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## Lesotho's Garment Exports: Attracting Foreign Direct Investment

Lesotho has built a small but significant manufacturing sector, representing about 18 percent of gross domestic product (GDP). During the past decade, the sector has increased 14-fold, an exceptional achievement by African standards. This growth was due largely to an export boom of ready-made garments and footwear fueled by foreign investors coming principally from the Republic of South Africa and Asia. Lesotho's success in attracting export oriented foreign direct investment was due primarily to Lesotho's comparative advantage with respect to productive labor and favorable trade arrangements. These advantages were supported and enhanced by a World Bank project which reduced the costs and risks of investment through a policy reform package, the financing of industrial infrastructure, and the establishment of an investment promotion institution and strategy to market the country as an attractive investment site.

In 1996, Lesotho's exports of clothing stood at about $154 million, making this small, landlocked country, with a population of only 2 million, the largest exporter of ready-made garments in continental Africa south of the Sahara. In 1993, Lesotho's garment exports stood at $106 million, while those of the Southern African Customs Union (SACU), excluding Lesotho, stood at $50 million, Zimbabwe's stood at $42 million, and Kenya's, at $9 million, came a distant fourth. Between 1985 and 1994, Lesotho's exports of light, labor-intensive products rose from less than $6 million to $123 million (see table 1). From 1985 to 1990, they rose from 25 to 55 percent of total exports, surging to more than 80 percent in 1992–94 and to 85 percent today.

***Table 1. Manufactured Exports in Lesotho, 1985–94***

***(millions of current U.S. dollars unless otherwise noted)***

| | | *Light manufactures* | | *As a percentage of total imports* | |
|---|---|---|---|---|---|
| *Year* | *Manufactured exports* | *Clothing and footwear* | *Electronics and equipment* | *Clothing and footwear* | *Clothing, footwear, electronics, and equipment* |
| 1985 | 8.2 | 5.6 | 0.4 | 1.7 | 1.9 |

| | | | | | |
|---|---|---|---|---|---|
| 1990 | 43.2 | 35.0 | 0.6 | 5.2 | 5.3 |
| 1991 | 53.3 | 46.7 | 1.9 | 5.8 | 6.0 |
| 1992 | 93.6 | 77.3 | 12.3 | 8.3 | 9.6 |
| 1993 | 118.3 | 106.3 | 7.8 | 12.2 | 13.1 |
| 1994 | 126.4 | 103.2 | 19.7 | 12.7 | 15.2 |

*Source:* Computed from Central Bank of Lesotho, *Annual Report* (Maseru, 1985–95), and from International Monetary Fund, *International Financial Statistics, Yearbook 1996* (Washington, D.C., 1996), table 1.

### Impact of the Sector

From 1988 to the present, Lesotho's economy has become much less dependent on the Republic of South Africa, due in no small part to expansion of the garment sector. In the 1980s, South Africa employed half of Lesotho's male labor force, and their remittances accounted for half of Lesotho's gross national product. These figures are now 40 percent and 33 percent, respectively. Moreover, Lesotho's export markets now include the US and Europe, so that South Africa, which once received 80 percent of Lesotho's total exports, now receives only 40 percent.

***Contribution to GDP.*** Overall, development of the sector has had a significant impact on the economy. In 1994, garment and footwear exports of $103 million represented about 10 percent of Lesotho's GDP, and total light manufactured exports represented about 12 percent. The increase in exports of garments, footwear, and electronics equipment from $35 million in 1989 to $123 million in 1994, added about 4.6 percent to GDP in 1994 (excluding foreign aid). This was earned by modern industries that helped to create industrial work habits and skills that may now be transferred to other activities.

***Direct and indirect employment***. Development of the sector has had a significant impact on employment as well. The 19,000 workers in the manufacturing sector make up 2.5 percent of the labor force (800,000) and about 8 percent of persons holding formal sector jobs. This is significant in a country where unemployment is 35–40 percent and the majority of the population work in agriculture and the informal sector, where returns are generally low. Since 1991, manufacturing employment has increased 66 percent, by about 8,000 workers including 3,800 jobs created by the expansion of existing factories. Ancillary services related to manufacturing—piece work, trucking, utilities, and financial and professional services—have created additional employment.

