5 Lesotho

Rose Ramalefane

5.1 Introduction

A. History

Lesotho, formerly called Basutoland was founded by King Moshoeshoe 1 who put together Basotho, the inhabitants of Lesotho under British protection (1868) establishing the protectorate of Basutoland. In October 1966, the Kingdom of Lesotho became independent, and functioned as the multi-democracy from independence until 1986, when a military regime took power. The country returned to an elective political system in 1993, although it remains a constitutional monarchy.

B. Geographical Location

Lesotho is an enclave in South Africa with geography co-ordinates between 29/30 degrees south and 28/29 degrees east. The climate is characterized by four seasons of the year, with cold, dry winters and frequent snowfalls in mountain areas; and hot and wet summers. The terrain mostly consists of highlands, with rugged mountains, deep valleys, hills and plateaus (this constitutes about 75 percent of total land). The high altitude keeps the country free from tropical diseases, this forms the reason Lesotho is being referred to as ***"The Kingdom in the sky"***. Lesotho is a very small country completely landlocked within South Africa and the land area is 30,350 sq km with the boundary line of 909 kilometers. The average height of the lowlands is between 1000 and 1800 square meters and this is where the capital city Maseru lies, and where majority of population lives. The population in general is 2,177,062 (2001 estimates) of which the minority is made up of Europeans and Asians. Many Basotho, particularly men reside outside the country, for a portion of each year working as laborers in the mines of Republic of South Africa. The life expectancy is 50years for women 48years for men. Sesotho and English are the official languages, though the former is widely spoken. English is used as the medium of instruction in schools. Religion consists of mostly Christians, indigenous beliefs and few Muslims.

5.2 Overview of Macroeconomic Activity and Fiscal Position

Lesotho is one of the poorest countries in the world. Small, landlocked and mountainous, the only important natural resource available is water. Her economy is based on subsistence agriculture of products such as corn, wheat, pulses sorghum and barley; and livestock. Although a large number of people are engaged in agriculture, production is still low due to climatic conditions, poor soil, poor farming methods and soil erosion. In addition, remittances from miners employed in South Africa form a major source of income, though the number of such mineworkers has declined steadily over the past several years. A small manufacturing base depends largely on farm products that support milling, canning, leather and jute industries. Proceeds from membership customs union with South Africa form the majority of government revenue. Although drought has decreased agricultural activity over the passed few years, completion of a major hydropower facility in January 1998 now permits the sale of water to South Africa, thus constituting an important source of income for Lesotho. The agreement to sell water was entered into in 1986 between the Government of the Kingdom of Lesotho and

Government of Republic of South Africa for implementation of the so called Lesotho Highlands Water Project (LHWP) which is a six –dam project scheduled to be completed in 2015. In addition to water royalties, LHDP will eventually result in generation of hydropower to meet Lesotho's electricity needs at the lowest economic cost thus reducing overdependence of imports from South Africa for commercial energy. Other benefits of the project lie in the associated job opportunities and infrastructure on which tourism and industrialization can thrive. Tourism in the mountain kingdom increased dramatically as visitors come to view the project as well as the reserves and other features associated with it. The positive impact of the water project and small but rapidly growing manufacturing sector contributed to the spurt in economic growth. The lessening economic of the project as it nears completion will be more than royalties payments from South Africa.

Civil disorder in September 1998 destroyed almost 80 percent of the commercial infrastructure in Maseru and other two major towns. Most firms were not covered by insurance and rebuilding of small and medium businesses has been a significant challenge in terms of both economic growth and employment levels. Unemployment remains high and is one of the most serious problems facing Lesotho with poverty still severe.

In order to attain its macroeconomic objectives, the Government of Lesotho is continuing to place high priority on high priority on parastatal privatization and private sector development, with this strategy forming the source of growth and employment creation. Based on free market principles and private ownership of property, the Lesotho economy presents a relatively open economic and business climate. Any institutional and regulatory constraints that impede growth are being addressed. Her fiscal policy for 1999/2000 and beyond is focused on maintaining budgetary expenditures at sustainable levels.

Lesotho's ability to achieve her sustainable human development objectives is closely linked to the evolving economic and political dynamics of South Africa, as well as other countries of the Southern African Development Community (SADC). The economic swings in South Africa are the largest single influence on Lesotho's economy, with inflation following the trend in that country.

5.2.1 Macroeconomic Activity

A. International Environment

A.1 Balance of Payments

Overall Balance

The Lesotho balance of payments position continued to register a surplus for the second consecutive year in 2001. The overall balance registered a surplus of M1637.2 million. Without the effect of the depreciation of the loti against major currencies, the position improved significantly from a deficit of M236.79 to a surplus of M203.4 million. Positive revaluation contributed 91.6% to the overall surplus. This reflects that gross foreign reserves, the largest proportion of which is held in US dollars and UK pound sterling, rose mainly as a result of the depreciation of Loti against major currencies.

At the end of 2001, the level of reserves were 11.4 months of imports as indicated in Figure 5.1, and this was a considerable improvement given that Lesotho has got a small open economy with a fixed rate regime. The build up in the level of reserves indicates the sustainability of the regime and hence bodes well for foreign direct investments.

Figure 5.1 Official Reserves in Months of Import

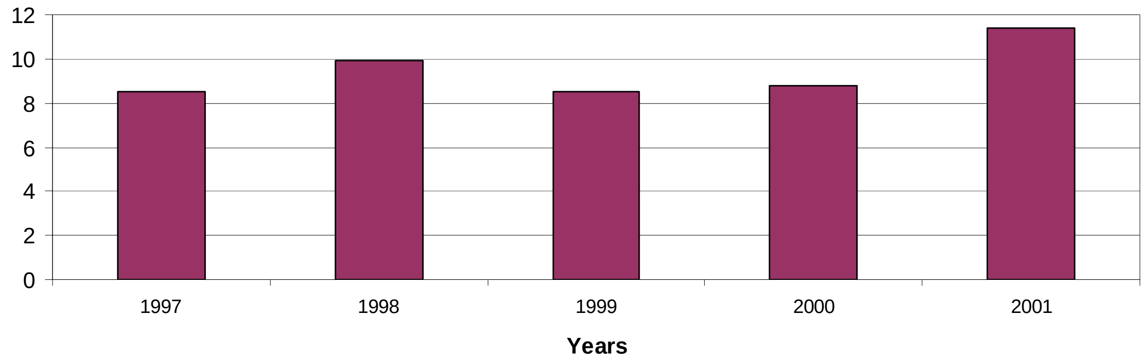


Table 5.1 Summary of Balance of Payments

Excluding LHWP (As a percentage of GNP)

	1997	1998	1999	2000	2001
Current Account	-4.34	-7.05	-9.94	-8.30	-2.70
Capital and Financial Account	11.38	5.53	1.70	2.13	1.34

Source: Central Bank of Lesotho
* Preliminary Estimates
LHWP excluded because it is a temporary shock to the economy.

The Current Account

The current account balance showed a significant improvement from the year 2001. Excluding LHWP, The current account deficit declined from 8.3% of GNP in 2000 to 2.7% in 2001. In 1998, it deteriorated to an unsustainable level and therefore the improvement observed during 2001 signals progress towards macroeconomic stability.

The current account position was mainly boosted by the strong performance of exports. The value of exports rose from 39.3% of GNP in 2000 to 65.2% of GNP in 2001. During the past three years, the current account balance has been negatively affected by declining miners' remittances due to the continuing retrenchment of mineworkers in RSA. Prior to 2001, labor income was always the largest source of foreign exchange for Lesotho. The improvement in 2001 was due to the expanded production in Lesotho's manufacturing sector and the depreciation of Loti against major currencies. Furthermore, the operation of African Growth and Opportunity Act (AGOA) enhanced the exports as more access was provided for exports for designated African countries, including Lesotho to the US.

