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Project Information Document (PID)

Appraisal Stage | Date Prepared/Updated: 18-Mar-2022 | Report No: PIDA33306

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Lesotho	P175783	Lesotho Competitiveness and Financial Inclusion Project	
Region	**Estimated Appraisal Date**	**Estimated Board Date**	**Practice Area (Lead)**
AFRICA EAST	04-Apr-2022	15-Jun-2022	Finance, Competitiveness and Innovation
Financing Instrument	**Borrower(s)**	**Implementing Agency**	
Investment Project Financing	Ministry of Development Planning, Ministry of Finance	Ministry of Trade and Industry	

Proposed Development Objective(s)

The project development objective is to increase access to business support services and financial products targeted at MSMEs and entrepreneurs, especially women and youth.

Components

Enhancing Financial Inclusion and Resilience for MSMEs
Scaling Support for Entrepreneurship and MSMEs
Project Management and Implementation Support

PROJECT FINANCING DATA (US$, Millions)

SUMMARY

Total Project Cost	52.75
Total Financing	52.75
of which IBRD/IDA	45.00
Financing Gap	0.00

DETAILS

World Bank Group Financing

International Development Association (IDA)	45.00

IDA Credit	45.00
Non-World Bank Group Financing	
Trust Funds	7.75
Global Facility for Disaster Reduction and Recovery	7.75

Environmental and Social Risk Classification

Moderate

Decision

The review did authorize the team to appraise and negotiate

Other Decision (as needed)

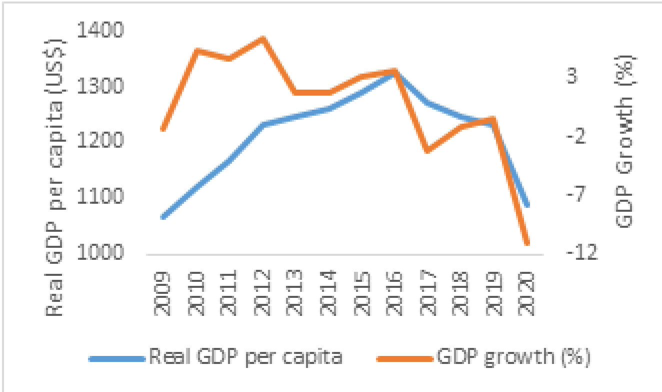
B. Introduction and Context

Country Context

1. **Despite being a lower-middle income country, Lesotho experiences persistently high levels of unemployment, informality, inequality, and poverty, which have been further exacerbated by the Covid-19 pandemic.** GDP growth declined from a peak of 6.3 percent in 2012 to -11.1 percent in 2020. (**Figure 1**). Lesotho's poor economic performance has been the result of compounding factors including declining revenues from the Southern African Customs Union (SACU)[1], recurrent climate related shocks that have drained fiscal resources[2], a high public sector wage bill that has inhibited spending on development objectives, and contraction of key economic sectors (manufacturing and tourism) due to the Covid-19 pandemic. Unemployment is at 22.5 percent[3], and while the poverty rate in Lesotho fell from 56.6% to 49.7% between 2002 and 2017, economic vulnerability persists with more than 75% of the population either poor or vulnerable to poverty, driven in large part by exposure to climatic shocks. Declines in remittances due to Covid-19 related border restrictions have further exacerbated poverty. Although income and other measures of inequality have fallen, Lesotho remains one of the most unequal countries in the world.[4] Overall, Lesotho's economic and social development is not commensurate with the country's lower-middle-income-status.[5]

[1] SACU revenues fell from 30% of GDP in FY2012/13 to 17.7% of GDP in FY2017/18 and are expected to decline further to 15.2% of GDP in FY 2019/20.
[2] The average annual cost of disaster response is estimated at US$19.3 million, or 1.6 percent of the total budget expenditure in the 2019/20 fiscal year.
[3] 22.5 percent unemployment (strict definition) or 38.3 percent (expanded definition) in 2019. Systematic Country Diagnostic. World Bank (Forthcoming)
[4] Lesotho Poverty Assessment. World Bank (2019).
[5] IMF Article IV Consultation (2019)

Figure 1: GDP growth has slowed substantially



Source: World Bank

2. **The public sector has a disproportionate role in the economy, crowding out private participation and resulting in a weak and largely informal private sector.** The government has been the main driver of economic activity, with public spending accounting for 60 percent of GDP and with public sector investment levels averaging around 29 percent of GDP since 2010. The public sector contribution to GDP now far exceeds that of the textile and apparel industry, which is the largest private sector industry in Lesotho (Figure *2*).[6] Lesotho's public sector wage bill (as a percentage of GDP) is one of the highest in the world and public sector workers earn an average monthly salary that is approximately seven times higher than the minimum wage of a skilled worker in the textile sector.[7] The recent Mid-Term Budget Review projects the compensation of employees to account for 45.9 percent of total government expenditures for 2020/21.

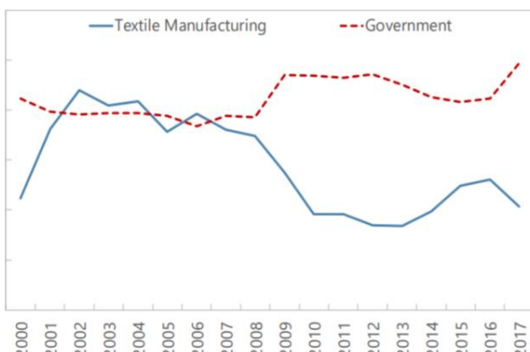


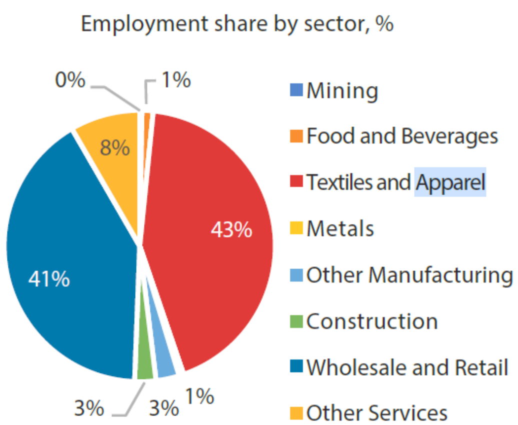
Figure 2: Value Added by Industry (% of GDP)

