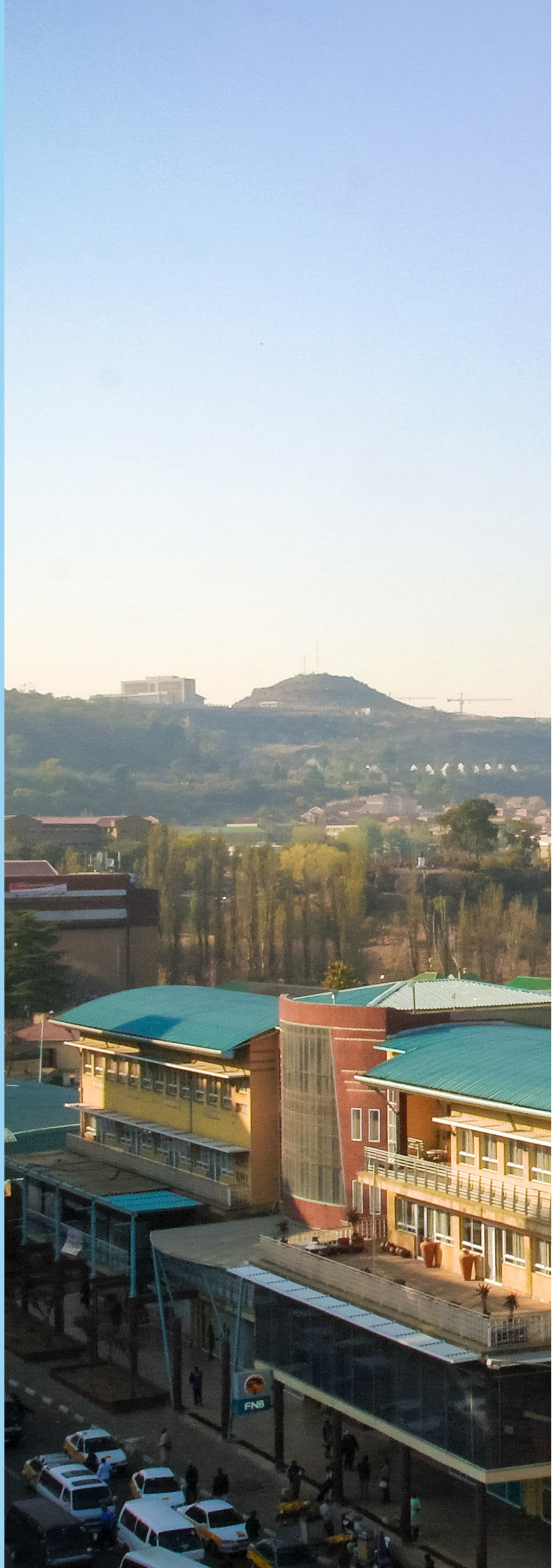
Lesotho



Lesotho 2018 Constraints Analysis Report

Millennium Challenge Corporation
United States of America

An Analysis prepared by the Government of Lesotho and the Millennium Challenge Corporation of the United States of America for the Development of a Millennium Challenge Corporation Compact Program.

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Authors & Acknowledgements

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he analysis was conducted in collaboration with the Government of Lesotho (GoL). The GoL's engagement with MCC under the Compact Program was led by Compact Development Lead Mr. Thabo Foulo.

Stefan Osborne and Derick Bowen were the economists for the CA team that included Michelle Adato (GSI), Kathy Vaughn (GSI), and Deidra Fair James (FIT). Development of MCC's Compact Program with Lesotho was under the overall leadership of Guyslain Ngeleza.

Abstract

The Kingdom of Lesotho is small, mountainous, landlocked, and located entirely within the borders of the Republic of South Africa (RSA). A significant portion of Lesotho's economic activity results from labor moving from Lesotho to work in mines in South Africa. Lately South Africa has debated whether to restrict migrant labor from Lesotho, meaning Lesotho would have to generate more job opportunities domestically. The private sector in Lesotho is so small, currently, that the government is almost 50% of GDP. The large size of the government relative to the private sector, combined with the difficulty it has collaborating effectively with the private sector to generate job-creating investment, is the primary constraint to economic growth. Lesotho also has a high incidence of HIV/AIDS, substantially lowering labor productivity and discouraging investment in job-creating sectors.

Constraints:

- **Poor Health Primarily Related to HIV/AIDS:** The burden of disease for working age individuals in Lesotho is by far the highest in the world, and is primarily driven by HIV/AIDS. Lesotho's rate of new HIV/AIDS infections is also the highest in the world, and the gap between the working-age burden of disease in Lesotho and that in neighboring Southern African countries has significantly increased over the past 10 years. This disease burden substantially reduces labor productivity, discourages investments in job-creating sectors, and imposes large direct costs on both the government and households in the form of health care expenditures and care for HIV/AIDS orphans and other dependents.
- **Ineffectiveness of Policy Planning, Coordination, and Execution:** This constraint manifests in two distinct ways:
    - ***Absence of Planning and Coordination:*** This problem is related to how effectively the government interacts with the private sector in deciding what to do (which roads to build where, etc.). Rather than creating an enabling environment to attract investment, the Lesotho government generally attempts to create businesses in a chosen sector, then turns the businesses over to private sector actors. Lack of coordination with key stakeholders means these turnkey operations are rarely financially successful. Often the intervention crowds out private sector investment, rather than attracting it. Examples include:
        - Absence of coordination between public and private sector for efficient public investment in the highlands to enable tourism and other sector developments.
        - Absence of coordination between public and private sector for efficient public investment in the highlands to enable commercialization of wool and mohair.
    - ***Inefficient Public Service Delivery, Public Investment Management, and Public Financial Management (PFM),:*** This problem is related to how well the government enacts/builds whatever it is it has decided to do. The Government of Lesotho's ability to execute planned projects is significantly hindered by poor processes for executing the government budget. As the GOL is the biggest procurer of goods and services, inefficient procurement processes and delayed payment for services rendered have had a significant negative impact on the operations and finances of many companies, especially Basotho-owned firms. Examples include:

- Inefficient health service delivery and expenditure.
- Inability of the Ministry of Public Works and Transport to spend the money accumulated from its Road Fund for the rehabilitation and maintenance of the failing road network.
- Large and inefficient public sector, excessive wage bill, and dysfunctional labor market.

Country Context

The Kingdom of Lesotho is small, mountainous, landlocked, and located entirely within the borders of the Republic of South Africa (RSA). The country is ethnically and culturally homogeneous, with a predominantly Basotho population (99.7 percent). The government is a constitutional monarchy with a dual legal system consisting of customary law, codified under the Laws of Lerotholi, and common law.

Political History

The society is patriarchal, with lineage devolving along the male line. As of 2016, the population was 2.204 million and demographically young, with approximately 40 percent of the population aged 15-35 (considered youth). Roughly 40 percent of the labor force is engaged primarily in subsistence and small stock agriculture. About 28 percent of the Lesotho population is urban, while the remaining 72 percent is located primarily in the rural lowlands. Because of its mountainous geography, many rural areas in Lesotho are isolated from centers of economic activity. About 180,000 Lesotho citizens (i.e., they visit Lesotho for a month at least once a year) live abroad.[1] Another sizeable number of Basotho (estimated 200,000 to 400,000) live permanently in South Africa, about three quarters of whom have not registered to work and are at risk of being returned to Lesotho. 11% of Lesotho migrants working abroad in South Africa are "skilled" workers (managers, professionals, technicians and associate professionals, and skilled agriculture, forestry, and fishery workers).

Economic History & Productive Sectors

The main features of Lesotho's economy are a persistently high unemployment rate (estimated by the International Labour Organization at 28 percent); an exceedingly large and dysfunctional public sector (the wage bill alone is an outlier at 17.8 percent of GDP); the highest incidence of HIV and HIV-related tuberculosis in the world; and

1 Source: 2016 Lesotho Census.

What is a Constraints Analysis?

MCC's evidence-based approach begins with a constraints-to-economic growth analysis (CA). In a CA, MCC works with a partner country to examine and prioritize the issues that constrain its economy. The CA approach builds on the "growth diagnostic" framework put forward by economists Ricardo Hausmann, Dani Rodrik, and Andrès Velasco (HRV). As HRV point out, all developing countries face significant economic and development challenges, but these challenges do not all equally restrict growth. The diagnostic framework provided by HRV helps to structure the investigation of potential binding constraints. It has been refined through application, both within MCC and the broader economic development community.