Current transfers also rose remarkably as a result of the 26.6% increase in SACU non-duty receipts which makes the largest proportion of current transfers. This was due to the strong recovery of the economy from 1998 socio political unrest as Lesotho experienced a rise in imports, including intermediate inputs.

Now that export of goods is the major source of foreign exchange for Lesotho, it is important that this source be enhanced so that it becomes sustainable. To continue this export growth, the authorities should look for avenues to diversify the export base to other commodities other than clothing and textiles; this may include agricultural and industrial products. In addition other markets should be explored, especially where the county has access through agreements like the

SADC protocol and the Cotonou agreement. Furthermore, priority should be given to the untapped tourism industry in the country.

Capital and Financial Account

This account which deteriorated over the past five year grew by 14.5 percent during 2001. The improvement contributed considerably to the build-up in foreign reserves during 2001. This occurred despite the massive depreciation of the local currency which increased the official loan repayments.

A.2 Foreign Exchange Rates

Lesotho follows a fixed exchange rate system with RSA such that Loti is at par with RSA Rand. In 2001 the rand was unstable due to volatility of global and regional financial markets. Factors contributing to depreciation of rand include among other things, distortion of investors' confidence in South African markets by events in emerging markets, such as financial crisis in Argentina as well as political crisis in Zimbabwe. The September attacks also contributed towards the Rand's turmoil in the year 2001.The negative investor sentiment on emerging markets led to further depreciation of Rand as investors opted to invest in more stable major currencies.
In real terms, the exchange rate of the loti against the US dollar depreciated by 36.9% in 2001. This boosted Lesotho's exports to record levels despite recessionary conditions that prevailed globally. Against the euro the loti depreciated by 15.2% in real terms.

Table 5.2 Loti per Unit of Foreign Currency Annual Average

	1996	1997	1998	1999	2000	2001
Botswana Pula	1.294	1.297	1.307	1.315	1.358	1.464
ECU/EURO	5.405	5.276	6.124	6.504	6.398	7.718
French Franc	0.835	0.798	0.928	1.019	0.965	0.856
German Mark	2.841	2.683	3.110	3.394	3.271	3.917
Japanese Yen	0.039	0.038	0.042	0.054	0.064	0.071
SDR	6.211	6.408	7.433	8.353	9.137	10.790
Swiss Franc	3.460	2.619	3.777	4.064	4.110	5.095
UK Pound	6.667	6.221	9.079	9.884	10.496	12.407
US Dollar	4.274	4.671	5.483	6.105	6.943	8.619
Zimbabwe Dollar	0.419	0.366	0.236	0.160	0.159	0.155

Source: Bureau of Statistics

A.3 Foreign Direct Investment

In Lesotho, the textile manufacturing industry constitutes the prominent proportion of foreign direct investment. The industries are primarily owned by foreign companies and operate as an enclave. The local exports are mainly destined to South Africa and United States. The performance of this industry is expected to continue improving due to increasingly depreciating currency that boosted demand for manufactured exports to U.S. In addition, the African Growth and Opportunity Act which provides liberal access to the U.S. markets to any country that does not have a Free Trade Agreement with U.S. resulted in unprecedented increase in investment. This industry currently employs about 30,000 workers and contributes about 75% of Lesotho's total exports.

B. Domestic Environment

B.1 Economic Growth Rate

In the year 2001, the projections indicated the modest growth with GDP increasing by about 3.5%. While this GDP growth marked an improvement on the year 2000 performance of 3.3% and was well above the population growth rate of 2.3%, it masked the problem of continued widespread poverty. However, it was far below the 5.0% annual growth, which many analysts believed was needed to reverse the high trend in the rising number of poor people.

Major challenges lie ahead. According to year 2000 estimates, GDP per capita was $2400 (purchasing power parity), equivalent to 16,660 Maloti. High unemployment and little progress in raising per capita incomes underscore the need for the country to implement strategies conducive to broader based economic growth. In this connection, the Government of Lesotho adopted a three-year programme supported by the IMF, in the form of a Poverty Reduction and Growth Facility (PRGF) to sustain on going efforts to foster macroeconomic stability and promote accelerated growth. In previous years performance of aggregate output has largely been influenced by some sectors of the economy, which have been slow to recover from 1998 civil unrest.

Table 5.3 Aggregate Economic Indicators

	1997	1998	1999	2000	2001
Constant 1995 Prices					
GDP % Change	8.1	-4.6	2.2	3.3	3.5
GNP % Change	5.8	-9.0	-2.8	-3.3	2.7
GDP Per Capita % Change	6.0	-6.8	0.0	1.1	2.3
GNP Per Capita % Change	3.7	-11.0	-4.8	-5.2	0.1

Source: Bureau of Statistics

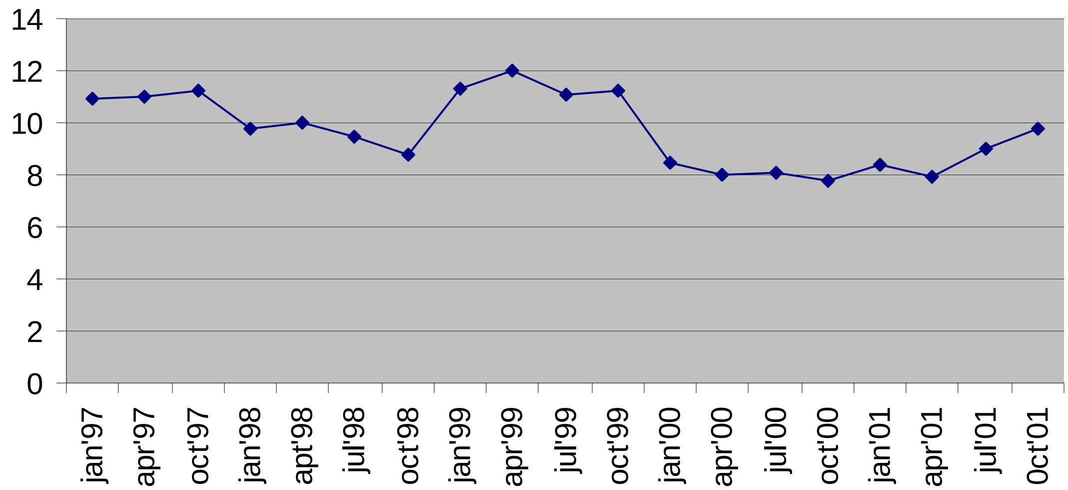
Much of the growth in the year 2001 was fuelled by a buoyant construction sub-sector. In addition, structural reforms in the financial, telecommunication and the electricity sub-sectors are expected to have continued to boost economic growth. The third major source of growth is expected to be manufacturing sub-sector. A weak domestic currency vis-à-vis the US dollar supported demand for the country's manufactured exports to the USA, despite recessionary pressures.

From the mid-1980's GNP has grown at a much slower pace than GDP.
Performance of GNP over the years has been adversely affected by a fall in net factor income from abroad. Miners' remittances, which constitute the largest share of net factor income, have declined in importance as a result of retrenchment as well as attrition of Basotho migrant mineworkers in South Africa.

B.2 Inflation

The major influence of Lesotho's inflation is South Africa which remains the source of nearly 90% of Lesotho's imports. Following relatively favorable price developments during the second half of 1999 and throughout 2000, inflation assumed upturn in 2001(see Figure 5.2). This was mainly due to higher food prices as a result domestic and regional shortages of cereal supply in 2001 caused by bad weather conditions. The impact has been felt strongly as the food; beverages and tobacco category carry a weight of 43.5% in the Consumer Price Index. In addition, real depreciation of 36.9% in the domestic currency against the Dollar exerted further upward pressure on a number of items in the consumer basket with a high import component. The most apparent effect was on prices of fuel, wheat and maize, whose prices were put in line with international standards. With respect to year 2002, the rate of inflation, still remains on 7% on average, however, the currency depreciation poses the threat of further increased inflation in the region through increased prices of imports.