Source: World Bank

[6] The public sector employed about 43,597 people as of Q2 2020, and it is the second-largest employer after manufacturing, at 48,685 employees during the same period. Lesotho's population was 2,142,252 in 2020. (World Bank)
[7] Lesotho Poverty Assessment. World Bank (2019)

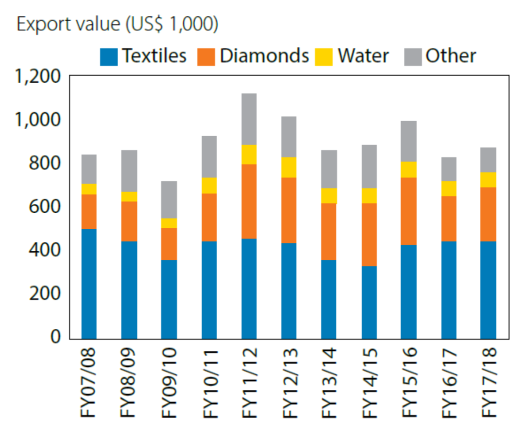
3. **Lesotho's private sector is largely concentrated in two sectors – mining and textiles/apparel manufacturing – and economic diversification has proven challenging due to structural constraints.** These two sectors which account for 84 percent of all formal sector employment (**Figure 3**) and over two-thirds of all exports (**Figure 4**) are facing serious challenges. Textile and apparel exports have been declining due to productivity and labor market challenges and Kenya has overtaken Lesotho as the leading apparel exporter to the United States under the African Growth and Opportunity Act (AGOA). Total employment in the export manufacturing sector dropped from a peak of 43,500 in February 2020 to a low of 31,000 in April 2020 before rebounding to 39,000 in September 2020[8] with additional job losses reported in 2021 primarily because of the pandemic. Job losses in the sector have had an especially adverse impact on women who comprise 80 percent of the workforce but occupy lower-skilled jobs compared to men.[9] Growth and job creation prospects from the mining sector (primarily diamond exports) are limited.

Figure 3: Employment is concentrated in mining and textiles and apparel



Source: World Bank (2018)

Figure 4: Exports remain highly concentrated in textiles and diamonds



Source: World Bank (2018)

4. **Lesotho's growth could be fueled by increasing the competitiveness of the small and medium enterprise (SME) sector, scaling domestic startups, and expanding and capturing more value within high potential global value chains (GVCs).** A more dynamic SME sector can shift the balance of economic output and job creation to the private sector as highlighted in the National Trade Strategy (NTS, 2021-25) with opportunities especially in the horticulture and export manufacturing value chains. To create jobs and attract investments targeted efforts are needed to strengthen competitiveness of GVCs, improve production capabilities, improve access to reliable infrastructure, strengthen business and trade facilitation for export promotion, and improve the overall regulatory framework to create a competitive business environment.[10] Addressing the low

[8] LNDC survey of 64 firms in eight industrial estates, November 2020; most of these factory workers are women
[9] Botea, Compernolle, and Chakravarty 2018
[10] Export Competitiveness of the Textile and Apparel Sector in Lesotho, World Bank, 2021 (forthcoming)

productivity of the large informal sector (more than 80 percent of household businesses in Lesotho were not registered) is critical.

5. **Lesotho's business environment remains weak despite recent reforms, with political instability, tax rates and practices of the informal sector highlighted as the top three constraints**. The Second National Strategic Development Plan (NSPD II) (2019-2023) identified an "uncompetitive business environment" as one of the key binding constraints for private investments. Recent reforms include new legislation for business registration and licensing and secured lending as well as starting adoption of digital systems and procedures in trade facilitation, land administration, and construction permits, all supported under the World Bank's Second Private Sector Competitiveness and Economic Diversification Project (PSCED2). Further support is needed for effective implementation of these reforms. Lesotho's ranking in the Global Competitiveness Index dropped from 123 to 131 out of 141 countries (from 2014 to 2019), and the Logistics Performance Index ranking also dropped from 133 to 139. Political instability, tax rates, practices of the informal sector and access to finance are amongst the major constraints faced by firms.[11]

6. **Access to finance remains a challenge, particularly for small firms, due to limited financial intermediation and limited use of digital financial services (DFS).** Although the financial sector is liquid and profitable[12], domestic credit to the private sector is one of the lowest among the SACU countries and is half as much as other lower middle-income countries (LMICs). In 2019, Lesotho's domestic credit to the private sector was 21.5 percent of GDP, compared to 42 percent for all LMICs. The financial sector largely channels domestic savings outwards to South Africa rather than lending to the domestic private sector while the textile and apparel firms are largely financed through foreign channels. The pension fund for public employees owns sizable assets of which only around 3 percent is invested in Lesotho. There seems to be a mismatch between the financing needs of the mostly micro and small enterprises and the stringent requirements of the lenders including documentation, cash flow projections, risk assessment and the availability of collateral.[14] These businesses resort to informal channels for financing given that microfinance institutions are not perceived as credible due to poor market practices in the past.

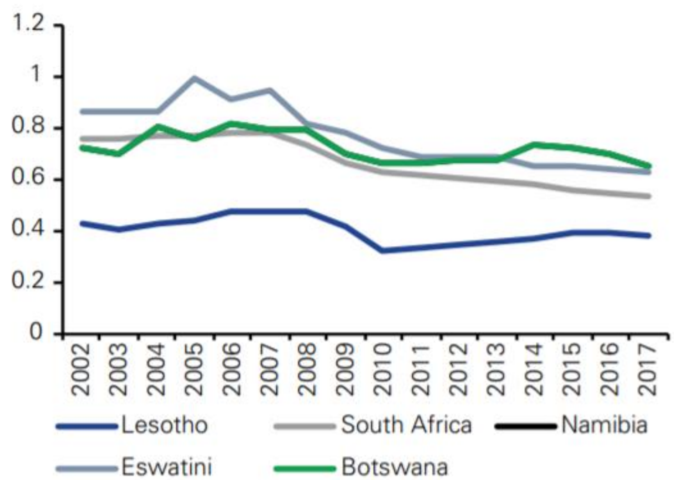
7. **Access to finance by women is particularly challenging, due to constraints on women's access to formal credit, low credit history, and high rejection rate of women loan applicants.[13]** Rural women in low-income categories are most vulnerable in this regard. As a result, women-owned businesses tend to start and stay small, with their lack of access to collateral resulting in overreliance on informal sources of finance and credit. For instance, as of 2021, only 27 percent of Basotho women have credit records.[14] The lack of women's credit history may partially be due to the very recent inclusion of more gender-informed credit reporting systems as well as a lack of market and user data for design of targeted policy interventions in Lesotho. This results in greater legal and regulatory barriers to women's access to financial inclusion.[15] To address this, the government of Lesotho has set a target of 30 percent of women recorded in the credit bureau by 2022 (Central Bank of Lesotho 2021). To move beyond inclusion in credit records to improving overall creditworthiness,

