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# KINGDOM OF LESOTHO

## SELECTED ISSUES

September 2025

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## SELECTED ISSUES

August 21, 2025

Approved By
**Andrew Tiffin (AFR)**

Prepared by Athene Laws, Ann-Alice Ticha, Qianqian Zhang (AFR) and Motseki Khiba (MoFDP). Erick Trejo Guevara and Sandra Paulaviciene (AFR) provided administrative assistance.

## CONTENTS

# SETTING UP FISCAL RULES IN LESOTHO[1]

*Lesotho's fiscal policy has long been shaped by volatile SACU revenues and persistent expenditure pressures, calling for a more rules-based and forward-looking framework to ensure sustainability. Recent efforts to formalize a fiscal rules framework offer an opportunity to strengthen medium-term planning, anchor debt dynamics, and build resilience to shocks. The proposed framework should center on a debt ceiling of 60 percent of GDP, a debt anchor of 50 percent of GDP, and a structural deficit target of 3 percent of GDP, supported by operational expenditure and wage-bill rules. A savings fund (stabilization fund) should be set up and be anchored on the fiscal rules, serving both stabilization and investment purposes.*

## A. Introduction

**1. Lesotho's small, open economy faces persistent macroeconomic challenges, with structural vulnerabilities and slow policy implementation hindering reform progress.** Heavy reliance on Southern African Customs Union (SACU) receipts makes the country's fiscal position highly volatile and vulnerable to regional economic conditions, while limited economic diversification exposes the economy to external demand shocks and competitiveness pressures. Fiscal management has been procyclical and is further complicated by the rigidity of public expenditures, particularly the large wage bill, which limits the government's ability to adjust spending in response to revenue fluctuations. As a member of the Common Monetary Area, Lesotho maintains a fixed exchange rate peg to the South African rand, restricting the use of monetary policy to respond to shocks. Limited access to international financing further reduces Lesotho's ability to buffer revenue shortfalls through borrowing. A relatively small private sector and episodes of political instability compound these challenges, creating a difficult environment for sustaining fiscal stability, maintaining uninterrupted delivery of key public services, and fostering resilient economic growth.

**2. Recent fiscal surpluses provide an opportunity to rebuild buffers and improve sustainability.** Latest developments indicate a notable shift in Lesotho's fiscal landscape with the emergence of a fiscal surplus starting from FY23/24, due to strong SACU receipts and a break from the previous pattern of procyclical spending. Another major development has been the renegotiation of water royalty rates under the Treaty with South Africa on the Lesotho Highlands Water Project (LHWP-II), which now provides a significantly higher and more stable revenue stream. This shift reduces Lesotho's reliance on SACU transfers and presents a unique opportunity to strengthen fiscal sustainability and support long-term growth. However, realizing these benefits requires disciplined fiscal management, particularly given low capital spending efficiency, chronic arrears, and still elevated debt-to-GDP ratios. Strengthening public financial management and ensuring that additional revenues are saved and invested strategically will be critical.

[1] Prepared by Qianqian Zhang and Motseki Khiba. Mr. Motseki Khiba is a senior economist at the Macroeconomic Policy Directorate of Ministry of Finance and Development Planning in Lesotho. The authors would like to thank Ms. Ann-Alice Ticha for her excellent research assistance.

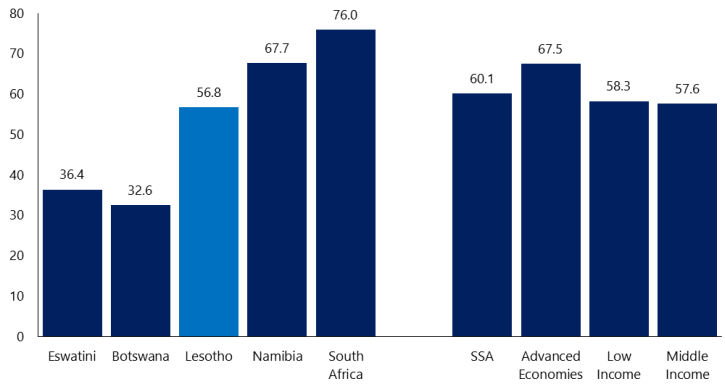
**3. Institutionalizing fiscal discipline through a rules-based framework will mitigate procyclicality and enhance policy credibility.** The authorities have recently advanced a policy paper stipulating a fiscal rules framework. Lesotho's history of fragile coalition politics and weak policy continuity have underscored the need for legally binding, well-calibrated, and enforceable fiscal rules. Such rules should be simple, transparent, and easy to operate (Eyraud et al, 2018), facilitating effective policy implementation while insulating fiscal decision-making from political cycles. Transitioning from discretionary fiscal adjustments to a structured rules-based framework will be critical to stabilizing the macroeconomy, enhancing debt sustainability, and fostering long-term economic resilience.

**4. This paper provides an analysis of Lesotho's proposed fiscal rules and their implications.** Section B discusses Lesotho current situation compared to international peers and outlines the latest fiscal rules put forward by the authorities. Section C evaluates the design and calibration of the debt rule and structural balance rule. Section D discusses strategic considerations in selecting appropriate fiscal rules. Section E explores options for the pace of savings accumulation and the proposed framework for managing these savings. AS a useful guide, section F discusses the experience of Chile. Section G concludes.

## B. The Case for Fiscal Rules

**5. Lesotho's public debt is elevated relative to some regional comparators, and is close to the average of Emerging Markets and Development Economies (EMDEs)** (Figure 1). Public debt declined from 61.5 percent of GDP in FY23/24 to 56.8 percent of GDP in FY24/25 in Lesotho, thanks to a pickup in the pace of redemption of domestic securities and arrears clearance. Lesotho's debt carrying capacity (CI score) is medium, reflecting its economic fundamentals, debt management practices, and the external environment.[2] However, this capacity may be more constrained than in advanced economies, highlighting the need for sustained fiscal discipline and effective debt management policies to preserve macroeconomic stability.

**Figure 1. Lesotho: Public Debt**
(2024; Percent of GDP)

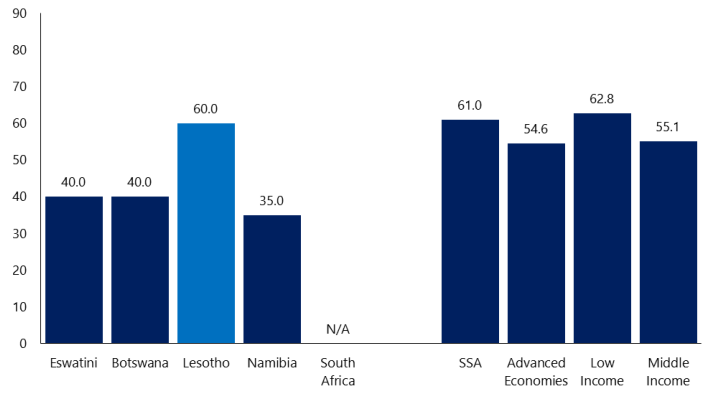



Source: Authorities' data and IMF staff calculations.

[2] Based on April 2025 World Economic Outlook and World Bank CPIA.

**6. Lesotho's debt ceiling, set at 60 percent of GDP, is notably higher than the thresholds adopted by most of its regional and global peers** (Figure 2). SACU peers in particular have adopted a more cautious approach to debt sustainability. While Lesotho's ceiling aligns with the average across sub-Saharan Africa and that of the low-income economies, it exceeds the average levels observed in advanced economies (AEs) and middle-income economies, considering its larger development gaps. An elevated ceiling provides space for countercyclical policy and critical development investments, but sustaining a high level of debt places an added premium on strong fiscal management, careful prioritization of spending, and prudent debt accumulation strategies. The authorities will need to ensure that any new debt is aligned with national development priorities, supported by robust project appraisal, and accompanied by sustained efforts to strengthen revenue mobilization and expenditure efficiency.

**Figure 2. Lesotho: Fiscal Rule: Debt Ceiling**
(Latest Available Value; Percent of GDP)




Source: Authorities' data and IMF staff calculations.

**7. To strengthen fiscal discipline and enhance macroeconomic stability, the authorities have advanced a rules-based fiscal framework.** This framework is anchored in a legally binding debt ceiling of 60 percent of GDP,[3] complemented by a debt anchor of 50 percent of GDP and a structural deficit rule set at 3 percent of GDP. The framework also includes indicative benchmarks on aggregate expenditure and the public wage bill, with automatic correction and escape clauses to reinforce compliance. The structural deficit rule adjusts for the volatility of SACU revenues to ensure consistency with the desired debt trajectory over the medium term. The legal underpinnings of the framework are embedded in the draft Public Finance Management and Accountability Bill and the existing Public Debt Management Act, which together formalize fiscal responsibility and enhance the credibility of budgetary processes. The authorities also propose establishing an independent Fiscal Council to strengthen oversight and transparency. These measures represent a welcome step toward institutionalizing fiscal discipline and reducing procyclicality.

**8. To prevent fiscal slippages and to offset a historical bias towards recurrent spending, the framework incorporates indicative expenditure rules and pre-specified debt correction thresholds.** Specifically, two expenditure benchmarks have been proposed: (i) a ceiling on total nominal expenditure growth of no more than inflation, and (ii) a limit on the wage bill to 60 percent of total revenues. Though indicative, both benchmarks aim to discipline expenditure growth and contain recurrent spending pressures, especially during revenue windfalls. If the debt-to-GDP ratio

[3] The public debt level of 60 percent of GDP is also a limit set by regional practices and convergence criteria by Southern African Development Community (SADC), and is assessed in the IMF-World Bank Debt Sustainability Analysis (DSA) to be "with limited space to withstand shocks".

exceeds 45, 50, or 55 percent, the government would be required to adopt an adjustment plan, with increasing intensity depending on the breach. Once debt exceeds 60 percent, measures to produce short-term adjustments will be prioritized, including spending cuts and/or targeted revenue increases. Additionally, the framework includes escape clauses to accommodate exceptional events—such as large external shocks or natural disasters—subject to transparent justification and a requirement to return to compliance within three years.

**9. Another key feature of the fiscal rule framework is the establishment of a Fiscal Council to provide independent oversight of rule compliance, fiscal forecasts, and the application of the framework's escape clauses.** The Council will validate the macroeconomic assumptions underlying the budget, assess the government's fiscal performance, and publish compliance reports. It will also review the feasibility and integrity of proposed corrective actions and triggers for escape clauses, adding a layer of accountability and technical credibility to the fiscal framework. The Council's structure—comprising five members with at least one member being an external expert, and an outsourced secretariat—aims to ensure cost-effectiveness and independence.

**10. To ensure credibility while accommodating institutional capacity, the fiscal rule framework may be subject to future revisions.** Recognizing that this is Lesotho's first formal adoption of rules-based fiscal management, the policy paper emphasizes simplicity and ease of implementation within existing capacity constraints, with room for future refinement as data quality and forecasting tools improve. The framework allows for review and potential revisions, particularly in light of a rebasing of GDP statistics in the near future and ongoing improvements in macro-fiscal analysis. In parallel, the establishment of a Revenue Stabilization Fund is proposed as a key institutional complement to the rules, with the dual objective of saving volatile SACU windfalls and shielding capital expenditure during downturns. Together, these elements are intended to support a gradual but credible transition toward a more stable, disciplined, and growth-friendly fiscal policy framework.

## C. Fiscal Rules Calibration

**11. Section C provides a quantitative basis for anchoring fiscal policy through debt and structural-balance rules tailored to Lesotho's macro-fiscal context**. Using stochastic simulations and calibration tools, it evaluates feasible deficit ceilings consistent with medium-term debt targets and fiscal sustainability, validating the authorities' proposed framework.

### Debt Ceiling and Anchor

**12. Lesotho's proposed maximum debt ceiling of 60 percent of GDP in nominal terms is based on a combination of fiscal policy considerations, regional benchmarks, and debt sustainability risks.** The 60 percent debt ceiling is aligned with SADC's fiscal prudence guidelines, which serves as a key regional debt benchmark. At the same time, according to the latest DSA, by 2045, Lesotho's nominal public debt-to-GDP ratio is projected remain close to this ceiling (61 percent), while its PV equivalent would be around 52 percent, close to the DSA's 55 percent threshold, leaving little room for error. Setting 60 percent of GDP as a debt ceiling provides a feasible

safeguard against excessive debt accumulation while preserving fiscal space for development priorities.

**13. Given the debt ceiling, a robust debt anchor calibration requires a systematic simulation of possible macroeconomic shocks to assess the conditions under which this ceiling might be breached.** Countries could experience sudden and sharp increases in debt due to adverse macroeconomic shocks and the realization of contingent liabilities. When calibrating the debt anchor, it is necessary to make sure that, with high probability, debt remains below a pre-defined maximum threshold even under adverse scenarios. In other words, the debt anchor should be set low enough to ensure that debt will remain below the debt ceiling with high probability even when negative shocks occur. Given Lesotho's economic structure and external dependencies, setting a conservative debt anchor is critical to maintaining fiscal sustainability and reinforcing policy credibility.