***Income***. In a country like Lesotho, wages in the production of light manufactured exports (including ancillary services) typically represent about 30 percent of exports—in Lesotho's case about $37 million. These wages support between 7 and 8 persons in an extended family, and their multiplier effect further stimulates growth. Lesotho's $90 per month minimum wage for the manufacturing sector (a training wage for first-time workers) compares favorably with the average GDP per capita of about $38 per month.

## Reasons for Lesotho's Success

This impressive growth and structural transformation has been achieved despite Lesotho's limited flexibility with respect to exchange rates and trade policy—a result of its membership in SACU and the Common Monetary Area—and despite nominal labor costs that are higher than those of very poor countries in Africa and elsewhere.

These achievements are even more remarkable in light of the political turmoil that occurred in 1993-94, which diluted Lesotho's ability to attract new foreign investment. Nonetheless, foreign investors continue to choose Lesotho because of a complex mixture of factors:

preferential access to South African, European, and US markets through SACU, the Lomé Convention and the General System of Preferences, and quota-free status under the Multi-Fibre Agreements;

a productive and well-educated labor force, competitive unit labor costs, and relatively stable labor relations;

efficient external trade mechanisms for exporters within SACU, including an automatic duty-exemption system based on bonded warehouse arrangements, and a favorable rand exchange rate throughout the period; and

above-average road and utility infrastructure due to Lesotho's location within South Africa, and easy and proximate access to the efficient Durban port.

***Costs of production and preferential access to markets*** explain much of Lesotho's ability to attract foreign investors (see table 2). Many garment manufacturers in Lesotho have relocated from South Africa, and their exports into South Africa represent 40 percent of Lesotho's exports. Interviews and cost surveys indicate that South African investors are primarily attracted by Lesotho's low unit labor costs. Nominal labor costs are 2 to 3 times higher in South Africa than in Lesotho and are associated with heavy labor union activity and relatively low productivity (due to lower levels of South African education and literacy).

Asian investors produce mainly for the competitive US and European markets and therefore must have an overall internationally competitive cost environment. Lesotho's high nominal wages, compared with those of some African countries, are compensated by the higher productivity of its labor and its much more reliable access to infrastructure (roads, utilities, and ports), which reduces the overall costs of production, shipping, and transportation.

Unit labor costs take into consideration both wages and worker productivity. The high productivity of Basotho labor—reported by Asian investors to be 80 percent of that in China—yields unit labor costs comparable to some of the world's lowest cost countries (see table 2). Lesotho's quota-free access to the US and access to the European market under the Lome Agreement are additional important considerations. For example, the quota cost for one shirt from China's EPZ could raise the landed price in the US by $2.00, adding 30 percent to its free on board (f.o.b.) cost.

***Table 2. Factor Costs and Task Level Efficiency in Standardized Garment Production in Select African and Other Countries, 1994***

| | *China EPZ* | *Ghana* | *India* | *Kenya* | *Lesotho* | *Mauritius* | *Republic of South Africa* | *Zimbabwe* |
|---|---|---|---|---|---|---|---|---|
| Monthly wage (U.S. dollars) | 120 | 30–45 | 60 | 55 | 82–95b | 120 | 244–267 | 70–75 |
| Number of garments produced per machine operator during an 8-hour shift | | | | | | | | |
| Men's casual shirts | 18–22 | 12 | 16 | 12–15 | 18-19 | — | 15 | 12–14 |
| Index of unit labor cost (for men's casual shirts)[a] | 0.040 | 0.022 | 0.027 | 0.026 | 0.026 | — | .59 | 0.034 |

— Not available.

a. The nominal wage rate divided by the dollar value of output per worker per month, assuming a 26-day work-month.

b. Wage rate for 1995.

*Source:* Tyler Biggs and others, *Africa Can Compete! Export Opportunities and Challenges for Garments and Home Products in the European Market*, World Bank Discussion Paper 300 (Washington, D.C.: World Bank, 1996); and author's calculations for Lesotho and Republic of South Africa.