[11] World Bank Enterprise Survey, 2016
[12] The three major banks are subsidiaries of South African banks and the fourth, the only domestic bank, is fully owned by the Government. All four banks are well capitalized, with an average Capital Adequacy Ratio (CAR) of 18 percent as of December 2018. Total assets of the four banks were about $1.2 billion as of December 2018, equivalent to 48% of the country´s GDP.
[13] World Bank, 2016
[14] Central Bank of Lesotho 2021
[15] Gates Foundation 2019

there is a need for reform in the mechanisms for evaluating women's bankability and creditworthiness. Mobile money is playing a critical role in driving financial inclusion in Lesotho, while microfinance has not met with much success.[16] 31 percent of women have mobile money accounts compared with 24 percent of men, and 40 percent of women made or received digital payments compared with 35 percent of men.[17] There is potential to enhance the impact of mobile banking especially for rural businesses.

8. **Increasing productivity growth by enhancing skills and digital technology adoption is critical for private sector development.** Total factor productivity (TFP) has been nearly stagnant and lags other countries in the region (***Figure* 5**), characterized by negative labor productivity growth (-3.5% between 2013 and 2015) especially for small firms. Rural areas tend to have a higher share of low productivity jobs while urban areas tend to have a higher share of wage-earning jobs apart from jobs in the agriculture sector. Exporting businesses, particularly in the textiles and apparel sector, are at risk of losing competitiveness without new investments in skills and technology, putting critical jobs at risk.[18] Improved digital connectivity combined with improvements in digital skills and literacy, access to digital payments and other financial services, platforms such as digital identity schemes and support to digital entrepreneurs can lead to new businesses and jobs.[23]

Figure 5: Lesotho's TFP growth lags other SACU countries.



Source: World Bank (2019)[19]

9. **While Lesotho has the highest rates of female participation in ownership of formal firms (39.1 percent) in sub-Saharan Africa, female-owned businesses in Lesotho tend to start and stay small and are concentrated**

[16] Finmark Trust, SADC and UNCDF, 2019
[17] Global Findex Database, 2017
[18] Measuring_Progress_Financial_Inclusion_in_selected_SADC_countries_-_2019_Report.pdf (finmark.org.za)

in a few sectors. The highest proportion of firms in Lesotho with majority female ownership (45 percent) are small while only 9 percent of large firms have a female majority. Most of the women entrepreneurs in Lesotho are livelihood or subsistence entrepreneurs, and very few are growth or opportunity entrepreneurs.[19] Despite limited data, consultations suggest that barriers faced by women entrepreneurs include access to credit, discrimination by financial institutions, high levels on unpaid care work resulting in lack of ability to engage in enterprise development, and limited access to business development, training, knowledge, and access to networks and markets (which are common to all entrepreneurs). The uptake of mobile banking and the implementation of the Land Act, 2010 (which granted new rights to women to own and inherit property) are creating new opportunities for women.[20]

10. **Lesotho is highly exposed to climatic and other economic shocks.** From 1980-2020 Lesotho was impacted by 22 shocks, 90% of which were climatic, and there is an expected increase in frequency of intense precipitation events leading to heightened risk of flooding, increased aridity, temperatures, and drought.[21] These climatic shocks will result in crop damage, hunger, wildfires and disease outbreaks which are expected to adversely affect 'working days', impacting businesses.[22] During the 2020-2021 period, Lesotho declared two states of emergencies for shocks (Covid-19 and heavy rains) that severely impacted businesses primarily due to damage to infrastructure disrupting trade logistics. The agricultural sector, including horticulture, is particularly exposed to climatic shocks. Horticultural crops are sensitive to climatic shocks because of their high-water demand and strict temperature requirements. In Lesotho, the vulnerability to temperature extremes, hail, and drought (expected to increase with climate change) are pertinent challenges to the sector, highlighting the importance of strengthening its climate resilience.

11. **MSMEs have been particularly hard hit by these compounding shocks, with no resilience-building mechanisms in place.** MSMEs were severely impacted by declining sales, closures, reduction in employment as well as supply chain and financial shocks while the suite of support measures fell below expectations in terms of impact given their ad-hoc and unbudgeted nature[21]. Furthermore, they put pressure on fiscal space, as they were not pre-financed, as the country embarks on a path of fiscal consolidation and debt sustainability. This experience, and the fact that the government does not have a comprehensive disaster risk financing strategy, demonstrates that MSMEs are highly vulnerable to future climatic shocks.[23]

12. **Political volatility is impeding private sector development.** When Fitch Ratings maintained its negative outlook on Lesotho in August 2021, it noted "Recurring bouts of political volatility and infighting within the government amid an overall weak institutional capacity constrain the government's ability to adjust fiscal policy and push forward reforms, and exacerbate problems with public-finance management."[24] High levels of leadership turnover in key ministries, such as the Ministry of Small Business Development, Co-operatives

[19] A necessity or livelihood entrepreneur is someone who has pursued entrepreneurship to acquire productive employment and livelihood for themselves; a growth entrepreneur sets out to create and grow a business that will generate jobs.

