁷ Lesotho Bureau of Statistics, *Health Statistics Report 2017–2018*.

⁸ The marriage age is 18 in the Child Welfare and Protection Act, and 16 in the Marriage Act, while there is no age limit in the customary law.

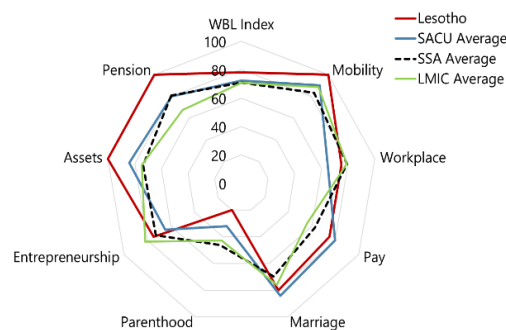
The estimated economic cost of violence against women and girls in Lesotho was as high as 5.5 percent of GDP in 2017 (Commonwealth Secretariat 2020). The pandemic has likely only made matters worse, as civil society organizations and the Child and Gender Protection Unit suggest that the incidence of domestic violence has escalated since the COVID-19 outbreak (UNDP 2020).

9. The authorities have been working on lifting gender-based legal restrictions, but much more remains to be done to eliminate structural gender inequalities.

De jure gender equality has been achieved in property and inheritance, freedom of movement, and pensions (Figure 8, World Bank 2021). The Land Act of 2010 allows equal access to land by men and women (Figure 9), which could potentially improve female access to collateral, and therefore, access to finance. This provides an opportunity for female business owners, who make up the majority of the micro- and small-enterprise owners, to shift to formal financing and expand their businesses. According to some indicators, Lesotho is ahead of regional peers in terms of women’s financial inclusion, with the lowest gap in account ownership, 33 percent for women versus 34 for men.⁹ Yet, large gaps in women’s access to credit remain, as firms led by women are four times more likely than those led by men to have their loan application rejected.¹⁰ Moreover, there is a gap in credit history reporting to the Lesotho Credit Bureau: in the second quarter of 2018, below 12 percent of total credit records were relating to women.¹¹ Due to customary law and traditional gender norms, women still face discriminatory obstacles in access to finance.

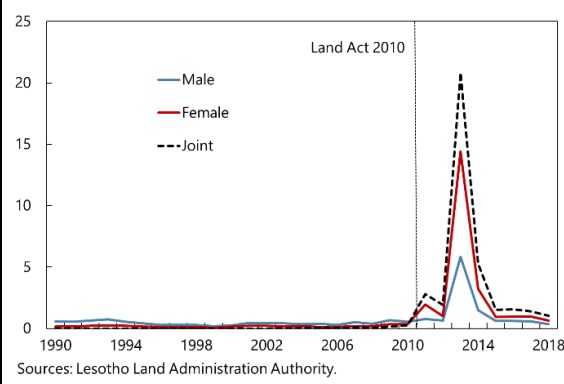
Figure 8. Women, Business, and the Law, 2021

(Higher score = more equality)



Source: Women, Business and the Law, 2021.

Figure 9. Registered Land Leases
(Number of leases, thousands)



Sources: Lesotho Land Administration Authority.

10. Further reforms can improve legal equality in terms of women’s decisions to work, women’s pay, and constraints related to marriage and business ownership. Lesotho lags regional and income-group peers in terms of the laws affecting women’s work after having children. To improve on this dimension of gender equality, the authorities may consider legislating for paid parental leave of at least 14 weeks and having the government administer 100 percent of maternity leave benefits. Finally, since elements in the customary law are still discriminatory against women and girls, the dual legal system continues to present a challenge for women’s rights, for example, by

⁹ Global Findex Database. 2017. *Women’s Digital Financial Inclusion in Africa*.

¹⁰ World Bank. 2016. *Enterprise Survey*.

¹¹ Credit Bureau Compuscan Second Quarter 2018.

creating loopholes that permit child marriages and complicating women's equal rights to inheritance, which is not permitted under customary law. The authorities may consider aligning these legislations and implementing the existing gender equality legal frameworks, as prescribed in Lesotho's National Strategic Development Plan II (NSDP II).¹²

11. More policies to ameliorate the disproportionate impact of the pandemic on women are needed. Such measures will help ensure a more equitable recovery and unlock the growth potential from reducing gender inequality. According to the UNDP COVID-19 Global Gender Response Tracker, out of eight policies instituted by the authorities to combat the effects of the pandemic, only one has attempted to view implications through a gender lens.¹³ Specifically, the government has pledged to launch a grant scheme of LSL50 million for micro-, small and medium-sized enterprises (MSMEs) with less than 50 employees, providing up to LSL20,000 matching grant to companies in the tourism sector, including hotels, restaurants, transport, and food sectors. The measure indirectly addresses women's economic security, as women make up about 76 percent of workers in the accommodation and food services. Other implemented measures that implicitly support women's livelihoods include one-off three-month salary subsidies of LSL800 to 40,000 workers in the textiles industry and payments of LSL500 for registered informal-sector vendors.

12. Due to the disproportionate impact of COVID-19 on women, the authorities should consider bringing a gender lens to pandemic mitigation measures. The authorities can also reinforce efforts to mainstream gender issues by operationalizing de jure rights and regulations and implementing social and gender responsive budgeting in Public Financial Management Reform, as suggested in the NSDP II.¹⁴

¹² The Government of Lesotho, *National Strategic Development Plan II (NSDP II)*, 2018/19 to 2022/23, p.162.

¹³ UNDP COVID-19 Global Gender Response Tracker, accessed on March 30, 2021.

¹⁴ The Government of Lesotho, *National Strategic Development Plan II (NSDP II)*, 2018/19 to 2022/23, p.143.

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POLICY COORDINATION IN LESOTHO¹

A. Introduction

1. The successful pursuit of a country’s macro policy objectives requires efficient and effective coordination of macro policies including fiscal policy and monetary policy. The structure of Lesotho’s economy forces an important need for close coordination between the key macro policymakers within the country—the Ministry of Finance (fiscal) and the Central Bank of Lesotho (monetary). Specifically, Lesotho is a small open economy in which its currency is pegged to the South African rand. As a country with high capital mobility and leakages abroad, the relationship between both fiscal, monetary, and exchange rate policy is intertwined, such that public spending and reserves are strongly linked.

B. An Overview of the Economic Institutions and Arrangements in Lesotho²

2. Lesotho’s history and geography has meant that it has maintained very close economic and financial ties with South Africa. When Botswana, Eswatini, and Lesotho gained independence in the 1960s, they were already members of a common customs area—the Southern African Customs Union (SACU)—and also de facto members of a currency union with South Africa.³ The currency union was formally established on December 5, 1974, with the signing of the Rand Monetary Area (RMA) agreement, and subsequently revised in April 1986 to establish the Common Monetary Area (CMA) of Eswatini, Lesotho, and South Africa. Under the terms of the CMA Agreement, the South African rand would continue to be legal tender in Eswatini and Lesotho, which would also have the right to issue their own national currencies.

3. Under the rules of the CMA, both the South African rand and the loti (plural: Maloti) are legal tender in Lesotho and pegged at par. Article 2 of the CMA Agreement permits SACU members to issue national currencies. Bilateral agreements with South Africa define the areas in which their currencies are legal tender. In general, the local currencies issued by the three members are legal tender only in their respective countries. The South African rand, however, is legal tender throughout the CMA. The national currencies issued by the three small countries are the loti in Lesotho, the lilangeni in Eswatini, and the Namibian dollar. Under the bilateral agreement between Lesotho and South Africa, both countries are required to allow authorized dealers within their territories to convert, at par, notes issued by the Central Bank of Lesotho (CBL) or the South African

¹ Prepared by Yibin Mu.

² This section draws heavily on the Selected Issues Papers of the 2005 Article IV Consultation for the Kingdom of Lesotho.

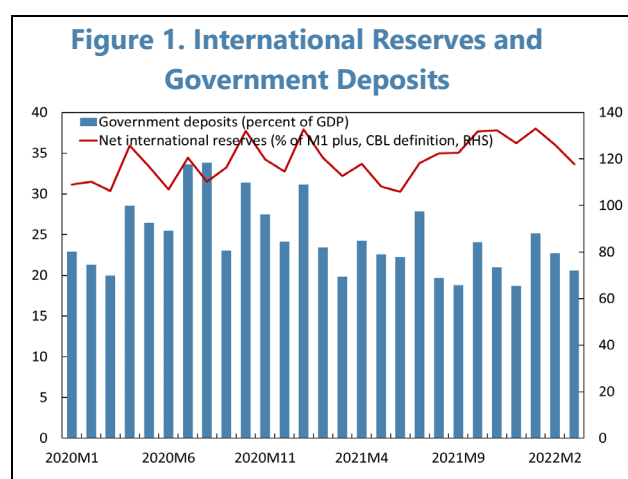
³ SACU was established in 1910, with membership comprising South Africa, Bechuanaland (now Botswana), Basutoland (now Lesotho), Namibia, and Swaziland (now Eswatini). In 1921, after the establishment of the South African Reserve Bank, the South African pound became the sole medium of exchange and legal tender across all territories.

Reserve Bank (SARB) without restriction and subject only to normal handling charges.⁴ Similar arrangements exist between the other two CMA members and South Africa.

4. The CBL is required to maintain foreign reserves equivalent to the total amount of maloti currency that it issues.⁵ Maloti and rand cash circulates freely and in parallel in Lesotho's economy, and market confidence in the system is high, as indicated by the low share of rand-denominated bank deposits (about 2 percent). Given close trade links with South Africa, the arrangement has served Lesotho well, but it obviously imposes tight restrictions on monetary policy. In particular, the CBL needs to maintain a reserves position that will prevent the possibility of a self-fulfilling confidence crisis, in which loti cash and deposit holders would simultaneously try to convert their holdings into rand to protect against a depreciation. Such reserves may comprise the CBL's holdings of rand balances, the rand currency the CBL holds in a Special Rand Deposit Account with the SARB, South African government stock (up to 10 percent of total reserves), and its investments with the Corporation for Public Deposit in South Africa.

5. Lesotho's exchange rate arrangement under the CMA shares certain characteristics of a currency board but differs in one important respect. All maloti currency issued by the CBL is backed entirely by the central bank's foreign exchange reserves. Such an arrangement has the advantage of insulating monetary policy from possible political interference and hence helps enhance the credibility of macroeconomic policies. However, currency boards are also typically prohibited by law from acquiring any domestic assets, so that all the currency it issues is automatically backed fully by foreign reserves. There is no such legal restriction for Lesotho under the CMA.

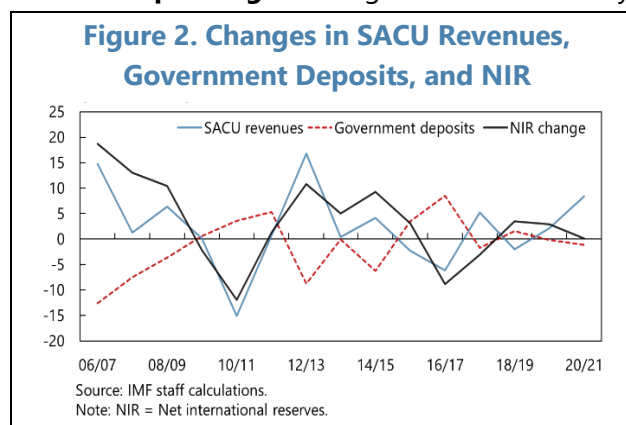
6. To enhance buffers and to allow for some domestic liquidity control, the CBL maintains a high reserve coverage of monetary aggregates. The coverage ratio is significantly higher than under a classical currency board, which would provide for 100 percent coverage of the monetary base and let domestic currency fluctuate with the supply and demand for foreign currency. However, to maintain financial stability, reserves coverage should focus more broadly on transferable monetary assets rather than the monetary base. Even when applying a wider measure of short-term bank liabilities ("M1 plus"), which includes callable deposits, coverage has remained comfortably above 100 percent (130 percent as of December 2021), giving the central bank significant firepower to defend the peg (Figure 1).