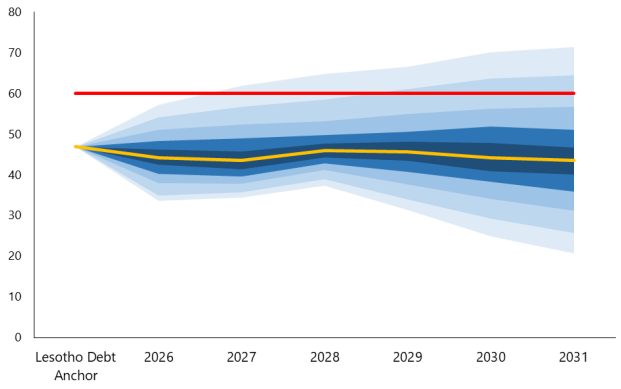
**14. The calibration process relies on stochastic simulations incorporating a range of economic and financial variables.** Leveraging the method by Baum et al (2017) when a maximum debt limit is known, stochastic simulations are used to calibrate the debt anchor by computing a safety margin below this debt limit. For Lesotho, key variables include GDP growth, interest rates on public debt, exchange rate fluctuations, terms-of-trade shocks, and external loan disbursements and concessionality—all factors that are particularly relevant for low-income developing countries (LIDCs). GDP growth volatility remains a key concern, particularly in light of the recent U.S. tariff shock, while economic activity continues to be heavily reliant on the LHWP-II. Revenue mobilization remains closely linked to SACU transfers, which could face heightened risks following the recent external shocks. Exchange rate risks, particularly depreciation pressures, could further amplify debt burdens, while fluctuations in concessional loan disbursements could impact the financing of capital projects. The calibration ensures that the debt anchor remains resilient to these economic shocks, preventing unsustainable debt accumulation and aligning fiscal policy with macroeconomic stability objectives.

**15. Two complementary approaches are used to calibrate the debt anchor, ensuring alignment with fiscal response dynamics and macroeconomic conditions.** [4] The first employs a fiscal reaction function (FRF), which models how fiscal policy historically adjusts to macroeconomic and fiscal conditions. The FRF is estimated econometrically using a panel of LIDCs, including Lesotho, to ensure the calibration reflects realistic fiscal adjustment patterns. The second approach adopts an ad hoc fiscal balance path, aligning fiscal targets with the latest macroeconomic framework over the medium term. This method allows for forward-looking policy assumptions while ensuring that the debt anchor remains consistent with fiscal sustainability objectives. By employing both approaches, the calibration process provides an assessment of Lesotho's fiscal resilience, ensuring that the debt anchor is set at a level that preserves debt sustainability while allowing fiscal policy to respond flexibly to economic shocks.

[4] Source: Fiscal Rules Calibration Tools, International Monetary Fund.

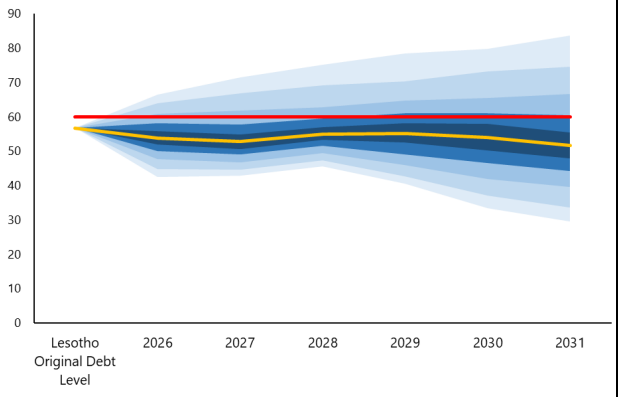
**16. The FRF simulation results validate the proposed debt anchor.** Figures 3 and 4 illustrate the debt path using the FRF approach, with 60 percent of GDP established as the upper limit that should not be breached. This approach incorporates fiscal shocks realized in each period, with debt trajectories summarized in the accompanying fan charts. The FRF model applied is particularly suited to LIDCs, where output gaps are difficult to measure—it thus specifies the reaction to terms-of-trade shocks and external financing disbursements, rather than to debt and the output gap as in advanced and emerging economies (Baum et al., 2017; Eyraud et al., 2018). Based on historical fiscal behavior and stochastic simulations of macroeconomic shocks, the debt anchor should be at approximately 47 percent of GDP (Figure 3), ensuring only a 15 percent probability of exceeding the 60 percent threshold while maintaining a low risk of debt distress, except under extreme shock scenarios. This aligns with the authorities' proposed multi-layered debt anchor framework—set at 45, 50, and 55 percent of GDP—by indicating that a more prudent and resilient anchor lies at the lower end of the suggested range. Figure 4, on the other hand, presents the debt simulation starting from the initial actual (observed) debt level at end-FY24/25, rather than from the debt anchor. It illustrates where current debt could evolve over the next six years under a sequence of adverse shocks. The results are broadly consistent with the DSA, suggesting that overall debt is likely to remain below but close to the 60 percent of GDP ceiling. The distribution also highlights a non-negligible probability of breaching the ceiling under adverse scenarios, underscoring the importance of maintaining fiscal prudence.

**Figure 3. Lesotho: Debt Path from Simulated Debt Anchor**




Source: Authorities' data and IMF staff calculations.

**Figure 4. Lesotho: Simulation of Debt Path from Current Debt Level**

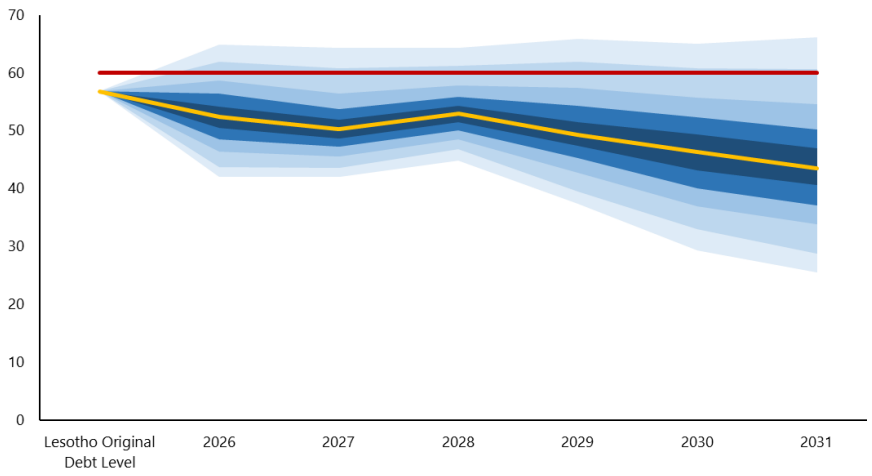



Source: Authorities' data and IMF staff calculations.

**17. Under the second approach—the ad hoc fiscal balance scenario, debt is projected to decline steadily, provided current macroeconomic assumptions hold and surpluses are maintained.** This approach simulates the debt trajectory under the baseline projections of real GDP growth, real interest rates, and primary balances, while maintaining the observed share of concessional borrowing. Figure 5 illustrates the resulting debt path, assuming a one-to-one relationship between the primary balance and public debt dynamics, with other assumptions held constant from the stochastic simulations under the fiscal reaction function. Under these conditions, public debt is projected to decline steadily to below 45 percent of GDP by the end of the medium term, provided sustained primary surpluses are realized and borrowing remains aligned with the

fiscal path. The likelihood of breaching the 60 percent debt ceiling remains low—less than 10 percent—even under simulated shock scenarios. This result provides a counterfactual for the debt path, and assumes that the authorities' borrowing strategy is shaped by projected fiscal surpluses in the medium term. The conclusions of simulation focus on the need to protect a country's fiscal position against negative shocks. While the simulations underscore the importance of maintaining fiscal buffers to withstand adverse shocks, it is equally important to preserve fiscal space for growth-enhancing investment and other development priority areas.

**Figure 5. Lesotho: Debt Path from Simulated Debt Anchor Lesotho Original Debt Level**
(Percent of GDP)




Source: Authorities' data and IMF staff calculations.

## Structural Balance Rule

**18. A well-defined fiscal framework ensures consistency between debt and deficit targets, recognizing their intrinsic link through an accounting identity.** Debt represents the cumulative stock of past deficits, while the deficit captures the annual change in debt levels. In practice, currency fluctuations, nondebt financing, and the accumulation of financial assets can temporarily disrupt this direct relationship, but over time, debt dynamics generally track deficit trends. Similarly, deficits are tied to government spending, reinforcing the need for coherence between debt rules and operational rules governing deficits and expenditures. A structural balance rule for Lesotho, which accounts for cyclical adjustments and revenue volatility especially for SACU receipts, provides a useful operational guide to ensure that fiscal targets remain credible and sustainable.

**19. To properly set a fiscal target and anchor the structural balance rule, it is necessary to derive a stable and credible measure of underlying "structural" SACU revenues.** From various options across varying windows of 4 to 20 years, the lower quartile of SACU receipts over the past 8 years emerges as the preferred measure—providing a relatively stable, conservative, and politically defensible benchmark for underlying SACU revenues. This choice reduces procyclicality and helps ensure that fiscal targets are met even in lower-revenue years. Going forward, this methodology

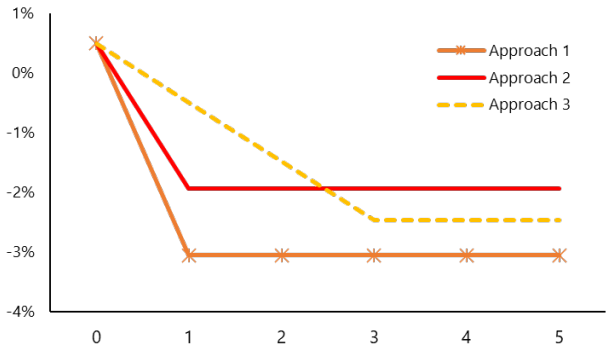
could strengthen medium-term fiscal planning and provide a more prudent anchor for structural deficit rules.

**20. Using the IMF fiscal rules calibration tool, three adjustment paths are simulated:** These include: (i) a constant balance that stabilizes debt at its ceiling over the long term; (ii) a path that achieves convergence to a preferred debt anchor of 50 percent of GDP within five years; (iii) a more front-loaded adjustment path to reach the 50 percent of GDP debt target within five years (Annex I). As shown in Table 1, with a debt ceiling of 60 percent of GDP and a long-term trend nominal GDP growth rate of 6.5 percent: the first scenario implies a fiscal deficit of 3.1 percent of GDP annually, but debt will only converge to 50 percent of GDP in about 15 years. Under the second scenario, convergence within five years requires a tighter deficit of 1.9 percent of GDP annually. The third, more aggressive scenario entails an initial fiscal deficit of 0.5 percent of GDP in the first year, followed by a 1.5 deficit in the second year, and deficits averaging 2.5 percent of GDP thereafter. These alternative paths are presented in Figures 6 and 7 and aim to guide fiscal rule calibration while considering trade-offs between ambition and feasibility.

**Table 1. Lesotho: Structural Balance Rule Methodology and Results**

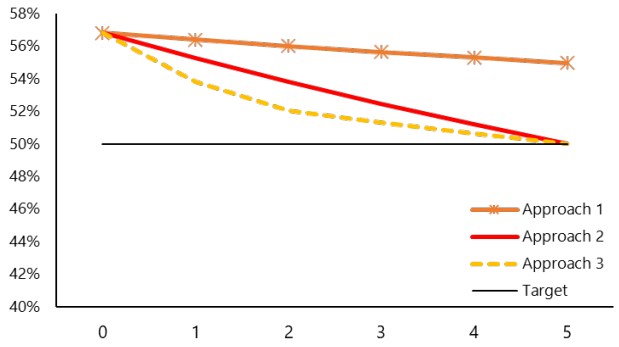
| Methodology | Structural Balance Rule |
|---|---|
| (i) | -3.1 percent of GDP every year for five years |
| (ii) | -1.9 percent of GDP every year for five years |
| (iii) | -0.5 percent of GDP in year 1 → -1.5 percent of GDP in year 2 → -2.5 percent of GDP in year 3–5 |

**Figure 6. Lesotho: Fiscal Balance Paths in Three Scenarios**




Source: Authorities' data and IMF staff calculations.