[20] Langweya, Mabuza, and Tshabalala, 2011
[21] Climate Change Knowledge Portal, World Bank
[22] EM-DAT: The Emergency Events Database – Universite catholique de Louvain (UCL) - CRED, D. Guha-Sapir, Brussels, Belgium. and UNHCR (2018). Lesotho Flash Update 01 – Hailstorms and Flash floods (period: March 1 2018–March 31 2018).
[23] World Bank Covid Business Pulse Survey, 2022
[24] https://www.fitchratings.com/research/sovereigns/fitch-affirms-lesotho-at-b-outlook-negative-02-08-2021

and Marketing and the Ministry of Trade and Industry has contributed to delays and shortcomings in addressing constraints to private sector development such as "insufficient access of small and medium-sized enterprises to finance...lack of equitable and effective regulation and enforcement, [and] lack of capacity in Government to implement reforms".[25]

13. **Economic and institutional transformation for private sector led job creation and inclusive growth requires a multi-faceted approach to address the myriad constraints.** Shifting the growth model from a public sector dominated approach to a private sector-led one requires a suite of integrated interventions in improving the enabling environment for private investments through more effective implementation of policy and regulatory reforms, enhancing financial inclusion, strengthening the ecosystem for firms and entrepreneurs to enable them to participate more effectively in high potential regional and global value chains and enabling businesses to tap opportunities from digital transformation through expanding support for skills development and technology adoption.

Sectoral and Institutional Context

14. **Substantial progress was made on business environment reforms under the PSCED2 project, but additional investments are needed for effective implementation.** Government to businesses (G2B) systems for registering a business, renewing licenses, trading across borders, and making tax payments are in place. The Company Registry system at the One-Stop Business Facilitation Centre (OBFC), the online automated Construction Permit system at the Maseru City Council (MCC), the Lesotho Electronic Registry in Movable Assets (LERIMA), and the credit bureau at the Central Bank of Lesotho (CBL) are notable achievements. The upgrading of the Automated System for Customs Data (ASYCUDA) at the Lesotho Revenue Authority (LRA), an online business licensing system, and an integrated land information system linked to an online payment system at the Land Administration Authority (LAA) were other significant investments. These past investments in G2B systems and services in Lesotho proved critical during COVID, allowing people to continue to use business services without the need for in-person interaction. Additional investments are needed to deliver seamless and integrated business services through strengthening inter-agency coordination and high-level oversight, increasing the technical capacity for implementation, and broadening and streamlining the services provided by the OBFC as well as establishing a national payment gateway. Parallel efforts are needed to implement an Insolvency Act and the Business Licensing and Registration Act.

15. **Regulations and systems to support access to finance for the private sector need to be strengthened.** Lesotho has made significant improvements in providing access to credit, particularly credit reporting, under the PSCED2 project. Important legislation including the Security Interest in Movables Act have been adopted and efforts are underway to expand coverage to include businesses which will especially benefit women entrepreneurs who have lower levels of access to immovable property. Sustainability of some credit related systems needs improvement to ensure reliability, including the Credit Reporting System under the CBL. Interoperability across digital platforms would be highly beneficial for facilitating financing to the private sector. For example, having the National ID, the LRA, business registries, and banking systems able to talk to each other would improve the business environment, increase access to finance and even domestic revenue mobilization.

[25] African Development Bank. 2013. *Kingdom of Lesotho, Country Strategy Paper, 2013-2017*. Abidjan: African Development Bank.

16. **Reforms to Lesotho's investment framework and institutions are needed to attract investment into high-potential economic sectors.** Lesotho does not have an Investment Promotion Bill or a designated Investment Promotion Agency (IPA) although an investment policy is being developed. The existing FDI regulatory framework does not provide for any fiscal, administrative (licenses, permits, approvals) or property and utility incentives (land, water, electricity, last mile infrastructure). Investments are subject to subjective treatment and based on unclear non-transparent criteria and ad-hoc legal agreements. The business licensing regulations restrict foreign investment in some important sectors such as commercial farming. The need for "a modern, competitive investment policy and legal regime", recognizing a critical lack of a structured legal, regulatory, and institutional framework on investment policy and promotion[26] is evident but is unlikely to be realized soon under prevailing political economy challenges.

17. **The Second National Strategic Development Plan (NSDP II) (2019 – 2023) NDSPII emphasizes the need for Lesotho to tap into its existing comparative advantages to broaden sources of growth and has identified horticulture, manufacturing and technology and innovation as high potential sectors.** The main binding constraints inhibiting private sector investment in these priority sectors are access to finance, access to land, infrastructure (including access to utilities and energy), access to skills, poor health and the regulatory environment (**Error! Reference source not found.**) need to be addressed concurrently through a multi-faceted approach and leveraging synergies between various interventions across Government and development partner financed programs. The NDSPII estimates that addressing these constraints could unlock private sector investment and entrepreneurship and create more than 20,000 new jobs.

Figure 6: Binding constraints inhibiting growth in four prioritized sectors in the NDSPII

Productive Sector	Severity of Constraints					
	Access to Finance	Access to Infrastructure	Access to Skills	Access to Land	Regulatory Environment	Poor Health
(1) Agriculture	**High**	Low	**High**	**High**	Medium	**High**
(2) Manufacturing	**High**	**High**	**High**	**High**	Medium	**High**
(3) Tourism and Creative Industries	**High**	**High**	Medium	**High**	Low	Low
(4) Technology and Innovation	Medium	Medium	Medium	**High**	High	Low

Source: NDSPII

18. **Additional investments are needed to build on the foundations laid under the PSCED2 project in supporting investments in high-potential economic sectors, including strengthening the tourism and horticulture value chains and supporting MSME growth.** Under PSCED2, in tourism, construction of the tourism information and crafts center (TICC) was completed, a star grading system was established, and a digital system was developed for the tourism promotion agency. In horticulture, three commercial fruit production farms were established, and the Agriculture Finance Department within the Lesotho Post Bank was established which disbursed more than M30 million to more than 140 agribusinesses. Finally, the MSME sector was supported through the Lesotho Enterprise Assistance Project (LEAP) matching grants facility which assisted more than 12,000

[26] https://openknowledge.worldbank.org/handle/10986/34434

businesses to access finance and improve their capabilities. Further investments in each of these sectors are needed to unlock their potential for growth and job creation.