Why Does MCC Use Constraints Analysis?

Identifying the most binding constraints to growth helps MCC target its investment on the areas that, if addressed, are most likely to promote sustainable, poverty-reducing growth in a given country. Prioritization helps maximize the limited financial resources and implementation capacity needed to effect change. As HRV also argue, focusing on the most binding constraints helps to minimize the risk that development interventions create negative unintended economic consequences.

persistent political instability. Recent economic growth has been driven by capital- and skills-intensive sectors such as mining, finance, and ICT, leading to "jobless growth" (for less skilled workers) and highly unequal economic outcomes.

Inclusion and Poverty

Lesotho shares a high youth unemployment rate with several other African countries, including the "small middle income countries" (SMICs) of sub-Saharan Africa.[2] Like other SMICs, Lesotho has tried to absorb surplus labor into the government. Lesotho's is the most extreme case of this strategy, leading to a government wage bill that is by far the highest among the SMICs, and among the highest in the world. This strategy has failed to significantly reduce structural unemployment, which is the result of a very slow rate of job creation, particularly in labor-intensive sectors of the economy such as agriculture and manufacturing—dominated by textiles and apparel, driven by US African Growth and Opportunities Act (AGOA) preferences.

Slow job creation has resulted in a disappointing impact of economic growth on poverty incidence. Despite nearly four decades of fairly robust per capita income growth (from $330 in 1980 to $1,039 in 2016), the national poverty headcount rate stayed virtually unchanged, at 57.1 percent, from 2002 to 2010.[3] Following Lesotho's political crisis, by 2016 the poverty headcount had increased to 59.6 percent. Lesotho's income distribution is one of the most unequal in the world, with a GINI coefficient of about 0.54. Lesotho barely achieved two out of eight of its Millennium Development Goals, including failing to reduce the proportion of people living below the poverty line by half (to 29 percent) by 2015. The United Nations Development Program (UNDP) estimates that the incidence of poverty is higher in rural areas (up to 61 percent) and amongst youth. Almost 80 percent of Basotho live on incomes of less than $3 per day, and about 60 percent live on less than $1.90 per day. Extreme poverty is concentrated in rural areas, particularly in the mountain regions, where 71 percent of the population lives below the poverty line. Weak service delivery and transport infrastructure continues to exacerbate this inequality.[4] Lesotho can be considered a vulnerable state given the high levels of inequality and economic exclusion, high incidence of poverty, and weak government capacity to provide conditions for meaningful development.[5]

2 Botswana, Cabo Verde, Lesotho, Mauritius, Namibia, Seychelles, and Swaziland.

3 The national poverty line is constructed based on the value of a minimal level of consumption, which was M246.6 (approximately. US$1.18)/person/month in 2011. *http://www.undp.org/content/dam/undp/library/MDG/english/MDG%20Country%20Reports/Lesotho/LESOTHO%20MDGR%202013%20-%20FINAL.pdf*

4 Bertelsmann Transformation Index 2016 (available on the internet at *https://bti-project.org/*)

5 Cilliers and Sisk 2013.

Inequality is not limited to urban-rural differences: poverty in Lesotho is closely linked to gender roles and power dynamics. Gender equality continues to be one of the government's main priorities, but meaningful progress has been slow. Lesotho has fallen from 16th place out of 136 countries in the 2013 Global Gender Gap Report, to 73rd of 144 countries in 2017.[6] This decline reflects strong, persistent, and well-documented gender inequalities across society, many of which play a role in the growth constraints examined below.

Poor health outcomes in Lesotho also contribute to poverty, and the nation ranks in the bottom quartile of SSA income group peers in several health indicators. According to the joint UN Program on HIV/AIDS (UNAIDS), in 2016 25.6 percent of the population between the ages of 15 and 49 were infected with HIV; approximately 9,900 people died of AIDS-related illnesses, and about 73,000 children under the age of 18 were orphaned due to AIDS. Data from the 2016-17 Lesotho Population-Based HIV Impact Assessment (LePHIA) show that among demographic groups HIV prevalence peaks at 49.9 percent for women age 35 to 39, and 46.9 percent among men age 40 to 44.[7] In response to the health crisis, the Government of Lesotho (GOL) has committed to the UNAIDS's 90-90-90[8] targets to reduce HIV infections and AIDS deaths by 2020. Initial results from LePHIA suggest that Lesotho is on track to reach these targets (status as of 2017: 78-90-88),[9] but the situation remains alarming.

Lesotho's growth patterns have not set the nation up for success in addressing these challenges. Economic growth in Lesotho over the past 14 years has been driven by a shift from dependence on exports to dependence on government spending. Between the 2004/2005 and 2016/2017 fiscal years, public spending rose from 36 percent to 47.3 percent of GDP, one of the highest such ratios in the world. Over the same period, exports declined from 17.8 percent to 10.9 percent of GDP. Four factors drove this decline in exports: weak growth in the textile and garment sectors, due to the global economic crisis in 2008; closure of several large factories in early 2014, alongside cancelation of major textile orders due to clients' fears regarding political uncertainty; a slowdown in the South African economy, from which Lesotho receives large fiscal transfers, remittances, and foreign direct investment (FDI); and under-execution of public investment as a result of the recent political turmoil. According to the World Development Indicators, GDP per capita growth fell from 4.2% in 2016 to -2.1% in 2017 and -1.2% in 2018. The negative growth in Lesotho has been associated primarily with slow economic growth in South Africa and Lesotho's political instability.

Lesotho also faces several growth challenges given its unique geopolitical environment. Lesotho is relatively poor in natural resources, with the exception of water and, as tapped more recently, diamonds. Because its domestic markets are small, Lesotho is highly open to international trade and depends on integration into international and regional supply chains. Lesotho relies heavily on preferential regional and international trade agreements, such as AGOA, to fuel its integration into international supply chains. Furthermore, Lesotho is highly vulnerable to international price and supply shocks because of its small size and undiversified production base. International downturns whittle away savings and exacerbate poverty. In fact, the International Monetary Fund (IMF) and rating agencies project a weak and concerning economic outlook for Lesotho, mainly reflecting the dampening effects on demand of a looming fiscal adjustment in response to a large drop in SACU revenues to Lesotho (41 percent of budgeted revenue in 2017/2018), which Lesotho is not expected to recover. The largest component of GDP, government spending (about 47.3 percent of GDP in 2016/2017), relies on SACU revenues (32 percent of government revenues) that are largely

6 Available on the internet at *http://www3.weforum.org/docs/WEF_GGGR_2017.pdf*.

7 Lesotho Population-Based HIV Impact Assessment (LePhia) 2016–2017 Survey figures from Summary Sheet of Preliminary Findings, released November 2017. Available on the internet at *https://phia.icap.columbia.edu/lephia-final-report/*.

8 90-90-90 HIV Treatment Cascade Targets: 90% of people with HIV know their status; of whom 90% are on antiretroviral treatment; of whom 90% are virally suppressed (meaning the human body is successfully controlling HIV).

9 LePhia 2016-2017.

dependent on South African economic growth. Weak South African growth, due to long-term structural issues, remains the main risk to Lesotho's growth. Due to limited flexibility to reduce wages, the Fitch Ratings agency expects the GOL authorities to respond by cutting capital expenditure with the deficit partly financed by drawing down of government deposits.[10] Economic weaknesses are compounded by risks arising from political instability and insecurity in Lesotho; in recent years this has manifested through a coup attempt in 2014.

Growth Question

The Kingdom of Lesotho is small, mountainous, landlocked, and located entirely within the borders of the Republic of South Africa (RSA). A significant portion of Lesotho's economic activity results from labor moving from Lesotho to work in mines in South Africa. Lately South Africa has debated whether to restrict migrant labor from Lesotho, meaning Lesotho would have to generate more job opportunities domestically. The private sector in Lesotho is so small, currently, that the government is almost 50% of GDP. The large size of the government relative to the private sector, combined with the difficulty it has collaborating effectively with the private sector to generate job-creating investment, is the primary constraint to economic growth. Lesotho also has a high incidence of HIV/AIDS, substantially lowering labor productivity and discouraging investment in job-creating sectors. This leads to the growth question that is the focus of this report: **How can Lesotho's government more effectively plan, coordinate, and execute policies that will unlock job creating investments?** The remainder of this report examines the constraints that prevent the country from achieving such growth.