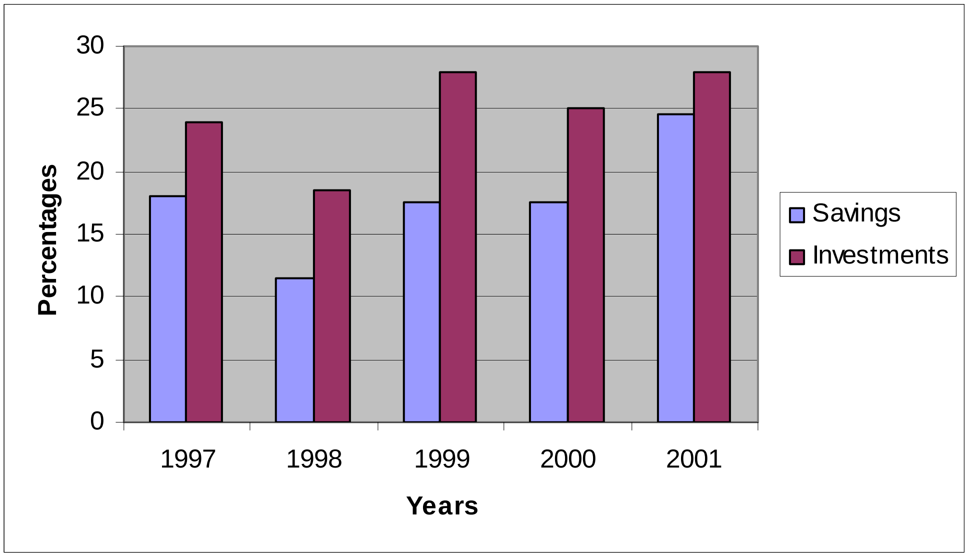
Figure 5.2 Annual Percentage Change in the Lesotho Consumer Price Index



B.3 Savings and Investment

Countries in the Southern Africa, Lesotho included, need individual GNP growth rates higher than 5% per annum to achieve the objective of reducing poverty by the year 2015. For Lesotho, a growth rate of higher than 5% needs investment levels in the range of 40 to 45%. However, Gross Domestic Investment (excluding LHWP) in the period 1997 to 2001 has, on average been slightly below one third of GNP. The disappointing level of GNP growth and the falling per capita incomes have largely been the result of low investment levels over the years. The challenge therefore is to expand the economy's capacity to produce goods and services more efficiently. For Lesotho, in the five years to 2001, gross national savings have been around one-fifth of GNP. It has therefore meant that the additional 20% must be sourced externally.

Figure 5.3 Savings and Investments * (as Percent of GNP)



*Investments excluding LHWP

In the short term, Government should continue working closely with the multilateral development institutions such as World Bank, International Monetary Fund and African Development Bank. In the medium term, the level of savings is expected to depend, among others, on the level of real income. In this regard, Government policies in the medium term are strongly growth-oriented. In addition, stabilization policies already adopted by Government are expected to stimulate savings by creating an environment in which private agents can plan their future with more confidence. Also, prudent Government behavior and fiscal restraint are expected to contribute to increased savings.

To further increase the level of investment, the Government needs to continue pursuing a policy of promoting private foreign investment to complement domestic enterprise. In general, policy-makers should target measures that increase the impact of public expenditure to attract private capital and raise domestic savings.

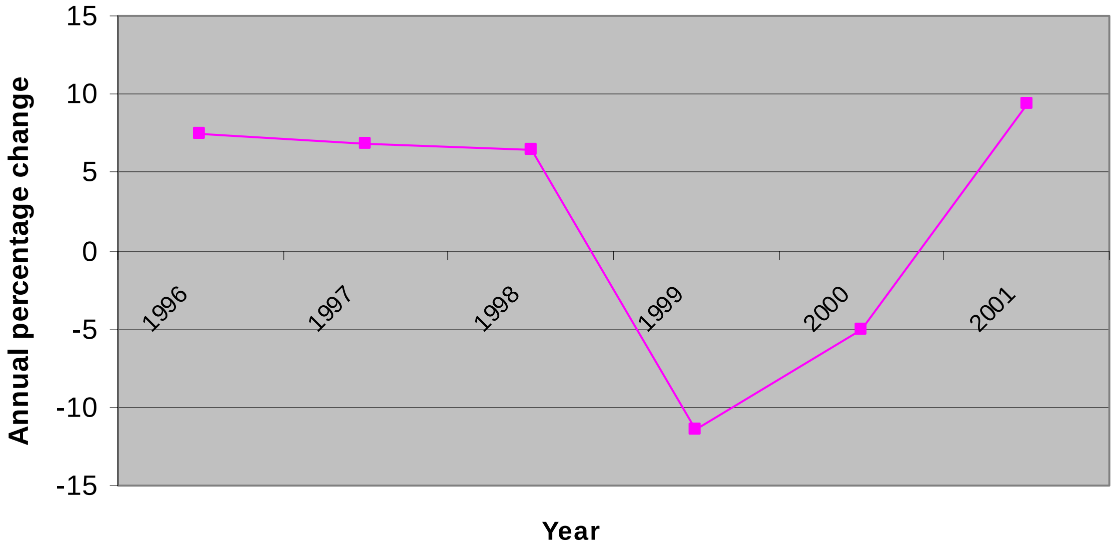
B.4 Money and Banking

Money Supply

The key money supply variable commonly used in Lesotho is M2. This include Maloti in circulation, demand, call savings and time deposits as well as deposits of official entities at the Central Bank of Lesotho. Although both the Rand and Loti currencies circulate freely in Lesotho, at present there is no plausible method to measure Rand in circulation in the country. As a result, it is generally difficult to obtain an accurate picture of movements in money supply. Nevertheless, measurement of the Maloti can serve as an indicator of the general trend in the growth of M2.

As displayed in Figure 5.4, real money supply grew by 9.4 percent at the end of 2001 following the decline of 4.7 percent realized in year 2000. This was attributed to both net foreign assets and domestic credit.

Figure 5.4 Real Money Supply Growth (Annual Percentage change): End of 2001



Domestic Credit

At the end of 2001 total credit extended was 57.5% more than its position at end of 2000. This was due to an increase in net claims of government. Total credit is made up of private sector credit and credit to statutory bodies, as well as net claims on Government which appeared as negative to show that Government deposits with the banking system far outweighed the credit it contracted. Government deposits were used to finance the shortfall revenue to domestic expenditure. Credit extended to private sector and statutory bodies collectively rose by 2.6% in 2001. The continued increase in credit extended to the private sector could be attributed to rising confidence in the financial sector as authorities embarked on measures to remove structural rigidities in the financial sector.

In the medium term, credit to the private sector is expected to continue growing, while credit to statutory bodies is expected to decline further. The reason for this is the combined effects of the ongoing financial sector reforms and the continuing privatization of state-owned enterprises. As the privatized enterprises become more efficient in the use of resources, they will be more creditworthy and hence contract more credit than they did as state-owned enterprises.

It is the aim of the Central Bank of Lesotho to encourage the entry of more commercial banks into the country, as this is likely to increase competition in the banking system and hence, lead to more credit extension to private sector. A financially health private sector is imperative for a sustainable growth of the economy.

Net Foreign Assets

Net foreign assets of the banking system continued to recover from their poor performance in 1999. The significant increase in net foreign assets resulted from the rise in both the net foreign assets of the Central Bank and the Commercial Banks. The increases were influenced by a huge revaluation gain that resulted from a continued and rapid depreciation of the domestic currency against major currencies in 2001. The improvement in the net foreign assets stemmed from the Government's intensified efforts at disciplined fiscal management. In the medium term, the introduction of the new liquidity management system in the economy is expected to play a major role in the improvement of the net foreign assets of the Central Bank of Lesotho. The Treasury bill rates are expected to stay above those in the RSA to rather reflect scarcity of funds in Lesotho than in that country. As a result, Commercial Banks are expected to reduce the volume of funds they move abroad for investment purposes on o high-return instruments, as the rates offered by local market would now be favorable.

