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Local embeddedness, upgrading, and skill development: Global value chains and foreign direct investment in Lesotho's apparel industry

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WORKING PAPER 32

Local Embeddedness, Upgrading, and Skill Development: Global Value Chains and Foreign Direct Investment in Lesotho's Apparel Industry

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Abbreviations

| | |
|-------|--|
| ACFRN | African Clothing and Footwear Research Network |
| AGOA | African Growth and Opportunity Act |
| BMA | Benchmarking and Manufacturing Analysts |
| CMT | cut-make-trim |
| DCC | Duty Credit Certificate |
| EPZs | Export Processing Zones |
| EU | European Union |
| FDI | Foreign Direct Investment |
| GDP | Gross Domestic Product |
| GVCs | Global Value Chains |
| IFC | International Finance Corporation |
| ILO | International Labour Organisation |
| LICs | Low-Income Countries |
| MFA | Multi-Fibre Arrangement |
| ROO | Rules of Origin |
| SACU | Southern African Custom Union |
| SSA | Sub-Sahara African |
| TCF | Third Country Fabric |

Abstract

Many low-income countries (LICs) are integrated into apparel global value chains (GVCs) through foreign direct investment (FDI). This is also the case in Lesotho that has developed to the largest Sub-Saharan African (SSA) apparel exporter to the US under the African Growth and Opportunity Act (AGOA). More recently, a new apparel export market has emerged in Lesotho – the regional market of South Africa. The two export markets – US and South Africa – are supplied by different types of FDI firms – affiliates of largely Taiwanese transnational producers and South African manufacturers that are incorporated into distinct value chains. This paper assesses the implications for upgrading of integration into these two value chains in Lesotho – the value chain characterized by Taiwanese investment and feeding into the US market under AGOA and the value chain characterized by South African investment and feeding into the South African market. These value chains differ with regard to ownership patterns, end markets, export products, governance structures and firm set up, investors' motivations, and perceptions on main challenges. These different characteristics have crucial impacts on upgrading possibilities, including functional, process and “local” upgrading. Thus, from the perspective of upgrading and sustainability, ownership patterns, local embeddedness and market diversification matter. The emergence of South Africa as an alternative end market and the different value chain dynamics operating in the South African retailer-governed value chain open up new opportunities from those of the AGOA/Taiwanese-dominated value chain.

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1. Introduction

Over the past decade, several Sub-Saharan African (SSA) countries have developed export-orientated apparel sectors. The central dynamics making this possible were the Multi-Fibre Arrangement (MFA) quota restrictions on large Asian producing countries, the African Growth and Opportunity Act (AGOA) securing preferential market access to the US, and foreign direct investment (FDI), primarily from Asian investors. In this context, Lesotho became the largest SSA exporter of apparel to the US with a share of 26 % of total SSA US apparel exports in 2004 increasing its exports fourfold from \$111 million in pre-AGOA 1999 to \$456 million in 2004. Other important SSA apparel exporters are Kenya and Swaziland that like Lesotho have almost exclusively exported to the US and Madagascar and Mauritius that have exported to the US and the EU market. Together these five countries have accounted for more than 90 % of SSA's total apparel exports in the 2000s.

The phase-out of the MFA end of 2004 and the consequent ability of China and other low-cost Asian apparel producer countries to export to developed country markets without being hampered by quota provisions as well as the global economic crisis of 2008/09 resulted however in a major decline in apparel exports from the whole of SSA, including Lesotho. In 2005 Lesotho's apparel exports to the United States dropped by 14 %. After some stabilization in 2006 and 2007, Lesotho's US apparel exports decreased again by 11 % and 18 % in 2008 and 2009 respectively, whereupon they stabilized in 2010.

These aggregate figures mask however an important change in ownership and export patterns in Lesotho's apparel sector (Morris et al. 2011). The large majority of FDI in the first half of the 2000s came from Taiwanese investors. While several of these investors left in the context of the MFA phase-out and the global economic crisis, a new type of investor entered post 2005/06 – South African apparel manufacturers. Unlike the Taiwanese firms, these South African investors were not interested in using Lesotho as a production base to take advantage of AGOA for their US exports. Instead their investment has been driven by the lower (labor) cost operating environment and duty-free market access to South Africa through the Southern African Custom Union (SACU).

The entrance of South African apparel manufacturers into Lesotho has resulted in the emergence of a different apparel value chain driven by South African retailers and operating under very different dynamics than the US retailer-driven value chain in which the Taiwanese firms are integrated. The Taiwanese and South African investors integrated in these value chains have distinct investment and sourcing strategies with crucial implications on the role and upgrading prospects of their plants in Lesotho. Although the role of buyers in enabling or constraining industrial upgrading in global value chains (GVCs) has been widely analyzed in the GVC literature, less is known about the role of the nature and (foreign) ownership of investors and how this coincides with buyers' governance structures. This paper assesses the characteristics and dynamics of two distinct value chains and foreign investors and the implications for upgrading prospects, local linkages and skill development in Lesotho's apparel sector.

Lesotho is an interesting case to study for two reasons. First, it is the most impressive example of the impact of AGOA on apparel exports and is generally perceived as a successful case of starting an industrial development process through preferential trade agreements and FDI. There remain however crucial questions: Will the success in apparel exporting to the US based on AGOA and FDI be sustainable and outlast AGOA? Is the South African market an alternative to the US market and will FDI and relocations of plants from South Africa remain a sustainable (regional) strategy? Has FDI promoted local skills, entrepreneurship and industrial capabilities that support a broader industrial development process? What do these developments mean for policy with the goal to further upgrading, skills, local linkages and industrial development?

Second, these questions are particularly relevant in the context of the Better Work program that was recently established by the International Labour Organisation (ILO) and the International Finance Corporation (IFC) in Lesotho in 2009 and aims to improve both compliance with labor standards and competitiveness in GVCs. Sustainable competitiveness ultimately requires upgrading as it is very hard to be internationally competitive in the long run and to comply with labor standards solely based on cost competitiveness. Understanding the dynamics of the distinct value chains in Lesotho (and other Better Work countries) and what this means for upgrading is therefore critical in identifying the opportunities but also the challenges of aligning

labor standards with meeting the dynamics of competitiveness. Certain value chain dynamics, buyers' and investors' strategies will be more coterminous with upgrading, skill development and labor standards than others. The contrast between the Taiwanese/US and the South African value chains brings this issue to the fore.