10 See *http://www.reuters.com/article/2015/04/24/idUSFit92070620150424*.

Discussion of Constraints

Prior to its first technical mission to Lesotho in February 2018, the Country Team worked with the GOL to establish a Constraints Analysis Panel (CAP), comprising economists from the GOL, private sector, and academia, to validate the binding constraints to growth that would be identified during its desk analysis.

During the mission, the MCC and LMDA teams conducted extensive consultations with public and private sector stakeholders to discuss the identified constraints to growth, present evidence, and solicit views on the sectors that offer the greatest potential for investment and growth.

Consultation stakeholders recommended that three specific sectors— Agriculture, Tourism and Manufacturing— would have the greatest potential to drive sustainable and inclusive private sector led growth and job creation; thus, contributing to the achievement of the government's critically important goal of producing shared and employment generating growth.[11]

Acknowledging the CAP's specific concerns about job creation, the Country Team focused on identifying the binding constraints to private sector led growth, including in sectors with job creation potential, using the data available and weighing appropriately the anecdotal evidence presented by the CAP and stakeholders. The Country Team economists ultimately identified the following two constraints as binding:

Poor Health Primarily Related to HIV/AIDS

The burden of disease for working age individuals in Lesotho is by far the highest in the world,[12] and is primarily driven by HIV/AIDS. Lesotho's rate of new HIV/AIDS infections is also the highest in the world, and the gap between the working-age burden of disease in Lesotho and that in neighboring Southern African countries has significantly increased over the past 10 years. This disease burden substantially reduces labor productivity, discourages investments in job-creating sectors, and imposes large direct costs on both the government and households in the form of health care expenditures and care for HIV/AIDS orphans and other dependents.

Lesotho's high burden of disease discourages investment, job creation, and economic growth by reducing the productivity of labor throughout the working age population and increasing business costs of dealing with health-related issues. Both these effects reduce returns on investment in Lesotho, hindering job creation and economic growth, particularly in labor-intensive industries. Poor health raises costs through higher absenteeism and staff turnover, which requires firms to recruit and train new workers. Poor health among firm managers also reduces technical efficiency and investment returns.[13] The health implications of HIV/AIDS are particularly problematic from a development perspective, as the disease tends to affect mainly people of working age. In addition to these indirect costs, HIV/AIDS imposes substantial direct costs on the government and individuals in the form of health care expenditures and care for HIV/AIDS orphans and other dependents.

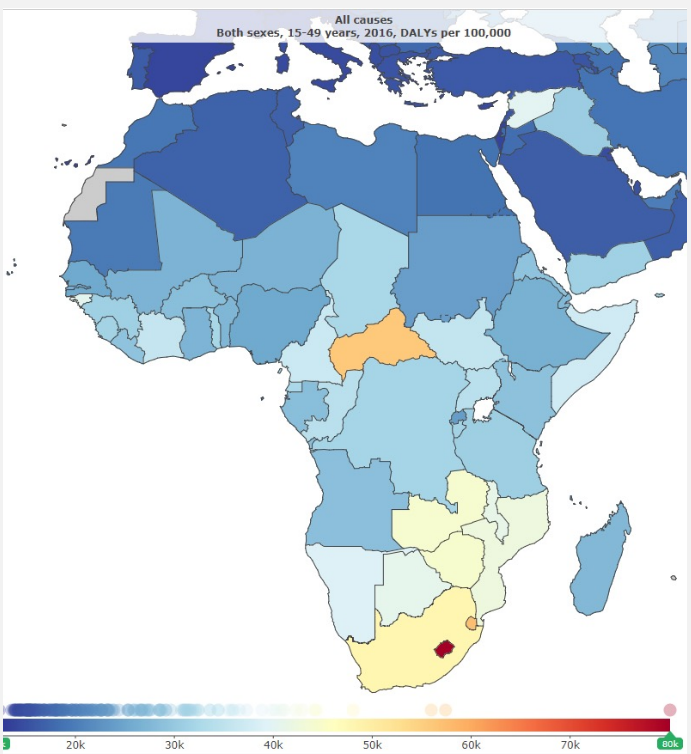
11 These findings are consistent with the opportunities for broad based, inclusive growth identified in Lesotho's National Strategic Development Plan (2013-2017), which identified agriculture, manufacturing, and tourism as strategic sectors for diversifying the economy; these sectors can contribute to inclusive economic development and poverty reduction by expanding economic opportunities for local people, particularly women and youth.

12 Institute for Health Metrics and Evaluation GBD (2017), comparison of DALYS worldwide for age 15-49.

13 HIV/AIDS status of firm managers has been shown to strongly predict firm growth and survival in other contexts (Chao et al. 2007). For examples of stochastic production frontier estimation of managerial characteristic determinants of technical efficiency, see for instance Battese and Coelli (1995) and Ali, Bowen and Deininger (2017).

A common measurement of the burden of disease is disability-adjusted life years (DALYs) lost to illness. A disability-adjusted life year can be thought of as a year of 'healthy' life. The sum of DALYs lost across the population (i.e., the burden of disease) reflects the gap between the current health status and an ideal situation where the entire population lived to an advanced age free of disease and disability. Among 15–49-year-olds, Lesotho lost 80,000 DALYs per 100,000 individuals in 2016, two-thirds greater than the average of 48,000 per 100,000 individuals in Southern Africa, and 150 percent greater than the average of 31,500 per 100,000 in Sub-Saharan Africa overall (Annex A, Figure 1).[14]

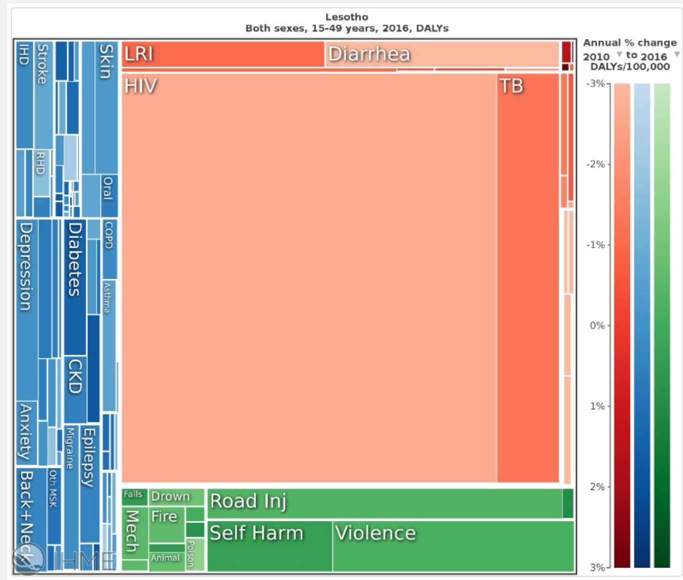
FIGURE 1 Working-age disability adjusted life years lost to disease by country (indicated by redness of shade)



Source: IHME GBD (2017)

This exceptionally high burden of disease among 15–49-year-olds is primarily driven by HIV/AIDS and associated tuberculosis. The World Health Organization (WHO) estimates that 52 percent of Lesotho's working-age disability-adjusted life years lost due to disease can be ascribed to HIV/AIDS, and another 9 percent to tuberculosis (see Annex A Figure 2).

FIGURE 2 Working-age disability adjusted life years lost by cause (indicated by size of rectangle)



