Economic Review

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The introduction of a revenue authority has already boosted government revenue; the public is gradually taking steps to benefit from the limited relaxation of capital account controls; while the development fund and deposit insurance scheme are still on the preparatory stage…

Lesotho Revenue Authority

Declining customs revenue and weaknesses in tax collection structures prompted the Government to review tax structure and administration. The new Lesotho Revenue Authority (LRA) was launched in January 2003. The Authority replaced three revenue departments **(**Customs and Excise, Income Tax and Sales Tax) operating within the civil service. The main functions of Customs and Excise Department were gathering imports and exports data and enforcing restrictions. The import data was used to determine Lesotho's share in the SACU revenue pool, which is shared with Botswana, Namibia, South Africa and Swaziland. The Income Tax Department was responsible for collecting personal income tax, company taxes, withholding tax, fringe benefits tax and the gaming levy. The Sales Tax Department handled collection of sales tax at five main border posts and from registered vendors. The set-up of the three departments impeded co-ordination, was administratively burdensome and was lacking in the area of taxpayers' audits and law enforcement on tax evaders.

The Government identified the establishment of an autonomous national revenue authority as the best way to improve revenue collection and tax administration. The Authority was expected to improve revenue administration through enhanced autonomy, acquisition of skilled staff, increased integrity and effective use of automated systems. The Authority would introduce private sector-style management practices to administration of revenue, competitive staff remuneration, securing of quality staff and introduction of a code of conduct that guards against corruption. In addition, the Authority would work closely with South African Revenue Service (SARS) in collection of Value Added Tax (VAT). All these measure were expected to result in increased collection of revenue, as experienced in countries such as South Africa, Zambia and Singapore. The Government noted that there are costs associated with establishing the revenue authority. Revenue authority would be paid a commission based on revenue collected.

The LRA has succeeded in improving revenue collection during the short time of its operations. The authority introduced measures that made tax payment easier; provided public tax education and established a tax advice centre. Harmonisation of the VAT with South Africa (at 14%) and capacity building at border posts helped remove long queues and encouraged more buyers to declare their transactions. The Authority also intensified efforts to enforce tax compliance by seizing goods of those who try to evade tax. Tax audits were also undertaken on those suspected to under-declaring their profits or the sources of their incomes. This resulted in an estimated 11.9 per cent rise in income tax collections for the fiscal year 2003/04, according to the 2004/05 government budget.

Value Added Tax

Another reform in the area of revenue administration was the introduction of VAT in July 2003. VAT was introduced at 14% (for most goods) to replace General Sales Tax (GST), which was charged at 10%. The higher tax rate was adopted to compensate for higher administration costs and the lower coverage that could arise under VAT as a result of the complex nature of the VAT system. VAT is a tax that is levied at each stage of production where value is added. VAT is a consumption tax, hence the provision of a mechanism enabling producers to offset the tax they have paid on their inputs against that charged on their sales of goods and services. This provision is sometimes referred to as input tax credits. The main difference between VAT and sales tax is that sales tax attempts to collect tax at just one stage in the process of production and distribution of goods and services to final consumers, whereas VAT collects the tax at every stage in the production/distribution chain.

It is generally accepted that VAT is a more efficient tax than GST. The coverage of sales tax could be limited if tax on certain goods is evaded at the distribution level. At each intermediate stage credit will be given for taxes paid on purchases to set against taxes due on sales. VAT is also a fairer tax than sales tax as it minimises or eliminates the problem of tax cascading, which often occurs with sales tax. Tax cascading refers to the possibility that some items of final consumption will bear more than the nominal rate of tax, as prices on these items would include tax charged at the final stage as well as that charged on intermediate goods used. Sales tax is often applied again to the sales tax element of the cost, thus there is a problem of tax on tax. The other strength of VAT over GST is that existence of an audit trail that is used to verify VAT amounts declared under the VAT system ensures greater administrative efficiency relative to the sales tax system. This audit trail is compiled by checking outputs declared by suppliers against inputs declared by their buyers.

Sales tax collections are expected to grow by 28.9 per cent by the end of the fiscal year, following the introduction of VAT. The strong growth was influenced partly by the new policy of tax payment by the Government. Government suppliers were exempted from sales tax in the past, and this system was sometimes abused.

Capital Account Liberalisation

Lesotho introduced limited liberalisation of the capital account in 2003 (see *Economic Review for July 2003).* This was made possible by the improvement of the macroeconomic and political environment. The improvement was driven by reforms which strengthened the financial sector; stronger economic conditions following the 1998 unrest; as well as more stable political situation after a change to a more representative electoral model and peaceful 2002 elections. In addition, other CMA members had moved ahead with limited liberalisation and this left Lesotho in a less competitive position.

Therefore, the changes on the exchange controls were designed to give maximum benefit to the economy while enjoying the most important advantages of controls. The advantages of the exchange controls are:

- to preserve the level of foreign currency reserves, which are important for the maintenance of the fixed exchange rate system.
- guard against sudden and unexpectedly large swings in capital outflows which may adversely affect confidence in the country's ability to honour its foreign currency obligations.
- to facilitate domestic savings and investments by encouraging those with excess funds to invest domestically. This also enables the authorities to have access to such funds for use in settling short-term balance of payments shortfalls.
- to harmonise Lesotho's exchange control regime with that prevailing in the rest of the Common Monetary Area (CMA).