⁴ Article 2 of the Lesotho–South Africa bilateral agreement.

⁵ Article 4 of the Lesotho–South Africa bilateral agreement.

7. While the exchange rate peg eliminates a key lever for demand management, it provides a nominal anchor and occasional constraint on spending. Exchange rate and monetary policy cycles in Lesotho are driven entirely by South African monetary and exchange rate policies. In the absence of a formal fiscal anchor, enforcement of a net international reserves (NIR) target has acted as a spending brake when SACU transfers dip, such that changes in reserves (and government deposits) closely track changes in SACU transfers. This has led to conflict between the Ministry of Finance and the Central Bank of Lesotho (CBL) on several occasions (Figure 2).



8. The government has established some principles to guide the conduct of fiscal policy.⁶ These principles are documented in the government's budget strategy paper but are unenforced. Consequently, public expenditure, as managed by the Ministry of Finance (MOF), has typically been more discretionary than rules-based. For example, while several budget principles specified in the FY21/22 Budget Strategy Paper, the FY22/23 budget tabled in Parliament in early March 2022 has large deficits over the next 3 years, with limited concrete adjustment measures nor financing plans. As a result, arrears are being accumulated.⁷

C. A Short Primer on Macroeconomic Policies Under a Fixed Exchange Rate

9. As a small open economy under a peg with perfect capital mobility, monetary policy is less effective. The peg, the parallel circulation of the loti and rand, currency convertibility, and regional capital mobility mean that the central bank does not have independent control of its money supply. The demand for maloti depends importantly on the public's confidence in the exchange rate parity, given the extensive financial linkages between Lesotho and South Africa. Lesotho's monetary base basically expands (or contracts) in line with central bank purchases (or sales) of foreign exchange. Given the small size of its economy relative to that of South Africa, interest rate movements in Lesotho largely mirror those in South Africa, except for a spread that reflects country risk.

10. Monetary policy is weaker as any expansion in domestic credit would be offset by an equivalent reduction in the level of net international reserves (NIR), leaving monetary aggregates unchanged. Typically, an initial increase in the money supply following an expansion of domestic credit will prompt a drop in local interest rates. As a result, capital will tend to flow out of Lesotho given relatively lower domestic rates, which will in turn reduce the money supply and be reflected as a drop in NIR. The capital outflow will continue until local interest rates return to their

⁶ See SIP: *Evaluating Fiscal Rules in Lesotho*.

⁷ As of end November 2021, it is reported that LSL 1.25 billion (3.4 percent of GDP) new arrears had been accumulated.

original level. Ultimately, the only effect of the expansionary monetary policy will have been a change in the composition of reserves, with no change in the overall level of monetary aggregates or interest rates.

11. On the other hand, fiscal policy can directly influence aggregate demand. Fiscal policy is particularly effective in influencing aggregate demand since changes in the fiscal stance do not affect the interest rate (which will remain equal to the international interest rate) or the exchange rate (as it is pegged). In such circumstances, expansionary fiscal policy would not give rise to any crowding out of private sector activity.

12. The degree of capital mobility and size of the nontradable goods sectors can alter the effectiveness of fiscal and monetary policies.

- **If capital mobility is less than perfect**, fiscal policy will lose part of its effectiveness since domestic interest rates now will move in response to changes in the fiscal policy stance. This, in turn, would lead to some crowding out of the private sector. Monetary policy will gain some effectiveness, since interest rates can move following policy actions on the part of the monetary authorities, and thus will affect the level of aggregate demand.
- **In the presence of nontradable goods**, fiscal policy is also less effective, while monetary policy would affect aggregate demand. For example, an expansion in money supply would not only affect the balance of payments but also output of nontradable goods; the higher the share of nontradable goods in total output in the economy, the more effective monetary policy will be even under a pegged regime.

13. Even though under a peg regime, the economy is shielded from nominal shocks from abroad, it becomes more prone to real shocks. Given the relative effectiveness of monetary and fiscal policies as discussed above, the role of shock absorber in the event of exogenous shocks would fall mainly (or entirely, in the case of small economy with perfect capital mobility and no nontradable goods) on fiscal policy.

14. Nonetheless, there are limits to the use of fiscal policy, which if excessive can lead to pressure on the peg and even its eventual collapse. These limits arise from the weakening of confidence on the exchange rate peg that could follow from an expansionary fiscal policy. Such a policy would lead to a current account deficit under the balance of payments; over time, a current account deficit becomes unsustainable, and market participants would expect a devaluation, which would lead to a hike in interest rates. Also, an expansionary fiscal policy would lead to inflation, which would erode competitiveness and even currency crises, for example, what happened in Indonesia and Thailand where local currencies used to be fixed/pegged with US dollars during 1997/98 East Asian Financial Crisis.

15. Ultimately, an economy with an exchange rate peg and a lack of monetary independence will have to rely heavily on fiscal adjustment to cope with shocks.

D. A Vital Role for Macro Policy Coordination in Lesotho

16. In the case of Lesotho, any increase in money supply tends to find its way out of the economy, leaving monetary aggregates unchanged and reserves depleted. For example, should the government draw down deposits to finance public procurement, a large proportion of these funds would eventually find their way out of the economy through either (i) businesses depositing payments from the government in bank accounts at the large foreign-owned banks, which then transfer the money to their parents in South Africa; or (ii) businesses using the payments on imports as inputs to the provision of contracted goods and services.

17. Three scenarios are set out to help illustrate the interaction between monetary and exchange rate policies in the absence of coordination. The links between fiscal policy (summarized by the fiscal deficit) and the sources for its financing, which are determined by debt, the money supply, and arrears, can be expressed as in the following equation:

$$FD_t = (B_t - B_{t-1}) + (M_t - M_{t-1}) + (A_t - A_{t-1}),$$

where at time t : FD_t is the fiscal deficit; B_t is government's borrowing from financial markets (including both domestic and external); M_t is the central bank's net claims on government, and A_t is arrears.

- Scenario 1: The Ministry of Finance and the fiscus dominate.** The fiscal authority determines the size of the fiscal deficit without consideration for the exchange rate peg (i.e., without consulting the central bank). Where financing is limited in domestic debt markets, the central bank can also be directed to supply whatever amount of financing is needed in the form of monetary base. In the case of Lesotho, the government maintains sizeable deposits (7 percent of GDP as of end 2021), which can be drawn down. If this exceeds the expansion of demand for real base money at the target price level—either the domestic price level or external price level (the exchange rate)—increased inflationary pressures, pressures on international reserves and the exchange rate, or arrears would arise. If the government directs financial institutions and institutional investors, such as the Pension Fund, to finance the deficit and/or withhold payments to contractors, this will distort the normal functioning of the economy through financial repression and the accumulation of arrears.
- Scenario 2: The central bank and exchange rate policies dominate.** The monetary authority determines base money independently of the financing needs of the government. The capacity to borrow from domestic and external markets and raise revenues would then constrain the size of the fiscal deficit. Assuming limited domestic market depth, as in Lesotho, the government might also be forced to rely excessively on external borrowing, which, if unchecked, could lead to a high risk of external debt distress. The government could also turn to aggressive domestic revenue mobilization through heavy taxation, which would also weight on incomes and activity. Ultimately, the government could be forced to reduce its fiscal deficit to match available financing with the danger of not paying due

regard to expenditure needs, which could jeopardize growth, social protection, and overall development.

- **Scenario 3: Both the central bank and Ministry of Finance act autonomously and do not coordinate.** As a result, the monetary and fiscal authorities make inconsistent decisions regarding the base money supply and the size of fiscal deficit, respectively. Either the fiscal or monetary authority would need to assume a subordinated role. Inconsistency of fiscal targets with the goals of monetary and exchange rate policies leads to an unstable equilibrium and depending on the relative power of the two institutions, would bring us back to one of outcomes under the previous two scenarios—most likely through political will. The longer the period of policy inconsistency, conflict, and stalemate, the greater the loss in confidence, the greater the risk to the exchange rate, the longer the delays to reforms, and the more growth will stagnate. The result is likely to be high financing costs and arrears for the government and growing pressure on the exchange rate for the central bank.

18. History has provided many examples of exchange rate crises caused by policy coordination failures:

- **1992/93 UK Exchange Rate Mechanism Crisis.** Like Lesotho, the UK in 1991 was experiencing a progressive deterioration in economic conditions: weak growth, high unemployment, and competitiveness problems. In the face of contractionary monetary policy to fend off higher inflation in Germany, speculators determined that country's policy stance was inconsistent with the current exchange rate value, i.e., domestic policy needs were inconsistent with the interest rates required to defend the peg.⁸
- **1994/95 Mexico Peso Crisis.** The expansionary fiscal policies and monetary policies pursued by the government and the central bank in 1994 in Mexico were ultimately inconsistent with the pegged exchange rate rule. These were seen as the root cause/ultimate trigger of 1994/95 Mexico Peso Crisis and collapse of the peg arrangement (Lustig, 1995).
- **1997/98 East Asian Financial Crisis.** The decade-long strong growth record of Thailand, Indonesia, the Philippines, and South Korea before the crisis masked a significant buildup of vulnerabilities. In particular, years of overreliance on foreign savings, reflected in mounting current account deficits and a build-up in external debt. Heavy foreign borrowing, often at short maturities, also exposed corporations and banks to significant exchange rate and funding risks—risks that had been masked by longstanding currency pegs. Rapid credit growth and inadequate supervisory oversight had resulted in a significant build-up of financial leverage and doubtful loans. When investor confidence evaporated and the pegs proved unsustainable, firms saw sharp increases in the local currency value of their external debts, leading many into distress and even insolvency. Months of speculative pressures had

⁸ According to second-generation currency models, if economic fundamentals deteriorate sufficiently then the government has an escape clause allowing it to change its exchange rate (e.g., float or devalue), which the private sector knows (Obstfeld 1994).

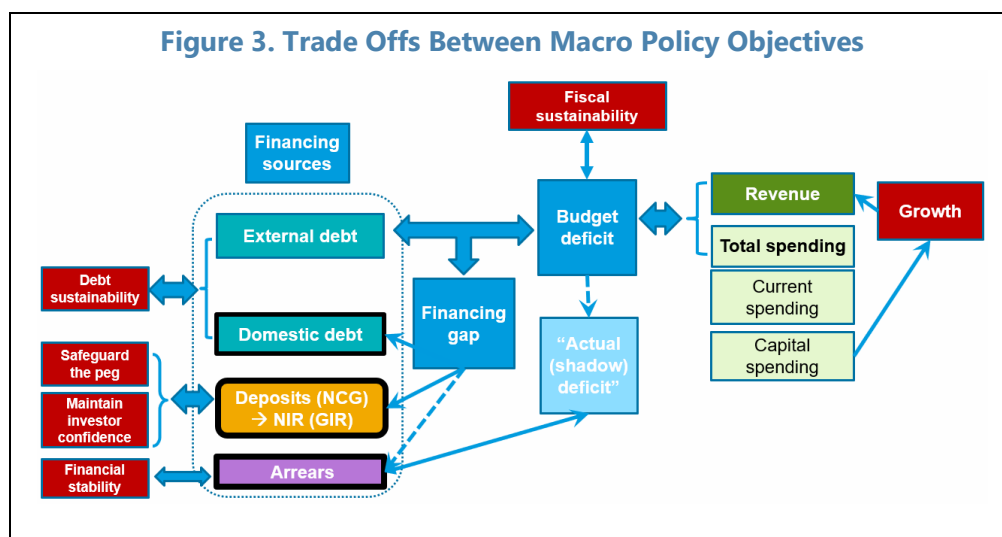
substantially depleted central banks' foreign exchange reserves, triggering a twin balance-of-payments and banking crisis—and the collapse of pegs across the region (Carson and Clark, 2013).