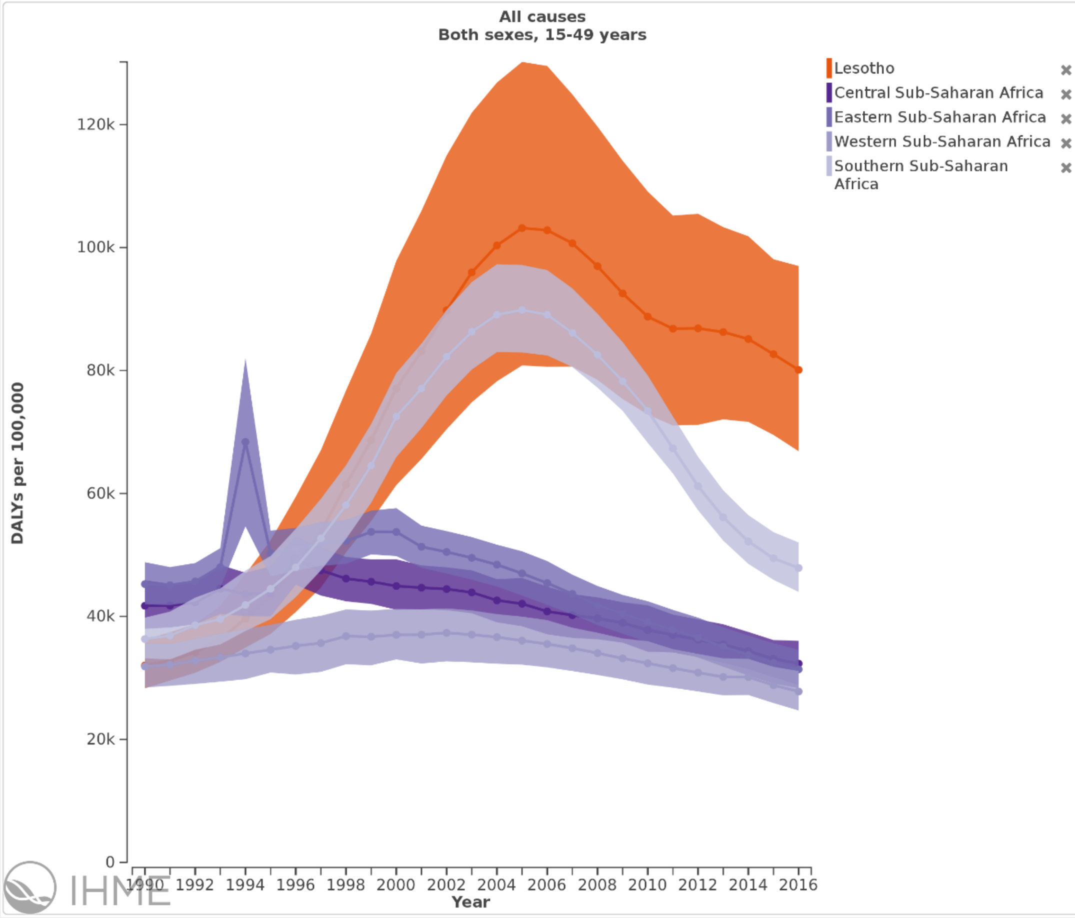
Source: IHME GBD (2017)

Among 15–49-year-olds, Lesotho experienced 1,460 new cases of HIV per 100,000 individuals in 2016, double the average of 735 per 100,000 in Southern Africa, and more than 5 times the rate of 235 per 100,000 in Sub-Saharan Africa overall. Moreover, the estimated gap between the rate of DALYs lost by Lesotho's working-age population per year and the rate of DALYs lost by Lesotho's Southern African neighbors has more than doubled over the past 10 years from 14,000 per 100,000 in 2006 to 32,000 per 100,000 in 2016 (Annex A Figure 3).[15]

14 IHME GBD (2017).

15 IHME GBD (2017).

FIGURE 3 Working-age disability adjusted life years lost to disease by year



Source: IHME GBD (2017)

Reflecting this, businesses in Lesotho are more concerned that HIV/AIDs will have a substantial impact on their companies' bottom line in the next five years (e.g., death, disability, medical and funeral expenses, productivity and absenteeism, recruitment and training expenses, revenues) than businesses in any other country in the world (Annex A Figure 4).[16]

One example of business impacts is the garment industry, where the prevalence rate is particularly high at 44 percent.[17,18] The Lesotho Textile Exporters Association reported that, at its peak, HIV/AIDs related absenteeism reached about 5 percent, productivity in factories declined, and a constant cycle of AIDS-related deaths and funerals significantly affected the industry. In response, the industry started the donor funded Apparel Lesotho Alliance to Fight AIDS (ALAFA), whose interventions contributed to a decline in absenteeism to less than 2 percent and a 10 percent increase in productivity. ALAFA ceased operations in 2014 due to lack of donor support. However, more than two thirds (27) of the 37 textile factories with ALAFA clinics on site self-financed these clinics' continued operation due to their impact on productivity. This is a clear indication of private sector efforts to circumvent poor public health.[19]

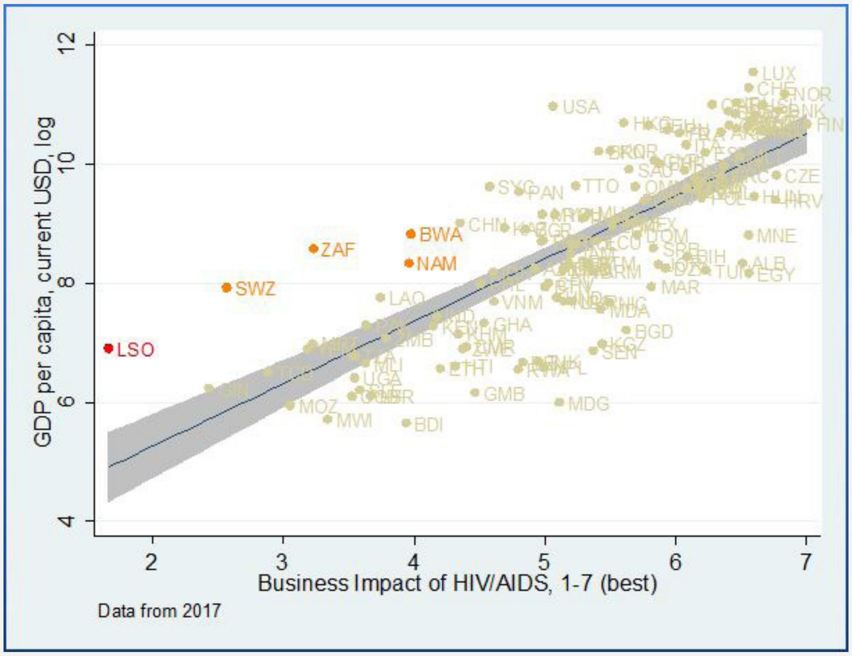
16 World Economic Forum Global Competitiveness Index (2017).

17 World Bank (2014).

18 HIV/AIDS prevalence is also particularly high among migrant workers, such as miners (often men), and domestic workers (often women). Botea et al (2018) find that 55 percent of migrant women working in garment factories, and 38 percent of domestic workers are HIV positive, relative to the national average of 30 percent.

19 ALAFA (2012).

FIGURE 4 Anticipated businesses impact of HIV/AIDS over next five years



Source: Global Competitiveness Index and World Development Indicators

In addition to indirect effects on household income, the high burden of disease imposes large direct costs on both the government and households in the form of health care expenditures and care for HIV/AIDS orphans and other dependents. UNAIDS estimates that domestic public expenditure on HIV alone was 2.6 percent of GDP in 2014, with international donors contributing the equivalent of an additional 2.4 percent of GDP.[20] Although UNAIDS estimates for private expenditures in Lesotho are unavailable, a systematic review of studies in lower to middle-income countries suggests that average direct household expenditures on HIV/AIDS care during the terminal period are over 30 percent of household income per annum in most countries, and as high as 50-100 percent in many. [21]

Since the disease primarily affects people of working age, households typically face these large direct costs at the same time as loss of income when wage earners die or become incapacitated, pushing many households into poverty. When workers die from HIV/AIDS, the number of wage earners in the household decreases, and more people are dependent on fewer income earners. This has contributed significantly to Lesotho's high dependency ratio, estimated at 67 percent.[22,23] These effects reduce savings and asset accumulation over time, increasing households' vulnerability to income and consumption shocks. They also reduce the stock of wealth available to finance investments such as education or entrepreneurial activities.

