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EBD/90/129
Correction 1

May 7, 1990

To: Members of the Executive Board

From: The Secretary

Subject: Lesotho - Structural Adjustment Facility - Policy Framework Paper, 1990/91-1992/93

The following corrections have been made in EBD/90/129 (4/30/90):

Page 6, para. No. 17, line 21: for "8.0 percent" read "8.03 percent"
line 23: for "50.2 percent" read "54.4 percent"
line 24: for "20.5 percent" read "24.4 percent"
line 25: for "47.4 percent" read "51.9 percent"

Page 7, line 6: for "to 1.7 percent" read "to 2.4 percent"

Page 8, lines 4 and 5: for "will reviewed" read "will be reviewed"
para. No. 22, last line: for "(SecM89-581)."
read "(EBD/89/143, 5/11/89)."

Page 9, footnote 1: for "paper, SecM89-581."
read "paper, EBD/89/143 (5/11/89)."

Page 16, last line: for "to 14.5 weeks" read "to 12.0 weeks."

Corrected pages are attached.

Att: (5)

Other Distribution:
Department Heads

sector management. Although funding is still awaited for several components, substantial progress has been made regarding both the installation of a microcomputer-based personnel management system, and the provision of management training to civil servants. In 1989/90, some 500 civil servants attended short management training courses. In the area of budget management, a new computerized accounting system has been successfully introduced in the Ministries of Education, and Water, Energy and Mining, and is currently being extended to other ministries. A unified budget comprising estimates for both recurrent and capital expenditure was presented for the first time in 1989. However, the recurrent cost implications of capital projects are not yet fully taken into account as yet in the budgetary process. As the full benefits of the proposed budget management improvement system will not be felt for several years, the Government has introduced substantial improvements in the existing expenditure control system at the commitment stage.

14. The Government has continued to encourage the retention of savings within Lesotho by adjusting the domestic prime lending rate and the minimum savings deposit rate according to interest rate developments in South Africa. More specifically, the minimum rate on savings deposits increased from 14.5 percent in September 1988 to 15.5 percent by end-December 1989, while the prime lending rate increased from 19 percent to 20 percent over the same period. This compares with an expected inflation rate of 14.9 percent during 1989/90. The differential between Lesotho's prime lending rate and that of South Africa was down to 1 percentage point by end-September 1989. This represents a sharp departure from earlier years when the differential sometimes widened to as much as 3 percentage points. The Board of Trustees for the Miners' Deferred Pay Fund was appointed at the beginning of 1989/90. This body will ensure that more competitive interest rates are paid on migrant workers' deposits, thus stemming leakages from the fund. The export financing scheme, first launched in October 1988 has been maintained as a means of increasing the flow of credit to productive industrial investment and exports by reducing credit risks to commercial banks. Agricultural production and exports are also expected to increase as a result of the introduction of a revolving fund, financed by the United Nations Capital Development Fund (UNCDF), to provide short and long-term credit to farmers through the commercial banks.

15. With respect to sectoral developments, progress was mixed. Although the four grazing associations established under a USAID-funded project now represent about 30 percent of livestock holders, grazing fees have yet to be introduced on a per-animal basis. 1/ The Government, however, has formally recognized the need to introduce such a grazing fee system. The introduction of an amendment to the 1979 Land Act, giving legal recognition to informal land-leasing arrangements, has been delayed. However, as a first step, the Report of the Land Policy

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1/ USAID, U.S. Agency for International Development.

Review Commission has been translated into Sesotho, and is being distributed at the village level to disseminate the Report's recommendations.

16. As noted above, foreign investment in domestic manufacturing continued to increase during 1989/90, while an acceleration in the implementation of the preliminary phase of the LHWP led to rapid growth in construction.

III. Macroeconomic and Structural Policies 1990/91-1992/93

Medium-term macroeconomic objectives and strategy

17. The Government's objectives during the program period are to sustain domestic growth with a view to expanding employment opportunities and improving living standards, while strengthening the economy's fiscal and external current account position. Over the period 1990/91-1992/93, increased emphasis will be placed upon: (a) raising production in agriculture and industry; (b) increasing both domestic saving and investment; (c) raising the rate of growth of employment; (d) placing more emphasis upon the social sectors within the allocation of future government expenditures; and (e) improving the overall capacity of the system of public administration, with special emphasis upon financial management and associated areas such as external debt management. The projected adjustment path remains broadly similar to that envisaged in the second year of the program, and fully takes into account the impact of the LHWP. The main assumptions regarding developments over the medium term are that: (a) migrant mineworker remittances will remain constant in real terms; (b) the LHWP will be implemented as envisaged at end-December 1989; (c) domestic prices will continue to move in line with price developments in South Africa; and (d) that existing SACU and Common Monetary Area (CMA) arrangements will be maintained. The target for real GDP growth is set at an annual average of 8.3 percent over the period 1990/91 through 1992/93, while gross investment as a share of GNP is targeted at an average of 54.4 percent over the same period, of which LHWP investment would comprise 24.4 percent. Similarly, national savings are targeted at an average of 51.9 percent of GNP. This reflects the substantial transfers to Lesotho associated with the financing of the water component of the LHWP.