**Figure 7. Lesotho: Debt Paths in Three Scenarios**

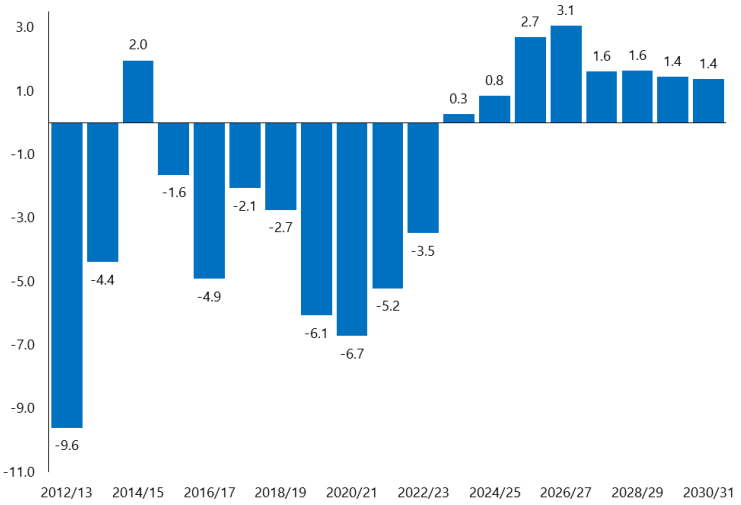



Source: Authorities' data and IMF staff calculations.

**21. The simulated results suggest that a 3 percent of GDP structural deficit rule is feasible for Lesotho.** Using the preferred measure of underlying revenue—calculated using the lower quartile of SACU and grant revenues over the past eight years—baseline projections suggest that the

structural fiscal balance will remain in surplus over the medium term (Figure 8). This would provide an opportunity to save revenue windfalls and allocate resources toward retiring costly domestic debt, thereby strengthening fiscal buffers and reducing debt vulnerabilities. Note that a deficit rule in the face of Lesotho's fiscal surpluses would typically assume a one-to-one relationship between the fiscal balance and the debt trajectory. Given that the authorities have not revised their future borrowing plans nor committed to financing capital spending from domestic resources, it would be prudent to begin repaying costly debt. This would help build fiscal space and enhance resilience to future shocks.

**Figure 8. Lesotho: Structural Balance**
(Percent of GDP)




Source: Authorities' data and IMF staff calculations.

## D. Fiscal Rules Selection

**22. The selection of the type of fiscal rule is an equally critical step that shapes how fiscal policy is anchored and implemented.** Selection decisions determine the operational character of the framework—whether it emphasizes debt sustainability, expenditure discipline, or deficit management—and therefore influences the kind of calibration that follows. In Lesotho's case, the choice of a debt anchor complemented by a structural balance rule reflects both the country's exposure to revenue volatility and its need for a credible operational guide. A debt rule provides a transparent signal of long-term sustainability, while the structural balance rule introduces flexibility to accommodate cyclical fluctuations and revenue shocks, particularly those tied to SACU transfers. The interplay between these rules ensures that operational fiscal targets remain aligned with broader debt objectives, providing both macroeconomic stability and space for development spending. The two indicative expenditure rules also serve as important operational tools to reinforce fiscal discipline—placing ceilings on total expenditure growth and the wage bill—thereby limiting procyclical spending pressures and supporting credible medium-term consolidation.

**23. Calibration and selection interact in an iterative process.** The calibration of Lesotho's debt anchor—based on stochastic simulations and fiscal response functions—helps validate the feasibility

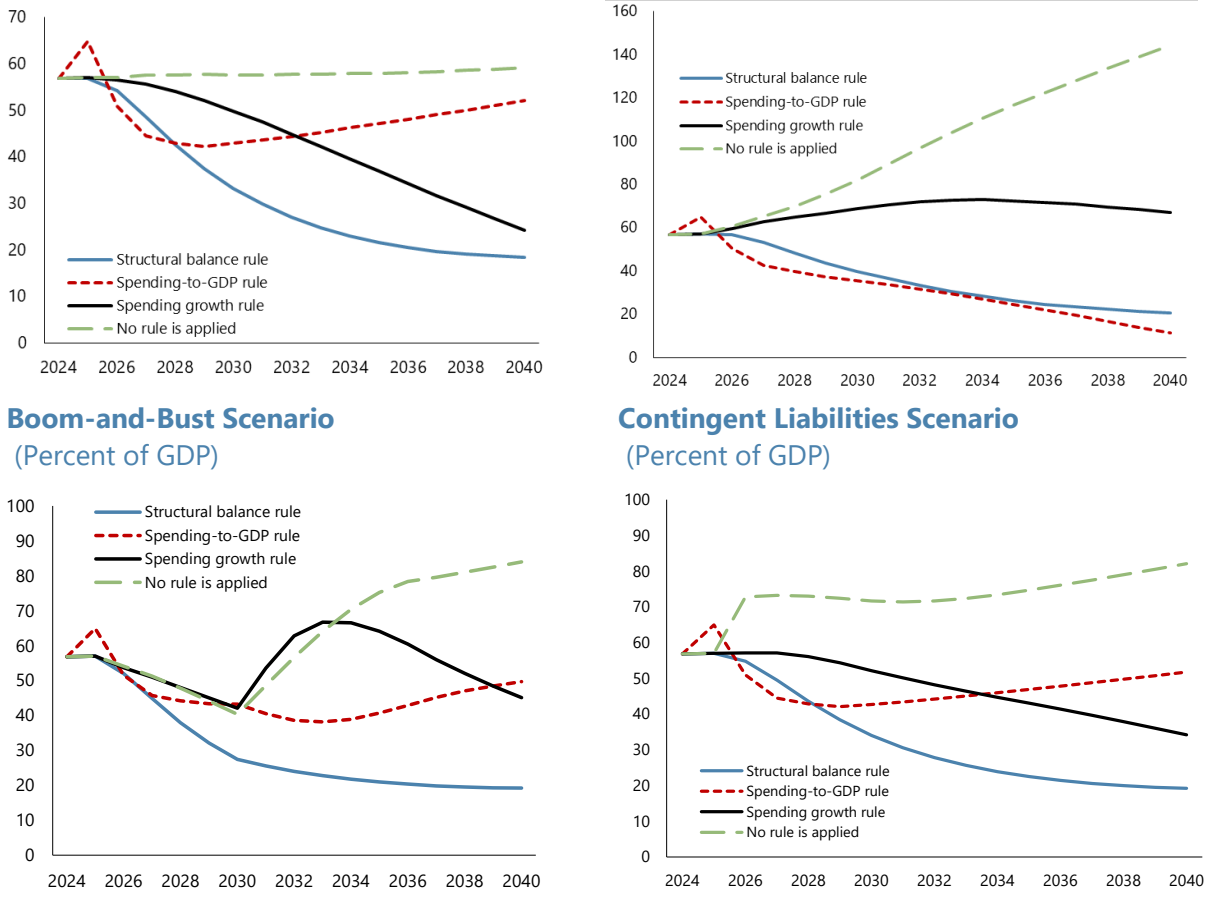
of the selected rule set under different macroeconomic scenarios. At the same time, the selection of rule types must be informed by institutional capacity, data quality, and economic structure. For instance, selecting a structural balance rule necessitates reliable estimates of potential output and structurally adjusted revenues, which in turn influences how stringently the rule can be calibrated and enforced. Ultimately, the credibility of the fiscal framework depends not only on technically sound calibration but also on the strategic selection of rules that are implementable, well understood, and suited to the country's fiscal risks and policy priorities.

**24. Forward-looking scenario analysis outlines how different fiscal rules perform under alternative macroeconomic shocks.** [5] The simulation is conducted over the forecast horizon and assumes the rule is introduced in the first year. Figure 9 shows the simulation results of the impact on debt levels from applying different operational rules, under four scenarios: a baseline scenario that is consistent with the macroframework discussed in the 2025 Article IV Staff Report; a low-growth scenario that envisages a large and temporary shock to growth in the first year of the projection, with no permanent effect on the level of real GDP over the long run; a boom-and-bust scenario that assumes a long period of strong growth followed by a decline in growth with permanent effects on the level of real GDP; and a contingent liabilities scenario where contingent liabilities amount to 15 percent of GDP in the first year while all other macroeconomic variables remain the same as in the baseline. For each of these scenarios, there are three types of operational rules being applied: a structural deficit rule of 3 percent of GDP, a spending-to-GDP rule of 55 percent, and a real spending growth rule capped at 0 percent indicating nominal spending growth at inflation rate.

**25. The results show that across all four scenarios, the structural balance rule consistently yields the strongest debt reduction path, ensuring a steady and significant decline in the debt-to-GDP ratio over time.** The spending growth rule offers moderate debt containment, performing better than having no fiscal rule, but with greater vulnerability to shocks, especially under the boom-and-bust scenario. The spending-to-GDP rule tends to stabilize debt but is less effective at putting debt on a downward trajectory, particularly under adverse or volatile conditions. The no rule scenario results in rising or flat debt paths across all simulations, underscoring the importance of adopting fiscal rules. Overall, the analysis suggests that rules anchored in fiscal balances offer the strongest safeguard against debt escalation, especially when countries face growth volatility or contingent fiscal pressures.

[5] Source: Fiscal Rules Selection Tools, International Monetary Fund.

**Figure 9. Lesotho: Debt Scenarios Under Different Rules**




Source: Authorities' data and IMF staff calculations

## E. Considerations for a Stabilization Fund

**26. The authorities are strongly encouraged to swiftly operationalize a well-governed stabilization fund, anchored by credible fiscal rules.** With gross international reserves expected to surpass six months of import coverage in FY25/26—a level deemed appropriate for Lesotho—staff recommends fiscal surpluses be redirected toward reducing public debt. Reducing debt to 50 percent of GDP over the next five years would significantly lower the risk of a shift to high-risk of debt distress.

**27. The comfortable level of reserves for Lesotho is calculated using a forward-looking, tailored framework for reserve needs in credit-constrained economies.** The IMF Assessment of Reserve Adequacy for Credit Constrained Economies (ARA-CC) framework was developed to address the unique vulnerabilities of credit-constrained economies, particularly LICs, whose reserve needs are largely driven by current account shocks (such as declines in aid, remittances, or terms-of-trade). Unlike traditional metrics that focus on capital flow risks, the ARA-CC approach uses a cost-benefit optimization model that balances the absorption-smoothing role of reserves during crises against

the opportunity cost of holding reserves. The adequate reserve level is derived as the point at which the marginal benefit of holding an additional dollar of reserves equals its marginal cost—proxied by indicators such as borrowing costs, sterilization costs, or the marginal product of capital. This makes the ARA-CC approach well-suited for LICs where fiscal space is tight and holding excessive reserves can be costly to development.

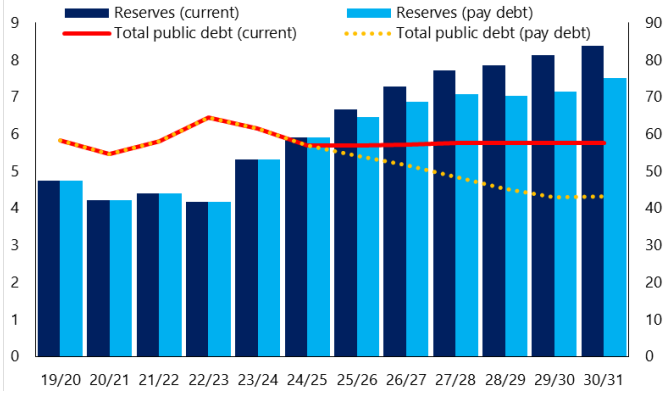
**28. In Lesotho's case, the marginal opportunity cost of further reserve accumulation is approximated by the cost of external borrowing.** The marginal benefit reflects the economic value of holding one additional unit of reserves, particularly in helping Lesotho absorb external shocks—such as smoothing imports or maintaining exchange rate peg during crises. In contrast, the marginal cost captures what the country gives up by holding that extra dollar in reserves instead of using it elsewhere. For credit-constrained countries like Lesotho, this cost is often proxied by the external borrowing rate, since reserves are typically accumulated by external borrowing, which is often in concessional rates[6]. Thus, reserve levels are considered optimal when the benefit of added insurance against shocks equals this borrowing cost, ensuring neither under- nor over-accumulation.

**29. Based on the simulation, the optimal level of reserves is about 4.5 to 6 months of imports for Lesotho.** This takes into account Lesotho's limited access to international capital markets, its exposure to large and frequent current account shocks—particularly from volatile SACU revenues—and the high economic costs associated with reserve depletion in crisis scenarios. The range reflects a balance between the stabilization benefits of holding reserves to smooth absorption during external shocks and the opportunity cost of holding those reserves, proxied by the cost of external borrowing. This level also incorporates a precautionary buffer to reflect emerging risks.