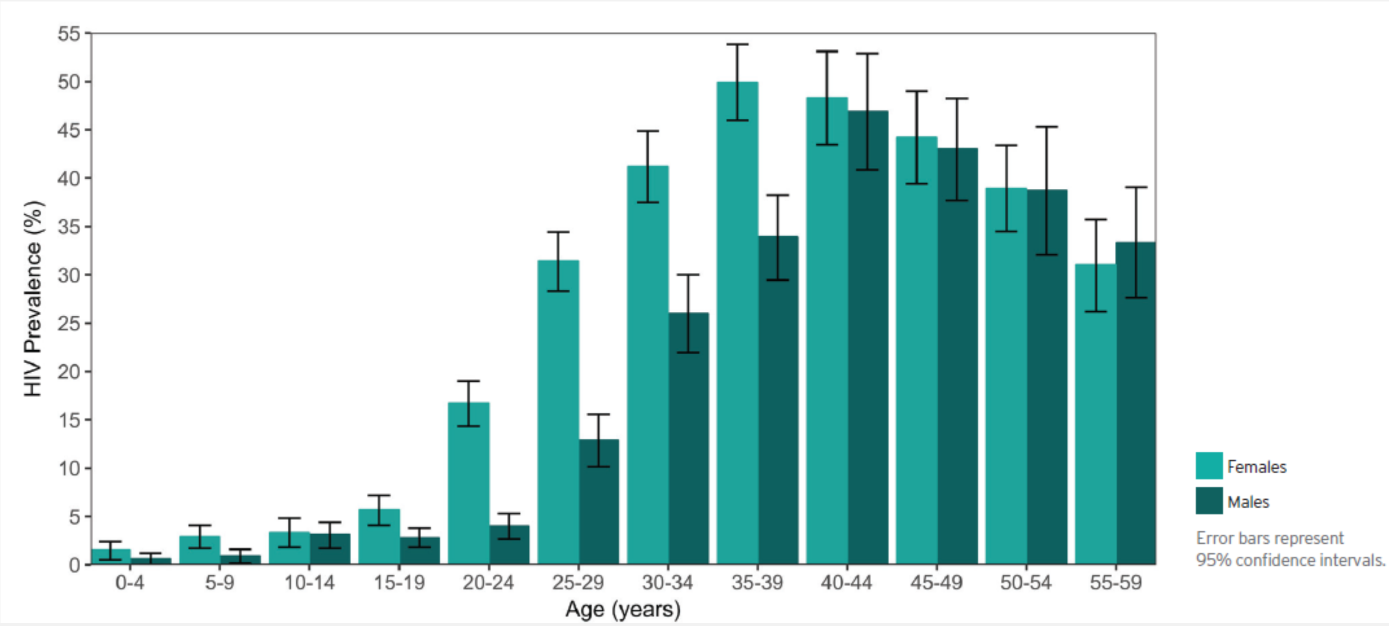
20 UNAIDS Data (2017).

21 Russell (2014).

22 WDI 2016.

23 Lesotho has a large number of orphans and vulnerable children, numbering anywhere from 100,000 to 200,000 (MSD 2012; Tamasane 2011) or 5–10 percent of the total population. This is an obstacle to long-term growth, as schooling and other investments in human capital have been shown to decline significantly with the death of a parent from HIV/AIDS, with impacts over twice as large following maternal deaths vs. paternal deaths (Evans & Miguel 2007). The impact of being an orphan on school enrollment and nutritional status is affected by many factors, among them household economic status, number and family relationship of orphans, and number and sex of deceased parents (Adato 2012). Controlling for economic status, Ainsworth and Filmer's (2006) review of 102 nationally representative datasets found statistically significant deficits in enrollment for children who have lost two parents in 58 percent of the surveys (38 percent for paternal orphans and 46 percent for maternal orphans). However, the impact of HIV/AIDS on children's human capital begins before the death of a parent. In Uganda, for example, Gilborn et al. (2001) found that children ages 13-17 living with an ill parent had lower school attendance rates than double orphans.

FIGURE 5 HIV prevalence by age and gender



Source: LePhia 2016–2017

There are important gender and age dimensions to the HIV/AIDS crisis. While the overall HIV prevalence rate for individuals 15 to 59 years of age was 25.6 percent in 2016, the rate was 30 percent for women versus 21 percent for men.[24] Figure 5 in Annex A shows the age and gender distribution of the HIV/AIDS epidemic in Lesotho. It shows that HIV prevalence peaks at 49.9 percent among women ages 35 to 39 as compared to 46.9 percent among men ages 40 to 44 years. The prevalence gap is highest for the 20- to 24-year-old age group, in which prevalence among women is 4 times higher than among men (17 percent vs 4 percent). While viral load suppression has been achieved by 68 percent of HIV-positive adults aged 15-59 years, this rate was 71 percent for women and 63 percent for men.[25] Interviews with PEPFAR suggest that fewer touch points between men and the health system led to a lower portion of men getting tested so that fewer are aware of their HIV status. The high level of gender-based violence in the region increases women's vulnerability to HIV/AIDS, as sexual assault or coerced sex increases the chance of infection. Over 85 percent of women report experiencing some form of violence in their lifetime, while 40 percent of men admit to having perpetrated violence against women.[26] Over 24 percent of women report experiencing sexual violence, and 30 percent report experiencing "economic violence" in their lifetime.[27] Refusing sex, inquiring about other partners, or suggesting safe sex are triggers for intimate partner violence, and fear of this violence can discourage these protective practices.[28]

On balance, the evidence suggests that poor health primarily related to HIV/AIDS is a binding constraint to economic growth. Lesotho's burden of disease for working age individuals is by far the highest in the world,[29] and this burden is primarily driven by HIV/AIDS. Lesotho's rate of new HIV/AIDS infections is also the highest in the world, and the gap between the working-age burden

24 LePhia 2016-2017.

25 LePhia 2016-2017.

26 The predominant form of gender-based violence is within intimate partnerships; 69 percent of women report having experienced such violence, while 41 percent of men admit having perpetrated it.

27 Chipatiso et al. 2014.

28 Lesotho National AIDS Commission, UNAIDS and World Bank 2009. HIV Prevention Response and Modes of Transmission Analysis.

29 IHME GBD (2017).

of disease in Lesotho and that in neighboring Southern African countries has significantly increased over the past 10 years. This disease burden substantially reduces firm productivity, and imposes large direct costs on both the government and households in the form of health care expenditures and care for HIV/AIDS orphans and other dependents that divert scarce resources, not to mention the lost value of life years themselves. These effects substantially reduce returns on investment in Lesotho, discouraging both job creation and economic growth.

Ineffectiveness of Policy Planning, Coordination[30], and Execution

Absence of Planning and Coordination

This problem is related to how effectively the government interacts with the private sector in deciding what to do (which roads to build where, etc.). Rather than creating an enabling environment to attract investment, the Lesotho government generally attempts to create businesses in a chosen sector, then turns the businesses over to private sector actors. Lack of coordination with key stakeholders means these turnkey operations are rarely financially successful. Often the intervention crowds out private sector investment, rather than attracting it. Examples include:

- Absence of coordination between public and private sector for efficient public investment in the highlands to enable tourism and other sector developments.
- Absence of coordination between public and private sector for efficient public investment in the highlands to enable commercialization of wool and mohair.

Inefficient Public Service Delivery, Public Investment Management, and Public Financial Management (PFM)[31,32]

This problem is related to how well the government enacts/builds whatever it is it has decided to do. The Government of Lesotho's ability to execute planned projects is significantly hindered by poor processes for executing the government budget. As the GOL is the biggest procurer of goods and services, inefficient procurement processes and delayed payment for services rendered have had a significant negative impact on the operations and finances of many companies, especially Basotho-owned firms. Examples include:

- Inefficient health service delivery and expenditure.
- Inability of the Ministry of Public Works and Transport to spend the money accumulated from its Road Fund for the rehabilitation and maintenance of the failing road network.
- Large and inefficient public sector, excessive wage bill, and dysfunctional labor market.

Lesotho's economy suffers from a lack of job creation, resulting in high structural unemployment, which has ranged between 25 percent and 40 percent since 1995. The high unemployment rates cause political tension in

30 By "coordination" we mean "soliciting and responding to private sector stakeholder input"

31 Public Investment Management refers to the way in which governments select, construct, and maintain economic infrastructure such as airports, roads, railways, water and sewage systems, public electric and gas utilities, telecommunications, and social infrastructure such as schools, hospitals, and prisons (IMF 2015, ODI 2016).

Public Financial Management is concerned with the laws, organizations, systems, and procedures available to governments wanting to secure and use resources effectively, efficiently, and transparently.

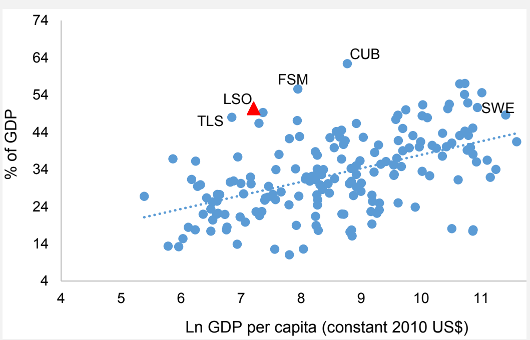
Public Service Delivery refers broadly to the way in which governments deliver services to people living within its jurisdiction, either directly (through the public sector) or by financing provision of services, such as health, education, urban planning, police, waste management, etc.