18. Given the openness of the Lesotho economy and the lack of exchange rate flexibility vis-à-vis the rand, the scope for conducting independent monetary policy is very limited. Fiscal policy is therefore the primary means available to the Government to control domestic absorption. To consolidate further upon improvements in the external position made during 1989/90, the Government recognizes that to achieve a satisfactory current account position over the medium term, and to achieve a more comfortable level of foreign exchange reserves, it will be necessary to reduce further the fiscal deficit as a proportion of

GDP. This proportion is thus targeted to fall from an estimated 6.1 percent (3.3 percent of GNP) in 1989/90 to a surplus of 5.0 percent (3.0 percent of GNP) in 1992/93. This is fully consistent with the Government's objective of reducing the external current account deficit (including unrequited transfers, and those associated with the LHWP) from an estimated 3.9 percent of GNP in 1989/90 to 2.4 percent in 1992/93. Net official reserves are expected to rise to a level equivalent to 11.3 weeks of imports by the end of the program period. As further nonconcessional borrowing by the public sector is to be strictly limited, debt service expressed as a proportion of exports of goods and services should fall to 3.0 percent by the end of 1992/93.

Fiscal policy

19. The Government will amend three revenue measures in 1990/91. First, with regard to the company income tax, following the recommendations of the World Bank study on Fiscal Incentives for Investment in Lesotho, the present system of six-year tax holidays will be abolished, and the present rate of 37.5 percent on manufacturing companies will be replaced by a no-exemptions rate of 15 percent. Present beneficiaries of tax holidays will be given the option of either immediately switching over to the lower tax rate, or maintaining the holiday and then moving to the present rate of 37.5 percent. The present rate will continue to apply to those firms that have benefited from a tax holiday in the past. This will: (a) generate an immediate increase in tax revenues, while leaving revenues as calculated on a present-value basis unchanged; (b) leave intact the net investment incentives provided to foreign-owned companies and indigenous enterprises; and (c) remove the administrative burden associated with the present system of tax holidays. Second, the Government will strengthen the enforcement of individual income tax on self-employed persons, including traders. As an additional safeguard against revenue losses, the Government will increase traders' license fees, which, in the future, will be renewed only upon production of evidence of a tax clearance. Third, the present system of assessing and collecting tax on the preceding year's profits will be replaced by a current basis of assessment, under which companies will be required to pay tax for each quarter on estimated profits with a final adjustment of tax liability based on actual profits. However, in order to ease the liquidity impact of paying the tax on two years' profit within a single year (1990/91), the actual payment of tax for the preceding year (1989/90) will be spread over three years. In the early part of 1990/91, the number of individual income tax bands will be reduced from nine to five with minimal variation in tax revenue. The income tax system will be also further simplified by reducing the number of abatements from seven to two. Cost recovery in health services will be increased from its present level of about 12 percent to 15 percent by mid-1992/93. The Government will continue to pursue the possibility of extending personal income tax to migrant mineworkers in South Africa. Tax administration will be strengthened to ensure that tax obligations arising from the implementation of the LHWP and related activities are fully collected.

While receipts from sumptuary taxes have increased as a result of rate increases implemented in June 1989, there appears to be a slowdown in the rate of growth of production and employment in the beer industry, with an associated increase in smuggling. The sales tax on beer will be reviewed in the light of this situation.

20. Policies to restrain the growth of current expenditures remain much the same as in the previous PFP. The Government will continue to limit civil service recruitment and will encourage early retirement of civil servants. However, staff levels will be increased in the essential technical, professional and managerial areas. The wage and salary bill of the Central Government will not increase faster than the targeted growth in nominal GNP over the program period, although real expenditure on salaries of essential technical, professional, and managerial levels should increase over the period. Expenditure on other goods and services will be restrained, to grow at a rate no faster than that targeted for the GNP deflator over the program period.

21. The Government will continue to reduce transfers to parastatals through its efforts to improve efficiency and by ensuring that cost increases are passed on to consumers through higher tariffs. In particular, tariff increases by the South African Electricity Supply Commission will continue to be reflected in corresponding tariff adjustments by the Lesotho Electricity Corporation. Moreover, through appropriate pricing policies, efforts will be made to transfer responsibility for financing capital expenditures to all public enterprises.