**30. From this estimate of the optimal level of reserves, the options for rapid debt repayment can be explored further.** Placing debt on a declining path to around 45 percent of GDP would still allow reserve accumulation to reach 7.5 months of imports at the end of the forecast horizon (Figure 10). And according to the LIC-DSF framework, this level of adjustment would improve Lesotho's status from "limited space to absorb shocks" to "some space to absorb shocks." In establishing a more rapid pace of debt repayment, the authorities would then have to assess the appropriate mix and sequencing of redemptions. On one hand, domestic debt carries a significantly higher interest cost, but this should be weighed against the fact that gradual repayment of external debt could help reduce external debt

**Figure 10. Lesotho: Reserve Accumulation and Public Debt**

(LHS: months of imports; RHS: Percent of GDP)




Source: Authorities' data and IMF staff calculations.

[6] From Lesotho's current creditors, the concessional rates range from zero to 2.5 percent.

vulnerabilities, and that maintaining some issuance of domestic debt would support the development of the local securities market.

**31. The stabilization fund should be firmly anchored within the broader fiscal rules framework.** A credible fund requires strong commitment to fiscal discipline, which should be enforced directly at the budget level and fully integrated into the medium-term fiscal framework (MTFF). Transparent and rule-based deposit and withdrawal mechanisms are essential to ensure predictability and safeguard against ad hoc political pressures. Such design features also enhance fiscal credibility and build public trust.

**32. Given Lesotho's macroeconomic volatility and development needs, the fund could be structured with dual objectives: stabilization and investment.** The stabilization component would serve to mitigate revenue volatility and support counter-cyclical fiscal policy—accumulating savings during periods of revenue windfalls and providing resources to finance temporary fiscal shortfalls during downturns. This would support expenditure smoothing and avoid procyclical fiscal adjustments. In parallel, the investment component would aim to build long-term fiscal buffers that could later be deployed to support growth-enhancing capital expenditure. Importantly, the dual-purpose design must ensure that stabilization needs are not crowded out by longer-term savings goals, particularly in a low-capacity, high-volatility environment like Lesotho's.

**33. Each component of the fund will require a distinct asset allocation strategy.** Assets held for stabilization purposes should be liquid and readily available to support the budget, and should therefore usually be invested in low-risk, highly liquid instruments. Conversely, the investment tranche can tolerate a longer time horizon and may pursue higher returns through a diversified portfolio, subject to prudent risk management. Clear operational guidelines, strong governance arrangements, and regular reporting will be critical to safeguard the fund's integrity and effectiveness.

## F. Experience from Chile

**34. Chile is recognized as a key international example for setting up a stabilization fund.** Since the introduction of its fiscal rule in 2001, Chile has demonstrated a strong track record of sound intertemporal fiscal management. The rule is frequently cited as a benchmark for fiscal responsibility and effective management of commodity-related revenue volatility (IDB, 2008; Sanchez, 2011). Of particular relevance to Lesotho, Chile successfully transitioned from high dependence on volatile copper revenues to a framework characterized by fiscal discipline, macroeconomic stability, and resilience to external shocks. Importantly, Chile's fiscal rule and stabilization mechanisms helped maintain debt levels well within sustainable thresholds over an extended period, offering valuable lessons for countries seeking to anchor fiscal policy amid revenue volatility.

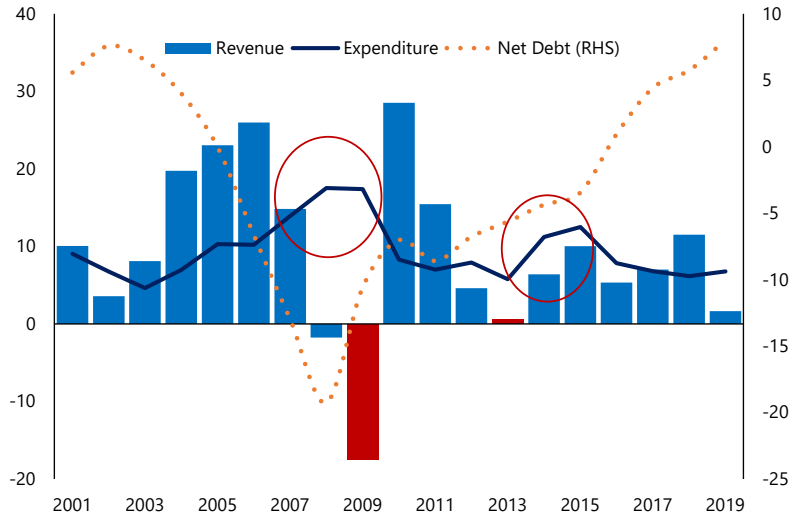
**35. Chile's adoption of a structural fiscal rule marked a pivotal shift toward strengthening fiscal sustainability and shock resilience.** In the aftermath of the early 1980s financial crisis, the country faced persistent fiscal deficits, including a widening pension system imbalance. In response,

the authorities introduced a fiscal rule in 2001 that targeted a structural surplus of 1 percent of GDP—serving as a self-insurance mechanism to mitigate fiscal risks and reduce dependence on debt. The rule was anchored on estimates of potential output and long-term copper prices, provided annually by two independent expert panels, lending credibility and transparency to the framework.

**36. The structural balance rule helped address procyclical fiscal management and allowed Chile to smooth expenditures across economic cycles.** Prior to the reform, fiscal policy had mirrored copper price cycles—expanding in booms and lacking sufficient adjustment in downturns. The rule corrected this by adjusting revenues cyclically while keeping expenditure fixed, enforcing discipline and predictability (Sanchez, 2011; Marcel, 2013). Structural surpluses were saved in two sovereign wealth funds—the Economic and Social Stabilization Fund (ESSF) and the Pension Reserve Fund (PRF)—which helped preserve macroeconomic stability and build buffers for future downturns.

**37. The rule's countercyclical design proved effective during major shocks, enabling Chile to maintain fiscal credibility while adapting to changing conditions** (Figure 11). Surpluses accumulated during copper price booms were deployed to finance deficits during the 2008 Global Financial Crisis and the 2014 commodity price crash, allowing the government to avoid abrupt austerity measures. Despite a temporary decline in the overall fiscal balance to -4.3 percent of GDP, Chile maintained prudent fiscal management and adjusted its structural target over time—from 1 percent to 0.5 percent, and later to balance—demonstrating the rule's built-in flexibility while preserving its anchoring role for fiscal policy.

**Figure 11. Chile: Revenue and Expenditure Growth**
(LHS: Percent Growth: RHS: Percent of GDP)

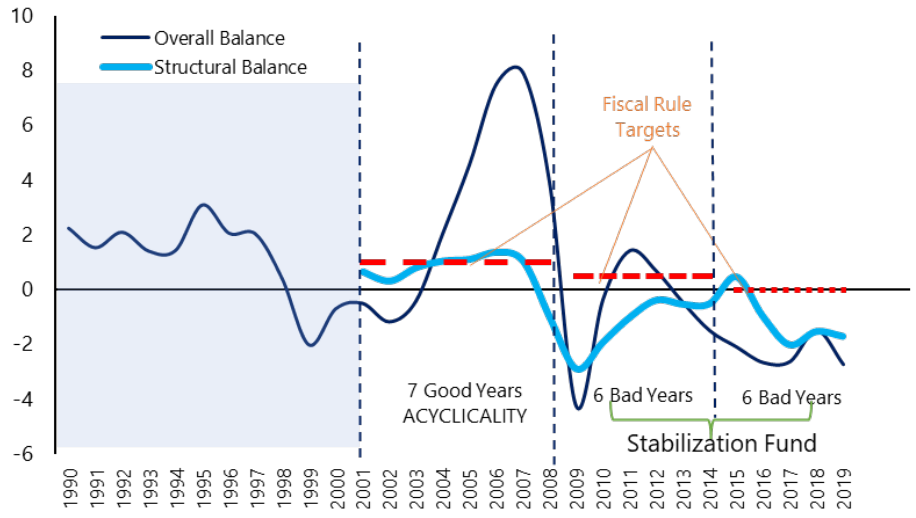



Source: Authorities' data and IMF staff calculations.

**38. Chile's fiscal rule successfully delinked public expenditure from revenue cycles, particularly during commodity-driven booms, and helped maintain prudent fiscal management** (Figure 12). Prior to the rule, expenditure growth often outpaced revenues, reinforcing procyclical patterns. However, in the first six years after the rule's adoption, despite average revenue growth of around 15 percent driven by rising copper prices, expenditure growth was contained to under 9 percent. During subsequent shocks—such as the 2009 global financial crisis and the 2014 copper price collapse—the government avoided abrupt fiscal consolidation by drawing on savings accumulated in the ESSF. This allowed Chile to preserve priority expenditures and maintain macroeconomic stability. Debt levels were kept within prudent bounds, with gross debt declining to

as low as 4 percent of GDP in the pre-crisis period and net debt contained within a 20 percent anchor (Figure 13). The stabilization fund served as an effective buffer, enabling a countercyclical response and sustaining investor confidence in the fiscal framework.

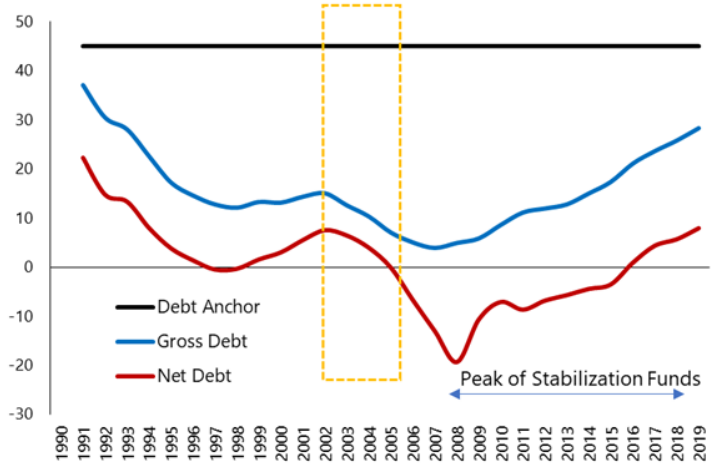
**Figure 12. Chile: Structural Balance Rule**
(Percent of GDP)




Source: Authorities' data and IMF staff calculations.

**39. Chile's experience offers valuable lessons for the design and implementation of fiscal rules and stabilization fund in Lesotho.** First, Chile addressed revenue volatility—stemming largely from copper exports—by adopting a structural balance rule that adjusted revenues for long-term trends in copper prices, thereby limiting fiscal fluctuations outside of large external shocks. A similar approach in Lesotho, where SACU transfers are highly volatile, would help smooth budget execution and support more stable expenditure planning. Second, Chile's fiscal rule helped embed discipline into the budget process, curbing procyclical and ad hoc spending while channeling windfall revenues into the ESSF. This approach not only enhanced macro-fiscal stabilization but also strengthened budget credibility and reduced the scope for off-budget mechanisms—reforms that could usefully support Lesotho's efforts to curb arrears and improve PFM practices. Finally, Chile anchored its fiscal framework with a debt sustainability objective, maintaining public debt well below

**Figure 13. Chile: Debt Management**
(Percent of GDP)




Source: Authorities' data and IMF staff calculations.

its 45 percent of GDP target for much of the pre-pandemic period. This offers a relevant example of how a credible fiscal rule can help maintain investor confidence, contain financing costs, and provide a durable anchor for long-term fiscal sustainability.

## G. Conclusion

**40. Lesotho currently faces a critical opportunity to strengthen its fiscal framework and enhance macroeconomic resilience through the adoption of a credible, legally binding fiscal rule.** The recent emergence of fiscal surpluses—unusual in a context of longstanding fiscal pressures and mounting external risks—offers a rare chance to anchor expenditure to structural revenues and save excess receipts for future stabilization. The government should seize this momentum to institutionalize fiscal discipline by establishing a rules-based framework and a stabilization fund. Doing so would help address entrenched challenges such as wage bill rigidities, domestic arrears, and debt accumulation. As demonstrated by international experience—particularly Chile—countercyclical fiscal frameworks can yield durable macroeconomic benefits and improve fiscal management credibility.

**41. Model-based calibration results suggest that a fiscal framework anchored on a debt ceiling of 60 percent of GDP, a debt anchor around 50 percent of GDP, and a structural deficit rule of 3 percent of GDP—alongside expenditure operational rules—would support fiscal sustainability while preserving space for priority spending and cyclical responses.** Implementing such a framework would promote greater fiscal transparency, strengthen medium-term budgeting, and reinforce political ownership of fiscal consolidation. Over time, these institutional improvements can help break the cycle of procyclical spending and foster a more predictable fiscal environment. Periodic—but infrequent—review of the rule parameters may be appropriate to maintain relevance while preserving credibility.