Table 5.4 Banking System's Net Foreign Assets+

Million Maloti: End of period.

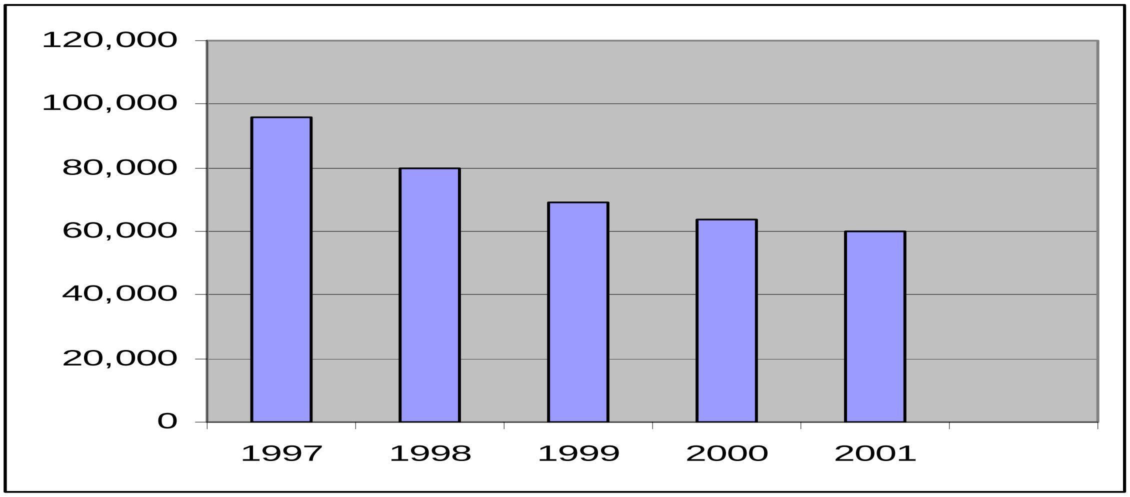
	1998	1999	2000	2001
Commercial Banks	380.4	454.8	469.1	686.8
Assets	427.6	494.7	909.1	789.6
Liabilities	-47.2	-39.9	-140.0	-102.8
Central Bank	3248.3	2953.9	3081.3	4574.4
Assets	3549.8	3349.3	3486.2	5136.9
Liabilities	-301.5	-395.4	-404.8	-562.5
Net Foreign Assets	3628.7	3408.7	3550.4	5261.2

Source: Central Bank of Lesotho.

B.5 Employment

Poverty in Lesotho is closely linked to the lack of employment opportunities. Unemployment is estimated at around 40% of the labor force. In a population that grows at slightly above 2%, it is estimated that between 20,000 and 26,000 people enter the labor force every year, but only 9,000 can be employed. The unemployment is compounded by a number of factors, the most prominent being diminishing employment prospects in the agricultural and government sectors, high growth rate of the landless population, weak linkages among economic sectors and retrenchment of Basotho mineworkers in the Republic of South Africa. For years the serious unemployment problem has been alleviated by migration to South African mines. However, since the late 1980s the massive retrenchments in the mining industry further worsened the prevailing unemployment problem in Lesotho. As can be seen in Figure 5.5 below, at the end of 2001migrant mine labor had dropped by a substantial 7.1 percent over the year to 59,861 However, Government remains the largest employer in the formal sector. There is also a considerable increase is number of workers in manufacturing industries. Employment in this sub-sector was estimated at 30,000 workers in 2001 and the expectation is that by the end of 2003, this number will have increased to over 40,000 workers, given the number of on-going initiatives to improve performance and hence employment levels in the sub-sector.

Figure 5.5 Average Number of Migrant Mineworkers in RSA



Employment by industry

Table 5.5 shows that 51.3 % of the total working population was subsistence farmers and of the total population employed, 5.9% were employed in the manufacturing sector. This is according to results of 1997 Labor Force Survey which is subject to review.

Table 5.5 Working Populations by Industry

Industry	Male	Female	Total
Agriculture Hunting & Forestry	6.5	3.6	5.2
Subsistence Farming	59.1	41.5	51.3
Mining and quarrying	3.1	0.5	1.9
Manufacturing	3.1	9.5	5.9
Electricity, Gas and Water	1.0	0.2	0.6
Construction	9.5	3.9	6.7
Wholesale & Retail Trade; Repair of Vehicle & Goods	5.8	12.6	8.8
Hotels & Restaurants	0.3	2.6	1.3
Transport, Storage and Communication	4.3	0.6	2.6
Financial Intermediation	0.5	0.8	0.6
Real Estate, Renting and Business Activities	1.1	2.0	1.5
Public Admin. & Defense Social Services	1.8	2.3	2.1
Education	2.2	7.4	4.5
Health & Social Work	0.4	1.6	1.0
Other Community, Social & Personal Services	0.7	1.1	0.9
Private Household Activities	0.6	10.5	5.0
Extra Territorial Organizations & Bodies	0.01	0.1	0.1
Total	100	100	100

Source: Bureau of Statistics

5.2.2 Fiscal Position

A. Budget Planning and Management Systems

The annual budget statement on the overall government resources is prepared by Fiscal Analysis and Policy Unit (FAPU) and Department of Economic Planning. After the release of the budget statement, the budget was historically prepared by individual line ministries under two essentially separate streams of activity. The recurrent budget was prepared by accounting clerks and the Chief Financial controller of each line ministry before submission to the Budget Co-ordination Office in the Ministry of Finance. Costing was on incremental basis, calculated from an escalation figures given by the Budget Co-ordination Office each year. Planning on the budget was typically based on previous expenditure patterns rather than any identification of line ministry priorities and programmes.

The capital budget is prepared by planning officers in each line ministry based on their identified pipeline of approved projects. The budget Co-ordination Office in the Ministry of Finance is responsible for monitoring expenditure against budget and for transferring funds as the financial year proceeds. There is no effective regular monthly system for reviewing progress of expenditure against the budget as the year proceeds. Line Ministries are warranted funds to spend on a quarterly basis, and as and when funds are exhausted they approach the Budget Co-ordination Office for additional funds. These funds are accessed firstly by transferring unspent funds from other areas, or in the latter half of the financial year by a supplementary budget that requires Cabinet approval

The Department of Economic Co-operation in the Ministry of Development Planning and the Budget Co-ordination Office in the Ministry of Finance have historically prepared the capital and recurrent budgets separately and then consolidated the figures to produce one budget document covering both the capital and recurrent budgets.

In its final report (March 2002) FAPU identified the existing shortfalls in the budget planning and management system and made it clear that there is a need for substantial strengthening in this process. Though some encouraging moves were also highlighted such as the early completion of the 2000/2003 budget and its approval by Cabinet and presentation to the Parliament in January 2002, possible recommendations were laid down as a step forward to improve budget planning and management systems.