19. Hong Kong SAR offers a successful case of policy coordination that helped support the peg in the midst of the East Asian Financial Crisis. Hong Kong SAR also faced several large speculative attacks but eventually weathered these attacks and successfully defended the peg mainly for the following reasons: (i) Hong Kong SAR had very strong fiscal stance, which had remained in surplus for decades. (ii) Hong Kong SAR adopted decisively critical structural reforms (e.g., cutting wages) to restore its competitiveness quickly.

E. A Macro Policy Framework in Context of Lesotho

20. Lesotho can be seen as a small economy with perfect capital mobility and a small (informal) nontradables sectors under a peg regime. As discussed, there are trade-offs and synergies between key macro policy objectives such as preserving debt sustainability, safeguarding the peg, maintaining investor confidence, protecting financial stability, maintaining fiscal sustainability, and achieving high growth (Figure 3). For example:

- *Preserving debt sustainability, safeguarding the peg, maintaining investor confidence, and protecting financial stability.* Debt sustainability requires limits to borrowing, which implies (i) greater use of government deposits and lower reserves, undermining confidence in the ability to defend the peg; or (ii) accumulating greater arrears, inducing NPLs, and undercutting financial stability. Likewise, enhancing the peg or enhancing financial stability will have similar trade-offs.
- *Preserving fiscal sustainability versus achieving high growth.* High growth through investment requires a larger fiscal deficit when current spending is sticky. This will undercut fiscal sustainability. Likewise, enhancing fiscal sustainability by cutting spending can harm growth.



21. Policy coordination would be instrumental to help depoliticize macroeconomic policies enabling the Ministry of Finance to pursue its fiscal mandate in coordination with the CBL. Policy coordination and consultation should not, however, entail subordination or compromise both the independence and accountability of the CBL. Key fiscal and monetary policies can be determined as follows:

- a. **Debt limits.** The debt office and the macro department at the Ministry of Finance should determine how much debt the government can take on. This should be informed by estimates of debt sustainability.
- b. **Reserve levels.** CBL should determine the reserve level required to safeguard the peg. The CBL can consult with the Ministry of Finance. The reserve requirement will determine the floor on net claims on government (NCG).
- c. **Fiscal deficit.** Safeguarding peg and preserving debt sustainability should determine the affordable fiscal deficit.
- d. **Spending composition.** The government optimizes the composition of spending within the fiscal deficit envelop informed by the CBL to achieve the macro policy objectives-- sustainable and inclusive growth.

22. The current institutional setup in Lesotho could be formalized to strengthen communication and coordination to achieve better macroeconomic outcomes (Figure 2).

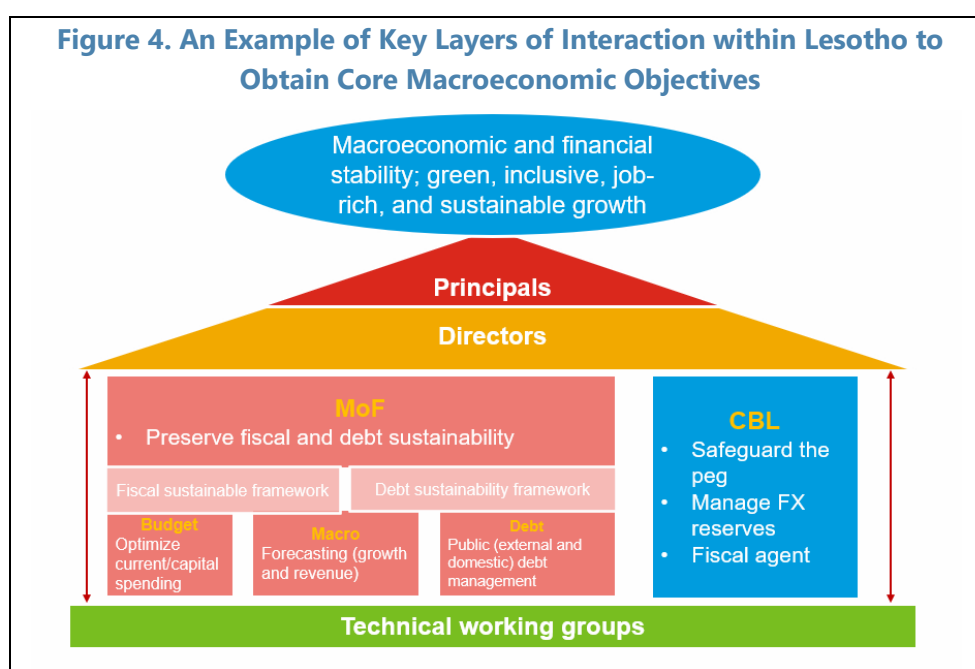
Lesotho has the institutional channels in place for coordination—for example, the inter-Ministerial Macro Working Group—which must be reinvigorated to enhance coordination. While the policy remits must remain independent—including the institutional independence of the central bank—the implications of policy choices must be discussed across both institutions to provide a well-informed, consistent policy decision. For example, setting up a debt policy committee under the Debt Department of the Ministry of Finance, with members from both the MoF and CBL, would bring together knowledge on external financing needs and financial markets. At the same time, capacity must be developed within the Macroeconomic Policy and Coordination Department of the Ministry of Finance for debt sustainability analysis.

23. Interaction at multiple layers (principals, directors, and technical staff) are recommended to ensure effective communication, data dissemination, modelling, and informed decision-making (Figure 4).

- **Principals’ meeting.** This is a high-level platform involving top officials from the MoF, the CBL, and other Ministries, Departments, and Agencies (MDAs), who would meet regularly to discuss strategic policy issues and responses to recent macro developments.
- **Directors’ meeting.** This would include the Macro Director, Budget Controller from the MOF; director of research, director of market operation from CBL; head of the debt office. Members could change depending on local situation/feedback from the authorities. They

meet regularly to implement the agreement reached at the principals' meetings. Senior policy makers from relevant MDAs can be included as needed.

- **Technical task forces and working groups** on specific technical issues. This would include the existing Macroeconomic Working Group. Technical staff would work closely to provide technical inputs/support for Directors and Principals, for example, on forecasting (growth, inflation, revenue, reserves, etc.).



F. An Example of Policy Coordination: The 2021 SDR Allocation

24. On August 23, 2021, the IMF allocated US\$650 billion of Special Drawing Rights (SDR) to member countries in proportion to their quota shares in the IMF⁹. About US\$275 billion is going to emerging and developing countries, of which low-income countries will receive about US\$21 billion – equivalent to as much as 6 percent of GDP in some cases. Lesotho received about US\$ 95 million of new SDR allocation. The IMF does not impose restrictions on the use of SDR allocation.

25. Theoretically, there are two ways for the government to access the SDR allocation— direct access by the government or indirect access. Both approaches have their pros and cons (Box 2, Table 1).

- Direct access.** This is on-lending the SDR allocation to the government, subject to Article 42 of the Central Bank of Lesotho Act, which specifies: (i) the total credit of central bank to the government shall not exceed 5 percent of the Government's actual revenue

⁹ <https://www.imf.org/en/News/Articles/2021/08/23/pr21248-imf-managing-director-announces-the-us-650-billion-sdr-allocation-comes-into-effect>

in the previous year's budget; (ii) any advance from CBL to the Government should be repaid within 93 days from the end of the Government's financial year to which it relates, and where any such advance remains unpaid after the due date, the power of the Bank to make further advances in any subsequent financial year shall not be exercised unless the amounts due in respect of outstanding advances have been repaid.

- b. **Indirect access.** Given that the government of Lesotho has positive balance of deposits with the CBL, part of these can be drawn down to indirectly access the SDR allocation. Specifically, the SDR allocation automatically increases NIR (above the current target), which creates additional space for the government to potentially draw down part of its deposits with the CB. Given perfect capital mobility and a high degree of leakage, the draw down in deposits will lead to a reduction in reserves.

26. In the absence of policy coordination, the cheaper option of indirectly drawing on the allocation will not be available. Without agreement over the size of the deposit drawdown and an understanding of the impact on reserves, the fiscal authority risks endangering the peg. The amount to be withdrawn must be determined within the context of safeguarding the peg, preserving debt sustainability, and maintaining external stability, as indicated by reserve targets (e.g., maintaining an adequate level of 4 months of import cover).

Table 1. Lesotho: Direct vs. Indirect Access

	Pros	Cons
Direct access On-lend SDR allocation to government (according to CBL Act)	<ul style="list-style-type: none"> Direct debt to the government, potentially increasing accountability. 	<ul style="list-style-type: none"> Drawing on SDRs incurs interest costs at SDR rate (holdings < allocation). Incur exchange risk. Direct increase external debt Repay within 93 days of the end of the government's financial year (CBL Act).
Indirect access Retain SDR allocation on CBL balance sheet	<ul style="list-style-type: none"> Creates space for government to draw down deposits at CBL. SDR allocation is not drawn down directly, saving interest costs at SDR rate. Avoid exchange rate risk. 	<ul style="list-style-type: none"> Hides the actual debt burden. Requires positive balances at the CBL.

G. Conclusions

27. Macro policy coordination matters, given Lesotho's economic institutions and arrangements. Lesotho is small open economy with a large foreign-owned banking sector and pegged exchange arrangement. The peg has served Lesotho well by anchoring macroeconomic policy and inflation. However, limited scope for nominal exchange rate adjustment calls for fiscal policy and structural reforms to play the key role in external adjustment. Without sound policy coordination, the government's spending and cash management plans are at odds with (i) the

minimum level of international reserves needed to safeguard the peg, (ii) the level of borrowing needed to preserve debt sustainability, and (iii) minimizing arrears.

28. The current institutional setup in Lesotho could be formalized to strengthen communication and coordination to achieve better macroeconomic outcomes. The inter-Ministerial Macro Working Group should be reinvigorated to enhance coordination. The institutional independence of the central bank needs to be preserved within a cohesive, well-coordinated, and commonly agreed macroeconomic framework.

29. Current practices can be augmented and formalized to enhance the policy coordination. (i) The Ministry of Finance should determine public debt limits based on prudent debt sustainability analysis; (ii) the CBL should determine a ceiling on NCG that secures the peg; (i) and (ii) will determine the fiscal deficit, the composition of which can be optimized by the Ministry of Finance to achieve key macro policy objectives--sustainable and inclusive growth.

Box 1. Understanding the Interactions between Debt, Spending, and Reserves

- a. Debt limits (determined by debt sustainability analysis) suggest a path for the debt stabilizing primary balance. (Ministry of Finance, Debt Department and Macro Department).
- b. In parallel:
 - The central bank can determine a ceiling on the net credit to government (change in government deposits) that will safeguard the peg by maintaining a certain level of NIR and GIR coverage.
 - The Ministry of Finance can review spending needs and determine the composition—i.e., current (including social) vs. capital spending—based on socioeconomic and development priorities, in coordination with other key development stakeholders.
- c. Revenue mobilization (both domestic and external) is estimated by the Ministry of Finance and the Lesotho Revenue Authority.
- d. Potential financing from domestic financial markets is determined by the central bank, in coordination with the Ministry of Finance’s Debt Department
- e. (a), (b), (c), and (d) jointly determine total potential financing sources.
- f. This resource envelope determines a maximum for total public expenditure for the Ministry of Finance. However, it is not advisable to spend up to this ceiling as fiscal space must be preserved to allow for response to shocks.

Box 2. Understanding the Impact of the SDR Allocation on Monetary Aggregates

A. SDR allocations and the external (BOP) sector

- “Holdings of SDRs”: Increase long-term debt liabilities (other investment inflows) under the Financial Account by the amount of SDR allocation.
- “Allocations of SDRs”: Under official reserve assets, Increase gross international reserves (GIR) by the amount of the SDR allocation below the line of the BOP.

As a result, both above-the-line and below-the-line under the BOP will increase accordingly.