## The Role of the World Bank and the Foreign Investment Advisory Service (FIAS)

A country's policy, regulatory, and institutional environment plays a substantial role in lowering the costs and risks of investment and in marketing the country as a potential investment site. It is in these areas that the World Bank and FIAS--building on Lesotho's comparative advantage--have contributed to Lesotho's success in attracting foreign investment. The policy package to improve the environment for foreign investment was introduced and in place by 1990 as part of the preconditionality associated with the Industrial and Agroindustries Development Project, which was launched in 1991. The Investment Promotion Center (IPC) began operating in January 1992. The key elements of the policy and institutional development package implemented under the project included the following.

***Establishment of an active investor promotion and service institution focused on creating well-paid jobs rather than large fixed investments***. Under the project, an investment promotion effort which had been limited to natural resource based projects was converted into one focused on labor intensive, export-oriented manufacturing activities, with an emphasis on pro-active investor promotion, information, and service. Establishing the IPC as an investor promotion and service organization--that facilitated the delivery of necessary licenses and permits and that voiced investors' concerns to government--reduced investors' perceived risk and the management costs associated with investment. In a recent survey by Coopers and Lybrand, investors named Lesotho's IPC the third best investment promotion agency in Africa and among the twenty best in the world. Table 3 indicates the employment results which IPC helped to achieve.

***Table 3. Promotional Activities of the Investment Promotion Center in Lesotho, 1992–97***

| *Activities* | *1992–93* | *1993–94* | *1994–95* | *1995–96* | *1996–97* | *Total* |
|---|---|---|---|---|---|---|
| New projects | 1 | 3 | 6 | 11 | 7 | 28 |
| Additional employment[a] | 730 | 1,060 | 1,020 | 2,630 | 2,680 | 8,120 |
| New | 130 | 50 | 750 | 1,760 | 1,600 | 4,290 |
| Expansions | 600 | 1,010 | 270 | 870 | 1,080 | 3,830 |

a. Estimated.

*Source:* John O'Brien, "The Assignment Completion Report by the Investment Promotion Advisor to the IPC" (World Bank, Washington, D.C. June 1997).

***Limiting Minimum Wage Increases***. The year before the project was appraised, the government had increased minimum wages by 50 percent, in line with an implicit policy to catch up with South African wage levels. Under the project the government gave a commitment that minimum wage policy would take into account Lesotho's competitive position and that real wage increases would be based on productivity improvements. The fact that Lesotho's wage rates remained competitive over the project period, combined with high levels of productivity, was a major promotional asset. If wages in Lesotho had continued to rise to the level of South African wages, Lesotho's unit labor costs would have risen to $0.59--which would have made it uncompetitive as an investment site for labor-intensive mass-produced manufactures.

***Investment in Industrial Infrastructure.*** This project and its predecessors financed a program of advance factory shell construction, and road, electrical and water infrastructure on industrial estates. Factory shells were available for rent to investors--substantially reducing their up-front investment costs and risks. To ensure the cost-effectiveness of this component, a cost-recovery rental program was developed which allowed the factory investments to make a 20 percent return.

***Reduced Regulation.*** Prior to the project, investors had complained most bitterly about the virtual impossibility of getting work permits for key management staff. Sometimes even the investor himself endured difficulties. Under the project, the government implemented a commitment to reduce regulatory burdens by introducing automaticity into the issuance of industrial licenses and work permits for investors and key management staff.

***Reduced Taxation***. Under the project, the government replaced an administratively cumbersome and nontransparent tax holiday with a 15 percent flat tax rate for manufacturing firms. Project preparation studies identified that Lesotho's attractiveness to investors was due to its attractive labor costs and trade arrangements and not to the tax holiday. Application for the tax holiday introduced uncertainty and delays into the investment process, as did reapplication. The costly administrative arrangements associated with the tax holiday were replaced by a low tax rate as a part of the regular tax code.

*This article was written by Thyra Riley and Refeal Benvenisti, who are respectively the task manager and foreign investment advisor for the Industrial and Agroindustries Development Project. "A Diagnostic Review of Lesotho's Investment Environment" (1990) by the Foreign Investment Advisory Service (FIAS) was the basis for the policy reform package.For further information, please contact Thyra Riley , Room J4-151, World Bank, 1818 H Street NW, Washington, D.C. 20433. Tel. no.: (202) 4734060; e-mail address : Triley@worldbank.org*