The paper is structured in the following way. The first part provides a conceptual overview of upgrading in GVCs and the role of FDI and ownership structures. The second part discusses the recent development of the apparel industry in Lesotho and the specific way Lesotho has been integrated into apparel GVCs related to MFA quota-hopping, preferential market access and foreign ownership. The third part identifies the two distinct value chains and assesses their different characteristics. The fourth part discusses what these differences imply for upgrading prospects, local linkages, and skill development. The last part concludes.¹

2. Conceptual discussion: Global value chains, ownership and upgrading

In the GVC literature, industrial upgrading is a core concept that is defined as moving to higher value activities in value chains in order to increase the benefits (e.g., security, profits, skill, technology or knowledge transfer) from participating in global production (Bair/Gereffi 2003). Upgrading is generally conceptualized in four types (Kaplinsky/Morris 2001; Gereffi et al. 2001, 2005; Humphrey/Schmitz 2002): process upgrading (improving technology and/or production systems), product upgrading (producing more sophisticated products), functional upgrading (increasing the range of functions or changing the mix of activities to higher value tasks) and chain upgrading (moving from one industry to another). Two further dimensions can be added – supply chain upgrading (establishing backward and forward linkages within the supply chain) and channel upgrading (diversifying to new buyers or new geographic or product markets) (Gereffi/Fredrick 2010; Frederick/Staritz 2011).

In the GVC literature on the apparel industry, it has been widely analyzed how buyers and their governance structures impact on industrial upgrading prospects of supplier firms and countries. There is however often insufficient attention to the role of ownership. Important exceptions are those who conceptually state the importance of ownership as a dimension in GVC analysis (e.g. Henderson et al. 2002), and others who notice the differential possibilities for industrial upgrading associated with EU and US based buyer-driven value chains (e.g. Gibbon 2003, 2008; Gibbon/Ponte 2005; Palpacuer et al. 2005; Morris/Sedowski 2009). Even less is however said about the ownership characteristics of key suppliers and foreign investors in the apparel GVC and how they relate to industrial upgrading (Phelps et al. 2009). This may be related to the apparel industry being organized in a buyer-driven value chain² where lead firms generally focus on non-production related activities such as design, branding and retailing and outsource all or

¹ The paper is based on a diverse set of primary and secondary data. It utilizes trade and national sector data, and draws on a number of published and unpublished firm level surveys and interviews conducted between 2008 and 2011, and information from experts and industry informants. It particularly is based on two surveys and firm level interviews undertaken by Benchmarking and Manufacturing Analysts (BMA) for the World Bank in 2010 (Barnes/Morris 2010) and for the African Clothing and Footwear Research Network (ACFRN) in 2011, as well as two sets of firm level interviews conducted by BMA for the ACFRN in 2008 and by Cornelia Staritz for the World Bank in 2009 (Staritz 2011). The 2010 survey covered 10 firms and the 2011 survey 17 firms.

² GVCs can be differentiated as producer- and buyer-driven. In producer-driven chains (which are common in capital- and technology-intensive products such as automobiles, electronics, and machinery) large, integrated (often multinational) firms coordinate production networks. Control is generally embedded in the lead firm's control over production technology. In contrast buyer-driven value chains (which are common in labor-intensive, consumer goods industries such as apparel, footwear, toys and consumer electronics) are characterized by decentralized, globally dispersed production networks, coordinated by lead firms who control activities that add "value" (e.g., design, branding), but often outsource all or most of the manufacturing process to a global network of suppliers (Gereffi 1994).

most of the manufacturing process to a global network of suppliers (Gereffi 1994, 1999; Gereffi/Memedovic 2003). Thus, FDI is less important than in producer-driven value chains where lead firms derive their power from their control over production technology. However, there are important exceptions and in particular LICs have often been integrated into apparel value chains through FDI (Gereffi 1999; Staritz 2011; Morris et al. 2011).

In these latter cases it is not only crucial to analyze buyers' strategies and related value chain dynamics but also the strategic interest of foreign investors and their extent of integration or specialization of activities along the triangular manufacturing network with important implications regarding the role and potential for upgrading of the foreign-owned plants. The concentration of buyers on their core competencies (i.e., design, branding and retailing) and the outsourcing of all other activities has offered upgrading opportunities for more capable suppliers – but only to the extent where they do not encroach on buyers' core competencies. However, upgrading prospects are different for suppliers that are integrated into apparel value chains through triangular manufacturing networks given the parent companies' control over key decisions and higher value-added functions. In this context, "ownership" of supplier firms specifying the extent to which firms are domesticated and have roots in the social and economic fabric of the host country, is an important criterion to understand and differentiate the behavior and activities of these firms.

Three main groups of foreign investors can be identified in apparel GVCs (Staritz/Frederick 2011): First, brand manufacturers, largely from the US and Europe, have established regional and global production networks largely via FDI. This group of lead firms has however declined in importance and many have shifted to marketers or retailers and sourcing networks based on contract manufacturing. Second, faced with quota restrictions, rising labor costs and high demands from global buyers transnational producers – initially based in East Asia (i.e., Hong Kong, Taiwan and Korea) but more recently also in other Asian countries (i.e., Singapore, Malaysia, China and India) and the Middle East – have developed triangular manufacturing networks. These networks were limited to the Asian region in the 1970s and 1980s but extended to Latin America, the Caribbean and SSA in the 1990s (Appelbaum 2008; Gereffi 1999). A third group of foreign investors is more diverse – regionally embedded investors that organize production networks within a region, e.g. Indian and Sri Lankan investors in South Asia, Malaysian and Thai investors in Southeast Asia, and South African and Mauritian investors in SSA.

These foreign investors differ with regard to their origin (high-income versus middle-income country), location (regional versus global) and most importantly the degree of integration/internalization versus specialization/externalization with important implications regarding the upgrading prospects in host countries. The extent of internalized versus externalized production varies depending on which activities firms consider to be part of their core competencies. If production or sourcing are highly internalized the foreign investor will have little interest in local sourcing beyond non-tradable services and standardized inputs (Paus/Gallagher 2009). If activities are organized on a global scale at the head office the investor has little interest in transferring broader functions and decision power to affiliates. Thus, ownership characteristics and organizational forms of investors are an important dimensions that impacts on possibilities for upgrading, local linkages and skill development in host countries.

This is however not only about firm ownership and organizational forms but about their interaction with the dynamics of the distinct value chain they are part of on the one side and the

operating environment in their home country on the other side. Firms survive and thrive on the basis of their insertion into particular value chains which determine who they supply to, what items they produce, and how they produce them. The distinct governance dynamics driving different value chains have to be factored in to grasp the complexities underlying the dynamics driving key suppliers and foreign investors. In addition, the home country's operating environment impacts on which functions are located at home or abroad. In this paper we discuss the different ownership characteristics and organizational forms of Taiwanese- and South African-owned plants in Lesotho and how these coalesce with dynamics in the two distinct value chains these plants are part of.

3. Development of the apparel industry in Lesotho: Taiwanese and South African investors

The apparel sector has had a central role in Lesotho's economy. It accounts for 18 % of Lesotho's GDP, nearly 70 % of total manufacturing production, 60 % of total exports, and employs nearly 50 % of the formally employed workforce and 80 % of Lesotho's manufacturing workforce (ComMark 2009; Better Work Lesotho 2011). Given the high unemployment levels in Lesotho and that almost half of the population lives below the poverty line, the industry is of crucial importance for employment generation, poverty reduction and industrial development.