The new changes have been designed to minimise capital outflows that would result from the reforms and other potential hazards. In addition, measures to further enhance the benefits of these reforms, and others to mitigate against the risk of liberalisation have been identified. The selected areas centred on allowing residents/citizens to invest in non-CMA countries and to hold foreign currency accounts. The relaxation also included the hiking of limits on capital transfers and foreign investments outside the CMA. The changes did not cover foreign investors as existing controls specifically target residents/citizens while foreigners enjoy a relatively liberal capital account environment in CMA countries. The purpose of limited liberalisation was to boost confidence of foreign investors on the economy. It is generally accepted that controls could be a deterrent to foreign investments as some investors are apprehensive of investing in countries where controls exist, even if such controls affect citizens only. This is driven by the thinking that such countries have a potential to change to more stringent exchange controls in times of economic instability. As mentioned earlier, relaxing controls was also expected to improve Lesotho's competitiveness in line with other CMA members. In addition, the relaxation of controls would improve the ability of residents to hedge against local currency depreciation or political risk by holding foreign currency (non-CMA) accounts or investing outside the CMA.

It was estimated that these reforms would result in a net capital outflow worth $20.0 million by the end of the 2003/2004 fiscal year. However, the actual outflow of capital was estimated at around M21.0 million, which is roughly $3.0 million using the M6.9634 per US dollar average exchange rate for January. This could imply that the public has been slower than expected in reaping the benefits of this policy.

Development Fund

- The Development Finance (DF) Division was created in the Central Bank of Lesotho (CBL) with a view to encourage the development of the private sector through provision of finance and other forms of assistance to viable projects. The Fund will provide credit to indigenous citizens who wish to set up or acquire existing businesses, or acquire shares in associations or companies will be eligible for financial assistance under the Fund. Businesses where Basotho hold majority shareholding (at least 51%) will be eligible to apply for credit to expand their businesses provided that these citizens will remain majority shareholders throughout the life of the loan. This is intended to ensure that the DF benefits indigenous people fully. Most types of businesses, including agricultural projects, will be allowed to apply for credit from the fund. The minimum limit will restrict participation to medium and large size projects while the maximum limit will ensure that the Fund does not benefit few large borrowers only. Small borrowers will be targeted under separate schemes. A maximum grace period of twelve months will be allowed on the loans, which will be repaid within a period not exceeding ten years.

- Logistical preparations for the establishment of the DF were completed and Cabinet decision is awaited. It was decided that amounts borrowed would be disbursed by participating commercial banks, which will contribute 20% of the amount borrowed and claim the 80% from the Fund. Interest paid on the loans will be shared equally between the Fund and participation institutions. This will allow the institutions to cover costs of administering the loans and give them a profit incentive to continue their participation.

Deposit Insurance Scheme

The CBL have been on a learning curve since the deposit insurance workshop held in May 2003. Two study tours to Kenya and Tanzania were undertaken, and a third to the Philippines is planned. A deposit insurance scheme (DIS) would protect small, less informed depositors against losing their savings in the event of failure of a bank. Contributors to the scheme would typically be commercial banks through lower profits, depositors (if the banks increase charges or lower deposit rates to finance the premiums) and the Government. The establishment of DIS could foster market discipline in the banking industry. It would also raise confidence of residents and foreigners on the stability of the domestic banking system.

Table 2. Monetary and Financial Indicators+

	Nov	Dec	Jan 2004
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	13.00	12.50	12.50
1.2 Prime Lending rate in RSA	12.00	12.00	11.5
1.3 Savings Deposit Rate	2.55	2.48	2.41
1.4 Interest rate Margin(1.1 – 1.3)	10.45	10.02	10.09
1.5 Treasury Bill Yield (91-day)	10.67	10.67	9.21
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	2237.4	2297.9	2217.9
2.2 Net Claims on Government by the Banking System	-267.4	-167.0	-386.4
2.3 Net Foreign Assets – Banking System	3499.9	3460.7	3699.4

2.4 CBL Net Foreign Assets	2767.6	2853.0	3188.1
2.5 Domestic Credit	285.9	380.6	171.6
2.6 Reserve Money	335.4	364.9	333.6
3. Spot Loti/US$ Exchange Rate (monthly average)	6.757	6.500	6.963
4. External Sector (Million Maloti)	**2003**		
	Q2	**Q3**	**Q4**
4.1 Current Account Balance	-304.8	-300.6	-299.8
4.2 Capital and Financial Account Balance	319.3	155.5	320.0
4.3 Reserves Assets	-0.8	391.7	-156.6

+These indicators refer to the end of period. Prime and deposit (savings) rates are averages of all commercial banks' rates operating in Lesotho. The Statutory Liquidity Ratio in Lesotho is 25 percent of commercial banks' short-term liabilities.

Table 2. Selected Economic Indicators

	2000	**2001**	**2002**	**2003***
1. Output Growth(Percent)				
1.1 Gross Domestic Product – GDP	1.3	3.2	3.8	3.3
1.2 Gross Domestic Product Excluding LHWP	0.0	3.5	3.3	3.2
1.3 Gross National Income – GNI	-3.2	0.6	2.0	2.7
1.4 Per capita –GNP	-5.0	-1.7	1.5	2.2
2. Sectoral Growth Rates				
2.1 Agriculture	2.9	0.6	-4.0	-0.4
2.2 Manufacturing	4.4	7.9	6.9	5.0
2.3 Construction	9.7	1.3	6.9	4.0
2.4 Services	-0.9	2.2	3.3	3.6
3. External Sector – Percent of GNP Excluding LHWP				
3.1 Imports of Goods	71.9	74.9	89.6	82.7
3.2 Current Account	-8.8	-2.9	-8.8	-8.0
3.3 Official Reserves (Months of Imports)	8.9	11.7	6.4	5.5
4. Government Budget Balance (Percent of GNP)	-4.9	-1.0	-2.8	-2.6

*Preliminary Estimates +Projections