32 For this manifestation, we mean all aspects of public service delivery, public investment management, and PFM as normally understood, but excluding actual project selection, since that is covered in the other manifestation of the constraint.

Lesotho, which is reflected in frequent turnover of the government (the average lifespan of the government in recent years is about 18 months). Like other countries in the region, Lesotho has responded to the political strain of high unemployment by absorbing excess labor into the government.

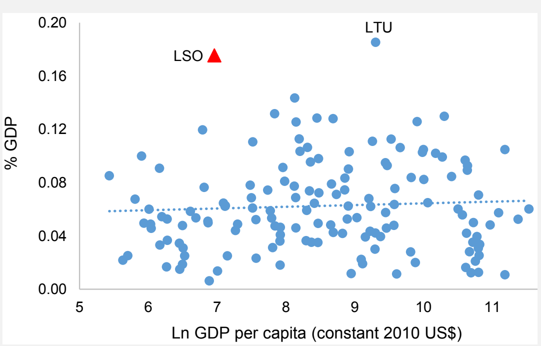
The GOL's strategy of directly absorbing excess labor has resulted in a very large central government relative to the rest of the economy. The size of the Lesotho central government expenditures (47.3 percent of GDP; see Annex A Figure 6) and the size of the government wage bill (17.8 percent of GDP; see Annex A Figure 7) are both outliers for the region, and among the highest in the world.

FIGURE 6 Government expenditure percent of GDP



Source: Heritage Foundation, 2017

FIGURE 7 Wage bill percent of GDP



Source: World Bank, 2017

Lesotho's wage bill has been high for as long as data is available. The current evidence indicates that what started out as absorbing excess labor into the government as a response to political tension has calcified into a long run "second-best" equilibrium. Because two of Lesotho's main sources of tax revenue are independent of internal tax policy—South African Customs Union (SACU) revenue was 42 percent of government revenue in 2016/17,[33] and diamond mine revenue represented another 14 percent—the causality now runs in the opposite direction: diamond mine and SACU revenues available for expenditure determines how much excess labor can be absorbed and, therefore, the level of political tension.[34]

The frequent turnover of the government reduces the incentive to develop efficient policy processes, resulting in ineffective planning, coordination, and execution. Combined with the sheer size of the government, the inefficiency with which the government interacts with the private sector is a constraint to growth. To benchmark this inefficiency, we compare Lesotho's performance on the "Public Expenditure and Financial Accountability" (PEFA) indicators,[35] and the World Bank's "Benchmarking Public Procurement" (BPP) indicators to that of similar countries.

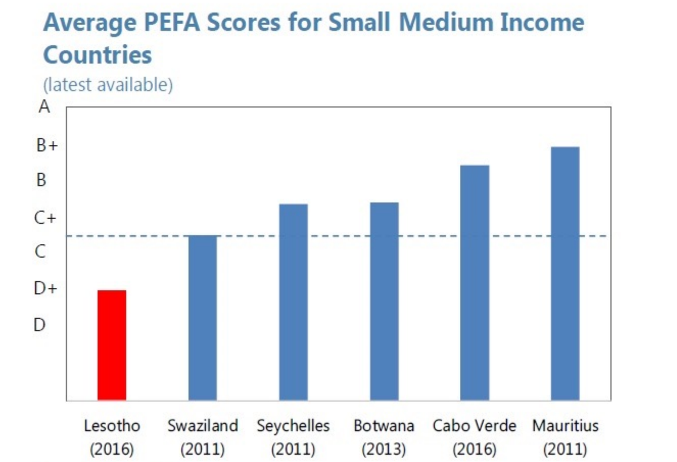
Lesotho's PEFA scores are the lowest among the SMICs, scoring below Cabo Verde, Botswana, and Swaziland, among others (see Annex A Figure 8). Lesotho has the worst score (out of 17 countries) in the "payroll controls" sub-indicator for 2016, is tied for last for the "procurement" sub-indicator, and scores poorly on the actual expenditure of funds compared to annually approved budgets. Likewise, for the BPP sub-indicators that correlate most strongly with GDP per capita ("call for tender and bid preparation"), Lesotho's score is the third lowest in the entire sample of 178 countries.

33 See IMF's Feb 2018 Article IV Consultation Report, available on the internet at *https://www.imf.org/-/media/Files/Publications/CR/2018/cr1854.ashx*.

34 The amount of political tension in Lesotho (as measured by political instability measures) can be predicted by the previous years' government expenditure. The relationship is statistically significant. However, political stability does not predict next year's government expenditure, because revenue available for expenditure is largely exogenous to domestic tax policy.

35 Available at *https://pefa.org/*. According to the website, "PEFA identifies seven pillars of performance in an open and orderly PFM. The pillars are as follows: I. Budget reliability… II. Transparency of public finances… III. Management of assets and liabilities… IV. Policy-based fiscal strategy and budgeting… V. Predictability and control in budget execution… VI. Accounting and reporting… VII. External scrutiny and audit.

FIGURE 8 Lesotho PEFA scores



Source: PEFA Secretariat.
Note: The dashed line represents the average PEFA score for 38 SSA countries in the sample.

As evidence of negative investment effects, we cite

- rationing of investment projects through the Lesotho National Development Corporation (LNDC)[36]
- a large surplus in the Road Maintenance fund, and
- cross-country indicators from the Global Integrity Index (GII)

Since foreign firms in need of serviced industrial sites are unable to lease land directly, the LNDC develops and sub-leases factory shells to foreign investors with the intention of facilitating access. The application list to access these sites is oversubscribed, however, and LNDC has been unable to increase supply to fulfill demand. LNDC sub-leases industrial sites at a rate of M7-M8 (about $0.50) per square meter, while the rate required to recover capital and maintenance costs is over four times higher—approximately M30-M35 (World Bank 2015). This has discouraged private investors from developing and sub-leasing sites to meet the shortage. Moreover, there is no clear rationale for prioritizing which applicants should receive access to LNDC sites. As a result, investor access to industrial service sites is highly rationed, signaling a high shadow price.

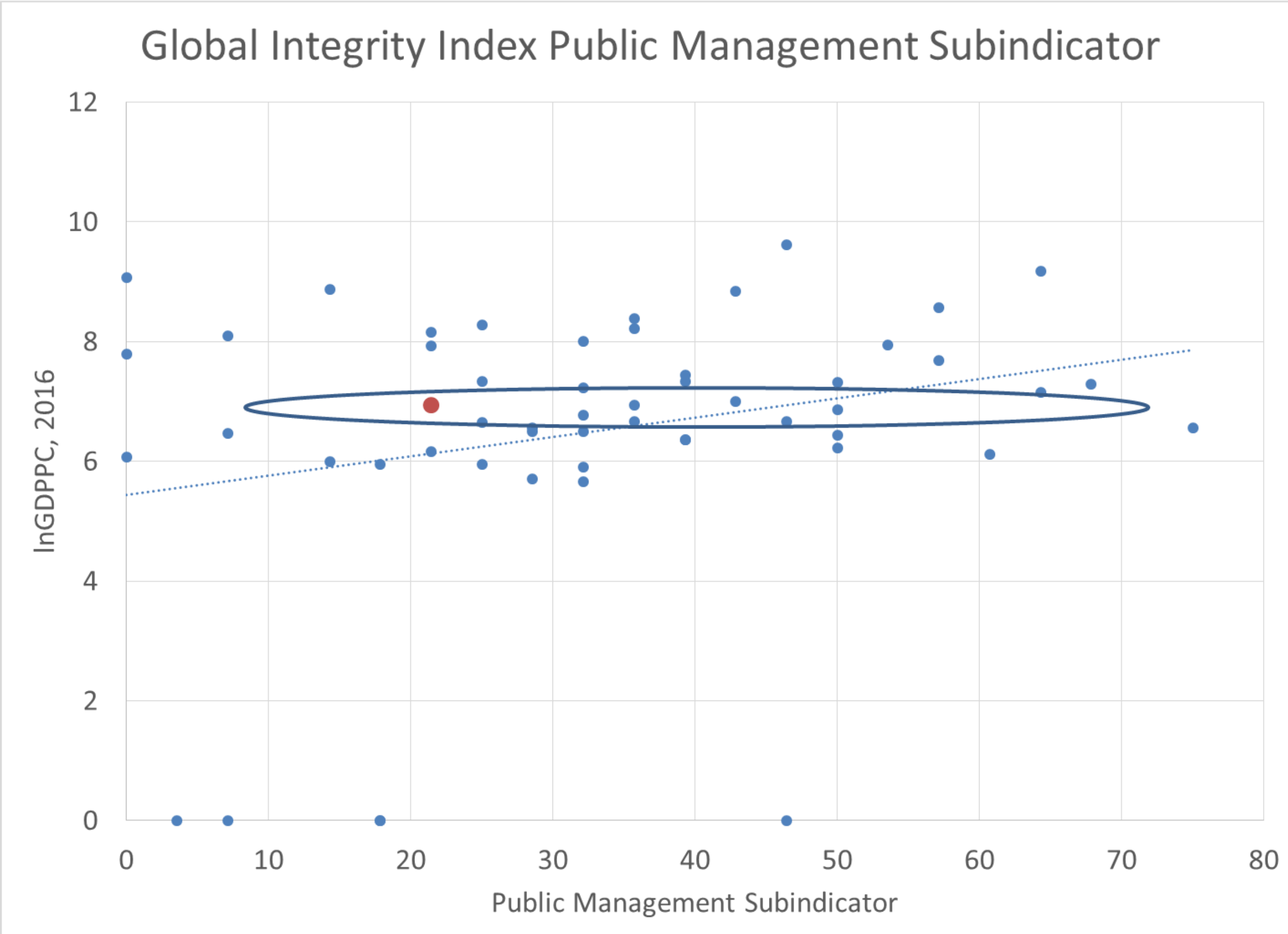
One striking example of poor public financial management is the surplus of roads maintenance funds due to the inability of the Ministry of Public Works and Transport to spend the money accumulated from its Road Fund (RF). Lesotho is somewhat unique in that it has both a surplus in its road fund and a backlog in rehabilitation and maintenance. Indeed, the current cumulative surplus amount is about M400 million (US$33.7 million equivalent). At the same time, the rehabilitation backlog of the paved roads exceeds the norm by 22 percent, and 90 percent of the unpaved roads remain in poor condition.[37] Moreover, the districts with the highest incidence of poverty in Lesotho (Botha-Bothe, Mohale's Hoek, and Mafeteng) are characterized by poor road conditions with routine maintenance being significantly underfunded.