Lesotho's export success under AGOA is based on the existence of an apparel-exporting industry pre-AGOA due to Lesotho's historic links with South Africa and Taiwan and the MFA quota regime (Lall 2005). Lesotho's apparel sector dates from the early 1980s when South African firms relocated plants to Lesotho. The motivation was: first, to take advantage of low-cost labor for exports to South Africa; second, to avoid sanctions on overseas exports to Europe and the US due to the Apartheid regime; and third, to take advantage of Lesotho's duty-free access to Europe under the Lome Convention and its special rules of origin (ROO) derogation which allowed for single transformation (Gibbon 2003).³ But actual activity in Lesotho's apparel industry was still minor in the 1980s as these investments were relatively small scale (Gibbon 2003; Salm et al. 2002).

First Taiwanese investments occurred in the late 1980s, motivated by MFA quota hopping and, as most investments involved relocations from South Africa, to avoid sanctions and take advantage of lower wages and FDI incentives. Investments were also politically motivated as Lesotho was part of the few countries that politically recognized and had diplomatic relations with Taiwan and therefore investments were encouraged by the Taiwanese government until 1994 when Lesotho ceased relations with Taiwan recognizing (mainland) China.⁴ The first Taiwanese investment occurred in 1986; by the end of 1991 four Taiwanese plants had opened and one plant from Hong Kong and one from South African. Growth continued in the 1990s and the number of firms doubled (Salm et al. 2002; Gibbon 2003).

Besides these activities in the 1980s and 1990s, the apparel industry only really took off with the coming into being of AGOA. From 2000 onwards AGOA has provided quota and duty free market access to the US market coupled with non-restrictive ROOs as the Third Country Fabric

³ Initially, the Lome Convention did not require local content requirements. In the late 1980s, the EU started to apply cumulation to ACP countries and required double transformation ROOs. Lesotho was however able to get a derogation for eight years until 1997 (Lall 2005).

⁴ Taiwanese investors were initially attracted to South Africa by incentives and political factors as Taiwan was one of the few countries that maintained ties with the Apartheid regime (Lall 2005).

(TCF) derogation allowed for single transformation for lesser developed countries.⁵ This, combined with MFA quota provision, started a growth path of apparel exports to the US in Lesotho. Lesotho was granted accession to AGOA in October 2000. Its apparel industry grew from 21 firms in 1999 to 49 firms in 2004 (Table 3; Morris/Sedowski 2006). In 2001, 13 new factories opened, in 2002 an additional six (Lall 2005). Apparel exports to the US commensurately jumped fourfold from \$86 million in 1997 to \$456 million in 2004 making Lesotho the largest SSA exporter of apparel to the US with a share of 26 % of total SSA US apparel exports in 2004 (Table 1). Nearly all of Lesotho’s apparel exports went to the US – 98 % in 2004 (Table 2). Employment increased from 9,847 in 1999 to 53,087 in 2004 (Table 3).

Table 1: US Apparel Imports from Lesotho

| | 1997 | 2000 | 2002 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---------------------------------|------|------|------|------|-------|------|------|-------|-------|------|------|
| Lesotho Total (\$US Mil) | 86 | 140 | 321 | 456 | 391 | 387 | 384 | 340 | 278 | 281 | 315 |
| Growth Rate (%) | 32.3 | 26.6 | 49.5 | 16.1 | -14.3 | -0.9 | -0.9 | -11.4 | -18.1 | 0.9 | 12.3 |
| Share of SSA (%) | 20.1 | 18.7 | 29.3 | 25.9 | 26.7 | 30.0 | 29.7 | 29.5 | 30.2 | 35.5 | 34.9 |

Source: USITC; General Customs Value; apparel represents HS 61+62.

Table 2: Lesotho’s Top 5 Apparel Export Markets⁶

| Partner Country | Value (\$US Millions) | | | | | | | | Share of Total (%) | | | | | | | |
|-----------------|-----------------------|------------|------------|------------|------------|------------|------------|------------|--------------------|--------------|--------------|-------------|--------------|-------------|-------------|-------------|
| | '00 | '02 | '04 | '05 | '06 | '07 | '09 | '10 | '00 | '02 | '04 | '05 | '06 | '07 | '09 | '10 |
| World | 153 | 348 | 494 | 422 | 418 | 414 | 303 | 318 | | | | | | | | |
| USA | 146 | 342 | 482 | 408 | 407 | 402 | 290 | 294 | 96.0 | 98.4 | 97.5 | 96.8 | 97.3 | 97.2 | 95.6 | 92.4 |
| Canada | 4 | 3 | 11 | 12 | 9 | 7 | 7 | 15 | 2.9 | 0.9 | 2.2 | 2.8 | 2.2 | 1.8 | 2.4 | 4.9 |
| EU-15 | 2 | 2 | 1 | 1 | 1 | 2 | 3 | 2 | 1.1 | 0.5 | 0.2 | 0.2 | 0.3 | 0.6 | 0.9 | 0.6 |
| Japan | -- | 0.3 | 0.3 | 0.3 | 0.3 | 1 | 1 | 2 | -- | 0.1 | 0.1 | 0.1 | 0.1 | 0.3 | 0.4 | 0.5 |
| Mexico | 0.0 | 0.2 | 0.1 | 1 | 0.4 | 0.4 | -- | 2 | 0.0 | 0.1 | 0.0 | 0.1 | 0.1 | 0.1 | -- | 0.5 |
| Australia | -- | -- | -- | -- | -- | -- | 1 | -- | -- | -- | -- | -- | -- | -- | 0.3 | -- |
| Total | 152 | 348 | 494 | 421 | 418 | 413 | 302 | 314 | 99.98 | 99.98 | 99.96 | 99.9 | 99.95 | 99.9 | 99.7 | 98.9 |

Source: UN COMTRADE; apparel represents HS1992 61+62; exports represent partners’ imports; Intra-SACU exports to South Africa are not or under-reported.

⁵ AGOA ROO generally stipulate triple transformation (yarn, fabric and apparel). The TCF derogation is a special rule which applies to lesser developed SSA countries (defined as countries with per capita incomes of less than \$1,500 in 1998) allowing them duty free access for apparel made from fabric originating anywhere in the world. This derogation was initially granted until September 2004 but then extended three times to September 2007, 2012 and 2015.

⁶ This table excludes SACU exports – in other words exports to South Africa - as they are not reflected in these data sources. We shall deal with this in Table 4.

Table 3: Number of Workers and Firms in Lesotho's Apparel Industry

| | 1994 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---------|-----------------|-------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|------|--------|
| Workers | 8,600 (est.) | 9,847 | 16,417 | 23,518 | 33,140 | 44,345 | 53,087 | 40,364 | 45,889 | 47,040 | 45,310 | 38,437 | - | 39,197 |
| Firms | 6 | 21 | 19 | 32 | 38 | - | 49 | 42 | 47 | 47 | 44 | 44 | - | 42 |

Source: LTEA 2008; CBL 2010; Bennett 2006; Lall 2005; Morris/Sedowski 2006; Better Work Lesotho 2011.