19. **The current pilot commercial horticulture projects can be scaled and replicated through a targeted horticulture business incubation program.** The pilot farms established under the first and second PSCED projects have successfully demonstrated the commercial potential to produce deciduous fruits and vegetables in Lesotho for both the domestic and export markets. There is significant interest from smallholder farmers to venture into commercial horticulture and several projects are currently being supported through the Second Sustainable Agriculture Development Project (SADP2). While there is significant potential to attract large scale investments in commercial agriculture, these investments would require a competitive investment regime including the availability of land parcels of adequate size, a transparent and credible land ownership and leasing system and ancillary infrastructure investments. While these longer-term initiatives are being implemented, there are immediate opportunities to support new and emerging smallholder farmers to participate in the horticulture value chain through a systemic horticulture business incubation program delivered through a public-private partnership that supports selected high potential farmers through business development and technical support services, access to markets and access to finance.

20. **While the tourism sector has promising potential, recovery is likely to be slow given the global challenges facing the travel and hospitality industry.** Lesotho's tourism potential is under exploited and there is scope to increase private investments and create new jobs. The tourism sector's challenges include scarcity of skills, limited online presence, poor infrastructure, inadequate facilitation of visitors at borders, and limited experience with eco-tourism. Addressing these barriers could stimulate job creation once the regional and global tourism industry returns to a new normal through the pandemic. According to the UN World Tourism Organization, every tourism job creates 1.4 additional jobs in related sectors. Lesotho's tourism industry will continue to rely heavily on South African and neighboring markets and, while the industry gradually recovers, there is scope to strengthen the investment policy regime to attract FDI in this sector, improve the availability and quality of skills required by the industry, and invest in required infrastructure to facilitate private investments.[27]

21. **The export manufacturing sector, especially textiles and apparel, has potential to attract new investments and create jobs.** The pandemic has exposed the underlying challenges that are stifling the export competitiveness of the export manufacturing sector, including liquidity (especially for the Basotho owned firms), ability to adopt digital solutions, improving labor conditions and resolving pay disputes and compliance with social and environment requirements of global supply chains. Dedicated efforts are required to build regional value chains (particularly intra-SADC), improve manufacturing capabilities and access to reliable infrastructure (especially water, energy, waste management, and factory space). There are opportunities to strengthen business and trade facilitation for export promotion, promote industrial clustering and integrated supply chains, and improve the overall regulatory framework to create a competitive business environment. Targeted public-private efforts to improve the competitiveness of the textiles and apparel sector include: (i) strengthening the cut-make-trim (CMT) business; (ii) expanding value-added products in yarn and fabric; (iii) generating capabilities to trade through Delivery Duty Paid Basis; and (iv) promoting the training of middle management human resources and upgrading the overall workforce skills.[28]

[27] United Nations Conference on Trade and Development
[28] Ibid.

22. **There is a nascent entrepreneurship ecosystem which can be nurtured to support young Basotho entrepreneurs.** Concerted action from key public and private sector actors is required to address the critical gaps, including in terms of gender equality, in the entrepreneurship ecosystem in five intersecting areas: (i) strengthening the policy and regulatory environment and institutional capacity and coordination, (ii) expanding access to early stage finance, (iii) building an entrepreneurial culture, developing skills, and a talent pipeline, (iv) helping entrepreneurs access new market opportunities, and (v) enhancing the capacity and quality of business support services. The existing support programs are all relatively recent, small in terms of investment size and beneficiaries, primarily concentrated in Maseru and (in their current form) of limited scope, impact and scalability as well as not fully leveraging the considerable resources that are available in the regional entrepreneurship ecosystem, especially in South Africa. The continuous mentoring, business counselling, and access to financing opportunities that are required by the startups for the initial years is conspicuously missing. Access to early-stage finance is extremely limited, particularly for women, and a critical gap as entrepreneurs do not have information about, or access to, existing financing opportunities in the region. There are untapped opportunities to leverage private funding to establish seed funding instruments with angel investors and the Basotho diaspora and to attract venture capital funds and foundations which are active in South Africa. However, the absence of a healthy pipeline of investible ventures is a key constraint for potential investors.

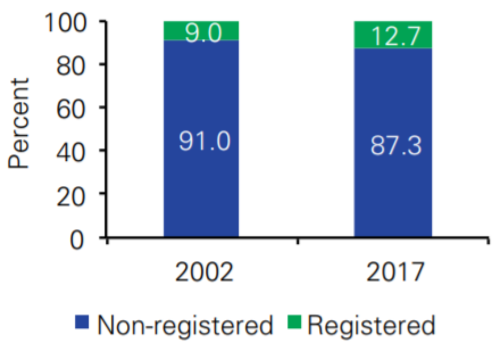
23. **Strengthening the capacity of MSMEs, particularly through support to digital transformation, is important to enable them to grow and be resilient.** Accelerating digital reforms and enhancing digital skills can unlock new business opportunities, enable business owners to reach new markets, and help MSMEs offer digital products – the World Bank Business Pulse Survey found that while firms are very keen to adopt digital technologies, government support is lacking. Putting in place a regulatory framework to facilitate digital transactions, promote fintech solutions, and support businesses to adopt digital tools and business models and leverage regional digital platforms can support the creation of new jobs in the digital sector. Complementary efforts are required to provide better quality and more affordable broadband access and enhance the availability of digital skills in partnership with the private sector. Digital businesses, including digital startups and SMEs that want to incorporate digital technologies, are hampered by poor digital infrastructure outside of urban areas. Only 8 percent of businesses currently use mobile money for business to business (B2B) payments.[29]

24. **Expanding access to MSME financing, particularly through digital financial services, would support the viability and growth of MSMEs.** Most MSMEs are micro, informal, and focused on survival rather than growth. There are an estimated 85,173 MSMEs in Lesotho, with an estimated collective turnover of M192 million (approximately USD 11 million). The MSME sector employs approximately 55,000 people in mostly low paying jobs. Eighty-three percent of them do not employ any workers and less than 3 percent employ 5 or more people.[30] These businesses are largely struggling to survive in a difficult business environment and lack financial and non-financial support including efficient infrastructure and impactful business development services to build capabilities and access new opportunities and markets. The rate of informality has not

[29] Ibid.
[30] Lesotho Finscope Study, Finmark Trust (2016).