B. Fiscal Performance in recent years

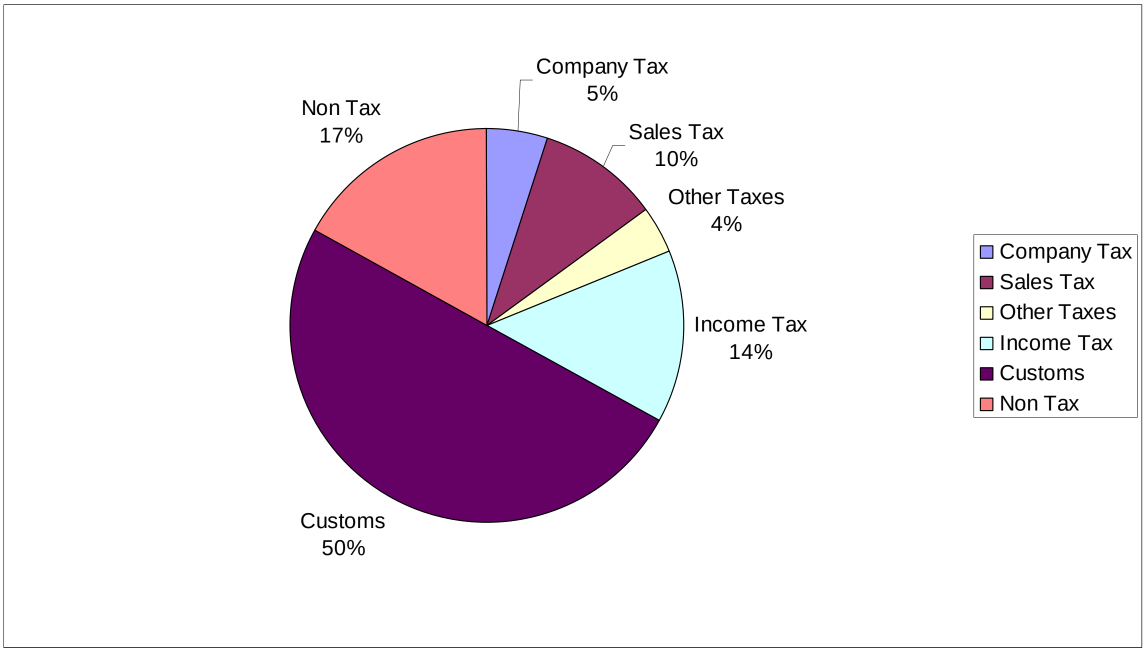
During the 1990s and prior to 1998/99 the Government enjoyed comfortable fiscal positions, with the budget recording significant overall surpluses. This was a result of prudent fiscal policies pursued by the authorities under various IMF-supported structural adjustment programmes. The situation deteriorated into an overall budget deficit in 1998/99. This was brought about by expenditure pressures emanating from the cost of restructuring state-owned banks. Also, external grants fell dramatically due to reduced donor support in the absence of an IMF-supported economic programme. Thus Government turned to domestic borrowing to finance the said deficit.

The situation continued in 1999/2000. This time expenditure pressures arose mainly from Government's settlement of Lesotho Highlands Development Authority (LHDA) loans. This was compounded by low tax collections, as the economy had not recovered from 1998 civil unrest. At the end of 1999 the Government entered into an IMF staff-monitored programme, with the aim of improving, among others, fiscal prudence. This manifested in an improvement of the overall budget deficit from 5.0 percent of GNP in 1999/00 to 2.6 percent of GNP in 2000/01. This was achieved through improved revenue collection efforts and tight expenditure control during the year.

C. Fiscal Performance in 2001/2002

There was a record of an overall surplus of 1.8 percent of GNP as opposed to the budgeted deficit of 0.5 percent of GNP. This reflected intensified Government efforts to fiscal stability through the containment of public expenditure as well as improved revenue collection. Total revenue and grants increased by 13.9 percent from fiscal year 2000/01 to 35.9 percent of GNP, with customs receipt constituting the bulk of Government revenue at 16.5 percent of GNP. (See Figure 5.5)

Figure 5.5 Sources of Government Revenue



In fiscal year 2002/2003, the Government's policy priorities will be implemented in an environment of limited financial resources. Overall tax revenue is projected to decline as a share of GDP because of a fall in Southern African Customs Union (SACU) and an expected decline in non tax revenue. There is also a risk that tax collections could fall short of projections because of (i) the possibility of an economic slowdown in Lesotho linked to the downturn in the global economy, and (ii) the uncertainties related to delays in Lesotho Revenue Authority and VAT implementation. SACU receipts account for 47.3 percent of the revenue projection while income tax and sales tax account for 23 percent and 11.2 percent respectively.

Total expenditure, excluding net lending, is expected to rise by 1 and 1/4 percent of GDP to 45 and 3/4 percent, almost entirely due to a 70 percent increase in externally financed capital spending. The budget records the after grants deficit of 0.3 percent of GDP. Current spending is budgeted to grow in line with GDP. Reflecting government priorities, education sector is continuing to constitute the largest expenditure item of 22.0 percent of the total spending. In addition, the next largest share is allocated to public works which accounts for 9.2 percent of the budget. This is inconsistent with the Government policy to build and maintain economic infrastructure and to create employment in order to enhance success in the fight against poverty and in creating a better life for all the Basotho.

The domestic balance, which measures the Government's absorption of local resources and, therefore, excludes externally financed projects with high import content, external interest payments, and exceptional factors, is projected to rise by ½ of 1 percent of GDP to a surplus of 2 percent. The domestic borrowing requirement would increase to about ½ of 1 percent of GDP, an acceptable level in view of the low level of government domestic debt. Looking ahead, drawing on resources of the banking system and the non-bank public will be kept to a minimum so that credit is available for private sector development. This constraint will become increasingly important as financial markets are modernized.

Table 5.6 Summary of Budgetary Operations

In Percent of GDP

	1998/99	1999/00	2000/01	2001/02 Revised	2002/03 Projections
Revenue and Grants	**35.2**	**38.8**	**34.6**	**36.3**	**37.5**
Revenue	33.4	32.0	33.0	33.3	33.3
Customs (in percent of revenue)	47.6	51.2	43.0	50.0	47.3
Grants	1.8	1.8	1.6	3.0	4.2
Total Expenditure	37.6	38.7	37.2	34.5	37.8
Overall surplus/deficit before grants	-4.2	-6.8	-4.2	-1.2	-4.5
Overall surplus/deficit after grants	-2.4	-5.0	-2.6	1.8	-0.3
Memorandum Item in current Prices:					
GDP	5078.9	5730.9	6197.1	6958.9	7646.2
GNP	6493.2	7233.0	7951.3	8598.1	9345.0

Source: Ministry of Finance.

D. Public Borrowing

In 2001, the total Government debt increased dramatically bringing Government indebtedness to 82.2 percent of GNP. This increase emanated entirely, form the external debt which rose by 44.6%. The external debt accounted for about 89% of total debt. The rise in the external debt was mainly the result of depreciation of the Loti against major currencies in which more than 60% of this debt was contracted. The depreciation of the
Loti against the US dollar and the SDR in the aftermath of USA attacks; the negative investor sentiment against the rand due to the Zimbabwe unrest; as well as the emerging market syndrome, was among other things that caused the external debt to rise significantly. Government continued to maintain its policy of borrowing on concessionary terms. This kind of borrowing is rather favorable as it allows for long maturity and grace periods for loan repayments, relatively low interest rates as well as the significant grant element being part of these loans. Concessionary loans constituted 76% of external outstanding debt. Most of this was contracted multilateral donors.

Domestic debt declined by 5.8% due to the retirement of special issue of treasury bills; reduction of Lesotho Bank (1999) Ltd treasury bills as some of the old Lesotho Bank assets were recovered; and the phasing-out of some of the M154.1 million issue treasury bills following the introduction of the open market operations based system of treasury bills. This new system is expected to be instrumental in determining the economy-wide level of interest rates, and the total face value of securities will no longer be set at M154.1 million but will be determined by liquidity position prevailing in the economy from time to time.

Table 5.7 Public Debt Indicators for Enc of Year 2001

(in percent)

	1998	1999	2000	2001
Total debt as a % of GNP	53.1	54.6	66.1	82.2
External debt as a % of GNP	50.5	44.2	55.7	73.3
Domestic Debt as a % of GNP	2.5	10.3	10.4	9.0
Confessional as a % of External debt	88.6	89.4	81.6	76.2
External debt as a % of total	95.2	81.0	84.2	89.1
Domestic debt as a % of total	4.8	19.0	15.8	10.9
Debt service ratio (1)	7.2	9.9	8.4	4.5
Debt service ratio (2)	17.5	24.6	17.4	7.9

Source: Ministry of Finance

(1) Ratio of debt service to exports of goods and services, including factor income.

(2) Ratio of debt service to exports of goods and non-factor services.