The growth of the export apparel industry was based on FDI that almost exclusively came from Taiwanese investors. These firms were motivated by quota hopping and preferential market access and used their existing global sourcing and merchandising networks to export to the US market. Their Lesotho plants are cut-make-trim (CMT) operations while financing, sourcing fabrics, product development and design, logistics, merchandising and marketing are carried out in the head offices in Taiwan. They export overwhelmingly large, bulk orders of low complexity apparel, particularly five pocket denim jeans and knit tops such as T-shirts and polo shirts, to large US retailers and some importers.⁷ Although Lesotho has no export processing zones (EPZs), Taiwanese investments have tended to agglomerate geographically in the industrial site in Maseru.

Exports, employment and number of firms reached their highest levels in 2004. The phase-out of the MFA resulted in a major decline in apparel exports from the whole of SSA, including Lesotho (Kaplinsky/Morris 2008; Staritz 2011). Apart from reduced orders from US buyers due to the MFA phase-out and the associated concentration of sourcing in Asia, there were a number of other external and internal aggravating factors for this decline. The rapid appreciation of the South African Rand had a major impact since the Maloti is pegged to the South African Rand on a one to one basis. Furthermore, the insecurity about the extension of the TCF derogation under AGOA in 2004 contributed to the decline. Besides these external factors, internal factors such as relatively low productivity in Lesotho's firms and infrastructural challenges played a role in the decline of the sector after 2004.

In 2005 Lesotho's apparel exports to the US decreased by 14 % (Table 1). Around eight Taiwanese factories closed in December 2004 (Bennet 2006) and around 13,000 workers were laid off in 2005 which accounted for around one quarter of total employment (Table 3). However, not as many firms left as had been expected and exports stabilized in 2006. Explanations for this are the imposition of safeguards quotas on China's exports by the US (and the EU), the extension of the TCF derogation to 2007 (and later to 2012), the Duty Credit Certificate (DCC) scheme in the context of SACU⁸, as well as some government support policies post-MFA.

By 2008, the downward development was again accelerated by the ending of the China safeguards and more importantly by the reduction in demand in the context of the global economic crisis. Overall, total US apparel imports decreased by 3.3 % in 2008 and by 12 % in

⁷ Most of the minimal apparel exports to the EU are specialist items (mainly chef jackets) and production for GAP stores located in Europe (Bennet 2006).

⁸ The DCC is a rebate of 25 % on the duty to be paid on imports of textile and apparel products based on the value of goods exported outside of SACU. It was introduced in March 2003 to run until March 2005 but was renewed until March 2007 and then again until March 2009. Only a minority of these DCCs were actually used for own account fabric imports but most were sold to South African retailers who used them for apparel imports. However, the regulation changed in 2006 to only allow reselling to other manufacturers which reduced the price of DCCs from around 80 % to around 50 % of the face value. In March 2009 and 2010 a one year extension to the scheme was agreed but the traded value of the DCC became worth even less as DCCs could only be used for imported inputs of seven product lines of yarns and fabrics down from 102 product lines including apparel. In March 2011 the DCC scheme phased out. Many firms indicated that DCCs were crucial for their survival post-MFA.

2009. In Lesotho, exports to the US decreased by 11 % and 18 % in 2008 and 2009 respectively. Employment increased in 2006 and 2007, with the recovery of exports, and stabilized around 45,000 to 47,000. However, it fell again to 38,437 in 2009. The numbers of firms increased from 42 in 2005 to 47 in 2007 but decreased to 44 in 2009 and then to around 33 firms in 2010 (Table 3). Despite the large decline in export to the US in 2008 and 2009, US exports stabilized in 2010 and 2011 and employment and number of firms have not experienced a proportional decline in 2008 and 2009 and also stabilized in the next two years.

These aggregate figures mask however important changes taking place in ownership and export patterns in the apparel industry in Lesotho in recent years. While several Taiwanese investors left in the context of the MFA phase-out and the global economic crisis, the remaining Taiwanese manufacturers have been joined, post 2005/06, by a new type of investor – South African apparel manufacturers. South African investments have been driven by three motivations: first, taking advantage of the lower cost operating environment (labor and overhead cost) in Lesotho; second, escaping the rigid and inflexible labor market conditions governing South African labor relations; and third, gaining duty-free market access through SACU to supply retailers in the South African market. In the context of increased imports, particularly from China, relocations to lower-cost locations, including Lesotho, have become a strategy by South African manufacturers to cope with increased competition and reduce costs. Despite large wage differences between metropolitan areas that comply with collective agreements and non-metropolitan areas that are non-compliant within South Africa, non-metropolitan wages for qualified machinists are still more than double the minimum wage for machinists in Lesotho and the difference is even larger when social benefit scheme contributions are included (Pike/Godfrey 2011). In contrast to Taiwanese firms that are largely located in Maseru, South African firms are concentrated in a new industrial estate in Maputsoe.⁹

The relocation of South African manufacturers has resulted in the growth of a new South African export market (Table 4). Between 2006 and 2011 apparel exports to South Africa from Lesotho increased nearly 27 fold (in Rand terms from R17m to R445m). If one includes cotton, yarn, knit and woven fabric (HS 50-63) the increase is even higher. While apparel exports to the US declined respectively from peaks of \$456m in 2004 to \$315m in 2011, by 2011 exports to South Africa jumped to \$61m respectively accounting for 20 % of US apparel exports. Survey data from 2011 shows that while employment increased by 5.5 % between 2008 and 2009 for the South African firms sampled it declined by 8.3 % for the Taiwanese firms sampled.

⁹ Both Maseru and Maputsoe are on the border with South Africa and opposite fairly large towns where almost all managers live commuting to Lesotho every day (Pike/Godfrey 2011, 10).

Table 4: Lesotho's Apparel Exports to South Africa

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|-----------------|------|-------|-------|--------|--------|--------|--------|
| HS 50-63 Rand m | 7,03 | 19,36 | 33,83 | 161,79 | 298,83 | 109,64 | - |
| HS 50-63 US\$ m | 1,11 | 2,86 | 4,80 | 19,58 | 35,27 | 14,98 | - |
| HS61-62 Rand m | 6,25 | 16,53 | 5,96 | 110,41 | 238,83 | 335,38 | 445,24 |
| HS61-62 US\$ m | 0,98 | 2,44 | 0,85 | 13,37 | 28,19 | 45,81 | 60,82* |

Source: South African Revenue Service (SARS).

Note: 1. According to SARS the accuracy of data for 2005 and 2006 should be treated with caution. 2. HS 61-62 data for 2007 does not correlate and is likely to be the result of a misclassification. Exchange rates are from UNCTAD Stat 2012; * calculated with an estimated exchange rate for 2011.