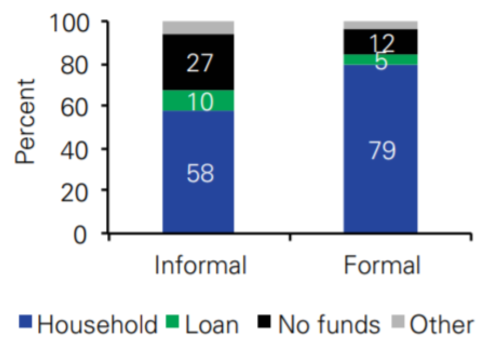
changed significantly over the last 20 years (**Figure 7**) with most businesses still not part of the formal financial sector and reliant on low levels of savings which limit their capacity to grow and create jobs (***Figure 8***).

Figure 7: More than 80% of household businesses were not registered in both 2002 and 2017.



Source: World Bank (2019)

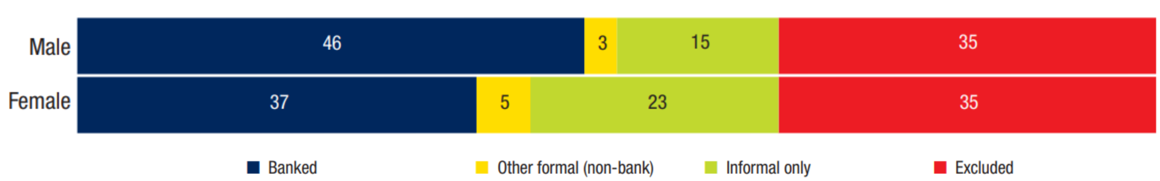
Figure 8: Most businesses, whether informal or formal, do not access formal finance



Source: World Bank (2019)

25. **MSMEs currently face multi-dimensional challenges accessing finance, particularly for women-led businesses**. Key findings from focus group discussions include very stringent requirements by banks, low efficacy of the current partial credit guarantee scheme, high co-financing requirements (MSMEs must put in 30-40% of total loan amount), costly digital transactions (6% fees for some systems), and limited support from the Lesotho National Development Corporation (LNDC) and the Basotho Enterprise Development Corporation (BEDCO). An important finding from the focus groups was that women had a particularly challenging time accessing financing for their MSMEs, even before the COVID-19 pandemic. Women stated that they were required to include their husband's name and income statements to access a loan and were less likely to be approved by a bank, particularly if they were unmarried, as they were perceived to be riskier borrowers. Evidence shows that this is a systemic challenge (Figure 9).

Figure 9: Lesotho MSME financial access (%)



Source: FinScope (2016)

26. **Strengthening the resilience of MSMEs can limit damage to these businesses from the climatic and other economic shocks that periodically impact Lesotho's economy.** The Covid-19 and recent droughts and floods have shown how acutely MSMEs are affected by climatic shocks, highlighting the importance of developing resilience building mechanisms. The focus group sessions conducted during the pre-appraisal mission shed

insight on the topic, with the majority of MSMEs noting the exposure of their business to climatic shocks. In addition, the team learned that MSMEs experienced challenges with receiving relief grants during the COVID-19 pandemic. Formal MSMEs cited the grant requirements to be onerous, particularly the mandated two years of bank statements. Even if MSMEs provided all required documentation, they only received a payment for one-month, rather than the intended three months due to lack of resources available. MSME owners noted that when impacted by the compounding shocks of Covid-19, drought, and floods, they were forced to retrench, reduce hours and/or reduce pay, force early retirement, shift their business model (leading to more a diversified business). Some had to abandon their buildings and/or close their operations. In the absence of resilience building investments, the expansion of the MSME sector will continue to be hampered by recurrent climatic shocks.

27. **Through targeted investments, the government can strengthen the resilience of both MSMEs and horticulture to climatic shocks.** While the Ministry of Finance (MOF) does maintain a contingency fund for unforeseen expenditures, these funds tend to be deployed early in the budget cycle (prior to the occurrence of climatic shocks) leaving no earmarked funds for MSMEs. Relatedly, existing digital finance service (DFS) infrastructure does not allow for efficient G2B payments in response to climatic shocks (or for other purposes). Expanding the financing instruments (such as sovereign insurance, contingency funds) available to government to rapidly deploy financial support to MSMEs during climatic shocks is critical. Key DFS reforms to allow G2B payments include: (i) implementation of a national switch to allow non-bank service providers access to retail payment infrastructure and simplifying e-money and agent banking regulations to increase the usage of DFS; (ii) facilitate the entry of fintech in the market by removing regulatory barriers; and (iii) move to accept and use digital payments in G2P and P2G payments, including tax payments and social transfers. Promoting investments and entrepreneur capacity to implement climate smart horticulture business plans will be crucial to develop a vibrant horticulture industry moving forward.

Scope of the Project

28. **The proposed project has adopted a selective approach by targeting interventions that link closely to business expansion and resilience and job creation, specifically those related to supporting entrepreneurship, MSMEs and high potential value chains.** The proposed interventions are targeted at increasing financial inclusion and resilience as well as strengthening the support for MSMEs and entrepreneurship along the high potential value chains. Under increasing financial inclusion and resilience, the proposed interventions focus on strengthening delivery of G2B services, increasing access to finance for MSMEs with a focus on ensuring inclusion of women owned MSMEs and enhancing resilience of the business sector from climate and other shocks. Support for MSMEs and entrepreneurship is focused on enhancing the scope and quality of business support services, access to early-stage finance and improving the overall competitiveness and climate resilience of horticulture and export manufacturing value chains. Drawing from the experience of the PSCED and PSCED2 projects, institutional, legal, and regulatory reforms pertaining to access to finance, investment policy and business environment reforms could be more effectively supported through a parallel accompanying technical assistance program such as under the current Jobs Platform. The project interventions proposed therefore target market and coordination failures through direct support to entrepreneurs and firms while leveraging private sector service delivery capacity to augment limited public sector capacity. Although the tourism value chain has not been explicitly targeted, entrepreneurs and existing MSMEs in the sector will be able to fully benefit from the project interventions.