**42. The stabilization fund should be explicitly anchored within the fiscal rules framework and designed to serve dual purposes—short-term stabilization and long-term investment.** This dual objective will allow the fund to cushion economic shocks, maintain the exchange rate peg, and support capital spending once implementation capacity improves. International experience underscores the importance of adequate liquidity buffers in enhancing policy space during downturns. Chile's example illustrates that combining fiscal rules with a well-managed stabilization fund can help build solvency, credibility, and institutional resilience. For Lesotho, embedding such a framework will be essential to address structural bottlenecks, improve investment planning, and strengthen the role of fiscal policy in promoting inclusive and sustainable development.

# Annex I. Calibration of Overall Balance and Primary Balance[1]

**Approach 1: Convergence in the Long Term**

This approach derives the fiscal balance that would lead to a gradual convergence toward the debt target in the long term. Overall balance or primary balance can be given as:

$$b^* = \lambda d^*$$

where $b^*$ represents either balance in percent of GDP, $d^*$ is a given debt-to-GD target, and $\lambda$ takes the form of $\frac{-\gamma}{1+\gamma}$ for an overall balance target, or $\frac{i-\gamma}{1+\gamma}$ for a primary balance target, where $\gamma$ is the nominal GDP growth over the long term. $i$ represents the nominal interest rate paid on public debt.

**Approach 2: Convergence by a Given Date**

This approach is similar to Approach 1, except that the $b^*$ is calibrated that that debt ratio hits its target $d^*$ after $N$ years. The equation is given as:

$$b^* = \frac{\lambda}{(1+\lambda)^N - 1}[d_0(1+\lambda)^N - d^*]$$

**Approach 3: Convergence by a Given Date Following a Transition Period**

This approach adds another layer of flexibility compared to Approach 2 by allowing for an initial transition period in which the balance gradually converges to its target. The numbers of years of the transition $T$ is exogenously given. The equation is given as:

$$b_t = \begin{cases} \alpha t + b_0, when\ 0 < t < T \\ \alpha T + b_0 = b_T^*, when\ T \leq t \leq N \end{cases}$$

where $\alpha$ represents the annual constant amount adjusted until it reaches the target $b_T^*$ after $T$ years. If $b_T^*$ is maintained afterward, this will ensure convergence to the debt target by the end of year $N$.

[1] Eyraud et al, 2018.

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# UNLEASHING PRIVATE SECTOR JOB CREATION: CHALLENGES AND OPPORTUNITIES FOR LESOTHO[1]

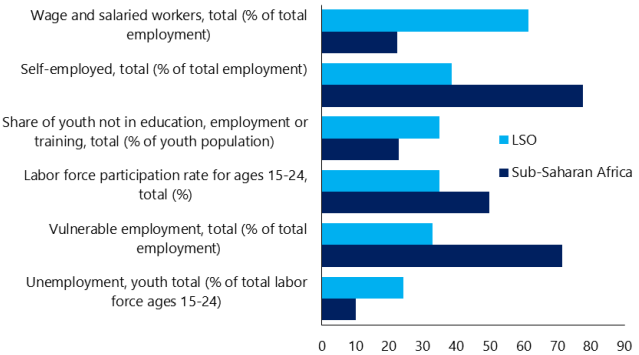
*Lesotho's public sector led growth and employment model has struggled to develop a flourishing labor market, and recent external shocks have made developing job-rich growth an even more urgent priority. The primary challenge is a lack of labor demand due to a small, undiversified private sector and steep barriers to firm growth. Nonetheless, labor supply issues, including skills mismatches also compound the challenge. Addressing this issue will require a concerted effort on multiple policy fronts; combining public-sector reform, business-environment reform, expanding financial access for firms, better skills matching, and careful macroeconomic management.*

## A. The Employment Landscape in Lesotho

**1. For decades, Lesotho has operated a public sector led growth and employment model that has failed to deliver increased living standards**. At 53 percent, Lesotho has one of the highest public expenditure to GDP ratios in the region, and 17 percent of GDP is spent on public sector wages alone (2024 estimates), accounting for 72 percent of tax revenue. Yet GDP per capita has fallen 14 percent between 2016 and 2023, with Lesotho possessing one of the lowest per-capita growth rates amongst its peers. Over half of the economy's formal workers are public sector employees and they earn, on average, over four times the median private sector wage (ILOSTAT, Lesotho 2023 SIP). The key engine for growth has been a series of mega projects, most recently the Lesotho Highland Water Project Phase II (LHWP-II). These projects tend to be capital intensive and source most of their workers and inputs from abroad, so spillovers to local employment and firms are small. Other key sectors, for example water exports and diamond mining, contribute significantly to GDP but generate little employment. The lack of job intensity from growth drivers matches regional trends: sub-Saharan African growth is not as job intensive as elsewhere in the world (IMF 2024).

**2. Consequently, the labor market is marked by high unemployment, high informality, high poverty and a reliance on remittances** (Figures 1 and 2). The unemployment rate is high, estimated at 16 percent in 2024 versus 6 percent in Sub-Saharan Africa and 5 percent for emerging market and developing economies (EMDEs) around the world (ILOSTAT). Only 60 percent of people

**Figure 1. Lesotho: Key Labor Indicators**
(Latest Available Value; Modeled ILO Estimate)




Source: World Bank, World Development Indicators, and IMF staff calculations.

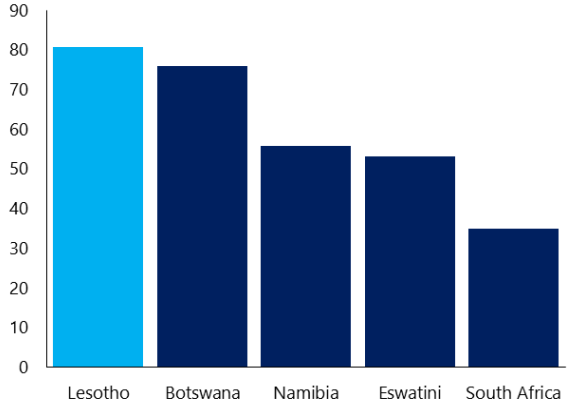
[1] Prepared by Athene Laws and Ann-Alice Ticha.

participate in the labor market (versus more than 70 percent for sub-Saharan Africa), and of those, nearly 80 percent are informally employed. Nearly four in ten people live in extreme poverty on less than $2.15 per day (World Bank 2025). With limited local jobs, many Basotho emigrate in search of better opportunities, sending over 20 percent of GDP home in remittances every year. While the humanitarian impact of remittances is essential, they are limited in their ability to drive jobs-rich, balanced growth (World Bank 2025).

**3. On top of these structural challenges, Lesotho faces a deteriorating external environment around trade, aid, and geopolitics**. Textiles has been a key sector for lower-skilled employment yet shrunk from a peak of 60,000 workers to around 30,000 currently due to declining global competitiveness, and an uncertain future outlook. In particular, textiles dominate exports to the United States (which account for near 10 percent of GDP) and could be severely impacted by possible trade policy changes—the African Growth and Opportunity Act (AGOA) may not be extended upon expiration in September, and potentially steep tariffs on exports to the United States are under discussion. Large cuts to official development assistance also include the possible cancellation of the Millenium Challenge Compact (MCC), which had been anticipated to kickstart significant private sector growth and increase employment opportunities in new sectors. Deepening geoeconomic fragmentation could also reduce growth in key trading partners, most notably South Africa. In light of this daunting outlook, there is an urgent need for private sector led job creation.

**4. The primary challenge in Lesotho is a lack of labor demand.** Given that public sector dominance has not generated the desired employment and living standard outcomes, Lesotho must switch gears toward enabling more private sector job creation. However, the private sector is small, undiversified, and subject to considerable constraints. At a macro-structural level, the economy is concentrated in a small number of low value-added sectors (Section B). At the micro-level, private firms are constrained by barriers including limited financial access, corruption, policy instability, and informal sector practices (Section C). A secondary challenge is a labor supply mismatch, particularly for key skills, with individual workers facing challenges in accessing the labor market – most notably women and youths (Section D). A broad suite of policies targeting these barriers will be required, which in turn will require a sustained multi-year reform agenda (Section E).

**Figure 2. Lesotho: Informal Employment**
(Latest Available Value; Percent of Total Employment)




Source: International Labor Organization and IMF staff calculations.

**5. A concerted, coordinated effort could change this bleak picture.** A feasible reform scenario that incorporates macro-fiscal reform could increase growth by 1.5 percentage points (2025 Article IV upside scenario). Using estimates of the median elasticity between growth and job creation for sub-Saharan African (IMF 2024), this growth

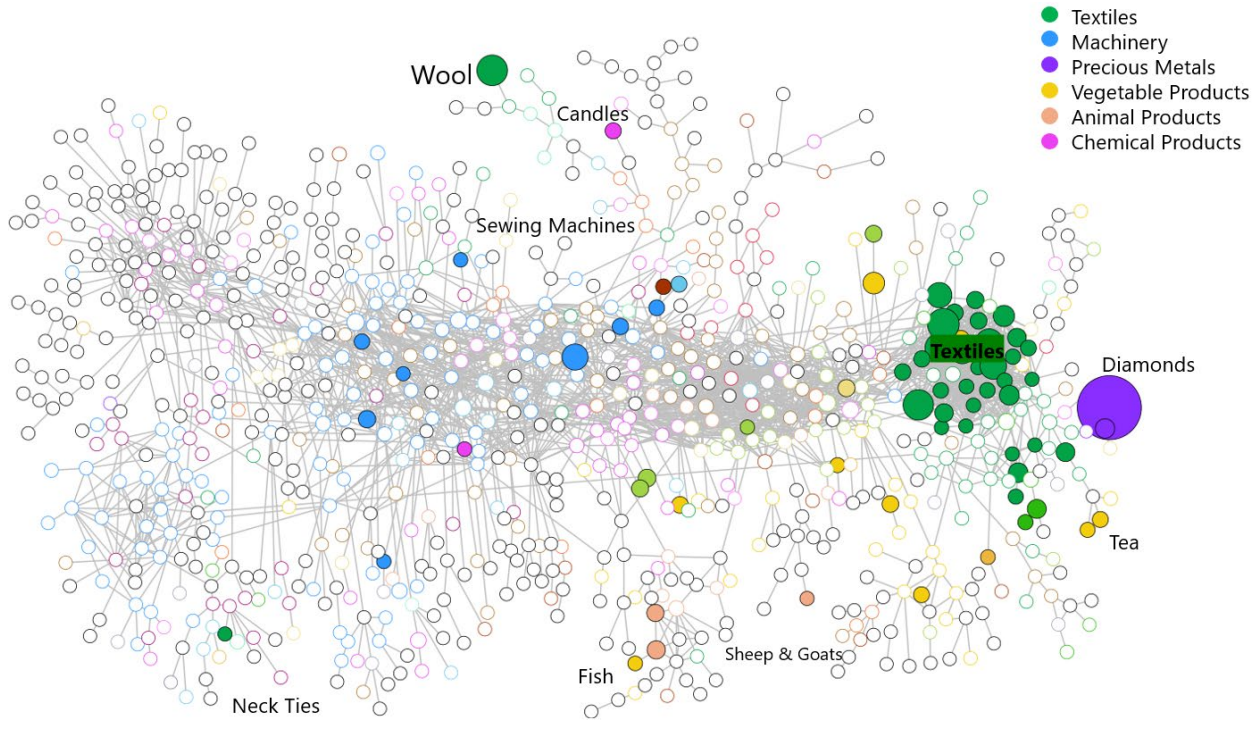
increase could be associated with the creation of 4,800 jobs per year. However, sub-Saharan Africa's growth is not job intensive as elsewhere in the world, generating only one-third the number of jobs seen in emerging markets and developing economies elsewhere. If comprehensive reforms boost the job-intensity of growth to levels seen outside the region, the same 1.5 percentage point increase in growth could create 14,000 jobs per year. Quantitatively, this would rapidly be enough to counteract the jobs lost through the recent shocks.

## B. Macro-structural Barriers to Job Creation: Economic Activity is Concentrated, Limiting Structural Transformation

**6. At the macroeconomic level, the economy is overly reliant on a few key sectors.** Figure 3 plots the product space of Lesotho and the linkages between different sectors in a network map. More central nodes are more connected—meaning there are more related industries to move towards. Lesotho's output is dominated by a small number of more peripheral (less connected) product clusters: most notably textiles, diamonds, wool, some machinery manufacturing and limited food and beverage manufacturing. A more diversified economy would have a greater number and spread of sectors, with more products located at the center of the chart.