E. Aggregate Tax Revenue.

Customs receipts constitute the bulk of Government revenue at 16.5 percent, 21 percent and 19.2 percent of GNP in 2000/01, 2001/02 and 2002/03 (estimates) respectively. This source is steadily declining, and in response to this, the Government is in the process of establishing Lesotho Revenue Authority and introducing Value Added Tax. These are expected to increase tax efficiency and widen the tax base.

Table 5.8 (Million Maloti in Current Prices)

Years	**1998/99**	**1999/00**	**2000/01**	**2001/02**	**2002/03***
Aggregate Tax Revenue	**1654.4**	**1892.0**	**1977.7**	**2328.2**	**2553.1**
Customs	1033.4	1183.0	1125.2	1438.2	1470.0
Income Tax (corporate + indiv.)	387.7	419.5	468.5	579.1	710.6
Sales Tax	233.3	238.6	279.0	306.5	353.6
Other tax revenues	0	50.9	105.0	4.4	18.9

Source: Ministry of Finance

* Projections

5.3 Tax Structure: Institutions and the Reality

In Lesotho, the tax system consists of three departments namely, income tax, sales tax and customs excise. These departments are under a direct jurisdiction of the Ministry of Finance. The responsibility of drafting the tax codes, negotiating tax treaties with international countries and administration in general is vested with the Ministry. All taxes are collected at national level, currently there are no district tax bureaus and taxpayers get all services from headquarters located in Maseru capital city.

The Kingdom of Lesotho is considerably not endowed with a vast variety of natural resources except for water which is available in relative abundance. Collection of government revenue in the form of taxes thus constitutes a major source of income. Though the current tax system presumably accounts for a very narrow tax base, the government of Lesotho with the support of tax departments has been striving for efficiency and effectiveness in tax collection as a device to attain social welfare and boost economic growth. Within this context, the government has further embarked on the major tax reform to establish the autonomous National Tax Revenue Authority.

Lesotho Revenue Authority is coupled with replacement of sales tax by VAT which will follow six months after implementation. The transition is scheduled to be effective by December, 2002 if not sooner.

Tax Codes

There are three tax codes corresponding to each tax department. Income Tax Act 1993 (amended) Order No. 9 of 1993, this Act repeals the 1981 Income Tax Act; Sales tax Act 1995 No. 14 of 1995 published in April 29, 1996 implemented from August 31, 1996, this Act repealed the Sales Tax Act 1982 except for certain transitional administrative arrangements; Customs and Excise consolidated Act No. 10 of 1982.

5.3.1 Direct Taxes

A. Types of taxes

Corporation tax; income tax on individual traders and professionals; withholding taxes on PAYE, dividends, interest, royalties, natural resource payments, management charges, service income paid to non residents; fringe benefits taxes; property taxes; and taxation on estates of deceased persons.

B. Income Tax Base

Gross income; this is income earned from all geographical sources in the case of resident taxpayers, for non-resident taxpayers, it is only Lesotho source income. In all respects it is the sum of employment income, business income, property income, and any other income or gain but does not include amounts exempt from income tax.

Chargeable Income; this is income of the taxpayer for a year of assessment determined by subtracting from the gross income of the taxpayer any deductions allowed under Income Tax Order, 1993.

C. Treatment of Persons as Residents

Resident Individual; an individual is a resident individual for the entire year of assessment if that individual: (i) has a normal place of abode in Lesotho and is present in Lesotho for part of the year of assessment; (ii) is present in Lesotho on more than 182 days in any consecutive period of twelve months which includes all part of the year of assessment; (iii) is an official of the Lesotho Government posted overseas during the year of assessment; or (iv) is otherwise a resident of Lesotho.

The reference to a person who is otherwise a resident of Lesotho means a person who is a resident in Lesotho according to ordinary concepts. This is determined according to the general principles established by United Kingdom judicial decisions.

Resident Company; a company is a resident company if: (i) is incorporated or formed under the laws of Lesotho; (ii) has its management and control in Lesotho; or (iii) undertakes the majority of its operations in Lesotho. A branch in Lesotho of a non-resident company is treated as a separate person, that is, a resident company.

Year of assessment; this means the period ending on the 31st March. However, in the case of a company the Commissioner may, on written application by a company grant a permission to use a twelve month period other than the twelve month ending on 31 March as the year of assessment.

D. Corporation Tax

Tax at the rate of 35% is imposed on taxable income of all resident companies in the year of assessment, with exception of manufacturing companies which are taxed at 15% only on manufacturing profit, if they have any other income; it is subject to 35%. In relation to distributable profits, dividends paid to a resident shareholder are not subject to income tax as a mechanism to avoid double taxation. Dividends paid to non resident shareholders are subject to 10% withholding tax.

E. Withholding Taxes

An employer is obliged to withhold tax from a payment of employment income(other than a domestic assistant) as prescribed in the regulations; tax at the rate of 10% is withheld at source on the gross amount of Lesotho source dividends, interest, natural resource payments, management charges and service contracts earned within Lesotho by non-residents. Again 10% on interest paid (in excess of the exempt amount) and at 5% on the gross amounts paid by government to Lesotho residents contractors and subcontractors is withheld at source, and such amount is a credit against the final amount of tax.

Tax Withholding Certificates; a withholding agent must deliver to the payee a tax withholding tax certificate setting out the amount of payments made and tax withheld during the year of assessment.

Record of Payments and Tax Withheld; a withholding agent must maintain, and keep available for inspection by the Commissioner, records showing in each year of assessment: payments made to a payee; and tax withheld from those payments.

Failure to Withhold Tax; a withholding agent who fails to withhold tax is personally liable for the tax which has not been withheld, but the withholding agent is entitled to recover the amount from the payee.

F. Fringe Benefits Tax

Tax imposed on every employer who has a fringe benefits taxable amount which is calculated in accordance with prescribed formula. Every employer must file a return of fringe benefits for each period of three months ending on 30 June, 30 September, 31 December, and 31 March, showing the fringe benefits taxable amount and fringe benefits tax payable for the period. The return must be filed within 14 days of the end of the period to which it relates.

G. Property taxes

These are taxes on investment assets' gains assessed periodically based on capital value of property. The cost base of an asset is the starting point in determining the adjusted cost base of the asset which is the first component in the formula for determining whether there has been a gain or loss on disposal of the asset. The general principle is that the tax base of an asset is the asset's tax cost which is determined in accordance with different prescribed rules. The other component of the formula for calculating the gain or loss on disposal of an asset is the consideration received by the taxpayer for the disposal. In most cases, the amount of consideration received on disposal of an asset will be clear, being the cash proceeds on sale. But there are special rules for other cases.

H. Taxation of Estates of Deceased Persons

These are estate duty paid by estate in respect of property passed on the death of the person who owned the property at the time of death. Income accruing or received in the year of assessment of the death of the taxpayer; and prior to the date of death, which would, but for the death of the taxpayer, have been chargeable to tax to the taxpayer for any year of assessment is charged to tax as chargeable trust income upon the executor or administrator of the deceased taxpayer for that year of assessment.

I. Deductions

According to Income Tax Order, 1993, an allowable deduction is described as any expense or loss (including a depreciation or amortization expense) incurred by the taxpayer during the year of assessment in the production of income subject to tax. This Order provides that no deduction is allowed for: (i) any expense or loss to the extent it of a personal nature; (ii) income tax; (iii) expenses of acquiring, producing, or improving property or for other expenses chargeable to capital account; (iv) the cost of a gift made directly or indirectly to an individual if the gift is excludable from the individual's gross income; (v) a fine or similar penalty paid to a government for breach of any law; and (vi) insurance premium paid to a non resident insurer in respect of an asset or risk located in Lesotho.

The following are specific deductions as per Order*:*

Limitation on Entertainment expenses; the law limits the availability of deductions for entertainment expenses to 50% of the expense incurred.