B. SDR allocations and the monetary sector

- Foreign Assets under the Net Foreign Assets (NFA) will increase by the amount of SDR allocation in local currency. This can be fed through the change of reserves from the BOP.
- Foreign liabilities under NFA also increase by the amount of the SDR allocation (in local currency)

Therefore, as SDRs are recorded as assets and liabilities in the central bank’s balance sheet, net foreign assets will be unchanged. The SDR holdings would directly increase GIR. Net interactional reserves (NIR) will also increase provided assuming only short-term foreign exchange debt liabilities are not subtracted from GIR.

C. The impact on base money largely depends on the exchange rate regime.

- Under a peg/currency board monetary regime, money supply (reserve money) is usually driven by the GIR and NIR. With the increase of GIR and NIR, money supply (reserve money) should increase accordingly (assuming no leakages).
- In some circumstances or some monetary regimes, the monetary authority can forcefully break the link between the GIR/NIR and money supply. In that case, a jump in either the ratio of GIR/reserve money or the ratio of NIR/reserve money should be observed.

Therefore, one of the following phenomena should be observed: (i) a jump in money supply (reserve money), or (ii) a jump of GIR/M1 ratio or NIR/M1 ratio.

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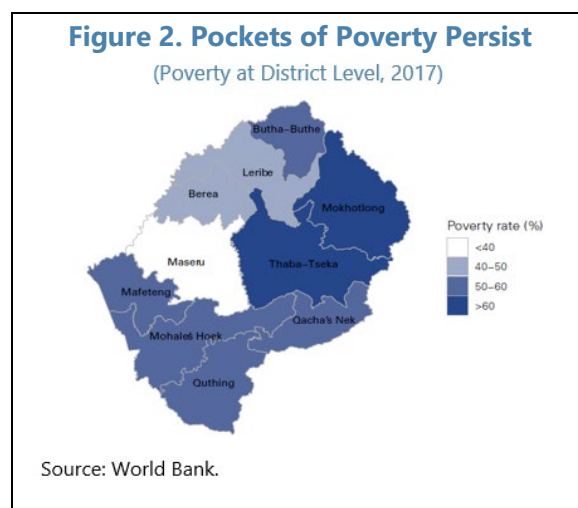
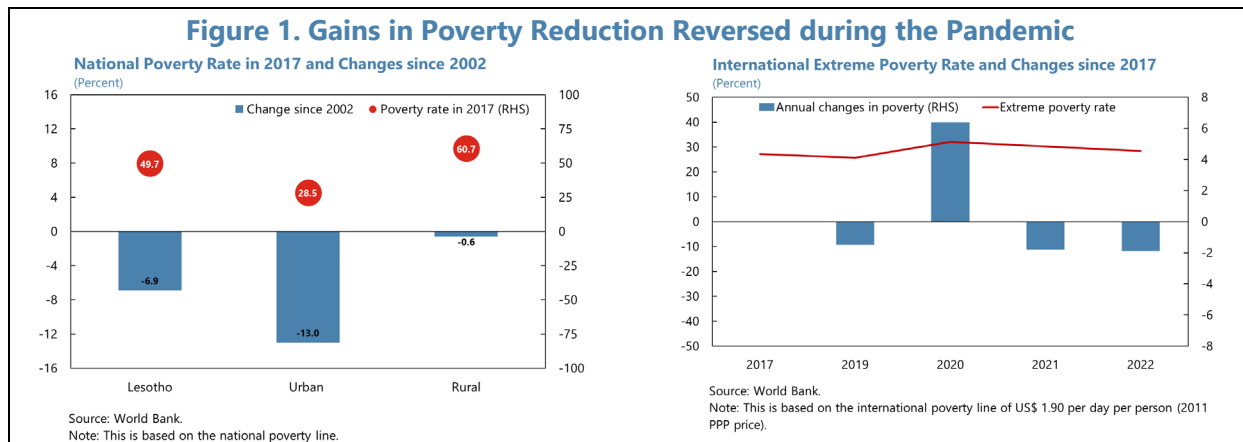
TOWARD POVERTY AND INEQUALITY REDUCTION: THE ROLE OF SOCIAL PROGRAMS¹

A. Poverty Decline Reversed by the Pandemic

1. **Lesotho has made considerable progress in reducing poverty during 2002–17.** Since 2002, poverty rates fell by 6.9 percentage points (ppts) to just under 50 percent in 2017, such that 47,000 Basotho were able to escape poverty during this period (Figure 1, World Bank 2019). In addition, the intensity (poverty gap ratio) and severity (squared gap ratio) of poverty fell significantly.² The greatest poverty reduction occurred in urban centers (13 ppts) rather than rural areas (0.6 ppts), where more than 60 percent are still below the national poverty line. The reliance of rural households on less productive, rainfed agriculture that is susceptible to frequent droughts and floods, with limited value added, has hindered poverty reduction in rural areas (World Bank 2019).
2. **Despite the overall drop in poverty nationally, the urban-rural divide has increased.** The rural lowland and mountainous areas accounts for larger shares of the poor population. For example, more than 60 percent of the residents in Mokhotlong and Thaba-Tseka districts, lived in poverty in 2017 (Figure 2), whereas the Maseru district has a lower poverty rate—as low as 15 percent in Maseru city. Similarly, the constituencies that are closer to the border tend to exhibit lower poverty rates, owing to their better access to economic opportunities, well-developed markets, and larger remittance flows from Basotho working in South Africa (World Bank 2019). Well-targeted policy measures are needed to support these lagging districts.
3. **The recent COVID-19 pandemic has reversed some of this progress.** Extreme poverty—using the international poverty line of US\$ 1.90 per person per day—is estimated to have increased from 25.7 percent in 2019 to 32.1 percent in 2020 (Figure 1). Despite the resumption of activity and relaxation of pandemic-related restrictions in recent months, extreme poverty is projected to remain elevated at 28.4 percent in 2022 (World Bank 2022).

¹ Prepared by Habtamu Fuje, with contributions from Alexander Massara.

² The poverty gap ratio is measured by taking the average poverty gap in the population as a proportion of the poverty line. The squared gap ratio averages the square of the poverty gap ratio, thus putting more weight on extremely poor households.

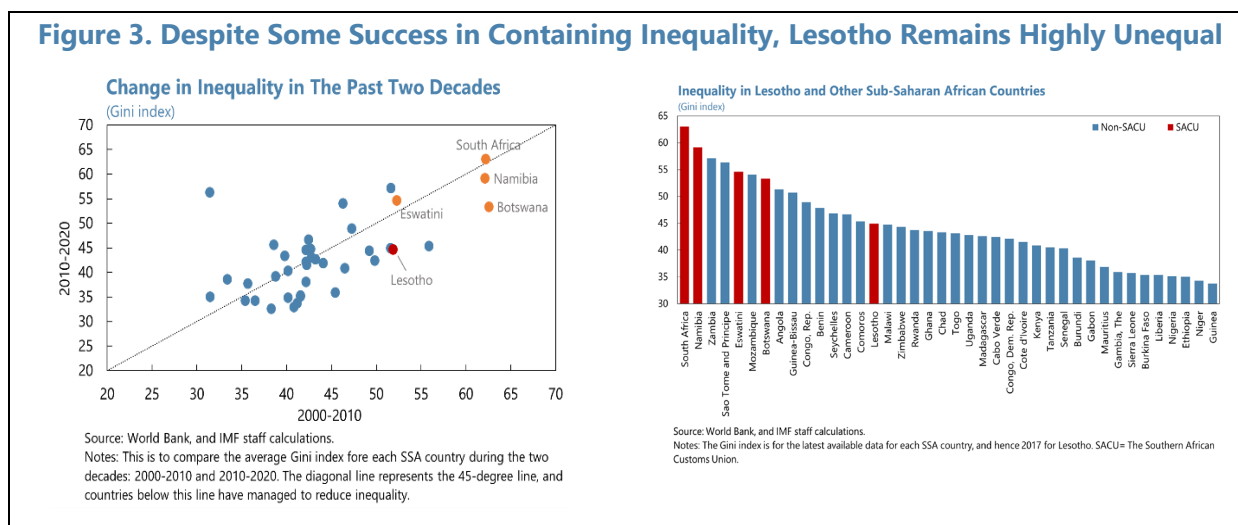


B. Persistent Inequality

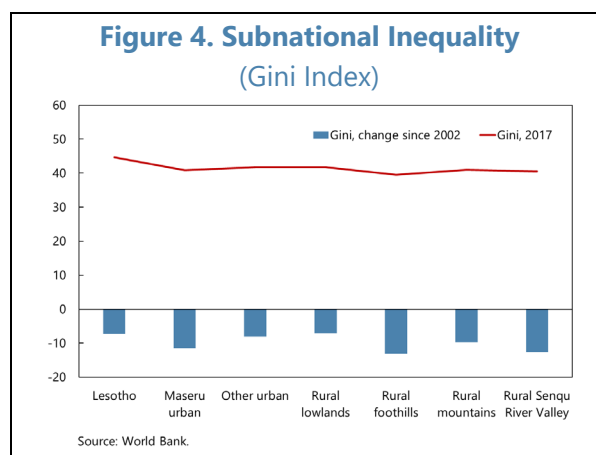
4. On inequality, changes in consumption shares and growth have contributed to an overall decline in inequality but more remains to be done. During 2002–17, the consumption share of the bottom 40 percent increased from 8.7 percent to 15.4 percent, while faster (annualized) consumption growth amongst the bottom 40 percent of households helped improve shared prosperity. Similar improvements have been observed amongst the middle class. On the other hand, the consumption shares of the wealthiest households (the top 20 percent) decreased from almost 60 percent of the total consumption in 2002 to 45 in 2017 (World Bank 2019).

5. Despite this important progress, Lesotho still has one of the highest levels of inequality in sub-Saharan Africa (SSA)—trailing other SACU member states. Welfare inequality, measured by the Gini coefficient, fell to 44.6 in 2017 from 51.9 in 2002, placing Lesotho in the top six countries that have made substantial progress in reducing inequality in the past two decades. However, even if Lesotho’s important strides has allowed it to show marked improvement relative to the poorer inequality outcomes across other SACU member states, it still ranks as the fifteenth most unequal country in the continent (Figure 3).

Figure 3. Despite Some Success in Containing Inequality, Lesotho Remains Highly Unequal



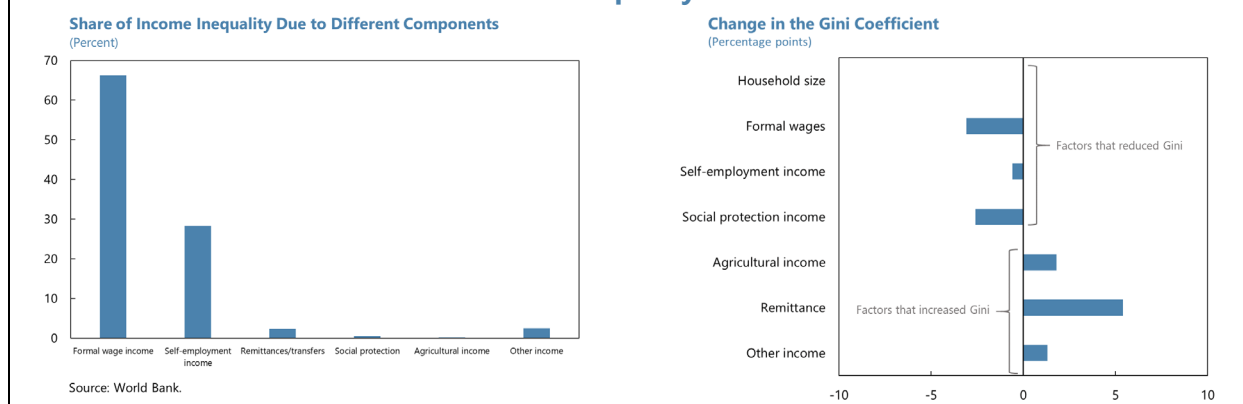
6. Inequality among households residing in the same subnational units has decreased since 2002. The decline has been broad-based, both urban and rural areas have seen remarkable reductions. The strongest reductions in inequality were observed in rural foothills and urban Maseru, where Gini coefficients declined by 13.1 and 11.5, respectively (Figure 4).