**Figure 3. Lesotho: Product Space Network**
(Lesotho, 2023)

*Lesotho's product space is defined by a cluster of products surrounding the textile industry and a few marginal products. To build a more resilient economy, the product space needs to diversify and move more towards the center where tight connections will help maintain agility even during sectoral shocks.*



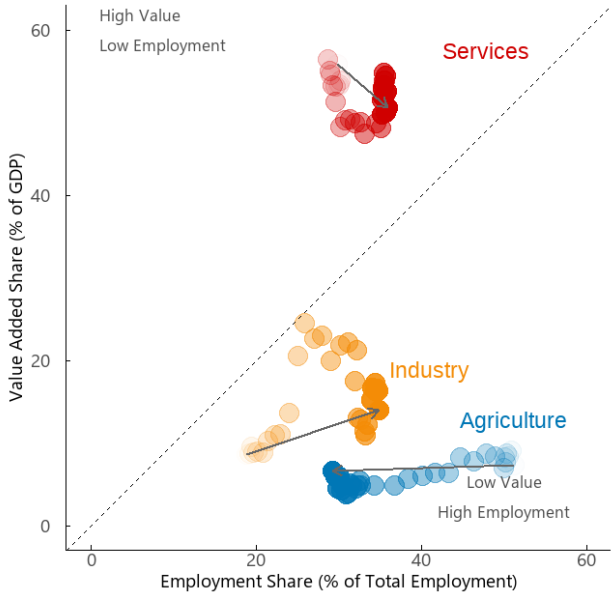

Source: Observatory of Economic Complexity, Lesotho Country Card and IMF staff.

**7. Several key sectors are at the start of the value chain and not well connected to other potential products.** Raw diamond mining and wool, for example, are large sectors that are located on the fringes of the network, limiting the opportunities to move into related industries. These sectors tend to also be at the bottom (upstream) of value chains, which typically offer less value added than higher (downstream) value chain stages. Bhorat and others (2019) outline how moving towards more complex, connected products tends to boost productivity, growth and resilience in an economy, allowing it to move up the value chain. However, it is much more difficult to enter industries that are less related to a country's existing product space. As such, it is more feasible to shift towards more central nodes of the existing product space and then move sideways to other related industries.

**8. The textiles sector is the largest, more centrally located product cluster, but current trends suggest that even this advantage is at risk**. If large trade shocks or declining competitiveness accelerate the downward trend in textile exports, the opportunities to move sideways into related manufacturing products will diminish. Food and beverage manufacturing and machinery manufacturing are other central sectors, but their scale in Lesotho is very small at present. So currently, Lesotho's economy risks not only losing its key existing employment industry, but also its ability to diversify easily into related industries.

**9. Structural transformation has been limited, keeping the economy in a low productivity job trap.** Structural transformation refers to the movement of workers and economic activities from low value-added activities into high value-added activities, for example from basic agriculture into manufacturing or modern services. This pattern has been observed in EMDEs around the world, but only to a lesser extent in sub-Saharan Africa (IMF 2024). In Lesotho, there is very weak evidence of structural transformation. Figure 4 plots the relative shares of employment and value added, with points above the 45-degree line indicating relatively productive sectors (a higher share of value added than employment), and points below the 45-degree line indicating relatively less productive sectors. The least productive sector, agriculture, has shed some employment share as workers have moved into services and industry since the early 1990s. However, the evolution in productivity shares does not reflect effective structural transformation. Industry's share of value added has not increased proportionally with its employment

**Figure 4. Lesotho: Limited Structural Transformation**
(Value Added vs. Employment Share by Sector in Lesotho, 1991-2023)



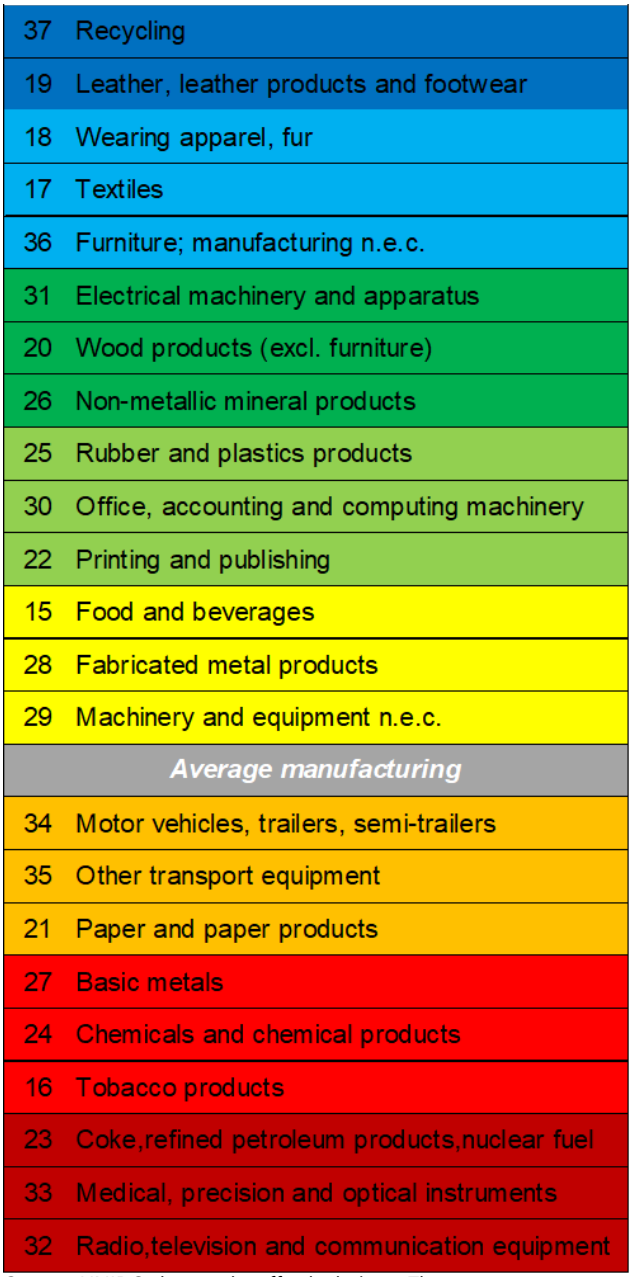

Source: World Bank, World Development Indicators and IMF staff calculations.

growth, indicating a deterioration in its relative productivity. Productivity in services is even more sobering: despite its share of employment increasing, the share of value added has fallen. Overall, the economy has not transitioned towards more productive sectors as hoped.

**10. Structural transformation requires moving up the value-added chain and diversifying, but not all high value sectors come with employment intensity.** Many high value-added sectors (e.g. mining, clean energy) are by their nature capital intensive, not labor-intensive. To illustrate, Figure 5 shows the labor intensity of all 2-digit manufacturing sectors internationally – services are excluded due to a lack of reliable data. One of Lesotho's key industries, textiles, is one of the most labor-intensive industries internationally. Others, such as food and beverage and machinery manufacturing, are still above average. Manufacturing of raw materials, most relevant to Lesotho's diamond industry, is one of the least labor intensive. Nonetheless, even lower-employment intensity sectors can generate employment spillovers through ancillary industries and local demand.

**11. Modern day structural transformation will look different to the past.** In historical episodes of economic change (for example East Asia in the twentieth century), workers moved out of basic agriculture into manufacturing and, later, modern services. However, technological change has meant manufacturing is less labor intensive than in the past, thus past patterns for generating mass employment are less easy to replicate (Rodrik 2016, 2022). Fortunately, there are several other industries that provide potential, sometimes called 'Industries Without Smokestacks' (Page 2020). These

**Figure 5. Lesotho: Job Intensity by Manufacturing Sector**
(2019; 2-Digit Manufacturing Sectors Ranked by Employment to Value Added)




Source: UNIDO data and staff calculations. The survey covers manufacturing firms around the world. Results are similar focusing exclusively on SSA economies.

feature a degree of labor intensity, scope for productivity growth and export capacity, and include: modern services such as tourism and financial services, high value agriculture and agro-processing.

**12. Tourism, one of Lesotho's most promising potential industries, but is overly constrained.** Tourism is a job intensive industry, and Lesotho's natural environment, cultural history and location in the Southern African tourist region present significant tourism growth potential, particularly in rural areas (UN 2023). Key barriers include inadequate infrastructure, with poor road and electricity access hampering investment and development of potential tourist sites. Air connectivity is also limited and expensive while more cost-effective bus options take long, indirect routes, making travel to Lesotho more challenging. Trains could be another alternative, but currently only provide freight services. The visa process is also a significant hurdle, with high costs and an unreliable online system. Additionally, the reliance on South African statistics for traveler data and the lack of comprehensive internal data collection pose challenges for effective planning and development. Political influences on infrastructure development decisions further complicate efforts to improve access to tourist sites. Despite being situated in a heavily tourism-focused region, Lesotho has been unable to capitalize on regional tourism opportunities due to these challenges.

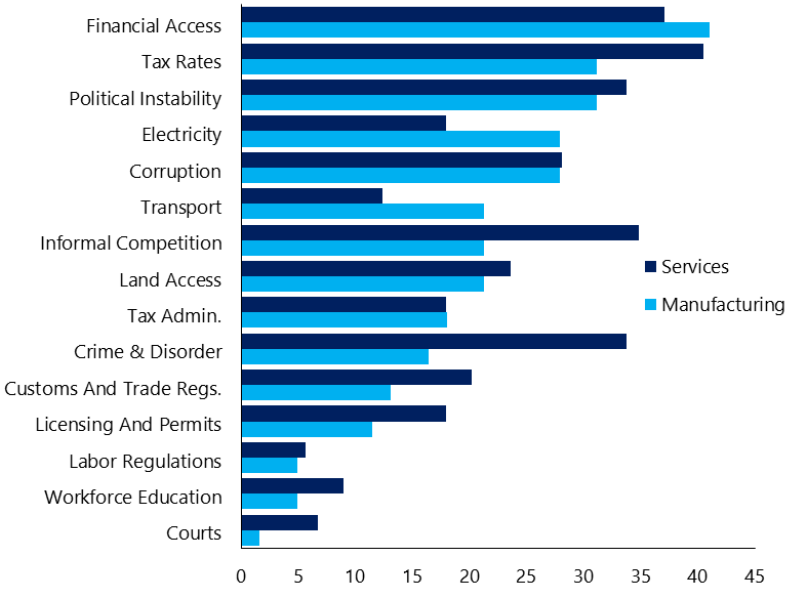
**13. Agro-processing and agricultural-product related manufacturing are other examples of potential, but currently constrained, diversification.** Lesotho holds significant potential in the horticulture, herbal (e.g. rosehip oil), natural cosmetics, honey and food processing industries, but these are struggling to scale upward appropriately. Rural infrastructure deficiencies are a key challenge here with insufficient irrigation, quality roads, rural logistics hubs, and cold chain storage. Meeting and certifying international standards are further challenges; the country has no current laboratory able to certify International Standards Organization (ISO) requirements. Various development partners, including the MCC and German Corporation for International Cooperation (GIZ), are supporting the development of industry specific national standards and the African Development Bank is funding a local standards lab to be built in the coming years. Businesses also struggle with the lack of a functioning e-commerce platform in Lesotho, because the current national payments system is not compatible with online payments. Reaching larger markets is therefore much more difficult.

## C. Firm-level Barriers to Job Creation: Firms Face Many Barriers to Growth

**14. Micro, small and medium enterprises (MSME) are a key source of employment in Lesotho.** The MSME sector employed an estimated 360,000 people in 2023, with 55 percent of MSMEs owned by women (FinScope, 2025). Almost half of MSMEs are in the wholesale or retail sector, with a further 20 percent in agriculture and 17 percent in manufacturing. Most are informal, but the formalization rate did increase from 18 percent in 2016 to 24 percent in 2023. These firms tend to be very small, with average monthly turnover ranging from USD $390 in manufacturing firms to USD $1,100 in household firms. Eighty-two percent are informal firms (unregistered), with half of those reporting the primary reason for informality is their small size. Many state they would formalize if registration were free, there were clear benefits explained to them, or if they had more information.

**15. But MSMEs struggle to grow into larger enterprises that can employ more people.** Internationally, job creation is often most marked in medium to large firms, and these firms tend to pay higher wages and drive productivity growth. A large body of literature posits a 'missing middle' for firm size in Africa, with an overabundance of micro and small firms that struggle to scale up (see, for example, Abreha and others 2022). Comprehensive data is limited, but it similar issues are likely in Lesotho. Many of the large firms present in Lesotho are subsidiaries of South African parent companies and respond primarily to South African conditions. To understand the barriers preventing MSMEs growing, multiple firm level surveys have been undertaken, including the World Bank Enterprise Surveys (Figure 6) and the B-READY surveys.

**Figure 6. Lesotho: Self-Reported Obstacles to Firm Growth**
(Percentage of Firms Reporting Major or Very Severe Obstacles)




Source: World Bank Enterprise Survey and IMF staff calculations.