29. **Leveraging analytical and advisory support under the Jobs Platform**. The proposed project draws extensively upon the analytical and advisory activities that were implemented under the World Bank's Southern Africa Jobs Platform.[31] The on-going support to the Lesotho Prime Minister's Delivery Unit (PMDU) is facilitating the Cabinet Sub-Committee on Business Environment Reforms and public-private dialogue on key value chains (tourism, export manufacturing and horticulture) as well as key themes such as business environment reforms, access to finance, and youth employment and entrepreneurship. The Jobs Platform supported a review of the draft Investment Policy, an assessment of the competitiveness of the textile and apparel sector, an assessment of business incubation services, participation of Lesotho in a regional Start-up Community and developing a business environment road map for Lesotho, all of which are directly relevant to the project design and implementation.

C. Proposed Development Objective(s)

Development Objective(s) (From PAD)

The project development objective is to increase access to business support services and financial products targeted at MSMEs and entrepreneurs, especially women and youth.

Key Results

30. **The proposed project supports results in two areas:** (i) improving financial inclusion and resilience through improvements in government to business services, government supported financial products that increase MSME creation, growth, and resilience to climatic and other shocks, and (ii) direct support for entrepreneurship and MSMEs to increase startup creation and growth and the capabilities of MSMEs to grow and participate in the value chains of high potential export industries. Please refer to Section II.D for the Theory of Change. Annex 2 highlights the links to ongoing or upcoming World Bank and development partner private sector projects in Lesotho.

31. **The following indicators will be used at PDO level:**

- Number of enterprises benefitting from private sector initiatives of the program (Of which are women owned, Of which are youth owned)
- Value of financing (seed funding, grants, partial credit guarantee, MSME resilience funds) accessed by enterprises through the program (Of which are women owned)
- Percentage of enterprises supported by the program with increased revenue (Of which are women owned, Of which are youth owned)
- Percentage of enterprises supported by the program with increased employment (Of which are women owned, Of which are youth owned)

Results targets as well as intermediate indicators are included in the results framework in Section VII of the project appraisal document (PAD).

[31] Jobs and Economic Transformation ASA (P171855)

D. Project Description

32. **The project has three components that will support the Government's efforts to expand the private sector in Lesotho.** The components focus on reforms and transformations in the following areas:

Component 1: Enhancing financial inclusion and resilience of MSMEs ($20.25 million)

33. **Component 1 will enhance financial inclusion through strengthening the delivery of efficient and reliable government-to-business (G2B) digital services to facilitate the establishment and operation of new businesses and reduce the time and cost of regulatory compliance which in turn will enhance access to finance and the competitiveness of MSMEs.** It will also provide support for firms to be more resilient to shocks from climate, pandemic, and other natural disasters. The component will include activities that support (i) optimizing the outcomes of investments in G2B digital systems and processes made under the PSCED2 project, to strengthen inter-operability, efficiency, and impactful service delivery for businesses, particularly those receiving support under Component 2, (ii) improving financial access through upgrading the security and reliability of credit infrastructure and expanding access to digital financial services, and (iii) instruments to expand financial resilience for businesses to cope with disasters and other shocks to the economy. These instruments will be particularly beneficial to the private sector. The component will finance technical assistance, goods, training and capacity building programs, and recurrent expenditures, including operating costs.

Component 2: Scaling support for entrepreneurship and MSMEs ($29.5 million)

34. **Component 2 aims to strengthen the nascent entrepreneurial ecosystem and access to early-stage finance for startups and youth owned businesses, support the digitization of MSMEs, and facilitate private investment in high-potential value-chains including encourage upgrading of skills and adoption of sustainable production practices by businesses to enhance productivity and green growth.** The component will include activities that support (i) establishing an Entrepreneurship Hub and Seed Financing Facility to increase the quality and scope of integrated startup business support services and increase access to early-stage financing, (ii) scaling the current Lesotho Enterprise Assistance Program (LEAP) focusing on supporting MSMEs to adopt digital technologies that allow them to transact in the digital economy and upgrade their capabilities, and (iii) facilitating investment into productive value chains that are linked to local MSMEs. The component will finance technical assistance, goods, training, recurring expenditures including operating costs, grants, and investments in a "seed financing facility."

Component 3: Overall project management and implementation support to the government ($3 million)

35. **Component 3 will provide support for the management and implementation of project-associated activities.** Activities to be financed include salaries of project management unit (PMU) staff/consultants in areas of project management, project coordination, fiduciary specialists (e.g., procurement, financial management), monitoring and evaluation (M&E) specialist, a dedicated environment, and social safeguards (E&S) specialist, project communication, and citizen engagement. This component will also cover modest office equipment and independent audits and learning/training for the PMU and beneficiary agencies, through the official closing date of the project. It is expected that all consultant terms of reference (TORs) will clearly stipulate knowledge transfer and hands on training to ministry staff. Special attention will be devoted to

promoting equal participation of women in all decision-making bodies under the project and contributing to tackling barriers in recruitment, retention, and promotion. This component will also support capacity building of the PMDU (Prime Minister's Delivery Unit under the Cabinet Subcommittee on Trade and Investment), given the importance of the PMDU to delivering on the goals of the NSDP II and the related objectives of this project.

Table. Summary Financing Table

Component	Sub-Component	IDA Financing ($ millions)	GRiF Co-Financing ($ millions)
1. Enhancing Financial Inclusion and Resilience for MSMEs	1.1 Enhancing G2B Digital Services to More Effectively Serve MSMEs	4.5	2.0
	1.2 Improving Access to Financial Services	3.0	
	1.3 Strengthening the Resilience of MSMEs to Climatic Disasters and Shocks	5.0	5.75
2. Scaling Support for Entrepreneurship and MSMEs	2.1 Establishing an Entrepreneurship Hub and Seed Financing Facility	12.5	
	2.2 Scaling the Lesotho Enterprise Assistance Program (LEAP) for MSMEs	5.0	
	2.3 Expanding SME Participation in High Potential Value Chains	12.0	
3. Project Management and Implementation Support		3.0	
TOTAL		**45.0**	**7.75**

Legal Operational Policies

	Triggered?
Projects on International Waterways OP 7.50	No
Projects in Disputed Areas OP 7.60	No