7. A large share of persistent income inequality can be attributed to differences in access to formal wage employment. Conditions in Lesotho are such that access to formal employment makes a significant difference to the incomes of families, with 66 percent of income inequality attributable to differences in formal wage income. Wage discrepancies—driven in part by a well-paid civil service and a big public-private wage gap—are the largest driver, followed by income from self-employment that contributed 30 percent of the inequality (Figure 5).

8. Increasing access to social protection has helped improve inequality. During 2002–17, social assistance programs for low-income households have increased considerably, leading to improvements in inequality. At the same time, continued reliance on agriculture-based sources of income has tended to increase inequality (Figure 5). Similarly, remittances, on which many low-income Basotho households depended, has declined markedly between 2002 and 2017, leading to increases in inequality (World Bank 2019).

Figure 5. Access to Formal Employment and Social Protection Supported the Decline in Inequality

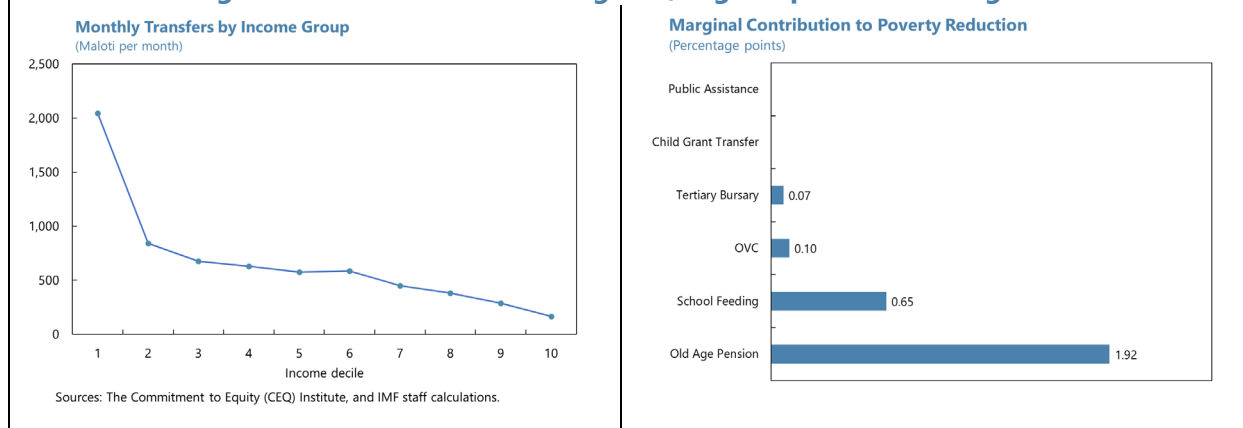


C. Impact of Social Programs

9. To combat the high poverty and inequality, Lesotho spends more than twice the SSA African average on social programs. Over half of the social spending is geared toward education, with the rest going toward food and pension transfers. Nearly two-thirds of households in Lesotho benefit from at least one social program and over 80 percent of poor households are beneficiaries. If Lesotho’s social spending was perfectly targeted, extreme poverty would be eliminated and the upper bound would be halved (World Bank 2021).

10. Most of Lesotho’s social programs are well-targeted, with a significant impact on poverty. In general, social spending is progressive, with most benefits going toward the poorest households (Figure 6). Using fiscal incidence analysis, the Old Age Pension has the biggest impact on poverty, followed by the School Feeding Program, which also covers the highest number of poor households. The Child Grant and Public Assistance programs, while progressive, do not provide large enough transfers to significantly reduce poverty. Overall social spending reduces the poverty rate by 3.4 ppts at the upper bound line and by 6.5 ppts at the extreme line and reduces the Gini coefficient by 4.1 percentage points (World Bank 2021).

Figure 6. Lesotho has Well-Targeted, High Impact Social Programs



11. However, the Tertiary Education Loan Bursary Scheme, which is the costliest social program, is regressive. A recent World Bank report found that more than 90 percent of the beneficiaries are classified as non-poor (World Bank 2021). The result is a social program that increases inequality and has a minimal direct impact on poverty. While the government offers universal primary education, secondary education is expensive, with 65 percent of the costs falling on households (World Bank 2017). Only 4 percent of secondary-age students receive the Orphan and Vulnerable Children Program (OVC) grants. As a result, the FY17/18 household budget survey indicates that just 10 percent of the adult population has completed secondary education, with close to half of dropouts—indicating that cost was the main reason for quitting secondary school.

Box 1. Summary of Social Programs¹

This Box summarizes the key social assistance programs in Lesotho, which vary significantly by both cost and coverage.

Cash-for-Work Assistance Program. (Ministry of Forestry, Range, and Soil Conservation) This program is designed to help support households in coping with temporary loss of income. Total spending on program is 0.3 percent of GDP with coverage of 98,000 beneficiaries (approximately 20 percent of the target group).

Public Assistance Program (PAP). (Ministry of Social Development) The PAP is the oldest social program in Lesotho. The program provides quarterly cash and in-kind transfers to the ultra-poor and disabled on a temporary or permanent basis. The total budget for the program equals roughly 0.24 percent of GDP and covers approximately 12,700 beneficiaries (around 6 percent of the target group).

Orphan and Vulnerable Children Program (OVC). The OVC program was established in 2000 and covers secondary school children with sick or disabled parents. Children that are accepted to a secondary school can apply to the OVC to pay tuition and other fees. Benefits are disbursed according to a district-level quota. The OVC covers roughly 21,000 beneficiaries (around 11 percent of the target group) at a cost of 0.2 percent of GDP.

Tertiary Education Loan Bursary Scheme. (National Manpower Development Secretariat, Ministry of Development Planning) The largest of Lesotho's social programs, the bursary costs an estimated 1.84 percent of GDP. The program covers tuition and other university fees for qualified students. Eligibility is determined by academic merit, rather than income level. Although the benefits are supposed to be repaid by beneficiaries, it serves as a de facto grant due to very low recovery rates. Despite its cost, the program covers just 19,500 beneficiaries.

Child Grant Program (CGP). (Ministry of Social Development) The CGP is the newest of Lesotho's social programs. The program provides cash transfer to poor households with children under the age of 18. The cash transfers are based on the number of children and are disbursed quarterly at a total cost of 0.2 percent of GDP, covering 27,000 households (around 22 percent of the target group).

School Feeding Program. (Ministry of Education and Training) The School Feeding program is the largest program in terms of coverage, with roughly 295,000 beneficiaries (100 percent of the target group). The aim of the program is to provide 1–2 meals per day to early childhood and primary school students. The program is administered in collaboration with the World Food Programme and costs about 0.5 percent of GDP.

Old Age Pension (OAP). (Ministry of Finance) Established in 2004, the OAP is a universal, non-contributory pension covering adults over 70 that do not receive a civil service pension. Monthly transfers are periodically increased, with annual benefits equaling roughly 50 percent of per capita GDP. The OAP covers approximately 84,000 people at a cost of 2.0 percent of GDP. According to the World Bank (2021), there are a significant number of "ghost" OAP pensioners, implying a coverage of over 100 percent.

¹ Cost and beneficiary data refer to FY17/18. For more detail on Lesotho's social programs, see World Bank (2021).

12. To further enhance their effectiveness in reducing poverty and inequality, resources should be redirected to the most successful social programs. For example, increasing transfers via the Public Assistance program as it is currently designed would do little to reduce poverty. Transfers are too small, and the coverage is too low for any expansion to have a significant impact. Conversely, increasing the School Feeding program by 50 percent would reduce poverty by 1¼ percent. As one of the most progressive schemes, the Old Age Pension scheme can be augmented but only after the incidence of “ghost pensioners” (fake claimants) is reduced. To mitigate the additional costs, expansions of well-targeted program could be combined with reducing the budget transfers to the regressive and ineffective tertiary education loan bursary program, introducing means-testing and pursuing loan recovery.

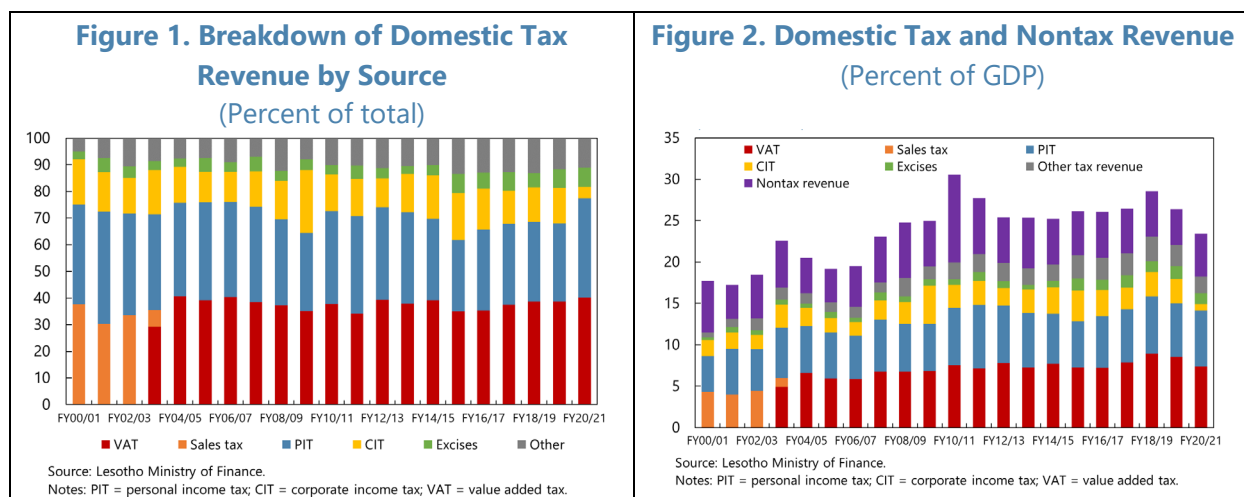
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AN OVERVIEW OF TAXATION IN LESOTHO¹

1. Lesotho possesses the core components of a modern tax system. While it has undergone important changes over time, there is still much room for improvement. Furthermore, the COVID-19 pandemic and the ongoing volatility in exogenously determined SACU revenues has reinforced the urgent need to improve domestic revenue mobilization.

2. The value added tax (VAT) provides the bulk of revenues, followed by the personal income tax (PIT) and corporate income tax (CIT), while excise taxes constitute a small yet nonnegligible portion with potential. Since its introduction in 2003 in replacement of a sales tax, the value added tax (VAT) has grown into the most powerful tax revenue-raising instrument, accounting for approximately 38 percent of tax revenues in the past decade (Figures 1 and 2). However, with several reduced rates and an economy characterized by high informality and significant cash-based transactions, the VAT has untapped potential. Contributing to nearly a third of total domestic tax revenue, the personal income tax (PIT) is another major source, due to the large number of salaried public servants employed by a government that dominates employment and consumption, overshadowing a weak private sector. As a result, PIT revenues are 2.5 times those from CIT, which have contributed on average 13 percent of the total domestic tax revenues over the past decade. Lesotho also levies excise taxes on specific goods and services such as fuel, cigarettes, and gaming. Furthermore, plans are underway to introduce a levy on alcohol and tobacco at 15 and 30 percent, respectively.



3. The collection of nontax revenue has been stable at 5 to 6 percent of GDP. Water and diamond royalties account for about three quarters of total nontax revenues (Figure 3), and there remains room for improvement in the mining sector. The government has proposed two new measures in the FY21/22 budget aimed at curbing perceived revenue losses from the mining sector.

¹ Prepared by Qiuyan Yin and Zhangrui Wang.