The Global Integrity Index for 2016 measures indicators such as whether "public procurements involve public bidding," "citizens can access procurement documents and associated documents," "procurement blacklists exist," "citizens have access to the records of public or private natural resource exploitation companies," "significant public expenditure requires legislative approval," and "a legislative committee exercises oversight of public funds." These are all aspects of the "planning, coordination, and execution" constraint as described to us by Lesotho stakeholders. Lesotho's score in this metric indicates it is underperforming compared to the other countries in the sample, and among countries of similar levels of GDP per capita, it has the lowest score (see Annex A Figure 9). Lesotho's scores on this indicator over time are positively correlated with changes in GDP per capita and gross fixed capital formation as a share of GDP (see Annex A Figures 10 and 11.

36 The LNDC is the primary state-owned enterprise charged with implementing the country's industrial development policies.

37 World Bank Project Appraisal Document for Transport Infrastructure and Connectivity Project (2017).

FIGURE 9 Cross country comparison of global integrity index public management subindicator (2016)



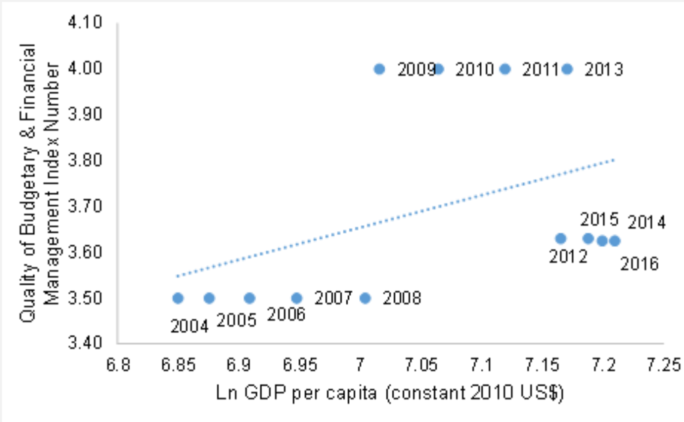
Source: Global Integrity Index and World Development Indicators

The constraint manifests in two ways: through the absence of planning and coordination, and through inefficient public service delivery and financial management. Below are examples of manifestations of the constraint discussed during our stakeholder consultations. Because most stakeholders were focused on potential investment projects, there are more examples in the "Absence of Planning and Coordination" section.

Absence of Planning and Coordination

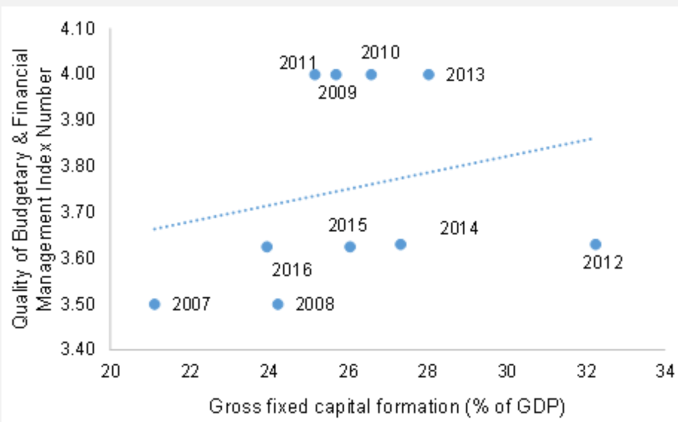
According to "conventional wisdom," apart from solving market failures in the provision of infrastructure and investment in human capital, the key roles of the government for attracting job-creating investment are to establish an institutional environment low on corruption and other regulatory and tax burdens, protect markets from monopolization, and effectively enforce property rights. Once this investment-enabling environment has been created, the less the government directly intervenes in commercial sectors (like agriculture, tourism, and other services), the more attractive the economy is to investors. However, while "planning" in the form of industrial policy that picks and subsidizes winners can be counterproductive, there nevertheless is often a need for the government to coordinate with the private sector, to set zoning, regulatory or other policies and prioritize public infrastructure investments. Effective policy coordination, therefore, can be considered a requirement for, rather than an impediment to, attracting job creating investment. Many of the urban areas in sub-Saharan Africa suffer from poor, or non-existent, planning, and Lesotho is no exception.

FIGURE 10 Public management subindicator over time (GDP)



Source: Global Integrity Index and World Development Indicators

FIGURE 11 Public management subindicator over time (GFCF)



Source: Global Integrity Index and World Development Indicators

In recent decades, GOL's strategy to drive private sector growth has been to establish state-owned enterprises (SOEs) with the intent of turning them over to the private sector. Because the various ministries involved in this approach do not consult with the private sector in creating these SOEs, the resulting combination of policies and infrastructure investments has not met the needs of the private sector. Because the government is large (government expenditure represents more than 47.3 percent of GDP) and engages in a large number of these activities, there is a strong "crowding out" effect of the private sector that hinders overall investment. For example, the GOL is interested in attracting investors in the tourism industry, a sector that is relatively labor intensive and will likely create jobs in rural areas, where poverty is more prevalent. In the past, the GOL has simply constructed resorts without collaborating with potential investors, and the result has been structures that will need to be at least partially torn down and redesigned, in effect increasing the costs to potential investors. Key members of the government recognize that this approach does not produce the desired result and that development of the sector should be private-sector led, but the cross-stakeholder coordination required to adopt a new strategy has not yet taken place.

Similarly, developing an economically viable tourism route or attraction in Lesotho would require a number of policy actions that must be closely coordinated with potential investors with an understanding of the market. This does not occur sufficiently in Lesotho. For example, there is no efficient prioritization and sharing of the costs of basic infrastructure (e.g., roads leading to the base of the mountains) that would make the investment viable. In addition, the GOL has not provided an effective way to authorize land to be converted to non-agricultural uses. Finally, the tourism industry may also want to coordinate with the government on environmental standards to preserve the value of the attraction for tourists.

The need to coordinate government strategy aimed at economic growth also manifests in the transportation sector. The Lesotho Ministry of Public Works and Transport (MPWT) engages in a sophisticated nationwide Highway Development and Maintenance Management System (HDM-4) modeling effort to construct a list of road expansion and maintenance priorities; however, generally speaking, the MPWT strategy does not take into account potential investments by the productive sector, so there is need for direct engagement among such potential investors, other ministries interested in attracting investors, and the MPWT. Furthermore, the importance of access to transport services as a means of accessing health and other social services also needs to be factored into transport sector investment decisions, particularly as these are areas of high government spending.