Summary of Assessment of Environmental and Social Risks and Impacts

36. The overall environmental and social risk rating for the project is Moderate. The social risk rating is Moderate. The majority of the proposed activities represent provision of technical assistance (TA), as well as minor repair works within existing structures in well demarcated and fenced areas owned by the Lesotho National Development Corporation (LNDC) and MoTI. Downstream impacts of the technical assistance activities are considered positive by potentially reducing the environmental impacts of manufacturing firms associated with ESS2 related occupational health and safety, ESS3 related environmental pollution, and ESS4 related community health and safety. The repairs, servicing and end-of-life disposal of ICT equipment may result in ESS3 related environmental risks resulting from electronic wastes (e-wastes), hazardous waste and solid wastes if not managed appropriately. The equipment required, the associated cycle of replacement or upgrades, existing e-waste, hazardous and solid waste management measures in project implementing entities, regulatory framework, and in-country capacities to manage end of life disposal of electronic equipment and parts will be analyzed during project preparation. To ensure the management of e-waste and other hazardous waste, the Environmental and Social Management Framework will include a Waste Management Plan (WMP). The WMP will include simple technical guidelines on how to manage the disposal of ICT equipment (end-of-life and during repairs). The potential use of pesticides and fertilizers in commercial agriculture will potentially result in ESS3 related environmental pollution (including the degradation of surface water and groundwater). The project will set up a Horticulture Incubator Center which will be established at an already existing facility at Mahobong that is owned by the National University of Lesotho. This will involve minor civil works including rehabilitation of already buildings. Rehabilitation works would potentially lead to ESS3 related noise and air pollution, generation of waste, loss of plant cover, ESS2 and ESS4 related increase in occupational and community health and safety risks. The risks and impacts will be managed through the preparation and implementation of sub-project specific ESMPs. The potential risks and impacts associated with the project activities are considered to be predictable and temporary and/or reversible; low in magnitude; site-specific, without likelihood of impacts beyond the actual footprint of the Project. No adverse impacts on biodiversity and habitats are expected.

37. Potential social risks are: (i) possible exclusion of vulnerable and disadvantaged groups from fully participating/benefiting from the project; (ii) challenges that may arise in conducting genuine stakeholder engagement, particularly involving beneficiary MSMEs and informal business entities; and (iii) relatively limited capacity of MoTI in handling ESF requirements, including in relation to requirements on establishing and maintaining a functioning project-level GRM. These potential risks are addressed through project ESMF which also include Labor Management Procedures and GBV/SH/SEA Prevention and Response Action Plan, all proportionate to the risks. The ESMF will be prepared, disclosed, and consulted upon by Appraisal. A Stakeholder Engagement Plan has been prepared and addresses the above risks. During preparation, the project conducted several consultations with various stakeholders, and ESF instruments were prepared considering feedback from stakeholders. Given the importance of outreach in both mitigating the risks as well as ensuring successful project implementation, Component 3 of the project will, among others, finance various stakeholder engagement activities which will be designed to take place throughout project implementation. The project may also face social and environmental challenges related to transmission of communicable diseases e.g., COVID-19 that could arise from people gathering for capacity building workshops and training activities. Despite these potential risks, the project activities are expected to have positive developmental and social outcomes related to business support services and financial products targeted at MSMEs and entrepreneurs, including vulnerable groups such as women and unemployed youth. The Project will not involve capitalization/access to finance on-lending to MSMEs/PFIs, and there will be no Financial Intermediaries under the Project at this stage. Thus, ESS9 is deemed not relevant, and there are no associated downstream social and environmental risks that could have resulted from sub-projects. The environmental and social risk ratings will be reviewed periodically throughout the project life cycle to ensure that it continues to stay current with project implementation progress.

E. Implementation

Institutional and Implementation Arrangements

38. **The project will be implemented by the same Project Management Unit (PMU) that is currently implementing the PSCED2 project under MTI.** The PSCED2 PMU has a strong performance track record of over 15 years and has established strong project implementation capacity as well as working relationships with key agencies and Ministries across the Government. The PSCED2 project will conclude on June 30, 2022, allowing the PMU to be available and ready for CAFI project implementation from the outset of the project. The PMU will be responsible for all fiduciary aspects of the project including FM and procurement activities.

39. The PMU will also act as a capacity building partner for the PMDU. This brings some additional responsibility for the PMU but also provides the PMU with access to the highest levels of government if implementation challenges arise. This should be beneficial to successful implementation of the project. The PMU also currently acts as the implementing agency for the AfDB's private sector development project. This has facilitated strong coordination between the Bank and AfDB's complementary projects and that coordination can be expected to continue under the new project while the AfDB project is reaching closure.

40. The PMU has established strong working relationships through the current project with the relevant Ministries and agencies which is expected to continue through this project and the PMU will continue to provide capacity building support to the agencies as needed. The project will endeavor to transfer implementation responsibilities to the beneficiary agencies to the extent possible to build sustainability. The key project beneficiary entities are listed below.

Sub-Component	**Beneficiary Agencies**
1.1 Enhancing G2B Digital Services	OBFC, DTT, MPWT
1.2 Improving Access to Financial Services	MOF, LRA, CBL
1.3 Improving the Resilience of the Private Sector to Climatic Disasters and Shocks	MTI, MOF, LRA, CBL
2.1 Establishing a Digital Entrepreneurship Hub and Seed Financing Facility	MSBD, BEDCO
2.2 Scaling Up the LEAP Program for MSMEs	MSBD, BEDCO
2.3 Expanding SME Participation in High Potential Value Chains	LNDC, Labor Commissioner, NUL
3. Financing and Capacity Building for the Project Management Unit (PMU) and the Prime Minister Delivery Unit (PMDU)	PMDU

BEDCO = Basotho Enterprise Development Corporation
CBL = Central Bank of Lesotho
DTT = Department of Traffic and Transport
LNDC = Lesotho National Development Corporation
LRA = Lesotho Revenue Authority
MOF = Ministry of Finance
MSBD = Ministry of Small Business Development, Cooperatives, and Marketing
MPWT = Ministry of Public Works and Transport
NUL = National University of Lesotho
OBFC = One-Stop Business Facilitation Center
PMDU = Prime Minister's Delivery Unit

41. Full implementation details are provided in Annex 1 of the PAD.

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