Economic and financial management

22. The Government has embarked upon a comprehensive program of remedial measures to improve public sector management and strengthen links between economic planning and public expenditures. The central problems associated with public administration in Lesotho and the various components of the program are described in the previous paper (EBD/89/143, 5/11/89).

23. The civil service reform component of the program aims to establish basic internal management consulting capabilities (Management Analysis Units) in the Ministry of Public Service and in selected core ministries (Health, Finance, and Agriculture). These functions will be augmented through further development of the computerized Personnel Management Information System, and through further training of managers and support personnel. Although some elements of the civil service reform are already under way with the assistance of the Swedish Agency for International Development (SIDA) and USAID, the remaining components are expected to be financed by the United Nations Management Development Programme and executed by the United Nations Directorate of Technical Cooperation and Development (UNDTCD) with the cooperation of the World

Bank and various donors. The civil service reform, including a full review of grading and classification, should be fully implemented by the middle of 1992.

24. The two remaining components of the overall program are the strengthening of public sector financial management and the development of a parastatal monitoring system. With the assistance of an advance from the World Bank's Special Project Preparation Facility (SPPF), the Government is designing a program with the following aims: (a) to extend the existing pilot budget management program to both the recurrent and development budgets of all ministries; (b) to strengthen ancillary systems, such as debt management, asset management, and internal control and audit; and (c) to improve the technical proficiency of the financial management cadre through the implementation of a suitable training program. The Government will seek donor funding for the financial management improvement component, which should begin during 1990/91. In furthering the preparatory work currently being undertaken at the Central Bank of Lesotho, a parastatal monitoring system will be established no later than end-September 1990.

25. As the impact of the financial management improvement program will not be felt fully until toward the end of the program period and beyond, the Government will take further short-term measures. These are: (a) the maintenance and strengthening of the interim expenditure control system 1/ through a shortening of the time lag incurred in the reporting of budgetary data to no more than six weeks; (b) the preparation and subsequent maintenance over the program period of an annually updated three-year public investment program; and (c) an improvement in the compilation of debt information and in the management of external debt.

26. The Government is concerned about deriving maximum benefit, in terms of the equitable development of Lesotho, from the expected royalty benefits associated with the LHWP. In view of existing weaknesses in the system of budgetary management, the Government therefore intends to set up a special development fund, fully under its own control, within which LHWP-related revenues could be set aside from other government revenues. Both revenues and expenditures associated with the fund would be fully integrated into the budgetary process. With the assistance of a study funded by the European Economic Community (EEC), the Government will examine the relevant guidelines for: (a) setting aside some LHWP-related revenues for development-oriented programs and projects; (b) coordinating expenditure of LHWP revenues with other central budget revenue and expenditure; (c) selecting activities to be funded with LHWP revenues; and (d) external investing of accumulated funds. The Government expects to identify the structure of the development fund early in 1990/91 and to create the fund later in the same year.

1/ This system was described in the previous paper, EBD/89/143 (5/11/89).

Public sector investment

27. As indicated under the existing public investment program (PIP) covering the period 1986/87-1990/91, the allocation of development expenditure during recent years reflected a heavy focus upon the provision of new economic infrastructure, and this will continue during 1990/91. The Government is preparing a new three-year PIP in which 1990/91 will be the first year. In future, the PIP will be updated annually on a three-year rolling basis, and will be integrated in the Fifth Five-Year Development Plan covering the period 1991/92-1995/96. Expected expenditures associated with the LHWP development fund will be incorporated in the PIP once the fund begins to operate. Although, implementation of construction of the Oxbow-Mokhotlong road will be an important development during 1991/92 and 1992/93, the PIP will otherwise emphasize investments in the social sectors over the construction of new roads. Road maintainance and improvements to existing routes will be given higher priority. Total government investment will grow in real terms at an average annual rate of around 4.5 percent over the program period. In the parastatal sector, capital expenditure will be dominated by investment arising from the implementation of the LHWP. A substantial investment program also will be undertaken by the LEC, which will both support increased private industrial investment and ensure that electricity generated by the LHWP-constructed hydroelectric power installation will be distributed efficiently.

Monetary and financial policies

28. To be consistent with the aim of improving the external current account deficit, the rate of domestic credit creation will be restricted to that compatible with the projected rates of economic growth and inflation, and the targeted increases in net official foreign exchange reserves. To encourage the retention of savings within Lesotho, the Government will continue to adjust appropriately the prime lending rate and minimum savings deposit rate according to interest rate developments in South Africa, while ensuring that interest rates are positive in real terms. Following the recommendations of the World Bank-assisted Financial Sector Review, the authorities will rationalize further the structure of interest rates in Lesotho by: (a) removing all tax exemptions on earnings from lending to the Government, such as interest on government bonds; and (b) using the yield curve prevailing in South Africa as an indicator for establishing the issue yield on government bonds. Setting net-of-tax yields on government bonds at lower and more realistic levels should generate an additional net gain for the Government. To partially counteract the existing oligopolistic structure of the banking system in Lesotho, the Central Bank of Lesotho will require more public disclosure of banks' charges and fees, and implement its proposed strengthening of its on-site supervision capacity. The problem of surplus liquidity in the banking system will be addressed by the encouragement of a higher flow of financial resources from the commercial banking system into productive investment. To this end, the Government will expand the export