The lack of policy coordination also extends into the health sector. The MCC team visited a clinic constructed under the first compact. The clinic had been designed and staffed in the anticipation that it would serve about 3,000 patients, but improvements in access for the local population increased the patient population to 7,000. Due to the lack of nationwide coordination of staffing needs at the compact-funded clinics, the clinic's staff remains at the level needed to serve 3,000 patients. The persistently high HIV prevalence rates, despite the levels of government and donor initiatives and funding to tackle HIV/AIDS, may indicate additional policy coordination failures, though the nature and causes of these are not yet understood.

Tourism, agriculture, and other sectors characterized by small and medium enterprises are also affected by the lack of policy coordination with respect to land and inheritance rights, which can impact investment decisions. A dual legal system of customary law and common law co-exists in Lesotho, with particularly problematic implications for women, who are treated differently from men under the two legal systems. While the Constitution enshrines non-discrimination on the basis of sex, it also explicitly recognizes customary law as a source of law, resulting in contradictory and discriminatory provisions, and continued uncertainty about which system of law will apply. Women's status and rights continue to be insufficiently protected, even when women assume that they are no longer governed by customary law. Male relatives and those with power and influence may question which system prevails in which circumstances, engaging in "forum shopping" to obtain the most favorable outcome for themselves at the expense of women and girls who thought they were living outside of custom. The impact of this dual system is particularly strong with regard to property rights and inheritance, which also affects non-first-born males, with implications for enterprise investment and household income. With the Legal Capacity of Married Persons Act (LCMPA 2006) and the Land Act (2010), passed in connection with the Lesotho I Compact, Lesotho has a progressive and gender-equal formal legal system. The MCC Lesotho I Compact's Gender Equality activity trained over 6,000 people in the LCMPA and related women's economic rights, with a focus on the judiciary, customary law officials, bank officers, etc. The number of women in urban and peri-urban areas holding land titles, solely or jointly, increased from 3,214 to 26,342. However, discussions with FIDA, Gender Links and others in February 2018 revealed that knowledge of these laws, and more generally by women of their legal rights, is very limited, and there is little or no outreach to support their effective implementation. In rural areas, where customary law exerts the strongest influence, this knowledge and outreach is particularly weak or non-existent. Moreover, some stakeholders suggest that, in the climate of political instability, the willingness to focus on protecting and promoting women's legal status and rights is weak.

Inefficient Public Service Delivery, Public Investment Management, and PFM

The Lesotho government's ability to promote growth through job-creating investments is also hampered by weak capacity to effectively spend public funds. This is reflected through investors' perceptions of Lesotho and multiple comparative assessments of the effectiveness of government spending, which was 47.3 percent of GDP in the 2016/17 fiscal year, a significant outlier.

Stakeholders in Lesotho perceive that the effectiveness of the government has declined significantly over the last ten years. See, for example, Annex A Figure 11, which shows Lesotho's scores on the Government Effectiveness metric from the World Bank's World Governance Indicators. The general downward trend in these scores was exacerbated by the political issues that led to the suspension of compact development in 2015. Many indicators show Lesotho's economy has not yet fully recovered from the risk and uncertainty from that episode.

Non-Binding and Near-Binding Constraints

Transportation

The CA identified road maintenance along internal routes between population centers as a near-binding constraint to growth. Limited data suggest that both traffic and freight costs along these routes are somewhat high, although not exceptionally high for Lesotho's level of GDP per capita. Likewise, firm perceptions of road quality have declined substantially in recent years, although are typical for Lesotho's level of GDP per capita. While poor road maintenance itself was not found to be a binding constraint over the near-term, it is one symptom of the Inefficient Public Investment and Financial Management constraint described above.

Land

Rather than finding land to be a binding constraint, the analysis found that the quality of Lesotho's land governance system improved substantially in recent years and that key remaining issues are best understood as elements of the poor policy coordination constraint described above. Lesotho now scores well relative to its GDP per capita in terms of WB Doing Business indicators for property registration, land dispute resolution, reliability of land administration infrastructure, and transparency of information. The geographic coverage of the formal land system remains limited, however, and there are outstanding issues related to laws and regulations to facilitate land transfer (e.g., lack of a sectional title law, high land transfer taxes, limited land appraisal capacity, and possibly poor court and land dispute resolution systems). Likewise, the government's over-involvement in the development of urban industrial service areas and inefficient procedures for converting rural land to non-agricultural uses—elements of the poor policy coordination constraint—are problematic.

Education

The analysis shows that, while stakeholders do find it difficult to find certain types of skills in Lesotho, this is a result of distortions created by the government's attempt to absorb surplus labor, rather than any fundamental flaw in the educational system. In other words, any perceived "skills gap" is a symptom of dysfunctional public decision making, rather than a constraint itself. For a skills gap to be a constraint, we would expect to see signs that there is excess demand for skilled laborers who are in short supply, as evidenced by high salaries paid in the private sector for skills, low unemployment for skilled workers, and net in-migration of skilled labor. In Lesotho we see the opposite – wages are higher in the public sector and there is high, persistent unemployment—including of more-educated workers—and a significant out-migration of labor.

Perhaps due to collective bargaining outcomes, real wages paid in the government have grown faster than labor productivity growth. Firms that are offering a wage for skills equal to the marginal revenue product of labor will not be able to attract workers at that salary, since workers can earn more in the public sector. As a result, firms perceive a genuine lack of skills at the offered salary that should suffice to attract them. Nevertheless, the lack of skills is a symptom of a distortion introduced by the government in response to a structural lack of job creation, and distorted wage setting by the public sector, not a lack of skills supplied by the educational system. The "skills gap" is not itself a binding constraint.

Notwithstanding this, there are important areas where skills remain an issue. These include: (i) herd boys who have very low levels of education and are poorly integrated into their communities; (ii) the high segmentation of the economy along gender lines, with men predominant in mining and construction, and women in textiles and hotels/restaurants; (iii) the lack of skill development by employers for the predominantly female workforce in the textile sector; and (iv) lack of business and entrepreneurship skills. The country's "youth bulge" means that skills development and job creation for youth are particularly important priorities for the country as it seeks to promote job-creating and inclusive growth.

Other Constraints

Lesotho's electricity infrastructure was also found to be non-binding – the cost of electricity is low relative to Lesotho's GDP per capita and energy quality is fairly high. Lastly, although Lesotho's formal financial sector clearly performs well relative to its level of GDP per capita (for example, collateral requirements are 100%, while the average for Lesotho's income level is 200%), the team separately analyzed access to informal finance as a potentially binding area. Ultimately insufficient data was available, however, to show a clear positive or negative result.

Conclusion

The Constraints Analysis identified two binding constraints to economic growth and poverty reduction in Lesotho: poor health primarily related to HIV/AIDS; and ineffective policy planning, coordination, and execution in the provision of government services.

The burden of disease for working age individuals in Lesotho is by far the highest in the world and is primarily driven by HIV/AIDS. Lesotho's rate of new HIV/AIDS infections is also the highest in the world, and the gap between the working-age burden of disease in Lesotho and that in neighboring Southern African countries has significantly increased over the past 10 years. This disease burden substantially reduces labor productivity, discourages investments in job-creating sectors, and imposes large direct costs on both the government and households in the form of health care expenditures and care for HIV/AIDS orphans and other dependents.

The ineffective policy planning, coordination, and execution constraint manifests in two ways: First, absence of planning and coordination—this problem is related to how effectively the government interacts with the private sector in deciding what to do (which roads to build where, etc.). Rather than creating an enabling environment to attract investment, the Lesotho government generally attempts to create businesses in a chosen sector, then turns the businesses over to private sector actors. Lack of coordination with key stakeholders means these turnkey operations are rarely financially successful. Often the intervention crowds out private sector investment, rather than attracting it. Second, inefficient public service delivery, public investment management, and public financial management (PFM)—this problem is related to how well the government enacts/builds whatever it is it has decided to do. The Government of Lesotho's ability to execute planned projects is significantly hindered by poor processes for executing the government budget. As the GOL is the biggest procurer of goods and services, inefficient procurement processes and delayed payment for services rendered have had a significant negative impact on the operations and finances of many companies, especially Basotho-owned firms.

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