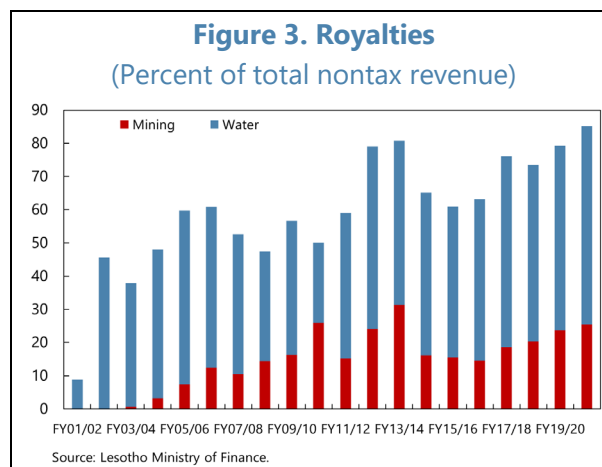
These include: (i) treating diamond royalties as a nondeductible expense for tax purposes; and (ii) eliminating the perpetual VAT refunds due to zero-rating of mining exports. While changing the zero-rating on diamond exports to exemption may save some money in the short term, it is ill-advised as this will distort the VAT system and impede the export competitiveness.

4. In response to the COVID-19 pandemic, the government introduced temporary tax relief measures in 2020 to assist taxpayers to meet their obligations. Specific measures include:

- Personal income tax payable by individuals engaged in the public transport business is remitted during the period of the COVID-19 lockdown.
- Instead of following the regular quarterly schedule of CIT collection, the government deferred the CIT payment in 2020. The deferred amount and period vary depending on the size of the taxpayers, and the measures are more lenient towards MSMEs.²
- For businesses closed during the national lockdown, the April, May, and June payments of VAT by the vendors and PAYE (pay-as-you-earn) by employers are deferred. The deferred amounts are payable from July 2020 to March 2021 in 9 equal monthly instalments.

5. Under the Income Tax Act 1993, the PIT is levied at progressive rates. Employment income is subject to a two-rate structure of 20 percent and 30 percent, while fringe benefits and passive income³ are taxed separately. Low income earners—with a monthly gross salary equal to or less than M4,200—are excluded from PIT by means of a non-refundable tax credit of M840 per month. Tax is withheld by employers through a pay-as-you-earn (PAYE) system and is remitted to the Lesotho Revenue Authority (LRA) on a monthly basis. Since the government is the largest employer in the economy, public servants account for the bulk of the PIT PAYE revenues.

6. The PIT regime features a sharp jump in marginal rates (Table 1). Although the top tax rate on employment income is near the mean level of the SACU region, the bottom rate (20 percent) is double the regional average of 10 percent (Figure 4).



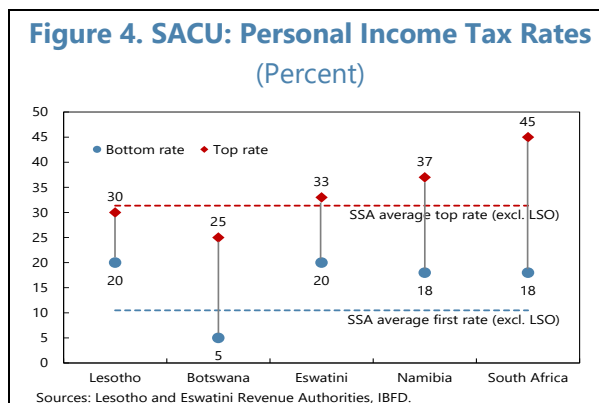
² For large taxpayers, 60 percent of the first quarter instalment and 80 percent of the second quarter instalment are deferred to June and September 2020, respectively; the deferred amounts of 40 and 20 percent are payable from October 2020 to March 2021 in 6 equal monthly instalments. For small and medium taxpayers, 100 percent of the first quarter instalment is deferred, while 80 percent of the second quarter instalment is deferred to September 2020; the deferred amounts of 100 and 20 percent from the first two quarters are payable from October 2020 to March 2021 in 6 equal monthly instalments.

³ For example, interest, dividends, royalties, management charge, patent fees, and trademark fees.

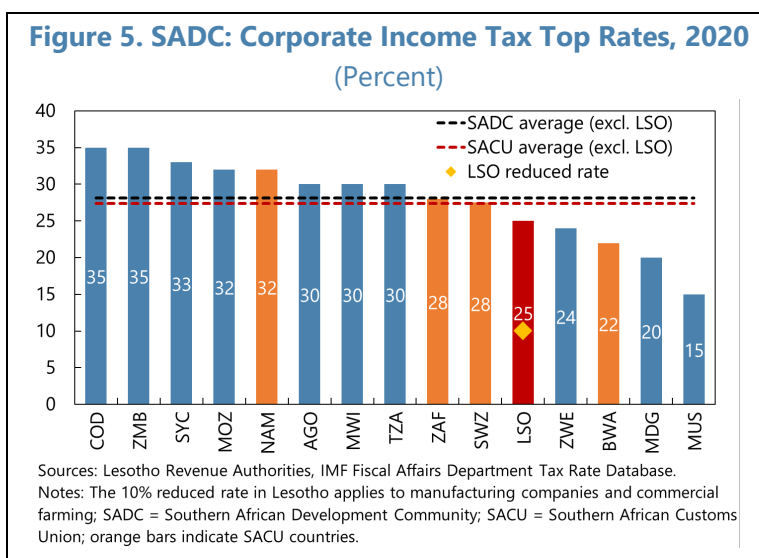
Table 1. Lesotho: Personal Income Tax

	Chargeable income (Maloti, per annum)	Tax credit (Maloti, per annum)	Tax rate (percent)
Employment income	< 50,400	10,080	20%
	50,400 - 64,200	10,080	20%
	> 64,200	10,080	30%
Fringe benefits	-	-	40%
Withholding tax	Resident contractors	-	5%
	Non-Resident Contractors	-	10%
	Non-Residents (Technical services) (For RSA only)	-	8%

Source: Lesotho Revenue Authority



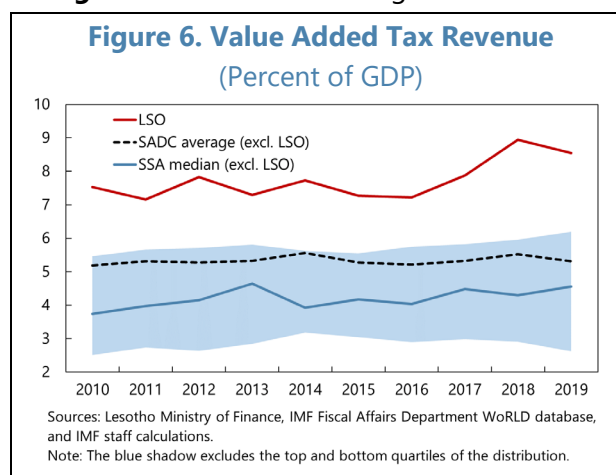
7. The CIT system is characterized by a relatively low standard rate in the Southern Africa region, and occasional concessional rates acting as tax incentives. The standard CIT rate in Lesotho is 25 percent, which is at the lower end relative to regional peers (Figure 5). A reduced rate of 10 percent is applied to manufacturing companies and commercial farming, including the textile manufacturing industry, one of the key growth engines of the economy. While this reduced rate may create some investment incentives in the short term, as a profit-based incentive, it is distorting activity and eroding the tax base. Although a unified CIT rate across sectors is generally advised, there are concerns that the largely foreign-owned textile companies are relatively mobile and may “pack and go” as soon as the preferential rate is removed. However, the credibility of these threats is unclear.



8. The VAT is Lesotho’s revenue workhorse, providing 38 percent of total domestic tax revenues in the past decade, or 7.7 percent of GDP (Figure 6). The VAT regime has many features in line with best practices: it excludes small businesses with a minimum registration threshold on annual taxable turnover of M850,000, although there remains an option for voluntary registration; it is also destination-based, which means exports are currently zero-rated and it is advised to remain that way.

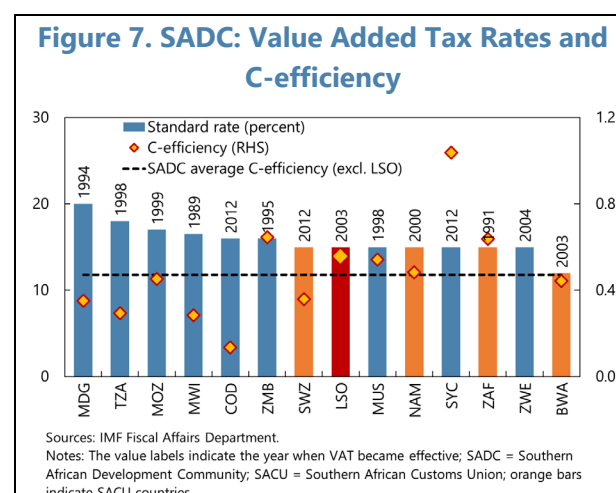
9. The standard VAT rate of 15 percent is in line with the region, and reduced rates, exemptions, and zero-ratings are applied to certain goods and services. The government

intends to gradually eliminate the rate differentials and unify the VAT rate, and has just increased the rate on telecommunications from 12 percent to the standard 15 percent in May 2020. In addition, the rate on electricity is scheduled to increase from 9 to 10 percent starting from April 1, 2021—the authorities are justifying the slow rate increase on the grounds of limiting cost increases on the poorest. Medical, dental, financial, transportation and educational services are exempt from VAT, and basic food supplies are zero rated.⁴



10. The VAT C-efficiency is 0.56 in 2018, which—although above the SADC and SACU averages—suggests room for improvement if measures are taken to harmonize rates and improve tax morale and compliance to reduce evasion and informality (Figure 7).

A sizeable amount of sales is cash-based and require no invoices, which increases the difficulty in tax administration and detecting evasion. In an effort to automate compliance, the LRA launched a Tax Modernization Project (LTMP), which aims to build a VAT invoice system along with a sector-specific custom-made compliance approach. Under this system, the LRA pre-populates tax returns based on verified information in an integrated data system and simplifies the process for taxpayers.



11. Recently-approved tax policy changes risk undermining the integrity the VAT. As of April 2022, Parliament approved amendments to the 2001 Value Added Tax law to remove zero-rating for the exports of the mining sector to curb what is seen as “perpetual refunds” to the mining sector. This can be harmful to the functioning of the VAT and introduce unintended distortions in business activity:

- For the mining sector, it usually takes several years to expand upfront capital investment before production, therefore, zero rating and refunding VAT on a timely basis are generally accepted policy measures. A non-creditable input VAT on capital assets will prevent the

⁴ Basic food supplies include maize meal, maize, beans, agricultural input, paraffin, milk, bread, peas, animal feeds, lentils, sorghum meal, unmalted sorghum grain, wheat grain, and wheat flour.

companies in the mining sector from improving modernization of plant and machinery, and will be passed through increased output prices, lower dividends to investors, and reduced wages and employment.

- In general, by removing zero-rating of exports, i.e., denying refunds of input tax credits, cascading will arise and the VAT would translate into a tax on exports or productive investment.⁵ Cascading also encourages vertical integration of businesses to minimize the VAT burden, which erodes competition. As the input VAT on capital becomes a tax burden on exports, this would commensurately reduce Lesotho's international competitiveness. Broad exemptions of inputs of raw materials and capital equipment is also a bad policy for a consumption-based VAT.
- Net refund positions are common. Appropriate VAT refund policies preserve the integrity of the VAT and render most exemptions unnecessary.
- Lesotho could instead consider a more targeted approach such as the import VAT deferral mechanism, to reduce the cash flow impact and potential refund claims from import VAT, or targeted VAT exemptions during the mining development phase.

12. The tax regime for MSMEs is still in its primary development stage, and the authorities have started laying the groundwork to bring more MSMEs into the tax net. At present, there is a presumptive tax system in place for the retail and transport sectors—the latter is based on the size of vehicles. To widen the tax net coverage, the LRA has proposed a turnover-based tax, with the aim of introducing it in a phased approach, starting with the transport sector. In the meantime, the new Business Licensing and Registration Act, 2019 (“the Act”) was developed and took effect on November 17, 2020, aiming to automate the business registration and licensing system and facilitate the inclusion of businesses into the formal sector. The Act makes provisions for online license application and payment of various fees, streamlines the procedures, and limits the application processing period to five business days.