persons enter the labor market each year. The Government is very concerned about this problem, and will intensify its efforts to provide both labor-intensive rural development through its agricultural policies, and additional jobs through industrial development. Additional relevant measures to be adopted include: (a) the establishment of a construction workers' training program supervised by the Lesotho Highlands Development Authority aimed at maximizing the employment of Basotho on the LHWP; (b) regular reassessment of legal minimum wage levels in the light of prevailing labor market conditions; (c) the promotion of small-scale enterprises through the extension of credit and the establishment of the BAPS; and (d) through continued provision of training in vocational skills by the Lesotho Opportunities Industrial Center and by the Basotho Enterprises Development Corporation (BEDCO).

40. Skilled labor shortages are appearing as skilled workers are attracted away from government employment and donor-aided projects to jobs related to the LHWP and to employment opportunities in South Africa. The ongoing IDA-funded Fourth Education Project is helping to relieve this situation by providing education abroad in engineering and other technical disciplines for Basotho undergraduates, and by funding temporary expatriate appointments in government ministries. In the medium to longer term, the salaries of highly experienced and skilled government employees will be regularly reviewed as part of the civil service reform.

IV. Environmental Action

41. The Government has recently adopted a National Environmental Action Plan. The Plan identifies the country's main environmental problems as including: (a) overgrazing and poor range management; (b) soil erosion and loss of fertility; (c) loss of unique natural and historical resources; (d) the impact of unplanned urban expansion; and (e) urban pollution. To provide an institutional base from which to address these problems, the Government is considering proposals regarding the establishment of a supervising body that, with the assistance of the World Bank, will review existing legislation regarding environmental protection.

42. Several elements of the Government's policy framework will have positive environmental implications. The implementation of grazing fees and improved land management following the legal recognition of informal leasing arrangements will help both to slow down soil erosion and improve soil fertility. An ongoing IDA-funded Land Management and Conservation Project is also helping local communities to formulate their own land use plans for sustainable agricultural development. Complementary efforts are also being made by other donors. The training programs envisaged for village councillors will not only be an essential prerequisite for the success of these initiatives, but also will increase awareness regarding the implications of local environmental

issues. An important attempt will be made to address the problems of unplanned urban expansion and urban pollution under the IDA-funded Urban Sector Reorientation Project. Finally, the Environmental Action Program to be implemented under the LHWP will include action in the areas of rural development impact, conservation, and cultural heritage, while compensation will be given to those whose homes and agricultural land are displaced by the project.

V. Social Impact

43. The program will help the poorer sections of the population in two ways: by allowing higher consumption per capita growth than would prevail in the absence of the productivity-raising aspects of the program; and by redistributing incremental income more equitably. The adverse effects of the program so far have been felt by a relatively small number of government employees who have been laid off and have not yet found alternative employment. A reduction in the number of government vehicles may also have limited the expansion of health care, particularly in rural areas. The land reforms outlined earlier will offer advantages to some current traditional allottees by allowing them to receive rent on their smallholdings, while working for wages on larger farms. Female heads of households in rural areas are particularly likely to benefit from these new alternatives and will gain greater security from the establishment of the right to land title. Likewise, the emphasis on cost recovery in infrastructural and social sectors should be redistributive as such charges will fall mainly upon urban communities, whose incomes are higher than those in rural areas. Measures proposed for enhanced cost recovery in health services will include continued exemptions for low-income groups. The Government has recognized the need to protect vulnerable groups within the economy from the effects of increased taxation. To this end, the sales tax exempts basic foods and other items that weigh heavily in the budgets of the poor. Food security will be maintained over the program by the continuation of the national food shortage early warning system, which facilitates prompt procurement of regional supplies where they exist. School supplementary feeding programs will be continued in all primary schools and in some secondary schools in highland areas.

VI. External Financing Requirements

44. In view of the existing resource constraints and projected higher levels of investment and imports needed to achieve the Government's growth objective, Lesotho will require larger amounts of foreign financing than in the past. In particular, a substantial increase in concessional lending will be required to finance the hydroelectric component of the LHWP from 1992/93 onward. A portion of this financing will initially need to be allocated to increasing reserves to a more comfortable level of 11.3 weeks of imports by the end of 1992/93, although reserves are projected to rise to 12.0 weeks of imports by the