This market diversification is not explained by the MFA phase-out and competition from cheaper Asian products in the US market (Kaplinsky/Morris 2006, 2008). Most producers in Lesotho who began to serve South African retailers were not previously exporting to the US. These exports largely come from the recently re-located South African firms seeking a lower cost operating environment to service South African retailers, and not from the Taiwanese-owned firms, which generally continued exporting solely to the US. The entrenchment of this regional South African value chain was also accelerated by the South African government's policy to impose quotas on Chinese apparel imports in 2007 and 2008. Although motivated by protecting domestic South African manufacturers, this policy led to import diversion as South African retailers searched for other sources of global apparel supply which they found in other Asian countries but also in regional SSA supplier countries (e.g. Lesotho, Swaziland, Mauritius and Madagascar) (Morris/Reed 2009; Morris et al. 2011; Kaplinsky/Wamae 2010).

Notwithstanding these positive developments, Lesotho's export apparel industry remains highly vulnerable in the context of cost competition from a number of locations, most notably China, Bangladesh, Cambodia and Vietnam. At the same time the Maloti, which is pegged to the South African Rand, appreciated in value to the US\$, whilst the DCC scheme, which effectively subsidized exports to the tune of 14 % to 25 % of sales, was phased out in March 2011. Taiwanese investments greatly depend on AGOA and the TCF derogation and their phase-out scheduled for September 2015 will potentially have crucial impacts on Taiwanese investments and US exports. Further, there exist infrastructural challenges as well as deficiencies with regard to productivity and skills at the firm level. These considerations raise serious questions about the sustainability of Lesotho's apparel exports but they play out in different ways in the two distinct apparel value chains.

4. Two distinct value chains: Characteristics of Taiwanese/US and South African value chains

Currently, there are 31 apparel firms and 37 apparel plants (as some firm sown more plants under different names) and one textile mill operating in the formal apparel and textile industry in Lesotho. All apparel firms are foreign-owned – 12 plants are Asian-owned (18 Taiwanese and four (mainland) Chinese), 15 South African-owned, and one firm is Mauritian (LNDC 2012). Firms can be classified in three types – (i) Taiwanese transnational producers, (ii) other Asian investors (including Taiwan and (mainland) China) and one Mauritian investor, and (iii) South African regional investors. Percentage-wise, around 40 % of firms are type 1, 20 % type 2 and 40 % type 3 accounting for around 60 %, 10 % and 30 % of total apparel industry employment

respectively. These firms are integrated into two distinct value chains with different characteristics and dynamics and with major implications for the activities and behavior of the foreign-owned plants feeding into these value chains. These are, for type 1 and 2 firms, the US buyer governed value chain and, for type 3 firms, the South African retailer governed value chain. They differ with regard to investors' motivation, governance structure and firm set up, end markets, export products, perceptions on main challenges, as well as with regard to their implications for upgrading, local linkages and skill development (Morris et al. 2011). Given their importance, the following discussion focuses on Taiwanese transnational producers and South African regional investors – notwithstanding the fact that at there exist around five Asian firms and one Mauritian firm that are more locally embedded.¹⁰

4.1. Investment motivation

The investment motivation differs significantly between Taiwanese- and South African-owned firms. The primary drivers for Taiwanese investment were costs and policy factors – MFA quota hopping coupled with AGOA and the TCF derogation. An additional motivation was the availability of special FDI incentives provided by Lesotho's government, including subsidized factory rentals and serviced industrial sites, a low corporate tax rate, free repatriation of profits, tax exemptions on imported machinery and equipment, and full rebates on imported inputs for exporting (Bennett 2006), and by SACU through the DCC scheme. In contrast, the primary drivers for South African investment were the low cost of labor, a flexible labor market, a more compliant union environment relative to South Africa, and preferential access (SACU) and proximity to the South African market. Geographical proximity refers not only to closeness to end markets and retailers. It also enables South African apparel manufacturers to maintain capacity at head offices in South Africa but still be able to send out management expertise to deal with problems or opportunities in Lesotho.

4.2. Governance structure and firm set up

The two types of foreign-owned firms are linked to different production and distribution networks which have crucial implications for the governance structure and firm set up. Most Taiwanese-owned firms in Lesotho are local affiliates of transnational producers with their head offices in Taiwan that own or source from production units in several countries on a global scale. They follow a global strategy involving long run production for export, mostly to the US, of a narrow range of basic products made in large plants with generally highly inflexible operating environments and specializing in a narrow range of functional activities (Gibbon 2008). This type of integration has on the one hand led to access to global sourcing and merchandising networks and made entry into apparel GVCs possible. On the other hand, it has implied a certain governance structure and firm set up where critical decision-making power and higher-value functions, including input sourcing (often drawing on their own textile mills or sourcing networks based in Asia), product development and design, logistics, merchandising and marketing, and the direct relationship with buyers, are located abroad. Production plants in Lesotho are generally only in charge of CMT activities. The fundamental determinant of the governance

¹⁰ These firms are single, owner-managed operations, have no head offices abroad and are not part of triangular manufacturing networks, and have more decision making power in Lesotho. They are part of US buyer-governed value chains, largely working with agents based in Asia or the US, but some have tried export to South Africa with limited success.

structure driving these triangular manufacturing networks is the extraction of rents from a preferential market access agreement (AGOA) with very limited interest in transferring more than manufacturing functions to Lesotho. The Taiwanese firms are not escaping from the hub of their production activities in East Asia. There is no push, only a pull to use Lesotho for as long as the preferential market access prevails and as long as they can keep their operating costs to a minimum.

In contrast, South African-owned plants are more regionally and locally embedded. South African manufacturers generally only own production plants in Lesotho, with their head offices – and occasionally also further production plants – in South Africa. The production plants in Lesotho also largely perform CMT functions with higher value-added functions being performed in the head offices in South Africa but some have more decision-making power in Lesotho. As South African firms do not act globally and generally do not own production plants in other countries, their plants in Lesotho are not as easily substitutable as are plants of transnational producers. These regional production networks also have a geographical advantage over Asian based networks. The South African firms have a very different firm set up – they are generally smaller employing around 300 to 400 workers (compared to around or above 1,000 workers in most Taiwanese firms), produce shorter runs and often quicker response and more complex products with a moderately higher fashion content supplying South African retailers. This can be confirmed by survey data from 2011 which indicates that the South African firms sampled export on average \$4.3m (with a minimum of \$591,000 and a maximum of \$6.4m) and the Taiwanese firms sampled \$13m (with a minimum of \$809,000 and a maximum of \$43.4m). Further, South African apparel manufacturers aim to transfer further production as well as some higher value adding pre- and post-production functions (e.g., pattern making, fabric management, logistic coordination), from South Africa to Lesotho as they are pushed out of the South African operating environment by high costs and labor market rigidities, and pulled to Lesotho by the lower operating costs and the proximity of these manufacturing locations to their operations in South Africa.