13. The diamond mining sector took off in the early 2000s but is viewed by many as not paying its “fair share” of taxes. The revenue sources from the mining sector are the government's equity interest, royalties, corporate income tax, and the withholding tax on dividends.⁶ The royalties on diamond exports constitutes roughly 21 percent of the total nontax revenues. However, the capital structures of most mines—characterized by loans from parent companies—means that profit shifting has undermined CIT revenues over time. As a result, it is possible that changes in the VAT are being used to address problem of international corporate income tax avoidance.

⁵ A destination-based VAT relieves exports from VAT by zero-rating exports and allowing exporters to reclaim all input tax. In jurisdictions with weak revenue administrations or governments facing revenue constraints, refund requests tend to build up, which is especially problematic during extraction firms' start-up phase. It effectively turns the VAT into a tax on investment or on exports.

⁶ Central Bank of Lesotho, *The Scope of Government Revenue Mobilization in Lesotho*, 2017.

14. There remains considerable potential to improve the revenue-raising capacity of the mining sector. The authorities have also proposed the enforcement of an export sales tax.

- **The diamond mining companies are subject to the standard CIT rate of 25 percent, which is significantly lower than regional peers** (Table 2). However, under the current CIT regime, indefinite carry-forward losses allow the mining companies to only start paying CIT when enough profits are generated to cover the perpetual losses. This not only results in lower taxable corporate income but can also create direct losses in already limited dividend income from the government's shareholding. While loss carry-forward reduces asymmetries in corporate taxation and supports risk-taking, it can be overly generous and risk abuse. Therefore, a time-bound loss carry-forward would be preferable: the period where losses can be carried forward could be longer than for ordinary economic activities given the capital-intensive nature of mining, resulting in a longer investment recovery period.
- **Actions are also needed to eliminate the royalty rate negotiability in mining agreements.** The statutory royalty rate is 10 percent according to the Mines and Minerals Act 2005, and the government had proposed in the FY21/22 budget to further increase it to 15 percent. However, in practice the rate can be negotiated on a case-by-case basis between the Ministry of Mining and mines. Despite efforts to eliminate the rate differentials, some mines are still operating under reduced rates as low as 4 percent.
- **The LRA needs improved tax expertise and regulations on transfer pricing.** Such measures would effectively detect tax avoidance behaviors, including mining companies changing ownership without paying tax on capital gains.
- **There is no sector specific profits tax.** Introducing an export tax would for all practical purposes be equivalent to increasing the royalty rate. The staff recommend reviewing the royalty rates instead of introducing an export tax, and removing the immediate expensing of capital expenditure under the CIT, which is a more common policy measure in the mining sector.

Table 2. Lesotho: Mining Sector: Revenue Sources

	Lesotho	Botswana	Namibia
Government shareholding (equity interest)	* 25% Liqhobong Mine * 30% Letšeng Mine * 20% Lemphane Mine * 25% Kao Mine * 20% Kolo Mine * 25% Mothae Mine	* 50% in Debswana, jointly owned with De Beers * 15% in De Beers * 50% Diamond Trading Company Botswana * 80% indirect beneficiary shareholding in Morupule Colliery	* 50% in Namdeb * De Beers Marine Namibia owned 30% by Namdeb and 70% De Beers
Royalty rate	Statutory royalty rate is 10%; increased to 15% in recent proposal. In practice the mining companies can negotiate lower rates.	10%	10%
Corporate tax	Standard 25%	22-55%	55%
Withholding tax on dividend	15%	7.50%	10%
Taxation on Downstream Processing	-	15%	-

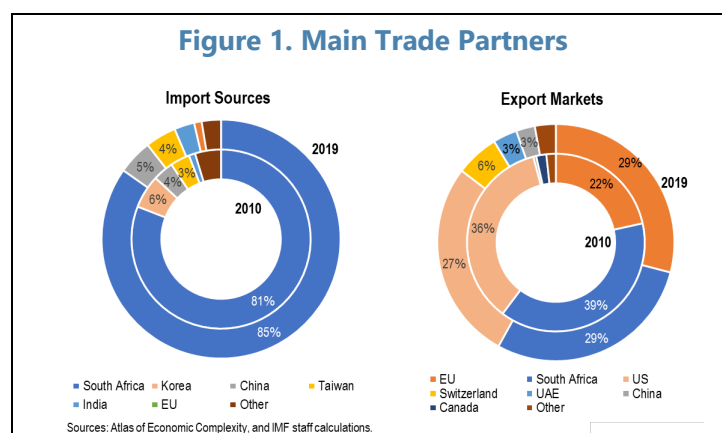
Sources: Lesotho - Lesotho Revenue Authority, Central Bank of Lesotho, Mines and Minerals Act 2005, and FY21/22 Budget Speech. Botswana - Mines and Minerals Act 1999, and Minister of Minerals, Energy and Water Resources. Namibia - Minerals (Prospecting and Mining) Act 33 of 1992.

LESOTHO'S TRADE: OVERVIEW AND RISKS¹

A. Introduction

1. **Lesotho relies on a handful of markets for the majority of its trade.** Trade patterns largely reflect geography, endowments, and preferential trade arrangements.

- **On imports.** 85 percent of goods imports come from South Africa, including most agricultural products (one-third of the total) (Figure 1).² Intermediate products, particularly fabrics, are sourced from China and Taiwan (around 5 percent of the total each). Households depend heavily on remittances from family members working in South Africa in mines, on farms, in the informal sector, and as domestic workers, though mining employment has declined substantially since the 1990s.
- **On exports.** Lesotho's exports are highly concentrated in few markets and products. Over 80 percent of exports comprise textiles and diamonds, and about 85 percent of exports go to three countries—Belgium, South Africa, and the United States (Figure 1). And while concentration in products has increased over the past decade, concentration in destination markets is lower than in 2010 when over 95 percent of exports went to only these three countries. The top export markets remained relatively stable over the past decade, with roughly 30 percent shipped to Belgium, South Africa, and United States each. While exports to South Africa are broad-based, exports to the US and Belgium are concentrated in a single key product category: apparel (85 percent of total exports to the US) and diamonds (100 percent of total exports to Belgium). Among the remaining destination markets, the majority either grant preferential access or have signed a bilateral free trade agreement with Lesotho as part of SACU or SADC (see Box 1).



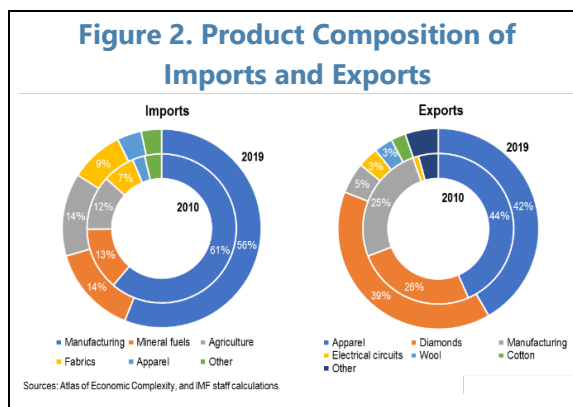
¹ Prepared By Shushanik Hakobyan.

² Such heavy dependence on South Africa for imports is partly being incentivized by the SACU revenue sharing formula, with its customs component based on the share of intra-SACU imports. Lesotho's share was about 9 percent on average over the last decade.

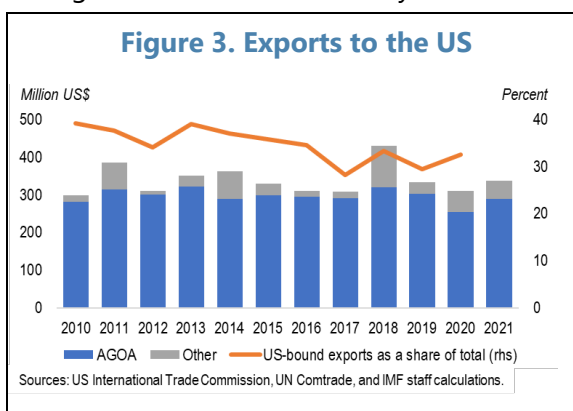
B. Evaluating Lesotho’s Export Performance

2. Lesotho’s growth in recent decades has relied on trade in few key export sectors.

While the country has limited natural resources, several are of considerable economic value—diamonds, cotton, wool, and water—and have become key export commodities. However, Lesotho’s exports are dominated by the apparel sector (Figure 2), which accounts for about 10 percent of GDP. Compared to 2010, Lesotho’s export basket did not change much, with apparel remaining the leading sector, accounting for over 40 percent of the total in 2019, followed closely by diamonds (just under 40 percent in 2019, compared to 26 percent in 2010).



- Apparel.** The largely foreign-owned textiles sector grew in the 1990s and early 2000s in large part due to the combination of cheap labor and the enactment in 2000 of the U.S. African Growth and Opportunity Act (AGOA) that attracted Taiwanese and Chinese investors to set up apparel factories in the country. Under AGOA, Lesotho has been highly successful in exporting apparel to the U.S. by utilizing the favorable rules of origin and duty-free and quota-free market access. Almost all of Lesotho’s exports to the U.S. (around 80–90 percent) take place in the apparel categories falling under Harmonized System (HS) Chapters 61 and 62 (70 percent of total apparel exports) (Figure 3). Moreover, the U.S. continues to remain a top destination market, with its share hovering around 30–40 percent in the past decade. Since then, the combined textile, apparel and footwear manufacturing industry has grown to become the Lesotho’s largest formal private sector employer with estimates in the range of 45,000 (mostly female) workers.

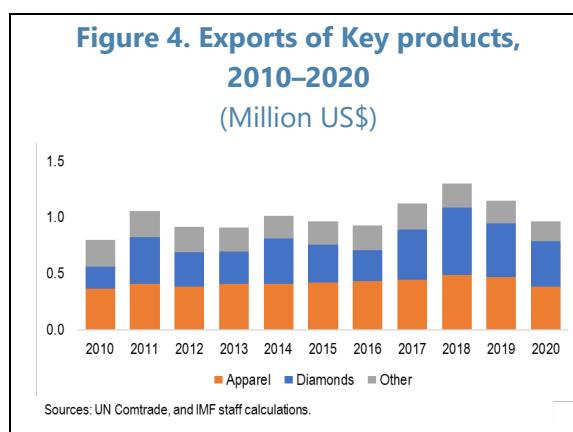


- Diamonds.** After a difficult year when COVID-19 restrictions decimated consumer markets, paralyzed supply chains, and led to the closure of mines, the diamond mining sector has bounced back strongly in 2021, supported by higher diamond prices driven by supply shortages, increased consumer demand, and the recent war in Ukraine. Following closures in 2020, three mines have reopened and are currently operational: Gem Diamond’s Letšeng, Lucapa Diamond’s Mothae, and Namakwa’s Kao. Despite the challenges presented by travel restrictions, supply chain constraints, extreme weather conditions and recurrent power outages, the Letšeng mine recovered 14 percent more carats in 2021 (115,335, compared to

100,780 in 2020), with the average price at \$1,835 per carat, which was 4 percent lower than in 2020, mainly due to fewer large and exceptional diamond recoveries. The Mothae mine has expanded its processing capacity by 45 percent in 2021, and continued its cutting and polishing partnership, which promises to move the sector up the diamond value chain. After over a year of inactivity, Firestone Diamonds’ Liqhobong mine was expected to restart its operations in the second half of 2021 but remains inactive due to ongoing debt restructuring negotiations. Two locally owned mines, Thaba-Telle and Qaqa, have been awarded diamond mining leases, but are not yet operational.