Interest Deduction; a taxpayer is entitled to a deduction for interest incurred on a borrowing used by the taxpayer in the production of income subject to tax. Where a resident company not principally engaged in a money lending business has a debt to equity ratio in excess of 3 to 1, the Commissioner may disallow a deduction for the interest paid on that part of the debt in excess of the 3 to 1 ratio. This constitutes a thin capitalization rule to ensure that foreign owners of resident companies do not use excessive related party debt as a means of repatriating profits instead of paying dividends on equity.

Bad Debts; A deduction is allowed for a bad debt incurred only when the debt is written off in the taxpayer's accounts. No deduction is allowed for provisions on doubtful debts.

Annuities Paid to Former Employees; the deduction is allowable only where the former employee worked in a business of the taxpayer the income from which was subject to income tax in Lesotho.

Approved Training Expenditure; a taxpayer carrying on business in Lesotho is allowed to deduct 125% of expenditure incurred for training or tertiary education of a citizen of Lesotho who is employed by the taxpayer in this expenditure must first be approved by the Commissioner.

J. Exemptions

Public International Organizations; these are organizations listed in the First Schedule of Income Tax Order, 1993. All such organizations are exempt from both income tax and fringe benefits tax.

Diplomatic and Similar Privileges; these include the official income of a diplomatic officer, consular officer, administrative or technical employee of a member of a diplomatic mission or consular post. The exemption however, does not apply to any other Lesotho source income.

Foreign Service Allowance; This is the allowance paid to a person serving in a Lesotho foreign mission, it is exempt from income tax to the extent declared by the Minister of Finance by notice in writing in the Gazette.

Property Income of Expatriate Taxpayers; this is property income derived from a foreign source or from the disposal of an asset investment asset generating foreign income by an expatriate taxpayer.

Exempt Organizations; These include income of an organization which is religious or charitable, an amateur sporting association or a trade union. The exemption is only available where the organization has a ruling from the Commissioner confirming its status and none of its income or assets confers or may confer a private benefit on any person.

War pensions; war pensions and gratuities paid by the Lesotho Government in respect of persons who retired before the date of enactment of Income Tax Order are exempt from income tax.

Scholarships; a scholarship payable for tuition fees for full-time instruction at an educational institution is exempt from income tax.

Farming; this refers to income derived by a resident individual from farming carried on in Lesotho. The exemption is only available for primary farming operations, whether pastoral or agricultural.

Maintenance and Child Support; maintenance or child support payments are exempt in the hands of the recipient.

Gifts; the value of property acquired by gift, bequest, devise, or inheritance is exempt from income tax. However, the exemption does not extend to any income derived from the property which is the subject of the gift; also the exemption does not apply where the gift is itself income.

Exemption under Other Laws; income exempted from income tax under any other law of Lesotho is exempt from income tax under Income Tax Order. For instance, the income of the King and Regent of Lesotho which is exempt from income tax under the Office of King Order, 1990, is also exempt under Income Tax Order, 1993.

K. Assessments

Filing of return of income; the year of assessment starts from 1st April to 31st March, unless specified otherwise, and every nominated officer of a partnership or trust must file a return of income for each year of assessment not later than the last day of the 3rd month following the end of that year. In the event where fraud, gross or willful neglect has been committed by or on behalf of a person in relation to income tax for the year of assessment, an assessment for that year may be amended at anytime by making such alterations or additions to the assessment as the Commissioner considers necessary and the Commissioner must serve notice of the amended on the person assessed. In the event the taxpayer fails to file a return on the due date, the Commissioner may make an estimated assessment on the basis of the available information; the estimated tax liability is valid and payable.

Objections to assessment; a taxpayer who is dissatisfied with an assessment (other than an amended assessment) may file an objection to the assessment with the Commissioner within 4 years after service of the notice of assessment.

L. Collection

Due Date for Payment; income tax payable is due and payable on the date on which the return of income is due, income tax assessed is due and payable 30 days after service of the notice of assessment. Where an objection to notice of appeal against or an application for amendment to an assessment has been filed, the amount of income tax payable under the assessment is due and payable, and may be recovered, not withstanding that objection, appeal or application.

Recovery of tax; from the date on which income tax becomes due and payable, the Commissioner has a preferential claim, as provided in the Insolvency Proclamation 1957, upon assets of the taxpayer until the tax is paid. The Commissioner may recover unpaid income tax by distress proceedings against the property of the taxpayer by issuing an order in writing, specifying the taxpayer against whose property the proceedings are authorized, the location of property, and the assessment to which proceedings relate; and may require police officer to be present while the distress is being executed. A taxpayer has the right to pay the tax due in the year of assessment in three installments, that is, 30 September, 31 December, and 31 March of that year of assessment.

Applicable statutory income tax rates
(All amounts in Maloti)

Income	Tax rates
Corporations:	
Manufacturing	15%
Non-manufacturing	35%
Individuals:	
Residents	
0----------- 30,000	25%
Above 30,000	7500 + 35%

NB. All residents receive a tax credit of 2640 per annum.

Non Residents	25%

Table 5.9 Income Tax Revenue Composition

Fiscal Year End	Million Maloti	GDP
1997/98	340.1	7.1%
1998/99	387.7	7.6%
1999/00	419.5	7.3%
2000/01	468.5	7.6%
2001/02	579.1	8.3%
2002/03*	710.6	9.3%

Source: Ministry of finance.
* Projections

5.3.1 Indirect Taxes

A. Sales Tax

Nature of tax; a general sales tax is imposed on every taxable supply in Lesotho and on every import of goods and services. The Act provides for the imposition of a single-stage sales tax at retail level. It also provides for a credit for certain taxes paid on goods on hand at the time a person becomes registered. The Act provides for voluntary and compulsory registration by the Commissioner of sales tax. Where the vendor has been registered, the Commissioner is obliged to issue a sales tax registration certificate. The Act provides criteria to be followed for the exemption certificate to be issued, e.g. fixed place of abode, keeping proper books of accounts.

Returns and Assessments; a vendor must file a sales tax return stating the sales tax payable for each tax period with the Commissioner within twenty days after the end of the period. Where a person fails to file a return, or the Commissioner is not satisfied with the return filed, or the Commissioner has reasonable grounds to believe that a person will become liable to pay sales tax under the Act but is unlikely to pay the amount due, the Commissioner may make an assessment of the amount of sales tax payable by the person, based on the information available estimate the sales tax payable.

Collections; due date for payment of sales tax in the case a taxable supply by vendor in respect of the tax period is the date the return for the tax period is filed; in the case of the assessment issued is the period specified in the notice of assessment . Upon written application by a person liable for sales tax, the Commissioner may, where good cause is shown, extend the time for payment of the tax beyond the due date or make such arrangements as appropriate to ensure payment of the sales tax due.

Applicable sales tax rates:

Exports	0%
Taxable goods and Services	10%
Alcoholic beverages	15%

Table 5.10 Sales Tax Revenue Composition

Fiscal Year End	Million Maloti	GDP
1997/98	223.5	4.7%
1998/99	233.3	4.6%
1999/00	238.6	4.2%
2000/01	279.0	4.5%
2001/02	306.5	4.4%
2002/03*	353.6	4.6%

Source: Ministry of Finance.
*Projections

B. Customs and Excise

Taxes on international trade and transactions

Customs duty is imposed on all goods imported into Lesotho. A three-column tariff scheduled based on Customs Cooperation Council (CCC) nomenclature with fiscal, general and most favored nation (MFN) rates of duty used. Goods originating from countries enjoying MFN status pay the fiscal and customs duties. There is no preferential rate of duty. According to Customs Union Agreements, a duty is collected by the Republic of South Africa and other partners (at port of arrival) and contributed to a common customs union pool held with Botswana, Namibia and South Africa and Swaziland. Lesotho's share is calculated according to a fixed formula which is presently being reviewed.

Exemptions and Deductions; there are free trade agreements with Botswana, Namibia, South Africa and Swaziland.