4.3. End markets

Export markets also fundamentally differentiate the Taiwanese- and South African-owned firms in Lesotho. The importance of AGOA to the Taiwanese firms is very clear, with well over 90 % of their apparel production exported to the US under AGOA. Survey data for 2011 show that 97 % of total output by sales value of the sampled Taiwanese firms goes to the US. Main customers are Gap, Levi's Strauss, Wal-Mart, K-Mart, Jordache, Russels, J.C. Penney, Children's Place, Gloria Vanderbilt, and some large US importers (Bennet 2006). The South African firms, on the other hand, are tightly linked to South African retailers, including Woolworth, Edgars, Foschini and Mr. Price, with around 90 % of their apparel being exported to South Africa. The two end markets are significantly differentiated and firms follow different strategies to access these markets and fulfill the requirements of the respective buyers. US and South African buyers have different demands, sourcing practices and expectations of suppliers' functions and capabilities. US buyers demand high volumes of largely basic apparel products. They emphasize the ability to produce to buyer specifications, nominate fabric and other input suppliers, mostly from Asia, and are generally not interested in suppliers' contributions to design (Gibbon 2002, 2008). South African buyers on the other hand use their Lesotho plants generally for products where lead times and volume flexibility are central as well as prices. Production for the South African market

tends to bring a firm set up and an overhead structure that is uncompetitive for the US market. Conversely, Taiwanese firms, have a firm set up which is geared to long run, basic products which is not competitive in the smaller run, higher fashion and more quick response business. Furthermore, the location of most decision-making functions, in particular sales and merchandising, in Taiwan, makes establishing relationships with South African retailers difficult. However, some more embedded Asian investors (type 2) have tried to export to the South African market but with limited success so far.

4.4. Export products

There are also some differences between Taiwanese- and South African-owned firms with regard to export products which are related to end market segmentation. Taiwanese-owned firms generally export long run and basic apparel products to the US. Some firms have changed their products to meet buyers' demands for more fashionable products. However, these changes are largely cosmetic, involving some additional styling detail, rather than fundamental changes to the types of products. While some South African-owned firms utilize their Lesotho operations to manufacture basic, higher volume apparel, most South African firms focus on shorter run products which are more time-sensitive and have larger fashion content. Looking more generally at export data¹¹, Lesotho apparel exports to the US are very concentrated; the top five export products (at the HS 6 digit level) accounted for 68 % of total US apparel exports in 2011. They are dominated by simple apparel products that involve relatively few operations, are relatively easily constructed and have a low level of technical difficulty, in particular cotton trousers (jeans, 43 %) and sweaters and pullovers (15 %).¹² Apparel exports to South Africa are also concentrated but to a lesser extent; the top five export products accounted for 42 % of total South African apparel exports in 2011. Only one product appears in the top five export list to the US and to South Africa (i.e., men's and boys' woven cotton trousers) which shows that top export products differ for the US and South Africa. The top five export products to South Africa are also basic products but with the inclusion of "men's jackets and blazers of other textiles materials" a non-commodity type, more technical product is also included. One South African firm, for instance, produces work wear for the mining industry which has upgraded its products related to regulations from the South African Bureau of Standards and health and safety requirements stipulated in the South African Labour Law. Two other firms produce ladies melton jackets and other wool and highly structured products, ladies formal wear and fashion tops.

4.5. Challenges

Challenges for apparel exporting in Lesotho are diverse. However, there are distinct differences between Taiwanese- and South African-owned firms in their perception of what are the most central challenges to their export activities. Taiwanese-owned firms see policy and cost-based challenges, including the phase-out of the DCC scheme, the insecurity with AGOA, the strengths of the Rand, and transport, logistics and customs-related costs as the main challenges. Another important challenge is distance from raw material suppliers and hence lead times, in particular

¹¹ The product classification data available (whether HS or SITC) is very crude and often disguises the levels of complexity. For example, a jacket that has no styling and is unshaped is much simpler to manufacture than a shaped, fitted jacket. Thus, it is necessary to be cautious in drawing conclusions with regard to manufacturing complexity and capability simply on the basis of product classification data without firm level knowledge derived from firm visits examining operational performance.

¹² For all SSA countries, three products accounted for 50 % of total SSA apparel exports to the US.

related to the unavailability of local or regional yarns and fabrics. In contrast, South African firms see skill-based constraints, i.e., the lack of skills at all levels of personnel from basic machinists, to technical and managerial staff, as the main challenge as they consider the local availability of these skills important to their business model and for transferring further production to Lesotho. South African firms also noted deficiencies in the support sector (e.g., embroidery, printing, etc.), lack of access to finance, transport, logistics and customs-related costs, and lead times related to the unavailability of local and regional yarns and fabrics amongst their critical challenges. The low level of productivity was mentioned by both types of firms as a key factor limiting their export growth. However, the perception of South African and Taiwanese firms on wages differs. Whilst for Taiwanese firms the wages of their operations in Lesotho are higher than at their competitors overseas, South African firms indicated the converse which is related to their different cost benchmarks – Taiwanese firms compare labor costs to their plants in countries such as China, Vietnam, Cambodia and Bangladesh whilst South African firms cost benchmarks are to their plants in South Africa.

5. Implications of distinct value chain characteristics for upgrading

The integration of Lesotho-based apparel firms into US/Taiwanese- and South African-based value chains has important impacts on the production processes, the technology used and the products produced. It has also crucial implications for the functions performed in those countries. Upgrading possibilities and dynamics are determined by local capabilities, skills and operating environments, but also by the role certain locations have in GVCs and thus by governance structures and the strategies of key suppliers/foreign investors in triangular manufacturing networks. Apparel manufacturers in Lesotho are locked into a particular set of activities not only as a result of deficiencies in local conditions, but as a deliberate strategy of the parent companies of the foreign-owned plants. In contrast to locally-owned firms, which functions are located in Lesotho and which production methods used is not only a question of local conditions. Rather, it is determined by the strategic choice of what and how to produce in their global or regional sourcing networks as foreign-owned firms are able to leverage the skills and expertise of their head offices and other production plants.

5.1. Functional upgrading

With regard to Taiwanese-owned firms, the specific integration of Lesotho through triangular manufacturing networks limits the possibility for taking over higher value-added functions as these functions are ensured by the head offices. The primary exporting strategy for the Taiwanese-owned firms is to continue to utilize their head offices in Taiwan to market their Lesotho capacities. Lesotho is a manufacturing centre for their centralized product development, design, fabric management, and merchandising operations in Taiwan. Only a few Taiwanese-owned firms have invested in more capital intensive finishing operations such as laundry, embroidery, screen printing and dyeing, and only one has integrated backwards into fabric and yarn production investing in a denim mill and a ring spun mill.¹³ There are also no independent yarn, fabric or accessories suppliers based in Lesotho; only five independent finishing units involved in embroidery and screen printing exist.

¹³ A second firm invested in regional fabric production in South Africa but the mill was closed.

Plants in Lesotho within South African-based value chains are also largely involved in manufacturing activities to support product development and design, fabric sourcing and merchandising functions based at the head offices in South Africa. However, some South African manufacturers have also relocated broader production-related functions to Lesotho and more appear to express an interest in relocating more functions to Lesotho as they attempt to escape from the high cost and labor market rigidities characterizing the South African production environment. South African investors appear to follow a displacement strategy, where their growing regional operations are intended to progressively displace their higher cost South African operations.