- Water.** Lesotho is a net exporter of water. The Lesotho Highlands Water Project (LHWP), established through a bilateral treaty in 1986, comprises a system of dams and tunnels throughout Lesotho to deliver water to South Africa’s Gauteng region. The project transfers about 900 million cubic meters of water annually and generates 72-megawatt (MW) hydropower at the Muela Power Station. Annual royalties from water transfers have averaged LSL950 million over the last five fiscal years, or 2.8 percent of GDP. While the revenue potential is significant, ongoing delays—exacerbated most recently by the pandemic and adverse weather—continue to beset Phase II of the project.

3. Textiles, clothing, and footwear exports were hit hard by the pandemic. Of the key export sectors, textiles, clothing, and footwear have contributed the most to growth over 2015–19. The containment measures imposed at the onset of COVID-19 pandemic (i) disrupted supply chains leading to limited availability of inputs; (ii) resulted in a decline in global demand for apparel, and (iii) caused labor shortages, all of which negatively impacted the sector. As a result, apparel exports declined from \$485 million in 2018 to \$385 million in 2020 (Figure 4).

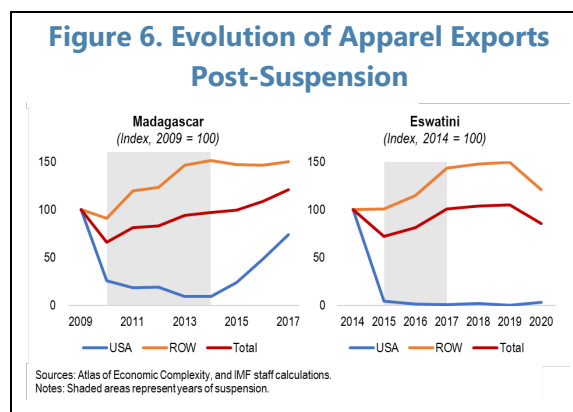


4. Lesotho is at risk of losing out to competitors in the apparel sector, both regional and global. The preferential access afforded by AGOA, coupled with a relatively low monthly wage of about \$150, helped Lesotho remain moderately competitive in the past (Figure 5). In sub-Saharan Africa, Eswatini, Ethiopia, Kenya, Madagascar, and Mauritius also have large export-oriented apparel sectors, while global textile giants outside of China like Vietnam, Malaysia, and Singapore also pose a challenge. However, the recent 14 percent minimum wage hike in the textile sector and the



anticipated expiration of AGOA in 2025 are expected to erode Lesotho’s competitiveness in the global apparel industry.

5. Historically, AGOA suspensions have had a significant negative impact on the apparel exports of affected countries.³ For instance, Eswatini, another SACU member, with predominantly apparel exports to the US, was removed from the AGOA in January 2015. Pre-suspension, in 2014, Eswatini claimed AGOA benefits for \$59 million of its exports to the US of which \$57 million were apparel products (one-third of the country’s apparel exports). Eswatini’s apparel exports to the US dropped to \$2.7 and \$1 million in 2015 and 2016, respectively, and never recovered despite its redesignation as an AGOA beneficiary by end-2017. It takes three or more years for the lost exports to recover as countries divert exports to other existing destination markets. In case of Eswatini, apparel exports were entirely diverted to South Africa (Figure 6). Similarly, in case of Madagascar, they were predominantly diverted to EU, with the US regaining its market share after the AGOA benefits were reinstated. More recently, anecdotal evidence from Ethiopia, another apparel manufacturing hub benefitting from AGOA, suggests that the suspension of AGOA benefits has led to apparel manufacturers closing shops and moving elsewhere. The US tariff rates on apparel are quite high, ranging from 15 to 32 percent. Hence, the estimated tariff savings from AGOA are sizable—over \$70 million (Table 1). The anticipated loss of preferential access will increase the pressure on the apparel sector in an increasingly competitive global market.



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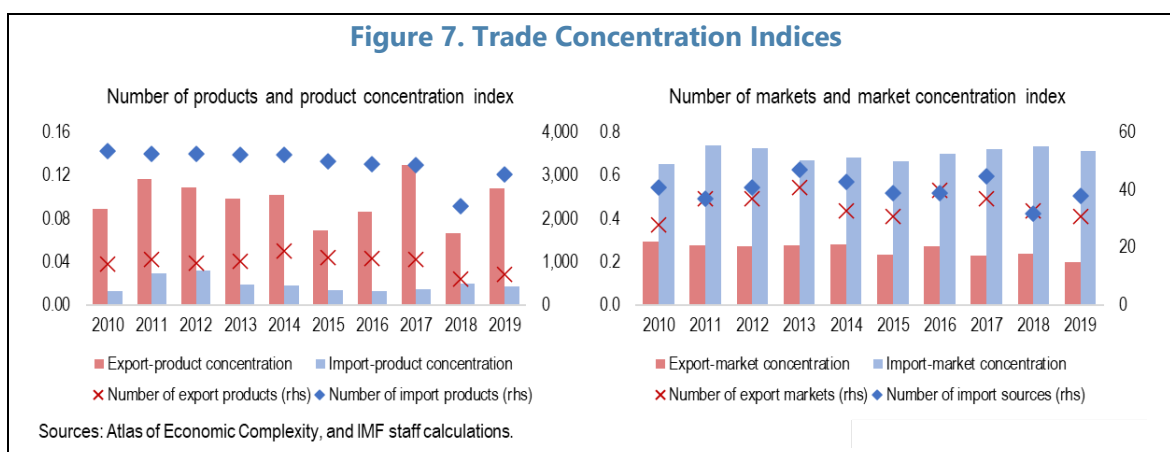
Table 1. Lesotho: Top 10 Products Exported to the US, 2021

Product	Value of exports (million US\$)	Share in exports (percent)	MFN tariff rate (percent)	AGOA eligible?	Estimated duty savings (million US\$)
Women's or girls' trousers, breeches and shorts, of synthetic fibers	100.5	29.8	28.2	yes	28.3
Men's or boys' trousers and shorts, of cotton	54.1	16.0	16.6	yes	9.0
Sweaters, pullovers and similar articles	33.3	9.9	32.0	yes	10.6
Nonindustrial diamonds, unworked	29.8	8.8	0	no	0
T-shirts, singlets, tank tops and similar garments	24.7	7.3	32.0	yes	7.9
Men's or boys' trousers, breeches and shorts, of synthetic fibers	19.8	5.9	28.2	yes	5.6
Men's or boys' shirts, of manmade fibers	18.0	5.3	32.0	yes	5.8
Women's or girls' trousers, breeches and shorts, of cotton	11.9	3.5	14.9	yes	1.8
Women's or girls' trousers, breeches and shorts, not knitted/crocheted	10.5	3.1	16.6	yes	1.8
Nonindustrial diamonds, worked, but not mounted or set	10.5	3.1	0	no	0
Total Top10	313	93			71

Sources: US International Trade Commission, and IMF staff calculations.

³ Prior to 2022, 15 AGOA eligible countries (out of 45) have seen their preferential access to the US market suspended. An empirical analysis of AGOA eligible countries’ exports to the US shows that the suspension of AGOA benefits leads to a significant and sizable drop in exports to the US. This effect is greater for apparel exports, for countries with longer suspension periods (more than three years) and for the first year of suspension.

6. While Lesotho’s export- and import-product concentrations are broadly comparable with the average for other SACU members, export- and import-market concentrations are the highest among SACU members. Lesotho exports about 700 products (out of the approximately 5,300 products), based on the HS6 classification, down from about 960 in 2010, significantly lower than SACU average of 2,500 products (Figure 7). Nevertheless, the export-product concentration index is comparable with the average for other SACU members, excluding Botswana. Imports are more diversified; the number of imported goods is much larger—about 3,000—and has been broadly stable, except for a dip in 2018. In terms of trading partners, Lesotho’s both exports and imports are highly concentrated—about 30–40 markets or source countries—significantly lower than the SACU average of 80, excluding South Africa. Over 85 percent of Lesotho’s imports come from South Africa.



7. Diversification will make Lesotho more resilience to external shocks. Going forward, to mitigate the impact of AGOA expiration and full implementation of African Continental Free Trade Area (AfCFTA), it would be important to move from heavy dependence on a narrow range of products and a small number of trading partners to diversification into new products and trading partners, as well as increase in the quality of existing products, which would also offer opportunities to move labor from the low productivity informal sector to higher productivity activities that are globally competitive.

C. Implications for SACU after AfCFTA

8. The AfCFTA provides an opportunity to diversify export markets. Given that Lesotho’s imports are highly concentrated and arrive predominantly duty-free from South Africa under SACU (imports from other African countries comprise less than 1 percent of total imports), there is little scope for change in import patterns, at least in the short run. Likewise, exports to African countries outside of SACU/SADC are negligible. However, the AfCFTA has the potential to open new market opportunities for apparel exporters to further diversify their markets toward other African countries that are net importers of apparel (e.g., Angola, Nigeria, Senegal, and Togo).

9. The full implementation of AfCFTA is likely to have a minimal impact on SACU transfers. SACU transfers have been in decline due to shifting global and regional trade dynamics, with imports increasingly entering SACU duty-free and at lower MFN duty rates. The SACU average external import duty against other non-SADC African countries stands at 11 percent, generating about \$40 million in customs revenues, which pales in comparison to the duties collected on imports from the rest of the world (over \$3.5 billion) (Table 2).

Table 2. SACU: External Tariff and Duties Collected

	SACU external tariff (percent)	Estimated duties collected (million US\$)
Africa (excluding SADC)	11.1	39
SADC	0.4	2
EFTA	2.5	18
EU (including UK)	2.7	498
Mercosur	7.4	63
Rest of the World	10.8	3,056
Total		3,676

Sources: UN TRAINS, Atlas of Economic Complexity, and IMF staff calculations.

Box 1. Lesotho’s Trade Arrangements and Tariff Regime

Lesotho’s participation in a number of trade arrangements reflects its decades-long efforts at trade integration both within the continent and outside the region (Figure 1.1). Lesotho has been a member of the World Trade Organization (WTO) since May 1995 and a member of GATT, the WTO predecessor, since 1988. At the regional level, Lesotho has been a member of the Southern African Customs Union (SACU), the oldest existing customs union in the world, since 1910. Lesotho has two other regional trade agreements in force: Southern African Development Community (SADC), founded in 2000, and Common Market for Eastern and Southern Africa (COMESA), founded in 1994 (Figure 1.2). Outside the continent, Lesotho has signed free trade agreements as part of SACU with (i) the European Free Trade Association (EFTA)—Iceland, Liechtenstein, Norway, and Switzerland, in effect since May 2008; (ii) the Southern Common Market (MERCOSUR)—Argentina, Brazil, Paraguay, and Uruguay, since April 2016; and as part of SADC (iii) an Economic Partnership Agreement (EPA) with the European Union, effective since October 2016. Following Brexit, Lesotho as part of SACU signed an FTA with the UK, which entered into force in January 2021. Negotiations are ongoing to conclude a free trade agreement between SACU and India and the Tripartite Agreement between COMESA, EAC and SADC. Lesotho is also among the 54 African Union nations that have signed a deal to form the African Continental Free Trade Area (AfCFTA), launched on January 1, 2021.

Figure 1.1 Lesotho’s trade arrangements



Sources: WTO Regional Trade Agreements Database, and WTO Database on Preferential Trade Arrangements.

Lesotho benefits from preferential access to a number of countries. Lesotho is a beneficiary of the generalized systems of preferences (GSP) granted by Australia, Canada, Eurasian Economic Union (Armenia, Kazakhstan, Kyrgyz Republic, and Russia), European Union, Iceland, Japan, New Zealand, Norway, Turkey, UK, and US. As a least developed country, it also has preferential or duty-free market access to Chile, China, Korea, India, Montenegro, Morocco, Tajikistan, and Thailand. Most importantly, Lesotho qualifies for duty-free and quota free access to the US market under the African Growth and Opportunity Act (AGOA).

Figure 1.2 Timeline of Lesotho’s reciprocal trade agreements