Customs revenue has been the profound source of Government revenue for years particularly in Southern African Customs Union (SACU) non duty receipts. Following the 1998 socio-political unrest, there was a remarkable increase of customs revenue as Lesotho experienced rise in imports including intermediate inputs. Though the new SACU revenue sharing is expected to enhance SACU receipts, this is expected to be in the medium term. In the long term, these receipts may decline on account of the pool becoming smaller. Hence, the Government attempts to intensify efforts to reduce more reliance on this source by establishing Lesotho Revenue Authority to enhance tax efficiency; and introducing VAT to widen the tax base.

Table 5.11 Customs Revenue Composition

Fiscal Year End	Million Maloti	GDP
1997/98	1172.7	24.6%
1998/99	1033.4	20.3%
1999/00	1183.1	20.6%
2000/01	1183.1	16.5%
2001/02	1438.2	20.7%
2002/03*	1470.0	19.2%

Source: Ministry of Finance
*Projections

5.4 Country Specific Fiscal Issues

The government of Lesotho is currently committed to the three year economic programme supported by the Poverty Reduction and Growth Facility (PRGF). The programme which relies on fiscal restrain and structural reform provides a framework to promote economic growth and reduce poverty. The fiscal strategy aims at short term external stability and medium term growth and poverty particularly through the removal of key infrastructure bottlenecks and increased spending on health and education. The scourge of poverty afflicts the large percentage of Basotho. Lack of food, shelter decent clothing, access to basic services such as health and education characterize painful levels of and deprive men, women and children of the dignity which is their birth right. It is within this context that strategies towards reduction of poverty will remain the central issue of concern.

Unemployment; Lesotho's real GDP has recovered to above 2% following the downturn in 1998/99 fiscal year, but remains constrained. Unemployment is widespread and remains high at an estimated 40% because of the mine workers previously employed in South Africa have not been absorbed into the formal sector. Lesotho's economic programme is directed towards raising growth by attracting foreign direct investment and enhancing export competitiveness. Productive workforce wage levels are low making it attractive mostly for Asian companies to set up manufacturing in Lesotho coupled with access to the U.S. markets for textiles. Private Sector Development Strategy supported by the Venture Capital Fund sourced from proceeds of privatization is one of the main steps aimed at generating economic activity and thus creating employment opportunities as well as investment and growth.

HIV/AIDS; this epidemic is currently at crisis levels. At least 40% of the population lives in poverty aggravated by the serious HIV/AIDS problem. An estimated quarter of the adult population is HIV positive and life expectancy is declining increasingly. Government policy on this epidemic emphasizes involvement of all members of the Basotho society to fight the scourge. Health education constitutes an important element of the strategy. Every sector of the economy is therefore mandated to include the fight against HIV/AIDS as an integral part of their programmes.

Human Resource Development; Government is committed to its policy of devoting a substantial proportion of the budget to education by maintaining the Free Primary Education Programme (FEP) for classes one to three. The programme satisfies the objective of human resource development by making it possible for people to attain literacy and a knowledgeable life. This reduces poverty by increasing the chances of people participating in economic activity later in life. Provision of infrastructure and services associated with FEP also plays a vital role in growth and employment generation.

Economic and Social Infrastructure; Investment in industrial infrastructure has proved very productive in terms of job creation. Efforts to provide industrial infrastructure as well as implementation of the Road Rehabilitation Programme supported by the World Bank will be maintained. Reforms in the developing institutions serving the tourism sector will also continue throughout 2002/03 with the policy formulation and essential legislation. The thrust of tourism policy will be towards attracting investment by offering investment incentives including tax concessions.

Management and Preservation of Natural Resource Base; in the agricultural sector, efficiency will be enhanced through privatization of some of 100 enterprises and introducing reforms focused at core activities. Extension services will be improved to support conservation and management of natural resources such as land, water and the environment. Programmes of support to farmers will also be sustained.

Good Governance; it is hoped that the general elections held in May 25 2002, will enhance political stability necessary for economic development. Efforts towards expediting local government, improving justice dispensation, ensuring the rule of law and fight against corruption will continue. The Anti- corruption Directorate will be fully set up with the assistance of developing partners.

Efficient Revenue Collection; the thrust of fiscal policy shall continue to ensure that government operations do not lead to an unsustainable situation and inflation. To this extent, efforts to collect all revenues due to Government shall be maintained and enhanced. Lesotho Revenue Authority will be established and the operations will be guided by business principles. Incentives will be granted to improved performance in order to enhance efficiency.

In general, the maintenance of macroeconomic stability is essential for economic growth. Efforts directed at the collective development of the long-term vision is yet another strategy to address many problems facing the economy, including the fore-mentioned priority objectives. Government of Lesotho will consolidate gains achieved since the start of the implementation of the Macroeconomic Reform Programme supported by IMF. A stable economic environment can also be sustained through adoption of prudent fiscal and monetary policies capable of maintaining inflation and exchange rates at acceptable levels; thus creating a climate conducive to political stability, increased investment and job creation. In terms of exchange rate policies, the government shall continue pegging Lesotho's currency at par with South African Rand despite the rapid depreciation in the Rand in recent years. The costs and benefits of de-pegging the Loti from the Rand have been considered, and remaining within the common monetary area proved worthwhile. More than 90% of Lesotho's imports come from South Africa, thus, remaining within this common arrangement requires healthy stock of foreign reserves to support parity of Loti and Rand. A sustainable fiscal stance requires that expenditure be tailored to revenues, and to avoid conditions for unsustainable deficits, which will in turn derail plans to create a stable climate for investment. It is within this context that the efforts of government are directed towards public sector reform aimed at improving financial management and public service delivery and rationalization of civil service. To this extend, the Government of Lesotho has recently decided to negotiate a loan amounting to US$5million with the World Bank in support of the Public Sector Improvement Programme. The government will maintain its policy of borrowing on concessionary terms and only for investment and never for financing consumption.

5.5 Conclusion: Where We Stand and Where We Go.

Until the late 1990's, economic performance in Lesotho was favorable. Construction under Phase 1A of the Lesotho Highlands Water Project (LHWP) and rapid expansion of manufacturing production and exports compelled economic activity, and real growth GDP averaged over 6% in decade ending in 1997. Monetary and economic integration with South Africa resulted in relatively low inflation, and prudent fiscal management led to the accumulation of sizeable government deposits in banking system and a comfortable net international reserve position.

Economic performance began to deteriorate in the late 1990's with the winding up of Phase 1A of the LHWP; a slowdown of manufacturing growth due to emergence of a shortage factory space in the manufacturing sector; and an increasingly declining of mine workers' remittances from South Africa. Though Phase 1B started in 1998, it is smaller than Phase 1A and its economic impact has been lower. In addition, the political disturbance of September, 1998 which resulted from discontent with the results of the 1998 general elections and led to the intervention of Southern African Development Community (SADC) troops adversely affected economic activity. As a result real GDP declined by almost 4% in fiscal year 1998/99 (April-March), and grew by only 2% in 1999/2000. All these adverse effects and emergence in fiscal pressures led to deterioration in the balance of payments.

The Government of Lesotho needs to diversify its production base by investment in manufacturing and other non-traditional activities such as tourism. Employment generation through economic growth is a linchpin of the government's efforts to reduce poverty. However, the government is also aware of the need for prudent financial management to generate confidence in the economy and to preserve macroeconomic stability.

In December, 1999 the government launched a nine –month economic programme which was monitored by the staff of IMF. This was the first step in the design of a medium-term economic program to tackle Lesotho's economic problems which are largely structural in nature. The staff-monitored programme emphasized growth-oriented policies as well as fiscal restraint and core reforms in tax policy and tax administration, privatization, financial sector reform, bank restructuring and supervision, and institution strengthening.

Following the successful implementation of this programme during the period January to September 2000, the Government of Lesotho reached an understanding on the 3-year successor economic programme for Lesotho under the Poverty Reduction and Growth Facility. The IMF therefore approved 3-year loan for SDR 24.5million (about US$32million) to support Lesotho's efforts to foster macroeconomic stability, promote accelerated growth, improve social services and reduce poverty.

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