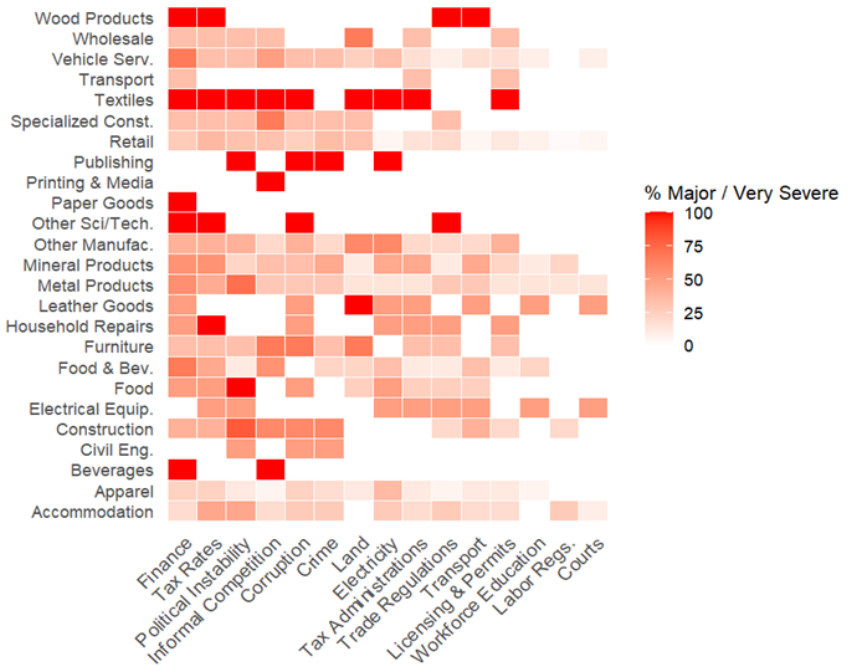
**16. Firms report access to finance as the primary barrier to growth, followed by a range of political and governance challenges.** Around 40 percent of firms report that accessing finance is a major or very severe obstacle (Box 1). Many firms also report political and governance challenges as key barriers, which mainly reflect concerns over regulation, tax rates, corruption, and political instability. In contrast, Lesotho performs relatively strongly for the effectiveness of the court system and its labor regulations, which is confirmed by the World Bank's B-READY analysis.[2] Adequacy of education is also not a key constraint, pointing again to the key role of labor demand, rather than labor supply, as Lesotho's main challenge.

[2] Several disclaimers are noted for the B-READY scores. The scores could be biased, reducing compatibility across indicators and economies, since the computed scores under the Regulatory Framework and Public Services pillars are mainly collected through expert questionnaires using a small sample of responses (up to five per topic). There are inevitable inconsistencies in raw data, given the significant disparities in development levels and contextual differences among countries. Since the enterprise survey currently includes data only from registered firms, B-READY does not provide insights into the informal sector. The methodology is expected to be refined and evolve through additional iterations and feedback during the three-year rollout phase, from 2024 to 2026. Therefore, comparability across time may be reduced. Complexity in the methodology can reduce transparency. The questionnaires and surveys are not conducted within the same timeline. Survivorship bias is one of the caveats for the interpretation of results obtained from firm-level surveys (the report already acknowledges this caveat).

**17. Lesotho's overall business environment is unfavorable.** It takes an average of 15 days to obtain an operating license, 73 days to obtain an import license and 78 days to obtain a construction related permit, all well above the SACU average (World Bank B-READY). Export-oriented firms have also identified the difficulties in obtaining employment visas and exchange restrictions. Many firms in the B-READY survey report having to pay unofficial 'compliance fees' to receive permits and services. Transparency International scores Lesotho at 37 out of 100 on the Corruptions Perception index in 2024, a score that has steadily declined since 2012.[3] Moreover, given the dominance of the public sector, inefficiencies in government tendering, from a lack of competition and delayed payment, also shape the business environment. Firms in the B-READY survey perceive that government tender requirements are difficult to comply with. Even in cases where firms successfully win the tender, it takes 152 days for firms to receive payment under government contract (more than twice the sub- Saharan African average). B-READY also assesses market competition as weak, perhaps reflecting the small size of the economy. Streamlining the tax and licensing systems, and leveraging digital tools can be effective at unburdening administrative procedures and tracking compliance (World Bank 2024).

**Figure 7. Lesotho: Self-Reported Obstacles to Firm Growth by Industry**

(Percentage of Firms Reporting Major or Very Severe Obstacles)




Source: World Bank Enterprise Survey and IMF staff calculations.

**18. Competition from the informal sector compounds the weak business environment.** Lesotho's high degree of informality is driven by weak institutional support, limited access to finance, and a lack of incentives to formalize. Insufficient levels of 'carrots' (incentives to formalize)

[3] The CPI does not tell the full story of corruption in a country, only the level of corruption in the public sector in the past two years. CPI scores before and after 2012 are not strictly comparable, given the change in methodology in 2012.

and 'sticks' (enforcement) are present. Indeed, four in five informal sector firms state they would be willing to formalize if registration were free, they understood clear benefits, or it was less time consuming (Finscope 2025). The government recently announced free registration for youth led businesses, which is a step in this direction. Formalization also becomes more attractive if it enables greater access to finance, social protections and public procurement opportunities (ILO 2025).

**19. Despite its natural endowments, reliable and accessible electricity is another private-sector bottleneck.** Despite having one of the lowest electricity prices for businesses in the region, operational inefficiencies and financial shortcomings of the Lesotho Electric Company (LEC) have undermined reliability and accessibility.[4] About 65 percent of businesses experience electricity outages. The effects on operations are exacerbated because only about a quarter of Lesotho's businesses have access to a back-up electricity generator, compared to nearly half of sub-Saharan African firms (World Bank B-Ready). Furthermore, is takes a long time for business owners in Lesotho to obtain an electrical connection: 52 days versus the SACU average of 38 days. Consequently, about 30 percent of businesses identified electricity as a major to severe obstacle. In addition, the USA ITA estimates that only one-fifth of a potential 450 MW is currently utilized. Efficiently exploring the renewable electricity potential could ensure a stable, plentiful and cheap domestic supply and export capacity, generating a key business environment advantage for Lesotho in an electricity constrained region. Deep reforms to the electricity market and LEC governance are required to establish an efficient, accessible and reliable electricity sector that supports foreign direct investment.

**20. These barriers are broadly shared across industries and geographic locations** (Figure 7). There is some variation – manufacturing, for example, is more constrained by electricity than services, while crime, theft and disorder matter more for services. Many barriers are exacerbated in rural areas - for example access to finance, internet and electricity are even more binding for rural businesses (FinScope 2025). In general, the strong correlation of barriers implies that addressing the steepest barriers will benefit a wide swath of Lesotho's private sector.

[4] Electricity prices for businesses in Lesotho are about 0.021USD/kWh, well below the African average of 0.123USD/kwh (Global Petrol Prices). While on paper an advantage for businesses, the prices are artificially low, with LEC importing around 50 percent of the nation's total electricity demand from South Africa and Mozambique and selling at a loss. LEC declared bankruptcy in 2025, underscoring the precarious nature of the electricity sector in Lesotho.

**21. Moving from survey impressions to actual outcomes, empirical analysis shows that firms employ fewer people and experience slower revenue growth when faced with these barriers.** Firm level data on revenue, employment and reported barriers are used to measure the impact on business performance (see Amine and others, forthcoming). Firstly, principal component analysis consolidates all the barriers into seven key areas: financial constraints, informal competition, corruption, inadequate labor education, weak business environment, inadequate infrastructure and lack of security. Then, the three-year growth rate of employment, or revenue, is regressed on these indexes. Even accounting for the small sample size of Lesotho's data, the results in Table 1 show that a one standard deviation increase in financial constraints in Lesotho are associated with a drop in firm employment growth by 0.5 percent over three years. Negative employment effects are also found at the SACU level for informal competition, corruption, and inadequate education. Addressing these barriers is therefore critical to unlocking employment growth in Lesotho.

**Table 1. Lesotho: Regression Results: Growth Constraints in Lesotho and SACU**
(Dependent Variables: Employee and Sales Growth)

| Variable | LSO: Employee Growth | SACU: Employee Growth | LSO: Sales Growth | SACU: Sales Growth |
|---|---|---|---|---|
| Financial Constraints | -0.512** | -0.0129 | -0.656** | -0.156*** |
| *Financial Constraints (Robust SE)* | *(0.258)* | *(0.0324)* | *(0.302)* | *(0.0316)* |
| Informal Competition | -0.146 | -0.148*** | -0.0189 | -0.240*** |
| *Informal Competition (Robust SE)* | *(0.125)* | *(0.0407)* | *(0.149)* | *(0.0477)* |
| Corruption | -0.269 | -0.310*** | -1.586 | -0.592*** |
| *Corruption (Robust SE)* | *(1.719)* | *(0.0708)* | *(1.747)* | *(0.0737)* |
| Inadequate Labor Education | -0.143 | -0.0748* | -0.479** | -0.139*** |
| *Inadequate Labor Education (Robust SE)* | *(0.156)* | *(0.0391)* | *(0.195)* | *(0.0483)* |
| Inadequate Infrastructure | -0.0731 | 0.0898** | 0.0166 | 0.220*** |
| *Inadequate Infrastructure (Robust SE)* | *(0.102)* | *(0.0422)* | *(0.134)* | *(0.0528)* |
| Weak Business Environment | -0.0495 | 0.0841** | -0.398** | 0.00704 |
| *Weak Business Environment (Robust SE)* | *(0.148)* | *(0.0365)* | *(0.171)* | *(0.0449)* |
| Lack of Security | 0.152** | 0.0553* | -0.0339 | 0.0143 |
| *Lack of Security (Robust SE)* | *(0.0775)* | *(0.0282)* | *(0.0929)* | *(0.0317)* |
| Constant | 1.993 | 0.391 | 5.340*** | 2.305*** |
| *Constant (Robust SE)* | *(1.218)* | *(0.255)* | *(1.299)* | *(0.296)* |
| Observations | 451 | 4,225 | 451 | 4,225 |
| R-squared | 0.073 | 0.110 | 0.121 | 0.199 |

**Note:** Robust standard errors in parentheses. *** p < 0.01, ** p < 0.05, * p < 0.1

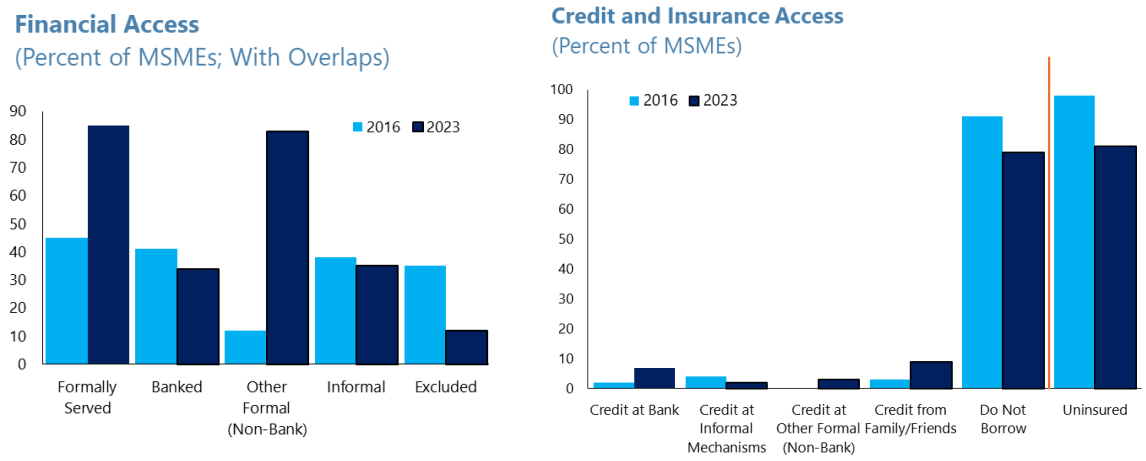
Source: World Bank Enterprise Survey and IMF staff calculations.

### Box 1. Lesotho: Financial Access is a Key Job Creation Bottleneck

**Lesotho's financial sector is shallow and highly concentrated, with few funds directed towards private sector firms.** The financial sector is dominated by four commercial banks—three subsidiaries of South African banks and one state-owned bank—which primarily serve salaried individuals through payroll-based personal loans, and which therefore have limited engagement in corporate or MSME lending. The banking sector is characterized by excess liquidity, limited competition, and a narrow product offering. Non-bank financial institutions (NBFIs), including microfinance institutions (MFIs), insurance providers, and savings and credit cooperative societies (SACCOs), play a marginal role in business finance. Capital markets are nascent, with only one equity listing on the Maseru Securities Market.