The Taiwanese/US-based and South African-based triangular manufacturing networks drive supplier firms into particular trajectories with respect to functional upgrading possibilities. In the case of Taiwanese firms the very reason why they set up operations in Lesotho and have a competitive advantage in maintaining these networks, is the very same reason why suppliers cannot or find it very difficult to upgrade. The dynamics of this value chain and specifics of the Taiwanese/Asian triangular manufacturing networks lock firms in Lesotho into certain low-value activities with very limited incentives to relocate more functions to Lesotho. The functional upgrading challenge is not therefore simply one of creating broader capabilities, e.g., with regard to input sourcing, product development or design, and developing the associated skills required to do so, but rather fundamentally challenging the very reason for the establishment of production facilities in Lesotho in the first place. On the other hand, the South African value chain with the triangular manufacturing networks embedded in the region creates certain tightness, proximity, and an incentive to relocate more production functions to Lesotho and maintain a flexible porous relationship between functions in South Africa and Lesotho.

5.2. Process upgrading

A key determinant of success for any apparel manufacturer is its ability to introduce new process technologies and work organization strategies which raise operational performance and ensure the ongoing competitiveness of the firm. When Taiwanese and South African investors came to Lesotho they brought crucial knowledge and capabilities with regard to production set up and processes. However, only few firms have undertaken major process innovations after their initial investment, and if introduced mostly only involve ongoing investment in machinery.

Although the Taiwanese firms brought relatively new technology and production processes when they came, there have been very limited improvements with regard to technology used, capital investments, efficiency-enhancing production processes and skill training. Insofar as the Taiwanese firms are producing apparel products that require more complex production processes as they incorporate more detailed styling, more difficult fabrics, more intricate embroidering and an increase in trims, this process has mainly been driven by buyers' demands rather than by the firms themselves. Taiwanese firms work largely off the basic assumption that worker costs and speed are the most critical components of competitive production and there is very limited awareness of alternative methods and philosophies of manufacturing.

Most South African firms are focusing on products which require shorter runs, quicker response and higher fashion content. For these products, besides costs, production flexibility and higher, more versatile skills are important. Furthermore shorter production runs necessitate reducing time lost in line changes, as extended change over times reduces labor productivity. In addition

shorter lead times associated with higher product variety requires building in quality at source, because there is no time to check quality at the end of the line and engage in substantial reworking of the product. Hence, dynamics in the South African-based value chain are pushing firms to upgrade their operational efficiency which involves a focus on achieving process upgrading. It is not surprising therefore that some of these plants exhibit a very different approach to process upgrading.

Survey data from 2010 and 2011 provides some evidence to support this. The measurement of inventory provides a good proxy for cost control at manufacturing firms as firms with good inventory control are usually in control of their manufacturing costs. This is especially the case with respect to work-in-progress inventory, since this remains under the direct control of the plant, whereas raw material inventory (fabric) and finished goods stock lie outside the control of and the costs of such inventory holding are not usually born by CMT operations. The Taiwanese-owned firms are organized functionally, with cutting, assembly, quality control, finishing, and packaging generally planned in weekly cycles, and with large lots of work in progress passed from one functional area to the next over the course of the production cycle. Survey data from 2010 shows that the Taiwanese-owned firms' average work-in-progress inventory holding (at 24.4 days) is three times the South African-owned firms (at 7.2 days) revealing the long-production run focus of their operations, as well as the batch oriented manner in which plants are organized (Barnes/Morris 2010). Survey data from 2011 confirm this large gap in work-in-progress holdings. In terms of value of work-in-progress inventory, the average holding of Taiwanese-owned firms sampled was \$1.95m compared to an average of \$39,200 for South African owned firms in the sample. Given that the average exports of the Taiwanese firms was \$13m and that of the South African firms was \$4.3m, the Taiwanese firms were holding on average 15 % of sales in work-in-progress compared to only 0.9 % for the South African firms. This is consistent with commodity-based apparel production exhibiting characteristics of inflexible long runs. This is also reflected in the relative internal flexibility - production time lost when plants shift from making one type of apparel style to another – of these two groups of firms. Survey data from 2010 shows that despite having much longer production runs relative to their South African-owned counterparts, the Taiwanese-owned firms lose more of their production capacity to style changeovers (7.5 % versus 7.1 %). Based on the fact that the Taiwanese-owned firms manufacture more basic, and higher volume orders, their changeover time losses should be substantially lower than the South African firms. This indicates that there is a higher level of operational inflexibility amongst Taiwanese than South African firms.

5.3. Local upgrading

FDI in the apparel sector has benefited Lesotho significantly in terms of employment and exports. It has also created new operating skills, industrial experience and improved the trade-related infrastructure (Lall 2005; Staritz 2011). However, besides these externalities linkages with and spillovers to the local economy have been limited. Supply chain linkages between foreign and local firms are non-existent in Lesotho's apparel sector because there are no local firms in formal manufacturing. There were two local apparel firms, largely involved in subcontracting work, that closed and there is still one local screen printing firm. All other apparel and related manufacturing firms are foreign-owned. One important benefit expected from FDI is the stimulation of local entrepreneurship through backward linkages, labor markets and human capital, or knowledge spillovers. This is however almost wholly absent in Lesotho. Even around

thirty years after the first apparel firm opened in Lesotho, almost no local firms have emerged to compete with the foreign firms, subcontract for them, or supply them with inputs (Lall 2005; Staritz/Frederick 2012).¹⁴

Input sourcing is generally organized at the head offices, either in Taiwan or in South Africa, where inputs are largely sourced from Asian-based firms. Taiwanese transnational producers often own textile mills in other countries or source inputs on a global scale from the head offices in Taiwan for their globally dispersed manufacturing plants. South African manufacturers are largely not directly involved in textile or other input production but still source the majority of textile inputs from Asia, with the rest coming largely from South Africa and few other SSA countries. Both groups of investors seem however to be interested in increasing regional sourcing given the lead time and flexibility advantage but name limited regional capacities and competitiveness (with regard to costs but also quality) as major constraints. In this regard, even though local textile sourcing is limited, regional sourcing, particularly from Mauritius with regard to knit fabric, has increased. Textile sourcing from South Africa has however declined as textile production does not compare favorably with Asia with regard to costs, quality and diversity. Moreover, in response to intensive Asian competition South African textile firms have closed down or upgraded from standard fabric needed in Lesotho (Roberts/Thoburn 2004).