**While financial access for individuals has seen gains in Lesotho, firm access remains a key barrier to growth.** The advent of mobile money has significantly enhanced individual financial inclusion. As a result, 7 percent of Basotho had financial access in 2021, up from 60 percent in 2011 (Finscope 2024). However, access for firms remains very limited, and two thirds of firms highlight insufficient operational cash flow as a key challenge (Finscope 2025). Only 17 percent of MSMEs have a formal bank account and only 10 percent receive credit from a formal financial institution in 2023 (Finscope 2025). Most MSMEs instead rely on mobile money (66 percent) for transactions, and informal mechanisms for saving and credit. Banks report SME lending as too high risk, with limited bankable projects, and instead focus on FDI and state-level projects. SACCOs provide localized business finance through their cooperative structure, but they are limited in scale. Banks, in turn, do not leverage SACCOs local networks and enforcement as intermediation to scale lending. There is an insurance gap too with 89 percent of firms not covered for any personal or business risk.

#### Box Figure 1. Lesotho: Access to Finance and Credit in Lesotho




Source: Lesotho FinScope 2025 and IMF staff calculations.

**A variety of factors ensure banks are hesitant to enter the credit business and assume direct lending to firms.** The high degree of informality and lack of financial records by many firms inhibit lending—only 22 percent of MSMEs reliably keep financial records and only 18 percent are registered (Finscope 2025). In addition, Lesotho's credit infrastructure remains weak – only banks and the few largest NBFIs consistently share credit information to the bureau, and MSMEs are currently excluded from credit record coverage altogether - making it difficult for lenders to assess SME risk. Collateral is a further challenge: a lack of asset recognition and enforceability limits the opportunity for securing transactions. Steps have been taken here: the Lesotho Registry of Interest in Movable Assets (LERIMA) was launched in 2021, and the World Bank's CAFI project plans to launch a collateral registry, but lenders report usage challenges.

**Box 1. Lesotho: Financial Access is a Key Job Creation Bottleneck** (concluded)

Several government programs aim to support MSMEs and reduce risk – for example through direct grants, or through partial credit guarantee schemes (PCGs) – but grants are of low value, take up of PCGs is underwhelming, and fragmentation across the system hinders effectiveness.

**On the other side of the market, firms are hesitant to use products from formal financial institutions.** Financial literacy is a factor with many entrepreneurs unaware of the financial products available, unsure how to access them, or afraid to take on financial risks. Only 11 percent of businesses have a written business plan, and only 35 percent have a business budget (Finscope 2025). Only four in ten firms are aware of support organizations, such as the Basotho Enterprises Development Corporation (BEDCO), with even fewer utilizing services available. Lending terms are another barrier—33 percent of firms report "unfavorable rates, collateral, or procedures as main reason for not applying to loans" (B Ready Lesotho 2025). The lack of business insurance is similarly driven by perceived costs, and a lack of knowledge of how to obtain, or the types of insurance, available. These gaps in financial knowledge and capacity hinder MSMEs from engaging with formal financial institutions or scaling their operations.

**The authorities have developed a comprehensive reform agenda to address the challenges, and recent developments are encouraging.** Discussions with industry stakeholders in June 2025 highlighted some green shoots of financial deepening to MSMEs: the take up rate of the main partial credit guarantee scheme is increasing, and banks and NBFIs are experimenting with new MSME-focused lending products, such as operating loans based on signed government tenders. In addition, coordination across the key actors in the system (BEDCO, banks, MFIs, industry groups, development partners) appears to be improving. The authorities have put forward a comprehensive reform agenda in the National Financial Inclusion Strategy II (2024–28) and (forthcoming) Financial Sector Development Strategy II (2025–30). Key pillars include strengthening credit infrastructure (e.g., expanding credit bureau coverage to include MSMEs, integrating registries), enhancing public support instruments (e.g., reforming partial credit guarantee schemes, establishing a development finance institution), and promoting financial literacy through targeted education programs. The strategies also emphasize digitization, fintech regulation, and the development of inclusive financial products. Success will depend on sustained political commitment, effective institutional collaboration, and mobilization of resources from both public and private sectors.

## D. Worker Level Barriers to Job Growth: Individuals Face Barriers Entering the Labor Market

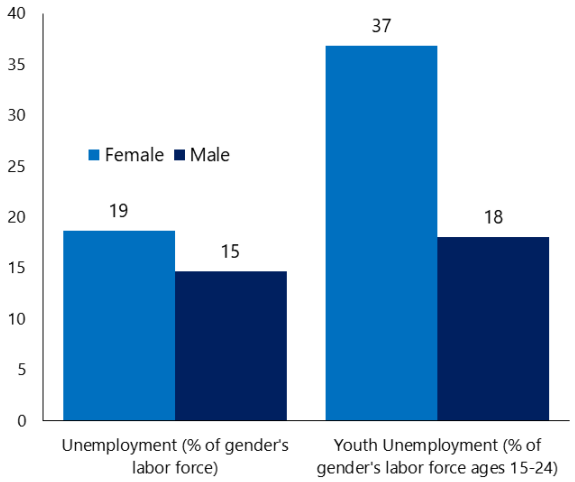
**22. Without established employment experience, youths struggle to enter the labor market.** The youth unemployment rate is 24.8 percent for 15–24 year olds versus 10.1 percent for sub-Saharan Africa (Figure 8). Furthermore, more than one in three youths are "neither in employment, education or training" (NEET) with the rate reaching over 40 percent for young women (ILOSTAT). Youths suffer from the experience paradox: the longer an individual is unemployed, the harder it can be to find employment as skills and networks atrophy (ILO 2024). And poor labor market outcomes early in a career are associated with poorer outcomes decades later. (ILO and ADB 2020, Kahn 2010). Youth in rural areas confront even steeper challenges: they have less access to job opportunities, and when employed they tend to have lower wages and are more likely to work in the informal sector. Generally, interventions linked to skills training and entrepreneurship are found to have a larger impact on youth labor market outcomes than employment services or subsidized employment (ILO 2025).

**23. Women face additional barriers, experiencing disproportionately poor labor market outcomes.** Across all age ranges, women face higher rates of unemployment than men. For example, 37 percent of young women are unemployed compared to 18 percent of their male counterparts (Figure 8). Labor force participation rates for women are lower (48.7 percent for women versus 67.7 percent for men in 2024), and the reliance on informal employment is higher (ILOSTAT). Lesotho has a high rate of female entrepreneurs relative to the sub-Saharan Africa average, but their businesses tend to be smaller, employ fewer people, operate in less-profitable sectors, and are subject to greater shocks (Cucagna and others 2025). The drivers of gender gaps align with many countries in sub-Saharan Africa, which include cultural, regulatory and legislative barriers (even with legislative progress, customary law differs), steeper domestic childcare responsibilities, early childbearing and maternal health challenges, and digital and financial access gaps (World Bank 2022; Kolovich and Newiak 2025). For example, maternal mortality was 478 deaths per 100,000 live births in 2020, significantly higher than the regional average, while 71 in every 1,000 girls aged 15–19 gave birth in 2023 (World Bank gender indicators). Women are far less likely to successfully access bank business loans; they are instead required to provide their husband's name and income statements, and are less likely to be approved than men, particularly if unmarried (Robakowski-Van Stralen and Roberts 2024).

**Figure 8. Lesotho: Unemployment by Age and Gender**

(2023; Modeled ILO Estimate; Percent of Gender's Labor Force)

*Women overall face higher unemployment than men, with female youth unemployment as high as 37 percent.*

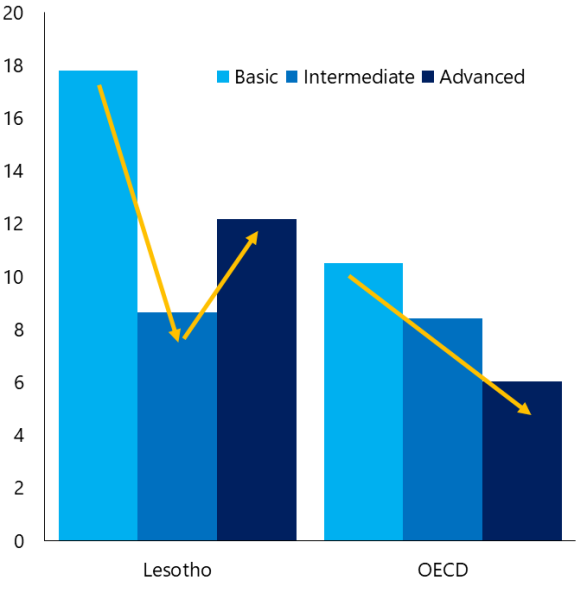



Source: World Bank World Development Indicators and IMF staff calculations

**24. Skills mismatch is also a barrier to employment**. Typically, unemployment rates around the world tend to fall for those with higher levels of education. However, in Lesotho, and sub-Saharan Africa more broadly, those with advanced levels of education have higher unemployment rates than those with

**Figure 9. Lesotho: Skills Mismatch – Unemployment by Educational Attainment**

(Latest Available Value; Percent of Total Labor by Educational Level)




Source: World Bank World Development Indicators and IMF staff calculations.

intermediate levels of education (Figure 9). This paradox is evidence of potential skills mismatch—a disconnect between what is taught and what employers require (ILO 2019). For example, two-thirds of tertiary graduates studied social sciences and education, while most private and public investment is oriented towards agriculture, manufacturing, tourism, and technology (Rasagam and others 2023). The skills mismatch in Lesotho is exacerbated by a lack of robust labor market data; there is no detailed understanding of which sectors are growing or what skills are in demand. Governance around skills development is fragmented. The Ministry of Labor lacks influence over training programs, which are often run independently by the Prime Minister's office without coordination or clear feedback mechanisms. Career guidance is weak, and training centers are under-resourced. South Africa's model of inclusive governance in skills development offers a useful regional example (Franz and Dulvy 2020). However, the extremely high youth unemployment in South Africa demonstrates that addressing the labor supply issues alone is insufficient for jobs to flourish.

## E. Policy Priorities to Spur Job Creation

**25. A coordinated, concerted structural reform effort is needed to spur private sector led job creation.** Broad-based structural reforms, sometimes called 'first generation reforms', are the priority. The most important set of these focus on unpicking the barriers to diversification and firm level growth. These should also be complemented by labor supply side policies that support job seekers and address skill mismatches. All of these will require a combination of learning from international best practice and tailoring to Lesotho specific circumstances. And it will require a long-term multi-year reform effort, placing an added premium on sustained political and social support. Measures to enhance effectiveness and build public trust include effective consultation and communication strategies to engage with stakeholders, explain trade-offs and discuss the importance of potential measures. Appropriate bundling, sequencing and pacing of reforms, with demonstrable upfront gains has been shown to improve chances of reform success (IMF 2024b, 2024c, 2025a).

**26. The dominance of the public sector means that fiscal-structural reforms are essential for private sector success.** The public sector will remain a key driver of economic activity but should switch roles: acting as an enabler of private sector development, rather than a substitute. Given the current role of large-scale construction and the growth benefits of effective infrastructure, improving public sector investment performance is a key issue. Capacity across the project management cycle must be built to improve capital budget execution, reduce delays, and generate stronger spillovers to the local construction economy. Public procurement should focus on efficiency and transparency, while the prevention of public sector arrears will improve direct links with private firms. Carefully addressing distortions from comparatively high public sector wages will address crowding out in the labor market.[5] In addition, government efforts to spur private sector

[5] Thevenot (2024) analyses the trade-offs and provides guidance on setting public sector wages.

development could be better coordinated, and all programs should be subject to transparency and evaluation throughout their lifecycle.

**27. Industrial policies should be approached with caution.** Structural reforms, in particular policies that address growth barriers, are found to bring larger benefits to economic performance than industrial policies (IMF 2025b). Identified barriers, such as access to finance, electricity market failures, business environment weaknesses, and infrastructure deficits are the key bottlenecks to private sector development. Policymakers should be very cautious with 'picking winners' by directly supporting individual firms or sectors without addressing these bottlenecks. Industrial policy methods can be fiscally costly or wasteful, prone to distortions, introduce governance challenges, and often do not solve the underlying market failures firms face. Industrial policies can also prove extremely difficult to unwind once they are no longer needed. In contrast, careful diagnosis of market failures with a targeted policy response is a more effective approach.

**28. Public sector employment programs have a checkered history and must be approached with caution.** The policies required to durably change the employment growth trajectory of Lesotho will take time to bear fruit. Given the acute needs now, the government is under pressure to provide a quicker solution. History shows that public employment programs often fail, primarily due to a lack of coordination, poor transparency and governance mechanisms, and insufficient exit pathways for employed individuals (ILO 2012, 2020). Therefore, if enacted as temporary social support, key principles for program design include having strong coordination mechanisms across agencies, ensuring employment is time limited with formal transition plans, embedding training and skills development throughout, and prioritizing transparency, and accountability. Additionally, designing evaluation from the start to build evidence and improve program performance is a key pillar. Most importantly, these programs are no substitute for the deep reforms required to spur durable, private sector led job creation.

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