Skill creation is one of the main benefits expected from FDI, particularly in export-oriented activities with stringent requirements for efficiency and quality (Lall 2005). Taiwanese firms have created local skills as employees are given some on the job training in handling sewing machines. But this training is generally limited to basic production. In contrast to foreign firms that have well developed training and technology transfer routines and try to maximize employment of locals for cost reasons, Taiwanese investors have made little effort to advance local skills. When Taiwanese firms came to Lesotho there were no local technical and management skills available. Instead of investing in local skills they largely imported technical and management skills on a contract basis with top management coming largely from Taiwan, middle management mostly from (mainland) China and other managers, supervisors and technicians from (mainland) China, Sri Lanka, Bangladesh, the Philippines, South Africa and Mauritius. Even today nearly all technical, management and even supervisory, machine maintenance and pattern making positions are filled with expatriates but there have been improvements in particular at the supervisory level (Morris et al. 2011; Staritz/Frederick 2012). The high use of expatriates with often little management experience and related language and cultural barriers limit skill transfer and learning by local workers (Lall 2005). Learning is further limited by the reluctance of owners to train workers due to high labor turnover and HIV/Aids-related deaths.

South African firms also employ expatriates for supervisory, technical and management positions with management positions largely filled by South Africans and technical and supervisory positions by South African as well as Asian workers. But there are more locals in supervisory positions and also management positions. In some firms all supervisors are locals and only certain key management positions are filled by South Africans. Concomitant with these differences in the utilization of expatriates as opposed to locals in supervisory and management positions, are differences in the depth of training available in these different categories of firms. South African manufacturers have more interest in local skill creation as this is a necessary

¹⁴ This contrasts with the experience of other apparel exporting countries such as Mauritius, Sri Lanka and Bangladesh (Staritz 2011).

condition for the transfer of further production functions from their South African to their Lesotho operations. This different strategy of South African firms can be confirmed by comparing investment in training of local supervisors between South African and Taiwanese owned firms. Survey data from 2011 show that, although, all firms in Lesotho – Taiwanese and South African ones – have relatively low levels of training investment, the Taiwanese-owned firms' training investment in supervisors is particularly weak. On average Taiwanese firms total expenditure on formal training of supervisors was \$22,000, compared to \$34,444 for South African firms. As a percentage of total salary and wage costs, expenditure on training of supervisory staff for Taiwanese firms was 0.6 % whereas it was 1.6 % for South African firms. The higher training expenses and use of locals in technical and managerial positions in South African firms is also related to the difficulties South African firms face in getting enough South Africans to move to Lesotho.

Thus, there exist different local upgrading prospects with regard to Taiwanese- and South African-owned firms related to the different value chains in which the two sets of firms operate and their different strategies and embeddedness. While the Taiwanese global exporting strategy is based on limited skills and largely low-cost machinist workers producing long run and basic products, an important part of the South African-owned firms already produces and is interested in producing more complex, more fashionable and quicker response apparel products and aims to transfer more production functions to their plants in Lesotho. This type of production and business model requires higher local skills and capabilities.

6. Conclusions

The existence of two distinct GVCs driving differently-owned production plants in Lesotho has major implications for the upgrading and innovation prospects of the apparel sector. The distinctive nature of the value chain and triangular manufacturing network in which the Taiwanese-owned firms operate relative to their South African-owned counterparts appears to be the major reason for the limited levels of industrial upgrading and skill development within the Lesotho apparel sector. Taiwanese firms are involved in CMT production in support of well established, higher value adding facilities located elsewhere, and manufacture commodity apparel ranges, engaging in no serious training, and little innovation. There is no strategic reason beyond the ongoing accumulation of AGOA trade rents for being located in Lesotho which stunts the need for investments in upgrading and skill development.

The South African-driven value chain is not dominated by long and basic production runs. Rather its competitive advantage lies in the flexibility dictated by close geographical proximity to its major market, and the lower (labor) costs in Lesotho. There is a greater potential for upgrading and local linkages in South African-owned plants, in particular as South African firms are interested in transferring more production functions from their South African plants. As the South African-owned firms take skill and capability development more seriously, they are frustrated by a different set of operating issues to the Taiwanese-owned firms whose local existence is almost solely focused on cost containment as their major challenge.

The limited local upgrading relates therefore to the nature of FDI and the strategic interest of foreign investors, in particular with regard to transnational producers from Taiwan that have limited the upgrading potential from the onset. But upgrading also depends on local conditions, particularly in the case of South African firms where the upgrading potential is larger. Poor

physical and institutional infrastructure¹⁵, low productivity and limited local capabilities and skills, particularly technical and management skills, related to deficiencies in training institutions constrain the use of this potential. A particular crucial constraint for local upgrading and broader industrial development is the non-existence of local firms and entrepreneurship. This can be explained by the reluctance of foreign firms to train locals in higher level skills but also by local public and private institutions that do not support entrepreneurial activity, including capital market deficiencies as there are very limited sources of finance, particularly risk capital for perspective investors without a track record (Lall 2005). These local conditions seem to be in particular constraining for South African investors as they have higher upgrading potential and tend to be interested in transferring more functions to Lesotho.

Whether the South African firms actually take advantage of the potential thrown up by this value chain in the long run is the challenge facing the Lesotho industry and government. There is only so much local upgrading and skill development that is likely to emanate from the private sector dynamics driving the South African-based value chain. The Lesotho government can also not expect much assistance from regional solidarity in making the South African-driven value chain sustainable in the long term and initiate upgrading. The South African government is faced with its own struggle to stem the decline of its apparel industry and will therefore not undertake any policy initiatives to support the migration of its domestic apparel industry to other parts of the SSA region. To the contrary, in the context of firm closures and relocations, the government recently put in place a production incentive scheme to provide supply side support to the apparel and textile sectors and prevent firms from migrating. Also the recent phase out of the DCC scheme after it has been extended several times is a sign of a backlash from South Africa.¹⁶

The Lesotho apparel sector has an opportunity to occupy an intermediate industrial space in the region – between low level CMT assembly (the Taiwanese path) and high end apparel production (found in a segment of Cape Town based apparel firms). But in order to do so the Lesotho industry and government will have to develop a strategic set of interventions to upgrade the public institutional fabric of training and infrastructure. The upgrading challenge is one of appropriately directed and capacitated industrial policy, with the dual aim of expanding the base of the skilled labor and management pool and fostering a culture to raise the operational competitive levels of their manufacturing operations. Further, a regional perspective will be crucial for sustainable competitiveness and upgrading in the apparel industry as the non-existence of regional sourcing networks for textiles and other inputs constraints competitiveness and value added (Staritz 2011). Unless this is done the benefits of the apparel industry in Lesotho will be limited to its direct employment creation, rather than its ability to generate skills and knowledge spillovers, greater levels of upgrading and local and regional linkages that support the industrialization of the Lesotho economy on a broader front. Even worse, with no public upgrading efforts the South African-driven value chain may start to stutter and decline along with the Taiwanese/US one.

¹⁵ Although Lesotho is linked to efficient infrastructure in South Africa, there are crucial infrastructure challenges related to transport, border and customs, inadequate water supply, lack of waste water treatment facilities and the shortage of factory shells and industrial infrastructure (Staritz 2011).

¹⁶ In South Africa the DCC scheme was replaced by a rescue package which is however not a SACU initiative and thus is not offered to firms in Lesotho.

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